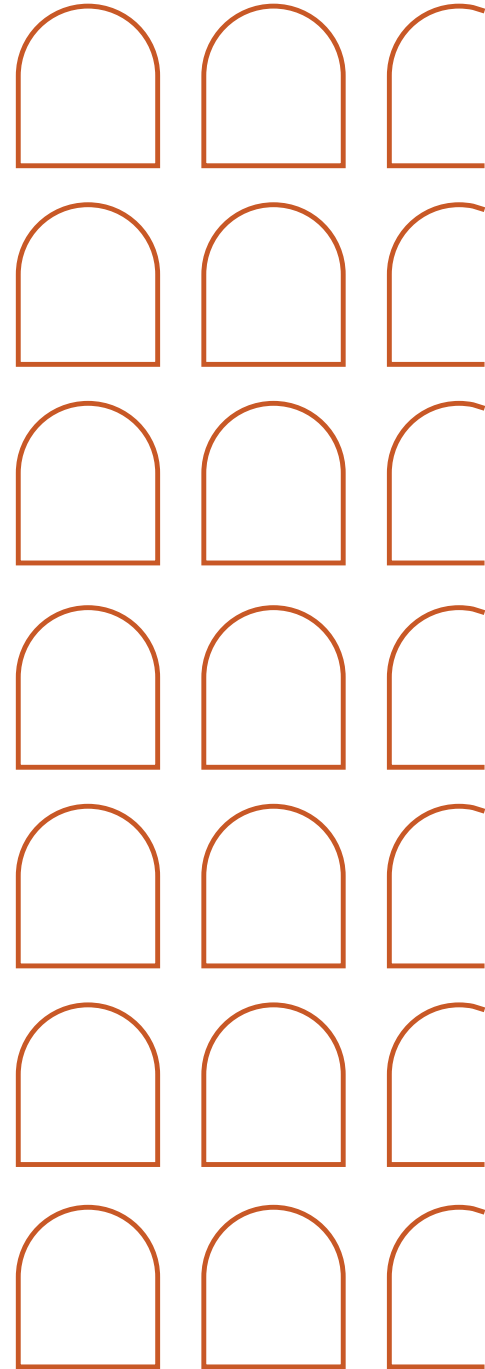


STG Policy Papers

# POLICY ANALYSIS

HOW THE EU CAN SUPPORT  
CARBON PRICING AT  
GLOBAL LEVEL

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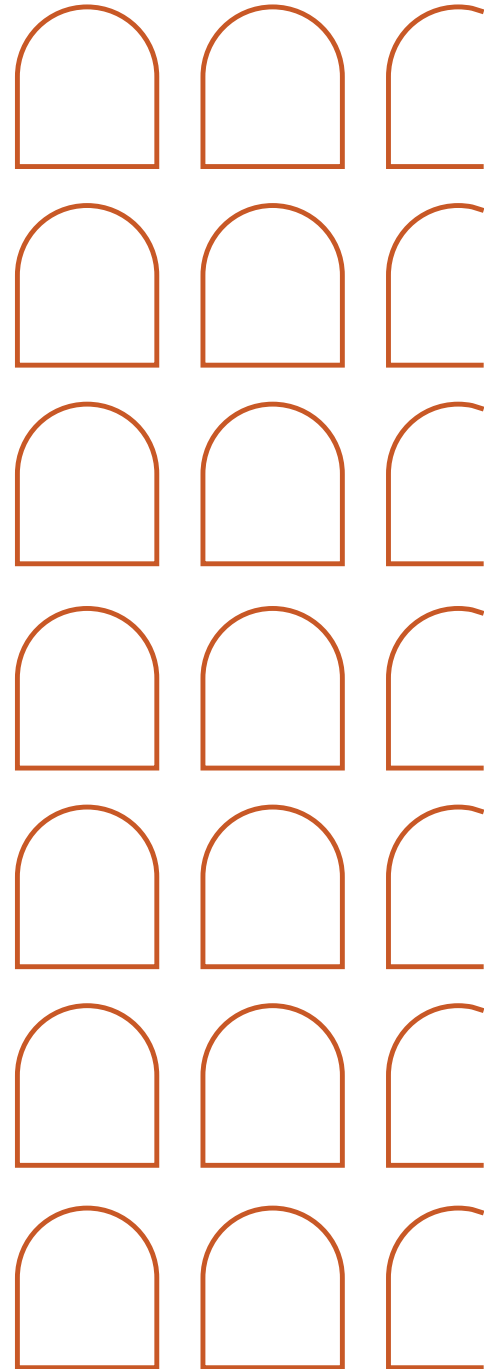
## EXECUTIVE SUMMARY

