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# Growth without Poverty Reduction: The Case of Costa Rica

by Juan Carlos Hidalgo

In the early 1980s, as was the case in much of Latin America, Costa Rica suffered its worst economic crisis in decades. Between 1980 and 1982 the economy contracted by 9.4 percent, and in 1982 average inflation reached 90.1 percent. In two years the proportion of the population living below the poverty line shot up by more than 20 percentage points to 54 percent. Multiple factors caused the crisis, including the exhaustion of the import-substitution model—a protectionist regime that aimed at replacing industrial imports with domestic production. Throughout the years this model encouraged the creation of numerous inefficient state-owned enterprises whose growing financial burden overwhelmed the government. By 1980 total public spending was 54 percent of GDP.

The country also faced a severe deterioration in the terms of trade as the price of oil soared while the price of the handful of products it exported (mainly coffee, sugar, beef, and bananas) plummeted. As foreign direct investment dried up, the current account deficit increased to 12.6 percent of GDP in 1980. Then-president Rodrigo Carazo (1978–1982) decided to resort to foreign financing to maintain the fixed exchange rate. Costa Rica's external debt quadrupled during his term in office. However, a rise in international interest rates aggravated the situation by increasing the cost of government financing. Instead of cutting public spending and getting rid of onerous state-owned enterprises, Carazo chose to deal with the government's deteriorating finances by printing money. Eventually the government was forced to devalue the currency. Inflation skyrocketed, sending hundreds of thousands of Costa Ricans into poverty.

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Subsequent governments implemented reforms aimed at transitioning Costa Rica from the import-substitution system that had been in place since the 1960s toward an export-oriented model. One of those key policy reforms was the introduction of a crawling peg exchange rate regime based on daily mini-devaluations of the colón, the national currency. The original goal was to provide more certainty to exporters for their investments by stabilizing the real exchange rate. However, since 1999 the crawling peg system increasingly enhanced the competitiveness of the export sector by undervaluing the domestic currency, which lowered the price of the goods being exported. This crawling peg system also boosted the tourism sector, which has become Costa Rica's most important industry.

In the 1990s Costa Rica implemented further reforms: it established free trade zones where companies would enjoy a tax-free regime as long as their production was solely for export purposes. Thanks to these and other incentives, in 1997 Intel chose Costa Rica as the site for one of its microchip plants. Soon after, semiconductors and computer accessories would replace banana and coffee as the country's top exports. In the early 2000s other technological, pharmaceutical and service, companies followed suit, investing in Costa Rica's free-trade zones.

In the mid-1990s Costa Rica also began negotiating free trade agreements whose main goal was to open new markets for its exports. The country now boasts free trade agreements with Mexico, Chile, Peru, Panama, the Central American

Common Market (Guatemala, Honduras, El Salvador, and Nicaragua), the Caribbean Community, the Dominican Republic, the United States, Canada, China, Singapore, and the European Union. It will soon implement agreements with Colombia and the European Free Trade Association (Norway, Iceland, Liechtenstein, and Switzerland). As a result of these reforms, the value of exports as a percentage of GDP rose from 27 percent in 1985 to 49 percent in 2007—the year prior to the global financial crisis. (The figure markedly declined after the crisis and was 37 percent of GDP in 2012).[1]

During the late 1980s and 1990s the Costa Rican economy also underwent significant structural reforms: most state-owned enterprises were privatized, although the government kept its monopolies on electricity, telecommunications, oil refinement and distribution, insurance, and alcohol production.[2] Private banks were allowed to operate checking accounts, but the government kept ownership of the four largest banks. Tariffs on many consumer goods were abolished or significantly reduced: while in 1985 the mean tariff rate was 55 percent, by 2000 it was only 5.4 percent—where it remains today.[3]

