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**Costa Rica:
Policies and Conditions
for Export Diversification**

Ennio Rodríguez

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ABSTRACT

Over the last thirty-five years, Costa Rican exports (in dollars) have grown at an average annual growth rate of 10.8 per cent. In the context of an import substituting industrialization and subregional integration, exports grew at increasingly higher rates through the sixties and seventies; but the severe external debt crisis in the early eighties led to export stagnation. In the late eighties and through the nineties, there has been a substantial recovery, which shows to some extent the effect of a second generation of export promotion policies.

The transition to a more open, less distorted economy has been gradual and carefully avoided recessions and massive unemployment after the 1981 crisis. The initial emphasis was on a more appropriate and stable exchange rate, and direct subsidies to compensate for the anti-export bias, targeted on promoting traditional exports to third markets. As export diversification gathered momentum tariffs have been reduced and other distortions removed.

Non-traditional exports exceeded the value of traditional exports in the nineties. Export growth rates averaged 12.3 per cent from 1987 to 1995 and are among the highest growth rates in Latin America for that period. Moreover, in the nineties, part of the export promotion effort has been made in areas that are not included in 'exports'.

The value added of *free-trade zone* exports has increased very rapidly, from \$25.4 millions in 1990 to \$142.1 millions in 1995, an average annual growth rate of 41.9 per cent. Local purchases from *free trade zones* increased at an annual rate of over 30 per cent during 1993-95, albeit from a small base. Average investment per firm increased 10 per cent per annum and average wages in US dollars increased at a rate of 21 per cent. On the other hand, the value added of *maquila* exports has been less dynamic due to quota restrictions, rising competition and the end of some export incentives. Nevertheless, this sector contributed with \$126 millions in 1995, which is an 11 per cent of traditional exports.

Tourism has also risen, which is explained in part by fiscal incentives. An indication of the structural change taking place is that the share of research and development intensive activities has increased in the industrial sector total production. The participation of 'Science Based Industries' increased from 5.7 per cent in 1989 to 14.1 per cent in 1995, and 'Differentiated

Products Industries' increased from 4.8 to 8.5 per cent. 'Natural Resources Based Industries' and 'Labour Intensive Industries' both decreased, from 59.4 to 51.0 per cent and from 10.8 to 9.0 per cent, respectively.

Another indicator of rising competitiveness is the increase in locally designed computer software, which in 1996 reached US\$11 million, the highest in Latin America. The competitiveness of Costa Rica in the electronics sector has been well documented. Further evidence is the fact that, in 1997, INTEL started setting up a plant for the assembly and testing of microchips, with an investment of between US\$300 and US\$500 and expected sales of US\$5.000 million.

I ANTECEDENTS

A few antecedents, even if outlined in broad strokes, are needed to assess Costa Rica's experience in export diversification, both to understand the results and why certain policies have been implemented.

Costa Rica is a middle income developing country with a total population of 3.5 million in 1997, and is expected to reach a net reproduction rate by the year 2005. Population density was 67 persons per square kilometer in 1995, and will reach 103 by 2020. Since the human development index began to be calculated, Costa Rica has been one of the top two Latin American countries. Moreover, life expectancy at birth of 76 years in 1995 surpassed that of the United States.

Although historians argue about the date at which a democratic form of government was firmly established, 1889 has been cited. In any case, important developments in the last third of the nineteenth century also include the abolition of capital punishment in 1870; the separation between state and church; the reduction of the military budget (the army was formally disbanded in 1948) and the increase in public education expenses, with the declaration of free and compulsory elementary education; and the strengthening of the judicial system. By the end of the last century, consensus-creating institutions had been firmly established.

Soon after independence in 1821 coffee was introduced. From 1832 onwards the expansion of coffee was extraordinary. The more specialized activities of processing and international marketing underwent, almost immediately, a process of concentration. Meanwhile the process of land concentration seems to have been much slower in manifesting itself and its timing is still subject to debate. The absence of large contingents of workers on the one hand, and of strong concentration of capital on the other, in the face of the intensive but seasonal requirements of labour in the cultivation of coffee, checked the development of large *haciendas* to some extent. A symbiosis between the *haciendas* and the surrounding family plots developed, thus ensuring the survival of small producers, who even today account for a significant share of total coffee production.

Banana production developed as a result of the construction of railroads for the increasing foreign trade towards the end of the nineteenth century. A system of plantations was developed by the builders of the railroads, as

land had been granted to them in partial payment for the investments made. On the other hand, the finalization of the construction of the railways had left idle a large contingent of workers brought mainly from Jamaica for their construction.

Large tracts of arable land in the hands of the state became the escape valve for the periodic crises resulting from fluctuations in coffee and banana prices. Spontaneous and organized colonization of the agricultural frontier absorbed displaced farm workers and brought new areas into production. This mechanism operated throughout the nineteenth century and up until the limit of the agricultural frontier was exhausted in the early 1970s. Following that, a more organized programme of distribution of untilled land was developed on the basis of the experiences of the colonization process, which played an important part in providing rural employment until the export diversification of the second half of the 1980s. To some extent, Costa Rica has been likened to a case of the 'staple theory of economic growth'.¹

Export diversification was slow and so was the development of industrial activities. Primary export-led growth provided for a fast growing population. To outside observers, change in Costa Rica appears to have been slow, but this reflects its past successes. In general, the case for change, in the absence of major crises, has had to be made carefully and the costs of the transition carefully weighed. Indeed in 1940 coffee accounted for 53 per cent of total exports, bananas for 25 per cent, and cocoa 8 per cent. From 1950 until 1954 bananas and coffee accounted for 88 per cent of total exports, and from 1955 to 1959 for 84 per cent. In the late 1950s and early 1960s new export commodities included beef and sugar, supported by subsidized credit programmes as well as increasing research and technical assistance. The banking system had been nationalized in 1949, and credit allocation and subsidized interest rates were normal tools of economic policy.

Over the last thirty-five years Costa Rican exports (in dollars) have grown at an average annual rate of 10.8 per cent. In the context of an import-substituting industrialization and subregional integration, exports grew at increasingly higher rates through the sixties and seventies, but the severe

¹ Rodriguez, E. 'Costa Rica: How far can primary production take a small economy?' in Bienefeld, M. and Godfrey, M., *The Struggle for Development: National Strategies in an International Context*. London, Wiley, 1982.

external debt crisis in the early eighties led to export stagnation. In the late eighties and through the nineties, there has been a substantial recovery, which shows to some extent the effect of a second generation of export promotion policies.

