The European Commission’s decision to include gas in the EU’s Taxonomy gave way to fears that the EU’s efforts to reach its climate goals have been compromised. The good news is that’s unlikely. The bad news is that this is because the Taxonomy has never been as important for reaching them as many came to believe.

The Commission’s move to include gas in the Taxonomy framework drew a flurry of criticism. Most of it concerns the environmental performance of gas plants and the feasibility of them switching to burning carbon-free fuels which the rules envisage. Some of it comes from a principal stance against the inclusion of a fossil fuel in what is commonly thought of as a framework for certifying green activities. Many, however, have more to do with the purported implications of gas being awarded a green badge rather than its environmental performance itself.

According to these voices, gas’s inclusion in the Taxonomy will lure investors in and lock in the capital in expensive new gas projects, diverting funding away from renewables and giving it an unearned funding discount. These arguments take the debate over gas’s inclusion beyond the issue of scientific credibility and raise the question of whether the move hinders the EU’s efforts to reach net-zero by the middle of the millennium.

This “consequentialist” critique is based on a strong belief that what the Taxonomy is supposed – and able – to achieve, is tilting the playing field in favour of renewables and sustainable activities more broadly, by “channelling capital to green investments” as the EU’s sustainable finance mantra goes. This presupposes that funding for investments deemed in line with the standard will be cheaper and more plentiful and that the ones left out will see their funding conditions deteriorate.

How the Taxonomy works or doesn’t

How exactly that is supposed to come about is less clear, however, or at least not always made explicit. The Taxonomy does not forbid any types of investments and creates no direct financial subsidies for green activities. The main idea is that capital will flow to these investments because asset managers want to package them into financial products to sell to their ESG-hungry clients. As with most disclosure-based regulations, the actual work of capital allocation will be left to the market.

Despite the market for ESG financial products growing rapidly, it is not obvious that investors care about Taxonomy alignment in particular. In fact, the EU regulation on “green” financial products introduces its own, separate definition of what counts as sustainable and offers as many as five categories of financial products, only two of them directly related to Taxonomy. Since EU rules do not sufficiently deter greenwashing, several

Member States are already working on their own green labelling schemes. Even the most ESG-minded investors might then not use the Taxonomy as their exclusive benchmark. Even if they do, the impact on Taxonomy-aligned CAPEX is still unclear.

Climate action beyond the Taxonomy

The hope that the Taxonomy is going to increase funding opportunities for Taxonomy-aligned activities by “channelling capital” to them is thus most likely misplaced. Fortunately, there are other, more dirigiste policies in the EU’s toolbox that could bring about the outcomes some have mistakenly attributed to the Taxonomy.

The most prominent of them is the Emission Trading Scheme, which attaches a price tag to the carbon emissions, making carbon-heavy technologies less price competitive against renewables. This financial penalty is a direct incentive for phasing out high polluting activities and investing in carbon-free alternatives. EU now plans to expand the ETS to transportation and building sectors and to impose a tax on carbon imported from abroad as well (CBAM).

The upcoming revision of the Energy Performance of Buildings Directive, constitutes an even more direct intervention, making a third of total EU building stock up for retrofitting. This will lower the EU’s energy use while crowding in funding flows. Comparatively, there is no direct push for retrofitting under the Taxonomy, as it merely hinges on potential pressure from investors, which is not guaranteed to materialise.

The future of the Taxonomy and sustainable finance

However, if labels for financial products were the only thing at stake here, Member States presumably would not fight that hard over gas’s inclusion. Taxonomy’s use can expand in the future, including for the purpose of dividing and earmarking EU funds, which could result in supplying otherwise unavailable public funding to gas projects. With the proliferation of its use, the Taxonomy could also grow into a universal metric for gauging the progress of transition, which the gas inclusion could distort.

This is not to say that the Taxonomy does not matter today or that the inclusion of gas will not have any perverse effects on private funding flows. Only that this, in line with Taxonomy’s underlying philosophy, is left largely for the financial markets to decide. As it stands today it represents a rather coy way of engaging private finance in the transition to net-zero. In this respect, the EU already sees itself being outrun by the UK which announced mandatory decarbonisation plans for the biggest issuers and financials.

Just as the EU relies on more potent tools in its climate policymaking such as the ETS or CBAM, it still has room to engage finance more forcefully within the realm of sustainable finance regulations, moving beyond simple disclosure requirements and making use of real carrots and sticks, CEE writes.