Program Information Document (PID)

Appraisal Stage | Date Prepared/Updated: 29-May-2020 | Report No: PIDA28629
BASIC INFORMATION

A. Basic Project Data

<table>
<thead>
<tr>
<th>Country</th>
<th>Project ID</th>
<th>Project Name</th>
<th>Parent Project ID (if any)</th>
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<tbody>
<tr>
<td>Costa Rica</td>
<td>P171912</td>
<td>First Fiscal and Decarbonization Management DPL (P171912)</td>
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<table>
<thead>
<tr>
<th>Region</th>
<th>Estimated Board Date</th>
<th>Practice Area (Lead)</th>
<th>Financing Instrument</th>
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<tr>
<td>LATIN AMERICA AND CARIBBEAN</td>
<td>25-Jun-2020</td>
<td>Macroeconomics, Trade and Investment</td>
<td>Development Policy Financing</td>
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<th>Implementing Agency</th>
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<tbody>
<tr>
<td>Republic of Costa Rica</td>
<td>Ministry of Finance</td>
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Proposed Development Objective(s)

The Program Development Objective of this DPL is to support Costa Rica's program to: (i) protect people’s income and jobs from the impact of COVID-19 and foster SME recovery; (ii) reinforce fiscal sustainability in the aftermath of COVID-19; and (iii) Lay out the foundations for a strong post-COVID-19 recovery by promoting green growth and low-carbon development.

Financing (in US$, Millions)

<table>
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<th>SUMMARY</th>
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<tr>
<td>Total Financing</td>
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DETAILS

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<tr>
<td>World Bank Lending</td>
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Decision

The review did authorize the team to appraise and negotiate.
B. Introduction and Context

Country Context

1. Costa Rica has been hit hard by the impact of coronavirus (COVID-19) pandemic, but containment and relief efforts have been adequate to flatten the curve and reduce deaths. As of May 28, 2020, 1,000 cases have been detected (10 deaths). The Government responded quickly by introducing strong containment measures, while reallocating spending and mobilizing revenue to create headroom to fund the response. The Government also rolled out programs to support vulnerable segments of the population. Containment measures included international travel restrictions, partial lockdowns and closures of schools, national parks and most economic activities. A relatively well-developed healthcare system rapidly expanded treatment capacity (including converting a rehabilitation center into a hospital) and testing has steadily increased.

2. While these measures helped flatten the infection curve, they also have – together with the effects of the global recession – brought to a halt the fiscal recovery of late 2019 and early 2020 and resulted in a sharp contraction of the economy. Households’ and businesses’ disposable income has sharply contracted. Data from the Central Bank suggests growth fell from 3.1 percent in the fourth quarter of 2019 to 0.5 percent in the first quarter of 2020, after only two weeks of lockdown. This rapid decline reinforced predictions that the economy would suffer a deep recession this year, with GDP expected to contract by 3.3 percent in 2020 and poverty (US$5.5/day) expected to increase by at least 3.5 percentage points, to 13.6 percent of the population (180,200 new poor). The total impact on annual poverty rates will depend on the duration of the crisis and the speed and extent of economic reactivation over the coming months. Approximately 60 percent of all workers (1.2 million) are expected to be impacted by the shock.

3. In crafting a short- to medium-term response to the crisis, the authorities have made it clear that additional public spending is temporary and does not imply a loss of control over public finances. Costa Rica had enacted a major fiscal reform at the end of 2018 to put the country’s debt on a sustainable path. The revenue measures included replacing the sales tax with a value-added tax with a broader base, increasing personal income taxes, harmonizing the treatment of capital income across taxation regimes, and introducing best practices to combat base-erosion and profit-shifting. Measures to contain the wage bill were also enacted, together with a fiscal rule that caps the nominal growth of spending by amounts that are inversely proportional to the country’s public debt ratio. While all measures continue to be in place, key elements have been “deactivated” during the pandemic. The moratorium on all tax filing and payments was required to ensure individuals and companies retain liquidity to confront the reduction in income and demand, respectively. The escape clause of the fiscal rule was also invoked, although temporarily and selectively to allow an increase in health, social protection, labor and law enforcement spending. The social and economic impact of COVID-19 has slowed down the fiscal adjustment, but only temporarily, as the fiscal response effort has been based on reversible measures, with a clear prioritization of objectives and consistent focus on contributing to expanding fiscal space.

