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TEN YEAR COSTA RICAN ASSISTANCE STRATEGY

1984 - 1993

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Introduction

This paper is an illustrative development strategy and program for Costa Rica. While we have tried to be specific and realistic as to what could be achieved, the strategy should not be regarded as definitive. Considerable additional analysis and fine tuning will be required to refine the strategy and determine the specifics of a program based on it.

Political Constraints and Assumptions

The political/military struggle now rending Central America and particularly the continued existence of an aggressive Marxist-Leninist regime in Nicaragua, means that this paper's economic assumptions and projections are subject to wide error if the political situation in Nicaragua, and in general in Central America, deteriorates or improves markedly. The mere continuance of the Sandinista regime in Nicaragua could mean that the already low level of private sector confidence in Costa Rica might be further eroded and economic projections, especially of CACM export performance and private capital flows, would prove unduly optimistic if business owners sought to disinvest. Alternatively, a substantial improvement in the Central American and particularly the Nicaraguan political situation would render economic projections too pessimistic. Therefore it should be clear that, in this paper, we assume no substantial change in the current political situation over

the projected time horizon. The economic variables that appear most optimistic, while assuming no improvement in the political climate, are private capital flows and exports to the CACM. However, the ongoing improvement in economic growth in the industrial countries and projected higher levels of economic assistance from all sources to Central America are sufficient reason for improvement in these variables. Therefore we conclude that the projected values for growth of these variables in this paper are not overly optimistic.

A. Country Situation and Background

1) General Political, Economic and Social Situation

During a quarter of a century ending approximately in the mid-1970s, Costa Rica appeared to be a model developing country: real growth of GDP averaged well over 6% per year; social security, obligatory workmen's compensation, and similar measures were institutionalized; and social infrastructure (schools, health facilities, water and sewerage installations) and physical infrastructure (roads, electricity and communications facilities) were widely distributed throughout the country. The results were dramatic: adult literacy reached 90%; infant mortality declined sharply to under 20 per thousand; the population growth rate dropped from 3.7% to 2.6%; and open unemployment and underemployment were held to 5% and 6% of the labor force, respectively. Progress in meeting needs for shelter was less spectacular, but satisfactory. Income distribution was quite equitable in comparison to most developing countries.

The private sector operated under a protectionist, import substitution model. Producing for the domestic and Central American markets, it benefited from considerable inflows of external private capital and was allowed a reasonably free hand. Productivity in traditional products, e.g. coffee, was markedly increased. An entreprenurial/managerial class came into being, in many instances sprouting from the traditional coffee aristocracy but also consisting of new blood, including expatriates and emigrees from the U.S. and Europe. This trend was partially offset, particularly in the latter part of this period, by a movement toward creation of state enterprises.

The above achievements were attained in a system of political democracy in which the dominant political force was a social democratic, center-left ideological grouping consolidated in the National Liberation Party (NLP). Over time, the NLP moved away from a market economy and towards a state-administered economic model as regards such variables as prices, wages, authorization to operate, and concessions for special interest groups. By mortgaging the future through internal and external borrowing, it rapidly expanded social services, created often inefficient state enterprises, and significally increased the size of the bureaucracy as a way of rewarding various political constituencies. The two presidencies of the conservative opposition during this period constituted "breathing periods", i.e. a time for consolidation of the social advances instituted by the NLP, rather than expressions of a different ideology.

It is fair to say -- and important in understanding the social and political constraints in dealing with the present crisis -- that the country

as a whole was satisfied with its image of itself, the direction in which it was developing, and the rules of the game. Little attention was given to the fact that the public sector was growing much faster than the output of the private sector upon which it depended for its financial support. By 1982 the non-financial public sector accounted for at least 27% of GDP. Autonomous institutions alone, responsible for such activities as electricity, telephone service, grain marketing, insurance petroleum refining, and other industrial production, accounted for at least 15% of GDP. Public sector employment increased from 6% of the labor force in 1950 to 20% in 1982. White collar public sector employees, a new segment of the middle class, organized themselves into strong unions and associations which bargained for and secured many fringe benefits and job security concessions.

Costa Ricans paid little attention to the structural problems inherent in the import substitution economic growth model being followed. High levels of effective industrial protection, an overvalued exchange rate, subsidized interest rates, and other incentives to capital investment resulted in an industrial sector with considerable excess capacity, heavy reliance on imported inputs and dependent for expansion on growing domestic and regional (CACM) markets.

In the 1980s, however, the CACM became a contracting and unreliable market. The terms of trade turned against Costa Rica and its partners in the CACM, as coffee prices fell sharply from their 1977 high and the price of petroleum doubled in 1979. Political turbulence in some CACM countries further contracted the demand for Costa Rica's manufactured exports. The

structural, political and social factors described above prevented any serious consideration of a major change in development strategy in response to the new situation. Instead, in an ill-considered attempt to maintain the status quo and compensate for the fall in the value of its exports, the Costa Rican Government engaged in substantial external borrowing, mainly at commercial rates, to cover the growing current account deficits. Net foreign exchange reserves were drawn down to negative levels. Uncontrolled monetary expansion, related to desperate attempts to maintain previous levels of public sector consumption, generated inflationary pressures. The results of these policies were a de facto moratorium on the foreign debt, estimated to be about US$3.5 billion at the end of 1982; a drop in GDP of 4.6% in 1981 and 8.8% in 1982; a doubling of open unemployment and underemployment rates to at least 9% and 14%, respectively (and probably higher because of likely statistical quirks); an inflation rate in 1982 of 90%; and a 13% decline in the value of exports in 1982.

By the time the present administration took office in May 1982, all elements in the country were sufficiently alarmed to make possible the imposition of the necessary discipline for a stabilization program. This was formalized in December 1982 under a stand-by agreement with the IMF, with significant support added via the US AID FY 1982 and 1983 ESF programs. Performance under the stand-by agreement to date has been satisfactory. Inflation has been reduced to an annual rate of about 12%; exchange rates have been unified; and the overvaluation of the colon has been reduced somewhat. Most of the external debt has been rescheduled, providing a two to three-year breathing space. The public sector deficit has been reduced from

14.5% of GDP in 1981 to approximately 5% in 1983. However, the economy as a whole has continued to deteriorate. Exports in 1983 have dropped by 13% in relation to 1982, and the decrease is particularly acute in non-traditional exports to world markets. The GDP may decline in 1983 by another 3%, and unemployment and underemployment can be expected to increase.

