Abstract: The EU Taxonomy stands in sharp contrast to the principles of a market economy. It requires regulatory knowledge that cannot be expected to exist and hampers rather than stimulates entrepreneurial initiatives for coping with socially relevant scarcities. For all objectives addressed with his approach, more efficient policy instruments exist that play with and not against market forces. Apart from allocative inefficiencies, the Taxonomy-approach opens the door for all kinds of particularistic maneuvers and hidden political agendas. The Taxonomy absorbs high-skilled labor that is in high demand elsewhere in the economy and creates a massive extra bureaucratic burden without any expectable benefit for the total economy. Given the fundamental flaws in the overall concept, policy makers should stop it rather sooner than later.

Keywords: EU taxonomy, market economy, knowledge problem, regulation, sustainability

In a nutshell, the EU Taxonomy is part of an industrial policy approach that aims at steering the production structure via modifying corporate financing conditions. In this context, the EU Taxonomy (taking shape in accessory Delegated Acts) sets up criteria by which economic activities are classified as to whether they (are considered to) make a substantial contribution to the EU’s sustainability objectives (climate change transition and adaptation, sustainable use and protection of water and marine resources, transition to a circular economy, pollution prevention and control, and protection and restoration of biodiversity and ecosystems). Earmarking sustainability-friendly investments is meant to foster green financing, thus providing more favorable financing conditions to those economic activities that comply with the criteria set forth in the Taxonomy.

Based on the Taxonomy, the envisaged new Corporate Sustainability Reporting Directive (replacing the current Nonfinancial Reporting Directive) prescribes comprehensive reporting exercises for large financial and non-financial companies. In these mandatory reports, companies must demonstrate the degree of alignment of the various aspects of their business models with the Taxonomy.
This includes the obligation for financial market participants “to disclose to what extent the activities that their financial products fund meet the EU Taxonomy criteria” (EU Commission 2021a, p. 8).

1 More Restrictive Economic Environment

While the regulations are so far not binding in a sense that they would prohibit non-compliant activities, the overall philosophy nevertheless paves the way for a more restrictive economic environment. Both by anticipating further steps in this direction and by fear of reputational risks in the case of non-compliance, commercial banks and other financial intermediaries are already making financing of non-compliant economic activities increasingly difficult. At the same time, all financing operations are becoming more costly as the reporting requirements create an immense extra bureaucratic burden for anyone seeking funds for investments. The EU Taxonomy Climate Delegated Act alone is 349 pages strong (EU Commission 2021b) while the Technical Annex to the Taxonomy Report on Sustainable Finance fills 593 pages (EU Technical Expert Group on Sustainable Finance 2020).

Environmental and climate goals are the first steps of a longer journey only. More generally, the idea behind the Taxonomy is to generally differentiate between socially desirable/useful and undesirable/harmful economic activities by a large set of regulatory criteria. Thus, further criteria are already on the agenda.

2 Sharp Contrast to Market Principles

The approach of assessing individual economic activities with respect to overarching (politically defined) goals stands in sharp contrast to the fundamental principles of a market system. In a market economy, entrepreneurs do business based on their individual calculations. These calculations use market data (price signals in particular) to assess the profitability of alternative business opportunities. The price system amalgamates all sorts of information on the scarcity of resources and condenses the underlying complexity into crisp numbers, called market prices.

Market prices convey the information on how much the anonymous mass of market participants values individual units of goods and services. This information which is the outcome of a comprehensive social coordination mechanism enables the individual actor to make reasonable economic decisions in a decentralized way. Profitable activities generate more revenue than cost, thus indicating social
desirability as inputs are valued lower than the output the individual economic activity brings about. For unprofitable activities the opposite applies.

To assess the profitability of individual projects, entrepreneurs bring together the value information (provided by market prices) and their individual knowledge on gaps in the market (arbitrage) or new technological solutions (innovation). By pursuing profitable activities and avoiding unprofitable ones, each market participant sends a feedback signal to the rest of the market community in terms of purchasing and selling decisions, thus enriching the price signal with the impact of the individual pieces of knowledge involved in the entrepreneurial decision making. Therefore, market processes allow for the most efficient use of local, situational, and person-bound dispersed knowledge in a society (Hayek 1945).

3 Ignored Social Complexity

It is the very reason for running a market economy that the dispersed knowledge on the micro level cannot be replicated by a set of bureaucratic indicators (and thus cannot be centralized in a public agency). However, the Taxonomy aims at just that. It thereby ignores the most fundamental insights into the raison d’être of a market system. And it asks for something that nobody can deliver (no matter how bright the persons involved may be), namely an assessment of socially desirable outcomes based on a bureaucratic procedure. This impossibility stems from the fact that the economic system is so complex (i.e., creates so many unforeseeable results) that one just cannot tell to what extent an individual activity promotes or hinders a desired outcome. By the same token, interventions (like the Taxonomy) are likely to create unexpected and undesired consequences. The belief in assessing the value of individual economic activities according to a list of criteria compiled by high-level expert groups (rather than relying on market processes) is therefore just a modern version of the pretense of knowledge (Hayek 1974).

