PUBLIC
SIMULTANEOUS DISCLOSURE

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

COSTA RICA

FISCAL SUSTAINABILITY SUPPORT PROGRAM

(CR-L1081)

LOAN PROPOSAL

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CONTENTS

Annexes	
Annex I	Summary Development Effectiveness Matrix
Annex II	Policy Matrix
Annex III	Results Matrix

Links

Required

1. Policy Letter
2. Means of Verification
3. Monitoring and Evaluation Plan

Optional

1. Proposal on the sustainability of public finances in Costa Rica. IDB, 2018
2. Calculating the impact of expenditure-side fiscal reforms in Costa Rica. IDB, 2016
3. The fiscal rule on current expenditure in Costa Rica. IDB, 2019

ABBREVIATIONS

BCCR	Central Bank of Costa Rica
CABEI	Central American Bank for Economic Integration
CAF	Development Bank of Latin America
CCSS	Caja Costarricense de Seguro Social [Costa Rican Social Security Fund]
CGR	Contraloría General de la República [Office of the Comptroller General of Costa Rica]
CIAT	Inter-American Center of Tax Administrations
DGT	Dirección General de Tributación [Taxation Bureau]
DPN	Dirección del Presupuesto Nacional [National Budget Bureau]
ECLAC	Economic Commission for Latin America and the Caribbean
FODESAF	Fondo Desarrollo Social y Asignaciones Familiares [Social Development and Family Allowance Fund]
GDP	Gross domestic product
GETES	Grandes Empresas Territoriales [Large Territorial Enterprises]
IFC	Independent Fiscal Council
IGV	Impuesto General a las Ventas [general sales tax]
IICE	Instituto de Investigación en Ciencias Económicas [Economic Sciences Research Institute]
IMF	International Monetary Fund
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
PBL	Policy-based loan
PBP	Programmatic policy-based loan
VAT	Value-added tax

PROJECT SUMMARY

COSTA RICA
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Financial Terms and Conditions				
Borrower			**Flexible Financing Facility** [(a)]	
Republic of Costa Rica			**Amortization period:**	20 years
Executing agency			**Disbursement period:**	1 year
Ministry of Finance			**Grace period:**	5.5 years [(b)]
Source	**Amount (US$)**	**%**	**Interest rate:**	LIBOR-based
IDB (Ordinary Capital):	350,000,000	100	**Credit fee:**	[(c)]
			Inspection and supervision fee:	[(c)]
Total:	350,000,000	100	**Weighted average life:**	12.75 years
			Approval currency:	U.S. dollars

Project at a Glance
Project objective/description: The objective of this programmatic series and the first operation is to strengthen fiscal sustainability by controlling expenditure and modernizing the tax system. 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). This is the first of two operations under the programmatic policy-based loan modality, to consist of two contractually independent and technically linked loans.
Special contractual condition precedent to the first and only disbursement of the loan: A special contractual condition precedent to the single disbursement of the loan for the first operation in the series will be compliance with the policy reform conditions, in accordance with the provisions of the Policy Matrix (Annex II), the Policy Letter, and the remaining conditions established in the respective loan contract (paragraph 3.3).
Exceptions to Bank policies: None.

Strategic Alignment						
Challenges:[(d)]	SI	☑	PI	☑	EI	☐
Crosscutting themes:[(e)]	GD	☐	CC	☐	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 reimbursement options of the Flexible Financing Facility (FFF), changes in the grace period are possible, provided that the original weighted average life (WAL) of the loan and the last date of payment as documented in the loan contract are not exceeded.

[(c)] The credit fee and the 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 relevant policies.

[(d)] SI (Social inclusion and Equality); PI (Productivity and Innovation); and EI (Economic Integration).

[(e)] GD (Gender Equality and Diversity); CC (Climate Change and Environmental Sustainability); and IC (Institutional Capacity and Rule of Law).

I. Description and Results Monitoring

A. Background, problem addressed, and rationale

1.1 **Macroeconomic situation.** Costa Rica is positioned as one of the countries with the best indices in Latin America and the Caribbean in terms of economic, social, and institutional performance. It had exhibited an average economic growth rate of 5.3% over the last 50 years, above the rate for Latin America and the Caribbean (4.42%) and for the countries of the Organisation for Economic Co-operation and Development (OECD) (3.4%). It has universal access to primary education[1] and health[2] services, a stable democratic system, and innovative environmental conservation policies. These factors have translated into high rates of well-being for its population and have played an important role in attracting foreign direct investment. The growth model has been based on trade openness and integration. At the start of the 1990s, less than 5% of exports were high-tech, while now that figure stands at over 35%.

Table 1. Macroeconomic data, Costa Rica*

%	2008	2010	2012	2014	2016	2018
Variation in real gross domestic product (GDP)	4.6	5.0	4.8	3.5	4.2	2.7
Variation in the consumer price index	13.9	5.8	4.6	5.1	0.8	2.0
Basic borrowing interest rate (average)	7.4	7.9	9.7	6.9	5.2	5.9
Exchange rate (average change)	2.1	-8.5	-0.4	7.8	1.9	1.6
Exports of goods, services, and tourism/GDP	43.3	34.4	35.5	37.1	35.7	38.6
Current account/GDP	-8.4	-3.3	-5.2	-4.9	-2.2	-3.1
Foreign direct investment/GDP	7.6	4.5	4.9	5.7	4.7	4.5

(*) Source. Central Bank of Costa Rica (BCCR) and Ministry of Finance.

1.2 The country has grown at an average annual rate of 3.4% of GDP over the last decade, driven by its mature foothold in the global economy. Growth has been particularly strong in the tourism sector and some technology sectors (medical devices, IT, and external services). Its openness to trade is diversified and financially solid based on agreements with Central America, North America, and the European Union, where exports have remained stable over the last decade, averaging over 34% of GDP. At the same time, foreign direct investment has averaged 5.3% of GDP, the second highest level in Latin America and the Caribbean, with the least variation, reflecting confidence in the country (Economic Commission for Latin America and the Caribbean-ECLAC, 2018).

1.3 At the monetary and exchange level, Costa Rica's price stability is reflected in average consumer price index growth of 4.2% since 2009, without sharp variations

1 Attendance in primary education is nearly universal; this was achieved over 20 years ahead of the average for Latin America and the Caribbean.

2 For example, the incidence of noncommunicable diseases has been reduced by 11% over the last decade, primarily affecting men (*Country Development Challenges,* Costa Rica, 2018).

in foreign currency rates. This is reflected in a stable basic borrowing rate for credit in local currency (averaging 7.2% over the last 10 years).

1.4 **Fiscal situation.** Since the international financial crisis of 2008-2009, Costa Rica's fiscal performance has deteriorated significantly, with increases in both the size of the fiscal deficit and in growth of public debt. The deterioration in public finances arises from structural weaknesses in the area of taxation, but particularly from increased spending, falling revenues, and thus increased public debt (Table 2). On the one hand, there are sufficiency, efficiency, and equity challenges in the main pillars of the tax system (the general sales tax (IGV) and income tax).[3] On the other, public expenditure, which is highly rigid, has shown significant increases in current expenditure, particularly under the heading of remunerations and transfers, which are highly inflexible.[4] Added to this are weaknesses in the macrofiscal institutional framework for consolidating public finances and effectively limiting current public expenditure growth. This situation has limited the space for productive public investment, the amount of which is lower than would be expected given Costa Rica's level of revenues.

Table 2. Fiscal Data, Costa Rica*

% of GDP	2008	2010	2012	2014	2016	2018
Public debt (nonfinancial public sector-NFPS)	38.4	41.9	50.3	55.6	63.0	70.6
Central government debt	24.1	28.4	34.3	38.5	45.2	53.6
Total deficit	-0.2	-5.3	-4.3	-4.5	-4.6	-4.8
Central government deficit	0.2	-5.0	-4.3	-5.6	-5.2	-5.9
Tax revenue (NFPS)	15.5	14.0	14.0	14.0	14.7	14.3
Social Security contributions (NFPS)	6.4	6.7	6.9	7.1	7.5	*7.4**
Current expenditure (NFPS)	20.1	23.8	24.4	25.1	25.5	*26.2**
Remunerations (NFPS)	9.9	12.8	12.8	13.0	12.7	*12.6**
Central government public investment	1.7	2.3	1.4	1.7	1.8	1.4
Government savings	3.5	-1.6	-1.5	-2.3	-1.5	*-2.3**

(*) Estimated data. Source: BCCR and MH.

1.5 The sustainability of the public debt in a deteriorated fiscal context constitutes the main challenge in the short and medium term. The country's fiscal imbalance has made the dynamic of public debt unsustainable. Specifically, the problem comes from the NFPS, where the problems of the central government stand out. Following improvement in the fiscal balance in the period leading up to the international financial crisis, with an average surplus of 0.4% of GDP between 2007 and 2008, the central government's public finances have deteriorated in the last eight years, reaching an average deficit of 5% of GDP between 2008 and 2018 and 5.9% in 2018 for the central government.

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[3] In fact, Costa Rica is the only Latin American country that, prior to the December 2018 comprehensive tax reform, did not have a value-added tax (VAT) and had two different systems for personal income tax.

[4] In addition to remunerations and pensions commitments, Costa Rica has a series of specific legal and constitutional allocations that define current transfer amounts. The result is that more than 80% of total expenditures are predefined.

