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Country Role Models for Development Success

The Case of Costa Rica

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Abstract

In this paper, I discuss the reasons for Costa Rica's economic performance over the last quarter of a century. Three complementary sets of policies (investments in human capital, careful stabilization, and an intelligent and aggressive integration into the world economy) explain the successful trends, and can be thought of—at least in hindsight—as a development strategy. While fruitful, this strategy has been incomplete, as there have been less results in other policy areas, including income distribution, infrastructure, adequate taxation and telecoms. These omissions result from the weakness of the political system to deliver decisions and implement chosen policies. Despite these problems, Costa Rica's case is interesting and worthy of study from the perspective of other small, developing countries.

Keywords: economic growth, economic development, economywide country studies, economic planning and policy

JEL classification: O1, O2, O4, O5

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1 Introduction: Costa Rican recent history and the implicit development strategy

While not as wealthy or dynamic as some other economies, Costa Rica has been moderately successful in terms of economic and human development over the last quarter of a century, with one of the highest incomes and growth rates in Latin America. Along with growth, the Costa Rican economy has become more diversified and sophisticated, and has been able to avoid the excess volatility afflicting other developing countries. There has been progress in reducing poverty and improving consumption standards. But at the current pace, Costa Rica will not become a developed country any time soon unless additional profound reforms are undertaken. Nevertheless, its performance has been better than most, and the country exhibits some enviable indicators.

In this paper, I discuss the reasons for Costa Rica's achievements in economic success over the last quarter of a century. To account for these achievements, I highlight the combination of three particular sets of policies, which have been implemented rather well, which complement each other, and which have had strategic importance. The first set of policies involves the substantial investments and unusual decisions made by Costa Rica during the twentieth century with regard to democracy, peace, education, healthcare and the environment. These explain the high levels of human development, institutional development, and labour productivity that the country today enjoys. At the time of implementation, these measures were not motivated by economic value, but rather by other—perhaps higher—objectives. Nevertheless, these measures offer the potential of productivity growth, as they reflect human capital, stability and rule of law in the business climate.

The second set of policies to be highlighted concerns the stabilization and (partial) liberalization measures undertaken after the 1980-82 debt crisis. Due to these efforts, Costa Rica has been able to maintain macroeconomic stability, as it is now in its 26th consecutive year of positive growth without having been affected by financial, fiscal, or balance-of-payments crises. While the stabilization pursuits are by no means complete—and the country still suffers in particular from inflation that exceeds international levels—progress has been significant. During the same period, microeconomic reforms and market liberalization have been introduced, and the heavy-handed state intervention of the past decades has been traded for more modern supervision and regulation. All of this was done very idiosyncratically. Costa Rica implemented, in its own creative way, some of the reforms proposed by the international conventional wisdom of the time while refusing to undertake others.

The third set of policies is the measures aimed at opening the Costa Rican economy and, more importantly, at promoting its exports and attracting foreign direct investment. This is a policy area that has been strongly prioritized for the last quarter century with continuity and consistency. The results have been quite impressive, amounting to diversification, technological improvement, higher incomes, and job creation.

The foregoing would suggest that the choice of these three types of policies make up 'a development strategy'. However, it is appropriate to point out that while such a statement can be made in hindsight, it should be interpreted with care. In particular, these decisions were not necessarily made simultaneously, based on any strategically planned selection or postponement of measures. Some of the policy omissions were indeed intentional, but other areas, where reform was attempted but did not succeed were failures. The political process itself shows some worrying signs, as the decisionmaking process has become cumbersome, and the day-to-day management of government increasingly difficult.[1]

However, one should underline that in the last 20 years, Costa Rica could have sacrificed or at least risked the large social and institutional achievements of the past, but chose instead to safeguard these, even during the period of the debt crisis and post-crisis fiscal stress. It was understood that no other economic goal could be attained without macroeconomic stabilization and some deregulation, and these objectives were pursued slowly but consistently. Finally, the priority given to export promotion was indeed a strategic choice, due to its complementarities with other measures. The rather good performance in a variety of areas since then is, in my mind, primarily the result of these decisions. Thus, in a sense, the three sets of policies discussed here constitute an incomplete but partially successful development strategy.

2 Is Costa Rica an economic success?

In terms of income, growth and overall economic performance, Costa Rica is well ahead of the average country, but not a dramatic success. With a per capita income of roughly US$5,560 in 2007,[2] Costa Rice is clearly no longer a very poor country, but is, nevertheless, still far from the output and quality of life of the developed nations.

According to the IMF, Costa Rican PPP-corrected per capita income grew at an annual rate of 5.1 per cent over the last 25 years, placing it second with regard to growth rates (Figure 1), and fourth with respect to per capita levels in Latin America. It is undoubtedly a dynamic economy, but its performance falls far short of a number of nations with double-digit growth rates year after year. Although Costa Rica's initial conditions were particularly adverse (the deep debt crisis in the early 1980s, and a large negative shock to terms of trade in the new millennium), it had the advantage of favourable circumstances as well, including many years of peace, democracy and high investments in human capital.

Costa Ricans fare better than this income level would suggest. According to UNDP (2006), a Costa Rican has a life expectancy of 78.2 years, and a 96.3 per cent probability of reaching the age of 40, both indicators among the range for European nations. Also, 98 per cent of the population has access to clean water, and 92 per cent to adequate disposal of waste water. A remarkable 98.3 per cent of the households have electricity, and 58.4 per cent a fixed phone line. The share of automobile owners (DGEC 2004) rose from 14 per cent in 1988 to 36 per cent in 2004. And finally, 22.4 per cent of the public budget is allocated to education, ensuring that most literacy and attainment indicators are quite positive. Costa Rica outranks almost all other countries at similar levels of income per capita.

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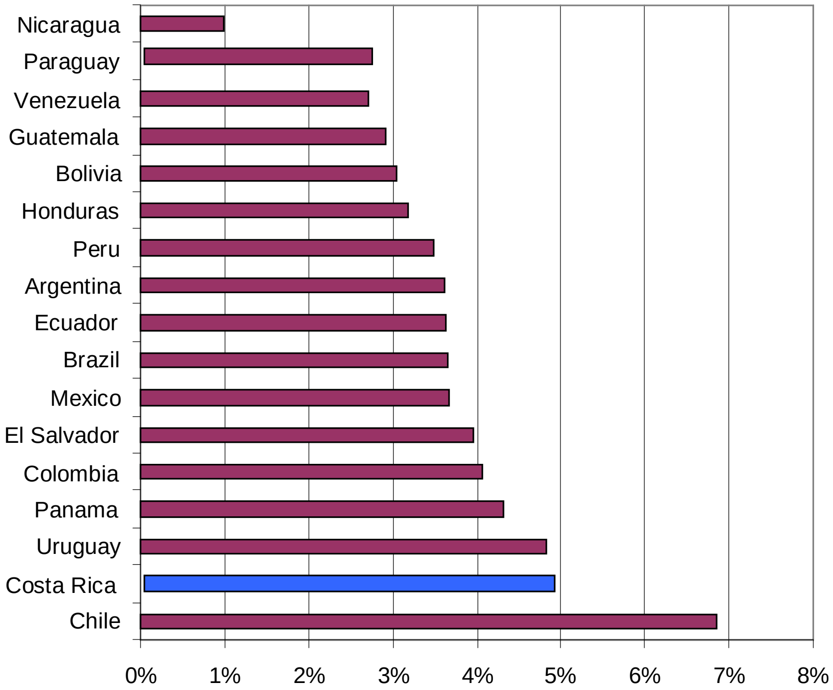
1 Cornick and Trejos (2008) discuss the pending agenda for economic reform in greater detail, particularly the new difficulties in policymaking in today's Costa Rica. I have borrowed extensively from the data work and preparatory efforts from that paper, and am thus indebted to Cornick and Laura Muñoz, the research assistant.

