

EVALUATION SUMMARY PART I

(BEFORE FILLING OUT THIS FORM, READ THE ATTACHED INSTRUCTIONS)

IDENTIFICATION DATA

A. REPORTING A.I.D. UNIT: USAID/COSTA RICA GDO <small>(Mission or AID/W Office)</small> (ES# 94-2)	B. WAS EVALUATION SCHEDULED IN CURRENT FY ANNUAL EVALUATION PLAN? yes <input type="checkbox"/> slipped <input checked="" type="checkbox"/> ad hoc <input type="checkbox"/> Eval. Plan Submission Date: FY 94 <input type="checkbox"/>	C. EVALUATION TIMING Interim <input checked="" type="checkbox"/> final <input type="checkbox"/> ex post <input type="checkbox"/> other <input type="checkbox"/>			
D. ACTIVITY OR ACTIVITIES EVALUATED (List the following information for project(s) or program(s) evaluated; if not applicable, list title and date of the evaluation report)					
Project #	Project/Program Title <small>(for title & date of evaluation report)</small>	First PROAG or equivalent (FY)	Most recent PACD (mo/yr)	Planned LOP Cost (000)	Amount Obligated to Date (000)
	Reform of the State Program				
515-0241	Funded under Policy and Training Support	8/89	9/98	\$4.2M	\$3.7M
ESF HCOLC	Sector programs	N/A	N/A	\$40M	\$40M
" "	CODESA divesture	N/A	N/A	\$140M	\$140M

ACTIONS

E. ACTION DECISIONS APPROVED BY MISSION OR AID/W OFFICE DIRECTOR Action(s) Required Reprogramming Activities with new GOCR after May, 1994.	Name of officer responsible for Action Sylvia Saborio	Date Action to be Completed August, 1994
(Attach extra sheet if necessary)		

APPROVALS

F. DATE OF MISSION OR AID/W OFFICE REVIEW OF EVALUATION: mo ___ day ___ yr ___

G. APPROVALS OF EVALUATION SUMMARY AND ACTION DECISIONS:

	Project/Program Officer	Representative of Borrower/Grantee	Evaluation Officer
Signature Typed Name: Sylvia Saborio ROS/GDO Date: <u> </u>	Date: <u>3/1/94</u>	Date: <u>6/30/94</u>	Mission or AID/W Office Director Signature: <u>[Signature]</u> Typed Name: Richard Whelden, A/MDIR Date: <u> </u>

H. EVALUATION ABSTRACT (do not exceed the space provided)

USAID/Costa Rica's Reform of the State (ROS) Program aims to support the Government of Costa Rica (GOCR) in its efforts to downsize and enhance the effectiveness and efficiency of the Costa Rican public sector. The purpose of the mid-term evaluation was to assess the status of the reform program and the effectiveness of AID support to that effort and make recommendations for future AID funded activities in this area. For operational/analytical purposes the ROS program is made up of 17 diverse elements, grouped in two broad categories: 1. *Fiscal Rationalization*, which comprises actions aimed at downsizing the public sector labor force, the concession of public works, privatization of public enterprises, rationalization of public pensions, and budget and tax reform; and 2. *Increased Operational Efficiency*, which includes measures in the area of customs administration, institutional restructuring, improvements to the legal/regulatory environment and financial reform. The evaluation was carried out by a team of US & Costa Rican experts in political economy and political science, on the basis of written material and interviews with relevant actors in each area.

The major findings and conclusions of the evaluation are: that the Public Sector Reform Program in Costa Rica has made significant strides, that AID support has been important --and in some areas, critical-- to that success, that the Public Sector Reform Program should continue to be the foundation of Costa Rican national development policy and that AID should continue to support that effort. The report identifies "decentralization" as a key missing ingredient in the Public Sector Reform Program and recommends that both GOCR and AID take up this challenge.

I. EVALUATION COSTS

1. Evaluation Team		Contract Number <u>OB</u> TDY Person Days	Contract Cost <u>OB</u> TDY Cost (US\$)	Source of Funds
Name	Affiliation			
Lawrence Harrison	Consultant	515-0241-C-002148-00	\$25,720	SIGMA ONE Contract
Eduardo Lizano	Consultant	P.O.515-3000214-00	\$11,000	
Edna Camacho	Consultant	.	.	
Constantino Urcuyo	Consultant	P.O.515-3000218-00	.	

2. Mission/Office Professional Staff Person-Days (estimate) 10

3. Borrower/Grantee Professional Staff Person-Days (estimate) _____

A.I.D. EVALUATION SUMMARY PART II

J. SUMMARY OF EVALUATION FINDINGS, CONCLUSIONS AND RECOMMENDATIONS (Try not to exceed the 3 pages provided)

Address the following items:

- Purpose of activity(ies) evaluated
- Purpose of evaluation and Methodology used
- Findings and conclusions (relate to questions)
- Principal recommendations
- Lessons learned

Mission or Office: USAID/COSTA RICA, GDO

Date this summary prepared: 03/18/94

Title and Date of Full Evaluation Report: _____

Evaluation of the USAID Role in Costa Rica's Public Sector Reform (Reforma del Estado) Program, 7 January 1994.

AID's Reform of the State (ROS) Program aims to support the Government of Costa Rica (GOCR) in its efforts to downsize and enhance the effectiveness and efficiency of the Costa Rican public sector. It is a comprehensive package of measures and activities whose aim is to redefine, streamline and make more efficient state intervention in the economy, as well as improve the operational effectiveness of the legislature and the judicial system. The main elements of the ROS Program include:

- * budget reform: to improve allocative efficiency, accountability and transparency
- * tax reform: to improve tax administration and collection
- * customs reform: to expedite customs clearance, improve trade information and tax collection, and reduce corruption
- * pension reform: to rationalize different pension regimes and make them fiscally and financially sound
- * labor mobility and public employment reform: to reduce the size of the public payroll and allow greater flexibility in deployment within the public sector
- * privatization/democratization: to downsize the public sector through divestiture and private delivery of non-essential services
- * institutional reform: to enhance operational efficiency of public entities
- * legal/regulatory reform: to improve both market and public enterprise efficiency, and consumer protection
- * financial reform: to reduce the cost of financial intermediation and enhance prudential supervision
- * legislative reform: to expedite the legislative process through procedural improvements as well as enhanced information systems and technical training
- * judicial reform: to expedite and improve the administration of justice through enhanced information systems, judicial training and alternative dispute resolution methods

The purpose of the evaluation was to assess the status of the reform program and the effectiveness of AID support to that effort, and make recommendations for future AID activities in this area. In terms of **scope**, the evaluation was limited to those elements of the ROS Program in the Executive Branch; hence it did not address legislative or judicial reform issues. In terms of **methodology**, the evaluators reviewed written materials and interviews with relevant actors in each area.

SUMMARY

MAIN FINDINGS AND CONCLUSIONS

On the whole, the report concludes that significant progress has been made towards the attainment of the basic objectives in most of the program areas. It further concludes that AID's role in support of the the GOCR's public sector reform program has been generally positive, and in some cases critical --e.g., labor mobility, privatization and customs reform.

Specific findings/conclusions include:

* impressive progress has been made in the transformation of Costa Rica's banking system from a highly interventionist, state-dominated system toward one that is more open, competitive and efficient. AID has made an important contribution both to the reform and to public awareness of the issues.

* limited progress has been made on tax reform. The biggest obstacle is indifference among politicians, professionals and the public, due in part to the political costs of tax reform and to vested interests in the status quo. AID contribution in this area has been modest: some \$40,000 towards the restructuring of the Tax Collection Authority and a Fiscal Lottery scheme.

* significant progress has been made in improving customs administration: the average time required for merchandise to pass through the system has been reduced from five weeks to one week. In addition, major improvements have been made in the areas of automation, statistics, internal controls, auditing and customs facilities. Nevertheless, overstaffing remains a problem and the budget is inadequate. Some \$2.2 million in AID resources channeled through a local entity the Fundación de Cooperación Estatal (FUCE) has been indispensable to the progress realized to date, particularly with respect to the functional reorganization of the customs service implementation of computerized systems and managerial training.

* progress on budget reform has been disappointing with unforeseen, complications in budget implementation. AID's technical assistance (some \$170,000) has been valuable in developing a conceptual framework for integrated financial management that would significantly enhance decision-making and control. However, there has been a lack of high-level leadership in this area.

* notwithstanding the 10 years it has taken to accomplish, the virtual dismantling of the government owned holding company Corporación de Desarrollo (CODESA) represents a major achievement: 20 subsidiaries/affiliates have been liquidated and 2 are in process of liquidation; 5 subsidiaries/affiliates have been passed to the public sector; 11 have been sold and the 2 major remaining subsidiaries are in the process of sale. AID played a transcendently important role in the process, at a cost of \$63 million in local currency.

* the labor mobility program has reversed the growth of public sector employment and its contribution to the fiscal deficit. The program would not have been possible without some \$27 million in AID resources and FUCE administration.

* significant progress has been made on rationalizing public sector pensions and establishing a complementary pension scheme. AID contribution to the process has been modest in financial terms but highly important both in its short-term and long-term impact.

* progress on public sector restructuring has been slow. AID support entailed mostly the financing of sectoral studies, whose quality turned out to be quite uneven.

KEY RECOMMENDATIONS

The principal recommendation of the report is that the Public Sector Reform Program should continue to be the foundation of Costa Rican national development policy and that AID should continue to support that effort, as it has in the past. Reluctant to set priorities, the team recommends that further progress be made on all fronts. In addition, it recommends that "decentralization" be included in the program. To this end, it suggests the creation of a bipartisan blue ribbon commission to develop a detailed decentralization plan.

SUMMARY (continued)

K. ATTACHMENTS (List attachments submitted with this Evaluation Summary; always attach copy of full evaluation report, even if one was submitted earlier)

PAGE 6

Evaluation of the USAID Role in Costa Rica's Public Sector Reform Program.

ATTACHMENTS

L. COMMENTS BY MISSION, AID/W OFFICE AND BORROWER/GRANTEE

The ROS evaluation report is very disappointing. One major shortcoming is the superficiality of the analysis and the lack of rigor in treating data and sources. Certain figures and assertions contained in the report are highly questionable, yet the report does not cite a single source of data, does not contain a list of the material reviewed or people interviewed and does not present a comprehensive account of the financial resources committed to the program or its constituent elements. Another weakness of the report is the inadequate prioritizing of program elements. The resistance of the team to assign priorities is based on the premise that such activities are non-competitive. It is our contention that they are, indeed, competitive in terms of the time, money, talent, effort and political capital required to push them through. Moreover, the fact that said actions also have a differentiated impact on the overall reform effort is a further justification for the need to set priorities. A separate but related shortcoming is that the report is not particularly forward-looking in its recommendations for future actions by either GOCR or AID. For the most part, it recommends continuing to do what is being done. The only fresh initiative noted is to take up the issue of decentralization.

MISSION COMMENTS ON FULL REPORT

**Evaluation of the USAID Role in Costa Rica's
Public Sector Reform (Reforma del Estado) Program**

Lawrence Harrison
Eduardo Lizano
Constantino Urcuyo
Edna Camacho

7 January 1994

Commissioned by the USAID Mission to Costa Rica

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Glossary of Acronyms and Abbreviations

AGEF	Auditoría General de Entidades Financieras
AID	(U.S.) Agency for International Development
BANCOOP	Banco Cooperativo
BANHVI	Banco Hipotecario de la Vivienda
BCCR	Banco Central de Costa Rica
BID	Banco Interamericano de Desarrollo
BNV	Banco Nacional de la Vivienda
CAUCA	Código Aduanero Uniforme Centroamericano
CCSS	Caja Costarricense de Seguro Social
CEMPASA	Cementos del Pacífico S.A.
CENADA	Centro Nacional de Almacenamiento y Distribución de Alimentos
CEPAL	Comisión Económica para América Latina (UN)
CEV	Comisión Especial de la Vivienda
CNP	Consejo Nacional de la Producción
CNV	Comisión Nacional de Valores
CODESA	Corporación de Desarrollo, S.A.
COMEX	Ministerio de Comercio Exterior
COREC	Comisión de Reforma del Estado Costarricense
CORFO	Corporación de Fomento (Chile)
DNP	Dirección Nacional de Pensiones
ECLA	Economic Commission for Latin America (UN)
ESF	Economic Support Funds (U.S.)
FANAL	Fábrica Nacional de Licores
FEDECREDITO	Federación de Cooperativas de Crédito
FEDEPRICAP	Federación de Entidades Privadas de Centroamérica y Panamá
FERTICA	Fertilizantes de Centroamérica
FODESAF	Fondo de Desarrollo Social y Asignaciones Familiares
FINTRA	Fiduciaria de Inversiones Transitorias
FUCE	Fundación de Cooperación Estatal
GNP	Gross National Product
GOCR	Government of Costa Rica
IBRD	International Bank for Reconstruction and Development (World Bank)
ICE	Instituto Costarricense de Electricidad
ICT	Instituto Costarricense de Turismo
IDA	Instituto de Desarrollo Agrario
IDB	Interamerican Development Bank
ILO	International Labor Organization
IMF	International Monetary Fund
INAA	Instituto Nacional de Acueductos y Alcantarillados
INCOFER	Instituto Costarricense de Ferrocarriles

INS	Instituto Nacional de Seguros
INVU	Instituto de Vivienda y Urbanismo
IPA	Institute for Public Administration
JAPDEVA	Junta de Administración Portuaria y de Desarrollo Económico de la Vertiente Atlántico
MAG	Ministerio de Agricultura y Ganadería
MEIC	Ministerio de Economía, Industria, y Comercio
MIDEPLAN	Ministerio de Planificación
MOPT	Ministerio de Obras Públicas y Transporte
NAFIN	Nacional Financiera (Mexico)
OEA	Organización de Estados Americanos
OAS	Organization of American States
PAE	Programa de Ajuste Estructural
PATS	Policy and Training Support project (USAID)
PLN	Partido de Liberación Nacional
PML	Programa de Movilidad Laboral
RACSA	Radiográfica Costarricense S.A.
RECOPE	Refinería Costarricense de Petróleo
SAL	Structural Adjustment Loan (World Bank)
SEC	Securities and Exchange Commission (U.S.)
SNE	Servicio Nacional de Electricidad
UNDP	United Nations Development Program
UNCTAD	United Nations Commission for Trade and Development
USAID	United States Agency for International Development

Executive Summary

In the late 1970s and early 1980s, in the wake of the oil shocks, skyrocketing international interest rates, and the Sandinista revolution in neighboring Nicaragua, Costa Rica confronted an economic crisis triggered by large budget and balance of payments deficits, and expansionary monetary policies. The crisis underscored the need for a reform of the public sector that would arrest its growth and make it more efficient.

The expansion of the public sector was stunning: from 34 percent of GNP in 1970 to 48 percent in 1988; from 6 percent of the labor force in 1950 to 20 percent in 1986. Consistent with the statist, import substitution model promoted by the most influential Third World theorist, Raúl Prebisch of ECLA/CEPAL and UNCTAD, the state involved itself increasingly in industrial and commercial enterprises, many of which enjoyed monopoly advantages. Yet many state enterprises chronically lost money and were kept afloat only by Central Bank accommodation. The Central Bank micromanaged a financial system dominated by state banks. Governmental regulatory activities often impeded the development of the private sector. Public sector growth was not accompanied by increased efficiency; many Costa Ricans believe that the quality of public services has in fact declined.

