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A Faustian bargain: Europe's answers to the US IRA

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EXECUTIVE SUMMARY

- The Inflation Reduction Act (IRA), enacted in summer 2022, is America's first serious attempt to tackle the climate crisis and reach its own emission-reduction goals. As such, it is overdue and more than welcome. At the same time, it entails a string of protectionist measures that – though aiming mainly at China – might hurt Europe's green industry. However, past experience with generous tax breaks under President Trump, for instance, do not justify a knee-jerk reaction by Europe.
- Supporting the green transition with numerous funds, initiatives and programs has long since been on the EU's agenda. Nonetheless, against the backdrop of the energy crisis and geopolitical shifts, there is a widespread belief that Europe might lose its supposed edge in green industries and innovations. As a result, many policymakers and business leaders urge the EU to up its game.
- The short-term reaction to the US IRA – entitled the "Green Deal Industrial Plan" by the EU Commission – builds predominantly on allowing more national support, including tax benefits, by relaxing state aid rules further. Although this relaxation is (still) temporary, it is a slippery slope: National support measures might be easier to implement, but they threaten to undermine the Single Market, the EU's greatest success, and to widen the gulf between richer and poorer EU members. At worst, they could open the Pandora's box of a subsidy race to the bottom – between the EU and the US and within the EU.
- In the long run, the EU and its industry will only stay relevant – as a geopolitical actor and global technology leader – if it acts as one. Therefore, it needs a clear and ambitious common industrial strategy, safeguarding its competitiveness in a splintering world, and underpinned by common funds to keep unity alive. Europe's competitive advantage does not lie in highly efficient decision-making and implementation – though it should make every effort to get better at these – but in its diversity and wealth of talents. United, they will succeed. That's why we see creating a new sovereignty fund as the best possible answer to the IRA challenge – and going nationalistic by abandoning state aid rules or introducing "buy European" features as the worst possible avenue.
- The EU Commission tends to agree but has struck a Faustian bargain: It opened the floodgates for national subsidies that will inevitably tilt the playing field in Europe – and thus strengthen the case for supranational remedies such as a new common fund underpinned by common debt. This is a hazardous strategy. There is a real danger that the EU Commission will end up empty-handed: State aid rules remain a mere fig leaf, but the hoped-for sovereignty fund never sees the daylight. The EU is stuck in the middle, torn apart between a rampant subsidies race and too few common goods.

The US Inflation Reduction Act (IRA) in a nutshell

The IRA is a game changer. Tax credits and incentives are set to unleash private green investments, with corporates investing in clean energy such as hydrogen or battery storage and households buying lower-emitting homes and cars. Thus, for the first time, the US is taking the climate crisis seriously and has a fair chance to reach its own emission-reduction goals, i.e. to reduce greenhouse-gas emissions by -50% by 2030 (against the 2005 level). This is welcome. Without the US, any attempt to limit the temperature rise below 2°C – not to mention the Paris target – is doomed to fail. Building green industries at scale in the US might also help similar efforts across the world via the price mechanism: such technologies are likely to become more affordable in a shorter time. In this context, the IRA deserves much praise.

There is, however, a sting in the tail: Domestic content requirements – which are attached to two-thirds of IRA tax incentives – not only violate World Trade Organization rules but are likely to hurt non-US producers The obvious way around: Go West and produce in the US. Anecdotal evidence that firms are ramping up their investments in the US already abounds. So far, however, these are mainly announcements. But without doubt, the US has become a more attractive place to invest in green technologies[1]. This presents a lot to fear for Europe, which tends to see itself as the vanguard of green industries. Adding insult to injury: Just at the moment when the IRA became law in the US, Europe suffered a severe blow as an industry location because of the energy crisis triggered by the war in Ukraine.

Yet, knee-jerk reactions are not justified. First, the size of the IRA is less than meets the eye. The headline figure – USD 370bn – sounds impressive but is spread over ten years; on an annual basis, a little more than 0.1% of GDP is budgeted. Second, it remains to be seen whether announcements are followed by hard decisions and real money. There is a precedent. President Trump previously implemented a whopping corporate tax cut of 14pps (from 35% to 21%); the idea, of course, was to lure companies to invest in the US, "bringing the jobs home". However, the result was not what was expected: greenfield foreign direct investments (FDIs) into the US continued their downward trend. It takes more than a (temporary) tax credit to change investment decisions. Third, this is even more so when it is uncertain what will happen to these benefits under the next US administration.

The bottom line: The next years will see a lot of investments in green industries in the US, not least by electric-vehicle manufacturers as the US market is still in its infancy (most car production is local). But whether this should be framed as a "distortion" that would require countermeasures is less clear. The green transition is not a zero-sum game but a win-win.

The EU answer – a summary

On 01 February 2023, the EU Commission unveiled its short-term (unofficial) answer to the US IRA, called the "Green Deal Industrial Plan". It is based on four pillars: less red tape, skills, trade and funding. The latter is mainly a write-up of all the existing measures, which add up to quite impressive sums, although it remains rather impossible to arrive at a final total figure[2].

