

## TAXONOMY – A BURDEN OR DRIVER FOR THE BUSINESS

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### Abstract

*The objective of this paper is to examine the impact of the Taxonomy (Regulation 2020/852) on business in the non-financial sector. It is a consecutive paper, written by the author on the topic of sustainability – the purpose of the company, the global value chains and the transition of the business model on the road to a climate neutral Europe. The regulators and the politicians see the Taxonomy mainly from the perspective of sustainable financing. Researchers and consultants analyze the new norms for sustainability as a driver for new financial products and an enabler for a better-functioning European Capital Market. The Taxonomy impacts the economic entities in the non-financial sector and shapes their priorities about sustainability. The implementation of the Taxonomy by the non-financial business is in the scope of the paper. Although the implementation period is short, it is important to examine how business reacts to the new norms of sustainability.*

**Keywords:** taxonomy, sustainability, climate changes, climate adaptation, sustainable activities

**JEL:** G38, K22, M10

### Introduction

At present the Taxonomy Regulation is a fact. The imperative nature of the Regulation for the EU Member-States is not a matter of discussion, but a matter of compliance by many business entities. The **objective** of this paper is to examine the **benefits and problems** that arise as a result of the implementation of the norms of Taxonomy. Information for the analysis and discussion follows the **traditional research strategy** for business studies: literature observation and analysis of the business information. The business information is embedded in two cases: case (A) – concerning companies in old EU Member-States, and case (B) concerning Bulgarian business. Certain pieces of information are extracted from the author's work with business (the ethnographic method for receiving firsthand information). EU Documents and international finance institution documents (e.g. World Bank) are considered, as well.

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The focus of this paper is on a topic, underestimated by researchers and consultants – the impact of the Taxonomy implementation on non-financial business entities. It should be pointed out that in the recitals of the Taxonomy, as well in the norms (Regulation 2020/852) the focus is on the various financial institutions and sustainable financial products (Taxonomy 2020/852, Article 1 para 2 b; Article 25) and on “clarifying investor duties to extend the time horizons of investment and bring greater focus on environment, social and governance (ESG) factors into investment decisions” (European Commission, 2018). As mentioned above, the issues under examination are related to the non-financial sector and the benefits and problems related to the implementation of the Taxonomy and the norms for the business entities<sup>2</sup>. The research for this publication is constrained by the short term of the compliance by business with the abovementioned norms and the lack of sufficient information. Conclusions are aligned with these constraints.

## About the Taxonomy: the perspective of non-financial business entities

### *A few words about the Taxonomy Regulation*

The multidimensional usage of taxonomy as a classification system is well known. Aligned with the topic of this research, it is important to begin with the classification of the experts that initiated it – the High Level Expert Group on Sustainable Finance. Their report recommends “establishing EU sustainability taxonomy, starting with climate mitigation, to define areas where investments are needed most” (European Commission, 2018). One study (Confetto & Covucci, 2020) underlines the classification function of taxonomy per se: “the taxonomy can be used as a way to set a guide able hierarchically organize concepts in a particular domain”. The authors use taxonomy to classify different topics in the domain of sustainability or sustainable development to enable the effectiveness of the communications on the above topics.

The Taxonomy Regulation sets: ***clear objectives*** for business for meeting climate neutrality; definitions ***of activities*** on how these objectives will be met ***and criteria*** that prove the realization of the objectives. From a management point of view, it has to do with a ***holistic and clearcut presentation of a strategy: where to go; what are the means and ways and what the criteria of this journey are***. This Regulation and its implementation add value to the Green Deal (European Commission, 2019). It is the ***Green Deal that sets the principles of the transformation and decarbonization of the EU economy and the areas of transition*** – clean energy;

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<sup>2</sup> About 4000 companies in the nonfinancial sector from EU Member States have to implement the Taxonomy Regulation.

a sustainable and environmentally friendly food system; circle economy, restoring and preserving biodiversity, avoiding pollution and clean air, shift to sustainable and smart mobility. The unique transition plan determines the legal and economic tools for green transformation. Resources in terms of finances and people are envisaged. The Taxonomy Regulation is one of the legal tools that drives changes and sets clear norms for the business for the transition of its production, research and development and investments.