Among the symptoms and causes of the problem were excessive numbers of personnel; inflexibility in hiring, transferring, and dismissing personnel; overlapping responsibilities among public institutions; budgetary rigidities importantly the consequence of legislative earmarking, which accounts for 35 percent of total resource allocation; a pension system out of control; a complicated tax structure; and inefficient tax administration.

These factors all contributed to a growing, destabilizing budget deficit that reached 16 percent of GNP in the early eighties. The fiscal deficits had contributed to inflation, the instability of the colón, and upward pressure on interest rates, all phenomena that impeded private sector growth. Rapid expansion of the public sector and its inefficiency presented obstacles to the normal growth of the private sector.

Public sector reform has thus been seen not only as a means of curbing the fiscal deficit but also as important to Costa Rica's successful entry into the world market, on which the long-term growth of the Costa Rican economy depends. A proportionally smaller, more efficient public sector can ease the difficult transformation of Costa Rican industries from production for the limited, protected Central American Common Market to production for the vast world market. A modernized public sector will assure the

private sector of an improved, more stable macroeconomic climate and greater access to financial resources. A modernized public sector will also improve infrastructure: greater efficiency in the ports and customs operations, more and better maintained roads, etc.

* * * * *

The crisis of the late 70s/early 80s helped to forge a national consensus for public sector reform--"reforma del estado." Extraordinary levels of USAID assistance--more than a billion dollars between 1980 and 1992--helped to avert an economic catastrophe, but it was obvious that the aid was temporary and that Costa Rica should take advantage of the breathing space to position itself for future economic stability and independence, and growth with equity.

The governments of Presidents Monge and Arias worked with the International Monetary Fund, the World Bank, and USAID to develop structural adjustment programs that incorporated measures aimed at reduction of the state's role in the economy with respect to finance, production, and regulation; greater public sector efficiency; and the shrinking of the fiscal deficit.

During the Monge administration, the Central Bank began to draw back from the highly interventionist policies and activities--e.g., sectoral topes and dictation of interest rates--that it had engaged in for decades. Private banking operations were encouraged, and the banking sector became more diversified and competitive. It was also during the Monge Administration that the decision was taken to privatize the enterprises of the Corporación de Desarrollo, S.A. (CODESA), a process which is now approaching completion. And with the passage of the Ley de Equilibrio Financiero del Sector Público, the stage was set for the subsequent labor mobility program.

The program of reform of the public sector substantially took shape during the Arias administration. A start was made on getting control of public sector employment through studies to rationalize the staffing of the Instituto Costarricense de Ferrocarriles (INCOFER), which was followed by the design of the broader program of labor mobility with USAID. Studies of the pension problem led to the drafting of a new basic pension law and a law that authorized private "pensiones complementarias." The Caja Costarricense de Seguro Social (CCSS) considered spinning off auxiliary services to private cooperative enterprises organized by former CCSS employees. The Minister of Agriculture supported the "democratización económica" of the retail stores of the Consejo Nacional de la Producción (CNP) as well as the restructuring of public sector support of the agricultural sector. A start was made on

modernizing and reducing corruption in the customs service. And the liberalization and diversification of the banking system were sustained.

The reform of the public sector has advanced during the Calderón administration. The large majority of Arias administration initiatives were carried forward. And some new initiatives were added to the program: civil service reform, price deregulation, public works concessions, budget reform, tax reform, and modernized oversight of capital markets.

* * * * *

Taken in its totality, Costa Rica's public sector reform program, which comprises seventeen activities, is an unprecedentedly ambitious bipartisan enterprise that reflects broad awareness of the lessons of Costa Rica's development experience in the last several decades. There is wide appreciation that the costs of Costa Rica's increasing statism have been high, above all in the seventies and eighties. Historically, government has played an important and constructive role in some aspects of Costa Rica's development, for example, education. But excessive government--statism--has contributed to Costa Rica's chronic economic fragility and dependency. There is a widespread sense that government is inefficient, corrupt in some of its functions, and unresponsive to the needs of average citizens. Ironically, there is also substantial popular resistance to downsizing the public sector.

Today's universal economic development model is predicated on the belief that growth will occur most rapidly and efficiently in an open world market in which private enterprise is responsible for production and distribution, competing on the basis of comparative advantage. The presumption is that the universal economic development model will be implemented within democratic institutions.

The state's role in the new model is to facilitate development of a creative, efficient, competitive private sector; to assure that competition is not compromised by monopolistic forces; and to provide the services--e.g., in education, health, infrastructure, the system of justice--that will enhance the productive capacity of the private sector, assure citizens of freedom and justice, and nurture their creativity, well-being, and pursuit of happiness.

The two functions at the core of the state's role in development are resource mobilization and resource allocation. A third function, related to resource allocation, is the effective and efficient provision of public services. A fourth function is oversight and regulation of financial institutions and monopolies in the public interest.

Significant progress has been made in each of these functional areas. With respect to resource mobilization, Central Bank policies and the banking system in general are far more consistent with the new model than they were ten years ago, and there is considerable promise in customs reform. Resource allocation has been significantly improved by the almost-complete privatization of the CODESA enterprises. A good start has been made on improved public sector effectiveness and efficiency, above all in downsizing of the public labor force and in rationalizing pensions. And measurable progress has been made toward strengthening the oversight/ regulatory functions of the Servicio Nacional de Electricidad (SNE), the Auditoría General de Entidades Financieras (AGEF), and the Comisión Nacional de Valores (CNV).

Costa Rica's cumbersome legislative/legal system has proven to be a major obstacle to public sector reform activities. Modernization of the Asamblea to make it more efficient and agile should be considered part of the overall process. While they are not evaluated here, AID-supported programs through the Center for Democracy are working toward Asamblea modernization with emphasis on information technology, budgetary analysis and control, and staff training. USAID is also providing assistance to the judicial branch through an Administration of Justice project whose principal objective is to improve efficiency and speed at all levels, including the Supreme Court. This activity, too, falls outside the scope of this evaluation.

We believe that the highest priorities for the future attach to (1) continuing improvement of public sector effectiveness and efficiency through the institutional restructuring, labor mobility, "democratización económica," "concesiones," budget reform, civil service reform, and pension and social security reform programs; (2) completion of the reform of the banking system; and (3) tax reform. This is not to say that privatization, oversight/ regulation, and non-tariff barriers should be neglected. We emphasize that the utility of the concept of "priority" is limited in the context of a program which is best thought of as an organic whole.

The one significant lacuna we have identified is decentralization--the strengthening of lower levels of government with respect to resource mobilization and allocation. We recommend the formation of a blue-ribbon, bipartisan commission with permanent staff to develop a decentralization plan. Outside technical assistance will be needed; this would offer AID an important concluding opportunity as it phases out.

We have noted a pattern of ingredients present in each of the more successful activities: most important, a high level government official whose interest is expressed through strong and tenacious leadership; adequate

financial and technical resources, often including outside experts; and active interest by private groups.

USAID assistance to public sector reform activities has been generally helpful and in some cases crucial (e.g., movilidad laboral, CODESA privatization, customs reform). Roughly \$80 million of GOCR-owned colones (subject to joint programming) generated by AID program assistance have been channeled through FUCE and FINTRA, and AID has programmed upwards of \$2 million in technical assistance dollars (see Annex 1). The volume and flexibility of AID resources have in several cases facilitated progress that would have been impossible in their absence. We were repeatedly told that Costa Rican government laws and procedures are cumbersome in the extreme, and while there are concerns about the existence of a "parallel government" (e.g., the Fiduciaria de Inversiones Transitorias (FINTRA) and the Fundación de Cooperación Estatal (FUCE)), most of the critics agree that without such institutions and their flexible resources, progress on the public sector reform program would have been much diminished.

USAID has also played a highly constructive role through the day-to-day dialogue between GOCR and USAID officials. AID has been an active participant in the macroeconomic "policy dialogue" but has also worked creatively in individual institutions and projects. Pension reform is an example of particularly effective GOCR-USAID collaboration.

With the pending termination of the USAID mission in Costa Rica, the future of FINTRA, which managed the CODESA privatizations, and FUCE, which has played a key role in the "movilidad laboral" and customs reform activities, comes into question. AID financing of these institutions is coming to an end, and the next Costa Rican government will have to decide whether to continue them and, in the event of a positive decision, whence to obtain the necessary financing.

There will be a continuing need for technical assistance in several activities as they progress from the analysis/legislation phases into implementation. Two examples are pensions and customs, where U.S. advisors have been particularly valuable. We also noted a pattern of highly positive impact from visits by Costa Ricans to other Latin American countries where progress has been made on the kinds of reforms Costa Rica is pursuing, for example price deregulation in Chile and Mexico, bank supervision in Bolivia.

In summary, Costa Rica has made an impressive start on a program that is indispensable to its future economic independence, stability, and growth with equity. The program has a bipartisan history, and it merits the active support of all political parties. AID can take pride in its contribution.

I. Background

In the late 1970s and early 1980s, in the wake of the oil shocks, skyrocketing international interest rates, and the Sandinista revolution in neighboring Nicaragua, Costa Rica confronted an economic crisis precipitated by large budget and balance of payments deficits, and expansionary monetary policies. The crisis underscored the need for a reform of the public sector that would arrest its growth and make it more efficient.

The expansion of the public sector was stunning: from 34 percent of GNP in 1970 to 48 percent in 1988; from 6 percent of the labor force in 1950 to 20 percent in 1986. Consistent with the statist, import substitution model promoted by the most influential Third World theorist, Raúl Prebisch of ECLA/CEPAL and UNCTAD, the state involved itself increasingly in industrial and commercial enterprises, many of which enjoyed monopoly advantages. Yet many state enterprises chronically lost money and were kept afloat only by Central Bank accommodation. The Central Bank micromanaged a banking system dominated by state banks. Governmental regulatory activities often impeded the development of the private sector. Public sector growth was not accompanied by increased efficiency; today, many Costa Ricans believe that the quality of public services has declined.

Among the symptoms and causes of the problem were excessive numbers of personnel; inflexibility in hiring, transferring, and dismissing personnel; overlapping responsibilities among public institutions; budgetary rigidities importantly the consequence of legislative earmarking, which accounts for 35 percent of total resource allocation; a pension system out of control; a complicated tax structure; and inefficient tax administration.

These factors all contributed to a growing, destabilizing budget deficit that reached 16 percent of GNP in the early eighties. When the deficit was addressed, it was usually through increased taxes or user fees. Rarely were expenditures scrutinized, and when cuts were made, public investment was most affected, with consequent adverse effects on production.

The fiscal deficits contributed to inflation, instability of the colón, and upward pressure on interest rates, all phenomena that impeded private sector growth. Rapid expansion of the public sector and its inefficiency presented obstacles to the normal growth of the private sector.

Public sector reform has thus been seen not only as a means of curbing the fiscal deficit but also as facilitating Costa Rica's successful entry into the world market, on which the long-term growth of the Costa Rican

economy depends. A proportionally smaller, more efficient public sector can ease the difficult transformation of Costa Rican industries from production for the limited, protected Central American Common Market to production for the vast world market. A modernized public sector will assure the private sector of an improved, more stable macroeconomic climate and greater access to financial resources. A modernized public sector will also improve infrastructure: greater efficiency in the ports and customs operations, more and better maintained roads, etc.

* * * * *

The crisis of the late 1970s and early 1980s helped to forge a national consensus on the need for public sector reform--"reforma del estado." Extraordinary levels of USAID assistance--upwards of a billion dollars between 1980 and 1992--helped to avert an economic catastrophe, but it was obvious that the aid was temporary and that Costa Rica should take advantage of the breathing space to position itself for future economic stability and independence, and growth with equity.

The governments of Presidents Luis Alberto Monge and Oscar Arias worked with the International Monetary Fund, the World Bank, and USAID to develop structural adjustment programs that incorporated measures aimed at reduction of the state's role in the economy with respect to finance, production, and regulation; greater public sector efficiency; and the shrinking of the fiscal deficit. This work came to fruition in the Programas de Ajuste Estructural--"PAE": PAE I, approved by the Asamblea in 1985 and PAE II, approved in 1989. PAE III is now pending.

During the Monge administration, the Central Bank began to draw back from the highly interventionist policies and activities--e.g., sectoral "topes" (ceilings) and dictation of interest rates--that it had engaged in for decades. Private banking operations were encouraged, and the banking sector became more diversified and competitive. The Auditoría General de Entidades Financieras (AGEF) was strengthened.

It was during the Monge Administration that the decision was taken to privatize the enterprises of the Corporación de Desarrollo, S.A. (CODESA), a process which is now approaching completion. And with the passage of the Ley de Equilibrio Financiero del Sector Público, the stage was set for the subsequent labor mobility program.

The program of reform of the public sector substantially took shape during the Arias administration. CODESA privatization proceeded impressively. A start was made on getting control of public sector employment

through studies to rationalize the staffing of the Instituto Costarricense de Ferrocarriles (INCOFER), which was followed by the design of the broader program of labor mobility with USAID. Studies of the pension problem led to the drafting of a new basic pension law and a law that authorized private "pensiones complementarias"--similar to the IRA and 401(k) programs in the United States. The Caja Costarricense de Seguro Social (CCSS) studied (with limited concrete results thus far) the possibility of spinning off auxiliary services (e.g., laundry, hospital clothing, production of serums) to private cooperative enterprises organized by former CCSS employees. The Minister of Agriculture supported the "democratización económica" of the retail stores of the Consejo Nacional de la Producción (CNP) as well as the restructuring of public sector support of the agricultural sector. A start was made on modernizing and reducing corruption in the customs service. And the process of banking system liberalization and diversification was sustained.

The reform of the public sector has advanced during the Calderón administration. Most of the Arias administration initiatives were carried forward, at least to the drafting of enabling legislation and in many cases toward full (e.g., CODESA privatization) or partial (e.g., customs reform) completion. And some new initiatives were added: civil service reform, price deregulation, public works concessions, budget reform, and tax reform. The process of liberalization and diversification of the banking system continued. Many of the reform activities are linked to PAE III (see Annex 3).

II. Evaluation Methodology

Our principal task has been to evaluate the impact of USAID assistance on the program of reform of the public sector. Inevitably, we have had to go beyond USAID contributions to assess the progress of the seventeen activities that comprise the program, and those assessments in turn have led us to some judgments on the significance and progress of the overall program.

To economize on time, we divided the activities among the four of us. However, we all attended the early broad briefings and we kept in touch as the more detailed work proceeded. At the end, we discussed our findings and recommendations as a team, and that is how the evaluation should be viewed--as representing a consensus of all members of the team.

The evaluation research consisted of (1) review of written material, including activity proposals, reports, books commissioned for the program, and evaluations; (2) interviews with some fifty public sector officials and private sector representatives, several of the interviews involving two or more team members; and (3) numerous interviews with USAID staff.

III. The Conceptual Framework

Costa Rica's Public Sector Reform Program has evolved and broadened through the Monge, Arias, and Calderón administrations from a narrow early focus on the banking system and the role of the Central Bank. To our knowledge, no one--neither the Costa Rican government, nor the International Monetary Fund, nor the World Bank, nor USAID--has ever articulated a comprehensive, integrated, priority-ordered structure to define "Reforma del Estado." What follows, then, is our 1993 *ex post facto* rationalization of a process that started small, grew like Topsy, and acquired an ambitious label --Reforma del Estado--well after the process had begun.

Some qualifications about "priority:" It is subjective, in the eye of the beholder. Some policies or activities may be intrinsically of lesser importance, but because they involve significant quantities of resource, their priority is promoted. Priority only comes into play when there is a competition for resources--money, people, natural resources/environment, time. If there is no competition for resources--if there is no significant cost to doing one thing rather than another--"priority" becomes a theoretical concept without operational significance. "Will"--*voluntad*--then becomes the decisive factor.

