

# Green Finance: Sustainable Growth And the Circular Economy

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In this article, the author explores EU initiatives and tools for generating green economic growth through the creation of a circular economy using sustainable finance and taxation.

In recent years, the EU has become significantly more ambitious in tackling climate change. The European Commission has taken unprecedented steps toward building the foundations for sustainable finance. The financial sector will be key in helping to meet the targets of the commission's "European Green Deal."

The current strategy<sup>1</sup> includes six sets of actions that:

- extend the existing sustainable finance toolbox to facilitate access to transition finance;
- include small and medium-size enterprises and consumers, by giving them the right tools and incentives to access transition finance;
- enhance the resilience of the economic and financial system against sustainability risks;

- increase the contribution of the financial sector to sustainability;
- ensure the integrity of the EU financial system and monitor its orderly transition to sustainability; and
- develop international sustainable finance initiatives and standards while supporting EU partner countries.

The commission will report on the strategy's implementation by the end of 2023 and will actively support member states in their efforts on sustainable finance.

A greener economy means growth and job opportunities. Eco-design, eco-innovation, waste prevention, and reusing raw materials can bring net savings of up to €600 billion for EU businesses. Measures to increase resource productivity by 30 percent by 2030 could boost GDP by nearly 1 percent, while creating 2 million new jobs. It also benefits the environment and reduces the EU's greenhouse gas emissions, according to the European Commission. However, the commission's statement on the Green Deal suggests it is also politically motivated.<sup>2</sup>

The European Commission has adopted a number of measures to increase sustainable finance. First, the new sustainable finance strategy sets out several initiatives to tackle climate change and other environmental challenges while increasing investment — and the inclusion of SMEs — in the EU's transition toward a sustainable economy. The European green bond standard proposal, for example, will create a high-quality voluntary standard for bonds financing sustainable investment. Finally, the commission

<sup>1</sup>European Commission, "Action Plan: Financing Sustainable Growth," COM(2018) 97 final (Mar. 8, 2018).

<sup>2</sup>European Commission, "A European Green Deal: Striving to Be the First Climate-Neutral Continent."

recently adopted a delegated act<sup>3</sup> on information to be disclosed by financial and nonfinancial companies on their sustainable activities, based on article 8 of the EU Taxonomy.<sup>4</sup>

These initiatives highlight the EU's global leadership in setting international standards for sustainable finance. The commission intends to work closely with all international partners, including through the International Platform on Sustainable Finance, to build a robust international sustainable finance system.

### Green Growth and the Circular Economy

According to the European Environmental Agency, the circular economy is a relevant part of the green economy that more widely addresses human welfare, lifestyles, and consumption models. The circular economy tries to build extensive and inclusive well-being with natural capital, ecosystem resilience, and ecosystem services preservation.

The root of the growing interest in the circular economy is the inevitable need to protect both renewable and nonrenewable natural resources and to develop more efficiency in their use. Since 1900 the world's population has quadrupled. Resource consumption has grown by a factor of 10 and is expected to double by 2030.

A circular economy is an industrial model that is intentionally regenerative. Products are designed to facilitate reuse, disassembly, restoration, and recycling to encourage the reuse of materials. Businesses keep resources in use as long as possible to obtain the maximum value, and then recover and regenerate products and materials at the end of their service lives.

Eco-design is a key element of the circular economy. New engineering (or re-engineering) of

production processes, goods, services, and value chains according to the eco-design criteria includes:

- boosting resource and energy efficiency;
- eliminating toxic and dangerous chemicals;
- reducing environmental impacts in production, consumption, and end-of-life management;
- increasing products' reuse, regeneration, and material recycling; and
- preventing waste production and disposal.

