

Policy Briefing

295

June 2024



Green Taxonomies in the Global South

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Recommendations

Global South countries seeking to use taxonomies to facilitate capital flow should:

- Look to create a taxonomy as one part of a broader framework to facilitate capital flows. This includes ensuring that guidance, policy tools and regulation are aligned with the taxonomy.
- Harmonise definitions globally to achieve scale. This requires adopting criteria from what is already available, adapting existing guidance where needed and creating criteria for new sectors.
- Focus on ensuring the taxonomy is usable locally, while also balancing the need for interoperability across borders.
- Incorporate adaptation and resilience objectives as a priority for Global South countries using international guidance to avoid fragmentation.

Executive summary

Climate change poses an existential threat to the global economy as countries look to mitigate its cause and adapt to its impacts. Emerging economies are estimated to require \$2 trillion in additional finance per year by 2030 to meet the goals of the Paris Agreement, approximately 60% of which would need to come from international sources of private and public capital. Between \$130 billion and \$415 billion per year is further needed to finance adaptation and resilience needs in emerging economies. The current state of financial flows to emerging and least developed economies is far from adequate. For example, in the thematic debt market, which includes green and social bonds and has grown to more than \$1 trillion per year, emerging markets represent less than 20% of green bond issuance and less than 1% is raised by African issuers.

A sustainable finance or green taxonomy is a classification system that identifies economic activities that deliver on given environmental or social goals and that can be labelled or marketed as 'green' or 'sustainable'. This policy brief explores the potential value and limitations of a taxonomy as both a technical tool and a policy tool for the Global South. The policy brief puts forward recommendations for how taxonomies can be used to boost financial flows to meet climate and other environmental goals.

Introduction

Football (soccer) was once a disparate game with different rules across countries. Over a century ago, rules began to be standardised, which meant people in different areas could compete against one another, allowing the game to grow rapidly around the world. It took standardisation to achieve scale.¹ The same is true of financial markets in which the financial system is built on architecture to help standardise reporting, transactions and processes. An example of this is [Swift](#).

By providing clear, granular and science-based definitions, taxonomies have emerged as tools to enable the shift of global capital to investments that support a low carbon economy by standardising green definitions and promoting scale.

The first green taxonomy was published by [Climate Bonds Initiative in 2013](#) as a high-level blueprint for a sustainable economy across a broad range of sectors and assets, many of which were not intuitively green (eg, rail infrastructure, low carbon steel, transmission grid infrastructure). The idea was adopted by Chinese regulators in 2015 with the [Green Bond Endorsed Project Catalogue](#), which underpinned the rapid growth of the Chinese green bond market. The European Commission then published [The Taxonomy Regulation](#) in

¹ Makhtar Diop, 'Harmonising global green taxonomies cannot come soon enough', Eco-Business, January 15, 2024, <https://www.eco-business.com/opinion/harmonising-global-green-taxonomies-cannot-come-soon-enough/>.

2020. There are now approximately 40 taxonomies around the world across developed and emerging markets, including Rwanda, South Africa, Thailand and Hong Kong. These taxonomies are in place, in development or in discussion.

Benefits: Standardisation can lead to scale

By standardising definitions, taxonomies have the potential to scale sustainable finance markets and enable cross border capital flows. Taxonomies create a common language for green and sustainable investments that can replace bespoke definitions and proprietary frameworks.

A taxonomy can also serve as a tool for the transition of high-emitting and hard-to-abate sectors. The transition to a low carbon economy will require the allocation of capital to the decarbonisation of high-emitting but necessary industries, such as cement and steel manufacturing. Allocating green capital to high-emitting industries, however, is a challenge given the complexity of assessing ambitious performance and the potential reputational risks of misallocating capital if the assessment is wrong. As a result, investors with green and social mandates have been hesitant to allocate green capital to heavy industry sectors.² Science-based taxonomies can resolve this complexity by providing simple binary criteria, developed by experts, to evaluate investments in hard-to-abate sectors.