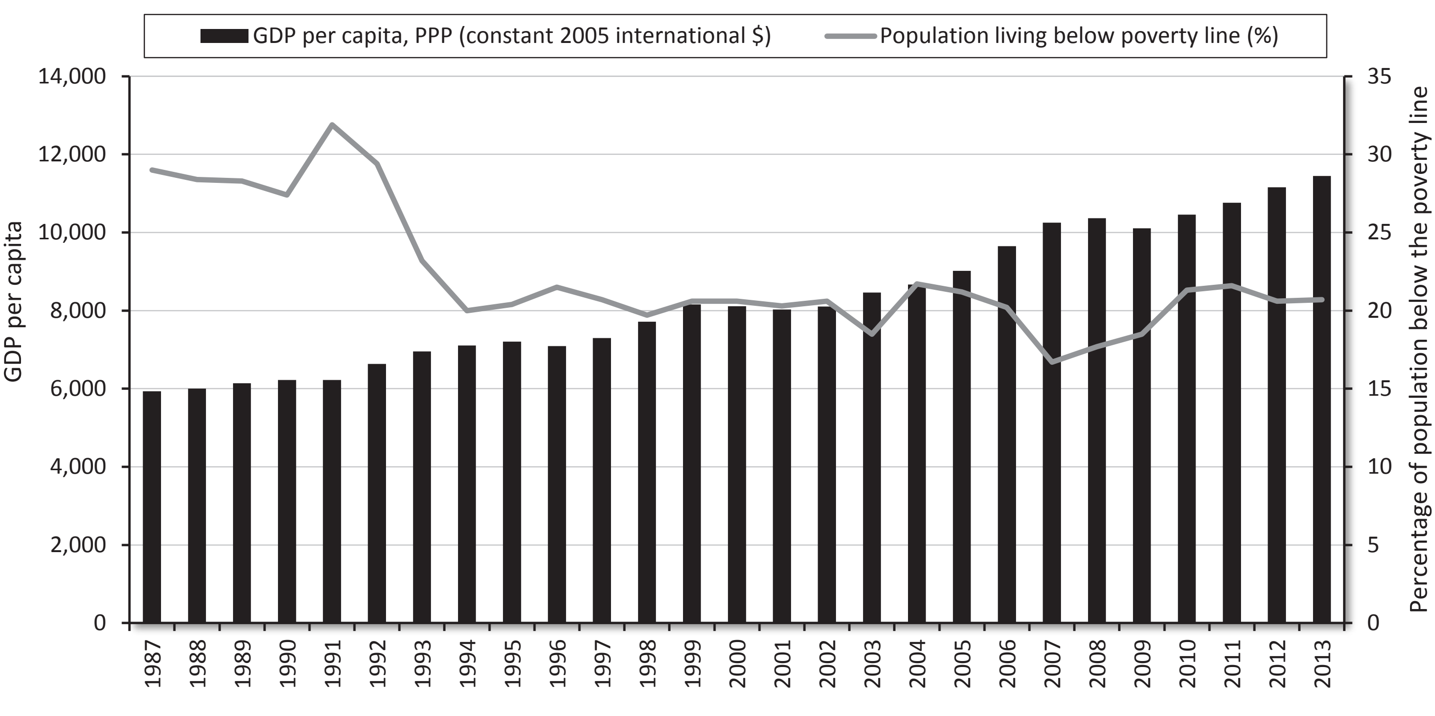
These reforms contributed to Costa Rica's significant improvement in economic freedom. The country went from 62nd in 1985 (among 109 countries) in the Fraser Institute's *Economic Freedom of the World* report to 23rd in 2005 (among 123 nations).[4] The economy grew an average 4.7 percent per year since 1987, one of the fastest rates in Latin America.