1.6 Central government debt reached 53.6% of GDP in 2018 and NFPS debt has nearly doubled, from 38.4% in 2008 to 70.6% (US$40.148 billion) in 2018. In turn, the domestic market proves inadequate to cover the government's financing needs. This has been reflected in reduced placement terms, variable-rate debt issues, an increase in funding cost, and increased bond-holding within the public sector itself.[5] The public sector's high financing needs have had a displacement effect on the domestic credit market, as this is the government's main source of financing given that external borrowing requires the approval of Congress. In effect, according to the BCCR, public sector credit doubled between 2009 and 2018 (at 11% of the total). Forty-four percent of the bonded domestic debt of the NFPS is in the hands of private savers,[6] with the result that the banking system's lending interest rates have risen.[7] The increase in the public debt has been accompanied by marked declines in Costa Rica's risk ratings, raising borrowing costs.[8]

1.7 In response to this situation, the Government of Costa Rica is implementing a series of policy measures that include: (i) comprehensive fiscal reform that combines a fiscal rule applicable to current spending with the introduction of the VAT and the revamping of income tax; (ii) the law on the modernization of public employment; and (iii) institutional administrative reform. The design of the reforms has relied on the support of the Bank during various administrations in coordination with the OECD, the Inter-American Center of Tax Administrations (CIAT), and the International Monetary Fund (IMF). It is important to note that the IMF's assessment under the 2019 Article IV consultation gives a favorable evaluation of progress made and ongoing projects.

1.8 Improving fiscal sustainability requires introducing improvements in the macrofiscal institutional framework, together with reforms to increase tax collection by improving the design of the tax system, controlling the growth in public spending and promoting its efficiency through changes in the civil service system and institutional reengineering, in addition to strengthening the sustainability of the judicial pensions system.

1.9 **Macrofiscal institutional framework.** There are institutional weaknesses that undermine fiscal discipline and the credibility of economic policy. Prior to the approval of the 2018 comprehensive fiscal reform, there were no legal policy and fiscal management instruments to promote fiscal sustainability (fiscal rule) nor was there any institutional framework for control and monitoring (Independent 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

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5 State financial institutions (five) totaled 2.7 billion colones, which represented 15.3% of their total assets and 99.7% of equity, as a weighted average.

6 BCCR, Economic Indicators (2018).

7 The banking system's average lending rate increased from 6.8% to 13.4% in real terms.

8 Interest on consolidated public debt rose from 2.1% in 2008 to 3.5% of GDP in 2018.

a significant increase in current expenditure, primarily in the wage bill.[9] Thus, current expenditure of the NFPS has increased by more than 30%, rising from 20.1% to 26.2% of GDP between 2008 and 2018. NFPS remunerations, for their part, rose by more than 25%, from 9.9% to 12.6% of GDP (2008 to 2018). In turn, the increase in current expenditure arising from increases in the public sector payroll[10] and the purchase of goods and services limits the ability to achieve a balanced primary balance, which has shown deficits from 2008 to 2018, with an average of 3.1% of GDP. As a corollary, with the creation of the fiscal rule and the independent fiscal council to complement the medium-term fiscal framework, the basic institutional trilogy for strengthening the sustainability of public finances is achieved.[11]

1.10 Public investment in 2018 reached a low of 1.4% of GDP for the central government, as it is the easiest expenditure line to adjust downward to contain the growing fiscal deficit. In the ten-year period from 2007 to 2016, Costa Rica invested an average of 2.4% of GDP, while the Latin American average for the same period was 4.3%.[12] In contrast, public savings since 2009 has been negative, with an average of -2% of GDP for the 2009-2018 decade, which puts strong pressure on the attraction of national savings, displacing domestic private investment. The growth of current expenditure should be restricted to allow fiscal space for public investment and works maintenance,[13] which is key for the country's growth and competitiveness.[14]

1.11 **Tax system design. Value-added tax.** Costa Rica did not have a VAT until the comprehensive tax reform of 2018; rather, it had the IGV, for which revenues are comparatively low and which had serious design problems. According to Revenue Statistics in Latin America and the Caribbean,[15] revenues from the IGV in Costa Rica were 4.4% of GDP for 2017, while the average was 6% in Latin America and 6.8% in the OECD. Specifically, the IGV had two[16] important problems: (i) zero-rate treatment for exempt goods; and (ii) the exclusion of most services. These

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9 According to Espinoza (2016), between 2007 and 2010 outlays for central government remunerations grew by 1.7 points of GDP, both due to the increase in positions (21.4% between 2007 and 2009) and the 50th percentile salary policy, which sought to make central government remunerations equal to those of the state autonomous sector. However, what in principle would affect some 6,000 employees impacted more than 55,000.

10 The increase in the number of central government employees (24.1%) was due to expansion of positions in health, education, and citizen security (Dumas and Lafuente, 2016), and in recent years was due primarily to salary increases in the health and education sectors.

11 Eyzaguirre, N. (2019). Diseño y conformación de un consejo fiscal independiente. Mimeo. IDB.

12 Armendariz E. and H. Carrasco (2019) and ECLAC (Public Finances Statistics, various years).

13 Ansorena, C. (2018). Un Análisis Económico-Institucional de la inversión pública en Costa Rica: Desafíos y Oportunidades. Consulting report. Mimeo. IDB.

14 On the macroeconomic costs of not adding new capital to existing stocks, see Cavallo and Powell (2019).

15 OECD, IDB, CIAT, and ECLAC. 2017. Revenue Statistics in Latin America and the Caribbean 1990-2015. *OECD Publishing, Paris*.

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

problems made it impossible to have the desirable characteristics of a VAT such as simplicity,[17] neutrality,[18] and competitiveness.[19]

1.12 Zero-rate treatment is an inefficient practice that saps the economy and at the same time prevents closing the links in the VAT's sales chain. This is because those who produce exempt goods and services for the domestic market[20] 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 any zero-rate system makes its administration complex due to refund of the VAT on purchases.

1.13 The exemption of services causes significant efficiency problems. First, there is a problem of timeliness and sufficiency in that, as in the rest of the world, the share of services in production has increased, so that Costa Rica can no longer allow itself not to tax those services. In addition, the exclusion of services made the IGV a regressive tax,[21] since while the first decile paid 5.9% of their income for the IGV, the last decile paid 4.6% of their income (Ministry of Finance, 2018).[22] 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 compared to imported substitute goods. Lastly, it is important to note that Executive Decree (41615-MEIC-H) adjusted the composition of the basic tax basket in March 2019, giving preference to the consumption of lower income sectors, and the number of goods that are taxed at the differentiated rate was reduced, so as to obtain less tax expenditure.[23]

1.14 **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 reduced efficiency and equity in the system, by allowing income from a different source and/or legal form[24] to be treated differently, despite being of the same magnitude (introducing a horizontal equity problem). In effect, there are numerous differential rates and exemptions[25] that create loopholes and allow arbitrage through which evasion filters taxable income (loss of efficiency) and produces inequities. For this reason, it became necessary to complete the current design of the tax by standardizing the tax on capital income and increasing the progressive nature of the tax on personal income.

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17 Reduced compliance and control costs.

18 Equal treatment for all goods and services.

19 Does not discriminate between domestic and foreign producers.

20 The customary practice is that zero-rate treatment is used only for exports.

21 OECD, 2017. OECD Tax Policies Reviews: Costa Rica 2017. OECD Publishing, Paris.

22 Study of yield and equity of the tax reform included in Law 9635. Ministry of Finance, 2018.

23 Incidencia de la nueva canasta básica tributaria. Ministry of Finance. 2019. It should be emphasized that the number of goods has been reduced from 218 to 189.

24 For example, "solidarista" entities and cooperatives.

25 In particular, there are differential rates for the following headings: (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 zones.

1.15 Accordingly, in the 2018 tax reform, it was necessary to tax (gross) capital income at a unified rate.[26] In addition, the marginal personal income rates were increased to the Latin American average (the highest would be close to 25%) to increase collections and make the tax more progressive.[27] In turn, to prevent evasion and facilitate tax control and compliance, it was beneficial to tax all (pure) investment income (interest, dividends, royalties, etc.) at a generalized rate higher than the current rates (15% on gross). We can point to the following advantages of the new system: (i) simplicity, because taxing at a single rate reduces administrative costs and compliance costs for companies; and (ii) a single rate prevents arbitrage among the different sources.[28]

1.16 **Tax administration**. Weaknesses have been detected in the Tax Administration that keep it from operating efficiently,[29] particularly in terms of the audit function and the invoicing system, due in part to the design of incomplete IGV bases that makes the comprehensive control process difficult. In fact, evasion of the IGV was estimated to average 30% between 2012 and 2015.[30] To improve collection performance and reduce taxpayer compliance costs, the Taxation Bureau (DGT) is developing the Electronic Invoicing project. The implementation of electronic invoicing consists of gradually extending the mandatory use of the system to all taxpayers, following the experience of the region's principal tax administrations,[31] addressing two major problems: (i) given that IGV invoicing is on paper, the DGT does not have timely, traceable information; and (ii) taxpayers face high compliance costs associated with printing invoices, storing them, and physically sending documentation to clients/suppliers, among others.

1.17 **Public expenditure management. Public employment.** Costa Rica is one of the countries with the highest central government wage bill in Latin America, measured as a percentage of GDP (12.6%) and total expenditure (36%).[32] This makes it necessary to modernize the current public employment system, as it generates an unfavorable dynamic in finances and does not align employees' incentives. The current, legally binding, wage policy rules lead to a total payroll that will grow continuously in real terms,[33] given that the performance-based compensation

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[26] Prior to the 2018 reform, income from employment (salaries) was taxed at a lower marginal rate and was treated differently (minimums, deductions, etc.) from the income of the self-employed, freelancers, and professionals.