The Model

Today's universal economic development model is predicated on the belief that growth will occur most rapidly and efficiently in an open world market in which private enterprise is responsible for production and distribution, competing on the basis of comparative advantage, given a framework of democratic law and order and macroeconomic stability. The model is importantly informed by the huge success in the past three decades of the East Asian countries, along with Brazil and more recently Chile among the few Third World countries to ignore the Prebisch import-substitution/statism recipe as it was applied in those years. While the East Asian, Brazilian, and Chilean "miracles" were initiated by authoritarian governments, the presumption today is that the universal economic development model will be implemented within democratic institutions.

The state's role with respect to economic development in the new model is essentially supportive of private enterprise: to facilitate development of a creative, efficient, competitive private sector; to assure that competition is not compromised by monopolistic forces; and to provide the services--e.g., in education, health, infrastructure, the system of justice--that will enhance the productive capacity of the private sector, assure

citizens of freedom and justice, and nurture their creativity, well-being, and pursuit of happiness.

The two functions at the core of the state's role in development are resource mobilization and resource allocation. A third function, related to resource allocation, is the effective and efficient provision of public services. A fourth function is oversight and regulation of financial institutions and monopolies in the public interest.

Resources are mobilized for the private sector through the operations of the financial system, for the public sector through taxation and other public revenues like user fees. Under the new model, private resources are allocated by the financial system, principally through the free play of the market. Public resources are allocated through the national budget. Capital markets mobilize and allocate private resources, but they operate with substantial independence of the state except with respect to the state's responsibility for oversight and regulation. That responsibility also extends to circumstances where the nature of production and/or distribution--in the private or public sector--lends itself to monopoly abuse.

The overriding objective for the financial system in the new model is the internal and external stability of the national currency. Stability is the key to resource mobilization by the financial system. Monetary volatility discourages saving and investment. In the past, Costa Rica's chronic fiscal deficits contributed importantly to monetary instability/inflation, which in turn not only distorted resource allocation but served as a strong incentive to capital flight.

A second objective for the financial system is flexible, responsive resource allocation guided by the free play of the market. In contrast with the interventionist, directive policies of Costa Rica's Central Bank in recent decades, the model calls for a system of commercial and development banks that operate in a free, competitive environment. The state's primary interest is to assure that banks conduct their affairs responsibly, with prudence.

Competition for resources between the public and private sectors is a reality both with respect to banking, where private sector needs should have priority, and to national budget revenues. State resource mobilization should aim at generating a level of fiscal resources and public sector activity that permits the state to discharge its responsibilities rationally and efficiently, balancing them with private sector needs. The scope of those responsibilities, both with respect to their total cost and the composition of programs, will ultimately be determined by the political process.

A principal issue illuminated by the new market-oriented growth model is the extent to which government will be directly involved in production and distribution. Several decades of experience with public enterprises in Third World countries demonstrate that they usually become politicized, overstaffed, inefficient, and a drain on fiscal resources. There is consequently a strong privatization presumption, above all where the enterprise is not in a monopoly position. Even where there may be a monopoly, having it in the private sector with effective public sector regulation may be the most efficient solution.

Once a general cost level of public sector activity is established, the means of financing that level must be assured. In practice, a revenue structure is usually more a function of history and inertia than it is of rational planning and decision-making. In most societies, the basic tax structure is a given. When revenue shortfalls arise, new taxes--usually those that are politically least painless--are tacked onto a structure that may already be irrational. Optimally, reform of the state will include an effort to rationalize the tax structure to assure the adequacy of its yield, a favorable--or the least unfavorable--impact on production and growth, the fairness of the tax burden, and the ease of administration.

An efficient democratic state will allocate fiscal resources in the first instance according to the policies and priorities of the elected party, if it has a clear mandate. At the second level, or in the absence of a clear electoral mandate, the budgetary/legislative process becomes the principal arena for establishing or clarifying those policies and priorities. The way the budget is organized can help executive branch officials and *diputados* understand both the macroeconomic and sectoral impact of proposed government spending. The budget should thus be forward-looking and comprehensive, covering all activities of the public sector.

Public sector reform must address the effectiveness and efficiency of government programs, seeking to assure maximum impact at minimum cost. This applies both to services provided to the public, for example in agriculture, health, and education, and to public sector housekeeping activities such as civil service regulations and pensions.

An efficient, responsive public sector will be organized on the basis of centralized policies and decentralized administration. The highly centralist traditions of Latin America lead to strong central governments and dependent, weak provincial and local governments. The ideas of political participation, civic responsibility, and local initiative are undermined by excessive centralization, just as the ideas of dependency and paternalism are strengthened. Moreover, what an excessively centralized government does

at the provincial and local levels will inevitably be less responsive to popular needs and aspirations.

This long-standing imbalance should be rectified.

To summarize, reform of the state embraces four basic elements: (1) resource mobilization, (2) resource allocation, (3) effectiveness and efficiency of public sector programs (including decentralization), and (4) oversight/regulation of financial institutions and monopolies.

Does it make sense to try to prioritize the four elements? Not in our view. We believe that it is more appropriate to think of them as the wheels of a vehicle. To be sure, one can focus on resource mobilization and resource allocation, which are in theory the most important functions. But it costs little to address the efficiency/effectiveness and oversight/regulation elements as well, and neglecting them will involve major costs. If the state is to function well, all four wheels must move.

IV. Evaluation Overview

Taken in its totality, Costa Rica's public sector reform program is an unprecedentedly ambitious bipartisan enterprise that reflects broad awareness of the lessons of Costa Rica's development experience in the last several decades.

We organize the 17 USAID-supported activities under the four basic reform elements as follows, admittedly with some arbitrariness, since the lines between some of the elements, for example resource allocation and effectiveness/efficiency, are not watertight:

A. Resource mobilization

1. Banking reform
2. Tax reform
3. Customs reform
4. Non-tariff barriers

B. Resource allocation

1. Budget reform
2. Privatization
 - a. CODESA
 - b. FANAL, INS, others

C. Effectiveness/efficiency

1. Downsizing the public sector labor force
 - a. Labor mobility
 - b. "Democratización económica"
 - c. Public works concessions
2. Civil service reform
3. Institutional restructuring
4. Pensions

D. Oversight/regulation

1. Servicio Nacional de Electricidad (SNE)
2. Prudential supervision
3. Securities and Exchange
4. Price deregulation

We believe that the 17 activities, if substantially realized, would assure Costa Rica of a modern public sector capable of playing an effective role in a market-driven, export-oriented economy. As we have mentioned, we note one major omission from the array of public sector reform activities: decentralization, that is, rectifying the historic top-heavy imbalance between the power, freedom of action, and fiscal resources of the central government, on the one hand, and the provincial and local governments on the other. We shall return to that omission in the concluding recommendations.

Costa Rica's cumbersome legislative/legal system has proven to be a major obstacle to public sector reform activities. Modernization of the Asamblea to make it more efficient and agile should be considered part of the overall process. While they are not evaluated here, AID-supported programs through the Center for Democracy are working toward Asamblea modernization with emphasis on information technology, budgetary analysis and control, and staff training. USAID is also providing assistance to the judicial branch through an Administration of Justice project whose principal objective is to improve efficiency and speed at all levels, including the Supreme Court. This activity, too, falls outside the scope of this evaluation.

Overview: Resource Mobilization

Within the cluster of resource mobilization activities, the reform of the banking system, which we consider the most important of all and which got the broader "reforma del estado" started, is most advanced. It is at the point where the final major steps--legislative confirmation of the banking reforms

of the past decade, placing the public and private banks on the same footing in terms of their authorities, and rationalizing the public banks--are within reach. The next government should give the necessary final push.

Limited progress has been made on tax reform. The existing tax structure has evolved in response to politico-economic exigencies rather than a comprehensive plan. With the advent of a new government, the moment is opportune to rationalize the structure with a view to assuring the adequacy of its yield, optimal impact on production and growth, fairness of the tax burden, and the ease of administration. With reform of the banking sector well advanced, tax reform merits a high priority for the next administration.

Against a long history of frustrated efforts, the progress made in customs reform in the past two years is noteworthy. But the real payoff in terms of greater yields for the treasury, greater efficiency, and reduced corruption depends on what happens in the next two years. A concerted effort at both the policy and operational levels will be necessary to assure the desired outcome.

Reduction of non-tariff barriers is a case in point where "priority" is not a helpful concept. By contrast with banking reform or tax reform, it is "*poca cosa*" but it *is* important in the context of Costa Rica's aspirations with respect to NAFTA and GATT. Moreover, particularly with the basic study done, it does not require significant resources, but does require will. The NAFTA and GATT implications should be sufficiently compelling to assure that the will is there.

Overview: Resource Allocation

Budget reform has gotten nowhere, bogged down in conceptual differences and bureaucratic infighting. The existing budget structure follows the traditional departmental lines of the central government without giving a clear picture of what resources are used for. Moreover, the Asamblea does not approve the budgets of the decentralized institutions, which account for 70 percent of total expenditures. The budget process as currently constituted is not an effective tool for intelligent policy and decision making by either the executive or the legislature. The next administration should consequently reactivate the budget reform initiative and give it the high level attention necessary.

The privatization of the CODESA enterprises has taken more than ten years, since the Carazo government first signaled its intention to do something about the problem, but it is substantially completed and represents a major contribution to the rationalization of the public sector

consistent with the new model. There are still numerous public enterprises that are candidates for privatization, FANAL and INS foremost among them. Decisions on their future will depend importantly on the disposition of the next government. In general, with the CODESA enterprises virtually privatized, privatization assumes a lower but still important priority.

With respect to privatization, the question should be posed for all public institutions: Is the national interest best served by continued government administration? By government ownership but private administration? By joint administration (coestión)? By full privatization?

Overview: Effectiveness/Efficiency

One of the most significant achievements of the public sector reform program has been to arrest the growth of the public labor force. Further reductions are probably in order, although not necessarily to the arbitrary target of 25,000. Passage of a new civil service law will facilitate modern personnel management, including the correlation of staffing levels with program needs. *Democratización económica* and public works concessions will also contribute to downsizing the public sector, although there are practical limits on what can be expected from these initiatives.

The overarching question with respect to downsizing is, "How many people are needed to discharge government's responsibilities effectively and efficiently?" That question can only be answered by an analysis of government programs and the organization of the government entities responsible for implementing the programs. This means new impetus for the institutional restructuring activity.

The pensions issue is similar to customs reform. Intrinsicly or conceptually it may not merit a high priority, but it involves very substantial resources which could significantly impinge, for good or bad, on the fiscal picture. Moreover, as in customs, much progress has been made. Pensions consequently merit high-priority attention from the next government.

The one significant lacuna we have identified--with respect to efficiency and effectiveness and indeed with respect to the Public Sector Reform program as a whole--is decentralization: the strengthening of resource mobilization and allocation at lower levels of government.

Overview: Oversight/Regulation

The concept of "priority" has limited relevance for oversight and regulation. Most people will judge these functions to be of significantly

lesser moment than resource mobilization and resource allocation. But the oversight/regulatory functions do not involve significant resources, which means that they don't compete significantly with the other program elements. Moreover, they have an important role to play in the new model.

The three key regulatory agencies are the Servicio Nacional de Electricidad (SNE), the Auditoria General de Entidades Financieras (AGEF), and the Comisión Nacional de Valores (CNV). SNE oversees the pricing and services of public and private monopolies. AGEF oversees the banking system. CNV oversees capital markets. SNE and AGEF are more mature organizations than CNV, which has been in existence since 1991. But the roles of each are important, and each warrants support from the government and technical assistance donors.

Major progress has been made in getting government out of price-fixing. Just a few years ago, the prices of 130 products were subject to governmental controls. That number is now seven.

General Observations

While much remains to be done, we are impressed by the progress that has been achieved during the Monge, Arias, and Calderón administrations. The most significant achievements--and they are very significant--include the transformation/liberalization of the banking system; the arresting of the growth of public sector employment; the privatization of the CODESA enterprises. Progress on pension rationalization and customs reform is significant, and on oversight of the financial sector, promising.

We believe that the highest priorities for the future attach to (1) continuing improvement of public sector effectiveness and efficiency through the institutional restructuring, labor mobility, *democratización económica*, *concesiones* budget reform, civil service reform, and pension and social security reform programs; (2) completion of the reform of the banking system; and (3) tax reform. This is not to say that privatization, oversight/regulation, and non-tariff barriers should be neglected. As we have repeatedly pointed out, the utility of the concept of "priority" is limited in the context of a program which is best thought of as an organic whole.

We have noted a pattern of ingredients in each of the more successful activities: above all, a high level government official whose interest is expressed through strong, persistent leadership; adequate financial and technical resources, often including outside experts; and support by private groups.

USAID assistance to public sector reform activities has been generally helpful and in some cases crucial (e.g., labor mobility, CODESA privatization, customs reform). Roughly \$80 million of GOCR-owned colones (subject to joint programming) generated by AID program assistance have been channeled through FUCE and FINTRA, and AID has programmed upwards of \$2 million in technical assistance dollars (see Annex 1). The volume and flexibility of AID resources have in several cases facilitated progress that would have been impossible in their absence. We were repeatedly told that Costa Rican government laws and procedures are cumbersome in the extreme, and while there are concerns about the existence of a "parallel government" (e.g., the Fiduciaria de Inversiones Transitorias (FINTRA) and the Fundación de Cooperación Estatal (FUCE)), most of the critics agree that without such institutions and their flexible resources, progress on the public sector reform program would have been much diminished.

USAID has also played a highly constructive role through the day-to-day dialogue between GOCR and USAID officials. AID has been an active participant in the macroeconomic "policy dialogue" but has also worked creatively in individual institutions and projects. Pension reform is an example of particularly effective GOCR-USAID collaboration.

With the pending termination of the USAID mission in Costa Rica, the future of FINTRA, which managed the CODESA privatizations, and FUCE, which has played a key role in the movilidad laboral and customs reform activities, comes into question. The next Costa Rican government will have to decide whether to continue them and, in the event of a positive decision, whence to obtain the necessary financing.

There will be a continuing need for technical assistance in several activities as they progress from the analysis/legislation phases into the implementation phase. Two examples are pensions and customs, where U.S. advisors have been particularly valuable. We also noted a pattern of highly positive impact from visits by Costa Ricans to other Latin American countries where progress has been made on the reforms Costa Rica is pursuing, for example price deregulation in Chile and Mexico, bank supervision in Bolivia.

In summary, Costa Rica has made an impressive start on a program that is indispensable to its future economic stability and independence, and growth with equity. The program has a bipartisan history, and it merits the active support of all political parties. AID can take pride in its contribution.

Y. Evaluation of Activities

For the purpose of more detailed evaluation, we organize the 17 USAID-supported activities under the four basic reform elements: A. resource mobilization; B. resource allocation; C. effectiveness/efficiency; D. oversight/regulation.

A. Resource Mobilization

1. Banking Reform

a. Background: The 1948 nationalization of Costa Rica's banking system was probably the single most controversial public policy decision in Costa Rica's modern history. Its objective was understandable: banking was disproportionately influenced by the coffee oligarchy, and nationalization was viewed as the best vehicle to assure access to the banking system for all Costa Ricans.