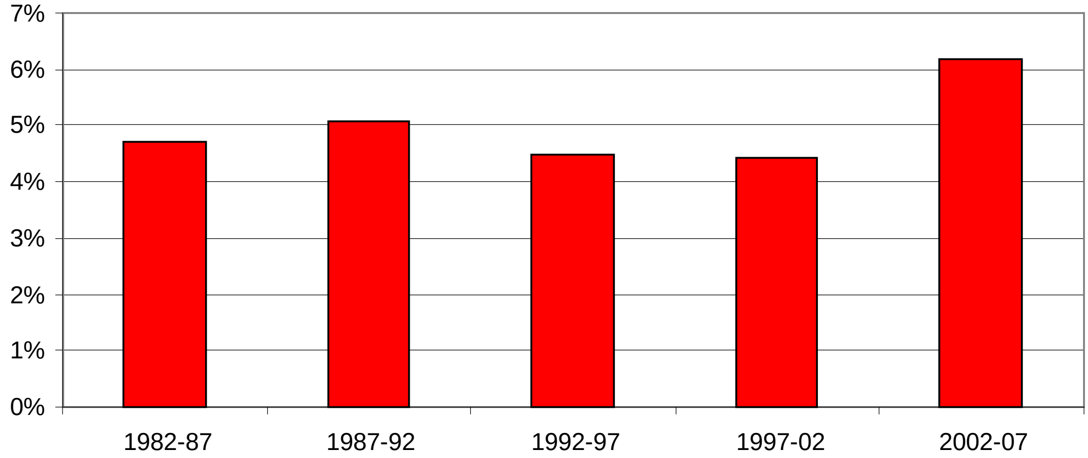
2 Unless otherwise indicated, macroeconomic data mentioned in the text come from the CEFSA database, which in turn is based on official Costa Rican statistics.

Figure 1
PPP per capital GDP growth, 1983-2006



Source: IMF (n.d.).

Figure 2
Costa Rican annual GDP growth



Source: Central Bank of Costa Rica (n.d.).

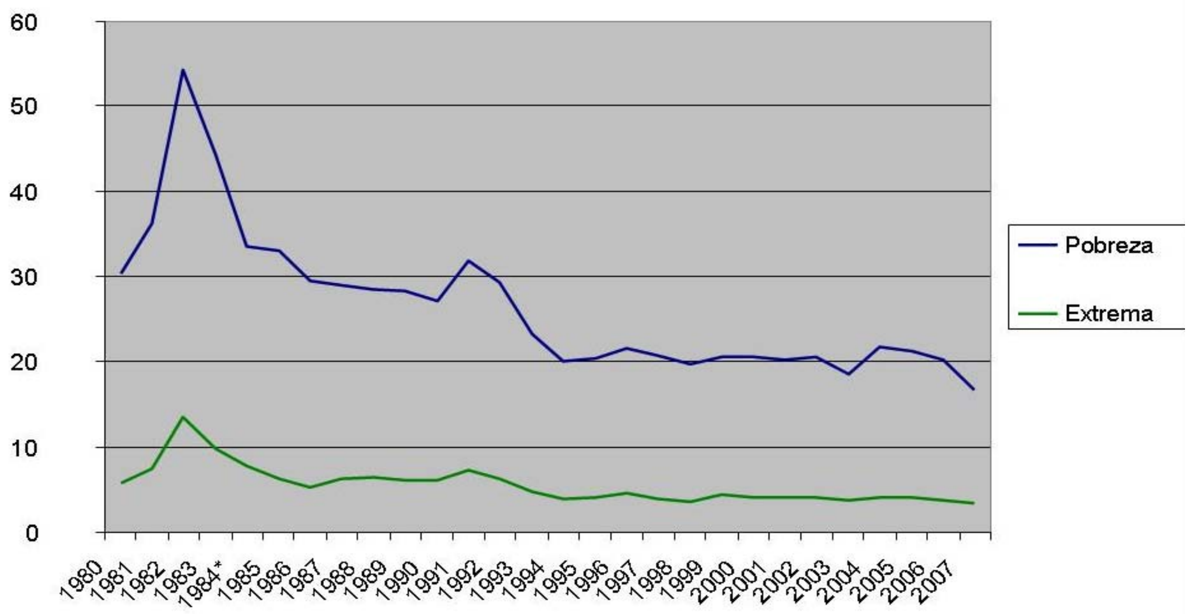
Growth has been stable, as is illustrated by Figure 2, with no economic contraction after the year 1983. Job creation has been brisk—not only because the productive sector has absorbed record numbers of new entrants into the labour market, generated by the demographically large generation and massive immigration—but also because unemployment was very low. The acceleration of growth in the last five years is made more remarkable by the fact that in the same period, this open and commodity-dependent economy had suffered a 24 per cent deterioration in its terms of trade due to the oil-metals-grains price fluctuations.

Growth has also enabled the country to significantly reduce its poverty rate in the last quarter century, as Figure 3 indicates. The extreme poverty rate (that is, the UNDP index of human poverty) is less than 5 per cent. The fraction of the population living below the national poverty line[3] which peaked at 55 per cent during the debt crisis, had returned by 1987 to the pre-crisis levels of around 30 per cent, and was under 17 per cent in 2007.

Successful poverty reduction has resulted from growth, not the better income distribution as inequality, in contrast, has increased over most of this period. Figure 4 shows three measures of the Gini coefficient (based on wage revenues, personal incomes and total household incomes). While not as high as during the volatile 1970s, nor during the debt crisis of 1980-82, inequality has increased since 1990. Costa Rica's income disparity, like in other Latin American nations, is very high; also, the country is strongly exposed to international trends (like the increase in the education premium) that exert pressure on income distribution.

In summary, Costa Rica's economic performance at first glance is not stellar, but the country has achieved objectives that many others have failed to reach, and it has grown faster than almost any other Latin American country in the last 25 years. Nevertheless, there are important weaknesses as well. Economic growth, compared to some Asian and European countries, has not been impressive; income distribution, already skewed, has been growing increasingly unequal, and successive efforts in a variety of policy areas have been unsuccessful. Still, there are interesting lessons to be pursued from the Costa Rican case.

