Overarching recommendations

> Europe’s wide array of public finance tools should be sustainability-proofed through use of the taxonomy and an exclusion list for significantly harmful investments, including the Multiannual Financial Framework, Next Generation EU and InvestEU.

> The European institutions should apply sustainability-related and taxonomy-linked conditionality to state aid decisions and should support Member States to green national budgets and fiscal policy.

> European institutions and Member States should adjust the mandates and capitalisation of public banks in order to achieve sustainability goals.

Today’s public finance decisions will have sustainability impacts at a scale that would have seemed unimaginable only a year ago.

Against the backdrop of the COVID-19 pandemic, the EU and Member States have deployed unprecedented financial support to workers and companies to help tackle the immediate economic crisis. EU and national leaders have also confirmed their continued commitment to the European Green Deal during the economic recovery.³

The European Green Deal Communication identified a goal of achieving climate neutrality by 2050. It also set out the need to redirect public spending towards sustainable priorities and away from harmful activities and proposed to mainstream sustainability across all policies.⁴ To fully implement these proposals, public finance decisions will be required to change how the public sector shapes investment in the real economy and to update the tools that it has at its disposal. In parallel, reforms to long-term structural economic policies

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³ Climate Change News (2020) European Green Deal must be central to a resilient recovery after Covid-19
will be needed to ensure that the restructuring of the economy is in line with sustainability goals.

**Guiding financial flows towards a sustainable economy**

Large pools of public and private capital will be required to make the investments that are needed for Europe’s economic transformation. The European Investment Bank and other national and regional public banks have a crucial role to play in the recovery by providing counter-cyclical investment. With the support of national and local governments, they can both ensure that capital flows to the right places and support project delivery through the local network of project developers and investors.

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**Info:** European public authorities and financial institutions have access to a wide array of economic tools to transition to a sustainable economy.

- **EU and national budgets:** budgeting can be proofed to prevent investment in harmful activities and increase sustainable investment
- **State aid:** aid provided to companies can be directed towards companies with a viable sustainability strategy and net-zero transition plan
- **Fiscal planning:** harmful subsidies can be eliminated and taxation on harmful activities increased
- **Public investment:** public finance institutions and national and local governments can invest in sustainable infrastructure and innovation
- **Macroeconomic policy:** the European Central Bank can use monetary and macroprudential policy to drive sustainable investment

The Sustainable Finance Action Plan adopted in 2018 led to the development of the EU taxonomy of sustainable activities. The Taxonomy Regulation was adopted by the Council and the European Parliament in June 2020. This EU taxonomy will define which activities are classed as ‘sustainable’ in terms of

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5 European Parliament and Council of the EU (2020) *Taxonomy Regulation*
6 European Commission (2020) *Sustainable Finance: Commission welcomes the adoption by the European Parliament of the Taxonomy Regulation*
climate change, environmental and social impacts. The taxonomy will gradually be embedded into law and will be regularly updated and reviewed. It will also underpin classification systems for other areas such as standards, the ecolabel and sustainability benchmarks.

Info: The EU taxonomy of sustainable activities

The taxonomy is a science-based tool for defining sustainable economic activities and reorienting investment towards a sustainable economy.

- The Delegated Acts determining the technical screening criteria for climate change mitigation and adaptation will be adopted by the end of 2020.
- The Delegated Acts determining the technical screening criteria for the other four environmental objectives – namely water, circular economy, pollution, biodiversity – will be adopted by the end of 2021.
- The sectoral coverage of the sustainable taxonomy is incomplete so far. It only covers a subset of sustainable activities and needs to be expanded.
- The taxonomy contains minimum social safeguards and will be reviewed by the end of 2021 to assess whether its scope should be extended to cover social objectives.
- The taxonomy will be reviewed by the end of 2021 to assess whether a taxonomy of unsustainable economic activities should be created.

