DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

COSTA RICA

PUBLIC SECTOR REFORM LOAN

CR-0025

LOAN DOCUMENT

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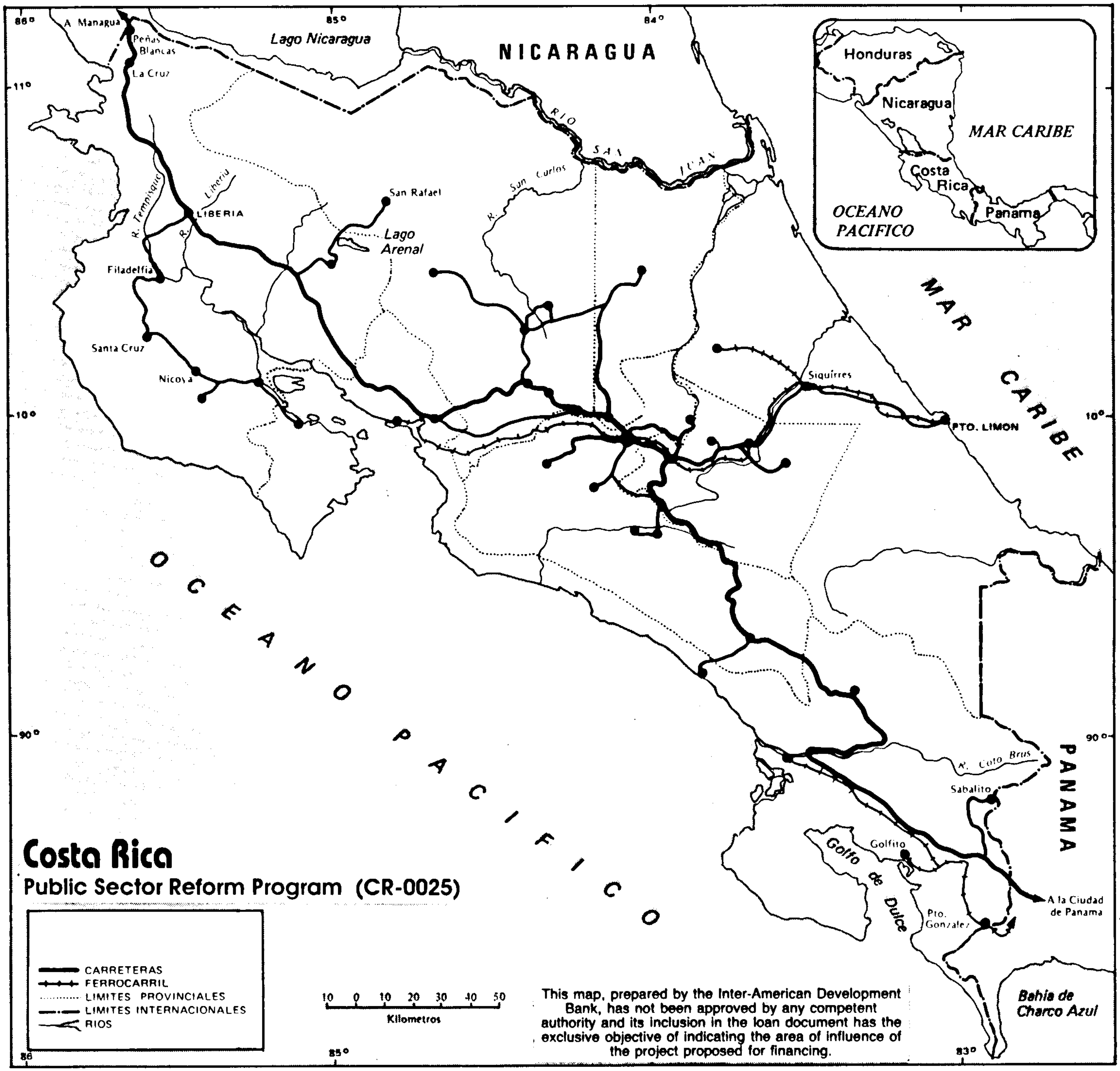
ABBREVIATIONS

AGEF	Banking Supervision Agency
AyA	Public Water and Sewer Company
BCCR	Central Bank of Costa Rica
CACM	Central American Common Market
CAUCA	Código Aduanero Unificado de Centroamérica
CNP	National Production Council
CCSS	Costa Rican Social Security
CEMPASA	Public Cement Company
DGA	Dirección General de Aduanas
DGTD	Dirección General de Tributación Directa
FANAL	Public Liquor Company
FUCE	Fundación para la Cooperación Estatal
FERTICA	Public Fertilizer Company
GATT	General Agreement On Tariffs and Trade
GDP	Gross Domestic Product
GOCR	Government of Costa Rica
IBRD	International Bank for Reconstruction and Development
ICE	Energy and Telecommunications Company
IDA	Institute for Agricultural Development
IDB	Inter American Development Bank
IMF	International Monetary Fund
INA	National Training Agency
ISL	Investment Sector Loan
MAG	Ministry of Agriculture
MOF	Ministry of Finance
MOPT	Ministry of Transport and Public Works
NFPS	Non-Financial Public Sector
OAS	Organization of American States
PSRL	Public Sector Reform Loan
RECOPE	Costa Rican Oil Refinery
SAL	Structural Adjustment Loan
USAID	United States Agency for International Development
UNICEF	United Nations Children's Fund
WEP	World Environmental Program



NICARAGUA
Lago Nicaragua
A Managua
Peñas Blancas
La Cruz
LIBERIA
R. Liberia
R. Tempisque
Filadelfia
Santa Cruz
Nicoya
San Rafael
Lago Arenal
R. San Carlos
RIO SAN JUAN
Siquirres
PTO. LIMON
MAR CARIBE
OCEANO PACIFICO
R. Coto Brus
Sabalito
PANAMA
Golfito
Golfo de Dulce
Pto. Gonzalez
A la Ciudad de Panama
Bahia de Charco Azul
Honduras
Nicaragua
Costa Rica
Panama
86°
85°
84°
83°
11°
10°
9°
Costa Rica
Public Sector Reform Program (CR-0025)
CARRETERAS
FERROCARRIL
LIMITES PROVINCIALES
LIMITES INTERNACIONALES
RIOS
10 0 10 20 30 40 50
Kilometros
This map, prepared by the Inter-American Development Bank, has not been approved by any competent authority and its inclusion in the loan document has the exclusive objective of indicating the area of influence of the project proposed for financing.

COSTA RICA

Basic Socio-Economic Data
Statistics and Quantitative Analysis
Economic and Social Development Department

Executive Summary

Social Statistics

Land Area (Km2)	1991	50,900
Population (Thousands)	1991	3,088
Population (Average Annual Growth Rate)	1982-1991	2.8
Rural (Percent)	1991	52.4
Density (Population per Km2)	1991	60.7
Vital Statistics		
Crude Birth Rate (per 1,000 Population)	1990	25.6
Infant Mortality Rate (per 1,000 Live Births)	1990	16.5
Crude Death Rate (per 1,000 Population)	1990	3.8
Life Expectancy at Birth (Years)	1990	75.2
Illiteracy (Percent)	1990	7.2
Primary School Enrollment Ratio	1990	93.0

Economic Statistics

Market Exchange Rate (Colones/US$)	8-1992	134.6
GDP per Capita (Average Annual Growth Rate)	1982-1991	0.0
Labor Force (Thousands)	1990	1,023
Unemployment Rate (Percent)	1991	5.0
Consumer Prices (Twelve Month Variation)	8-1992	20.1
NF Public Sector Overall Balance (As % of GDP)	1991	-0.1
Domestic Credit (As % of GDP)	1991	25.9
Balance of Payments (Millions of US$)		
Current Account Balance	1991	-82
Trade Balance	1991	-207
Capital Account Balance	1991	317
Change in Reserves (- Increase)	1991	-348
Total External Debt (Millions of US$)	1991	3,966
Total Debt Service (Millions of US$)	1991	512
Debt to GDP Ratio (Percent)	1991	73.0
Debt Service Ratio (Percent)	1991	22.5

16 November 1992

COSTA RICA
Basic Socio-Economic Data

1. Exchange Rates

Colones/US$, End of Period
Index 1980=100

	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Market Rate	40.3	43.4	47.8	53.7	58.9	69.3	79.5	84.4	103.6	135.4
Real Effective Index	136.2	118.4	120.5	122.2	135.9	149.8	163.6	157.7	160.8	176.3

2. Prices

Average Annual Growth Rates in Percent

	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Consumer Price Index	89.9	32.6	12.0	15.1	11.8	16.9	20.8	16.5	19.0	28.7
Wholesale Price Index	108.4	26.1	7.7	10.4	9.0	10.6	17.8	14.6	14.9	28.1

3. International Liquidity

Millions of US$

	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Reserves	249	311	405	525	549	489	668	743	521	920
Reserves minus Gold	226	311	405	506	523	489	668	743	521	920
Special Drawing Rights (SDRs)	0	3	0	0	0	0	0	0	2	0
Reserve Position in the IMF	...	...	...	...	...	...	...	...	...	...
Foreign Exchange	226	308	405	506	523	489	668	743	519	920
Gold (National Valuation)	23	...	...	19	26	...	...	...	...	...

4. National Accounts

Millions of 1988 US$
1988 US$

	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Gross Domestic Product	3674	3772	4066	4098	4319	4515	4658	4905	5081	5138
GDP Per Capita	1517	1513	1584	1551	1590	1618	1625	1668	1685	1664

Annual Growth Rates in Percent - Constant Prices

	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
GDP Per Capita	-9.9	-0.1	4.9	-2.2	2.7	1.9	0.7	2.9	1.1	-1.4
GDP by Type of Expenditure (MP)	-7.3	2.9	8.0	0.7	5.5	4.8	3.4	5.6	3.7	1.0
Consumption	-8.4	4.0	6.7	3.8	4.8	3.5	2.3	4.9	3.8	0.2
Gross Domestic Investment	-25.5	33.1	10.9	7.7	31.1	3.4	-6.8	9.5	8.7	-27.1
Exports of Goods and Services	-5.5	-1.3	11.3	-4.0	3.6	20.9	7.2	16.1	9.9	5.8
Imports of Goods and Services	-18.1	15.8	10.7	6.0	17.6	17.6	-0.9	18.1	13.4	-9.5
GDP by Sector of Origin (MP)										
Agriculture, Forestry and Fishing	-4.7	4.0	10.1	-5.5	4.8	4.2	4.6	7.4	2.7	2.5
Mining and Quarrying	...	...	...	...	...	...	...	...	...	...
Manufacturing	-11.4	1.8	10.4	2.0	7.3	5.5	2.2	3.4	3.0	1.0
Electricity, Gas and Water	4.2	20.2	3.2	-7.4	6.1	7.7	2.5	5.0	6.5	3.1
Construction	-31.9	4.7	23.6	5.6	3.1	1.1	0.0	12.4	-2.6	-13.4
Wholesale and Retail Trade	-11.7	3.2	11.4	4.6	7.0	4.0	1.3	5.3	4.8	0.5
Transport and Communications	-0.8	1.5	3.6	2.3	7.5	8.8	8.4	9.0	6.7	1.9
Financial Services	0.9	2.9	3.4	2.6	4.6	5.2	5.7	5.8	5.2	1.9
Government	-2.9	-1.6	1.5	0.5	2.0	2.5	2.0	2.0	1.5	1.5
Other Services	-3.6	2.0	3.0	2.8	3.7	4.9	4.5	5.3	5.0	3.3

COSTA RICA
Basic Socio-Economic Data

4. National Accounts (cont.)

Composition in Percent - Current Prices

	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
GDP by Type of Expenditure (MP)										
Consumption	72.4	76.6	76.9	75.9	73.9	77.0	78.0	78.1	79.9	78.2
Gross Domestic Investment	24.7	24.2	22.7	25.9	25.2	27.1	23.8	25.8	27.7	22.5
Exports of Goods and Services	45.1	36.0	34.4	30.7	31.3	31.6	34.3	35.1	34.7	37.9
Imports of Goods and Services	42.2	36.8	34.0	32.5	30.5	35.8	36.1	39.0	42.2	38.6
GDP by Sector of Origin (MP)										
Agriculture, Forestry and Fishing	24.5	22.0	21.2	18.9	20.9	18.1	18.1	17.4	15.8	17.3
Mining and Quarrying	...	...	...	...	...	...	...	...	...	...
Manufacturing	20.3	21.9	22.5	22.1	21.3	21.3	20.5	19.6	18.8	18.8
Electricity, Gas and Water	2.3	3.8	3.4	3.2	3.0	3.0	3.0	3.2	3.1	3.6
Construction	3.1	2.9	3.6	3.6	3.3	3.2	3.0	3.4	3.2	2.6
Wholesale and Retail Trade	21.7	19.7	19.4	20.5	19.2	20.6	20.4	19.7	20.2	19.8
Transport and Communications	4.6	4.9	4.8	4.9	4.7	4.9	5.0	5.0	5.3	5.3
Financial Services	8.3	8.4	8.1	9.0	9.9	10.9	11.4	11.8	12.4	11.7
Government	11.6	12.2	12.6	13.0	12.8	12.7	13.3	14.2	15.0	14.5
Other Services	3.6	4.2	4.4	4.8	4.8	5.2	5.3	5.8	6.2	6.3

5. Non-Financial Public Sector

As a Percent of GDP

	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Current Revenues	24.4	31.4	31.5	30.4	30.3	33.2	32.2	32.0	30.6	31.0
Current Expenditures	20.6	22.9	22.6	22.0	23.9	24.5	24.7	26.4	26.9	25.8
Current Savings	3.8	8.6	8.9	8.4	6.4	8.7	7.6	5.6	3.6	5.2
Capital Expenditure	6.7	8.2	6.8	6.4	7.0	6.2	6.1	7.2	6.2	4.4
Overall Balance (- Deficit)	-9.0	-3.1	-1.9	-1.9	-1.7	-0.3	-0.3	-2.9	-3.0	-0.1
Domestic Financing	2.8	11.4	-0.3	-0.5	0.0	-0.4	0.7	2.0	2.7	-0.1

6. Monetary Survey

As a Percent of GDP

	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Domestic Credit	33.0	27.9	38.4	35.4	31.0	33.0	32.6	29.1	28.1	25.9
Public Sector	18.8	11.3	19.6	17.7	15.3	16.3	15.4	13.0	13.1	12.0
Private Sector	14.2	16.6	18.7	17.7	15.7	16.7	17.2	16.1	15.0	13.9
Money (M1)	13.6	15.1	15.8	13.8	14.1	13.6	10.9	11.9	12.5	8.5

7. External Trade

Direction in Percent
Index 1980=100

	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Exports of Goods (fob)										
Developed Countries	65.5	61.1	68.6	69.8	79.0	77.7	76.1	77.2	80.6	79.5
Developing Countries	34.5	38.9	31.4	30.2	21.0	22.3	23.9	22.8	19.4	20.5
Latin America	28.1	29.0	26.0	22.8	17.1	16.2	16.4	17.0	15.9	17.5
Imports of Goods (cif)										
Developed Countries	56.3	58.8	61.8	63.2	66.3	64.0	62.4	62.6	65.1	64.0
Developing Countries	43.7	41.2	38.2	36.8	33.7	36.0	37.6	37.4	34.9	36.0
Latin America	38.2	33.9	32.6	31.3	28.0	28.8	31.3	30.7	28.1	30.1
Terms of Trade Index	83.6	85.9	90.4	88.0	106.1	87.5	87.8	83.6	73.3	75.0

7. External Trade (cont.)

Composition in Percent	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Exports of Goods (fob)										
All Food	72.1	69.8	72.6	73.4	75.3	70.7	68.7	...	...	...
Agricultural Raw Materials	1.3	1.5	2.0	2.5	2.7	3.6	4.9	...	...	...
Fuels	1.0	1.8	1.9	1.9	1.4	1.1	0.8	...	...	...
Ores and Metals	0.2	0.6	0.6	0.5	0.5	0.9	0.6	...	...	...
Manufactured Goods	25.3	26.4	22.9	21.8	20.2	23.8	24.8	...	...	...
Chemicals	7.5	7.6	6.4	6.6	5.7	4.8	4.7	...	...	...
Machinery and Transport Equipment	4.4	3.5	3.1	2.8	2.6	3.3	3.7	...	...	...
Other Manufactured Goods	13.5	15.3	13.4	12.4	11.8	15.7	16.4	...	...	...
Imports of Goods (cif)										
Capital Goods	18.6	15.3	19.1	20.8	24.4	24.7	20.4	20.6	...	...
Consumption Goods	15.0	17.9	18.6	18.4	20.3	20.2	22.0	22.6	...	...
Intermediate Goods	65.3	66.0	61.2	59.6	54.1	53.6	56.5	55.7	...	...
Fuels	20.5	18.2	14.8	16.2	10.2	10.0	9.5	9.5	...	...
Other	1.1	0.8	1.1	1.2	1.2	1.4	1.0	1.1	...	...

8. Balance of Payments

Millions of US$	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Current Account Balance	-267	-280	-151	-126	-80	-256	-179	-415	-424	-82
Trade Balance	64	-42	5	-62	40	-139	-98	-239	-443	-207
Exports of Goods (fob)	869	853	998	939	1085	1107	1181	1333	1354	1491
Imports of Goods (fob)	805	894	993	1001	1045	1245	1279	1572	1797	1698
Service Balance	-367	-307	-297	-283	-272	-344	-336	-368	-173	-9
Freight and Insurance	-72	-87	-95	-96	-101	-127	-124	-155	-175	-165
Travel	89	81	66	65	71	68	105	94	130	166
Investment Income	-374	-334	-314	-282	-278	-297	-352	-380	-245	-165
Other Services	-10	33	46	31	36	13	34	74	117	156
Unrequited Transfers	36	69	141	219	152	226	255	191	192	135
Private	30	23	32	43	37	39	40	39	55	51
Official	6	46	109	176	115	187	215	121	...	108
Capital Account Balance	228	249	-8	43	77	163	196	352	171	317
Non-Monetary Sector	207	360	7	62	88	156	195	347	171	326
Private Sector	-156	-285	-115	-87	-23	64	68	129	93	259
Direct Investment	27	55	52	65	57	76	121	95	160	137
Portfolio Investment	-2	-3	0	-14	-3	0	-6	-13	-28	-13
Other Long-Term	51	-37	-86	-34	-57	-53	-1	13	17	36
Other Short-Term	-231	-301	-81	-105	-22	40	-46	34	-56	99
Government Sector	363	645	122	149	111	93	127	218	79	66
Long-Term	-33	1174	128	344	-40	-378	-202	-33	401	280
Short-Term	396	-529	-7	-195	151	471	329	251	-323	-214
Monetary Sector	21	-112	-15	-19	-11	6	1	4	-1	-8
Long-Term	-20	-15	-27	-16	-14	-8	-10	-3	-2	-2
Short-Term	42	-97	12	-2	3	14	11	7	1	-6
Change in Reserves (- Increase)	-125	-47	55	-60	-95	-37	-242	-146	197	-348
Errors and Omissions	164	78	104	143	98	131	225	209	56	113

COSTA RICA
Basic Socio-Economic Data

9. External Debt

Millions of US$
Ratios in Percent

	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Total Debt	3641	4177	3988	4399	4575	4720	4544	4603	3772	3966
Long-Term Debt	2773	3490	3497	3834	3930	4009	3877	3863	3380	3505
Public and Publicly Guaranteed	2391	3142	3180	3532	3624	3707	3560	3559	3076	3203
Bilateral	551	830	848	967	912	978	1088	1129	1234	1346
Multilateral	526	556	573	763	940	1091	1043	1069	1141	1197
Bond Holders	432	217	211	221	207	165	57	41	609	...
Banks	816	1315	1281	1535	1519	1413	1317	1267	41	16
Suppliers	36	29	23	14	13	12	9	12	11	26
Other Creditors	31	195	243	31	33	48	46	42	41	...
Private Non-Guaranteed	381	348	317	302	306	302	317	304	304	302
Use of IMF Credit	93	192	156	189	172	132	71	35	11	81
Short-Term Debt	776	495	335	377	472	579	596	705	380	380
Interest Arrears on Debt	229	15	66	13	80	220	280	385	80	...
Total Debt Service	244	698	424	526	499	334	402	345	501	512
Public and Publicly Guaranteed	134	606	329	452	382	190	267	274	432	...
Bilateral	38	50	57	87	168	6	46	62	40	85
Multilateral	48	77	54	83	106	122	140	155	156	73
Private Non-Guaranteed	96	61	53	35	37	38	41	0	8	...
IMF Repurchases and Charges	12	21	39	36	51	74	62	39	29	11
Short-Term Debt (Interest only)	1	10	3	3	30	32	32	32	32	20
Debt to GDP Ratio	110	122	105	113	111	107	98	91	70	73
Debt Service Ratio	21	60	32	41	35	22	24	18	24	23

... Not Available
0.0 Indicates that the amount is nil or negligible

COSTA RICA
Basic Socio-Economic Data

Sources and Notes

Executive Summary

Social Statistics:

Land Area: Organization of American States (OAS), América en Cifras 1974.

Population: IDB estimates based on data from Latin America Demographic Center (CELADE) and United Nations Population Division.

Vital Statistics:

World Bank, Social Indicators of Development - 1991-92 Edition and Economic Commission for Latin America and the Caribbean (ECLAC), Statistical Yearbook - 1991 Edition.

Economic Statistics:

Labor Force: World Bank, Social Indicators of Development - 1991-92 Edition.

Unemployment: Programa Regional del Empleo para América Latina y El Caribe (PREALC).

1. Exchange Rates:

International Monetary Fund (IMF), International Financial Statistics (IFS).

Real Effective Index: IDB estimates based on data from the IMF, IFS.

2. Prices:

IMF, IFS.

3. International Liquidity:

IMF, IFS.

4. National Accounts:

GDP in 1988 US Dollars: IDB estimates.

GDP by Type of Expenditure and Sector of Origin: Banco Central de Costa Rica. Mining and Quarrying included in Manufacturing.

5. Non-Financial Public Sector:

IMF based on data from the Ministerio de Hacienda. Current Revenue includes Operating Surplus of Public Enterprises; Overall Balance includes adjustment.

6. Monetary Survey:

IMF, IFS (mid-year observations).

7. External Trade:

Trade by Direction: IMF, Direction of Trade Statistics (magnetic tapes).

Terms of Trade: ECLAC, Balance Preliminar de la Economía Latinoamericana, December 1991.

Export Composition: United Nations Statistical Division (UNSTAT) Commodity Trade (COMTRADE) Data Base; Exports include Re-Exports.

Import Composition: Banco Central de Costa Rica, Balanza de Pagos de Costa Rica. Fuels include Crude Petroleum.

8. Balance of Payments:

Banco Central de Costa Rica and IMF, Balance of Payments Statistics (magnetic tapes).

9. External Debt:

World Bank, World Debt Tables (magnetic tapes).

