OECD Territorial Reviews

The Mesoamerican Region: Southeastern Mexico and Central America

Summary in English

The Mesoamerican countries' shared economic potential includes a strategic geographic location… Mesoamerica has a variety of rich but often under-utilised resources that contrast with the poor overall economic conditions of the region. First, linking the continents of North and South America and serving as an intermediate location between Asia and Europe, the MAR's geo-political position is one of its greatest assets. Mesoamerica has the potential to become an effective link between large markets and serve as a crucial logistical base for the transport of both cargo and passengers. Currently, the United States remains the number one destination of the region's exports (40.15% in 2003), followed by the region itself (28.75%) and then the OECD countries, excluding the USA and Mexico (16.47%). However, weak infrastructure and logistical services continue to hamper the region's growth and competitiveness.

The combination of Mesoamerica's close proximity with many of its major trading partners (or relatively easy access to its more distant partners) and efficient connections between producers and ports could translate into large competitiveness gains. But to further improve the region's connectivity, access to markets and its business and trade climate, improvements are needed in energy infrastructure, transport infrastructure and other elements of the overall logistics sector. To help turn the MAR's strategic location into a competitive advantage, efforts are under way to strengthen the links between the southeast region of Mexico and Central America, including projects to expand the MAR's logistical corridors and to integrate the region's electricity markets.

… economic opportunities linked to rich natural and cultural resources…

Second, Mesoamerica's rich natural and cultural environment can become a key factor in the region's economic development and offer the opportunity to orientate the tourism and agricultural sectors towards high value-added markets. There are four major characteristics, many of which are closely intertwined, that together help make the MAR an attractive tourist destination: natural resources, archaeological sites, colonial cities and cultural heritage. Focusing the tourism sector around Mesoamerica's commonalities creates a larger tourist attraction base. One of the key challenges for the sector will be finding ways to strengthen the links between the region's large beach resort areas and the smaller eco- and cultural tourism niche markets, both within the same country and across borders.

As for the agricultural sector, the MAR possesses vast resources and ability to produce year round. However, growth in the sector remains modest due to its limited diversification, concentration in low-value added production and high vulnerability to commodity price shocks. To allow Mesoamerica to capitalise on its rich heritage and wealth of natural resources for years to come, the issues of environmental deterioration and resource protection need to be addressed. Many of the region's natural resources currently tend to be utilised as extremely low level inputs in production processes or simply as refuges for garbage and waste, which lead to negative externalities for society and lost opportunities. Better linking the environment to competitiveness strategies will not necessarily cure all of the region's environmental problems but it could help to increase the stock, quality and economic importance of Mesoamerica's natural resources.

… and light manufacturing industries.

Third, the apparel and light manufacturing industries have opportunities for future gains in productivity and competitiveness. Despite facing growing competition from China, the apparel industry can still count on its privileged location and logistical advantages for exporting to the USA. To overcome the new competitive challenges, the industry is looking to diversify its production processes through the adoption of innovative techniques, such as "full package" production. Other light manufacturing industries, including consumer electronics and software, are also emerging throughout the region. Capacity building policies geared towards developing the software industry have been successfully introduced in El Salvador and Guatemala, Honduras has various electronics *maquilas* and important advances have been made by Costa Rica in attracting and developing software and electronic components industries (such as INTEL). To successfully attract to the region firms from these industrial sectors, further advances are needed to ensure that the overall business environment and the quality of the labour supply meets the firms' labour demands. Capacity building, labour training and cluster policies will thus play an important role in promoting these new industries.

Despite its many exploitable resources, the MAR economy is characterised by overall modest growth rates and stark disparities between countries…

In the midst of fluctuating but positive overall growth rates for all countries in the region, distinct above average (Belize, Costa Rica and Panama), average (El Salvador, Guatemala and SE Mexico) and below average (Honduras and Nicaragua) performers emerge based on GDP per capita (Purchasing Power Parity or PPP) figures. The average GDP per capita (PPP) of the MAR in 2003 was USD 5 454, but the range from the highest to the lowest country ran from USD 9 605 in Costa Rica to USD 2 665 in Honduras. The average growth rates from 2000 to 2003 of the high-end (2.05%), mid-range (0.9%) and the low-end (0.8%) groups show that the high-end producers are growing faster and extending their gap over the other groups.