The European Commission is also assessing the potential development of a taxonomy of environmentally harmful activities to reallocate capital away from activities which are not in line with sustainability objectives and facilitate financial institutions’ management of climate and environment-related risks.\(^7\) A growing number of financial institutions including the European Central Bank have voiced their support for the development of such a taxonomy.\(^8\)

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\(^7\) European Commission (2020) Consultation on the renewed sustainable finance strategy

In addition to the uses originally envisaged for the taxonomy, in the context of economic recovery the European Commission has signalled an intention to use the EU taxonomy to guide the allocation of public spending in the EU budget and recovery package.\(^9\) It is also the European Commission’s intent to support the greening of national budgets.\(^10\)

Info: The EU budget and Next Generation EU

> The Multiannual Financial Framework, also known as the EU budget, has been revamped into a €1.1 trillion package to play a central role in the economic recovery. Despite its limited size, it is an important source of public investment to finance the transition towards a climate-neutral economy.

> The EU’s recovery instrument, also known as Next Generation EU, has been proposed with funding of €750 billion to support the recovery, providing funding through the EU budget to programmes designed to kick-start the economy in line with European priorities and ensuring EU solidarity with the most affected Member States.

However, not all actors are supportive of the current scale and pace of progress on sustainable finance policy and the use of the taxonomy for greening public finances is far from agreed among Member States. Lobbying against climate and environmental regulation has been increasing, putting pressure on the European Commission and Member States.\(^11\) Some Member States are still to be convinced that the transition is viable without further investment in fossil infrastructure, notably in Central and Eastern Europe where coal continues to play a key role.

\(^9\) European Commission (2020) Europe’s moment: Repair and prepare for the next generation
\(^10\) European Commission (2020) European Green Deal Investment Plan
\(^11\) Corporate Europe Observatory (2020) Corona Lobby Watch: Opportunistic lobbyists abuse the EU’s unprecedented health crisis
EU Heads of State and Government reached a €1.82 trillion deal on the overall budget and recovery package at the special meeting of the European Council of 17-21 July.\(^\text{12}\) The €750 billion Next Generation EU is to be composed of €390 billion in grants and €360 billion in loans, and will be attached to a €1.074 trillion seven-year EU budget. The European Parliament’s main groups adopted a resolution saying that they do not accept the European Council’s deal as it stands and are ready to improve the proposal.\(^\text{13}\)

Throughout the remainder of 2020, the European Parliament and Member State governments will negotiate legislation. The German presidency, Members of the European Parliament, and Member State governments will agree details of conditionalities, governance and potential exclusion lists that will bring bite to broad political principles. Throughout the process, the European Commission will play a key role in proposing new ideas notably on the use of the taxonomy of sustainable activities.

**Mainstreaming sustainability in public finance instruments**

In recent years, there has been a steady increase in sustainable investments in Europe, driven by both the public and private sectors.\(^\text{14}\) However, the level of investment has been insufficient compared to the level that is needed to meet the EU’s sustainability ambitions. Since the COVID-19 pandemic, public investment has fallen in several countries.\(^\text{15}\) Concerted public investment in sustainability will be needed to attract private investment and rebuild the economy.

\(^\text{12}\) European Council (2020) *European Council conclusions, 17-21 July 2020*
\(^\text{13}\) EU Law Live (2020) *European Parliament resolution on post-pandemic economic recovery: European Council’s agreement is unacceptable as it stands*
\(^\text{14}\) ESMA (2020) *ESMA Report on Trends, Risks and Vulnerabilities*
\(^\text{15}\) European Central Bank (2020) *Public investment in Europe*
The investment needs to finance Europe’s future sustainability

> The additional investment need for the climate transition stands at €340 billion per year. This includes €240 billion to meet the EU’s current 2030 climate and energy targets and €100 billion for transport infrastructure.

> Meeting the EU’s other policy goals will require a further €447 billion, including €130 billion to deliver environmental goals, €125 billion for the digital transformation, and €192 billion for social goals including housing, health and long-term care, education and life-long training.

> The above are conservative estimates of investment needs. They exclude the higher costs of raising the EU 2030 climate ambition, adaptation and resilience, marine issues and the agri-food sector.

Climate mainstreaming of the EU budget is currently implemented through an expenditure target which can vary across different funding streams. The European Commission proposed a climate mainstreaming target of 25% for the EU budget. At the special meeting of the European Council of 17-21 July, the European Council proposed to raise the target to 30%. However, a report by the European Court of Auditors found that the EU is falling short of meeting the 20% climate target in the 2014-2020 EU budget, and that climate spending is overestimated.