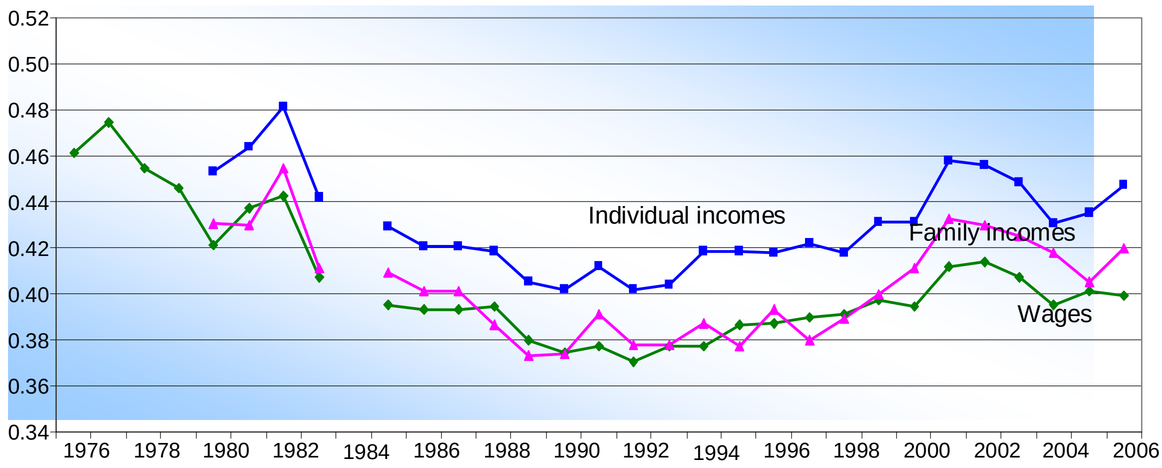
Figure 3
Poverty and extreme poverty rates



Source: CEFSA (n.d.).

3 Here, this measure is estimated with a local methodology based on the ECLA definition, and is not appropriate for cross-country comparisons.

Figure 4
Gini coefficients



Source: CEFSA (n.d.).

3 Identifying a development strategy

In the introduction, I posed the main supposition of this paper: that Costa Rica's comparatively high economic growth and other positive indicators of economic performance are largely due to the effects of the three sets of policies implemented in the last 20-25 years. First, Costa Rica took steps to protect (particularly against the impact of the debt crisis) and to enhance certain social and institutional achievements in terms of human capital accumulation, democracy and human development, which had been attained earlier. Second, it enacted in the post-crisis era certain basic economic reforms that were aimed especially at macroeconomic stabilization, but also at deregulation and liberalization. Third, on the basis of a freer and more stable economy, the high potential productivity resulting from human development was unleashed through the intelligent integration of the economy into the international markets through successful measures aimed at export promotion and the attraction of foreign direct investment. The rest of this paper analyses each of these areas of policy in more detail.

3.1 Human capital, social achievements and institutional development

Costa Rica has a very distinct political history, throughout which it has made some rather remarkable choices, and pursued objectives more in line with the goals of the developed nations than of developing countries.

Democracy: Costa Rica is one of the oldest and most mature democracies in the developing world. The country has been governed for decades by civilians with limited powers that have been legally established and institutionally supervised, and who have been voted into office in elections perceived according the standard of their times as open, participatory and fair. Institutional design and division of powers in Costa Rica are—and have for long been—analogous to western style democracies; rule of law is strong. Citizens have clear, multiple rights that are transparent and well defended.[4]

Peace and disarmament: In 1949, Costa Rica enacted a new constitution that disbanded the armed forces, among other things. Since then, the country has been without an army, preferring to use diplomacy to defend its interests in the world, and deviating resources to civilian and social objectives that otherwise would have gone to weapons.[5] Internal and border security is supervised by the police force; there are no soldiers, heavy weapons, military orders or mandatory service. The country has been effectively and fully disarmed, unilaterally, for six decades.

Environmental preservation: Since the 1970s, Costa Rica—aware of the biological treasures within its borders—has invested very heavily in the protection of its environment, which, in terms of biomass, biodiversity and the number of indigenous species, is much larger than the size of the country would suggest. Today, about 26 per cent of the country has been granted national park status, which is strictly guarded. Accounting for other forms of environmental preservation brings the total protected areas to over a third of the national territory. This has made Costa Rica one of the few nations in the world whose forest cover in the last years has increased, rather than shrunk. The country is nearly carbon-neutral, and has the second-lowest level of carbon emissions per capita among the 57 countries rated as 'high human development' by the UNDP. Costa Rica has become one of the leading global destinations for environment-related tourism, biological research and bioprospecting. Around 96 per cent of the electricity is generated using renewable resources (hydro, Aeolic and geothermic) rather than fossil fuels.

Infrastructure networks: Costa Rica's infrastructure networks are particularly extensive. Even the smallest village has a reasonable road connection to key highways,[6] and enjoys electricity, phone service and potable water. Schools and small clinics are disseminated throughout the country. These networks have existed for a long time, and are built from the bottom-up, so that what makes them special is not the quality or size of the central arteries (the main highway, the key port, the big campus), but rather the quantity, connectivity and density of these capillaries.[7] Basic services are therefore disseminated across the country instead of being concentrated in the main cities.

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4 Most historians place the starting date of Costa Rican democracy with the 1889 elections, as this was the last event during which there was any danger of military intervention influencing the choice of the voters. Civilian, electoral-based rule has been maintained since then. Less than a dozen countries in the world can claim to have been democratic at that time. An alternative view considers that the 1948 episode—when an attempted election fraud led to violence, government resignation and a new constitution—as a major interruption to democratic order, and that the new resultant constitution which emerged in 1949 is the true birth of mature national democracy. Even according to this criterion, Costa Rica has been a democracy for 59 years old, the longest in Latin America.

5 Only two countries, Iceland and Costa Rica, are reported as having no military expenditures at all (UNDP 2006).

6 For instance, Costa Rica has more miles of paved road per square mile of territory than any other country in Latin America.

7 Certain telecom services, in particular internet and mobile phones, are an exception. At 181 per 1000 inhabitants, Costa Rica has the second lowest rate of ownership of cell phones among high human development countries (UNDP 2006) (Cuba has the lowest ownership rate), and lower than 30 mid- or

Human capital: Basic education has been mandatory since the nineteenth century, and enrolment rates are (and have been) high at all levels of education. There is an effective national system for job training, and a large number of universities and professional schools. The national healthcare system is extensive, with 87.6 per cent of the population covered by health insurance through the *Caja Costarricense del Seguro Social* (the resulting positive healthcare indicators were cited earlier). Worker's rights are strong and widely respected. As a consequence, Costa Ricans enjoy high levels of human capital, and have therefore high labour productivity. The Costa Rican worker is trained, disciplined, creative and industrious.[8]

The reasons for pursuing these goals were not all economic. Environmental preservation and demilitarization, for instance, are important objectives in their own right, and as such are favourably viewed by the population; there does not have to be an economic benefit in order for an objective to be worthwhile. Nevertheless, once society achieves these goals, they become huge economic assets. Institutional development, predictability and democracy's rule of law; the security, and the saving in fiscal resources, thanks to not having an army; the added value of environmental preservation to tourism and agriculture; the low operating costs promoted by extensive connectivity networks, etc., enhance productivity and business competitiveness. In particular, the impact of human capital on potential wages and output is enormous. These sources of wealth cannot be tapped sufficiently in a backward, isolated and over-regulated economy (such as Costa Rica in the 1970s) but in a freer and more open economy, they can.

In many countries, the objectives mentioned in this section are perceived as 'luxuries' that society can afford only after it achieves growth (rather than goals to be reached in order to secure growth), and there is the fear that they cost money that governments do not have. The history of Costa Rica suggests the opposite; these higher goals can be more valuable economically than almost any other shorter-term objective.

3.2 Stabilization and deregulation

Nearly 25 years ago, during the Latin American debt crisis, Costa Rica suffered a cumulative per capita income loss of nearly 20 per cent.[9] It was the consequence of structural problems associated with the economic model followed in the two previous decades, and of short-term financial disequilibria—both weaknesses became

low-development nations. Cellular signal can be absent in the oddest places, including many spots of the metropolitan area.