### The Social Deficit of the Model

Despite economic liberalization and healthy growth rates, Costa Rica has not been able to significantly reduce its poverty rate in the last 20 years. The proportion of families living below the poverty line fell in the early 1990s to 20 percent, but since then it has remained mostly steady with a few ups and downs. In 2013 the poverty rate was 20.7 percent[5] (see Figure 1). Disturbingly, inequality has risen in the last decade—one of only three Latin American countries where this has happened since 2000. According to the United Nations Economic Commission for Latin America and the Caribbean (ECLAC), Costa Rica's Gini Index, a measure of inequality, went up from 0.47 in 2000 to 0.50 in 2011.[6]

Costa Rica's poor performance in social indicators comes despite having a multitude of programs to fight poverty. For example, in 2010 the government spent 2.2 percent of GDP in 44 anti-poverty programs[7]—and this figure does not include other large entitlement programs such as social security and government-provided healthcare insurance. According to ECLAC, Costa Rica's social expenditure is among the highest in Latin America as a percentage of GDP.[8] There is something wrong with an economic

**Figure 1**
**GDP Per Capita (PPP) vs Population Below Poverty Line, Costa Rica (1987–2013)**




Source: International Monetary Fund, *World Economic Outlook Database*, Washington, and National Institute of Statistics and Census (INEC), *Encuesta Nacional de Hogares*, San José, Costa Rica.
Note: In 2010 the INEC changed the way it calculated the poverty level in Costa Rica, stating that poverty data prior to that year is not "strictly comparable" with subsequent years.

model that produces robust economic growth but is unable to lower the poverty rate.

In fact, Costa Rica's economic model is still in significant ways based on a mercantilist system that is biased in favor of certain sectors of the economy. A look at three important economic policies makes this evident.

**Monetary Policy**

From 1987 until late 2006 Costa Rica's Central Bank (BCCR) adopted a crawling peg exchange rate regime. The stated goal was to provide exchange rate certainty to the external sectors of the economy (exports, tourism). During this period of nearly two decades the country experienced a high inflation rate which averaged 14.9 percent a year. A significant factor contributing to high inflation in the late 1980s and the 1990s was the fact that the Central Bank monetized the huge debts it inherited from the loss-making state-owned enterprises that were liquidated in the early 1980s.

Whereas during the first 12 years of the crawling peg regime the BCCR effectively stabilized the real exchange rate, by 1999 the evidence[9] suggests that the Central Bank's interventions undervalued the currency to a greater extent, giving a competitive edge to the external sectors of the economy. This fueled inflation since the BCCR devalued the currency by printing new colones. Thus, the crawling peg regime became a subsidy from those who suffered from high inflation (average citizens holding the colón) to those whose incomes and assets were denominated in U.S. dollars (exporters, the tourism industry, and private banks, for example).

In December 2006 the BCCR adopted a new exchange rate regime in which the U.S. dollar is allowed to float within fixed bands. However, since its inception—and with only a brief reprieve during the 2008 financial crisis—the dollar has been stuck at the lower band of 500 colones per dollar, forcing the Central Bank to intervene repeatedly in the exchange market to maintain this rate by buying dollars with (newly printed) colones. Since December 2006 net foreign exchange reserves of the BCCR have increased by 134 percent—and now amount to $7.3 billion. This has created significant inflationary pressures since the newly printed colones enter the economy, dilute the value of the colones that were already circulating, and, thus, push up prices.[10] As a result, even though inflation levels have decreased since the adoption of the exchange rate bands, inflation has still averaged a hefty 7 percent a year since 2007.[11]

There are multiple reasons the exchange rate sticks to its lower band. The flood of dollars to emerging economies as a result of the Federal Reserve's monetary stimuli is certainly one of them. But it could also be the case that the equilibrium exchange rate—in the absence of the FED stimuli—should be below the 500 colones band. In any case, the BCCR's constant intervention in the exchange market aims at maintaining a "competitive" exchange rate that benefits the external sector even though it creates inflationary pressures. In a candid interview in Costa Rica's daily *La Nación*, the president of the Central Bank, Rodrigo Bolaños, openly admitted that the monetary policy of the last 30 years amounted to a massive subsidy to exporters and other groups.[12]

Inflation is the most regressive tax since it punishes the poor the most.[13] Unlike the upper and middle classes who can protect themselves more effectively from inflation by owning assets or switching their savings to foreign currencies, the poor tend not to own assets or have significant savings. Thus, they cannot shield their colón-denominated incomes (salaries, pensions, or other) from inflation. Costa Rica's monetary policy in the last 30 years has subsidized the well-off sectors of the economy at the cost of higher inflation.

