



COSTA RICA

TECHNICAL ASSISTANCE REPORT—UPGRADING THE RULE-BASED FISCAL FRAMEWORK

January 2023

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I N T E R N A T I O N A L M O N E T A R Y F U N D

COSTA RICA

Upgrading the Rule-Based Fiscal Framework

W. Raphael Lam, Virginia Alonso Albarran, Daniel Garcia-Macia, and Carlos Herrero Garcia



Technical Assistance Report

January 2023

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ABBREVIATIONS AND ACRONYMS

CCSS	Social Security Entity of Costa Rica
CG	Central Government
CGR	Office of the Comptroller General of the Republic
CNE	National Commission for Risk Prevention and Emergency Response
DGCP	Directorate General of Public Credit
DGPN	General Directorate of National Budget
EBE	Extrabudgetary Entities
FAD	Fiscal Affairs Department
GFSM	Government Finance Statistics Manual
ICE	Institute of Electricity of Costa Rica
ID	Decentralized Institutions
ICT	Institute of Tourism of Costa Rica
LA	Legislative Assembly
LGs	Local Governments
LSPF	Law on Strengthening Public Finance (Law 9635)
MFU	Macro Fiscal Unit
MoF	Ministry of Finance
MTFF	Medium-Term Fiscal Framework
NFPS	Nonfinancial Public Sector
PCs	Public Corporations
PIM	Public Investment Management
PPPs	Public-Private Partnerships
PROCOMER	Trade Promotion of Costa Rica
RECOPE	Costa Rican Oil Refinery
SIPP	Information System for Plans and Budgets of the CGR
STAP	Technical Secretariat of the Budgetary Authority
TA	Technical Assistance
WEO	World Economic Outlook

PREFACE

In response to a request from the Minister of Finance, a Fiscal Affairs Department (FAD) mission conducted hybrid discussions from October 31 to November 22, 2022 to provide technical assistance (TA) regarding the design and implementation of fiscal rules. The mission was led by W. Raphael Lam and comprised Virginia Alonso Albarran, Daniel Garcia-Macia (all FAD), and Carlos Herrero Garcia (FAD Short-term Expert).

At the Ministry of Finance (MoF), the mission held discussions with Finance Minister Costa Jaen, Marco Solera, Michael Contreras; Ana Miriam Araya, Jose Luis Araya, Carlos Oviedo, Kenneth Acuña, Néstor Chinchilla, Olman Cortés, Rafael Oviedo from STAP, DGPN, and *Grupo Regla Fiscal*. At the *Contraloría General de la República*, the mission held discussions with Amelia Jiménez, Daniel Sáenz, Karen Garro, Nancy Campos, María Salomé Murillo, Marilyn Zúñiga, Vivian Garbanzo, Fabiola Rodríguez, Sujey Montoya, Edwin Zúñiga. The mission also met with representatives from various agencies, including Gustavo Picado (Caja Costarricense del Seguro Social); Ing. Jorge Zapata, Mariela Solís, Natalia Vega (*Instituto Costarricense de Acueductos y Alcantarillados*); Guisella Morera, Silvia Mora, Marco Acuña, Jacqueline Hidalgo (*Instituto Costarricense de Electricidad*); Eddie Villalobos, Víctor Díaz, Mariela Calderón (Procomer); Rodolfo Fonseca (*Municipalidad de San José*); Ennio Rodríguez, Magda Brenes (Colegio de Ciencias Económicas); Ricardo Monge, Gloriana Ivankovich (*Academia de Centroamérica*); Ruth Andrade, Alberto López, Olga Espinoza, William Rodríguez, Mariela López, Alejandra Fernández, Rafael Soto, Wilson Orozco (*Instituto Costarricense de Turismo*); Jorge Vargas, Pamela Jiménez, Susan Rodríguez (*Estado de la Nación*); Betty Sanchez y Juan Carlos Quirós (BCCR); and Jose Luis Arce (Consejo Fiscal). The mission also presented the key findings to Kattia Cambronero Aguiluz, Pilar Cisneros Gallo, María Daniela Rojas Salas, Eli Feinzaig Mintz, Óscar Izquierdo Sandí, Jonathan Jesús Acuña Soto, Olga Lidia Morera Arrieta, and Rosaura Méndez Gamboa of the Legislative Assembly.

The mission expresses its gratitude for the excellent cooperation it received from all government officials and for the candid discussions. Particular thanks are due to Mr. Marco Solera, Mr. Michael Contreras, and Ms. Jimena Ureña for their insights and excellent cooperation before and during the mission. The mission also received administrative support, research assistance, and interpretation services from Claudia Diaz Saldias, Zhonghao Wei (all FAD); Anette Schorr, Martha Florez, Yvonne Fisher, Cynthia Abad, Silvina Bresler, and Mariano De Anton.

EXECUTIVE SUMMARY

The fiscal rule that came into force in 2020 has bolstered fiscal discipline and served Costa Rica well. The rule sets ceilings on nominal expenditure growth for current and total expenditures linked to past nominal GDP growth and debt levels. The rule—explicitly identified in the Law 9635—is transparent, relatively simple, and allows flexibility in crises through an escape clause. The rule has been instrumental in the policy framework. It not only guides the fiscal policy in the budget, but also coalesces public opinion on the need for fiscal discipline. Along with other fiscal reforms, the government commitment to the fiscal rule has been instrumental to fiscal adjustment in 2021-22.

Nonetheless, several limitations of the fiscal rule came to light during the early stage of implementation. The limitations of the rule were reinforced by the inherent budget fragmentation as well as adverse effects from the pandemic. Outside the national budget of the central government, fiscal rules are applied uniformly at the entity level for a wide range of public institutions, leading to distortions or excessively tight constraints for some. Moreover, the verification of compliance with the rule also brought an unintended tightening in 2021-2022 from under-execution of the budget during the pandemic.

The expenditure limits are set to become more binding amid rising debt and high inflation in the near term. Although the escape clause allowed for higher spending during the pandemic, the ceilings on nominal expenditure growth have turned tighter as debt exceeded 60 percent of GDP and GDP contracted in 2020. The rule implies an expenditure cut in real terms amid high inflation in the near term. The government is therefore under pressure to accommodate spending needs in response to the cost-of-living crisis.

To address these immediate challenges, the government and lawmakers have enacted or proposed amendments to the fiscal rules. An executive decree revised the method to verify compliance in July 2022 to avoid the unintended tightening from an under-execution of the budget in some entities. Various amendments to Law 9635 propose to (i) exclude certain entities (such as some decentralized institutions or public corporations) from the rule; and (ii) exclude expenditure items such as capital expenditure or interest payments. Some amendments would bring permanent changes to the fiscal rule without necessarily addressing the near-term challenges. The proposed amendments would further reduce the coverage of the rules from about 60 percent to 45 percent of total expenditures in the nonfinancial public sector (or from 93 to 65 percent in the national budget of the central government). While excluding some nonstate public entities and public corporations is reasonable, ad-hoc changes without precise and verifiable criteria could undermine the credibility of the fiscal rule framework.

It is thus urgent to develop objective criteria to prevent ad-hoc exclusions of entities from the fiscal rules. A principles-based classification would allay political pressure for ad-hoc exclusions. The criteria should follow the statistical principles of the Government Finance Statistics Manual: entities under government control and classified as a non-market producer should be included in the fiscal rule. Entities that fall outside by these criteria should be monitored according to a risk-based set of indicators agreed by STAP, such as debt ratio, revenue to cost ratio, or the degree of central government transfers to the entity. Whereas including the social security and local governments is not feasible at present, they should be subject to monitoring by the MOF.

The compliance with the fiscal rule should be assessed at the aggregate level, at least for the central government statistical concept (including extrabudgetary entities). The MoF and STAP should be empowered by law to allocate resources across decentralized institutions (extrabudgetary entities) and the national budget among competing needs. The rule will be assessed for the overall central government instead of by individual entities.

Expenditures covered by the fiscal rule should remain broad. Key items such as capital expenditure and interest expense should not be excluded from the rule. The proposed amendments to exclude capital expenditure when debt levels are high will weaken the link between the fiscal rule and debt dynamics, may create incentives for creative accounting, and ultimately undermine the credibility of the fiscal rules. To better address contingencies such as court rulings, the government should create a contingency reserve line in the budget within the overall expenditure limits.

Externally financed expenditure should be included in the expenditure rule. The budget documents can include an annex to provide information on externally financed expenditure. This would help reduce budget fragmentation and allow for a more comprehensive capital budget, in line with the Public Investment Management Assessment (PIMA). This information will also be useful for verifying ex-post compliance with the fiscal rules.

Ex-post compliance of the expenditure rule could be verified based on the fiscal outturn relative to the initial budget of the previous year. This would avoid the unintended effects from an under-executed budget. The verification of compliance with the fiscal rules should be made comparing this base (initial budget of the previous year, adjusted with the best estimate of external financing) with the spending outturn (on an accrual basis) of the current year. Compared to the current method to assess compliance (July 2022 Decree), it would increase transparency and link more closely to debt reduction.

Over the medium term, introducing an explicit debt anchor would supplement the expenditure rule in upholding debt sustainability. A combination of an expenditure rule with a medium-term anchor is common across countries. In Costa Rica, it can help align annual fiscal policy with the objective of maintaining debt sustainability over the medium term. The best practice is to maintain a debt level that provides a prudent safety buffer to respond to adverse shocks while keeping debt below its limit—the level that could exert a drag on growth, raise the borrowing cost significantly, or risk debt distress.

A risk-based approach in determining the debt anchor would consider the macroeconomic shocks and debt composition in Costa Rica, alongside with the sizable development needs. Our analysis suggests it would be appropriate to aim for a medium-term debt anchor of about 40-50 percent of GDP. This is lower than the elevated level at present but still credible for the government to commit to achieve by the mid-2030s with sustained fiscal efforts. After a debt anchor is established in the fiscal rule framework, ensuring consistency between the anchor and expenditure rule (ceilings on expenditure growth) would be important.

Integrating the debt anchor in the medium-term fiscal framework (MTFF) would reinforce consistency. Significant progress was made in developing the MTFF, introduced in 2021 to provide transparent communication of the fiscal strategy and forward guidance to the budget process. The MTFF would lay out the expenditure growth rate consistent with the expenditure rule and reaching the anchor over the medium term.

The fiscal council can strengthen oversight. The monitoring of compliance with the fiscal rules would require a broader assessment of the macro-fiscal projections in the MTFF and debt sustainability beyond just verifying that fiscal outturns comply with the expenditure ceiling. Resources commensurate to the fiscal council's mandate need to be allocated so that it can fulfill its responsibilities.

The main recommendations to support the revision and implementation of the fiscal rule are shown in the Table below.

Table of Key Recommendations

Report	Main Recommendations	Short- (ST) or Medium-term (MT)
Section III	The institutional coverage of the fiscal rule should be the general government, as defined in Government Finance Statistics Manual (GFSM). As local governments and the social security (CCSS) are currently excluded from the rules, MOF should monitor them under a risk-based approach. Over time, the Legislative Assembly should consider including these entities in the fiscal rule.	ST
	Ministry of Finance should develop verifiable and objective criteria to identify which public entities should be included in the fiscal rule and seek approval of those criteria by Legislative Assembly, in accordance with GFSM. Entities that are under government control and nonmarket producers should be considered as government entities and included in the fiscal rules. Other entities need to be monitored under a risk-based approach to be developed by MOF and enhance debt regulations to cover the authorization outside of central government.	ST
	Amend Bill 23330 submitted to the Legislative Assembly to indicate that the exclusion of entities from the fiscal rules should be based on GFSM criteria specified by Ministry of Finance.	ST
	Ministry of Finance should present an assessment on legal changes needed to empower the ministry and in particular STAP to make the expenditure limits applicable to the overall central government (GFSM) at the aggregate level, including extrabudgetary entities such as Decentralized Institutions, instead of by individual entities.	ST
	Amend Bill 23330 submitted to the Legislative Assembly to avoid references to excluding capital expenditure, court rulings, and interest expenses from the expenditure rule. Create a general contingency reserve in the budget (e.g., a separate budget line) that could cover expenditure from court rulings, among others, subject to the aggregate expenditure ceilings.	ST
	Amend the executive decree to include a comparison of expenditure growth between the final outturn (accrual basis) at the end of a fiscal year (instead of final budget) and the initial budget of the previous fiscal year (adjusted by an estimate of externally funded expenditure). Ex ante and in-year compliance verification at budget level remains the same, adding the estimate of externally funded expenditure.	ST
	Include the best annual estimate of externally funded expenditure in an annex to budget documents provided to the Legislative Assembly.	MT
	Modify the escape clause provision (<i>Decree N° 41641-H Article 25; Article 16 of the LSPF</i>) by amending Bill 23330 such that the maximum transition period applies when the escape clause is activated in either one of the conditions (emergency or recession).	MT
Section IV	Amend the Law to introduce a medium-term debt anchor in the fiscal rule to ensure debt sustainability. Periodic review (e.g., every 5 years) on the overall fiscal rule framework (including calibrating expenditure rule limits to ensure the consistency after the medium-term debt anchor is established) can help ensure fiscal rules contribute toward debt sustainability.	MT
Section V	Integrate the debt anchor in the medium-term fiscal framework. The MTFP would lay out the expenditure growth rate consistent with the expenditure rule and reaching the debt anchor over the medium term.	MT
	Amend the law to strengthen fiscal oversight with an operational and independent fiscal council.	MT

Note: 'Short-term' indicates the recommendations can be completed by end-March 2023, while 'medium-term' indicates recommendations to be implemented over the next 2-3 years.

I. INTRODUCTION

1. After a strong rebound in 2021, slowing trading partner growth and tightening of global financial conditions are weighing on activity in Costa Rica. Elevated inflationary pressures—partly because higher international food and energy price were allowed to pass through to retail prices—have prompted the central bank to accelerate its move to a neutral policy stance.

2. Fiscal performance has exceeded the Fund’s program target in fiscal year 2022 so far, driven by higher tax revenues and higher than expected yields from 2018 tax reforms (Figure 1). Expenditures were restrained by the fiscal rule, contributing to a lower public debt relative to Fund program targets. The strong fiscal performance provides scope for a modest increase in social spending—comprising conditional cash transfers and temporary food vouchers—to support the most vulnerable households. The central government primary surplus is expected to reach 1 percent of GDP by end 2022, the highest since 2008.

3. Costa Rica’s fiscal rule continues to play a pivotal role in anchoring debt sustainability, though there is scope for improvements. The authorities approved an executive decree in July 2022 and submitted a bill to the Legislative Assembly to address operational constraints in the implementation of fiscal rules and allow for additional spending. The authorities are considering, with technical support from the Fund, reforms to the fiscal rule. The technical advice aims to help authorities determine an appropriate institutional coverage of the fiscal rule and facilitate a better reallocation of resources given the budget fragmentation, while maintaining a broad coverage of the rules and essential role in reducing debt. The existing expenditure rule covers a subset of expenditures in the nonfinancial public sector (NFPS), in which the central government accounts for less than half of the total expenditures (Figure 2).

Figure 1. Recent Fiscal Developments in Costa Rica
(Percent of GDP)

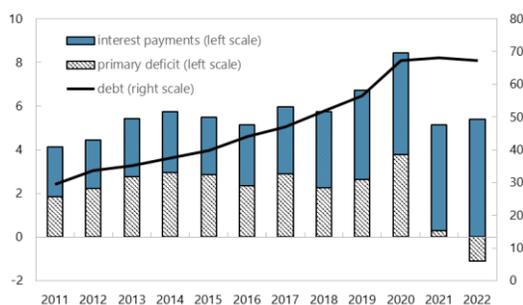
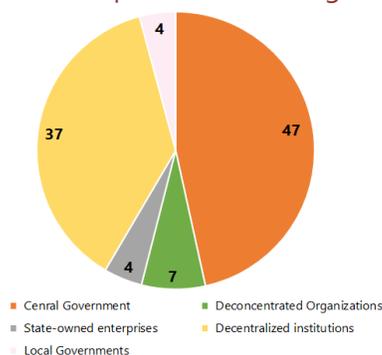


Figure 2. Nonfinancial Public Sector in Costa Rica
(Percent of total consolidated nonfinancial public sector expenditures, average 2017-21)



Sources: National authorities, Haver, IMF World Economic Outlook, and IMF staff calculations.

Notes: Data for 2022 are projections.

