GIES OCCASIONAL PAPER

The Global Energy Crisis | January 2023

# THE RETURN OF INDUSTRIAL POLICY IN THE EUROPEAN UNION

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*Industrial policy is making a surprising comeback in the European Union. This return is a response to industrial policies of others, the Union's increased climate ambitions, and reinforced geopolitical tensions. While the EU for some time has tried in vain to create the world economy in its own image, has more recently started to assertively protect its model against the policies of others, it is now embracing industrial policy itself. A new European industrial policy could democratize, accelerate, and render more just the green and digital transitions. To achieve these benefits, it requires funding from the European rather than national level, needs to boost additional investment rather than the profits of established firms, and needs to happen in a transparent, conditional, and inclusive way.*

Staff of the International Monetary Fund have called it "the return of the policy that shall not be named".[1] For four decades, industrial policy – an umbrella term for policy measures with which governments aim to stimulate specific economic activities within their territory – had a bad reputation among western pundits and policymakers. It had become associated with politicians wasting taxpayers' money, either in fruitless attempts to save inefficient firms in old sectors from inevitable closure, or in making wrong bets when trying to pick winners in new fields. After the economic crisis of the 1970s and the neoliberal revolution in economic thinking, politicians were advised to take a backseat and to let market forces spontaneously discover the comparative advantages of their country through the process of creative destruction, and almost all of them across the political spectrum acquiesced to that credo.

Nowhere was the renouncing of industrial policy done with more conviction than in the European Union. In addition to ideological conversion to neoliberalism and learning from perceived policy failures of the 1970s, in the EU also the integration logic militates against industrial policy. The EU Single Market, the core project of European unification, is seen as incompatible with national industrial policies as these would create an unlevel playing field between firms located in different member states. To ensure free and fair competition on the Single Market, the European Commission therefore received the competence over competition policy from the very start of the integration project. After the 1970s it would start using this power with fervour to get tough on national state aid. Given the limited size of the EU budget, this was not compensated by the introduction of EU industrial funds.

Today, industrial policy is making an unexpected comeback in the European Union. In a recent speech[2], European Commission President Ursula

Von der Leyen called for a "common European industrial policy [with] common European funding". This rehabilitation of industrial policy in the EU is being driven by three trends: the intensification of industrial policies by third countries; the increase in the EU's climate ambitions, which requires abundant additional investment and risks putting EU firms at a competitive disadvantage; and the rise of geopolitical tensions and a new way of thinking about the relationship between economic interdependence and security. Recent events, not least the energy crisis following the Russian war of aggression in Ukraine, have given these drivers much higher urgency.

## The failure of exporting the EU model

The European Union believed for some time that it could create the world economy in its own image, as a free and fair market undistorted by state aid or other forms of anti-competitive behaviour. Within the World Trade Organization (WTO), agreements indeed allow states to apply remedies to address dumped or subsidized imports from other states. When countries like China or Russia joined the WTO in 2001 and 2011 respectively, the EU hoped that their membership would quickly turn them into liberal market economies. But this has not happened. The rulebook of the WTO that was written in the "end of history" days of the early 1990s is now widely seen as insufficient to rein in the market-distorting behaviour of the likes of China and Russia. However, reforming the rulebook within the WTO has proven impossible given the diversity of the membership and the principle that agreements are concluded by consensus.

Since the United States' failure to ratify the 1997 Kyoto Protocol, the EU has set itself up as the global leader in the fight against climate change. Starting in 2005, a cap-and-trade system called emissions trading scheme (ETS) has been the cornerstone of its climate policies. In 2020, the EU ramped up its climate ambitions with the European Green Deal, which was translated a year later in a package of legislative proposals under the "Fit for 55" banner. With this package, the EU aims to become the first major climate neutral economy by the middle of the century and has set an intermediate target of reducing net greenhouse gas emissions by at least 55% in 2030. The EU's reinforced climate ambitions have led to a significant increase in the price of emission allowances within the ETS from less than 10 euros per metric ton of CO2 until the beginning of 2018 to around 85 euros in December 2022. This in turn heightens the risk of and concern for "carbon leakage", whereby energy-intensive firms would shift production from the EU to third countries where they do not have to buy emission permits or equivalent carbon taxes, which would undermine the objective of reducing global carbon emissions and would lead to deindustrialization in the Union.

