# Market-Based Environmental Leadership

## The Case for Carbon Credits

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**About EPIC**

The European Policy Innovation Council (EPIC) is a Brussels-based think tank dedicated to revitalising European policymaking through bold ideas and strategic communication. As a knowledge partner to the European Liberal Forum (ELF) under a framework agreement, EPIC contributed targeted research capacity and analytical expertise to support the Innovation Policy Labs. EPIC collaborated closely with ELF and FNF Europe to develop high-impact content and contribute to the broader policy debate at the European level.

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# Introduction

As climate challenges intensify, environmental sustainability and economic competitiveness need to be pursued as mutually reinforcing goals. While regulatory frameworks set clear climate targets, overregulation can slow innovation and increase compliance costs. Instead, the EU can leverage market-based mechanisms that drive sustainability while maintaining industrial competitiveness.

For example, Germany's new coalition agreement includes a proposal to allow countries to use international carbon credits under Article 6 of the Paris Agreement to meet part of their 2040 climate targets; this could also signal a potential shift in the EU's position on international carbon markets. At the same time, the Green Claims Directive is moving towards restricting credit use to EU-generated units under the Carbon Removal Certification Framework, signalling a more protectionist approach. These diverging trends underscore the importance of designing climate policies that ensure environmental integrity without shutting down effective, flexible tools, including voluntary carbon markets (VCMs).

Market-driven approaches such as VCMs allow businesses to reduce emissions flexibly and cost-effectively, fostering innovation and economic resilience. The EU Emissions Trading System (ETS) and Carbon Border Adjustment Mechanism (CBAM) exemplify how carbon pricing can encourage emissions reductions while preventing carbon leakage. However, similar principles can be applied beyond carbon pricing, particularly through carbon credits – a tool that enables businesses to invest in verified emissions reduction projects while offsetting their own carbon footprint.

Expanding market-driven sustainability models to areas such as renewable energy certificates (RECs) and circular economy credits could incentivise waste reduction, energy efficiency, and green innovation. Additionally, as the EU integrates sustainability into trade and industrial policies, these models could extend beyond Europe, influencing global markets and encouraging other regions to align with EU sustainability standards.

This paper explores how carbon credits and similar market-based tools can complement regulatory frameworks, ensuring that climate action enhances, rather than hinders, economic competitiveness in an evolving global economy.

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Chapter 1

# Market-driven approaches to sustainability and competitiveness: ETS and CBAM

Ensuring environmental sustainability while maintaining economic competitiveness is an ongoing challenge for the EU. While regulation plays a crucial role in setting clear environmental standards, overregulation can create inefficiencies, stifle innovation, and impose excessive burdens on businesses. Instead of micromanaging every aspect of sustainability through rigid rules, the EU can leverage market-based mechanisms that drive both green innovation and industrial competitiveness.

In principle, a market-driven approach to sustainability recognises that businesses will adopt sustainable practices not just because of regulatory pressure, but also because sustainability can reduce costs, increase efficiency, and improve long-term resilience. That said, a well-designed mix of regulation, market incentives, and private-sector innovation can ensure that environmental goals are achieved without undermining economic dynamism or industrial strength. The EU ETS, the world's largest cap-and-trade programme, demonstrates how market-based mechanisms can drive sustainability without excessive regulation. It sets a cap on total emissions, issues tradeable allowances, and gradually lowers the cap to ensure steady decarbonisation. This flexibility allows companies to reduce emissions cost-effectively, selling surplus allowances as an incentive for cleaner operations.

A key challenge is carbon leakage, where companies move production to countries with weaker environmental rules. The CBAM addresses this by applying a carbon price to imports of high-emissions goods, ensuring foreign producers face the same carbon costs as EU manufacturers. This prevents unfair competition and incentivises cleaner production globally.

While ETS and CBAM illustrate how market-driven mechanisms can align sustainability with competitiveness, the same principle can be applied in other areas. One example is carbon credits, which allow businesses to invest in verified emissions reduction projects – such as reforestation or renewable energy – in exchange for offsetting their own emissions. A robust and transparent carbon credit market can complement cap-and-trade systems by providing flexibility and additional incentives for companies to decarbonise.

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Chapter 2

# Expanding the market approach: The case for carbon credits

A carbon credit is a tradeable permit representing the reduction or removal of one metric ton of carbon dioxide (1t $CO_2e$) or its equivalent in other greenhouse gases, such as methane, nitrous oxide, and fluorinated gases. These credits serve as a market-based tool that allows organisations, companies, and governments to offset their emissions by investing in projects that actively reduce or capture greenhouse gases.

Carbon credits are generated through a variety of emissions reduction and carbon removal projects, which typically fall into the following categories.

## Avoidance and reduction projects

These projects prevent emissions from being released into the atmosphere. They include:

- renewable energy projects (e.g., wind, solar, hydropower) that replace fossil fuel-based electricity;
- energy efficiency initiatives that reduce energy consumption and emissions;
- methane capture projects, such as landfill gas recovery or livestock waste management; and

- nature protection and improved forest management projects, which seek to reduce rates of deforestation or to change how forests are managed in order to reduce emissions from land systems.

