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***Country Program Evaluation  
Costa Rica: 2002-2006***

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*Office of Evaluation and Oversight (OVE)*

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## ABBREVIATIONS

BCS-CR	The Bank's country strategy with Costa Rica
CABEI	Central American Bank for Economic Integration
CCLIP	Conditional credit line for investment projects
CCSS	Caja Costarricense de Seguro Social [Costa Rican Social Security Fund]
CNC	Consejo Nacional de Concesiones [National Concessions Council]
CPE	Country program evaluation
DR-CAFTA	Dominican Republic – Central America – United States Free Trade Agreement
FDI	Foreign direct investment
FTA	Free trade agreement
ICE	Instituto Costarricense de Electricidad [Costa Rican Electricity Authority]
IIC	Inter-American Investment Corporation
MIF	Multilateral Investment Fund
NFP	Nonfinancial product
PBL	Policy-based loan
PCR	Project completion report
PGE	Plan de Expansión de la Generación Eléctrica [Electricity Generation Expansion Plan]
PND	Plan Nacional de Desarrollo [National Development Plan]
PPMR	Project performance monitoring report
PRI	Private Sector Department
SINE	Sistema Nacional de Evaluación [National Evaluation System]
TC	Technical cooperation
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme

## EXECUTIVE SUMMARY

### Introduction

This document presents the Costa Rica Country Program Evaluation (CPE) prepared by the Office of Evaluation and Oversight (OVE) for 2002-2006. This period spans the years between the end-date of the preceding CPE (1990-2001) and the start of the Bank's next programming cycle (2006-2010). The CPE therefore relates to the Bank's programming exercise for its 2003-2006 country strategy with Costa Rica.

The CPE has been prepared in coordination with the Bank's programming exercise. OVE and the Country Division of Regional Operations Department 2 (RE2/OD3) worked in coordination with one another.

### General context

Costa Rica has successfully applied a development model that seeks to capitalize upon the comparative advantages it enjoys in terms of institutional and political stability and a skilled workforce. The Costa Rican model has proved successful over the years. It has not only generated virtually uninterrupted growth since the 1960s, but also earned the country some of the best social indicators in Latin America and the Caribbean.

This quite positive overall profile notwithstanding, at the start of the new millennium various major sources of concern had arisen. These issues were discussed in the preceding CPE and in the document setting out the Bank's country strategy for 2003-2006. The diagnostic assessments provided in these two documents identified the same main strengths and weaknesses. The strong points included the country's open and diversified economy, steady GDP growth, the presence of a modern export sector, the economy's competitiveness within the region, low poverty rates, and extensive coverage of social services. Some of the main weak points or risks identified in these assessments were the country's low domestic investment rate and heavy reliance on external savings, a chronic and growing fiscal deficit, an inefficient tax structure, the fact that mandated expenditures exceed available resources, a large domestic debt and the crowding-out effect on domestic interest rates, the difficulty experienced in trying to lower inflation below the 10%-mark, a chronically large current-account deficit, and a lack of success in reducing poverty.

### Program for 2003-2006

The program intent represented by the Bank's country strategy with Costa Rica (BCS-CR) for 2003-2006 can be regarded as relevant, consistent, coherent, and evaluable. This program intent has not, however, materialized in the "de facto" program.

The BCS-CR is ambitious. Its high-case scenario calls for nearly US\$700 million in approvals, and its low-case scenario US\$400 million, whereas approvals for the three previous programming exercises have all been under US\$100 million.

The proposed operations program includes a large-scale hybrid operation (i.e. partly a sector-targeted policy-based loan (PBL) and partly an investment loan) that would be equivalent to nearly 90% of total programmed resources. The operation's sector component would be linked to passage of a fiscal reform bill, while the investment component would be

composed of a series of subprojects. These subprojects would concern different areas, but would have a synergistic effect. The operation was devised in response to a request made by the government, which was in need of budgetary support and wished to minimize the number of requests for ratification that it submitted to the Legislative Assembly. The government had originally requested a global loan tied to economic policy outcomes (reduction in the fiscal deficit), but at that time the Bank did not have a suitable instrument for meeting such a request.

By concentrating almost the whole of the strategy on just one program, the Bank was focusing its efforts on a single idea or plan that, in the event, never came into being. It is true, on the one hand, that this hybrid program was an innovative attempt to meet the country's needs in line with the 1990-2001 CPE, which recommended that innovative tools be used. The Bank was also, however, tying its largest operation to the passage of structural (fiscal) reforms. This ran counter to one of that same CPE's main recommendations, which was that Bank operations should not be tied to reforms or to the passage of given laws.

The lending program ultimately approved by the Bank did not correspond to the BCS-CR's major objectives in relation to macroeconomic stability, and only the Reforms for Competitiveness and Investment Program related directly to the objective of boosting the country's competitiveness in order to further its effort to position itself in the world economy and make its own economy more open.

From a strictly "mechanical" standpoint, the BCS-CR is quite evaluable, since the matrix clearly defines indicators for the government's medium-term objectives and for the objectives of the Bank's two strategic areas of intervention. Nonetheless, the BCS-CR's evaluability is jeopardized by its attempt to use unsuitable indicators to measure complex, long-term objectives. Thus, the outcomes of this "technically" evaluable BCS-CR may be of little relevance or usefulness. In point of fact, the major development goals set out in the matrix have been reached even though: (i) the Bank has not approved the strategic program for Costa Rica; (ii) the tax reform bill has not been passed; (iii) the free trade agreement for Central America (DR-CAFTA) has not yet been ratified; and (iv) the country's macroeconomic stability and fiscal sustainability are not assured. The stated indicators' validity and the proposed matrix's usefulness must both therefore be called into question.

In terms of the Bank's relations with other donors, the IDB and the World Bank have formed a collaborative relationship and division of labor, but the same cannot be said with regard to the Central American Bank for Economic Integration (CABEI). CABEI has taken a quite aggressive approach to operations in the country, and Costa Rica is currently that institution's biggest borrower. The rapid growth of the CABEI portfolio is, at least in part, a reflection of its more nimble project preparation process and lower transaction costs, as well as less demanding technical requirements.

Despite the problems encountered in implementing the BCS-CR, and unlike the situation in the past, the country-Bank dialogue is proceeding smoothly and is free of tensions. The Bank has made an effort to provide the country with technical support independently, to some extent, of the size of its loan portfolio. In fact, during the current period, Costa Rica has the highest technical cooperation/loan ratio in all of Central America. The average size of the technical cooperation (TC) operations approved for Costa Rica is also larger than it is

for other Central American countries and even for higher-income countries such as Chile and Uruguay. This technical support is recognized and appreciated by the country.

### **Efficiency in project preparation and execution**

While it is true that, according to the available data, the average preparation time for the five projects approved during this period was shorter than for other relevant comparison groups, it is also the case that the amount of time required to implement Bank projects and the duration of such projects in Costa Rica are both significantly above the Bank average. Portfolio execution has improved since 2002, but not enough to avert negative net flows between the country and the Bank.

A number of difficulties were encountered in preparing the hybrid program, largely because of its size and innovative nature. The cost to the Bank of preparing this operation was also significant: at least US\$2.4 million, and as much as US\$3.1 million if the cost of the TCs approved to support its design and preparation are included.

Delays in project ratification appear to be a recent issue in Costa Rica. Up to 2001, the country's average did not differ greatly from the Bank's overall average for the same period.

Project evaluability indices for 2002-2006 conform, on average, to the expected pattern, with the indices for project goal and component indicators being somewhat higher than for purpose indicators.

### **Findings and conclusions**

The Costa Rican economy's recent overall growth pattern is much stronger than in 2000-2002, but domestic economic conditions nonetheless indicate that problems remain in the areas of macroeconomic equilibrium and fiscal sustainability, both objectives of the Bank's program. The fiscal deficit has been cut not only by reducing current expenditure but also (and principally) by sacrificing public investment. The public debt stock is also still quite large, with interest payments taking up over one fourth of central government expenditure. The fiscal fragility associated with a lower level of public investment interferes with the delivery of public services. Inflation remained fairly high in 2003-2005.

In social terms, results have been mixed. On the one hand, poverty has shown no signs of abating. On the other, the Gini coefficient has been declining throughout 2003-2005.

In 2004 the political situation was marked by corruption charges implicating senior government officials, some private entrepreneurs, and respected public institutions. These scandals were so serious that they appear to have tarnished Costa Rica's international image. These same difficulties have also, however, served to demonstrate the judiciary's independence, the legislature's responsiveness via the passage of anticorruption bills, and the citizenry's repudiation of corruption, all of which reinforces the perception of solid institutions and democratic awareness.

The comparative analysis done by OVE of 13 indicators for economic factors, governance, and social development during the evaluation period shows that, in the case of Costa Rica, only four of these indicators displayed a more positive trend than in the top 10% of Bank member countries: life expectancy at birth, the human development index, economic freedom, and gross fixed capital formation. The indicators reflecting the most significant relative deterioration were in such areas as macroeconomic environment, political stability,

and per capita GDP. Generally speaking, Costa Rica has moved away from the top decile and is now closer to the regional average for various indicators, so its relative ranking has worsened.

The analysis of Costa Rica's position in terms of competitiveness (the main focus of the BCS-CR) indicates that, in operational terms, two projects approved prior to 2002 and executed mainly during the period covered by this CPE concerned areas that have an influence on factor productivity: the Improvement of Health Services in Marginal Areas Program, approved in 1992, and the Preschool and Lower Secondary Education Project, approved in 1997. The Electric Power Development Program, Stage III, approved in 1993, involved efforts to reduce the transaction costs of market access. These projects, and particularly those relating to education and electric power development, address critical issues in terms of Costa Rica's competitiveness (secondary education and infrastructure) and appear to have attained their development objectives.

A comparative analysis of a selection of competitiveness indicators for Costa Rica and two of its main competitors (Chile and Panama) shows that, for most of the variables, Costa Rica is still quite distant from Chile but not from Panama. The main indicators for which Costa Rica ranks lower than these two countries are: lending to the private sector, private capital flows, foreign direct investment (FDI), business startup times, and secondary education coverage. These findings appear to indicate that the limited availability of credit and constraints on financing for private investment are among the main factors hurting the country's competitiveness.

The analysis of trends in indicators for 2002-2005 yields mixed results. In 2002-2005 Costa Rica showed a stronger improvement than these two competitors as measured by some of the indicators for which it had initially had a lower rating. This was mainly the case for indicators of private capital flows and credit to the private sector.

FDI indicators, on the other hand, show that Costa Rica not only had lower ratings than Chile and Panama, but that it also experienced a sizeable deterioration vis-à-vis those two countries. The same occurred, although to a lesser extent, in the coverage of secondary education. These findings are of great concern because one of the drivers of Costa Rica's recent growth has been FDI, and the outlook therefore becomes even more worrisome, since in early 2009 the country will presumably have to do away with the free trade zones and foreign-trade tax incentives that the government has used to attract foreign investment. In the area of secondary education, the implication is that the country may be jeopardizing its ability to compete successfully in the medium and long terms.

### **Recommendations**

The lessons learned from the way in which the 2003-2006 BCS-CR has unfolded once again demonstrate the need to recommend that the Bank should not structure its programming exercises around targets and objectives relating to structural reforms. The Bank's support for such efforts on the country's part should focus on technical assistance and on economic studies and analyses. The new BCS-CR should be based on the lessons learned from previous programming efforts and should propose realistic approval levels in keeping with conditions in the country.

In view of the amount of time it takes to design new operations and secure their approval, the new BCS-CR should view the existing portfolio as its main vehicle of action in the country for the next few years. This approach will maximize the benefits to be derived from the BCS-CR through the use of TCs supplemented by nonfinancial products (NFPs).

In order to minimize any potential difficulties in obtaining ratification for its operations, the Bank should keep the Legislative Assembly apprised of its objectives and of progress on their preparation from the outset.

Competitiveness continues to be a clearly relevant issue for the country. Two points should be made in this connection:

- (i) The Bank should support the country's efforts to determine whether or not its recent growth model is deepening its economic and social dualization. An understanding of this phenomenon is of critical importance in designing complementary programs and policies to reduce poverty and inequality;
- (ii) The Bank should continue to track the DR-CAFTA ratification process and support the country in the design of policies to minimize its impact (if ratified) on any groups adversely affected.