II. ASSESSING THE CURRENT FISCAL RULE

A. The Current Fiscal Rule

4. **The 2018 Law to Strengthen Public Finance (LSPF) introduced a fiscal rule that sets limits on expenditure growth.** The fiscal rule entered into force in 2020. The rule sets a ceiling on current expenditure growth (as well as total expenditure growth if debt exceeds 60 percent of GDP) for the central government and most entities in the Non-Financial Public Sector (NFPS). The rule establishes that the growth on current expenditures will be a function of the average nominal GDP growth over the previous four years, adjusted by a parameter that depends on the government debt-to-GDP ratio (Table 1). As central government debt has risen above 60 percent of GDP in 2020, the growth in current and capital expenditures cannot exceed 65 percent of the average nominal GDP growth of the previous 4 years, suggesting a tighter expenditure limit in the coming years. The expenditure rule that came into force in 2020 supplements the pre-existing ‘golden rule’, which requires current expenditure cannot be financed by government debt but has not been complied since 2009.

Table 1. Parameters of the Existing Fiscal Rules on Expenditure Growth

Government Debt-to-GDP Thresholds	Expenditure Growth Limits
Debt to GDP < 30% or current expenditure of central government \leq 17% of GDP	Growth in current expenditures \leq 100% of average nominal GDP growth over the previous four years.
30% \leq Debt to GDP < 45%	Growth in current expenditures \leq 85% of average nominal GDP growth over the previous four years.
45% \leq Debt to GDP < 60%	Growth in current expenditures \leq 75% of average nominal GDP growth over the previous four years.
Debt to GDP \geq 60%	Growth capital and current expenditures \leq 65% of average nominal GDP growth over the previous four years.

Source: Law to Strengthen Public Finances, 2018.

5. **Initially, the fiscal rule covered the central government and most entities in the rest of the NFPS.** Decree 41641-H (Art. 2), that regulates the fiscal rule, states that “The ceiling on expenditures applies to the National Budget of the central government *as a whole* and *individually* to the decentralized public bodies in the NFPS”. It means that, in practice, each entity in the NFPS would be subject to the same annual expenditure growth ceiling, although the LSPF did not explicitly indicate such application at the individual entity level.

6. **Some major nonfinancial public sector entities and local governments, however, were excluded from the fiscal rule** (Table 2). When the 2018 LSPF Law was legislated, some entities were excluded, such as (i) the Social Security (CCSS) regarding expenditures on pensions; (ii) Public Corporations (PC) that were classified to carry out commercial activities under market competition and whose debt-to-assets ratio is below 50 percent (such as ICE-Telecom); and (iii) the national oil company (RECOPE) on its spending on oil imports. In 2020, Local Governments (LG) were also excluded from the fiscal rule, though transfers from the national budget were subject to the rule. The

Constitutional interpretations also excluded health in CCSS and the CCSS as a whole from the expenditure rule. In May 2022, several specific expenditure items from selected institutions were excluded, including the Social Development and Family Allowances Fund (FODESAF) (see Section III).¹

7. The LSPF defined ex-ante compliance on a budgetary basis and ex-post compliance on an execution basis. The LSPF (Art. 19) establishes that the central government and the NFPS entities must formulate their initial budgets and modifications in compliance with the fiscal rule. Therefore, growth in current expenditure in the initial budget of year t or in-year modifications could not exceed the pre-determined growth ceiling relative to the initial budget of year $t-1$. Ex-post compliance is also defined in the LSPF Law in terms of outturn expenditure (Art. 21 LSPF “liquidación”), Compliance with the fiscal rule is monitored on a quarterly and annual basis. The General Directorate of the National Budget (DGPN) and the Technical Secretariat of the Budgetary Authority (STAP) prepare quarterly reports on the outturns of current and recently of total expenditures. They must also prepare an annual compliance report, based on the previous year's budget execution. This report is submitted to the Comptroller Office (CGR) that, in turn, prepares its own report and submits it to the Legislative Assembly (LA). According to the 2018 LSPF, the CGR evaluates ex-post compliance based on executed expenditure growth in year t relative to executed expenditure in year $t-1$. However, in July 2022, the basis of ex-post compliance was revised to comparing the growth rate of expenditure in the final budget relative to the initial budget of the previous year (Executive Decree N° 43589-H) (see Section III).

8. The fiscal rule came into force in 2020 budget preparation and the escape clause was soon activated at the onset of the COVID-19 pandemic. In March 2020, the government activated the escape clause for two years by declaring a national emergency (confirmed by the National Emergency Commission (CNE)) and communicated that expenditure of the central government and 16 other decentralized institutions would not be subject to the expenditure ceiling (Table 3).² As government debt crossed above the 60 percent of GDP threshold in 2020, the growth ceilings would apply to total expenditures starting from 2022 budget preparation. This also implies that certain NFPS expenditure items will be tightened, for example, (i) pensions can only be indexed to the rise in the cost of living, and (ii) the wage bill for public employees will be frozen. Additional restrictions also prohibit that the central government subscribes loans or credits, except to finance the public debt or capital expenditure, and bail-out or subsidies to private entities will need the approval of the Legislative Assembly.

¹ Law to strengthen regional competitiveness and to promote the attraction of investments outside the Greater Metropolitan Area. N° 10234 May 4, 2022.

² Emergency spending totaled 295 billion colons (or 0.8 percent of GDP) in 2020 and another 137 billion colons in 2021 (or 0.4 percent of GDP), respectively, on *Bono Proteger* to families, health supplies, vaccinations, and to CCSS to mitigate the minimum contribution base reduction.

Table 2. List of NFPS Entities and Local Governments Excluded from the Fiscal Rules

Institution	Scope of exclusion	Year of exclusion	Share NFPS total expenditures, 2021 (percent)
Social Security (CCSS)	All expenditure (pensions by Law, health spending at a later stage, not in the LSPF)	2018	20.5
Public corporation carrying out commercial activities in a competitive market and has debt is less than 50 percent of assets	Expenditure related to commercial activities in a competitive market setting	2018	3.4
National Oil Company (RECOPE)	Oil import spending	2018	8.0
INEC	Free surplus and financial yields allocated to national census	2019	-
Municipalities and district councils	Transfers from the CG are not excluded	2020	3.1
Cantonal Sports Committees	All expenditure	2020	-
Fishing Institute (Instituto Costarricense de Pesca y Acuicultura) (*)	IDB-funded fisheries and aquaculture sustainable development project expenditure	2021	0.04
National Guarantee Fund (*)	Contributions of the Ministry of Finance	2022	0.3
National Fund for Forest Financing (FONAFIFO)	Payments to forest owners to finance their environmental services	2022	-
National Institute for Women 911 Emergency Service	Financing for the Domestic and Gender Violence Service	2022	-
Board of Port Administration and Economic Development of the Atlantic Coast (Japdeva)	Capital expenditure on regional and local development plans financed by the port charges from Moin Port's Cargo Terminal	2022	-
Costa Rican Drug Institute	Funds seized in counter-narcotics operations	2022	-
Fund for Social Development and Family Allowances (FODESAF)	All expenditure	2022	3.5
911 Emergency Service	Fee on telecommunication services	2022	0.03

Source: Compiled by the mission team based on national authorities' documents.

(*) Projected expenditure in 2022.

Table 3. Ceilings on Expenditure Growth under the Fiscal Rules, 2020-2023

(Percent)

	2020	2021	2022	2023
Current Expenditure	4.67	4.13	1.96	2.56
Total expenditure	Not-applicable	Not-applicable	1.96	2.56

Source: Authorities' Medium-term Fiscal Frameworks 2021 – 2025 and 2022 -2027.

Note: Escape clause was activated during the COVID-19 pandemic in 2020-21. Government debt exceeded 60 percent of GDP in 2020.

B. Strengths and Challenges of the Fiscal Rules Framework

9. The expenditure rule has desirable features supporting fiscal responsibility and has served Costa Rica well.

The objectives of the rule are explicitly identified in the LSPF, which sets clear criteria to assess the functioning of the rule. Second, the expenditure rule is relatively simple and transparent, in that the ceilings on expenditure growth are communicated and widely recognized in the budget preparation and implementation. Third, the rule envisages nominal current expenditure growing less than nominal GDP, which helps mitigate expenditure pressures that often lead to excessive deficits. Before the expenditure rule came into force in 2020, current expenditure grew at a faster pace than nominal GDP growth by about 2-3 percentage points on average between 2012 and 2019. The expenditure rule has facilitated fiscal discipline and helped contain expenditure growth, contributing to the improvement of fiscal balances in 2021-22.

10. Several other design features have been in line with good principles of fiscal rules.

According to the LSPF, the rule must hold both ex-ante in budget preparation, as well as in ex-post verification to contain the risk of slippages during budget execution (*Art. 19 and 21 LSPF*). It also has an escape clause to provide flexibility in response to severe shocks. Moreover, enforcement of the rules is supported by the CGR, a separate entity from the Ministry of Finance. The government is also required in the Law to specific reporting obligations and information sharing.

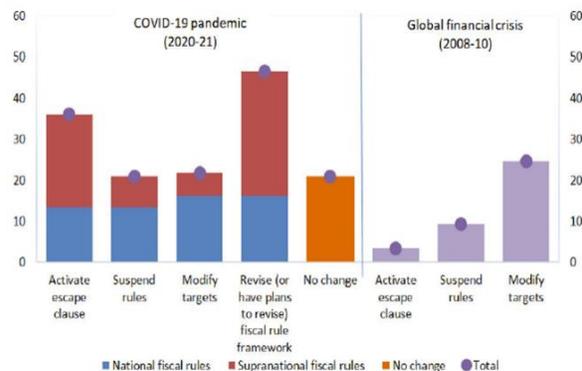
11. The fiscal rule has been instrumental in Costa Rica's policy framework. It does not only provide predictability of fiscal policy, but also coalesced political consensus for fiscal responsibility and anchored the public debate on the budget. Policymakers have a general consensus that expenditure rule help contain government spending, making the needs for reducing government debt and improving public financial management more prominent. Compliance with the expenditure rule was largely met and the activation of escape clause in 2020-21 was broadly appropriate. The central government complied with the expenditure rule in 2020 excluding the emergency spending under the escape clause (CGR 2022).³ The CGR indicated that only 12 institutions out of 154 did not

³ According to the Decree 41641-H, the excluded expenditure in one year due to the activation of the escape clause must be subtracted from the base for calculating the ceiling in the next year 2022.

comply with the fiscal rule in 2020, while 22 institutions did not comply in 2021.⁴ In terms of executed current expenditure, non-compliant entities excluding the central government increased from less than 1 percent in 2020 to nearly 5 percent in 2021. The executed current expenditure for the central government grew by 5.9 percent in 2021, well above the 4.2 percent ceiling.⁵

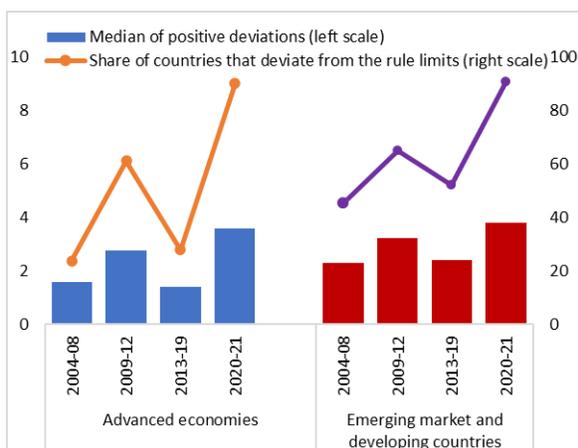
12. As in most countries, including Costa Rica, the pandemic put the fiscal rules and frameworks to test. During the pandemic, over 80 percent of countries with fiscal rules have activated the escape clauses or suspended temporarily fiscal rules, a much higher percentage than during the global financial crisis (Figure 3; Davoodi and others 2022). About half of countries with fiscal rules have had deficits or debt exceeding the limits of their fiscal rules. As a result, many countries, including Costa Rica, are facing the challenge of how to return to the fiscal rules (Davoodi and others 2022; Valencia and Ulloa-Suarez 2022) (Figures 4 and 5).

Figure 3. Changes in Fiscal Rules during the Pandemic vs Global Financial Crisis
(Percentage of countries with fiscal rules)



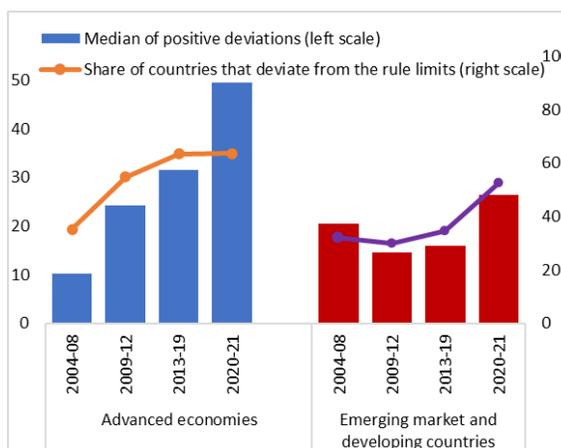
Source: Davoodi and others 2022, IMF Fiscal Rules Dataset 2021.

Figure 4. Deviation from the Deficit Rule Limits
(Percent of GDP by income group)



Sources: Davoodi and others 2022; IMF Fiscal Rules Dataset: 1985-2021; IMF WEO Database.

Figure 5. Deviation from the Debt Limits
(Percent of GDP by income group)

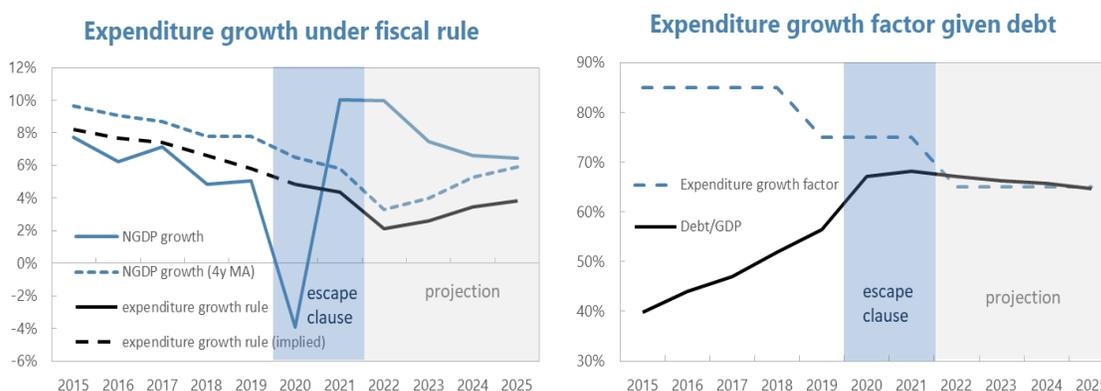


⁴ According to the CGR report, in 2020, 29 entities did not provide enough information to the CGR to verify their compliance to the fiscal rules. In 2021, only 104 entities were subject to the rule, due to the integration of the Deconcentrated Entities (OD) into the national budget. In 2021, 22 entities did not comply with the rule and 25 did not provide enough information.

⁵ In contrast, the legal requirement on current expenditure being financed only with current revenues (Article 6 of the Law 8131 for Financial Management and Public Budget, passed in June 2000) was not complied with in the last decade.

13. While the escape clause provided some flexibility during the pandemic, the expenditure limits are set to become more binding over the near term. Out of prudence, the government chose not to invoke the recession part of the escape clause even though there was a recession in 2020. The escape clause allowed the government to put in place an additional spending of 1.2 percent of GDP in 2020-21 to respond to the pandemic. The government, out of prudential reasons, did not invoke the recession provision of the escape clause. This implies that the government would need to return to the expenditure ceiling when they exit from the escape clause starting in 2022 rather than having a 3-year transition period (allowed if the escape clause is linked to a recession). The specification of the expenditure rule implies tighter limits in the coming 2-3 years starting from 2022 despite nominal GDP growth recovering to pre-pandemic levels. Since the rule prescribes that annual expenditure growth ceilings for year T are linked to the 4-year average of nominal GDP growth between years T-5 and T-2, the effect of the growth slowdown in 2020 will kick in from 2022 to 2025. In addition, the rise in government debt-to-GDP over 60 percent of GDP during the pandemic has triggered a lower debt-linked adjusting factor, from 85 percent in 2018 to 65 percent starting in 2022, with the expenditure ceilings also applied to total expenditures rather than just current spending. These imply that the expenditure growth ceilings under the fiscal rule would diminish from about 6 percent before the pandemic to less than 4 percent in the coming 2-3 years (Figure 6). Ceilings would then be higher from 2026 onwards as the decline in 2020 nominal GDP growth will no longer enter the calculation of the expenditure ceilings.

