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Europe's Industrial Policy and the Response to IRA

Europe is seeing a renaissance in industrial policy. Industrial policy usually involves influencing an economy's sectoral development by means of subsidies, partial state ownership of companies, or regulations. It can also include promoting mergers of companies to form national champions – large companies which are supposed to conquer the world's markets with their governments' support. It's also common to bar foreign investors from taking over domestic companies that are deemed strategically important.

Industrial Policy Has a Long Tradition in Europe

While such interventions have a long track record, they aren't always successful. France is considered the motherland of industrial policy; the number of industrial policy initiatives taken there is especially large. These include the development of the Concorde supersonic aircraft as well as the Plan Calcul, a program launched in the late 1960s to develop a French computer industry that would rival US companies such as IBM: an expensive flop. Also questionable were interventions in company takeovers. When the US corporation PepsiCo wanted to take over the French company Danone in 2005, the then president of France, Jacques Chirac, intervened. Why he did so remains a mystery, but his "strategic yogurt policy" certainly earned him ridicule. Founding the European aircraft company Airbus together with Germany also swallowed up billions in subsidies, but at least it increased competition in the aircraft market and led to the emergence of an industry that is considered competitive today. However, France's industrial policy has not been able to prevent its manufacturing sector from shrinking more and more. Today, manufacturing generates less than 10 percent of the value added in the country, compared to 18 percent in Germany, for example.

Two Reasons for the Most Recent Renaissance of Industrial Policy

There are essentially two reasons why Europe is rediscovering industrial policy at the present time. To begin with, Europe wants to be climate neutral by 2050. Decarbonizing industrial production without deindustrializing Europe is a major challenge. Taxing and regulating CO_2 emissions alone will not do the job. Second, Russia's invasion of Ukraine and the resulting end of Russian gas deliveries have shown how much of a problem economic dependencies can become in the event of geopolitical conflict.

As far as the transformation of the economy toward climate neutrality is concerned, European policymakers have long been hoping that clean industries will not only protect the climate but also give the European economy additional advantages in the markets of the future. In Germany, the view that domestic industry could take the lead in climate-friendly technologies is particularly popular. However, in the country's most important industry, the automotive industry, this has worked only to a limited extent. Here, it is Tesla, a US company, that is the driving force, with German companies such as Volkswagen and BMW currently following suit.

Now the US government's Inflation Reduction Act (IRA) has put another damper on Europe's hope for a leadership role in environmental technologies. Over the next ten years, this law will provide USD 369 billion in subsidies for climate-friendly products and technologies such as electric cars, heat pumps, solar cells, wind turbines, and even nuclear power plants. These subsidies in part require that goods be produced in the US or in countries that have a free trade agreement with the US. This would disadvantage imports from Europe and incentivize European companies to move their production facilities to North America. However, the US and the EU are now negotiating about opening up the subsidies to European products as well.

Yet there are many voices in Europe calling for a new subsidy program in response to the IRA, preferably one funded by joint debt. Such demands are premature. They overestimate how attractive the IRA makes the US as a location for investment; they neglect that Europe has already launched extensive programs subsidizing clean technologies; and they distract from the urgent need for action in other areas. Nor does new, debt-financed government spending make much sense in light of the macroeconomic situation, where inflation is high.

The Impact of the Inflation Reduction Act

In fact, the most important consequence of the IRA is that it will lower greenhouse gas emissions. This is to be welcomed from a European perspective as well. The IRA is not primarily a program that aims to generally strengthen the US as a location for investment – for two reasons: First, for companies active in the US, the IRA entails not only subsidies but also higher tax burdens, i.e., a minimum tax for large companies as well as a new tax on share buybacks. Ultimately, the plan is to more than completely offset the costs occasioned by the IRA by raising taxes. Second, it is questionable whether investing in factories for solar panels, heat pumps, and car batteries that use established technologies is sustainable. It is not clear why the US should have comparative advantages in these fields. There is a high probability that these factories will stay in the country as long as there are subsidies to be had, but will move away again once payments stop. However, the US government may still go down that road, hoping to score points in the upcoming presidential campaign by claiming to have created industry jobs in the US. Subsidizing efforts to research, develop, and scale cli-

mate-friendly products and technologies may have longer-lasting effects, but that's not the IRA's main focus.

The reason the US is currently more attractive than Europe as a location for investment is primarily due to other factors, most notably a cheap and secure energy supply, low taxes, direct access to US markets and those of the country's free trade partners (e.g., Canada and Latin American countries), and – last but not least – security in light of geopolitical tensions and the threat Russia poses to the EU.

Given this background, what action is required from European and German policymakers, and what role do instruments of industrial policy play in all this? One basic problem of national industrial policy is that comparative advantages need to be discovered in the market. Political decisions to subsidize certain sectors can turn out to be expensive flops if they do not result in industries that, after an initial phase, become self-sustaining and competitive.

Government Intervention Can Make Sense in the Context of Decarbonization

However, when it comes to transforming the economy toward climate neutrality, there are several arguments for government intervention. This isn't so much a question of directly acting to protect the climate, for which carbon pricing and regulations can provide sufficient incentives. What's more important is the positive externalities of research and innovation. Individual companies' efforts in research, development, and the improvement of production processes with the aim of reducing costs benefit not only those companies but also other companies that learn from them. To the extent that this is the case, too little is being invested in these activities absent state subsidies. For examples of such cost reductions, we can look to solar and wind power. Between 2010 and 2020, the production costs of photovoltaic systems fell by roughly 90 percent, while wind turbines became about 50 percent cheaper to make. Similar effects are to be expected in the hydrogen economy and in decarbonized steel production.