But as in most nationalizations in Latin America, the benefits of broader access were overtaken by the costs of inefficiency, politicization, distortion of credit flows, and corruption. Created in 1950, the Central Bank exercised tight controls over credit allocation and interest rates, at the same time having to bail out the chronic and destabilizing central government fiscal deficits--16 percent of GNP in the early eighties.

In the wake of Costa Rica's late seventies/early eighties economic crisis, the Monge, Arias, and Calderón governments, with encouragement of the IMF, World Bank, IDB, and AID, have moved steadily toward liberalization of the banking system, opening up the system to private financial institutions and curtailing Central Bank interventionism.

In addition to promoting the process through ESF conditionality, AID has made available \$625,000 through the Academia de Centroamérica for studies, technical assistance, and professional and political debate aimed at creating a favorable environment for reform.

b. Objectives: To reform the banking system so that it contributes more effectively to economic development by assuring the internal and external stability of the colón. Supporting objectives include:

- (1) Increased competition in the banking system.
- (2) Increased role for the market in determining interest rates.

(3) Increased Central Bank independence of the central government.

(4) Improved prudential supervision of the banking system.

c. Accomplishments:

(1) The central bank has stepped back from its earlier activist role, exercised, for example, through sectoral "topes" (ceilings) and lending criteria, and through dictation of interest rates and margins.

(2) The Costa Rican banking system is now far more diversified with the rapid growth of private financial institutions, a phenomenon promoted by AID.

(3) The Central Bank's independence has been strengthened by the removal of two of three ministers from the Junta Directiva and the elimination of automatic access to the Central Bank by public sector institutions, e.g., the CNP.

(4) Initial steps have been taken to strengthen oversight of banks (see below).

(5) Many of these reforms reflect decisions by the Junta Directiva that should be confirmed in new banking legislation. Such legislation has been drafted and is currently under review in the Asamblea.

d. Obstacles: Several issues concerning the future of the banking system are the subject of intense debate, for example, the future of the government banks and the role of the Central Bank with respect to development lending. These should not be thought of as obstacles but as issues that must be decided through the political process. On the other hand, a failure to permit private banks to accept sight deposits and enjoy rediscount facilities would clearly be retrograde.

e. Findings:

(1) Impressive progress has been made in the transformation of Costa Rica's banking system from a highly interventionist, state-dominated system toward one that is open, competitive, and efficient. The transformation reflects a sea change in Costa Rican thinking on the structure and role of the financial sector.

(2) AID has played an important role in the reform and particularly the diversification of the Costa Rican banking system. AID has also facilitated the debate on reform of the financial sector, principally through the Academia de Centroamérica contract, which has furnished decision makers with high quality analysis and advice. AID has provided the resources for visits of diputados and other government officials to study, for example, Federal Reserve Bank operations in the United States, cooperative financing in Bolivia, and microenterprise promotion in Indonesia. The Academia has also produced a valuable book, Reforma Financiera en Costa Rica, that airs all sides of the debate on the future of the financial system. AID has thus made an important contribution to public awareness of the issues--to *concientización*

f. Recommendation: The need to bring the debate on financial reform issues to a conclusion and pass the pending banking system legislation is obvious, if for no other reason than the links to PAE III. Much of this should be accomplished through the electoral process: the successor government should take the actions, e.g., with respect to the future of the public banks and of public development banking as well as private bank sight deposit and rediscount authority, that reflect the outcome of the debate. Our preference would be to preserve the Banco Nacional de Costa Rica as a public bank and privatize the others. We also see no compelling need for a state development bank, particularly in the wake of the CODESA experience.

2. Tax Reform:

a. Background: Costa Rica's tax structure has evolved over the past several decades through essentially uncoordinated initiatives that responded in part to fiscal crises. The resulting structure lacks coherence and suffers from inefficiencies and inequities. Yet, although the tax structure affects the pocketbooks of all Costa Ricans, tax reform has not surfaced among the prominent public policy issues, reflecting in important part the interests of influential pressure groups in preserving the status quo. More attention has been accorded to tax administration, which is politically less sensitive.

This is not to say that tax reform has been ignored. All administrations in the past fifteen years have introduced reform legislation, but the results are largely limited to customs reform, including the reduction of exonerations; tariff reductions; administrative reform of the Dirección General de Tributación Directa; and the draft tax efficiency law, currently being analyzed in the Asamblea, that would eliminate nuisance taxes and reform the property tax.

But these are piecemeal approaches to a broad and complicated problem that remains on the back burner.

In addition to its active support of customs reform, AID has approved the use of about 6 million colones (about \$40,000) to help in the restructuring of Tributación Directa and the Fiscal Lottery project.

b. Objectives:

(1) Taxes should have the broadest possible base, permitting moderate rates.

(2) The central concern of the tax system should be its impact on production and capital accumulation, not on income distribution. However, where feasible, progressiveness--proportionally greater tax contribution from those more able to pay--should be a criterion. (It has proven unfeasible in the case of the property tax.) Concern about income distribution should be a central theme of public spending.

(3) Tax administration should be efficient: tax evasion should be suppressed, and the costs of collection should be a small percentage of the yield.

(4) The tax structure should assure steady absolute growth of revenues reflecting the growth of the economy. Revenue as a percent of GNP should not decline.

c. Accomplishments: There has been virtually no progress on comprehensive restructuring of the tax system. As indicated above, a few elements (e.g., customs, nuisance taxes, the property tax) have been addressed.

d. Obstacles: The biggest obstacle is indifference among politicians, professionals, and the public at large. The indifference is partly attributable to the political costs of tax reform, partly to vested interests in the status quo.

e. Findings: "Accomplishments" and "Obstacles," immediately above, summarize our findings.

f. Recommendation: A comprehensive study of the tax system and its relationship to government spending should be undertaken with particular reference to growth and equity questions. A time-phased reform plan

should be the end product. Technical assistance might come from the International Monetary Fund.

3. Customs

a. Background: The customs service has been on Costa Rica's reform agenda for at least three decades--AID had a full-time U.S. customs team in Costa Rica in the 1960s--with very little impact. Mutually reinforcing inefficiency and corruption have cost importers, consumers, and the treasury tens of millions of dollars each year. (FUCE estimates the cost of "mordidas" --bribes--at \$25 million annually.)

Until recent years, customs reform projects have made little headway. The Arias administration sought help from AID in 1988, and early in 1990, an agreement was signed allocating 162 million colones (about \$1.1 million) for technical assistance and equipment procurement, particularly computer hardware and software. That amount has since been increased to 307 million colones (\$2.1 million), and an additional \$36,000 has been made available for U.S. technical assistance, including the visits of U.S. customs expert Enrique Archibold (see Annex 6). In the process, AID has substantially displaced OAS/IDB assistance.

The momentum was sustained in the Calderón administration, and, in 1991, FUCE began its comprehensive program of technical assistance. The then Vice Minister, now Minister, of Hacienda, Carlos Muñoz, played an active, persistent role in promoting the reform, a role that has been crucial to the progress it has thus far achieved. The reform has also had the full support of the Director General de Aduanas, Fernando Saenz.

The program comprises five basic elements:

(1) A new customs law, based on the recent revisions to the Código Aduanero Uniforme Centroamericano ("CAUCA II")

(2) Automation of all customs activities, including the functions of registry of ship manifests, registry of entry documents, control of vehicle entries, calculation of duties, payment of duties, controls in bonded warehouses, all with computer links to other involved public and private institutions (e.g., the banks, the Registro Público, shipping line representatives, customs brokers).

(3) Construction and modernization of customs facilities (paid for by the government).

(4) Reorganization, stressing decentralization and including the use of program budgeting.

(5) Training.

b. Objectives:

(1) To increase the efficiency of the customs service, increase collections, and reduce contraband and corruption.

(2) To facilitate Costa Rica's entrance into the world market.

(3) To simplify the legal framework and procedures of the customs service with a view to reduction of non-tariff barriers in terms of unnecessary documentation and regulations, also with a view to the reduction of corruption.

c. Accomplishments:

(1) The computerization of the elements of the system is largely completed, but the elements have not yet been fully interconnected.

(2) The customs service has been reorganized to the extent permitted by the CAUCA I regulations, and its budget is now based on decentralized program concepts. Passage of the law reflecting CAUCA II will permit significant further improvements.

(3) The average time required for merchandise to pass through the system has been reduced from five weeks to one week.

(4) Significant improvements have been made to customs facilities.

(5) Upwards of 200 people, the large majority in the customs service, have received training.

d. Obstacles:

(1) The principal obstacle to customs reform is corruption: the vested interest of many customs employees and others (e.g., truck drivers) in preserving a status quo that has generated levels of income far in excess of their legitimate salaries.

(2) Until the new customs legislation is passed, it will not be possible to effectuate important elements of the reform program, including the dismissal of as many as 40 percent of customs personnel who are considered redundant.

(3) AID-generated funds will run out in mid-1994, at which time FUCE estimates that it will need resources to continue until mid-1995.

e. Findings:

(1) Significant progress has been made on computerization, accumulation of statistics, internal controls, auditing, renovation and construction of buildings, and speed of flow-through from international carrier to importer.

(2) Computerization is not complete, however, and until there is an operative, integrated national customs network, the full benefits of the reform program in terms of efficiency and reduction of corruption cannot be substantially realized.

(3) Although progress has been made on internal modernization, customs clients do not perceive significant change except that merchandise flows through the system more rapidly.

(4) Customs reform has been impeded by Costa Rica's adherence to CAUCA I, which leaves management with little flexibility in operational and personnel decisions. The CAUCA II reforms, translated into national legislation, are very important for further progress.

(5) The customs service is overstaffed, and the operating budget is inadequate. Were it possible to eliminate redundant workers, which would be facilitated by a new civil service law as well as the new customs legislation, the current budget level would be adequate for efficient operations of an institution through which 60 percent of government revenue flows (tariffs, sales taxes, etc.).

(6) FUCE assistance has been indispensable to the progress realized to date, particularly with respect to concepts and systems.

(7) The periodic visits of U.S. customs expert Enrique Archibold have been useful for tracking progress and identifying problems, also in terms of motivation of key personnel.

(8) The sustained, direct interest of Finance Minister Carlos Muñoz and Director General of Customs Fernando Saenz has been crucial to the progress achieved.

f. Recommendations:

(1) Because of the customs's key role as a collector of revenues and its costly tradition of corruption and inefficiency, customs reform should continue to receive direct and sustained high level attention. There will be problems of discontinuity whichever party wins the impending elections. Everything possible should be done to minimize them. One way of helping to achieve this would be the briefing of both candidates and their key advisors.

(2) Passage of the CAUCA II and civil service legislation should be a high priority goal of the current and, if necessary, successor governments.

(3) Every effort should be made to have the nationwide computerized system in place by the end of 1993. Once it is operating comes the moment of truth--the moment when those with a vested interest in the corrupted prior system will either succumb to or defeat the new system.

(4) The current and successor governments should give high priority to dismissing redundant customs employees.

(5) FUCE technical assistance should be sustained until the entire new system is in place and functioning smoothly--another one to two years. This will in all probability mean the need for additional financing, since AID-generated resources will run out in the middle of 1994. FUCE should now be giving top priority to implementation of the concepts and the system, staying in close touch not only with key customs personnel but also with private sector clients.

(6) U.S. Customs Service officer Enrique Archibold should periodically review progress, at least once a year for the next two years.

4. Non-Tariff Barriers

a. Background: Costa Rica has made significant progress in reducing its tariff structure. But tariff barriers are not the only impediments to imports. Many countries have taken advantage of other non-tariff barriers to impede the flow of imports, e.g., licensing requirements, arbitrary application of

health standards. The opening of the economy requires that some procedures be abandoned while others are activated.

AID has financed a study of non-tariff barriers by Jorge Corrales. It is clear from the study that a number of laws, regulations, and dispositions will have to be changed.

b. Objectives: To eliminate, or at least reduce, non-tariff barriers that are not based on legitimate health, security, and environmental considerations.

c. Accomplishments: Thus far, the only significant step has been the completion in May of this year of Jorge Corrales's report, "Trabas al Comercio Exterior Contenidas en Decretos del Ministerio de Agricultura y Ganadería, del Ministerio de Economía, Industria y Comercio, y del Ministerio de Salud."

d. Obstacles: Some business people and professionals are opposed to the entry of foreign products and are using protection of health and the environment as pretexts for protection of their economic interests.

e. Finding: Much remains to be done before Costa Rica can demonstrate that it is conforming to international standards of free trade with respect to non-tariff barriers.

f. Recommendations:

(1) The problem of non-tariff barriers should be taken seriously. Costa Rica's image as a free trade country will be adversely affected by a failure to do so.

(2) Broaden the Corrales study to include other areas such as mining, transport, and civil aviation.

(3) Seek modifications of the pertinent laws, decrees, and regulations, especially with respect to health.

B. Resource Allocation

1. Budget Reform

a. Background: In 1991, an effort was begun to redesign the Costa Rican budgetary system the principal shortcomings of which are:

(1) The budget approval process neither (a) reflects priorities nor competition for resources; nor (b) articulates goals, facilitates coordination of plans/programs/budget, or protects against duplication of effort.

(2) Control of expenditures is excessively legalistic and does not reflect results or efficiencies.

(3) There is no legal framework for a managerial approach to budget management.

(4) Budget levels are rarely determined by program decisions and are usually the result of arbitrary percentage applications.

(5) There is no systematic evaluation of the efficiency and effectiveness of governmental programs.

(6) Funds are allocated not by purpose or program but by governmental department.

(7) About a third of the budget is earmarked by prior legislation.

(8) Execution of the budget is encumbered by excessive controls.

(9) The Asamblea does not approve budgets of decentralized institutions, which account for 70 percent of total expenditures.

(10) The Asamblea approves foreign loans one by one rather than in a single global program.

AID provided \$30,000 for technical experts and conferences and about 20 million colones (about \$140,000) for consultant and other support to MIDEPLAN. Budget reform is an element of PAE III conditionality.

b. Objectives:

(1) Transform the budget into a management tool that rationalizes the allocation of resources by reflecting national, regional, sectoral, and institutional plans and programs.

(2) Establish program goals that will facilitate later evaluation.

(3) Facilitate rapid and responsive budget development and execution through decentralization.

(4) Focus legislative review on policy issues and disencumber the executive's implementation authority from detailed legislative oversight.

(5) Establish pilot programs in six institutions to test the model that responds to the foregoing objectives.

c. Accomplishments: Except for the customs service, which has been undertaking its own organizational, operational, and administrative reform on the basis of decentralization, there has been little concrete progress on budget reform. Progress was made in a conceptual and methodological sense under the leadership of Ana Mercedes Brealey in MIDEPLAN. But since she departed from the project, momentum has dissipated, although some work has proceeded in the health and agriculture sectors.

d. Obstacles: Two factors have impeded progress on budgetary reform: (a) Unlike those activities where significant progress has occurred (e.g., labor mobility, CODESA privatization, customs reform), sustained and vigorous high-level leadership has been lacking, perhaps reflecting a revealed low priority; and (b) it has not been possible to achieve a consensus at the technical level. The absence of an adequate legal framework has added an impediment, albeit not an insuperable one.

e. Findings:

(1) Progress on budget reform has been disappointing and could pose problems in connection with PAE III conditionality.

(2) AID's technical assistance, directly and through FUCE, has been valuable, particularly in sustaining the focus of studies on the most important issues and design methodology.