The Bank should also assist the country to meet the challenges posed by the elimination of free trade areas and other tax incentives, which is scheduled to occur in 2009. Particular attention should be devoted to the design and implementation of new instruments for promoting and attracting FDI.

Support for secondary education should be a priority for the Bank in Costa Rica. There is clear evidence that this sector represents a bottleneck for the country's future, and the Bank has a long history of relative success in this area that can be drawn upon.

The country's infrastructure has deteriorated significantly in recent years, and the demand for assistance in this sector is therefore quite strong. The Bank should clearly map out its comparative advantages and value added, and then prioritize its actions on that basis. One of the projects for Costa Rica now in the Bank's pipeline is a conditional credit line for investment projects (CCLIP) operation for the electric power sector which is classified as 2007-A. The regulatory agency for the electricity sector in Costa Rica—the Instituto Costarricense de Electricidad [Costa Rican Electricity Authority] (ICE)—is considered to be one of the best in the region, and its efficiency indicators are quite high. Nevertheless, all of the project performance monitoring reports (PPMRs) prepared for the Electric Power Development Program, Stage III (CR-0036, 7966/OC-CR) since 2001 have noted problems in terms of institutional capacity. Because this instrument has been designed for use "*in those cases where successful project performance can be demonstrated both with respect to execution and results . . . . [and] the executing agency has had a solid track record of satisfactory performance in the execution of the previous project*" (document GN-2246-1, pages 1 and 4), the Bank and the country should work together to ensure that these problems are solved.

The continuing weaknesses of the Consejo Nacional de Concesiones [National Concessions Council] (CNC), which are part of the reason for the problems encountered in the country's concessions process, raises some question as to the wisdom of continuing to support it before planning out operations with the private sector which may not do well. A MIF project

that has disbursed just 5% of its loan three years after approval suggests that it may be advisable to keep closer track of the difficulties faced by this institution.

In view of the specific limitations affecting the Bank's progress in promoting private-sector participation in Costa Rica, a close and well coordinated working relationship between the MIF and the Private Sector Department (PRI) could benefit the operations of both. The same holds true, in cases where political support is forthcoming, for TCs designed to deal with bottlenecks that are impeding the private sector's participation. The changes made by the Board of Governors in the PRI's activities in 2006, broadening its range of clients and sectors, could make it feasible for the PRI to increase its operations in Costa Rica with public enterprises such as the ICE and others. For all of these reasons, it is recommended that the BCS-CR for 2006-2010 adopt an integrative approach to the public and private areas of Bank action.

## **I. THE COUNTRY AND CONTEXT DURING THE EVALUATION PERIOD**

### **A. Introduction**

- 1.1 This document presents the Costa Rica Country Program Evaluation (CPE) prepared by the Office of Evaluation and Oversight (OVE) for 2002-2006. This period spans the years between the end-date of the preceding CPE (1990-2001)<sup>1</sup> and the start of the Bank's next programming cycle (2006-2010). The CPE therefore relates to the Bank's programming exercise for its 2003-2006 country strategy with Costa Rica, and corresponds to the term of office of President Abel Pacheco de la Espriella.
- 1.2 This CPE has been prepared in coordination with the Bank's programming exercise. Activities by OVE and the Country Division of Regional Operations Department 2 (RE2/OD3), which worked independently but in coordination with one another, included a joint mission to the country. According to RE2, this process enhanced the strategic nature of the recommendations and their incorporation into the programming exercise for 2006-2010.
- 1.3 An evaluation of the programming exercise for 2003-2006 is presented in Chapter II. Chapter III looks at how efficiently Bank outputs were delivered. The development outcomes achieved in the areas and issues targeted by the Bank's program are discussed in Chapter IV. Chapter V sets forth this report's conclusions and recommendations.

### **B. General**

- 1.4 Costa Rica's economy is small and open. Its GDP for 2005 is estimated at approximately US\$19.8 billion, or US\$43.2 billion if measured in terms of international purchasing power parity. This makes Costa Rica the 11<sup>th</sup> largest of the 26 IDB member country economies.<sup>2</sup> Its per capita income (US\$4,600 in 2005), however, is above the averages for the Bank's member States and the Central American countries.<sup>3</sup> In 2005 the indicator for economic openness (the ratio between exports plus imports and GDP) was around 85%, whereas the average for the Bank's member countries was roughly 76% in 2004, and the weighted average tariff level was about 4%. In addition, the trade restriction index for Costa Rica (i.e. the ad valorem equivalent of the tariff and nontariff barriers applied by the country as an importer) are lower not only than those of other Central American countries, but also than the estimated indices for the United States and the European Union.<sup>4</sup>
- 1.5 Costa Rica has a participatory governmental structure, a solid institutional framework, and an autonomous judiciary that have engendered a balance of power, political stability, and a sound democratic system.
- 1.6 The country has successfully applied a development model that seeks to capitalize upon the comparative advantages it enjoys in terms of institutional and political stability and its skilled workforce. The model is built around the external sector, but it is also based on consensus-building. In addition, unlike other countries in the region, Costa Rica has maintained a strong State presence in economic affairs.

- 1.7 The Costa Rican model has been successful in achieving positive growth rates ever since the 1960s (with the only interruption in this trend coming in the 1981-1982 crisis) and in posting some of the highest ratings for social indicators (education, health, housing, etc.) in Latin America and the Caribbean.
- 1.8 This quite positive overall profile notwithstanding, at the start of the new millennium various major sources of concern had arisen.

**C. The baseline: Macroeconomic, social, and political conditions in 2002**

- 1.9 In 2000-2001, the Costa Rican economy underwent its most serious slump of the past 20 years. After growing at an average annual rate of over 5% during the second half of the 1990s, and at over 8% in 1998 and 1999, the economy was hit by the slump in world economic growth (particularly in the United States, which is Costa Rica's biggest importer), deteriorating terms of trade, and a crisis in the microprocessor market. Its growth rate plunged to just 1.8% in 2000, and to 1.1% in 2001, which translated into negative growth rates for per capita income.
- 1.10 In addition to these exogenous factors, domestic conditions in 2002 also yielded disturbing macroeconomic statistics: the government's accounts showed a consolidated deficit of 4.3% of GDP, the balance-of-payments current account deficit amounted to 5.4% of GDP, and the public debt was equivalent to 59% of GDP. Meanwhile, annual inflation hung around 10%.
- 1.11 On the social front, increasing inequality (the Gini coefficient climbed from 0.387 in 1994 to 0.432 in 2002) and the fact that poverty rates, although low in Latin American terms, showed no signs of abating but had instead held steady at around 20% since 1994 were a cause of concern (see Annex Figure A-1.1). These statistics were all the more worrisome because the open unemployment rate rose to 6.4% in 2002, after having averaged around 5% in the 1990s. Annex Table A-1.1 presents a number of indicators that provide an overview of economic and social conditions in the country in 2000-2002.
- 1.12 On the political front, even though the soundness of the country's institutions and democratic culture were never called into question, the February 2002 presidential elections (when President Abel Pacheco was elected) marked a breakdown in Costa Rica's bipartisan tradition. A new party (the Partido Acción Ciudadana [Citizens' Action Party] (PAC)), founded primarily by dissenters from the Partido Liberación Nacional [National Liberation Party] (PLN), emerged as a third political force, winning a sizeable number of votes and seats in the Legislative Assembly.<sup>5</sup> This state of affairs obliged the country to hold a second round of elections for the first time in its history and led to a fragmentation of the Legislative Assembly. As a result, the victorious party, the Partido Unidad Social Cristiana [Christian Social Unity Party] (PUSC), fell short of a congressional majority.<sup>6</sup> It was therefore reasonable to expect that the decision-making process, which had traditionally been based on consensus-building, would run into difficulties.
- 1.13 Annex Figure A-1.2 shows how Costa Rica ranked in relation to the other member countries of the Bank around 2002. Clearly, as was to be expected given the factors discussed above, the country had some of the best indicators in the region (near or

even above the figures for the top decile) for social development and governance, but some of the variables for its economic environment were closer to, or even lower than, the average for the Bank's member countries. The figures for gross fixed capital formation and per capita GDP growth are particularly interesting.

- 1.14 This state of affairs was clearly reflected in the preceding CPE and in the country strategy prepared by the Bank. The two documents presented quite similar analyses of the overall situation.

**1. Context as described in the Bank's country strategy with Costa Rica for 2003-2006, and the Country Program Evaluation for 1990-2001<sup>7</sup>**

- 1.15 The document setting out the Bank's country strategy with Costa Rica (BCS-CR) described the deterioration in public finances in 2000-2002 as the "*primary chronic problem*" in the Costa Rican economy's efforts to "*preserve macroeconomic stability*" (document GN-2263-1, page 4). The country's fiscal imbalances had given rise to a large public debt whose servicing requirements put additional pressure on the government's accounts. As noted earlier, the upswing in interest rates associated with the pressure generated by the public sector's borrowing requirements made it more difficult for small and medium-sized enterprises to obtain credit.
- 1.16 The BCS-CR's analysis of the external sector drew attention to the economy's external vulnerability and its reliance on external savings as a result of the country's mounting trade and current account deficits, which were being financed through the use of capital markets and FDI flows.
- 1.17 The CPE also underscored the country's fiscal problems and discussed the gap between tax receipts from large-scale investments (from high-tech firms or service enterprises in such areas as tourism) and the corresponding tax concessions: "*In other words, the most dynamic sector of the economy makes a low fiscal contribution, which could not be counterbalanced by expanding the tax base in other sectors or through higher income and employment taxes*" (document RE-277, page 24).
- 1.18 The preceding CPE presented a matrix that provides an overview of the main strengths and weaknesses to be found in Costa Rica. The strong points identified in this table include the Costa Rican economy's openness and diversification, steady GDP growth, its modern export sector, its competitiveness in the Latin American and Caribbean region, its low poverty rates, and its high social-service coverage ratios. Some of the main weak point or risks identified in the CPE are the country's low domestic investment rate and heavy reliance on external savings, a chronic and growing fiscal deficit, an inefficient tax structure and the fact that mandated expenditures exceed available resources, a large domestic debt and the crowding-out effect on domestic interest rates, the difficulty experienced in trying to lower inflation below the 10%-mark, a chronically large current account deficit, and a lack of success in reducing poverty.

## II. THE 2003-2006 PROGRAMMING EXERCISE

2.1 The purpose of this chapter is to review factors influencing the relevance, consistency, and coherence of the Bank’s program for 2003-2006 within the framework of its country strategy with Costa Rica (BCS-CR, document GN-2263-1).<sup>8,9</sup> The following analysis is divided into two parts. The first assesses the Bank’s programmatic effort in terms of its overall strategic framework and the operational program that the Bank planned and agreed upon with the country. The second looks at the “de facto” program or, in other words, the outputs that were actually approved and the mix of instruments used by the Bank.

### A. Program intent

#### 1. The strategic framework

2.2 The main lines of action set out in the BCS-CR for 2003-2006 tied in directly with the government’s Plan Nacional de Desarrollo [National Development Plan] (PND). Thus, the BCS-CR’s program intent reflected existing development challenges and was therefore relevant in terms of the country’s needs. It was also consistent with the government’s objectives.

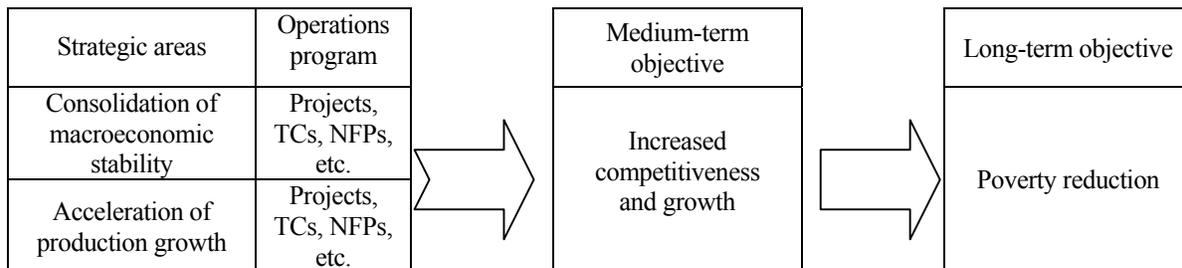
2.3 The BCS-CR’s objective was to “*support the government’s efforts to achieve more rapid, sustained economic growth driven by competitiveness improvements in the production sectors and making the most of the opportunities afforded by integration. This will enable the country to continue making inroads against poverty*” (document GN-2263-1, Executive Summary, page 2).

