

**MEMO# 33764**

September 10, 2021

# European Commission Consults on Social Taxonomy

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TO: ICI Members

ICI Global Members

ESG Task Force

EU ESG Disclosure Regulation Working Group SUBJECTS: ESG

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On 12 July 2021, the European Commission's Platform on Sustainable Finance (PSF) published a survey<sup>[1]</sup> seeking public feedback on the draft report on a proposal for a social taxonomy (Draft Report).<sup>[2]</sup> The survey closed on 6 September 2021.

The aim of the social taxonomy is to enable investors to identify and allocate capital towards economic activities that are socially sustainable and make significant contributions to human rights objectives. This Draft Report follows the European Commission's revised Sustainable Finance Strategy, which committed to actions that support credible social investments.<sup>[3]</sup> The Draft Report proposes objectives and sub-objectives for a social taxonomy, as well as possible approaches for defining "substantial contribution" and "do no significant harm" criteria.

The PSF acknowledges that some of its members are not convinced that the arguments provided in the Draft Report justify extending the EU Taxonomy Regulation<sup>[4]</sup> to social objectives. This difference of opinion will be taken into account before final recommendations are put forward. The PSF will submit the final report with their advice to the Commission in autumn 2021. By the end of 2021, the Commission will publish a report on the provisions required for a social taxonomy, as required by the Taxonomy Regulation.<sup>[5]</sup>

The memorandum summarizes the key aspects of the proposed social taxonomy.

## 1. Background: rationale for a social taxonomy

The PSF recognized that there is a need for significant social investments in order to achieve the United Nation's sustainable development goals (SDGs) on the 2030 Agenda, as well as to realize the social internal market envisaged in the Treaty on the European Union

(Article 3). There is also a need for investment in a just transition, maximizing the benefits of the move to a sustainable economy while minimizing hardship for workers, consumers and communities affected by that shift. Further, there is a growing appetite for socially orientated investments as investors acknowledge that it is risky not to take social factors into account in investments. Yet, as with green investments, the lack of a clear definition of the essential characteristics of 'social investments' hinders their development and potentially their contributions to solving social problems. Hence, the PSF sees merits in building a social taxonomy to harmonize how social aspects are measured. It would facilitate investors' ability to make informed and consistent decisions and at the same time help to direct resources towards socially responsible activities and companies.

The Draft Report also acknowledges significant concerns regarding a potential social taxonomy, such as increasing an already heavy reporting burden, and different definitions of what may be socially beneficial for multinationals operating in various markets. Some are concerned that objectives of a social taxonomy may go beyond EU competencies in social affairs, which are predominantly managed at a national level. The PSF clarifies that a social taxonomy is not intended to replace national regulation, nor create incentives in opposition to national legislation or social partners' autonomy. Rather, it is intended to support investments in activities and economic entities that substantially contribute to achieving social objectives.

## 2. Proposed structure of a social taxonomy

The PSF proposes that the development of a social taxonomy follows the existing approach in the Taxonomy Regulation. In particular, it would define social objectives and establish criteria reflecting the "do no significant harm" (DNSH) principle in relation to other objectives. It is important for investors to be able to compare the degree to which a fund is considered to be in line with the environmental taxonomy, with the social taxonomy, or with both taxonomies. Also, a similar approach would ensure that companies obligated to provide data on environmental as well as social topics would not be overburdened by having to work with two completely different systems.

### **A. International frameworks as foundations of the social taxonomy**

A social taxonomy cannot be based on science like the environmental objectives within the existing Taxonomy Regulation, whose foundations are natural science and international frameworks (e.g., Paris Agreement). The PSF recommends that internationally agreed authoritative norms and principles form the foundations of a social taxonomy. These social norms and standards emerge from structured discussions among stakeholders, thereby gaining acceptance. The suggested foundations<sup>[6]</sup> include, but are not limited to, the ILO Declaration on Fundamental Principles and Rights at Work, the European Social Charter, the UN Guiding Principles on Business and Human Rights (UNGPs), the UN Global Compact and the OECD Guidelines for Multinational Enterprises.

These principles and standards can be applied in two ways. First, they can define benchmarks for processes integrated into economic entities to avoid and address adverse impacts on human rights. Second, they provide a definition of what constitutes relevant contributions by business to fulfilling economic and social rights, for instance, providing certain products and services that can contribute to the fulfillment of the right to an adequate standard of living.