Businesses involved in these activities need to analyze and modify existing products and production processes. This includes:

- Verifying and improving scientific and management models — life-cycle assessment algorithms, environmental management systems, and the certification of products — to make the circular economy criteria more effective.
- Adopting specific models to maximize resource efficiency toward zero waste.
- Developing research and eco-innovation. To enable circular economy models to reduce consumption while improving well-being, it is important to develop the greatest renewable resource we have: knowledge arising from the reuse, regeneration, and recyclability of products, components, and materials.
- Developing renewable energy and materials. Circular economy models require businesses to move away from fossil fuels (which are nonrenewable and contribute to global warming) in favor of renewable energy sources.
- Generating zero disposable waste. In a circular economy model, waste is reused as a resource.
- Addressing inner, multiple, and cascading circles. Inner circles minimize material usage by recovering end-of-life products in the value chain close to their consumption phase. This approach brings a high return on collection and treatment costs in comparison to the costs of disposal.
- Increasing the efficiency of materials used to facilitate the lowering of production costs and prices. This can increase consumption and the pressure on natural resources.

<sup>3</sup>European Commission, Commission Delegated Regulation supplementing Regulation (EU) 2020/852 by specifying the content and presentation of information to be disclosed by undertakings subject to Articles 19a or 29a of Directive 2013/34/EU concerning environmentally sustainable economic activities, and specifying the methodology to comply with that disclosure obligation, C(2021) 4987 final (July 6, 2021).

<sup>4</sup>The EU Taxonomy establishes a list of environmentally sustainable economic activities, providing companies, investors and policymakers with appropriate definitions for which economic activities can be considered environmentally sustainable. See European Commission, "EU Taxonomy for Sustainable Activities."

## Disclosing Nonfinancial Information

EU Directive 2014/95/EU,<sup>5</sup> also called the nonfinancial reporting directive (NFRD), sets out the rules on nonfinancial and diversity disclosure and requires some large companies to disclose information on how they operate and manage social and environmental challenges. This helps investors, civil society organizations, consumers, politicians, and other stakeholders to assess the nonfinancial performance of large companies and encourages these companies to develop a responsible approach to business.<sup>6</sup>

To address shortcomings, planned NFRD revision seeks to:

- ensure that investors have access to adequate nonfinancial information from companies so that they can consider sustainability-related risks, opportunities, and impacts in their investment decisions;
- ensure that civil society organizations, trade unions, and others have access to adequate nonfinancial information from companies so that they can hold them accountable for their impacts on society and the environment; and
- reduce the unnecessary burden on companies of nonfinancial reporting.

On April 21 the commission adopted a proposal for a directive called the corporate sustainability reporting directive, which would

amend the NFRD reporting requirements.<sup>7</sup> The proposal extends the scope to all large companies and all companies listed on regulated markets (except listed micro-companies). It requires the auditing of reported information, introduces more detailed reporting requirements, and mandates that companies report on the adherence to obligatory EU sustainability standards. Companies must digitally “tag” their reported information so that it can be read and integrated into a fully digital system called the “European Union’s capital markets access point.”<sup>8</sup> The corporate sustainability reporting directive proposal foresees the adoption of standard sustainability reporting within the EU. The standards will be developed by the European Financial Reporting Advisory Group and will be adapted to EU policies in accordance with international standardization initiatives.<sup>9</sup>

## The EU Taxonomy for Sustainable Activities

To meet the EU’s 2030 climate and energy targets and achieve the objectives of the European Green Deal, redirecting investments toward sustainable projects is crucial. The COVID-19 pandemic has reinforced the need to redirect capital flows to sustainable projects to make economies, businesses, societies, and health systems more resilient in the face of climate and environmental shocks.

The EU Taxonomy classifies and establishes a list of environmentally sustainable economic activities. It is an important tool for increasing sustainable investments and implementing the European Green Deal. In particular, by providing its list to companies, investors, and policymakers, the EU Taxonomy can create certainty for investors, protect private investors from greenwashing, help companies plan for transition, mitigate market fragmentation, and

<sup>5</sup> European Commission, Directive 2014/95/EU of the European Parliament and of the Council of Oct. 22, 2014, amending Directive 2013/34/EU as regards disclosure of nonfinancial and diversity information by certain large undertakings and groups (Nov. 11, 2014).

