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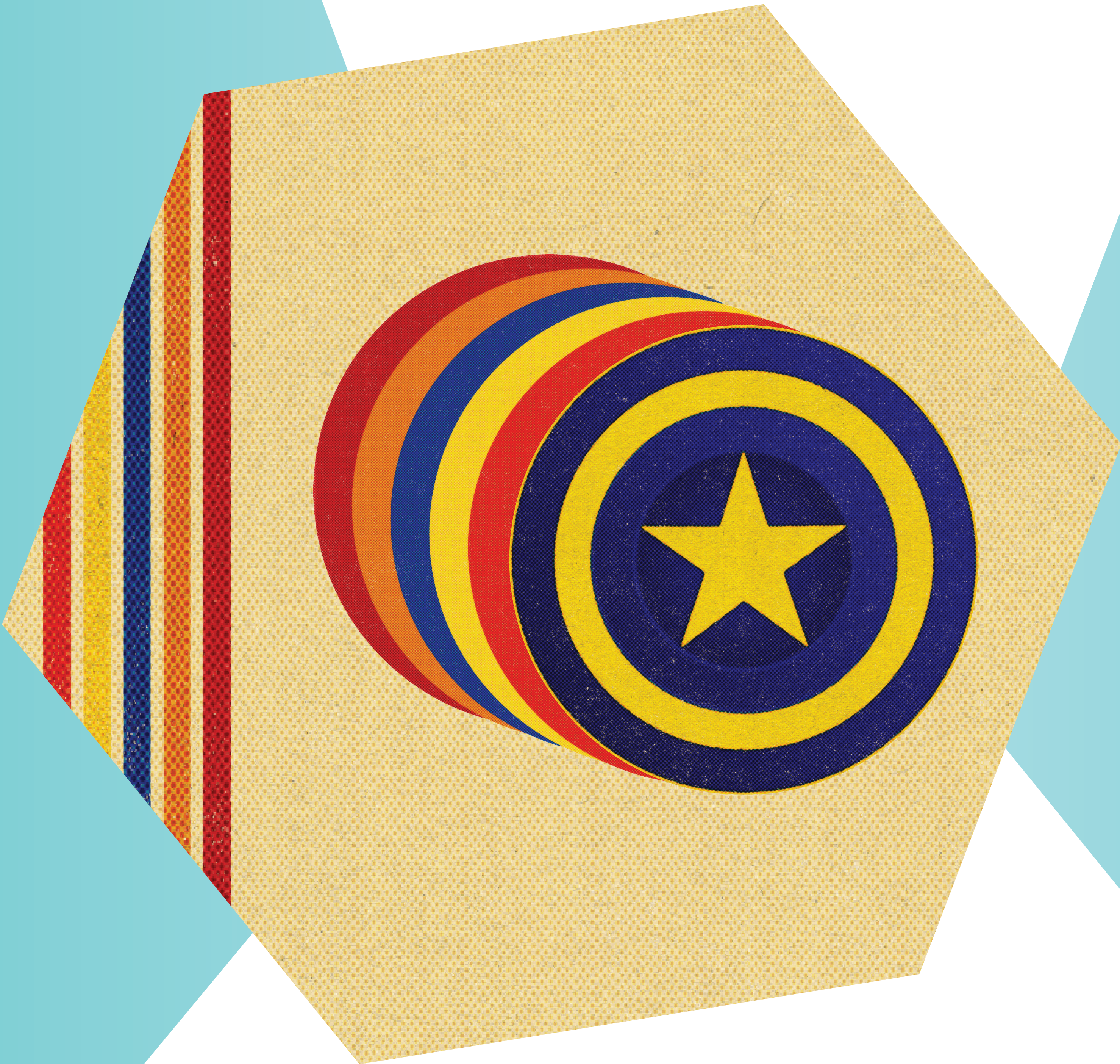

Industrial Policy - An EU Response to the Challenge of Competitiveness

By Alexander Conway | February 2023

The implications of the IRA for European Competitiveness

The 2022 US Inflation Reduction Act (IRA), which marshals US$369bn in industry subsidies for green tech, presents an existential challenge for the future competitiveness of critical European industries, in particular for the automotive, microelectronic semiconductor, and pharmaceutical sectors. This US Act has thrown down a gauntlet in the global battle between the EU, US, and China in ramping up the battle to retain critical industries and technologies in their respective markets.