The EU Emissions Trading System (EU ETS) – by far the world’s largest carbon market – has been an effective means of reducing emissions in the EU. As of 2027 the EU ETS will include emissions from road transport and heating and is expected to cover 75% of the EU’s emissions. The EU has also decided on a new Carbon Border Adjustment Mechanism (CBAM) which imposes a carbon price on imports, thereby *de facto* externalising the EU ETS price to goods produced elsewhere in the world. The EU now needs to deploy much more effort to promote carbon pricing in a global context based on the considerable policy learning that the EU ETS represents.

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Views expressed in this publication reflect the opinion of individual authors and not those of the European University Institute



## 1. INTRODUCTION

The EU has been covering new ground in establishing an effective and sizable carbon pricing system through its Emissions Trading System (EU ETS). Effective, because in the sectors it covers - power, manufacturing, and intra-EU aviation - emissions have been reduced by 47% since 2005.<sup>1</sup> Sizable, because the market volume hovers around €800bn, which is the largest carbon market worldwide by far. The auctioning of allowances currently raises some €40bn per year. As of 2027 the EU ETS will include emissions from road transport and heating and is expected to cover 75% of the EU's emissions. The price of allowances has been fluctuating within the range of €50-90 per tonne and continues to serve as a fundamental economic incentive to reduce emissions towards climate neutrality by 2050. The EU has decided on a new Carbon Border Adjustment Mechanism (CBAM) which imposes a carbon price on imports, thereby *de facto* externalising the EU ETS price to goods produced elsewhere in the world.

The EU now needs to deploy much more effort to promote carbon pricing in a global context based on the considerable policy learning that the EU ETS represents. This promotion could be developed together with other partners, such as the World Bank and the IMF, who call for a reinforcement of global action on carbon pricing. An interesting perspective to pursue is the 'Call for Action for Paris Aligned Carbon Markets'.<sup>2</sup> Such efforts could create more climate finance. This policy analysis outlines some avenues for further action.

## 2. ESTABLISHING CARBON PRICING IN PRACTICE

In the wake of the reports of the Club of Rome (1972) and based on theoretical work of Pigou, Hardin and Coase, economists launched a debate on how to put into practice the pricing of economic externalities such as climate change. Carbon prices transmit information through the economy and influence behaviour, right down to the levels of individual producers and consumers. Carbon pricing is a cost-effective policy instrument as it offers flexibility to economic agents who have the choice to reduce their emissions themselves, or to pay someone else to do this for them.

Establishing a price on carbon is a complicated process politically as well as administratively. There are three basic avenues to pricing carbon: carbon taxes, emissions trading systems, and carbon crediting.

### 2.1. Carbon taxation

In the 1990s the EU tried hard to introduce a carbon/energy tax but failed because of the requirement for unanimity in matters of taxation in accordance with the EU's founding Treaty. Tax issues are always politically sensitive, and therefore hard to deal with beyond the national context. Tax administrations are rather lukewarm on carbon taxes as they question the long-term stability of the revenue. Some countries such as Sweden or Singapore have established carbon taxes. Adding a carbon component to existing fuel taxes may be considered in countries that have limited administrative capabilities.

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<sup>1</sup> 'Record reduction of 2023 ETS emissions due largely to boost in renewable energy', ec.europa.eu, 03.04.2023. The reduction of emissions covered by EU ETS is reached in combination with other policy instruments.