<sup>6</sup> The objective of the NFRD is to increase the transparency of social and environmental information provided by companies in all sectors to the same high level in all member states. EU rules on nonfinancial reporting apply to large public-interest companies with more than 500 employees. This covers around 11,700 companies and groups across the EU, including:

- listed companies;
- banks;
- insurance companies; and
- other companies designated by national authorities as public-interest entities.

According to Directive 2014/95/EU, large companies must publish information relating to:

- environmental issues;
- social issues and treatment of employees;
- respect for human rights;
- anti-corruption and bribery; and
- diversity on company boards (age, gender, educational and professional backgrounds).

<sup>7</sup> European Commission, Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC, and Regulation (EU) No 537/2014 as regards corporate sustainability reporting, COM/2021/189 final (Apr. 21, 2021).

<sup>8</sup> European Commission, “Capital Markets Union 2020 Action Plan: A Capital Markets Union for People and Businesses” (2020).

<sup>9</sup> The first set of standards will be adopted by October 2022.

### The Sustainable Grid

Environmental	Social	Governance
<ul style="list-style-type: none"> <li>• Mitigation of and adaptation to climate change.</li> <li>• Water and marine resources.</li> <li>• Resource use and circular economy.</li> <li>• Pollution.</li> <li>• Biodiversity and ecosystems.</li> </ul>	<ul style="list-style-type: none"> <li>• Equal opportunities, access to the labor market, gender equality, and disability.</li> <li>• Working conditions, including wages, social dialogue, and work-life balance.</li> <li>• Human rights, fundamental freedoms, and democratic principles, with reference to the International Bill of Human Rights.</li> <li>• Adequate or equal presence of women in management positions (boards of directors) and during meetings (webinars, Zoominars).</li> </ul>	<ul style="list-style-type: none"> <li>• The role of administrative, management, and control bodies.</li> <li>• Ethics and corporate culture, including the fight against corruption.</li> <li>• Political commitments and lobbying activities.</li> <li>• Management of relations with business partners.</li> <li>• Internal control and risk management.</li> </ul>

ultimately help shift investments to where they are most needed.<sup>10</sup>

The EU Taxonomy uses the “ESG method,” which assesses and monitors a company’s long-term strategic position, operational management, and actual behavior in the areas of society, the environment, and markets.

Under the ESG method (see table):

- “E” stands for environmental strategy assessment, policy, and management system, and the industry-specific environmental impact of production processes and products;
- “S” stands for strategy and social policy, which assesses the quality of the company’s relations with its stakeholders (customers, competitors, employees, management, public and regulatory bodies, shareholders, creditors, local government, international institutions), market positioning, and competitor analysis; and
- “G” stands for governance structure and assesses both market and internal management issues, identifies the company’s governing bodies structure and

main operational characteristics, and connects it with the political, regulatory, and legal specificities of the company’s jurisdiction.

### Toward a Sustainable Taxation System

Shifting toward a circular economy will involve designing a new sustainable tax system for renewable and nonrenewable resources.

Sustainable taxation should encourage positive activities and discourage negative activities. In a sustainable economy, taxes on renewable resources (including labor) are counterproductive and should be abandoned. The resulting loss of revenue could be made up by taxing the consumption of nonrenewable resources and undesired wastes and emissions.

Such a shift in taxation would promote a circular economy with local low-carbon and low-resource solutions. It would be more labor-intensive than manufacturing because economies of scale in a circular economy are limited. Taxes on nonrenewable resources could be charged in a similar way to today’s VAT, including on imported goods. Also, not taxing labor would considerably reduce tax administration — labor tax is based on a large number of small incomes — and reduce incentives for work in the shadow economy, which accounts for a double-digit percentage of many national GDPs.

To get businesses on board with environmental initiatives, governments should consider:

<sup>10</sup> Corporate responsibility plays a key role in highlighting hidden weaknesses. Indeed, the numerous indicators in annual reports offer a second key to understanding companies. The indicators render companies comparable in absolute terms within a sector and over time. The performance of some indicators offers a complementary analysis that is often not yet integrated into financial statements. In this context, the European Commission’s “Corporate Social Responsibility” webpage is an excellent source of information for forecasting the risks and opportunities facing companies, particularly in their relations with their stakeholders (employees, suppliers, customers, local communities, shareholders, and so forth), whatever their sector.



