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Testing Oscar Arias

By Richard W. Rahn
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SAN JOSE, Costa Rica -- Oscar Arias, while serving his first term as president of Costa Rica, won the Nobel Peace prize in 1987 for helping to negotiate the peace that ended the civil wars in Central America. Last month, after a long absence, he was elected to a second term as president by the narrowest of margins. This time his challenge will be that of revitalizing the Costa Rican economy rather than dealing with the misdeeds of its neighbors.

Costa Rica is as close to a natural paradise as can be found on our little planet. It has beautiful mountains (including a number of live volcanoes) and lovely beaches on both its Pacific and Caribbean coasts. It has many very pleasant micro-climates, enabling one to choose his or her ideal temperature and amount of rainfall. The people, for the most part, are very pleasant and helpful. As a result, it has become a major tourist destination and retirement center for many Americans.

Costa Rica has been an independent country since the first half of the 19th century, and a democracy for most of its history. Its population is well-educated and largely of European descent. The country prides itself on having a reasonably high-quality national health-care system and a peaceful civil society. The agricultural lands are rich and bountiful, and a number of high-tech companies, such as Intel, have established major plants in Costa Rica.

Despite all of these advantages, inflation is high -- over 12 percent last year, and wages are low -- roughly one quarter of the equivalent U.S. wage (on a purchasing power parity basis). So the question is: Why don't the Costa Ricans earn close to their European and American counterparts, given their education levels and natural advantages?

The short answer is they suffer from an excess of bureaucratic statism and corruption (ranking only 46 on the Index of Economic Freedom and number 51 on the index of corruption). Businesses are overregulated, with many nitpicking regulations that only undermine respect for the law and serve as fuel for corruption. The tax system suffers from complexity, poor administration and counterproductive high rates.

The economy is weighted down with all too many state-run monopoly businesses, including the power and telephone companies. The lack of competition results in cell phone services lagging much of the rest of the world. The state owns a number of commercial banks, which undermines the integrity of the financial system. The conflict of interest should be obvious when the referee and the owner is one and the same. The government of Costa Rica owns a monopoly insurance company, which contradicts the basic purpose of insurance -- to diversify risks. With state ownership, it has concentrated the risks and reduced the level of service, something you find with state-owned industries almost anywhere on the globe. The state is involved in many businesses that are totally inappropriate for government, such as a cold storage business.

The vested interest union bosses and other apologists for the welfare state socialism that infects Costa Rica argue that they are just emulating the Scandinavian countries, forgetting that these countries became rich before they engaged in welfare state redistributionist policies. These same countries are now trying to reform those welfare policies because they have resulted in economic stagnation. In addition, most of the European socialist countries have been privatizing many of their state monopoly companies for the last couple of decades because of the inefficiencies and poor service associated with such enterprises.

Costa Rica is also the only Central American country not to have yet ratified the Central American Free Trade Agreement (CAFTA) because some of its politicians have the naive belief that they can negotiate a better deal. The agreement is not perfect, but these local politicians are letting the perfect be the enemy of the good by failing to realize the U.S. has no incentive to reopen negotiations now that the other countries have ratified it. Failure to ratify the agreement will be an economic disaster for Costa Rica.

The good news is that all of Costa Rica's problems have been faced and solved by other countries during the last two decades. Many Costa Ricans like to refer to their country as the Switzerland of Central America -- and the analogy could be more correct if they would pay more attention to looking at and emulating the reasons for Swiss success.

President Arias now needs to use his strong reputation and diplomatic skills to accomplish a true tax reform (lower rates with a broader base, less complexity and better enforcement -- and not instituting a proposed capital gains tax, which would kill the real estate and venture capital markets). In addition, he needs to undertake massive deregulation and de-bureaucratization; wholesale privatization; monetary reform; and a cleanup of corruption and property crime. If he succeeds, he will be once again a domestic and global hero -- and if he fails, his reputation will evaporate.

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