(3) The Institute for Public Administration (IPA) has developed a plan for the integration of the subsystems that comprise the financial management sector of the central government: budget, treasury, public credit, and accounting. The plan, by linking the four elements of the sector with one another within a conceptual framework, would facilitate coordination of legislative reforms with the financial management sector. Each of the elements and the system as a whole would achieve more flexibility, efficiency, and simplicity in its operations. The integrated system would significantly enhance decision making and control.

f. Recommendations:

(1) The successor government should give careful consideration to the benefits of budgetary reform and decide whether those benefits warrant attaching to it the high priority necessary to make it happen.

(2) If the necessary priority is established, that priority must be reflected in sustained high-level attention to the process.

(3) Since the implementation of new budget procedures for six institutions is an early PAE III condition, and since this pilot program will produce important lessons for the broader reform, work should begin at the earliest possible time, linked to institutional restructuring.

(4) A new budget reform director should be named to work closely with concerned institutions, especially the Autoridad Presupuestaria and the Contraloría. The director and staff should be physically located in the Ministry of Hacienda.

(5) The reform effort should be broadened to include other areas of financial administration: Contabilidad, Tesorería y Crédito Público, Proveeduría, and Auditoría Interna y Externa of the Contraloría. The recommendations of the Institute of Public Administration team with respect to an integrated financial administration system should be carefully studied.

(6) The Comisión Especial de Ingresos y Gastos of the Asamblea should focus on the reform program in order to advance the necessary legal reforms, including a Ley Orgánica del Presupuesto and whatever other necessary legal changes are illuminated by the six pilot programs.

(7) The Asamblea should review the budgets of the decentralized entities.

(8) Future technical assistance should focus on the practical implementation of concepts, including institutional strengthening (e.g. in accounting and computer systems) necessary for budget reform implementation.

2. Privatization: CODESA

a. Background: The Costa Rican government first signaled its intention to privatize the CODESA enterprises, about 40 in number, in a 1982 Letter of Intent to the International Monetary Fund. Most of the enterprises were

losing money, and the Central Bank had for years been keeping them afloat. The legal authority for privatization was included in the 1984 Ley de Equilibrio Financiero del Sector Público. Further impetus toward privatization was imparted by AID Economic Support Fund conditionality during the 1985-1990 period. A Comisión Nacional para la Reestructuración de CODESA operated between 1985 and 1988. FINTRA was created in 1985, principally with AID-generated resources, to buy and temporarily administer the largest CODESA enterprises, rationalize their financial situation, and put them up for sale.

A decade after the privatization process started, there is still some work to be done with CEMPASA and FERTICA. The sad history of CODESA is similar to that of CORFO in Chile and NAFIN in Mexico.

AID channeled about nine billion colones (about \$63 million) to this activity, about one-half of which was used to reduce CODESA indebtedness to the Central Bank.

b. Objectives:

(1) Stop the flow of Central Bank credit to the CODESA enterprises and reduce CODESA's indebtedness. Central Bank accommodation of CODESA reduced the amount of credit available to other sectors of the economy.

(2) Promote efficiency and competitiveness in Costa Rican industry.

(3) Take government out of competition with the private sector.

c. Accomplishments:

(1) CODESA has ceased to be a drain on the Central Bank.

(2) Twenty subsidiaries/affiliates have been liquidated and two are in process of liquidation; 5 subsidiaries/affiliates have been passed to the public sector; 11 subsidiaries/affiliates have been sold; two major subsidiaries (CEMPASA and FERTICA) are in the process of sale/liquidation.

(3) The privatized industries are generally doing well, providing employment, in some cases earning foreign exchange, and paying taxes.

d. Obstacles: The process of dismantling CODESA was slow importantly because of ideological support for state capitalism; excessively detailed legislation; and the contraloría's involvement in determination of the value of the enterprises.

e. Findings:

(1) Notwithstanding the ten years it has taken to accomplish, the privatization of the CODESA enterprises represents a major achievement for Costa Rica. By one calculation, it has saved the Central Bank \$150 million.

(2) AID has played a transcendently important role in the process. FINTRA was created specifically to help the process in its financial, juridical, and administrative dimensions. Without the AID resources and the participation of FINTRA, the privatization of the CODESA enterprises would not have been possible.

f. Recommendations:

(1) With FINTRA's help, the sale of CEMPASA and sale/liquidation of FERTICA should proceed forthwith, permitting the definitive closing of CODESA.

(2) CODESA's debt to the Central Bank should be assumed by the central government as part of its bonded debt.

(3) Privatization can create monopoly problems. The most important case is cement, since only two plants exist in Costa Rica, and the current cost of importing is so high, even were there no tariffs, that it doesn't offer adequate competition. Consequently, the government ought to oversee the price of cement to avoid the possibility of price-fixing by the two plants. This is not a problem with most other industries (e.g., fertilizers) because tariffs are low and the products can be imported easily.

(4) A detailed evaluation of the various impacts--e.g., fiscal, employment, production, prices, balance of payments--of the CODESA privatizations would be indispensable for an accurate appreciation of the costs and benefits of this initiative.

3. Privatization: FANAL, INS, others

a. Background: The Fábrica Nacional de Licores (FANAL) has been a state enterprise since the last century. It is obsolete and inefficient. It is

also a source of revenue for the CNP, with which it is affiliated. According to polls, the large majority of Costa Ricans agrees with its privatization, notwithstanding negative attitudes about privatization in general.

The Instituto Nacional de Seguros (INS) was created as a state monopoly in 1928. Because of its monopoly status, it does not lose money. But the Costa Rican consumer is the loser, both in terms of the cost and the limited variety of coverages available.

In part because of the long history of these two public enterprises, movement toward privatization/opening up to the private sector, which is a condition of PAE III, has been slow. A consensus has been achieved on FANAL that will lead to the sale/liquidation of its facilities except its San José laboratory, which will be used to assure the quality of alcoholic beverages. The necessary law has been drafted but has not yet been sent to the Asamblea.

A law has been drafted that would open up the insurance sector to private companies over a period of two and one-half years. It would also lead to the restructuring of INS; would establish a regulatory body to oversee the sector; would transfer professional risk insurance to CCSS; and would transfer fire departments to a foundation, but with financing still coming from fire insurance revenues.

AID assistance has been channeled principally through FINTRA, but with a small amount through FUCE, for technical studies of FANAL and INS, including the drafting of the necessary laws. Together with the studies that led to the privatization of the CNP retail outlets (see "Democratización Económica"), a total of 96 million colones (about \$675,000 at current exchange rates) was used.

b. Objective: To end state monopolies in insurance and alcoholic beverage production, thereby assuring greater variety of services/products at lower prices.

c. Accomplishments:

(1) A consensus on the disposition of FANAL has been achieved and reflected in draft legislation.

(2) Some progress has been made toward decisions on the future of INS and the insurance sector. But the debate continues and may not be resolved until the successor government is installed.

d. Obstacles:

- (1) FINTRA's focus on CEMPASA and FERTICA resulted in delayed attention to FANAL and INS.
- (2) Sound policy for the insurance sector requires careful study of INS and the Costa Rican insurance market, which has taken time.
- (3) Ideological and emotional factors have been in play, in part because of the long history of the two state monopolies.
- (4) The employee unions in both enterprises have adamantly opposed change.
- (5) The policy debate has not been decided. While in general agreement with the goals, the PLN wants to restructure INS and create an insurance regulatory body before opening the sector to private companies. Resolution may have to await the installation of the successor government.
- (6) FANAL's sale/liquidation requires that it be legally separated from the CNP.
- (7) The CNP has been insisting that another source be found to replace the income it derives from FANAL.

e. Findings:

- (1) There is a good probability that the FANAL privatization will occur before long. The obstacles are essentially legal and technical.
- (2) Ending the INS insurance monopoly is more problematical. The outcome is in doubt and will depend on the working of the political system.
- (3) AID resources channeled through FINTRA and FUCE for studies and law drafting have been very important to the progress achieved thus far.

f. Recommendations:

- (1) With the privatization of CEMPASA and FERTICA in the offing, and with a consensus substantially achieved on the privatization of FANAL, efforts should be redoubled to open up the insurance sector.

Modernization of the Costa Rican economy depends in part on the existence of a competitive and diversified insurance sector.

(2) Costa Rica is approaching the end of a first phase of privatization. It must now decide whether the national interest is served by the privatization of other public enterprises, including the processing plants and warehouse/silos of the CNP, the National Printing Office, RECOPE, and some of the commercial banks. Helpful to this decision would be a definitive cost-benefit analysis of the CODESA experience.

(3) In our view, notwithstanding the real progress that has been made through the Reforma del Estado program, much remains to be done to create an efficient public sector capable of playing an effective role in the modernization of the Costa Rican economy and society. The question should be posed for all public institutions: Is the national interest best served by continued government administration? By government ownership but private administration? By joint administration (cogestión)? By full privatization? In answering that question, profitability should not be a decisive criterion for maintaining a function in the public sector. The sale of a profitable enterprise, such as a cement plant, can produce resources that can be invested with greater social return in such activities as computer facilities in schools.

C. Effectiveness/efficiency

1. Downsizing: Labor Mobility

a. Background: As noted above, the public sector labor force had grown steadily in recent decades, both in absolute terms and relative to private sector employment: the state employed 6 percent of the labor force in 1950, 20 percent in 1986. Salaries account for one-third of the national budget, and the growth of public sector employment was one of the principal contributors to fiscal deficits. The late 70s/early 80s economic crisis precipitated a profound reexamination that illuminated the problem of public sector employment, which was addressed in the Law of Financial Equilibrium of the Public Sector, passed during the Monge administration.

The Arias administration focused staff reduction studies on INCOFER, the CNP, the Ministry of Agriculture, and the Instituto de Desarrollo Agrario (IDA). The current labor mobility program was instituted late in 1991 with the establishment of FUCE and the channeling of substantial quantities of AID-generated colones to provide financial incentives for public employees

to shift to the private sector. As of mid-1993, 3.7 billion colones (about \$26 million equivalent) had been committed.

b. Objectives: The principal objective of the labor mobility activity is reduction of the fiscal deficit. Subordinate objectives include waste reduction and increased efficiency, particularly in those public institutions that are overstaffed, e.g., customs.

The target under the "Ley de Equilibrio Financiero para el Sector Público" (1984) was to avoid any personnel increases except in the health sector. This target was confirmed in the PAE I (1985) conditionality. Public sector employment nonetheless continued to increase (see below).

The PAE III conditionality establishes targets of 13,000 by the end of 1992, an additional 5,900 by the end of 1993, and an additional 6,100 by the end of 1994, for a total of 25,000.

c. Accomplishments: Two significant indicators demonstrate that important progress has been made: (1) whereas the public sector accounted for 20 percent of total employment in 1986, today the figure is 16 percent; and (2) total public sector employment had declined in 1993 to slightly above the 1987 level of 131,200 after reaching a high in 1990 of 135,600. If the trend of 1987-90 (an additional 1,300 employees annually) is projected through 1990-93, then the actual reduction of 6,200 jobs would mean a net reduction of 10,100 below the trend line. That's short of the PAE III target, but nonetheless considerable progress. The personnel contribution to the fiscal deficit has been reduced, both by the direct personnel expenses as well as related expenses (e.g., office supplies, electricity) of personnel who have left public service (see Annex 2).

d. Obstacles: The principal obstacle to continuation of the labor mobility program is the availability of funds. Earlier administrative bottlenecks that resulted in long processing delays have been broken, but there are still many public employees who would like to take advantage of the program. In a broader sense, downsizing of the public sector has been slowed by the rigidities in the existing civil service law and the delays in the democratization and privatization activities.

e. Findings:

(1) The labor mobility program has made substantial progress. It has reversed the growth of public sector employment and its contribution to the fiscal deficit.

(2) The program would not have been possible without the AID resources and FUCE administration.

(3) Savings achieved by the program are difficult to assess: studies by FUCE and the Planning Ministry (MIDEPLAN) disagree on the amount.

(4) The large majority of program participants have been office workers and support staff. Only about 5 percent of the participants are from the professional category.

(5) The target of a net reduction of 25,000 government employees may be ambitious, particularly when one considers that the Ministries of Health, Education, and Public Security, and the CCSS, which account for roughly one-half of the 131,000 public labor force, are excluded from the program.

(6) Participation in the program has been spotty in terms of the number of participating institutions.

(7) In several cases, participation in the program was not linked to institutional restructuring.

(8) The controls to prevent rehiring of former employees are inadequate, although evidence suggests very few such cases.

(9) There is little evidence of a link between the program and a generalized deterioration of public services, although, as noted above, the impact of the program would have been improved had it been linked more to institutional restructuring.

(10) The vast majority of program participants have found employment in the private sector.

f. Recommendations:

(1) The next government should accord a high priority to further reductions in public employment. However, the labor mobility program is not the only way of achieving this. A new civil service law that facilitates dismissal--including, of course, adequate severance pay and other lawful benefits--for the convenience of the state would eliminate the need for the more costly incentives of the labor mobility program. Further implementation of the "democratización económica" and other privatization activities would also contribute to the objective.

(2) If the labor mobility program is continued, it should be tied to institutional restructuring/modernization across the board.

(3) While the program should be carried forward, the 25,000-person target should be reexamined within the context of a comprehensive program of restructuring.

(4) A definitive cost/benefit study of the labor mobility program should be undertaken.

(5) Registration and control procedures should be strengthened to protect against re-recruitment of program participants.

2. Downsizing: "Democratización Económica":

a. Background: "Democratización Económica" is designed (1) to spin off auxiliary functions of public institutions to private enterprises, often organized as cooperatives and staffed by the same people who, as public employees, performed the same functions; (2) to encourage the comanagement by public and private sectors of essential public services such as health and education; and (3) to enable private administration of some public services (e.g., ports, airports, railroads) while ownership remains with the government. The program took shape in the Arias administration, above all in the leadership of CCSS and the Ministry of Agriculture. The CCSS focus has been an array of auxiliary services--janitors, drivers, security guards, laundry workers, kitchen workers, eyeglass technicians, and serum technicians. The interest of the Minister of Agriculture was focused on the CNP's retail outlets.

In 1988, the Arias administration promulgated a "Decree of Democratization" that was subsequently impugned before the Sala IV and limited in its application by a restrictive interpretation of the Contraloría. In 1990, the Calderón administration effectuated the Arias administration's Law of Financial Equilibrium and the Democratization decree (see Annex 4). Passage of the "democratización" law is a PAE III condition.

AID made 64 million colones available to FINTRA for studies of the CCSS auxiliary functions and the feasibility of spinning off clinics; stevedoring at Puerto Caldera; and the maintenance, loading/ unloading, and piloting services of the Junta de Administración Portuaria y de Desarrollo Económico de la Vertiente Atlántica (JAPDEVA). FUCE received 7.4 million colones for, among other things, analytical work on the legal and economic aspects of the democratización initiative.

b. Objectives: As part of the process of rationalization of the public sector, Democratización Económica seeks greater efficiency in the provision of public services at a reduced cost by blending the social criteria of the public sector with the efficiency criteria of the private sector. It seeks to achieve this objective without prejudice to the interests of workers formerly on the public payroll, who would transfer to the new private enterprises formed under the program.

Subordinate objectives include stimulation of entrepreneurship; improved use of the factors of production; and reduction of the public sector labor force.

c. Accomplishments:

(1) "Democratización" has been achieved in the CCSS clinics at Pavas and Tibás with striking success: better service, better coverage, lower costs.

(2) Radiográfica Costarricense S.A. (RACSA) has transferred several auxiliary services to ex-employees with good results.

(3) CNP retail operations were transformed into four cooperatives with generally good results.

(4) The text of a new law of "Democratización Económica del Sector Público," which provides the legal framework for the three types of activities mentioned above, has been approved unanimously in an Asamblea committee.