There are few visible signs of this economic deterioration, at least in downtown San José. Of course, there are undoubtedly large and increasing pockets of severe poverty, both urban and rural. But anecdotal evidence suggests that the middle and upper classes may have concluded, mistakenly, that their belt-tightening has ended and that there is no need for continued sacrifice to avoid a new round of inflation and destabilization. In part this is due to the fact that the impact of the recession has been felt mostly by wage earners, but also to a belief that the U.S. Government will come riding to the rescue because of Costa Rica's democratic image.

In view of the need for continued stabilization, there are other disquieting signs on the horizon. The government failed in the latter part of 1983 to maintain agreed-upon rate increases for some public services, principally electricity. The approved budget for 1984, if executed in anything like its present dimensions, would result in a public sector deficit equivalent to 11-12% of GDP. Also indicative of future fiscal problems is the recently revealed fact that, in spite of a much publicized freeze on public sector employment, at least 6,300 new positions have been created since the present administration took office.

Although there is widespread recognition--at least at the lip service level--that future development will be a function of growth in extraregional exports, ministers, NLP congressmen and party leaders are reluctant to face up to the structural reforms implicit in such a change in development strategy. They argue that the social costs of such change are more than what a fragile socio-political situation can take, especially given the Marxist-Leninist threat to the North. The perception is that the unions and the population in general will not accept more "adjustment". But equally responsible for this lack of will, is the lack of conviction that market forces should be allowed a freer hand in the economy.

Several attempts have been made during 1983 to formulate a program of structural reform. These include an IBRD proposal related to a possible Structural Adjustment Loan, which dealt with the management of public finance, handling of the foreign debt, public sector salary policy, administration of autonomous public sector agencies, and restructuring (primarily divestiture) of the activities and enterprises owned by the government development corporation (CODESA); several policy oriented documents prepared internally in the Central Bank; a strategy document dealing with export and investment promotion, prepared in mid-year by the newly-appointed minister without portfolio for these matters; and recommendations on structural reforms needed to improve management of public sector finance prepared by a Commission of Ex-Ministers of Finance. The Export and Investment Promotion Strategy document has been approved, but does not deal adequately with all of the underlying structural issues that affect investment climate and financial incentives for producers and exporters.

A more promising development has been an effort by the President of the Central Bank, and the Ministers of Planning, Finance, Economy and Exports and Investment to prepare a document entitled: "Strategy and Actions in Economic Policy, 1984-1986" for presentation to the Economic Council and the President. This document, in which AID has participated on an intellectual level, draws on all of the above efforts and attempts to put together a program of structural changes at the policy level needed for attaining extraregional export led growth. The strategy proposed provides for a gradual modification of relative prices, continued stabilization efforts, and a larger role for the private sector. The actions proposed relate to money and credit policy, fiscal policy, pricing policy, wage and salary policy, external trade policy (exchange rate, customs tariffs, and foreign debt), and export and investment promotion. It is anticipated that this document will shortly be transmitted to AID by the Government as a statement of intent with regard to structural reform, and that it will serve as a framework for conditionality negotiations on the FY 1984 ESF program. The Assistance Agreement itself would have to be much more specific than the GCCR document in setting conditionality targets. However, if formally adopted and publicized by the Government, the GCCR document would represent a major step forward in the dialogue on needed structural reform.

The experience of AID and other institutions in working with government on the above documents illustrates the great reluctance to make commitments to structural changes designed to permit market forces to operate more freely. Also, considerations of short-term potential political impact are given undue weight. Nineteen eighty-six is an election year in Costa

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Rica, and electioneering begins in mid-1985. Structural reforms often cannot be put into effect overnight (legislative action is required in some instances). It is thus imperative that decisions on what actions are to be taken are made in the next few months. Failure to act now on these matters could mean a delay of several years.

Policy reform in Costa Rica will not be easy to achieve. The private sector, which could be the motivating force, is very vociferous and supportive of removal of certain disincentives to exports, e.g. elimination of export taxes, but it remains to be seen whether it is similarly enthusiastic with regard to removal of protectionist tariffs and quotas. The government will take very little initiative on its own, but will have to be both led and pressured to undertake specific structural changes, including the adoption of a realistic exchange rate policy. Both the government and the population at large have yet to realize how difficult it will be to return to the deeply desired pre-1980 consumption levels without fundamental structural reforms. The iron of economic depression has not bitten deeply enough into the Costa Rican psyche to make people receptive to a new approach. Perhaps the suffering that such a realization would entail can be avoided, or at least minimized, if sufficient patience and resources are applied to the problem over a long enough time period.

2) Basic Overall U.S. National Interests and Objectives

As historically the most successful democracy in Latin America, Costa Rica has unique credibility and influence as a spokesman in regional and

international force. Costa Rican support is a major factor in developing broad-based domestic and international support for our Central American policy. Both because of our shared values and to preserve Costa Rica as a model of democratic development for the region, a primary U.S. interest and objective is the preservation of Costa Rican democracy. Recent economic failure has called into question, for the first time in forty years, the ability of the democratic system to respond to the legitimate aspirations of the Costa Rican people. U.S. policy must therefore seek to achieve economic recovery in order to forestall Marxist-Leninist challenges. It is U.S. policy to assist Costa Rica to move towards a more market oriented economy without compromising policy considerations.

[illegible] and direction contemplated is that it is crucial for achieving U.S. objectives. Without such assistance, Costa Rica would be faced with the alternatives of defaulting on its external debt, which would lead to deeper economic depression and consequent social turmoil, or utilizing a disproportionate share of its export earnings to service the debt, with the same end result.

B. Problem Analysis, Program Objectives and Strategy, and Costs

1. Overall Objectives and Strategy

The major objective of U.S. government assistance to Costa Rica [illegible] years is to consolidate [illegible] economic

stabilization and restore economic growth, without an unmanageable increase in Costa Rica's external debt. However, in examining prospective balance of payments gaps, which will determine the level of U.S. assistance, we have assumed that there will be a continuous process of rescheduling commercial bank debt, even if this results in some increase in the size of the overall debt during the 1989-93 period. On this basis, the required level of ESF and PL 480, Title I flows is approximately $100 million in 1984, rising to about $230 million each year in the 1985-88 period. As of this writing, we cannot project any substantial decrease in assistance levels during the 1989-93 phase.

We considered a scenario under which there would be little rescheduling of commercial bank debt during the 1984-88 period, in the interest of substiantially reducing the size of the overall debt by 1993. The only way to accomplish this desirable end result would be to increase the ESF input during the 1984-88 period by approximately $200 million per year. We believe it preferable to place relatively more responsibility on the GCCR and the banks to work out solutions to their mutual problems than to increase the requirements for assistance from the U.S. However, in recognition of the desirability of not increasing the size of the debt, and also because we believe it will improve our negotiating stance vis a vis securing policy reform, we recommend that ESF assistance be provided on a grant basis.