II SUBREGIONAL INTEGRATION AND IMPORT-SUBSTITUTING INDUSTRIALIZATION

The high growth rates of the sixties and seventies are associated with the import substitution strategy² and regional integration with the other Central American countries (in the Central American Common Market – CACM). The first generation of export incentives were devised as incentives for manufactured exports within the framework of subregional integration, accompanied by some efforts to diversify primary exports to third countries. The incentives included high common external tariffs and tax rebates on imports of capital goods and raw materials. Exports to the rest of Central America rose from less than 5 per cent to 20 per cent of total exports in just a few years in the sixties. They remained stable afterwards, reaching a peak in 1980. However, due to a combination of internal conflicts in the region and the payments crisis arising from the debt crisis, Central American markets lost dynamism during the eighties, while non-traditional exports to other markets became increasingly important.

In 1954 a moderate tariff for industrial protection was introduced, and in 1959 it was replaced by the Law of Protection and Industrial Development. In the 1950s the manufacturing sector consisted mainly of traditional consumer goods; firms were small and family owned. Food processing, beverages, tobacco, textiles, shoes, clothing, lumber and wooden furniture and accessories accounted for about 80 per cent of industrial output in 1955. The pressure from the Chamber of Industry in favour of an import-substituting strategy had met with some resistance. However, a decline in coffee prices meant a 40 per cent decline in the barter terms of trade between 1954 and 1962. There was a growing perception that the limits to staple growth had been reached. The agricultural frontier was rapidly being exhausted and attempts to diversify agricultural exports had achieved only limited success. Industrialization was then seen as the alternative. At the

² Although the highest growth rates, achieved in 1976–78, are explained by a boom in coffee prices.

time, the recommendation of the United Nations Economic Commission for Latin America and the Caribbean to tackle the limitations imposed by the small size of the internal market was regional integration. Further pressure for regional integration came from the US Alliance for Progress. Costa Rica joined the Central American Common Market (CACM) in 1963.

Free regional trade was established for industrial products behind a high common external tariff. Protection was high for consumer goods and low for intermediate and capital goods, resulting in high nominal and effective levels of protection. In 1962, the five CACM member countries signed the Central American Agreement of Fiscal Incentives for Industrial Development, which included total or partial exemptions from import duties for capital goods, intermediate products and raw materials; and an income tax deduction for certain investment expenditures. Other instruments included: an overvalued exchange rate; subsidized interest rates that were sometimes negative in real terms; other extraordinary tariffs and surcharges; and higher selective consumption taxes for imported goods from outside the region. A vocational training institute was created (Instituto Nacional de Aprendizaje) funded by a surcharge on the payroll of both the private and the public sectors, largely dedicated to the training of technicians in demand for the industrial activities. A high level technical university was also established (Instituto Tecnológico de Costa Rica).

Industrial production soared, and manufacturing increased its share of GDP from 14 per cent in 1962 to 20 per cent in 1973; employment in manufacturing increased its share of total employment from 11 to 12 per cent; and industrial exports, which represented 14 per cent of total exports in 1962, increased to 25 per cent in 1973. The overall rate of growth of the economy was 7.1 per cent per annum from 1962 to 1974. Although the share of traditional exports had dropped to 73 per cent in 1972, down from 85 per cent in 1963, only 7 per cent of non-traditional exports were sold outside the CACM in 1972.³

During the seventies, trade within the CACM lost dynamism. The oil shocks in 1974 and 1978 and the wide fluctuations in commodity prices, especially coffee and beef, generated payments problems. The limits to the 'easy phase' of import substitution were becoming apparent. From 1974 to

³ Non-traditional exports are comprised of all exports except coffee, bananas, beef and cocoa. [All other exports are considered 'non-traditional' except 'maquila' and 'free-trade zone' exports which are registered as services.]

1978 Costa Rican exports to the CACM grew at the lower rate of 7 per cent per annum. However, industrial GDP still grew at the slightly higher rate of 7.4 per cent per annum.

The most significant internal determinant of the limits of import-substituting industrialization was the highly skewed income distribution of the region (excluding Costa Rica, it is among the worst in Latin America). The internal market is thus smaller than what population figures might suggest. Nevertheless, while the CACM as a whole was witnessing a decline in the rate of industrial investment in the 1970s compared with the 1960s, Costa Rica saw an increase in the rate of capital formation throughout the decade from under 20 per cent in the 1960s to over 25 per cent at the end of the following decade. Part of the explanation is the financial reform of 1972 which allowed private financial intermediaries to tap savings and lend for consumption purposes; that in its turn led to a consumer durables boom. This later exhaustion of import-substituting possibilities in Costa Rica, as compared with the other members of the CACM, may also be explained by the different patterns of specialization of their industrial sectors. Costa Rica had specialized in consumer durables (metal goods and electrical equipment), her neighbours in the traditional manufacturing sectors (textiles/clothing and leather/shoes).⁴ To the extent that income elasticity of demand is higher for durables than for traditional manufactured goods, it was to be expected that Costa Rican industry still showed growth while her partners might have already exhausted the possibilities of the regional market.

From 1978 to 1982 exports to the CACM grew at an annual rate of 1.3 per cent and GDP at 2.3 per cent. Costa Rica had a severe debt crisis in August 1981. The factors leading to the crisis include: a severe decline in the terms of trade; a crisis of the CACM as all members faced a difficult external environment;⁵ and internal policy mismanagement leading to increasing foreign indebtedness, until the sharp increase in international interest rates made the situation untenable.⁶

⁴ Bulmer-Thomas, V. 'Trade structure and linkages in Costa Rica. An input-output approach'. *Journal of Development Economics*. No. 5, 1978.

⁵ Political and military conflicts added strain to the already faltering dynamism of the CACM. Consequently, far from counterbalancing external shocks, the CACM added to them.

