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"We are all protectionists now!"

Green and geopolitical protectionism on both sides of the Atlantic

Executive Summary

At the 2023 World Economic Forum, the President of the European Commission Ursula von der Leyen said "China has been openly encouraging energy-intensive companies in Europe and elsewhere to relocate all or part of their production. They do so with the promise of cheap energy, low labour costs and a more lenient regulatory environment. At the same time, China heavily subsidises its industry and restricts access to its market for EU companies."

Even if the President of the Commission was speaking of China, von der Leyen could easily be referring to the US, and to the newly signed Inflation Reduction Act (IRA). **The IRA is incentivizing "companies in Europe and elsewhere to relocate all or part of their production**". Tesla announced in September that it will open a battery plant in the US, instead of Germany, while Spanish energy company Iberdrola and French aviation, defense, and space company Safran decided to relocate part of their activity to the US. Other companies such as the German carmakers Volkswagen, BMW and Audi, the Italian Energy company Enel, the German chemicals company Linde, the Swedish battery company Northvold, expressed their interest in altering production decisions to benefit from US subsidies.

Just as China, the US offers "cheap energy" and "a more lenient regulatory environment" than the EU. In addition, even if it is far from clear that the US has lower labor costs (it depends on the sector and on the Member State that serves as a comparison), it seems evident that it has less protective labor laws. Finally, **the US will "heavily subsidize its industry" and "restrict access to its market for EU companies" through local content requirements**. However, perhaps more importantly than attracting investment, **the US is creating incentives to become a dominant player in the clean technology of the future and, simultaneously, creating jobs and revamping their industry**.

As noted by IMF economists in a famous paper called "the Return of the Policy That Shall Not Be Named: Principles of Industrial Policy", the days when industrial policy suffered from "bad reputation" are long gone. If the US is shifting to a more interventionist industrial strategy, the EU had already signaled a different approach before the peak of the COVID crisis and the war in Ukraine when it presented the 2020 Industrial Strategy. In the meantime, Commissioner Thierry Breton has been vocal on the need for an effective strategy to boost EU industry for a while. On the 17th of January of this year, **President Ursula von der Leyen announced a Green Deal Industrial plan, a package that aligns with a new form of green and industrial protectionism**.

In order to fulfill climate objectives and simultaneously decrease the geopolitical dependencies, it adopts a strategy of loosening state aid rules and promoting import substitution of both critical raw materials and clean tech components and products.

The IRA might have been a game changer for industrial policy on both sides of the Atlantic. With a more interventionist approach, Americans and Europeans can decrease their dependencies vis-à-vis countries such China, while making available more funds to fight climate change. **In this new paradigm, both the US and the EU may increase the resilience of their supply chains and, simultaneously, accelerate the green transition at the global level**. If President Nixon, who could hardly be referred to as a pro-interventionist, had popularized the famous statement “We are all Keynesians now!”, we can say that, as the world enters 2023, “We are all Protectionists now!”

What is the IRA?

Before debating the European responses to the IRA, it is important to pose the following questions: what is the IRA? Is it a climate policy? Is it an industrial policy? Is it a trade policy? Is it a geopolitical move? In a way, it is all of the above.

Initially proposed by President Joe Biden as the "Build Back Better Plan" in 2020, the IRA was later reframed as an inflation reduction programme, given the lasting consequences of the COVID pandemic and the effect of the war Ukraine in prices.

Nonetheless, the IRA is way more than an inflation reduction program. **It has climate, industrial, trade and geopolitical objectives**.

- **Climate policy**: the IRA aims to reduce U.S. greenhouse gas emissions by 50-52 percent below 2005 levels by 2030.
- **Industrial and trade policies**: It is a means to promote industry and create jobs, and increase competitiveness.
- **Geopolitical approach**: Increase the resilience of supply chains and safeguard national security and, as a result, decrease dependencies vis-à-vis China and other non-cooperative countries.

The IRA will mobilize up to $369 billion to advance the green transition, stimulate industry and strengthen the resilience of supply chains, roughly half of what the EU amassed in its post-Covid response package, the NextGeneration EU.

These $369 billion will be aimed at "lowering energy costs for families and small businesses", "accelerating private investment in clean energy solutions in every sector of the economy and every corner of the country", "strengthening supply chains for everything from critical minerals to efficient electric appliances", and "creating good-paying jobs and new economic opportunities for workers". On top of these massive $369 billion of investment, there will be additional funding to reinforce the the Affordable Care Act ($64 billion). Finally, the IRA will make the US tax system more progressive (through the 15% Corporate Minimum Tax, a Prescription Drug Pricing Reform, and IRS tax enforcement, etc) and will allocate $300 billion to budget deficit reduction.

How does the EU see the IRA?