2.4 The BCS-CR described the need to quicken the pace of economic growth as a key factor in continued progress in improving the population’s living conditions and reducing poverty, which is the long-term objective of the PND and of the strategy.

2.5 In order to boost competitiveness (a medium-term objective of the PND and the BCS-CR), actions were proposed in two strategic areas:

- (i) Strategic Area I: Consolidation of macroeconomic stability; and
- (ii) Strategic Area II: Acceleration of production growth to seize global integration opportunities.

The line of reasoning implicit in the BCS-CR is mapped out below.



Note: TC: technical cooperation; NFP: nonfinancial product.

2.6 Three notable aspects of the BCS-CR are the following:

- (i) As may be gleaned from the line of reasoning followed by the BCS-CR, one of the strategy's assumptions is that there is a direct relationship between economic growth and poverty reduction. The BCS-CR does state that economic growth has not led to a reduction of poverty since 1994, but fails to go into any detail on this subject, at least explicitly (see subparagraph (ii)), and continues to focus exclusively on quickening the pace of growth.
- (ii) In paragraph 1.5, the BCS-CR discusses, although not in an entirely explicit manner, the possibility of economic and social dualization in Costa Rica and the fact that the stagnation of progress in poverty reduction and increasing inequality could therefore be related to structural factors: *“the rate of poverty reduction (using the income measure of poverty) began to level off, even though the economy continued to grow. This could be indicative of two things: the scant connection between free zone and high-tech export businesses and the rest of the economy and the limited access of the poor to good jobs and higher incomes because of their low skills levels. Another telling trend in recent years is income concentration.”* These considerations notwithstanding, in paragraph 1.21 the BCS-CR appears to suggest that this duality is an inherent part of Costa Rica's economy and that it will not only continue to exist in the future, but will actually be heightened by the reforms being advocated by the Bank in connection with the move to open up the economy and promote competitiveness: *“Costa Rica's sources of growth will continue to be high technology industries and the local suppliers of those firms. As a result of the application of those reforms, these firms will forge stronger productive linkages with the free zone export businesses. Other sources of growth include tourism and the SMEs that participate in the nontraditional goods and services export clusters.”*
- (iii) The BCS-CR is based on the premise that Costa Rica will become increasingly integrated into the world economy and, in particular, on the opportunities to be opened up by the Dominican Republic – Central America – United States Free Trade Agreement (DR-CAFTA). The document makes it clear that the Bank viewed Costa Rica's increasing economic openness as an extremely positive development and that it supported the country's efforts to ready itself for the forthcoming FTA. Economic integration is a recurring focus throughout the strategy and figures as its core element.

2.7 The BCS-CR's approach to Strategic Area I (consolidation of macroeconomic stability) is in keeping with the diagnostic assessment discussed in the preceding chapter. It identifies the need to increase the tax ratio, heighten the flexibility of expenditure and control spending, take steps to deal with the potential deterioration of the pension system in the future, and extend the scope of reforms to encompass public enterprises and subnational levels of government in order to reduce the fiscal

- deficit. Work in this strategic area sought to achieve fiscal sustainability and make public spending more efficient by supporting the government's proposed fiscal reform bill.<sup>10</sup>
- 2.8 The objectives and actions for the first strategic area were clearly defined, but the same cannot be said of Strategic Area II (acceleration of production growth). This strategic area was defined in broad enough terms to permit the inclusion of interventions aimed at supporting everything from sustainable rural development or improvements in the urban environment to the types of reforms needed to open up the public sector in such areas as infrastructure and financial services. Some of the subject areas that the Bank could support within this strategic area include: fiscal management and e-Treasury; municipal financial management; strengthening of the public agencies responsible for trade liberalization and FTAs; legislative management; the administration of justice; private investment in concessions; electric power integration; transport; reduction of financial costs; increased access to credit; horizontal and vertical integration of SMEs; modernization and liberalization of the financial sector; innovation and technology; and investment in human capital.
- 2.9 Such a situation arises because of the almost inevitable tension encountered in the Bank's programming exercises between its strategic, conceptual framework, which generally has a very clear focus (in the case of the BCS-CR, support for efforts to promote economic stability and external openness), and potential project requests by the Bank's operations departments or the country's line ministries.
- 2.10 From an operational standpoint, in the past this tension has resulted in country strategies that include a long list of target areas. The more recent attempt to identify programs that are more selective and strategy-focused<sup>11</sup> has resulted in the definition of a few broadly defined, ad hoc strategic areas, such as in the BCS-CR. As a result, projects dealing with such areas as the environment, the modernization of the State, and human development have all been classified under the *same* strategic area, as will be discussed below.
- 2.11 The BCS-CR's conceptual framework is in keeping with the preceding programming exercise (BCS-CR 1999-2002 (document CP-1756)). Actually, the four target areas of the 1999-2002 BCS-CR are distributed among the two strategic areas identified in the BCS-CR for 2003-2006. Those four areas were: (i) the consolidation of structural reforms as a means of boosting productivity and attracting investment that would lead to physical and human capital improvements; (ii) modernization of infrastructure by establishing conditions that would allow for the best possible use of inbound investment and the regulation of its use to ensure that it contributes to the general welfare; (iii) strengthening of human capital by making social spending more efficient, decentralizing decision-making, and attracting private investment; and (iv) promotion of activities that will generate foreign-exchange earnings (document CP-1756, page 13).
- 2.12 The risks it identified included the difficulties that would probably be encountered in reaching a consensus on a comprehensive fiscal reform program, the economy's vulnerability to external changes, the private sector's uncertain response to the new

economic situation that would be created by trade liberalization, and the slow pace of the processes involved in the negotiation and approval of multilateral operations. These issues cannot, however, be properly classified as risks. The problems involved in negotiating and approving operations, the difficulty of arriving at a consensus on structural reforms, and, as noted in the preceding chapter, the Costa Rican economy's vulnerability are all well-known factors and, as such, should be incorporated into the programming process.

## **2. The proposed operations program**

- 2.13 Annex Table A-2.1 consolidates the basic information on the loan operations proposed in document GN-2263-1. As the table illustrates, the strategy was divided into two stages (2003 and 2004-2006), with low-case and high-case scenarios for the second phase. The scenario to be used for the second stage was to be determined by how much progress was made in the two strategic areas during the programming exercise's implementation. That progress was to be measured with the help of two outcome indicators that would serve as triggers for the high-case scenario. The use of objective, quantifiable baselines and criteria should be underscored as an example to be emulated in other country strategies.<sup>12</sup>
- 2.14 The proposed operations program also has other outstanding features. The most salient is its inclusion of a large-scale hybrid operation (i.e. partly a sector-targeted policy-based loan (PBL) and partly an investment loan) that accounted for nearly 90% of total programmed resources (US\$600 million out of a total of US\$695 million in the high-case scenario and US\$300 million out of US\$395 million in the low-case scenario). The operation's sector component is tied to passage of a fiscal reform bill, while the investment component is composed of a series of subprojects that, although conducted in different areas, will have synergistic effects.
- 2.15 The operation was devised in response to a request made by the government, which was in need of budgetary support and wished to minimize the number of requests for ratification that it submitted to the Legislative Assembly. The government had originally requested a global loan tied to economic policy outcomes (reduction in the fiscal deficit), but at that time the Bank did not have a suitable instrument for meeting such a request. A hybrid loan program was therefore designed that would include a second stage in the event that the triggers for a high-case scenario were to occur.
- 2.16 The second special feature of this program was its strong concentration on the strategic area of productive sector development for competitiveness.<sup>13</sup> As stated in the BCS-CR, all programmed investment loans were to be directed toward supporting competitiveness and would represent over 70% of the resources to be made available under either of the two scenarios.
- 2.17 The BCS-CR provided for a coherent program of outputs based on the Bank's main instruments, including TCs and projects of the Multilateral Investment Fund (MIF), the Inter-American Investment Corporation (IIC), and the Private Sector Department (PRI), as well as nonfinancial products and studies. The proposed outputs replicate the loan operations' emphasis on the second strategic area.

- 2.18 A total of 16 TCs involving US\$7.7 million were programmed. Almost 90% of these resources are concentrated in the strategic area of productive sector development for competitiveness.
- 2.19 Four MIF operations totaling approximately US\$2 million were also programmed, together with two IIC loans (US\$21.5 million) and a US\$64 million PRI operation for the San José-Caldera highway. By definition, the operations prepared using these three instruments concern the strategic area of productive sector development for competitiveness.

## **B. The “de facto” program**

### **1. Loan operations**

- 2.20 Annex Table A-2.2 compares the program intent with the operations program actually approved by the Board of Executive Directors for the period covered by the BCS-CR. As shown in the table, the six approved projects, totaling around US\$217 million, represent 31% of the sum originally called for in the BCS-CR’s high-case scenario, and 55% for the low-case scenario. It should be noted that the failure to implement the program mapped out in the BCS-CR was unrelated to the economic situation in Costa Rica and that the hybrid program’s sector component, in particular, proved to be unviable because the fiscal reform bill on which it was conditioned was never passed. Interestingly enough, however, the trigger conditions for the high-case scenario were met.<sup>14</sup>
- 2.21 Two other points should be made:
- (i) The US\$14.4 million Sustainable Agricultural Development Project (CR-0142, 1436/OC-CR) was approved in 2002, a year not covered by either the BCS-CR or the preceding CPE. Thus, in 2002-2005, five projects for a total of US\$161.8 million were approved.
  - (ii) The Health Sector Development Project (CR-0144, 1451/OC-CR), approved in January 2003, does not appear on the BCS-CR’s list of approved projects issued in May 2003. The reason for this is unknown.
- 2.22 This means that three of the six approved projects had been programmed in the BCS-CR: the US\$9.2 million Sustainable Development Program for the Sixaola River Binational Watershed (CR-0150, 1566/OC-CR), the US\$50 million Urban Poverty Alleviation Project (CR-0145, 1830/OC-CR), and the investment component of the US\$116.8 million Reforms for Competitiveness and Investment hybrid program (CR-0156, 1636/OC-CR). The last of these was originally supposed to total US\$200 million. This program was initially designed to include five subprojects dealing with external trade, science and technology for competitiveness, a participatory rural roads rehabilitation project, e-Treasury, and secondary education. The last two of these subprojects were removed from the final project.<sup>15</sup>
- 2.23 The main conclusion to be drawn from the above is that the operations approved by the Bank were not related to the BCS-CR’s major objectives of ensuring macroeconomic stability, and that only the Reforms for Competitiveness and

Investment Program was directly related to the objective of boosting the country's competitiveness as it becomes more integrated into the world economy.

- 2.24 In order to set the BCS-CR for 2003-2006 within its long-term context, Annex Table A-2.3 provides data on programming efficiency for all the programming exercises evaluated by OVE. The table shows that the 2003-2006 programming exercise was more efficient than prior ones in terms of the approval of planned operations. However, the table indicates that a substantial percentage (50%) of approved loans did not figure in the 2003-2006 BCS-CR.<sup>16</sup>

## **2. Technical cooperation operations**

- 2.25 During the period covered by the BCS-CR for 2003-2006, a total of 28 nonreimbursable TCs for a total of approximately US\$6.6 million were approved.<sup>17</sup> This means that a significantly larger number of TCs were approved than had been planned (28 versus 16), but that the total monetary amount they represented was smaller than planned (US\$6.6 million versus US\$7.7 million). Interestingly, the anticipation index for the TCs (50%) is higher than it is for the operations program (25%).
- 2.26 The resources approved for TC operations equals 4.5% of the approved loan amount, which is the highest TC/loan ratio in all of Central America for this period. The average size of the TCs approved for Costa Rica is also larger than it is for other Central American countries and even for higher-income countries such as Chile and Uruguay.
- 2.27 For 2002-2005, 34 TCs totaling about US\$9.4 million were approved. The TC/loan ratio for this period is 5.8%, and the absolute values for the TCs were higher than they were during this period for any of the other Central American countries except Guatemala and Honduras. The average size of TCs during this period is also the largest of any Central American country. Although this high TC/loan ratio is accounted for primarily by the low value of the corresponding denominator, the available data do suggest that the Bank has made an effort to provide the country with technical support independently, to some extent, of the size of its loan portfolio. This technical support is recognized and appreciated by the country.
- 2.28 The TC program is aligned with the operations program, inasmuch as 10 of the approved TCs (36% of the total) were related to planned projects. In addition, another two TCs approved in 2005 and 2006 were related to projects not yet approved by the Bank.