⁶ For a detailed account of the factors leading to the debt crisis, as well as of its management and ensuing reform see Rodríguez, E., 'Costa Rica: A Quest for

Although intended as a transitory phase leading to the eventual development of third market exports, import-substituting industrialization had left an industrial sector generating less than half of the exports needed for imports of capital and intermediate goods, and raw materials. A decrease in tariff protection never took place until after the crisis, when the distortions introduced by currency overvaluation and subsidies for capital investment were also corrected. The system of incentives had been biased against export diversification for sales outside the CACM, particularly against agricultural exports. Again the relative success of the strategy and the interests of those favoured by its implementation kept it in place until the payments crisis; after more than two decades of record high growth rates, the crisis forced change.

However, industrial development brought about a new more dynamic entrepreneurial group, new technological knowledge, more efficient financial and professional services, and a better trained labour force. Competition within the CACM also reduced potential inefficiency levels as some initially relatively similar and protected industrial sectors were made to compete. Additionally, the 'second phase' of import substitution including the development of a capital goods sector under heavily subsidized and protected conditions was never attempted. All these elements later facilitated the transition towards a more open economy.

It is also worth mentioning that some efforts to diversify exports outside the CACM were undertaken during the seventies. The Export Promotion Law of 1972 included: tax certificates (certificado de abono tributario – CAT) for exports with a 35 per cent or higher value added domestically by firms of at least 60 per cent Costa Rican capital and producing from a list of preselected products, which consisted of a 12 to 15 per cent subsidy on the value of exports (a higher subsidy the greater the value added); reimbursement of taxes paid on raw materials and intermediate goods used to produce exports; the 'increase in export' certificates (certificados de incremento de las exportaciones – CIEX), providing a one-year subsidy of 1 to 10 per cent paid on the increase in value of exports from one year to the next; and, finally, a drawback system for the promotion of the *maquila* industry. The impact of the Export Promotion Law was limited as its

Survival' in Griffith-Jones, S., *Managing World Debt*, London, Wheatsheaf, 1988.

application was cumbersome, export taxes remained, export procedures were complicated, and the currency was highly overvalued.

III EXPORT DIVERSIFICATION AND STRUCTURAL CHANGE

The transition to a more open less distorted economy has been gradual and carefully avoided recessions and massive unemployment after the 1981 crisis. The initial emphasis was on a more appropriate and stable exchange rate, and subsidies to compensate for the anti-export bias, targeted on promoting non-traditional exports to third markets. As export diversification gathered momentum tariffs have been reduced and other distortions removed. Shock treatment of the external sector has been avoided. External support to the export diversification strategy came mainly from USAID, following the debt crisis, which took place one year before the Mexican crisis. Support from the IMF and the World Bank only came after some success in macroeconomic stabilization and export diversification had already been achieved.

This section describes, first, trade policies and export incentives in the eighties and the first half of the nineties. Second, some export diversification achievements are analyzed.

Exchange rate policy. Prior to and during the import-substituting phase, there was a fixed exchange rate system to which several adjustments in parity had to be made. In 1981, after a speculative attack on the currency, a floating exchange rate system was temporarily adopted, which was then followed by a crawling peg. Some modifications have been introduced since then, but it is basically the same system that is still in place. The rate of depreciation has been mostly determined by purchasing power parity considerations, though the behaviour of capital flows has also been taken into account. Exchange rate policy has been key to the promotion of exports by contributing to the creation of competitive conditions.

In the eighties, the exchange rate policy actively sought to promote exports, while in the nineties, it has aimed at maintaining purchasing power parity. From 1980 to 1990, the real effective value of the currency depreciated by 55 per cent, but it has remained fairly stable since then. It is also noticeable that Costa Rica was one of the first countries in Latin America that had

important real depreciations in the first part of the eighties. Then in the nineties, while there has been a trend towards real appreciation in many countries, Costa Rica's real effective exchange remained fairly stable.

Tariffs. Tariff reduction has been gradual, and has allowed for an adaptation of firms to the more competitive environment. The exchange rate policy contributed to smoothing the transition. There never was a process of generalized closures or reduction in employment levels in the manufacturing sector. High tariffs were not used as a result of regional competition. The first tariff reduction programme of the CACM in 1986 revealed the presence of 'water' in the tariffs. Initially, there was a simplification and reduction of maximum tariffs, which did not lead, however to a generalized reduction in effective protection.⁷ Central America was among the first to start liberalizing trade in Latin America. By 1990 its tariffs were reduced to within a range of 5 to 40 per cent. In 1993, a further reduction of tariffs took place still leaving the maximum tariff at 40 per cent. Finally, in 1996 another planned reduction was agreed, a CET range of 0 to 15 per cent by the year 2000.

Direct subsidies to non-traditional exports. In February 1984, the Public Sector Financial Equilibrium Law was passed in Congress. Its main objective was to reduce fiscal imbalances by creating new taxes and granting new powers to Central Government to control the fiscal deficit. It imposed taxes on traditional exports (coffee, bananas, sugar cane and meat), which were deemed to be realizing windfall profits after a 500 per cent exchange rate devaluation in 1982. At the same time, this law approved the following incentives to non-traditional exports under an 'export contract':

- A. Duty-free intermediate goods importing
- B. Income-tax exemption
- C. Tax-saving certificates (CAT)

The right to *ex-ante* duty-free importing was granted to exporting companies, in the absence of a duty drawback system. It is not a subsidy so much as a mechanism to facilitate trade for exporters. The income-tax exemption benefit appears to have been significant, but there are no firm data to confirm this. According to informal estimates by the Ministry of

⁷ Mange, R. *La Reform arancelaria: El caso de Costa Rica*. San José: Prodesarrollo, 1987.

Finance, the fiscal cost of this benefit in 1996 could have been around 0.25 per cent of GDP.

The CAT had existed since 1972, but it was enhanced by the 1984 Law. It is a subsidy granted initially for a period of ten years as a way to compensate exporters for domestic distortions that impair competitiveness and as a way to cover possible costs of entry to new markets with new products. It is intended for non-traditional exports only. The CAT is equivalent to 15 per cent of the F.O.B. value of exports, when they are destined to the Western Hemisphere, or 20 per cent, when destined elsewhere. The entitlement itself has a maturity period of 18 months.