<sup>2</sup> Summit for a New Global Financing Pact, June 2023: <https://pactedeparis.org/en.php>

## 2.2. Emissions Trading Systems (ETS)

The second avenue is the creation of an emissions trading system (ETS), also called a 'compliance carbon market'. The core of an ETS is to define an overall emission limit, a 'cap'. It allows emitters that lower their emissions to sell their surplus units (or 'allowances') to those for whom it is more expensive to reduce emissions, thereby establishing a market price for emissions. The World Bank states that today some 23% of global emissions are covered by ETS's and raise some \$95bn revenue annually.<sup>3</sup> Well established systems exist in California, Quebec, China (pilots and national), the EU, Korea, New Zealand, the UK, and Switzerland.

ETS's are in practice created by law at national or sub-national levels of governance. A legal requirement is established to hold allowances for every tonne of emissions in a given compliance period (normally a year). The trading authorities organise the distribution of allowances. A public registry monitors transfers of emissions according to strict rules that are well enforced. In most systems compliance entities as well as financial intermediaries are allowed to trade.<sup>4</sup>

The EU started with its EU ETS in 2005 and refined the system in successive steps thereafter. It had to overcome several problems, such as finding a satisfactory solution to competitiveness concerns, fixing technical issues (such as those related to registries), or addressing the surplus of allowances following the banking crisis and the related recession that started in 2008. Similar refinements have also been taking place in other ETS's. Today the EU ETS

enjoys widespread trust by market participants as well as by the public and this is reflected in its carbon price, which reached a record of €100 per tonne in February 2023. Market oversight is ensured by the European Securities and Markets Authority (ESMA).

A well-functioning ETS requires a solid governance system. Behind many of the 'administrative' tasks, complicated political issues arise. The first and most difficult issue is to define the overall cap, in other words the degree of scarcity of allowances. The EU ETS has an absolute declining cap, defined as a precise number of tonnes that can be emitted, that sets the pre-determined environmental outcome. Most other systems have emissions intensity targets that can still lead to higher overall emissions with increased economic activity. An ETS can also allow for the inclusion of carbon credits, the amount of which then needs to be added to the foreseen cap. The allowed quantities of credits that can be used for compliance purposes need to be carefully specified beforehand, or the market will be over-supplied and deliver little reduction of emissions. It needs to be decided which sectors are to be covered by the ETS. Is it electricity generation, manufacturing industry and intra-EU aviation – as is currently the case of the EU – or would it also include emissions from road transport and heating, or agriculture and forestry?

Another critical design issue concerns "carbon leakage", a term referring to the relocation of industry to countries outside the jurisdiction to maintain competitiveness on global markets. While auctioning allowances is the most efficient and the least distortive method of allocation, all systems provide free allowances to shield companies

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<sup>3</sup> World Bank Carbon Market Report 2023

<sup>4</sup> But not (yet) in China

from adverse competitiveness impacts due to the carbon price. However, the EU ETS will over time phase out the system of free allocation of allowances in favour of a new Carbon Border Adjustment Mechanism (CBAM), that will apply an equivalent carbon charge on the greenhouse gas emissions associated with the production of certain imported goods.

Countries differ widely in their emission profiles, their economic development, and their political systems. As the design of an ETS is generally the outcome of difficult political negotiation, it is not a surprise that existing ETS's differ significantly across the world.

### 2.3. Carbon crediting

The third way to establish a carbon price is through crediting. Carbon credits are created compared to a baseline and these can be sold to an interested party that may want to 'offset' its emissions. In some cases, regulations such as carbon taxes or ETS also allow for such credits.<sup>5</sup> Crediting received a first serious boost when the Clean Development Mechanism (CDM) was agreed as part of the Kyoto Protocol. Several developing countries hosted projects that generated such carbon credits, and a sizeable amount entered the EU ETS that provided an attractive price for them. Today so-called Voluntary Carbon Markets (VCM) exist mainly as a response to companies or institutions wanting to make voluntarily green claims based on carbon credits.