Given the considerations put forward in the preceding section, and the impact of the external debt on an economy in which exports are a major determining factor in the level of economic activity, it is believed that

under optimistic assumptions, including assistance levels estimated in this paper, the most that can be hoped for is zero GDP growth in 1984, a gradual rise to 5% by 1989 and maintenance of that growth rate for the next five years. As stated in the introduction to this document, the political assumption of no major change in the Central American political situation, but improvement in world economic conditions and in assistance flows to the region underlie the projection of a 13% nominal increase per annum in CACM exports and the 10% net private sector capital inflow. These might be considered mildly optimistic projections and, in any case under current circumstances they are highly sensitive to political developments.

We have examined the posibility and cost of achieving a 6.5% rate of GDP growth by 1988. This would entailed increasing the total public debt by approximately $3.5 billion over the 1984-93 period, exclusive of increased debt from any rescheduling. Also, the 6.5% growth target would require ESF assistance of about $350 million more than the level proposed in this paper over the 1984-88 period, and will build a considerable "dependency" element into the Costa Rican development model. For these reasons we believe that the 5% GDP growth target, which adds only $1.6 billion to the total public debt by 1993 and allows debt to decline thereafter, is more appropriate for Costa Rica. This is the target that is used in the following sections of this paper.

In assisting Costa Rica to achieve the 5% GDP growth target, heavy reliance will be placed on non-project assistance, using ESF and PL 480 resources. Substantial structural and policy reform requirements will be

built into the assistance agreements, and disbursements will be tranched and conditioned on compliance. The conditionality of the assistance will include, but not be limited to, stabilization measures needed to obtain IMF assistance or stay in compliance with the terms of agreements reached with the IMF. Other specific reforms, designed to improve the climate for investment and exports, will be developed through an on-going policy dialogue and incorporated into measurable performance check points in the annual ESF and PL 480 agreements (see section 4).

The local currencies generated by non-project assistance will be carefully programmed for specific activities designed to implement the strategies set forth below. The overwhelming bulk of these resources will be used in support of private sector activities. The programming and monitoring of these activities will constitute the main thrust of the direct development efforts in which the U.S. would be involved. Development assistance funded, dollar denominated projects will be held to an absolute minimum, possibly one new project per year. Unless otherwise indicated, the cost figures in later sections of this paper refer only to local currency generations. The amounts that may be programmed for dollar denominated projects will, in any event, be small in relation to non-project assistance.

Assuming assistance flows of approximately $1 billion during 1984-1988 and $800 million during the 1989-93 period, the local currency derived from ESF and PL 480 programs would be programmed for the following purposes:

(million of dollars equivalent)

	1984-88	1989-93
Productive sector activities, including credit	675	600
Lack of Employment	150	160
Inadequate Spread of Benefits	25	40
Investment Budget Support	150	-
Total	1,000	800

We have given careful thought to the question of phasing of U.S. assistance in relation to emphasis on program objectives and program content. In the Costa Rican context we believe that the initial phase of dealing with financial instability, i.e. achievement of a first phase stabilization, was achieved in 1983. We see the five year period, 1984-88, as one in which the stabilization effort needs to be consolidated and simultaneously, economic recovery actions initiated. Both the consolidation of stability and the initiation of recovery will require major structural and policy reform. The dialogue in this regard is already underway and will be a continuing effort. The second phase, 1989-93, will not differ appreciably from the preceding period as regards program objectives and program content. Hopefully, the major policy changes and structural reforms will be well underway by 1989 and the relative emphasis in the policy dialogue can shift somewhat from changing the investment and export climate to one of emphasis on how to take full advantage of the change.

Given the magnitude of the concessional resources that Costa Rica will require, the only real possibility we see of decreasing the burden on the U.S. is to pursuade other donors to increase their concessional

inputs. For this reason, it is believed that consideration should be given to the formation of a consultative group for Costa Rica under IBRD or OECD/DAC leadership, or to strengthening the IDB led consultative process began in Brussels in September of 1983. Such a move seems called for, not only as a device for sharing the assistance burden, but also to reduce the visibility of the U.S. and the IMF in negotiating needed policy and structural reforms.

2. Balance of Payments/External Debt

i. Nature of the Problem: The major long-term economic problem facing Costa Rica is the servicing of its external debt. The public external debt at the end of 1983 is approximately $3.4 billion, and private debt of between $0.5 and $1.0 billion brings the total to between $3.9 and $4.4 billion. The per capita debt of between $1,729 and $1,946, at the current exchange rate, exceeds the per capita income figure for 1983 of about $1,280. The striking conclusion of the analysis below is that Costa Rica will be unable to develop the capacity to repay this debt without a combination of import austerity, increased exports, large scale foreign assistance inflows and continued rescheduling over the next decade.

Costa Rica's debt problem results from failure to deflate the economy after the fall of coffee prices in 1979 and the unfavorable terms at which debts were contracted between 1979 and 1981 when medium and long-term debt increased by $1.3 billion. The average interest rate on debt rose from 8.7% in 1978 to 11% in 1981 (average maturity - 9.1 years). By the end of

1982, 55.6% of Costa Rica's external public debt was on commercial terms (with 36% held by commercial banks), 21.6% was owed to multilateral donors, and 22.8% was concessional bilateral debt. Debt service requirements for 1984-86 equal 78% of projected exports. Shifting the mix of this debt and extending the average maturity will be necessary if the problem of repayment is to become manageable.

One key to understanding the magnitude of this problem is the level of public debt repayments required after the debt reschedulings carried out in 1983. Table 1 shows debt service requirement after the recent reschedulings on disbursements of all loans contracted by 1982, including multilateral debt (e.g. IBRD, IDB), but excluding debt service on IMF transactions, short-term loans, and any new borrowing after 1982.

TABLE 1
($ millions)

	1983	1984	1985	1986	1987	1988
Total	476	348	547	550	612	600
Principal	(90)	(109)	(274)	(299)	(403)	(409)
Interest	(386)	(239)	(273)	(251)	(209)	(181)

SOURCE: Costa Rica: Recent Economic Developments, IMF, July 5, 1983.

When estimates are added of service on new debt incurred between 1983 and 1988, and under the IMF program, the requirements rise dramatically as shown in Table 2. This new debt corresponds to the additional resources needed to meet GDP growth rate targets of 0% in 1984; 1.5% in 1985; 2.5% in 1986; 3.5% in 1987; and 5% in 1988.