8 Notice, for instance, the emergence and dynamism of hi-tech activities in Costa Rica like the production of computer parts, medical equipment and complex services. Costa Rica is a low-wage producer of these goods because the main competitors are the developed nations, as other poor countries simply lack the basic human skills to participate in these markets, even at much lower costs. After eight years of being substantially involved in the national FDI efforts, I am surprised about how often the quality, ability and mental flexibility of the Costa Rican people are cited as the reason why many sophisticated companies choose to operate in the country instead of other places that are, on paper, more competitive.

9 In general, the fiscal and balance-of-payments crisis of the early 1980s was proportionally bigger and developed earlier in Costa Rica than in the rest of the hemisphere. For instance, Costa Rica announced the default of its public foreign debt a year earlier than other Latin American countries.

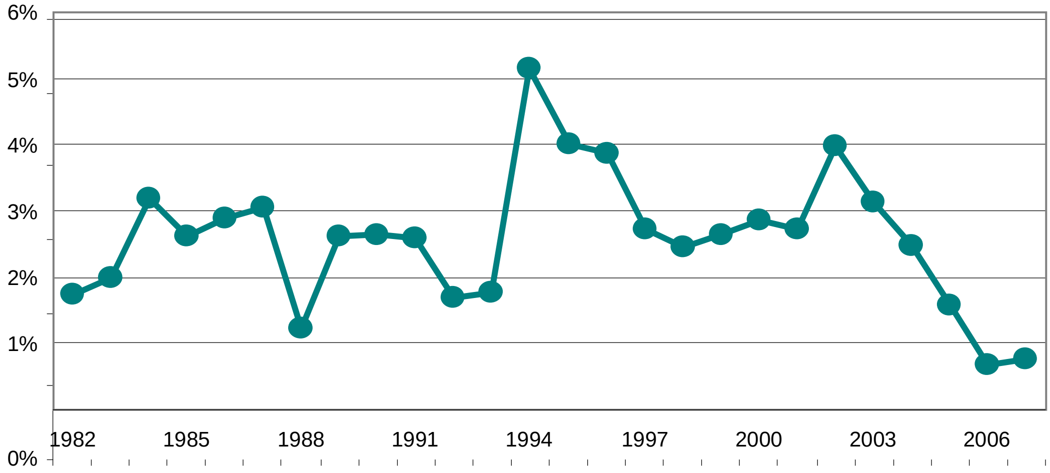
unmanageable once the terms of trade worsened during the oil crises. The structural components of the crisis were similar to those afflicting the rest of Latin America at the time: heavy-handed state intervention in the economy, a protectionist model offering good short-term results but one that encouraged rent-seeking behaviour rather than productivity and competitiveness, and an unsustainable long-term balance-of-payments situation.

Financial mismanagement exacerbated the problems: exchange rate adjustments were postponed; foreign (bland) loans were used in lieu of tax increases and/or reduction of public expenditure; and rapid monetary expansion was allowed. By mid 1980, the public-sector deficit had reached 17 per cent of GDP, annual inflation exceeded 80 per cent, real wages had dropped one-third, and the exchange rate skyrocketed when foreign reserves ran out. External debt was approximately 100 per cent of GDP.[10]

After the crisis hit bottom, a new government with strong electoral mandate took over in 1982, and Costa Rica went through reform in an attempt to stabilize the economy and solve some of the most blatant structural problems. This reform took place along several fronts:

Fiscal adjustment: As the following figures reveal, government deficits have been low since adjustment measures were implemented in 1982,[11] and indebtedness has plummeted. Costa Rica has had a relatively good record since renegotiating its foreign debt in 1987, regaining access to national and international credit and maintaining acceptable credit ratings. To achieve this, the congress frequently passed both permanent and transitory tax reforms. Budgetary priorities were clearly established, protecting expenditures on health, education and the environment, along with the network of safety-net institutions, while total outlays were kept within manageable limits, mostly by postponing investments in infrastructure.

Figure 5
Central government deficit

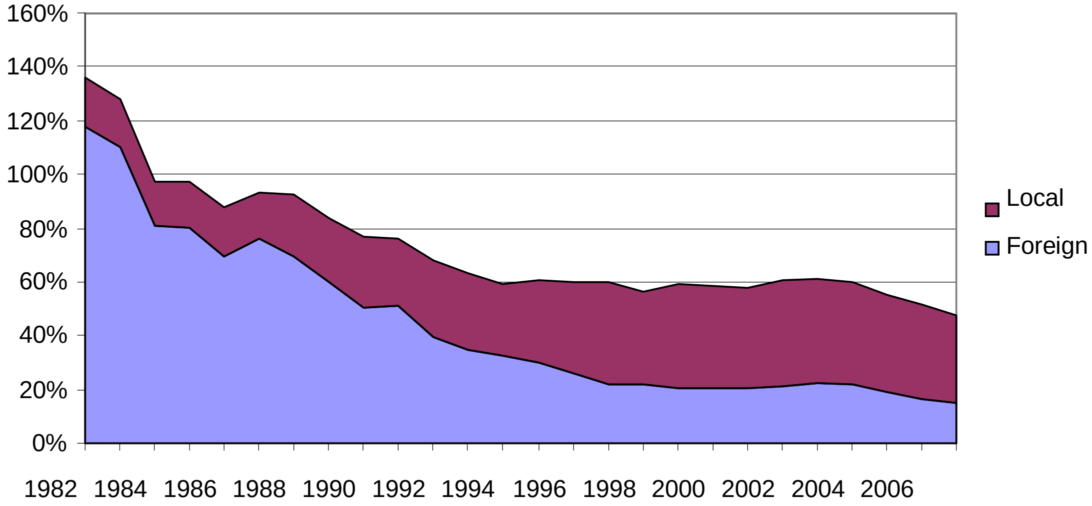


Source: CEFSA (n.d.).

10 This summary borrows on Lizano (1999).

11 The 1994 spike reflects an one-time, non-recurring event: the bankruptcy of a government-owned bank, the losses of which were absorbed by the treasury.

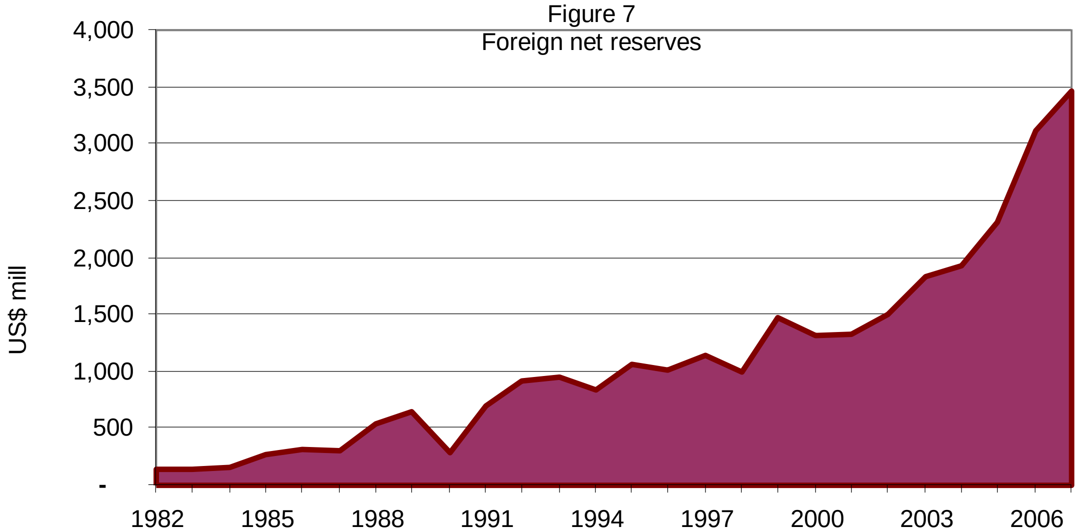
Figure 6
Costa Rican public debt



Source: CEFSA (n.d.).