It can be argued that as a subsidy, the CAT has not been efficient because it does not address specific distortions. Rather, it has been general (the only exception being traditional exports) with only some minor restrictions in terms of value added requirements and other qualifications. However, it seems to have been very effective according to Agosin, Gitli and Vargas,⁸ who studied the impact of CAT on export growth. In their work, the growth of US imports from the Caribbean Basin countries, excluding oil, is compared to the growth of Costa Rican non-traditional exports destined to markets other than Central America from 1985 until 1994, on the assumption that the difference in growth rates is due to the subsidy. They also assume that the average added value of exports is 40 per cent, which allows them to estimate an increase in the value added due to the CAT. Finally, they compare the value of the CAT granted to the increase in the exports' value added. This leads them to conclude that for each US\$1 of subsidy the increase in value added was between US\$1.42 and US\$2.05. This would mean that, in spite of its fiscal cost, the CAT subsidy has been very successful in promoting export growth. However, it is hard to argue that the difference in growth rates between the Caribbean Basin countries and Costa Rica can be attributed solely to the CAT incentive. For instance, some of the countries in the region were experiencing political turmoil that impeded their exporting capacity. Costa Rica did respond faster and more vigorously than her neighbours to the incentives of the CBI, but this could also be related to longer-term competitiveness advantages such as the education and health levels of the work force, and the credibility of macroeconomic and trade policies.

⁸ Agosin, M., Gitli, E, and Vargas, L. 'La promoción de exportaciones en Costa Rica: Diagnóstico y recomendaciones para la próxima etapa'. San José, COMEX, February, 1996.

Hoffmaister,⁹ on the other hand, concludes that export subsidies had little effect on Costa Rica's impressive export growth rates on the basis of his estimate of exports in the absence of CATs. Using quarterly data for the years 1970 to 1989, Hoffmaister fits a regression model in which export volume is a function of: CAT subsidies, relative prices, nominal exchange rate and real GDP. Based on his simulation of a scenario without CATs, Hoffmaister concludes that each dollar of subsidy appears to have increased exports only by US\$1.35. The estimated model, however, has serious limitations. Due to data limitations, the dependent variable is the volume of all non-traditional exports including very large categories not eligible for CAT subsidies: export processing zones and exports to the CACM.

A more simple approach, undertaken by Willmore,¹⁰ allows him to conclude that for each dollar of subsidy exports increased by US\$3.70 for the 1984–90 period. Willmore fits a linear trend to non-traditional exports for the years 1970 through 1983 and projects for the subsequent period 1984–94. The projection is only 2.5 per cent above the actual exports. However, if non-traditional exports are separated into exports to CACM and Panama, and those destined to the rest of the world, interesting results can be observed. Actual intraregional exports drop sharply while the projected trend is positive. The result is the reverse for exports to the rest of the world, for which no positive trend is projected and actual exports mushroom. CAT subsidies would explain the expansion in non-traditional exports to the rest of the world. In fact, much of the increase in extraregional exports is offset by a decrease in intraregional sales.

From a fiscal perspective, the CAT may indeed have had an excessive opportunity cost. In 1989, 1990 and 1991, export subsidies represented more than 1 per cent of GDP. These high costs led Congress to pass a new law in 1992 extending the maturity of CATs from 12 to 18 months, which caused a reduction in costs in 1993. It also eliminated the possibility of granting export contracts to new companies. The existing contracts began to expire in 1996, which has also meant the end of the income-tax

⁹ Hoffmaister, A. 'The cost of export subsidies: evidence from Costa Rica'. *IMF Staff Papers*, Vol. 39, No. 1, 1992.

¹⁰ Willmore, L. 'Promotion of exports in Central America: An analysis of second-best policies'. United Nations, Department for Economic and Social Information and Policy Analysis. Working Papers, No. 14, ST/ESA/1997/WP14, 1997.

exemption benefit to some exporters, but CAT issuance will not end until the year 2000. In contrast, the remaining taxes on traditional exports were removed in 1995. The taxes on coffee exports were transformed into an income-tax equivalent, while the tax on banana exports was drastically reduced and will be completely eliminated in 1998.

Limits to the second generation of incentives were reached both from fiscal considerations and because of the implementation of Uruguay Round agreements. A third generation of export incentives is currently under consideration.

Credit. Following the financial reforms of 1972, before which the banks were state-owned, private sector financial institutions were increasingly able to tap into private savings, and in the eighties were quite prepared to finance the rapidly expanding foreign trade.¹¹ Additionally, commercial banks had access to special credit lines made available by the Central Bank, to finance both working capital and fixed capital investments. These programmes have been specifically targeted on non-traditional exporting firms. Most of the time, interest rates on loans in these programmes have been lower than on regular credit lines.¹²

International trade agreements. On 1 January 1984, the Caribbean Basin Economic Recovery Act (CBI) came into effect in the United States granting duty free access to US markets for exports from beneficiary countries for 12 years. It was later extended for an indefinite period and some improvements added, such as exemption from the cumulation clause.¹³ However, important products were excluded, namely, textiles and apparel, canned tuna, petroleum and byproducts, leather goods and footwear. Sugar was subject to quotas. Eligibility for duty-free access is relatively lax, including a requirement of 35 per cent of value added in one or more of the beneficiary countries, of which up to 15 per cent can be US components, and that the product be 'substantially' transformed whenever foreign components are included.

¹¹ The final reform enabling private banks to offer current accounts was approved in 1995, although several financial instruments had been devised prior to this formal approval.

¹² It has been argued that the weight of this benefit has not been important relative to export value. Corrales, J. and Mange, R. 'Exportaciones no tradicionales en Costa Rica'. San José, ECONOFIN, 1990.

¹³ This exemption means that the United States will not add exports from CBI countries to those from other countries when determining injury to US producers.

CBI has provided a good opportunity for Costa Rican exports. Macroeconomic stabilization started as early as 1982 and export promotion of non-traditional exports in 1984, the first country in Central America to embark upon it. However, the exceptions to the CBI are important. More than 50 per cent of Costa Rican exports to the United States are excluded from CBI benefits.¹⁴ Indeed, the fast growing sector of textiles and apparel was excluded from the CBI. On the other hand, more intangible benefits may have been derived from the CBI, notably the increased attention of potential investors to an area very close to the United States and of some political importance to the US government.

As part of the efforts to increase its participation in international markets, Costa Rica joined the World Trade Organization and subscribed to a free-trade agreement with Mexico, which began gradually to be implemented in 1995.