To date, taxonomies have focussed on addressing climate change mitigation, but their structure allows them to be used to meet any environmental objective, including climate resilience. Taxonomies can be used to expand the scope and breadth of what is considered green and can help to channel capital to environmental objectives beyond climate mitigation. The [EU Taxonomy](#) addresses six environmental objectives: climate change mitigation, climate change 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. In the Global South, where adaptation and resilience are critically under-financed, this component is key.

Lastly, a taxonomy can help to align investments with a country's environmental priorities or plans and direct budgets towards more sustainable activities. It can serve as a guiding document for disclosure and labelling of financial products, guide green bond issuance and align green or climate economy policies and incentives. Essentially, it can act as a blueprint to green the economy.

² Asian Development Bank, 'An Overview of Approaches to Transition Finance for Hard-to-Abate Sectors', December, 2023, <https://www.adb.org/publications/an-overview-of-approaches-to-transition-finance-for-hard-to-abate-sectors>.

Limitations: A taxonomy is not a silver bullet

While a taxonomy has immense potential, it is not a panacea. There are valid criticisms from users and developers alike. The existence of a taxonomy alone is insufficient to steer capital. To be effective, it needs to be complemented by other guidelines, implementation support for users and complementary policy measures.

Poor support in the development process also has an impact on taxonomy usability, which can act as a barrier to effectiveness. One criticism is that taxonomy criteria can be highly complex and require sophisticated data inputs to assess compliance, particularly for Do No Significant Harm (DNSH) criteria.³ This is a particular issue for users in the Global South where data availability is limited.

A further potential issue is the trade-off between interoperability and local applicability. This is not the case in all sectors but tends to be problematic for sectors with local standards, such as building, or highly variable baseline data, such as the production of aluminium which is highly dependent on the emissions intensity of the grid. Failing to address this issue can result in gold-plated taxonomies that are not used.

Lastly, the proliferation of taxonomies can create confusion for investors and users. This remains a common criticism of taxonomy development processes worldwide.

While many of these criticisms are legitimate, they can be reduced by designing a taxonomy with associated criteria that is fit for purpose for the jurisdiction it is being applied to.

Relevance of taxonomies for the Global South

The need for North–South financial flows for projects that address climate, environmental and social challenges has been well documented. At the same time, experience from the green bond market has shown that green investors, constrained by limited supply of product, have flocked to buy credible green investments.⁴

To unlock international investment, credibility is key. This is even more important for emerging markets that are often viewed by international investors as having weaker

3 DNSH refers to the checks in place to ensure that an activity does not substantially contribute to one objective but cause harm to another, such as cutting down a forest to build a solar farm. The DNSH tests in the EU Taxonomy have been subject to criticism based on usability grounds – see more here: European Commission Finance, 'Platform recommendations on data and usability', Platform on Sustainable Finance, October, 2022, https://finance.ec.europa.eu/system/files/2022-10/221011-sustainable-finance-platform-finance-report-usability_en_1.pdf.

4 Climate Bonds Initiative, 'Green Bond Pricing in the Primary Market: H1 2023', September 14, 2023, <https://www.climatebonds.net/resources/reports/green-bond-pricing-paper-h1-2023>.

regulatory environments and practices. A science-based taxonomy that is interoperable and aligns with international investor expectations is crucial to this credibility.

Taxonomies have already been developed in emerging markets to meet a range of objectives. In South-East Asia, the Association of Southeast Asian Nations (ASEAN)⁵ developed a regional taxonomy. This taxonomy recognises ‘that a common understanding of what is sustainable is essential for ASEAN to attract and orient capital towards sustainable investments and away from non-sustainable activities’.⁶

The Colombia Green Taxonomy will be used to guide the issuance of green bonds and is anticipated to ‘play a key role in channelling private sector capital towards its environmental priorities’. While it has been adapted to the local context, it also follows international standards such as those of the EU Taxonomy.⁷

The South African Green Finance Taxonomy is intended to provide clarity to the financial sector on identifying green investments, reducing the costs of issuing a labelled financial instrument, supporting regulatory and supervision oversight of the financial sector and providing regulators with a reference to align green financial products.

Lessons for the future: Creating usable and interoperable taxonomies for the Global South

Developing a taxonomy as a first step

Taxonomies will not address barriers to accessing finance. Given this, a taxonomy should be viewed for what it is – an important building block or first step.