The climate mainstreaming approach is based on climate markers assessing the relative contribution to climate change as opposed to the actual impact of European funds. As such, this approach makes it difficult to assess whether EU budget spending has an impact on reducing emissions and climate vulnerabilities across Europe. The lack of comprehensive data on investment needs, planned investments and actual expenditure disaggregated into the various sectors relevant to climate change is a further challenge to a transparent and accountable allocation of funds.

17 European Court of Auditors (2020) Tracking climate spending in the EU budget
18 CAN Europe (2018) Climate mainstreaming and climate proofing
19 European Court of Auditors (2020) Tracking climate spending in the EU budget; European Parliament Research Service (2019), Mainstreaming of climate action in the EU budget; European Court of Auditors (2017) Landscape review: EU action on energy and climate change
20 Trinomics (2017) Assessing the state-of-play of climate finance tracking in Europe
The European Commission is preparing a new climate and environmental tracking methodology based on the EU taxonomy to improve the tracking of public expenditure at EU level. To be effective in steering the EU towards climate neutrality, the European Commission will also need to devise a role for the taxonomy towards national spending priorities. Advances made in France could serve as the basis for an EU-wide climate and environmental tracking methodology.\(^{21}\)

The European Commission should monitor alignment with agreed targets for mainstreaming sustainability in the Multiannual Financial Framework, Next Generation EU and InvestEU using the taxonomy.

- The taxonomy should be used when designing the climate and environmental aspects of the new methodology for monitoring the proportion of public expenditure that is sustainable, recognising that the taxonomy so far only covers a small set of sustainable activities and will need to be broadened with time.

- Monitoring should be based on the proportion of spend aligned to the ‘substantial contribution’ criteria of the taxonomy as they stand at the time, i.e. monitoring should refer to the climate taxonomy from early 2021, the environmental taxonomy from early 2022, and the social taxonomy from the date when it is agreed.

- In relation to public funding that is specifically ringfenced for sustainability, the taxonomy should be integrated into the guidance, procedures and methodologies used for programme and project selection and appraisal.

- However, new use of the taxonomy should not distract from the existing need to improve the existing assessment tool for impact measurement of EU spending, including inclusion of measures such as emissions reduction and vulnerability reduction.

\(^{21}\) IKEM and I4CE (2019) *Tracking investment into energy transition in Germany and France: a comparison of methodologies and selected results*
The European Commission should improve the reporting and monitoring framework to measure how EU and national spending contribute to sustainable activities.

> For effective use in the public sphere, it will be necessary to update reporting and monitoring to measure how EU and national spending contributes to sustainable activities. For example, an electronic reporting language based on data tagging could be used in national accounts.²²

> Work will also be required to map taxonomy-compliant activities against the Statistical Classification of Economic Activities within the European Community (NACE) codes.

**Strengthening sustainability and resilience proofing**

The EU and Member States continue to finance high-carbon infrastructure, directing public financial resources to projects which could increase the risk of stranded assets and increase the overall costs of getting to climate neutrality.²³

Due to the long lifespans of infrastructure assets, investments must be future-proofed in line with sustainability goals.

The European Green Deal Communication introduces a green oath: ‘Do No Harm’,²⁴ which mirrors the ‘Think Sustainability First’ principle developed by the High-Level Expert Group on Sustainable Finance²⁵ to improve the way the better regulation guidelines and supporting tools address sustainability and innovation issues. The European Commission is preparing new sustainability proofing guidelines which will be based on the taxonomy. These guidelines are intended to be applied by InvestEU implementing partners, providing a reference for private investors and financial intermediaries, and possibly more widely to the EU budget and Next Generation EU. This still needs to be agreed in legislation.

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²² Climate Disclosure Standard Board (2020) eXtensible Business Reporting Language (XBRL)
²³ Euractiv (2019) EU’s new list of energy projects includes 32 gas facilities
²⁵ HLEG (2018) Financing a Sustainable European Economy
The European Commission should require a binding implementation of sustainability proofing throughout the entire Multiannual Financial Framework, Next Generation EU and InvestEU.

> The sustainability proofing guidelines should be used to proof the Multiannual Financial Framework, recovery fund and InvestEU. The sustainability proofing guidelines should be developed based on the ‘Do No Harm’ thresholds and ‘minimum safeguards’ of the taxonomy in addition to an exclusion list for all fossil fuels and other significantly harmful activities which are not covered by the taxonomy.\(^{26}\)

> When a taxonomy of unsustainable activities is developed, this should be used as a basis for the exclusion list.