COSTA RICA
OPERATIONS DEPARTMENT
OPS/IRO

IDB LOANS

APPROVED AS OF OCTOBER 31, 1992

	US$Thousand	Percentage
TOTAL APPROVED *	1,523,260	100.0%
DISBURSED	1,035,278	68.0%
CANCELLATIONS	69,453	4.6%
UNDISBURSED BALANCE	487,982	32.0%
PRINCIPAL COLLECTED	363,691	23.9%
APPROVED BY FUND		
ORDINARY CAPITAL	1,041,450	68.4%
FUND FOR SPECIAL OPERATIONS	352,184	23.1%
SOCIAL PROGRESS TRUST FUND	11,700	0.8%
VENEZUELAN TRUST FUND	117,926	7.7%
OTHER FUNDS	0	0.0%
APPROVED BY SECTOR		
AGRICULTURE AND FISHERY	277,646	18.2%
INDUSTRY AND MINING	91,329	6.0%
TOURISM AND MICROENTERPRISE	0	0.0%
ENERGY	639,055	42.0%
TRANSPORTATION AND COMMUNICATIONS	150,659	9.9%
EDUCATION SCIENCE AND TECHNOLOGY	102,881	6.8%
PUBLIC AND ENVIRONMENTAL HEALTH	118,502	7.8%
URBAN DEVELOPMENT	28,051	1.8%
PLANNING AND REFORM	0	0.0%
EXPORT FINANCING	99,000	6.5%
PREINVESTMENT AND OTHER	16,137	1.1%

* Net of cancellations with monetary adjustments and export financing loan collections.

OPERATIVE PROGRAM 1992-1994

PROJECT NO.	NAME	LOAN US$ MILLION
	1992	
CR-0025	Public Sector Reform Program	80.0
CR-0032	Investment Sector Loan and Multisector Credit Program	170.0
CR-0120	Health Services Improvement Program	42.0
	TOTAL 1992	292.0

	1993	
CR-0036	Electrical Development Program III and Program of Energy Conservation	370.0
CR-0125	Rural Road Rehabilitation and Maintenance Program	35.0
	TOTAL 1993	405.0

	1994	
CR-0121	Management and Protection of National Parks Program	30.0
CR-0040	Urban Sanitation Program in Principal Cities	100.0
CR-0041	Arenal-Tempisque Irrigation Program III	50.0
	TOTAL 1994	180.0

LOAN DOCUMENT
PUBLIC SECTOR REFORM LOAN
(CR-0025)

I. SUMMARY OF THE OPERATION

A. Loan Context

1.1 In a letter dated July 9, 1991, the Ministry of Finance set out its commitment to a program of extensive economic reform being developed within the context of a third Structural Adjustment Loan (SAL III) with the IBRD and requested a fast-disbursing sector loan to cofinance its execution. In response, the Bank developed jointly with the IBRD this proposed Public Sector Reform Loan (PSRL) which represents one of three components covered by SAL III. Other components of the SAL III include trade and price liberalization along with a program of financial sector reform whose content complements those measures being supported under the Bank's Investment Sector Loan (ISL).

1.2 The loan under consideration supports public sector reform in Costa Rica as a cornerstone of the GOCR's economic program. The public sector has long played an important part in Costa Rica's development, contributing to relatively rapid economic growth with substantial redistributive impact. However, the fast growth of public spending resulted in chronic overall public sector deficits of about 5% of GDP during 1986-90 with the central government deficit averaging above 3%. This growth was characterized by duplication of programs and functions, excess or inadequate staffing, all of which led to low levels of efficiency in government operations.

1.3 In the absence of significant public sector spending cuts and/or revenue increases, the fiscal imbalance could once again fuel inflation, and lead to higher interest rates, as public sector financing demands crowd out private sector credit and produce balance of payments problems. As the GOCR embarks upon trade liberalization, the need to address this fiscal imbalance takes on even greater importance. First, the demands of a more competitive environment will require greater investments in human and physical capital (particularly roads, ports, and airports) which are now crowded out by current government expenditures. Second, the public sector deficit interferes with efforts to maintain a real competitive exchange rate by its pressure on the price level of nontradeables and attraction of speculative capital.

1.4 The present administration has taken important steps to control the public sector deficit such as initiated public employment reductions, contained public pensions, and eliminated important tax exemptions. However, additional measures that go beyond the absolute reduction in the size of government and the resources devoted to it are needed to address underlying structural problems. The rapid expansion of the public sector

was accompanied by decreasing efficiency and equity in the provision of services and distortions in factor and product markets. The challenges now lie in improving both the efficiency and equity of public sector expenditures and revenues.

B. Principal Aspects of the Loan

1. Program objectives

1.5 This loan will seek to improve the efficiency and equity of public sector operations. In an effort to rationalize public expenditures, the proposed loan will support the GOCR's institutional restructuring of five key ministries through privatization, employment reduction, budgetary and pension reform.

1.6 The privatization program targets three main areas: i) the remaining industrial public enterprises producing cement, fertilizers and liquors, and initiates the analyses for privatizing the public oil refinery, ii) the construction and repair of public works to be contracted out in concession to the private sector, and iii) ancillary services to be contracted out to former public sector employees who now provide these services.

1.7 The employment reduction program targets 25,000 public sector jobs over 1991-1994. This target represents about 19% of non-financial public sector (NFPS: Central Government, the social security agency (CCSS), and public enterprises) employment. It was estimated on the basis of the scope of the Government's privatization program and the degree of excess positions which were identified through sectoral analyses of the five ministries and related agencies.

1.8 Reforms to the budgetary process focus on improving the control, monitoring and evaluation of government services so that the budget may reflect policy priorities rather than the application of historic formulas unrelated to programs or their achievements.

1.9 Pension reform will consolidate programs to ensure greater uniformity (in benefit formulas) as well as reduce the fiscal costs of public pensions. New operational rules seek to improve the actuarial position of the national social security agency (CCSS) and transform the public pension system from an entitlement program to a capitalization fund.

1.10 To rationalize revenues, reforms will target comprehensive tax reform through a simplification and rationalization of major taxes as well as tax and customs administration through a restructuring of their respective organizations within the Ministry of Finance.

1.11 Simplification and rationalization of the tax structure will focus on: i) abrogating low yielding taxes, ii) restoring the integrity of remaining taxes by broadening their bases and eliminating discriminatory and preferential treatment across economic activities, iii) reducing the distortions and inequities caused by inflation, and iv) reestablishing the

fairness of the income tax by considering all sources of income within its base.

1.12 Tax administration reform will strengthen institutional capabilities to implement a rationalized tax structure while focusing on decentralization of taxpayer services and improved policy formulation and performance evaluation by the central office.

1.13 Customs reform will also focus on institutional reorganization and capacity building as well as updating the legal and regulatory framework in accordance with the new customs code recently approved by the signatories of the Central American Common Market.

2. Program benefits

1.14 Rationalization of key aspects of GOCR expenditures and revenues, as described above, are expected to improve both the efficiency and equity of government operations (those of the non-financial public sector). On the expenditure side, the benefits will include more efficient public service provision and a release of resources for productive investment, both public and private. Private participation in service provision and infrastructure would introduce a measure of competition and free the Government to focus on key functions such as regulation and policy formulation. Improvements in the budgetary process will allow the GOCR to channel its resources to programs which reflect policy priorities, including current ones to focus social expenditures on vulnerable groups.

1.15 On the revenue side, reforms will increase tax revenues while reducing the distortions upon resource allocation that characterize the current tax structure. Specifically, by equalizing the tax burden on capital income (compared with other sources of income), the reforms will reduce the disincentive for savings and investment with own capital. The rationalization of incentive regimes will improve the efficiency of private investment by equalizing private with social rates of return across sectors. These reforms not only improve efficiency but also horizontal equity as well as like groups are given the same treatment. Finally, the broadening of the income tax base to include all sources of income will have a substantial and positive impact upon vertical equity.

3. Program risks

1.16 As past experience (including Bank operations and IBRD's SALs) indicates, the main risk to the PSRL reform program lies in obtaining the necessary legislative approvals. Despite the broad consensus on the need for public sector reform, proposed measures require specific legislative modifications which will likely involve lengthy debate and negotiation, particularly with the approach of the electoral campaign.

4. Borrower, loan amount, tranches and financing plan

1.17 The Republic of Costa Rica will be the borrower. The loan amount proposed is US$ 80 million of fast-disbursing funds from ordinary capital to be

disbursed in three tranches: the first for US$ 24 million, the second and third for US$ 28 million each. IBRD financing for the entire SAL III (including trade and financial sector components that will not receive Bank co-financing) will total US$ 100 million also to be disbursed in three tranches: the first and second for US$ 35 million each, the third for US$ 30 million.

5. Waivers requested

1.18 It is recommended that public bidding for the importation of petroleum products and their derivatives be waived given that prices for such products are negotiated in open, international markets.

C. Bank's Strategy

1.19 In accordance with the GOCR's program of economic reactivation and public sector restructuring, the objectives of the Bank's strategy for 1993-95 are to: i) define new areas of participation for private investment in the provision of public works and services; ii) strengthen public sector decentralization and rationalization of public investment priorities; and, iii) promote coordination between public and private sectors in human resource development.

1.20 These objectives are being pursued through four main operations supporting the GOCR's economic reform package: i) a Public Sector Reform Loan, as a major component of the SAL III, ii) an Investment Sector Loan, iii) a Multisector Credit Program (MCP), and iv) a Health Services Improvement Program (HSIP), all currently under preparation. The PSRL opens up to private participation areas of public works and services and promotes the sector's decentralization. Building upon a rationalized public sector, ISL reforms consolidate financial liberalization by removing important distortions inhibiting the financial sector and increase the scope and improve the climate for efficient private investment including participation in public works and human resource development. The MCP will channel resources to productive sectors through a newly modernized and more competitive financial sector. Finally, the HSIP will build upon PSRL institutional and budgetary reforms in the health sector and rationalize the provision of health services.

D. Other Multilateral Support

1.21 The Bank's operations have been closely coordinated with other multilateral support. This Public Sector Reform Loan co-finances the corresponding component of the IBRD's SAL III. Reforms in the trade and finance sectors are the two other components of the SAL III and continue the efforts towards liberalization begun in previous structural adjustment operations. In the trade area, reform measures include further reductions in effective protection, improvements in anti-dumping practice and export promotion mechanisms, and elimination of controls on price and profit margins. In the financial area, the main thrusts of policy reform are in reducing the discriminatory treatment that limits private financial intermediaries and improving the operations of public ones -- measures

which complement those supported by the Bank's ISL. These operations collectively support the GOCR's overall economic program to rationalize government's role in the economy while enhancing that of the private sector.

1.22 In terms of the overall macroeconomic context as monitored by the IMF stand-by targets, the PSRL directly addresses the problem of the fiscal deficit. Although the current stand-by was extended to September, PSRL revenue and expenditure reforms, which are programmed to begin to take effect the coming fiscal year, would impact upon the forthcoming negotiations for a new stand-by arrangement and its fiscal targets. Based upon performance to date, the GOCR expects to meet IMF targets calling for a reduction of the central government's deficit from 3.1% of GDP in 1991 to 2.2% in 1992. Estimates of the fiscal impact of PSRL reforms, that would materialize by 1995, suggest a possible further reduction of this deficit to 1.1% of GDP given continued expenditure restraint. Further assuming a continuation of the surplus from the social security agency (CCSS) and the public enterprises, there would be a surplus of 1.6% of GDP for the non-financial public sector (NFPS). Given that these reforms will not affect Central Bank losses in any significant way, these estimates suggest a projection for the overall fiscal account of a surplus of 0.1% of GDP compared with 1992 IMF deficit targets of 1.0%.

II. FRAME OF REFERENCE

A. Macroeconomic Framework

1. Overview

2.1 Since the 60s, the public sector has played an activist role carrying out major works of infrastructure and redistribution through social services. By the late 70s public sector expansion could only be financed through external borrowing and an increasing share of available domestic credit. In 1981, the non-financial public sector (NFPS) deficit peaked in excess of 14% of GDP. Capital flight, fueled by uncertainties regarding the exchange rate along with lack of access to external credit, led the GOCR to suspend payments of its external commercial debt. Rapid devaluation and the sudden adjustments in the domestic prices of petroleum products, water and electricity, caused an historic surge of inflation. This crisis prompted a program of stabilization and structural adjustment, the latter supported by two SALs in 1985 and 1988 financed by the IBRD.

2.2 Despite the achievements of these programs in terms of trade reform and fiscal and external imbalances reduction, fiscal policy appears to maintain its expansionary effects from previous years; the NFPS deficit increased from 0.3% to 3.0% of GDP between 1988 and 1990. When inaugurated in May 1990, the present government embarked upon a stabilization program of tighter fiscal and monetary policies to deal with severe disequilibria in fiscal and trade accounts. These policies were mostly of a temporary nature except for those initiating automatic tariff adjustments for petroleum derivatives and utility services and a program

of public employment reductions. However, the overall fiscal deficit reached 4.6% of GDP in 1990, in part reflecting revenue shortfalls and expenditure increases associated with deregulated international prices for coffee and oil, respectively.

2. Recent economic performance

2.3 During 1991, the Costa Rican economy slowed further as real GDP grew 1%, the lowest rate since 1985, while consumer prices continued the rapid increase exhibited the previous year from 19% to 28.7%. Nevertheless, important gains were achieved as a result of tighter fiscal and monetary policies -- the public sector deficit was reduced considerably, the trade deficit was more than halved, arrears on the external public debt were cleared or rescheduled with the Paris Club and net international reserves increased substantially.

2.4 Although Central Government finances improved during most of the year, narrowing by more than two percentage points of GDP. This deficit equivalent to 3.1% of GDP was still higher than envisaged in IMF targets. As noted, this performance resulted from a combination of short-term revenue measures and further reductions in capital expenditures. Revenue increases stemmed from a temporary increase in the sales tax rate (from 10% to 13%), and a temporary import surcharge (10%). These measures compensated for the fall in coffee tax revenues due to tariff reductions, so that the tax burden (tax revenues as a percent of GDP) remained at a level similar to the previous year at about 14.5%.

2.5 Current expenditures, however, reflected the doubling of interest payments on domestic debt as well as rapidly growing transfers due to pensions and the costs of export incentives. These were offset by the implementation of an austere wage policy, the dismissal of some 4,500 employees through the labor mobility program and the postponement of arbitration awards to 1992. Total Central Government outlays fell modestly as a result of lower capital transfers, particularly to state enterprises. The resulting deficit was financed mostly with bonds, which in turn exerted upward pressure on interest rates.

2.6 The rest of the public sector performed better than expected, generating a substantial overall surplus thereby offsetting the Central Government deficit so that the NFPS was in virtual balance. The surplus was due to sharp adjustments in prices and rates charged by state-owned enterprises, mainly the oil refinery (RECOPE) and the energy and telecommunications company (ICE). The losses of the National Production Council (CNP) were reduced as its retail food stores were privatized. In turn, the overall public sector deficit was almost halved to 2.0% of GDP, as operating losses of the Central Bank remained at that level. This represented one of the lowest levels attained since 1980, though above the 0.5% overall target of the IMF stand-by.

3. Prospects

2.7 Costa Rica's prospects for 1992 are moderately optimistic. A slightly more expansive domestic demand, stemming from a recovery of the external sector is expected to contribute to a modest output expansion of about 2.5% to 3%. The GOCR's economic program has been supported by an extension of the current stand-by with the IMF to September 1992. This program requires lowering the overall public sector deficit to 1% of GDP instead of the 0.5% original target. A new stand-by for the period October 1992-December 1993 is currently under discussion and an agreed letter of intent is expected before end of year.

2.8 While the overall public sector deficit was reduced sharply during 1991, this was accomplished mainly through tax and tariff increases and capital spending cuts. Further deficit reduction depends upon the implementation of long-term measures to increase fiscal efficiency. Some of these have been approved recently by the Legislative Assembly: a) a law to contain the outlays associated with pensions financed by the Central Government, and b) a law eliminating some important tax exemptions. According to GOCR estimates of their fiscal impact, these reforms will yield about 1.1% of GDP in tax revenues during the fiscal year. However, their effect is offset by losses from sales tax reduction (from 13% to 12%) and elimination of import surcharges and prior deposits.

2.9 The GOCR expects to contain the wage bill with a further reduction in public employment of about 4,500, under a new voluntary labor mobility program. The sector's wage policy will continue to be austere and a recent decision by the Constitutional Chamber on court mandated wage settlements has been approved. These politically sensitive measures indicate that economic stability and public sector reform are GOCR priorities; in recognition that the adjustment process has not been completed and that in the future the country may suffer from fiscal and external sector disequilibria unless appropriate measures are undertaken.

2.10 The GOCR's commitment to a growth-sustaining policy mix are demonstrated by recent measures to open the economy by reducing import tariffs, liberalizing the foreign exchange regime including opening up the capital account (February 1992), as well as rationalizing exports incentives (suspending new issuance of export tax incentives; CATs). In this context and in order to avoid an overappreciation of the colon, the Bank will support GOCR's efforts towards sustaining a competitive and unified foreign exchange rate, in coordination with the IMF.

B. Bank's Strategy

2.11 The Bank's strategy for Costa Rica for 1993-95 focuses on sectoral reforms to: a) consolidate financial and trade liberalization, b) improve basic social services on a regional basis, and c) improve programs for human resource development and employment absorption. More specific objectives, in accordance with the GOCR's program of economic reactivation and public sector restructuring, are to: i) define new areas of participation for private investment in the provision of public works and services; ii)

strengthen public sector decentralization and rationalization of public investment priorities; and, iii) promote coordination between public and private sectors in human resource development.

2.12 These objectives are being pursued through four main operations supporting the GOCR's economic reform package: i) a Public Sector Reform Loan, as a major component of the SAL III, ii) an Investment Sector Loan, iii) a Multisector Credit Program (MCP), and iv) a Health Services Improvement Program (HSIP), all currently under preparation. The PSRL opens up to private participation areas of public works and services and promotes the sector's decentralization. Building upon a rationalized public sector, ISL reforms consolidate financial liberalization by removing important distortions inhibiting the financial sector. Together with complementary measures outside the financial sector, ISL reforms seek to increase the scope and improve the climate for efficient private investment including participation in public works and human resource development. The MCP will channel resources to productive sectors through a newly modernized and more competitive financial sector. Finally, the HSIP will build upon PSRL institutional and budgetary reforms in the health sector and rationalize the provision of health services.

2.13 Bank operations will also support sectoral reform programs in basic social services, investment and export promotion, energy and transportation infrastructure, agroindustry and forestry, and environmental tourism. Recently, the Bank approved a project to improve the quality of education cofinanced with the IBRD. The Bank's current pipeline for 1993-95 totals US$959 million.

III. THE SECTOR PROGRAM

A. Goals

3.1 The GOCR has drawn attention to the size and scope of the public sector with indicators of the share of total employment in the sector (16%), the percentage of GDP represented by domestic public debt (20%) and a relatively high fiscal burden (total revenues registered 22.3% of GDP), and a history of chronic fiscal deficits. But, more importantly, the efficiency of public sector operations has suffered. With the rigidities in the use of human and financial resources, payroll has come to consume about a third of budgetary resources as capital investment has declined. Thus, the goals of the GOCR's public sector reform are to trim its size, by reducing and maximizing the amount of resources destined to its operation, and increase public savings and investment. Specifically, on the expenditure side, the reform program seeks to: i) reduce the size of the public sector by eliminating duplication and unnecessary functions and reducing employment and fixed assets, ii) reform the budgetary process from initial allocation to monitoring and evaluating the effectiveness of public spending, and iii) reform the pension system. This would release relatively underutilized resources to the private sector and restore this sector's primary role in the country's market-oriented development strategy.

3.2 On the revenue side, reform measures also seek to promote greater efficiency in resource use while generating some increases in revenues. The complex and distortionary tax system demands overhaul to eliminate biases such as those against the use of labor and in favor of capital financed through debt. These distortions are magnified by numerous exemptions, which together with the especially generous treatment of certain groups on the expenditure side, benefit the least needy groups disproportionately. Accordingly, the tax structure requires a reorientation according to principles of allocative neutrality and equity. Rationalization and simplification of the tax structure will substantially increase the efficiency of tax administration as well as improve revenue collections. Both tax and customs administration are specific targets of reorganization and decentralization.

3.3 The reform program is summarized in the policy matrix (Annex I) and detailed in the following sections.

B. Public Sector Expenditure

3.4 Public expenditure of the central government has followed an upward trend registering between 17.7% and 18.1% of GDP during the last five years. However, as external financing has declined and the consequences of the public sector deficit have become more obvious, there is broad consensus in Costa Rica that the public sector must be restructured. As the country's development strategy restores the primacy of the private sector and markets to allocate resources, the State's role needs to be redefined. The GOCR has begun this redefinition through its program of institutional restructuring.

3.5 This program seeks to reduce functional overlaps by restructuring a number of key institutions and privatizing some entities as well as ancillary services. Institutional reform to eliminate duplication and merge overlapping activities will cover five of thirteen ministries -- Housing, Agriculture, Health, Transportation, and Security -- where specific action plans have been prepared by sectoral working groups. The sectoral analyses and plans have shown that in most sectors there is a need to: i) rationalize functions among sector entities to maximize the effectiveness of public resources, ii) strengthen ministerial budgetary oversight, iii) build ministerial policy formulation capabilities, and iv) provide the legal and administrative support for these enhanced ministerial functions. These plans include measures to consolidate functions (in the case of Health between the Ministry and the CCSS), merge two ministries (responsible for Security), and redefine functions where activities will be contracted out to the private sector (Housing and Transportation).

3.6 Although the identified reforms can be initiated by administrative means, the Government will press forward with a set of legal reforms to consolidate the restructuring program. In each of the five sectors, specific legislation will be required. This institutional restructuring program will involve significant regulatory, legislative, and administrative efforts. This suggests the advisability of monitoring the progress of these efforts through: i) the general objectives stated in the

Letter of Sectoral Policy (Annex II) and ii) the specific components with measurable results as described below.

1. Privatization

3.7 The Government will intensify its privatization program. The divestiture of the public cement company (CEMPASA), the public fertilizer company (FERTICA) and the public liquor company (FANAL) are slated for 1992-94 finalizing the first stage of privatizations of production oriented activities begun with the divesture of CODESA and its many subsidiaries. The Government's program also targets the petroleum sector in which it currently holds legal monopoly over exploration and drilling. Moreover, through the public refinery (RECOPE), this legal monopoly extends to wholesale distribution of petroleum products. Accordingly, the Government has formed an ad hoc group to study the petroleum sector, its regulatory framework, the role of RECOPE, and recommend measures to improve efficiency and increase competition.

3.8 While laws for the privatization of CEMPASA and FERTICA have been presented to the Legislative Assembly, a Board presentation condition would call for presentation of the corresponding law for FANAL. Subsequent tranche conditionality would require bringing these entities to the point of sale; prior to second tranche for CEMPASA and FERTICA and prior to third tranche in the case of FANAL. Since their indebtedness was limited by executive decree some years earlier, the importance of these privatizations lie in their contribution to public employment: about 300 each, in round numbers. In the case of RECOPE, second tranche conditionality calls for agreement on an action plan to rationalize the petroleum sector and for third tranche, its implementation.

3.9 Drawing upon the findings of the five sector analyses, the privatization program will extend its scope to increase the participation of the private sector in public works and in the provision of ancillary state activities. The areas to be opened to the private sector are those not considered vital to public functions where there was no initial justification for public action. This part of the Government's public sector reform program relies critically on the approval of two laws recently submitted to the Legislative Assembly: the Public Works Concession Law and the Law for Economic Democratization. The former will allow the private sector to construct and operate major infrastructure, which the state will control upon termination of the concession and after the private sector operator has recovered an appropriate return on investment. Such concession should alleviate what is an infrastructure bottleneck affecting private sector investment. The Bank's Investment Sector Loan is supporting an action plan that will identify pilot projects for concession, specify the rules and bidding procedures and a timetable for their implementation.