*What are the six Taxonomy objectives?: (1) climate change mitigation, (2) climate change adaptation, (3) sustainable use and protection of water and marine resources, (4) transition to a circular economy, (5) pollution prevention and control, and (6) protection and restoration of biodiversity and ecosystems.*

The essence of the Taxonomy (Regulation 2020/852 art art. 8) is the definition and criteria of a sustainable economic activity. An activity must: contribute to at **least one of six environmental objectives** listed in the Taxonomy; and **Do no significant harm** to any of the other objectives, while respecting basic human rights and labour standards<sup>3</sup>; and activities: “carried out in compliance **with minimum safeguards**, and Activities that “**comply with technical screening criteria that have been established by the Commission** – delegated acts and regulation<sup>45”</sup>. “The Taxonomy sets standards about sustainable activities or it is “a first and foremost classification of standardization the sustainable activities” (Schutze & Stede, 2020). Several sectors of the economy (NACE) are covered: agriculture and, forestry, manufacturing and energy”. Within the activities that substantially contribute to one or more environmental objectives, the Taxonomy also defines two classification categories: enabling activities and transitional activities.

Finally, it is useful to shed light on the above mentioned criteria. The non-financial entities have to prove their readiness to obtain a “license for green transition” with three indicators: **sustainable product** (the proportion of their turnover derived from products and services associated with economic activities that qualify as environmentally sustainable); **sustainable investment** input (the proportion of their capital expenditures – CAPEX) and their **sustainable expenditures** (the proportion of their operational expenditures, related to assets and operations associated with economic activities that qualify as environmentally sustainable – OPEX). In reality, the Taxonomy Regulation sets new determinants or limits for non-financial business entities concerning resources, concerning R&D, concerning technologies and business processes, and the output of their product policy – sustainable products.

<sup>3</sup> More on this issue Boeva (2021).

<sup>4</sup> Technical Screening Criteria (TSC) define the specific requirements and thresholds for an activity to be considered as significantly contributing to a sustainability objective. These TSCs are being elaborated in secondary legislation called Delegated Acts (DAs).

<sup>5</sup> The paper does not aim to make comments on the various types of activities.

### ***How academic research and consultants evaluate the Taxonomy Regulation and its implementation by the non-financial sector<sup>6</sup>***

The answer to this question is not an easy one. The examination of publications in two databases: Scopus and ProQuest reveals different views, mainly with a focus on the relationship Taxonomy – financial institutions. Energy is another topic that researchers examine. Researchers that look for the impact of the Taxonomy regulation on the non-financial sector consider it an instrument to minimize the “externalities” of the business activities. It is true that the problems caused by the business – pollution; negative impact on the climate – are mitigated by the new norms incl. Taxonomy Regulation. In the literature under observation this new instrument is described as an “intervention”, that is a threat for market democracy. Some authors focus on the problems: extra disclosure and, of course, new initiatives to cope with global warming. Broughton (2020) states that some companies align closely with taxonomy, but “some of the companies are finding some of the required calculations to be a head-scratcher”. Irrespective of the fact that the findings refer to the very beginning of disclosure according to the Taxonomy Regulation (2020/852), my personal impressions from the start of 2023 have confirmed the abovementioned problems.

The observation reveals positive signals about the implementation of the Taxonomy Regulation (2020/852). The benefits of the new practice for business include: a new approach for data collection; a better response to the investors’ expectations, and a demonstration of ambitions for green transition (Madsen & Madsen, 2022).

Evidence supports the view that EU Taxonomy contributes to the sustainability-driven business initiatives, investors’ focus on sustainability, stakeholders and the society as a whole. It is noteworthy to underline that the Regulation sets new milestones on the long journey to climate neutrality and new disclosure requirements that meet the expectation for more transparency (Schutze & Stede, 2020). This position is supported by investors (Concalves, 2022) “sustainability is not a compliance exercise, it is fundamentally about trying to understand how the world is changing”.

### ***Evidence derived from practice***

In alignment with the research strategy of this publication, a case study as a research instrument is implemented. The above statements and theoretical observations are supported by two cases: The implementation of EU Taxonomy

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<sup>6</sup> As mentioned, the observation of literature is only on the publications that are focused on non-financial business entities.

by three EU member-state companies (Case A), and certain stylized information about Bulgaria incl. Bulgarian companies (Case B).

### *Case A*

The companies in the Case are selected by the following criteria:

- with regard to the expectations that the *Taxonomy Implementation impacts the expenditures of the companies and their value* (Schutze & Stede, 2020), the most valuable companies (market capitalization) in EU are selected: *Novo Nordisk (Denmark) and LVMH (France)*<sup>7</sup>.
- with regard to the *Taxonomy focus on different sectors and the Delegated Act Stora Enso (Finland) – forestry sector and manufacturing* was selected.