**Agricultural Protectionism**

As mentioned earlier, the Costa Rican economy opened up to imports in the early 1990s by slashing tariffs on many consumer goods. However, the country kept high tariffs on a number of key agricultural products such as milk (65 percent), rice (35 percent), chicken (40–150 percent), beans (15–30 percent), pork (35 percent), potatoes (45 percent), and onions (15 percent). When negotiating free trade agreements, the Costa Rican authorities have managed to get long phase-out periods for the tariffs of these products, or even outright exclusions. As it happens, these are precisely the products consumed by the poorest segments of the population.

The impact on the poor is significant: A 1998 study by two prominent Costa Rican economists showed that agricultural protectionism reduced the income of the poorest 70,000 families in the country by 41 percent.[14] Another study in 2002 found that agricultural protectionism constitutes a burden of 17.5 percent on the income of the poorest 20 percent of the population.[15] The situation of the poor since those studies were published has not gotten considerably better. A look at the average per capita income of the poorest 20 percent of Costa Ricans reveals that the cost of a basic food basket–as estimated by the National Institute of Statistics and Census–still represents a substantial share of their per capita income (see Table 1).[16]

Despite the official rhetoric about protecting small farmers, agricultural protectionism in Costa Rica mostly benefits large producers, such as the cooperative Dos Pinos, a behemoth that exports dairy products to the Americas and even to China but that doesn't face competition from abroad. Meanwhile, the company Pipasa, currently owned by Cargill, largely dominates the domestic poultry market.

The case of rice is particularly telling. All rice producers in the country belong to a government-established cartel called Corporación Arrocera (Conarroz). By law Conarroz is the only private entity allowed to import rice duty free. Moreover, rice is the only good produced by the private sector that is still subject to price controls. Since domestic rice production normally covers national consumption for only about half a year, Conarroz can buy rice internationally at a low price, import it duty-free, and sell it in the domestic market at the same high, fixed price at which it sold the rice it produced. According to a monthly survey by the UN Food and Agriculture Organization (FAO), in November 2013 Costa Rica had the third most expensive

**Table 1**
**Cost of Basic Food Basket per Month as Percentage of Average Monthly Per Capita Income of Poorest Costa Ricans (in current colones, 2004–2013)**

| Year | Cost of Basic Food Basket (BFB)* (₡) | Average per Capita Income, First Quintile (₡) | BFB / Average per Capita Income of First Quintile (%) |
|---|---|---|---|
| 2004 | 15,402 | 15,216 | 101.2 |
| 2005 | 18,683 | 19,009 | 98.3 |
| 2006 | 20,361 | 21,324 | 95.5 |
| 2007 | 23,335 | 27,778 | 84.0 |
| 2008 | 28,597 | 33,337 | 85.8 |
| 2009 | 31,422 | 35,225 | 89.2 |
| 2010 | 37,729 | 46,519 | 81.1 |
| 2011 | 39,187 | 47,685 | 82.2 |
| 2012 | 41,602 | 50,491 | 82.4 |
| 2013 | 42,370 | 51,667 | 82.0 |

Source: National Institute of Statistics and Census (INEC), *Encuesta Nacional de Hogares*, San José, Costa Rica.
Note: June figures as used by INEC.

price of rice in the world.[17] Instead of passing the savings to consumers, the earnings are distributed among Conarroz members according to the amount of rice they produce each year. There are over a thousand rice producers in Costa Rica but a group of 100 large producers is responsible for 70 percent of the country's production.[18] They are the main beneficiaries of the current protectionist scheme.

A study commissioned by the World Bank and the International Finance Corporation found that protectionism in the Costa Rican rice market represented a direct transfer from consumers to producers and industrial firms of nearly $49 million a year between 2001 and 2005.[19] The amount of the subsidy more than doubled since then, and it reached $104 million in 2012.[20] According to one study, the least well-off suffered the most: the poorest fifth of the population spends 7.9 percent of their household per capita income to buy rice, while the richest fifth spends only 0.6 percent.[21]

As with monetary policy, agricultural protectionism is highly regressive. Due to the free trade agreements negotiated in the last decade, most agricultural protectionism will be phased out, but in periods that extend up to 20 years. In the meantime, the poorest families in Costa Rica will keep spending a significant portion of their incomes on overpriced basic foods staples.