3.10 The Law for Economic Democratization will allow the privatization of ancillary activities by providing incentives for the public employees now providing these services to organize into cooperatives or businesses contracting to the state. Rather than being covered under the public sector payroll, former employees will be able to sell their services to

the private sector. After a consolidation period of 3 to 5 years, these enterprises would have to compete for Government contracts with others in the private sector. Estimates suggest that this program of small enterprise spin-offs would produce budgetary savings equivalent to about 20% to 25% of the costs of providing these services while allowing for civil service employment reduction without adding excessive pressure on the labor market. Proposed tranche conditions call for the implementation of this program of enterprise spin-offs.

2. Employment reduction

3.11 The Government's employment reduction program aims to achieve a significant and sustained reduction in public sector employment through privatization of enterprises and services (described above) and early retirements. The detailed sector analyses which provide the technical support for the Government's institutional restructuring were the bases used to arrive at the targeted employment cuts, their phasing, and the required incentive package. These analyses included studies to identify areas of excess staffing, a survey to determine interest among public sector employees, and extensive consultations with unions affected by the program.

3.12 The program seeks to reduce total public employment by 25,000 positions over the period 1991-94. This figure corresponds to a rough but conservative estimate of the magnitude of excess or underutilized staffing. It is equivalent to about 19 percent of total non-financial public sector employment and excludes essential categories in areas such as education, health and security. This program is already underway and by end 1992, the Government expects to have achieved a reduction of about 13,000 positions. This will include 11,000 positions already cut and 2,000 new cuts through the voluntary labor mobility program and normal turnover. During 1993, another 5,000 positions will be eliminated through privatization of firms and services, and another 900 through further labor mobility and turnover. The remaining 6,100 positions will be eliminated during 1994, mainly through privatization of government services. Of these 1993 and 1994 targets, one-third will be achieved through firm privatizations, while about 60% are expected from services privatizations.

3.13 The Bank's proposed Health Services Improvement Program includes the restructuring of the Ministry of Health which focuses on the transfer of primary care to CCSS and strengthening of the Ministry's policy making capabilities. Current estimates of the impact of this rationalization of resources suggest a reduction of approximately 700 positions in the Ministry incorporated in the employment reduction program.

3.14 Regarding the operational guidelines for the employment reduction program, line managers will decide on the final allocation of employment cuts within each sector, taking into account the need to retain essential personnel and ensure the efficient functioning of activities that will remain within the purview of the state.

3.15 Independent surveys of public employees affected by the labor mobility program indicate that a majority have made the transition to private sector employment. While this suggests that, thus far, public employment cuts have not occasioned severe dislocation, the continuation of the program depends on specific and mitigating actions. The Bank is supporting such actions through the ISL and its strengthening of the national labor training agency (INA) to focus on labor retraining and private sector involvement. In terms of the timing, these Bank operations are running in parallel such that private sector training programs would be initiated by first tranche.

3.16 Specifically, the mitigating measures supported by the ISL include: (1) revisions to labor legislation to increase labor adjustment, (2) strengthening the financial and institutional capacity of the state training agency (INA), particularly to allow INA to incorporate private sector involvement, and (3) design and implementation of a training programs for displaced workers. With respect to the latter, current estimates suggest that about 6,000 of the remaining 13,000 targeted reductions may require these programs. Ongoing work on the design of these programs is taking account of the specific training needs of women.

3. Budgetary reform

3.17 Reform of the budgetary system is a critical complement to the Government's efforts to restructure the public sector. Preparation of the annual budget is currently a mechanical exercise largely based on historical allocations. The Government has little flexibility, especially on the recurrent expenditure side, to reallocate expenditures as priorities change and as programs evolve. This lack of flexibility leaves public investment as the residual component to be squeezed at times of fiscal stringency. Moreover, budgetary control mechanisms are weak or ineffectual, and the Government lacks operational tools to effectively monitor and evaluate expenditures. The budgetary reform program seeks to establish an integrated financial management system, which can increase budgetary flexibility, impart greater programmatic content to public expenditures, and strengthen control and monitoring systems.

3.18 Over the past year, the Government has been preparing a new budgetary system along these lines and will initially apply the new procedures in six institutions (MAG, IDA, CNP, MS, CCSS and AyA covering the agriculture, health and water and sewer sectors targeted for institutional restructuring) during 1993. To carry out the reforms, the Government is strengthening the role and technical capabilities of the Budgetary Authority and has set up a coordinating body headed by the Authority, including representatives of the Ministry of Planning and Controllers. The main characteristics of the new system are:

(1) Explicit programmatic and financial guidelines/restrictions will be formulated by the Authority in coordination with the Ministries of Planning, Finance and the Central Bank;

(2) Budgetary restrictions will be negotiated within the context of the entities' programs, quantifiable targets and verifiable objectives;

(3) Entities will have autonomy to program and define justifiable modifications in their budget while their managers will be accountable through a system of incentives and sanctions;
(4) An effort to improve information flows will aid corrective action and prompt decision making;
(5) Budgetary control will focus on improved auditing procedures and ex post evaluation (using unit costs and other cost/benefit indicators);
(6) Reforms in budget classification, inter-entity and inter-sectoral coordination will allow greater control and facilitate policy formulation and oversight by the executive and legislative bodies.

As the Government gains experience with the new system, it will seek to extend the new budgetary procedures to the rest of the public sector for 1994. Proposed conditionality follows the implementation of the new budgetary system: for Board presentation its application to the six agencies selected for the pilot study; for second tranche an evaluation of pilot study results and agreement on an action plan for comprehensive reform of the budgetary system; and for third tranche, implementation of the action plan including submission to the Legislative Assembly of any necessary legal changes.

4. Pension reform

3.19 Costa Rica's public social security system, which is financed by contributions from employers, employees and the Government is complex, generous, financially unsustainable and carries a high fiscal cost. Costa Rica has 21 pension regimes including *Invalidez, Vejez y Muerte* (IVM), *Regimen No Contributivo* (RNC), and 19 special regimes (SRs). IVM is partially funded by employer, employee and government contributions and covers about 45% of the labor force of which one-third are in the private sector. RNC is a welfare program for the elderly and disabled poor not otherwise covered by the social security system. SRs cover 78,000 public sector employees and about 80% of these are under the Magisterio regime. Nine of the SRs are financed entirely by the government with the balance complemented by employee contributions.

3.20 According to GOCR estimates, SRs are financed largely by the budget with public sector employees contributing only 10% of pension costs. Although SRs cover about 20% of pensioners, they absorb 42% of pension benefits. This highlights the need to unify and redesign benefit schemes (reducing benefits and increasing retirement age) to restore financial solvency (some estimates suggest a 25% difference between the present value of the system's capital and liabilities).

3.21 The Government's pension reform program has four major elements: i) improving the actuarial position of the national security agency (CCSS); ii) unifying all pension regimes under common rules; iii) transforming the public pension system from an entitlement program to a capitalization fund; and iv) creating a system of complementary pensions. In early 1992 the GOCR introduced new operational rules in CCSS which increased the minimum qualifying age (60 and 62 years respectively for women and men)

and modified other elements of the benefit structure in order to strengthen this entity's financial position. At the same time, the GOCR reformed the pension scheme for teachers, by far the largest and most generous of the special pension regimes, by capping the maximum fiscal contribution, tightening eligibility criteria, and modifying the formula for benefits.

3.22 Two additional legal changes are required to complete the GOCR's pension reform program. In order to unify special regimes outside of CCSS, a new General Framework Pension Regime Law was approved by the Legislative Assembly June 15, 1992--a proposed Board presentation condition. This law brings special regimes (except those for teachers and employees of the judicial branch) under common rules and sets benefit limits. These two exceptions are being rationalized under separate measures; with the teachers regime reformed as noted above, the judicial regime will be adjusted within six months as provided by the cited law. To complement the public pension system, the GOCR has also presented to the legislature the Law of Complementary Pensions to allow the development of private pension funds where employees will be able to supplement their public pensions and tailor their contributions and benefits to their own needs. Given its potential contribution to the development of the country's capital market, the implementation of this law is being supported by the Bank's ISL reform program.

C. Public Sector Revenues

3.23 Costa Rica's tax structure performs poorly when evaluated by four common public finance criteria: revenue adequacy, allocative neutrality, equity, and efficiency of tax administration. Many minor taxes fail the test of revenue adequacy given their meager collections. Allocative neutrality is violated by the combined impact of payroll and income/corporate taxes which have an anti-labor bias and favor capital and debt financing. Equity, both vertical and horizontal, appears seriously compromised by numerous exemptions and special treatment to varied groups. Finally, the efficiency of administration is impeded by inappropriate institutional organization and resources. This applies both to the administration of internal taxes, under the charge of the *Dirección General de Tributación Directa* (DGTD), and to those imposed on foreign trade administered by the customs arm of the Ministry of Finance (MOF), the *Dirección General de Aduanas* (DGA). These problems and the proposed actions designed to ameliorate them relating to these areas of tax structure, tax administration and customs administration are detailed below.

1. Simplification and rationalization of the tax structure

3.24 The current tax structure includes over two hundred taxes, most of which have low yields. Moreover, the most significant taxes in terms of revenue yield and impact upon economic activity are diluted by exemptions, multiple rates and preferential treatments. The Government of Costa Rica has already taken an important first step to remedy this situation which significantly reduces the efficiency and equity of the tax system. On March 31, 1992 the Legislative Assembly approved legislation (Law No.

7293) to eliminate some of the most important exemptions in the sales, income, and foreign trade taxes which in 1991 yielded 5.2%, 2.1%, and 4.3% of GDP, respectively, and collectively contributed about 78% of total tax revenues. The net yield from this recent legislation is expected to equal the 1991 yield from the income tax.

3.25 Ongoing initiatives by the Government, supported by the proposed loan, focus on improving allocative neutrality and horizontal equity by imposing more uniform treatment across all the major tax categories of sales, income, selective consumption, and land/property. Rather than expect each of these taxes to contribute significantly to yields as well as to fulfill a redistributive function, each is calibrated to fulfill a certain objective. For example, the income tax is the most appropriate instrument to achieve a redistributive function. Sales taxes, on the other hand, cannot be targeted to low income groups such that exemptions serve mainly to narrow the tax base and complicate tax collection without achieving any significant redistributive function. Updated estimates indicate that a low and uniform sales tax rate of 10%, following the principles suggested by a 1990 IMF study, could increase sales tax revenues to about 6.5% of GDP. Many items now covered by selective consumption taxes could be incorporated into the general sales tax base. Uniform rates (for both imports and domestic production) would be applied to the five or so items yielding 90% of selective consumption tax revenues to preserve the 2.5% share of GDP contributed by these taxes in 1991. Preparation of the corresponding legislation to expand the sales tax base is proposed as a condition for Board presentation while its submission to the Legislative Assembly and approval would be a second tranche condition.

3.26 Currently, income tax rates vary by source of income. Treatment differs for income from capital vs. labor, for dependent vs. independent workers, for small vs. other size firms, for cooperatives and public enterprises vs. other forms of incorporation, for income from promoted sectors (such as forestry, agriculture, tourism and non-traditional exports) vs. other sectors. This differential treatment serves to promote specific economic activities, but introduces serious distortions in resource allocation in factor and product markets as well as erodes the tax base. Equally important, because the income tax does not consider total earnings from all sources, progressivity is seriously compromised. Under a truly progressive income tax, those with the highest income (understood as total income whatever the source) would contribute a greater share of their earnings than those with the lowest income.

3.27 In addition in the case of firms, since the current tax system makes no adjustment for inflation, it creates a strong bias in favor of debt and against equity financing. This presents a clear obstacle for the development of Costa Rica's capital market and the efficiency of the financial system. By lowering the firm's "equity cushion" against business risk, it exposes the entity to financial distress during an economic downturn. This exposes the financial sector, and society at large, to the excessive costs of liquidating bankrupt firms or condoning their substantial debt. Moreover, firms with similar earnings but a different structure of assets are affected differently by this inflation

distortion. By contracting more debt through investments in relatively riskless real assets (which are easier to leverage) firms in the productive sectors have an important tax advantage over those sectors dependent upon a high proportion of monetary assets, as in the case of the financial sector.

3.28 Given these weaknesses, the Ministry of Finance is preparing a legislative package, the Law for Tax Efficiency (*Proyecto de Ley de Eficiencia Tributaria*), to amend the income tax. The main features of this law, whose submission to the Legislative Assembly is proposed as a condition for Board presentation, are:

(a) Expansion of the income tax base to include all sources of income -- Individuals with earnings from sole proprietorships, more than one salary or other sources such as dividends and real interest will be required to present an additional form to declare the total of their income from different sources. All individuals, salaried as well as independent or self-employed, will be taxed on the basis of their total income from different sources, according to one progressive tax rate scale from 0% to 30%.

(b) Indexation will be applied to key items of the corporate balance sheet and income statement to eliminate the distortions produced by inflation. Bank estimates of marginal effective tax rates confirm that deductibility of nominal interest payments under 80% debt financing allows firms to reduce their tax burden to one-third of the statutory rate.

(c) Integration of firm and individual taxation to eliminate double taxation of firm profits and stockholders dividends that further discourages equity financing.

3.29 Presentation of a revised Property Tax Law (*Proyecto sobre el Impuesto Territorial*) to rationalize the property tax system is also a Board presentation condition. This rationalization would focus on consolidating property taxes, applying uniform rates, and most important from a revenue-raising perspective, the adjustment of property values for inflation. A first tranche condition calls for completion and presentation to the Bank of the law's regulations.

3.30 Remaining legislative initiatives to be prepared by first tranche focus on continuing to broaden the tax base by rationalizing sectoral incentive regimes, expanding the sales tax to previously excluded services, and consolidating selective sales taxes. Conditions proposed for second and third tranche call for presentation to the Legislative Assembly (of the remaining initiatives), implementation, and monitoring of the revisions to the tax structure incorporated in the Tax Efficiency and Property Tax Reform laws. Annex III outlines the proposed modifications to the tax structure and the results of the technical analyses which attempt to identify and measure the distortions in the current tax structure.

2. Tax administration reform

3.31 Since 1982 the Government has used external financing of technical assistance to improve tax administration and introduce a modern tax information system. This assistance was provided by a variety of agencies including the Bank, OAS and USAID. Bank assistance has provided for development and installation of an information system (*Sistema Integral Tributario*, SIT) including a national registry of taxpayers, their current accounts covering the most important taxes (income, sales, selective consumption and property) and the internal processing of these taxes from data entry of tax returns to collections. However, the time and resource savings from this system have not been realized due to the organizational structure of the DGTD characterized by a hybrid organization by function and type of tax where a large number of departments report to the DGTD's director and deputy director. For example, only recently as the MOF technical teams have focused on restructuring the DGTD have the possibilities of cross-referencing (within the SIT across different taxes and with other databases from the CCSS and banks) been actively explored as a means to control widespread evasion (non-presentation of tax returns).

3.32 Recently, with the support of this loan, the Government has taken the first steps toward restructuring the DGTD. The Director of the DGTD has endorsed an action plan to decentralize tax administration by delegating taxpayer services to regional offices and focusing management and control functions at DGTD headquarters in San Jose (Annex IV). Decentralization will improve client access to services while freeing the DGTD central office to carry out policy formulation, coordination, and evaluation of tax administration. This new division of functional responsibilities is needed not only to improve the efficiency of specific functions, but also to implement the significant changes in tax structure described in the previous section.

3.33 The measures in the action plan are already underway. However, in order to assure the success of these efforts, proposed first tranche conditions call for the completion of efforts to update the National Taxpayer Registry (*Registro Unico de Contribuyentes*), reconcile the integrated taxpayer accounts, and establish the effective operation of the regional office in San José.

3.34 In order to implement the restructuring and overcome the difficulties imposed by the a rather inflexible civil service code, the Ministry will promulgate a law creating a National Tax and Customs Collections Agency. The Agency will allow the Ministry of Finance to take advantage of a special civil service regime obviating the current inflexible scheme that would otherwise preclude new job classifications, in accordance with the new organizational framework, and their corresponding salary scales.

3.35 In order to support the implementation of the tax structure and administration reforms described above, the GOCR has agreed to finance a program of technical assistance. This program would achieve the following specific objectives: i) review the legal framework and prepare supporting

regulations to implement the proposed changes in the tax structure and regulate the new procedures for management operations, collections, and taxpayer audit; ii) aid the implementation of the new organizational structure for tax administration along the criteria of organization by function and regional decentralization; iii) develop new applications and information systems for management and taxpayer audit; iv) carry out training specific to the implementation of a new tax structure and efficient use of information systems; and v) define and make operational a unit for large taxpayers.

3. Customs reform

3.36 In the area of customs administration, institutional and resource deficiencies are particularly serious. Even the most basic instruments (e.g., cargo weights, appropriate physical space) and qualified human resources are in short supply. Airport, port, warehouse and other facilities are in critical need of modernization. The Government has made a diagnosis of the needs and policy reforms required to transform the current customs service. Complemented by Bank analyses, the consensus is that substantive reform is critical as Costa Rica seeks to open its economy and integrate with international markets. Assistance from USAID, specifically channelled through FUCE (*Fundación para la Cooperación Estatal*) target development of a customs information system and the operational aspects of regionalization. Bank technical assistance (ATN-SF-3319-CR) has focused on strengthening the legal and regulatory framework and customs management and decision making in the main customs office. Both programs of technical assistance will support customs reform efforts supported by this loan.

3.37 The key areas for customs reform are: i) establishing an appropriate institutional structure to rationalize functions, responsibilities, and procedures in each of the units of the customs service and their relationship to the central customs service in San José, ii) completing the revision of the now obsolete regional customs system (*Código Aduanero Unificado de Centroamérica*, (CAUCA) within the context of the Central American Common Market (CACM) to allow national discretion in administrative matters and adaptation of a regulatory framework consistent with GATT standards, and iii) introducing systems of control (for example, to monitor freight from port entry to warehouse storage and final release with duty collection) that will abide by the objectives of trade facilitation and the principle of user obligation to declare, estimate and pay duties subject to selective ex-post fiscal auditing. With the support of this loan an action plan for customs reform has been prepared to address these needs (Annex V).

3.38 As in the case of tax administration, the creation of the National Tax and Customs Collection Agency will allow the Ministry of Finance to implement the restructuring and other reforms agreed with the GOCR in the customs administration action plan.

D. Fiscal Impact of Expenditure and Revenue Reforms

3.39 As noted earlier, the objective of PSRL reforms are not only to reduce in absolute terms the resources devoted to public sector operations, but also to improve the efficiency and equity of resource use. The latter goals are more difficult to measure. In qualitative terms, expenditure and revenue reforms are expected to make a significant impact on the efficiency of public services, particularly in the medium-term when institutional restructuring efforts will take effect. The supporting technical analysis of effective tax rates provides an indication that the impact of proposed changes in the tax structure is important from the perspective of allocative efficiency. This section focuses on the fiscal impact whose estimation appears a more manageable task. The estimates presented are based on extrapolation of past trends (relying on 1991 and 1992 base data) and are indicative of an order of magnitude. These estimates of the fiscal impact of the expenditure and revenue reforms are each discussed below and conclude with the overall effect of the PSRL.

1. Expenditure reforms

3.40 The direct fiscal impact of the GOCR's institutional restructuring supported by this operation can be estimated by the cost savings from rationalized public pensions and employment reduction. In terms of the former, the GOCR has estimated savings of about 0.1% of GDP. In terms of the latter, estimates of the impact of the 1993-1995 employment reduction program suggest a gross savings of about 0.9% of GDP. This represented about 9% of the total payroll or slightly above 3% of total fiscal expenditure in 1991. These gross savings would be reduced by: i) the likely unavailability of USAID funds for 1993 severance payments thereby affecting the short-run savings, and ii) in the case of the privatization of services, the GOCR would still have to pay for the contracted services even when saving about 25% of the cost of in-house service provision. At this moment both are difficult to estimate. However, in terms of the privatization of services, considering that about 60% of the employment reduction is expected through this means, gross savings could be reduced by about half.

3.41 Together pension reform and the employment reduction program would produce savings of about 0.5% of GDP. In terms of other expenditure reforms, the fiscal impact of improved budgeting is likely to be positive (though even an order of magnitude is difficult to venture) while privatization will yield the greatest impact through public employment reduction.

2. Revenue reforms

3.42 The most significant fiscal impact would result from a further broadening of the sales tax by including professional services and from the implementation of the inflation adjustment to property values. These reforms, contemplated in the Law for Tax Efficiency and the New Property Tax Law, are expected to increase revenues by about 0.25% of GDP. The elimination and rationalization of tax incentives to agriculture, non-traditional exports and forestry contemplated in a later tax package, to

be implemented by third tranche, would yield another 0.35% of GDP approximately.

3.43 The income tax reforms included in the draft Law for Tax Efficiency are targeted to improving vertical and horizontal equity and are not expected to have a significant fiscal impact. The substitution of cedular taxes by a single moderate progressive tax scale applied to the total earnings from different sources will result in additional revenues as the tax burden of wealthier individuals is increased. This positive effect, however, would be compensated by the reduction of the tax on nominal interest earnings (from 8% to 1.5%) and of the tax burden of small shareholders and small sole proprietorships. In order not to increase the corporate tax burden, the revenue increases obtained by implementing inflation adjustments to corporate profits will be compensated roughly by the revenue losses from the elimination of double taxation and the reduction of the corporate rate (from a 10%-20%-30% scale to a uniform 25%).

3.44 The impact of reforms on the revenue side excludes the likely increment from greater administrative efficiency. In terms of improved efficiency in tax and customs administration, only a qualitative positive impact can be noted. As noted above the PSRL reforms to the tax structure would produce additional revenues of approximately 0.6% of GDP by 1995.

3. Overall program

3.45 Estimates of the overall direct fiscal impact of PSRL reforms, that would materialize by 1995, suggest a reduction of the Central Government deficit on the order of 1.1% of GDP (0.5% from expenditures + 0.6% from revenues) assuming continued expenditure restraint. Based upon the likely compliance with the 1992 IMF target of 2.2% of GDP, PSRL reforms could lead to a further reduction of the Central Government deficit to 1.1% of GDP by 1995. Assuming a continuation of the surplus from the social security agency (CCSS) and the public enterprises, this scenario would result in a surplus of 1.6% of GDP for the non-financial public sector. Given that these reforms will not affect Central Bank losses in any significant way, these estimates suggest a projection for the overall fiscal account of a surplus of 0.1% of GDP compared with 1992 IMF deficit targets of 1.0%.

E. Impact on Low Income Groups and the Environment

3.46 For sectoral loans, particularly those whose action will likely affect many sectors of the economy, there is no defined methodology for quantitatively assessing their impact upon low income groups. In terms of indirect effects, in the medium and long term, the reforms on the expenditure side will increase competition by reducing public sector monopoly over goods, services and the resources needed for their provision while expanding the competitive scope of private sector participation. This will provide an incentive to increased labor productivity as redundant and duplicate functions are eliminated from public sector activities and employment is transferred to expanding tradeable private sector activities. Public sector employment cuts are not likely to impact

especially on low income groups given the generous indemnization packages that have been offered and the incentives to be provided under the Law of Economic Democratization. However, increased access to resources and opportunities could benefit low income groups. Greater efficiencies could free resources that could then be targeted to vulnerable groups that have suffered from economic adjustment. Nonetheless, with public employment cuts expected to continue, measures to retrain and aid workers' transition to private sector employment are critical and will be supported by the Bank's ISL reform program.