Figure 6. Expenditure Rule Limits Depend on Nominal GDP Growth and Government Debt Levels (Percent)



Sources: IMF World Economic Outlook and authors' calculations.

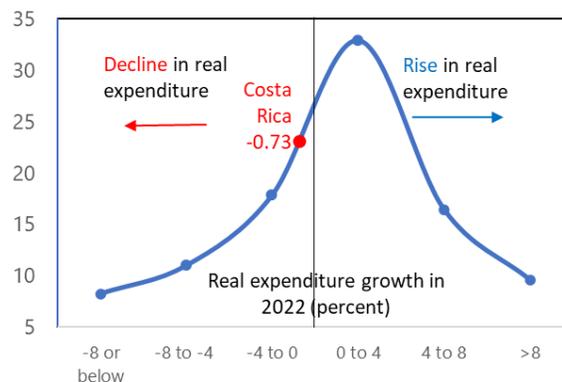
Note: The 4-year moving average of nominal GDP growth for year T is based on years T-5 to T-2, while the debt-linked adjustment factor is based on year T-2, according to the fiscal rule.

14. The tightening of expenditure limits takes place amid high unanticipated inflation. Inflation surprises affect public finances through multiple channels, including by reducing real expenditure in the short term (because some items are not fully indexed to inflation), as well as lowering the debt-to-GDP ratio given nominal GDP is higher. In 2022, growth in real expenditure is projected to be negative, at the lower part of the distribution across emerging market economies (Figure 7), but real growth in social benefits will remain positive (even if deflated with CPI inflation).

15. Several limitations of the fiscal rule came to light during its early implementation.

- *Unintended effects from an under-execution of budgets.* The pandemic has led to an under-execution of the budget of many decentralized entities, as their activity was hampered by lockdown restrictions and social distancing. As a result, the expenditure base—which the expenditure growth limits are applied on—was reduced such that some entities were constrained with smaller expenditure ceilings and could not undertake normal operations in 2021 and onwards. The tighter base given the under-execution of the previous year has imposed an unintended tightening on expenditures, giving rise to repeated legislative requests to exclude certain spending or exclude entities from the coverage of the fiscal rule.
- *Budget fragmentation.* The long-standing fragmentation of the budget has made implementation of the fiscal rules even more challenging. The non-financial public sector (NFPS) comprises the national budget central government, local governments (82), social security (CCSS), other decentralized institutions (43), and public corporations (30). The expenditure rule limit, in practice was not applied at the *aggregate level* for the general government or NFPS but individually applied to entities. Therefore, spending allocation is limited to within the national budget of the central government. The verification of the rules has not provisioned for compensation among those entities. While this reflects a long-standing challenge, the application of the expenditure ceiling at individual level made compliance challenging for some basic services provision (e.g., 911 emergency service). The large needs to expand social spending during the pandemic were constrained, partly because of the ceiling on expenditure growth.
- *Lack of a medium-term debt anchor.* The absence of a specific reference to debt in the LSPF has made it difficult to substantiate the objective of fiscal sustainability and assess if the parameters of existing expenditure rules is adequately set to achieve the objective. For example, a counterfactual analysis shows that if the existing expenditure rules had been in place since 2013, they would only have led to a small reduction of current spending and debt to GDP relative to the actual levels, with debt continuing to rise as a share of GDP (Figure 8). This is because, in the reference period, nominal GDP growth was strong and debt low, implying loose expenditure growth ceilings. The rising debt has cast doubts whether the expenditure rule is sufficient to ensure debt sustainability and build buffers against protracted shocks. On the other hand, if the government had adhered to the requirement not to borrow for current expenditure (stipulated in Article 6 of Law 8131 in 2001) since 2016 (with a transition period starting in 2013), government

Figure 7. Distribution of Real Government Expenditure Growth by Countries, 2022
(Percent of countries)

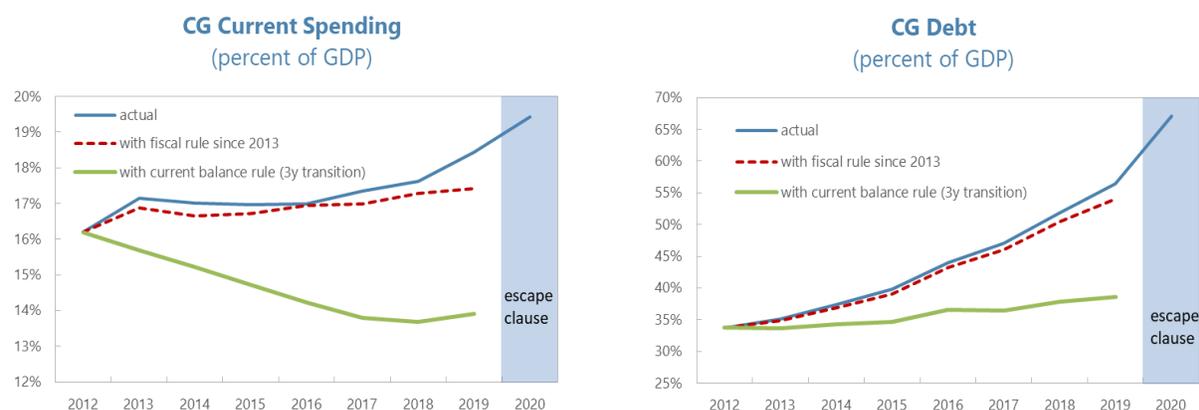


Source: IMF World Economic Outlook Database.

Note: Deflated with GDP deflator.

debt would have remained broadly stable between 2012 and 2019, but with a decline in current expenditure that would be socially infeasible.

Figure 8. Counterfactual Scenarios: Expenditure Rule and Constraint on Current Budget Balance Applied since 2013



Sources: Ministry of Finance, World Economic Outlook, and authors' calculations.

Notes: All variables other than current spending and debt are kept as in the actual data. The current balance scenario assumes a 3-year transition period to comply by 2016.

- *Limited independent fiscal oversight.* In principle, the monitoring of compliance would require a broader assessment of the macroeconomic assumptions underlying the MTFF and an assessment of the debt sustainability beyond just verifying that fiscal outturns meet the expenditure ceilings. The CGR has been transparent and fulfilled its reporting obligations, but its current mandate does not cover these assessments and has focused on auditing whether expenditures of the government and other entities grew within the prescribed limits. The existing fiscal council does not have sufficient resources nor capacity to provide such fiscal oversight.

16. It is understandable that some implementation challenges emerged as the rule just came into force in 2020, at the same time as the pandemic hit the economy. As the expenditure ceiling becomes tighter in the near term, the authorities face pressure from both legislative and executive proposals to exclude certain entities or spending items from the fiscal rule. But some proposals would bring permanent changes to the rules and are not well suited to resolve near-term challenges.

III. ADDRESSING IMMEDIATE IMPLEMENTATION CHALLENGES

17. To address the immediate implementation challenges, the government as well as parliamentary members have presented various proposals to revise the rules. These proposals broadly include (i) revising the measurement of rule compliance, (ii) excluding certain expenditure items from the fiscal rule, and (iii) excluding non-state public entities and other entities from the expenditure limits. These revisions likely bring permanent changes—some of these exclusions were

approved without a set of common criteria, while others are under consideration by the Legislative Assembly (Table 4). However, ad-hoc or frequent amendments to the fiscal rule may fall short of the principles of well-designed fiscal rules and could undermine credibility. Those amendments may not be well-suited to address the tighter expenditure limits or constraints arising from entity-level compliance. Since the fiscal rule was put in place, the decree regulating the LSPF has undergone 7 revisions and 11 entities were excluded by law. Further revisions to the fiscal rule will need to be based on good principles including maintaining broad coverage to achieve the final objective of debt sustainability, while ensuring enforcement of the fiscal rules.

A. Amending the Coverage to Exclude Entities from the Fiscal Rules

Proposals by the government and parliamentary members

18. In September 2022, the government submitted a bill to reform the fiscal rules aiming to address implementation shortcomings. Bill N° 23330 proposes to further exclude the following entities from the fiscal rule: i) all public corporations (PC) that carry out commercial activity in a competitive market, even those with high debt, except for the part of the current transfers from the central government; ii) non-state public entities except for those receiving transfers from the central government. The bill also proposes to exclude various types of expenditure items (Section III.B).

19. In parallel, the Legislative Assembly is considering several other amendments to exclude entities from the fiscal rules. Twenty draft bills are pending discussion at the Legislative Assembly. Various parties have put forward proposals to exclude entities or amend the fiscal rules, arguing that expenditure limits have imposed constraints on critical spending and investment, especially for entities that under-executed their budgets owing to lockdown restrictions during the pandemic. In some cases, those entities run a surplus and have adequate resources to invest but cannot do so because the fiscal rules are applied at the individual entity level (Table 4). These amendments often are entity specific without a set of common criteria. Aside from exclusions, the base reference variable was modified in the case of National Tourism Institute (ICT) when applying the ceilings on expenditure growth, thus allowing it to increase actual spending while still complying with the expenditure rule.

20. The government proposal aims to enhance flexibility for these excluded entities. In the imminent term, it would relax spending limits and alleviate political pressures from the cost-of-living crisis as expenditure growth ceilings are falling short of headline inflation. Among the entities subject to potential exclusion are decentralized institutions, public corporations, and non-state public entities that follow different budget procedures owing to the budget fragmentation in Costa Rica.

Assessment and Recommendations

21. Well-designed fiscal rules tend to have broad institutional coverage, encompassing all key components of fiscal operations that have significant effects on the economy or on fiscal sustainability. In principle, fiscal rules should cover all relevant fiscal and quasi-fiscal operations, provided that reliable data on those operations are available on a timely basis. A broad coverage prevents incentives to reallocate expenditure toward entities or activity that are not covered in the

fiscal rules, which could undermine the objectives to curb overall spending and reduce government debt.

Table 4. Proposed Amendments to the Fiscal Rule for Specific Institutions Pending Approval by the Legislative Assembly

Bill	Institution	Scope of exclusions	Share of 2021 NFPS Expenditure (percent)
22669 and 23255	National Production Council	All expenditure / Purchases under the Institutional Supply Program	0.66
22732 and 22726	911 Emergency Service	All expenditure	0.03
22814	Professional associations	All expenditure for those associations that do not receive public transfers	Not included in the SPNF
22823 and 22999	Non-state public entities	All expenditure the expenditure financed by transfers from the CG	Not included in the SPNF
22993	Foreign Trade Promoter of Costa Rica (Procomer)	All expenditure	0.11
23004	National Fire Department	All expenditure	0.24
22721	Municipalities from banana producer district	Tax on bananas	-
22695	National Animal Health Service and State Phytosanitary Service	All expenditure during emergency periods	0.15
22960 and 23199	National Child Welfare Agency	Expenditure from the National Child Care and Development Network	0.45
23039 and 23102	Public Services Regulatory Authority (Aresep)	Expenditure financed by the fee charged by Aresep	0.08
22949	Costa Rican Institute of Pacific Ports	Modifies the expenditure growth parameter for this institution	0.04
23209	CCSS	CCSS 10% transfer's EFF-IMF	6.24

Sources: CGR and authors' compilation.

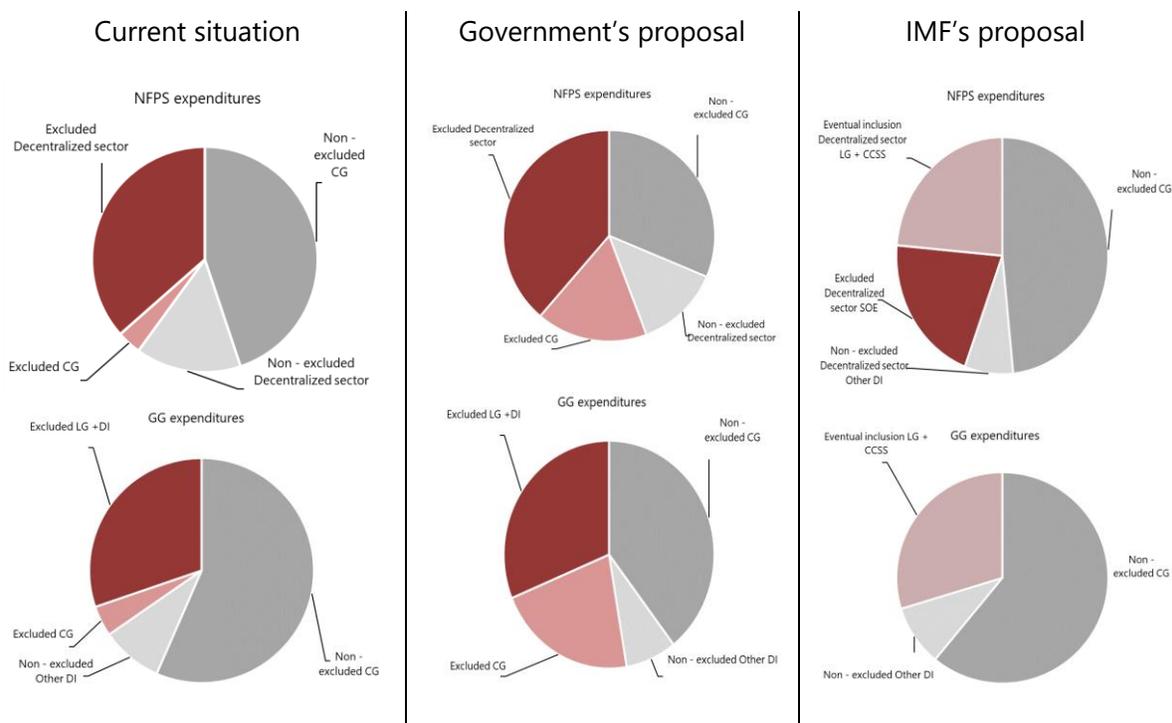
22. The proposals to exclude further entities and expenditure items in the draft bill (No. 23330) may go against good principles. The proposed revisions appear to lack common criteria. If applied, the exclusions of entities and expenditure items would significantly reduce the coverage of the rule from 60 percent to 44 percent of total NFPS expenditures, according to the final outturn data in 2021 (Figure 9). Similar large reduction of the coverage by the fiscal rules will also happen in the national budget of the central government as well as in the decentralized sector. The fiscal rule would then have covered only two-thirds of central government spending. Some other countries that adopt expenditure rules, such as Paraguay and Peru, the coverage of the fiscal rules has reached more than 90 percent of total government expenditures. Therefore, further exclusions of expenditure items and government entities will put the coverage of Costa Rica's fiscal rule below the typical coverage in Latin America.

23. The bill may help ease the imminent expenditure constraints under the fiscal rules but at a high risk. As spending in selected entities will not be counted towards the expenditure ceilings, the government may meet imminent spending pressures by scaling up spending in those activities without breaching the expenditure growth limits. Even if the intention is not to accommodate higher spending, there would be considerable pressures to approve budgets at the limit. However, the bill would bring structural changes to the fiscal rules by reducing their coverage significantly.

24. As a result, there is an imminent need to identify the coverage and perimeters of the fiscal rules and establish a sound framework to determine which entities should be included.

Such a framework will help the government address repeated ad-hoc requests to amend the rules—which could further undermine credibility—and implementation challenges noted in Section II. Some criteria put forward in various proposals, such as the entities generating own revenues, may not be fully aligned with international statistical concepts in GFSM, while some others such as the debt-to-asset ratio would help serve as complementary indicators.

Figure 9. Total Expenditures Excluded under Various Proposals
(Share of Expenditures in Percent)



Sources: CGR reports (2022), national authorities' data, and authors' calculations.