The forthcoming EU summit on 9-10 February 2023 will provide an opportunity for EU leaders to discuss the ideas proposed for the EU's response to the IRA and to evaluate the implications for EU industry of industrial subsidies provided for US firms in the IRA. This Act has prompted a debate in the EU about the need for a European industrial policy to shore up the EU's competitiveness and a related debate on where to source the required funding for it. At a philosophical level, it pits the free market economy liberals against the more interventionist-minded Member States and has prompted the proposal of a series of remedies to deal with a world that has changed to such an extent that competitiveness could now become a bedfellow of a new European industrial policy, rather than being anchored in traditional EU competition policy.

The US$369bn sum aims at reducing greenhouse gas emissions by 40% by 2030, making it the largest-ever US program to combat climate change, and is also a strategic investment to anchor the future of crucial technologies, from hydrogen and electric vehicle batteries, to green aviation fuel, and from critical raw material supplies to renewable energy projects and solar panels, in the United States. It does so by providing tax credits and federal support for key industries and by incentivising companies to reorganise their supply chains, so as to make, assemble or manufacture critical content in the US or in its partner countries. Media commentators have even pointed out a political impetus behind the policy which is evident particularly in swing-states like Ohio and Michigan, where manufacturing and the automotive industry wield significant influence.

The EU has responded to the IRA in a few different ways: by consolidating existing expenditures such as the €20bn for batteries via Important Projects of Common European Interest (IPCEI's); providing subsidies for electric vehicles; and by utilising the green provisions for the disbursement of Recovery and Resilience Facility funds. A proposed "European Sovereignty Fund" (ESF) may provide the requisite speed and firepower needed to counter the IRA, by forming the basis for an EU green industrial policy funded through common borrowing by the European Commission to the tune of €350bn. Such a policy could alleviate concerns about disruptions to the Single Market which could arise if Member States were to follow their own individual State aid policies, could lower overall interest rates and create better conditions for the Union as a whole, by achieving the sheer scale needed to match Chinese and US endeavours.

Most of these proposals, which have emerged in a piecemeal manner, are collated and explored in the "Green Deal Industrial Plan for the Net Zero Age" (COM(2023) 62 Final) – a communication which was published on 1 February 2023 by the European Commission. The document argues that a common response anchored in EU policies and instruments would be far more effective than the addition of 27 national approaches to maintaining Europe's competitiveness in a fragmented global market. The Green Deal Industrial Plan would be based on four pillars: (i) A predictable and simplified regulatory environment; (ii) faster access to efficient funding; (iii) skills; (iv) open trading for resilient supply chains. A review of the impact of the IRA on the semiconductor, automotive and pharmaceutical sectors below provides an analysis of the current state of play in these industrial sectors in the EU.

Automotive Sector

For the automotive sector, the Single Market has concentrated significant resources into electric vehicles and lithium-ion battery production, and the EU is on track to become the second-largest battery manufacturer behind China by 2030. The risk for the European automotive industry is that the IRA will simply outspend European efforts, and funnel investment into the United States, given the IRA provisions to be met in order to qualify for the full tax credits available. This however is not the primary rationale for European efforts. Rather, it is based on the commitment to long-term investment and policy measures to support the development of battery production and critical raw material ecosystems, from extraction to recycling. The significance of this is that level of capital required to develop this infrastructure will have significant long-term knock-on implications for where future industries will choose to locate.

Pharmaceuticals

Contemporary pharmaceutical production comprises a network of primary and secondary manufacturers (which produce raw ingredients and compounds respectively), distributors, wholesalers, and end-customer retailers, which is highly specialised, globally decentralised, and places an emphasis on just-in-time inventory management. This structure privileges efficiency of supply over resilience of production, and while reducing costs it renders global supply or value-chains potentially vulnerable to disruption. Furthermore, advanced manufacturing techniques, R&D facilities and drug discovery are highly capital intensive, and levels of European investment in the biopharma sector have declined relative to US and Chinese levels. In addition, policies like the Inflation Reduction Act, as well as the prospect of significantly cheaper energy, lower labour costs, and greater profit potential in the US present risks for European pharmaceutical production vis-à-vis the United States.