TABLE 2
($ million)

	1983	1984	1985	1986	1987	1988
Total	476	520	774	859	826	828
Principal	(90)	(135)	(379)	(449)	(418)	(454)
Interest	(386)	(385)	(395)	(410)	(408)	(374)

To determine assistance inflows required under different assumptions, four current account balance-of-payments projections through 1993 were made, with capital account projections through 1988 (Tables in Appendix 1).

For all four projections, total exports were assumed to grow by 10% a year from $800 million in 1983 to $1.2 billion by 1988. Within this total, non-traditional exports outside the region were assumed to grow by 17% p.a., exports to the CACM by 13% p.a., and traditional exports by 4.5% p.a. Private capital flows were also assumed to increase at a 10% annual rate in all four projections. Projection No. 1 assumed a GDP growth rate of 1.5% in 1984 rising to 6.5% in 1988 and remaining constant thereafter. Projections two through four assumed a GDP growth rate of 0 in 1984, rising slowly to 5% in 1989 and remaining constant thereafter.

The major variable affecting the projections is import elasticity with respect to GDP. Projection No. 2 assumes an import elasticity of 1.3, which corresponds to historical trends in the economy. The other projections assume an austerity and economic

restructuring program to limit import elasticity to 1.0. Projection No. 4 adds to No. 3, a rescheduling of a revolving fund of $225 million dollars extended to Costa Rica by foreign commercial banks in 1983 and scheduled to be repaid in 1985 and 1986.

Table 3 shows the gross external requirements needed to balance international accounts for each of the four projections.

TABLE 3
($ million)

	1984	1985	1986	1987	1988
Projection 1	458	724	809	780	801
Projection 2	443	692	760	715	720
Projection 3	443	687	746	685	667
Projection 4	443	601	633	752	728

From a standpoint of political stability and achievement of the GDP growth targets of 6.5% by 1988, Projection No. 1 appears to be the most appropriate scenario from which to proceed. However, the external resource requirements over the five-year period are higher ($3.6 billion) than in the other two projections (between $3.3 and $3.2 billion). While the last three projections do not substantially reduce total external resource needs in the next five years, they require lower levels of resources in for 1985 and 1986.

A comparison of Projection No. 3 in Table 3 with Table 2 shows that debt service obligations are greater than the resource inflow requirements in every year of the five year period. Even at these high

Rica. In addition, by 1988 the public debt rises to $4.2 billion. However, total debt under this projection could start declining around 1993 and would become manageable thereafter. Table 4 shows how the external resource requirements gap derived from Projection No. 3 could be met.

TABLE 4

Gross Resource Requirements and
Unfinanced Resource Gap
(1984 - 1988)
($ million)

	1984	1985	1986	1987	1988
External Resource Requirement	443	687	746	685	667
Less Donor Disbursements:					
ESF	70	200	200	200	200
PL 480	20	28	30	30	30
DA	10	10	12	12	12
IBRD	16	70 1/			
IDB	50	65	140	150	160
CABEI	30	31			
Other	50	40	40	40	40
C.B.Revolver	43	-	-	-	-
Total	289	444	422	432	442
Unfinanced Resource Gap	154	243	324	253	225
Compensatory Financing:					
IMF	100	75 2/	75	75	-
Net Requirement 3/	54	168	249	178	225

1/ Includes a Structural Adjustment Loan of $80 million disbursed over 3 years.
2/ Assumes a three-year extended fund facility.
3/ To be financed by rescheduling of debt, new commercial bank loans or additional donor assistance not programmed in this table.

ii. Strategy: Economic Support funds of $70 million in 1984 and $200 million annually from 1985 through 1988 should be considered to help cover projected balance-of-payments gaps. All disbursements would be conditioned against performance targets set by the IMF or targets set by specific programs proposed under strategy sections elsewhere in this paper.

The GOCR is seeking to negotiate with the IMF a stand-by arrangement in 1984 for approximately $100 million. We are assuming that an Extended Fund Facility arrangement for $75 million annually is possible during 1985-87, and that an IMF program will continue to establish most of the macroeconomic conditionality we would deem desirable. Additional conditions would be expected under a possible World Bank Structural Adjustment Loan (SAL), now under discussion at a level of approximately $80 million over a three-year period, begining probably in 1985. As with IMF assistance, compliance with the terms of such a SAL would be a condition of ESF disbursements.

To the extent that additional external resources are required to achieve GDP growth targets, we would expect the GOCR to seek additional debt reschedulings with its commercial bank and official bilateral creditors.

A strategy for covering the balance-of-payments resource gap between 1989 and 1993 is difficult to formulate in specific terms because data are not available beyond 1988 to make reasonable projections of

amortication. Interest on new debt in the current account was estimated to average 5%, on the assumption that large-scale EST and other concessional debt will have a greater weight in newly-acquired debt than commercial debt. If this is not possible, and the GOCR is forced to reschedule large amounts of commercial debt or make additional borrowings, interest projections would rise. High levels of resources might also be needed in the second half of the 10 year period if debt rescheduling on more favorable terms and substantially improved export performance are not achieved.

For the second five year period, we are tentatively projecting somewhat lower levels of U.S. assistance. Emphasis will be increasingly shifted to capital financing of an expanded export drive as outlined in other sections of this paper.

3. Fiscal Situation and Investment Budget Support

i. Nature of the problem: Fiscal policy must seek both to continue restraining public sector expenditures and to further reform the tax system. Under the current IMF supported stabilization program the government succeeded in reducing the overall public sector deficit from 14% of the GDP in 1981 to 9% in 1982 and to about 5% in 1983. But in 1984 the fiscal crisis threatens anew: the 1984 budget contains expenditures that, if implemented without increases in anticipated revenues, would push the deficit to perhaps 12% of GDP. Alternatives for reducing expenditures include (1) across-the-board program cuts, (2) wage restraint, (3) increases in rates and

charges by public sector corporations to at least cover their recurrent costs, and (4) a suspension or slowing down of capital expenditures. None is attractive, and alternatives (2) and (3) are politically highly charged.