Carbon credits originate because they claim that one metric tonne of CO<sub>2</sub>eq is being avoided, reduced, or removed compared to

a baseline. Lax rules about setting such baselines and the lack of oversight in the creation of carbon credits have led to a reputational problem. Integrity concerns bedevilled the CDM which led the EU to close CDM access to its carbon market.<sup>6</sup> The flaws and malfunctioning of VCM have repeatedly received negative press coverage, with accusations of 'greenwashing'.<sup>7</sup>

A persistent oversupply of credits combined with the inability to deal with the integrity issues has kept prices well below \$10. The global market for carbon offset credits remains limited and is estimated to be around \$2bn. Many credits have been created in nature-based projects, mostly in the field of avoided deforestation, but a significant amount also originated from renewable energy projects. The Taskforce on Scaling Voluntary Carbon Markets chaired by Mark Carney in the run up to COP26 in Glasgow forecasted a 15-fold increase by 2030.<sup>8</sup> This is unlikely to happen. Despite many useful initiatives it seems difficult to create the trust a well-functioning market requires. On top of that COP28 in Dubai failed to reach an agreement on Article 6 of the Paris Agreement that *inter alia* intended to create a successor to the CDM which - if implemented in a robust way - could serve as a benchmark for standards used in the VCM.

## 3. THE EU ETS AS A GLOBAL BENCHMARK

The EU's Carbon Border Adjustment Mechanism (CBAM) aims to ensure a global level playing field by charging the EU ETS price on the carbon content of imports of aluminium, cement, electricity, fertilizer,

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5 Some of these allow for the use of carbon credits such as California, Quebec, Korea, with a respective limit of 4, 8 and 5%.

6 Cornillie, J., Delbeke J., Runge-Metzger, A., Vis, P., Watt, R., What future for voluntary carbon markets? STG Policy Brief 2021/08.

7 See a frequently mentioned article from 'The Guardian', 18/01/2023.

8 Taskforce on Scaling Voluntary Carbon Markets (2021).

hydrogen, or steel. However, this CBAM duty may be reduced to the extent that a carbon price has already been paid in the country of production. This incentivises carbon pricing in countries producing goods consumed in the EU, wherever these are produced in the world. Countries exporting carbon-intensive commodities to the EU have an interest to establish their own carbon pricing system to make sure they keep the carbon revenues themselves instead of paying them to the EU. Establishing an ETS is currently being considered in a wide range of countries including Brazil, Chile, India, Indonesia, Malaysia, Vietnam, Thailand, and Turkey.

The obligations under the CBAM Regulation are addressed to the importer, whose obligation it is to report on the embedded carbon contained in the goods imported, and to demonstrate which carbon price had to be paid in the country of origin. The CBAM Regulation only contains a waiver for countries implementing the EU ETS, which is the EU's 27 Member States, Norway and Iceland that implement this legislation as part of the EEA, and Switzerland, which has a formal linking agreement with the EU.

### 3.1. Inclusion in EU ETS

Neighbouring countries aspiring to become a member of the EU must prepare for their accession and hence also for full inclusion in the EU ETS. It may be agreed that the Western Balkans and Ukraine have EU ETS carbon pricing applied even before becoming members of the EU. Apart from capacity building, a process could be considered with investment support under the Modernisation Fund in view of an

accelerated modernisation of their power sector which still heavily relies on coal and lignite.<sup>9</sup> A first concrete step could be to include international aviation into the EU ETS from 2027 and to let the created revenues flow to the Modernisation Fund. For Ukraine, a similar gradual approach could be developed adapted to the size and challenges of the country.