Thus, issues such as drug price controls, overly onerous regulation and higher energy costs in Europe are leading pharma companies to de-prioritise investment in Europe due to relative decline in their returns. While EU investment in R&D has been strong, the commercial challenges facing the pharmaceutical sector are significant and may pose considerable challenges to the future business viability for firms in Europe.

Semiconductors

Semiconductors are vital for future manufacturing, economic productivity and innovation, with memory chips, processors and integrated circuits all providing pivotal underpinning for the software and hardware of modern life, like phones, automobiles, online services and defence technologies. A secure supply is critical to achieve the EU's stated green and digital transition goals, with an aim of securing 20% of global semiconductor production in the Single Market by 2030.

Geopolitical tensions between the United States and China, the situation of Taiwan, and measures such as industrial subsidies and export controls have highlighted the relative vulnerability of European semiconductor supply-chains and raw material imports. Semiconductor manufacture is globally dispersed and dominated by highly specialised firms focused on discrete aspects of design, fabrication, and assembly, and concentrated in the United States, Taiwan, Korea, China, Japan, and the European Union. However, no one region or firm has a complete industrial ecosystem which highlights the relative mutual vulnerability present in semiconductor production. The EU is relatively strong in primary design, chemicals, and machinery supply, but is lacking in broad manufacturing and assembly capabilities as well as funding incentives compared to US and Chinese efforts.

Member State Perspectives on the US Inflation Reduction Act

While larger Member States support the proposal for greater European industrial State aid, this is tempered by scepticism in some Member States over collective borrowing to fund it.

France has been highly critical of the US Inflation Reduction Act, calling it "super aggressive", and President Macron stated that it risked "fragmenting the West" by unfairly distorting competition and disadvantaging firms in Europe.[1] In response, France has led the charge in the European Union for a counterpart to the US "Make it in America" provisions in the IRA, and called for a "Buy European Act" which would similarly privilege and support EU firms vis-à-vis foreign competitors in strategic sectors. France also favours a European industrial policy which would help to secure EU supply chains for critical industries.

Italy, Greece, and Portugal are all broadly supportive of potentially pooled borrowing to invest in long-term investment in strategic industrial sectors across the Single Market.[2] However, Germany and the Netherlands are less supportive of such a measure, and have concerns about the long-term sustainability of subsidising industries; they are concerned about how funding would be dispensed and regulated, and highlight the potential risk of economic moral hazard of shared borrowing, when there is no incentive for subsidised firms/industries to avoid financial risky. It is, therefore, worth noting that if the EU is, as President von der Leyen suggested, to become a global hub for clean-tech and industrial innovation towards net-zero economies, the foundations of the Single Market in terms of fostering dynamic business and growth may need to be reassessed as a result.

Since the pandemic, the EU has invested huge sums in creating the €672.5bn Recovery and Resilience Facility, as part of the €800bn Invest EU R&D funding, while the EIB has facilitated offers of loans and grants for projects. Suggestions have been made that some of the 100bn in Cohesion funding for regional development could be repurposed and targeted towards specific industrial sectors, and consideration has been given to possible allocation of EU budget funds in the context of a review of the MFF to support a European Solidarity Fund.

However, the levels of funding in the EU are lower than those of the US, the processes involved in accessing funds are complex and take longer in the EU and they are more piecemeal in nature compared to the IRA, as they often require a comprehensive understanding of all the available EU funding sources, which is difficult for smaller firms and newcomers to the market to grasp.

France, Italy and Spain are concerned that loosening State aid restrictions would give German companies an unfair advantage over others and allow the German government to disburse more State aids to companies in order to retain them in Germany. They would prefer a European response instead, as they argue that national subsidies could fracture the Single Market, endangering the "level

1 Subscribe to read | Financial Times (ft.com)
2 Brussels Playbook: Weber's migration push — 'Marx on steroids' — Ukraine eyes Strasbourg – POLITICO

playing field" between the wealthier and the poorer Member States which is a key feature of the Single Market. Furthermore, it could lead to harmful subsidy competitions between individual Member States, as well as being detrimental to public finances.

As Germany is the second largest dispenser of nationally derived State aid support in the EU after France, and, as the largest economy in the EU, it is argued that Germany stands to potentially benefit most from an industrial subsidy policy. Many firms being courted by the US to relocate to America are specialised SMEs based in Germany and this "Mittelstand" is the backbone of the German economy. So the IRA could be seen as a potentially significant threat to long-term German economic interests, if the German SMEs are lured to invest in or relocate to the US.