[1] One man's gain is another's loss. Less noticed are the sweeping law's drug pricing provisions which will impact the pharma industry negatively over the coming years.

[2] The EU Commission itself seems to be lost in its own jungle of funds and programs: While cohesion funds available for the green transition stood at around EUR36bn in the document leaked just a day before the meeting, the number in the final document was EUR100bn, a seemingly miraculous increase in money.

The best guess might be the sum of the already approved EUR250bn of the Recovery and Resilience Fund (RRF) for the green transition plus the still available EUR270bn through REPowerEU. This already exceeds the US IRA's funds by a wide margin, before including funds available through the EU budget (cohesion funds) and various other programs such as Horizon Europe, Invest EU or the Innovation Fund. However, as these programs and funds have a wider scope than the green transition, it is hard to end up with one precise number.

The only new measure with regard to funding is the extension and expansion of the relaxation of state aid rules until end-2025. It is now called the "Temporary Crisis and Transition Framework" and gives EU members more leeway in supporting their own industries, not least through tax benefits, to counter the (supposed) largesse of the US government. For companies, that plan to invest in new operations or enlarge existing ones opens up the pleasant prospect of a cross-Atlantic bidding game between governments to lure factories to their shores.

The other three pillars, namely less red tape, and emphasizing skills and trade, are "business as usual", routinely summing up all the initiatives in these fields. Skepticism is warranted. An unbureaucratic EU, for example, is just an oxymoron. Nonetheless, the efforts are welcome and some of the ideas sound promising, for example one-stop-shops for permissions with maximum approval periods and regulatory sandboxes for new and emerging technologies and start-ups. The same can be said for the looming war for (green) talent, also acknowledged by the US IRA that is explicit on funding for promoting skills. In the EU, too, awareness of future labor shortages is rising but for now, the EU measures for attracting and promoting the necessary skills seem underwhelming: A bold migration policy to open up labor markets to skilled migrants is still not on the cards. Admittedly, finding common ground on this is particularly tricky. But not even trying gives the impression that EU politics still underestimates the coming demographic shock. Within the trade pillar, the most interesting part is a glaring void. Although many Free Trade Agreements (FTAs) are mentioned, as well as the ongoing negotiations with the US to address some of the protectionist measures within the IRA, no reference is made to a wider pact with the US. The "Transatlantic Trade and Investment Partnership" (TTIP) seems to be dead as a dodo.

The bottom line: All in all, the "Green Deal Industrial Plan" is a very pragmatic approach by the EU Commission. When it comes to answering the protectionist measures of the IRA, the buck is passed to the member states. No new EU funds or programs for now, but some efforts to get more bang for the existing buck. This approach buys time, but it is no alternative for a real (green) industry strategy that takes into account not only the climate crisis but the new geopolitical reality post the war in Ukraine.

So what are the policy options the EU could pursue to make its (green) industry and economy fit for the future?

Further policy options

We present some of the most obvious options the EU could take, ordered by a simple scoring system with two indicators: feasibility and impact. Each indicator can score from 1 (very bad) to 5 (very good). While feasibility addresses the easiness of organizing unanimous approval – in other words, the divisiveness of the policy option – the impact scores measure the expected boost to the green transition and European competitiveness in general. Thus, the total score of the option can be seen as a measure of its desirability.

Creating a new sovereignty fund

Without doubt, the Ukraine war has multiplied the challenges for Europe. The green transition has gained in importance and urgency as the only road to energy sovereignty. But the significance of the Ukraine war goes beyond the energy crisis. Geopolitical shifts were visible well before – the US-China rivalry, for instance, which is as fierce or even fiercer under President Biden. But until 24 February 2022, the EU wasn't ready to take up the challenge: Muddling through by dodging the hard questions of the new global power game was the route taken. This is no longer possible as there are no illusions left: Russia is a rogue state; China can no longer be seen as a partner and the US may turn isolationist. Among many other things, this has wide-ranging consequences for Europe's global industry, too. Nothing less than a new comprehensive strategy is required, building the foundation for its survival in a splintering world. It goes without saying that such a transformation requires huge investments. Ideally they should be financed by common funds, not least to keep the EU together. Because in the new geopolitical climate, the price for any dislocations within the EU has become much higher than in the preceding years of US hegemony.

The verdict: A new sovereignty fund might be difficult to launch as many EU members are opposed to new funds and common debt. However, it can hardly be denied that the challenges Europe faces go beyond the Recovery and Resilience Fund: The EU needs a lot of stamina to overhaul its business model. Without unity, it might not succeed. So the real value of such a new fund might not lie in the new money available but in the fact that it is deployed equally, sending a strong signal of European solidarity. However, one caveat remains: If the new fund distracts from the task of making existing programs more efficient and merely adds to EU's "money jungle" it might be not worth the effort.