Finally, the EU's old way of thinking about the economy has been thrown out of balance by a series of economic and geopolitical upheavals, including the covid-19 pandemic, the Sino-American trade war, and the Russian invasion of Ukraine. The pandemic and its economic fallout raised questions about the security risks of being overdependent for critical equipment on a limited number of suppliers. The trade war between the US and China reinforced concerns about European dependencies on critical raw materials from China and microchips from Taiwan, where tensions with mainland China are boiling up. The reconceptualization in the EU of the relationship between economy and security was given an extra push by the Russian invasion of Ukraine, and the weaponization by Russia of the EU's dependence on its gas exports, leading to a major spike in energy prices. In this more geopolitical way of thinking, it matters what you produce and where you get your imports from, and politicians have become less inclined to leave such decisions completely to markets.

## Protecting the EU model

While each of these upheavals individually deal a severe blow to the EU's existing economic policies and paradigm, especially their combined impact presents a major earthquake. European (energy-intensive) industrial firms must now deal with an unlevel playing field in terms of subsidies, climate policies and energy prices. Subsidies by third countries, especially if they are seen as systemic rivals, are no longer just a commercial nuisance but also a climate and security challenge. The EU's hope that trade integration and summitry (the recipes of the EU's own integration process) would turn other countries into liberal market economies, ambitious custodians of the planet, and responsible stakeholders of a multilateral order has not come true. The EU itself now regularly calls this previous way of thinking "naïve".

Having failed to create a world in its own image, the EU has recently reinforced an arsenal of trade defence instruments to protect itself from the threats posed by the policies of third countries.[3] The foreign subsidies regulation and the international procurement instrument should protect the EU market against subsidized public bids and investments and improve the access of EU firms to foreign procurement markets. The carbon border adjustment mechanism (CBAM), which will equalize carbon pricing for imports and EU-made products, should help protect the integrity of the EU's climate policy as well as the competitiveness of EU industry. The framework on foreign investment screening mechanisms and the anti-coercion instrument need to safeguard the security and strategic autonomy of the EU from unacceptable foreign interference.

## Adapting the EU model

However, a growing chorus of voices in the EU argue that it is not enough to ramp up the trade defence instruments to protect EU policies against the industrial, sustainability and geopolitical (non-)policies of third countries. They claim that the EU should develop a stronger industrial policy itself to promote the triple goal of accelerating the green and digital transition and fortifying the EU's strategic autonomy. Although the new unilateral trade defence instruments help protect the integrity of EU policies and level the playing field, they indeed suffer from several weaknesses.

While these instruments help restore equal competition on the EU market in the face of different policies between the EU and third countries, they do not guarantee a level playing field on export markets outside of the Union, which become more important every year as growth outside exceeds growth within the Union. Moreover, the EU's new unilateral instruments are administratively challenging to implement and require EU authorities to gather and verify a daunting amount of information from third-country producers, related to *inter alia* $CO_2$ emitted and $CO_2$ costs paid, the geolocation of harvested wood or soya and the fate of forests abroad, or the amount and nature of subsidies received. Providing subsidies on a conditional basis is comparatively much easier to administer. Finally, trade defence instruments are reactive in nature. They try to restore a competitive balance in response to some action by a third country government, but this may come too late after the damage is already done.

As a result, the EU has, cautiously at first, started to revive industrial policy. The European Commission is now actively promoting the instrument of "Important Projects of Common European Interest" (IPCEI). European competition rules allow member states under certain conditions to give subsidies to EU companies (and other actors) to undertake joint large-scale projects with significant benefits to the Union that would otherwise not be executed. In the meantime, IPCEI on micro-electronics, batteries, hydrogen, and cloud computing have been launched, in each instance combining billions of public and private funding to promote the EU's leadership in these areas. A bolder industrial policy initiative is the European Chips Act proposed by the European Commission in February 2022. This was a direct response to the global semiconductor shortages that emerged in the wake of the outbreak of the covid pandemic. The EU's chips dependency on a very few manufacturing firms in East Asia has been identified as a geopolitical vulnerability, especially in the context of heightened geopolitical tensions around Taiwan. The European Chips Act will, among other things, mobilize more than 43 billion euros of public and private funding to strengthen the EU's capacities in the different parts of the semiconductor supply chain, including design and manufacturing.