A related debate between those advocating temporary targeted measures to protect Europe's competitiveness, such as Germany and those who favour a more strategic long-term approach, like France and Spain, is being conducted in parallel to the debate about funding a Green Deal industrial policy and is likely to lead to animated discussions at the summit on 9-10 February.

Disturbing the Balance between Big and Small Member States

Smaller Member States, like Ireland, Finland, Estonia Czech Republic, Slovakia, Austria, and Denmark are wary of a-policy to counter the US IRA, as it would distort the Single Market and render them unable to match the resources of bigger Member States.[3] In a letter to EU trade Commissioner, Valdis Dombrovskis, the Ministers of Finance of Ireland, and the above-named countries argued that:

> *[The] EU's competitiveness and better investment environment rests on ensuring strong, adaptable economies and sound public finances that can foster private investment and innovation. It cannot be built on permanent or excessive non-targeted subsidies.*[4]

Another concern is that while a simplification of EU State aid rules may aid long-term investments, such a policy could disproportionately benefit larger Member States with deeper pockets, such as Germany or France, and those endowed with transport links, natural resources, and favourable geologies, while disadvantaging less well-resourced and physically peripheral Member States, like Ireland.

The perspective of the countries like Sweden, which currently holds the EU's Council Presidency, is that the European Commission is responsible for coordinating the EU's response to the IRA. In recent months, the European Commission has been under pressure from Member State governments to draw up detailed analyses of expected negative impacts of the implications of the IRA for the Single Market, and to provide a guide for EU leaders' discussions over future policies at the forthcoming summit. The 21-page Commission communication on a Green Deal Industrial Policy for the Net Zero Age may provide a framework for these discussions.

So, to avoid disrupting the level playing field of the Single Market, the prospect of a European Sovereignty Fund which enables the Union as a whole to develop its industrial base, and not privilege certain countries over others, similar to Cohesion Funding, may offer a way to preserve the Single Market and reinforce European economic competitiveness. However, fiscally conservative Member States like Germany and the Netherlands are likely to reject the idea of any additional EU borrowing or joint debt at the February summit and argue that there are sufficient pots of EU funding which have

3 Brussels Playbook: Postcard from Thessaloniki — Czech election — Weber's euros – POLITICO
4 Ireland one of seven EU countries to oppose new funding for green industry – The Irish Times

not yet been exhausted and which may need to be explored in order to confirm whether adequate EU funding is available to facilitate resilient industrial value chains across the EU.

Ireland and Sweden

Traditionally, Ireland and Sweden have been broadly aligned on their approach to competition policy, favouring more open liberal approaches to trade and the economy, and the removal of internal barriers within the Single Market, particularly in the area of services and digital trade. Sweden has a significantly larger number of both indigenous industrial firms, such as IKEA, Volvo, Saab, Ericsson, Electrolux, and Vattenfall, as well as a large primary resource extraction sector focused on forestry and mining, particularly iron ore, copper, and zinc. Ireland is, however, more reliant on foreign direct investment and foreign multinational firms and has deeper trade links with the UK and US as a result.

As negotiations are still continuing between the EU and the US on reducing the impacts of the Inflation Reduction Act on the EU, viable options will need to be proposed by EU leaders at the forthcoming summit to avoid an exodus of EU investment to the US. The EU may have no other option in the short term than to temper its liberal free market philosophy in favour of temporary measures to protect its industrial base and jobs for EU citizens, in the hope that a focus on Common projects of European Interest (IPCEIs) buttressed by targeted temporary funding will foster the scale of innovation and R&I required in pharmaceuticals, semiconductors and e-car technologies to retain and support companies operating in these critical sectors for the EU economy as a whole. Meanwhile, consideration may need to be given to the question of whether coercive instruments and defensive measures to protect the Single Market are preferable to resetting the compass of existing trade partners to allow ratification of trade agreements with Chile, Mexico, New Zealand and Kenya, foster SIFA agreements with Africa, progress dialogue with the Mediterranean countries to the south and the Western Balkans and Eastern Partnership countries which would facilitate new sources of critical materials, foster more resilient supply chains and provide new markets for EU products while enhancing the global competitiveness of the EU.

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