4. Costa Rica’s growth and economic diversification strategy builds on the country’s key strengths, including its trademark natural resource management. Costa Rica’s development success is an anchor of stability in the region. It is the only tropical country in the world that has managed to reverse deforestation. Per capita income has doubled over the past two decades due to openness to trade and foreign investments as well as a significant investment in human capital and institutions. Costa Rica is also a worldwide leader in environmental management policies, receiving the “2019 Champions of the Earth” award, the United Nations’ (UN) highest environmental honor, for its leadership in natural resource conservation and its commitment to ambitious climate policies. On May 15, 2020, Costa Rica was invited to become the Organization for Economic Cooperation and Development’s (OECD’s) 38th member and the fourth Latin American country. The accession process required approving and implementing structural reforms in areas that also support medium-term growth prospects (environment, fiscal, health, education, governance, labor and finance).
5. The country’s National Decarbonization Plan 2018-50 (NDP) aims to modernize and revitalize the economy through a green growth lens as much as reverse increases in greenhouse gas (GHG) emissions. By introducing incentive schemes to accelerate and scale-up the deployment of low-carbon technologies in the agriculture sector, and by strengthening the country’s green branding, Costa Rica can pioneer ways to enhance market access and export zero-emission/green products, that will bring added value to these products along the quality and price ladders. In the energy sector, the national electric system will be strengthened to increase capacity and resilience needed to supply and manage renewable energy at competitive costs.

Relationship to CPF

6. The DPL series is fully aligned with the FY16-20 Country Partnership Framework (CPF) discussed by the Board of Executive Directors on May 26, 2015 and recently extended through FY22, and IBRD’s policies for Upper Middle-Income Economies. The DPL series is a core instrument to achieve CPF Objective 4 on “Strengthening fiscal management capacity to enhance efficiency,” and Objective 6 on “Expanding capacity to promote climate-smart and environmentally sustainable development.” The series also contributes to the WBG Climate Change Action Plan and climate targets for 2021-2025 by supporting Costa Rica’s efforts toward decarbonization. Specifically, the series targets mitigation benefits through strengthening capacity to monitor carbon emissions, coordinating subnational low-carbon efforts, and implementing priority sectoral, climate-smart actions, which are part of the NDP. Equally important is the opportunity for the WBG to accompany and learn from Costa Rica’s efforts in these key areas for other developing countries.

C. Proposed Development Objective(s)

7. The Program Development Objective of this DPL is to support Costa Rica's program to: (i) protect people’s income and jobs from the impact of COVID-19 and foster small and medium enterprise (SME) recovery; (ii) reinforce fiscal sustainability in the aftermath of COVID-19; and (iii) lay out the foundations for a strong post-COVID-19 recovery by promoting green growth and low-carbon development. Supporting the Government in effectively responding to the pandemic is critical to assist the population in greatest need, prevent job loss, and foster job creation, while at the same time tapping non-distortionary revenue sources to partially fund these efforts. Once the crisis moderates, the authorities plan to reinforce their fiscal and decarbonization programs, which the Government had vigorously launched prior to the pandemic. Swift and continued implementation of fiscal and decarbonization reforms is essential to boost the country’s stabilization efforts and generate new sources of sustainable growth.

Key Results

8. Key results include: (1) providing income support to people affected by the COVID-19 crisis through a special cash allowance and increasing the share of families in the lowest quintile of the income distribution covered by “Avancemos”; (2) supporting SMEs to remain in business during the COVID-19 crisis by providing additional liquidity and simplifying procedures to start a business; (3) increasing the contribution of state-owned enterprises (SOEs) to government revenues; (4) increasing revenues from value-added taxes (VAT) and income taxes through the transformation of the sales tax into a VAT and the reform of the income tax; (4) increasing annual government budgets in compliance with the fiscal rule; (5) reducing fiscal deficit through decrease in average nominal growth rate of public wage bill of the Central; (6) reducing the proportion of direct issuance made by non-competitive auctions; (7) increasing the number of public agencies formally reporting their greenhouse gas emission data in the National Climate Change Metrics System (SINAMECC); (8) increasing the number of municipalities and public and private organizations participating in the National Carbon Neutrality Program, and increasing the number of products using the Program’s branding ; (9) increasing the percentage of livestock and
coffee producers applying Nationally Appropriate Mitigation Actions (NAMA) model, and the number of farmers receiving environmental service incentives; and (10) increasing the number of power plants registered to provide ancillary services.

D. Project Description

9. **The proposed operation supports Costa Rica in mitigating the social and economic impacts of the COVID-19 outbreak and lays the foundations for sustainable fiscal recovery that also promotes green growth and low carbon development.** The proposed US$300 million operation is the first in a programmatic Development Policy Financing (DPF) series of two. Supporting the Government in effectively responding to the pandemic is critical to assist the population in greatest need, prevent job loss, and foster job creation, while at the same time tapping non-distortionary revenue sources to partially fund these efforts. The second operation would seek to reinforce the Government’s fiscal and decarbonization programs once the COVID-19 crisis moderates. Swift and continued implementation of fiscal and decarbonization reforms is essential to boost the country’s stabilization efforts and generate new sources of sustainable growth.

