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EU facing the IRA: beware of Tit for Tat

Faced with industrial policies in other parts of the world and a surge in energy prices, industrial policy has recently returned to the forefront of the EU's agenda. In this respect, the IRA has drawn much attention in the EU as it is feared it will take away EU companies and jobs. It is worth stressing that the passage of the IRA is obviously good news for climate action and that the forecasted subsidies are of similar size to those available in the EU. Moreover, despite the fact that the IRA encompasses USD 369 billion of tax credits for low-carbon investments (about 1.5% of US GDP) over a 10-year period and that it includes trade-distortive subsidies, including local-content requirements prohibited under WTO rules, the spectre of production/investment leakage is largely exaggerated as the primary target of the IRA is China. Lastly, trade data from Eurostat shows that the US is the EU's largest trading partner. Total trade in goods has grown on average by 5% annually from 2010 through 2019 and the trade surplus of the EU with the US has grown from EUR 68 billion in 2011 to EUR 167 billion in 2021. As long as the IRA does not call into question the European Green Deal, Europe's response should be restrained. Indeed, the EU would have more to lose if it would enter into a frontal trade war with the US.

In this context, policy-makers in the EU have responded to these challenges by having recourse to some "old-favoured" instruments. This could drag the EU into a subsidy race that would be detrimental to all parties.

Among the levers that have been identified to promote industrial policy, state aids, i.e. subsidies or any other aid provided by a Member State, are in the spotlight. State aids represent a distortion of competition and are prohibited under article 107(1) of the Treaty on the Functioning of the European Union (TFEU), unless exceptionally justified by reasons of general economic development, like market failures in environment and innovation. Despite their adverse effects on competition, the EUCO has called on 9 February 2023 for a "targeted, temporary and proportionate" support for sectors that are strategic for the green transition.

State aids have already been used from the onset of the pandemic crisis in March 2020 until the end of 2021 to cushion its economic effects. Data from the Directorate-General for Competition show that between March 2000 and December 2021, the European Commission has authorised in this context EUR 3.1 trillion of aid. In the sole year 2022, the European Commission has authorised EUR 672 billion of state aids, 53% of which went to Germany (representing over 9% of its GDP) and 24% to France. The distribution of aid approved during that period appears to be uneven across Member States and may raise potential concerns on the level- playing field in the Single Market and on the risks of fragmentation of Europe. Moreover, state aids are characterised by a lengthy approval process.

It may thus encourage firms to design their investment below the bloc exemption to avoid the need for notification. This could lead to the development of under-scaled, and hence suboptimal investment projects. In short, state aids provisions should remain a 'discipline for Member States'.

The second lever proposed by the European Council is to increase the number of IPCEIs. The latter materialise in large-scale consortia aimed at research and development (R&D) and the first industrial deployment stage, excluding mass production and commercial activities. IPCEIs are supposed to overcome market failures and enable breakthrough innovation in sectors and technologies considered strategic, and to deliver positive spill-over effects for the EU economy at large. Several IPCEIs have already been launched in semi-conductors (2018), electric batteries (2019 & 2021) and hydrogen (2022). Others are supposed to follow in the cloud, in photovoltaics and in the health sector.

The public support by Member States to the projects and companies participating under the IPCEI, which constitutes state aid under EU rules, has to be notified to the Commission for assessment and approval to ensure that the aid is limited to what is necessary and to prevent undue distortions of competition. This is again a lengthy process, in sharp contrast with the agility and amount of capital provided by venture capital for instance. Moreover, in order to qualify for an exemption to state aids, IPCEIs must encompass at least four Member States, with the participation of small- and medium-sized enterprises (SMEs), involve substantial co-financing by the companies that will receive state aid; and must comply with the "do no significant harm" principle. These conditions are complex and difficult to meet, compared to the IRA which focus mainly on mass deployment of green technologies rather than innovation as such.

Overall, a comparison of the two sides of the Atlantic shows a pragmatic and massive support based on tax credits in the US versus more indirect and much complex measures in the EU. If the imperative of sovereignty in some strategic sectors make sense, we should be careful to maintain market signals high enough. The development by the Directorate-General for Internal Market, Industry, Entrepreneurship and SMEs of an indicator-based mechanism (SCAN) to monitor the evolution of supply chains in the EU and increase EU resilience to trade disruptions is to be welcomed. We should also try to expand the CBAM to make sure carbon-intensive imports in the EU do not substitute to low carbon domestic products. A key advantage of the CBAM is that it is much more compatible with WTO rules. The CBAM on the verge to be put in place by the EU covers only some of the sectors regulated under the EU-Emissions Trading System (ETS). Additional sectors could be included to shield the EU economy against relocations, given that sectors regulated by the EU-ETS are often energy intensive sectors. For those sectors that are not currently covered by the EU-ETS, and which cannot benefit from the CBAM, the EU should either expand the EU-ETS or adopt maximum carbon footprint standards as planned in the battery regulation.