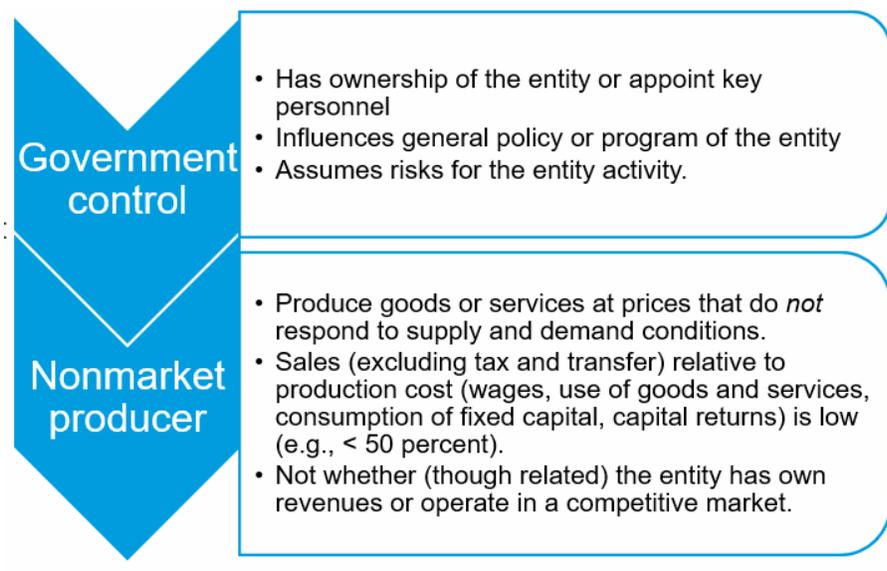
25. The fiscal rules in Costa Rica should ideally cover the general government. This would have two important implications:

1. All fiscal operations classified to be government activities, including those currently performed by decentralized institutions or some nonstate public entities, would be included in the fiscal rules, while activities that are not fiscal operations would be excluded.
2. Local government spending and spending on social security and healthcare by the CCSS would ideally be covered by the fiscal rules over the medium term.

26. Identifying government entities would require an objective set of criteria regarding decentralized or nonstate public entities. The IMF Government Finance Statistics Manual (GFSM) classifies an entity as part of the government if two broad criteria (among others) are met: the entity is under government control *and* a nonmarket producer (Figure 10; full details in GFSM 2014 Figure 2.4). The use of GFSM is also consistent with other public sector reforms like Hacienda Digital, the transition to IPSAS in accounting, and the technical assistance on the reporting of fiscal statistics

under the Fund EFF program. The authorities commit to gradually report fiscal statistics according to the GFSM by 2025.

Figure 10. GFSM Statistical Principles in Identifying General Government Activity



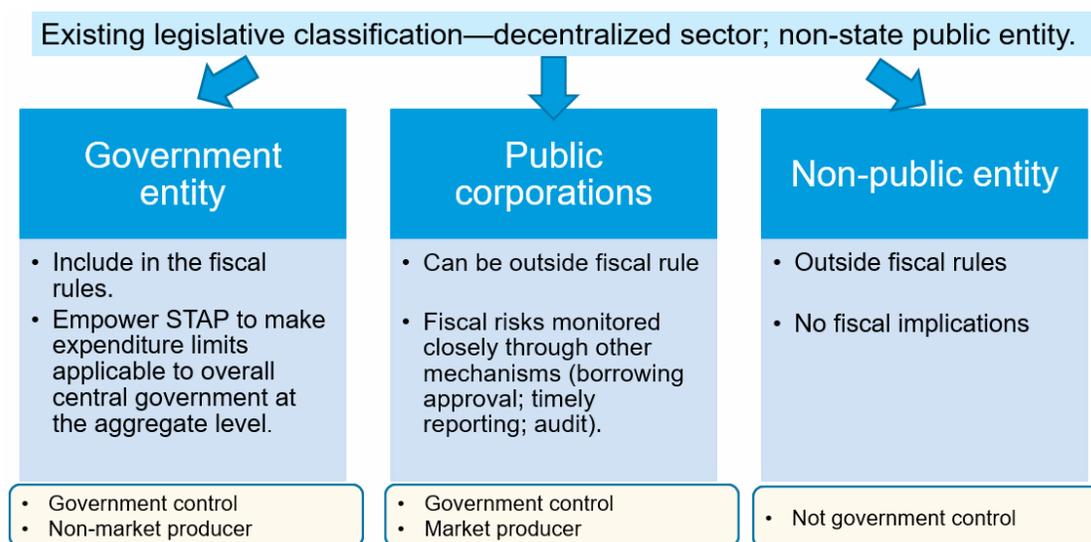
Source: Authors' compilation based on Government Finance Statistics Manual 2014.

- **Government control.** Government control is defined as the ability to determine the general policy or program of an entity (GFSM 2014). Several indicators can help determine if the entity is controlled by the government, including (i) the ownership or the rights to control the board or appoint or remove key officers; (ii) provisions or existence of a contractual agreement for governments to determine general policy and program; (iii) high degree of financing by the government, including borrowing from the government; and (iv) the government takes on risk exposures for the activity of the entity. A single indicator could be sufficient to determine control, though in some cases a consideration of separate indicators may collectively help determine it. Entities that are not financially viable and expose government to risks are likely to be classified as government entities.
- **Nonmarket producer.** A nonmarket producer provides its output to others for free or at prices that are not economically significant. This means that prices have little or no influence on how much the producer is prepared to supply and on the quantity demanded. Private corporations are generally market producers. When there is government control, however, prices may be modified for public policy purposes. Even when the sales of public corporations cover a large portion of their costs, they may not respond to market conditions like a profit-maximizing firm. In general, an entity is classified as a nonmarket producer if its sales (excluding taxes and transfers) is less than half of the production cost (including wages and investment costs) over a sustained multiyear period, although this value is just a reference and a case by case judgement

is needed.⁶ It is likely that a corporation receiving substantial government transfers or financial support, or enjoying risk-reducing factors such as government guarantees, would respond to market conditions differently because of softer budget constraints and is therefore likely to be a nonmarket producer.

27. The government should classify all decentralized institutions or public corporations according to the above GFSM principles to determine whether they should be included in the fiscal rules. Entities that are not controlled by the government should be excluded (for example, some professional associations currently classified as non-state public entities) (Figure 11). Entities that are controlled by the government and operate as a nonmarket producer should be included, whereas those operating as a market producer are classified as public corporations and excluded from the fiscal rules. The GFSM principles of government control and nonmarket producers are related to but different from the criteria specified in the decree. For example, an entity running on a commercial basis could be a market producer although an entity running at a surplus or profit over the years may rely on government support and therefore not be a market producer. Similarly, a nonmarket producer can be receiving or not receiving government transfers or can have high or low debt-to-asset ratios.

Figure 11. Selected GFSM Classification Categories



28. For entities classified as public corporations outside the fiscal rules, other monitoring will still be necessary to ensure they do not pose significant fiscal risks. The Fund has developed some tools for fiscal risks assessment (FRAT and SOE health check) categorizing the level of risk and

⁶ It is necessary to compare between sales value and the production costs when determining an entity is a public corporation (state-owned enterprise) or a government entity (belong to the general government). Sales are measured before any taxes applicable and exclude all payment receivable from government unless they would be granted to any producer of the same activity. Production costs are calculated as the sum of compensation to employees, use of goods and services, consumption of fixed capital, and other taxes on production. The return to capital is included in production costs. Subsidies receivable on production are not deducted from the production cost.

mitigating measures ([IMF Fiscal Risk Toolkit](#)). For example, the government should expand the report on their operations, cashflow statements, and balance sheet to monitor their financial viability and government exposures. Public corporations should continue to be subject to approval for new material borrowings, be audited, and have clear performance indicators. Fiscal risks statements should incorporate public corporations and follow a risk-based approach concentrating the monitoring to high-risk entities. High-risk entities should be subject to enhanced control to be made explicit in the regulations.

29. The current debt monitoring and authorization is fragmented among the entities of the NFPS. The Law 7010 establishes that only the MoF has borrowing capacity at the central government. The annual budget approves the domestic bonds issuance and each new loan requires approval by the Legislative Assembly (external loans by qualified majority and internal loans by simple majority). The sovereign guarantee for public entities will undergo the same process. However, the other entities with “autonomy” such as Universities, local governments and social security, and public banks do not need approval, except for sovereign guarantees. Overall the debt among those entities is moderate but some are rising rapidly in recent years. In order to mitigate the fiscal risks, tighter debt authorization is necessary to scrutinize the financial and debt servicing conditions of the borrowing entity, the conditions of the loans, and the final approval of the MoF. Many countries have implemented a system of alerts and thresholds plus prudent financial conditions are required (Mexico, Spain).

30. The expenditure growth ceiling could apply to central government (statistical concept) including the aggregate of national budget and decentralized institutions. Applying the expenditure ceilings individually to each decentralized institution creates rigidity in their budgets and pose challenges on the compliance of the fiscal rule. Ideally, the government should minimize the use of extrabudgetary entities (EBE) and integrate them into the national budget. As this is not feasible at present, at least the fiscal rule could apply to the aggregate of national budget and decentralized institutions. This would allow flexibility to compensate expenditure growth among the entities, for instance, higher social spending in some decentralized entity can be compensated by less expenditures in others so as to meet the aggregate ceiling (Annex 1). It would need that STAP is empowered by law to approve and monitor the compensating activity according to fiscal policy guidelines and priorities.

31. In the medium term, the authorities should consider including the local governments and social security (CCSS) in the fiscal rule. These entities are part of the general government under the statistical principles and therefore should eventually be covered by the fiscal rule. The fiscal rule will *not* affect the autonomy of local governments, as other countries with varying degree of intergovernmental relations are able to establish fiscal rules covering the general government or adopt subnational fiscal rules (Ralyea and others 2018). Recognizing the inclusion is not feasible at present, the CGR and Ministry of Finance should put in place enhanced monitoring and control to avoid fiscal slippages, including reflecting them in the fiscal risk report and publishing regularly long-term projections for health and pension spending. The MOF should also require monthly or quarterly financial information from these entities, require authorization when they incur new debt, and enhance information exchange. Incentives can also be applied to encourage prudent public finances,

such as balanced budget principles for local governments, and good PFM practices. When modifying the legal framework to include them in the fiscal rule over time, however, each local government or social security (CCSS) should *not* be subject to a uniform expenditure limit at individual entity levels. Certain flexibility needs to be built in, while respecting the overall fiscal envelope under the expenditure limits. For example, bringing the social security and health care spending into the national budget or central government (statistical concept) would give the government flexibility to better prioritize spending among competing needs.

B. Excluding Expenditure Items from the Fiscal Rule

Government proposal

32. The government submitted a bill in September 2022 to exclude several expenditure items from the fiscal rule. The proposal (Bill N° 23330) excludes the following items: capital expenditures (regardless of the debt level), interest expenditure (only for the central government), externally-financed projects (both existing projects that have financing rolling over (*revalidaciones*) and new international grants and loans), court rulings pending a final judgement, and contractual obligations of the airport concessions. These items to be excluded represent about 35 percent of the total expenditure of the central government (or 17 percent of total NFPS expenditures) (Figures 12 and 13). The bill is under discussion at the Legislative Assembly.

Figure 12. Share of Proposed Exclusions in the Total Expenditure of the Central Government
(Share of expenditures in percent)

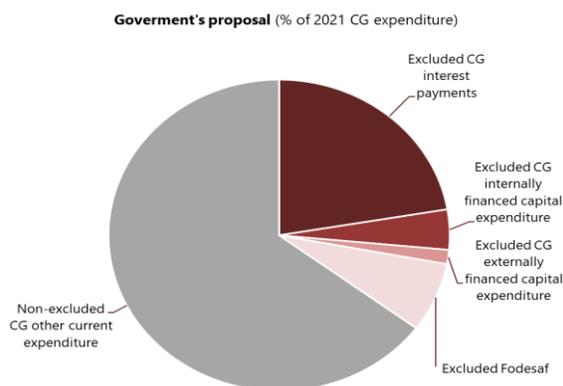
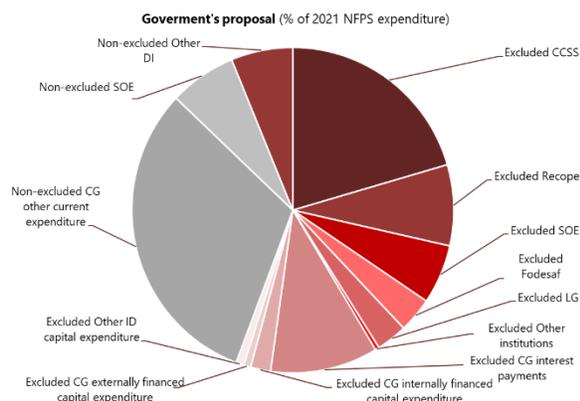


Figure 13. Share of Proposed Exclusions in the Total Expenditure of the NFPS
(Share of expenditures in percent)



Sources: CGR reports (2022), national authorities' data, and authors' calculations.

Assessment and recommendations

33. The fiscal rule would cover a much narrower share of expenditure under the proposed exclusions. The exclusions are against the principle that a well-designed fiscal rule should cover all main fiscal aggregates that can affect fiscal policy and debt sustainability (Eyraud and others 2018). They tend to undermine fiscal credibility, as a large share of fiscal activity would not be monitored or covered by the fiscal rule. In such case, even full compliance with the fiscal rule would not guarantee

reducing debt vulnerabilities. Activity excluded from the rule could pose significant risks to public finances. The exclusion also reduces the counter-cyclical property of the expenditure rule during adverse shocks.

34. Many countries exclude certain expenditure items in their fiscal rules but the experience has been mixed (Box 1 and Table 5). Some spending items are excluded to safeguard priority spending such as social protection or public investment for development needs. On the other hand, some expenditure items are not easy to monitor, due to the lack of or delays in information. Although exclusions are common, such exclusions often give rise to implementation challenges, as they make fiscal rules less transparent and harder to monitor. Additional distortions are prevalent as those exclusions give incentives for creative accounting to reclassify expenditure to other categories not subject to fiscal rules. The latter risk can be mitigated because the Law 9635 includes certification from the entities on capital expenditure classification and control from STAP and DGPN.

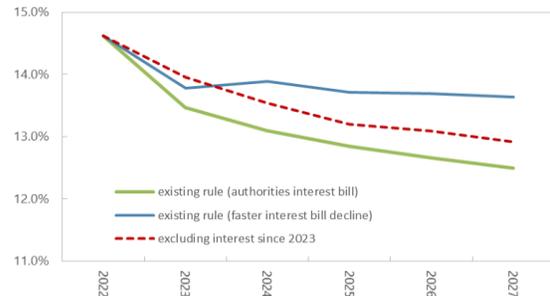
35. The proposed exclusions in Costa Rica create limited spending space but present significant risks. Although the exclusion of expenditure items could give rise to additional policy space to spend, it could bring risks and undermine fiscal discipline and efforts to control expenditures and fiscal consolidation.

- *Capital expenditures.* The existing fiscal rule already has a provision to protect capital expenditures: expenditure growth ceilings only apply to current spending when debt is below 60 percent of GDP. As capital expenditures often involve multi-year spending, excluding them from the fiscal rules will lead to distortions, less transparency, and give incentives for creative accounting with potential undue classification of expenditure items. Over the past few years, capital expenditures were always under-executed relative to the budget amount; it is therefore unclear whether the key binding constraint on aggregate public investment is the fiscal rule or rather unintended under-execution.
- *Externally financed projects.* At present, the government does not include all capital expenditures in the initial budget because at the time of budget preparation the nature and size of externally-financed projects are uncertain. Externally-financed projects are included through in-year budget modifications, which can be large for some institutions and unrelated to expected annual execution, and are reflected in the final budget. As the government has revised the reference (July 2022 decree) to assess the compliance of fiscal rule (Section III.A), it intends to exclude externally-financed projects from the fiscal rule. Excluding externally-financed projects from the rule might encourage relying further on external financing.
- *Interest bill.* A key rationale for excluding interest payment from the fiscal rule is that interest spending represents the cost of previous deficits (incurred in the form of debt) and is outside the direct control of government. Some countries therefore adopt limits on primary spending or primary balance. However, for countries whose priority is to reduce debt over time, focusing on overall expenditure or balance (that is, including the interest bill) in the fiscal rule is appropriate as they link directly to the debt dynamics. In Costa Rica, an exclusion of interest bill in the fiscal rule might loosen the primary expenditure limit modestly in the near term (by up to 0.4 percent of GDP under the authorities' projection), but the additional space could be offset in the future

depending on the macroeconomic outlook (Figure 14). For example, a faster decline in the interest bill would relax primary expenditure growth under the existing rule but would leave it unchanged if interest was excluded. Frequent amendments to the rules may also undermine the credibility of fiscal rules, in turn raising the borrowing cost of the government.