### 3.2. Mutual recognition between emissions trading systems

It seems reasonable to insist that at least G20 members develop their own ETS or carbon taxation, as their governance structures are well developed compared to many other countries. The EU should be generous in sharing expertise, if asked, together with other partners such as the PMR/PMI of the World Bank or ICAP.<sup>10</sup>

Economists have been proposing to link the ETS of different countries with one another in view of letting a global carbon price emerge. This is possible but not easy as the linking process between the EU and Swiss ETS demonstrates. The many political and administrative issues that were difficult to sort out at national level, risk having to be modified and aligned among the parties who want to engage in linking. Moreover, the political environment can change, as happened in the case of Ontario in Canada that had its own ETS that was linked with those in Quebec and California, but which discontinued its system. When ETS's are linked, allowances and money cross the national boundaries without restriction, and only one carbon price emerges. Also, compliance provisions need to be comparable. Linkage is hard to imagine

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<sup>9</sup> The Modernisation Fund receives part of the EU ETS revenues that are being used to support the modernization of the economy of EU Member States with a lower average income, not least in the field of energy. See, for example, Christian Egenhofer, 'The solution to phasing out coal in the Western Balkans? Extending the EU ETS to the region', CEPS Policy Brief, December 2023.

<sup>10</sup> Partnership for Market Readiness (PMR) and Partnership for Market Implementation (PMI) by the World Bank. International Carbon Action Partnership (ICAP), Berlin.

between countries having different structures or legal traditions, and hence it is hard to see direct linking between for example the EU and the Chinese ETS.

What is more realistic, however, is that countries mutually recognize each other's ETS, without allowances and payments crossing the border. Countries having established their ETS may seek a CBAM waiver from the EU for their exporters based on the argumentation that their climate policy efforts are mirroring the EU ETS. Mutual recognition may indeed make things simpler compared to reducing liability in respect of carbon pricing already paid in the country of production of goods.<sup>11</sup> The OECD has started a systematic data collection and modelling exercise comparing climate efforts of countries.<sup>12</sup> Such analyses are complex, as climate policies may be stringent without relying on carbon pricing at all, or the modalities of different ETS's may be hard to compare. The EU may have to accept that other countries will establish an ETS that is not identical to its own and start to elaborate criteria against which mutual recognition could be established.

However, a country-wide approach is different from one based on products under CBAM, and multilateral trade rules mainly focus on flows of goods as opposed to country-specific preferences. Compatibility with WTO rules is essential for the EU. Reassurances about the absence of trade distortive measures will undoubtedly be sought for CBAM-covered products, which is not necessarily guaranteed by mutual recognition agreements. Over time, the reporting of embedded carbon in the six products currently covered by CBAM will

generate large quantities of new data and should allow for an improved factual comparison of climate performance.

Issues related to a possible mutual recognition of ETS may well become part of the discussions on carbon or climate clubs, alongside other issues such as on technology or industrial cooperation. Difficult issues such as 'common but differentiated responsibility' may re-appear. Pragmatic arrangements such as those during the accession process to the EU can also be considered for other developing countries. This could fit with the current geopolitical re-orientation the EU is going through following the Russian invasion of Ukraine, as it seeks new industrial partnerships and more diversification of imports of energy and raw materials.

#### **4. IMPROVING THE INTEGRITY OF CARBON CREDITS**

Beyond the G20 and EU accession countries, it is difficult to expect all countries exporting to the EU to establish a full ETS. African countries, for example, benefit from favourable trade arrangements and hence question why the EU CBAM also applies to them. Cooperating through carbon credits could be part of the answer provided that the environmental and social integrity of credits can be assured.

The EU has taken a low profile in international debates on carbon credits as its target for 2030 must be delivered through domestic emissions reductions.<sup>13</sup> There are, however, good reasons to engage on this issue. Carbon credits can bring climate finance to remote and poor

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<sup>11</sup> EU Electricity carbon tax will hit net zero targets and consumers, industry warns, FT 19/3/2024.

<sup>12</sup> The OECD hosts the Inclusive Forum on Carbon Mitigation Approaches, for more info see here. Effects of measures are being modelled on emissions, but it does not include abatement costs or carbon price equivalents.