3.47 Reforms on the revenue side focus on increasing vertical and horizontal equity among taxpayers as well eliminating key distortions in resource allocation within the tax system that have not benefitted low income groups. Although broadening of the sales tax is likely to adversely affect these groups, this impact would be mitigated by a more progressive income tax system which currently fails as a redistributive mechanism.

3.48 The GOCR has implemented a number of measures to protect vulnerable groups during the adjustment period. These include: i) introducing a food stamp program in August 1990 now covering about 50,000 families, ii) converting the previous subsidized housing loan program into a direct subsidy, iii) establishing a program of community-based child care centers in San José with UNICEF, WEP and other donor support, and iv) developing information systems to monitor and evaluate social programs, including detection of duplication and gaps in coverage. SAL III supports the latter through the technical assistance provided to establish the national registry of beneficiaries and the Living Standards Measurement Survey designed to evaluate the impact of social programs. The national registry of beneficiaries is based on a single form containing basic information on age, sex, employment status, education, housing conditions and income. This information, which is being gathered by the IMAS (the Social Welfare Institute), will be shared by social sector institutions to help detect duplications and gaps in coverage. The GOCR expects that both systems will be operational by end 1992 and will be used the following year to prepare a social action plan to improve the effectiveness of social programs.

3.49 Other reforms supported under SAL III and the Bank's Health Services Improvement Program which fall under the institutional restructuring of the public sector, focus on rationalization of social sector agencies (in the Health and Housing sectors). As in other cases, the aim is to eliminate overlapping functions and responsibilities, develop clear budgetary procedures and financial arrangements by program and project, as well as enhance community participation. This approach follows from a diagnostic that Costa Rica's problem is not a lack of social spending, but rather the inefficient operation of existing programs.

3.50 In terms of the impact on the environment, the most significant changes are those related to tax incentives for forestry. Currently, these activities receive the most generous of sectoral incentives: a 100% investment tax credit applicable to any investment including machinery and equipment and duty free imports. Such incentives make even marginal

investments in forestry feasible and attractive. In its program to continue to broaden the tax base and rationalize incentive schemes, the Government will consider limiting forestry incentives to investments: i) with at least a 50% capital participation, ii) in replantings, and iii) in fragile soils. Such consideration would take account of the recently completed IBRD Forestry Sector Review to assure that these changes would reduce the fiscal cost of forestry incentives as well as promote more efficient use of natural resources in accordance with a more rational overall forestry management policy.

IV. PROGRAM EXECUTION

A. Financing

1. Amount and form

4.1 The Bank's financing for the proposed public sector reform loan is US$ 80 million to be disbursed in three tranches. Given the importance of assuring the sustainability of the public sector reform program which relies heavily on legislative modifications and consequent implementation by respective agencies, the tranching is backloaded -- 30% first tranche and 35% for each of the remaining tranches. The IBRD's financing for the entire SAL III (covering reforms in the trade and finance sectors as well) totals US$ 100 million, also in three tranches under a 35%-35%-30% distribution.

4.2 The Government of Costa Rica is both borrower and guarantor for the proposed loan. The Ministry of Finance is the Program executing agency. The Ministry of Planning as well as the Caja Costarricense de Seguro Social will also be involved in the implementation of the reform program.

2. Board presentation loan conditions

4.3 A global condition proposed for Board presentation would be the maintenance of a macroeconomic framework consistent with the public sector reform program. More specific conditions to be complied with to the Bank's satisfaction are proposed below:

a. On the expenditure side, they are:

(1) Present law to privatize FANAL to Legislative Assembly.
(2) Form group and agree on terms of reference to study the petroleum sector, including the role of RECOPE and regulatory framework.
(3) Continue to implement the employment reduction program through voluntary leaves and early retirement.
(4) Implement agreed budgetary reform program, in at least six major entities for 1993 budget exercise, aimed at achieving an integrated financial management system.
(5) Approve General Framework Pensions Regime Law, new operational rules for CCSS, and the law reforming the Teacher's Pension Regime.

b. On the revenue side:

(6) Present to Legislative Assembly laws for Tax Efficiency (Proyecto de Ley de Eficiencia Tributaria) and for Property Tax reform (Proyecto de Ley sobre el Impuesto Territorial) incorporating key tax reforms, as well as needed improvements to the tax code to simplify and facilitate tax procedures and administration.
(7) Prepare program to continue to broaden the tax base by rationalizing incentive schemes, extending the sales tax to previously excluded services, and consolidating selective sales taxes.
(8) Implement program for updating and correcting the taxpayer Registry and reconciling integrated taxpayer accounts.
(9) Present to the Legislative Assembly proposed Law creating the National Tax and Customs Collection Agency and define the Agency's staffing requirements and selection criteria for both tax and customs personnel.
(10) Ministerial ratification of the Regional Treaty for the new Central American Uniform Customs Code (CAUCA II).

3. <u>First tranche loan conditions</u>

4.4 The conditions to be complied with to the Bank's satisfaction are proposed below:

a. On the expenditure side, they are:

(1) Approve Law for Economic Democratization.
(2) Approve Public Works Concession Law.
(3) Approve law to privatize CEMPASA and FERTICA.

b. On the revenue side:

(4) Complete legislative tax package(s) designed to continue to broaden the tax base (see 4.3 above).
(5) Complete regulations for Property Tax Law.
(6) Complete program for updating and correcting the taxpayer Registry and reconciling the integrated taxpayer accounts.
(7) Effective operation of the tax administration office in San José.
(8) Ratification by the Legislative Assembly of the Regional Treaty for the new Central American Uniform Customs Code (CAUCA II).
(9) Implement tax and customs administration action plans (Annexes IV and V, respectively).

4. <u>Second tranche loan conditions</u>

4.5 A global condition proposed for second tranche release would be the maintenance of a macroeconomic framework consistent with the public sector reform program. More specific conditions to be complied with to the Bank's satisfaction are proposed below.

a. On the expenditure side, they are:

(1) Bring to the point of sale privatization of CEMPASA and FERTICA.
(2) Continue to implement the employment reduction program through the privatization of enterprises and services.
(3) Evaluate pilot program and agree on an action plan for comprehensive budgetary reform.
(4) Continue to implement new General Framework Pensions Regime Law.

b. On the revenue side:

(1) Implement the provisions of the Laws for Tax Efficiency and for Property Tax reform and put into effect the necessary regulatory provisions related to the income, sales and property taxes.
(2) Present to Legislative Assembly the legislative tax package(s) referred to in para. 4.3 and prepare supportive regulatory provisions.
(3) Implement tax and customs administration action plans (Annexes IV and V, respectively).

5. <u>Third tranche loan conditions</u>

4.6 In addition to the global conditions related to the macroeconomic framework, proposed third tranche conditions for the expenditure components of the PSRL include continued satisfactory implementation of new budgeting procedures as well as:

(1) Bring to the point of sale privatization of FANAL.
(2) Continue to implement the employment reduction program through privatization of enterprises and services.
(3) Implement action plan for comprehensive budgetary reform.
(4) Continue to implement new General Framework Pensions Regime Law.

4.7 Proposed third conditions on the revenue side are:

(1) Continue to implement and monitor changes contained in the Laws for Tax Efficiency and for Property Tax reform.
(2) Implement remaining tax reforms related to incentive regimes and expansion of sales tax base described in para. 4.3.
(3) Implement tax and customs administration action plans (Annexes IV and V, respectively).

6. <u>Status of compliance with Board presentation conditions</u>

4.8 After review of the documentation, the Project Team has established that the Government has complied in a satisfactory manner with all of the cited conditions prior to Board presentation. And with respect to first tranche, the laws relating to the privatization of CEMPASA and FERTICA and public works concessions are currently in the final stages of consideration by the Legislative Assembly and the GOCR expects their approval by year's end.

B. Execution

1. Procurement procedures for imports

4.9 Loan resources will finance the cost of eligible imports determined in accordance with the negative list agreed with the executing agency (Appendix III-A). In terms of retroactive financing of eligible expenses incurred prior to the loan contract date, the Project Team recommends maintaining the limit of up to six months and 50% of loan proceeds in line with the Bank's policy (Document GP-116-4) for sectoral projects.

4.10 Analysis of procurement procedures applied in Costa Rica to imports, in both public and private sectors, suggests that these are in conformity with the basic principles of Bank policy. In Costa Rica imports have been liberalized; the private sector importer can purchase foreign exchange in any commercial bank without any restrictions. The public sector must channel its purchase of foreign exchange for payment of imports through the Central Bank of Costa Rica (BCCR). Commercial banks inform the BCCR about their sale of foreign exchange for statistical purposes.

4.11 The analysis of procurement practices and a qualitative evaluation of the system of customs registration are the basis used to recommend a maximum of US$ 5 million as specified in Document GP-116-4. For contracts exceeding this amount, procurement practices relevant to both private and public sector should follow Bank guidelines as agreed in Appendix IV, except in the case of petroleum products and related derivatives which is explain below.

4.12 According to BCCR statistics, Costa Rica imported approximately US$ 1,850.7 million during 1991. Of this amount about 8% of total imports were comprised by petroleum products and related derivatives. These purchases were made following commercial practices and, in general, contract amounts exceed US$ 5 millon, but do not follow closely Bank procurement procedures.

4.13 GOCR authorities have requested that the Bank consider waiving the provision requiring international competitive bidding for imports of petroleum and derivatives. Consideration of this request by the Project Team indicates that these purchases are negotiated in a competitive international market for these products and are supported by the necessary documentation required by the Bank. Given the importance of petroleum imports, such a waiver would simplify the procedures for gathering supporting evidence for disbursement and the available documentation indicates that these purchases are comparable to those in other countries which they have been accepted by the IBRD and the Bank for disbursement of similar loan operations. In accordance with this analysis and the Bank's policy, the Project Team recommends waiving the bidding requirements for petroleum products and derivatives. However, to be eligible, these purchases must correspond to imports from member countries and their payments must take place within the periods specified by the Loan Contract.

2. Disbursements

4.14 Disbursements will conform to Bank guidelines. In terms of the request for disbursement from loan resources and detailed payments used to support this request, the staff of the Ministry of Finance and the Central Bank of Costa Rica noted their procedures would, in general, observe these guidelines as to form and content. However, some potential difficulties were noted regarding the supporting documentation for private sector imports given simplified import procedures. After having reviewed the current import system, original documentation and some alternatives to the transactions documentation which appears in the detailed payments information attached to the disbursement request, the Project Team considers that acceptable documentation for proof of payment would include the customs declaration, bill of lading, and commercial invoice. This documentation would be available for review by the Field Office (by sampling) and independent auditors whose task it is to review the accounts for the project's disbursement.

3. Records and auditing

4.15 The borrower shall have the responsibility of maintaining separate records and accounts of all transactions against which disbursements will be requested in order to facilitate the timely preparation of the statement of expenses and other reports about the project.

4.16 The borrower shall present to the Bank, within ninety (90) days after the last disbursement of each tranche, a statement of expenses corresponding to that tranche. This statement of expenses shall be appropriately certified by independent auditors acceptable to the Bank and conform to the terms of reference to be agreed.

4. Inspection and supervision

4.17 The Bank shall establish such inspection procedures as it deems necessary to ensure satisfactory execution of the program. To this end, the borrower shall cooperate fully in providing such assistance as is needed for accomplishment of this purpose. The sum of US$ 800,000 from the proceeds of the financing shall be credited to the account of the Bank to meet general inspection and supervision expenses.

4.18 The borrower, the Bank and as necessary, the IBRD, shall hold quarterly meetings, at the request of any one of the parties, to exchange views on the progress achieved in implementing the program and on the fulfillment of the conditions established for the disbursement of the tranches and the consistency between the economic policy framework and the program. For this purpose, the borrower undertakes to furnish to the Bank, for its review and comments, prior to each meeting, a report containing such degree of detail as the Bank may reasonably request on the advance of the program and the fulfillment of the above mentioned obligations.

4.19 Program execution and, consequently, the Bank's task of supervision will be complex and require the almost constant attention of the project team and the field office specialist to monitor the borrower's progress and compliance with the conditions that will determine tranche disbursement. The field office is currently hiring a specialist with qualification in the policy reform area to work alongside the project team and the borrower to study issues and resolve problems that might arise during execution.

5. Ex post evaluation

4.20 The ex-post evaluation will be conducted between six and 12 months after disbursement of the last tranche is authorized. Bank staff will take part in the analysis, for the purpose of making the study as complete as possible. It is expected that focus will be placed on the evaluation of the process of the execution of the loan, including in the analysis the fulfillment of the agreed policies. So far as possible, the ex post evaluation will also look at the immediate impact of the measures taken. The specific details for the evaluation will be determined with the participation of the Bank's Operation Evaluation Office (OEO).

6. Technical Assistance

4.21 The Government has secured external funds from various sources to provide the needed technical assistance to support implementation of PSRL reforms. On the expenditure side, bilateral aid from Norway and Mexico is financing the petroleum study and the implementation of the public works concessions, respectively. As noted, on the revenues side, there is an ongoing program of technical cooperation for customs administration (ATN-SF-3319-CR). The Government plans to allocate about US$ 2 million of the PSRL/SAL III counterpart resources to finance additional technical assistance. This assistance, as agreed with the Bank, will focus on the areas of budgetary reform and tax administration.

4.22 The unit within the Ministry of Planning established to monitor the SAL III/PSRL will be the executing agency for the technical assistance program. While this ministry will have the lead in selecting and contracting consulting services, the Ministry of Finance will oversee the technical day-to-day aspects of the loan and continue to interface with the Bank on the details of its progress. As noted in the tax administration action plan (Annex IV), the GOCR has committed to carry out the selection and contracting process by first tranche and will submit for Bank review the terms of reference and curricula of prospective candidates.

V. VIABILITY AND RISKS

5.1 The implementation of the reform package described above requires political will to carry out the specific measures. A main risk to the successful implementation of these reforms lies in obtaining the necessary approval from the Legislative Assembly. Many structural and budgetary reforms require legislative changes which usually involve lengthy debate

and negotiation. Moreover, the constitutional tribunal (Sala IV) is empowered, at the request of any individual, to review the constitutionality of any law or regulation opening the possibility for further delays as new laws are contested. Although the Government is committed to public sector reform, past experience suggests reforms may be stalled by legal and legislative obstacles. Already, the GOCR has made several attempts at tax reform, first, to enact a comprehensive tax package, and more recently, to enact discrete provisions. It is clear that reforms must be initiated during the year before the start of 1993 pre-electoral campaign. While PSRL reforms will be initiated during the current administration, they will be put into effect by the next administration to take office in May 1994.

5.2 The institutional reforms proposed in the current operation will not be easily implemented. The customs department will require a significant overhaul including changes in its incentive structure and training to make civil service personnel more efficient. Similarly, without substantive restructuring of the DGTD, the rationalization of the tax structure is not likely to produce significant revenue increases and higher administrative efficiency. Throughout the public sector, reductions in overstaffing will fuel increased unemployment. Although the labor mobility program has proceeded and to date some 9,000 public sector positions have been eliminated, reaction from the public sector unions has been relatively restrained. Access to retraining as well as greater absorption of these workers by the private sector are needed to assure success in this area. The PSRL includes reforms to enhance flexibility in public sector employment. The specific labor component under development in the ISL will focus on training and furthering labor mobility and absorption by the private sector.

5.3 The experience of previous structural adjustment programs shows these efforts are complex and take time. In view of the modest success of the IBRD's SALs in achieving envisioned reforms and the substantial resources proposed, every effort should be made to establish clear and specific targets to assure disbursement *pari passu* with the implementation of policy reforms. In fact, SAL II was approved in 1988 and its final and third disbursement was completed in April 1992 after granting a waiver on the public sector deficit target.

COSTA RICA: PUBLIC SECTOR REFORM LOAN
POLICY MATRIX OUTLINE

JES/OBJECTIVES	PRIOR ACTIONS (BOARD PRESENTATION)	ACTIONS TO BE TAKEN BEFORE		
		FIRST TRANCHE RELEASE	SECOND TRANCHE RELEASE	THIRD TRANC
CONOMIC CONDITIONS				
le macroeconomic t appropriate to program.	Macroeconomic performance consistent with program objectives.	Macroeconomic performance consistent with program objectives.	Macroeconomic performance consistent with program objectives.	Macroeconomic consistent wit objectives.
EXPENDITURE				
ization				
e greater efficiency using public sector ons and privatizing tion oriented and ary activities.	Presented to Legislative Assembly the Law of Public Works Concessions and the Law of Economic Democratization.	Approve Law of Public Works Concessions and the Law of Economic Democratization	Implement laws.	Maintain.
	Presented to Legislative Assembly laws to privatize CEMPASA, FERTICA and FANAL.	Approve Laws to privatize CEMPASA and FERTICA.	Bring to the point of sale privatization of CEMPASA and FERTICA.	Bring to the p privatization
	Formed ad-hoc group and agree on TOR's to study the petroleum sector, including the role of RECOPE and regulatory framework.		Complete study and agree on an action plan for reform of petroleum sector.	Implement agre plan.
ment Reduction				
ent program to reduce staffing in the sector by about positions to se efficiency and e long-term fiscal s.	Implemented initial phase of employment reduction program by phasing out 11,000 positions.	Continue with employment reduction program through voluntary leaves and early retirement.	Continue with employment reduction program through privatization of enterprises and services.	Continue with reduction prog privatization and services.
ary Reform				
the budgeting s to improve the l, monitoring and tion of government itures.	Prepared budgetary reform program designed to achieve integrated financial management.	Implement agreed new budgeting system for the 1993 budget in at least 6 major public sector entities.	Evaluate pilot program for budgetary reform and agree on action plan for extending and consolidating comprehensive reform.	Implement acti comprehensive reform.

COSTA RICA: PUBLIC SECTOR REFORM LOAN
POLICY MATRIX OUTLINE

JES/OBJECTIVES	PRIOR ACTIONS (BOARD PRESENTATION)	ACTIONS TO BE TAKEN BEFORE		
		FIRST TRANCHE RELEASE	SECOND TRANCHE RELEASE	THIRD TRANC
n Reform				
the high fiscal of public sector ns, ensure greater mity and consistency efits, and encourage pment of competitive of complementary ns.	Approved the new General Framework Pensions Regime Law.	Satisfactory implementation.	Maintain	Maintain
	Approved new operational rules for CCSS and the new law reforming the Teacher's Pension Regime.	Satisfactory implementation.	Maintain	Maintain
SECTOR REVENUES				
fy and rationalize ructure				
effort on a few major expanded bases and tes to promote equity ency.	Approved Law for Reduction of Tax Exemptions (Law No.7293) in April 1992. Prepared program to continue to broaden the tax base by rationalizing incentive schemes, extending the sales tax to previously excluded services, and consolidating selective sales taxes.	Complete legislative tax package(s) designed to broaden the tax base.	Present to Legislative Assembly the legislative tax package(s), and their regulatory provisions.	Implement chan in the legisla package.
	Presented to Legislative Assembly the Law for Tax Efficiency and the Law for Property Tax Reform.	Complete regulations for Property Tax Reform Law.	Implement the reforms in the Laws for Tax Efficiency and for Property Tax Reform and put into effect their necessary regulatory provisions.	Implement and reforms contai Laws for Tax E for Property T
ministration Reform				
e the efficiency and iveness of the tax stration system.	Approved and published the Decree for the restructuring of the DGTD. Reached agreement with Bank on tax administration action plan (Annex IV).	Implement tax administration action plan focusing on defining training unit and initiating its human resource development activities.	Continue to implement tax administration action plan focusing on approval of tax administration regulations related to Management, Collection and Auditing.	Continue to im administration focusing on Au Program.
	Initiated program to update and correct taxpayer Registry.	Complete program to update taxpayer Registry and reconcile integrated taxpayer accounts.	Maintain.	Maintain.

COSTA RICA: PUBLIC SECTOR REFORM LOAN
POLICY MATRIX OUTLINE

JES/OBJECTIVES	PRIOR ACTIONS (BOARD PRESENTATION)	ACTIONS TO BE TAKEN BEFORE		
		FIRST TRANCHE RELEASE	SECOND TRANCHE RELEASE	THIRD TRANC
	Presented law to create the National Tax and Customs Collection Agency to the Legislative Assembly and defined the Agency's staffing requirements and selection criteria consistent with and facilitating the implementation of the tax administration action plan.	Agree on number of job positions required for the new structure of the DGTD based on relevant studies.	Select and appoint at least 70% of tax administration staff and carry out technical training courses.	Select and app administration
	Effective operation of the regional tax administration office in Cartago.	Effective operation of the regional tax administration office in San José.	Effective operation of the regional tax administration offices identified under the action plan.	Effective opera regional tax a offices and pr their adequate budget allocati 1994 and 1995
s Reform				
e the efficiency of stoms administration .	Approved and published the Decree for restructuring the DGA (Customs System). Reached agreement with the Bank on the customs administration action plan (Annex V).	Implement customs administration action plan focusing on legal and administrative framework, and definition of training unit.	Continue to implement customs administration action plan focusing on effective operations of the Central Customs Office (San José) information system and the new important procedures.	Continue to im customs admini action plan fo effective oper information sy customs office import/export
	Presented law to create the National Tax and Customs Collection Agency to the Legislative Assembly and defined its customs administration staffing requirements consistent with and facilitating the implementation of the customs administration action plan.	Agree on number of job positions required for the new structure of the DGA based on relevant studies.	Select and appoint remaining customs administration staff.	Select and app remaining cust administration
	Ministerial signature of the Regional Treaty for the new Central American Uniform Customs Code (CAUCA II).	Ratification by Legislative Assembly for ratification of the Regional Treaty for the new Central American Uniform Customs Code (CAUCA II).	Prepare and implement Customs Regulations according the new CAUCA.	Maintain

Original: Spanish

SECTOR POLICY LETTER FOR THE PUBLIC SECTOR REFORM PROGRAM

San José, Costa Rica
November 23, 1992

Mr. Enrique Iglesias
President
Inter-American Development Bank
Washington, D.C. 20577

Dear Mr. Iglesias:

1. Since the economic crisis that took hold in the early eighties, Costa Rica has undertaken a stabilization and adjustment process with support made available under several standby agreements with the International Monetary Fund and two structural adjustment loans from the World Bank. Despite these efforts, in 1988 the country faced a sizable fiscal deficit, a weak balance-of-payments position and high inflation. Measures implemented to solve these problems met with mixed results. Although gross domestic product grew 5.6 percent in 1989 (as compared to 3.4 percent in 1988) and inflation dropped to 10 percent (from 25 percent in 1988), the structural problems persisted. The public-sector deficit reached 5.5 percent of GDP and the Government's diminished access to external financing led to higher domestic interest rates, to the detriment of investment.

RECENT ECONOMIC CONDITIONS

2. The deterioration in the fiscal accounts and the balance of payments in 1989 and early 1990 was attributable to both domestic and external factors. Although the marked decline in coffee prices led to falling fiscal revenues and international reserves, the year before the elections saw higher public spending (including wage increases sanctioned by the Supreme Court), while adjustments in public-sector prices lagged behind. If no corrective measures had been applied, these trends would have caused the public-sector deficit to swell from 5.1 percent of GDP in 1989 to 7.5 percent in 1990.

3. To prevent this from occurring, the Calderón Administration, which came to power in May 1990, set in motion a stabilization program to adjust rates for public services, introduce new measures to generate government revenues, and accelerate currency devaluation. These measures prevented a further decline in the fiscal accounts. However, unfavorable structural factors stood in the way of correcting the balance-of-payments disequilibrium, at least in the short term, and it intensified as oil prices rose in the second half of the year. Accordingly, the deficit on current account topped US$500 million in 1990, causing a substantial loss of reserves. Reflecting expansive domestic policies in the first half of the year, the consumer price index jumped 27 percent in 1990 and GDP showed a 3.6 percent rise.