### **B. Dimensions of a social taxonomy**

Given that most economic activities have inherent social benefits (e.g., job creation and contribution to taxation), the role of a social taxonomy is to differentiate between inherent and additional social benefits. Also, the respect for human rights avoiding and addressing adverse impacts associated with economic activities is a key part of realizing social sustainability. Thus, a social taxonomy should adequately encompass this dimension.

The PSF suggests the social taxonomy consists of two dimensions - vertical and horizontal. The vertical dimension concerns products and services essential for basic human needs and basic infrastructure. From this perspective, economic activities that make these products and services more accessible, while doing no harm to efforts to achieve social objectives, could be considered social. The horizontal dimension takes into account impacts on different groups of stakeholders affected by economic activities. This dimension concerns processes implemented to improve respect for and protection of human rights across economic activities.

### **C. Substantial contribution and DNSH criteria at both activity-level and entity-level**

While the existing Taxonomy Regulation defines substantial contribution and DNSH criteria for specific economic activities, the PSF notes that this approach can only be followed in part by a social taxonomy. In addition to activities that are essential for the fulfillment of adequate living conditions, social impacts also come from respecting human rights, including labor rights, by implementing processes to reduce negative and maximize positive impacts on stakeholders. Such processes do not relate directly to one or the other economic activity, but operate at the level of the economic entity. A social taxonomy might therefore need to include criteria at both entity and activity levels.

Although the PSF has not defined the specific criteria for substantial contribution and DNSH in the Draft Report, it proposes the approaches and considerations in developing these criteria for the vertical and horizontal dimensions respectively.

## **3. Social objectives and criteria - Vertical dimension**

### **A. Vertical social objectives**

The main objective of the vertical dimension of a social taxonomy is to promote adequate living standards, which is linked to the Universal Declaration of Human Rights and the International Covenant on Economic, Social and Cultural Rights. On this basis, the PSF proposes the following two sub-objectives and topics in a future social taxonomy:

- improving accessibility of products and services for basic human needs, such as water, food, housing, healthcare and education;
- improving accessibility to basic economic infrastructure, for instance, transport, telecommunications, and internet, clean electricity, financial inclusion, and waste management.

### **B. Approach to define substantial contribution and DNSH criteria in the vertical dimension**

In this dimension, criteria for substantial contribution and DNSH will be attached to economic activities in the sense that the provision of social products and services will be assessed at the level of economic activity. It is proposed to develop these criteria based on the concept of availability, accessibility, acceptability and quality (AAAQ),<sup>[7]</sup> in order to

address all possible obstacles to the fulfillment of social, economic and cultural rights and to find ways to overcome them. The PSF notes that it is an internationally recognized way to implement and test the fulfillment of these rights and could be used as such for a social taxonomy.

The substantial contribution by which activities meet the social objectives of the vertical dimension will be that the availability and accessibility of these products and services have improved. While the availability and accessibility could be used to define substantial contribution, acceptability and quality of a product or service could serve as DNSH criteria. In other words, when improving availability and accessibility, this should not be at the expense of the quality, and where relevant the acceptability, of the products or services. The second source of DNSH for social objectives in the vertical dimension would be the objectives of the horizontal dimension, i.e., respect for human rights. This will be discussed further in the next section.

#### 4. Social objectives and criteria - Horizontal dimension

##### A. Horizontal social objectives

In contrast to the vertical objectives, horizontal objectives focus on the degree to which the economic activities can be considered socially sustainable. Such objectives have less to do with the products or goods being produced, and more with the impact on people that are associated with economic activities - not just where such impacts are inherent to the nature of the products and goods. The PSF recommends a stakeholder-centered approach to define the horizontal objectives in order to focus on key individuals and groups that can be both positively and negatively affected by businesses or by outcomes related to these groups of stakeholders.

The objective of the horizontal dimension is to promote positive impacts and avoiding and addressing negative impacts on the three stakeholder groups - workers, including value chain workers, consumers and communities. Hence, the following three stakeholder-centric objectives are proposed to include in the social taxonomy:

- ensuring decent work;
- promoting consumer interests;
- enabling inclusive and sustainable communities.

##### **B. Preliminary considerations on criteria for substantial contribution and DNSH in horizontal dimension**

The PSF further identifies the sub-objectives and considerations when defining the criteria for substantial contribution and DNSH in relation to the three stakeholder-centric objectives respectively.