<sup>13</sup> Finland, Sweden, Netherlands have been actively looking at how to use carbon credits beyond their EU obligations.

areas which otherwise would be deprived from such support. Major parts of the world may be interested to engage in carbon pricing but lack the governance structures needed for developing their ETS. Starting with carbon crediting offers a learning process and helps to create some basic infrastructure that later may evolve into a full-fledged ETS. China, for example, developed many CDM projects - even if some of them were flawed - but that paved the way for its pilot emission trading systems and since 2020 the nation-wide Chinese ETS. Japan is currently developing a carbon credit regime that finds itself in between a voluntary and regulatory system. Getting started with carbon pricing also creates a better understanding at political level about what can be achieved, and how to avoid that the lowest-cost abatement opportunities are appropriated by international buyers at the expense of a host country's own efforts to reduce its emissions.

#### **4.1. Efforts currently being undertaken by VCM participants**

Actors in the VCM agree that radical improvements are necessary, not least on governance structures, and useful initiatives have been undertaken over the last few years. The implementation of the Core Carbon Principles advanced by the IC-VCM pushes towards higher integrity of carbon credits.<sup>14</sup> The VCMi provide companies with guidance on how to make credible claims that involve the use of credits.<sup>15</sup> ISO guidelines were adopted for achieving and demonstrating carbon neutrality, encompassing the use of carbon credits.<sup>16</sup> The Carbon Action Data trust aims at connecting different registries developed by private market participants and public

authorities.<sup>17</sup> Rating agencies have been established and shed useful light on the quality of projects.

The efforts undertaken by the VCM operators are not yet showing tangible results or are bogged down in lengthy discussions. This is not entirely surprising as many market actors have conflicting interests, as is normal in any market. Supervisory roles remain weak, such as coordination between registries of different programmes to ensure that credits are only used once. In normal regulatory systems, oversight is clearer to ensure good compliance, including through sanctions if necessary. It will take time to see many of the changes come to fruition

#### **4.2. Efforts being undertaken by the EU**

At the level of the UNFCCC, difficult negotiations continue to take place on the operationalization of Article 6 of the Paris Agreement. At COP28 in Dubai the EU supported by many other Parties made fundamental points about how to improve the necessary transparency of the system, be it on Article 6.2 related to transfers of parts of a country's Nationally Determined Contribution (NDC) or on Article 6.4 on the creation of carbon credits. Ultimately what needs to emerge, is a UN centralised register governing transfers and trades of such credits. The European experience shows the benefits of transparency and oversight.

The EU has undertaken one important step to improve the transparency of carbon credits in the climate strategies that European companies need to report on under the newly adopted disclosure

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14 The Integrity Council for the Voluntary Carbon Market

15 The Voluntary Carbon Markets Integrity Initiative

16 ISO 14068-1

17 Supported by the World Bank and Singapore, see: <https://climateactiondata.org/>



regulation. The Corporate Sustainability Reporting Directive (CSRD) establishes legally binding reporting obligations on the extent and quality of carbon credits purchased by companies and these need to be disclosed separately from emission reductions. This will undoubtedly create over time a wealth of new information, but implementation has only just started. Obviously, refinements will be necessary and additional reporting obligations will be required, including information on the specific projects from which credits originate and on the identity of third-party verifiers.

The EU is also making a start in regulating the use of credits. The Empowering Consumers for the Green Transition and Green Claims Directives aim to ban climate neutrality claims at product and company level in the case that they rely only on the use of carbon credits to offset emissions.<sup>18</sup> Companies would only be allowed to use certain types of credits, such as permanent carbon dioxide removals, to cover their residual emissions. Such residual emissions, however, still need to be defined in more precise terms, including sector-specific definitions. The policy framework is still in its infancy, with much more clarity and coherence needed on key terminology and on the interoperability between the different rules.