## **3. Private sector**

- 2.29 The MIF approved five projects in 2002-2005 for a total of US\$11.6 million, three of which had been programmed in the BCS-CR; 83% of these resources were concentrated in two projects under the Small Enterprise Development Facility which had not been called for in the BCS-CR.<sup>18</sup>
- 2.30 Despite the BCS-CR's emphasis on competitiveness and on strengthening the private sector, the PRI did not approve a single operation during this period. The US\$64 million San José-Caldera highway project (CR-0143) was not approved. The explanation for this situation appears to lie, on the one hand, in the

- uncertainties, failings, and high transaction costs of Costa Rica's concession process (see Chapter IV)<sup>19, 20</sup> and, on the other, in the constraints affecting the PRI during this period, owing to which only fairly large infrastructure and capital-market operations were viable. These two factors placed major limitations on the PRI's actions in a country such as Costa Rica, where the State maintains a strong presence in the energy, telecommunications, and even financial sectors.
- 2.31 The Action Plan for the IDB Group Activities related to Private Sector Development in C & D Countries (document GN-2193-2) of November 2002 proposed five activities for Costa Rica in that year: programming and policy dialogue, the Competitiveness Support Program, the PRI's San José-Caldera highway operation, and two MIF projects (Support for the San José-Cartago Highway Concession and Analysis of Options for Financing Water and Sanitation Services in Heredia).<sup>21</sup> Only two of the planned projects or TCs were approved during the period of analysis: the latter of the MIF's TCs (approved in 2002, as planned) and the Pro-Competitiveness Productive Investment Program (CR-0156) (approved in 2005).<sup>22</sup>
- 2.32 The IIC approved five operations (two in 2003, one in 2004, and two in 2005) amounting to roughly US\$20.8 million, including one of the two loans outlined in the BCS-CR.<sup>23</sup>
- C. Program evaluability**
- 2.33 The matrix presented in the BCS-CR sets out the tools, objectives, and goals of the Bank's program with the country (see Annex Table A-2.4). The matrix's main purpose is to outline the key factors involved in the BCS-CR's monitoring and evaluation.
- 2.34 In the last two columns, the matrix identifies two major types of performance indicators: one relating to the government, and the other to the Bank. According to the BCS-CR, *"for timely monitoring of the strategy to be able to quickly identify any required adjustments, a set out output and input indicators more closely related to the Bank's direct interventions needs to be used"* (document GN-2263-1, page 33). The document seems to suggest that these output and input indicators will serve as "milestones" in monitoring the program. The use of these indicators as milestones would be feasible if they were complementary or directly related to the outcome indicators. This is not necessarily the case, however, particularly with regard to the indicators for productive sector development for competitiveness. This situation makes it difficult or impossible to gauge how much progress has been made towards achieving the targets defined in terms of outcome indicators.
- 2.35 As may be seen from Annex Table A-2.5, the BCS-CR is quite evaluable from a strictly technical standpoint, since the matrix clearly defines indicators for the government's medium-term objectives and for the objectives of the Bank's two strategic areas of intervention. The targets and baselines for these indicators are also clearly identified and quantifiable. The great majority of outcome indicators are also clearly defined and accompanied by targets and baselines. The indices for output and input indicators are not as high, but are still significant.<sup>24</sup> It should be

noted that no quantifiable targets or baselines are required in cases where an indicator refers to a new output.

- 2.36 These positive factors notwithstanding, the BCS-CR's evaluability could be jeopardized by the selection of isolated indicators that are consequently not very meaningful in measuring progress toward the strategy's objectives. For example, reducing the fiscal deficit (the indicator to be used to evaluate the achievement of Strategic Area I's objective) is not a *sufficient* condition for the "consolidation of macroeconomic stability." The BCS-CR's weak point in this respect is that it attempts to use unsuitable indicators to measure complex, long-term objectives, and the possibility therefore exists that the outcomes of this "technically" evaluable BCS may be of little relevance or usefulness.
- 2.37 The BCS-CR provided for the Ministry of National Planning and Economic Policy's National Evaluation System (SINE) to be used in tracking the indicators. The Bank also included a TC in the same BCS-CR designed to strengthen the SINE's monitoring and evaluation capacity. Neither of these two actions was actually carried out, however. The TC was never approved, and the Bank did not use the SINE to monitor the program's or the BCS-CR's progress. The reason for this appears to have to do with tensions existing between the Ministry of National Planning and Economic Policy and the Ministry of Finance during this time as a result of the increasingly important role in evaluation and planning processes taken on by the latter through its development of a budgetary evaluation procedure and the budget's conversion into a planning tool via the creation of a national public investment system. The Bank actually provided support for this effort, most recently through the Program to Implement the External Pillar of the Medium-Term Action Plan for Development Effectiveness (PRODEV).
- 2.38 The failure to carry out these actions represents a missed opportunity. It would have made sense to use the SINE to evaluate the BCS-CR since it has been selected to evaluate the PND, which is the underpinning for the BCS-CR and is necessarily involved in assessing the various government agencies' strategic actions, including those defined by Bank operations.

#### **D. Relations with other donors**

- 2.39 Among multilateral institutions, in 2005 the Central American Bank for Economic Integration (CABEI) had the largest loan portfolio (US\$774 million), followed by the IDB (US\$597 million) and the World Bank (US\$110 million).
- 2.40 The World Bank's activities in Costa Rica in recent years have been quite limited, with only one loan approved between 2002 and 2005 (a loan in the education sector in 2005). This institution has, however, prepared a major report on social expenditure and poverty ("Costa Rica: Social Spending and the Poor")<sup>25</sup> and, in 2004, developed its first strategy for Costa Rica in over 10 years.<sup>26</sup> The strategy's diagnostic assessment identifies essentially the same development challenges as the IDB and identifies the following priority areas for action: education, water and sanitation, infrastructure, the environment, agriculture, and information and communication technology.

- 2.41 The IDB and the World Bank have established a collaborative relationship and a division of labor (in the education sector, for example, the IDB is working on secondary education while the World Bank is focusing on basic education), and the two institutions have also worked together to prepare the Country Financial Accountability Assessment (CFAA) for 2005. The same cannot be said in the case of CABEI, however.
- 2.42 CABEI has taken a considerably more aggressive approach to operations in the country. Its portfolio in Costa Rica expanded by nearly 61% between 2002 and 2005, and Costa Rica is now its largest borrower, accounting for almost 25% of the institution's loan portfolio. The rapid growth of the CABEI portfolio is, at least in part, a reflection of its more nimble project preparation process and lower transaction costs, as well as less demanding technical requirements (e.g. CABEI does not require environmental assessments).
- 2.43 CABEI and the IDB work together in such fields as health, modernization of the State, and energy, but the fact that CABEI approved an e-Treasury project that was prepared (and therefore paid for) by the IDB as part of its work in developing the hybrid program has created displeasure in the IDB.<sup>27</sup>

**E. Concluding observations**

- 2.44 The 2003-2006 BCS-CR program intent can be regarded as relevant, consistent, coherent, and evaluable. It has not, however, materialized in the "de facto" program. The loan program ultimately approved by the Bank did not correspond to the BCS-CR's major objectives in relation to macroeconomic stability, and only the Pro-Competitiveness Productive Investment Program is directly related to the objective of boosting the country's competitiveness as it becomes more integrated into the world economy.
- 2.45 By concentrating almost the whole of the strategy on just one program, the Bank focused its efforts on a single idea or plan that, in the event, never came into being. It is true, on the one hand, that this hybrid program was an innovative attempt to meet the country's needs in line with the 1990-2001 CPE, which recommended that innovative tools be used. The Bank was also, however, tying its largest operation to the passage of structural (fiscal) reforms. This ran counter to one of that same CPE's main recommendations, which was that Bank operations should not be conditional upon reforms or the passage of given laws.
- 2.46 The absolute and relative scales on which the hybrid program was designed are diametrically opposed to one of the previous CPE's conclusions: "*Smaller operations, perhaps involving multiple stages, and high elasticity of impact in terms of efficiency and effectiveness appear to be more recommendable in the current context*" (document RE-277, page xii).
- 2.47 Despite the problems encountered in implementing the BCS-CR, and unlike the situation during earlier periods, the country-Bank dialogue is proceeding smoothly and is free of tensions. The Bank's efforts to meet the country's requirements and needs are recognized in Costa Rica.

### III. EFFICIENCY IN PROJECT PREPARATION AND DELIVERY

3.1 In this chapter an effort will be made to describe the projects approved during the period covered by the CPE, and to assess how efficiently these operations were prepared and implemented. Since the projects approved between 2002 and 2006 have not entailed a significant level of disbursements, information on projects having high disbursement levels during the evaluation period that were approved before 2002 will be used to analyze the efficiency of project implementation.

#### A. Projects approved between 2002 and 2006

3.2 Annex Table A-3.1 provides basic information on the projects approved between 2002 and 2006. As may be seen from this table, the only operations entailing some level of disbursement, albeit quite low, are Sustainable Agricultural Development (CR-0142, 1436/OC-CR) and Health Sector Development (CR-0144, 1451/OC-CR). The other three projects—the Sustainable Development Program for the Sixaola River Binational Watershed (CR-0150, 1566/OC-CR), Reforms for Competitiveness and Investment (CR-0156, 1636/OC-CR), and the Program for the Sustainable Development of the Atlantic Huetar Region (CR-0157, 1615/OC-CR)—had not yet been approved as of October 2006.

3.3 In addition, one of the components of the Health Sector Development Project, which accounted for 30% of the project funds originally approved, was cancelled. The project performance monitoring reports (PPMRs) do not give the reason for its cancellation, however, and the PPMR issued prior to the cancellation rated this component's implementation as satisfactory.<sup>28</sup>

#### 1. Efficiency in project preparation

3.4 Annex Table A-3.2 shows the amount of time required for project preparation (i.e. the time elapsed between a project's entry into the pipeline and its approval) and post-approval processing (the time between a project's approval and the determination of eligibility) for the five projects approved during the period in question and compares them with the Bank averages. The data indicate that preparation times for three of the projects (Sustainable Agricultural Development (CR-0142, 1436/OC-CR), Health Sector Development (CR-0144, 1451/OC-CR), and the Sustainable Development Program for the Sixaola River Binational Watershed (CR-0150, 1566/OC-CR)) were shorter than the averages for the three comparison groups (i.e. the average for Bank-approved investment projects in 2002-2006 and the averages for investment projects approved by Costa Rica and those approved by the Bank between 1990 and 2001). It also shows that, despite the long lead times required for the other two operations and particularly for the Reforms for Competitiveness and Investment Program (CR-0156, 1636/OC-CR) (the remnant of the hybrid program), which took over two years to win approval, the average preparation time for the five projects is shorter than it is for the other comparison groups.

3.5 Delays in project ratification appear to be a recent issue in Costa Rica. Up to 2001, the country's average did not differ greatly from the Bank's average for the same

period (eight months and seven months, respectively). As of October 2006, the Sustainable Development Program for the Sixaola River Binational Watershed (CR-0150, 1566/OC-CR) and the Program for the Sustainable Development of the Atlantic Huetar Region (CR-0157, 1615/OC-CR) had been awaiting ratification for 10 months, while the Reforms for Competitiveness and Investment Program had been waiting 15 months. The fact that the time required to secure ratification has increased since 2001 fits in with the prevailing view in the country, according to which this phenomenon is largely due to the political fragmentation that has occurred since the 2002 elections.