## Regulatory and Tax Policy

While the Costa Rican government offers tax and regulatory incentives to multinational companies, it suffocates local businesses with high taxes and crippling regulations. Costa Rica ranks 102nd (out of 189 economies) in the World Bank's *Doing Business* report, which measures the costs of business regulations and taxes across national economies. The total tax rate (including labor, income, and other taxes) amounts to 55.3 percent of an average local business's profit, compared to the still high 47.3 percent average in Latin America and 41.3 percent in the Organisation for Economic Co-operation and Development.[22]

Moreover, in recent years the government has crowded the private sector out of credit by running large fiscal deficits financed by debt. The public sector's debt rose from 39 percent of GDP in 2008 to approximately 54 percent in November 2013. The estimated fiscal deficit for the public sector in 2013 was 5.8 percent of GDP, and it is expected to increase to 6.6 percent for 2014. This will only mean higher interest rates for Costa Rica's private sector.

The hostile business environment is also captured in Costa Rica's competitiveness score, as measured by the World Economic Forum's *Global Competitiveness Report*. Overall, the country ranks fairly well at 54 (out of 148 nations). However, in the particular indicator of "burden of government regulation" it falls to 94. In fact, according to the report, the most problematic factors for doing business in Costa Rica are inefficient government bureaucracy, lack of access to financing, and onerous tax and labor regulations—along with poor infrastructure.[23]

Many Costa Ricans can't cope with the heavy burden of government regulations and taxes and thus turn to informality. The latest data show that 33.6 percent of the country's labor force works in the informal sector.[24] The country's ability to further reduce poverty will be severely hindered as long as one out of every three adult working Costa Ricans is employed in the informal sector.

**A "Lost Generation"**

Other economists point out that rising inequality in Costa Rica can be explained by the widening gap in workers' skills and education.[25] The demand for skilled labor has increased relatively more than the demand for unskilled labor, especially in the most dynamic parts of the economy. The transformation that the Costa Rican economy underwent in the last 30 years has contributed to this phenomenon.

But there is another reason the difference between incomes of skilled and unskilled workers has widened. As a result of the economic crisis in the early 1980s, the high school enrollment rate–which had been rising steadily since the 1950s—dropped significantly by nearly 10 percentage points between 1980 and 1985[26] as families sent their teenage children to work. The high school enrollment rate did not return to pre-crisis levels until 1999, which means that there is an entire generation of low-skilled Costa Rican workers currently in the labor force. According to *Estado de la Nación*, a yearly review of the state of the nation, 60 percent of the country's labor force is unskilled (did not finish high school). The report adds that most of the new jobs are created in sectors that require skilled labor.[27] Thus, the widening gap in salaries will continue.

The country is still paying the price from the collapse of the previous state-dominated economic model. Rising inequality over the last decade is a byproduct of that lost generation of Costa Ricans who could not finish high school and pursue higher education due to the acute crisis of the early 1980s. And it has been aggravated by misguided economic policies that hold down the incomes and thwart the entrepreneurial endeavors of the poorest segment of the population.

**Conclusion**

Costa Rica's economic transformation of the last 30 years included numerous liberalization measures, but a closer look reveals a strong mercantilist bias. Successive administrations adopted monetary, trade, tax, and regulatory regimes that benefited the export-oriented sectors of the economy at the expense of the overall population, particularly the poor. As a result, even though the country has enjoyed a healthy growth rate for over 25 years, the proportion of Costa Ricans living below the poverty line remains pretty much the same as it did in 1994 at around 20 percent, while income inequality is on the rise.