In terms of meeting the Millennium Development Goals (MDG) for poverty reduction and universal primary education, those same countries with average and below average GDP per capita are the ones facing the highest extreme poverty rates and poor education performance. Despite Belize, Costa Rica, Mexico and Panama being further along towards reaching the MDGs, the region as a whole still lags behind the developed countries (MAR's average HDI is 0.734 compared to the OECD average of 0.910).

… between regions within the countries…

Mesoamerica's rural-urban dualism is a prime example of the disparities that exist between regions within the countries. According to 2002 figures from the Economic Commission for Latin America and the Caribbean (ECLAC), 58.6% of the rural inhabitants lived in poverty and 36.6% lived in extreme poverty, compared to 40.3% and 17.3% in the respective urban categories. Rural-urban disparities are not only found in poverty levels but also reflected in overall living conditions and access to labour opportunities. Rural areas are also home to the vast majority of the MAR's indigenous populations which often belong to the poorest, most vulnerable and marginalised segments of the society in Mesoamerican countries.

The poorer economic conditions in many rural areas compared to urban explain in part the rising urbanisation trend in Mesoamerica. The 2005 population figures indicate that the MAR's urban population is 52.4%, and 53.7% of the economically active population is located in urban areas compared to 46.3% in rural areas. Urbanisation in the MAR is not typically marked by modernisation and development but instead it has been linked with a very unequal distribution of population and services. The internal migration to cities is more the result of a lack of income, services and opportunities in the rural areas than a sufficient offer of employment and improved living conditions in the cities. Most metropolitan areas lack the infrastructure and services to handle the population influx and this increases social vulnerabilities and the deterioration of living standards.

… and in terms of individual income distribution.

Mesoamerica's per capita household income distribution by deciles is indicative of the region's high inequality. Income poverty is an issue affecting large segments of the population, leaving them unable to meet their basic consumption needs. In Mesoamerica, a very high proportion of income accrues to the wealthiest segments of the population relative to the poorest. Whereas the richest decile of the people earned 41.9% of the total income in 2000, the poorest decile earned only 0.9%. By contrast, in developed countries the top decile received 29.1% of total income, compared to 2.5% for the bottom decile. Worker remittances represent a growing and important income source for the MAR countries, especially considering the region's lagging economic growth and insufficient creation of formal sector jobs. The remittances can aid in regional development, but since they are spent primarily on private consumption, they can also create negative macroeconomic impacts, such as inflation and real exchange rate appreciation.

Economic and social disparities highlight the magnitude of the MAR's challenges in terms of improving education levels…

Education and access to knowledge are key determinants of poverty levels, yet despite efforts to reform the system Mesoamerica still faces significant challenges in providing effective and sufficient education services. In 2002, only 59.34% of the 15-64 aged population, on average, had completed primary education. The relationship between low education levels and high poverty levels creates a vicious circle since better education is an important tool to move out of poverty but in impoverished areas the access to education is often limited. In Guatemala and Nicaragua, only three out of every five youth aged seven to fifteen in the bottom 20% income bracket attend school, and in El Salvador and Honduras the proportion is three out of every four. Costa Rica and Panama, the countries with the region's lowest poverty rates, performed the best with rates surpassing four out of every five.

The other half of the poverty-education relationship is exemplified by the decrease of poverty incidence as the years of education increase. Poverty incidence exceeds 60% for the population with zero or one year of formal schooling. In contrast, for those that complete primary education (six years) the incidence is below 40% and for those that completed secondary education (eleven to twelve years) the incidence is slightly over 10%.

… and coping with the persistence of the large informal economy.

Gaps in GDP, income and overall human development are not closing in part because of the weaknesses in the labour market. Costa Rica, Belize and Panama, which are consistently the region's leading economies, are the only countries where the formal sector is *larger* than the informal sector. Labour income is the main factor in determining family income in Mesoamerica, yet the labour market is filled with low productivity, low wage and unstable jobs that often do not cover health and insurance benefits. Since the majority of new jobs are created in the informal sector, the productivity and income gains for the region are limited (the average monthly labour income for an informal sector worker in 2000 was USD 171 compared to USD 374 for a formal sector worker).

Thus, to help reduce the MAR's poverty and inequality, it is not just that *more* jobs need to be created, but that *more formal sector and productive* jobs need to be created. Measures that could help increase the productivity and human capital of the informal and low productivity sectors include capacity building programmes and improving credit access. To further reduce informal activity and facilitate the transition of informal businesses into the formal sector, there is a greater need for support for micro businesses and legal framework reforms.