10. **The proposed operation combines crisis-response measures with structural reforms that will help strengthen Costa Rica’s economic position to navigate the COVID-19 crisis and its aftermath.** The three proposed pillars -- (1) protecting people’s income and jobs from the impact of COVID-19 and fostering SME recovery; (2) reinforcing fiscal sustainability; and (3) laying out the foundations for a strong post-COVID-19 recovery -- are interlinked and mutually reinforcing. Measures under Pillar 1 support COVID-19 crisis response, helping maintain the livelihoods of vulnerable segments of the population through cash transfers to those who become unemployed due to the pandemic. Measures also help maintain formal jobs in the private sector, creating fiscal space for crisis response. Pillar 2, which aims at increasing structural tax revenues and containing spending growth, ensures sustainability of public finance in the aftermath of the COVID-19 crisis. Finally, Pillar 3 promotes green growth and low-carbon development measures, laying the basis for post-crisis recovery.

11. **The operation is being prepared as part of an international financing package to support Costa Rica during the COVID-19 emergency.** The series is part of a coordinated effort by the international community to support Costa Rica’s macroeconomic stabilization and sustainable growth program.

E. Implementation

Institutional and Implementation Arrangements

12. **The Ministry of Finance will be the main coordinating agency for monitoring and evaluation among the other participant ministries.** The operation’s prior actions are the prime responsibility of several ministries, including: Ministry of Finance, Ministry of Energy and Environment, Ministry of Planning (MIDEPLAN), and Ministry of Agriculture. The Ministry of Finance will coordinate with other ministries on the monitoring of the results indicators, which are based on publicly available information. The World Bank will monitor implementation of the proposed operation through the regular supervision missions and the preparation of its follow up operation.

13. **Program outcomes will be monitored through the measurement of the progress toward the achievement of results indicators included in the operation’s policy and results matrix.** Program monitoring seeks to assess progress toward the implementation of the policy and institutional measures supported by the proposed DPF series and will be evaluated following the disbursement of the first Development Policy Loan (DPL). The Ministry of Finance will have the
responsibility of presenting the information related to the reform implementation and progress made toward results on time upon request, and in a format satisfactory to the World Bank.

F. Poverty and Social Impacts, and Environmental, Forests, and Other Natural Resource Aspects

Poverty and Social Impacts

14. **This operation supports actions that are expected to have direct effects on poverty in the short term and a positive redistributive impact, including by supporting the COVID-19 response efforts; however, the Government, with World Bank support, will have to carefully monitor the impact of its overall fiscal adjustment program on the poor over the medium-term, given the size of both, the adjustment and the larger poverty and vulnerability pool.** To monitor medium-term impacts, the World Bank is providing technical assistance to the Ministry of Economy and Finance (MEF) to assess the distributional impact of fiscal policies, accompanied by a micro-simulation tool. Recognizing the difficulties of quantifying a counterfactual scenario, the timing and scope of measures in the operation’s second pillar (Reinforcing fiscal sustainability in the aftermath of COVID-19) reduce risks of larger fiscal adjustments which could have entailed more drastic implications on poverty and inequality outcomes. From a medium- and long-term view, the measures in this operation increase fiscal and environmental sustainability, also preserving the fiscal space necessary to sustain Costa Rica’s social compact.

15. **Considering the COVID-19 crisis, the supported measures under the first pillar are expected to contribute to reducing upward pressures on poverty and inequality, through mitigation of the negative labor market effects on vulnerable workers.** For example, a measure supporting the introduction of a temporary social transfer to households affected by a change in their working conditions and/or labor income, is estimated to reduce the number of affected households (those with incomes falling below the poverty line, $5.5/day) during the quarantine period. The measure is also expected to reduce pressures on rising inequality as it focuses on mitigating impacts on the most vulnerable with fewer coping mechanisms.

16. **Measures aimed at improving fiscal sustainability, under the second pillar, through reforms on the revenue side are expected to have small effects on poverty and are, in combination, progressive.** For example, a measure supporting the introduction of the VAT, is estimated by design to have a limited impact on poverty: simulations estimate that the poverty rate marginally increases from 20 to 20.3 percent (in particular because the poor consume very little of the previously exempted services and the ones they do consume maintain lifelines, e.g., electricity, to protect poorest households). The reform is also estimated to reduce the regressivity of indirect taxes. In turn, a measure supporting the reform to the income tax law is not expected to have an impact on the poorest segments of the population. The measure largely affects high-income households, thus making it progressive and contributing to reducing inequality.

