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SAFEGUARDING EUROPEAN LEADERSHIP ON 'DEFINING GREEN'

Why a strong outcome on the sustainable finance taxonomy is important for the EU's domestic and international policy goals

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The EU's sustainable finance taxonomy provides clarity on what economic activities are 'green'. In the context of the European Green Deal it is inevitably being used to judge whether Europe is serious about its goal of climate neutrality by 2050.

Internal debates that focus on technical classification of activity at the margins risk missing the big picture geopolitically. The potential impact for Member States of undermining the EU's international reputation is much greater than those that could result from confirming that certain economic activities will not be compatible with the climate transition in the long term.

Context

This briefing makes the case for supporting an ambitious, internationally credible, and evidence-based outcome from the current process of finalising the Delegated Act.

The EU taxonomy is a tool for defining which economic activities are classed as 'sustainable'. Its original purpose was to eliminate greenwashing and support investors to make informed decisions. It has more recently been considered as a tool to guide and shape disbursement of EU budget and recovery funds. While it was not the Commission's original intention, the taxonomy now has the visibility and symbolic power to define the 'green' in European Green Deal.

By creating the taxonomy, the EU set a bold new international finance norm.

The taxonomy was a key measure within the 2018 Sustainable Finance Action Plan and many countries have now followed the EU's example by creating their



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own taxonomies. The EU has initiated an international harmonisation process, with China, through the International Platform on Sustainable Finance. The new US administration **has acknowledged** that it will need to take action in this area.

The taxonomy refers to scientific thresholds, but how it is used is a political decision. Deciding on what is environmentally sustainable over the long term is a matter for scientific and technical discussion, rather than a matter for political debate. In the case of climate change, ‘what is green’ is based on the best current understanding of climate science and what is required to reach the EU’s goal of climate neutrality by 2050. The Delegated Act sets out which activities are in this category but does not say anything about how the list should be used or place any investment restrictions on Member States.

Political Dynamics

The Taxonomy Regulation was passed in 2020. It has proved extremely difficult so far in 2021 for the Commission to finalise the details of the taxonomy as set out in the Delegated Act.

Pushback has been strong from high-emitting and incumbent industry sectors. The fossil gas sector has been particularly notable in its resistance to the taxonomy proposals, together with the agriculture and forestry sector. Low carbon sectors have been less well represented with mixed views expressed about the future of hydrogen, and the financial sector has expressed split views. Nevertheless, to date, the principle that the taxonomy is a science-based tool has been maintained by the Commission.

Several Member States have pushed back on the proposed text of the Delegated Act, on a range of issues but cumulatively raising the prospect of a veto in Council. The treatment of fossil gas has been a particular flashpoint, with ten Central and Eastern European Member States requesting that it should be included in the green criteria as a transitional fuel. Although not constituting a blocking majority, a majority could be achieved if these Member States join forces with other Member States – including some from the Nordic region - which wish to weaken the criteria on agriculture and forestry in relation to bioenergy. Given the volatile dynamics of the current moment, there is a risk that enough different constituencies within the European Parliament could find fault with the taxonomy to enable a parliamentary veto.

Within the last week, a leaked document indicated that the Commission is considering permitting the inclusion of fossil gas in the taxonomy. Options said to be under discussion have included adding a new category related to electricity grid reliability (which Germany is said to support), greater leeway for including electricity generation from Combined Heat and Power, or loosening the



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restrictions on gas-fired generation within the criteria for Do No Significant Harm. In the same timeframe, Ireland, Spain, Austria, Luxembourg, and Denmark have written to the Commission calling for stringent limits on the taxonomy's lifecycle emissions threshold for energy generation, stating that 'these elements are fundamental to preserve the scientific integrity of the taxonomy'.

Implications for European goals and institutions

The European Green Deal is a growth strategy for the EU that also aims to address the existential threat that climate change and environmental degradation pose to Europe and to the world. It has become Europe's calling card internationally to signal its identity and values.

The taxonomy is a transparency mechanism that reinforces the EU's commitment to science-based assessment and environmental integrity. Even though this may not have been the original intention for the taxonomy, it is now Europe's flagship means of defining 'what is green'.