4 Better Instruments to Address Externalities

It might be argued that market prices may be distorted due to (marginal technological) externalities, such that individual profit maximization is no longer in line with socially desired results. This, of course, can be the case. But in such cases policy interventions must aim at internalizing the externalities within the market system, not by coming up with an alternative value scheme for individual
economic activities. The latter becomes superfluous once the external effect is internalized. In the field of climate policies, the cap-and-trade approach of the European Union Emissions Trading System (EU ETS) is the way to go for and should be extended further to all sources of emissions. This ensures that overall emission targets are met. By providing a price tag to each ton of CO2 emissions, this restriction shows up in the individual calculations of all market participants whose activities directly or indirectly cause CO2 emissions. It then becomes just another scarcity that market participants will take into consideration (as they reliably do with respect to all other resources that enter their business calculations).

The incentive to avoid costs for CO2 licenses will trigger all the incentives it takes to promote dynamic efficiency leaving no room for “the EU Taxonomy criteria [to] provide a reference point for companies in their decision-making regarding their green transition” (EU Commission 2021a, p. 11). If entrepreneurs seeking for funds to push through new ideas must wait until their innovations get the approval of being officially Taxonomy-aligned a lot of time is lost. Plus, many entrepreneurial endeavors are built on speculative assessments that are hard to formalize. The more restrictive the financial environment becomes the less room to maneuver is left to the entrepreneurial element without which no market system can thrive (Kirzner 1973).

According to the EU Commission “the added value of the EU Taxonomy is that it can help scale up investment in green projects that are necessary to implement the European Green Deal” (EU Commission 2021a, p. 2). There is no such added value. No high-level expert council can come up with criteria that are more efficient in avoiding CO2 emissions (or in pursuing other sustainability goals) than profit incentives for individual businesses. Rather than modifying financing cost based on Taxonomy-criteria, policy making in the EU shall focus on setting up a market framework that defines the rules of the game including environmental standards. This is all the market system needs to function properly.

5 Bureaucratic Indicators Blur Responsibility

On the economy-wide regulatory level the Taxonomy-approach faces problems similar to those known on the corporate governance level from substituting stakeholder value for shareholder value (Smith 2003). When financial success is mixed with other success factors (usefulness to society, customer satisfaction, participation of employees, etc.) the measurement of the non-financial factors as well as the trade-offs between the various dimensions of the widely defined
corporate performance become extremely difficult (i.e. impossible). As a result, responsibilities are blurred as the corporate management expands its latitude for arbitrary actions arising from hard-to-control trade-offs. It is thus more promising to design the overall framework within which the management operates in such a way that profit maximizing goes hand in hand with the long-term interest of shareholders. In this way, the interests of other stakeholders are indirectly taken into consideration as they are typically necessary enablers for long-run financial success (e.g., satisfied customers or motivated employees are prerequisites for long-term profitability).

In a similar way, it takes a regulatory framework that addresses the root cause of externalities rather than redirecting investment flows based on a value scheme that is alien to the market economy. As Friedman coined it: “There is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud” (Friedman 1962, p. 133).

6 Room for Lobbyism and Hidden Political Agendas

Apart from allocative inefficiencies, the Taxonomy-approach opens the door for all kinds of particularistic maneuvers and hidden political agendas. Whoever has the power to define the criteria, controls an instrument that gives preferential treatment to some business models (including strong incentives for green-washing) and that puts others at a disadvantage. Given the complexity of the matter, democratic control is illusionary. Thus, lobbyists will spend a lot of efforts to make sure that the Taxonomy supports their own interests and harms those of their competitors. As always, larger companies will find it easier to comply with (and to campaign for) complex regulations than smaller ones. Also, the Taxonomy as such is prone to massive lobbyism as it provides a rich new business model for the financial industry and business consultants. Thus, it paves the road towards an even broader rent-seeking society (Tullock 2005).

More generally, the Taxonomy runs the risk of politicizing economic activity in an unwarranted manner. The example of how to treat the armaments industry (are weapons contributing to sustainability or not?) demonstrates how highly normative aspects or arbitrary assessments are smuggled into a policy tool that claims to merely enhance the transparency of business models. Weapons are not per se good or bad. It always depends on what they are used for. This basically
applies to all goods and services. Thus, it makes no sense to gauge the contribution of an individual economic activity to sustainability or other political goals. The permissible use of goods and services (e.g., export controls of military equipment) must be defined by the overall regulatory framework making any restrictions on productive economic activities superfluous.

7 EU Needs Productivity Boosters, Not Blockers

EU member states face substantial headwinds for economic growth in the upcoming years. Demographics reduce the workforce, decarbonization requires substantial investment spending for rebuilding (rather than extending) production capacities and neo-protectionism threatens the gains from globalization. While the increase of economically inactive people in relation to the labor force would require a shift towards more consumer goods and services, the path towards zero net emissions implies the opposite for the foreseeable future. Thus, distribution conflicts and political tensions tend to increase. The current energy crisis exacerbates the situation as additional resources are needed to bypass Russian gas deliveries and as parts of the capital stock become obsolete given structurally higher energy prices.

Given the gloomy perspective for potential growth, policy makers should focus on those measures that support productivity growth. This includes the abstention from all initiatives that impair productivity. Unfortunately, the EU Taxonomy belongs into the latter category. It absorbs high-skilled labor that is in high demand elsewhere in the economy and creates a massive extra bureaucratic burden without any expectable benefit for the total economy. Given the fundamental flaws in the overall concept of the EU Taxonomy there is little that can be done to repair it. The best way to go for is to drop it entirely.

References

Significant Harm to Any of the Other Environmental Objectives. Also available at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32021R2139&from=EN.