[27] Barreix, A., J. Benítez and M. Pecho. (2017). *Revisiting personal income tax in Latin America: Evolution and Impact. OECD Development Centre Working Papers,* No. 338*, OECD Publishing, Paris.*

[28] Barreix, A., Garcimartín, C. and Velayos, F. 2013. Personal Income Tax: An Empty Shell. In Corbacho, A., Fretes, V. and Lora, E (Ed.). More than Revenue, IDB, Washington, D.C.

[29] For example, weaknesses such as inconsistency in the taxpayer's tax current account and the lack of mass cross-checks and risk analysis in the audit process are among the most notable.

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

[31] The Latin American countries that are advanced in the implementation of electronic invoicing include Argentina, Brazil, Chile, Ecuador, Mexico, Peru, and Uruguay. Bolivia, Colombia, Costa Rica, the Dominican Republic Panama, and Paraguay are also in the process of implementing it. See Barreix and Zambrano (2018), Electronic Invoicing in Latin America, IDB and CIAT.

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

[33] Without assuming any change in the current number of employees nor guaranteeing greater public sector productivity.

system does not function properly. The lack of a mandatory retirement age[34] combined with a system that rewards tenure indiscriminately rather than productivity creates perverse incentives for civil servants.

1.18 **Control of salary incentives.** There are also inadequate controls to prevent decentralized institutions from agreeing to salary increases above what the State can pay. The highly complex nature of the system makes it difficult and costly to administer and control. Because supplemental benefits (annual payments, termination indemnities, full-time dedication, etc.)[35] represent the major part of compensation in the highest income deciles and governmental entry-level salaries are not competitive, negatively affecting the ability to attract and retain suitable personnel (Green and Lafuente, 2013). An example of issues to be resolved is control of what are called *anualidades* [annual payments] that are paid to more than 99.5% of public employees on the base salary (about 45% of compensation), without measuring their performance and are quite broad, depending on what entity grants it (from 1.94% to 6% of the base salary) without considering any technical productivity criterion.

1.19 **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, child care, etc.). However, they currently generate inefficiencies in the budgetary process, violating the principle of a unified account and flexibility of spending in response to new demands from the population. Transfers from the central government to the public sector nearly doubled from 2.8% of GDP in 2008 to 5.4% in 2018. These are primarily intended for other institutions in the rest of the public sector, for specific purposes, and most of them which were created by law[36] and include salary items. Indeed, the Office of the Comptroller General of Costa Rica (CGR)[37] 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. This practice is not advisable as it does not take into account the institution's execution capacity nor the size of the financing compared to each institution's needs over time.

1.20 **Institutional design.** The system of public institutions in Costa Rica is excessively fragmented, limiting control over the budget by the government and generating duplication of functions and inefficiencies. According to Solera et al. (2016),[38] there does not seem to be a simple, direct relationship between population size, the economy, and economic development in the countries of Central America and the number of public institutions. For example, Costa Rica has many more public

[34] This practice exists in only five OECD countries.

[35] Annual payments are an annual longevity premium on the base salary and the termination indemnity is compensation paid upon termination of the employment relationship.

[36] 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).

[37] CGR. (2017). Presupuestos Públicos 2017: Situación y Perspectivas.

[38] Solera, M., Durán, E., Prat, J., Dumas, V., Lafuente, M., Ardanaz, M., Gutierrez, P., Vargas, J. & Beverinotti, J. (2016). Una mirada al gasto social en Centroamérica, Panamá y República Dominicana: 2007-2013.

institutions than Panama (330[39] versus 130), but GDP and human development are quite similar and Panama even has a higher per capita GDP.[40] In this context, it seems necessary to do a review of public institutions and their functions in Costa Rica, in order to identify efficiency savings and gains without affecting the government's priority development programs.

1.21 In Costa Rica, 49 institutions have been created since 2000, increasing the number of institutions from 281 to 330 over that period. This growth occurs primarily in institutions attached to ministries, which includes deconcentrated bodies and bodies with legal status. In fact, of the total number of institutions created since the year 2000, 53% were institutions of this kind (26). The CGR (2011)[41] 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 and duplication of administrative support costs and has not been reflected in tangible results from the social policies they implement. Added to the number of institutions is the creation of organizational units within the ministries themselves. During the period 2007-2015 alone, there have been 518 changes in organizational structures within the ministries.[42] It is thus crucial to review all these units and the functions they carry out so as to eliminate possible duplications, make the State more efficient, and improve the effectiveness of expenditure.

1.22 **Judicial branch pensions and retirement system.** The system currently has approximately 3,600 pensioners and 12,800 contributors. An actuarial study prepared by the Instituto de Investigación en Ciencias Económicas [Economic Sciences Research Institute] (IICE, 2017) shows that by the end of 2015, the system showed an actuarial deficit with a present value of ¢5.3 billion (US$8.7 billion), equivalent to approximately 16% of GDP. Under this scenario and before the recent reform in 2018,[43] the study projected that in the year 2029 contributions to the fund would be insufficient to pay the pensions, and interest generated by investments of the reserve would be used to make the monthly pension payments. The study indicates that the fund was at that time in a situation of actuarial insolvency and that, if reforms were not implemented, the reserves would begin to decline in 2040 and be exhausted in 2048.[44] The future of this system is important because this fund is guaranteed by the State. If the system does not have sufficient funds to pay pensions, the State must assume payment.

1.23 With reform of the fund approved in May 2018 (Law 9544),[45] pensions spending was projected according to the Actuarial Study of the Retirement and Pensions

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[39] Figure updated to 2018 according to the Ministry of National Planning and Economic Policy (MIDEPLAN).

[40] US$15,668 for Panama compared to US$13,630 for Costa Rica in 2017.

[41] CGR. 2011. Memoria Anual 2011. San José, Costa Rica.

[42] MIDEPLAN. 2017. Estudio de duplicidades estructurales: Ministerios and órganos adscritos, segunda etapa. San José, Costa Rica.

[43] Reform of the Judicial Branch Retirement and Pensions System, Law 9544.

[44] 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.

[45] The changes made in the judicial pensions reform included: (i) retirement age increased from 60 to 65; (ii) maximum pension cap is ¢4 million; and (iii) pension calculation.

Funds of the Judicial Branch prepared by IICE, 2017 at the University of Costa Rica. According to the study, the proposed changes exceed the actuarial solvency tests, reducing the actuarial deficit in present value terms to a range between ₡0.31 and ₡0.14 billion (US$517 million to US$230 million), thus allowing the reserves to begin to become exhausted over the long term (between the years 2102 and 2109). For this program, consideration was given to reform of the Judicial Branch retirement system (2018), because it represented a medium term fiscal risk (2029, paragraph 1.22). However, there are other systems with longer-term risks, for which the country is already considering corrective measures. Costa Rica is in a demographic and financial transition process, characterized by higher salary costs and a weaker reserve ratio.[46]

1.24 **Bank experience and support for reforms in the country.** The Bank has been supporting the reforms promoted by the current program in terms of their diagnostic assessment, design, and implementation. Thus, it has spearheaded support in the diagnostic assessment and preparation of proposals to strengthen the macrofiscal management framework (fiscal rule) and modernize the tax system, with financing from technical cooperation operations ATN/FI-12917-CR (2011) and ATN/FI-14553-CR (2014). In particular, the Bank has proposed implementing the VAT and increasing the tax base and modernizing income tax, by increasing its rates for both personal income and capital income. In addition, it has led the fiscal rule proposal, including studies and seminars with the Ministry of Finance as well as the Legislative Assembly, academia, and local experts. In addition, the Bank has collaborated with the OECD and CIAT on compliance with the fiscal transparency commitments assumed by Costa Rica, which earned it the rating of largely compliant in December 2017 (Annual Report of the Global Forum on Transparency and Exchange of Information for Tax Purposes). In public employment, since 2013 the Bank has prepared various studies on public employment and salary policy, in particular the first work proposing the single salary methodology for Costa Rica,[47] in the context of regional technical cooperation operations on the subject and has provided technical assistance to the country on various occasions. Through a technical assistance operation now in preparation (Support for the Fiscal Institutional Framework), support will be given to the process of implementing the reform of public employment, institutional capacity for use of electronic invoicing, and the formulation of administrative reforms. In addition, ATN/OC-16528-CR is supporting the government's efforts to improve the link between the budget and outcomes in selected sectors.

1.25 **Bank experience in the sector.** This program is consistent with the support that the Bank has provided to other countries on tax reform processes, the strengthening of fiscal sustainability, and consolidation of the pension system. Recent notable policy-based loan operations include the Fiscal Consolidation Support Program in Honduras (3590/BL-HO), the Public Finances Strengthening

[46] Costa Rica has three systems: (i) the Judicial Branch pension system with the problems described earlier; (ii) National Teachers Pensions Board (JUPEMA), which is technically in balance but could present problems over the long term (Actuarial Evaluation of the Collective Capitalization System (RCC), March 2019); and (iii) the Disability, Old Age, and Death System (IVM) the sustainability of which could be affected within more than two decades (Actuarial Study of the Disability, Old Age, and Death Insurance administered by the CCSS, December 2015).