Costa Rica is actively engaged in the Free Trade for the Americas (FTAA) process, initiated at the Miami Summit of 1995, which is to achieve its goal of a free trade area by the year 2005. Costa Rica has chaired the FTAA during 1997. Moreover, Costa Rica has agreed to have joint and/or coordinated trade negotiating positions with the other CACM members in future FTAA negotiations.

Science and technology. The Costa Rican development strategy has included the provision of innovation finance in some predefined sectors and training in renowned universities overseas.¹⁵ Many of the success stories of new exports with a technological component developed locally benefited in early stages of product development from the innovation financing facility.¹⁶ This facility is characterized by interest rates only slightly lower than those in the market. The important difference from the market is in the collateral required, as the project itself has normally been accepted for this

¹⁴ Mange, R. and González, C. 'Políticas de protección e incentivos a la manufactura, agroindustria y algunos sectores agrícolas en Costa Rica'. San José, ECONOFIN, 1988.

¹⁵ Rodríguez, E. and Grinspan, R. 'Selección de actividades estratégicas del sector industrial'. Universidad de Costa Rica, Instituto de Investigaciones en Ciencias Económicas, 1983.

¹⁶ Viceministerio de Ciencia y Tecnología. 'Sí se puede! Casos exitosos de investigación y desarrollo de Costa Rica'. San José, 1996.

purpose. Additionally, the link between universities and the productive sectors has been actively promoted by strengthening research and service centers which sell their services. The Center for Food Technology and the Post-Harvest Institute of the University of Costa Rica have been of particular importance for the support of non-traditional agricultural exports.

Investment promotion and institutional development. Prior to the reforms of the early eighties, the private sector was already well organized, particularly in the industrial sector, but also in agricultural and commercial activities. Private sector organizations participated actively both in policy dialogue and in the setting up of new export organizations, such as in textiles and the exporters' chamber, which have also been very active in international trade negotiations, especially fighting against quotas, and when unavoidable, in their administration.

Of particular importance was the creation of a private sector foundation financed by USAID called CINDE. CINDE spent its first two years defining its role, but from 1985 onwards three of its most successful programmes included attraction of foreign investment, a training programme (PROCAP), and the Private Agricultural and Agroindustrial Council (CAAP). In 1988, CINDE also started to promote tourism.¹⁷

CINDE's current programmes are: (i) the economic environment programme, which organizes seminars and promotes studies; (ii) foreign investment attraction; (iii) promotion of export investment projects; (iv) the intelligence system (data bases and trade related studies); (v) the agricultural services programme, which provides quality certification services and has a laboratory to respond to agricultural and agroindustrial technical demands; (vi) the supply of university texts; and, (vii) the training programme.¹⁸

The investment programme has been targeted on specific activities considered important given the macroeconomic environment. During the first stage (1984–90), rising unemployment and a difficult Central American climate due to political and military conflicts in the subregion were the context in which a decision was made to promote light assembly operations, particularly apparel *maquila*. The second stage (1991 onwards)

¹⁷ Camacho, E. 'Trade Policy and Instruments'. USAID impact on Costa Rica's development during the last fifty years. San José, 1996.

¹⁸ *Ibid.*, p. 16.

included higher technology- and skill-intensive industries, such as electronics, metal mechanics and health and care products. The economy was by then closer to full employment and the highly educated and flexible labour force was already being recognized abroad. The investment attraction strategy was based on the Irish model of targeting potential companies in the United States, Europe and later in Asia in those sectors in which Costa Rica was considered internationally competitive.

Independent evaluation of CINDE's impact on investment attraction has been positive. It was concluded that CINDE had positively influenced 61.3 per cent of the US\$556 million of direct foreign investment flowing into Costa Rica between 1986 and 1990, and that 42 per cent of the decisions to invest overseas had not yet even been made when CINDE approached the company to promote Costa Rica.¹⁹

CINDE's training programme was targeted on the human resource needs of non-traditional exports, including managers and top level administrators, university lecturers, and personnel from private financial institutions and the Central Bank. The training programmes emphasized practical information and strategy formulation, through 'hands on' observational learning.

The evaluation showed it had a greater impact on small and medium sized firms than on larger ones, and seems to have been more effective in the industrial and tourism sectors than in the agricultural sector. CINDE's programme was the first training programme targeted on the non-traditional export sector. Today many organizations offer training programmes to help solve export problems.

CAAP emphasized its relationship with universities and research centers and with producer organizations on the one hand, while on the other, it performed its own product selection, constraint identification and technical assistance. By 1987, twelve potential crops had been identified (cut flowers, ornamental plants, cocoa, macadamia, black pepper, asparagus, melons, root and tuber crops, papaya and pineapples), and by 1994, six new products were added (plantain, blackberries, vegetables, industrial

¹⁹ Lanza, K. E. 'Institutionalizing Export and Investment Promotion Organizations: The case of Costa Rica's CINDE'. North Carolina, Center for International Development Research, Sanford Institute of Public Policy, June, 1994.

tomatoes, hot peppers and onions). In general, two types of constraints were identified: those affecting a group of products, such as general economic policies, and those affecting a particular product, such as diseases. The programme surpassed the initial goals in terms of hectares assisted, investment, and foreign exchange generated.²⁰

Another important institutional simplification was the development in 1988 of a one-stop window for exporters, the whole process taking only a few hours; in the nineties, the time imports spend in customs was reduced to an average of half a day.

Export diversification results. Non-traditional exports have exceeded the value of traditional exports in the nineties. Overall export growth rates averaged 12.3 per cent from 1987 to 1995 and are among the highest in Latin America for that period. Moreover, while from 1980 to 1983 exports of non-traditional products to markets outside the CACM accounted for only 15 to 18 per cent of total exports, they doubled from 1984 to 1987, and by 1995 represented 46 per cent of total exports.

The manufacturing sector increased its participation in total exports outside the CACM from a similar share to that of agriculture before 1985, to 63 per cent of total non-traditional exports in 1995. Exports from *free trade zones* increased at an average annual rate of 30 per cent during 1993–96. Higher value added industries are being attracted to free trade zones, as reflected by increasing investment per worker ratios.