## Carbon removal projects

These initiatives physically remove $CO_2$ from the atmosphere. They include:

- afforestation and reforestation (planting new trees or restoring degraded forests);
- soil carbon sequestration, where regenerative agricultural practices enhance carbon storage; and
- direct air capture (DAC) technologies, which extract $CO_2$ directly from the air for long-term storage.

Each credit corresponds to a verified and quantifiable reduction in greenhouse gas emissions, certified by independent standards such as the Gold Standard, Verified Carbon Standard, or Climate Action Reserve. These standards ensure that carbon credits are real, additional, and permanent, preventing greenwashing and maintaining market integrity.

Today, the voluntary carbon market is undergoing a major transformation. The development of robust standards such as the Integrity Council for the Voluntary Carbon Market's (ICVCM) Core Carbon Principles is helping to establish a clearer and more credible baseline for what constitutes a high-integrity credit. These improvements provide a critical foundation for scaling climate finance and integrating voluntary markets into broader regulatory and industrial frameworks.

## Chapter 3

# Raising standards, not barriers: The case for smart integrity

Over the past few years, voluntary carbon markets have come under scrutiny over concerns of low-quality or unverifiable credits. While these concerns are valid, they have also catalysed a period of rapid reform—an 'integrity renaissance' – that is reshaping the market.

The ICVCM has launched a set of Core Carbon Principles to ensure that carbon credits are real, additional, and verifiable. These internationally recognised standards aim to restore trust and prevent greenwashing, enabling VCMs to serve as credible instruments of climate finance.

Instead of responding with overly rigid regulation that risks disqualifying entire categories of credits, policymakers should recognise how the market itself is evolving. Innovations such as credit ratings systems (e.g., by BeZero, Calyx, Sylvera) and insurance products for carbon delivery risk now offer scalable solutions to differentiate high-quality credits from low-quality ones.

A useful analogy can be drawn from financial markets, where governments use credit ratings to define risk levels in regulations (such as in pensions or investment rules). Rather than micromanaging every aspect of carbon credit integrity, regulators should embed similar tools – ratings, risk metrics, and insurance mechanisms – into climate policy. This would ensure accountability while preserving market dynamism and innovation.

Chapter 4

# How carbon credits can drive climate action and economic efficiency

Carbon credits can play a crucial role in mobilising private-sector finance for climate action, enabling businesses and governments to invest in emissions reductions and removal. Given the enormous need for private investments in sustainable practices to achieve environmental goals, EU policies should facilitate rather than hinder carbon market participation, ensuring that funding flows to projects that deliver meaningful and immediate impact.

## Key benefits of carbon credits

- Driving climate finance: carbon markets help bridge the climate funding gap by channelling capital into emissions reduction projects that might not otherwise receive investment. Notably, VCMs are currently one of the only mechanisms capable of financing nature-based solutions at scale, such as forest preservation in the Global South – where protection of ecosystems is critical to achieving net zero.
- Enabling near-term climate action : businesses and governments can compensate for emissions through carbon credits, allowing them to take immediate climate action while working towards long-term reductions. This is especially important for sectors where eliminating emissions entirely is not yet technologically or economically viable.

- Flexibility and innovation: carbon credits introduce market-driven flexibility, ensuring that emissions reductions happen in the most cost-effective and innovative ways. By funding cutting-edge climate technologies, carbon credits support advancements in sustainability solutions, from DAC to regenerative agriculture.
- Encouraging global participation: carbon credits facilitate international collaboration on climate action by aligning projects with global standards and trading mechanisms. Emerging developments under Article 6 of the Paris Agreement offer a regulatory path to expand and formalise these activities, enabling countries to meet part of their emissions targets through verified international cooperation.
- Promoting sustainable development : beyond reducing greenhouse gases, carbon credit-funded projects generate additional social and environmental benefits. Many initiatives improve air quality, create jobs, enhance biodiversity, and support local communities – particularly in the Global South, where a significant share of carbon projects are based.
- Efficient cost allocation for emissions reduction : climate change mitigation carries substantial costs, but carbon credits enable smarter resource allocation. Companies can invest in high-impact emissions reductions where they are most cost-effective, ensuring that climate goals are met without unnecessary economic strain.

Carbon credits are more than just a tool for offsetting emissions – they unlock capital, incentivise innovation, and create economic opportunities while driving real climate impact. When integrated into a broader sustainability framework alongside ETS, CBAM, and carbon pricing mechanisms, carbon credits can enhance global climate action while maintaining economic growth and competitiveness.

## Conclusion

# Expanding market-driven sustainability for global impact

By reducing regulatory micromanagement and expanding market-based incentives, Europe can accelerate the green transition while maintaining its global leadership in clean technology, resource efficiency, and sustainable finance. A balanced approach – combining market incentives, regulatory frameworks, and industry-led innovation – ensures that sustainability enhances competitiveness rather than weakening it.