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

Program in Mexico (3201/OC-ME, 3676/OC-ME), the Strengthening for Inclusive Growth Program in El Salvador (4542/OC-ES), the Finances for Sustainable Development Program in Paraguay (4667/OC-PR), and the Program to Support Transparency and Integrity Reforms in Argentina (4244/OC-AR). In the area of fiscal reform (including expenditure and subsidies), the Bank has spearheaded support in Argentina (4500/OC-AR), Panama (2473/OC-PN), El Salvador (2296/OC-ES and 2710/OC-ES), Honduras (2452/BL-HO and 3590/BL-HO) and the Dominican Republic (3110/OC-DR).

1.26 Regarding the modernization of pensions, the Bank has supported various reforms, including Support for Health Sector and Social Security Consolidation in the Dominican Republic (3326/OC-DR, 3585/OC-DR), the Fiscal Consolidation Support Program in Honduras (3590/OC-HO) and the Fiscal Consolidation Support Program in Jamaica (3511/OC-JA). With regard to public employment, this program is based on the Bank's prior experience in other projects and analytic work[48] to improve public sector efficiency and civil service management, including: Program to Support Public Sector Transformation in Jamaica (4373/OC-JA), the Public Management Institutional Reform Program in Ecuador (2653/OC-EC), Fiscal Strengthening for Inclusive Growth Program in El Salvador (4542/OC-ES), Support Program for Reform of Pension Institutions and the Human Resources Management System (2627/BL-HO) and the Tax Administration Institutional and Operational Strengthening Program in Honduras (3541/BL-HO).

1.27 **Lessons learned.** The design of the operation took into account the recommendations of the Office of Evaluation and Oversight (OVE) for preparing the Country Strategy 2018-2022 (document RE-535-1) related to the fiscal area, specifically to promote structural measures on fiscal sustainability policies. In addition, this program draws lessons learned from the Bank's experience in the tax policy and administration sector (document RE-509-1), such as having a broad-based VAT and a progressive income tax. Support was also provided in technical inputs derived from ATN/FI-14553-CR and ATN/OC-16528-CR, to prepare at the request of Ministry of Finance authorities proposals on tax reform, the fiscal rule, and public sector salary policy reform, demonstrating the complementarity between technical cooperation operations and policy-based programs. Experience with approval of the reform highlights the importance of ongoing dialogue between the Bank and the various actors involved in fiscal matters, such as universities, the Legislative Assembly, and private sector experts to inform the most important technical aspects of the reform.

1.28 In the area of tax reform, the implementation of a generalized, broad-based VAT, elimination of the zero rate, and the reduction of exemptions, increasing collections and tax uniformity, were the basis for the programs cited above (paragraph 1.25). As for income tax, international experience and academia recommend having a single system for personal income tax and uniform rates for capital income, in

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[48] IDB (2018) Better Spending for Better Lives; IDB (2016) Gestión de Recursos Humanos en el Estado: ¿Cómo lograr mejores resultados? in Una Mirada al Gasto Social en Centroamérica, Panamá y República Dominicana financed by the technical cooperation operation "Improving the Efficiency of Public Sector Human Resources" (ATN/FI-14338-RG); and IDB (2014) Serving Citizens: A Decade of Civil Service Reforms in Latin America (2004-2013).

order to avoid arbitrage among types of income.[49] In addition, the Bank has supported the application of fiscal rules for the implementation of fiscal consolidations (as in the operations in Honduras and Jamaica cited above, paragraph 1.26) or reaffirming fiscal discipline processes (such as Mexico, Panama, and Paraguay).[50]

1.29 Lessons learned from the pension and tax areas include the importance of constant dialogue with the government to anticipate possible demands, through technical cooperation with sufficient flexibility to address short-term requests and being persistent with the key recommendations. The fiscal reforms, particularly taxation and the fiscal rule, incorporated the Bank's recommendations after continued effort to maintain dialogue and provide technical support to the country. Another lesson is the importance of technical coordination among donor agencies in order to create synergies, particularly to encourage policy changes based on best practices, promote their economic policy, and ensure its effective implementation thereof.

1.30 Lessons learned in the area of public employment (paragraph 1.26) include: (i) the ownership of reforms and support at the highest political level are essential for the success of civil service reforms; (ii) the risk of resistance to change in salary reforms in the public sector is best mitigated when the reforms are part of a broader approach to enhance the civil service; and (iii) implementation of changes on a voluntary basis for existing civil servants and on a mandatory basis for new civil service hires.

1.31 **External and internal validation.** Well-designed fiscal rules have helped countries at different levels of development to achieve better fiscal outcomes (Caselli and Reynaud, 2019). Measuring the design quality of a fiscal rule takes into account factors such as broad institutional coverage, independence of monitoring bodies, a legal basis, flexibility to respond to shocks,[51] and the existence of correction and sanctions mechanisms.[52] An average improvement of 0.64 percentage points of GDP is found in the fiscal balance of countries that strengthen the design of the fiscal rule. Other outcomes affected by the presence of fiscal rules include public debt levels and the likelihood of incurring debt crises (Asatryan et al. 2018). In addition, Cordes et al. (2015) found evidence that spending rules are related to lower expenditure and primary deficit levels. Finally, Ardanaz et al. (2019) have found for Latin America during the period 2015-2017 that the countries with a fiscal rule show a fiscal deficit that is 76% lower and (gross) public debt that is 85% lower than countries that have not applied it.[53]

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[49] Agosín, M., Barreix, A., Machado, R., Sabaini, J., Cornick, J. Acevedo, C., González, M., Schenone, O., de la Torre, C. Recaudar para Crecer: bases para la reforma tributaria en Centroamérica. IDB, Washington, D.C.

[50] Barreix, A. and Corrales, L.F. 2019. Reglas Fiscales Resilientes en América Latina. IDB, Washington, D.C.

[51] This flexibility allows countries to reduce procyclical biases in public spending (Guerguil et al. 2017), and protect public investment from sharp cuts (Ardanaz, Cavallo, Izquierdo, and Puig 2019).

[52] In effect, Costa Rica's fiscal rule contains all these components. For further reference, see Agüero et al. (2019).

[53] Recent studies using appropriate identification strategies show fiscal rules' significant direct effects on fiscal performance at both the national and local level (Caselli and Reynaud 2019; Guerguil et al. 2017; Grembi et al. 2016).

1.32 The independent fiscal councils (IFCs) strengthen the commitment to sustainable public finances and the prevention of possible fiscal risks (Debrun et al. 2008). The IFCs' inclusion of independent experts of high technical quality is essential to fulfillment of their role: to ensure compliance with the rule and strengthen the credibility of the budget. Beetsma et al. (2018) find that IFCs improve compliance with balance sheet and spending rules while improving the accuracy of fiscal projections, in both developed and emerging countries.[54] Among the lessons learned, it is important that they be designed in accordance with the reality of the country in question and that there be a clear communication strategy (Kopits, 2011).

1.33 In the area of public employment, the differentiated selection of government managers through merit-based criteria and the adoption of transparent procedures, with incentives that make them responsible for their performance, are some of the recommendations for improving civil service leadership and capacity approved by the OECD countries (OECD, 2019) that have led to more efficient management of the public sector in countries such as Chile and Peru (IDB, 2016). In addition, having a base salary that represents the totality of civil servants' compensation (understood as the single salary in Costa Rica) is a widespread practice in the OECD that promotes transparency and efficiency and prevents inequities unrelated to the responsibilities of each position and risks of capture of variable remuneration schemes and other supplemental compensation (World Bank, 2014). In addition, it has been implemented in the BCCR and CGR with good results in terms of efficiency in the medium term and in competitiveness for attracting and retaining suitable personnel.

1.34 The implementation of a broad-based modern VAT is superior to an IGV in various respects: (i) it permits credit of the tax on purchases and thus avoids exporting taxes or competing on equal terms with imported goods whose VAT was returned in the original jurisdiction; (ii) expansion of the base to services and reduced rates on goods in the basic basket and health services allows traceability in the production chain, promoting control by the administration; and (iii) financial deduction of the VAT on purchases applied throughout the region and in Europe is higher than physical deduction in terms of economic efficiency.[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 both 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]

1.35 With regard to personal income tax, public finances theory and international good practice recommend unifying bracket schemes and tax progressivity rates 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 among types of income to maintain equitable treatment and simplify compliance

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

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

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

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

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

1.36 With regard to electronic invoicing, the coverage and quality of the information the tax administration has on taxpayers have been pointed to as essential in explaining the wide variation in tax collection performance among countries (Kleven et al. 2015; 2011). Electronic invoicing allows the tax administration to obtain a greater level of information on the universe of taxpayers. In particular, it records taxes on sales, income and, when applicable, social security contributions, instantaneously, reliably, and traceably. 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).

1.37 Administrative reform is a process of reviewing duplications and functions in all public sector institutions. The ultimate objective is to optimize public sector functions and thus make spending more efficient. Zero-based budgeting is a possible methodology for addressing this objective, and experience with this has been gained in both the public and private sectors. In Latin America, there is the experience in Mexico, where the results were as expected and at the same time produced many lessons learned that should be taken into account in other exercises of this kind (Durán et al., 2018).