Balance of payments adjustment: Costa Rica put its balance of payments in order, and has even been able to accumulate sizeable foreign reserves as a buffer. The Costa Rican *colon* is fully convertible, with no restrictions on the amounts that can be held, brought into or taken out of the country, or traded into another currency, whether for 'current' or 'capital' transactions. Also, short-term interest rate policy was applied during the 1980s and 1990s to prevent excessive flows of short-term capital without imposing quantitative restrictions. The real exchange rate remained fairly stable between 1984-2006, due to a crawling-peg system designed for that purpose.[12]

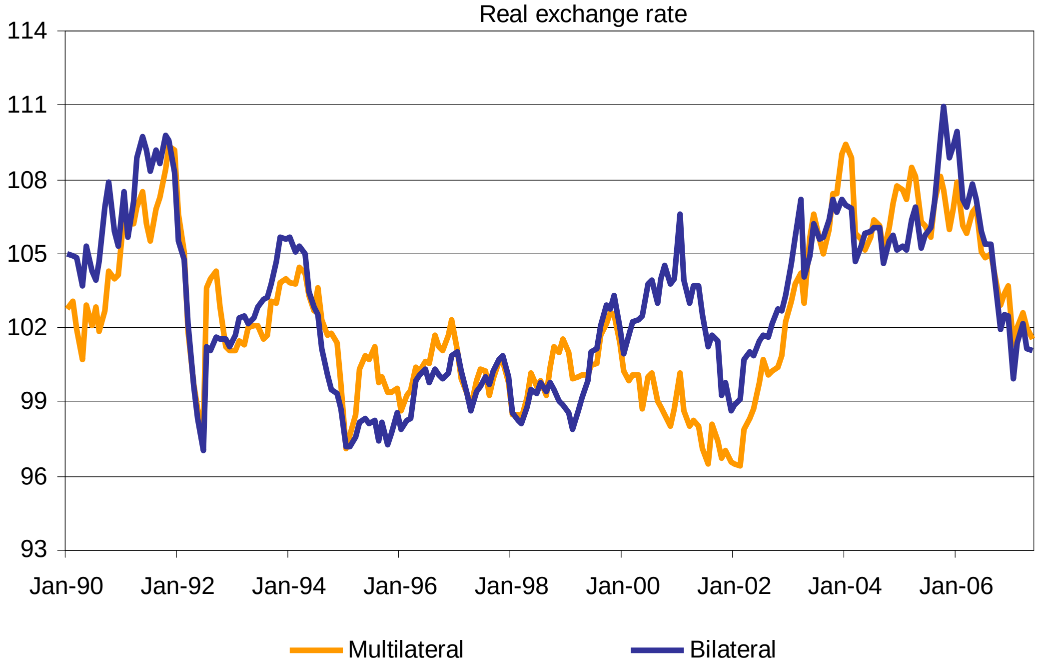
Figure 7
Foreign net reserves



Source: CEFSA (n.d.).

[12] In October 2006 the central bank, after 22 years, announced a departure from the crawling peg system, moving to price bands. Unlike the previous years, significant flows of short-term financial capital entered and exited Costa Rica while the band system was in place. The experiment has been deemed a failureby many, and at the time of writing (September 2008) it seems as if this shift is being reversed.

Figure 8
Real exchange rate



Source: CEFSA (n.d.).

Financial markets: Until 1995, Costa Rican law permitted the government to conduct financial intermediation only through commercial banks. Allowing for the existence of private banks was a big change, which promoted more competition in interest rates, better services and wider access to credit. On the other hand, it necessitated the improvement of the institutions that perform financial supervision, and of regulatory law. In addition to banking reform, a comprehensive reform to the pension system was undertaken, transcending from a pay-as-you-go and demographically bankrupt system in which all pensions were managed by the government, to a capitalized, solvent system of individual accounts that allows each individual worker to choose the (private or public) institution to manage his pension.

Simplification: Various efforts were made to eliminate redundant paperwork and excessive regulation. These attempts have not been entirely successful, as red tape has a tendency to re-emerge on its own. In fact, as documented in detail (Cornick and Trejos 2008), one could argue that rules and procedures for the day-to-day operation of government have become increasingly cumbersome and costly. Be that as it may, the interaction of private citizens and private firms with the government was significantly simplified.

Industrial policy deregulation: The pre-crisis Costa Rican economy was very heavily micro-managed by the government. Some reforms since then attempted to create the freedom that would allow private initiative to undertake most decisions. For example, the central bank ceased to set detailed loan portfolio quotas and predetermined interest rates, by sector and bank. The economics ministry gradually reduced the number of goods on which it regulated maximum prices; today, there is only one product, rice. A separate authority, based on purely technical criteria, handles the price regulation for public services. Government no longer carries out the commercialization of grains and other foodstuffs (as it did through the *Consejo Nacional de la Producción*) nor does it subsidize any products. All the publicly owned business under CODESA, a public corporation, were either closed or privatized.[13]

These policies created the basis of stability for individuals and companies to operate in. Costa Rica has not been affected by an economic crisis since 1982: government runs ordinary finances, borrows at reasonable rates, and has never been in arrears after the debt renegotiation of 1987. Reserves are sufficient and the central bank has been able to conduct the exchange rate policy of its choice; financial intermediation is adequately supervised and, despite a few isolated bank failures (none of which evolved into a system-wide problem), financial institutions (including the 50 per cent portion of the banking sector owned by the state) operate effectively. In the last quarter of a century, Costa Rica has not experienced a single year of GDP contraction. This stability, and the simpler, less distorted economy resulting from basic deregulation, have became the foundation for an economy where private initiative can respond to market incentives, operate and grow.

While these measures were a natural response to the situation faced in the early 1980s, they also followed the consensus at the times of policy analysts throughout Latin America and the developing world. In this sense, it is interesting to note the actions taken by Costa Rica, as well as the measures it chose not to implement. For instance, unlike other countries in the hemisphere, public utilities (water, power and telecommunications) were not privatized; the government continued to hold the companies providing these basic services, learning to run them profitably. Another example is social services: despite the severity of the expenditure restraints that were necessary to balance the fiscal situation, the budget for key social services was protected, not cut. Expenditures on health and education, for instance, rebounded relatively quickly after the crisis was defeated.[14] Costa Rica, thus, implemented a rather heterodox reform package which, broadly speaking, matched the policy consensus of the times.

Moreover, Costa Rica was a slow reformer but a deep one; deep because the country based its reform on the foundation of good institutions and historically-acquired strengths (most importantly, in human capital). Also whatever reform was implemented, it was done comprehensively, seeking public support, and conducted with care for detail. But it can also be considered as slow, as evidenced most dramatically by the fact that macroeconomic stabilization is incomplete, at least in the sense that inflation

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13 At its peak CODESA encompassed two cement plants, two sugar mills, an aluminum foil manufacturing plant (in a country without aluminum), several boats and ferries, and the Costa Rican stock exchange, among other companies, all operating without profit.