Costa Rica needs genuine market reforms that eliminate the government's power to pick winners and losers or otherwise bestow favoritism. In the areas aforementioned, the country should

- Implement a neutral exchange rate regime either by allowing the colón to freely float against the U.S. dollar or by adopting the latter as the country's official currency.
- Abolish all tariffs on agricultural products as well as other regulations that provide monopoly powers to conglomerates that produce farm goods such as rice, beef, and sugar, and eliminate price controls on rice.
- Dismantle regulations that stifle domestic entrepreneurship, following the guidelines laid out by the World Bank's *Doing Business* project.
- Adopt a neutral and competitive tax regime that taxes all businesses domiciled in the country equally but at a low flat rate.

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**Notes**

1. World Bank, "World Development Indicators Online," World Bank Data & Statistics, http://data.worldbank.org/indicator/NE.EXP.GNFS.ZS.
2. The state monopolies in insurance and telecommunications ended in 2008 as part of the implementation of CAFTA. However, the government kept ownership of its companies in those areas that still dominate their respective markets.
3. James D. Gwartney, Robert A. Lawson, and Joshua Hall, *Economic Freedom of the World: 2013 Annual Report* (Vancouver: Fraser Institute, 2013), p. 60.
4. Ibid. Since 2005 Costa Rica's rating and ranking in the index have deteriorated, and it now stands at 49th among 152 countries.
5. In 2010 the National Institute of Statistics and Census (INEC) changed the way it calculated the poverty rate, stating that poverty data prior to that year is not "strictly comparable" with subsequent years. The proportion of Costa Ricans living below the poverty rate rose by 2.8 percentage points between 2009 and 2010, when INEC implemented its new method of calculating poverty. However, the poverty rate was already increasing since 2008 prior to the INEC change. Despite the data not being "strictly comparable" after 2010, it is the only information at hand to compare poverty rates across the last 25 years. It is worth noting that nobody, including the government, has suggested that the increase in the poverty rate is an artifact of the change in methodology. The data are available at http://www.inec.go.cr/enaho/result/pobreza.aspx.
6. In the Gini Index, zero implies perfect equality, while one represents perfect inequality. United Nations Economic Commission for Latin America, CEPALSTAT- Databases, http://websie.eclac.cl/sisgen/ConsultaIntegrada.asp.
7. General Comptroller of the Republic, Report No. DFOE-SOC-IF-12-2011, November 18, 2011, p. 3, http://www.elfinancierocr.com/accesolibre/2011/diciembre/11/informe_ayudasocial.pdf.
8. United Nations Economic Commission for Latin America, CEPALSTAT- Databases, http://interwp.cepal.org/sisgen/ConsultaIntegrada.asp?idIndicador=134&idioma=i.
9. As economist Melvin Garita documents, Costa Rica's Central Bank (BCCR) exponentially increased the pace of accumulation of foreign reserves since 1999, which, in the context of a pegged or crawling peg exchange rate, indicates that the currency is being undervalued. Melvin Garita, "Tipo de cambio y sector exportador: Impactos y propuestas," commisioned by Promotora de Comercio Exterior de Costa Rica, May 2010, p. 10.
10. The BCCR has actively engaged in "sterilizing" the newly printed colones by selling bonds domestically to financial institutions and thus withdrawing the amount of money in circulation. However, even though that has contributed to a decline in the inflation rate in recent years, the policy has its limits since the levels of monetary emission have been excessive.