Agricultural export diversification has also been successful. Non-traditional agricultural exports which accounted for less than 8 per cent of total exports during 1981–83 increased to 17 per cent in 1992, hovering around 15 per cent thereafter. Interestingly, four of the 'winners' picked by CAAP (ornamental plants; foliage, leafs and plant parts; pineapples; and melons) accounted for more than half of total non-traditional agricultural exports. Other important crops include flowers, chayotes, yucca, root and tuber crops and 'raicilla', three of which were also originally preselected. Though it is difficult to quantify the effect of CAAP,²¹ the technological packages designed and constraints overcome, including lobbying for policy and administrative change, undoubtedly had a decisive impact in the initial diversification efforts. In particular CAAP was effective in the case of root

²⁰ Camacho, E., 1996.

²¹ *Ibid*, pp. 23–25.

and tuber crops, in which there is major participation of small producers, many in the areas of land redistribution programmes of the seventies and early eighties. The research centers in the universities and their service orientation also proved important in areas such as disease diagnosis and treatment, and post harvest management of perishable crops.

Moreover, in the nineties, part of the export promotion effort has been undertaken in areas that are not included in Costa Rican data on 'exports': *maquila* and *free trade zone* exports, and tourism. The value added of *maquila* exports has been less dynamic in recent years due to quota restrictions, rising competition and the end of some export incentives. Nevertheless, this sector contributed value added of US\$126 millions in 1995, which is 11 per cent of traditional exports. On the other hand, the value added of *free-trade zone* exports has increased very rapidly, from \$25.4 millions in 1990 to \$142.1 millions in 1995, an average annual growth rate of 41.9 per cent. Local purchases from *free trade zones* increased at an annual rate of over 30 per cent during 1993–95, albeit from a small base. Average investment per firm increased 10 per cent per annum and average wages in US dollars increased at a rate of 21 per cent. Tourism has also risen, which is explained in part by fiscal incentives. Revenues have gone up from \$275 millions in 1990 to \$661.3 millions in 1995, an annual growth rate of 19.7 per cent, making tourism the single most important foreign exchange earning activity in the country, ahead of coffee or bananas.

It is interesting to note that the structural change in total industrial production is evident in some of its most promising sectors. The share of research and development-intensive activities has increased in industrial sector total production. The participation of 'Science Based Industries' increased from 5.7 per cent in 1989 to 14.1 per cent in 1995, and 'Differentiated Products Industries' increased from 4.8 to 8.5 per cent. While 'Natural Resources Based Industries' and 'Labor Intensive Industries' both decreased from 59.4 to 51.0 per cent, and from 10.8 to 9.0 per cent, respectively.²²

Another indicator of rising competitiveness is the increase in locally-designed computer software, which in 1996 reached US\$11 million, the highest in Latin America.²³ Moreover, a recent study has concluded that

²² Central Bank, based on OECD definitions.

²³ CEFSA.

Costa Rica is competitive in the electronics sector.²⁴ Foreign investment in this sector has come in three waves, the first during the second half of the 1970s, the second during the late eighties and early nineties and the third since 1995. The first wave seems to be explained by particular circumstances, such as the instability in neighbouring countries. Firms mainly produced electrical products and only two manufactured electronic components, and served mainly the CACM.

In the second wave there was a surge in investment for the production of electronic components, particularly power conditioning components. There also were the first investments in highly sophisticated sensors for industrial and medical applications. Sensors and power conditioning components have production processes in which Costa Rica has a comparative advantage. They are produced in low volumes for niche markets with unique specifications and require a large amount of testing. Therefore, skilled labour is a major production cost, with which the country is relatively well endowed.

The third wave of investments reflects a greater concentration in power conditioning components and sensors. Recent investments include more sophisticated power conditioning components. The United States is by far the most important market for electronics exports of Costa Rica. Four-fifths of the companies export to US markets, most of them exclusively to their parent companies.

CINDE has played an active role in attracting many of these firms to Costa Rica. The factors these companies cited for locating in Costa Rica include: (i) a well educated and low-cost labour force with considerable dexterity (clearly the main factor); (ii) the fact that a large number of Costa Ricans speak English;²⁵ (iii) the speed for setting up a plant and starting operations, in some cases within six to nine months, revealing the absence of bureaucratic hurdles; (iv) cost savings of around 35 per cent over their operations in the United States; (v) the long tradition of political stability and clean business environment; (vi) the flexibility of the *free-trade zone* legislation; (vii) duty-free access to US markets under the CBI; (viii) the

²⁴ Foreign Investment Advisory Service (FIAS). 'A strategy for foreign investment in Costa Rica's Electronics industry'. Washington, DC: International Finance Corporation and World Bank, 1996.

²⁵ For example, this is one of the reasons why Acer chose to establish their Customer Service Call Operations in Costa Rica.

relative ease with which firms can bring in technical and managerial staff; and, (ix) proximity to the US. In general it was found that companies were attracted to Costa Rica because it is seen as a location enabling continuing improvement in productive processes and productivity.²⁶

For the future, instead of picking *product* winners, FIAS proposes to select *firms* from selected technology areas as they are not subject to the relatively short life cycles of products. The characteristics of the technological processes should include: (i) high value but low volume production; (ii) product lines with many different models or part numbers, requiring a large number of set ups; and, (iii) products in which final testing constitutes a relatively large part of total costs.²⁷

In 1997, INTEL started setting up a plant for the assembly and testing of microchips, with an investment of between US\$300 and US\$500 million and expected sales of US\$5,000 million.

New export or other incentives. As many of the existing export incentives are expiring, there is growing consensus that the 'third generation' of such incentives should concentrate neither on non-traditional exports, nor on global exports, but rather should assist both tradables and non-tradables as appropriate to increase overall competitiveness. The areas mentioned include among others: further economic de-regulation; an increase in infrastructure investment, including greater private sector participation; opening up of trade in services sectors; promotion of innovation, strategic alliances, technological transfers and foreign direct investment; support for market intelligence; and efficient institutions.²⁸

Social results. Many observers agree that during the process of market opening (1986–90) inequality and poverty levels were reduced in Costa Rica in contrast to other such processes in Latin America such as in Chile. Parts of the explanation are the non-recessionary path of reform and the initial conditions prior to the crisis of 1980–82. Also important were

²⁶ *Ibid.*, p. 13.

²⁷ *Ibid.*, p. 22.