- Contingent liabilities from court rulings and contractual obligations on airport concessions.* The authorities indicated that there are two court rulings that may incur as an expense to the central government at (0.4 percent of GDP) if government loses in the legal cases. Excluding such contingent expenses is not recommended. A more appropriate way will be to keep a contingency reserve in the budget to account for the court rulings as well as other possible spending contingencies. Some other countries maintain a reserve of about 2-3 percent of annual government expenditures for such contingencies and the council of ministers (or the cabinet) approves its use. Over the medium term, the potential realization of contingencies should be incorporated through better fiscal planning under the MTFF fiscal path. The same would apply for the contractual obligations with companies operating the concessions for airports (Juan Santamaría and Daniel Oduber). The accrued expenditure should be included as part of overall expenditure when assessing compliance with the fiscal rule for the general government.

Figure 14. Implications for Primary Expenditure of Excluding Interest Payments from the Fiscal Rules (Percent of GDP)
CG Primary Spending (percent of GDP)



Sources: Authors' estimates.

Notes: the path for spending excluding interest (red dotted line) is independent of the interest bill assumptions. A faster decline in the interest bill generates more room for primary spending growth under the existing rule projection. The blue line is indicative as it refers to a specific set of macroeconomic assumptions.

36. Existing proposed amendments represent a departure from good principles of fiscal rules and could affect the implementation of fiscal rule in a permanent way. The additional spending space from these exclusions in the near term does not seem to outweigh the costs and risks involved, including undermining the credibility of the fiscal rule given it is still at the early stage of implementation. To rectify the bills already submitted to the Legislative Assembly, it is recommended to propose a modification in line with principles of well-designed fiscal rules as the bill is under review by relevant legislative committees. Further proposals to amend the fiscal rules would benefit from thorough and unified cost-benefit analyses.

Box 1. Selected Country Examples of Exclusions from Expenditure Rules

This Box illustrates the coverage of expenditure rules in selected countries in Central and Latin America. While a well-designed fiscal rule calls for a broad coverage of key fiscal aggregates, many countries exclude certain expenditure items in their expenditure rules. The exclusions arise from several causes. On the one hand, some spending items are excluded to safeguard priority spending such as social protection or public investment. On the other hand, some expenditure items are not easy to monitor, due to the lack of or delay in available information.

From an economic point view, there are some reasons to exclude specific expenditure items in a fiscal rule (Cordes and others 2015). Interest payments are sometimes excluded from fiscal rules as they are not under the direct control of governments. Certain cyclical automatic-stabilizing expenditures, such as unemployment benefits, are sometimes excluded in expenditure rules (e.g., in the European Union).

Exclusions of expenditure items in the fiscal rule vary among countries. Some exclude capital spending from the expenditure rule or set a floor of capital spending, though that can give rise to implementation challenges (Davoodi and others 2022). Some countries exclude interest payments, pensions, or cyclical expenditure such as unemployment benefits. In some cases, the expenditure rule is directly defined in terms of primary (or primary current) expenditure ceilings, excluding interest payments.

Several Central and Latin American countries have exclusions in their expenditure rules (Table 5). Many expenditures rules in Latin America are usually defined in terms of primary spending, with interest payments excluded. Exceptions are Costa Rica and Peru, with the latter including interest payments in the current expenditure rule, but also specifying that the limits on non-financial spending exclude interest payments. Some other countries have budget balance rules (Chile, Mexico, Peru), with a few defining them in terms of structural or primary balances. Several cases (Colombia, Ecuador, Peru) also have debt rules in place.

Public investment is often excluded from Central and Latin American expenditure rules. For example, the expenditure rule in Mexico is set on current spending only, thereby excluding all investment spending. In Argentina, capital expenditure is excluded from the rule in the jurisdictions that registered a surplus the previous year, while only partially for those jurisdictions with a deficit.

Some other exclusions depend on countries' institutional framework. In countries where subnational governments get large transfers from the central government, for instance through automatic revenue sharing formula, these transfers tend to be excluded from the fiscal rule (Mexico and Argentina). Countries with rigid and earmarked expenditures, such as pre-allocations to specific items, sometimes exclude them. For example, Ecuador excludes spending items that are specified in the constitution for pre-allocated expenditure to education, health, and transfers to regional governments. The expenditure rule of Mexico excludes expenditure items such as pensions and fuels for electricity generation.

Even though exclusions of spending items are common in expenditure rules, such exclusions often give rise to implementation challenges. The exclusions make fiscal rules less transparent and harder to monitor. Exclusions also limit the ability to restrain aggregate expenditures, posing more challenges to reducing debt vulnerabilities. Additional distortions are prevalent as those exclusions give incentives for creative accounting to reclassify expenditure items not subject to fiscal rules. These challenges are particularly relevant for capital expenditures as it often involves multi-year spending and efficiency concerns. Certain current expenditures may be reclassified to public investment to bypass the rule limits. Including capital expenditure in the fiscal rule would promote better transparency and use of resources.

Table 5. Selected Country Examples on the Use of Expenditure Rules

Country	Expenditure aggregate	Benchmark	Investment exclusion	Interest payment exclusion	Other exclusions	Regulation	Debt rule
Argentina	Primary net current expenditure (jurisdictions with fiscal surplus)	CPI	Yes	Yes	Expenditure financed by loans from international organizations Transfers to subnational governments from the GC (sub-national revenue-sharing or to implement national policies) Current spending from investment in health, education and security (jurisdictions with fiscal surplus)	Art 10 Ley 25.917 Regimen Federal de Responsabilidad Fiscal	No
	Primary net total expenditure (jurisdictions with fiscal deficit)	Nominal GDP growth	Partial: investment financed by specific resources and to implement national				
Brazil	Primary spending	CPI	No	Yes	Some transfers from CG to subnational governments	Art 107 Constituição da República Federativa	No
Colombia	Current expenditure	Nominal GDP growth	No	No	Capital expenditure		Yes
Costa Rica	Current spending if CG debt < 60% GDP	Four-year average nominal GDP growth	Yes	No	Social Security pensions SOE operating in market conditions National oil company imports Fund for Social Development	Título IV Ley N° 9635 de Fortalecimiento de las Finanzas Públicas	No
	Total spending if CG debt > 60% GDP		No				
Ecuador	Primary spending	Long term growth	No	Yes	CG pre-allocated spending, established by the Constitution, on education, health and transfers to regional governments	Section III Código Orgánico de Planificación y Finanzas Públicas	Yes
El Salvador	Wages and salaries and expenditure on good and services	Nominal GDP growth	Yes	Yes		Artículo 10.c Decreto No. 533	Yes
México	Structural current spending	Potential GDP growth	Yes	Yes	Transfers from the GC to subnational governments Pensions Fuels for electricity generation	Artículo 1 Ley Federal de Presupuesto y Responsabilidad Hacendaria	No
Paraguay	Primary spending	Inflation rate + 4 p.p.	No	Yes		Artículo 7 Ley 5098 De responsabilidad fiscal	Yes
Peru	Non-financial spending	20 year (t-15, t+4) moving average of real GDP growth ± 1pp	Partial	Yes	Replacement spending and replacement investment	Artículo 6 Decreto Legislativo N° 1276	Yes
	Current spending	20 year (t-15, t+4) moving average of real	Yes	No	Replacement spending		
Uruguay	Real primary spending growth	Potential GDP growth	No	Yes		Artículo 208 Ley 19889 de Urgente consideración	No

Sources: Authors' compilation based on IMF Fiscal Rule Dataset 2021.

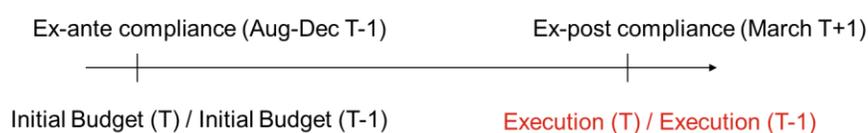
C. Revising the Ex-post Compliance Measurement

Government executive decree

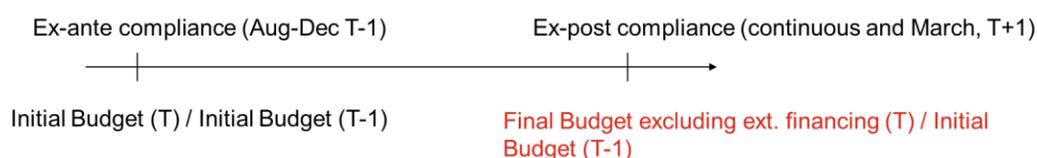
38. The government modified the methodology for verifying compliance with the fiscal rules in July 2022. Executive Decree N° 43589-H, enacted in July 2022, changed the reference variable for verification of ex-post compliance to the final budget of a given fiscal year relative to the initial budget of the previous fiscal year (Figure 15). This implies that the compliance is assessed based only on budgetary terms rather than final outturn and does not consider the externally funded spending.⁷

Figure 15. Verification of Compliance with the Expenditure Rule

Before July 2022 Decree:



After July 2022 Decree:



IMF Proposal:



Sources: Authors' compilation of the compliance reference variables based on executive decree N° 43589-H.

Assessment and Recommendations

39. The revision of the reference variable used to verify compliance was an attempt to address a shortcoming in the fiscal rule. Under-execution of the budget had carry-on effects for future limits of expenditure growth and thereby discouraged saving through improving spending efficiency. For example, the lower-than-anticipated execution in 2020 owing to lockdown restrictions led to a lower base regarding the 2021 expenditure growth limit.

40. While the revision may address the unintended effects of budget under-execution, it brought up other challenges. First, the monitoring of the final budget becomes less

⁷ A new executive decree (N° 43589-H) was enacted in July 2022, which amended the executive decree 41641-H implementing the LSPF.

transparent for the public. Monitoring the budget modifications to arrive at the final budget would require frequent access to Information System on Plans and Budgets (SIPP) and dedicated websites. The final budget often does not have the same comprehensive explanatory notes as the execution data. In general, the use of final budget in verifying compliance deviates from common practice. The CGR also indicated that compliance based on the final budget cannot be subject to legal sanctions because the final budget remains an estimate and not an outturn. The use of the final budget should still be kept for ex-ante and in-year monitoring and preventive action.

41. Using the final budget as a base for applying expenditure growth ceilings creates a challenge related to externally financed projects. Those projects are included in the final budget through in-year modifications, but are not included in the initial budget. The final budget includes the multi-year funding without annualizing the expected execution. Table 6 contains estimates of what would have been the ex-ante and ex-post assessment before and after the executive decree (Decree 43589-H) over recent years. Externally-financed expenditure accounts for one-fifth of capital expenditure of the national budget of central government. Instead, the rest of NFPS entities include the externally-financed expenditure both in the initial budget and modifications. CGR and Ministry of Finance have different interpretations on the inclusion. The Ministry of Finance intends to exclude externally financed projects from the final budget to verify the compliance relative to the initial budget, while CGR includes those but do not adjust the initial budget reference with the estimated externally-financed spending.

Table 6. Measuring Compliance with Expenditure Growth Ceilings

<u>CG spending growth rate (percent)</u>	2020	2021	2022
Rule			
total spending	n.a.	n.a.	2.0
current spending	4.7	4.1	2.0
Ex-ante verification (initial (T) vs initial (T-1))			
total spending	5.4	1.1	2.0
current spending	4.4	2.1	2.1
New ex-post verification (final w/ ext. fin. (T) vs initial (T-1))			
total spending	11.5	14.6	14.4
current spending	4.5	5.2	3.1
New ex-post verification (final w/o ext. fin. (T) vs initial (T-1))			
total spending	-1.7	-4.4	2.4
current spending	-1.2	-3.0	2.5
Old ex-post verification (executed (T) vs executed (T-1))			
total spending	-3.3	9.0	n.a.
current spending	0.7	7.4	n.a.

Sources: National authorities' Medium-term Fiscal Frameworks 2021 – 2025 and 2022 -2027, *Ministerio de Hacienda*, and authors calculations.

Note: Excluding spending covered by the escape clause from the final budget and execution amounts in 2020 and 2021 (0.8 and 0.4 percent of GDP, respectively). The rule ceiling does not apply to total spending in 2020 and 2021 (marked as n.a.) as T-2 debt was below 60 percent of GDP.

42. A preferred approach to assess ex-post compliance would be to compare the final outturn relative to the initial budget of the previous year while making an estimate of externally-financed expenditure. The final outturn is observable and relates directly to debt

dynamics. The comparison of the final outturn with the initial budget would resolve the under-execution challenges arising when using the final execution of the previous year. The execution accounts for all funding sources, including externally-financed projects, but the initial budget used as reference does not include those. In that context, one option would be to add the estimated annual execution of the externally-financed expenditure to the initial budget such that the reference would be comparable to the final execution. To this end, the budget document (or a supplementary annex to the budget) can include the list of projects and estimated expenditure with external financing for the next budget year, for information purposes. This would be the same practice as other NFPS entities apply today.⁸ It would help improve budget unity on the capital expenditure and strengthen the link between verification of compliance and the fiscal sustainability objective.

43. However, this approach may involve procedural changes in STAP and DGPN. It is because the initial budget only involves domestic financing items, while the external financing of projects is approved in separate procedures. If the preferable option of comparing final outturns with initial budget is not feasible, a closer analysis on the annual execution of externally-financed projects as well as their implications on government debt is necessary. In case the reference base is the initial budget of the previous fiscal year without including an estimate of externally-financed projects, a separate expenditure control is necessary as externally-financed projects represent an important part of government expenditures and external loans add to government debt.

44. For ex-ante compliance with fiscal rules, the comparison of budgets would still be useful to avoid large deviations before the final execution (as in Art. 19 LSPF). The ex-ante verification helps prevent large deviations from the rule during the year. The base reference (initial budget) would have to be adjusted with the estimate of the annual externally-financed expenditure as noted above. The first time of adjusting the initial budget with an estimate can apply the effective execution of the previous year to avoid an overestimate.

D. Escape Clauses

45. The fiscal rule includes an escape clause in the event of a national emergency or sharp economic downturn. The escape clause can be activated for two years if (i) there is a state of national emergency, which allows emergency spending of at least 0.3 percent of GDP; or (ii) there is an economic recession or if GDP growth is projected to fall below 1 percent. In case (ii), the suspension of the rule is up to two years if the previous levels of real GDP are not recovered before, and there is a three-year transition period to return to the rule. In periods of

⁸ The Congress would not have to approve the estimate because it had already approved those projects in separate occasions when the government borrowed externally. But the inclusion of such information in the annex to the budget would give comprehensive information of the capital expenditure for the year independent of the funding source.

extraordinary favorable economic growth (real GDP growth over 6 percent for two years) the Ministry of Finance (MoF) can raise the current expenditure growth parameter up to 85 percent.

46. The escape clause provision could allow for a transition period also after national emergencies (Decree N° 41641-H Article 25; Article 16 of the LSPF). A two- to three-year transition appears appropriate when countries exit from national emergencies or recessions, which may help avoid an abrupt withdrawal of primary spending. A robust procedure to activate the clause and a narrow set of circumstances remain important.

E. Recommendations

Coverage of the expenditure rule

- The institutional coverage of the fiscal rule should apply to general government, as defined in Government Finance Statistics Manual (GFSM). Over time, the Legislative Assembly should consider including local governments and the social security (CCSS) in the fiscal rule. In the interim, Ministry of Finance will closely monitor them under a risk-based approach.
- MOF should develop verifiable and objective criteria to identify which public entities should be included in the fiscal rule, in accordance with GFSM and other indicators.
- Amend Bill 23330 submitted to the Legislative Assembly to indicate that the exclusion of entities from the fiscal rules should be based on GFSM criteria specified by MOF (or including those criteria in the law). Entities that are under government control and nonmarket producers should be considered as government entities and included in the fiscal rules. Other entities need to be monitored under a risk-based approach to be developed by MOF, and debt regulations to cover the authorization outside of central government should be enhanced.
- MoF will present an assessment on legal changes needed to empower the ministry and in particular STAP to make the expenditure limits applicable to the overall central government (GFSM) at the aggregate level, including extrabudgetary entities such as Decentralized Institutions, instead of by individual entities.

Excluding expenditure items

- Amend Bill 23330 submitted to the Legislative Assembly to avoid excluding capital expenditure, court rulings, and interest expenses from the expenditure rules. Create a contingency reserve in the budget (e.g., a separate budget line) that will cover court rulings, among others, subject to the aggregate expenditure ceilings.