How could Mesoamerica better exploit its economic potential and improve both competitiveness and social cohesion? Regional integration sets the stage for competitive policies.

MAR countries are focusing on improving their competitiveness but their policies could be more strategic to target those factors with the greatest impact on competitiveness overall and for promising sectors in particular. Integration within the region and with external partners serves to enlarge the market size and attractiveness of the region for both local and foreign investors. It also serves to facilitate the movement of labour and capital to more optimal intra-regional levels. There already exists notable movements of goods (28.75% excluding Mexico), labour and capital within the region. DR-CAFTA, the foreign trade agreement between the CA-5[1] countries, the Dominican Republic and the USA, will facilitate deeper integration through the required measures that should improve the predictability of the investment climate by "locking-in" a number of macroeconomic policies. The challenge for the governments of the region lies in the complementary measures that will have to be adopted to optimise benefits of this trade agreement.

Measures to improve the business climate could be complemented by measures to support growth sectors and cluster development at the regional (MAR), national and local levels.

Policy makers in the region, as elsewhere, increasingly emphasise strategies to promote competitiveness. Overall, despite successes with macroeconomic stabilisation, structural reforms and better investment legislation, MAR countries score poorly on international evaluations of competitiveness. Research suggests that, although each country context has its particularities, competitive strategies face similar challenges. Both business environment and cluster/growth sector support policies can be implemented on supranational, national or local levels, or a combination of the above, depending on the nature of the policy and the specific context. Improving competitiveness involves, on the one hand, up-grading capacities in areas that have a general impact on productivity. And, on the other, it involves seising opportunities in more specific sectors where the region has some comparative advantage. With respect to the more general factors, three stand out: 1) human capital development, 2) technology upgrades and quality standards and 3) better regional linkages and co-ordinated supply of basic and higher order services.

Regional programmes to improve human capital development are a priority.

The most significant general constraint is that of limited human capital. Sustained productivity growth depends on human capital investment. Over the last decade, the countries of the region have instituted ambitious reforms to improve the quality of their education systems. Public spending on education, as a share of both GDP and government spending, has increased. Despite greater investment and commitment to reform, the education systems in the region face daunting challenges (high drop-out rates, poor school infrastructure, etc.) with very limited resources. Although the overall situation remains poor by international standards, several regional success stories such as EDUCO in El Salvador, PRONADE in Guatemala and a number of programmes in Mexico (*e.g.*, PIARE or PAREIB), suggest that innovative solutions and systemic reforms can increase educational system access, equity and local autonomy.

For higher education, opportunities to increase quality and supply would involve greater harmonisation of diplomas to facilitate labour mobility and resource pooling, accreditation mechanisms to help monitor quality and other regulations to facilitate multi-country consortia. MAR countries have also made some progress in combining education and vocational training with the needs of firms, but greater progress is needed to transition from a public to private centred model. Given that fewer than 20% of skilled workers in surveyed

[1] The CA-5 is formed by Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua.

firms had training in 2002, public policy could provide greater incentives for firms to invest in human capital.

Improved quality standards and technological upgrades will help increase productivity and access to new markets for the region's firms.

The countries in the region have had limited success in helping local businesses to compete in global markets. This is partly because of limited human capital, partly because of inadequate integration into key markets, but also because of the relative "isolation" of both small and large firms in the region from international production chains. In addition, MAR countries tend to have weak innovation systems with insufficient links between universities, public research and private sector research. Costa Rica is one of the exceptions where the public university has played an important role in key clusters like software and food technology.

Strategies for technology upgrading should take into account the type of upgrade relative to the nature of the firm's position in the value chain and its relationship to other actors in the chain. FDI policies have so far produced few linkages between foreign firms and local suppliers, even though FDI is generally considered to be a key source of upgrading. To reach the large number of disparate firms throughout the MAR who need to improve quality standards, there are alternative upgrade methods such as learning by monitoring. There is great scope for public policy in this area. Government research institutions and universities could play a stronger role in linking firms to the information and methods for the upgrades required to expand into new markets opened through intra-regional or extra-regional trade integration. This requires support for co-ordination among firms as well as the use of capacity building agents who can reach entrepreneurs and producers at the local level. This issue should be closely related to the training aspect of human capital development.

Regional networks between cities could foster the co-ordinated and specialised supply of services.