1.38 **Coordination with other multilateral organizations and donor agencies and the additionality of the Bank.** In the preparation of this operation, the Bank headed up coordination with the IMF and the OECD with regard to comprehensive fiscal reform and modernization of taxation in particular; with the OECD in regard to the fiscal rule and the IFC that is part of the requirements for the country's admission to the OECD. 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 (tax reform, fiscal rule) and also with the Central American Bank for Economic Integration (CABEI) on the subject of revenues. The efforts made to date will continue in the project implementation stage. A joint Tax Administration Diagnostic Assessment Tool (TADAT) evaluation has been planned among the Bank, CIAT and the IMF, to include recommendations on the application of electronic invoicing (cybersecurity, risk models, etc.).

1.39 **Strategic alignment.** The program is aligned with the Update to the Institutional Strategy 2010-2020 (document AB-3008) and the development challenges of: (i) Social Inclusion and Equality, by creating a more distributive tax policy, in that 80% of the tax reform will be assumed by 20% of the highest-income households;[59] 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. The program also modernizes the tax administration through electronic invoicing for more efficient and equitable management of taxes. In addition, the operation is aligned with the

[58] Study of yield and equity of the tax reform included in Law 9635. Mimeo. Ministry of Finance, 2018.

[59] Ministry of Finance, 2018. ¿Quién paga la reforma fiscal en Costa Rica?. In addition, 92% of the increase in income tax falls on the highest-income decile.

crosscutting area of Institutional Capacity and Rule of Law, through the implementation of the fiscal rule, a pillar of tax sustainability and economic stability. This is in turn reinforced with the creation of the IFC, which affirms the transparency and credibility of fiscal policy. In addition, the program will contribute to the Corporate Results Framework 2016-2019 (document GN-2727-6) through the indicators: (i) taxes collected as a percentage of GDP; and (ii) countries benefitting from Bank projects to improve the mobilization of domestic resources. The program is also consistent with the Fiscal Policy and Management Sector Framework Document (document GN-2831-8), related to strengthening growth in a context of fiscal sustainability and economic stability; and the efficient mobilization of public resources for development. This operation is also aligned with the Sector Strategy on Institutions for Growth and Social Welfare (document GN-2587-2) with respect to improvements in the management and financing of the public sector through the generation of revenues (tax reform) and macrofiscal management (fiscal rules and councils) and public sector management (administrative reform). This operation is aligned with the Country Strategy with Costa Rica 2015-2018 (document GN-2829-1) and the strategic objectives of supporting fiscal sustainability and expenditure efficiency, particularly with the reform of salary incentives and the implementation of the Public Employment Law, which are crucial for this.

B. Objectives, components, and cost

1.40 **Objective.** The objective of this programmatic series and the first operation is to strengthen fiscal sustainability through control of expenditure and modernization of the tax system. The specific objectives are to: (i) improve the effectiveness of the macrofiscal institutional framework; (ii) increase efficiency in the management of the tax system; and (iii) improve efficiency in the management of public expenditure (employment, administrative reform, and judicial pensions).

1.41 The policy conditions of the first programmatic operation include the approval of two laws.[60] The first is comprehensive fiscal reform that includes: (i) greater control of spending through the fiscal rule; (ii) rationalization of specific allocations; (iii) control of remunerations; and (iv) modernization of the tax system. The purpose of the second law is to achieve the actuarial sustainability of the Judicial Branch pensions system. This combination of actions reflects an adequate mix of expenditure and revenue measures with a view to making public finances sustainable. The second operation will seek adoption of regulations for these laws and their implementation, as well as the approval of a public employment law and the creation and implementation of an IFC as a monitoring entity for effective compliance with the fiscal rule, among other measures.[61]

1.42 The approved tax reform, the fiscal rule, and the expenditure control measures (salaries and transfers) have an estimated return close to 4% of GDP, although the

[60] Law to Strengthen Public Finances (9635) and Law on Reform of the Judicial Branch Retirement and Pensions System (9544).

[61] Indeed, the regulation of the tax reform and the fiscal rule and fiscal council as well as the public employment legislation will be supported technically through a technical cooperation operation now being prepared (Support for the Fiscal Institutional Framework).

fiscal rule continues the tax savings over time.[62] When the tax reform is fully in force, given that the VAT and income measures have a gradual effect, they would yield 1.7% of GDP in 2023.[63] Meanwhile, from the application of the fiscal rule, the Bank estimates a return of 2.1% of GDP by 2023. This return includes the expenditure containment measures prescribed in the Law to Strengthen Public Finances, described in paragraph 1.18, estimated at 0.68% of GDP.[64] As a result of these measures, debt would begin to decline in 2023, when it would reach levels close to 60% of GDP for the central government. The relevant challenges are in complying with these measures, for which the second operation includes plans to require: (i) correct regulation of the fiscal law, supported by deepening of the salary incentives measures, through approval of the Public Employment Law; (ii) the start-up of the IFC; and (iii) administrative reform measures (institutional reorganization, which includes elimination, merger, and creation of entities, and their implementation in at least two sectors). Approval of the Public Employment law will establish changes in the contracting and compensation of civil servants, as well as their recruitment and evaluation based on merit, applying the competitive single salary methodology, as provided in the conditions of the first operation. Finally, full application of the reform to the Judicial Branch pensions system is anticipated.

1.43 **Component I. Macroeconomic stability.** The objective is to maintain an appropriate macroeconomic policy framework consistent with the program's objective as established in the Policy Matrix (Annex II).

1.44 **Component II. Policy reforms and management of expenditure and revenues.** The objective is to approve legal policy and fiscal management instruments to strengthen fiscal sustainability and efficiency on both the expenditure side and revenue side. This component is divided into four subcomponents:

a. **Improvement in the macrofiscal institutional framework.** Among the improvements to the macrofiscal institutional framework, the first operation in this programmatic series establishes: (1) approval of a fiscal rule (Strengthening Public Finances Act) for the control of expenditure, which includes: (i) control of growth in current expenditure, based on borrowing and (medium-term) economic growth; (ii) coverage of the entire NFPS;[65] (iii) presentation of a medium-term fiscal framework consistent with the fiscal rule and international best practices; and (iv) well-defined escape clauses for exceptional circumstances and corrective mechanisms;[66] and (2) proposed design of an independent fiscal council by the Ministry of Finance that:

[62] In the taxation portion, collection of the VAT will begin on 1 July 2019. In terms of income tax, the increase in the rates for personal income tax and capital income tax begins on 1 July 2019. The fiscal rule will govern as of 1 January 2020 and the public employment rules began to govern as of 4 December 2018.

[63] This return from the measures is based on comparative statics (base 2017); it does not include higher returns that may be generated by increased GDP.

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

[65] Except public enterprises with debt to assets ratios of less than 50% because they do not represent a tax risk.

[66] There are two major grounds for application of the escape clause: (i) national emergency when its cost to the State is greater than 0.3% of GDP; and (ii) when projected growth is less than 1% of the level of activity.

(i) revises the macrofiscal parameters of the budget and the medium-term fiscal framework; and (ii) monitors compliance with the fiscal rule.[67] The second operation calls for the creation by Executive Decree and start-up of the IFC and compliance with the fiscal rule according to reports from the CGR and IFC.

b. **Modernization of the design and management of the tax system.** To improve the design of the tax system and contribute to fiscal balance in the medium and long term, the first operation defines the following policy measures: (1) Approval of a tax reform (Law to Strengthen Public Finances) that includes: (i) replacement of the IGV by a VAT, increasing collections and productivity: (a) expansion of the base through: inclusion of services, and a series of goods at differential rates and elimination of the zero rate; and (b) financial deduction allowing all tax credits;[68] and (ii) changes in income by increasing collection and the progressive nature of taxation; (a) creation of two personal income tax brackets (20% and 25%); and (b) generalization and increase in the rate on capital income, including a withholding system; (2) the start-up of electronic invoicing for large taxpayers required to use it.[69] The second operation provides for the regulation and entry into effect of the tax reform (VAT and income tax). In particular, the VAT's regulations include expansion of the base through the inclusion of services (particularly digital, tourism, and medical services) and a series of goods at differentiated rates, and elimination of the zero rate. In addition, regulations for the income tax will also be included, including the conditions for bracket 1, and implementation of the capital income withholding system. Lastly, widespread utilization of electronic invoicing is planned (at least 90% of large taxpayers and Grandes Empresas Territoriales [Large Territorial Enterprises] (GETES) are required to issue it).

c. **Improvement in the management of public expenditure.** Within the first operation of this programmatic series the following policy measures are defined for the improvement and control of public expenditure: (1) presentation to the Legislative Assembly of a draft Public Employment Law with the following characteristics at a minimum: (i) encompasses the NFPS; (ii) contains a public employment system applicable to all special subsystems, and application of the competitive single salary methodology in all cases for new civils servants; (iii) recruits and selects based on merit with specific tests for the position and skills; and (iv) recruits, selects, and evaluates on a differentiated basis a segment of government managers (senior management), based on the merit principle; (2) approval of

[67] For monitoring of the fiscal rule, the Bank is supporting, through technical cooperation operation (ATN/OC-16526-CR) the coordination among the CGR, the Ministry of Finance's National Budget Bureau (DPN), and the Technical Secretariat of the Budget Authority (STAP) and the conditions for formation of the fiscal council: (i) suitability criteria; (ii) the term of the appointments; (iii) prohibitions (no conflict of interest with other activities); and (iv) conditions for removal.

[68] The financial deduction not only allows deducting the VAT paid for the purchase of inputs but it also allows deducting all goods and services directly and indirectly involved in the production of the taxed good or service.