The information is extracted from the annual reports and sustainability reports of the companies for FY 2022, published on the company websites. The analysis offered the following results:

The value of *Novo Nordisk and LVMH is determined by strategies and policies that are not directly impacted by activities on climate* (climate mitigation and climate adaptation).

In the report of the pharmaceutical company *Novo Nordisk* the topic is communicated as follows: “The EU Taxonomy’s currently published environmental objectives on climate change mitigation and climate change adaptation *do not directly apply to the pharmaceutical sector*. However, we reviewed the relevant activities and assessed their applicability to our core business. Because of the nature of our business activities, we do not have any Taxonomy-eligible Turnover. Regarding OpEx, we apply the exemption and report this at zero. “The company reports CAPEX ration – 8% for the investments in the renovation of existing buildings.

The second choice is *LVMH* – the fashion trend-setter and the most valuable company in the EU in previous years. Their Taxonomy report disclosed only CAPEX (capital expenditure) in real estate at 3% in accordance with climate mitigation and climate adaptation. Most of their efforts are in the domain of the circle economy (Taxonomy Objective N 4) and biodiversity (Taxonomy Objective N6).<sup>8</sup>

The third company under observation is the Finnish company *Stora Enso*<sup>9</sup>. The annual report for 2022 disclosed information about the compliance of the

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<sup>7</sup> Novo Nordisk market capitalization equals \$ 438,70 billion; LVMH – \$ 372,70 billion for 2022 (CompaniesMarketCap, 2022).

<sup>8</sup> For FY 2022 the requirement for reporting is only for Objective N 1 (climate mitigation) and Objective N2 (climate adaptation).

<sup>9</sup> Stora Enso ranks 2<sup>nd</sup> among the manufacturing companies in Finland. Stora Enso shares are listed on NASDAQ Helsinki Oy (STEAV, STERV) and NASDAQ Stockholm AB (STE A,

company with the Taxonomy. Several sectors covered in the Taxonomy section shed light on the company engagement (forest management; manufacturing of energy efficient equipment) in activities for the mitigation of climate change and climate adaptation. The sustainable product lines (turnover) as a proportion of turnover in forest management is 0.9% (forest management) and 3.5% (manufacturing) and in CAPEX 1.6% and 3.5% of capital expenditures for sustainable CAPEX (forest management and manufacturing). There is information about the minimum safeguards and respective company policy. What is interesting for the company reporting activities on the Taxonomy is the management of the new reporting activities: company and external experts work on the evaluation of the compliance with the Regulation on Taxonomy and Delegated acts and the elaboration of the report. The new practice of reporting that rests on interdisciplinary knowledge is also present. This new practice proves the author's view and recommendations to Bulgarian companies that the disclosure requirements of Taxonomy Regulation need to be met by interdisciplinary knowledge and, respectively, by an interdisciplinary team (composed of experts from various functional departments of the company).

### ***Case B***

The websites of the listed companies, as mentioned above, facilitate the researchers in the course of collecting data. The same research plan was followed for the examination of Bulgarian listed companies – the data on Taxonomy compliance was researched. The results are not conclusive. The impediment – lack of information of annual reports includes non-financial information, was overcome by the information in the EIB (2023) publication on the topic of climate<sup>10</sup>.

The ***EIB publication*** clearly states that European firms have mixed views about the impact of climate transition on their business (EIB, 2023). But it should be pointed out that European companies are fueling climate transition: EU – 56% vs 45% in the US. Certain stylized facts reveal the difference in the companies' investment policies in EU Member-States: only 50% of companies from Central and Eastern Europe are investing in the climate or plan to invest (mitigation of climate changes or adaptation to climate changes) as opposed to 60% of companies from North and Western Europe.

With regard to the Taxonomy objectives, it was discovered that only 26% of Bulgarian companies have climate targets as opposed to 41% for the compa-

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STE R). In addition, the shares are traded in the USA as ADRs and Ordinary Shares Market capitalization equals to 9,89 billion USD. Ranks 212th in EU (CompaniesMarketCap, 2022).