Total score: 8 (feasibility 3, impact 5)

Concentrating on implementation

There are already enough European initiatives to foster the green transition; the bottleneck is not funds but implementation. Efforts should not be directed at every new program but at making the existing ones better. Bringing light into the EU jungle of subsidies should be the order of the day.

The verdict: Improving existing programs, striving for leaner processes and easing access to funds are no-brainers. Most if not all EU members are likely to agree. And if this focus on de-bureaucratization and effectiveness also leads to a more efficient use of the funds of the general budget, steering them away from traditional agriculture and infrastructure towards the green transition, it would pay a double dividend. However, one caveat remains: this approach seems to be connected to more action at the national level. The EU Commission has struck a Faustian bargain: restraint at the EU level is complemented by the relaxation of state aid rules – with the latter being a dangerous path (s. below).

Total score: 7 (feasibility 4, impact 3)

Reviving TTIP

The most elegant way to avoid the thorny issue of domestic content requirements is to aim for exceptions, ideally under the framework of a Free Trade Agreement (FTA). The model could be the embryonic "climate club" on steel.

The verdict: The failure of TTIP is one of the great missed opportunities in the relationship between the US and Europe. However, it would be too easy to blame its failure on President Trump alone: it failed for many reasons. Politically, TTIP remains a zombie on both sides of the Atlantic.

Total score: 6 (feasibility 1, impact: 5)

Appealing to the WTO

The fact that the US is finally taking the climate crisis seriously is welcome but the domestic content requirements of the IRA clearly violate WTO rules, which is not acceptable. So the EU's answer to the IRA should be targeted at these rules, trying to get rid of them. The WTO is the forum to bring the US to justice.

The verdict: It is certainly appealing to use the IRA to try to uphold multilateralism and its institutions. It would strengthen the EU's self-image as the "good guy" in geopolitics. However, given the state of the WTO's dispute-settlement function, there is no realistic chance of success. And even if this might be fixed someday, any verdict might very likely come too late, as in the saga of Airbus and Boeing. Thus, appealing to the WTO is more performance than substance. It will not have any real impact.

Total score: 5 (feasibility 4, impact 1)

Relaxing state aid rules further

Covid-19 and the energy crisis have already spurred national governments into action: We have seen the return of the "strong" or bailout state. Given the scale of the Covid-19 shock, this was inevitable. And there is a good reason: National measures are (much) easier and faster to implement than coordinated European ones. And fast action was required. But it is not only speed that speaks for national action. Given the fact that the fight for supremacy in green technologies will be decided at the micro-level – where will the new chip or battery factory be located? – it seems only consequentially to shift more responsibilities to the national level. But there is also a more sinister explanation. The fallout of factory closures is felt locally; so it is up to the local politician (and their party friends in the capital) to come to the rescue. There is nothing that comes closer to a sure vote winner than saving hundreds of well-paid jobs (even if it is only until after the next election). It is a temptation only few politicians can withstand, no matter what the mid- or long-term consequences are.

The verdict: Single-handedly implemented measures are a boon for national policymakers. This could stimulate a wave of additional funding on the national level. However, the price the EU as a whole might pay is high: undermining the Single Market, arguably EU's biggest success; pitching rich versus poor EU members, opening old rifts, and falling back into old industry policy traps by trying to create national champions. For now, the policy is labelled as "temporary". But already the new name of the policy – temporary crisis and transition framework – is a strong indication that it might stay until long after its expiration date of end-2025.

Total score: 4 (feasibility 3, impact 1)

Introducing "buy European" features

Domestic content requirements are the most controversial aspect of the IRA. The logical answer would be to implement similar rules as long as the Americans keep theirs. But it remains to be seen if the Americans would be really impressed by such "tit for tat"-policies.

The verdict: This sort of rude protectionism could appeal to many voters. However, besides its more than uncertain success, implementation would be nightmarish as every EU member would fight for the "domestic content" to be produced in their country. It would require a level of coordination among EU members that seems elusive.

Total score: 3 (feasibility 1, impact 2)

The bottom line: There are many policy options on the table with varying degrees of desirability. In our view, a new sovereignty fund seems to be the best option. But clearly these options are not exclusive but combinable. For example, while striving for a new fund, the EU can at the same time streamline its existing programs and try to revive the TTIP. Except for the TTIP part, this seems exactly to be the strategy of the EU Commission – but with a dangerous twist: The short-term focus on streamlining goes hand in hand with the relaxation of state aid rules. The intention might be a pure tactical one. Allowing for more national action will inevitably make the playing field within Europe more uneven – and thus strengthen the case for remedies such as a new common fund underpinned by common debt. Call it a Faustian bargain or playing with fire, the hazardousness of this strategy is obvious: Once the Pandora's box of national subsidies is opened, it might be hard to close again. There is a real danger that the EU Commission will end up empty-handed: State aid rules remain no more than a fig leaf, but the envisaged sovereignty fund never sees the daylight. The EU is stuck in the middle, torn apart between a rampant subsidies race and too few common goods.

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