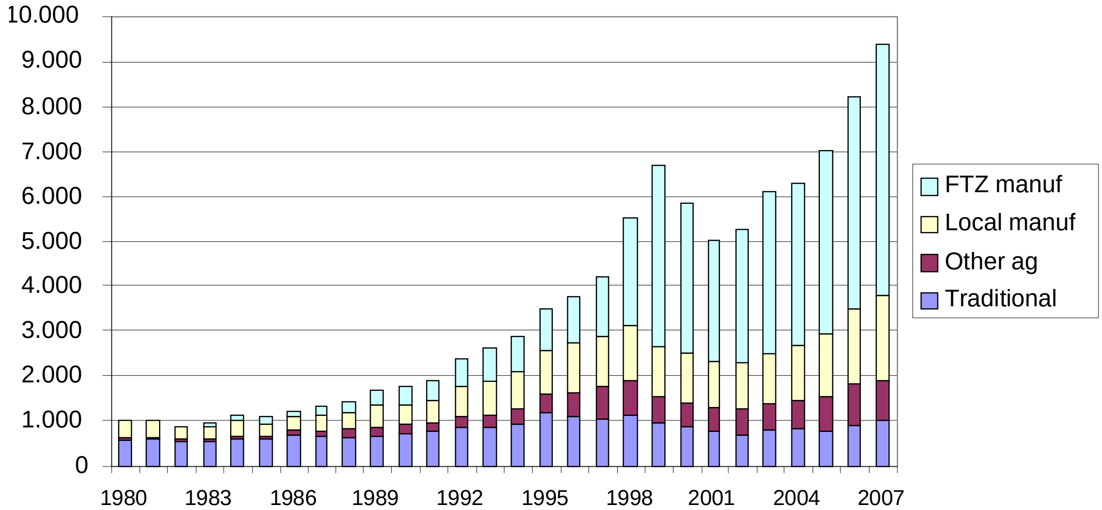
14 There is a lesson in this. Countries that pursue, perhaps under the incentive and supervision of international financial institutions, fiscal probity and macro stability in the short run without caring about the political sustainability of their actions in the long run, will probably exhibit good results for only a little while. The same applies for countries where good investments in growth foundations are the ones that get sacrificed; debt sustainability and dynamic tax collection are usually possible only with fast-growing economies.

remains in double digits, and that in some key markets (telecoms, for instance) deregulation has taken very long.[15]

3.3 Trade and investment

As argued in Trejos (2007) the main reason why Costa Rica has been able to enjoy relatively high economic growth is its success in internationalizing the economy, liberalizing trade, promoting exports and attracting foreign direct investment. In any economy, there are several reasons why globalization is a better option. These reasons are compounded when the country is unique, thus improving its comparative advantage from potential gains; if the country is small, there are economies of scale to be gained from the international market, and if the country is backward, technological transfers often implicit in trade and FDI can introduce value. But more to the point, in the case of Costa Rica, entering the international market has become a feasible way of taking economic advantage of the many non-economic benefits mentioned in section 3.1. Costa Rica is a uniquely productive country, able to compete in the production of complex goods in a stable environment with an educated labourforce; it is not merely the exporter of raw materials and low wages.

Figure 9
Exports of goods, FOB



Source: Elaborated by the author from PROCOMER data.

There are several dimensions in which the internationalization of the Costa Rican economy has been successful:

Export growth: As Figure 9 illustrates, exports of goods have grown dramatically, from US$870mm in 1982 to US$9,400mm in 2007, accounting for an average annual growth rate of 9.5 per cent. This growth has been almost uninterrupted: exports fell only during the 2000-02 global recession. The engine for the expansion is not the traditional export products (coffee, bananas, beef and sugar), but rather new goods and services. For instance, other ‘non-traditional’ agricultural goods grew from virtually nothing to

[15] Despite the healthy finances of the non-financial public sector, the Costa Rican Central Bank still holds a large deficit, as it was the repository of many international obligations acquired before the crisis, and consolidated during the debt renegotiation. This helps to explain the high inflation.

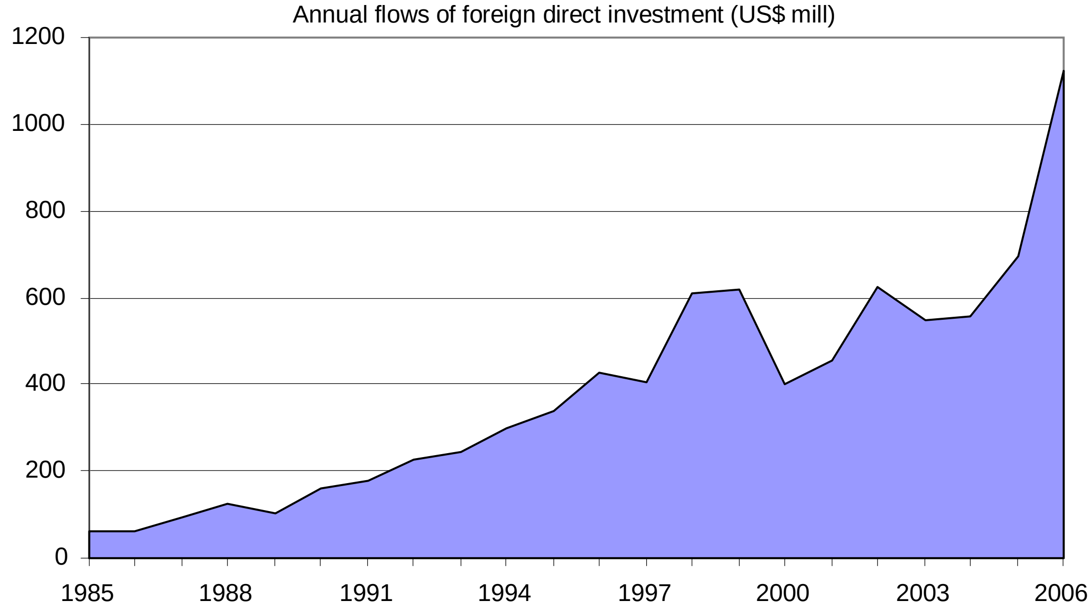
surpass the old products by 2005. Manufacturing exports have boomed, both from local firms and from foreign firms in special processing zones (FTZs). Finally, Costa Rica has become an important services provider worldwide, including prominently high-value ecological and adventure tourism, and professional and business-related services, such software, back offices, medical services, etc.

The policies pursued for achieving this have been varied. Notably, trade liberalization, in the form of unilateral tariff phase-outs and non-tariff barrier reductions, has reduced the anti-export bias (which is high in a country that depends on foreign raw materials for its manufacturing) and induced a more competitive supply of logistics and trade-related services. Preferential access to key markets has been achieved and protected. This has been in the form of unilateral preferences received from the US and Europe, membership in the Central American Common Market (CACM, which is slowly evolving into a customs union), very active participation in multilateral negotiations and, notably, bilateral free trade agreements with partners that amount to 93 per cent of current trade, including the United States (Costa Ricans voted for membership in CAFTA, the Central American Free Trade Agreement with the United States and the Dominican Republic, in a national referendum held last October 7) and the European Union. These agreements have also been instrumental in committing the country to some necessary reforms. As was mentioned before, exchange rate policy has avoided real over-valuation, and secured competitive and stable terms of trade for exporters. Finally, between 1983 and 1998, there was an export subsidy (in the form of a tax credit worth 15 per cent of the value of exports) that also encouraged many local companies, especially in agriculture, to enter the export markets. Even though these subsidies were eliminated once they had become corrupt and too costly, today there are more sophisticated methods of support for exporters, in particular in the form of training, technical support, simplified paperwork and improved logistics, facilitated partly by PROCOMER, a private branch of the ministry of foreign trade. DAACI, another branch of the ministry, oversees the implementation of trade agreements and offers support to local exporters in dealing with the trade policies of foreign governments.