## The final push of the IRA

But calls for a more assertive EU industrial policy have grown much louder after the United States passed its Inflation Reduction Act in August 2022. The bill pursues several objectives, but its main feature is a 369 billion dollars investment plan in energy security and climate. While the EU initially welcomed this most ambitious US climate initiative ever, it quickly took issue with the fact that many of the subsidies for green technology come with local content requirements. For example, the IRA provides thousands of dollars of subsidies to US' consumers that buy an electric car, but conditional upon the car and its battery being primarily made inside the US or a country with which it has a trade agreement. This would currently exclude electric vehicles made in Europe from the IRA's subsidies and disadvantage EU-made cars on the American market.

In combination with the much higher energy prices in Europe compared to the US, the IRA threatens to lure firms into relocating to or making new investments in the US rather than in the EU. Therefore, the EU has asked the US to reconsider these domestic content provisions, or to at least extend the subsidies to EU producers, and has alluded to launching a trade dispute or countermeasures if its desiderata are not considered. But this response is naïve about the political economy context of the IRA inside the US: without sufficient guarantees that a more ambitious climate policy would directly lead to domestic green job creation, a desperately needed climate bill would not have passed Congress.

As a significant reversal of the IRA's domestic content requirements seemed increasingly unlikely, some European decision-makers started calling for the EU to develop its own IRA-like industrial policy. French President Macron was quick to propose a "Buy European" response to the IRA, copying the US' policy.[4] The French Commissioner Thierry Breton called the IRA (together with the Buy American Act, the US Chips Act and Defense Production Act) "examples of determination and audacity" and called for a more assertive EU industrial policy.[5] With her reference to a new European Sovereignty Fund in her State of the European Union speech in mid-September, Commission President Ursula von der Leyen seemed to endorse that idea.[6] However, while a consensus has grown within Europe that an industrial policy answer is necessary to avoid the deindustrialization of the EU, there remain different views on how this should be done.

## The national or European route?

Some advocate further changes to the EU's state aid rules that should make it easier for member states to subsidize industries investing in the green and digital transition. In response to covid and the Russian invasion of Ukraine, the Commission adopted broad temporal crisis exemptions to state aid control. Some, including Competition Commissioner Margrethe Vestager, now propose an even broader and longer-term "Temporary Crisis and Transition Framework", which would simplify state aid for renewable energy technologies and in support of new investments in facilities that are at risk of relocation. However, this would risk fragmenting the Single Market. Some member states have deeper pockets than others to dole out green subsidies to firms. Larger member states and those with more fiscal space can more easily provide state aid than smaller member states and those with already overburdened public finances. Since the entry into force of exemptions to state aid control after the Russian invasion of Ukraine, 53% of the total of 672 billion euros of approved state aid in the Union comes from Germany, while 24% comes from France.

If further relaxing state aid control becomes the EU's main industrial policy tool, this risks tilting the playing field on the Single Market even more to the advantage of member states with ample resources and fiscal space. Therefore, a better solution would be to finance green industrial subsidies at the EU level so that all member states can share in the benefits. A European industrial policy fund could be designed analogous to the Union's revolutionary post-covid recovery and resilience fund or support to mitigate unemployment risks in an emergency (SURE) instrument.[7] If relaxation of state aid rules is adopted before agreement on new EU funding for industrial policy, the risk is that larger Member states will lose interest in common funding.

## Opportunities and threats

A new European industrial policy could bring significant opportunities. It could strengthen public control over the green and digital transition. By visibly creating new jobs in green sectors, it could give a more positive connotation to these transitions than current public discourses about higher prices, prohibited consumption and disappearing jobs. A carrots-based approach might produce more public support for the green transition than the current sticks-based schemes. Public authorities could make the receipt of state aid conditional upon respect for the highest standards of labour and social rights (as in the IRA), thereby promoting the "just" character of these transitions.

