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Costa Rica: Reducing Income Inequality and Poverty Through Fiscal Measures

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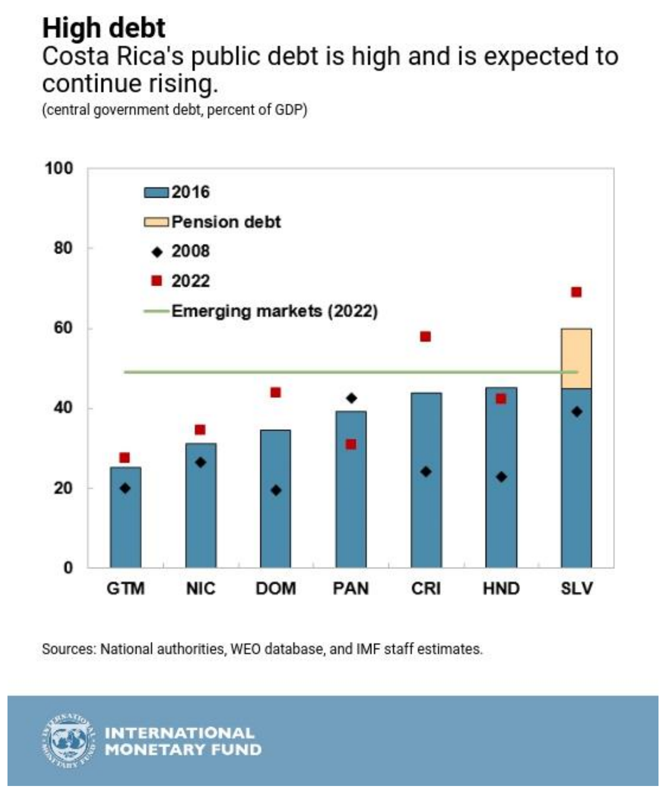
The Costa Rican economy is growing robustly, boosted by favorable global conditions, notably continuing low commodity prices and ample liquidity in financial markets. Nonetheless, the persistence of large fiscal deficits and continued increases in the public debt-to-GDP ratio make Costa Rica vulnerable to adverse changes in financial market sentiment. A reduction in the fiscal deficit—mainly through a tax reform that also improves progressivity and reduces income inequality—is therefore necessary.

Costa Rica's economy is growing at its estimated trend rate of about 4¼ percent and the output gap is essentially closed. Headline inflation turned positive again in the second half of 2016 and is rising moderately, with both headline and core indicators (which exclude items with high price volatility) still below the 2–4 percent target range. Strong exports together with still low oil prices contributed to a further narrowing of the current account deficit to about 3¼ percent of GDP in 2016. Notwithstanding these positive developments, the colón has been depreciating moderately while international reserves have declined since mid-2016. Pressure on the colón has been driven by the decrease in external budget financing, after the expiration of Congressional approval for Eurobond issuance, as well as reduced premia on savings in local currency and expectations of a decoupling from the U.S. dollar, which have prompted portfolio switches by the public into dollar deposits and led banks to decrease foreign funding and increase deposits abroad in foreign currency. Concerns about the weak domestic fiscal situation are also likely to have played a role.



Ambitious reforms

The IMF's latest annual report on the health of Costa Rica's economy strongly recommends that the government adopt a comprehensive reform strategy to restore long-term fiscal sustainability. Without additional policy actions, the central government deficit would rise over 8 percent of GDP and debt would reach 65 percent of GDP by 2022 (from 45 percent at end-2016), owing to a mounting interest bill and constitutionally-mandated spending increases.

To prevent this very risky situation, the government has crafted a tax reform proposal, that—together with some reductions in expenditures—could, according to our estimates, yield the adjustment needed to stabilize the debt ratio over the medium term within safe levels. The implementation of a frontloaded adjustment plan could also trigger a favorable market reaction, thus reducing credit spreads (the difference in yield between a benchmark bond and a debt security with the same maturity), currently being pushed up by the large financing needs of the government.

In addition, the fiscal adjustment would facilitate the central bank's efforts to reverse the monetary easing cycle, as inflation is returning to desired levels with output already at potential, restoring in the process the premium on savings in colones. Indeed, continuing large fiscal deficits could undermine the central bank's ability to conduct an effective monetary policy, if it faced pressures to maintain government financing costs low (what is called, in economic jargon, "fiscal dominance"), or if it had to implement larger-than-desirable increases in interest rates to keep inflation within target.

Striking the right balance

The government's comprehensive fiscal adjustment package maintains an appropriate balance between revenue and expenditure measures. Its key elements include:

Costa Rica: Fiscal consolidation measures
(percent of GDP)

Legislative measures	2.3
VAT	1.5
Base widening (services)	0.5
Tax rate hike (13 to 15 percent)	0.8
Vehicle and real estate sales	0.2
Income tax	0.8
Administrative expenditures measures	0.7
Total	**3.0**