This market-driven model should not be limited to carbon pricing alone. Similar certificate trading systems, such as RECs for clean power adoption or circular economy credits to incentivise waste reduction and resource efficiency, could be expanded to other sustainability challenges. These mechanisms reward innovation, lower compliance costs, and maximise environmental impact without imposing excessive regulatory burdens on businesses.

> By expanding market-based incentives, Europe can accelerate the green transition while maintaining its global leadership in clean technology.

Furthermore, as the EU continues to integrate sustainability into its trade and industrial policies, these principles can extend beyond Europe. Countries and companies seeking access to the EU market will be required to align with its sustainability standards, encouraging the adoption of similar market-driven models worldwide. In this way, the EU can leverage its economic influence to promote global environmental progress, making sustainability not just a European competitive advantage, but also a global standard for trade and investment.

## What this publication is about

This book is about policy innovation, influencing change in a way that guarantees our fundamental liberal values while also delivering tangible results for people. It is about convincing the public that the EU is not only relevant in their everyday lives, but also capable of implementing policies that will significantly improve their quality of life. By presenting forward-thinking solutions and actionable strategies, this guide aims to demonstrate how liberal policies can address the pressing issues Europe faces today. Through effective governance, we can showcase the EU's potential to drive positive change, ensuring that our vision for a progressive and inclusive Europe becomes a reality. In answering the question of what kind of Europe we want, the answer is clear: we want a renewed Europe – a Europe with institutional reforms that make it fit for the current geopolitical circumstances, capable of responding swiftly and effectively to external pressures. We envision a renewed Europe that leads in technological progress and sustainability, setting global standards and driving innovation in a way that benefits all its citizens. Furthermore, we seek a Europe that can guarantee the safety of its citizens and uphold the European way of life, ensuring security and stability in an increasingly uncertain world. This vision of a renewed Europe is one that not only meets the challenges of today but is also prepared to seize the opportunities of tomorrow.

## Outcome of the Innovation Policy Lab 2.0

This publication is the outcome of a joint undertaking between the European Liberal Forum (ELF) and the Friedrich Naumann Foundation for Freedom Europe (FNF Europe). Most of the ideas and proposals contained in this book were discussed and developed during a two-day conference of the ELF–FNF Innovation Policy Labs held in Brussels on 23 and 24 November 2024. The editor extends heartfelt thanks to Gréta Kiss from FNF and Bálint Gyévai from ELF for organising the conference, and to the participants for their invaluable contributions. Special gratitude goes to Benno Schulz, Maximilian Luz Reinhardt, Dr Antonios Nestoras and Ailbhe Finn, who served as moderators during the conference and captured the participants' discussions and policy recommendations that form the backbone of this publication. Without the dedication and expertise of all these persons, this work would not have been possible.

## Methodology

This publication is the outcome of a joint undertaking between the European Liberal Forum (ELF)and the Friedrich Naumann Foundation for Freedom Europe (FNF Europe). It represents a culmination of collaborative efforts, discussions, and expert insights aimed at addressing the multifaceted challenges confronting Europe. The ELF–FNF Policy Labs brought together a diverse group of policymakers, academics, practitioners, and civil society representatives from across Europe. This dynamic gathering fostered an environment conducive to in-depth analysis, debate, and creative thinking. The participants, each bringing their unique perspectives and expertise, played a crucial role in shaping the discussions and formulating the policy recommendations presented in this book. The process was highly participatory, with structured sessions designed to maximise interaction and the exchange of ideas. Through a series of workshops, panel discussions, and breakout groups, participants delved into key topics, identified pressing issues, and proposed actionable solutions. These insights were rigorously analysed and synthesised by the editorial team, ensuring that the chapters reflect the collective wisdom and innovative thinking of the Policy Labs. It is important to note that not all chapters in this publication were developed solely through this conference. While the majority of the content is derived from the Policy Labs, some chapters were influenced by additional research, expert consultations, and policy discussions. These contributions were integrated to provide a comprehensive and well-rounded set of policy proposals.

## About ELF

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## About Friedrich Naumann Foundation for Freedom Europe (FNF Europe)

The Friedrich Naumann Foundation for Freedom Europe (FNF Europe) is one of the regional offices of the Friedrich Naumann Foundation for Freedom (FNF), a German political foundation dedicated to promoting liberal values and policies. Headquartered in Potsdam, FNF operates offices across Germany and in numerous countries worldwide. FNF Europe maintains offices in Brussels, Prague, Vilnius, and Geneva, serving as a platform for connecting EU experts, civil society actors, and policymakers. Its mission is to foster open dialogue and advance liberal policy solutions to address Europe’s key challenges. In close cooperation with liberal partners, FNF Europe organises innovative formats and campaigns to promote fundamental rights, the rule of law, geopolitics, and geoeconomics. It also coordinates EU co-funded projects focusing on areas such as the internal market, digitalisation, and innovation.

# A liberal future in a united Europe

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