ELSEVIER

Ecological Economics 37 (2001) 199–215

ECOLOGICAL ECONOMICS

www.elsevier.com/locate/ecolecon

ANALYSIS

Financial sector reform and sustainable development: the case of Costa Rica

Don Goldstein *

Department of Economics, Allegheny College, Meadville, PA 16335, USA

Received 23 December 1999; received in revised form 20 July 2000; accepted 15 November 2000

Abstract

How can financial sector reform be designed specifically so that it enhances the prospects for sustainable development? This paper begins an analysis of this little-discussed intersection, with a focus on the problems and possibilities facing Costa Rica. Policy changes that encourage financial markets to incorporate long-term environmental sustainability concerns will require moving beyond a standard model of financial liberalization. Flighty financial flows, systemic pressures against innovation, and unpriced environmental externalities all mean that real sector environmental performance will be adversely affected by financial sector dynamics, lacking appropriate policy markers. Financial market policies must encourage market forces to channel capital flows that build productive capabilities based on complementarities between development and environmental quality. Costa Rica's reform process and unusual depth of experience in pursuing sustainable development make it an ideal place for such financial market innovations to be attempted. Getting its incentive system right in financial restructuring could aid immensely in the emergence and application of sustainability-based competitive capabilities. A set of market-based 'green' financial reforms is proposed, including tax-advantaged banking and bond programs, rural group lending, and a single certification entity for potential borrowers in these programs.

Keywords: Financial market; Financial liberalization; Capital flow; Sustainability-based competitive capabilities; 'Green' financial reforms

1. Introduction

Much has been written about financial sector reform in developing countries, and also about the problems of financing sustainable development in those nations. But little attention has been paid to the intersection of these issues: How can financial sector reform be designed specifically so that it enhances the prospects for sustainable development? This study is intended to begin to fill that gap, with a focus on the problems and possibilities faced by Costa Rica. Its central arguments are that lacking appropriate public policy

* Tel.: + 1-814-3323340; fax: + 1-814-3322789.
E-mail address: dgoldste@alleg.edu (D. Goldstein).

PII: S0921-8009(00)00278-0

innovations, financial markets will not effectively incorporate long-term environmental sustainability concerns; that adopting such policy innovations will require moving beyond a standard model of financial liberalization (see Stiglitz, 1998) and that Costa Rica's reform process and unusual depth of experience in pursuing sustainable development make it an ideal place for such financial market innovations to be attempted.

Like the concept of development itself, it is difficult to define 'sustainability' in an operationally precise way. Efforts to do so have mostly led to a recognition that in practice it is sufficient to identify a set of widely shared concerns, along with their underlying assumptions and values. Sustainability is generally thought to mean that the interests of future generations are explicitly considered in current choices about the development path, by recognizing growth's spillover effects on the natural ecosystems and social institutions that support human development. In particular, it is thought that sustainable development will require sharply reducing the ongoing, costly (and, in principle, quantifiable) loss of nature's ecosystem services to human society. It is widely assumed that the socio-economic infrastructure inherited from the past — technological, financial, and political — in many respects fails to account for such spillovers, a legacy of times when issues of sustainability were not well understood. Efforts to identify and correct these failures are often motivated also by beliefs that there is intrinsic value in the natural environment and its species diversity, that preservation of social equity and justice is of equal importance, and that the two are closely linked (see for example Costanza and Folke, 1997). In what follows, I focus on problems of environmental sustainability.

The need for sustainable development carries its own set of problems in developing countries. Pressure to play catch-up in standards of living often encourages decision makers' adherence to the widespread notion that for now environmental concerns must be downplayed in a sharp tradeoff with development and growth. Although a growing body of research questions the necessity of such a tradeoff (Porter and van der Linde, 1995; for a Costa Rican application, see Dessus and Bussolo, 1998), the notion remains influential. This problem may be intensified by the state of institutional development in the public sector: even where environmental regulations are on the books, enforcement is often lax or nonexistent.

An additional constraint faced by developing countries is that financial resources are more scarce and financial structures less deep and broad. The financing requirements for sustainable development in the less developed world are immense. Meanwhile, external concessionary aid in general has become sharply limited, and assistance aimed at sustainability in particular shows little prospect of even approaching the level of need (Panayotou, 1997). Lacking a basic reversal of this trend, private financial flows will have to be harnessed to the maximum possible extent to the task of financing sustainability. It is therefore important at the outset to specify the analytical lens through which the problem of financial reform policy will be viewed.

Economic impacts on the environment are mediated, as with any dimension of real sector activity, by the structure and performance of the financial system. Financial markets are comprised of social processes and institutions, and are subject to social and institutional dynamics in handling their stock in trade: promises to pay in a highly uncertain future. Two general problems are most relevant here. First, financial markets may over- or under-fund classes of economic activity that have captured or repelled investor interest. Post Keynesian research has emphasized this problem of 'flighty' financial flows (Grabel, 1995; Kregel, 1998). Unsustainable bubbles in some markets — commercial real estate, in many recent cases — may coexist with other markets in which potential borrowers cannot get funded at rates commensurate with apparent risks — as, for example, mortgage applicants in minority neighborhoods.

Second, capital allocation systems, depending on their institutional and policy frameworks, can enhance or discourage the building of productive capabilities among firms in the private sector. Competitive capabilities theorists have focused on this dimension of national financial structures (for