***Ensuring decent work.*** Under this objective, the sub-objectives should emphasize the key aspects of respecting and supporting human rights in terms of impacts on affected workers, including on core labor rights. The PSF recommends including the following sub-objectives when developing the criteria for substantial contribution and DNSH in relation to the "ensuring decent work" objective:

- social dialogue, including freedom of association and collective bargaining;
- non-discrimination and equalities;
- no child labor;

- no forced labor;
- decent employment conditions, including living wage and working hours;
- health and safety;
- skills, life-long learning, and employment generation for certain groups;
- social protection;
- impact on workers in the entity's value chain, as it relates to the above sub-objectives.

The criteria that relate to the worker objective, whether on substantial contribution or DNSH, would be a mix of entity- and/or activity-specific thresholds. Both substantial contribution and DNSH criteria should be rooted in relevant international standards, e.g., the International Bill of Human Rights, ILO's Declaration on Fundamental Principles and Rights at Work and the EU's Charter of Fundamental Rights. These international labor standards would represent a threshold that must be met in order to fulfill the DNSH expectation and a baseline for substantial contribution, which would be expected to go beyond established standards and norms. The PSF further notes that the criteria development should reflect relevance across businesses of different sizes and consider the complexity associated with national differences.

**Promoting Consumer Interests.** This objective will include sub-objectives that emphasize key aspects of respecting and supporting the human rights of consumers. Notably, the term "consumer" includes both consumers and end-users. The following sub-objectives are proposed to include when developing criteria in relation to the consumer objective:

- safety and quality of products and services;
- protection of consumers' personal data and privacy as well as cybersecurity;
- responsible marketing practices.

Given that all business entities, let alone economic activities, are consumer-facing or have direct impacts on consumers or end-users, this should be reflected in the approach taken to developing technical screening criteria for the consumer objective. Similar to the worker objective, international standards, in particular the UN guidelines on consumer protection, should be embedded in the substantial contribution and DNSH criteria. It is noted that the DNSH criteria would likely be activity-agnostic as it would primarily be defined by negative duties. On the other hand, substantial contribution criteria are likely to involve economic activity level criteria since the potential benefits to consumers will vary significantly across sectors and activities.

**Enabling inclusive and sustainable communities.** This objective will include sub-objectives that emphasize key aspects of respecting and supporting human rights in terms of impacts on communities. The following sub-objectives are proposed to include when developing criteria in relation to the communities objective:

- equality and inclusive growth;
- impacts on land and livelihoods;
- safety and security, human rights defenders, civic space.

Similar to the above two objectives, community-related benchmarks for substantial contribution and DNSH should be based on international standards to the extent possible, including international human rights conventions, Sustainable Development Goals and OECD and UN due diligence standards. As with the consumer objective, not all business entities/economic activities have a direct impact on communities. In this regard, it will be important to ensure that criteria for substantial contribution do not promote philanthropy or

a return to early versions of corporate sustainability reporting, where companies engage in "do good" activities that have little connection to their operational footprint or the negative impacts associated with their business model. As the opportunity to make a substantial contribution to communities may vary significantly based on geographic and other contextual factors, the PSF proposes to consider the geographical dimension in defining substantial contribution to communities.

## 5. Governance

Apart from the vertical and horizontal perspectives, the PSF highlights that the governance of economic entities should also be considered. Governance factors can be relevant to both the environmental and social taxonomies. Not only do good corporate governance structures provide a company with the framework for setting guidelines and incentives for behavior that can benefit its social and environmental performance, they can also further help a company mitigate or even avoid any risks stemming from social and environmental factors. Seen in this light, governance objectives can be an enabler for both social and environmental objectives.

The PSF, however, clarifies that taxonomy would not need to include the full range of "hard" corporate governance factors. The focus would be on topics listed in international guidelines such as the OECD Guidelines for Multinational Enterprises and those considered important for what could be called "sustainable governance". It is likewise suggested the below two objectives be included as part of an environmental and social taxonomy:

- good sustainable corporate governance;
- transparent and non-aggressive tax planning.

Criteria and topics proposed for further consideration in relation to these two governance objectives include:

- diversity of the highest governance body, including employee participation;
- diversity in senior management;
- executive remuneration linked to environmental and social factors;
- anti-bribery and anti-corruption;
- responsible auditing;
- responsible lobbying and political engagement;
- tax transparency and tax approach.

## 6. Significant harmful activities

As the existing Taxonomy Regulation excludes power generation using solid fossil fuels on the basis that such activity cannot be compatible with the Paris Agreement, a social taxonomy should similarly exclude activities causing significant social harm or adverse impacts. The PSF proposes that socially harmful activities are those activities fundamentally and under all circumstances opposed to the social taxonomy objectives. The reasoning for declaring activities socially harmful would be based on internationally agreed conventions or research on detrimental effects of certain activities.