If Member States agree a "green" classification process for economic activities that is not aligned with climate neutrality by 2050, the credibility of the Green Deal among European citizens and market actors will be cast into doubt.

Reputational damage has already been done by Europe's decision not to use the taxonomy as a guide for green recovery spending. A departure from the use of science-based evidence in the Delegated Act could cause environmental groups to disengage from the taxonomy process. **This would erode its legitimacy for citizens and financial actors, calling into question the integrity of Europe's overall approach to climate change, at home and in international fora.**

The EIB's Climate Bank Roadmap for 2021-25 commits the Bank to aligning its climate and environmental tracking methodology with the EU taxonomy from the start of 2021. **If the taxonomy is permitted to be weakened through the inclusion of fossil gas, the EIB may be forced to reject elements of the taxonomy in favour of its own Energy Lending Policy which rules out investment in fossil fuel projects.**

Implications for Europe's international profile

Internationally, the EU has been a pioneer for introducing the taxonomy concept and leading harmonisation efforts through the International Platform on Sustainable Finance. The current delay of the Delegated Act and rumours of weakening the criteria under political pressure leave space for **questions over the EU's leadership and the criteria's credibility.**

Many countries have followed the EU in creating green taxonomies. If the EU dilutes its ambition, then there is a real risk that one of these will become the de



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facto leader. Candidates for this role include the United Kingdom and the United States. The **UK Government has already announced its intention to create its own sustainable finance taxonomy based on the EU taxonomy's scientific metrics** but with inevitable divergence. John Kerry, during his visit to Brussels and Paris, **suggested that the US will create its own taxonomy, working with other countries.** China, which has been working with the EU to create a 'common ground' international taxonomy, will now co-chair the G20 Sustainable Finance Working Group with the US Treasury. Meanwhile, weaker taxonomies have been produced by Japan and Canada, which would vie for influence with the EU.

The world's leading Multilateral Development Banks agreed on a **methodology** in 2011 that does not permit greenfield conventional fossil fuel power generation to be counted as climate finance. It would be a major blow to the EU's climate credibility if the EU taxonomy was weaker than this long-standing global consensus among multilateral banks.

As the EIB is the champion for climate action among the world's Multilateral Development Banks (MDBs), a divergence between EU and EIB climate ambition would be a very visible development. Some of the shareholders of other MDBs were already reluctant to push them to fulfil their commitments to align with the Paris Agreement. **Therefore, in the worst-case scenario, weakening the EU taxonomy could spark a 'race to the bottom' dynamic on climate action both among the world's multilateral financial institutions and between major economies.**

Key lines to take:

- > **The credibility of the EU Green Deal and 2050 climate neutrality is at risk:** It may not have been the Commission's original intention, but the taxonomy now has the power to define the 'green' in Green Deal. Delivering an evidence-based tool will be essential for the credibility of the EU's leadership both domestically and internationally.
- > **The taxonomy is not a mechanism for controlling Member States' investment decisions.** None of the proposed uses for the taxonomy would stop Member States from setting their own national economic strategies. However, its strategic use could unlock new sources of national finance for future-fit industries and investments that are in line with European policy goals. It will also shed light on how Europe is progressing on shifting finances into green activities.



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- > **If the EU’s international leadership role was damaged this would have a far bigger impact for Member States than any short-term effect from forcing marginal activities onto a list.** There will always be some projects and activities that are worth investing in over the short term even if they may not be compatible with long-term climate neutrality – this is a judgment call for Member States to make and does not outweigh the long-term reputational and economic damage that would be caused by undermining the EU’s flagship definition of ‘green’.
 - > **We don’t have time to get this wrong:** Climate goals such as the EU 2050 climate neutrality target require the energy sector to be decarbonised by mid-century, and this will need to be recognised in an investment classification approach that preserves environmental integrity. Classifying investments that have no long-term future under the Green Deal would slow the reallocation of critical private capital to meet Europe’s targets, and could risk their achievement. The resulting market and policy signals could also slow the achievement of international climate goals which are a strategic priority for Europe.