(5) FUCE has completed a study of non-essential services that could be transferred under the program.

d. Obstacles:

(1) The lack of adequate legislation.

(2) Opposition by some of the public sector unions on ideological and special interest grounds.

(3) Opposition in the PLN to the inclusion of essential services.

(4) The need for studies to clarify the possibilities and instrumentalities of the program.

e. Findings:

(1) Progress has been made in "democratización económica," which amounts to partial privatization. The two clinics and RACSA auxiliary services are clear successes, the four CNP retail cooperatives a partial success.

(2) There are numerous promising opportunities for "democratización económica" in the CCSS.

(3) AID resources through FUCE and FINTRA, principally for studies including legislative research and diagnosis of possible sectors for democratization, have been helpful.

f. Recommendations:

(1) The program of economic democratization is useful in rationalization of the public sector; it should be continued and broadened.

(2) The program should focus on essential as well as auxiliary services, particularly in health and education. The experience of the Pavas and Tibás clinics should be replicated, and special effort should be made to incorporate hospital services in the program. In education, privatization of public school common services should be promoted.

(3) If resources are available, AID should continue to channel them to FUCE/FINTRA, chiefly for identification of new opportunities for partial privatization, above all with respect to "non-essential services."

3. Downsizing: Public Works Concessions

a. Background: Other countries, e.g., Mexico, have encouraged private enterprise to build or administer infrastructure projects to relieve pressure on the public sector investment budget and to improve the efficiency of maintenance and operations. Perhaps the best-known example of public works concessions in the United States is the New Jersey Turnpike, which was built and is operated by a private enterprise.

The sustained pressure of recent years to reduce Costa Rica's budget deficit has affected public investment and infrastructure maintenance. Public works concessions have been viewed as a means of attenuating this problem, particularly with respect to roads, ports, and airports. The Ley

General de Concesión de Obra Pública, an element in PAE III conditionality, has been passed, and work is underway on the implementing regulations.

The law authorizes the executive branch, the decentralized institutions, and local government to contract with private firms for construction and operation of public works for a fixed period during which the government takes on a regulatory/oversight role. At the end of the period, the project is transferred back to the government. The awarding and administration of concessions must comply with three basic conditions: the participation of the General Accounting Office; the use of competitive bidding processes; and determination by government agencies of the usage fees/fares to be charged the public.

AID assistance has been limited to legislative consultants through FUCE.

b. Objectives:

- (1) Establish alternative sources of financing for public works.
- (2) Improve the efficiency of services as well as maintenance and repair.

c. Accomplishments:

- (1) The basic law has been passed, and a substantial consensus exists to make maximum feasible use of the authority.

d. Obstacles:

- (1) Special care is required in drafting the implementing decree so that a complicated law is not rendered useless by excessive conditions.
- (2) Public works concessions have been used in other countries, but the results have not all been positive. In some cases (e.g., highways in Mexico), user fees have been excessive. Projects will have to be studied with care to assure that they are both beneficial for users and financially viable.

e. Findings:

- (1) Public works concessions may both add to the stock of national infrastructure and result in improved operation and maintenance. But there are pitfalls in the program, e.g., questionable economic/financial feasibility of some projects, that require careful implementation.

(2) This new method of financing and administering public works projects must be viewed as a supplement to, not a substitute for, more traditional approaches. All, indeed most, of Costa Rica's infrastructure problems cannot be solved by public works concessions.

(3) The limits of public works concessions underscore the continuing importance of strengthening the MOPT, including its role in administering concessions.

(4) AID assistance in this activity has been limited to small quantities of technical assistance.

f. Recommendations:

(1) Stress simplicity in the drafting of the implementing decree.

(2) Implement the program gradually and with careful attention to the feasibility of proposals.

(3) AID and/or other donors should provide technical assistance to MOPT to strengthen its capacity to administer concessions.

4. Civil Service Reform

a. Background: The current civil service law is forty years old and is responsive neither to the needs of the government, the interests of government workers, nor to the aspirations of citizens for efficient services. It has provided an unsatisfactory, ambiguous legal framework within which public sector employment has grown disproportionately to the growth of the total economy without significantly improving the quality of most public services. The law has impeded the government's ability to transfer and dismiss public servants; to regularize pay scales; to negotiate equitable, uniform work conditions; and to assure the public of continuity of essential government services such as public security and health.

Civil service reform was included in the public sector reform program during the Arias administration and confirmed in the AID conditionality for Economic Support Fund programs in 1988 and 89. AID's principal contribution has been the financing of visits by a French and an American expert to review draft legislation aimed at correcting the shortcomings of the existing legislation. AID also made colón resources available in connection

with the personnel and organizational restructuring of the customs service, a component of the customs reform program.

The new legislation is currently being negotiated with representatives of government worker unions. It is linked to PAE III but is not an indispensable condition.

b. Objectives: The principal objectives of the new law are:

(1) To reestablish, within a sound legal framework, the preeminence of the authority of the state and its prerogatives with respect to personnel administration.

(2) To guarantee the rights of public employees to negotiate their conditions of work, but with salary questions being subject to budgetary authority.

(3) To recognize the right of citizens to efficient public services.

c. Accomplishments: The principal accomplishments to date are (1) the drafting of a modern civil service law that--if it passes the legislative process substantially intact--should meet Costa Rica's legislative needs for efficient and responsive public services consistent with the policies and priorities of elected authorities; and (2) progress toward more rational staffing of the customs service.

d. Obstacles: The principal concern is the extent to which the draft law is watered down in negotiations with employee unions and in the Asamblea.

e. Findings:

(1) The draft civil service law prepared by the Ministry of Planning contains the elements Costa Rica needs for modern, responsive, and effective public service. The law clarifies and delimits employee rights, including government-wide collective bargaining and the right to strike. It establishes a simplified salary structure and clearly defines employee entitlements, e.g., with respect to retirement, vacations, severance pay. The draft law also clarifies the authorities of government with respect to hiring, promoting, transferring, and dismissing employees both for cause and for the convenience of the government. Also of importance are sections that emphasize competitive entry and merit, and insulation of the career service from politics; that discourage moonlighting; and that clarify and simplify personnel evaluation practices.

(2) Had the new law been in effect, other elements of the public sector reform program would have been facilitated, for example, the downsizing of the public sector and customs reform.

(3) The technical experts financed by AID were very helpful to the MIDEPLAN staff that drafted the new law. (MIDEPLAN received help from other donors, including the International Labor Organization.) The AID-financed experts did not, however, work with the General Directorate of Civil Service.

f. Recommendations:

(1) Negotiation and passage of the new civil service law should have a high priority in both the current and successor governments. As mentioned in the labor mobility section, a good civil service law could substantially eliminate the need for the labor mobility program. In the broadest sense, public sector reform will not be possible without a modern, efficient public service.

(2) Technical assistance may well be needed during the first years of implementation of the new law. Other donors (e.g., ILO, UNDP, OAS) should be able to meet such needs.

5. Institutional Restructuring

a. Background: The focus on public sector institutional problems first appeared in the conditionality of AID's 1988 ESF program, which included reference to the several institutions working in housing and investment/export promotion. In 1989, then Minister of Agriculture and Livestock José María Figueres sought AID technical assistance in the restructuring of the institutions of the agriculture/livestock sector. Among other results were the conversion of CNP retail outlets to private cooperatives and computerization of the Ministry.

These early efforts led, in the Calderón administration, to further institutional analyses, guided by evaluation commissions, in agriculture, housing, public works, health, public security, international commerce, and finance, including the customs. AID has channeled about \$1 million in dollars and colones, principally through FUCE for institutional reform studies.

b. Objectives: Increase the efficiency of government by eliminating duplication, reducing unnecessary expenditures, improving the use of human

resources, and improving services to the public, partly through various privatization alternatives.

c. Accomplishments:

(1) In the transport sector, staffing of MOPT and INCOFER has declined, importantly through participation in the labor mobility program; some institutional reorganization has occurred; and the percentage of contracting of projects to the private sector has increased.

(2) With AID's help, some progress has been made in the agriculture sector with respect to definition of responsibilities and decentralization, and in budget reform, including program budgeting in response to MAG guidelines for the principal institutions of the sector. Analytical capacity has been strengthened.

(3) In the housing sector, some understandings have been reached on institutional specialization among the Ministerio de Vivienda, the Instituto de Vivienda y Urbanismo (INVU), the Banco Hipotecario de la Vivienda (BANHVI), and the Comisión Especial de Vivienda (CEV). INVU has reduced its staff. The consulting work of Pedro Lasa, financed by AID, has helped to reduce state involvement in low-cost housing construction and increase the involvement of the private sector.

(4) The Ministries of Economy, Industry, and Commerce (MEIC) and the Ministry of External Commerce (COMEX) have been unified administratively but not legally. There has been no reduction in MEIC's staff to reflect the fact that price controls have been dropped for 123 of 130 products.

(5) Some progress has been made toward a reorganization of the Ministry of Hacienda with the goal of integrating and strengthening the functions of budgeting, debt management, treasury management, accounting, and planning and utilization of resources.

(6) The Ministries of Government and Security have been unified administratively although not legally. Some duplications have been eliminated. A study of functions is near completion.

(7) Significant progress has been made in the health sector: improved coordination of the programs of the Ministry of Health and the CCSS through the Consejo Técnico Interinstitucional; strengthening of patient services; elaboration of alternative models of health services and their financing; better health sector information systems; improved financing of

the national system; sector-wide procurement; institutional strengthening of CCSS; and human resource development.

d. Obstacles:

(1) Significant institutional changes usually require changes in the legal framework, which are very time consuming.

(2) The existing civil service law is a major obstacle to institutional reform, both with respect to reorganization and downsizing.

(3) Bureaucratic inertia, including protection of fiefdoms, has been encountered repeatedly, as one would expect.

(4) In the face of the legal and bureaucratic problems, policy level officials have often been reluctant to expend time and energy on institutional reform.

e. Findings:

(1) Progress on public sector restructuring has been slow.

(2) The numerous analytical reports were prepared at the behest of the sectoral commissions with widely differing scopes of work: some focused on global analysis, others on functional restructuring, others on resources; some developed general recommendations, others, specific recommendations; some focused on the definition of boundaries between the public and private sectors. Often, the commission did not distinguish between legal and administrative measures, between short and medium term measures.

(3) Assessment of the many studies prepared under this activity is beyond the scope of our evaluation. But we have reviewed the sectoral reports derived from the studies. Their quality is uneven, but their analyses and recommendations are clearly useful.

(4) Whatever the shortcomings of the studies, the study contracts were awarded by FUCE to recognized professionals consistent with prudent contracting practice.

(5) It is important to distinguish between the participation of AID and the results achieved by the government. AID has served a useful purpose in financing studies that analyze institutional problems by sector. It is up to the government to effectuate the recommendations.

f. Recommendations:

(1) The program of restructuring should be continued, but in coordination with other public sector reform activities, particularly personnel downsizing, civil service reform, and budget reform, and with emphasis on implementation.

(2) Greater progress will depend on the high level, persistent leadership necessary to overcome the natural resistance to change.

(3) Continuing technical assistance will be necessary if the next government accords priority to restructuring. FUCE's experience in managing the complicated program of studies would be valuable.

(4) In the transport sector, the highest priority needs are decentralization of services, particularly through "democratización económica," and effective implementation of the concessions law, which will require the design of new systems and training of personnel. Reorganization of MOPT should also receive priority attention. For all of these, technical assistance will be important, and given AID's past involvement, the transport sector should receive additional attention as AID winds down.

(5) Technical assistance should be continued to the agriculture sector, particularly to sustain progress in budget reform.

(6) In housing, the recommendations of the consultant Eduardo Fuentes should be heeded. Fuentes calls for a reorganization of the sector, freezing INVU and developing a new institution, with representation from government and the private sector, that promotes private construction of low-cost housing without subsidies. A major challenge will be to define INVU's future role. AID can also play an important role here.

(7) The goals for the commerce sector should include:

- (a) formal unification of MEIC and COMEX;
- (b) a new, unified ministry that is small but staffed with high-quality personnel who can define effective policies and provide quality services to the private sector, including good data on national production, foreign trade, and identification of what is necessary for Costa Rican goods and services to compete in the world market;
- (c) creation of a high-level advisory council focused on Costa Rica's successful entry into the world market;
- (d) effective regulation of activity that threatens the efficiency and competitiveness of the market.

(8) With respect to the Ministry of Hacienda, the reform effort should be reinvigorated across the board. Major legislative changes are needed to overcome legal restrictions impeding effective financial management, e.g., the civil service, administrative contracting, and financial administration laws. The Demoscopia report, financed by AID, provides a useful blueprint for improved management in the headquarters and field offices; better information acquisition and dissemination; improvement of human resources; and more efficient organization. AID should give high priority to financial management, particularly short-term training, in its termination planning. FUCE help to the Oficina Técnica Mecanizada should continue.

6. Pensions

a. Background: In 1989, it became apparent to the GOCR and AID that public pensions were chaotic and financially unsound, and threatening to destabilize the national budget. Only the judicial branch pension system was healthy. Progress on pension reform was included in ESF conditionality, and a multisectoral technical group was formed. A program of analysis of public pensions, including actuarial studies and legal entitlements, was initiated. A United States pension expert, Dr. Francisco Bayó, has served as principal advisor for the reform process. AID also financed observation visits to Chile by representatives of both political parties, the Dirección Nacional de Pensiones (DNP), and the private sector. This process has led to a substantial consensus both about the need for reform and the shape the reform should take. The consensus is reflected in internal reforms within the DNP; in the recent approval by the Asamblea of new framework legislation; and in the progress of legislation to establish "pensiones complementarias."

AID resources have been dedicated to pension reform financed technical assistance and observation visits. The World Bank has included pension reform as a SAL III condition and is supporting a pension study.

b. Objectives:

- (1) Reduce the burden of pensions on the national budget while assuring the system's viability.
- (2) Simplify the pension system and its administration.
- (3) Improve supervision of pension operations.
- (4) Develop private sector options for future retirees.

c. Accomplishments:

(1) The legal framework for a modernized pensions system has been enacted

(2) The burden on the national budget is declining (from 87 percent of pension payments in 1991 to 77 percent in 1993) as the result of an increase in the minimum retirement age to sixty years (in some institutions, retirement was possible as early as age 48); the establishment of ceilings on pensions; and, in terms of overall personnel costs, the accelerated processing of some 5,000 accumulated pension requests.

(3) With the help of FUCE, the DNP has reorganized and modernized procedures, including a comprehensive computer system; improved administration and control of preparation/distribution of pension checks; produced manuals for internal operations; improved client and public services; and established a direct channel to the Oficina Técnica Mecanizada. One important consequence: significant reductions in corruption.

(4) The "Pensiones Complementarias" draft law, now under consideration in the Asamblea, establishes a framework for a new pension supervisory organization.

(5) Wide support exists for the "Pensiones Complementarias" program: the presumption is that the law will be enacted early next year.

(6) A significant professional upgrading of pension personnel has occurred in the CCSS, the DNP, and the Ministry of Hacienda.

d. Obstacles: Among the principal obstacles have been the political pressures of affected groups, above all the teachers, who succeeded in influencing the Asamblea to reduce their retirement age; bureaucratic inertia, in part driven by corruption; and lack of awareness of the extent of the problem and the ways it could be tackled. The problem of legal rights acquired under previous pension regimens is particularly difficult, seriously complicating the calculation of benefits.

e. Findings:

(1) Significant progress has been made on rationalizing public sector pensions, also on establishing a system of "pensiones complementarias."