[69] Subject taxpayers do not include the financial sector or taxpayers under the Simplified Taxation System (RTS), pursuant to Laws 7092 and 6826).

expenditure control measures (Law to Strengthen Public Finances) including: (i) rationalization of salary incentives: annual payments, termination indemnities, and full-time dedication; and (ii) limits on the growth of current transfers;[70] (3) designation of the Ministry of National Planning and Economic Policy (MIDEPLAN) as the lead agency and coordinator for administrative reform, intended to streamline the organizational structure of public sector entities through executive decree. The second operation provides for: (i) approval, regulation, and implementation of the Public Employment Law containing the guidelines of the first operation; (ii) regulation and implementation of expenditure control measures described in the first tranche with the following characteristics; annual payments not to exceed 2.54% of the base salary; termination indemnities not continuing beyond eight years (12 collective bargaining agreements are in effect); and full-time dedication falls from 55% of the base salary to 25% for those with masters' degrees and from 20% to 10% for those with bachelors' degrees; and (iii) start-up of public sector administrative reform, including the presentation of an action plan and its work schedule, as well as its implementation in two sectors (Housing and Social).

d. **Reform of the judicial branch pensions and retirement system.** The first programmatic operation includes approval of the Law on Reform of the Judicial Branch Retirement and Pensions System, the objective being to achieve financial sustainability over the long term, considering the following components at a minimum: (i) creation of a special and progressive contribution on the highest pensions; (ii) expansion of the contribution base (increase in the contribution rate and number of contributions); (iii) increase in the regular retirement age and the minimum age for taking early retirement; and (iv) inclusion of a periodic actuarial review to evaluate the system's sustainability.[71] The second programmatic operation will support the regulation and execution of the changes in the legal framework of the Judicial Branch Retirement and Pensions System, including the validity of the measures agreed upon for the first operation. An actuarial study will also be contracted to evaluate the sustainability of the system.

C. Key results indicators

1.45 A Results Matrix (Annex III) was developed to measure the impact and outcomes of the policy actions and reforms under the program. These outcomes will be monitored and evaluated by mutual agreement with the borrower.

1.46 The main expected outcomes are: (i) the medium-term return on the reform is estimated at 3.8% of GDP as of 2023, made up of 1.7% of tax revenues and the remainder in rationalized expenditure, particularly the application of the fiscal

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[70] Rationalization of specific allocations, including the allocation to the National Child Welfare Agency (PANI), the inclusion of the National Learning Institute (INA), and preschool education in the constitutional mandate of 8% of GDP to education.

[71] The following were also established: (i) reduction of the replacement rate; (ii) establishment of a maximum pension cap; and (iii) institutional strengthening through the administrative separation of the fund.

rule;[72] and an improvement in the central government's primary balance as a percentage of GDP, which will increase from -2,3% of GDP for 2018 to +0.66% in 2023; (ii) the anticipated outcomes are: (a) that the percentage of years of compliance with the fiscal rule for the period 2020-2023 will be 100%; (b) that the percentage increase in the personal income tax paid by the quintile (20%) with the highest incomes will be 75%; (c) that the increased tax burden will go from 13.2% in 2018 to 14.9% in 2023; (d) in tax administration, the expectation is that the percentage of large taxpayers and GETES using electronic invoicing as a percentage of the number of taxpayers[73] will reach 90% in 2023;[74] and (e) the savings produced by measures to rationalize incentives on public salaries contained in the fiscal reform (annual payments, termination indemnities, full-time dedication, etc.) will reach 0.68%[75] of GDP in 2023.

1.47 **Economic analysis.** Based on the OVE recommendations in its 2011 Evaluability Review of Bank Projects[76] and in the results of the review of evaluation practices and standards for policy-based loans carried out by the Evaluation Cooperation Group, made up of the independent evaluation offices of the multilateral development banks,[77] as provided in paragraph 1.3 of document GN-2489-5 (Review of the Development Effectiveness Matrix for Sovereign Guaranteed and Non Sovereign Guaranteed Operations) as well as others, indicate that it would not be necessary to include an analysis of efficiency in the use of financial resources,[78] it was determined that an economic analysis would not be performed for this type of loan as was reported to the Bank's Board of Executive Directors. Thus, this loan operation does not include an economic analysis and, as a result, the economic analysis is not considered for purposes of measuring the evaluability score in this programs' Development Effectiveness Matrix.

1.48 **Beneficiaries.** This project benefits the entire Costa Rican population, improving the country's fiscal situation due to increased efficiency in the management of public spending and tax collection. Bearing in mind that 80% of the tax reform will be assumed by the 20% of households with the highest incomes, the tax system is

[72] The IMF (Article IV, 2019) has calculated that the reform would have a return of 4.03% of GDP. In addition, they estimated that, due to the impact of the tax reform, in 2024 the central government's debt begins to decline and they considered an additional short-term fiscal effort to reduce central government borrowing to 50% of GDP in 2030. Meanwhile, the Bank has estimated that the debt will begin to fall in 2023 and that the additional adjustment is higher, between 1.25% and 1.5% of GDP, in that it includes an increase in central government public investment of nearly 0.5% of GDP to reach, at least, 2% of GDP over current levels (1.4% of GDP in 2018 for the central government), to rebuild the physical infrastructure.

[73] Subject taxpayers do not include the financial sector or those under the RTS (Laws 7092 and 6826).

[74] It should be recalled that electronic invoicing is expected to be used by at least 90% of subject large taxpayers exclusively who are required to issue it as a condition for the second tranche.

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

[76] Document RE-397-1: Currently, the score in the economic analysis section is calculated using the maximum value from the analysis of costs and benefits and the cost-effectiveness analysis. However, these analyses cannot be applied to policy-based loans.

[77] *Good practice standards for the evaluation of public sector operations.* Evaluation Cooperation Group, Working Group on Public Sector Evaluation, 2012 Revised Edition. February 2012.

[78] According to the Evaluation Cooperation Group, PBLs must be evaluated according to relevance, effectiveness, and sustainability. Efficiency was not included as a criterion, given that the sizing of the PBLs is linked to a country's financing gap and is independent of the project's benefits.

expected to become more progressive and the lower-income population will be protected, particularly with the income tax measures, given that close to 70% of lower-income households will not pay this tax and it will be the decile with the highest incomes that will assume 92% of the income tax.[79] It also benefits the Costa Rican government, particularly the Ministry of Finance, through better management of public finances, which will contribute to their consolidation and the sustainability of the Judicial Branch Pensions System.

II. FINANCING STRUCTURE AND MAIN RISKS

A. Financing instruments

2.1 **Financial instrument.** This operation has been structured under the PBP modality and corresponds to the first operation in a programmatic series to consist of two contractually independent but technically linked loans, in line with the provisions of document CS-3633-2 for the preparation and implementation of PBPs. The programmatic modality was selected because it: (i) strengthens policy dialogue with the government; (ii) provides the terms necessary for its implementation due to 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 contexts, events, or knowledge acquired during execution of the agreed measures.

2.2 **Dimensioning.** The amount of this first operation is US$350 million charged to the Bank's Ordinary Capital resources. This amount will cover the country's fiscal resource needs in the broad sense, linked to the reforms, that will fall on 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 NFPS in Costa Rica for 2019 are estimated to be approximately US$8.235 billion. This operation assumes 4.3% of those requirements and 12.6% of the external financing planned by the Ministry of Finance for 2019. The amount and the date of the second operation will be agreed upon with the government considering progress made in compliance with the triggers and the parameters that guide the Bank's programming exercise with the country. In addition, the implementation process will be supported with a technical cooperation operation that is in the approval process (Support for the Fiscal Institutional Framework), as described above (paragraph 1.24).

B. Environmental and social risks

2.3 The operation supports the definition of policies, standards, management tools, and institutional strengthening actions, so that no socioenvironmental risks are anticipated. Pursuant to Directive B.13 of the Environment and Safeguards Compliance Policy (OP-703), this program does not require classification.

C. Fiduciary risks

2.4 No fiduciary risks associated with the operation are identified. On the one hand, a financial instrument that does not include procurement is being used. On the other, the resources from this operation will go directly to the Treasury Single Account, to

[79] Ministry of Finance. 2018. ¿Quién paga la reforma fiscal en Costa Rica?.

cover the financing needs, for which the executing agency has the necessary financial management tools and control systems. The funds will be disbursed once the policy measures established in the loan contract have been fulfilled.

D. Other risks and key issues

2.5 **Fiscal sustainability risks.** There are two medium-level risks. The first consists of the financial risk arising from the lack of interest on domestic and international markets with regard to financing public debt servicing. However, the fiscal reform that this program supports has strengthened fiscal sustainability, helping to mitigate the potential effects of this risk. As a result, there are two actions that help to partially close the 2019 financial gap with significant savings on financing cost: (i) the Government of Costa Rica is coordinating financing operations, based on the reform, with other international organizations (CAF and CABEI); and (ii) the significant reduction in interest rates fostered by approval of the fiscal reform.[80]

2.6 The second risk consists of the decentralized agencies' resistance to complying with the spending limits established by the fiscal rule. To control compliance with the fiscal reform, an IFC will be established at a high technical level and with political representation for the periodic monitoring of the fiscal rule. In turn, the Bank is providing technical assistance (ATN/OC-16528-CR) to the Ministry of Finance in support of the regulation and implementation of the fiscal rule and the IFC. In addition, the regulation of the IFC is being coordinated with the OECD as this is a requirement for the country's admission to that organization (paragraph 1.38).