11. In fairness, the BCCR's inflation record has improved in the last couple of years: it was 4.5 percent in 2012 and 3.7 in 2013.
12. "Hay que discutir cómo financiar el subsidio a los exportadores," *La Nación* interview with Rodrigo Bolaños, March 25, 2013, p. 26A.
13. A study in 2001 by William Easterly, then at the World Bank, and Stanley Fisher, then at the International Monetary Fund, looked at data from 31,869 households in 38 countries and found "direct measures of improvements in well-being of the poor—the change in their share in national income, the percent decline in poverty, and the percent change in the real minimum wage—to be negatively correlated with inflation in pooled cross-country samples." William Easterly and Stanley Fisher, "Inflation and the Poor," *Journal of Money, Credit and Banking* 33, no. 2 (May 2001): 160–78.
14. Ricardo Monge-González and Julio Rosales, "Apertura comercial e inversión extranjera," in Ronulfo Jiménez (ed.), *Estabilidad y desarrollo económico en Costa Rica: Las reformas pendientes* (San José: Academia de Centroamérica, 1998).
15. Luis Figueroa and Víctor Umaña, "Los retos de la política comercial y de la agricultura en Centroamérica: Elementos para la discusión," Working Paper CEN 560, CLACDS-INCAE Business School, 2002.
16. The Basic Food Basket (BFB) represents the cost of the minimum caloric need of an average person. It doesn't measure an adequate caloric consumption, but a bare minimum. The table presents a broad picture of the average cost of the BFB as a proportion of the national average per capita income of the first quintile of the population. A more detailed analysis would require looking at regional averages of income and regional costs of the BFB, which is beyond the scope of this paper. The methodology for calculating both the national average per capita income and the national average cost of the BFB underwent several changes during this period. Given the changes in methodology, the construction of the table follows the recommendations of INEC experts in order to present the figures in a comparable way. The table shows that, while the cost of the BFB represented 101.2 percent of the average income for the first quintile of the population in 2004, that ratio had dropped to 82.0 percent in 2013. It might seem counterintuitive that despite this improvement, the proportion of Costa Ricans living in poverty has not improved during this period. However, the BFB serves as the threshold to measure extreme poverty: a person who cannot purchase this BFB is deemed to suffer from extreme poverty. On the other hand, the threshold to measure standard poverty is the Basic Total Basket (BTB), which includes other non-alimentary goods and services, in addition to the BFB. While in the last decade the average person in the first quintile has seen his income increase faster than the CBA, this increase has not been fast enough to offset the rise in the cost of the BTB during this period.
17. Food and Agriculture Organization of the United Nations, *Rice Market Monitor* 16, no. 4 (November 2013): 22–23, http://www.fao.org/fileadmin/templates/est/ COMM_MARKETS_MONITORING/Rice/Images/RMM/RMM-Nov13.pdf.
18. Nelson Arroyo, Rudolf Lücke, and Luis Rivera, "Análisis sobre el mecanismo actual para la estimación y determinación de los precios del arroz bajo el contexto de la cadena de separate comercialización," Instituto de Investigaciones de Ciencias Económicas de la Universidad de Costa Rica (IICE), April 24, 2013, p. 95.
19. Diego Petrecolla, "Costa Rica: agrocadena del arroz," commissioned by the World Bank/International Finance Corporation, June 2006, p. 71, http://www.coprocom.go.cr/documentos/informes/InformeFinalArroz.pdf.
20. "Países de OMC están satisfechos con posible fin a subsidio arrocero en Costa Rica," *La Nación*, June 14, 2013, http://www.nacion.com/economia/Paises-OMC-satisfechos-Costa-Rica_0_1347665422.html.
21. Petrecolla 2006, p. 73.
22. World Bank, *Doing Business 2013: Understanding Regulations for Small and Medium-Size Enterprises* (Washington: World Bank, 2013).
23. World Economic Forum, *The Global Competitiveness Report 2013–2014* (Geneva: World Economic Forum, 2013), pp. 176–77.
24. "Empleo informal se redujo cuatro puntos porcentuales en la región," *El Financiero*, December 18, 2012.
25. Ronulfo Jiménez and Víctor Hugo Céspedes, "La desigualdad en la distribución del ingreso en Costa Rica: 1988–2004," in Víctor Hugo Céspedes and Ronulfo Jiménez (ed). *Distribución del ingreso en Costa Rica; 1988–2004* (San José: Academia de Centroamérica, 2007).
26. Information provided by the Minister of Public Education, Leonardo Garnier, on his Facebook page on December 30, 2013, http://on.fb.me/1dYMLXM. The data come from the Statistics Department of the Ministry of Public Education.
27. Programa Estado de la Nación, *Decimonoveno Informe Estado de la Nación en Desarrollo Humano Sostenible* (San José, Programa Estado de la Nación, 2013).

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