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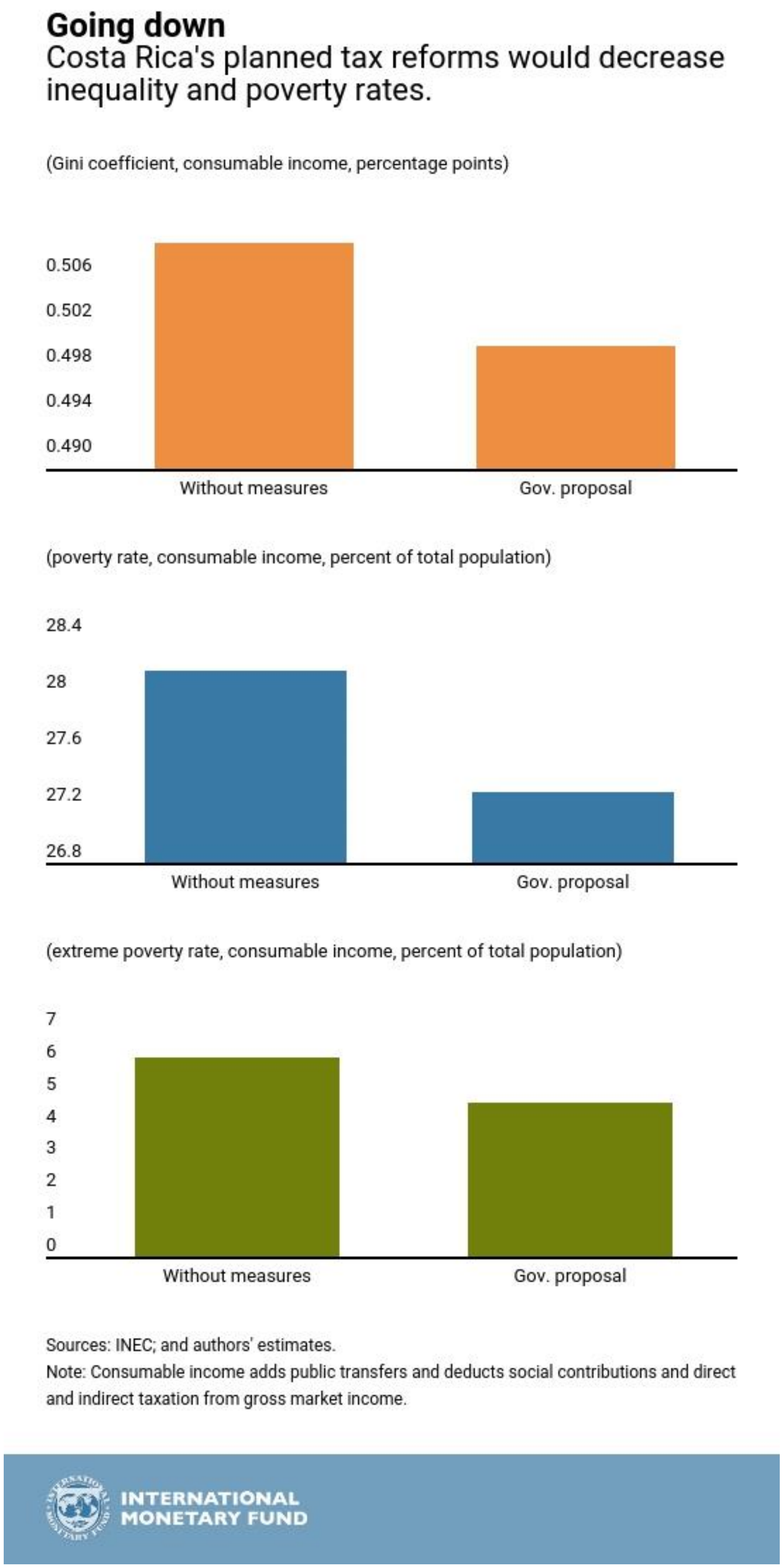
- ***Tax reform***. This includes the conversion of the current sales tax into a full-fledged value-added tax, widening its base to include services, and gradually increasing the tax rate to 15 percent; and introduction of new marginal tax rates of 20 and 25 percent on higher income brackets, elimination of exemptions on the 15 percent tax on income from investments, and introduction of a new capital gains tax at the same rate.
- ***Spending reductions***. This would be take place through administrative means, mostly through a partial hiring freeze and holding base salary increases below inflation.
- ***Public employment and fiscal responsibility laws***. These would provide additional consolidation benefits over the long term.

Impact on inequality and poverty

Two important features of the tax measures would reduce income inequality and poverty. First, the proposed reforms of personal income taxes would decrease the inequality of income distribution by introducing new marginal rates on higher income brackets. Second, the basic consumption basket currently exempted from the value-added tax would be limited, but a new mechanism of targeted transfers would be introduced to compensate taxpayers in the lowest four deciles of the income distribution. These value-added tax refunds to lower-income households would offset the adverse impact on income distribution of the increase in value-added tax rates and enlargement of the base.


Going down
Costa Rica's planned tax reforms would decrease inequality and poverty rates.
(Gini coefficient, consumable income, percentage points)
0.506
0.502
0.498
0.494
0.490
Without measures
Gov. proposal
(poverty rate, consumable income, percent of total population)
28.4
28
27.6
27.2
26.8
Without measures
Gov. proposal
(extreme poverty rate, consumable income, percent of total population)
7
6
5
4
3
2
1
0
Without measures
Gov. proposal
Sources: INEC; and authors' estimates.
Note: Consumable income adds public transfers and deducts social contributions and direct and indirect taxation from gross market income.
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Thus, the cumulative effect of the personal income tax and value-added tax reforms, including the refunds to the lower-income group, would be progressive, reducing both income inequality and poverty. Obviously, this would be conditional on smooth implementation of targeted transfers to compensate lower-income households for the higher value-added tax payments.

In sum, Costa Rica's proposed fiscal reform package is what the country badly needs. It would pave the road for robust and sustainable growth, while also reducing income inequality and poverty. The adjustment plan should be implemented urgently to eliminate the biggest risk—large and protracted fiscal imbalances. Doing so would strengthen Costa Rica's ability to deal with possible worsening in international economic conditions and to extend the social progress the country has achieved so far.

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