Verification of compliance

- Clarify the executive decree to include the comparison of expenditure growth between the final outturn at the end of a fiscal year relative to the initial budget of the previous fiscal year plus an estimate of externally funded expenditure. Ex ante and in-year verification at budget level remains the same but adding the annual estimate of the externally funded expenditure.

- Include the best estimate of annual externally funded expenditure in an annex to budget documents provided to the Legislative Assembly.

Other provisions

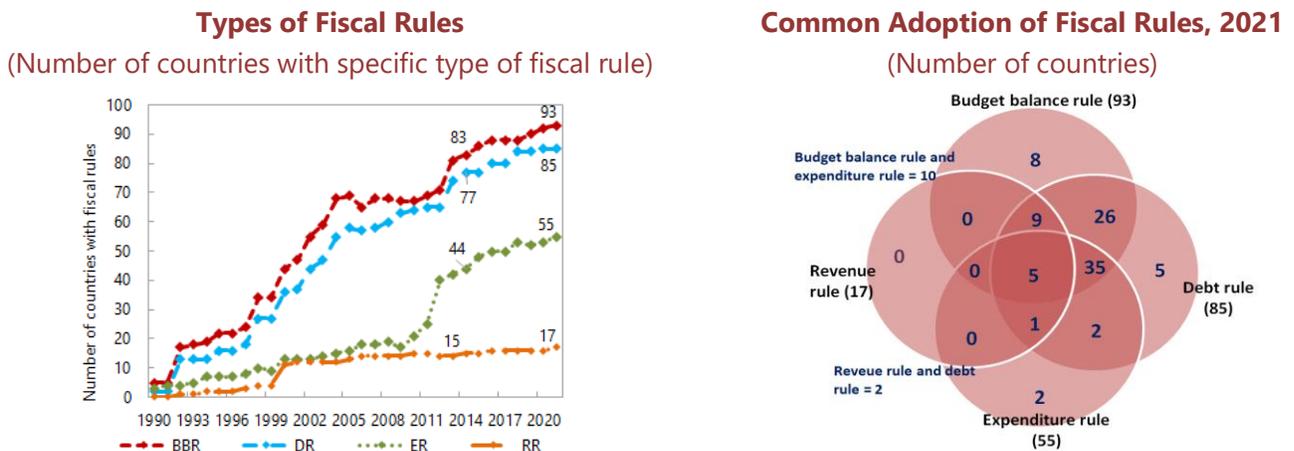
- Modify the escape clause provision (Decree N° 41641-H Article 25; *Article 16 of the LSPF*) such that the maximum transition period applies when the escape clause is activated in either one of the triggering conditions (emergency or recession).

IV. MEDIUM-TERM CONSIDERATIONS OF THE FISCAL RULES

A. Risk-Based Approach in Setting a Medium-term Debt Anchor

47. The annual ceilings on expenditure growth could be supported by an explicit medium-term debt anchor. International experience suggests that well-designed fiscal rules have a medium-term anchor linked to the objective of fiscal sustainability and defined in terms of a stock variable (typically, gross debt in percent of GDP). Anchoring fiscal policy to a stock variable is appropriate because fiscal sustainability is determined by the government balance sheet, and its capacity to meet financing needs and service debt. However, because the debt stock is not under the full control of the government, the debt anchor should guide fiscal policy over the medium term (Caselli et al. 2018, Caselli and others 2022). One (or a few) operational limit(s) should instead guide near-term fiscal policy and budget preparations. The operational limits such as expenditure rule should have a clear link with the fiscal anchor—in which adhering to the expenditure rule over time would ensure a high likelihood of achieving the debt anchor and maintain debt sustainability over the medium term. In addition, operational limits such as deficit targets or expenditure limits should contribute to macroeconomic stability over business cycles, for example through a countercyclical primary balance.

Figure 16. Fiscal Rules of Worldwide



Source: Davoodi and others (2022).

Note: The Venn diagram (right-hand-side chart) shows the overlap of different rules across the world. For example, there are 5 countries that adopt all four types of fiscal rules and 35 countries that adopt debt rules with both budget balance rules and expenditure rules

48. A combination of expenditure rules with a debt rule is common in practice. As of 2021, 85 countries adopted fiscal rules that included an explicit ceiling on government debt, and this number has been increasing over time (Figure 16). At the same time, more than 80 percent of countries with a debt ceiling have also rules imposing constraints on the (nominal or structural) budget balance, and among those, almost a third has expenditure ceilings (Figure 16).

49. A risk-based approach to set the medium-term anchor requires determining a debt limit and a precautionary buffer:

- *A (maximum) debt limit.* The debt limit is the level debt should not exceed. There is consensus that debt could be in distress with debt dynamics getting out of control when debt surpasses a certain level, and the literature abounds with estimates of this threshold (IMF 2016). However, this country-specific threshold is highly uncertain in the post-pandemic environment, in part because of unanticipated inflation, rapid rises in nominal interest rates, uncertainty about the neutral interest rate, and concerns about government efforts in undertaking adjustments. The latest literature suggests that the debt limit can be sensitive to growth and interest rates differentials, as well as to the elasticity of interest rates to debt (Caselli and others 2022; Mian, Sufi, and Straub 2022). As a result, considerations other than the risk of debt distress also motivate the choice of a maximum debt limit, for example, the adverse impact of higher debt on growth and financing conditions. Debt should not exceed the level that drags growth or that triggers a sharp rise in spreads or ratings downgrade.
- *A safety buffer.* Keeping debt close to the limit would not be prudent, as an adverse shock (for example, from a tightening of financial conditions) could quickly push debt above the limit and lead to a surge in spreads or debt distress. It would be prudent to maintain a safety buffer such that under normal circumstances, debt would stay sufficiently below the limit. The safety buffer raises the likelihood that debt would remain sustainable (that is, below the limit) even under negative shocks, and that policymakers have space to respond to shocks and stabilize the economy. The safety buffer also allows governments time and space to take corrective measures if debt starts trending up.

B. Estimating a Medium-Term Debt Anchor for Costa Rica

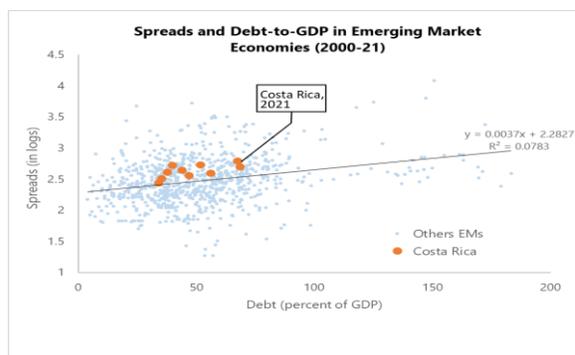
50. The authorities should consider introducing a medium-term anchor on gross government debt. The current fiscal rule in Costa Rica has an operational limit—a ceiling on expenditure growth linked to the 4-year moving average of previous nominal GDP growth and the previous debt-to-GDP ratio—but without a debt rule it is uncertain if the expenditure ceilings are consistent with the objective of reducing government debt over time and maintaining debt sustainability. The following discusses an appropriate government debt anchor based on the IMF guidance note on calibrating fiscal rules (Caselli and others 2018). This involves two steps:

- **Setting a debt limit:** We consider that an appropriate range for the debt limit would be about 65 to 70 percent of GDP, slightly below the 70 percent threshold applied to emerging

market-access countries in the IMF Debt Sustainability Analysis (DSA) framework for Market Access Countries (IMF 2013).⁹ A level below the 70 percent of GDP benchmark is justified because sovereign spreads and credit risk in Costa Rica have recently surpassed those of the average emerging-market economy for a similar level of government debt (Figure 17). Moreover, spreads for Costa Rica sovereign bonds have been higher than those of 75 percent of emerging market economies since 2014 (Figures 18 and 19).

- Estimating the debt anchor:** The sustained rise in government debt over the last decade in Costa Rica calls for a precautionary approach when setting the debt anchor. Costa Rica experienced a doubling of debt from 34 to 68 percent of GDP between 2012 and 2021 as adverse shocks occurred and nominal growth slowed down. We determine a safety buffer based on the stochastic nature of the debt, the tolerance for risks, and the size and likelihood of contingent liabilities.¹⁰ The debt anchor is calibrated so that the distribution of debt dynamics (a fan chart) starting from the debt anchor stays below the maximum debt limit over a 6-year horizon with a high probability. Intuitively, the debt anchor is the highest level of debt that the government could reach and still have a relatively low risk of experiencing fiscal distress over the medium-term. The methodology is described in Annex II.

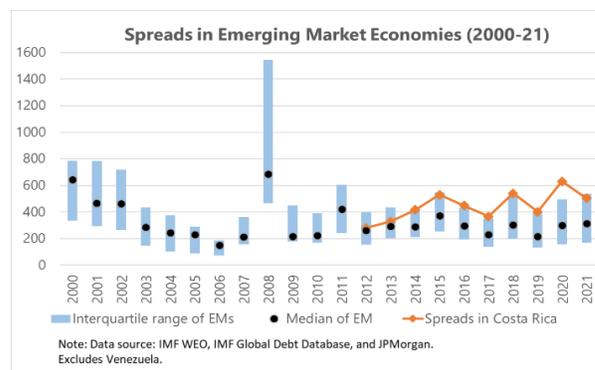
Figure 17. Debt Levels and Spreads in Emerging Market Economies (Percent)



Sources: IMF World Economic Outlook, IMF Global Debt Database, and JPMorgan.

Notes: Spreads in log terms. Excludes Venezuela.

Figure 18. Spreads in Emerging Market Economies, 2000-21 (Basis points)



Sources: IMF World Economic Outlook, IMF Global Debt Database, and Fitch.

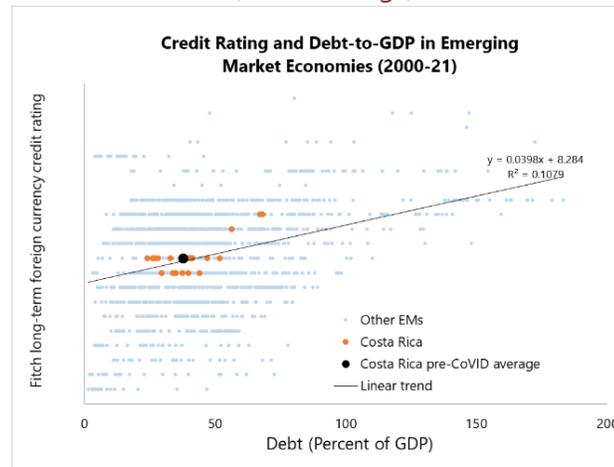
Note: Data for sovereign spreads of Costa Rica are not available before 2012.

⁹ The DSA methodology was revised recently (IMF, 2021), but has moved away from homogeneous debt thresholds across countries within an income group.

¹⁰ In Costa Rica, the possible contingent liabilities arise from government guaranteed debt of public entities, natural disaster risks, pensions, court rulings, local governments, financial sector risks, and public-private partnerships. As of mid-2022, the quantified medium-term contingent liabilities were about 9 percent of GDP. This is similar to the average in a sample of advanced and emerging market economies (Bova and others 2016), which finds that the probability that contingent liabilities exceeding 1 percent of GDP materialize in a year is about 6 percent, with the average fiscal cost of these realizations at about 10 percent of GDP.

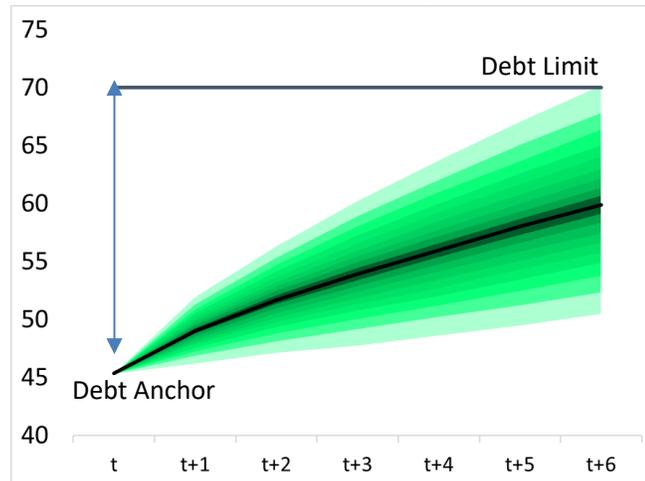
- Based on the historical realization of macroeconomic shocks and contingent liabilities in Costa Rica, a prudent gross debt anchor for Costa Rica's central government is estimated to be between 35 and 50 percent of GDP if policymakers are tolerant of a 10 percent probability that debt may breach the maximum debt limit of 65-70 percent of GDP over the medium term (Figure 20). This would provide a reasonable safety buffer allowing Costa Rica to withstand typical adverse macroeconomic shocks in the medium term. A lower debt limit or a lower tolerance for risk would require a lower debt anchor (Table 7).

Figure 19. Debt Levels and Sovereign Ratings in Emerging Market Economies
(Credit ratings)



Sources: IMF World Economic Outlook, IMF Global Debt Database, and Fitch Ratings.

Figure 20. Debt Anchor with Sufficient Buffers
(Percent of GDP)



Sources: IMF World Economic Outlook and IMF Staff estimates.

Notes: using the IMF [Fiscal Rule Calibration Tool] (Eyraud and others, 2018). The chart simulates the evolution of debt from an anchor level under a distribution of shocks based on historical data.

Table 7. Sensitivity Analysis of Simulated Gross Debt Anchor

	Baseline scenario	Higher risk tolerance	Lower debt limit	No Contingent Liabilities
<u>Parameters</u>				
Debt limit (percent of GDP)	70	70	65	70
Risk tolerance (probability of exceeding limit, percent)	5.0	10.0	5.0	10.0
Contingent liabilities (percent of GDP)	9.3	9.3	9.3	0.0
<u>Results</u>				
Debt anchor (percent of GDP)	45.3	49.8	35.4	61.5
p10-p90 range at year 5 (percent of GDP)	13.8	14.1	13.9	13.0

Source: IMF Staff estimates.

Note: Assuming a maximum primary balance of 2.5 percent. The contingent liabilities are estimated by the national authorities. The simulation assumes that about 1.5 percent of contingent liabilities materialize every year, cumulating to 9.3 percent of GDP over 6 years.

51. Additional considerations of fiscal risks and development needs in Costa Rica will affect the choice of the debt anchor. Mapping these spending needs to a medium-term debt anchor would require some judgement. For example, public spending on health and social protection (through transfers by central governments to CCSS) are expected to rise over time. Investing in infrastructure (such as education, roads, and climate adaptation) remains a priority. It could increase productive capacity, but also financing needs, so its implications for the debt-to-GDP ratio will need to be considered when setting a medium-term debt anchor.

52. Complying with the existing expenditure rule is expected to put debt on a path reaching the debt anchor at about 50 percent of GDP by 2035. Based on the projections in the IMF 2022 Staff Report for the Third Review under the EFF (IMF 2022) and the application of the existing expenditure rule, current spending would be contained, while debt-to-GDP would gradually fall to about 50 percent of GDP by 2035 (Figure 21). However, adhering to the expenditure rule will require a sizeable reduction in total expenditure as a share of GDP by 3 percentage points of GDP over next 15 years. To the extent cutting expenditure proves economically or politically difficult, additional revenue measures will be needed to finance additional spending needs. Setting a medium-term debt anchor would allow policymakers to recalibrate the expenditure path following structural shocks (e.g., a permanent increase in revenues), and still attain the same debt anchor levels over a similar horizon (Table 8).

Table 8. Sensitivity to Macroeconomic Shocks under Existing Rule Ceilings, 2024-2035

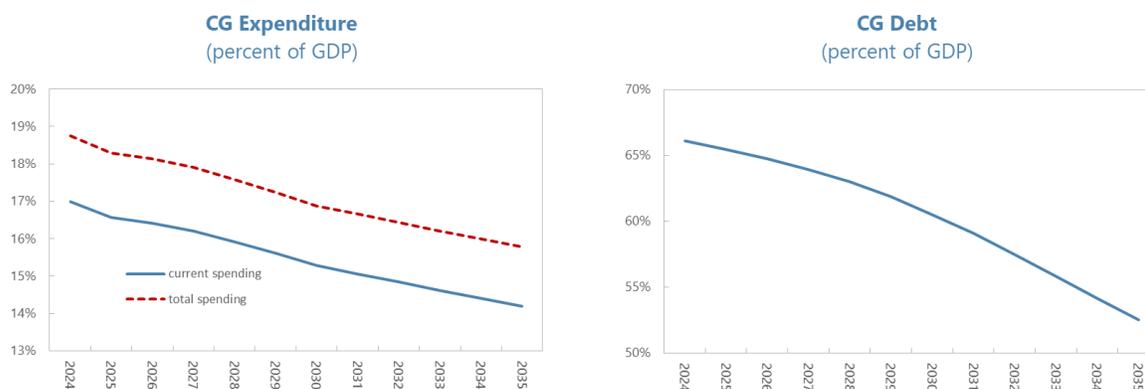
	Current expenditure growth, 2024-2035 average, percent	Debt in 2035, percent of GDP
Baseline	4.5	52.5
Higher NGDP growth (+1ppt)	5.2	39.6
Higher interest rate (+1ppt)	4.3	56.7
• Higher revenue (+1 pct of GDP)	4.7	36.3

Sources: IMF Staff Estimates.