## 7. Possible models for linking an environmental and a social taxonomy

The Draft Report discusses a spectrum of approaches to the potential relationship between environmental and social taxonomies. One end of the spectrum would be a single taxonomy defining activities that are both socially and environmentally sustainable. This is

not a practical approach as it would drastically reduce the number of sustainable activities. Another end of the spectrum would leave the two taxonomies entirely separate. However, this option is already ruled out given that Article 18 of the Taxonomy Regulation links the environmental taxonomy to social factors. Between these two extremes, the PSF seeks opinion on two possible models for linking an environmental and a social taxonomy.

**Model 1** - The social and environmental taxonomies would only be related through social and environmental minimum safeguards with governance safeguards being valid for both. The UN Guiding Principles on Business and Human Rights would serve as the minimum safeguard for the environmental taxonomy, while the environmental part of the OECD Guidelines for Multinational Enterprises would serve as the environmental minimum safeguard for the social taxonomy.

Model 1 is proposed based on the assumption that companies will report separately on their turnover/capital expenditures or operating expenses for social and environmental activities respectively. With this model, activities with a strong environmental or social profile will be acknowledged on their respective merits without being punished for not meeting specific and strict criteria under the other part of the taxonomy. Yet, companies may focus on meeting whatever criteria are easier, be they social or environmental, and be content with superficial due diligence process for the other part of the taxonomy.

**Model 2** - There would be one taxonomy with a list of social and environmental objectives and DNSH criteria. An activity would have to meet either at least one environmental or at least one social substantial contribution requirement, as well as meet all relevant environmental and social DNSH criteria.

The design of Model 2 would essentially be one system with the same detailed DNSH criteria for the social and environmental objectives. Depending on how strict these DNSH criteria are, there might be fewer activities that could meet both social and environmental DNSH criteria. There will be environmental activities that will not attract sustainable investment capital because of not meeting specific social standards, and vice versa. The distinction between "socially sustainable" and "environmentally sustainable" would be less profound as they only relate to substantial contributions. On top of this, with this model, there would be a smaller risk of declaring socially harmful activities as environmentally sustainable and environmentally harmful activities as socially sustainable.

## 8. Further work

The PSF also recommends coordinating the legislative processing of the taxonomy, the Sustainable Finance Disclosure Regulation (SFDR), and the Corporate Sustainability Reporting Directive (CSRD), as well as those on sustainable corporate governance and mandatory human rights and due diligence. Given the complexity of these topics, it is crucial to define a common ground of topics covered and indicators to be reported on. In particular, while the SFDR and CSRD might address the reporting requirements for a social taxonomy, including the reporting necessary for the substantial contribution criteria, the PSF notes that this would require considering the sequencing of these legislative initiatives.

A final report will be submitted to the Commission in the autumn and then the Commission is expected to publish its own report on a possible social taxonomy by the end of the year.

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#### endnotes

[1] See Call for feedback on the Platform on Sustainable Finance's draft proposal for an extended taxonomy to support economic transition, *available at* <https://ec.europa.eu/eusurvey/runner/social-taxonomy-report-2021?surveylanguage=EN>.

[2] See Draft Report by Subgroup 4: Social Taxonomy, July 2021, *available at* [https://ec.europa.eu/info/sites/default/files/business\\_economy\\_euro/banking\\_and\\_finance/documents/sf-draft-report-social-taxonomy-july2021\\_en.pdf](https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/sf-draft-report-social-taxonomy-july2021_en.pdf).

[3] See Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: Strategy for Financing the Transition to a Sustainable Economy, *available at* <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021DC0390>, Action 2(d).

[4] See REGULATION (EU) 2020/852 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 18 June 2020 on the establishment of a framework to facilitate sustainable investment (Taxonomy Regulation), *available at* <https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32020R0852&from=EN#d1e40-13-1>.

[5] See Taxonomy Regulation, *supra* note 4, at Article 26(2b).

[6] See Draft Report, *supra* note 2, at Chapter 4.1, p.21.

[7] "Availability" means that a certain good is available in a sufficient quantity and is functioning. "Accessibility" means that a product or service is economically (affordability) and physically accessible without any discrimination and that the related information is also accessible. "Acceptability" means culturally acceptable, respecting the sensitivity of marginalized groups. "Quality" means that it is safe and that it meets internationally recognized quality standards that are scientifically approved. See Draft Report, *supra* note 2, at Chapter 4.3, p.29.