- Changes in depreciation methods. The development of secondhand product markets increases the products' value and prevents them from being depreciated to zero. It also brings up the question of when in the life cycle a reusable resource should be taxed.
- Changing the VAT system to influence behavior. Lower VAT on labor-intensive services encourages repairs and reduces waste.
- Increasing the tax on emissions and technical material consumption. A higher tax reduces the consumption of nonrenewable resources.

The tax system plays a key role in achieving an inclusive circular economy. High taxes on labor push businesses to minimize employees. Resources, however, tend to be untaxed and are therefore used without restraint. This causes unemployment, overconsumption, and pollution. The plan is to put taxes on natural resource usage and pollution and use the revenues to lower the tax burden on labor while increasing social spending. This kind of tax reform would incentivize companies to save resources and the natural world. It would spark job creation and support those who need it most.

### European Green Bonds and Carbon Tax

The European Commission's proposal for an EU green bond standard, published on July 6, comes at a time when the issuance of so-called green bonds<sup>11</sup> is booming, with most issuance and trading taking place within the EU. A green bond is a traditional bond in which the proceeds are used for a project that meets predetermined environmental criteria like the ESG criteria. However, definitions of sustainable activities are often confusing or conflicting. The EU green bond standard would address these inherent problems with a strict transparency and oversight regime.

Investor demand for these assets is strong, although there are growing concerns about greenwashing — particularly with regard to the environmental impact of the underlying projects

financed by the bonds. The dubious practices of some issuers could undermine the entire market.

Although the EU's green bond standard may still be in the future, the commission's proposal could go a long way toward steering investors toward higher-quality bonds and projects. If used widely, a new asset class could emerge in global capital markets. Only projects that are in line with the EU Taxonomy of sustainable activities would be eligible for funding. Issuers would have to provide information at the time of issuance, and subsequently through regular reporting on the use of proceeds and their impact on the environment. Crucially, external auditors supervised by the European Securities and Markets Authority must sign off on a draft EU green bond issue.

Green bonds will be a crucial part of low-carbon transition financing, given their typically long duration and repayment structures (amortization schedule), which are well suited to large infrastructure projects. The use of the EU green bond label will be voluntary, so the extent to which investors use it and mobilize capital for the low-carbon transition should be a measure of its success.

However, the standard described so far is also intended to set a framework for green, and therefore sustainable, assets that are likely to be more successful in the capital markets. Green bond funds and securitization of green bank loans could also mobilize additional funds, but this will depend on whether there is a uniform standard across different issuers and member states.

The European carbon tax is expected to come into force in 2026.<sup>12</sup> It will apply to the cement, steel, aluminium, fertilizer, and energy production sectors. Key elements of the tax include the following:

- At the border, EU importers of goods covered by the carbon tax will register with national authorities and will be able to purchase carbon border adjustment mechanism certificates.<sup>13</sup> The price of the

<sup>11</sup> European Commission, "European Green Bond Standard."

<sup>12</sup> European Commission, Proposal for a Regulation of the European Parliament and of the Council, establishing a carbon border adjustment mechanism, COM(2021) 564 final (July 14, 2021).

<sup>13</sup> See European Commission, "Carbon Border Adjustment Mechanism: Questions and Answers" (July 14, 2021).

certificates will be calculated on the basis of the weekly average price of the EU emissions trading system allowance auction expressed in euros per ton of carbon dioxide emitted.

- By May 31 of each year, the EU importer will be required to declare the quantity of goods and the emissions incorporated in the goods imported into the EU during the previous year.

- At the same time, the importer will deliver at the border the same number of carbon tax certificates as the amount of greenhouse gas emissions embedded in the products.
- If importers can prove, on the basis of information verified by third-country producers, that a carbon price has already been paid during the production of the imported goods, the corresponding amount may be deducted from the final invoice. ■