17. **Also, under the second pillar, measures supporting the fiscal responsibility framework on public expenditures and the reforms to public employees’ remuneration are expected to have neutral effects on poverty and could contribute to reducing inequality.** These measures will contribute to fiscal consolidation and can affect, over time, wages of employees or programs supporting the bottom forty percent of the income distribution. For example, a measure supporting public employees’ remuneration is expected to have neutral direct effects on poverty and positive redistributive effects. The measure does not reduce wages but limits earnings’ growth for public employees. The gender

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2 Cordero Peña, Jose Antonio; Luis Ángel Oviedo Carballo and Rudolf Lücke Bolaños (2018).
impact of this measure is expected to be limited as both men and women are equally represented in the public workforce (48 vs 52 percent, respectively).

18. **Reforms supported by the third pillar, are expected to have limited direct effects on poverty and no redistributive effects in the short-term.** The measures, supporting priority climate actions, are expected to have neutral effects on poverty and inequality, while strengthening the monitoring mechanisms for evidence-based decision-making and creating enabling conditions for emission reductions.

**Environmental, Forests, and Other Natural Resource Aspects**

19. **Costa Rica’s environmental legislation is well structured, including in aspects related to environmental licensing.** The legal framework, policies and procedures are materially consistent with the requirements of World Bank Policies. Costa Rica is highly regarded for its environmental conservation policies, which serve as a model worldwide. Costa Rica’s environmental offer also makes it one of the world’s top ecotourism destinations. In addition, almost all (around 98 percent) of Costa Rica’s electricity currently comes from renewable sources, with 80 percent coming from hydropower.³

20. **The policies supported under the first and second pillar of this operation are not likely to cause any negative effect on the environment, forests, or other natural resources.** A measure supporting the fiscal responsibility framework is institutional in nature and thus, does not have direct effects on the environment. Measures on public employee remuneration are also not expected to have an impact on the environment. Specifically, they are not expected to result in reduced staffing for agencies responsible for environmental protection. Further, policy actions in the areas of tax administration are not likely to have either significant positive or negative environmental impacts.

21. **The policies under the third pillar are designed to improve low-carbon development and environmental management and thus, will have significant positive effects.** Measures supporting the development of climate management tools provide support in climate impact assessment and knowledge management, with a view to fostering climate-related decision making and policies. Further, measures fostering carbon neutrality commitments by municipalities and public and private organizations, in the agriculture, waste management, transport, and forestry sectors, will have an impact on greening their production processes and reducing their greenhouse gas emissions. Finally, supporting measures that displace polluting energy sources with a greater use of renewable energy will have a direct impact on reducing greenhouse gas emissions. Similarly, efficiency gains under these measures promote greater utilization of renewable energy sources instead of more polluting fuels will improve air quality by reducing energy-related emissions.

**G. Risks and Mitigation**

22. **While the overall risk rating for this operation is substantial, the reforms supported by the operation are a high priority for the Government of Costa Rica, benefit from strong ownership of the Government and are already being implemented.** In fact, the National Assembly has become an important accountability player to ensure the executive fully respond to the COVID-19 pandemic - but also reinforce implementation of the 2018 fiscal package. The Assembly, and other stakeholders like the private sector and the unemployed, have voiced their desire of further financing the response to the COVID19 impact by further downsizing the state, including the public sector’s wage bill. Taking into consideration the support offered by the DPF series, the most relevant downside risks are related to the complex political situation, uncertain external and internal shocks (macroeconomic), sector strategies, institutional capacity for implementation and sustainability and stakeholders.

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³ Other sources include geothermal, biomass, solar, and wind power.
23. **There is, however, an important upside to risks as well.** Political and governance risks will be mitigated by authorities carrying out broad consultations and undertaking a carefully designed communication strategy to secure the necessary strong and broad consensus in society. Macroeconomic risks, including refinancing of public debt, will be mitigated by a revamped debt management strategy and by boosting the credibility of the fiscal reform program through the enactment of complementary reforms. The program also faces institutional risks, with the risk of being hindered by a lack of coordination between line ministries and agencies, as well as inadequate financing. Mitigation measures for these risks include the establishment of climate change offices and focal points within line ministries. A high-level commission will also be formed to provide oversight, operating from the President’s Office, which will be comprised of representatives from the President’s Office, Ministry of Planning, Ministry of Finance, and Ministry of Environment. The Government is also examining ways to attract public and private finance, including the establishment of new climate finance funding mechanisms, to support the Decarbonization Plan’s implementation.

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## APPROVAL

<table>
<thead>
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<th>Task Team Leader(s):</th>
<th>Pedro L. Rodriguez</th>
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### Approved By

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<tr>
<th>Country Director:</th>
<th>Seynabou Sakho</th>
<th>28-Feb-2020</th>
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