4. In January 1991 the Government raised temporary import tax surcharges and prior deposits for foreign exchange purchases, and accelerated the rate of devaluation of the colon in order to reverse the unfavorable trend in the external accounts. These measures helped dampen imports in the first months of the year. Still, the Government realizes that bringing the fiscal deficit under control will be fundamental to reducing macroeconomic imbalances and correcting the trend in economic growth over the long term. This is the focal point of the standby agreement which the Executive Board of the IMF has postponed until September 30, 1992. The plan calls for a reduction of the consolidated fiscal deficit equal to one percent of GDP in 1992. Public finances will be strengthened as the central Government's deficit is trimmed from 3.2 percent of GDP in 1991 to 2.2 percent in 1992, while the combined public-sector deficit this year will remain unchanged from the previous year (2 percent of GDP). The Government intends to pursue the stabilization program, and will seek to continue to receive support from the International Monetary Fund for this purpose.

5. Thanks to a more efficient tax administration, Government revenues will rise from 15 percent of GDP in 1991 to 15.5 percent in 1992, despite the elimination of certain temporary taxes that represented about 1.1 percent of GDP in 1991. A substantial contribution will be made to achieving this goal by the recently approved Law Eliminating Tax Exemptions. Also, spending by the central Government will shrink from 18.4 percent of GDP in 1991 to 17.7 percent of GDP in 1992, despite the proverbial inflexibility of spending whereby 33 percent is earmarked for wages and salaries, 35 percent for statutory current transfers, 25 percent for public debt service, and only 4 percent for actual investment. Accordingly, the downsizing of the public service will continue until a cumulative reduction of 25,000 positions has been achieved by 1994, including the 12,000 already cut. The program excludes teachers, policemen and medical personnel, and those let go have not exerted pressure on the labor market but have been absorbed by the private sector.

6. Henceforth, the goal will be achieved on the basis of voluntary mobility and privatizations, and through the creation of businesses by employees within the private sector as provided for in the forthcoming Law Democratizing the Public Sector, in addition to other legal mechanisms such as freezing posts and eliminating vacant positions by express application of the recently adopted Framework Law on Pensions. New legislation will enter into effect to streamline export subsidies, generating savings of close to 0.3 percent of GDP in 1992. Also, teachers' pensions, and those pensions which fall under the Framework Law on Pensions (which applies to 19 systems), will be reinforced by an increase in contributions by active employees, now expanded to the retired population, with an accompanying increase in the revenue base. All these steps are intended to improve the public finances on a sound basis and to provide the private sector with an appropriate environment that will enable it to grow and develop to maximum potential.

7. The Government of Costa Rica is deeply committed to the structural adjustment process. The country today exhibits an adequate framework of macroeconomic stability, substantial progress on liberalization and significantly looser controls on the system of incentives, leading to more competitive markets for inputs and end products. The stabilization efforts and reforms need to be entrenched, however, in order to facilitate the free exchange of goods and services, make financial and currency markets more competitive, and eliminate discriminatory taxes and subsidies, thereby enhancing the conditions that will put the country on the path towards sustained long-term growth. In order to place these elements in a broader context, the development policy promoted by the Government is outlined below.

DEVELOPMENT POLICY

A. Objectives

8. Although it is true that the aim of any development policy is to ameliorate the well-being of its citizens, it is important to specify the goals of the economic and social structural changes that would make it possible to achieve that aim, and then to break that postulate down into more specific objectives that reflect the priorities of a society such as that of Costa Rica. Accordingly, the process that began when the country received the first World Bank structural adjustment loan in 1985 must be pursued through those structural aspects that have yet to be transformed.

9. The backbone of the adjustment consists of the following four elements: (i) an open economy; (ii) public-sector reform to promote the opening process; (iii) reform of the financial sector and capital markets as the life support of structural reforms; and (iv)

the moral obligation to protect natural resources in support of sustainable development over the long term. In other words, it is considered necessary for Costa Rica to achieve sustained growth based on a more open economy, eliminating existing distortions to optimize the use of our resources for production. It is crucial that the institutional apparatus of the State be modernized so that it will cease to be an obstacle and contribute rather to the desired transformation of production. Also, the rational use of natural resources must be assured, along with the preservation and restoration of essential ecological processes. Finally, mechanisms must be designed to ensure that economic growth goes hand in hand with effective and equitable income redistribution.

10. The Government of Costa Rica recognizes that the education-technological development-industrial reconversion-open economy sequence is fundamental to adjustment success. Fortunately, the country's performance is already excellent on indicators measuring the skills and physical condition of its human resources, and sector reforms are under way in the areas of health (with funding from the World Bank, the IDB and the Spanish Government) and education (funded jointly by the World Bank and the IDB). Also, business efficiency as a desirable goal has been included in the industrial reconversion program backing the adjustment program. These objectives would be achieved with support under the third stage of the structural adjustment program and the public-sector reform component to be financed jointly by the World Bank and the IDB, and under the prospective multisector lending and investment sector operations with the IDB. In this way the public-sector reform program will bolster state reform, the investment sector program will give substance to financial reform, and the multisector lending program will stimulate industrial reconversion.

B. Components

1. Macroeconomic environment

11. An appropriate macroeconomic environment is a necessary condition for achieving growth and development. The Government will pursue its stabilization efforts to correct domestic and external imbalances and bring down inflation and interest rates. In this connection, fiscal policy should seek to eliminate superfluous or nonessential spending, which entails an effort to assess the effectiveness of the public sector in its various spheres of action. A conservative monetary policy limiting growth in money aggregates to real economic growth is a necessary accompaniment to correct fiscal policy. Temporary deviations must be corrected by using indirect instruments, principally open market transactions, thereby achieving greater transparency in establishing monetary value. And as a last element, an exchange policy that is consistent with our country's integration into the world economy must be applied to

ensure free currency convertibility, thus creating a favorable climate for foreign investment.

2. State reform

12. In past decades, public-sector institutions played a positive role in transforming production in the country, acting as a key factor in development and the attainment of substantial social well-being. The political framework adopted made it possible to attain a satisfactory pace of development within the Latin American context.

13. Despite the foregoing, this same institutional apparatus, given its size and inefficiency, has proved to be incapable of meeting the country's current development needs. Overlapping budgetary programs and responsibilities and excessive staffing levels are some of the causes of the inefficiencies. The public sector has a substantial impact on the economy, as is apparent in indicators such as its spending in relation to GDP (52 percent), its employment share (16 percent of all those employed), its contribution to GDP (27 percent), and public-sector domestic debt burden in relation to GDP (20 percent). These indicators point to the need for an in-depth reconsideration of the State's role in the economy, and of the tiny percentage of spending earmarked for capital formation. Given this situation, a reform of the state apparatus must be undertaken immediately, in order to: downsize the public sector, trimming the funds earmarked for its operations and thereby giving a boost to public investment; expanding the areas open to private-sector involvement, which implies a deregulation; and, finally, bolstering civil participation in the democratic process. In short, the aim is to move from a model favoring a leading economic role for the State to one in which it takes on a more flexible, more modern role. Some of the more significant elements of the public sector reform program are outlined below.

2.1 Actions with multiplier effects

14. The reform process includes a series of measures or actions, some already adopted and others in the process of being adopted, that will generate their own energy and momentum or that cut across the various areas of the public administration.

15. Public Works Concession Law: This law would allow the private sector to undertake, at its own cost and risk, the construction and operation of essential public works, which would be transferred to State ownership at the end of the concession by the buy-own-operate and transfer procedure. This would relieve the pressure to allocate fiscal resources to infrastructure works.

16. Economic Democratization Law: This law strengthens the role of the State in the activities inherent to it, and transfers to the market

minor services that can be delivered by third parties. The law also provides for a broad range of incentives for the creation of businesses by public employees now providing services, who by organizing businesses would move to the private sector and sell their services to the State. This lowers costs, prevents unemployment and strengthens the productive sectors. For essential public services, the State's role would be fundamentally one of monitoring and quality control.

17. Opening up monopolies: As part of the process of redefining the public sector's spheres of action and reestablishing the private sector's role as the force driving the capital market, those monopolies which still exist must be broken up: in insurance, production and the sale of ethyl alcohol.

18. In the insurance field, the Bank, through the investment sector program, will support the Government in its program to gradually open up this market, which requires an appropriate regulatory mechanism.

19. The monopoly on ethyl alcohol cannot be justified, since this is clearly a private production activity and not one inherent to the public sector. Accordingly, it should be eliminated in the short term. Mechanisms will need to be established to offset the drop in fiscal revenues, as well as quality controls to protect the population's health.

20. The monopoly on refining and distributing petroleum byproducts poses a unique problem. This activity is undeniably important to the economy, and any decision taken on the future organization and structure of the sector should be the result of an exhaustive evaluation of the various options available, and of a national consensus. Accordingly, the first step was to set up an analytical body at the highest level to assess the current situation, with the aim of proposing a new sector structure on the basis of a detailed study of the three elements in the oil chain: exploration, refining and distribution. The analytical body will need to prepare a plan to implement the Governments strategies for the sector including: (i) decentralizing actitivities in the oil sector, (ii) deregulating activities, (iii) a specific and a general regulatory framework, an institutional framework defining the organization to carry out the functions of the State and of RECOPE, including the reforms to enable it to perform the new functions assigned to it.

2.2 Institutional reform

21. Privatizations: Finally, along with the actions described above, the privatization of CEMPASA and FERTICA, now being discussed in plenary session of the Legislative Assembly, will close the book on the Costa Rican Development Corporation in concluding the

liquidation, transfer or sale of 29 of its subsidiaries. In addition, the sale of FANAL, which is about to be placed before the Legislative Assembly in pursuance of the objectives stated in paragraph 17 above, will contribute to this process of transferring to the private sector productive activities which are not compatible with the public sector.

22. Overcoming the structural shortcomings of the development model applied in past decades means seeking out new and different options to undertake growth and achieve a sound economic structure in preparation for the coming millennium. The aim is to move towards a long-term approach to growth, which implies a complete transformation that must be led by the State – in providing appropriate conditions and clear ground rules – so that the production apparatus can play its part in creating wealth in order to maximize growth and extend benefits to the most numerous population segments.

23. It is necessary, therefore, to modernize the public sector in order to adapt it to existing and foreseeable conditions in the international context, in which the State's role continues to be a fundamental one as the driving and coordinating force behind the process to boost international competitiveness in the framework of economic globalization and a leading role for the private sector.

24. Institutional restructuring and entrenchment: The Administration should make an ongoing attempt to eliminate overlapping and reduce inefficiencies in public-sector institutions. As a first effort, sector task forces were set up for health, agriculture, housing, transport and public safety, and have already submitted their reports and conclusions along with sector restructuring proposals. These studies, in addition to those done by Government task forces, gave rise to the national sector reform programs in those areas. The programs include an action plan and a timetable for the implementation of institutional changes. The next stage in the process will cover the reorganization of the sector in conjunction with economic opening and export promotion.

25. The measures to reform the public sector are directed towards restructuring key areas in the public administration, to identify those institutional bottlenecks that stand in the way of sustained development in the medium and long term. Of the thirteen sectors of government activity, five strategic sectors have been selected to advance the reform process. Thus, reforms in the areas of health, housing, transport, agriculture and public safety seek to eliminate institutional overlapping (both between and within institutions) to ensure a more efficient and rational use of public funds. They are also intended to reduce inefficiencies in the provision of public services, to ensure greater coverage and higher quality at the lowest possible cost. Also, sector reforms are meant to ensure the

political leadership of the sectors by the ministers concerned, such that the ministries act as policymakers but not necessarily as executing agencies.

26. The reforms in each sector include the following measures:

(i) Agriculture: (a) sector specialization and modernization as contemplated in the agricultural sector adjustment program (PASA); (b) elimination of transfers from the Ministry of Agriculture to other sector institutions, by creating nongovernmental agencies in the private sector to replace the current ICAFE, OFIARROZ, JUDETAB and ONS (the state coffee, rice, tabacco and seeds boards); (c) application of maximum intervention rates by the National Production Council (CNP) in markets for grains identified in PASA; (d) sale of the Public Liquor Company (FANAL) and breakup of the monopoly on ethyl alcohol production; (e) reform of the PL-480 operating system, privatizing its operations, which are now handled by CNP;

(ii) Public security: (a) creation of a Ministry of the Interior by merging the existing Ministerio de Seguridad and Ministerio de Gobernación; (b) reorganization of the National Printing Office and the Immigration and Citizenship Division as fully decentralized agencies; (c) organization of the state post and telephone company (CORTEL) as an autonomous enterprise that will be self-sustaining financially and receive no transfers from the National Budget; (d) adoption of legislation on police procedures;

(iii) Health: (a) implementation of the agreement to merge Social Security Institute (CCSS) and Ministry of Health services; (b) transfer of occupational risks from the National Health Institute to CCSS; (c) transfer of municipal water systems to the Water and Sewer Authority (AyA);

(iv) Transport: (a) restructuring of the Ministry of Transport by setting up councils to act as specialized agencies in air, water and rail transport policy; (b) restructuring of JAPDEVA to separate port activities from development promotion activities; (c) restructuring of INCOP; (d) restructuring of INCOFER;

(v) Housing: (a) legal creation of the Ministry of Housing; (b) transfer of the City Planning Department from the National Housing and Urban Planning Authority (INVU) to the Ministry of Housing and Human Settlements (MIVAH); (c) restructuring of INVU; (d) transfer of functions and activities from the Special Housing Commission (CEV) and the Institute on Social Assistance (IMAS), and of financial resources from the CEV to

INVU. All of the foregoing will take place in accordance with a pre-established timetable.

As part of the institutional reforms, consideration has been given to setting up a special commission to examine the status of the existing Ministries of Foreign Trade and of Economy, Industry and Commerce, in order to determine the best structure to be adopted by the Government for this sector, which is fundamental to the adjustment process, through the rationalization of resources now allocated separately to each of these ministries.

27. Budget reform: The objective is to improve the budgetary process and the control, monitoring and evaluation of public spending. The new system will be oriented towards the use of modern budgeting techniques, with the flexibility required to reflect the Government's priorities in allocating resources (e.g. program budgets, etc.). The reform will include determining unit costs for public services to monitor efficiency and assess the achievement of pre-established objectives, in order to ensure effectiveness in public spending.

28. Incumbents of managerial posts will be subject to a system of accountability and a series of appropriate incentives and sanctions. The process began with a strengthening of staff in the Budget Office such that the 1993 budget would reflect the establishment and implementation of the rules which are to underly the new budget system for the public sector, making it possible to identify programs which are redundant, inefficient or overstaffed. One priority task is that the Legislative Assembly shape a comprehensive vision of public spending to enable it to issue opinions on overall budget content and assess the results of public agencies, in which process it will be supported by the Office of the Comptroller General. The new system is being implemented gradually - beginning in 1993 with a pilot project in the Ministry of Agriculture, the CNP, IDA, CCSS, AyA and the Ministry of Health - and then extended gradually in subsequent fiscal years to the entire public administration. Additionally, given the importance of personal services in the composition of public spending, an integrated payroll monitoring system is being developed for the nonfinancial public sector. This system will not only serve as a basis for tracking voluntary and horizontal mobility programs, but will make it possible for the first time to draw up an inventory of human resources within the public sector. A prototype of the system will be operative by the end of the current year.

29. Tax and customs reform: The implementation of a plan to enable the production sector to meet its fiscal obligations will contribute greatly to ensuring that the State ceases to be an obstacle to development, particularly since the aim is to ease international

trade in the context of the economic opening being promoted with structural adjustment. The reform strategy in this area presupposes substantially improved efficiency in the tax structure and tax base coverage, as well as in the precision of the mechanisms used to make it effective. Tax efficiency will come about as a result of reinforcing income tax to make it an instrument of redistribution.

30. Tax rates currently vary according to the source of income. Although this differential treatment seeks to foster certain economic activities, it does so at the cost of introducing serious distortions in the allocation of resources for production, as well as eroding the tax base. Since income tax is not based on an aggregation of all income sources, its progressive nature is in serious jeopardy. Only under a genuinely progressive tax system will those receiving more income be required to make a proportionally greater fiscal contribution than those receiving less income, regardless of the sources of their income as a whole. This aggregation of all sources of income, or globalization of income tax, and its integration between natural and legal persons to avoid double taxation, as well as the elimination of distortions introduced by inflation, will be pivotal in achieving a more equitable and efficient tax structure while avoiding disincentives to business capital formation and savings.

31. Also favorable to tax efficiency will be the consolidation of the existing taxes to facilitate their administration, leaving only the eight or ten taxes that generate the highest percentage of revenues, and broadening their tax base. In addition, in order to recover the land tax base, a review will be performed of mechanisms to update current property assessments. The general reassessment process will continue, but an adjustment mechanism will be introduced as well to ensure that properties are taxed on their true value and to avoid the current inequities caused by updating values based on property transfers.

32. Many of the exemptions have been eliminated to broaden the tax base and enhance equity, but there is an acknowledged need to complete the task of rationalizing the system of sector incentives, which favor certain economic activities to the detriment of others. The taxation powers of the internal revenue service will be strengthened, along with the system of sanctions applicable in cases of evasion. Also, a regionalization of services will ensure better service for taxpayers.

33. These improvements in tax structure and tax administration have been initiated by placing the tax efficiency bill and the land tax bill before the Legislative Assembly.

34. The action plan that has been undertaken to improve tax administration sets forth the measures to implement a new modern

taxation system, and will be supported by a program of technical assistance for the tax administration in order to offer a better service to the taxpayer and at the same time increase tax collection. The specific objectives proposed are as follows: (1) to review the legal framework and draft regulatory provisions to implement the changes made to the tax system and regulate the new procedures for collection, management and inspection; (2) to implement a new organizational structure for the Direct Taxation Directorate based on the criteria of functional organization and territorial decentralization; (3) to develop new computer applications and systems for management levels and for inspection purposes; (4) to execute specific training plans in application of the new tax framework and for the efficient use of computer systems; and (5) to define and implement the tax management model for large-scale taxpayers.

35. The reform process in both the tax and the customs areas will contribute to creating a national collection agency as a decentralized entity under a special employment system within the Ministry of Finance. The corresponding legislation placed before the Legislative Assembly gives the agency this special system to make it possible to implement a new organizational structure and to hire qualified personnel to carry out the new administrative customs procedures. In the case of customs, the new processes will be reoriented toward streamlining international trade, coordinating procedures under a single window and supervising operations by making a greater and better use of information systems. The customs administration is being reorganized according to an action plan which forms the basis of the technical assistance programs being carried out.

36. Improving the public service: Although this area is not the specific object of the public sector reform program, it is extremely important given the need to implement a series of medium-term reforms designed to raise the quality of the public service as a fundamental requirement to make the changes within the State viable ones. Essential to this process is training for human resources. Efficient management of the State apparatus will require substantial staff cuts. To support this action plan, pay systems and retraining programs will be reinforced to speed the absorption of public employees by the private sector. Finally, to streamline the use of funds earmarked for payroll costs and to achieve an appropriate system of incentives for public servants, it is necessary to plan reforms to the current system, and a proposed public employment law will be drafted to this effect.

37. Pension system: In order to move towards a fairer system in which abuses are not permitted, the special pension systems must be entrenched through a process of reform whereby parameters will be unified. Simultaneously with these measures to streamline pension

systems, an attempt is being made to stimulate the financial market by using employee retirement plan contributions to full advantage in highly profitable production activities that will ensure that pension funds are sound. Administrative measures have already been taken to ensure the financial self-sustainability of the CCSS disability, old age and death scheme; the Teachers' Pension and Retirement Law has been approved, incorporating elements of equity in the State's contribution and converting the system to a capitalization fund; the Pension Law has been approved, unifying 19 systems chargeable to the national budget; and draft bills have been placed before the Legislative Assembly in connection with judicial branch pensions and supplementary pensions. The latter sets forth the necessary conditions for creating voluntary pension funds. These changes will need to be joined by the creation of a supervisory body to audit and monitor the various systems.

2.3 Social policy

38. The social policy contemplated within the overall development strategy seeks to preserve and enhance the levels of well-being attained by Costa Rica in past decades by maintaining policies with universal coverage in the areas of health, education and the provision of resources for collective consumption, and the implementation of social assistance and housing policies addressed to the country's most disadvantaged population groups. Three levels of action are envisaged:

- Policies to invest in human capital, which have to do with the structural aspects of poverty and permit vertical social mobility from one generation to the next. This includes action in connection with health, education and nutrition.

- Policies to transfer tangible assets to the most vulnerable groups to increase their assets, including programs for low-income housing, construction of rural water supply systems, land titling, and entrepreneurial promotion, e.g. microenterprise.

- Policies to guarantee minimum income levels to meet permanent or temporary situations of need on the part of poor individuals who, for reasons of age, unemployment or poor education, are incapable on their own of generating the income necessary for a decent existence.

39. A parallel improvement should be made in the short term to mechanisms to coordinate and reorganize institutions in order to rationalize the delivery of social services. In the medium term, nongovernmental agents should be brought into the delivery system for social services, to yield parameters that would guide improvements in the quality of the services while broadening

coverage without expanding the State's direct action. For this purpose, the beneficiary selection system and the social investment survey are the two instruments being implemented. They will permit the Government to better direct its policies to benefit the neediest classes and will give rise to better coordination among the state agencies operating in the social sector.

40. Education: Thanks to the national educational system, Costa Rica enjoys a privileged place within the Latin American region, which positions it better for carrying out productive activities that require skilled human resources. This does not mean, however, that the system does not need to be improved. In fact, in the short term a series of urgent measures must be taken to prevent it from collapse. Among them are investments in eduational infrastructure and teaching materials, an extended academic year and better teacher training, particularly in rural areas. The Government has already made progress in this direction in arranging for the approval of an educational sector loan to be financed by the IBRD and the IDB, which is designed to meet the needs described. In the medium term, changes must be made in the educational model to orient educational policy toward civic training, productivity in production, and social cohesiveness. Institutionally, the guiding role of the Ministry of Education must be reinforced and efforts to decentralize the administration and implementation of administrative policy must be bolstered.

41. Health: The Ministry's leadership must be strengthened in the area of sector planning, conduct and evaluation, while simultaneously entrenching comprehensive care programs and seeking to shift the emphasis from curative to preventive care. A process of regionalization and decentralization, together with a strengthening of local health systems, will form the basis of this transformation. These efforts to restructure the sector are being supported through the Health Service Improvement Program being financed by the IDB. New funding and administration models for health services are needed, with the participation of third parties under the supervision of sector institutions, thereby streamlining delivery and gaining increased satisfaction on the part of the population.

42. Housing: In this field, powers have been granted to many different institutions, resulting in overlapping, inefficient program execution and the resulting waste in resources. Given this situation, progress must be made towards building an appropriate institutional structure in the sector in which the Ministry's leadership would be strengthened, thus rationalizing the use of resources earmarked for housing solutions. Alternative mechanisms will also be established to obtain financial resources in order to strengthen the national housing financing system.

43. Social promotion: A series of measures are to be undertaken to democratize the economy by expanding potential access to the means of production. The object is to increase the number of small-scale entrepreneurs in order to achieve a more cohesive and integrated society. A comprehensive approach will be taken that includes improving the ability of loan officers to reach this client category, implementing technical assistance programs by using the advantages of nongovernmental organizations, and streamlining the administrative procedures needed in support of their undertakings, particularly with respect to property rights.