Export diversification: In 1982, the four unprocessed commodities that had been Costa Rica's staple products for one hundred years (coffee, sugar, bananas and beef) accounted for 61 per cent of total exports; non-durable consumption goods to the highly protected CACM constituted the remainder. The exceedingly high trade barriers, the strong anti-export bias, and the overvalued currency made all other products other than the traditional commodities totally uncompetitive in the world markets (from which the country still had to acquire most raw materials as well as oil). Due to this concentration of trade, the volatility in the terms of trade was a major source of instability for the economy. In the last 25 years, as the economy opened and the CACM ceased to be the enhanced domestic market for import substitution, exports have diversified significantly. Today, Costa Rice exports over 3000 products, and while some individual items have become relatively important, no single export item exceeds 17 per cent of the total and the implicit real price of exports is rather stable. This indicates that the reforms mentioned earlier have opened up Costa Rica's hidden potential in new export activities, instead of merely enhancing the performance of the old economic drivers.

Export sophistication: With diversification comes sophistication. The new exports are mostly goods and services intensive in human capital, technology and advanced inputs rather than unprocessed commodities. Emblematically, Costa Rica's lead export has switched from bananas to Pentium chips; the second largest item is hospital equipment, not coffee. More formally, Lall, Weiss and Zhang (2006) develop an index of export sophistication, and find that Costa Rica's exports are technically more complex by one standard deviation than the income and location of the country would predict. Sophisticated export products grant bragging rights, a strategic dimension of trade policy. On the one hand, the advantages that enable a country to produce medical equipment, software or specialized electronics, for instance, are deep, stable and hard to acquire. In today's world economy, these industries are the most dynamic, and once they emerge in a country, they can also be developed, and are unlikely to disappear. Furthermore, the natural resources and low wages that promote competitiveness in unsophisticated commodities and activities are fragile and easy to emulate. On the other hand, industries related to complex exportable goods are a much better reflection of a country's development objectives than its traditional products. A nation investing heavily in education wants its labourforce to be working high technology, not cutting fruit; in targeting investments to the environment, the country is striving for ecotourism, not extensive crops; it prefers to have the women of the workforce in jobs in light manufacturing and services, not herding cattle.

Figure 10
Annual flows of foreign direct investment (US$ mill)



Source: CEFSA (n.d.).

Attraction of high-quality FDI: Much of the growth in exports, especially in manufacturing, hi-tech goods and services, has taken place through foreign firms choosing to relocate into Costa Rica; foreign direct investment has been the key, expanding very quickly, as Figure 10 illustrates. Foreign-owned productive capital was estimated in 2006 at nearly US$6.7 billion. FDI per capita in 2007 was US$360, or eight times that of China. Most of this FDI is 'greenfield', i.e., new productive assets, not acquisitions, in activities that are new and strategic for Costa Rica.[16] Furthermore, most

16 The exception to this is the portion of FDI associated to real estate. Not unlike other popular tourism destinations, Costa Rica in the early years of this decade underwent a real estate boom, especially in beachfront properties, which are used as second homes by US and European buyers. One of the

seek out Costa Rica as a production facility. The attraction is *not* the size of the local market (which is small), the presence of a key natural resource (except for tourism, which is driven by ecological preservation), nor the value of privatized state assets (since nothing has been privatized since the late 1980s).

The driver of foreign investment, then, is the fact that Costa Rica is a stable country (politically and macroeconomically), with a sufficiently competitive business climate and, in particular, superb labour productivity. It is the human capital that attracts companies, especially in hi-tech activities, to Costa Rica. Of course, other policy initiatives also have a role in this. These inclue tax incentives, such as the special tax regime for foreign investors, established in free trade zones, which are exempt from taxes on profits, purchases and foreign trade, and which also enjoy special, simplified administrative procedures for all imports and exports. In addition, there is CINDE, a private non-profit institution that was established for the purpose of facilitating the foreign investment process, by promoting country brand, identifying and enticing potential investors, helping with their visits and information gathering, aiding in the decisionmaking and installation process, and maintaining contact after initial investment.[17]

4 What the 'strategy' has missed

The case study outlined above is one of incomplete success: it is the story of a country with some severe limitations, facing the worst economic crisis of its history, but striving to build upon the real abilities amassed in better times to initiate an agenda of reform. The country succeeded in stabilizing the economy and resolving the crisis. Next, some basic measures directed at deregulation and trade liberalization triggered economic opportunities through the value of the 'real abilities' mentioned above. Growth accelerated. But important as growth is, the reform agenda is incomplete, as much more still needs to done. Several major policy areas were deferred to later dates, or were pursued without the desired outcome, and which have now become priorities.

Perhaps first among these is the need to recover the capability to produce infrastructure. Let us be clear here. As was mentioned above, one of Costa Rica's historical strengths was the fact that the country by the second half of the nineteenth century had developed a valuable and dense infrastructure network in which priority was given, *correctly*, to the capillaries (multiple small connections throughout the country) rather than arteries (major central projects). It was also stated that the post-crisis design of fiscal policy prioritized stabilization, and preserving the value of social services, so that large infrastructure projects were *correctly* postponed until later.

This is not a contradiction, as the situation has changed. While it was good policy to give priority to rural roads over mega highways, clinics over large hospitals, and local water projects over large ports, now after thirty years of no major projects, the delay is

consequence of the global subprime financial crisis is that this type of real estate market has shrunk significantly as of recently.

17 CINDE also assumes a think-tank role with respect to the national debate—and the facilitation of the implementation of policy—regarding business climate improvement and competitiveness initiatives, on matters like education and training, logistics, infrastructure, energy, communications, finance, government regulation, standards, etc.

catching up. Currently, Costa Rica could afford to build some of the badly needed infrastructure along with other attending needs without placing too great a stress on public finances. In fact, failure to build certain roads, ports and facilities is probably costing the country (in loss of growth and hence tax revenue) more than it is saving through their postponement.

The problem today is that even when resources are allocated for this purpose, it is difficult to see the results. Weakened government institutions confront an increasing and now overwhelming network of checks and balances. Not only does the country need to convince itself that it can afford—and desperately needs—some key highways, at least one new airport, investment in ports, etc. Costa Rica needs to re-learn how to untangle the administrative difficulties that have amassed over the years and which today impede the undertaking of any large public project.

The second priority concerns reform in some important services, in telecoms in particular. As mentioned above, the impressive achievements in human development that make Costa Rica appear to be a richer country than it is in reality, fade when one reviews the data on telecommunications, particularly on mobile and internet services. These services are vital for a country's competitiveness in business, especially if software, back-office services and tourism are to be its key industries. Intense ideological debate on the topic has impeded the execution of almost all related projects, and the country has fallen behind.[18] As of now, it seems that Costa Rica will be able to surpass that particular hurdle. A compromise found acceptable by the majority of Costa Ricans (although too moderate for the polarized extremes) is available within CAFTA, the free trade agreement with the US.