However, a new European industrial policy also comes with risks that need to be avoided or mitigated. A global subsidy race between the major powers, which some warn for[8], is not one of them. The world currently has a multiple trillion investment gap to meet the climate target of net zero emissions by 2050.[9] A green subsidy race is therefore to be welcomed, on the condition that the net effect on $CO_2$ reduction is positive. That means that subsidies need to fund additional rather than already planned investment. Cooperation between countries (like the EU and the US) on their respective industrial policies can ensure that these are complementary and do not cause inefficient and wasteful overproduction. Considerations of global justice also require the EU (and other large powers) to ensure that subsidies do no significant harm to developing countries, or that they are compensated. Industrial policy should boost green and digital output and not profits of existing champions. Layering industrial policy on top of the pre-existing economic structure will not automatically produce desired outcomes.[10]

## Make industrial policy's comeback a success

European industrial policy is back. Its return is a response to the industrial policies by others, the climate challenge, and a more geopolitical perspective on economic integration. The war in Ukraine, the energy crisis and the United States' inflation reduction act has given industrial policy's comeback the final push. While industrial policy carries the potential to democratize and accelerate the green and digital transformation and ensure that they become "just" transitions, these positive effects are not guaranteed. To ensure a successful comeback of industrial policy, it needs to be funded at the European rather than national level, should target new rather than existing investments, and should ensure transparent, conditional and inclusive allocation of subsidies rather than reinforcing the market power of dominant firms.

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[1] Reda Cherif & Fuad Hasanov, *The return of the policy that shall not be named: Principles of industrial policy*, International Monetary Fund, 2019.

[2] Ursula Von der Leyen, "Speech by President von der Leyen at the College of Europe in Bruges (speech, Bruges, December 4, 2022)," European Commission, https://ec.europa.eu/commission/presscorner/detail/en/speech_22_7487.

[3] See Ferdi De Ville, "The European Union's unilateral turn in trade policy," Paper presented at the ECPR Joint Sessions, April 19-20, 2022.

[4] Giorgio Leali, "Macron calls for Buy European measures for cars," *Politico*, October 17, 2022, https://www.politico.eu/article/emmanuel-macron-buy-european-act-cars-united-states-china/.

[5] Thierry Breton, "A European Sovereignty Fund for an industry "Made in Europe," *Statement*, *European* Commission, September 15, 2022, https://ec.europa.eu/commission/presscorner/detail/en/STATEMENT_22_5543.

[6] Ursula Von der Leyen, "State of the Union address by President von der Leyen (speech, Strasbourg, September 14, 2022)," European Commission, https://ec.europa.eu/commission/presscorner/detail/en/speech_22_5493.

[7] See Philipp Heimberger & Andreas Lichtenberger, "RRF 2.0: A permanent EU investment fund in the context of the energy crisis, climate change and EU fiscal rules," *The Vienna Institute for International Economic Studies*, Policy Notes and Reports No. 63 (2023).

[8] Giorgio Leali, "EU's free-trading Vestager warns against subsidy war with America," *Politico,* December 1, 2022, https://www.politico.eu/article/vestager-warns-against-imitating-us-amid-buy-european-debate/.

[9] The Swiss Re Institute puts the global investment gap between 2022 and 2050 at a mind-blowing 270 trillion US dollars, SwissRe (Press Release), "Over USD 270 trillion in climate investments needed to meet 2050 net-zero targets," Zurich, October 7, 2022, https://www.swissre.com/media/press-release/pr-20221007-USD-270-trillion-in-climate-investment-needed.html#:~:text=Zurich%2C%207%20October%202022%20%E2%80%93%20Climate,progress%20on%20decarbonising%20the%20economy. According to the European Commission, the EU has to fill an investment gap of about 180 billion euros per year, Council of the EU, "Sustainable finance: EU reaches political agreement on a unified EU classification system (Press release)," Brussels, December 18, 2022, https://www.consilium.europa.eu/en/press/press-releases/2019/12/18/sustainable-finance-eu-reaches-political-agreement-on-a-unified-eu-classification-system/.

[10] Lenore Palldino & Isabel Estevez, "The need for coporate guardrails in US industrial policy," Washington: Roosevelt Institute, August 18, 2022, https://rooseveltinstitute.org/publications/the-need-for-corporate-guardrails-in-us-industrial-policy/.