The region has urbanised significantly. At the same time, the region's cities remain relatively small and tend to provide the same kinds of services, both within and between countries. In the framework of an "open" mesoregional economy, MAR's urban areas will face increased competition from much larger metropolitan hubs which count on strong agglomeration economies. In this context, there is some potential to develop a more strategic approach to the issue of the respective roles of the cities by means of networking or other mechanisms to structure the complementarities among urban areas. Both citizens and enterprises would gain better access to higher order and more specialised services than are currently available. There are international examples of such co-ordination that could prove useful for the MAR.

Policies to support industries with significant potential could address specific barriers as well as develop cluster linkages.

Macroeconomic stabilisation and structural reform programmes can be effectively complemented by strategies that target specific sectors, whether located in regional clusters or more diffuse specialisations. The four sectors discussed below – which are far from being the only such options – have significant growth and employment-generation potential, given the regional endowments. Strategies to overcome "horizontal" impediments, such as low human capital and poor standardisation and technology, along with business environment reform, will have a strong influence on each sector. At the same time, in parallel with more general policy actions, investment in targeted measures for these sectors in a cluster framework could produce good returns.

First, although MAR countries should not rely exclusively on tourism, this sector can become one of the principal drivers of future development.

Tourism has a significant potential to employ the abundant unskilled and semi-skilled workforce and even reach poor communities in rural areas. It can also represent a stable source of export earnings. The principal barriers to tourism development include: high intra-regional transportation costs, poor tourism-specific infrastructure, insecurity, weak tourism promotion, weak protection of natural resources and a lack of regional co-ordination. Nonetheless, the success of the Tikal cultural tourism, ecotourism in Costa Rica and even the mass tourism of beach resorts such as Cancun demonstrate that the region's assets can be harnessed effectively.

Overall, however, the tourism industry in each country does not appear to be reaching its full potential. Initiatives such as the *Ruta Maya* or the *Ruta del Café* show the potential benefits of going beyond purely national strategies towards the identification and promotion of cross-country resources. A significant initiative to improve the performance of the region as a tourism destination is currently being developed by the Technical Secretariat of the Central American Tourism Council (STCCT), which launched, in collaboration with the national governments, the Central American Tourism Promotion Agency (CATA) to promote Central America as a multiple destination by means of a regional "brand name".

Second, diversifying agro-industry to move from regional production to world exports.

MAR countries could increase agro-industry exports with upgrades to standards and technology, while also better serving neglected rural areas. The agro-industry has great potential in Mesoamerica to expand beyond regional production to world export and to diversify and upgrade to higher quality products. Drivers of this potential include: long experience in agricultural production and processing, limited requirements for technology or economies of scale, abundant natural resources to help integrate agricultural production and processing, and a favourable climate that allows for year-round exports. Despite generally low labour and land productivity, unequal land distribution and weak food quality standards, several local food processing success stories in the region, such as Alimentos Kern de Guatemala, the Guatemalan Mahler (Maldonado Hermanos) Company or Dos

Pinos in Costa Rica, illustrate the potential for initially local firms to expand into international markets. The potential positive benefits of agro-industrial development include tighter vertical integration of small and medium-sized producers with consequent improvements in product quality. Many of the issues relating to standards and technology could be addressed through the several agricultural institutions that already exist in the region, such as the Tropical Agricultural Research and Higher Education Center (CATIE), the Inter-American Institute for Cooperation on Agriculture (IICA), the Central American Livestock School (ECAG) and the Pan-American Agricultural School.

Third, light manufacturing industries in the MAR will face increased competition from overseas as a result of integration and will need to move to higher value-added production.

The apparel industry has emerged as the leading industry in the region, both in terms of employment and export earnings, but it is now undergoing a phase of restructuring. Adjustment will inevitably have costs and require measures to help vulnerable households. At the same time, it can be an opportunity to rationalise production and increase productivity. The long-term sustainability of the industry will therefore largely depend on the ability to gain access to quality fabric in a timely and cost-effective manner, to move towards higher value-added products and to upgrade from mere assembly to original equipment manufacturing or full package production. The experience of industrial upgrading of Mexican producers can be a useful reference.

The assembly industry also has clear potential that remains undeveloped. Unlike northern and central Mexico, the MAR outside of Costa Rica has not yet managed to diversify its industrial base in areas such as household appliances, consumer electronics, software or automotive parts. Geographical closeness to large markets (USA, Mexico), abundance of a semi-skilled labour force and imminent preferential trade agreements all make industrial assembly a potentially viable sector. However, there are neither local suppliers nor previous experience that can be transferred from other industrial sectors. The success of some Mexican states in attracting large FDI in electronics and upgrading the skill and technological content of production could provide key lessons.