> In addition, methodologies for public investment should include a ‘Think Resilience’ principle to ensure that relevant sustainability risks have been considered. This is covered in more detail in chapter 5.

**Encouraging sustainable reforms to public banks**

The European Investment Bank and other national and regional public banks are crucial to provide counter-cyclical investment and invest in a green recovery. However, investing in a green recovery will require aligning their activities with climate goals. The European Investment Bank’s revised Energy Lending Policy is a major step in this direction.\(^{27}\) It foresees the phasing out of fossil fuels after the end of 2021. The European Investment Bank will develop a Climate Bank Roadmap to guide its transition.

The European Council has encouraged other public banks to adopt responsible investment policies and to phase out financing of fossil fuel projects.\(^{28}\) Other than KfW in Germany, Cassa Depositi e Prestiti in Italy and Hrvatska Banka za Obnovu i Razvitak in Croatia, no other public banks have as yet made commitments to align with the Paris Agreement. On the other hand,

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\(^{26}\) For an example of significantly harmful activities, see: WWF (2020) *Operational tools for ‘do no harm’ and ‘do good’ approaches in MFF, InvestEU, EU recovery fund and state aid*

\(^{27}\) European Investment Bank (2019) *EU Bank launches ambitious new climate strategy and Energy Lending Policy*

\(^{28}\) European Council (2019) *Council Conclusions on Climate Finance*
EU development finance institutions have shown strong climate leadership, e.g. Agence Française de Développement in France and FMO in the Netherlands.

The European institutions and Member States do not have a clear joint vision for the role of public and development finance institutions in building a more sustainable global economy. Public and promotional banks need clear mandates for sustainability to be provided by national governments. The Finance in Common summit in November 2020 is expected to include a joint declaration which will seek to align 450 public development banks with the Paris Agreement, SDGs and Convention on Biological Diversity, creating an opportunity for shareholders to update the mandates of the banks and align their activities with sustainability goals and a sustainable recovery from the COVID-19 crisis.

The European Investment Bank has asked EU governments to provide nearly €18 billion and commit €175 billion more to support the EU’s economic recovery and climate ambitions. A capital increase of the European Investment Bank could be agreed by EU Heads of State and Government by the end of 2020.

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European institutions and Member States should adjust the mandates and capitalisation of public banks in order to achieve sustainability goals.

> European institutions and Member States should support the emergence of a strong joint declaration from public banks at the Finance in Common summit in November 2020.

> Public finance institutional mandates should be adjusted to support these institutions playing a transformational role in green recovery, making counter-cyclical investments to support climate neutrality by 2050 and acting as climate banks to mobilise public and private funds at scale. Substantial increases in capitalisation should be considered in support of these expanded mandates.

> European public finance institutions should adopt policies which replicate of the European Investment Bank’s Energy Lending Policy, and which apply to all financial intermediaries.

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29 Politico (2020) EU bank demands €18B plus pledges for more to help pandemic recovery, climate plans
30 European Council (2020) European Council conclusions, 17-21 July 2020
Strengthening sustainability in state aid

The European Commission polices state aid to ensure a level playing field within the single market. State aid refers to any form of assistance to selected “undertakings” by public actors which has the potential to distort competition and affect trade between member states. It can take the form of wage subsidies, relief from tax and social contribution, financial support, and loans and guarantees via banks.

State aid rules are in place to prevent member states from distorting competition, for instance by supporting their own industries or propping up failing sectors. The treaty on the functioning of the EU forbids state aid, apart from in certain specific circumstances: where government interventions are deemed necessary for a well-functioning and equitable economy. In other words, where public intervention can be justified, including for environmental purposes, it can be exempt from the prohibition under specific conditions.

These exceptions are set out in state aid guidelines issues by the European Commission. The guidelines send a strong signal of where intervention is appropriate and where not. From a sustainability perspective, these guidelines would ideally give Member States more space for more sustainable spending, allowing for cleaner markets to be scaled up and “ruling out” support for inefficient and polluting industries in the absence of science-based and just transition plans.