44. The measures described above provide an outline of the major components of the Government's development program. This comprehensive program will contribute to converting production through more efficient resource allocation. Eliminating the structural fiscal deficit will reduce pressure on domestic prices and interest rates, thus promoting more local and foreign investment. Better directed social services will channel resources to the neediest groups and areas, and will improve the mechanisms whereby spending is earmarked for the poor, thus achieving a more equitable and cohesive society.

45. Developing the economy to the best of its potential and distributing the benefits to the population as a whole is a difficult task. The Government of Costa Rica is confident that the measures described above are crucial steps towards this end. Assistance from the IDB and the IBRD is essential to the success of the program. We trust that together we will be able to place Costa Rica on the path to accelerated economic and social growth, within the democratic and peaceful ways that characterize our country.

Rafael Angel Calderón Fournier
President of the Republic

Rodolfo Méndez Mata
Minister of Finance

Carlos Vargas Pagán
Minister of National Planning
and Economic Policy

PROPOSED REFORMS TO TAX STRUCTURE

I. INTRODUCTION

1.1 A characteristic of the tax system in Costa Rica is its complexity -- many taxes with multiple rates and exemptions. As shown in Table III.1 for the 4 main types of taxes (excluding taxes on foreign trade), this is true for consumption as well as income taxes. Although such complexity adds to the administrative costs of tax collection, its effects on efficiency and equity are perhaps more worrisome. The varied aspects of differential treatment violate horizontal equity and distort resource allocation as economic agents seek to reduce their tax liability. Differentiated treatment in terms of exemptions to a broad bundle of goods and services erodes the substantial yield potential of consumption taxes. In the case of the income tax, together with the distortionary impact of inflation, the fact that different sources of income are taxed with different rates erodes its substantial potential for promoting equity and economic efficiency.

1.2 The argument for promoting a few sales/excise taxes with uniform rates and minimum exemptions is well-known and in the case of Costa Rica has been thoroughly detailed by a 1990 IMF study (*Informe sobre Costa Rica: El Sistema Tributario*, Vito Tanzi, P. Shome, A. Atachabahian y M. Beytía, April 27,1990). As noted in the main text of the present document, the Bank supports the implementation of reforms to abrogate low yield taxes, delegate user fees to appropriate agencies, and provide uniform treatment in terms of coverage, rates, and other provisions to the 4 or 5 key sales/excise taxes.

1.3 The purpose of this annex is to present less familiar arguments for the three major changes recommended in the income tax -- expanding its base to include all sources of income, introducing a methodology to correct for inflation which particularly impacts upon corporate taxation, and integrating corporate and individual income taxes to eliminate double taxation at the level of the firm and the stockholder. The argument for considering all sources of income to judge an individual's wealth is perhaps the easiest to understand given the criteria of horizontal and vertical equity and economic efficiency. This global income concept subjects total earnings whatever their source to a single progressive tax scale. There is no incentive to disperse earnings among different economic activities subject to differential taxation in order to reduce tax liability. The other reforms impact upon firms and their justification is based upon a wide literature of diverse practice and argumentation. For this reason, Part II analyses the corporate income tax and the magnitude of its distortions. Part III attempts to quantify the likely fiscal impacts of the recommended tax reform package. The proposed tax reforms are summarized in Table III.2. Tables are included at the end of this Annex.

II. THE CORPORATE INCOME TAX AND EFFECTIVE TAX RATES

A. Overview

2.1 This first part analyzes the effects of inflation and investment incentives on effective business tax rates. Given a number of incentive schemes to private investment in many economic activities, the statutory tax rate turns out to be a poor indicator of the business tax burden. Moreover, double- digit inflation rates and nominal interest deductibility from taxable income reduce significantly the effective tax rates of firms with large debt financing and a high share of real assets.

B. Distortions Produced by Inflation

2.2 The current tax system does not correct for the effects of inflation on company net-worth as shown by the balance sheet, and it corrects only partially the income statement by adjusting depreciation allowances. The lack of a comprehensive system of indexation induces firms to reduce their tax liability by increasing debt and reducing equity financing. Another important distortion is that firms with similar earnings but a different structure of assets are treated differently by the tax system. Firms in economic activities that require maintaining a high proportion of monetary assets such as financial institutions face a higher tax burden than those activities with a high proportion of real assets. Estimates of the magnitude of these two sources of distortions are provided in the following two sections.

1. Inflation and the financial structure of firms

2.3 Inflation under the current tax system creates a strong bias against equity financing and in favor of debt. By contracting more debt the firm can reduce taxable income by more than the real increase in expenditures; inflation reduces real firm debt and increases firm net-worth. This bias is reinforced by the double taxation of firm profits and shareholder income.

2.4 The effective tax rates associated with different mixes of financial assets can be calculated using the marginal effective tax rate (METR) model 1/. The METR model calculates a rate of return for the after tax cash flow of an hypothetical project. The METR is the difference between the before and after tax rates of return, expressed as a percentage of the before-tax rate of return. It measures the differential -- subsidy or penalty -- that the income tax system imposes on the market for

1/ This model has been used in several World Bank studies and country reports. For a discussion of the model developed in a Lotus spreadsheet see D. Dunn and A. Pellechio, "Analyzing taxes on business income with the marginal effective tax rate model". World Bank Discussion Paper #79, 1990.

investment. The calculations of the METR are carried out assuming a "typical" industrial project with a pre-tax rate of return of 10% and the following asset mix: machinery and equipment 40%, buildings 40%, vehicles 10% and land 10%. A 25% inflation rate and a 35% interest rate on project debt are other assumptions.

2.5 Applied to the METR model these assumptions yield that depending upon the structure of its financing, the effective tax rate for a firm subject to the maximum 30% tax rate is 40.5% for equity financing, 30% for retained earnings and 9% for 80% debt financing (this is the maximum debt financing allowed by the model; the other 20% is assumed to be equity). In this example, the project registers losses during the first 4 years and these can be carried forward up to five years for tax purposes. The effective rate for equity financing is higher than the statutory rate because of double taxation of the project's return -- 30% at the firm level and 15% at the personal level (=30 + 0.7 * 15 = 40.5). If current earnings are fully retained, and assuming these funds are used to finance new projects (with the same asset structure), the METR is equal to the statutory corporate income tax (i.e. 30%). This is because the earnings realized when stockholders sell their shares are tax-exempt. The METR model indicates that under debt financing and because of the deductibility of nominal interest, the firm can reduce its tax burden to one-third of the statutory rate.

2. <u>Inflation and effective tax rates for different economic sectors</u>

2.6 Another distortion produced by inflation is that tax treatment varies across sectors. The productive sectors with opportunities for investment in relatively riskless assets (which are easier to leverage) have an important tax advantage over service sectors with a high proportion of monetary assets such as the financial sector. This distortion seriously distorts the investment decisions of economic agents and results in inefficient resource allocation.

2.7 Table III.3 shows the results of the effective tax rate calculations for the different sectors identified in a sample of 125 firms. The effective tax rate is defined as the ratio of taxes paid in 1990 by a measure of inflation- adjusted taxable income (using the methodology proposed). As a result of the high levels of debt financing, surpassing 95%, agriculture and construction have effective rates only slightly above zero. Although the commercial sector is also highly leveraged (with 79% debt financing), the large proportion of monetary assets (66.5 %) results in an effective rate much closer to the corporate tax rate. Given the 1990 inflation rate of 27.3% the effective tax rate for the entire sample is only 17.8% -- almost half the statutory corporate tax rate.

2.8 The financial sector is the only sector with an effective tax rate above the statutory corporate rate. The structure of assets of financial institutions is characterized by a high proportion of monetary assets

which under inflation causes significant losses that are ignored in the calculation of taxable income. The Costa Rican tax system, however, by taxing similar financial assets with different rates creates the opportunities for tax arbitrage and a reduction of the tax burden of financial institutions. Banks are allowed to deduct nominal interest paid for deposits from taxable income (taxed at 30%) and to invest in financial assets that are taxable at 0% or 8%. Therefore, the net effect of the tax system on the financial sector depends significantly on reserve and leverage requirements. For example, high reserve requirements for a given level of debt implies an increase in capital financing of monetary assets and a larger overestimation of taxable income. On the other hand less strict leverage and reserve requirements increase the amount of resources available for tax arbitrage. According to sample results the first effect (inflationary losses) dominates the second effect (tax arbitrage) and the effective tax rate of financial institutions is larger than the corporate rate.

2.9 The lack of indexation in the Costa Rican tax system and the existence of preferential tax treatment for some financial assets can partially explain the large spreads observed in the financial sector. Taxing the inflationary losses of financial institutions increases intermediation costs. Investment in such assets diverts financial resources away from the private sector thereby putting pressure on lending rates and spreads. Moreover, the nominal interest deductibility artificially increases credit demand by the private sector, which results in additional pressure on the level and cost of financial intermediation.

C. <u>Investment Incentives</u>

2.10 The Costa Rican tax system is also characterized by a complex structure of incentives that affects most economic sectors. The most frequently used investment incentive are exemptions of import duties for capital goods and business income taxes. These are used to promote investments in agriculture, tourism, industry, forestry and non-traditional exports. Investment deductions (accelerated depreciation and deduction of investment expenditures) are utilized to encourage new investment in the agricultural and tourism sectors and investment tax credits are issued to promote new projects in manufacturing and forestry. The forestry sector enjoys very generous incentives including a transferable tax credit for 100% of plantation and other investment expenditures, and duty exemptions for capital goods.

2.11 Economic activities exempted from income taxes can perceive other incentive benefits from deduction and investment tax credits by transferring losses and tax credits to other activities of the same firm, or by selling the tax rebates to a different firm. Firms in sectors not exempted from the income tax can reduce taxable income and their tax liability by investing in the stock of firms in sectors that are favored by these investment incentives. The investment tax credits (especially

CAFs and CATs) are easily transferable and represent a serious erosion of fiscal revenues. In 1990, they reduced corporate taxes by almost one-fourth. Their transferability adds to the difficulties of coordination among the many agencies involved in the administration of the different regimes and makes it virtually impossible for the Ministry of Finance to keep an account of the fiscal costs and benefits of these incentive schemes.

2.12 The administration of the different incentives involves the participation of five government agencies from four different ministries creating serious problems for fiscal control. The number of bureaucratic procedures and the subjective criteria used to concede many benefits also introduces significant costs for the private sector, particularly for smaller firms. These costs and the existence of overlapping incentives for some firms such as nominal interest deductibility, accelerated depreciation, and investment deductions seems to induce many firms to forgo some fiscal benefits. In the sample of 125 firms, only a few firms claimed some deductions such as accelerated depreciation and indexation of depreciation allowances.

2.13 The investment tax credits generate large subsidies to some activities and bias production decisions toward an intensive use of capital. Table III.4 shows the effect of investment incentives on the marginal effective tax rates of agriculture, tourism, industry and forestry. The incentives for investments in agriculture reduce the METR to about half of the 40.5 rate estimated under the scenario of no special sectoral treatment and equity financing. Under debt financing, the METR is further reduced slightly to 12.3%. For the other sectors promoted by the GoCR the situation is much more favorable; taxable income is not only reduced, but the investment is in effect subsidized by the combination of sectoral incentives for investment and its financing through debt. An interpretation of Table III.4 would demonstrate that an investment project with a 10% rate of return would yield 18%, 14%, and 38%, respectively in tourism, industry, and forestry, given the impact of investment tax credits and the tax system's subsidy on debt. The condition that only invested resources generated by the same activity are eligible for deduction from taxable income limits the potential benefits of these incentives in the agriculture sector.

III. LIKELY FISCAL IMPACT OF REFORMS

3.1 Estimates from the 125 firm sample suggest that the impact of inflation adjustment would produce significant and positive increases in revenue yields. As shown in Table III.5, with a 30% uniform corporate rate, tax revenues would increase overall by 68%, with comparable increases of 40% and 12% with rates of 25% and 20%, respectively. As the table demonstrates, the most heavily indebted sectors are the most impacted with substantial increases in their tax liability previously reduced by

nominal interest deductions. Given the importance of these sectors, the Government may want to trade off a lower corporate tax rate for the efficiency gains of effectively implementing inflation adjustment.

3.2 However, these positive fiscal impacts would be diminished by considering the elimination of double taxation which in effect makes the corporate income tax a credit or type of withholding for the individual income tax. The specific tax of 15% (or 5%) on dividends is replaced by the income tax corresponding to the individual shareholder after having credited him with the taxes paid at the firm level. Similarly, the specific tax of 8% on nominal interest earnings is replaced by the individual's income tax rate on total earnings which include real interest earnings.

3.3 This analysis suggests that the revenue increases obtained by indexation will approximately equal the revenue losses from the elimination of double taxation and the reduction of the corporate tax rate which the GOCR has announced will decline from 30% to 25%. As Table III. 6 shows, if inflation declines to an optimistic 16% from 27.3%, as the GOCR expects, this result changes somewhat. However, though the gains from indexation are expectedly lower, the net fiscal impact may not change dramatically as lower inflation translates into lower interest payments on public debt.

TABLE III.1 CURRENT TAX TREATMENT DIFFERENTIATED BY SOURCE OF INCOME

f Income	Tax Treatment	Collection Method
Work	By monthly salary in colones, the marginal tax rate scale is: < 55,000 0% 55,000 --<= 83,000 10% >83,000 15%* *limited to 1/12 of annual salary effectively setting a maximum rate of 8.25%	Quarterly Employer Withholding
piertorship	By annual net income in colones, the marginal tax rate scale is: <245,000 0% 245,000 -- < 367,000 10% 367,000 -- < 612,000 15% 612,000 -- <=1,225,000 20% > 1,225,000 25%	Yearly Income Tax Declarations (Form R2) with quarterly provisional payments
Earnings	8% (applies to nominal earnings); returns on assets issued by Banks or in the stock exchange are excluded from taxable income; returns on assets issued by cooperatives, Banco Popular or the mortgage institutions are tax exempt	Retained by Bank
s	15% (applies to nominal earnings); when stocks originate in the Costa Rican stock exchange the applicable tax rate is 5%	Retained by Firms
e Income	By gross sales in colones with tax rate applied to net income: <= 3,675,000 10% > 3,675,000 -- <7,350,000 20% > 7,350,000 30% there is a minimum tax of 12,000 colones; Cooperatives and public sector enterprises are tax exempt	Yearly Income Tax Declarations (Form R3) with quarterly provisional payments

TABLE III.1A: SALES, EXCISE AND OTHER TAXES (excluding foreign trade taxes)

	Tax Treatment	Collection Method
Sales	Currently at 12% and scheduled for reduction to 11% in 1993 and to 10% in 1994. Exemptions still exclude from the tax base the goods and services defined within the sectoral canastas including basic foodstuffs, agriculture, housing.	Point of Sales Withholding with quarterly filing of sales tax retained; choice of 4 regimes including two that apply to small and micro retailers.
e Consumption	Differential rates apply according to origin of product and inputs: Alcohol 12% to 50%; Tobacco 50% to 75%; Beer 5% Soft drinks 5% to 14%; Electrical Appliances various rates	Point of Sales Withholding with quarterly filing of sales tax retained
	Property 0.36% to 1.17%; High value construction 1% to 1.5%; Automobile Property 1% to 2%; Transfer tax on automobiles 75%	Administered by Ministry of Finance through National Registry

Table III.2: SUMMARY TABLE OF PROPOSED TAX REFORMS

E	PROPOSED MODIFICATION IN TAX STRUCTURE
den income tax to include all ces of income and y uniform tment	(1) individuals with other sources of income besides one salaried job must file a tax return declaring all earnings for al (2) reduce bank retained tax of 8% on nominal interest earnings,which discourages savings, to 1.5%; (3) to minimize evasion and limit the transfer of losses, eliminate the possibility of declaring losses indefinitely and transferring them across different income sources; (4) eliminate provision establishing the maximum income tax for salaried income as the year's average monthly salary; (5) set uniform tax rate for corporate and sole proprietor income; (6) eliminate differentiated family deductions for different sources of income; (7) eliminate presumptive income for high income taxpayers; (8) create integrating mechanism to eliminate double taxation of distributed firm profits to their shareholders. We recom partial integrating mechanism in which dividends are integrated into the total earnings declared by the individual. T individual is then granted a tax credit for the tax paid at the firm level and corresponding to those dividends receiv This implies replacing the 15% specific tax on dividends with the income tax rate on corresponding to the individual's earnings.[2] In the case of sole proprietorships (R2), the integrating mechanism is comprehensive since total individua earnings include all profits from the business.[3] Included within the concept of total earnings are the profits genera then distributed to shareholders, partners or members of <u>all</u> types of incorporated units including cooperatives, found associations; (9) include within the income tax base occasional capital gains by abrogating its exemption in Art. 6 (d);[4] (10) apply to all individuals a single progressive tax scale from 0% to 30%. (11) simplify the tax regime for small enterprises based on a corresponding simplification of their treatment under the sa
inate distortions uced by inflation	(1) apply inflation adjustment by adjusting the firm's non-financial assets and total net-worth by the consumer price inde (2) adjust annually by decree all monetary values now established in the income, sales and property tax laws by the variat CPI.[6] This adjustment is especially important for the definition of tax scales and maximum limits as well as for the liabilities owed by taxpayers.

[1] We recommend to grant credit only to firms under no preferential treatment.

[2] In the case of repatriated profits, the appropriate tax rate to be applied depends upon the foreign investor's tax rate in his country of ori he objective is to promote competitive investment conditions while avoiding transfers of tax revenues from the Government of Costa Rica to a for vernment. Given that most foreign investment in Costa Rica originates from the USA, we recommend applying a tax rate of 34% (the rate applie rporate profits in the USA) minus the rate paid by the firm.

[3] For those filing R2 to declare sole proprietorship income, there is no problem in terms of assigning profits based on the shareholders shar e firm.

[4] The exemption on capital gains arising from changes in stock prices is maintained.

[5] After examining alternative systems for inflation adjustment, we simulated using the 125 firm sample the relative simplicity of a system sin that used in Chile. While Argentina and Brazil also presented alternatives, these were rejected given the sacrifice of accuracy and applicab ross sectors for a few additional calculations. For example, in Brazilian practice there is no adjustment of inventories which are simply valued e FIFO method. This tends to encourage higher levels of inventories and underestimates the cost of sales thereby resulting in an overestimate of ta come. The system recommended is simpler than what is currently practiced in Chile which has a variety of indices and takes more precise account of the year transactions were made. Using the financial statements provided as part of firm tax returns, fixed assets, inventories (treated as real as d valued using the LIFO method) as well as net-worth are adjusted by the variation in the CPI, while financial assets and liabilities in foreign exc e adjusted by the variation in the exchange rate.

[6] To simplify this updating, we recommend expressing amounts in tax unit equivalents. For example in the Proposed Law of Tax Efficiency, th t is defined as 25,000 colones to be updated monthly by the previous month's CPI.

onalize production ntives	(1) Industry: (a) Law 7017, Art. 5 granting the investment tax credit; (b) Law 2426 (to promote industrial development) granting television advertising 100% import duty exemption on equipm income tax rebates for 90% of investment. (2) Agriculture: (a) land/property tax exemption; (b) Law 7064 (Fodea) Art. 24 granting accelerated depreciation, investment tax credit on corporate income and exempti trade taxes including surcharge on imported capital goods, equipment and inputs. (3) Tourism: (a) reduction of income tax exemption from 12 to 6 years and investment tax credits for up to 50% of investment; (b) Law 6990 granting hotels, air & water transport for tourists total income tax exemption on retained earnings for depreciated acceleration; (c) Art. 8 granting deduction (on corporate income tax) from taxable income the costs of employee vacations provided firm. (4) For nontraditional exports, eliminate the deduction on income taxes from export profits, awarded by export contracts de exportación).
onalize forestry ntives	(1) limit incentives to fragile soils where forestry is the only ecologically sustainable economic activity, i.e., limit soil types which currently cover classes III to VII; (2) unify incentive schemes by eliminating specific exemptions (to land, income, and trade taxes) and the <u>fideicomiso</u> (gr subsidized credit); (3) increase private sector investment to a minimum of 50% of total investment in plantings and eliminate emission of CAF types of investments;
den general sales base	(1) eliminate exemption to electricity consumption over 250 kwh and to construction materials; (2) tax base expansion following Tanzi's recommendations and including the elimination of important exemptions to profess services (which is critical for cross referencing with income tax data on these activities),transport services and o products/services included in the five sectoral canastas. (3) broadening general sales tax base should be coordinated with the rationalization of selective consumption taxes. Thi focus on reducing the number of affected products (o the 4 or 5 which yield about 90% of tax revenues while transferr to the general sales tax base) and providing for more uniform tax rates.
gate low yiedling s	(1) abrogate stamp and culture tax and other minor taxes as specified by Tanzi whose administrative costs far outweigh th yield; (2) delegate taxes which are user fees to those agencies charged with managing the resources in question rather than impo earmarked taxes.
lify and onalize the erty tax	(1) consolidate land/property taxes by applying uniform tax rates and developing mechanism for the regular updating of va through annual inflation inflation adjustment and reassessment every 4 years including the broadening of the base to properties not currently included in the property registry; (2) transfer automobiles to the property tax system in order to simplify their current treatment by specific vehicle tran other taxes. The reduction of exemptions and tariff levels no longer justify maintaining the widely evaded vehicle t tax.