Finally, the privileged geographical location of the region would support further development of logistics industries.

There are a number of examples of coastal regions that have built strong sectoral strengths around transhipment, grouping increasingly advanced logistical services and processes around transport hubs. The MAR’s unique position offers great opportunities for the development of a logistical sector taking advantage of both north-south trade and trade between Asia and Europe. Panama and its activities around the channel provide an example of potentials that could be further developed across the region. However, there are some significant policy challenges to be addressed. These relate to the quality of the MAR’s transport infrastructure and inter-modal systems, the limited size of ports, duplication between adjacent ports and the transaction costs related to customs regimes and difficult border crossings. Overcoming these hurdles will require greater coordination and harmonisation at the MAR level as well as large investments and changes to regulatory frameworks.

Within these four sectors, cluster initiatives should not be limited to large firms but should also focus on micro-enterprises and SMEs.

Initial competitiveness and cluster efforts have begun primarily at the national level with the largest business owners and a focus on broad industries for export promotion and FDI. This is typical for countries at the same stage of economic development as MAR countries. The next step for the MAR is to complement these macro level initiatives with stronger support for firms of all sizes in key sectors. This also involves a greater focus on more local processes for cluster audits that are more targeted than simply broad industry categories. The MAR can draw on a number of policy measures specifically targeted on cluster support, such as providing common resources for groups of inter-related firms or encouraging linkages between and amongst firms and research providers. These services can be provided by a variety of different actors, government, quasi-government or private depending on their respective comparative advantages. While SMEs and small producers would benefit from cluster policies, it requires a greater level of outreach and co-ordination that is difficult to achieve using typical national level policies and is perhaps best performed at the local level.

Competitiveness and poverty reduction can be mutually reinforcing to create a virtuous circle, but this will require an alignment of two strategies developed on separate tracks.

Competitiveness and poverty alleviation can be mutually reinforcing, thereby creating a virtuous circle in areas such as human development, social dialogue and the business climate. Overall country competitiveness and productivity could also be supported by policies to help transition businesses from the informal to formal economy. For this reason, the multi-lateral agencies have been working to better combine overall economic development and PRS initiatives. Important opportunities for synergies between these two objectives in the MAR region include active linkages between local producers and entrepreneurs and larger national and international suppliers and the ability to capture locally those parts of the supply chain that have greater added value. Measures to upgrade productivity need to address the market failures that prevent the poor from engaging in more productive activities.

Human capital development (basic education, literacy, etc.) and technical assistance with production and microfinance for small-scale producers and entrepreneurs are key elements of more inclusive development approaches. The use of capacity building agents such as NGOs and local governments is important here. Some positive examples of linkages between groupings of small producers and large firms outside the region include Starbucks and Conservation International with small coffee producers in southern Mexico, dairy producers in Nueva Guinea with Parmalat and the Juan Francisco Paz Silva Co-operative in Achuapa which sells sesame oil to the Body Shop. Identifying opportunities such as these is necessarily a task shared by a wide range of national and local stakeholders.

Economic integration per se is just a part of the solution to the MAR's challenges. Realising the potential of the region requires modifying its governance at mesoregional, national and local levels.

The strategies outlined and the policy actions suggested to exploit the MAR's competitive advantages require modification in the governance framework of Mesoamerica as a whole and within its member countries. On the one hand, it is important to reconsider the status of *mesoregional governance*, that is, to what extent are countries co-ordinating their policy in the region. On the other hand, it could help to consider *multi-level governance* issues and in particular, to what extent decentralisation processes and bottom-up initiatives can contribute to engage and co-ordinate into development processes relevant actors at all levels of government.

At the mesoregional level, while economic integration has advanced regional institutions are not in the position to design and implement a common development strategy.

While on the one hand key private sector players have not waited for the advances of the customs union to give a Central American regional dimension to their activities and exploit the potentials of this market, on the other hand institutions, both regional and national, are not responding at the same pace to the challenges and opportunities characterising an increasingly integrated region. Despite advances in mesoregional co-ordination in key policy areas such as tourism development, disaster prevention and border regions management, the lack of policy co-ordination among Mesoamerican countries emerges as a key obstacle to the development of the area. The modest coherence between national and mesoregional agendas in key policy areas, such as competitiveness, trade or infrastructure policy, is evident and has only partially been corrected by the recent launch of the Puebla Panama Plan (PPP) in June 2001, which is currently mainly working as a portfolio of large infrastructure projects. Mesoamerica as the target area of co-ordinated policy is a recent concept whose functioning will largely depend upon the successful integration of Mexico (and possibly other countries) into a renewed Central American system. To help establish a governance of the mesoregional integration process, three key areas for action stand out.