On the revenue side, the tax and tariff system must be restructured to favor export growth, particularly of nontraditional goods. This requires substantial reduction or elimination of such taxes as the ad valorem tax on exports, the exchange rate differential tax, and surtaxes on port charges, which now account for about 12% of central government revenues. Costa Rica's nominal tariff structure under the CACM Common External Tariff, designed to encourage import substitution rather than extraregional exporting, needs to be lowered to make Costa Rican production more competitive in extraregional markets as well as to stimulate greater efficiency in production for the domestic and regional markets. The revenue loss from the tariff reductions could be offset by elimination of the tariff exemptions now in effect, imposition of selective consumption taxes, and improved efficiency of tax collections. Still, total tax revenues would be unlikely to increase significantly until the economy begins to experience renewed real growth.

A model has been constructed to project public sector finances over the next six years under two scenarios which reflect our judgment of worst-case and best-case outcomes stemming from the following assumptions and constraints: an economic growth pattern leading to a 5% GDP growth rate by 1988; an annual domestic inflation rate through 1989 of 12%, or about twice the assumed world inflation rate; a minimum savings rate in the

current account of the central government equal to 10% of revenues, to be used for financing capital formation in state enterprises; a constraint on the overall public sector deficit ranging from 4% of GDP in 1984 to 2% in 1989; increases in the rates and charges of state enteprises so that the deficit in their operational account falls to zero by 1984 under an optimistic scenarion or by 1987 under a pessimistic scenario; and wage increases limited to 12% a year (zero real growth) under an optimistic scenario or to a 1.8% real growth rate under a pessimistic scenario.

The model is presented in complete detail in annex 2 and contains footnotes that explain other assumptions employed in the calculations.

The results show that a gradual improvement in the public sector surplus/deficit as defined is possible over the next six years. Under the optimistic scenario, and after 1986 under the pessimistic track, the public sector generates a surplus in excess of the required savings constraint on the current account. However, under the worst case scenario the numbers indicate that, even if the government were to impose a strict program of fiscal austerity, the cap on the deficit would be exceeded until 1987 in order to meet capital account expenditures. It should be noted that the constraints on expenditure imply a decrease in government services on a per capita basis in both scenarios.

ii. Strategy: The government of Costa Rica will be encouraged to adopt a program of fiscal austerity and tax and tariff reform incorporating these elements: public sector wage restraints, self-sustaining operational costs for public sector enterprises, positive public sector savings, a cap on the overall public sector deficit, and a restructuring of taxes and tariffs to remove their anti-export bias. In addition, improvements will be sought in the efficiency of tax collections and in the management of public sector finance. Technical assistance will be provided, as needed.

It is assumed that the IMF will deal with many of these measures in its negotiations for stand-by or extended fund facility agreements. The IMF will be supported in such conditionality. To the extent that any of these areas is not covered under IMF conditionality, USAID will require progress toward the objective(s) outlined above.

In spite of the government's best efforts, shortfalls may occur in the fiscal program. As can be seen in the two scenarios, the limits on the public sector deficit (as well as public sector savings) could be exceeded during the early years of the program. In such an event, a justification could be made for temporary investment budget support to maintain a minimum level of public sector investment. For purposes of this discussion we are defining "investment budget support" as the financing of items included in the initial and supplemental annual budgets and not new, additional items.

We are already providing a limited amount of investment budget support from PL 480 local currency generations. This takes the form of transferring to executing agencies the counterpart they are required to provide for certain AID and IDB projects in order for dollar disbursements to be made. Approximately $8 million equivalent is being utilized in this manner. It may become desirable to finance counterpart requirements of other IDB project loans and of IBRD project loans, and to double the amount of local currency programmed for this purpose.

iii. Costs: The program of investment budget support, including approximately $15 million in counterpart financing, might range from $50 to $75 million per year for the two-year period 1985-86. The local currency generations from ESF disbursements over these two years would be used for this purpose.

4. Other Structural Reforms/Policy Changes

i. Nature of the Problem: Aside from fiscal reforms, the changes needed to improve the climate for investment and exports may be summarized illustratively as follows:

- Credit Policies: (1) movement away from administratively set ceilings on credit by specific uses toward market allocation of credit; (2) a narrowing and consolidation of interest rate differentials; and (3) a gradual reduction of subsidized credit and the

financing of such operations from special funds created by the Central Bank for this purpose, rather than by obliging commercial banks to lend some of the savings they capture at lower than cost.

- Banking System: (1) access for the private banks to the rediscount and external loan resources of the Central Bank; and (2) a change in the monetary law so that banks can provide dollar financing to borrowers, with the latter assuming the exchange risk.

- Price Policy: (1) reduction of the number of products and services subject to price control; (2) setting of public utility tariffs on a pay-as-you-go basis; and (3) elimination of subsidies provided through support prices and other devices.

- Wages and Salaries: (1) limiting income increases, including fringe benefits, to the level of current inflation, at least through 1989, and (2) establishing ground rules for fringe benefits.

- Exchange Rate: Flexible adjustment mechanisms to keep exports competitive.

- Customs and Tariffs: (1) a substantially lower level of protection, (2) rationalization and approximate uniformity in the rate structure at a reasonably low level, (3) elimination of customs exemptions, except for inputs for export industries, and their replacement by selected consumption taxes; and (4) [illegible] in [illegible] tariff.

- Export and Investment Promotion: (1) revised rules governing drawback industries, and (2) improved fiscal incentives. In some instances, legislation is required.

ii. Strategy: There is an ongoing policy dialogue on all of the above reforms. As indicated earlier, it is hoped that this will result in the GCCR producing a policy paper covering these points in conceptual terms. We would then plan to incorporate measurable performance targets with regard to all topics in successive FSF Agreements and to monitor compliance, adjusting disbursements accordingly. In some instances the performance targets will be quantifiable, in other cases we would plan to specify dates by which certain steps in the structural reform process will be accomplished, e.g. submitting draft legislation to the Assembly or issuing a regulation or policy directive.

We plan to incorporate initial performance targets as convenants on as many of the above areas as possible in the FY 1984 FSF Assistance Agreement, and to continue incorporating successive steps in the Agreements for each future year. We also expect to provide substantial technical assistance to assist in both conceptualizing and designing successive reform activities.

5. Productive Sector Activities

i. Nature of the Problem: In order to re-establish positive economic growth, Costa Rica must increase the output and efficiency of its

productive sector, and compete effectively with foreign products and in foreign markets. Experience in Costa Rica and elsewhere indicates that if such efforts are to be successful, they must emanate from the private sector.

Existing agriculture and manufacturing activities require increases in efficiency and productivity. In addition, there is a need to diversify production away from traditional products -- such as coffee, bananas, sugar -- for which price prospects are not bright, and from products which have been protected, towards those in which Costa Rica has a comparative advantage. As a result of past protectionism and a focus on the local and regional markets, most manufactured products are non-competitive from the standpoint of price, quality, and quantity available despite excess capacity in many plants.