TABLE III.3: SAMPLE SUMMARY RESULTS OF IMPACT OF REFORMS BY SECTOR USING 1991 DATA

SECTOR (# Observations)	AGRICULTURE (18)	COMMERCE (46)	CONSTRUCTION (3)	INDUSTRY (19)	SERV. BAR/ RESTAURANT (5)	FINANCIAL SERVICES (2)	OTHER (32)
E OF: (AS A PERCENT OF ALL ASSETS)							
ilities (colones)	96.3	79.0	93.0	35.2	52.6	79.2	65.7
ilities (foreign exchange)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
tal	3.7	21.0	7.0	64.8	47.4	20.8	33.2
sets:							
inery & equipment	7.2	2.1	0.6	36.2	42.3	0.6	7.1
cles	4.5	0.9	0.0	3.7	1.2	1.8	6.8
dings	20.5	0.4	0.0	18.3	2.7	0.0	9.1
	21.1	0.0	0.0	1.6	0.0	0.0	1.3
l Assets:							
olones	16.2	66.5	35.9	17.9	41.7	85.0	45.6
s, securities	0.0	0.7	0.0	21	0.7	0.0	9.1
oreign exchange	0.0	0.0	0.0	0.0	0.0	0.0	0.0
ies	19.0	21.8	62.8	14.2	8.5	0.0	11.5
sets	11.5	7.8	0.6	5.9	2.8	12.6	8.3
CTURE							
Income w/out reforms	(21,104.9)	67,717.6	1,803.6	34,899.7	1,538.4	2,172.4	12,417.4
w/ reforms	6,671.4	73,454.5	25,932.3	63,101.3	2,654.5	1,458.0	18,585.5
Income (/a) w/ reforms	18,267.9	83,266.0	26,412.2	65,942.0	3,376.0	1,458.0	26,998.5
oss from Indexation	28,870.4	5,549.1	24,128.7	32,060.4	1,116.1	(1,311.7)	6,171.7
ility (/a) w/out reforms	842.7	20,389.0	541.5	12,661.1	654.8	621.2	4,521.9
(/a) w/ reforms	5,480.4	24,979.8	7,923.7	19,782.6	1,012.8	437.4	8,099.5
e/tax credit w/out reforms	0.0	983.3	0.0	0.0	0.0	0.0	0.0
y Tax Rate (/b)	28.4	29.9	29.7	29.7	28.2	29.8	27.3
e Tax Rate (/c)	4.6	24.5%	2.1%	19.2%	19.4%	42.6%	16.7%

ncating negative values at zero
ghted average
ctive Tax Rate=Tax liability w/out reforms/Taxable Income w/ reforms (truncating negative values to zero).

sets	340,913.3	1,706,968.8	154,250.5	514,672.8	39,418.5	41,103.1	506,169.7
	10.3%	51.7%	4.7%	15.6%	1.2%	1.2%	15.3%

TABLE III.4: MARGINAL EFFECTIVE TAX RATES: IMPACTS OF INVESTMENT INCENTIVES UNDER TWO FINANCING OPTIONS USING 1991 DATA
(in percent)

	Alternative Financing Options Considered	
	50% Equity Financing and 50% Retained Earnings	50% Debt Financing and 50% Retained E
ure	16.6	12.3
	-22.7	-83.0
	-6.2	-44.9
	-101.6	-280.7

TABLE III.5: SENSITIVITY ANALYSIS -- INCREASE IN CORPORATE INCOME TAX YIELD AT DIFFERENT TAX RATES USING 1991 DATA
(as percent of the tax yield without reforms)

AX RATE	**SECTOR** (Number of Observations)						
	AGRICULTURE (18)	COMMERCE (46)	CONSTRUCTION (3)	INDUSTRY (19)	SERV. BAR/ RESTAURANT (5)	FINANCIAL SERVICES (2)	OTHER (32)
	550	23	1363	56	55	-30	79
	442	2	1119	30	29	-41	49
	333	-18	875	4	3	-53	19

TABLE III.6: SENSITIVITY ANALYSIS -- INCREASE IN CORPORATE INCOME TAX YIELD AT DIFFERENT TAX RATES ASSUMING 16% INFLATION RATE WITH 1991 DAT
(as percent of the tax yield without reforms)

AX RATE	**SECTOR** (Number of Observations)						
	AGRICULTURE (18)	COMMERCE (46)	CONSTRUCTION (3)	INDUSTRY (19)	SERV. BAR/ RESTAURANT (5)	FINANCIAL SERVICES (2)	OTHER (32)
	366	13	777	34	54	-3	48
	288	-6	631	12	28	-19	24
	211	-25	485	-11	3	-36	-1

TAX ADMINISTRATION REFORM

I. INTRODUCTION

1.1 As noted in the main text of the present document, the organizational structure of the *Dirección General de Tributación Directa* (DGTD) which is responsible for internal taxes has been identified as an obstacle to its administrative efficiency. This structure suffers from an ad hoc combination of organization by function and by type of tax where functions are duplicated across a long list of departments which report directly to the Director and Deputy Director of the DGTD. The regional offices have only recently been networked to the DGTD's main information system and have not been able to provide taxpayers with even the most basis services. Instead, operational responsibilities have concentrated in the DGTD's main office within the Ministry of Finance in San José adding to a lack of clear definition of management/control functions. Civil service inflexibilities have also forestalled needed improvements to streamline procedures and functions, particularly those related to taking better advantage of the computational facilities and freeing DGTD personnel to perform other non-routine tasks.

1.2 Although, the DGTD may not adequately or efficiently deploy the resources at its disposal, there are cases where the legal and regulatory framework is also an obstacle. As described in the main text and in Annex C, an overly complex tax structure where non-uniform and discretionary treatment abounds clearly works against administrative efficiency. Under these circumstances it is difficult to identify taxpayers and assure their inclusion within the tax system. Recently, beginning with Law No. 7293 eliminating some exemptions, the DGTD has focused on strengthening the penalties for tax evasion or fraud allowed by law.

1.3 In light of these weaknesses, the following general principles guided the design of the action plan agreed with Government for reform presented in Section III. The Government's document (*Plan de Acción para la Administración Tributaria*) has additional details (*notas explicativas*) that are not presented here.

II. PRINCIPLES FOR IMPROVING TAX ADMINISTRATION

2.1 The basic principles for the DGTD restructuring focus on an organization by function to be carried out by a National Collection Agency, the regionalization of tax administration activities, and the establishment of a unit dedicated to the largest taxpayers. The creation of a National Tax and Customs Collection Agency will allow the decentralization of collection functions from the regulatory functions currently under the DGTD responsibility. The Agency will be created under a special civil service framework of the current civil service law, which the GOCR considers the more effective institutional alternative for appointing the

new human resources needed to improve tax collection efficiency in Costa Rica.

2.2 A functional organization recognizes that there are certain procedures which are standard in the administration of most taxes. As such, these procedures need to be rationalized and simplified so that their routine components can be accomplished through automation while non-routine and, in particular, client service functions can be appropriately designed focusing staff talent and training on efficient service provision.

2.3 The purpose of decentralization is to provide for more accessible taxpayer services where currently most services require travel to San José. By greater proximity to the taxpayer, inscription into the tax registry (*Registro Unico de contribuyentes*; RUC), updating of the information stored therein, as well as a number of services from information assistance to tax collection and filing of tax returns can be provided at the regional offices. In the short-term, both Land Assessment and Taxpayers Claims will remained centralized in the San José main office. By focusing taxpayer services near the client, this would free the main office for administrative control functions including work measurement and evaluation of performance to policy formulation and monitoring.

2.4 The specialized unit for larger taxpayers recognizes that the tax burden is relatively concentrated in these large entities. For example, if ranked by the amount of tax liability, over three-quarters of corporate income tax revenues come from about the top 2% of the largest firms. Such a unit would focus DGTD efforts to provide streamlined services to the most important taxpayers as defined by their relative contribution to revenues. In addition, these larger entities can provide a wealth of information related to various taxes (both income and sales and excise taxes) which can then be cross-referenced backwards and forwards to suppliers and clients in order to minimize tax evasion and fraud.

III. TAX ADMINISTRATION ACTION PLAN

3.1 ACTIONS TO BE COMPLETED PRIOR TO BOARD PRESENTATION

(1) Approve and publish the Decree for the restructuring of the Dirección General de Tributación Directa (DGTD) assigning the functions corresponding to each of the Subdirecciones and Organos at a similar level.

(2) Present to the Legislative Assembly the supplementary budget for financing the DGTD restructuring during the fourth quarter of 1992.

(3) Define the personnel requirements for the new DGTD organization as well as the qualification requirements at each professional level and corresponding job descriptions.

(4) Define the criteria to be used in the personnel selection process in accordance with the legal framework foreseen in the upcoming law for the creation of an Agencia Nacional de Recaudación. This will be evidenced by comparing these criteria with the legal framework in the law.

(5) Present to the Legislative Assembly the proposed law for the creation of an Agencia Nacional de Recaudación under the Ministerio de Hacienda (which will join the current Direcciones Generales de Tributación Directa y de Aduanas) legally empowering it with autonomy in regard to its finances and resource management and which establishes disciplinary action applicable to Agency personnel.

(6) Approve and establish satisfactorily the standards for direct registration of taxpayers in the RUC and for mailing notices of tax payment liability.

(7) Design and install an information system which permits the daily management of collections by bank offices and merge this data with Central Bank transfers to the National Treasury.

(8) Include in the proposed Law for Tax Efficiency the following modifications to the Tax Code;

art. 44:	eliminate assumed payment liability and delete the phrase "entero de Gobierno".
art. 47:	delete last paragraph which establishes a Fund for the guarantee of tax refunds.
art. 48:	eliminate transfer of refunds to third party.
art. 160:	delete the third paragraph (delinquency notice)
art. 166:	substitute the incorrect cross reference to art. 168 for art. 164.

3.2 ACTIONS TO BE COMPLETED PRIOR TO FIRST TRANCHE RELEASE

(1) Complete program for updating the Unified Taxpayer Registry (RUC) and reconciling the *Cuenta Integral Tributaria*. The plan i) will take into account the results of the work completed by the Auditoria during 1991 regarding the taxpayers registered for the Sales Tax and the Social Security Tax (CCSS), among others; ii) will finalize the mailing of letters/notices to allegedly delinquent taxpayers advising them of their tax situation.

(2) Open and install the Regional Office in Cartago and San José. This will include: 1) the approval and publication of criteria for the assignment of taxpayers at these offices; ii) the satisfactory operation in both offices of registration, collection and auditing mechanisms; iii) the design of the Programa de Servicio y Fiscalización for large businesses; and iv) the elimination of "constancias" or certifications of payment of taxes as well as the

adivising of taxpayers regarding their appealed debts before the tax administration authorities.

(3) Select and contract the personnel to carry out the program of technical assistance agreed with the Bank in the Government's *Plan de Acción para la Administración Tributaria*.

(4) Define the unit of the Ministry that will charged with executing the training and human resource development activities and the center or provider of these activities; initiate the training courses as agreed with the Bank in the Government's *Plan de Acción para la Administración Tributaria*.

(5) Approval by the civil service unit of the qualifications required for each one of the professional levels and the job descriptions.

(6) Implemented an information system which permits the daily management (reconciliation) of collections by the Banco de Crédito Agricola offices and merge this data with Central Bank transfers to the National Treasury.

(7) Eliminated use of the "enteros de Gobierno" form for the payment of taxes leaving only those forms containing the data to identify the taxpayer and the tax paid.

(8) Agreed with the Bank on the number of job positions required for the new structure of the DGTD on the basis of relevant studies.

(9) Harmonized the structure and titles of the units of the DGTD with those of similar level in the DGA (Customs).

3.3 ACTIONS TO BE COMPLETED PRIOR TO SECOND TRANCHE RELEASE

(1) Select, according to previously approved criteria, and appoint at least 70% of the DGTD staff.

(2) Draft and approve the Regulations for General Tax Management Procedures and Tax Collection.

(3) Draft and approve the General Regulation for Tax Control and Monitoring and the Auditing Manual.

(4) Approve the modifications to the Income Tax, Sales Tax and Selected Consumption Taxes. Among the modifications to be included will be broadening of the definition of income and monetary correction (Income Tax) and the elimination of special Sales Tax treatment (Pharmacies and Gas Stations).

(5) Draft and approve Property Tax Regulations.

(6) Improve computerized monitoring of transactions and complaint resolution.

(7) Carry out the Programa de Servicio y Fiscalización of large businesses.

(8) Develop and apply the management information system for the evaluation of the efficiency of the Tax Administration offices based on the levels of completion of assignments and measured results.

(9) Offer training courses on auditing techniques, tax legislation and computer applications, for at least all staff members with duties and responsibilities related to tax control and monitoring.

(10) Agreed program of technical assistance in process.

3.4 ACTIONS TO BE COMPLETED PRIOR TO THIRD TRANCHE RELEASE

(1) Select, according to previously approved criteria, and appoint the rest of the Tax Administration staff.

(2) Define selection criteria for drafting tax control and monitoring plans.

(3) Design and implement information systems for the support of tax control and monitoring and present tables on tax collection yields obtained from the execution of the approved tax control plans.

(4) Put the rest of the Regional Administration Offices into operation, defining their respective taxpayers and providing them with the necessary resources for the satisfactory delivery of services for tax registration, collection and auditing.

(5) Decentralize the Appraisal system.

CUSTOMS ADMINISTRATION REFORM

I. INTRODUCTION

1.1 The current customs reform effort is meant to be a comprehensive effort to transform an institution that is widely believed to be an inefficient in the management of its resources and ineffective in achieving its main objectives. There is wide consensus that customs operations should facilitate the process of opening Costa Rica's economy and integrating with international markets. This requires streamlining the flow of trade while effectively administering trade taxes and providing related statistical and management information. The current state of affairs is characterized by an obsolete infrastructural base complemented by poorly trained public employees carrying out ill-defined tasks not directly related to customs main objectives.

1.2 Given this situation, comprehensive reform must be based upon a thorough re-examination of the requirements for institutional organization, human and material resources, and the legal and regulatory framework in which these elements must interact so that the providers of customs services, under the direction of the Dirección General de Aduanas, deliver these services with maximum efficiency. Part II of this Annex presents the main principles guiding this comprehensive reform effort while Part III presents an outline of the main actions needed to carry out this reform. This action plan is presented with some further detail (*notas explicativas*) in the Government's document *Plan de Acción para la Administración Aduanera*.

II. PRINCIPLES OF COMPREHENSIVE REFORM

2.1 The creation of a National Tax and Customs Collection Agency will allow the decentralization of collection functions from the regulatory functions currently under the DGA responsibility. The Agency will be created under a special civil service framework of the current civil service law, which the by the GOCR considers the more effective institutional alternative for appointing the new human resources needed to improve tax collection efficiency in Costa Rica.

2.2 Phased implementation of reforms - which reflects the priorities and needs of instituting new organization and operating procedures in the various regional offices of customs.

2.3 Streamlining trade - New simplified procedures should seek to minimize processing times, limiting the waiting period for access to imports (while simultaneously reducing the DGA's risk of fraud) and shipment of exports. The efficiency of these new procedures should be carefully monitored and

measured in terms of the quality and cost of the customs services for both users and the DGA.

2.4 Adapting the legal and regulatory framework to international standards - Legal and regulatory modifications must meet GATT guidelines and the Council of Customs Cooperation efforts toward international uniformity as stated in the Kyoto Convention. These modifications will affect customs operational procedures, valuation methods and anti-dumping actions particularly.

2.5 Adapting the institutional organization to new simplified procedures - Restructuring the DGA to accommodate new procedures is a prerequisite to correct the current skills mismatch and related overburdening of higher management levels.

2.6 Automation and Objectivity - Automation of procedures under the DGA's information system should contribute to greater processing efficiency as well as limit discretional behavior on the part of customs agents. However, prior to automation, there is a need to clearly and precisely define the functional responsibilities of users and customs agents in the different phases of import/export processing.

2.7 Presumption and verification of user accuracy - Rather than presume that users will provide incorrect information (often a reaction to overly burdensome bureaucratic procedures), presume that clear and transparent rules will properly guide users in filing customs declarations and estimating the amount of trade taxes due. This would be complemented with selective checks and controls to assure compliance with regulations. For example, physical examination of merchandise to verify quality, quantity and other product specifications should be performed on a selective basis guided by a combination of technical and randomness criteria. In addition, the DGA should have the ability to effect spot or periodic verification at importers/exporters premises.

III. CUSTOMS ACTION PLAN

3.1 ACTIONS TO BE COMPELTED PRIOR TO BOARD PRESENTATION

(1) Approval of the Decree for the restructuring of the Dirección General de Aduanas, assigning the functions corresponding to each of the Subdirecciones and Organos at a similar level.

(2) Dimension the personnel requirements to the structure and functions of the new customs organization as well as the qualification requirements at each professional level and corresponding job descriptions. (considering the number of customhouses and the volume of Costa Rica's international trade, the total payroll should not exceed 650 persons, including the Customs police).

(3) Define the criteria to be used in the selection process in accordance with the legal framework foreseen in the proposed law referred to in the following point.

(4) Present to the Legislative Assembly the proposed law for the creation of an Agencia Nacional de Recaudación under the Ministerio de Hacienda, which will join the current Direcciones Generales de Tributación Directa y de Aduanas, legally empowering it with autonomy in regard to its finances and resource management and which establishes a disciplinary action applicable to Agency personnel.

3.2 ACTIONS TO BE COMPLETED PRIOR TO FIRST TRANCHE RELEASE

(1) Ratification by Legislative Assembly of the new Uniform Customs Code for Central America (CAUCA II) to replace the current one.

(2) Select and contract the personnel to carry out the program of technical assistance agreed with the Bank in the Government's *Plan de Acción para la Administración Aduanera*.

(3) Approval by the civil service unit of the qualifications required for each one of the professional levels and the job descriptions.

(4) Define the entity to be responsible for training of Customs staff executing the training and human resource development activities and the center or provider of these activities as agreed with the Bank in the Government's *Plan de Acción para la Administración Aduanera*.

(5) Agreed with the Bank on the number of job positions required for the new structure of the DGA on the basis of relevant studies.

(6) Harmonized the structure and titles of the units of the DGTD with those of similar level in the DGTD (Tax Branch).

3.3 ACTIONS TO BE COMPLETED PRIOR TO SECOND TRANCHE RELEASE

(1) Ratification of the new Uniform Customs Code for Central America (CAUCA II).

(2) Draft and approve the Regulations for the Customs Law and establish simplified procedures in all customhouses for import and export activities.

(3) Approve import and export operations manuals and procedure manuals.

(4) Prepare and approve new import and export forms in accordance with approved procedures and information system specifications.

(5) Install the computerized information system, at least in the Central

Customhouse (San José).

(6) Select, according to previously approved criteria, and appoint at least 50% of the staff required according to the new Customs organization.

(7) Prepare courses in the areas of customs legislation, procedures, computer networking and merchandise appraisal, directed primarily to new employees; and specific courses in accounting, computer applications and auditing techniques for staff working in areas related to tax control and monitoring.

(8) Prepare and approve an ongoing program for training in the areas of international trade, merchandise appraisal, computer networking, and computer applications for accounting and auditing.

3.4 ACTIONS TO BE COMPLETED PRIOR TO THIRD TRANCHE RELEASE

(1) Select, according to previously approved criteria, and appoint the rest of the staff for the Customs organization.

(2) Establish satisfactorily the remaining customs procedures (Regímenes Especiales y Tránsito) in all customs houses and draft the corresponding Manuals.

(3) Draft Manuals for Internal Auditing.

(4) Design Procedure Manuels and designate criteria for the preparation of Plans for Tax Control and Monitoring "a posteriori" to trading companies.

(5) Install the information system in the remaining customs houses.

(6) Prepare the documentation and manuals to assure the effective operation and maintenance of Customs Administration offices.

(7) Establish the permanent training program referred to in point (8) above.

PROPOSED RESOLUTION[1]

COSTA RICA. LOAN /OC-CR TO THE REPUBLICA DE COSTA RICA
(Public Sector Reform 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 República de Costa Rica, as Borrower, for the purpose of granting it a loan to cooperate in the execution of: (a) a public sector reform program, hereinafter referred to as the "Program", and (b) a project for the importation of eligible goods, hereinafter referred to as the "Project". This Financing shall be subject substantially to the following conditions:

1. Amount and Currencies: Up to US$80,000,000, or its equivalent in other currencies, except that of Costa Rica, which are part of the ordinary capital resources of the Bank, to pay for goods of external origin acquired through international competition and which originate in the member countries of the Bank and for such other purposes as may be specified in the loan contract. Payments of amortization and interest shall be made in the currency or currencies specified by the Bank, in a quantity equivalent to the corresponding amount owed, calculated in units of account in terms of dollars of the United States of America, in accordance with provisions to be included in the loan contract.

2. Source of Funds: The ordinary capital resources of the Bank.

3. Guarantee: The general responsibility of the Borrower.

4. Credit Fee: 0.75% per annum on the undisbursed portion of the Financing, commencing to accrue 60 days after the date of the loan

[1]The provisions contained in this Appendix I and in Appendices II, III y IV shall be final only when the Board of Executive Directors has approved the loan proposal.

contract and payable in dollars of the United States of America on the same dates as the interest.

5. Amortization: The Borrower shall amortize the loan in a period of 20 years from the date of the loan contract, by means of semiannual, consecutive and, insofar as possible, equal installments. The first installment shall be paid sixty-six months after the date of the loan contract.

6. Interest: The Borrower shall pay interest semiannually on the daily outstanding balances of the loan. The first payment shall be made six months after the date of the loan contract. The Bank shall determine the rates of interest to be applied during the life of the loan, in accordance with the lending rate policy of the Bank.

7. Disbursement: The term for disbursement of the Financing shall expire 3 years after the effective date of the loan contract. Disbursements shall be made in three tranches, the first in the amount of up to US$24,000,000 and the second and third tranches each in the amount of up to US$28,000,000, or their equivalent in other currencies which are part of the ordinary capital resources of the Bank. Compliance with the respective conditions precedent shall be required before commencing disbursement of each of the tranches.

8. Special Conditions:

   (a) The execution of the Program shall be carried out by the Borrower through the Ministerio de Hacienda. The execution of the Project shall be carried out and the resources of the loan shall be utilized in their entirety by the Borrower, through the Banco Central de la República de Costa Rica, hereinafter "BCCR". If modifications in the macro-economic or sector policies described in the Public Sector Policy Letter referred to in Clause 8(g) herein or in the legal provisions or the basic regulations concerning the Ministerio de Hacienda or the BCCR are approved which, in the opinion of the Bank, may substantially affect the Program or the Project, the Bank shall have the right to require the Borrower, the Ministerio de Hacienda and the BCCR to provide explanatory and detailed information in order to determine whether such modification or modifications have or may have a substantially adverse impact on the execution of the Program or Project. Only after hearing the Borrower, the Ministerio de Hacienda or the BCCR and assessing their information and clarifications, may the Bank take such measures as it deems appropriate, in accordance with provisions to be set forth in the loan contract.

(b) Prior to the initiation of disbursements of the first tranche of the Financing, the Borrower shall demonstrate to the satisfaction of the Bank, that:

(i) its macro-economic policy performance is consistent with the objectives of the Program;

(ii) the laws approving the privatization of CEMPASA and FERTICA have entered into full force and effect;

(iii) it has enacted and put into full force and effect legislation which adopts substantially the provisions of the Proposed Law of Public Work Concessions (Proyecto de Ley de Concesiones de Obra Pública);

(iv) it has enacted and put into full force and effect legislation which adopts substantially the provisions of the Proposed Law for Economic Democratization (Proyecto de Ley de Democratización Económica);

(v) it has completed and submitted to the Bank the text of the draft laws necessary to carry out the legislative reforms proposed in the Program to Broaden the Tax Base (Programa Ampliación de Base Tributaria);

(vi) it has agreed with the Bank on the text of the draft regulations for the Proposed Real Property Tax Law (Proyecto de Ley sobre el Impuesto Territorial);

(vii) it has completed the program for updating the Unified Taxpayer Registry [el "Registro Unico de Contribuyentes" o el "RUC"], corrected and brought up to date the integrated taxpayer accounts and put into operation the Regional Administration in San José; and

(viii) it has made satisfactory progress in complying with the objectives and provisions established in the Sector Policy Letter referred to in Clause 8(g) of this Resolution.

(c) The Bank shall authorize the initiation of disbursements under the second tranche of the Financing only when the Borrower has demonstrated to the Bank's satisfaction that it has:

(i) maintained its macroeconomic policy performance in a manner consistent with the objectives of the Program;

(ii) brought CEMPASA and FERTICA to the point of sale;

(iii) completed a study on its petroleum sector under terms of reference acceptable to the Bank and submitted to the Bank an action plan, based on the results and recommendations of the referred study and the Bank's comments thereon, for the reform of its petroleum sector;

(iv) substantially achieved the targets for 1993 of the Labor Mobility Program through mechanisms which may include the privatization of enterprises and services;

(v) completed an evaluation of its Pilot Program for Budgetary Reform and submitted to the Bank an action plan for comprehensive budgetary reform based on the results of the evaluation;

(vi) continued implementation of the new General Pensions Regime Law (Ley Marco de Pensiones);

(vii) enacted legislation which adopts substantially the provisions of the Proposed Tax Efficiency Law (Proyecto de Ley de Eficiencia Tributaria) and the Proposed Real Property Tax Law (Proyecto de Ley sobre el Impuesto Territorial) and put into full force and effect said legislation and the corresponding regulations concerning the income, sales and property taxes;

(viii) presented to the Legislative Assembly the bill or bills of law which adopt substantially the provisions of the Program to Broaden the Tax Base and prepared the corresponding regulations;

(ix) complied substantially with the provisions of the Tax Administration Action Plan;

(x) complied substantially with the provisions of the Customs Administration Action Plan; and

(xi) continued to make satisfactory progress in complying with the objectives and provisions established in the Sector Policy Letter referred to in Clause 8(g) of this Resolution.

