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George Rodríguez

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Moody’s Downgrade of Costa Rica’s Credit Rating, President's Tax Announcement Stir Opposition

by George Rodríguez

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On Sept. 16, the ratings agency Moody’s Investors Service dropped a bombshell on Costa Rica: it announced it was downgrading this Central American nation’s bond rating from Baa3—the level reached in 2010—to Ba1.

In a communiqué, the US-based agency pointed out that the measure was triggered by what it described as institutional weakness regarding fiscal reform and by a forecast for the immediate future of large fiscal deficit plus growing debt burden. The action reflects the agency’s view of unlikely fiscal improvement in Costa Rica in the next couple of years, it specified.

Regarding "institutional weakness," Moody’s stated that it is "evidenced by continued political obstacles to comprehensive fiscal reform."

"Several attempts in recent years to address Costa Rica's growing fiscal deficits and debt have not brought these levels lower. The new Solis administration, which took office in May of this year, has indicated it will only gradually introduce fiscal consolidation," Moody's said, referring to Costa Rican President Luis Guillermo Solís' taking office on May 8, for the 2014-2018 period (NotiCen, April 17, 2014, and May 22, 2014).

Regarding the second factor, Moody's said, "As a consequence of inaction, we expect the current large fiscal deficits and increasing debt burden are likely to continue for the next few years. The fiscal deficit has averaged 4.5% of GDP since 2009, largely driven by spending growth, and is expected to reach 5.8% of GDP in 2014 and 6% next year. The high deficits have materially worsened Costa Rica's debt burden, with debt to GDP expected to rise close to 40% this year, compared to 25% of GDP in 2008."

"The outlook assigned to Costa Rica's Ba1 government bond rating is stable indicating further rating changes are unlikely in the next 12 to 18 months," Moody's added.

Rating agency finds improvements “unlikely”

The downgrade "reflects our expectations that material fiscal improvements are unlikely in the next one to two years," the agency said. "A negative consequence of Costa Rica's entrenched democratic tradition has been the cumbersome process of consensus-building. For the past few administrations, the government's weak position in Congress has delayed approval of legislation because of the need to forge ad-hoc alliances. Consequently, efforts to approve significant fiscal reforms have been impeded."

"We expect continued political obstacles to comprehensive fiscal reform during the Solis administration, in office since May 2014. The government aims to introduce new revenue measures by early 2015, but successful implementation will be difficult and the impact on the fiscal deficit insufficient to undo the rise in the debt burden. We expect that the current government will only gradually introduce fiscal reforms going forward," Moody's forecast.
The rating agency said another driver of the downgrade is "continued weakness in Costa Rica's main fiscal and debt metrics as the country has been unable to bring its deficit back to pre-2009 levels. The central government deficit, which averaged a 0.9% of GDP from 2004 to 2008, rose significantly to an average of 4.5% of GDP from 2009 to 2013." The agency thus referred to the administrations of Presidents Abel Pacheco (2002-2006), Oscar Arias (2006-2010), and Laura Chinchilla (2010-2014), the country's first woman president.

Moody's also forecast "a fiscal deficit of 5.8% of GDP for 2014, which will be almost double the 3.0% median for the 'Ba' category. Absent any change fiscal deficits will average 6%-7% in 2015 and 2016."

"The higher deficits are mostly the result of the steady rise of current expenditures, which have increased 4.5% of GDP since 2008 reaching over 18% of GDP in 2014," the announcement said.
"Expenditure growth was mainly due to increases in wages and transfers that Costa Rica has found difficult to constrain."

"As a result of high fiscal deficits Costa Rica's debt burden, which had fallen to 25% of GDP in 2008, will reach close to 40% in 2014 according to Moody's estimates, and will continue rising in 2015 and 2016," predicted the rating agency, headquartered in New York city.

**Private sector, government respond**

In one of the earliest reactions to Moody’s announcement, the Costa Rican private sector’s top leadership stated that the action was no surprise and that it came as punishment for what it described as this country’s inability to reverse the increasing fiscal deficit.

"The punishment will be seen in the form of a higher debt cost for the public sector and for the private sector," warned economist Luis Mesalles, a member of the Unión Costarricense de Cámaras y Asociaciones de la Empresa Privada (UCCAEP) Board of Directors. "Obtaining funding abroad will be more expensive for the government as well as companies, and Costa Rican families, because confidence is lost in the country’s future payment capability."

Later the same day, Costa Rica’s First Vice President and Finance Minister Helio Fallas said the government informed rating agencies about measures, both in force and to be implemented within months, to strengthen the country’s finances, whose deterioration was passed down to this government by previous administrations.

"Nevertheless, the present government seriously recognizes this situation. The fiscal measures that have been enforced in the short term and those that will be implemented in the following months are aimed at strengthening public finances," Fallas added.

The following day, President Solís told reporters, after a meeting with the Asociación Bancaria Costarricense (ABC), "I don’t see that there’s a crisis here at all. What we’re going to do is to take it (Moody’s action) calmly ... seriously."

Accompanying the president, Fallas said, "We’ve already begun the [fiscal] reform. We’ve taken a bunch of measures to reduce fiscal evasion." He added that a bill has been sent to the unicameral Asamblea Legislativa (AL).

Four days later, the president addressed the nation, and, among other things, he announced two bills to be sent to the Asamblea, one before the end of this year and another sometime next year.
Referring to what Moody’s pointed out, Solís said in his evening message on radio and television, "Of course, we will take measures to start reversing it. Before the end of the year, the government will send the Asamblea Legislativa a bill to transform the sales tax into a value-added tax, without changing the taxation rate of 13% and respecting the exemptions for fields such as health and education."

"This measure will make tax evasion more difficult and will improve tax collection by some 300 billion colones [around US$600 million]," the president said in a recorded message broadcast as he was taking part in the 69th Meeting of the UN General Assembly in New York City. "Also, we’re going to send a bill next year for global income tax, requiring those who receive money from various sources in different countries to pay for all they receive."

"We’ve said it many times; our commitment is to enable the country to create more wealth, to distribute it better, and, in this way, to ensure that our people live in dignity and with more and better opportunities," he underlined.

During the congressional debate of Sept. 22, the day after the presidential announcements, conservative opposition deputies launched strong criticism against Solís’ statements, mostly saying that he was going back on his campaign word that he would not create new taxes during the first two years of his four-year administration and that he would focus on strengthening tax collection.

One of the loudest critics was Otto Guevara, head of the rightwing Movimiento Libertario (ML), a three-time losing presidential candidate and party co-founder who, in his latest bid for office, was one of Solís’ adversaries in this year’s election (NotiCen, Jan. 23, 2014). Guevara said, "That’s fraud," because Solís was "violating what he mentioned during the campaign."

**Legislature calls vice president to testify**

After all the expressions of criticism were heard, the 42 deputies present—of the 57 making up the AL—unanimously voted for calling Fallas to explain Costa Rica’s fiscal situation.

Mario Redondo, sole deputy of the opposition Alianza Demócrata Cristiana (ADC), the key promoter of the initiative, said Falla’s presence in Congress should create a broad debate between the government official and members of the Asamblea.

Emilia Molina, head of the ruling center-left Partido Acción Ciudadana (PAC), said that Fallas had to explain the situation the new government found the country in.

The following day, with Solís abroad, Second Vice President Ana Helena Chacón and Economy Vice Minister Fernando Rodríguez rejected the legislators’ criticism and pointed out that, in view of the usual congressional procedure, in case the fiscal bills were passed, they would not be in force before 2016.

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