All this suggests that it makes sense to support, above all, research into climate-friendly technologies and the development and manufacture of climate-friendly products with the latest technology – perhaps also as part of public procurement. US military spending offers examples of this. However, research externalities cannot justify subsidy competitions to attract battery factories that employ established production technology. One could argue against this citing a wish to avoid, at a time of growing geopolitical tensions, being dependent on imports when it comes to crucial goods such as batteries. But this would be to overlook the vanishing likelihood of a geopolitical conflict with the US that would halt battery exports to Europe.

Another possible argument for state subsidies is that the absence of such subsidies could lead to carbon leakage, i.e., a relocation of industrial production and associated greenhouse gas emissions to other parts of the world. If, say, conventional steel production becomes more expensive in Europe due to high carbon prices, moving production to other regions with less restrictive climate policies is an obvious choice. This would deindustrialize the EU while doing nothing to protect the climate. For imports to the European single market, a border adjustment designed to level competitive disadvantages for climate-friendly EU products is set to take effect. Whether this will work in practice, only time will tell. After all, other countries could regard this border adjustment as a protectionist measure. At any rate, exports from the EU to third countries are becoming less competitive. Here, a possible solution would be to provide temporary subsidies for the hardest-hit products, such as steel. In the long term, however, it makes no economic sense for Europe to supply the world with green steel if other countries that do nothing to protect the climate produce conventional steel more cheaply. This highlights the limits of Europe going it alone when it comes to climate policy.

What's more, private investors will develop climate-friendly technologies only if they can trust that future conditions will ensure these technologies are competitive and in demand. They will not, for example, invest in electric vehicles if they fear that charging infrastructure will be lacking or power grids insufficiently expanded. Conversely, it will be hard to find investors for charging points if it's unclear whether there will be enough electric cars. This highlights the importance of providing reliable conditions.

The European Approach: Pricing Polluters

How can these principles help shape and finance industrial policies that make sense? When it comes to climate action, to date the EU has relied on different concepts than the US. In Europe, the key instrument is carbon emissions trading. This follows the polluter pays principle: those who cause environmental damage bear the costs. With the IRA, the US is taking a different approach. Rather than penalize companies that cause greenhouse gas emissions, the government subsidizes those that avoid them.

The downside of this strategy is that such subsidies must be financed with tax revenue from other sources. In European countries, by contrast, applying the polluter pays principle is a way for the government to raise revenue. On its own, however, Europe's climate policy affects European companies' competitiveness in the global markets, while the US subsidy policy avoids this drawback. This is why the EU is attempting to protect the European economy's international competitiveness with compensatory measures such as the Carbon Border Adjustment Mechanism.

That said, European climate policy is no stranger to subsidies either. Germany in particular has spent billions subsidizing wind and solar power. Only recently, the EU launched the NextGenerationEU (NGEU) funding program for the digital and green transformation of the economy. The program is worth around EUR 800 billion, to be spent by 2026. At least 37 percent of the funding – that's EUR 296 billion – goes toward the green transformation. That share could increase in light of the intensified competition between the EU and the US. This also applies to the funding used to directly subsidize the decarbonization of industrial production. However, we are already seeing bottlenecks – not so much in the availability of subsidies but in terms of sensible projects. That is why a significant portion of NGEU funding goes toward projects that would have been financed by the member states anyway. But reluctant use of subsidies can also be due to overly bureaucratic application processes. So it might make sense to move away from subsidies toward accelerated depreciation or tax credits.

NGEU funding primarily goes to EU member states with low income levels, high unemployment, and high debts. Italy, the largest recipient, receives around EUR 200 billion from the fund in the form of transfers and loans – Spain gets around EUR 150 billion. This puts into perspective the concern that countries with historically lower levels of debt, such as Germany or the Netherlands, might use larger subsidies to the advantage of their industries.

Here, a possible objection would be that EU state aid rules prevent member states from being able to compete with the US when it comes to attracting individual companies. Indeed, there have been calls to ease EU state aid rules. It should be noted in this context that larger, highly visible projects in particular can easily trigger a bidding war. This is especially damaging for whoever wins the bid in the end, as the subsidies may easily exceed what the country stands to gain from attracting the company in the first place. What's more, competition between the EU and the US as well as among member states would most probably drive up subsidies. EU member states have a shared interest in preventing the latter in particular. These arguments suggest that EU state aid rules should not be eased to a point where all barriers to subsidy races are removed. There should, however, be room for targeted industrial policies that promote innovation.

Thinking beyond Decarbonization

Europe's industrial policy should not be limited to funding decarbonization. The debate surrounding the response to the IRA distracts from the urgent need to work on other dimensions of European competitiveness and to make up for past failures. Energy policy is the top priority here. Inexpensive and secure energy supply requires stronger integration of European energy markets, an expansion of energy networks, renewables, and nuclear power, and funding for research in these fields. What is also needed is a new regulatory framework enabling the development of a platform economy in the energy sector, in which private households and companies simultaneously act as consumers and producers of energy.

Furthermore, Europe lags far behind when it comes to digitalization. Often, the General Data Protection Regulation thwarts the development of digital business models without serving justified interests in privacy. On top of that, EU countries needlessly burden their companies – not only with taxes and contributions but also with increasingly complex reporting and monitoring obligations such as sustainability reporting and supply chain monitoring.

The most significant failing, however, has been the EU's hesitancy to develop its greatest strength: the European single market. To this day, cross-border business in the EU often involves a great deal of effort, causing many companies to try their luck in the US, where the size of the market facilitates fast growth. All this requires political fine-tuning beyond the gaze of the public eye, work that is more important for Europe's economic future than debates about new subsidies.

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