First, regional institutions need to be reformed.

The institutional framework created around the Central American Integration System (SICA) by the Tegucigalpa Protocol in 1991 has been hampered for years by a lack of strategic focus and by the discrepancies between the commitments assumed in Presidential Summits and the actual policies pursued by Central American governments. An example is represented by the difficult and still unresolved process to establish the CA-5 customs union. The complexity of the institutional system and the lack within it of a civil career raise concerns on the sustainability and effectiveness of the present system. Since the end of the 1990s several attempts at reform have been undertaken aimed mainly at revising the role and functioning of the Central American Parliament (PARLACEN), the Central American Court of Justice and SICA's system of Secretariats. Despite important advances made in 2004 a lot remains to be done to establish an actual governance of the MAR. Advisable reforms could include:

- Re-organising SG-SICA's institutions to favour greater institutional efficiency and effectiveness. A *pro tempore* presidency of the SICA has shown potential to better articulate mechanisms of the system and its procedures could now be better defined drawing on positive experiences from other regional integration frameworks. SICA's links with the civil society could be strengthened and the co-ordination difficulties with SIECA could also be addressed. The creation of an Executive Committee with national representatives working closely with the SG-SICA Secretariat was included in the Tegucigalpa Protocol, but it is not clear to what extent this is functioning. Its reinforcement could greatly foster the coherence of the agendas of Presidential Summits and the follow up of their decisions.
- The member countries reassessing the role of PARLACEN. Created in 1986 with the object of serving as a forum for peace this institution has achieved its primary objective and could now be reformed to respond to new challenges. Its dimension and costs could be reassessed in relation with its functions and impact and new membership and working rules should not replicate anomalies that have affected its reputation impacting the image of the whole integration process as a whole.
- Reforming the Central American Court of Justice. Its competences could be better defined and it would be beneficial if all countries ratified its statute and committed to respect it.

Second, institutional reforms could allow for the design and implementation of a territorial development policy for Mesoamerica.

A key challenge for the MAR's institutions is to find new ways to address the relations between regional integration and territorial development so to ensure that integration results in balanced growth across the region. To this aim integration could be coupled with place-based development policies that are capable 1) to help areas in an advantageous position to reap all the benefits (see northern Mexico-NAFTA); 2) to prevent negative effects of trade opening to some regions (see southeastern Mexico-NAFTA) and 3) to foster a bottom-up approach to regional integration thereby enhancing civic participation and reducing public opposition to this process.

There are on-going discussions involving Presidents and the Central American Bank for Economic Integration (CABEI) upon the creation of mechanisms to counterbalance regional effects of the elimination of customs. Instead of focusing exclusively on the effects of reduced border activities in specific border regions, a positive alternative is to develop a regional development programme covering the entire MAR. Drawing on lessons provided among others by the EU's regional competitiveness policy, a MAR territorial development policy would work to valorise the competitive advantages of all regions and to counterbalance the inequalities resulting from the advancements of the integration process. In this framework a prominent role would be given to sub-national governments. A territorial development fund could be created within the PPP as an additional initiative which could serve to give more strategic focus and co-ordination to the PPP's existing sectoral initiatives. This fund could be financed by a redefinition of financial resources assigned to different PPP axes and by resources proceeding from a common customs system. Moreover, a territorial development fund could provide the opportunity to better frame the action of international agencies whose contributions are decisive to the development of Central America but also often a source of distortions and un-coordinated actions.

Third, a mesoregional territorial information system should be created.

Reforming the MAR governance system by introducing regional development mechanisms would not be possible without filling the current lack of intelligence concerning development dynamics at the local level. A permanent forum should be formed putting together those responsible for territorial development policy in the MAR countries as well as experts on territorial indicators. This forum could act initially as a consulting body within the PPP framework and would have as its priority tasks to develop a regional information system capable of providing policy makers with up to date comparable data on socio-economic trends at the local levels. The forum should not only work on setting standards for the collection of quantitative information but also sharing qualitative information on successful local development policies that already exist in the MAR but that are mostly unknown by other countries in the region. To this extent, in the short term, a MAR website could be created to facilitate exchanges at low cost. This forum would benefit from assuming an observatory status in international committees, including some specialised bodies of the OECD, discussing trends in regional policy and indicators.