Notes: Each row other than baseline introduces one shock at a time. The shock applies to the entire period 2024-2035. For reference, the current expenditure growth ceiling in 2022 was 1.96 percent of GDP. The projections assume government expenditures are at the ceilings prescribed under the fiscal rule. If the government adopts more ambitious adjustment with expenditures growing within the ceilings, then debt levels would decline further by 2035.

53. The debt anchor can be set to cover central government debt (in gross terms), with an aim to include debt incurred by municipalities and local governments when consolidated data become timelier and available. Local government debt remains modest at 0.2 percent of GDP in 2021 at the aggregate level. The central government is the main source of borrowing, contributing 85 percent of the consolidated NFPS debt level in 2021.

Figure 21. Current Spending and Debt Projections under the Fiscal Rule, 2024-2035



Sources: IMF Debt Sustainability Analysis.

Note: Corresponds to baseline scenario in Table 8. Notes: The Debt Sustainability Analysis extends until 2031. Beyond 2031 all macroeconomic variables except for current spending and debt are assumed to remain constant, and the current spending path is determined by the fiscal rule.

54. Introducing a debt limit and anchor likely requires an amendment to the current Fiscal Responsibility Law (Law 9635). The concept of debt anchor should be described in the law in terms of its role in contributing to fiscal sustainability, rather than as legally binding constraints on near-term fiscal policies. The constraining role of debt exceeding the anchor level would be formalized in a correction mechanism. The introduction of a medium-term anchor

should be consistent with the fact that expenditure ceilings are the operational constraint on near-term fiscal policy in Costa Rica. The expenditure rule parameters, along with other non-parametric aspects of the fiscal rule framework, would need to be reviewed periodically (e.g., every 5 years) when the debt anchor is in place to ensure that they remain consistent with reaching the debt anchor under the MTFF.

C. Recommendations

- Include a medium-term debt anchor in the current fiscal rule framework. The government, through consultation of stakeholders, would propose a gross debt anchor for the central government consistent with maintaining fiscal sustainability with high probability and to be operationalized through an expenditure rule. The proposal would also specify the institutional and economic coverage of the debt anchor.
- Recalibrate expenditure rule limits periodically (every 5 years) after the debt anchor is established in the fiscal rule to ensure the consistency with the medium-term debt anchor.

V. STRENGTHENING THE MTFF TO SUPPORT THE RULES-BASED FRAMEWORK

A. Reinforcing the MTFF framework

The role of the MTFF and its linkage with fiscal rules

55. The fiscal rule needs to be complemented by a medium-term fiscal framework (MTFF). The MTFF sets the fiscal envelope for 3-5 years, guiding the annual budgets, and needs to be consistent with the fiscal rules to achieve fiscal sustainability. Many countries, like Costa Rica, have established numerical fiscal rules on expenditures that impose ceilings on expenditure growth in a legislation.¹¹ The expenditure limits need to be consistent with the fiscal path set in the MTFF, converging to the medium-term debt anchor and credibly guiding the annual budgets. To support the credibility of the fiscal path and underlying MTFF projections, countries often (1) prepare alternative macroeconomic scenarios that impact the fiscal projections and sensitivity analysis, and (2) empower independent fiscal councils to assess macroeconomic and fiscal forecasts.

56. MTFFs tend to include fiscal risk assessments not only at the macroeconomic level but on specific fiscal risks. The government needs to control for the fiscal risks arising from entities or expenditure items that are excluded from the fiscal rules, such as public corporations,

¹¹ Some countries with well-established MTFFs can, alternatively, set the operational limits in the MTFF to reach a sustainable level of debt and not in the legal framework. The expenditure limits would be binding for the period of the MTFF plan (Caselli and others 2022). Then, those parameters of the fiscal rules can be calibrated periodically. How to make those expenditure ceilings binding is still a challenge and will in most cases need legal provisions on corrective action to avoid or correct excessive expenditure or deficits.

subnational governments, and pension funds to avoid putting fiscal sustainability at risk. A better assessment of fiscal risks includes preparing a debt sustainability analysis (DSA) following a risk-based approach (Table 9). The management of fiscal risks can be divided into four stages: identification, mitigation, provision for risks that cannot be mitigated, and building of fiscal buffers to accommodate residual risks (IMF 2016). Good practices in the management of specific fiscal risks are described in Table 9.

Table 9. Fiscal Risks Management Toolkit

Risk	1. Identify & Quantify	2. Mitigate			3. Provision			4. Accommodate
		Direct Controls	Indirect tools (regulation and charges)	Risk Transfer Instruments	Expense	Contingencies	Buffer funds	
Financial sector	Quantify contingent exposures; Monitor financial soundness and risk indicators Incorporate financial sector stress tests into debt sustainability analysis	Reduce state participation in banks	Increase bank loss absorbing capacity (capital adequacy standards) Macroprudential tools to reduce procyclicality Reduce debt bias in tax system	Require banks to fund deposit insurance schemes Resolution mechanisms (e.g. Living wills)	Appropriate expected payments	Maintain cash buffers	Pre-fund deposit guarantee schemes	Fiscal headroom for residual risks
Natural disasters and environmental risks	Early warning systems	Planning to reduce footprint in risky areas	Tax premia in high risk areas Environmental standards Building codes Disaster preparedness strategies	Reinsurance Catastrophe bonds Cap payouts and require deductibles for govt. schemes Mandate insurance in high risk areas	Appropriate expended payments	Disaster contingency	Natural disaster funds	
Macro shock: e.g. Commodity Prices	Sensitivity analysis, alternative scenarios, probabilistic fan charts	Privatization of commodity producers	Commodity market regulation Tax base diversification	Hedging instruments (options, commodity futures)	Resource-based fiscal rules	Prudent price assumptions	Stabilization funds	
Guarantees	Maintain a central registry of guarantees and assess risks of at time of issue and over their life	Central authorizing entity Ceilings on liabilities Standard criteria for issuing Conditions on access	Charge risk-related fees	Partial guarantees Require collateral Reinsure if feasible	Appropriate expected cash flows	Provision for expected calls	Guarantee funds	
Public Private Partnership	Maintain central registry of PPP commitments Subject projects to sensitivity analysis	Central authorizing entity Ministry of Finance gatekeeper role Ceilings on PPP commitments	CBA and value for money checks Charge guarantee fees	Risk sharing allocation framework Cap payments linked to demand Insure retained contract risks where feasible	Appropriate expected cash flows	Provision for expected calls on guarantees	Guarantee funds	
State Owned Enterprises	Quantify explicit exposures Monitor financial performance Scenario analysis or stress testing	Reduce size of the SOE sector	Hold boards accountable for performance Reporting requirements	Explicit no-bail-out clauses	Appropriate expected subsidies and QFAs	Provision for cost in case of restructuring	-	
Subnational government	Monitor financial performance against benchmarks	Fiscal rules and limits on borrowing	Link degree of financial autonomy to performance Reporting requirements	Establish credible no-bail out clauses Retain authority to liquidate assets / appoint administrator	Appropriate expected support		Rainy day funds	

Source: Analyzing and Managing fiscal Risks: Best Practices (IMF 2016).

57. Strengthening the budget process is critical for a successful implementation of fiscal rules and a credible MTFF. The fragmented budget process and non-comprehensive budgets—such as the existence of significant extrabudgetary entities or dual budgets for capital and current expenditures, or for external and internal funding—complicate the implementation and monitoring of fiscal rules, which could eventually undermine their credibility. The MTFF often faces coordination issues with different entities involved in projections, delays in information sharing, and less transparent monitoring if information is not easily available. The lack of a comprehensive budget requires more efforts to coordinate the MTFF that includes the NFPS and different sources of fiscal reporting.

58. Another pillar of the fiscal rule’s framework is enhancing the transparency of government finance statistics. In general, countries with good quality, coverage, and timeliness

of fiscal reporting will enable the monitoring of fiscal rules. Governments can take early or preventive action in case of deviation from the rule limits. At the same time, a broader coverage of fiscal rules becomes possible in countries with monthly or quarterly fiscal statistics covering the general government and NFPS, and with timely consolidation of accounts. This enables the fiscal rules to better contribute toward the objective of fiscal sustainability. In that context, covering extra-budgetary activities within the central government statistics is crucial for the well-functioning of fiscal rules.

59. The MTFF includes the policy mix of current spending and investments for the medium-term. Instead of excluding capital expenditures in fiscal rules (that is, the golden rules) or setting a limit on current expenditure by law, it is more effective and credible to consider the composition in the government fiscal plans (MTFF) and the cycle for investment execution. In this sense, the MTFF should present the most likely investment scenario as the baseline and compliant with the overall expenditure limits, instead of putting public investment as a residual value or as an optimistic path in national development plans.

B. Recent Progress of the MTFF in Costa Rica

60. The authorities have made progress in developing an MTFF since 2020 and aligning their fiscal strategy consistent with the fiscal rules and debt projections. The development of the MTFF has been supported by FAD capacity development during 2020-2022 and led to the fulfilment of two Structural Benchmarks of the IMF EFF program, which requires the publication of the MTFF for the central government in 2021 and for the NFPS in 2022 (Annex III). The development of the MTFF was also supported by a medium-term debt strategy report (April 2022). The MTFF report presents the no-policy change scenario, the policy reforms, and the final scenario, and assesses the compliance with fiscal rules (expenditure ceilings) of the previous and following years. The macro-fiscal model is being enhanced with IMF-ICD support to incorporate the macroeconomic part and be able to do shock scenarios.

61. The MTFF in Costa Rica also includes an analysis of fiscal risks, which is deemed good practice. This analysis includes macroeconomic risks and specific risks (public corporations, pensions, natural disasters, court rulings, local governments, private-public partnerships (PPPs), financial sector and public debt). Most analyses are qualitative but some risks are quantified, and mitigation measures are included in some cases.

62. The expansion of the MTFF to the NFPS in 2022 has partly overcome the fragmentation in the fiscal plans between the national budget and rest of the NFPS. The fiscal rules and MTFF follow a top-down approach by setting the fiscal aggregates to guide the budget preparation. However, in Costa Rica, the expenditure rule is based on individual entities, with a rather bottom-up approach except for the budgetary CG. In this case, the MTFF provides a top-down overview of deficit and debt consistent with the expenditure ceilings under the fiscal rules, as well as an overall projection with the contribution of the subsectors to the fiscal objectives.

63. The MTFF is the link between the fiscal rules and annual budget. The preparation of the MTFF should guide the budget, and the projection should reflect the envisaged execution.

The MTFF has to be in line with the expenditure rule in the budget and in execution. Table 10 shows that the MTFF complies with the annual expenditure growth ceilings for the national budget. However, NFPS expenditure growth exceeds the ceiling because some entities in the NFPS are excluded from the rule.

Table 10. Expenditure ceilings and MTFF 2021-2023
(Percent)

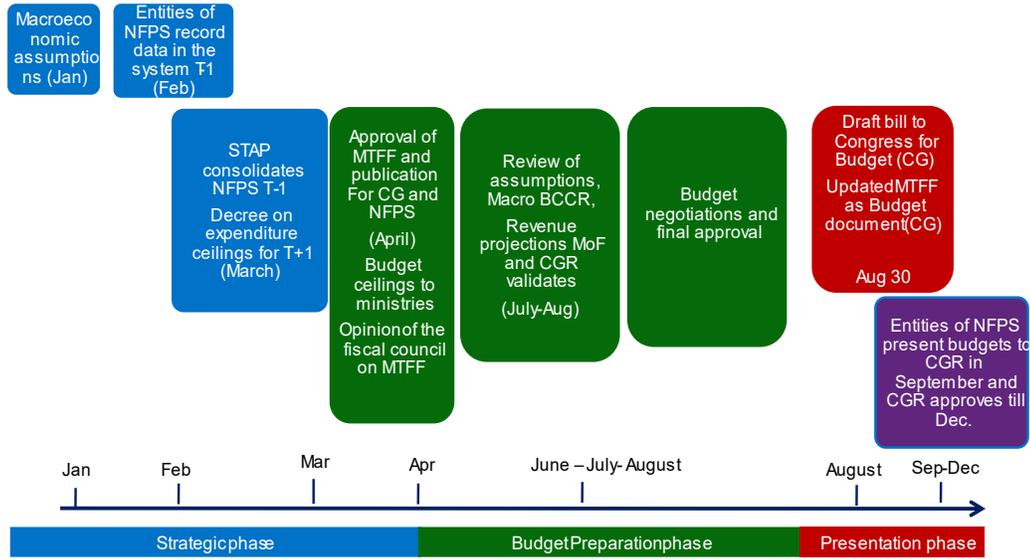
	2021	2022	2023
Expenditure Rule: Current Expenditure	4.13	1.96	2.56
MTFF expenditure growth projection CG	5.8	1.25	2.61
MTFF expenditure growth projection NFPS	Non-applicable	5.22	4.69
Expenditure Rule: Total expenditure	Non-applicable	1.96	2.56
MTFF expenditure growth projection CG	Non-applicable	1.96	2.56
MTFF expenditure growth projection NFPS	Non-applicable	5.6	5.0

Note: Expenditure growth projections for the CG are actual executed data in 2021 and exclude Covid-19 related expenditure and the excess expenditure over the ceiling of the previous year. For 2022 and 2023 it excludes some items exempted from the rule.

64. The calendar of the MTFF publication (April and August each year) reflects the budget preparation and the budget proposal. The MTFF requires having final execution data of the previous fiscal year that is consolidated by STAP in March each year. It also needs the decision on the expenditure rule in March and the macroeconomic scenario from the central bank (BCCR). The MoF has successfully published the MTFF in April in 2021 and 2022 and updated it for the central government in August (Figure 22).

65. The projection model of the MTFF needs assumptions on the consolidation of the NFPS. The framework developed with FAD capacity development includes a fiscal database and the projection model (for the central and local governments, social security (CCSS), rest of decentralized institutions (ID), and public corporations) to consolidate to the NFPS projections. The model includes the baseline scenario, policy measures, and final scenario in compliance with the fiscal rule by subsector. Some assumptions are needed to project the subsectors as many of those are excluded from the fiscal rule (central government, ID sector (without Social Security) and around 50 percent of the expenditure of public corporations are assumed rule-compliant). The rule's compliance in the model is ensured by adjusting public current transfers (CG), private transfers (ID sector) and good and services expenditure in public corporations. In this exercise, the role of national budget transfers is key as it is used for the consolidation among subsectors, ensuring compliance with the fiscal rules at each subsector and consolidated levels.

Figure 22. Calendar of the MTFF and National Budgets



Sources: Authors' compilation.

C. Pending Issues Regarding the MTFF in Costa Rica

66. Demands for exclusions from the expenditure rule have complicated the MTFF projection exercise, making it less transparent. An increasing number of expenditure items and significant entities are excluded from the fiscal rule. Without a medium-term debt anchor, it is possible that entities not covered by the rule could overspend and contribute to the debt buildup. The MTFF exercise is important as it brings a transparent discussion of the feasibility of the expenditure ceilings to reach a debt anchor and how the subsectors could contribute or compensate each other. However, the exclusions and difficult coordination in obtaining information of entities outside the fiscal rules have reduced the transparency.

67. The MTFF only reports on central government debt as the rule thresholds apply. It is advisable to expand the scope of the debt sustainability analysis to cover NFPS debt as there is published data at MoF, including the government guaranteed debt. However, there are limitations to the NFPS consolidated public debt. The debt management office (DGCP) does not have detailed data on public debt holders within the NFPS regarding terms, interest rates, and currency denomination that are required to calculate the average effective interest rate of the consolidated debt. For this reason, the projection was based on the interest rates of the central government non-consolidated debt, which could have overestimated the interest payments.