In practice, the impact has been mixed. The guidelines have given Member States space to accelerate the deployment of renewable energy. In 2018, excluding aid to agriculture, fisheries and railways, about 55% of total state aid expenditure was aimed at environmental and energy savings. However, its impact on increasing small-scale renewables has been limited. At the same time, large amounts of state aid are still being granted to activities that have a negative impact on the environment. State aid guidelines have been used to reinforce the dominant market positions of fossil fuel incumbents, through capacity mechanisms, and to subsidise power costs for energy-intensive industries.

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31 E3G (2014) What is state aid?
32 Linklaters (2020) Competition and sustainability: Evolving industrial and State aid policies to fuel green initiatives
Moreover, in the context of the COVID-19 pandemic, state aid rules have been temporarily loosened to give member states room to stabilise their economies.\textsuperscript{34} The European Commission has been approving government plans to support companies, including airline bailouts, without attaching any green conditions to this aid. The latest update of the guidelines includes an obligation on large companies to report on how aid received will be aligned with the green and digital transitions but no further requirements at this stage, though the European Commission has called on member states to ensure that state bailouts have green conditions attached.\textsuperscript{35} Some member states have done so, for example France in its state aid for Air France, but there is a risk of large sums of money going to carbon-intensive sectors in the absence of EU-wide guidance on green conditions.

The European Commission is currently conducting a “fitness check” of several guidelines, including a revision of its Energy and Environmental State Aid Guidelines by the end of 2021, the rules on Important Projects of Common European Interest (IPCEI) and the General Block Exemption Regulation (GBER). This provides an opportunity to further integrate sustainability-related conditionalities in line with the taxonomy and the principles of Do No Significant Harm while phasing out support for fossil fuels. The updated guidelines will also be key in shaping member state recovery efforts over the next few years ensuring that these are consistent with the European Green Deal.

\textsuperscript{34} European Commission (2020) \textit{Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak}

\textsuperscript{35} Euractiv (2020) \textit{EU decides: No green strings attached on cash to virus-hit firms}; Business Green (2020) \textit{EU urges member states to attach green conditions to State Aid, after revamped rules omit mandatory climate conditions}
The European Commission should set sustainability-related conditions for companies requesting state aid based on science-based transition plans and referencing the taxonomy and Do No Significant Harm.

> In the short term, while the temporary state aid framework is in place, the European Commission could require Member States to only give aid to large companies in carbon-intensive sectors in instances where they have climate-neutral transition plans in place or on the basis of commitments to meet emissions and material usage reduction targets. It could also impose conditions on specific types of state aid, e.g. requiring any car-scrappage schemes to promote purchases of electric vehicles.

> In the medium term, the European Commission could propose extended flexibility for a set of “green” activities where it will continue to approve state aid rapidly to give Member States space to lock-in a greener recovery. In the power and transport sectors, the taxonomy could be used as a guide for which activities could be fast tracked. In the buildings, industry and agriculture sectors the European Commission would need to go beyond the taxonomy to define a list of “no regret” investment options in line with climate neutrality.

> In the longer term, once an “unsustainable” taxonomy has been defined, this could be used as a basis for defining activities and sectors for which the European Commission will no longer grant state aid approval.

NB: All these safeguards rely on enhanced reporting and verification procedures.

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36 Bruegel (2020) A green recovery
Strengthening sustainability in national budgets and fiscal policy

Public finance tools and frameworks used by national public authorities have, to date, not been central in advancing sustainable finance. Yet a lack of quantification of either the fiscal risks of climate change or the costs of measures to offset them will undercut the effectiveness of government recovery spending. The European Green Deal Communication sets out the need to redirect national budgets towards sustainable priorities and away from harmful activities. It also signals a need for distribution of responsibility for greening public finances across public finance actors such as national authorities and the European Semester.  ^{37}

Sixteen of the EU’s Member States joined the Coalition of Finance Ministers for Climate Action launched in April 2019 and have endorsed the Helsinki principles which include a principle to take climate change into account in economic and fiscal planning.  ^{38} In addition, 17 of the EU’s Member States are represented in the Network of Central Banks and Supervisors for Greening the Financial System (NGFS), launched at the Paris One Planet Summit in December 2017. EU Member States are also represented by the European Investment Bank, the European Supervisory Authorities (ESAs) and the European Central Bank. These initiatives have operated in silos but there is potential for collaboration to ensure consistencies in approaches to greening public finances.