To be effective in attracting finance to the Global South, taxonomies will ultimately need to be complemented by, integrated into and consistent with policy measures, de-risking tools, currency hedging tools and guarantees. Attracting green investors to any of these structures depends on investors trusting that the allocation of capital to ‘green’ investments is credible. This is the role of the taxonomy.

In many countries, including in the Global South, there is limited appetite by regulators to mandate the use of taxonomies in green bonds or corporate disclosure. This is due to a range of factors, including that green bonds and corporate disclosures are not currently regulated, the additional reporting burden may receive pushback from private sector

5 Members: Brunei Darussalam, Burma, Cambodia, Indonesia, Laos, Malaysia, Philippines, Singapore, Thailand and Vietnam

6 ASEAN, ‘ASEAN Taxonomy for Sustainable Finance’, June 9, 2023, <https://asean.org/wp-content/uploads/2023/03/ASEAN-Taxonomy-Version-2.pdf>.

7 The World Bank, ‘Colombia: Leading the path to sustainability in Latin America’, September 7, 2022, <https://www.worldbank.org/en/news/feature/2022/08/31/colombia-leading-the-path-to-sustainability-in-latin-america>.

stakeholders and regulation of green claims to reduce greenwashing is a low priority issue with limited capacity for enforcement. The alternative is for voluntary taxonomies to represent market best practices. This is currently how most of the green bond market is governed, that is, through voluntary structures such as the [Green Bond Principles](#), with one major advantage: the use of common definitions across the market.

Ensuring interoperability to counter fragmentation risks

Interoperability is the term used to describe the design attributes of taxonomies that allow them to be used across borders, despite their not being identical. To be interoperable, taxonomies should have similar guiding principles, objectives, sector classification systems and approaches to defining eligibility. If taxonomies are not interoperable, their role as a tool to facilitate the flow of international capital is reduced.

Interoperability is important because there is no one single global taxonomy and it is unlikely there will be just one. There are, however, some significant benefits to creating, owning and maintaining a national taxonomy over adopting one. The process of developing a taxonomy usually involves multiple government ministries, bureaucrats, external advisors, NGOs and other stakeholders – this process is critical to securing local buy-in which, in turn, is crucial to the taxonomy's success.

In most countries, an advisory group is set up with participants from the private and public sectors. For example, in Colombia, the Taxonomy Supervisory Committee includes the Ministry of Finance and Public Credit, the Financial Superintendence, the Ministry of Environment and Sustainable Development, the National Planning Department and the Department of National Statistics Administration.

Many critical aspects of interoperability are already being normalised around the world. At a principle level, there is acceptance that the science basis of a taxonomy is core to its credibility. Using scientific evidence as a basis for ambition will help to ensure similar levels of ambition across taxonomies. From a prioritisation perspective, there is broad adoption and consensus globally around the use of the six environmental objectives put forward in the EU Taxonomy, with almost every jurisdiction starting by addressing climate mitigation. Further, sector priorities across most taxonomies include energy, buildings, transport and industry.

The use of common metrics to measure impact is critical to interoperability. Given that most taxonomies use available taxonomies as a starting point, there is increasing use of common metrics and indicators to assess performance or eligibility, particularly in some sectors.

Lastly, to facilitate implementation, various tools are being created to help users navigate the multiple taxonomies and compare investments across jurisdictions. Tools can be built on comparison work, such as the [Common Ground Taxonomy](#).

Taxonomy developers should do the following to facilitate greater interoperability:

- adopt as much as is possible from current taxonomies;
- adapt established criteria where needed to fit local context;
- lead where required, for example, in new areas where there are no pre-existing criteria; and
- collaborate within a region to support regional taxonomies and reduce duplication of efforts across countries.

Balancing interoperability with usability and implementation

For taxonomies to play a role in scaling up sustainable finance, they need to be usable. Usability will mean different things in different jurisdictions, depending on data availability, materiality of sectors to the context and maturity of reporting obligations, among other factors.