- 3.6 In the specific case of the Bank's projects, this problem may have been heightened by the association between the Reforms for Competitiveness and Investment Program and DR-CAFTA (see paragraph 3.9) and by the existence of so many different objectives and a lack of clarity about the various components of the Sustainable Development Program for the Sixaola River Binational Watershed and the Program for the Sustainable Development of the Atlantic Huetar Region.<sup>29</sup> It is clear, in any event, that in the case of the Reforms for Competitiveness and Investment Program, the combination of various projects into a single operation was not enough to overcome these difficulties in facilitating its ratification.

## **2. Evaluability**

- 3.7 Project evaluability indices for projects approved in 2002-2006 conform, on the whole, to the expected pattern (see Annex Table A-3.3), with the indices for the more readily definable project goal and component indicators being somewhat higher than for purpose indicators, which often need to be designed specifically for each project. The main exception to this rule is the Reforms for Competitiveness and Investment Program, whose goal and purpose indicators are all accompanied by targets and baselines (only the milestone or benchmark indicators are missing). This is a particularly interesting finding which suggests that the innovative character of this program might warrant further evaluation in the future.

## **3. Considerations regarding the hybrid program**

- 3.8 As discussed in the preceding chapter, the hybrid program was the core element of the Bank's programming exercise for 2003-2006, but it has not given rise to the outputs or outcomes that it was expected to produce. Many of the problems encountered in the program's preparation (which were reflected in how long it took) can be accounted for by the combination of two interrelated factors: its scale and its innovative nature. In other words, to a great extent, the operation was innovative because it was a large-scale undertaking, both in absolute and in relative terms (*vis-à-vis* the programming exercise and the country).
- 3.9 Some of the difficulties encountered in this operation's preparation were as follows:
- (i) The program involved a large number of stakeholders, both in the Bank and in the country. This led to problems with its coordination as well as differences in how its objectives and mechanisms were perceived and interpreted. All of these elements hindered efforts to arrive at agreements during the negotiation process.

- (ii) Because of its innovative nature, the operation called for adjustments in the Bank's modus operandi. The project's preparation demanded an exceptional coordination effort among regional operational units and between the region and other areas of the Bank.
- (iii) The reshuffling of finance ministers (there were four different ministers during this period) and resulting shifts in the priorities of the political agenda were influential factors.
- (iv) The investment component's design appears to have been especially difficult, particularly with regard to the generation of synergies among its subprojects (see paragraph 3.11). Members of the country team who were involved in some of the subprojects told OVE that they were unaware of other subprojects.
- (v) The program was seen as being politically associated with the approval of CAFTA, and this sparked strong political opposition in certain sectors of civil society and the legislative Assembly. The project document indicates that the operation was submitted to the Legislative Assembly and to Costa Rican society as a "complementary agenda to CAFTA" (document PR-2938, page 1).

3.10 In addition to these problems, two of the original subprojects of the investment component were withdrawn from the program: the subproject on secondary education and the e-Treasury subproject. The first of these subprojects was cancelled by the government, which had two projects in the education sector that were in the process of being prepared (one with the IDB and the other with the World Bank). In order to cut expenditures and ease the fiscal situation, the government decided to use external loans to finance just one of these projects, and it chose the World Bank's. It noted, however, that "*although this operation does not take the place of the activities that would have been financed under the IDB operation, it will cover many of the existing needs and execution capacity in the sector.*"<sup>30</sup> The second project was taken up by CABEL, which took steps to have it approved very quickly.

3.11 The loss of these subprojects will inevitably jeopardize the synergy that the Bank said it was incorporating into the investment component of the program. Ultimately, however, the project was approved without any further modifications in its structure or remaining subprojects. The analyses of these projects do not make mention of the need for complementarity among the various project interventions. Generic references are made to the synergies existing among the three projects, but very little substantive content or clarification is provided regarding the associated gains or benefits. It has not been made clear, for example, whether or not a subcluster of beneficiaries exists that is shared by all three projects, or at least two of them. The three subprojects are ultimately merged into a single operation, but no joint implementation scheme has been devised to facilitate the identification of causal relationships among them.<sup>31</sup>

3.12 The preparation of the hybrid program generated significant costs for the Bank. OVE data indicate that the cost of preparing this program amounts to at least

US\$2.4 million. This sum includes staff, travel, and other minor expenditures, but not the cost of external consulting services paid for out of administrative funds. This sum rises to US\$3.1 million if the cost of the TCs that have been approved to support the program's design and preparation are included.

**B. Efficiency in project execution**

- 3.13 As discussed above, the projects approved since 2002 do not have significant execution levels. The analysis of project execution efficiency for 2002-2006 is therefore necessarily based on projects approved prior to 2002. In order to ensure that the results reflect what occurred during that period as accurately as possible, information was used for projects that disbursed over half of their resources between 2002 and 2006.<sup>32</sup>
- 3.14 The data given in Annex Table A-3.4 show that the amount of time required for project execution and the duration of those projects are significantly longer than the Bank averages. The projects that disbursed the bulk of their resources in 2002-2006 had, on average, execution times 49% longer and extensions 81% longer than the average figures for all investment projects approved by the Bank between 1990 and 2001.
- 3.15 The main causes identified by the PPMRs for delays in execution and/or difficulty in achieving these projects' development objectives had to do with institutional capacity issues (52% of the problems encountered)<sup>33</sup> and situations related to a lack of commitment on the part of the country or executing agencies (32% of the problems identified).<sup>34</sup> In the first of these categories, a lack of sufficient institutional capacity on the part of the executing agency was frequently at fault (32% of all problems identified), while the main problem pinpointed in the PPMRs in terms of the second category (lack of commitment) was political opposition to the project (15% of the problems). The PPMR data clearly show that the Bank has been aware of the difficulty of implementing politically sensitive measures in Costa Rica since at least the start of the new millennium. Surprisingly, the PPMRs do not draw attention to the limitations imposed by national laws or the requirements of the Comptroller-General of the Republic (including ex ante supervision), which play a role in slowing down project execution.
- 3.16 It should be noted that execution of the portfolio has clearly improved since 2002, as the percentage of the active portfolio disbursed each year climbed from 9% in 2001 to 13% in 2002, 28% in 2003, and 45% in 2004, before dropping to 27% in 2005 (see Annex Figure A-3.1). However, this improvement has not been great enough to avert negative net flows between the country and the Bank (see Annex Figure A-3.2).<sup>35</sup>

#### IV. OUTCOMES ASSOCIATED WITH THE PROGRAMMING EXERCISE

- 4.1 Under this chapter heading, CPEs usually seek to evaluate development outcomes in areas covered by the Bank's program. As discussed in the preceding chapters, however, the program intent defined by the BCS-CR never took concrete form, and the disbursement levels of the projects that were approved have been negligible. Thus, at this point in time, there have been no development outcomes directly associated with new projects programmed in the BCS-CR for 2003-2006. Accordingly, the following analysis focuses on the main development outcomes observed in the country in subject areas related to the Bank's programming exercise in Costa Rica in 2002-2006. Insofar as the programmatic effort and the issues raised by the BCS-CR have proved to be relevant, however, the points discussed in this chapter take on crucial importance for future action by the Bank.
- 4.2 This discussion will begin by referring back to the general economic baseline analyzed in the first chapter, in order to examine how the situation has changed during the period in question. Then, the indicators proposed in the BCS-CR will be used to assess the results achieved in the areas directly related to the Bank's program. The discussion will conclude with an analysis of how Costa Rica has changed specifically in terms of competitiveness, which has been the main focus of the Bank's program during this period. To this end, information on some projects approved by the Bank prior to 2002 but nonetheless relevant to the analysis will be employed.
- A. Trends in macroeconomic, social, and political conditions: 2003-2006**
- 4.3 The Costa Rican economy's recent overall growth pattern is much stronger than in 2000-2002, as discussed in Chapter I. The economy was aided by a more favorable international environment, which translated into higher exports (especially from the country's free trade areas).
- 4.4 On the external front, the current account deficit narrowed, after having spiked in 2002, thanks in part to increased merchandise exports and tourism. The economy's terms of trade deteriorated by an estimated 11% in 2002-2005, however, due almost entirely to climbing import prices (especially petroleum prices). In 2004 Costa Rica, along with other Central American countries and the Dominican Republic, signed a free trade agreement with the United States (DR-CAFTA). However, this agreement has yet to be ratified by Costa Rica's Legislative Assembly.
- 4.5 An analysis of the different components of GDP shows that the economy's growth in 2002-2005 stemmed primarily from current private-sector expenditure and from investment, rather than from the net results of the external sector (exports minus imports). The first two components accounted for over 90%, on average, of the growth recorded during this period (see Annex Figure A-4.1).<sup>36</sup>
- 4.6 An examination of domestic economic conditions indicates that problems remain in the areas of macroeconomic balance and fiscal sustainability, both objectives of the Bank's program. The economic authorities' efforts to improve the tax, customs, and financial administration systems and to keep the increase in expenditure under

- control have succeeded in strengthening the central government's accounts, measured as percentages of GDP. The total deficit was lowered from 4.3% in 2002 to 2.1% in 2005, while the primary surplus went from 0% to 2% during that same period. The fiscal deficit has been cut not only by reducing current expenditure, however, but also (and principally) by sacrificing public investment, which began to slacken from 2003 on, falling to less than half of its 1995-2000 level, measured as a percentage of GDP. The public debt stock is also still quite large (55% of GDP in 2005), with interest payments taking up over one fourth of central government expenditure. This fiscal fragility, which is associated with a lower level of public investment, interferes with the delivery of public services.
- 4.7 Inflation remained fairly high in 2003-2005, partly as a consequence of the upswing in petroleum prices. Even if the effect of oil price trends is factored out of the calculations, however, inflation was still bordering on 10%.
- 4.8 In social terms, the results were mixed. On the one hand, poverty showed no signs of abating during this period, standing at over 21% in both 2004 and 2005. On the other, the Gini coefficient declined throughout 2003-2005.<sup>37</sup> Unemployment remained above the historical average at 6.5% to 6.7%. Annex Table A-4.1 provides data for 2003-2005 on the same economic and social indicators given in Annex Table A-1.1 for the baseline period.
- 4.9 In 2004 the political situation was overshadowed by charges of corruption involving senior government officials (including the three presidents who preceded President Abel Pacheco in office), some private entrepreneurs, and respected public institutions such as the Caja Costarricense de Seguro Social [Costa Rican Social Security Fund] (CCSS) and the Instituto Costarricense de Electricidad [Costa Rican Electricity Authority] (ICE). These scandals were so serious that they appear to have tarnished Costa Rica's international image.<sup>38</sup> The political crisis may also have been one of the contributing factors to the economy's weaker performance in 2004.
- 4.10 These same difficulties have also, however, served to demonstrate the judiciary's independence, the legislature's responsiveness via the passage of anticorruption bills, and the citizenry's repudiation of corruption, all of which reinforces the perception of solid institutions and democratic awareness.
- 4.11 Annex Figure A-4.2 replicates the exercise depicted in Chapter I (i.e. Costa Rica's ranking among the Bank's member countries) for 2005. In order to facilitate the comparison, Figure 1.1 is reproduced in the upper portion of the graph. As shown here, a comparison of the two periods demonstrates that, in the case of various indicators, Costa Rica has moved away from the top decile and is now closer to the regional average. Its relative ranking has worsened accordingly. The most striking differences are seen in the indicators for the macroeconomic environment and political stability. The first of these differences is accounted for mainly by the inflation rate, the interest rate spread, and the public deficit. The second is attributable to the political crisis sparked by cases of corruption.<sup>39</sup>
- 4.12 This situation is clearly depicted in Annex Figures A-4.3 and A-4.4. The first of these graphs shows the variations seen in the corresponding indicators throughout

this period for Costa Rica and for the top decile. The instances in which the greatest progress was made between the starting and ending dates are represented by the points farthest away from the center of the graph. The figure clearly shows that greater improvements occurred in most of the indicators for the top decile; the strongest advances for Costa Rica were seen in gross fixed capital formation (in line with the observations made previously regarding the breakdown of GDP growth into its various components) and economic freedom. The second figure synthesizes these results into a differences-in-differences depiction of the indicators for Costa Rica and for the highest decile, with positive values representing stronger improvements for Costa Rica. As may be seen, the only four areas (out of the 13 evaluated) in which the indicators for Costa Rica as a whole improved more than they did for the top 10% were life expectancy at birth, human development index, economic freedom, and gross fixed capital formation. The indicators reflecting the most significant relative deterioration were in such areas as macroeconomic environment, political stability, and per capita GDP. The downturn in various governance indicators are probably related to the political crisis spurred by the corruption cases discovered in 2004, as discussed above.