In terms of advancing sustainable finance, the development of national finance strategies which are costed with specific capital mobilisation plans will be crucial to raise the finance required to meet the EU’s climate and sustainability goals at scale and pace.  ^{39} Some countries have made progress in the development of a national financing strategy. For example, France adopted its Strategy for Green Finance in 2017 while Germany is set to release its Sustainable Finance Strategy later this year.  ^{40} However, the mainstreaming of this practice across Member States lags behind the level of ambition in the European Commission.

The European Commission has several governance tools to monitor national spending, notably the European Semester process which conducts detailed

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38 Finance Ministers for Climate Action (2020) The Coalition of Finance Ministers for Climate Action
analysis to coordinate economic policies across the EU. The European Commission has recently focused on greening the European Semester and aligning it with the SDGs. However, the implementation of country-specific recommendations from this process has declined over time. It will be important to ensure that future recommendations on sustainable investments are implemented through a strong governance process.

**The European Commission should support Member States in adopting national financing strategies aligned with the EU’s vision for sustainable finance.**

> There is a need to reframe economic analysis and planning to drive the required systemic change. The European Commission should provide Member States with guidance on the creation of national financing strategies that translate the priorities identified in the European Semester and national planning processes into specific and coherent integrated investment plans which are costed with specific capital mobilisation plans.

> This could form part of the planned process for refocusing the European Semester process of macroeconomic coordination to integrate the United Nations’ sustainable development goals.

**The European Commission should support Member States to green national budgets and fiscal policy and should work with ECOFIN to define a screening process.**

> National authorities should align national budgets with the taxonomy, eliminate harmful subsidies (such as fossil fuel subsidies) and increase taxation on harmful activities and companies.

> Screening and benchmarking should be based on the taxonomy and should apply ‘Do No Harm’ criteria and stress-testing for different climate impact scenarios to 2050. The taxonomy should be integrated in budget guidelines, pre-budget statements and budget documents.

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41 European Commission (2020) *About greening the European Semester*

The European Commission should improve the machinery of governance to oversee the sustainability of national budgets, state aid and fiscal policy.

- The European Commission should issue Country Specific Recommendations under the European Semester to align national budgets with the taxonomy, eliminate harmful subsidies (such as fossil fuel subsidies) and increase taxation on harmful activities.

- Governance of public spending and fiscal policy should include a stronger role for national parliaments, and for the national finance and economic ministries which set the European Semester’s policy priorities.

- The European Commission should produce an annual report for the European Parliament on the alignment of national budgets, state aid and fiscal policy with the taxonomy.

Integrating sustainability into governance for recovery

The Recovery and Resilience Facility under Next Generation EU, through which most of the money will be disbursed, will sit within the European Semester. Member States will be required to draft National Recovery and Resilience Plans by October 2020 based on the priorities identified through the National Energy and Climate Plans, Just Transition Plans and the European Semester.

There is currently no binding governance to oversee effective spending in line with climate neutrality under the National Recovery and Resilience Plans.\(^{43}\) The National Energy and Climate Plans and Just Transition Plans will be crucial in directing public spending towards the EU’s climate objectives. However, assessments of the National Energy and Climate Plans, on which the Just Transition Plans will be based, have found that they are not consistent with the 2050 climate neutrality target.\(^{44}\)

\(^{43}\) Jacques Delors Centre (2020) \textit{How to spend it right: A more democratic governance for the EU Recovery and Resilience Facility}

\(^{44}\) CAN Europe (2020) \textit{Pave the way for increased climate ambition: Opportunities and gaps in the final National Energy and Climate Plans}; CAN Europe and Sandbag (2019) \textit{Just transition or just talk?}
The European Commission should improve the machinery of governance to oversee the sustainability and fair distribution of recovery spending.

> The European Parliament should be given the oversight to approve national spending priorities submitted under the Recovery and Resilience Facility to ensure compatibility with green, fair and resilient investment goals and to ensure that funding is distributed in those regions of Europe which have the greatest needs.

> Governance of recovery spending should include a stronger role for national parliaments, and for the national finance and economic ministries which set the European Semester’s policy priorities.

> Regular checks should be conducted by the European Court of Auditors in absence of an independent Clean Economy Observatory as part of the Climate Law and action taken to course-correct investments on an annual basis.