The government's telcom (ICE) is to remain within government ownership, with special status and monopoly rights on the provision of some services, but it will also be strengthened and given more administrative autonomy. Meanwhile, a regulatory body is to be created to supervise competition, as the company is to remain in business but without its monopoly status with regard to three service lines: mobile telephony, internet and dedicated lines. This solution –opening the market to regulated competition in some telecom services, while preserving the status quo for others— is a compromise between those that wanted the existing telecoms regime to remain unchanged, and those that hoped for more aggressive reforms, including privatization. Competition is allowed, but regulation involves a number of checks and concerns that are important to the Costa Ricans, including the provision to guarantee incentives for universal service with progressive pricing.

The third priority concerns changes to the tax system, to enhance not only fairness and to seal off a number of loopholes, but also to raise the level of revenue collected. This priority, however, is not justified by the current macroeconomic situation; recall the greatly reduced debt and the surplus of 2007. But one should go beyond this fact: the

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18 Oddly, the government's telecom monopoly—called ICE—has come to symbolize the state-run economy of the past that some remember fondly, and the largely practical matter of how to run an efficient telecoms sector has developed into a very political issue, the battleground of different parties and ideologies. The biggest anti-government protests in decades occurred in 2000 when legislation was discussed and voted in Congress to allow other companies to compete with ICE and offer their own services to the public. The biggest corruption scandals in history are sadly also related to ICE procurement, making the issue even more controversial.

Costa Ricans expect a lot from their government, and some of these expectations are not being adequately met today due to fiscal restraints. It is also important to bring the inflation rate to international standards, an objective that would require the executive branch to reabsorb the service of old debts now being held by the central bank, and to account for its financial losses.

Fourth, as described at length in Cornick and Trejos (2008), it is vital that the Costa Rican government recovers its ability to make and implement decisions, and to efficiently manage the day-to-day running of public affairs. During the early stages of macroeconomic stabilization, government reform was confused with downsizing, a myriad of checks and balances were created, and the weakened institutions lost their effectiveness. Also, the political system works very slowly, because congressional rules and procedures are arcane, and were designed for a two-party rather than a multi-party, parliament.

Last but not least is the topic I consider as most important. Costa Rica needs to find ways to improve income distribution and become more equitable. It is important to realize that inequality is not a consequence of the measures undertaken in the last 25 years to accelerate economic growth—in fact, the distributional problem was much worse in the earlier decades—but is rather the result of the absence of new measures and policies. Rather than simply dismantle recent measures (as some propose), or increase the resources allocated to the same social institutions and programmes that exist today, confronting Costa Rica's distributional challenges will require new thinking, because the nature of the distributional problem has changed.

The demographics of the Costa Rican household are different. There are perhaps 10-15 per cent of the people who will never be able to solve their income problems through aggregate economic growth alone. The immigration phenomenon presents a considerable challenge, not only because of its sheer size and the stress factor imposed by the many new 'clients' needing government services, but more importantly, because immigrants with similar skills and education levels compete with the domestic labourforce, and these are the poorest workers in Costa Rica.

Today, distributional problems are also related to the increase in the skill premium: the wage returns of additional education and training. This constitutes both a very valuable instrument (schooling is more effective than ever at closing income gaps) as well as a challenge (individuals missed by these educational efforts become even more disadvantaged). Much of the inequality in Costa Rica is regional: poverty rate among the 64 per cent of the population who live in the central region is less than half that of the 36 per cent who live in the periphery. There are new aspects to the distributional challenges, such as issues related to security and crime. To resolve these issues, reducing inequality will require new measures, not simply endowing the old distributional institutions with more resources.

A more complete development strategy would have included among the three sets of policies mentioned earlier more effective action on infrastructure, telecoms and income distribution, and higher taxation. More importantly, if the government cannot deliver better outcomes soon on some of these other policy areas, sustainability of the so-far successful combination of policies would fall in question. It is important to note, for example, that political opponents to reform are very conservative in Costa Rica; they idealize the country as it was in the distant past, and they put higher priority on dismantling the post-crisis reform rather than on adding to it.

5 Conclusion

In this paper, I have argued that Costa Rica's economic performance in the last quarter of a century can be characterized as more of a success than a failure, and that this is the natural result of policies that have had a certain unifying logic. I have highlighted the role of three sets of policies. First are the policies that have made Costa Rica a special place for decades: peaceful, stable and with valuable skills. Next are the policies that have enabled the Costa Rican economy to maintain stability and which have allowed certain basic market institutions to flourish until very recently. Finally, there is the aggressive pursuit of export-led growth and FDI attraction.

This collection of policies became a development strategy because they made 'collective sense': they involved priority problems and opportunities, and complemented each other well. For example, FDI attraction is particularly valuable in a location where human skill, among other characteristics, is going to be the pull for the modern companies with sophisticated operations that could provide the country with large future potential. If a country's key comparative advantage is the presence of a specific mineral, for example, FDI attraction would neither be difficult nor important.

On the other hand, it is obvious that many features are lacking in Costa Rica. In other words, many of the policy areas were not consciously postponed in an effort to prioritize, but were placed front-and-centre, attempted, and failed. In the last ten years, distributional policies, and those related to the creation of major infrastructure, are the main failures.

What can other countries learn from this experience? I believe that certain very fundamental societal challenges related to social, human and institutional development are too valuable to be postponed until later. I can think of no economic decision undertaken by Costa Rica that has yielded better economic results than democracy, disarmament, environmental protection and social programmes. The very phrase 'second generation of reforms', lately used to refer to concerns about human capital, politics and institutions, suggests, in a way, that these are goals to be attempted later, once a stable and dynamic market economy had been built. But looking back at the comparative growth rates, there is something to be said in Latin America at least about the fact that Chile, Costa Rica and Uruguay—the three countries that seemingly attempted to undertake improvement in the reverse order—are also the fastest growing nations of the last two decades. Strategies that overlook this fact in trying to find quick solutions from quicker policies, while leaving these fundamental priorities for later, are unlikely succeed beyond the simple achievement of apparent macroeconomic stability, and the growth of some simple, low-cost industries.

The second lesson from the experience of Costa Rica is the role of consensus, local validation, and the 'tailor-made' approach in the country's policymaking procedure. The country may have been slow to implement these policies, but it was also consistent, and certain directions, once taken, were not reversed on a whim. This has a lot to do with the fact that the reform push came from within the country, from a strong body of technocrats and political leaders who consistently pursued these aims. Countries, where policy design is instigated from the outside, say, by the international financial institutions, so that there is little customization, or countries in which governments act without creating a sufficiently wide basis of support, may be quicker to act, but are probably also quicker to dismantle.

The third and final lesson concerns the value of trade for a very small developing economy. Reforms in Costa Rica were able to generate some quick successes, and a basis of support because of the speed and strength with which trade policy produced results. I am convinced that it is not a coincidence that no *small* country has achieved very fast rates of growth in isolation. The benefits of exploiting comparative advantages, of operating in a larger market, of subjecting local monopolies to competition, of adopting technology and of having a sector of the economy grow to double digits are simply too great to overlook. The Costa Rican trade story is not a defence of *laissez faire*, as successful policies were often proactive. It offers no guarantees, as the process to develop a dynamic export sector and to attract interesting companies involved complex challenges and required good design. But it does help to conclude that joining the global markets is a great opportunity for the small countries of the developing world—at least when it is done well.

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