## **B. Outputs of the BCS-CR**

- 4.13 As discussed in Chapter II, the BCS-CR matrix sets forth a series of indicators that can be used to measure how much progress was made toward achieving the objectives defined through the programming exercise.
- 4.14 OVE has collected the necessary information to evaluate the main BCS-CR indicators. The results are shown in Annex Table A-4.1. This table does not include output or input indicators that, by definition, have not been fulfilled, whether because the project has not been approved, because it is in its initial phase of execution, or because its implementation has not begun.
- 4.15 As indicated in the table, information was obtained for 10 out of the 12 indicators. Five of those 10 objectives have been reached: one of the government's two medium-terms objectives, the two strategic area development objectives, and two specific indicator-based objectives. Three will probably not be undertaken, and two are questionable but possible.
- 4.16 These results corroborate what was said in Chapter II about the inapplicability of the findings of the BCS-CR's evaluation based on the proposed indicators. In other words, the main development goals set out in the matrix have been achieved even though: (i) the Bank has not approved the strategic program for the country; (ii) the fiscal reform bill has not been passed; (iii) the DR-CAFTA has not yet been ratified; and (iv) as noted in the preceding section, the country's macroeconomic stability and fiscal sustainability have not been ensured. This raises some question as to the validity of the indicators and the usefulness of the proposed matrix.

## **C. Outcomes in terms of competitiveness**

### **1. Relationship to Bank-approved projects**

- 4.17 As discussed in Chapter II, the Bank's strategy was built around the idea of promoting and ensuring Costa Rica's competitiveness at the international level.

Competitiveness issues can be divided into those that have an influence on factor productivity (human resources, capital, technology) and those that represent transaction costs involved in securing market access (infrastructure, governance). In operational terms, two projects approved before 2002 that were executed primarily during the period covered by this CPE are related to human resource development: the US\$42 million Improvement of Health Services in Marginal Areas Program (CR-0120, 711, 712 OC/CR), approved in 1992, and the US\$28 million Preschool and Lower Secondary Education Project (CR-0044, 1010/OC-CR), approved in 1997. In the area of infrastructure, in 1993 the Bank approved the Electric Power Development Program, Stage III (CR-0036, 7966/OC-CR) for US\$320 million. The Reforms for Competitiveness and Investment Program (CR-0156), the remnant of the hybrid program, includes subprojects in the areas of foreign trade, science and technology, and participatory rural roads rehabilitation, but this operation is still awaiting ratification by the Legislative Assembly and its implementation has therefore not yet begun.

- 4.18 Costa Rica is known to have some of the highest social indicators in the region, and its main indicators in the health sector have improved in recent years. The available information points to an upturn, for example, in life expectancy at birth (which rose from 77.7 years in 2001 to 78.7 years in 2004) and a reduction in infant mortality from 12.5 deaths per 1,000 live births in 2000 to 11.3 per 1,000 live births in 2004. The Bank-funded project in this area set forth two development objectives: to rationalize resource use, and to expand the coverage of health services while reducing inequality in access to basic services. The project appears to have attained the first objective by eliminating the duplication of basic service delivery by the Ministry of Health and the CCSS. The information made available in the project completion report (PCR) and other sources is not sufficient to determine whether or not the second objective has been achieved because it refers to the theoretical expansion of coverage (i.e. it does not take into consideration physical and/or economic obstacles to access) and is not disaggregated by income level. It is worth noting, however, that public expenditure on health services in Costa Rica is progressive.
- 4.19 But while results in the health sector have been good, there is general agreement in Costa Rica that the country is grappling with a major bottleneck in secondary education: (i) one fifth of all students drop out of school in seventh grade, when the secondary cycle begins; (ii) only a third of all students graduate from secondary school; (iii) school attendance rates differ significantly by income level, as the overall rate of 95% for children between the ages of 13 and 17 falls to around 70% for those in the bottom quintile. The causes of these problems include the physical and geographic separation of primary and secondary educational facilities, the use of different teaching methodologies, the quality of education, and the socioeconomic status of many households, which tends to pressure young people into joining the labor market at an early age (the proportion of students in secondary school who both study and work rose by 2.4 percentage points between 2001 and 2004).

- 4.20 The Preschool and Lower Secondary Education Project has taken a long time to implement (over seven years), but it appears to have surpassed all of its targets. (i) Expansion of the coverage of preschool education: for the lower and upper kindergarten levels from 5.6% and 81.2% in 1998, respectively, to 42.2% and 92.2% in 2004; (ii) repeater rate for the lower secondary cycle of public day schools: lowered from 15.5% in 1998 to 13.4% by December 2004; (iii) coverage of lower secondary cycle: raised from 101,439 students in 1998 (77.5%) to 143,146 (80.1%) by December 2004; (iv) intrayear dropout rate in the lower secondary cycle in public day schools: reduced from 13.9% in 1998 to 12.7% by December 2004; and (v) repeater rate in secondary school: lowered from 12.3% in 1998 to 11.5% by December 2004.
- 4.21 The condition of infrastructure in Costa Rica is seen as one of the main sources of market-access transaction costs that are hurting the country's competitiveness. As a consequence of the spending restrictions announced by the Executive Branch, gross public investment in the transport sector has dropped sharply, falling from 0.8% of national output in 2002 to 0.5% in 2004. The downturn in spending amounted to 30% in the roads subsector (which accounts for over half of all transport investment), 89% in the case of airports, and 80% for ports. The public sector's gross capital formation also dropped by a hefty 26% of national output between 2002 and 2004.
- 4.22 A 2004 survey of the road network found that just 14% of it could be classified as in good condition, while 64% was either deficient or very deficient. According to the Ministry of National Planning and Economic Policy, one of the main reasons for this situation is the low level of funding provided by the Consejo Nacional de Vialidad [National Roadways Council] (CONAVI). The fact that total allocations for 2005 were just 50% of what they had been for the preceding year provides a clear indication of what is occurring. In addition, nearly 85% of the routes in the cantonal road system are in fair, poor, or very poor condition.
- 4.23 Costa Rica's ports are lagging far behind in terms of technology. This is particularly true of its Atlantic ports (the Limón-Morín complex, which handles 75% of the country's total cargo and 65% of all passenger traffic). The limited nature of allocations for machinery and equipment, coupled with fee increases in recent years, has been mentioned as one of the causes of the Limón-Morín port's declining competitiveness. A study on this port's competitive position in 2004 underscored the long average waiting time per ship and the low efficiency rate of shipside cargo handling as reflections of the port's low level of international competitiveness.
- 4.24 The results attained in the area of public works concessions during the evaluation period are clearly negative. Attempts to arrange for road concessions have run into all sorts of difficulties: (i) delays in securing authorization for the contract (San José-San Ramón highway); (ii) abandonment of the work by the concession holder and the resulting delay involved in reassigning the contract to another firm (San José-Caldera highway); (iii) the unexpectedly long time required to complete social impact studies prior to the startup of construction work (San José-Cartago highway); and (iv) a lack of government counterpart resources or the financial

- unviability of works unless government funds are forthcoming (San José-Limón and San José-Heredia highways).
- 4.25 Although the country does have the Concessions Act and its accompanying regulations, together with the Private Enterprise Regulation, a broader legal framework is needed as an underpinning for the actions to be implemented. Other limitations include the reliance of the Consejo Nacional de Concesiones [National Concessions Council] (CNC) on external agencies for the execution of crucially important operations and budgetary actions (expropriations and other approvals) and the absence of a guaranteed supply of complementary budgetary resources. These problems are reflected in the underimplementation of the CNC budget in 2005 (38% of the estimated total) and in the CNC's poor rating in the PND evaluation matrices prepared by the SINE for 2005 (its rating was 3.1/10).
- 4.26 In 1997, the MIF approved the Project to Support the Development of the Concessions System (MIF/AT-137). This project, which was completed in March 2003, gave rise to a process involving the amendment of laws and regulations that would probably not have occurred without the presence of a unit assigned specifically for that purpose. In the event, this did not happen because of the existence of an external executing agency.<sup>40</sup> This operation was followed by the Project for the Strengthening of the National Concession Board (MIF/AT-532), which was approved in June 2003. This project had disbursed only 5% of its funds as of October 2006, and the progress made in its implementation since June 2004 has been rated "unsatisfactory." According to members of the executing agency, the project was delivered as a "done deal," not open to discussion, despite the proposal submitted by the MIF.<sup>41</sup>
- 4.27 One of the subprojects included in the Pro-Competitiveness Productive Investment Program (CR-0156), which has been approved but not yet ratified, is designed to improve the year-round transitability of the rural road network.
- 4.28 The national electric power system has thus far been able to cover the demand for electricity and has even reported a surplus supply. Costa Rica has one of the highest degrees of electrification in the entire Latin American and Caribbean region. The ICE may face problems down the road, however, owing to the economic constraints on investment and/or delays in issuing authorizations. As a result of these factors, the construction of strategic projects has not kept pace with the timetable contained in the Plan de Expansión de la Generación Eléctrica [Electricity Generation Expansion Plan] (PGE) for 2004-2020. High oil prices, the possible passage of the Water Resources Act, the opposition of various groups of stakeholders to new projects, and the lack of investment in electricity infrastructure are all factors that may complicate the country's energy situation in the medium and long terms.
- 4.29 As noted earlier, the Bank still had the Electric Power Development Program, Stage III (approved in 1993) in its portfolio during the period covered by this evaluation. This project was reviewed at great length in the preceding CPE, which found it to be achieving good results. This assessment has been corroborated, now that disbursement of the project funds has been completed (after nearly 12 years of project execution). The project targets for installed capacity, the electrification

index, and the frequency of power outages caused by distribution failures have all been met. There is, however, some shortfall in net public power generation.

- 4.30 Some of the main lessons learned in the course of this program are the following:
- (i) The scale of the program in terms of both its financing and its components was too large relative to the executing agency's institutional and implementation capacity. In addition, the time spans and other specific characteristics of concession procedures in Costa Rica were not taken into due account. As a result, procurement plans were not aligned with the average time periods for project development and execution provided for by the Bank. As of May 2006, the country had paid out a total of US\$13.8 million in commitment fees on this loan owing to its long execution period.
  - (ii) The Government of Costa Rica, working through its liaison body (the Ministry of Finance), did not play a catalytic role in supporting this program's implementation, particularly with regard to budget allocations and monitoring.
  - (iii) As pointed out in the most recent PPMR, executing units should be properly sited within borrowers' organizational structures and need to be adequately staffed. The report goes on to note that, in this case, the coordinating unit was not originally located in a suitable position within the institution's organizational structure and was understaffed, but that this was later rectified. ICE staff believe that it would be better, however, for a semi-independent agency to serve as the executing agency, since this would help ensure that loan funds are not mixed with the institution's regular resources.
  - (iv) Neither the ICE nor the Bank fully foresaw the types of problems that arose in securing rights of way or easements.
  - (v) According to ICE staff, although it took a long time to negotiate the loan with the Bank, approval for the project's reformulation was obtained very quickly.