²⁸ Alonso E. 'Tercera generación de incentivos'. San José, Ministerio de Comercio Exterior, 1995.

explicit poverty reduction programmes. Moreover, better than pre-crisis levels were soon achieved thereafter.²⁹

IV EXPORT DIVERSIFICATION AND COMPETITIVENESS

Another way to evaluate the impact of export promotion policies is through a Competitiveness Analysis of Nations (CAN), which is a methodology developed by the United Nations Economic Commission for Latin America and the Caribbean (ECLAC) to assess a country's relative position in international trade. It employs the OECD trade database, containing information for 88 countries. It is however limited in that the methodology uses only imports to OECD countries, excluding, particularly, South–South trade.

Methodology

CAN methodology is based on several types of indicators, as described in Agosin, Gitli, and Vargas (1996), who applied it to the case of Costa Rica. Among them, two indicators are used to construct a competitive matrix for the country:

1. Sector participation:

$$\frac{M_i}{M} * 100$$

where M_i is the OECD's sector 'i' imports from all countries and M is the OECD's total imports from all countries.

This shows the weight of a specific sector in global markets. A 'dynamic' sector is one with an increasing share in OECD trade, while a 'stagnant' one has a declining share. A given country is said to be 'better positioned', the larger is the weight of 'dynamic' sectors in total exports.

²⁹ Céspedes, V. H. and Jiménez, R. 'Apertura comercial y mercado laboral en Costa Rica'. San José, Academia de Centroamérica and Centro Internacional para el Desarrollo Económico, 1994. Morley, S. and Alvarez, C. 'Poverty and Adjustment in Costa Rica'. IDB Working Paper, No. 123, 1992.

2. Market participation:

$$\frac{M_{ij}}{M_i} * 100$$

where M_{ij} is the OECD's sector 'i' imports from country 'j' and M_i is the OECD's sector 'i' imports from all countries.

This shows the national share in the international sector market. An increase in market participation is associated with an increase in national sector competitiveness, particularly when it is compared to a rival country's market participation. A given country is 'more competitive', the larger is the proportion of sectors with increasing participation in the world market.

A three-year average for each of these indicators is used to classify all sectors of a given country in a competitive matrix, showing a country's relative position in international trade, according to the following four categories:

- **Rising stars:** (Optimal situation) Dynamic sectors in the global economy (increasing share in world trade) and in which the country is competitive (increasing its participation in the world market).
- **Declining stars:** (Vulnerable situation) Declining sectors in world trade (decreasing share in world trade) and in which the country is competitive (increasing its participation in the world market).
- **Lost opportunities:** Dynamic sectors in world trade (increasing share in world trade) and the country is not competitive (decreasing its participation in the world market).
- **Setbacks:** Declining sector in the world markets trade (decreasing share in world trade) and the country is not competitive (decreasing its participation in the world market).

		Sector participation	
		Increase	Decrease
Market participation	Increase	Rising stars	Declining stars
	Decrease	Lost opportunities	Setbacks

A third indicator is used for the construction of an 'adaptability' index:

3. Contribution:

$$\frac{M_{ij}}{M_j} * 100 \quad \text{where } M_{ij} \text{ is the OECD's sector 'i' imports from country 'j' and } M_j \text{ is the OECD's total imports from country 'j'.$$

This shows a sector's relative weight in the country's total trade volume. An increase in this index reveals a change in trade structure, which may be used to point towards possible trends, such as an increase in the relative importance of dynamic or declining sectors or a trend towards diversification of the export structure.

In addition, there are two 'adaptability' indices, that show the extent to which a country is moving towards more dynamic sectors:

(1)

$$MPAI = \frac{RP_j}{DP_j}$$

where

MPAI is the market participation adaptability index, which shows the gains in competitiveness,

Rpj: Competitive sectors of country 'j' in terms of OECD market participation,

Dpj: Declining sectors of country 'j' in terms of OECD market participation,

and (2)

$$SCAI = \frac{RS_j}{DS_j}$$

where

SCAI is the sector contribution adaptability index, which shows the gains in 'position' or country dependence of dynamic sectors in the world markets,

Rsj: Dynamic sectors, in terms of their OECD sector contribution, of country 'j',

Dsj: Declining sectors, in terms of their OECD sector contribution, of country 'j'.

The competitive matrix and adaptability indices of Costa Rica

The following table shows the competitiveness matrix of Costa Rica, Chile and Korea for 1985 and 1994 in terms of per centages of contribution to total exports (measured by OECD imports), as calculated by Agosin, Gitli and Vargas (1996).

TABLE 1
COMPETITIVENESS MATRIX

Sector	Costa Rica		Chile		Korea	
	1985	1994	1985	1994	1985	1994
Rising stars	15,3	41,5	6,4	20,1	23,0	48,4
Declining stars	65,3	49,8	41,1	48,8	10,5	12,2
Lost opportunities	15,3	7,7	3,0	2,5	57,5	35,0
Setbacks	4,1	1,1	49,6	28,7	8,9	4,5

Source: Agosin, Gitli and Vargas (1996)

Since 1985, the 'rising stars' sectors of Costa Rica have increased their contribution from 15.3 per cent to 41.5 per cent, which is greater than Chile's but less than Korea's. The dynamic and competitive sectors in Costa Rica are: clothing (men and children), underwear, vegetables, jewellery, domestic appliances, fresh fish and medical instruments.

The importance of the 'declining stars' sectors in Costa Rica has fallen from 65.3 per cent in 1985 to 49.8 per cent in 1994, while in Chile and Korea this type of sector has increased in importance, but it is less than what it still is in Costa Rica. In the case of Costa Rica, these sectors are fruits and nuts (fresh or dry), coffee, fruit preserves, alcohol and alcohol derivatives, textile fibers, gold, leather, aluminium, animal products, and photographic equipment.

The 'lost opportunities' sectors have fallen from 15.3 per cent in 1985 to 7.7 per cent in 1994. Chile and Korea follow a similar trend, but with very different values. In 1994 these sectors represented 2.5 per cent and 35 per cent in Chile and Korea, correspondingly. In the case of Costa Rica these sectors are clothing for women, meat, crustaceans, electric appliances, electricity conductors, cereals, telecommunications equipment, metal manufactures, canned foods and other processed foods, and woods.