(2) Progress includes consolidation of the numerous small pension programs that existed before the program. However, of the 40,000 public sector pensioners, only 7-9,000 are currently affected by the reforms.

(3) The "pensiones complementarias" program, assuming proper management and supervision, represents an important new resource with which to develop Costa Rica's capital markets, for example the floating of long-term private bonds. (Currently, only the GOCR issues long-term bonds.) The resources could be channeled to development projects and also the purchase of foreign equities to assure prudent diversification of portfolio.

(4) The AID contribution to the process has been modest in financial terms but highly important both in its short-term and long-term impact. The design of modern management systems for the DNP and the creation of a technified, professional pension culture reflect the profound imprint of the contribution of consultants Bayó and Torrado, a contribution that will endure.

(5) The observation visits to Chile to study its pension system had a positive impact--the participants became active advocates for reform. Particularly significant was the emergence of bipartisan support of "pensiones complementarias."

f. Recommendations:

(1) Careful analysis of the politics of pension reform must be undertaken to assure that the outcomes are implementable and equitable.

(2) An in-depth study of the legal dimensions of "acquired rights" is necessary to permit the development of a strategy to overcome the serious distortions that result from the inadequacies of prior regimens.

(3) Particular attention should be paid to the actuarial studies of the teachers' pension fund to assure that its fragile condition is corrected and that greater equitability is achieved.

(4) High priority should be assigned to passage of the "pensiones complementarias" law and an effective supervisory entity to oversee the operators of pensiones complementarias. The existence of an effective supervisory body will create confidence and permit the healthy development of this promising new instrument of capital mobilization and personal financial security.

(5) More attention should be focused on Dr. Bayó's recommendations with respect to the creation of three levels of pensions, above all the creation of a basic or minimum pension that guarantees universal coverage.

(6) It will be highly desirable for Dr. Bayó to make periodic visits as the pension reform program is implemented.

D. Oversight/Regulation

1. Regulation of Public Utility Rates (SNE)

a. Background: The Servicio Nacional de Electricidad (SNE) was created in 1928 to oversee the pricing of electricity, then generated and distributed by private enterprise, in the interests of the consumer. Subsequently, water, telephone service, and petroleum products have been added to its scope of responsibility, which now includes oversight of public institutions like the Instituto Costarricense de Electricidad (ICE), the Instituto Nacional de Acueductos y Alcantarillados (INAA), and the Refinería Costarricense de Petróleo (RECOPE). The 1990 AID ESF package included conditionality that sought a system for automatic, periodic adjustment of public utility and petroleum product rates on the basis of objective criteria of efficiency. SNE has also been the subject of PAE II and III conditionality.

AID's contribution has been minimal: about \$50,000 in colones channeled through FINTRA and FUCE for technical assistance and an observation visit to the United States to observe public utility oversight mechanisms at the federal and state levels.

b. Objective: To defend the interests of the consumer with respect to the price, quality, and continuity of public utilities and petroleum products, all of which are monopolies.

c. Accomplishments: A draft law has been prepared to revise and update SNE's legal charter and was approved by the Asamblea Committee on Social Affairs in March of 1993. Since then, a dispute between MIDEPLAN and SNE has surfaced in which the former has expressed concern that the draft law is excessively broad in terms of SNE's responsibilities.

d. Obstacles:

(1) Under the new draft legislation, SNE would become a dependency of the Asamblea Legislativa, which would name its board. If

SNE had only oversight responsibilities, this would not be a problem. But its primary responsibility is the fixing of rates and prices, which may more logically be considered an executive function.

(2) The draft legislation links SNE's pricing responsibilities to the costs of production, expansion, and return to capital but does not clarify SNE authorities with respect to groupings of customers or regional considerations.

(3) The draft law's definition of "public utility" is overly broad, creating unnecessary uncertainty. MIDEPLAN's concerns are well founded.

e. Findings:

(1) Updating and clarification of SNE's responsibilities and authorities is clearly desirable.

(2) The draft law needs further work.

(3) AID's very limited involvement was useful.

f. Recommendation:

(1) The draft law should be reworked to focus SNE's responsibilities and authorities on goods and services that are provided through both state and private sector monopolies.

(2) AID and/or other donors should provide technical assistance to SNE to strengthen it.

2. Prudential Supervision (AGEF)

a. Background: As the financial system has grown and diversified, the need for an effective auditing/regulation institution has become increasingly apparent. The Auditoría General de Entidades Financieras (AGEF) is a dependency of Central Bank--AGEF does not have a separate board--charged with these responsibilities. The need for effective oversight was underscored by the retirement in 1990 of Auditor General Rafael Díaz and an interregnum during which it became necessary to intervene the Banco Germano and BANCOOP. (Sr. Díaz has since returned to his post.) It was further underscored by the difficulties of the credit union system under FEDECREDITO, which now views AGEF'S oversight of credit union audit as crucial to the health of the system.

AID financing has been very modest: support of a visit of AGEF personnel to Bolivia.

b. Objective: To assure appropriate and effective oversight of an increasingly diversified system of financial institutions by an independent, professional AGEF, thereby providing depositors and other bank customers with a sense of security that Costa Rica's financial system is solid and reliable.

c. Accomplishments: With the return of Rafael Díaz, momentum exists both to strengthen AGEF internally and to obtain new legislation that will give greater assurance of AGEF's independence. A draft legal framework that would assure AGEF of its own board of directors is now in the Asamblea.

d. Obstacles: A substantial consensus exists about the need for a strong AGEF, particularly in the wake of the Banco Germano and BANCOOP problems. There may be some reluctance in the Central Bank with respect to an independent AGEF board, but such a board could be created without totally severing AGEF's relationship to the Central Bank, as in the case of another Central Bank dependency, the Comisión Nacional de Valores.

e. Findings: Progress is being made to strengthen AGEF. The modest AID help has been useful.

f. Recommendations:

(1) The current and successor governments should assure that momentum for the strengthening of AGEF is sustained, and particularly that the new legal framework is processed expeditiously in the Asamblea.

(2) AID should help with training of AGEF personnel, particularly in countries where the oversight function is well developed (e.g., Chile). AID may also be able to help expand the AGEF library.

3. Securities and Exchange

a. Background: While the Bolsa Nacional de Valores (BNV) has existed for 17 years, Costa Rica's capital market is still very small and thin and is dominated by short-term paper, much of it issued by the government.

The Comisión Nacional de Valores, which oversees financial markets, is a dependency of the Central Bank that has been in operation since 1991.

The CNV operates within an inadequate legal charter, based on an obsolete Mexican law, that includes representatives from institutions regulated by the CNV on its board of directors, an apparent conflict of interest. (Unlike AGEF, the CNV has its own board of directors.) The law is also vague with respect to sanctions.

An improved law is being drafted for review by interested institutions (e.g., the BNV) and subsequent presentation to the Asamblea.

AID sent the CNV director and two senior CNV officers to Washington for three weeks to work with the Securities and Exchange Commission (SEC). The IDB has also brought SEC experts to Costa Rica to discuss regulation and disclosure issues. The only AID assistance to the BNV has come through the Federación de Entidades Privadas de Centroamérica y Panamá (FEDEPRICAP).

b. Objectives:

(1) To broaden and deepen Costa Rica's capital markets, at the same time assuring their professional, responsible, and proper management.

(2) To assure adequate oversight of capital market operations by an independent, professional, effective CNV.

c. Accomplishment: The CNV has made progress in its brief existence, but it is still feeling its way and needs help.

d. Obstacles:

(1) As is apparent from the limited size of Costa Rica's capital market, even after 17 years, much needs to be done to enhance the role of securities and commodity exchanges in the Costa Rican economy.

(2) The current tax structure discriminates against equity investments in favor of interest-producing instruments.

(3) There is a significant imbalance in experience between the BNV and the CNV.

(4) Costa Rica has little experience with judicial branch involvement in financial market oversight.

e. Findings:

(1) There is high interest in both the BNV and the CNV in changes to the pensions law that will facilitate private sector investment from pensiones complementarias.

(2) There is a gap in Costa Rica's capital mobilization structure with respect to investment banks, which can help mobilize resources for new enterprises and expansion of existing ones.

(3) AID's help to the CNV was very useful both in terms of orienting CNV policies and operations and for its contribution to the drafting of new CNV legislation.

f. Recommendations:

(1) The expansion of Costa Rica's capital market should receive priority attention because of its key role in the mobilization of the capital needed to drive the investment, production, and exports on which the country's economic stability and development depend.

(2) A new legal charter for the CNV should be given priority attention by concerned public and private sector institutions.

(3) Coordination with other Central American capital markets should be encouraged.

(4) AID should continue to support relationships between the CNV and the SEC, for example, to help strengthen the capacity of the Costa Rican judiciary, through the Escuela Judicial, to deal with capital market cases.

4. Price Deregulation

a. Background: "Price deregulation" is perhaps better labeled "consumer protection." The activity does involve decontrol of prices and profit margins on a large number of products. But it is also designed to protect the consumer against monopoly price fixing and generally to enhance competition. These goals are directly relevant to a macroeconomic policy framework that opens Costa Rica to the world market, particularly via significant tariff reductions.

Efforts in this direction began in the Arias administration, were pushed in the Calderón administration, and have been included in the PAE

III conditionality. AID support amounted to about \$50,000 that was used (1) for visits to Chile and Mexico to observe the experience of those countries with relaxation of price controls, and (2) to support a seminar on deregulation.

b. Objective: To protect the interests of the Costa Rican consumer through the encouragement of competition, including the oversight of monopolies and the facilitation of imports and exports.

c. Accomplishments:

(1) The number of price-controlled products has been reduced from 130 to 7: rice, milk, margarine, sugar, beans, wheat, and white corn.

(2) A draft Law of Promotion of Competition and Protection of the Consumer has been prepared, presented in the Asamblea, and temporarily withdrawn for review by business associations. A revised draft reflecting private sector views is now circulating (see Annex 5). The law would eliminate all licenses, permits, and authorizations for the import and export of agricultural products; the only remaining controls would involve health, safety, and the environment. The law would establish three bodies: the Tribunal Administrativo de la Competencia, the Tribunal de Consumo, and the Comisión de Desregulación Económica, which would be responsible for implementation of the law.

d. Obstacles:

(1) The principal obstacle is the opposition of producers of protected products for the local market, above all agricultural products. Some opponents believe that price controls are an effective way of protecting the consumer.

(2) There is an understandable concern that one set of government controls is being eliminated while another set (the two Tribunals and the Commission) is being created, with a possible net effect of substantial residual government intervention in the market.

e. Findings:

(1) Significant progress has been made toward an understanding of (a) the adverse consequences of governmental price controls for the consumer, and (b) the way the market can operate to benefit the consumer.

(2) The AID resources have played a major role in this transformation. The visits to Chile and Mexico were decisive in changing the attitudes of key Costa Ricans.

f. Recommendation: The current and successor governments should expeditiously process the draft law, assuring that the views of concerned interest groups are considered, but without significantly distorting the intent of establishing a system consistent both with free market principles and the interests of the consumer.

VI. Summary of Key Recommendations

We all feel strongly that Costa Rica's long-term economic well-being and social progress depend importantly on consolidating the substantial achievements of the Public Sector Reform Program and moving ahead to assure that the structure and policies of a modern democratic-capitalist state are fully in place. Particularly with the NAFTA and GATT breakthroughs and the quantum leap toward a truly internationalized economy that those breakthroughs represent, Costa Rica has got to be competitive: it has to be able to generate domestic investment and attract foreign investment; it has to be able to produce efficiently; and it must have the power, transport, and communications infrastructure necessary for a modern economy.

The Public Sector Reform Program has a bipartisan history that should assure its continuity. It is not just a question of satisfying international donor institutions in order to qualify for the very substantial assistance earmarked for Costa Rica--assistance that will make it considerably easier for Costa Rica to adjust to the major changes in policies and institutions called for by the Program. In the long run, the reforms themselves will be far more important than the assistance. That forecast is borne out by the experiences of Spain, Taiwan, and Korea over the past three decades.

Our principal, overarching recommendation, then, is that the Public Sector Reform Program continue to be the foundation of Costa Rican national development policy whoever wins the February 1994 election.

With respect to resource mobilization, we urge that the pending banking law be passed as soon as possible and that the new administration define its policies with respect to the role of public commercial and development banks. We believe that it is time to undertake a comprehensive review of the tax structure with a view to rationalizing it. We urge the new administration to give customs reform the final push that will be necessary to overcome the deeply-entrenched (and corrupted) vested interests. And

we also urge that the new administration not lose sight of the importance of doing away with non-tariff barriers whose real motive is to deter trade.

With respect to resource allocation, we recommend that the new government revive the stalled budget reform initiative and continue the process of privatization based on an objective assessment of the national interest, not on outdated ideological prescriptions.

With respect to public sector effectiveness and efficiency, we endorse continuation of the downsizing activities but urge that they be implemented within institutional restructuring plans. A final push on the new civil service law will be a major contribution to rational management of the public sector, with favorable consequences for several other Public Sector Reform activities. And further progress on pension reform is necessary to assure that the pension system does not again threaten fiscal stability.

Truly responsive government and popular participation imply decentralization to that level of government best able to assure effective governance and services. Like other Latin American countries, Costa Rica's government is highly centralized in a policy, political, financial, and administrative sense. The provincial governors are appointed by the central government; local governments have little freedom of action with respect to revenue generation and are heavily dependent on central government subventions.

The goal is a significant enhancement of political, financial, and administrative autonomy at levels below the central government, a policy that is likely to strengthen democratic sentiment and institutions in general, as Robert Putnam has demonstrated in the case of Italy in his recent book, Making Democracy Work. Achievement of the goal will require the building of a national consensus that will support the necessary legal and structural reforms. It will require a transformation of the values and attitudes of (a) central government leaders, away from traditional centralization and dominance toward delegation, and (b) people at the grass roots, away from dependency and subordination toward local responsibility and initiative. It will also require active civic and political institutions at the grass roots.

We recommend that the new president name a bipartisan, blue ribbon commission to develop a detailed decentralization plan, including election of governors, within the first year of the new administration. The commission should have high level representation from the central government (e.g., the Ministers of Planning, Hacienda, and Gobernación), the Asamblea (from both parties), local leaders, and private sector organizations. The commission should have qualified full-time staff and should count on the availability of

high quality technical assistance. This would make a highly useful last initiative for AID.

With respect to the last of the functional areas, oversight and regulation, we urge (a) that SNE, AGEF, and CNV receive the support necessary to their important functions, including effective programs of public awareness; and (b) that efforts continue to eliminate price controls.

AID should develop a phase-out plan with the new government as soon after the elections as possible. The new government should understand what AID resources are available, what AID's role has been in the past, and what new starts are possible. Understandings should then be reached that will guide the allocation of the AID resources. The most important ongoing AID activities support banking reform, customs, labor mobility, institutional restructuring, and pensions. The important new opportunity is decentralization.