A renewed mesoregional governance should be mirrored by reforms within each country where the capacity of both national and local governments, and the co-ordination among them, is still weak.

Reforms of regional institutions should be coupled by reforms at national and sub-national levels so that economic integration of Mesoamerica develops towards a process of *integración desde abajo* (bottom-up integration). This implies that strategic policy decisions are nourished by knowledge held at different levels of government and that the design and implementation of policies is supported by appropriate horizontal co-ordination mechanisms at both national and local government levels. Important obstacles towards an effective multi-level governance framework in the MAR are the weak fiscal, administrative and planning capacities of both national and sub-national governments. The tax burden of some Central American countries has increased between 1990 and 2000 but is still very low (an average of 13% compared to 30% in OECD countries). The resulting limited fiscal capacity of these countries has an important impact on spending in key areas, such as education and health care, and these low levels of social expenditure are reflected by the key social indicators in the region. While decentralization trends in all MAR countries, together with numerous international donor supported projects, have increased local governments' responsibilities and resources, their fiscal capacity is still very low. Central government transfers to local governments vary between 5 and 10 per cent in most of the countries. Information on revenues and expenditures at the sub-national level is often incomplete, favouring discretionality and inefficiency in intergovernmental transfers. There is little evidence of clearly established mechanisms for fiscal equalisation which remains largely pursued via political negotiations. Forms of local financing through the emission of municipal bonds are also non-existent.

The administrative and technical capacity of Central American municipal governments is also extremely limited. Only the largest municipalities have professionally trained personnel. The rural and small ones, which constitute more than two-thirds of the total, generally have employees with only primary level education and clerical skills. In Costa Rica, for example, only 5% of local government employees have a professional or technical degree. Until recently, planning processes have been nearly absent from local governance in the Central American region. During the past decade, internationally funded projects have particularly targeted local planning capacity building.

If on the one side, there is a lack of resources at both national and sub-national level, on the other side the introduction of coherent territorial development strategies is often hampered by the lack of co-operation among and within levels of government.

Vertical relations across levels of government are regulated by complex sets of administrative laws which are often unknown to the officials. These laws tend to assign competences for territorial development to different central level ministries without specifying how sub-national authorities should be involved. The result is that there are several areas where neither the central nor the local level act. This is often the case in policy areas such as urban and rural development, environmental protection and water management. Problems with horizontal co-ordination mechanisms are found in both national and sub-national governments. At the central level, there is little sign of co-ordination across sectoral ministries. This is exemplified by the lack of widely shared national strategies for rural and urban development. At the local level, thanks to the action of agencies such as the National Development Commission (CND) in El Salvador or the Nicaraguan Institute for Municipal Promotion (INIFOM), the *asociacionismo municipal* is more and more diffused and takes the form of *mancomunidades* or *asociaciónes de municipios*. These are often geared towards the supply of services to contiguous municipalities but are rarely framed within a provincial or departmental development plan.

An agenda for reform at national and sub-national levels should include three main issues.

The limits of the governance framework described above do not facilitate the design and implementation of regional policies. A number of issues could be addressed within both the vertical and the horizontal governance dimensions in order to couple good governance at the mesoregional level with capacity to involve intermediate and local actors in the design and implementation of development strategies. An agenda for reforms should aim at:

- Improving co-ordination across levels of government.

- Fostering co-ordination mechanisms within levels of government and innovative frameworks for local development in both urban and rural areas.
- Strengthening the administrative and planning capacity of both national and local governments.

First, more and better co-ordination could be achieved through the introduction of innovative contractual relations across levels of government.

A key policy challenge for the MAR countries is to design arrangements that introduce into the traditional hierarchical relations across levels of government some innovative form of organisation based on negotiation and learning processes, with the "sub" level not being looked upon as the mere recipient of a mandate but involved in the design and the implementation of policies. The main instrument that the MAR national governments can use to this aim is fiscal transfers and the contractual arrangements that govern them. As experience in OECD countries shows, the debate in the MAR would benefit by shifting its focus from the mere discussion of the amount of resources available to sub-national level of government, to the issue of how spending capacity should be transferred to sub-national actors. Innovative transfer schemes between different levels of government could lead to new ways for more effective central government involvement in local spending.