#### 4.3. Creating European demand for high-quality carbon credits

The above-mentioned efforts are both useful and necessary but are unlikely to bring the standard of environmental

integrity close to what is present in most ETS's. The EU could envisage creating more demand for high quality carbon credits of foreign origin as part of an international carbon pricing strategy that could bring much needed climate finance to developing countries. This could also create climate benefits at lower cost. This element has been underlined by the European Scientific Advisory Body on Climate Change indicating that it is becoming increasingly more cost-effective to avoid, reduce or remove emissions elsewhere than in Europe.<sup>19</sup>

In addition to the climate targets agreed in the EU's Climate Law, a quantity of carbon credits of foreign origin could be allowed to enter the EU. In the 2040 Communication it is stipulated that implementing existing legislation is likely to bring the EU's emission reduction to 88%. The agreed ambition level could be increased by defining a maximum amount for the import of foreign credits. This could also be expressed as a percentage of 1990 emissions, for example 2%, thereby bringing the total ambition level to 90% or add it to the recommendation by the Commission which then would elevate the overall target to 92%. Such an additional international part in defining ambitious targets is *de facto* what is being done by countries such as Norway, Singapore, or Switzerland. They define a target and allow part of it to be reached through the import of foreign carbon credits or parts of NDCs agreed by other countries.<sup>20</sup>

The EU has experience from the period it allowed CDM credits as some quantitative

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18 Proposal for a Directive of the European Parliament and of the Council of 22.03.2023 on substantiation and communication of explicit environmental claims (Green Claims Directive) and proposal for a Directive of the European Parliament and of the Council of 30.03.2022 amending Directives 2005/29/EC and 2011/83/EU as regards empowering consumers for the green transition through better protection against unfair practices and better information.

19 ESABCC, Scientific advice for the determination of an EU-wide 2040 climate target and a greenhouse gas budget for 2030-2050, 2023, p10 and 49.

20 This refers to the exchange of Internally Transferred Mitigation Outcomes (ITMO's) under Art 6.2 of the Paris Agreement.

and qualitative restrictions were adopted, but these turned out to be far too open. It is also important to learn from other constituencies, such as California, how they combine a solid functioning of ETS with allowing carbon credits. Major attention needs to be given to avoiding a destabilisation of the EU ETS market as carbon credits influence the overall cap. There are several issues that cover some of the functions notably on liquidity management that have been suggested as core tasks for a possible EU Carbon Central Bank.<sup>21</sup> The EU should therefore specify how gradually and cautiously such carbon credits could be included in the EU ETS. Several bridging instruments could be considered such as exchange rates, the use of tendering for carbon credits of high quality, or the use of carbon credits in respect of ETS coverage going beyond the EU's NDC such as on extra-European flights.

The next crucial question is which type of carbon credits could be considered for inclusion in the EU ETS. Under the CDM, the EU used *de facto* a negative list where from the start all credits were accepted except those related to land use, forestry, and nuclear electricity. Gradually more elements were added, until the final decision was taken to discontinue the use of CDM credits altogether. In contrast, it could now be considered to accept carbon credits from a limited number of activities, i.e., to establish a positive list. Clear criteria will have to be elaborated, including environmental and social minimum standards. Carbon removals seem an obvious candidate for such a list, and the EU could develop an international dimension to its ongoing work on this issue, bilaterally or regionally. Some countries may want the EU to accept project categories as part of a partnership, such as using

cookstoves replacing the burning of wood or supporting the transition away from coal towards renewables, possibly as part of the Joint Energy Transition Partnerships. By increasing demand for high-quality credits, the EU should be open to support prices well above the level currently paid in the VCM. It could be considered to add further conditionalities to the accepted credits, such as requiring that a predominant part of the revenue accrue to the local communities involved.

Another source of high-quality demand could potentially be generated through aviation. ICAO developed the offset instrument CORSIA. By 2026 the EU will have to assess *inter alia* whether major third countries have implemented CORSIA. The Commission will make a proposal on whether and how long-distance flights departing from Europe should contribute more to climate action. Several options could be considered, including the broadening of the EU ETS to include departing flights or applying kerosene taxation to all flights, or the insistence that much higher quality credits than those already considered as CORSIA Eligible Emissions Units must be used. Combinations of these options could also be considered in addition to the use of ETS revenues.