## **2. Competitiveness indicators**

- 4.31 A brief analysis of trends in terms of Costa Rica's level of competitiveness follows. This examination is based on a number of indicators for variables influencing factor productivity (human resources, capital, technology) and transaction costs for market access (governance, the financial sector, and the labor market). Since, by definition, competitiveness is a relative term, the indicators for Costa Rica are compared to the indicators for two of its main competitors in the region: Chile and Panama. These three countries use a similar growth model based on an outward-looking economy that seeks to capitalize upon its comparative advantages. All three also have fairly skilled workforces.<sup>42</sup>
- 4.32 Annex Figures A-4.5 and A-4.6 compare the indicators for Costa Rica with those for Chile and for Panama, respectively, around 2005. The first figure shows that Costa Rica's competitiveness indicators are considerably lower than Chile's,

- particularly in the case of the World Economic Forum's competitiveness index, secondary education coverage, foreign direct investment (FDI), the Heritage Foundation's index of economic freedom, and private-sector borrowing. The only indicators in which Costa Rica outperforms Chile are in the proxy variable for trade openness (measured by the percentage of GDP represented by trade) and expenditure (as a percentage of GDP) on information and communications technology. The indicators for political stability and for freedom in the determination of prices and wages are similar for the two economies. This suggests that the Chilean economy could also be regarded as a benchmark for Costa Rica.
- 4.33 Costa Rica compares much more favorably with Panama. Its indicators are higher than Panama's in most cases, but especially so for Internet users per 1,000 inhabitants, corruption control, and other governance indicators. On the other hand, as is to be expected given the scale of Panama's financial sector, Panama's indicators tend to be better in the areas of financial flows and access (e.g. private-sector credit and private capital flows) and in FDI.
- 4.34 In both cases, the main areas in which Costa Rica appears to be at a disadvantage are private-sector borrowing, private capital flows, FDI, business startup times, and coverage of secondary education. These findings suggest that the limited availability of credit and constraints on financing for private investment are some of the main constraints on the country's competitiveness.<sup>43</sup>
- 4.35 Annex Figures A-4.7 and A-4.8 show where Costa Rica stands in terms of these competitiveness indicators. The results are ambiguous in the sense that the two figures show that, in terms of some of the indicators in which Costa Rica had been at a disadvantage (mainly private capital flows and private-sector borrowing), the country made more progress in 2002-2005 than its two competitors. Unfortunately, the same cannot be said in the case of FDI. Costa Rica not only had lower coefficients for this indicator than either Chile or Panama at the outset, but its rating then grew significantly worse relative to the coefficients for these other two countries. The same is true, although to a lesser extent, for the coverage of secondary education. These results are clearly shown in Annex Figures A-4.9 and A-4.10, which give the differences-in-differences estimates.
- 4.36 The following points should be made regarding the results for FDI and secondary education:
- (i) The results for FDI are disturbing because Costa Rica's recent growth has been buoyed by these resource streams, and the outlook therefore becomes even more problematical given the fact that in early 2009 the country will have to do away with the free trade areas and other external-sector tax incentives that the government has used to attract foreign investment. In fact, the United Nations Conference on Trade and Development (UNCTAD) ranks Costa Rica among the group of countries having a low potential as FDI recipients in 2002-2004 that actually received more such resources than expected.<sup>44</sup>
  - (ii) The results for secondary education are a cause of concern because they indicate that the country may be jeopardizing its ability to compete

effectively in the medium and long terms. Annex Figure A-4.11 provides data on the coverage of secondary education in Costa Rica relative to the average coverage, the median rate of coverage, and coverage in the top decile of the Bank's member countries. Annex Figure A-4.12 presents the same type of information but compares Costa Rica with Chile and Panama. The data clearly show that Costa Rica is not only below the region's average and median rates, but is also quite far behind countries whose indicators put them in the top decile. Costa Rica's coefficient for secondary education coverage is substantially below Chile's, but is less so in the case of Panama in terms of gross rates (i.e. the rates for all enrolled students, regardless of age). The gap between Costa Rica and Panama is wider, however, in the case of net rates (i.e. when using the indicator that reflects only the expected age group for that level of education) because of Costa Rica's high repeater rate. The data on the percentage of students who drop out of secondary educational institutions are also noteworthy. This situation is illustrated by the large difference between the percentages of children enrolled in lower secondary educational institutions and upper secondary schools.

## V. CONCLUSIONS AND RECOMMENDATIONS

### A. Conclusions

- 5.1 The programming effort represented by the Bank's country strategy with Costa Rica (BCS-CR) for 2003-2006 can be regarded as relevant, consistent, coherent, and evaluable. The BCS-CR is also ambitious. Its high-case scenario calls for nearly US\$700 million in approvals, and its low-case scenario US\$400 million, whereas approvals for the three previous programming exercises were all under US\$100 million. An even more conspicuous feature of the strategy, however, is its very heavy concentration (more than 90% of the total resources) in a single hybrid operation. This operation is composed partly of a sector-specific policy-based loan (PBL) that is conditional upon the passage of a tax reform bill, and partly of an investment loan consisting of various subprojects. This proposal was prepared in response to a request made by the government, which was in need of budget support and wished to keep the number of requests for ratification that it submitted to the Legislative Assembly to a minimum.
- 5.2 By concentrating almost the whole of the strategy on just one program (and one that, in addition, was contingent upon the approval of structural reforms and thus ran counter to the recommendation made in the previous CPE), the Bank was focusing its efforts on a single idea or plan which, in the event, never came into being. The Bank eventually approved four operations totaling approximately 37% of the amount called for in the low-case scenario.
- 5.3 With regard to the program intent and the BCS-CR that was implemented, this evaluation has found that:

- (i) The lending program ultimately approved by the Bank did not correspond to the BCS-CR's major objectives or strategic areas in relation to macroeconomic stability, and only the Reforms for Competitiveness and Investment Program related directly to the objective of boosting the country's competitiveness in order to further its effort to position itself in the world economy and make its own economy more open.
- (ii) The line of reasoning followed by the BCS-CR had two major limitations: first, it assumes that there is a direct relationship between economic growth and poverty reduction, despite the "stability" of the country's poverty rates since 1994; and, second, it appears, on the one hand, to recognize the fact that poverty and inequality are related to the structural aspects of an economic and social dualization process, but, on the other, it also seems to imply that the reforms advocated by the Bank would maintain or reinforce that dualization process. These problems could make the Bank's program less relevant.
- (iii) The Bank has made an effort to provide the country with technical support independently, to some extent, of the size of its loan portfolio. This technical support, which is recognized and appreciated by the country, reflects an improvement in the dialogue between the Bank and Costa Rica in recent years.
- (iv) From a strictly "mechanical" standpoint, the BCS-CR is quite evaluable, since the matrix clearly defines indicators for the government's medium-term objectives and for the objectives of the Bank's two strategic areas of intervention. The targets and baselines for these indicators are also clearly identified and quantifiable. The great majority of outcome indicators are also clearly defined and accompanied by targets and baselines. The BCS-CR's evaluability and the usefulness of the outcome matrix are jeopardized, however, by its attempt to use unsuitable indicators to measure complex, long-term objectives. This gives rise to a paradox in that the main development goals outlined in the matrix have been achieved despite the fact that: (i) the Bank has not approved the country's strategic program; (ii) the tax reform bill has not been approved; (iii) DR-CAFTA has yet to be ratified; and (iv) the country's macroeconomic stability and fiscal sustainability are not assured.

5.4 The evaluation's findings with regard to the efficiency of output delivery are as follows:

- (i) In terms of the efficiency of project preparation, even though it took a long time to secure approval for the Reforms for Competitiveness and Investment Program, the average preparation time for the projects approved during this period was still shorter than for other relevant comparison groups.

- (ii) A number of difficulties were encountered in preparing the hybrid program, largely because of its size and innovative nature. The cost to the Bank of preparing this operation was also significant: at least US\$2.4 million, and as much as US\$3.1 million if the cost of the TCs approved to support its design and preparation are included.
  - (iii) Since the projects approved in the period covered by the BCS-CR have, as yet, very low execution levels, the analysis of project execution efficiency was based on projects that were approved prior to 2002 but disbursed over half of their resources between 2002 and 2006. The amount of time required to implement Bank projects and the duration of such projects in Costa Rica are both significantly above the Bank average. The projects that disbursed the bulk of their resources in 2002-2006 had, on average, execution times 49% longer and extensions 81% longer than the average figures for all investment projects approved by the Bank between 1990 and 2001.
  - (iv) Despite the inefficiencies observed in project implementation, the data on portfolio execution show a major improvement since 2002, but not enough to avert negative net flows between the country and the Bank.
- 5.5 In macroeconomic terms, the domestic economic situation indicates that, despite a favorable external environment and higher GDP and external-sector growth rates, problems remain in the areas of macroeconomic equilibrium and fiscal sustainability—objectives of the Bank’s program—and the fiscal adjustment effort has led to sizeable cuts in public investment that have interfered with the delivery of public services.
- 5.6 The comparative analysis done by OVE of 13 indicators of economic factors, governance, and social development during the evaluation period shows that, in the case of Costa Rica, only four of these indicators displayed a more positive trend than in the top 10% of Bank member countries: life expectancy at birth, the human development index, economic freedom, and gross fixed capital formation. The indicators reflecting the most significant relative deterioration were in such areas as macroeconomic environment, political stability, and per capita GDP. Generally speaking, Costa Rica has moved away from the top decile and is now closer to the regional average for various indicators, so its relative ranking has worsened.
- 5.7 The analysis of Costa Rica’s position in terms of competitiveness (the main focus of the BCS-CR) indicates that, in operational terms, two projects approved prior to 2002 and executed mainly during the period covered by this CPE concerned areas that have an influence on factor productivity: the Improvement of Health Services in Marginal Areas Program, approved in 1992, and the Preschool and Lower Secondary Education Project, approved in 1997. Another project, the Electric Power Development Program, Stage III, approved in 1993, involved efforts to reduce the transaction costs of market access. These projects, and particularly those relating to education and electric power development, address critical issues in terms of Costa Rica’s competitiveness (secondary education and infrastructure) and appear to have attained their development objectives.

- 5.8 A comparative analysis of a selection of competitiveness indicators for Costa Rica, Chile, and Panama shows that, for most of the variables, Costa Rica is still quite distant from Chile but not from Panama. The main indicators for which Costa Rica ranks lower than these two countries are: lending to the private sector, private capital flows, FDI, business startup times, and secondary education coverage. These findings appear to indicate that the limited availability of credit and constraints on financing for private investment are among the main factors hurting the country's competitiveness.
- 5.9 The analysis of trends in indicators for 2002-2005 yields mixed results. In 2002-2005 Costa Rica showed a stronger improvement than these two competitors in some of the indicators for which it had initially had a lower rating. This was mainly the case for indicators of private capital flows and credit to the private sector.
- 5.10 FDI indicators, on the other hand, show that Costa Rica not only had lower ratings than Chile and Panama, but that it also experienced a sizeable deterioration vis-à-vis those two countries. The same occurred, although to a lesser extent, in the coverage of secondary education.
- 5.11 These findings are of great concern because one of the drivers of Costa Rica's recent growth has been FDI, and the outlook therefore becomes even more worrisome, since in early 2009 the country will presumably have to do away with the free trade areas and foreign-trade tax incentives that the government has used to attract foreign investment. In the area of secondary education, the implication is that the country may be jeopardizing its ability to compete successfully in the medium and long terms.