Annex I
Financial Resources Disbursed for the Reform of the State Program

A. Resources disbursed to FUCE as of 6/30/93 (in millions of colones):

1. "Movilidad laboral"	C3,763
2. Customs reform	232
3. <u>"Reform of the State:"</u>	<u>370</u>
a. Budget reform	21.8
b. "Democratización económica"	5.2
c. Price deregulation	0.5
d. Institutional restructuring	47.1
e. Pensions	3.3
f. Privatization (FERTICA, CEMPASA, INS)	4.3
g. SNE	2.4
h. Tax reform	5.8
i. Others:	
(1) Decentralization, municipal develop.	1.4
(2) Social sector	3.0
(3) Technical secretariat (MIDEPLAN)	33.9
(4) COREC II	12.3
(5) Civic education, citizenship	34.8
(6) Diplomatic service economic training	1.2
(7) High level seminars	23.0
(8) MIDEPLAN statistical network	13.9
(9) Prequalification of consultants	9.9
(10) Costs of administration	<u>146.2</u>
Total FUCE	C4,365.0

B. Resources disbursed by FINTRA (millions of colones):

1. CODESA privatization	7,633.0
2. "Democratización económica"	64.1
3. Institutional restructuring	4.0
4. Privatization of INS, FANAL, CNP stores	94.2
5. SNE	4.7
6. Courses, seminars, publications	<u>7.0</u>
Total FINTRA	C7,807.0
Total FUCE and FINTRA	C12,172.0

(continued)

C. Resources disbursed by USAID through PATS (US dollars):

1. Banking reform	\$7,590
2. Budget reform	31,789
3. CODESA privatization	14,342
4. Customs reform	258,121
5. "Democratización económica"	22,550
6. Price deregulation	46,818
7. Institutional restructuring	679,452
8. Pensions	203,558
9. Sigma I contract	147,887
10. Lecturers for State Reform Seminar	<u>7,074</u>
Total	\$1,419,181

D. Academia de Centroamérica macroecon policy contract \$625,000

Total US dollars \$2,044,181

Annex 2
Achievements of Program of "Movilidad Laboral" (PML)

A. FUCE data

1. 1,998 autonomous institution employees paid by FUCE
2. 4,502 central government employees paid by FUCE
3. 6,500 (all) public employees paid by FUCE at cost of C3,395 million
4. Total number of employees paid by FUCE and government: 7,254
5. Profile of participating employees (FUCE and central government):
 - a. with incentives: 3,746 employees (49%); without incentives: 3,498 employees (51%)
 - b. by occupation: professionals 5.2%; office workers 15.1%; operators 6.9%; laborers 46%; technicians 18.4%; others 8.3%
 - c. by age: up to 24 4.2%; 25-29 10.9%; 30-34 19.9%; 35-39 19.2%; 40-44 13.6%; 45-49 9.5%; 50-54 9.1%; 55-59 6.9%; over 60 6.9%
 - d. by years of service: 0-4 9.8%; 5-9 18.7%; 10-14 30.8%; 15-19 19.9%; 20-24 11.3%; 25 or more 9.5%
 - e. gender: men 71%; women 29%
6. Cases of induced "mobility": ICT (without incentives), INCOFER (incentives of up to three months, horizontal mobilization, and pension. After the resolution of the Sala IV, 494 cooks opted for voluntary mobilization without incentives; MOPT and INVU did not employ induced "mobility," but did encourage voluntary decisions.
7. Only 1% of the former employees have returned to the public sector. Some cross-controls exist to avoid the return of former employees, although there are still problems with public institutions outside of Civil Service. The Ministry of Hacienda is trying to strengthen the cross controls.
8. 76.5% of PML participants come from entities where there has been a restructuring effort--INCOFER, MOPT, CNP, MIDEPLAN, CODESA, BCCR, FANAL, MAG, Gobernación, and Seguridad.

9. The reform efforts with the Dirección Nacional de Pensiones has resulted in a diminution of the amount of pending work, resolving about 1,800 requests for pension as of February 1993.

10. The savings projected to April 1994 total C13,090 million.

B. Summary of report of Silvia Saborio and Victor H. Céspedes:

1. During Phase I of PML, a significant number of INCOFER employees were "mobilized," but FODESAF employees appealed to the Sala IV, and the process was arrested. The goal of 5,000 employees was not realized because of bureaucratic (one might say human) aversion to risk and because of slowness in delivering severance pay.

2. Between 1990 and 1993, the number of employees mobilized was 8,149--6% of total employment.

3. Between 1990 and 1993, the net reduction of employees has only been 3,737: 8,675 slots eliminated versus 4,938 slots created. Excluding slots created in sectors (e.g. education) not subject to PML, the net reduction is about 6,200.

4. As of February 1993, the amount disbursed for mobilization with incentives totaled about C4,000 million.

5. The historic trend of increasing public employment was reversed.

6. Mobilization by sector: 46% of mobilized employees come from institutions of concentration within the PML (MOPT, CNP, and INCOFER); 21% from other central government entities; 15% from other decentralized institutions; 13% of the mobilized employees come from institutions exempted from the PML (ministries of education, health, and security; CCSS); 5% from others.

7. Variety of institutional response to PML: some institutions have mobilized significant percentages of their labor force, while in other institutions, the impact has been virtually nil. This may be explained by the PML's lack of focus, its voluntary character, and the fact that in most cases, the program has not been linked to a rational and integral process of structural transformation.

8. Profile of participating employees:

a. by occupation: executives, administrators, or professionals 25%; technicians about 37.5%; workers without specialized skills about 37.5%.

b. by category: Technicians 12%; administrative personnel 10%; professionals 6%; service personnel 6%. This pattern adversely affects the human resources that remain in the public sector.

c. by age: 2 out of every three participating employees were less than 45 years old, the majority between 30 and 40.

d. by length of service: about 70% had 10 or more years of service.

e. gender: the large majority of participating employees were males.

9. Effect on expenditures:

a. The observed reduction in wages and salaries is attributable both to the reduction in employment and a significant decrease in the average salary of public employees.

b. The reduction in employment has been smaller than the reduction in current and total spending in part because of the multiplier effect of reductions in the labor force (e.g. consumables) as well as factors not related to the PML.

10. Adequate procedures and cross-controls are lacking with respect to the recontracting of former employees who try to return to public service.

C. Summary of Demoscopia study (April-May 1992): evaluation of former employees who participated in PML

1. 4 of every 6 former employees were self-employed; 1 in 6 worked in private enterprise; 1 in 6 were unemployed

2. 7 of each 10 participants indicated no problems with respect to their expectations. Many of the former INCOFER employees have experienced deterioration in their circumstances and difficulties finding work.

Annex 3

Targets of PAE III with Respect to Reform of the State

A. Labor Mobility Program

1. Achieve a cumulative reduction of 25,000 slots by the end of 1994 to increase efficiency and reduce spending. This goal excludes slots created in the health, education, and security sectors. The target breaks down into phases as follows:

a. Phase 1 (1991-92): 13,000 employees (to qualify for presentation of PAE III to the IBRD board)

b. Phase 2 (1993): 5,900 employees for the second disbursement

c. Phase 3 (1994): 6,100 employees for the third disbursement

B. FANAL and INS Privatization

1. Presentation of the FANAL privatization law to the Asamblea to qualify for presentation to the IBRD board; sale of FANAL for the third disbursement.

2. For presentation to the IBRD board, a draft law to authorize the operation of private enterprises in the insurance sector within 30 months of the approval of the legislation.

3. For the second disbursement, passage of the new insurance law, which should also include the establishment of an institution of supervision.

4. For the third disbursement, all implementing regulations should be promulgated and the supervisory institution should be functioning.

C. CODESA Privatization

1. For presentation to the IBRD board, the privatization law for CEMPASA and FERTICA should be approved.

2. CEMPASA and FERTICA should be up for sale for the second disbursement.

D. Democratización Económica--The law must be approved as a precondition.

E. Budget Reform

1. For presentation to the IBRD board, new procedures should be implemented in 6 institutions, as a pilot program.

2. For the second disbursement, a plan an agreed comprehensive reform of the budget system.

3. For the third disbursement, implementation of the comprehensive plan.

F. Public Works Concessions--For presentation to the IBRD board, the law for public works concessions should be approved.

G. Deregulation of Prices

1. For presentation to the IBRD board: eliminate all controls except on three products; eliminate controls on profit margins; and prepare the draft law of promotion of competition.

2. Promulgation of the law of promotion of competition is a precondition of PAE III, and its implementation is a condition of the second and third disbursements.

H. SNE

1. For presentation to the IBRD board, a working group should be established that will prepare the necessary regulation to implement the law of regulation of public services, and an action plan should be prepared to restructure SNE.

2. For the second disbursement, the law and implementing regulation should be promulgated, and the restructuring plan should be initiated.

3. For the third disbursement, restructuring of SNE should be implemented.

I. Tax Reform

1. For presentation to the IBRD board: the law of tax efficiency and the law to reform the property tax should be submitted to the Asamblea; a tax package should be prepared; and an action plan for tax and customs administration reform should be prepared.

2. For the second disbursement, the tax efficiency and property tax reform laws should be promulgated, and the tax package should be submitted to the Asamblea.

3. For the third disbursement, the tax package should be promulgated.

J. Banking System Reform

1. For presentation to the IBRD board, private banks should be authorized to accept deposits at whatever term; an action plan to strengthen prudential supervision of the financial system should be prepared and the program of modernizing AGEF should be continued; and a law should be prepared to broaden the concept of financial intermediation that will include the Banco Popular and BANHVI.

2. For the second disbursement: implementation of an arrangement to assure access of private financial enterprises to the Central Bank as creditor of last resort; satisfactory progress in implementing an action plan to strengthen the regulating framework and modernization plan of AGEF; and promulgation of a law that will establish AGEF's supervision of cooperatives.

3. For the third disbursement, full implementation of the framework and modernization plans for AGEF.

K. Pensions

1. For the second disbursement, the Ley de Pensiones Complementarias should be promulgated.

Annex 4**Principal Aspects of Draft Law of "Democratización Económica"**

1. The draft law has two parts: "co-gestión" of public services and auxiliary activities. In "co-gestión," at least 50% should be offered to current employees.
2. With respect to auxiliary activities, priority would go to private enterprises comprised of current public sector employees. One incentive would be an exclusive three-year contract. Other incentives would include participation in the labor mobility activity, credit, and the possibility of transferring physical assets from the public institution to the new enterprise.
3. The draft law authorizes a public institution to contract with third parties partial management or "co-gestión" of the new enterprises. Contracts would be offered, during the first five years, to enterprises organized by former employees, municipalities, or, as a last resort, the private sector.
4. Two additional elements of the draft law: (a) with respect to the labor mobility program, some additional criteria including cases of horizontal "mobility;" and (b) norms related to incentives for contracting former employees (training and payment of social costs for one year); elimination and replacement of public sector slots, permitting mobility within the public sector; consultations and negotiations with employees, their representatives, and their unions); and incentives for the new enterprises with respect to credit and technologies).

Annex 5
Principal Aspects of the Law of Promotion of Competition and Consumer Protection

1. The draft law covers three areas: deregulation of commercial activities; establishment of rules of market competition; and the legal incorporation of mechanisms that guarantee the defense of the interests of consumers.

a. Commercial deregulation: Many requirements and processes that don't protect health, the environment, the security, nor the quality of products are eliminated. In reality, such requirements are unnecessary obstacles to commerce--they get in the way of, slow down, or distort transactions in the domestic and international markets. The draft law maintains but simplifies the administrative regulations for oversight of human, animal, and plant health; environmental protection; security; and compliance with minimum standards of product quality.

b. Promotion of competition: The objective is to remove or regulate those practices that impede, distort, or make more difficult access to and open competition in the marketplace. In particular, the law prohibits public and private monopolies that impede or limit access to the market or try illicitly to force competitors out. Excepted are agents who provide public services consistent with a governmental concession and the state monopolies created by law. Also included are norms to protect against sharp commercial practices. Practices that tend to restrict competition are also covered.

c. Defense of the interests of consumers: The draft law guarantees the right of the consumer to clear, accurate, adequate, and reliable information. It regulates advertising. The state is assigned responsibility for testing quality without impinging on the responsibilities of enterprises to conduct such testing. Other regulations cover futures, sale of products on terms, house-to-house sales, and sales by mail; also abusive clauses in "contratos de adhesión" (frequently used in banking, insurance, and transport).

2. The draft law creates an administrative organ (the Comisión para la Promoción de la Competencia) with sufficient powers to enforce the law with respect to deregulation and competition.

3. Another administrative organ (the Comisión Nacional del Consumidor) is established to enforce consumer protection without prejudice to judicial action in the case of violations of the law.

Annex 6
Findings, Recommendations of 1992 Customs Evaluation

A. Findings:

1. The Vice Minister of Finance, Carlos Muñoz, and the Director of Customs, Fernando Saenz, are both interested in effecting change in the current customs system. However, the project merits much more attention than they can provide.

2. It appears that, for the most part, FUCE has discharged its responsibilities with respect to development of automated systems. FUCE has encountered obstacles: inadequate funding for equipment and inadequate conditions in the facilities destined to receive the equipment.

3. BID/OEA's participation has not been very fruitful. Their role has been diminished, and their future participation will be very limited. FUCE has displaced BID/OEA with good results.

4. Most of AID's resources are aimed at automation. The perception of AID's involvement in the project is very positive at the field level. But the process has been slow. The director's office has not been directly involved in the design and implementation of the systems.

5. Customs facilities were affected by the earthquake.

6. The construction of the new customs facility at CENADA is well advanced and will produce the best facility in the service.

7. Costa Rican customs does much of its business at outside facilities, like fiscal warehouses and free zones, that are in better shape than the customs facilities. There is insufficient supervision of customs employees at the outside facilities, leading to management control problems.

8. The customs service has failed to attract highly educated personnel for field positions, chiefly because salaries are low and working conditions bad. Also, civil service laws are a constraint.

9. Customs personnel duties have been divided up into tasks that often duplicate one another because of mistrust of employee capabilities and integrity.

10. Employees receive little training. What they do receive focuses on basic tasks. This is improving. The Ministry of Finance's training division is working to improve the quality and quantity of training.

11. Bribery is involved in customs transactions. There is very little direct supervision of employees.

12. Importers do not have a customs chain of command to deal with. They either resolve problems with the employee or appeal to the director of customs.

13. Several laws bind the customs service, above all CAUCA and civil service.

14. CAUCA denies the administrator discretion in making changes to job descriptions or assignments because they are specified in CAUCA I. The authority of the customs service to penalize importers/brokers is virtually void because CAUCA penalties are very small. Only inspectors can examine goods. Costa Rica, by the way, is the only one of the five Central American countries that adheres so rigidly to CAUCA.

15. In the few cases where customs has tried to fire employees, the dismissals have been challenged under the civil service law and the employees have won, leaving management very reluctant to fire additional employees. Civil service hires for customs but does not do it well because of ignorance of customs' needs. Customs has often limited itself in personnel actions beyond the limits of civil service.

16. There is concern that some employees will sabotage the computer system out of fear that the computers will displace them.

17. FUCE has amassed a great deal of technical knowledge, but it may be excessive to the needs of operational employees.

18. There is some doubt that the computer system will be completed on time because of fund availability and the need to upgrade facilities.

B. Recommendations:

1. A full-time administrator/coordinator is needed.
2. Customs should improve their facilities and organizational structure.
3. More coordination between FUCE and BID/OEA is in order.

4. Further work is necessary to improve customs facilities.

5. Better controls are needed in fiscal warehouses and free zones, e.g., periodic rotation of employees.

6. A better defined chain of command would help to improve control. Objectives should be set, and supervisors should be held accountable.

7. With energetic work by lawyers and the will of the government, changes can be made in organization and personnel administration even with the CAUCA. Several amendments to CAUCA have been proposed by the GOCR, but there is no final determination.

8. If customs worked more closely with civil service, better results could be achieved in hiring and firing. Even if a new civil service law is not passed, more can be done with the existing law.

9. FUCE should work more closely with training personnel of the Ministry of Finance.