## 5. CONCLUSION

The EU ETS has become a global benchmark of high-quality performance on carbon pricing. A more outward looking strategy is now required. This could help reaching the climate targets cost-effectively and could also make sure that the difference in carbon prices being paid in Europe compared to the rest of the world remains

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21 Edenhofer, O., Franks, M., Kalkuhl, M., Runge-Metzger, A. (2024): On the Governance of Carbon Dioxide Removal – A Public Economics Perspective. FinanzArchiv. [DOI: 10.1628/fa-2023-0012]

manageable. Such a strategy could also bring a new and welcome source of climate finance to developing countries and make it as part of new partnerships. It could start from elaborating the following five points.

Firstly, the CBAM regulation is particularly helpful to spread ETS's in the world. The EU should intensify its efforts on capacity building and specify more details about how it intends to implement CBAM. Over time one could envisage mutual ETS recognition according to a set of critical parameters which needs to be elaborated.

Secondly, EU candidate countries could be supported by the EU ETS, even before they become a full member. Creating early access to the Modernisation Fund in exchange for starting a gradual application of the EU ETS seems a promising option.

Thirdly, the EU should further elaborate the disclosure of climate information of companies and financial institutions, particularly on the use of carbon credits and removals, and through clarifying what is covered by residual emissions.

Fourthly, the EU could define an attractive demand for carbon credits, particularly on carbon removals, that would apply in addition to the EU's targets that are set for delivery through internal policies. These could be included in the EU ETS subject to several modalities that need to be elaborated.

Finally, the review of third countries' implementation of CORSIA in 2026 offers an opportunity for the EU to require high quality credits for offsetting emissions related to flights to and from Europe.

The EU has the policy tools and the capability of bringing higher integrity to initiatives on carbon pricing in the world. An ambitious outreach strategy on ETS, CBAM,

and carbon credits could help achieving a so-called 'Brussels effect' on carbon pricing.

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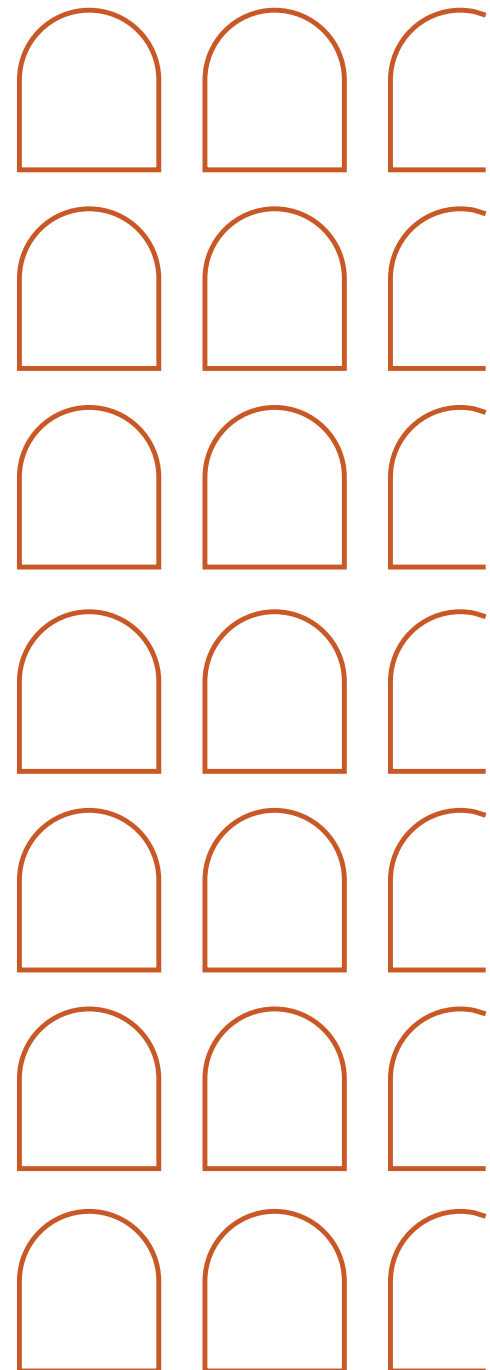
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