These arrangements should aim to stimulate knowledge pooling and effective co-operation across and within levels of government but also greater civil society participation into policy design and implementation. To this aim several examples of innovative contractual schemes, incentives as well as sanction and reward mechanisms could be borrowed from OECD countries. The direct technical assistance, or at least informal exchanges, could be established with countries such as France or Italy that have successfully implemented these types of arrangements.

Second, the MAR countries need to introduce more effective horizontal co-ordination mechanisms at both national and local levels.

Introducing a territorial approach to policy making is largely justified by the necessity of increasing coherence between different sectoral actors at both central and local levels of government. At the national level, moving away from a sectoral approach, the MAR governments face the issue of how to organise their policy action to embrace an integrated approach. Co-ordination is recommended to encourage the various institutional actors to work together to design and implement a national regional policy. Consistency is also requested to ensure that sectoral policies are not contradictory, and that they converge in a coherent strategy. This implies a strong political will to overcome sectoral tendencies and an overall clarification of roles and responsibilities of different ministries or agencies. A key element of an effective institutional and legal framework for regional policy would be the creation of an upper-horizontal co-ordination mechanism for the joint definition and implementation of a National Territorial Development Strategy and for the design of rural and urban development policies. A clear leadership would need to be defined and there would be various options available ranging from *a)* a clear-cut attribution of this responsibility to either an *ad hoc* institution (as in France) or a prominent ministry (as in Italy), to *b)* more flexible forms of inter-ministerial co-ordination headed by the Presidency (as in Mexico).

At the local level, innovative local co-ordination frameworks could be introduced. These could be developed on the basis of existing successful practices in and outside of the MAR. Several options are available ranging from governance tools typically adopted in metropolitan areas (agencies, municipal mergers, etc.) to a wide variety of local co-operation schemes implemented in rural areas. To this regard, the European experience is particularly rich and policy tools like the EU LEADER initiative, the Italian Territorial Pacts, UK's Local Strategic Partnerships and Germany's Regionen Aktiv provide excellent models that could be adapted to MAR's specific conditions. Action will be needed to design and implement two particular types of territorial development schemes which transcend purely administrative/hierarchical relations. The first one consists of introducing micro-regions as target areas for local development policy. This approach, which is already implemented in several EU countries and is particularly advanced in Mexico, has proved to be effective in coping with the challenges that are shared by most of the MAR's rural areas: dispersion of the population (and subsequent difficulties in delivering basic services to remote areas), poverty and strong reliance on agriculture. A second specific territorial approach to be more extensively applied across the MAR is the cross-border one. Following the successful experience of the CABEI's *Programas Fronterizos*, pilot areas could be identified throughout the MAR where cross-border relations are particularly dense and where innovative cross-border governance mechanisms could be tested. Again such areas could borrow international experiences such as the EU INTERREG program.

Third, action is needed to strengthen administrative and planning capacity as well monitoring and evaluation systems.

Introducing a territorial focus on policy making requires changes in organisational structures and governance but also the need to foster the capacity of individuals and the quality of their interaction. Policies for capacity building and knowledge transfer could be developed towards two main objectives. The first relates to the overall need for more efficient and accountable public officials. The second one should focus on the new skills that a territorial approach requires in terms of strategic planning. These are often missing at all levels of government. Successful experiences such as the World Bank led PROTIERRA project or the current capacity building programmes developed by the INIFOM and Honduras's Ministry of the Interior and Justice should be extended to all MAR countries. A technical assistance unit linked with the MAR's regional information system should be created in each country to co-ordinate a number of regional technical units to which knowledge would be transferred and that progressively act also as "terminals" for a two-way feedback relation across levels of government.

The introduction of a territorial approach, and the innovative multi-level governance relations it entails, requires strong monitoring and evaluation systems. Key aspects are the selection of appropriate contextual indicators (both soft and hard) capable to monitor the impact of local development policies. The evaluation system should be linked to an effective communication strategy that works at two levels. Internally, it should involve public and private actors at all tiers of government in a co-operative game showing them the advantages of participating and the disadvantages of not participating. Externally, an effective communication strategy should address both policy makers and citizens to explain the nature of structural disadvantages and promote consensus on policies which may have visible effects only in the medium and long term. Positive results of flagship programmes need to be diffused to the public and to other regions through both communication and networking initiatives.