The chief problems which must be addressed in order to turn the productive sector around include the following: government policies biased against export production, and administrative practices which contribute to inefficient management in agricultural and industrial activities; inadequate financing due to credit squeeze, inefficient financial intermediation and insufficient foreign investment; insufficient technical know-how to improve and diversify agricultural and industrial production in an efficient and competitive manner; lack of linkages to new markets, particularly in the United States; and lack of trained manpower adequate to new methods and types of production.

ii. Strategy: Proposed activities would be focussed on private sector development, and most would be conducted through private sector entities. Policy measures to remove disencentives will be dealt with as a component of the structural reforms described in Section 3.4 above.

Financing problems will continue to be addressed first, by assuring that adequate credit resources are available through both the public and the private banks; some dollar funds will be provided under AID projects and local currency will be made available from ESF programs. Also, through specific projects efforts will continue to channel funds through the more efficient private banks and financieras, and to obtain policy and administrative reforms which promote operations of private financial institutions, and reduce inefficiencies of the public banks. Availability of foreign exchange for outright purchase by private, productive enterprise will continue to be assured by making available and conditioning the use of ESF dollars provided for balance of payments support.

A substantial effort is underway and will be maintained to help the Costa Rican private sector identify more efficient and cost-effective means of production in agriculture and manufacturing, new products, possible substitutions, improved designs, and new markets. Drawback industries will be one focus of attempts to diversify manufacturing. Free zones and industrial parks will also be supported. Efforts will be continued to streamline customs and other administrative procedures which inhibit production, particularly for export. Technical assistance will include help in establishing links with

foreign producers/investors who can provide capital and/or know-how, and with potential buyers or intermediaries. Emphasis will be placed on developing an on-going capacity for export and investment promotion.

In the agricultural sector, support will be given to such activities as irrigation, reforestation and water conservation, applied research, seed/plant production, and extension work. Private sector producer associations and similar entities will be the preferred instrument.

Assistance in skills training to meet the demands of new and increased production will be provided through on-the-job private sector programs and through the Costa Rican National Training Institute (INA), which has a well-established program, but one which must become more responsive to the changing requirements of the productive sector.

iii. Cost and Source of Funds: The cost of such activities described above is in the order of $675 million equivalent during the 1984-1988 period, and $600 million equivalent during the 1989-93 period.

6. Lack of Employment

i. Nature of the Problem: Of a total labor force of 844,000, approximately 193,000 are unemployed or underemployed. The macroeconomic projects above make it clear that lack of employment will remain a serious problem well into the 1990's. In an attempt to deal with the consequences of

this situation, over the past year the government has been operating a national feeding program which takes care of the basic food requirements of approximately 35,000 families. The program is funded only through December, 1983. Other feeding programs of a more supplementary nature, e.g. school lunches, reach a considerable number of individuals.

A principal source of employment, the construction sector, has been particularly hard hit. Whereas in 1979 the construction sector grew by 12%, producing about 10,000 new housing units, real output in 1981 and 1982 declined by 12% and 40%, respectively. Estimates of the number of new units needed over the next ten years are about 100,000. An additional 60,000 homes need improvement.

Another major source of employment relates to road maintenance and water and sewerage installations. Due to budget stringencies, but also to deficiencies in management, these costly investments are deteriorating because of inadequate maintenance.

ii. Strategy: The most important means of dealing with the unemployment problem is a sound economic policy that will enable Costa Rica to meet the GDP growth targets established in this paper, but other more specific actions are needed. We are already using PL 480 and ESF local currency generations to support INVU and Savings and Loan programs. While the INVU funds go through the government housing agency, the actual work is done by private sector contractors. [illegible] programs [illegible]

estimated that each $10,000 invested in housing creates 7 to 14 jobs. As a condition to substantial AID assistance to the housing sector, the government will be required to modify its rent control legislation, which has significantly affected the supply of private sector provided low and medium income rental housing. We will also attempt to secure the creation of a national savings and loan bank, separating the present SSL central unit from the Banco Popular.

We plan to use a technique similar to that with INVU to provide funds for road, water and sewerage, and possibly, school and hospital maintenance. The funds will go through public sector institutions, but the work will be done by private sector contractors. Also some attempt will be made to expand rural water supply services. A massive public works programs, however, is not contemplated.

It may also be necessary to continue some level of food aid to the unemployed.

iii. Cost and Source of Funds

These activities will be financed exclusively from ESF and PL 480 Local Currency. The costs are estimated at $1[illegible] million equivalent during the 198[illegible] period, [illegible] million during the [illegible] period.

7. Inadequate Spread of Benefits

Since Costa Rica has a broad based network of social infrastructure, no new investment is justified at present. Much of what needs to be done in terms of equity considerations will flow from the strategies proposed under the Productive Sector section and the Lack of Employment section. One additional area that merits consideration is land distribution which is discussed below.

i. Nature of the Problem - In terms of numbers, there is probably not a very large group of families who need and are seeking land in order to survive. However, there is a well organized and persistent campaign of land invasions, especially in the Atlantic and Southern Pacific coastal regions. The organizers are communists and their motivation is believed to be essentially disruptive, rather than a commitment to land reform, per se. Impulse towards land redistribution is also coming from another direction. Some large landholders and multinational land owners are concerned about the political pressures being generated by the radical left. They are looking for ways and means to convert their holdings into cash and to turn over the ownership of the land to cooperatives, small scale individual units, etc. In some instances, the present owners propose to continue to own and operate the processing facilities, e.g. for palm oil, while divesting themselves of the land.

The problem of dealing with this situation in a positive and imaginative fashion is complicated by the policies being followed by the government land reform agency (IDA). The agency attemps to provide heavily subsidized (or sometimes free) support services and infrastructure to the "beneficiaries" that it settles on land it purchases. This includes internal roads, schools, community centers, credit, and marketing services. Of more importance, mortgage payments on the value of the acquisition of the land are usually not collected. There is no known instance of an IDA sponsored settler being evicted for non payment of his mortgage.

ii. Strategy - There may be possibilities for creating some sort of mortgage financing facility for graduates of agricultural schools and for people with equivalent experience, through the banking system. More efficient means of settling the rural poor also have to be found. To be workable, a concurrent change in IDA practices would probably be necessary. In addition, some financing might be provided to facilitate ESOP type plans for large farming units, e.g. some of the sugar estates and, on a target of opportunity basis, for facilitating ownership transfer to cooperatives along the lines of the scheme presently being developed in connection with a large palm oil plantation.

iii. Cost and Source of Funds - All costs would be in colones derived from ESF and PL 480 programs. A rough estimate of the amounts that could usefully be spent is $25 million equivalent over the 1984-88 period; and $40 million over the 1989-93 period.