68. The recent decree that established the compliance with the rule at budget level introduces challenges to the MTFF projections. The MTFF reflects expenditure projections in terms of expected execution and including all expenditure items. Since the introduction of the July 2022 decree, only the initial and final budgets are considered for the expenditure rule compliance, excluding all externally-financed projects that account for around 20 percent of

central government capital expenditure in 2021, as currently these are not included in the initial budget. The starting point of the MTFF projections is the execution of last fiscal year and not the final budget of last year for a consistent presentation of the fiscal path, and the projection includes all expenditures irrespective of their financing sources. Therefore, the MTFF includes an estimate of expenditures funded across all sources. In order to make it comparable to the initial budget the assumptions on external funding have to be made explicit. Also, the assumptions of under-execution if any should be made explicit. The MTFF should comply with the fiscal rules and explain the deviations and underlying assumptions compared to the budget.

69. The operation of the macro fiscal unit (MFU) to improve projections and the MTFF report remains a challenge. There are resource constraints in the MoF that limit the ability to carry out NFPS medium-term projections. The MTFF is prepared by a small group of two stable staff at the Minister's office whose tasks do not allow for full-time dedication to the projections, making it difficult to sustain in the future. A MFU led by a directorate in charge of macro-fiscal issues at MoF with sufficient resources would be needed.

70. In the short term, the MTFF could explicitly integrate the debt anchor as the final objective that guides the fiscal path. Even if the LSPF could take time to introduce the debt anchor, the MTFF could include it as a government long-term objective that is needed to guide the central government and NFPS projections, and its link to the expenditure rule.

D. Independent Fiscal Council

71. Costa Rica established a Fiscal Council in 2019 but has not been operational. The council was established as an independent body conformed by five members (initially only three). Four of the Fiscal Council members are designated by the Government and the fifth one is chosen by the Legislative Assembly. They must be independent professionals with a solid knowledge of macroeconomics and public finance. However, members of the Council work ad-honorem without remuneration. The establishment of the Fiscal Council was one of the loan conditions by Inter-American Development Bank (IADB) in 2021 for improving fiscal sustainability. Currently, the Council only has one member, with two having resigned in 2021 and another two in 2022.

72. The Fiscal Council's main task is to evaluate macro-fiscal developments. The Fiscal Council is tasked to be responsible for preparing reports to evaluate the performance of the MoF regarding fiscal policy developments, fiscal rule monitoring, and fiscal risk assessment. More specifically, the Fiscal Council should give its opinion on the fiscal projections in the MTFF and on the macro projections in the annual budget, as well as the underlying assumptions and methodologies of those projections. It also should give its opinion on the MoF's management of fiscal risks. Finally, it should comment on the quarterly and annual reports monitoring the fiscal rule.

73. The Fiscal Council does not have resources to perform its duties. The Council does not have its own staff to perform its duties such as elaborating the reports. It does not have its own communication channel (e.g., a designated website). While recognizing the overall need to limit spending in Costa Rica, it is advisable to have the Fiscal Council to have its own budget line

to secure adequate resources commensurate with its mandate over time. It will need to voice its opinion publicly on fiscal issues within its mandate, including the compliance with fiscal rules and assessment of debt sustainability. The MoF will also need to share information on a timely basis with the Council so that it can perform its duties. The regulation should clarify the calendar of information sharing from Ministry of Finance and the timing of fiscal council inputs and reports to enhance accountability.

E. Recommendations

- Continue to strengthen the MTFF that presents the fiscal path consistent with fiscal rules compliance and aligned to a medium-term debt anchor.
- Reinforce Hacienda Digital project to allow for timely fiscal reporting on consolidated NFPS fiscal accounts and public debt.
- The MOF should present to the Ministry of Planning a proposal to create the Macro Fiscal Unit (MFU) with a directorate and sufficient personnel and resources.
- Amend the law to strengthen independent fiscal oversight with the necessary provisions to make the independent fiscal council operational.

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Annex I. List of Entities Included in STAP Fiscal Statistics, 2021

National budget of the central government	
<i>Asamblea Legislativa</i>	ASAMBLEA
<i>Contraloría General de la República</i>	CGR
<i>Defensoría de los Habitantes de la República</i>	DEFENSORIA
<i>Ministerio de Agricultura y Ganadería</i>	MAG
<i>Ministerio de Ciencia, Tecnología y Telecomunicaciones</i>	MICITT
<i>Ministerio de Comercio Exterior</i>	COMEX
<i>Ministerio de Cultura y Juventud</i>	MCJ
<i>Ministerio de Economía, Industria y Comercio</i>	MEIC
<i>Ministerio de Educación Pública</i>	MEP
<i>Ministerio de Gobernación y Policía</i>	MGOBER
<i>Ministerio de Hacienda</i>	MHD
<i>Ministerio de Justicia y Paz</i>	MJUSTI
<i>Ministerio de la Presidencia</i>	MP
<i>Ministerio de Obras Públicas y Transportes</i>	MOPT
<i>Ministerio de Planificación Nacional y Política Económica</i>	MIDEPLAN
<i>Ministerio de Relaciones Exteriores y Culto</i>	RE
<i>Ministerio de Salud</i>	MSALUD
<i>Ministerio de Seguridad Pública</i>	MSP
<i>Ministerio de Trabajo y Seguridad Social</i>	MTSS
<i>Ministerio de Vivienda y Asentamientos Humanos</i>	MIVAH
<i>Ministerio del Ambiente, Energía</i>	MINAE
<i>Poder Judicial</i>	JUDICIAL
<i>Presidencia de la República</i>	PREREP
<i>Regímenes de Pensiones con cargo al Presupuesto de la República</i>	REGPEN
<i>Servicio de la Deuda Pública</i>	DEUDA
<i>Tribunal Supremo de Elecciones</i>	TSE
Decentralized Institutions	
<i>Autoridad Reguladora de los Servicios Públicos</i>	ARESEP
<i>Benemérito Cuerpo de Bomberos de Costa Rica</i>	BCBCR
<i>Caja Costarricense Seguro Social</i>	CCSS
<i>Comisión de Energía Atómica de Costa Rica</i>	CEA
<i>Academia Nacional de Ciencias</i>	CIENCIAS
<i>Consejo Nacional de Cooperativas</i>	CONACOOP
<i>Comisión Nacional de Asuntos Indígenas</i>	CONAI
<i>Consejo Nacional de Rectores</i>	CONARE
<i>Corporación Arrocera Nacional</i>	CONARROZ
<i>Consejo Nacional Investigación Científica y Tecnológico</i>	CONICIT
<i>Corporación Ganadera</i>	CORFOGA
<i>Colegio Universitario de Cartago</i>	CUCA
<i>Colegio Universitario de Limón</i>	CUNLIMON
<i>Ente Costarricense de Acreditación</i>	ECA
<i>Sistema de Emergencias 9-1-1</i>	EMERGENCIAS 911
<i>Instituto Costarricense del Deporte y la Recreación</i>	ICODER
<i>Instituto Costarricense de Turismo</i>	ICT

<i>Instituto de Fomento y Asesoría Municipal</i>	IFAM
<i>Instituto Mixto de Ayuda Social</i>	IMAS
<i>Instituto Nacional de Aprendizaje</i>	INA
<i>Instituto Nacional de las Mujeres</i>	INAMU
<i>Instituto Costarricense de Pesca y Acuicultura</i>	INCOPESCA
<i>Instituto de Desarrollo Rural</i>	INDER
<i>Instituto Nacional de Estadísticas Y Censos</i>	INEC
<i>Instituto Tecnológico de Costa Rica</i>	ITCR
<i>Junta Administrativa del Colegio San Luis Gonzaga</i>	JACSLG
<i>Junta de Desarrollo Regional de la Zona Sur de la Provincia de Puntarenas</i>	JUDESUR
<i>Junta de Pensiones y Jubilaciones del Magisterio Nacional</i>	JUPEMA
<i>Oficina Nacional Forestal</i>	ONAF0
<i>Oficina Nacional de Semillas</i>	ONS
<i>Patronato Nacional de Ciegos</i>	PANACI
<i>Patronato Nacional de Rehabilitación</i>	PANARE
<i>Patronato Nacional de la Infancia</i>	PANI
<i>Programa Integral de Mercadeo Agropecuario</i>	PIMA
<i>Promotora de Comercio Exterior</i>	PROCOMER
<i>Servicio Nacional Aguas Subterráneas Riego Y Avenamiento.</i>	SENARA
<i>Sistema Nacional de Acreditación de la Educación Superior</i>	SINAE
<i>Sistema Nacional de Información Unificado y Registro Unico de Beneficiarios del Estado</i>	SINURIBE
<i>Superintendencia de Telecomunicaciones</i>	SUTEL
<i>Universidad de Costa Rica</i>	UCR
<i>Universidad Nacional de Costa Rica</i>	UNA
<i>Universidad Estatal a Distancia</i>	UNED
<i>Universidad Técnica Nacional</i>	UTN
Local governments	
<i>Gobiernos Locales</i>	GOBLOCAL
<i>Federación de Municipalidades Cantones Productores de Banano</i>	CAPROBA
<i>Federación de Municipalidades de Cartago</i>	FEMUCARTAGO
<i>Federación de Municipalidades de Heredia</i>	FEDEHEREDIA
<i>Federación Metropolitana de Municipalidades de San José</i>	FEMETRON
<i>Federación Occidental de Municipalidades de Alajuela</i>	FEDOMA
<i>Junta Administradora del Cementerio General y las Rosas de Alajuela</i>	JACGRA
<i>Junta Administrativa de Cementerios de de Goicoechea</i>	JACGOICOECHEA
<i>Federación de Consejos Municipales de Distrito de Costa Rica</i>	FCMDCR
<i>Unión Nacional de Gobiernos Locales</i>	UNGL
Public corporations	
<i>BANPROCESA S.R.L</i>	BANPROCESA
<i>Compañía Nacional de Fuerza y Luz</i>	CNFL
<i>Consejo Nacional de Producción</i>	CNP
<i>Correos de Costa Rica S.A.</i>	CORREOS
<i>Editorial Costa Rica</i>	ECR
<i>Empresa de Servicios Públicos de Heredia</i>	ESPH

<i>Empresa Hidroeléctrica los Negros S.A.</i>	EHLN S.A.
<i>Gestión Cobro Grupo ICE S.A.</i>	ICE-G COBRO
<i>Hospital del Trauma</i>	IRSS (HOSPITAL TRAU)
<i>Instituto Costarricense Acueductos y Alcantarillado</i>	ICAA
<i>Instituto Costarricense Electricidad Energía</i>	ICE(ENERG)
<i>Instituto Costarricense Electricidad Telecomunicaciones</i>	ICE(TELEC)
<i>Instituto Costarricense de Ferrocarriles</i>	INCOFER
<i>Instituto Costarricense de Puertos del Pacífico</i>	INCOP
<i>Junta Administrativa del Servicio Eléctrico de Cartago</i>	JASEC
<i>Junta Administrativa Portuaria y de Desarrollo Vertiente Atlántica</i>	JAPDEVA
<i>Junta Protección Social de San José</i>	JPS
<i>Radiográfica Costarricense S.A.</i>	RACSA
<i>Refinadora Costarricense de Petróleo S.A.</i>	RECOPE S.A
<i>Sistema Nacional de Radio y Televisión S.A.</i>	SINART S.A.

Annex II. Calibrating the Medium-term Debt Anchor

This Annex describes the methodology to determine a safety buffer and the debt anchor. The methodology first generates stochastic macroeconomic and fiscal shocks based on historical data and an econometric model and subsequently simulates possible paths for government debt using a debt accumulation equation and a fiscal reaction function. The full description of the stochastic approach is in IMF (2016) and Debrun and others (2018).

First, we construct a variance-covariance matrix to account for typical macroeconomic shocks in Costa Rica at annual frequency. Data are obtained from the IMF World Economic Outlook database. The variance-covariance matrix obtained from historical data describes the joint dynamics of the macroeconomic (non-fiscal) variables needed to project public debt, namely real interest rates, real GDP growth, the exchange rate, debt stock-flow residuals, and terms of trade shocks. The results are estimated over a relatively short period starting from 1990 due to data availability, and excluding the pandemic period. The estimated variance-covariance matrix is then used to generate 5,000 sequences of macroeconomic shocks $\varepsilon_{i,t}$ over the six-year projection horizon.

For each of the 5,000 shock simulations, macroeconomic variables are computed over the six-year horizon, adding the generated shocks each year as the error term. A preferred approach would use a VAR to estimate the underlying shocks and make projections, as the lagged effect of macroeconomic shocks can be taken into account through the autoregressive structure of the model, but that would require quarterly data.

Third, the methodology uses a fiscal reaction function based on a panel estimation of 26 emerging market economies. The fiscal reaction function links the primary balance to public debt, while also accounting for economic conditions measured by the output gap. More specifically, the estimated equation takes the following form:

$$pb_{i,t} = \alpha_i + \beta_1 pb_{i,t-1} + \beta_2 ygap_{i,t} + ygap_{i,t}(1 - D_{i,t}) + \beta_4 d_{i,t-1} + \varepsilon_{i,t}$$

where pb is the ratio of the primary fiscal balance to GDP; d is the gross public debt-to-GDP ratio; $ygap$ is the contemporaneous output gap; D is a dummy variable equal to 1 if the output gap is nonnegative (actual output above or equal trend) and 0 otherwise to capture the potential asymmetric effects of the output gap on the primary balance; and α are country fixed effects and t refers to the year. To account for the possibility that fiscal policy can itself be a source of shocks, the primary balance is subject to a fiscal policy shock $\varphi_{i,t} \sim N(0, \sigma_2 \varphi_i)$, where $\sigma_2 \varphi_i$ is calibrated to the country-specific variance of the residuals of the reaction function.

The reaction function is restricted by assuming that the maximum primary surplus that a country is capable of achieving following a shock is capped at 2½ percent of GDP for emerging market economies, following Escolano and others (2014). The fiscal reaction function allows for an asymmetric response to the output gap, so that the primary balance may deteriorate more when the output gap is negative than it improves when the gap is positive ($\beta_3 > \beta_2$). The output gap is projected over the forecast horizon using GDP growth forecasts obtained from simulations

(based on the joint distribution of macroeconomic variables) combined with a Hodrick-Prescott filter to estimate potential output.

Fourth, the debt trajectories are obtained by combining the shocks with the fiscal policy response and debt accumulation equations. A projected debt path is computed for each set of country-specific shocks, which include shocks to the macroeconomic variables from the variance-covariance matrix, and fiscal specific shocks.

For each projection year, the frequency distribution of the projected debt-to-GDP ratios is calculated and allows for a probabilistic analysis of debt trajectories. In particular, it is possible to calculate the share of the debt paths that cross a given debt limit at a certain year.

The validity of this approach is conditioned on the quality of the shocks generated to produce the forecasts. Some shortcomings include the possibility that relationships estimated using past data may not be relevant for the future or/and the forecasting model does not have a satisfactory goodness-of-fit.

Annex III. Progress of MTFF since the Capacity Development Missions in 2020-21

Main 2020-22 Technical Assistance Mission Recommendations	Deadline	Preliminary assessment of progress
Improve fiscal strategy		
Address the lack of a debt anchor. Change the legal framework to establish it and define 4-year debt and deficit sustainable paths in the MTFF. Clarify the fiscal rule and its monitoring in terms of budget and execution.	2020	Not met
Improve the budgetary process		
Contingency reserve in the budget and the MTFF for both the CG and other institutions	2021	Not met
Prepare the MTFF		
Prepare the MTFF for the NFPS in April, and update it for the CG in August, focusing on fiscal policy measures, fiscal risk assessment and debt paths.	2021 and 2022	Done 2021 and 2022
Develop fiscal projection capacities, by using and updating the fiscal model and the databases developed with FAD	2021 and 2022	In progress
Expand debt sustainability analysis in 2022 from the CG to the NFPS	2022	Not met
Institutional and legal framework		
Establish a Macro Fiscal Unit as soon as possible, with enough human resources to perform its duties.	2022	Not met
Regulate the process for preparing the MTFF: information flows between institutions and MOF, process of approval by the Council of Ministers, opinion by the Fiscal Council.	2021	Not met
Fiscal projections		
Develop macroeconomic projection capacities and analyze the sensitivity of fiscal projections to macro shocks	2023	In progress (ICD 2022-2023 technical assistance)

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