## **B. Recommendations**

- 5.12 The lessons learned from the way in which the 2003-2006 BCS-CR has unfolded once again demonstrate the need to recommend that the Bank should not structure its programming exercises around goals and objectives relating to structural reforms. The Bank's support for such efforts on the country's part should focus on technical assistance and on economic studies and analyses. The new BCS-CR should be based on the lessons learned from previous programming efforts and should propose realistic approval levels in keeping with conditions in the country.
- 5.13 In view of the amount of time it takes to design new operations and secure their approval, the new BCS-CR should view the existing portfolio as its main vehicle of action in the country for the next few years. This approach will maximize the benefits to be derived from the BCS-CR through the use of TCs supplemented by NFPs.
- 5.14 In order to minimize any potential difficulties in obtaining ratification for its operations, the Bank should keep the Legislative Assembly apprised of its objectives and of progress on their preparation from the outset.
- 5.15 Competitiveness continues to be a clearly relevant issue for the country. Two points should be made in this connection:
- (i) The Bank should support the country's efforts to determine whether or not its recent growth model is deepening its economic and social

dualization. An understanding of this phenomenon is of critical importance in designing complementary programs and policies to reduce poverty and inequality;

- (ii) The Bank should continue to track the DR-CAFTA ratification process and support the country in the design of policies to minimize its impact (if ratified) on any groups adversely affected.
- 5.16 The Bank should also assist the country to meet the challenges posed by the elimination of free trade areas and other tax incentives, which is scheduled to occur in 2009. Particular attention should be devoted to the design and implementation of new instruments for promoting and attracting FDI.
- 5.17 Support for secondary education should be a priority for the Bank in Costa Rica. There is clear evidence that this sector represents a bottleneck for the country's future, and the Bank has a long history of relative success in this area that can be drawn upon.
- 5.18 The country's infrastructure has deteriorated significantly in recent years, and the demand for assistance in this sector is therefore quite strong. The Bank should clearly map out its comparative advantages and value added, and then prioritize its actions on that basis. One of the projects for Costa Rica now in the Bank's pipeline is a conditional credit line for investment projects (CCLIP) operation for the electric power sector which is classified as 2007-A. The regulatory agency for the electricity sector in Costa Rica—the Instituto Costarricense de Electricidad [Costa Rican Electricity Authority] (ICE)—is considered to be one of the best in the region, and its efficiency indicators are quite high. Nevertheless, all of the project performance monitoring reports (PPMRs) prepared for the Electric Power Development Program, Stage III (CR-0036, 7966/OC-CR) since 2001 have noted that problems exist in terms of institutional capacity. Because this instrument has been designed for use "*in those cases where successful project performance can be demonstrated both with respect to execution and results . . . . [and] the executing agency has had a solid track record of satisfactory performance in the execution of the previous project*" (document GN-2246-1, pages 1 and 4), the Bank and the country should work together to ensure that these problems are solved.<sup>45</sup>
- 5.19 The continuing weaknesses of the CNC, which are part of the reason for the problems encountered in the country's concessions process, raises some question as to the wisdom of continuing to provide it with support while scheduling operations with the private sector which may not do well. A MIF project that has disbursed just 5% of its loan three years after approval suggests that it may be advisable to keep closer track of the difficulties faced by this institution.
- 5.20 In view of the specific limitations affecting the Bank's progress in promoting private-sector participation in Costa Rica, a close and well coordinated working relationship between the MIF and the Private Sector Department (PRI) could benefit the operations of both. The same holds true, in cases where political support is forthcoming, for TCs designed to deal with bottlenecks that are impeding the private sector's participation. The changes made by the Board of Governors in the PRI's activities in 2006, broadening its range of clients and sectors, could make it

feasible for the PRI to expand its operations in Costa Rica with public enterprises such as the ICE and others. For all of these reasons, it is recommended that the BCS-CR for 2006-2010 adopt an integrative approach for the public and private areas of Bank action.

## Endnotes

- 1 Document RE-277, submitted to the Bank’s Board of Executive Directors in April 2003.
- 2 Data for 2005 using measurements based on international purchasing power parity. *World Development Indicators* (WDI), World Bank.
- 3 Measured in dollars or in terms of international purchasing power parity.
- 4 “Nota Sectorial Sobre Comercio e Integración” [Sector note on trade and integration], INT/ITD.
- 5 The PUSC obtained nearly 39% of presidential votes and 19 seats in the Legislative Assembly; the PLN garnered 31% of the votes cast in the presidential election and 17% seats; and the PAC won 26% of the votes and 14 seats in the Assembly.
- 6 The 2002 elections were also marked by the highest abstention rate in the country’s history (31%).
- 7 No attempt is made to provide a comprehensive summary of the diagnostic assessment of the BCS-CR or of the preceding CPE in this subsection anterior, which seeks only to bring out the main points made in those documents.
- 8 Relevance, consistency, and coherence are examined by asking the following questions: Did the program address the main development challenges facing the country? Does the program contain elements that run counter to the preceding program cycle or flaws in its internal logic? Does the program make use of all Bank instruments and does it coordinate the actions it contains with those of other actors?
- 9 Submitted to the Bank’s Board of Executive Directors in June 2003. Programming missions are also part of the programming exercise.
- 10 Particular emphasis was placed on the objective of increasing the efficiency of public spending.
- 11 “Country Paper Guidelines. Final Revised Version” (document GN-2020-6, page 3).
- 12 The indicator chosen for the first strategic area was the reduction of the fiscal deficit at an average annual rate of 1%, starting from the 2002 deficit of 5.9%. The indicator selected to measure progress in the second strategic area was the increase in nontraditional exports (excluding Intel products). The high-case scenario would be achieved if the annual increase in such exports averaged 5%, using the average level of exports in 2001-2002 (US\$3.49 billion) as a baseline.
- 13 This was a foreseeable development, given the way in which the second strategic area was defined (see paragraphs 2.8-2.10).
- 14 See the discussion in Section C concerning the relevance of the indicators established in the BCS-CR.
- 15 The program’s concentration on Strategic Area II (productive-sector development and competitiveness) in the BCS-CR is heightened in the “de facto” program, since all the approved projects fall into this strategic area.
- 16 In addition to the projects approved in 2002-2005, as of December 2005 Costa Rica’s loan portfolio included four other nonregional operations that were approved in three of the four programming exercises evaluated in the previous CPE.

### Projects Approved in 1990-2001 and Under Way as of December 2005

Number	Name	Year approved	Amount (US\$ millions)*
CR-0036 7966/OC-CR	Electric Power Development Program, Stage III	1993	320.0
CR-0044 1010/OC-CR	Preschool and Lower Secondary Education Project	1997	28.0
CR-0134 1284/OC-CR	Cadaster and Registry Regularization Program	2000	65.0
CR-0141 1377/OC-CR	Judiciary Modernization Program, Stage II	2001	22.4
Total			435.4

Source: Oveda.

The portfolio still includes a regional operation (CA-007) that is part of the regional Sistema de Interconexión Eléctrica para los Países de América Central [Electrical Interconnection System for Central American Countries] (SIEPAC). The Costa Rican components (1368/OC-CR and 3/SQ-CR) total US\$40 million.

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- 17 Data for the period from 2003 to October 2006.
  - 18 The MIF also approved a project involving approximately US\$1.1 million in 2006.
  - 19 For example, before selecting the first concession holder for the San José-Caldera highway, on several occasions the Office of the Comptroller-General sent the contract back with observations (without having approved it). This greatly delayed the selection process.
  - 20 These are also problems for the MIF, which has not approved a project in connection with the concession for the San José-Cartago highway.
  - 21 The Action Plan also included public-sector operations that would have an impact on competitiveness and the private sector.
  - 22 The report on the plan of action (document GN-2193-5, April 2003) continued to propose the three activities for 2003 that were not approved, in addition to proposing four other activities (an IIC operation that was approved, a TC for the National Transport Plan that was cancelled, a MIF project to strengthen airport security and a MIF project to strengthen the National Concessions Council. Another six activities that had not been planned were approved in 2003. Clearly, the success rate for forward programming efforts for the private sector has not been satisfactory either.
  - 23 The IIC also approved two other operations in 2006 (up to October).
  - 24 The evaluation regarded such terms as “designed” and “functioning” as acceptable. Thus, for example, the indicator “Budget programming, control, and evaluation system designed in 2004” was considered to be “clearly defined,” since it could be associated with a specific output to be produced by a project.
  - 25 The English-language version of the report was published in 2002; the Spanish-language version, entitled “Costa Rica: El Gasto Social y La Pobreza,” was published in 2003.
  - 26 See “Country Partnership Strategy for the Republic of Costa Rica” (April 2004), which covers the World Bank’s fiscal 2004-2007 period.
  - 27 This operation has not yet been ratified by the Legislative Assembly.
  - 28 Failure to fulfill an eligibility clause led to this component’s cancellation.
  - 29 The Program for the Sustainable Development of the Atlantic Huetar Region (CR-0157, 1615/OC-CR), for example, has a series of very ambitious objectives which include institution-strengthening, job creation, poverty reduction, services for vulnerable groups, and environmental protection. The objective of the project’s first component is to *develop the economic, social, and environmental management capacity of the various stakeholders having responsibilities at the local and regional levels*. Component 2’s objective is to *promote economic alternatives and permanent job creation processes that include extremely poor and vulnerable groups by complementing and enhancing government actions*. Component 3’s objectives is to *reduce the vulnerability of the region’s main watersheds, protect the environment, and improve sustainable resource management with community participation*. These issues could jeopardize the project’s (actual or perceived) effectiveness, and in this respect the operation therefore does not conform to the recommendation made in the preceding CPE, which counsels that projects in Costa Rica should be have a high degree of impact elasticity in terms of efficiency and effectiveness (see paragraph 2.45).
  - 30 Loan Committee memorandum: “COSTA RICA. Programa de Inversiones Productivas para Apoyar la Competitividad (CR-0156). Nota de Actualización” [Costa Rica. Pro-Competitiveness Productive Investment Program (CR-0156). An update]. 27 April 2005.
  - 31 Two of the three subproject executing units have said that they do not know how the projects’ synergies would be generated or verified, even though they do acknowledge that staff attended a workshop on inter-component synergies that was held during the project’s preparation.
  - 32 The projects approved prior to 2002 and partially executed during the period in question which were excluded on the basis of this criterion are: (i) the Sewerage and Water Supply Program – Intermediate Cities (CR-0117, 636, 637/OC-CR), approved in 1991, which had disbursed 86% of the loan funds by the start of 2002; (ii) the Improving the Quality of Education Program (CR-0132, 667/OC-CR), also approved 1991, which had disbursed 94% of its resources by the beginning of 2002; (iii) the Judicial Administration

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Improvement Program, Stage I Project (CR-0073, 859/OC-CR), approved in 1995, which had disbursed 78% of the loan proceeds by the start of 2002; (iv) the Cadaster and Registry Regularization Program (CR-0134, 1284/OC-CR), approved in 2000, which had disbursed 6.5% of its resources as of December 2005; and (v) Judicial Administration Improvement Program, Stage II (CR-0141, 1377/OC-CR), which had disbursed 18% of the loan funds as of December 2005.

- 33 These issues touch upon the executing agency's institutional capacity, the *performance* of consultants, interagency coordination problems, the *performance* of contractors, procurement difficulties, excessive costs, "qualified" external audits, policy changes in executing agencies, and the lack of a monitoring/evaluation system.
- 34 These issues have to do with the difficulties involved in winning legislative approval, the commitment of executing agencies and borrowers, the lack of counterpart funds, political/community opposition, and changes in national policy.
- 35 Debt service climbed very steeply in 2004 and 2005, jumping from US\$153 million to US\$250 million owing to the prepayment made by the ICE.
- 36 If, however, exports' contribution to GDP is looked at individually, it will be seen that they accounted for a sizeable proportion of the economy's growth during this period. On average, the contribution of exports in 2002-2005 is similar to that of private consumption and investment.
- 37 This improvement notwithstanding, the Gini coefficient was higher in 2005 than it had been in 1999.
- 38 See the discussion on Annex Figures A-4.3 and A-4.4, as well Section C of Chapter IV.
- 39 It is important to note that these movements do not necessarily signal a deterioration in these indicators in absolute terms but rather a relative deterioration in Costa Rica's indicators relative to the top 10% of Bank member countries.
- 40 In its independent evaluation of the MIF (final report, MIF/GN-78-18), OVE found that activities had been properly planned out and that the division of the project into phases and the concise delimitation of its objectives contributed to this. The relevant documents did not, however, provide an extensive institutional analysis that would have pinpointed the executing agency's weaknesses and strengths. The problems of the external executing unit were identified as one of the project's most serious shortcomings by all the evaluations that were prepared.
- 41 The PPMR of August 2006 mentions the additional complication created by the Office of the Comptroller-General in connection with the execution of TCs by public agencies. In addition, the PPMR points up the fact that although, on the one hand, having an executing unit staffed by regular employees (incorporating the lessons learned from the previous project, which had an external executing unit) results in increased ownership of the issues addressed by the project, there is also, on the other hand, the fact that outside demands will compete for priority within the limited time available to such employees and may therefore slow its pace of progress.
- 42 In addition to their closer geographical proximity, Costa Rica and Panama have a number of other very significant similarities. For example, a large part of both countries' exports come from their free trade areas; both of them are making an effort to promote science and technology and information and technology; and their services sectors, in general, and their tourism industries, in particular, are major sources of revenues.
- 43 Costa Rica's financial sector also has a large local-currency interest-rate spread that hinders small and medium-sized enterprises access to credit.
- 44 These results are for the most recent period for which data are available. In the preceding period (2000-2002), Costa Rica was ranked among the countries with a high potential as FDI recipients that received a large flow of such resources.
- 45 This operation has taken almost 12 years to implement and had to obtain an extension of nearly 7 years (see Chapter III-B and Table 3.4).