Occasionally, the principles of usability and interoperability are in conflict. The building sector is a common example. Where jurisdictions already have local codes, labels or regulations in place, these should be used to enhance usability. However, they may not be easily understood or mapped across regions. While this may be a short-term issue, almost all codes, standards and labels are based on common metrics that can be mapped to demonstrate how different labels compare to other national or regional labels.

In Colombia, the taxonomy identifies agriculture as a priority sector for the economy but, because of a lack of pre-existing criteria, new criteria had to be developed. There was also a need for criteria to be fit for purpose for small farms, which make up most of the Colombian agriculture sector. The resulting land-use criteria are usable for farms of all sizes, which enables them to introduce improvements according to their circumstances.

Malaysia's Climate Change and Principle-based Taxonomy provides guidance on eligibility based on high-level principles rather than granular, binary and numerical criteria. The principles-based approach has received valid criticism for being vague and open to greenwashing. However, it can have usability advantages by providing a more flexible approach for users as they become more familiar with new reporting guidelines that can be made more detailed and stringent over time.⁸

Usability has also been a key topic of discussion in the EU where the Platform on Sustainable Finance published an extensive report on data and usability.⁹ Among its recommendations were providing implementation guidelines for users, eliminating

8 PRI, 'How Policy Makers can Implement Reforms for a Sustainable Financial System', June 13, 2022, <https://www.unpri.org/download?ac=16315>.

9 Platform on Sustainable Finance, 'Platform Recommendations'.

imprecise criteria, providing pathways and timeframes for how criteria will change going forward and allowing for equivalent information or eligible proxies.

Along with these examples, nations in the Global South can enhance usability in a number of ways. First, they can focus on sectors that are critical to the local economy, rather than trying to ensure broad coverage of sectors with limited local relevance. Second, they can look to align criteria with pre-existing local standards, reporting obligations or codes that use standardised metrics. Third, they can provide a whitelist, that is, a list of automatically eligible technologies or processes that are easy to identify for users to get started. Last, they can partner with development banks or other institutions to provide capacity building for users to understand criteria, enable them to collect the information needed and report back to the market.

Including adaptation resilience and social considerations for the Global South

Most countries have taken a phased approach to developing their green taxonomy, with climate mitigation as the first objective. This is the lowest hanging fruit of greenhouse gas (GHG) emissions criteria for the majority of economic sectors and activities covered by current taxonomies, science-based pathways, standards and labels.

Expanding a taxonomy beyond mitigation becomes more complex given the relatively limited criteria available and the challenges in measuring impact regarding climate adaptation and resilience. A further challenge is in establishing a binary threshold or criterion (as preferred by investors), which is which is less clear for adaptation and resilience as it raises questions around how you measure resilience and what level would be sufficient to qualify as sustainable.

Least developed economies with low GHG emissions have a minimal impact on climate mitigation. As a result, other goals such as climate resilience are much higher priorities. Work is under way to develop a [global resilience taxonomy](#) to help investors direct capital to this much needed space. The first phase of this work is expected to be released in June 2024. All countries, including those in the Global South, should look to use this guidance or other global guidance available rather than pioneering a regionally specific approach that will lead to fragmentation.

A phased approach is recommended. This may include 1) considering the development of a mitigation taxonomy as an easier first step to understanding the development process and to gaining credibility internationally; 2) monitoring international developments on adaptation and resilience to assess relevance for use locally; and 3) adopting and using current international guidance to create national or regional green taxonomies.

Conclusion

Green taxonomies have become a norm for standardising green definitions around the world. They can be a useful tool for the Global South to attract international capital that is aligned with national investment priorities. Green taxonomies provide investors with assurance on the impact of climate investments but, for taxonomies to fulfil their potential, they need to be interoperable; this requires using present-day guidance, collaborating with neighbouring countries and adopting common principles.

Ultimately, other policy and support tools will also be needed to shift capital to finance the transition in the Global South. A taxonomy is a critical first step in helping to kick start the process, provide credibility and prepare the ground for other tools, schemes and support to follow.

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Acknowledgement

SAIIA gratefully acknowledges the support of the Swedish International Development Agency (Sida) for this publication.

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