<sup>10</sup> The data in the Report is for 2022. It corresponds to the limits of this research – data from the business documents/annual and sustainability reports are about FY 2022.



nies in EU Member-States. As mentioned, the Taxonomy Regulation requires the disclosure of the ratio of the turnover of sustainable products. The EIB Report (2023) disclosed that only 13% of Bulgarian companies declare that their production (technology, products) is green versus 32% of the companies in EU Member-States. Considering the Taxonomy Regulation, it was found out that only 34% of Bulgarian companies invest in<sup>11</sup> climate change versus 53% for companies from EU Member-States. Information about the future investment plans in climate change for Bulgarian companies is 43% versus 51% for the companies in EU Member-States.

The lack of consistent information limits discussion and speculation. But certain facts (EIB, 2023) shed light on the behaviour of the companies towards climate transition. Only 10% of Bulgarian firms perceive climate transition as an opportunity as opposed to 25% of the firms from EU Member-States, and 38% of Bulgarian respondents perceive climate transition as risks versus 30% of the respondents from EU Member-States.

How to decipher the above results and could the benefits of the implementation of the Taxonomy be reaped immediately: information; possibilities for investors for benchmarking and “sustainability determined decisions and green transformation of the business”. Certain views about cost reduction and investment attractiveness are difficult to support. The most valuable companies in the European Union have different profiles and different value drivers. Concerning the statement that the implementation of Whether regulation is a burden is not supported by the facts. My personal involvement in the training on the implementation of the Taxonomy and information from interviews with a number of companies<sup>12</sup> enable the findings – a new stage for the business and new approaches have to be developed for the green transition. The search for evidence for the new regulation environment in Bulgaria led me to the analysis of the latest developments in Bulgaria – the implementation of the National Recovery and Resilience Plan (2022). It is noteworthy to underline that the document sets requirements for the implementation of the Taxonomy Regulation. In the component “local development 2.B.2”, the view that the respective initiatives have to be aligned with the Taxonomy Regulation (Council of Ministers of Republic of Bulgaria, 2022) is clearly communicated. The same component sets requirements for the execution of the project for the water system that potential applicants/offerees have to comply with the 6 objectives laid down in the Taxonomy Regulation (Attachment 26, Green Bulgaria, 2B2 local development – Investment N1).

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<sup>11</sup> As above mentioned according to Taxonomy companies have to disclose their investment to cope with climate change.

<sup>12</sup> In the introduction it is stated that “ethnographical approach” was implemented. Field research (interviews and inquiries) is not mentioned. Field research was planned, conducted but results (low level of response) are not used accordingly.

The information from the two cases, as expected, does not fully support the authors' preliminary conceptual views – objective, scope incl. research thesis. Although the period under investigation is short, certain thoughts and conclusions have crystalized.

## **Conclusions**

At present the facts, the studies and the revealed results do not answer the main question of the article. Taxonomy Regulation is one of the enablers or shapers of sustainable business, management and sustainable corporate governance (Boeva, 2019). The established objectives, the classification of activities that have to meet the objectives and the criteria for technical screening made the management and the corporate boards better equipped for the “greening” of the company. Preliminary discussions with the business community revealed difficulties in the implementation. The latest initiatives of the European Commission – consultation on the implementation of the EU taxonomy (stakeholder request mechanism) signals the EC's intension to assess the feedback and to decide whether to amend or not (European Commission, 2023).

Analyzing the benefits from the implementation, it is interesting to see the process beyond the EU. Many Non-EU governments (Bangladesh, China, Malaysia, Mongolia) launched their own Taxonomies. World Bank published Guidelines on Taxonomy (2020). The representative of the judicial company Allen & Overy (Franklin, 2020) states that “Europe has provided a framework for the world, but I predict Asia will be more piecemeal in its approach to ESG. Decisions to align with EU standards such as Taxonomy on sustainable finance will be made incrementally... I hope that Taxonomy acts as an inspiration internationally as it is the first step towards a universal classification system”.

The evaluation of the role of the Taxonomy has to include other, very important documents of the system of EU Regulations and Directives on sustainability – Sustainability Corporate Reporting Directive and Corporate Sustainability Due Diligence Directive (expected to be voted by EU Parliament in 2024)<sup>13</sup>. These are documents that enable companies to follow a systematic approach to a green transition.

The above views and thoughts allow me to point out that this publication contributes to the clarification of new, long-term horizon issues on the transition to a green economy and sets questions for future studies on this topic.

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<sup>13</sup> Corporate Sustainability Due Diligence Directive focus on human rights and labour conditions in the value chains of the companies and is aligned with the “minimum safeguards” in the Taxonomy Regulation.



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