2.7 **Public management and governance risks.** The medium level risk in this category is resistance to implementing the reform of public employment. The submission of the Law on Reform of Public Employment (with the single salary methodology) was a condition of parliamentary agreement for approval of Law 9635 which required special majorities (66%), and thus the likelihood of legislative approval is increased, mitigating this risk. In addition, the support of the multilaterals (IMF, OECD, and CAF) backs the content of the Law, to include technical support in the country. In turn, the approved fiscal reform included significant changes in public sector remuneration, rationalizing some benefits (annual payments for attendance and termination indemnities paid upon retirement based on years worked, etc.), and these were all unanimously upheld by the Fourth Chamber (Constitutional Court). For its part, the Bank will continue to support all the stakeholders involved through the technical cooperation operation (Support for the Fiscal Institutional Framework).

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) maintain official communication with

[80] Costa Rica's sovereign risk measured by the Emerging Markets Bonds Index (EMBI) fell by 23% (132 basis points) between November 2018 and May 2019, while Latin America and the Caribbean's risk fell by an average of 10% (56 basis points).

the Bank by itself or through whomever it appoints and to submit reports and evidence of compliance with the conditions of the operation and any other report the Bank might require by the deadlines and under the conditions agreed; (ii) promote actions designed to achieve the policy objectives defined in the program; and (iii) gather, file, and deliver to the Bank all the information, indicators, and parameters contributing to the monitoring, measurement, and evaluation of program outcomes.

3.2 **Institutional coordination mechanism.** Responsibility for coordinating compliance with the measures in the programmatic series falls to the Ministry of Finance, which will coordinate compilation of the 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 with respect to the policy measures incorporated in this operation (Ministry of National Planning and Economic Policy and the Judicial Branch Retirement and Pensions Fund). In addition, it will 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. Compliance with 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 will be a special contractual condition precedent to the only disbursement of financing in this first operation in the series**.

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 hold periodic meetings to monitor the results of the operation and resolve technical difficulties associated with its execution. The Ministry of Finance will provide the Bank on a timely basis with all the information needed to measure compliance with 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 impacts and expected outcomes of the program. In particular, an evaluation will be conducted on the impact of implementing electronic invoicing and the fiscal rule.

IV. POLICY LETTER

4.1 The Policy Letter reiterates the commitment of the Government of Costa Rica to the objectives and actions contemplated for all the programmatic operations and the consistency of national policies for strengthening fiscal sustainability for inclusive growth.

Development Effectiveness Matrix		
Summary		
I. Corporate and Country Priorities		
1. IDB Development Objectives	**Yes**	
Development Challenges & Cross-cutting Themes	**-Social Inclusion and Equality -Productivity and Innovation -Institutional Capacity and the Rule of Law**	
Country Development Results Indicators	**-Percent of GDP collected in taxes (%) -Countries benefited by IDB's projects aimed at improving domestic resource mobilization (#)***	
2. Country Development Objectives	**Yes**	
Country Strategy Results Matrix	**GN-2829-1**	**Support fiscal sustainability and spending efficiency**
Country Program Results Matrix		**The intervention is not included in the 2019 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	**9.4**	
3.1 Program Diagnosis	**2.4**	
3.2 Proposed Interventions or Solutions	**4.0**	
3.3 Results Matrix Quality	**3.0**	
4. Ex ante Economic Analysis	**N/A**	
5. Monitoring and Evaluation	**6.6**	
5.1 Monitoring Mechanisms	**1.1**	
5.2 Evaluation Plan	**5.5**	
III. Risks & Mitigation Monitoring Matrix		
Overall risks rate = magnitude of risks*likelihood	**Medium**	
Identified risks have been rated for magnitude and likelihood	**Yes**	
Mitigation measures have been identified for major risks	**Yes**	
Mitigation measures have indicators for tracking their implementation	**Yes**	
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/FI-14553-CR AND ATN/OC-16528-CR**

Note: (*) Indicates contribution to the corresponding CRF's Country Development Results Indicator.

Evaluability Assessment Note: *The main objective of the operation is to strengthen fiscal sustainability, by controlling spending and modernizing the tax system. To achieve these ends, the proposal defines three specific objectives, namely: (i) improving the effectiveness of the macro-fiscal institutional framework; (ii) increase efficiency in the management of the tax system; and (iii) improve efficiency in public expenditure management (employment, administrative reform and judicial pensions).*

The proposal diagnoses that the fiscal sustainability of Costa Rica is compromised by challenges of sufficiency, efficiency and equity in the General Sales Tax; high levels of rigidity in current spending for remunerations and transfers that are highly inflexible; and weaknesses of the macro-fiscal institutional framework to consolidate public finances. In order to solve these weaknesses, the following is considered: 1) the implementation of the Fiscal Rule to which the design of an independent Fiscal Council is annexed that would ensure compliance; 2) the approval of a tax reform that replaces the VAT for VAT and implements the electronic invoice for large taxpayers; 3) the approval of the Public Employment Law and the Strengthening of Public Finances that implement the competitive single salary and rationalize salary incentives, and; 4) the reform of the pension and retirement system of the Judicial Power to give it financial and actuarial sustainability. The quantification of these problems / needs is provided, and their magnitudes are expressed quantitatively given the existing knowledge and data.

The vertical logic appears robust since the products promoted by the reform would allow the development of measurable activities and consonants with the achievement of the objectives that the program proposes and that are reflected in the outcome indicators.

Monitoring will be based on information from official reports with appropriately identified sources. The costs of monitoring and evaluation are adequately quantified. The ex post evaluation plan includes an impact evaluation to identify the effects of the electronic invoice using the difference in differences method and another using the synthetic control method to quantify the impact of the fiscal rule. The econometric assumptions on which the proposed evaluation strategies are based could be better validated on the document.

POLICY MATRIX

Objective: The objective of this programmatic series and the first operation is to strengthen fiscal sustainability by controlling expenditure and modernizing the tax system. 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).

Components/ Policy Objectives	Policy Conditions, PBP I	Status of Fulfillment of Conditions for PBP I[1]	Triggers, PBP II
Component I. Macroeconomic stability			
Macroeconomic stability	1.1 Maintenance of an appropriate macroeconomic policy framework consistent with program objectives as established in the Policy Matrix.	Fulfilled	1.1 Maintenance of an appropriate macroeconomic policy framework consistent with program objectives as established in the Policy Matrix.
Component II. Policy reforms and management of expenditure and revenues			
Improvement of macrofiscal institutional framework	2.1 Approval of a fiscal rule (Law to Strengthen Public Finances) 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.[2] (iii) Presentation of a medium-term macrofiscal framework consistent with the fiscal rule and international best practices.	Fulfilled (4th Quarter, 2018)	2.1 Compliance with the fiscal rule according to reports from the CGR and IFC and the regulations including: (i) Control of growth in current expenditure, based on borrowing and (medium-term) economic growth. (ii) Coverage of the entire nonfinancial public sector. (iii) Presentation of a medium-term macrofiscal framework consistent with the fiscal rule and international best practices.

1 This information is merely indicative as of the date of this document. In accordance with document CS-3633-2, fulfillment of all the conditions specified for disbursement, including the maintenance of an appropriate macroeconomic policy, will be verified by the Bank at the time of the corresponding disbursement request from the borrower and reflected on a timely basis in the memorandum on eligibility for disbursement.

2 Except public enterprises with debt-to-assets ratios below 50% because they do not present a fiscal risk.

Components/ Policy Objectives	Policy Conditions, PBP I	Status of Fulfillment of Conditions for PBP I[1]	Triggers, PBP II
	(iv) Well-defined escape clauses for exceptional situations and corrective mechanisms.		(iv) Well-defined escape clauses for exceptional situations and corrective mechanisms.
	2.2 Proposed design of an IFC by the Ministry of Finance, that: (i) Reviews the macrofiscal parameters of the budget and the medium-term fiscal framework. (ii) Monitors compliance with the fiscal rule.	To be fulfilled (3rd Quarter, 2019)	2.2 Creation by Executive Decree and start-up of an IFC that: (i) Reviews the macro-fiscal parameters of the budget and the medium-term fiscal framework. (ii) Monitors compliance with the fiscal rule put into effect.
Modernization of the design and management of the tax system	2.3 Approval of a tax reform (Law to Strengthen Public Finances) that includes: (i) Replacement of the IGV by a VAT, increasing tax 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]	Fulfilled (4th Quarter, 2018)	2.3 Regulation and entry into effect of the tax reform, in VAT and income tax (Law to Strengthen Public Finances), that includes: (i) The regulations of the VAT created should include: a. Expansion of base through: inclusion of services (particularly digital, tourism, and medical services) and a series of goods with differentiated rates, and elimination of the zero rate. b. Financial deduction allowing all tax credits. In particular, establishing refund mechanisms for taxpayers with debit and credit transactions at differentiated rates.

[3] The financial deduction allows not only deducting the VAT paid for the purchase of inputs but also deducting all goods and services used directly and indirectly in the production of the good or service taxed.