8. Rapid Population Growth

The crude birth rate which was 48 per 1,000 in 1960 dropped to 30 per 1,000 by 1976. Between 1978 and 1982 the population growth rate rose to 2.8% from 2.4%. New efforts in the population area are therefore justified. AID has recently authorized a $2.5 million "Planning Self Reliance Project" for a family planning PVO. These resources, which will be supplemented by the IPPF and the UNFPA, are considered adequate to cover the needs of Costa Rica during the next five years. Assuming current policies are maintained by the government, the UNFPA project is approved and the A.I.D. project achieves its objectives, subsequent assistance by AID may not be needed.

APPENDIX No. 1

Main assumptions utilized in the Balance of Payments Projections

1/ Exports are estimated to grow at an average rate of 9.2% from 1983 to 1988 and 12.3% from 1988 to 1993 for all projections.

Exports	Average percentage 1983 - 1988	Growth 1988 - 1993
Traditional	4.4	4.6
CACM	13.5	16.0
Non-traditional rest of the world	17.0	20.0
Weighted average rate	9.2	12.3

2/

Imports	Average percentage 1983 - 1988	Growth 1988 - 19923
Projection 1	9.1	12.5
Projection 2	8.4	11.0
Projection 3	8.4	11.0

Under Projection 2, a historical income elasticity of imports of 1.3 was utilized. Under projections 1, 3 and 4, elasticity was restrained to 1.0. This seems reasonable since the historical estimate is biased upwards by oil price increases and overvaluation of the currency.

Under all projections a 6% world inflation rate was utilized. Projection 1 assumes a GDP real growth rate of 1.5% in 1984, 3.5% in 1985, 4.5% in 1986, 5.5% in 1987 and 6.5% for the following years. Projections 2, 3, and 4 assume a GDP real growth rate of zero in 1984, 1.5% in 1985, 2.5% in 1986, 3.5% in 1987, 4.5% in 1988 and 5% for the following years.

3/ Under Projections 1, 2, and 3 the $225 million revolving credit provided by the commercial banks is repaid as stipulated in the agreement: $40 million in 1985 and $135 million in 1986.

Under Projection 4 the revolving credit is rescheduled over a five year period. To be repaid in annual installments of $45 million from 1987 to 1991.

For all projections net reserves are assumed to remain at the year-end 1983 level.

COSTA RICA: BALANCE OF PAYMENTS
Projection No. 1
(US$ Million)

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
Current Account	- 423	- 455	- 481	- 495	- 493	- 466	- 514	- 554	- 599	- 640
Trade Balance	- 149	- 181	- 202	- 233	- 276	- 322	- 370	- 419	- 459	- 517
Exports, FOB	851	914	1,008	1,116	1,241	1,385	1,550	1,741	1,962	2,217
Imports, CIF	1000	1,095	1,210	1,349	1,517	1,707	1,920	2,160	2,431	2,734
Services Balance	- 289	- 289	- 294	- 282	- 237	- 169	- 169	- 165	- 160	- 153
Tourism	95	105	115	126	139	153	168	185	204	224
Transportation & Others	32	36	40	45	50	56	63	71	79	89
Factor Services	- 416	- 430	- 449	- 453	- 426	- 378	- 400	- 421	- 443	- 466
Official Interest	(- 386)	(- 397)	(- 413)	(- 413)	(- 382)	(- 330)	(- 347)	(- 363)	(- 379)	(- 395)
Other	(- 30)	(- 33)	(- 36)	(- 40)	(- 44)	(- 48)	(- 53)	(- 58)	(- 64)	(- 71)
Transfer Net	15	15	15	20	20	25	25	30	30	30
Capital Account	423	455	481	495	493	466	514	554	599	640
Private Net	100	110	121	133	146	161	177	195	214	234
Official Net	323	345	360	362	347	305	337	359	385	406
New Loans	458	724	809	780	801					
Amortization	- 135	- 379	- 449	- 418	- 454					
Basic Balance	-	-	-	-	-	-	-	-	-	-
Gross Resource Requirement	458	724	809	780	801					

COSTA RICA: BALANCE OF PAYMENTS
Projection No. 2
(US$ Million)

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
Current Account	- 408	- 423	- 432	- 430	- 412	- 373	- 405	- 430	- 457	- 480
Trade Balance	- 135	- 151	- 156	- 171	- 199	- 235	- 272	- 310	- 345	- 378
Exports, FOB 1/	851	914	1,008	1,116	1,241	1,385	1,550	1,741	1,962	2,217
Imports, CIF 2/	- 986	-1,065	-1,164	-1,287	-1,440	-1,620	-1,822	-2,051	-2,307	-2,595
Services Balance	- 288	- 287	- 291	- 279	- 233	- 163	- 158	- 150	- 142	- 132
Tourism	95	105	115	126	139	153	168	185	204	224
Transportation & Others	32	36	40	45	50	56	63	71	79	89
Factor Services	- 415	- 428	- 446	- 450	- 422	- 372	- 389	- 406	- 425	- 445
Official Interest	(- 385)	(- 395)	(- 410)	(- 410)	(- 378)	(- 324)	(- 336)	(- 348)	(- 361)	(- 374)
Other	(- 30)	(- 33)	(- 36)	(- 40)	(- 44)	(- 48)	(- 53)	(- 58)	(- 64)	(- 71)
Transfer Net	15	15	15	20	20	25	25	30	30	30
Capital Account	408	423	432	430	412	373	405	430	457	480
Private Net	100	110	121	133	146	161	177	195	214	234
Official Net	308	313	311	297	266	212	228	235	243	246
New Loans	443	692	760	715	720					
Amortization 3/	- 135	- 379	- 449	- 418	- 454					
Basic Balance	-	-	-	-	-	-	-	-	-	-
Gross Resource Requirement	443	692	760	715	720					

COSTA RICA: BALANCE OF PAYMENTS
Projection No. 3
(US$ Million)