(d) The Bank shall authorize the initiation of disbursements under the third tranche of the Financing only when the Borrower has demonstrated to the Bank's satisfaction that it has:

(i) maintained its macroeconomic policy performance in a manner consistent with the objectives of the Program;

(ii) continued to make progress in the implementation of the action plan for comprehensive budgetary reform referred to in Clause 8(c)(v) of this Resolution;

(iii) brought to the point of sale FANAL;

(iv) continued to make progress in the implementation of the action plan referred to in Clause 8 (c)(iii) of this Resolution;

(v) substantially achieved the targets for 1994 included in the Labor Mobility Program;

(vi) continued the implementation of substantially all the provisions of the new General Pensions Regime Law (Ley Marco de Pensiones);

(vii) continued the implementation of substantially all the provisions of the Laws for Tax Efficiency and Real Property Tax and monitoring of the changes thereunder;

(viii) enacted legislation which substantially adopts the provisions of the proposed bill or bills of law referred to in Clause 8(c)(viii) of this Resolution and put this legislation and the corresponding regulations into full force and effect;

(ix) continued to comply substantially with the provisions of the Tax Administration Action Plan;

(x) continued to comply substantially with the provisions of the Customs Administration Action Plan; and

(xi) continued to make satisfactory progress in complying with the objectives and provisions established in the Sector Policy Letter referred to in Clause 8(g) of this Resolution.

(e) Resources of the Financing may be used to compensate the Borrower for foreign currencies expenses incurred in the acquisition of imported goods within the six months prior to the date of the loan contract, provided that requirements substantially similar to those of this Resolution and the loan contract have been fulfilled and that the amount does not exceed the equivalent of US$40,000,000.

(f) In order to utilize the resources of the Financing in the acquisition of goods by either the public or private sector, except crude oil and petroleum fuel products, the system of

international public bidding shall have been followed in each case in which the value of such acquisitions exceeds the equivalent of US$5,000,000. For purchases below such limit, acquisitions by the public sector shall follow the normal procedures established by local law to the extent such law does not conflict with the Bank's procurement policies and acquisitions by the private sector shall follow established commercial practices applicable to the goods in question; where possible, such acquisitions by the private sector shall be made on the basis of quotations from eligible suppliers from at least two member countries of the Bank. Acquisitions shall be subject to the procedures to be appended as an annex to the loan contract.

(g) The Borrower and the Bank have agreed that the substantial content of the Public Sector Policy Letter of November 23, 1992, from the Borrower to the Bank, describing the plan of action, objectives and policies designed to achieve the reform of the public sector, and which states the Borrower's commitment to the execution of the Program and to the implementation of macro-economic policies, is an integral part of the Program, for the purpose of Recommendation 1 of Appendix II.

(h) The Bank shall establish such inspection procedures as it deems necessary to assure the satisfactory execution of the Program and the Project, and the Borrower shall extend all cooperation which is required for the most effective accomplishment of this purpose. From the amount of the Financing, the sum of US$800,000 shall be allocated for credit to the accounts of the Bank to meet expenses of general inspection and supervision.

(i) Should discrepancies of interpretation arise between the Spanish and English versions of Clauses 8(b), 8(c) and 8(d) of this Resolution, of Recommendation 1 of Appendix II or of Section VIII of Appendix III, which were initially negotiated in English, the English version shall prevail. The loan contracts shall include an annex with the English version of said clauses.

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Original: English
Appendix II

RECOMMENDATIONS

A. It is recommended that the following conditions, to be fulfilled to the Bank's satisfaction, be included in the loan contract in addition to those set forth in the proposed resolution:

1. The Borrower and the Bank shall meet, from time to time, at the request of either party and on the date and place agreed upon, to exchange views on: (a) the progress achieved in carrying out the Program and the compliance of the obligations set forth in Clauses 8(b), 8(c) and 8(d) of Resolution DE-___/92; and (b) the consistency of Costa Rica's macroeconomic framework with the Program. Prior to each such exchange of views, the Borrower shall furnish the Bank, for its review and comment, a report in such detail as the Bank shall reasonably request on the fulfillment of the obligations referred to in sub-paragraphs (a) and (b) of this Recommendation.

2. The Borrower shall maintain separate accounting records and an appropriate internal control structure, to allow the Bank to identify imports financed with resources of the loan as well as the respective disbursements.

3. With resources of the Financing, no disbursement shall be made for:

   (a) imported goods included in the groups or sub-groups of the United Nations Standard International Trade Classification (SITC) list referred to in Section VI of Appendix III;

   (b) expenditures in Costa Rican colones or for the purchase of goods from Costa Rica;

   (c) imported goods acquired under contracts in an amount less than US$10,000 equivalent;

   (d) imported goods financed in foreign exchange, under medium or long terms;

   (e) imported luxury goods;

   (f) imported weapons; and

   (g) imported goods for use by the armed forces.

4. The Borrower shall present to the Bank, within 90 days following the last disbursement of each tranche of the Financing, a statement of account for such tranche detailing the imported goods which were the

basis for the disbursement requests for the corresponding tranche. Such statement of account shall be duly certified, in accordance with terms of reference agreed upon with the Bank, by an independent firm of public accountants designated by the Borrower and acceptable to the Bank.

B. Annexes substantially similar in content to Appendix III (The Program and The Project) and Appendix IV (Tender Procedures) shall be included in the loan contract.

ANNEX A

THE PROGRAM AND THE PROJECT

I. Description

1.01 The Program consists of the reform of Costa Rica's public sector by means of: (a) rationalizing public expenditures through the institutional restructuring of five key ministries, improving the budget process and social security reform; and (b) improving its tax laws, regulations and administration to increase public revenues.

II. Objective of the Program

2.01 The principal objective of the Program is to support the plans of the Government of Costa Rica aimed at reforming the public sector by means of: (a) on the expenditure side, seeking reductions in public spending through budgetary reform, institutional restructuring and social security reforms; and (b) on the revenue side, taking measures focusing on comprehensive tax reform, including simplifying and rationalizing the tax structure based on principles of allocative neutrality and equity and creating an improved tax and customs administration system.

III. The Project

3.01 The Project consists of a group of eligible imported goods acquired by the public and private sectors of Costa Rica. The eligibility criteria for such goods is set forth in Recommendation 3 of Appendix II.

IV. Financing

4.01 The Bank shall finance the Project up to an amount equivalent to US$80,000,000 in foreign exchange from the ordinary capital resources. The Financing provided by the Bank shall be fast-disbursing and will be disbursed in three tranches, the first up to US$24,000,000 and the other two tranches up to US$28,000,000 each, or their equivalent in other currencies.

V. Use of the Resources

5.01 The resources of the loan shall be used to: (a) reimburse 100% of the cost in foreign exchange of eligible imports, up to an amount equivalent to US$79,200,000; and (b) to meet the expenses of general inspection and supervision, up to an amount equivalent to US$800,000.

VI. Negative list

6.01 The goods referred to in Recommendation 3(a) of Appendix II are included in the following groups and sub-groups of the United Nations Standard International Trade Classification (SITC) [1], including any amendment that may be made to these groups or sub-groups and of which the Bank shall notify the Borrower:

Groups	Sub-groups	Description of item
112	-	Alcoholic beverages;
121	-	Tobacco, unmanufactured, Tobacco refuse;
122	-	Tobacco, manufactured (whether or not containing tobacco substitutes);
525	-	Radioactive and associated materials;
667	-	Pearls, precious and semi-precious stones, worked or unworked;
718	718.7	Nuclear reactors, and parts thereof, fuel elements (cartridges), non-irradiated for nuclear reactors;
897	897.3	Jewelry of gold, silver or platinum group metals (except watches and watch cases) and goldsmiths' or silversmiths' wares (including set gems);
971	-	gold, non-monetary (excluding gold ores and concentrates)

VII. Procurement

7.01 All procurement of eligible imported goods shall have been carried out allowing the free competition of goods originating in the Bank's member countries. Accordingly, no conditions shall be imposed in the acquisition procedures or bidding conditions that might limit or restrict the offering of goods from those countries.

VIII. Definitions

8.01 For the purpose of Clauses 8(b), 8(c) and 8(d) of Apendix I, the following definitions shall apply:

[1]See the Standard International Trade Classification, Revision 3 (SITC, Rev. 3), published by the United Nations in Statistical Papers, Series M, No. 34/Rev.3 (1986).

(a) "brought to the point of sale" shall mean the Borrower has completed all preparation as may be necessary, including issuing the public call for bids, in order to bring the asset to market;

(b) "CEMPASA" means the Borrower's Cementos del Pacífico Sociedad Anónima, the public cement company controlled by the Borrower;

(c) "FANAL" means the Borrower's Fábrica Nacional de Licores, the public liquor company controlled by the Borrower;

(d) "FERTICA" means the Borrower's Fertilizantes de Costa Rica, the public fertilizer company controlled by the Borrower;

(e) "Labor Mobility Program" means the Borrower's program of objectives, actions and targets designed to achieve a reduction of staff positions in the public sector, as such program is described in the Borrower's document entitled "Programa de Eliminación de Plazas Públicas en Costa Rica" and presented to the Bank by letter dated November 18, 1992;

(f) "Pilot Program for Budgetary Reform" means the Borrower's application of the Program for Budgetary Reform for its National Social Security Agency (Caja Costarricense de Seguridad Social, "CCSS"), Agricultural Development Institute (Instituto de Desarrollo Agrícola, "IDA"), Health Ministry (Ministerio de Salud), Water and Aqueducts (Agua y Acueductos), Ministry of Agriculture (Ministerio de Agricultura) and the National Production Council (Consejo Nacional de Producción);

(g) "Program to Broaden Tax Base" means the Borrower's program (Programa Ampliación de Base Tributaria) of proposed legislative reforms to rationalize tax incentive schemes and extend the application of the Sales Tax, as described in its letter to the Bank dated November 13, 1992;

(h) "Proposed Law of Economic Democratization" means the Borrower's Draft Law (Proyecto de Ley de Democratización Económica), attached to the Borrower's letter to the Bank dated November 18, 1992, and which draft law has been presented to the Costa Rican Legislative Assembly;

(i) "Proposed Law of Public Works Concessions" means the Borrower's Draft Law (Ley de Concesiónes de Obra Pública), attached to the Borrower's letter to the Bank dated November 18, 1992, and which draft law has been presented to the Costa Rican Legislative Assembly;

(j) "Proposed Real Property Tax Law" means the Borrower's Draft Law (Proyecto de Ley sobre el Impuesto Territorial), attached to the Borrower's letter to the Bank dated November 13, 1992;

(k) "Proposed Tax Efficiency Law" means the Borrower's Draft Law (Proyecto de Ley de Eficiencia Tributaria), attached to the Borrower's letter to the Bank dated November 13, 1992; and

(l) "Sales Tax" means the Borrower's taxes imposed on sales of goods as a percentage of the purchase price.

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Appendix IV

TENDER PROCEDURES FOR SECTOR ADJUSTMENT OPERATIONS

(Annex B of the Loan Contract)

(Public Sector Reform Program)

I. APPLICABILITY

1.01 This procedure shall govern all procurement of eligible goods connected with the Project, whether carried out by the public or private sector. Procurement shall only be for goods imported from member countries of the Bank, as stipulated in paragraph 2.01(b).

II. PUBLIC SECTOR PROCUREMENT, AMOUNT ABOVE THRESHOLD

2.01 The procurement of goods carried out by the public sector [1] in amounts greater than the equivalent of US$5,000,000, must comply with the following requirements in order to be eligible for disbursements under the sector adjustment programs:

(a) International public bidding

The system of international public bidding shall be used. The procedures and specific requirements for the bidding shall permit the unrestricted competition of bidders from the member countries of the Bank. Consequently, no conditions that would limit or restrict the offer of goods or the participation of bidders from such countries may be imposed.

(b) Origin of goods

Only imported goods from member countries of the Bank will be eligible. The origin of a good shall be:

(i) the country in which the material and/or equipment has been mined, grown, produced, manufactured or processed; and

(ii) the country in which, through manufacturing, processing or assembly, another commercially recognized article results which differs substantially in its basic characteristics from any of its imported components. The nationality or country of origin of

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[1] This sector includes enterprises or other institutions in which state participation is greater than 50% of the capital.

the firm producing or selling the goods or equipment shall not be considered in determining the origin of such goods.

(c) Notices of the call to bid and invitations to bid

Calls to bid published in the press must specify, at a minimum, the following information:

(i) exact description of the goods for which the call for bids is being held;

(ii) the office or place, date and time at which the bidding documents, including the bidding guidelines, plans, specifications, and draft contracts may be obtained;

(iii) the office where the bids are to be delivered and the authority responsible for their approval and award; and

(iv) the place, date and time at which the bids will be opened in the presence of the bidders or their representatives.

(d) Publicity

The call for bids shall be:

(i) published in at least one of the most widely circulated newspapers in the country on at least three separate occasions. There must be a space of at least three calendar days between each of the three public notices; and

(ii) published in a journal or specialized newspaper with wide international circulation; or in the United Nations journal entitled Development Business; or distributed to the embassies of the member countries. To that effect, the tendering entity shall deliver copies of the invitation to bid on the same date as the invitation is delivered to the national newspapers for publication. If there are no embassies, it shall be delivered to the respective consulates.

(e) Clarity of the documents

The bidding documents prepared by the tendering entity must be coherent and comprehensive. Particular care must be taken to ensure that the goods to be supplied are described with sufficient clarity and in sufficient detail. The cost of such documents must be reasonable.

(f) Free access to the tendering entity

The tendering entity shall be available, once the bidding documents have been collected by bidders and up to the time the bids are opened, to answer questions or clarify the bid documents for bidders. These

inquiries shall be answered promptly by the tendering entity, and clarifications, if any, made available to other interested parties.

(g) Standards of quality

If particular standards with which equipment or materials must comply are cited, the specifications should state that goods meeting other authoritative standards, which ensure an equal or higher quality than the standards mentioned, will also be accepted.

(h) Specifications for equipment: brand names

Descriptions contained in specifications should not prescribe brand names, catalog numbers or types of equipment of a specific manufacturer unless it has been determined that this is necessary to ensure inclusion of certain essential design, performance or construction features. In such a case the reference should be followed by the words "or equivalent," and a measure to determine the "equivalence" included. The specifications should permit offers of alternate equipment, articles or materials which would have similar characteristics and provide equal performance and quality to those specified. In special cases with previous approval of the Bank, specifications may require that a proprietary item be supplied.

(i) Currency Clause

The bidding documents should state the currency to be used in payment.

(j) Bid bonds

Bid bonds or other tender guarantees, if any, should not be set so high [2] or their validity stretched out over long periods, as to discourage suitable bidders from tendering. Bid bonds shall be returned as follows:

(i) to the winning party once the contract is executed;

(ii) to the second- and third-place bidders within a term of no more than three months from the date of the award or upon execution of the contract, if the latter occurs prior to such deadline. Nevertheless, if such bidders indicate lack of interest, the bond shall be returned within five days following the award; and

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[2] Some bidding practices limit the amount of the bid bonds (tender guarantees) to 1% of the price of the contract. Others recommend that the agencies calling for bids set a fixed price in cash for all bidders instead of requiring the bidder to base his guarantee on a given percentage of the value of his bid. This is to avoid undue publicity of the price of each tender prior to the opening of the bids, should the amount of the guarantee or bid bond become public knowledge.

(iii) to other bidders within five days following the award.

(k) Deadlines for submission of bids

The deadline for submitting bids shall not be less than 45 calendar days from the date of the last publication of the invitation to bid or the date of availability of bidding documents, whichever is later.

(l) Confidentiality of bids

The officers in charge of receiving the envelopes containing bid registration forms shall verify that such envelopes are delivered properly sealed. These envelopes shall be kept in a safe place until the date set for their opening. Once opened, no copies shall be taken of these documents. Except as may be required by law, information relating to the examination, tabulation, clarification and evaluation of bids and recommendations concerning awards, may only be communicated to officials of the tendering entity officially concerned with the respective bidding procedures, after the public opening of bids and before the announcement of the award of contract to the successful bidder.

(m) Modification or extension of the bidding documents

Any modification or extension of the bidding guidelines, specifications, or the filing date must be communicated to all interested parties who are in possession of the bidding documents. In the event that such modification or extension is substantial, in the opinion of the tendering entity, there must be an interval of at least 30 calendar days between the date of notice to interested parties and the date bids are opened.

(n) Consultations should not modify the bidding documents

Consultations on the interpretation of bidding documents addressed to the tendering entity by interested parties may not be used to modify or expand the bidding guidelines and specifications. Consultations and replies thereto shall in no case cause a suspension of the term for presentation of bids.

(o) Opening of bids

Offers shall be submitted in writing in sealed envelopes. They must be signed by the legal representatives of the bidders and comply with the prerequisites set forth in the bidding documents. They shall be opened in public on the scheduled date and hour. Representatives of the bidders may attend the bid opening and shall be entitled to inspect the bids. Bids received after the filing date shall be returned unopened. The names of the bidders, the price of each bid, the term and amount of guarantees, and any substantial change submitted separately, before the deadline but after the principal bid is submitted, shall be read aloud. All of the above shall be recorded in the proceedings, which shall be

signed by the representative of the tendering entity and by any bidders present who so desire.

(p) Clarification of bids

The tendering entity may request clarifications from the bidders with respect to their tenders. Clarifications requested or given shall not alter the essence of the offer or its price, nor shall they violate the principle of bidder equality.

(q) Analysis and comparison of bids

(i) Purpose

Bids shall be analyzed and evaluated to determine whether they comply with the terms and conditions stipulated in the bidding documents, and the value of each bid shall be fixed for the purpose of awarding the winning bid.

(ii) Lowest evaluated bid

In addition to the bid price adjusted to correct arithmetical errors, the tendering entity may also consider other relevant factors in determining the lowest bid.

(iii) These factors should be expressed in monetary terms or, as a minimum, given a relative weight according to criteria specified in the bidding documents. No criteria may be used in bid evaluation that are not set forth in the bidding documents. The amount of escalation for price adjustments, if any, included in the bids should not be taken into consideration.

(iv) The currency or currencies in which the price offered in each bid would be paid if that bid were accepted, should be valued in terms of a single currency selected by the tendering entity for comparison of all bids and stated in the bidding documents. The rates of exchange to be used in such valuation should be the selling rates published by an official source, and applicable to similar transactions on the day bids are opened or at such later date (30 or 60 days after bid opening) as shall be specified in the call for bids.

(v) Regional margin of preference

The following regional margin of preference may be applied in the comparison of bids:

Where suppliers of a country (other than the country of the borrower) that is a party to an integration agreement, [3] to which the country of the borrower is also a party, participate in such bidding, such suppliers of goods are entitled to a regional margin of preference utilizing the following criteria:

(1) Goods shall be considered to be of regional origin if they originate in countries that are parties to an integration agreement to which the borrower is also a party and comply with the standards governing origin and other matters relating to trade liberalization programs established in the respective agreements;

(2) The value added is not less than that stipulated for the national margin of preference; and

(3) In comparing foreign offers the borrower may add to the price offered for goods originating in countries not parties to the respective integration agreement, either 15% or the difference between the import duty applicable to such goods when they originate in countries not parties to the integration agreement and that which is applicable to those goods when they originate in countries which are parties to the agreement, whichever is lower.

(vi) Rejection of bids

The tendering entity shall reject all bids where no bids meet the intent of the specifications, or where there is evidence of lack of competition and/or collusion. The tendering entity may reject all bids if the low bids exceed the official estimate by an amount sufficient to provide reasonable justification for such action. In such cases, new bids should be requested from at least all who where invited to submit bids in the first instance and a reasonable amount of time should be allowed for the submission of the new bids. In the absence of a 100% performance bond, individual bids may be rejected in cases where the particular bid is so much lower than the official estimate that it is reasonable to conclude that the bidder will not be able to complete the works or supply the product within the specified time at the price offered.

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[3] For purposes of this provision, the Bank recognizes the following regional or subregional integration agreements: (i) Central American Common Market; (ii) Caribbean Community; (iii) Cartagena Agreement; and (iv) Latin American Integration Association. If the country where the borrower is located has signed more than one integration agreement, either the subregional margin of preference or the regional margin of preference may apply depending on the country of origin of the article to be procured.

(vii) Bid evaluation report

The tendering entity shall prepare a detailed report on the analysis and comparison of bids, describing precisely the reasons for selection of the lowest evaluated bid.

(r) Award of contract

The award shall be made to the bidder whose responsive bid has been determined to be the lowest evaluated bid.

(s) Notification of award and signature of the contract

The tendering entity shall notify all bidders of the award at the addresses they have provided within three working days after the date of the award. The contract to be signed shall not modify the winning bid or the terms and conditions stipulated in the bidding documents.

(t) Modification of the award

If for any reason the winning bidder does not sign the contract within the period set for that purpose, the tendering entity may award it, without a new invitation to bid, to the next lowest responsive bidder.

(u) Bidding declared null and void

The tendering entity may, on reasonable grounds, declare the bidding null and void.

(v) Effects of the declaration

Once the bidding is declared null and void, the tendering entity shall issue a second invitation to bid following the provisions set forth in this procedure. If the second bidding is declared null and void, the tendering entity shall establish the procedure to be followed for the procurement involved.

(w) Due process

This procurement procedure must guarantee the legal protection of bidders, establishing the right of administrative and judicial review.

III. PUBLIC SECTOR PROCUREMENT. AMOUNTS BELOW THRESHOLD

3.01 The procurement of goods carried out by the public sector in amounts less than the equivalent of US$5,000,000 must comply with the following requirements in order to be eligible for disbursement under sector adjustment programs:

(a) It must be carried out in accordance with the procedures prescribed under local law.

(b) When such procedures require public bidding, the latter must be acceptable to the Bank, and must therefore satisfy all the pertinent conditions and guarantees required under Chapter II of this Procedure.

IV. SUPERVISION BY THE BANK

The Bank reserves the right to conduct ex post supervision of the different stages and documents of each procurement connected with the Project, after the contract has been signed with the respective winning bidder. For this purpose, the borrower agrees to provide the Bank with all the documentation it may require regarding the procurement to be supervised. The Bank reserves the right not to make disbursements for goods which have been procured without complying with the regulations prescribed in this Procedure.

V. PRIVATE SECTOR PROCUREMENT

In order to be eligible for disbursement, the procurement of goods by the private sector:

(a) for contracts whose amounts are above US$5,000,000, public international bidding shall be required pursuant to the terms specified in Section 2.01 of these procedures; and

(b) for contracts whose amounts are less than US$5,000,000, purchases shall be made following established commercial practices and, where possible, on the basis of quotations from eligible suppliers from at least two member countries of the Bank.

VI. REIMBURSABLE IMPORTS

In order to be eligible for disbursement under the Project, all procurement of goods must:

(a) have been carried out according to the regulations of this Procedure; and

(b) have been carried out for goods not included in the categories of goods whose import the borrower and the Bank have agreed to exclude from the financing, as stipulated in Annex A of this Contract.