Components/ Policy Objectives	Policy Conditions, PBP I	Status of Fulfillment of Conditions for PBP I[1]	Triggers, PBP II
	(ii) Changes in income tax increasing collections and progressivity: a. Creation of two brackets in personal income tax (20% and 25%). b. Widespread application and increase in the capital income rate, including a withholding system.		(ii) The regulations on income tax should include the conditions of tranche 1 and the implementation of the capital income withholding system.
	2.4 Implementation of electronic invoicing for large taxpayers[4] required to use it.	Fulfilled (1st Quarter, 2018)	2.4 Use of electronic invoicing is widespread (required for at least 90% of large taxpayers and GETES).
Improvement in public expenditure management	2.5 Submission to the Legislative Assembly of a draft Law on Public Employment with at least the following characteristics. (i) Encompasses the NFPS. (ii) Contains a public employment system applicable to all special subsystems and that in all cases applies the general (single) competitive salary methodology for new employees. (iii) Recruits and selects based on merit with special tests for the position and skills. (iv) Recruits, selects, and evaluates on a differentiated basis a segment of government managers (senior management), based on the principle of merit.	Fulfilled (2nd Quarter, 2019)	2.5 Approval, regulation, and implementation of the Law on Public Employment containing at least the following characteristics: (i) Encompasses the NFPS. (ii) Contains a public employment system applicable to all special subsystems and that in all cases applies the general (single) competitive salary methodology for new employees. (iii) Recruits and selects based on merit with special tests for the position and skills. (iv) Recruits, selects, and evaluates on a differentiated basis a segment of government managers (senior management), based on the principle of merit.

[4] Subject taxpayers do not include the financial sector or those under the Simplified Taxation System (RTS - Laws 7092 and 6826).

Components/ Policy Objectives	Policy Conditions, PBP I	Status of Fulfillment of Conditions for PBP I[1]	Triggers, PBP II
	2.6 Approval of expenditure control measures (Law to Strengthen Public Finances) including: (i) Rationalization of salary incentives: annual payments, termination indemnity, and full-time dedication. (ii) Limits on growth in current transfers (rationalization of specific allocations including the allocation to the National Child Welfare Agency (PANI), inclusion of the INA and preschool education in the constitutional mandate of 8% of GDP to education).	Fulfilled (4th Quarter, 2018)	2.6 Regulation and implementation of expenditure control measures including: (i) Rationalization of salary incentives: annual payments not to exceed 2.54% of the base salary; termination indemnities not to exceed 8 years (12 when collective bargaining agreements are in force); and full-time dedication falls from 55% of the base salary to 25% for those with masters' degrees and from 20% to 10% for those with bachelor degrees. (ii) Limits on growth in current transfers (rationalization of specific allocations including reduction of the allocation to the PANI and the inclusion of the INA and preschool education in the constitutional mandate of 8% of GDP in education).
	2.7 Designation of the MIDEPLAN as the lead agency and coordinator for the administrative reform, directed to rationalization of the organizational structure of public sector entities through executive decree.	Fulfilled (3rd Quarter, 2018)	2.7 Implementation of the administrative reform of the public sector that includes: (i) Presentation by MIDEPLAN of an action plan for administrative reform and its implementation schedule. (ii) Implementation of the administrative reform in two sectors: Housing and Social.[5]

[5] The social sector consists of the: Joint Institute for Social Welfare (IMAS), National Rehabilitation Agency (PANARE), National Agency for the Blind (PANACI) National Scholarship Fund (FONABE), National Directorate of Education and Nutrition Centers and Comprehensive Childcare Centers (CEN-CINAI), National Council for Persons with Disabilities (CONAPDIS), Council on Youth, Vice Ministry of Youth, National Employment Program (PRONAE), National Program to Support Microenterprise and Social Mobility (PRONAMYPE), FODESAF, Noncontributory system of the Costa Rican Social Security System (CCSS), National Institute of Women (INAMU), PANI. The housing sector is made up of the Ministry of Housing and Human Settlements (MIVAH), National Institute of Housing and Urban Development (INVU), Housing Mortgage Bank (BAHNVI), and Institute for Municipal Development and Consulting (IFAM).

Components/ Policy Objectives	Policy Conditions, PBP I	Status of Fulfillment of Conditions for PBP I[1]	Triggers, PBP II
Reform of the Judicial Branch pensions and retirement system	2.8 Approval of the Law on Reform of the Judicial Branch Retirement and Pensions System to achieve financial sustainability over the long term, which includes the following components at a minimum: (i) Creation of a special and progressive contribution to the highest 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 pension. (iv) Inclusion of periodic actuarial review to evaluate the sustainability of the system.	Fulfilled (2nd Quarter, 2018)	2.8 Regulation and execution of the changes in the legal framework of the Judicial Branch Retirement and Pensions System to include at least the components of the first operation and the contracting of an actuarial study to evaluate the sustainability of the system.

RESULTS MATRIX

Project objective:	The objective of this programmatic series and the first operation is to strengthen fiscal sustainability by controlling expenditure and modernizing the tax system. 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).

EXPECTED IMPACT

Indicators	Unit of Measure-ment	Baseline		Targets		Means of Verification	Comments
		Value	Year	Value	Year		
Impact 1. Yield from Fiscal Reform/GDP	%	0%	2018	3.8%	2023	Ministry of Finance, Medium-term Budgetary Fiscal Framework and other reports	**Baseline:** Cumulative return from tax reform of 1.7% of GDP (2019-2023) + cumulative return from fiscal rule and spending measures of 2.1% of GDP (2018-2023) Yield based on the Law to Strengthen Public Finances (9635)
Impact 2. Central government primary balance/GDP	%	-2.3%	2018	+0.6%	2023	Ministry of Finance, Medium-term Budgetary Fiscal Framework	Estimates of the final target according to the fiscal reform approved

EXPECTED OUTCOMES

Indicators	Unit of Measure-ment	Baseline		Final Target		Means of Verification	Comments
		Value	Year	Value	Year		
Objective 1: To improve the effectiveness of the macrofiscal institutional framework							
Percentage of years of compliance with the fiscal rule for the period 2020-2023	%	0	2018	100%	2023	Fiscal rule monitoring reports from the CGR, STAP and the Ministry of Finance's DPN	Assumes compliance with the fiscal rule each year in the period 2020-2023
Objective 2: To increase the efficiency of tax system management							
Tax burden/GDP	%	13.2%	2018	14.9%	2023	Ministry of Finance, Medium-Term Budgetary Fiscal Framework	
Percentage increase in the personal income tax paid by the highest-income quintile (20%)	%	0%	2018	75%	2023	Official data from the DGT and the National Institute of Statistics and Census	
Large taxpayers and GETES using electronic invoicing/Total number of large taxpayers and GETES[1]	%	0%	2017	90%	2023	Official data from the DGT	
Objective 3: To improve efficiency in public expenditure management							
Savings derived from measures to rationalize public salaries incentives contained in the Law to Strengthen Public Finances (annual payments, termination indemnity, full-time dedication, etc.)	% of GDP	0%	2018	0.68%	2023	Ministry of Finance report	Methodology established in the consulting report prepared in the context of ATN/FI-14553-CR[2]

[1] It is important to emphasize that the following entities are not required to issue electronic vouchers: taxpayers under the simplified system, the Costa Rican Social Security Fund, state universities, the National Road Council, the Supreme Court of Justice, the Central Bank of Costa Rica, the Social Protection Board, Supreme Court of Elections, financial institutions, the National Institute of Learning, "solidarista" associations, National Production Council, ministries, the Legislative Assembly and those mentioned in Article 11 of the Regulations for the Income Tax Law.

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

OUTPUTS

Outputs	Unit of Measure-ment	Baseline		Final Target (year)	Means of Verification	Comments[2]
		Value	Year			
Component II. Policy reforms and management of expenditure and revenues						
a. Improvement in the macrofiscal institutional framework						
Law creating the fiscal rule on current expenditure approved (Law to Strengthen Public Finances)	Law	0	2017	1 (2018)	Publication in the Official Gazette of the Law to Strengthen Public Finances. Link	Title IV of this law deals with the creation of the fiscal rule with all its characteristics: definitions, target variable, sanctions, escape clauses, etc.
Document with proposed design of IFC prepared	Document	0	2018	1 (2019)	Ministry of Finance report	
b. Modernization of the design and management of the tax system						
Law to Strengthen Public Finances (9635) with changes in the VAT and income tax approved	Law	0	2017	1 (2018)	Publication in the Official Gazette of the Law to Strengthen Public Finances. Link	
Detailed report on use of electronic invoicing in the large taxpayers' sector	Report	0	2018	1 (2019)	DGT report submitted to the Bank and Resolution DGT-R-012-2018. Link	
c. Improvement in management of public expenditure						
Draft Law on Public Employment submitted to the Legislative Assembly	Draft Law	0	2018	1 (2019)	Executive Branch referral of the draft law to the Legislative Assembly	
Expenditure control measures (Law to Strengthen Public Finances) approved	Law	0	2017	1 (2018)	Publication in the Official Gazette of the Law to Strengthen Public Finances. Link	Title III of this law deals with restricting salary incentives of public employees.
Decree approved designating MIDEPLAN as the coordinator of the process of administrative reform	Decree	0	2017	1 (2018)	Publication of the decree designating MIDEPLAN as the coordinator of the reform of public administration. Link	
d. Reform of the Judicial Branch pensions and retirement system						
Law on Reform of the Judicial Branch Retirement and Pensions System approved	Law	0	2017	1 (2018)	Publication in the Official Gazette of the reform of the Judicial Branch Retirement and Pensions System. Link	

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PROPOSED RESOLUTION DE-___/19

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

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. Such financing will be for the amount of up to US$350,000,000 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 __ ____________ 2019)

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