TABLE 2
COSTA RICA: RISING STARS, MARKET PARTICIPATION AND SECTOR CONTRIBUTION

	<u>Market participation</u>		<u>Sector contribution</u>	
	1985	1994	1985	1994
Clothing (men and children)	0,4	1,3	1,3	1,8
Underwear	1,1	2,2	0,6	0,9
Vegetables	0,7	1,5	0,9	1,0
Jewellery	0,1	0,4	0,4	0,4
Domestic appliances	0,0	0,2	0,6	0,7
Fresh fish	0,2	0,2	0,5	0,6
Medical instruments	0,0	0,3	0,2	0,4

Source: Agosin, Gitli and Vargas (1996)

The setback sectors represented 4.1 per cent of total exports in 1985, but fell to 1.1 per cent in 1994. Chile and Korea follow a similar trend, but with higher values, 28.7 per cent in Chile and 4.5 per cent in Korea. In the case of Costa Rica, these sectors are sugar, cocoa, boats and ships, minerals, skins.

The adaptability indices show an increase in market participation for Costa Rica, that is, sectors with an increasing market share have grown relative to those with a declining market share. This is also the case of Chile. Korea has already achieved a high index, but it fell. The dependence of these countries on dynamic world markets, as opposed to declining markets, has increased according to the sector contribution index.

TABLE 3
ADAPTABILITY INDICES

Sector	Costa Rica		Chile		Korea	
	1985	1994	1985	1994	1985	1994
Market participation	0,36	0,40	0,08	0,12	3,36	2,07
Sector contribution	0,44	0,97	0,10	0,29	4,14	5,00

Source: Agosin, Gitli and Vargas (1996)

V SUMMARY OF CONCLUSIONS

1. Over the last thirty five years Costa Rican exports have grown in dollars at an average annual growth rate of 10.8 per cent. In the context of an import-substituting industrialization strategy and subregional integration, exports grew at increasingly higher rates through the sixties and seventies, but the severe external debt crisis in the early eighties led to export stagnation. In the late eighties and through the nineties, there has been a substantial recovery, which shows to some extent the effect of a second generation of export promotion policies. The transition to a more open less distorted economy has been gradual and carefully avoided recessions and massive unemployment after the 1981 crisis. The initial emphasis was on a more appropriate and stable exchange rate, and subsidies to compensate for the anti-export bias, targeted on promoting non-traditional exports to third markets. As export diversification gathered momentum tariffs have been reduced and other distortions removed. Shock treatment of the external sector has been avoided. Some of the success with export diversification in non-traditional agriculture was the result of 'picking winners' and solving technological and marketing problems. Selectivity has also been employed in relatively successful investment attraction programmes.

2. Longer term factors enabling export diversification include a well educated labour force with high health and living standards; a relatively good distribution of income; the managerial and entrepreneurial experiences accumulated during the import-substituting industrialization; the investment in physical infrastructure, and in research and development centers. Finally, close location and access to the US market has also been a factor.

3. Export diversification results are reflected in the growth of non-traditional exports. Non-traditional exports have exceeded the value of traditional exports in the nineties. Overall export growth rates averaged 12.3 per cent from 1987 to 1995 and are among the highest growth rates in Latin America for that period. Moreover, while from 1980 to 1983 exports of non-traditional products to markets outside the CACM accounted for only 15 to 18 per cent of total exports, they doubled from 1984 to 1987, and by 1995 represented 46 per cent of total exports. The manufacturing sector increased its participation in total exports outside the CACM from a similar share to that of agriculture before 1985, to 63 per cent of total non-traditional exports in 1995. Another indicator of rising competitiveness is the increase in locally designed computer software, which in 1996 reached US\$11 million, the highest in Latin America. Also, the electronics sector is one of the fastest growing sectors and has been very successful in attracting foreign investment.

4. Agricultural export diversification has also been successful. Non-traditional agricultural exports which accounted for less than 8 per cent of total exports during 1981-83 increased to 17 per cent in 1992, hovering around 15 per cent thereafter.

5. Moreover, in the nineties, part of the export promotion effort has been undertaken in areas that are not included in 'exports'. The value added of *maquila* exports has been less dynamic in recent years due to quota restrictions, rising competition and the end of some export incentives. Nevertheless, this sector contributed value added of US\$126 millions in 1995, which is 11 per cent of traditional exports. On the other hand, the value added of *free-trade zone* exports has increased very rapidly, from \$25.4 millions in 1990 to \$142.1 millions in 1995, an average annual growth rate of 41.9 per cent. Local purchases from *free trade zones* increased at an annual rate of over 30 per cent during 1993-95, albeit from a small base. Average investment per firm increased 10 per cent per annum

and average wages in US dollars increased at a rate of 21 per cent. Tourism has also risen, which is explained in part by fiscal incentives. Revenues have gone up from \$275 millions in 1990 to \$661.3 millions in 1995, an annual growth rate of 19.7 per cent, making tourism the single most important foreign exchange earning activity in the country ahead of coffee or bananas.

6. It is interesting to note that the structural change in total industrial production is evident in some of its most promising sectors. The share of research and development-intensive activities has increased in industrial sector total production. The participation of 'Science Based Industries' increased from 5.7 per cent in 1989 to 14.1 per cent in 1995, and 'Differentiated Products Industries' increased from 4.8 to 8.5 per cent. While 'Natural Resources Based Industries' and 'Labor Intensive Industries' both decreased from 59.4 to 51.0 per cent, and from 10.8 to 9.0 per cent, respectively.

7 Increasing competitiveness of Costa Rican exports is also reflected in a report following the 'Competitive Analysis of Nations' methodology. It shows an increase in the participation of Costa Rica in OECD trade in dynamic sectors (those increasing their share in OECD trade) when comparing 1985 and 1994, and the dependence on dynamic OECD markets, as opposed to declining markets, has also increased.

8. Finally, as many of the existing export incentives are expiring, there is growing consensus that the 'third generation' of such incentives should concentrate neither on non-traditional exports, nor on global exports, but rather should assist both tradables and non-tradables as appropriate to increase overall competitiveness. The areas mentioned include among others: further economic de-regulation; an increase in infrastructure investment, including greater private sector participation; opening up of trade in services sectors; promotion of innovation, strategic alliances, technological transfers and foreign direct investment; support for market intelligence; and efficient institutions.

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