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
Current Account	- 408	- 418	- 418	- 400	- 359	- 288	- 281	- 257	- 225	- 176
Trade Balance	- 135	- 146	- 142	- 143	- 150	- 159	- 164	- 162	- 150	- 127
Exports, FOB 1/	851	914	1,008	1,116	1,241	1,385	1,550	1,741	1,962	2,217
Imports, CIF 2/	- 986	-1,060	-1,150	-1,259	-1,391	-1,544	-1,714	-1,903	-2,112	-2,344
Services Balance	- 288	- 287	- 291	- 277	- 229	- 154	- 142	- 125	- 105	- 79
Tourism	95	105	115	126	139	153	168	185	204	224
Transportation & Others	32	36	40	45	50	56	63	71	79	89
Factor Services	- 415	- 428	- 446	- 448	- 418	- 363	- 373	- 381	- 388	- 392
Official Interest	(- 385)	(- 395)	(- 410)	(- 408)	(- 374)	(- 315)	(- 320)	(- 323)	(- 324)	(- 321)
Other	(- 30)	(- 33)	(- 36)	(- 40)	(- 44)	(- 48)	(- 53)	(- 58)	(- 64)	(- 71)
Transfer Net	15	15	15	20	20	25	25	30	30	30
Capital Account	408	418	418	400	359	288	281	257	225	176
Private Net	100	110	121	133	146	161	177	195	214	234
Official Net	308	308	297	267	213	127	104	62	11	- 58
New Loans	443	687	746	685	667					
Amortization 3/	- 135	- 379	- 449	- 418	- 454					
Basic Balance	-	-	-	-	-	-	-	-	-	-
Gross Resource Requirement	443	687	746	685	667					

COSTA RICA: BALANCE OF PAYMENTS
Projection No. 4
(US$ Million)

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
Current Account	- 408	- 422	- 440	- 422	- 375	- 299	- 286	- 257	- 225	- 176
Trade Balance	- 135	- 146	- 142	- 143	- 150	- 159	- 164	- 162	- 150	- 127
Exports, FOB[1]	851	914	1,008	1,116	1,241	1,385	1,550	1,741	1,962	2,217
Imports, CIF[2]	- 986	-1,060	-1,150	-1,259	-1,391	-1,544	-1,714	-1,903	-2,112	-2,344
Services Balance	- 288	- 291	- 313	- 299	- 245	- 165	- 147	- 125	- 105	- 79
Tourism	95	105	115	126	139	153	168	185	204	224
Transportation & Others	32	36	40	45	50	56	63	71	79	89
Factor Services	- 415	- 432	- 468	- 470	- 434	- 374	- 378	- 381	- 388	- 392
Official Interest	(- 385)	(- 399)	(- 432)	(- 430)	(- 390)	(- 326)	(- 325)	(- 323)	(- 324)	(- 321)
Other	(- 30)	(- 33)	(- 36)	(- 40)	(- 44)	(- 48)	(- 53)	(- 58)	(- 64)	(- 71)
Transfer Net	15	15	15	20	20	25	25	30	30	30
Capital Account	408	422	440	422	375	299	286	257	225	176
Private Net	100	110	121	133	146	161	177	195	214	234
Official Net	308	312	319	289	229	138	109	62	11	- 58
New Loans	443	601	633	752	728					
Amortization[3]	- 135	- 289	- 314	- 463	- 499					
Basic Balance	-	-	-	-	-	-	-	-	-	-
Gross Resource Requirement	443	601	633	752	728					

Appendix No. 2

Costa Rica: Six-Year Projection of the Financial Position of the Consolidated Public Sector Under Two Scenarios (billions of Colones)

	1984 ΔGDP=0%	1985 ΔGDP=1.5%	1986 ΔGDP=2.5%	1987 ΔGDP=3.5%	1988 ΔGDP=4.5%	1989 ΔGDP=5%
(1) Nominal GDP[1]	121.8	138.4	158.9	184.3	215.8	253.6
(2) Central Government Revenues[2]	22.4	25.5	29.2	33.9	39.7	46.6
(2a) (Pessimistic Scenario)	(20.0)	(20.0)	(23.0)	(30.8)	(38.7)	(46.6)
(3) Central Government Saving[3]	2.2	2.5	2.9	3.4	4.0	4.7
(3a) (Pessimistic Scenario)	(2.0)	(2.0)	(2.3)	(3.1)	(3.0)	(4.7)
(4) Central Government Overall Deficit[4]	4.9	4.4	4.6	4.8	4.9	5.1
Total Resources = (2)-(3)+(4)	25.1	27.4	30.9	35.3	40.6	47.0
(Pessimistic scenario)	(22.9)	(22.4)	(25.3)	(32.5)	(39.7)	(47.0)
(5) Public Enterprise Current Account Deficit	0	0	0	0	0	0
(5a) (Pessimistic Scenario)	(- 1.5)	(- 1.0)	(- 0.5)	(0)	(0)	(0)
(6) Public Enterprise Capital Formation (net of (3))[5]	- 1.8	- 1.7	- 1.5	- 1.2	- 0.8	- 0.3
(6a) (Pessimistic)	(- 2.0)	(- 2.2)	(- 2.1)	(- 1.5)	(- 0.9)	(- 0.3)
(7) Central Government Salaries[6]	-11.8	-13.2	-14.8	-16.6	-18.6	-20.8
(7a) Pessimistic Scenario)	(-12.0)	(-13.7)	(-15.6)	(-17.8)	(-20.3)	(-23.1)
(8) Central Government Capital Formation	- 2.0	- 2.2	- 2.4	- 2.6	- 2.8	- 3.0
(9) Central Government Interest	- 4.0	- 4.2	- 4.5	- 4.8	- 4.9	- 5.0
(10) Central Government Goods & Services[7]	- 4.1	- 4.6	- 5.1	- 5.8	- 6.5	- 7.2
(11) Gap[8]	1.4	1.5	2.6	4.3	7.0	10.7
(11a)(Pessimistic Scenario)	(- 2.7)	(- 5.5)	(- 4.4)	(- 0)	(4.3)	(8.4)

1/ A 12% domestic inflation rate was assumed to prevail over the six-year period.

2/ For the optimistic scenario an elasticity of tax revenues with respect to GDP of 1.0 was assumed. For the pessimistic scenario tax revenues were assumed to stagnate for three years (see text).

3/ Ten percent of total revenues.

4/ An overall deficit of 4% of GDP for 1984 was set. For subsequent years the percentage was gradually reduced to 2%.

5/ Fixed capital formation for the public enterprises was allowed to increase from ¢4 billion to ¢5 billion.

6/ Salaries were allowed to increase by 12% a year (no real increase) under the optimistic scenario and by 14% annually (1.8% real increase) under the pessimistic scenario.

7/ Increases at 12% annually.

8/ The gap should be interpreted as an overall deficit that exceeds our constraint or savings that are greater than our target.