The EU is in a complicated position. When the Green Deal was announced in 2019, President Ursula von der Leyen referred to it as "Europe's 'man on the moon' moment". More than 3 years later, President Biden puts the US in the race. The Americans prevailed in the Space Race, but can Biden win the Climate Race? Even if it is impossible for the von der Leyen Commission to oppose the IRA's climate ambitions, the EU has a number of industrial policy, trade and geopolitical concerns.

Industry and trade policy concerns: a "race to the bottom"?

In Brussels, these heavy subsidies were seen not as a Climate Race but a "race to the bottom". On the 14th of December of 2022, President von der Leyen said it herself: **the green transition should be a "race against time, not a race against each other (…), it should be a race to the top, not a race to the bottom**". In particular, she criticized the IRA's "Buy American logic" in the form of potentially "discriminatory tax breaks", and "production subsidies".

The President of the European Commission was referring to the local content requirements of the Act which de facto discriminated against EU-based production. The IRA had several provisions restricting the eligibility of subsidies and/or tax breaks to goods produced in the US or by partners with free trade agreements such as Canada and Mexico (or, alternatively, goods that use raw materials from these countries). As the EU and the US do not have a free trade agreement, Europe is excluded from these benefits.

Naturally, these discriminatory incentives were not well received in Europe. In a visit to Washington, French President Emmanuel Macron stated that the IRA was "super aggressive". His Minister of Economy and Finance Bruno Le Maire said that American subsidies exceed by "4 to 10 times" the maximum that would be allowed under EU state aid rules whereas its German counterpart, Christian Lindner, called the IRA an "enormously protectionist" act. Alexander de Croo, Belgium's prime minister, was blunter and claimed that the US is "calling firms, in a very aggressive way, to say 'don't invest in Europe, we have something better'".

Belgian's head of government was onto something. There are considerable incentives for companies to invest in North America (rather than in Europe or elsewhere). The best example of this differentiated treatment is the case of electric vehicles- the IRA will provide a subsidy of $7500 per vehicle but imposes two strict cumulative criteria:

- At least 50% of the battery components are assembled in the US, Mexico or Canada (this threshold increases to 100% by 2029)

- At least 40% of the critical raw materials used in production of the batteries are extracted from the US or a country with a free trade agreement (this threshold increases to 80% by 2026)"

These (growing) thresholds set clear incentives for firms to relocate to the US. Furthermore, they threaten to **increase competitiveness pressures for EU produced goods**. The US already has some competitive advantages including lower energy prices, a qualified labour force, and less protective labour and environmental regulations. Thus, with a more sizable and effective government intervention, it might be difficult for EU goods to compete in international markets.

On 1 February 2023, President von der Leyen said "we are competitive, we need competition". The EU is arguably a project grounded on free international trade. Despite the lack of success in concluding the Transatlantic Trade and Investment Partnership (TTIP), the Commission is known for its efforts to dismantle trade barriers around the World. In addition to promoting free trade agreements, the EU has been endorsing a multilateral rules-based trade system based on WTO compliance, that the IRA seems to threaten. The local content requirements contained in the IRA are most likely not WTO-compatible and can mark the beginning of a new paradigm of international trade. **President von der Leyen insists that the EU is competitive in a free trade scenario, but can it "compete" with (and/or in the presence of) US heavy subsidies?**

Geopolitical concerns: US as an ally or a rival?

Finally, the EU expressed serious concerns related the geopolitical consequences of the IRA. As argued above, the IRA was a decisive step to make the US a real contender in the Climate Race. However, the EU and the US are not the only players in this race. Beijing is no stranger to industrial policy, and it has been making considerable green investments at home and beyond its borders by establishing investment and trade partnerships across the world. Washington claims that the IRA will allow for the development of clean tech technology that can be useful to partners. Americans argue that the IRA will create alternative supply chains to Europe and, simultaneously, increase the bargaining of power of the EU vis-à-vis of China and decrease European dependencies. Nonetheless, leaders in Europe see it in a different way. They assert that **the IRA turns the US and the EU into rivals rather than allies, as it discriminates against Europe just as it does with China but not against other partners such as Canada and Mexico**. In addition, **they claim that the IRA hinders clean tech development in Europe which makes Europeans more dependent on Chinese imports**. Regardless of the interpretation that Brussels has, can the EU preserve its open strategic autonomy when the two great powers are investing heavily in the critical tech of the future?

The EU's response to the IRA: Green Deal Industrial plan

In a fierce industrial, trade and geopolitical competition scenario, how can President von der Leyen deliver "Europe's 'man on the moon' moment"? Will the Climate race be a race to the bottom or a race to the top?

Early this year the Commission announced a Green Deal Industrial Plan. The Plan creates **new funding opportunities for the net-zero industries both at the national and EU levels** with the expansion of the Temporary Crisis Framework and the creation of a European Sovereignty Fund, respectively. At the same time, it proposes **a conductive regulatory framework with significant protectionist measures - the Net Zero Industry Act - while promoting a liberal trade agenda with new partners**, by trying to conclude new Free Trade Agreements.

State aid dilemma: level playing field at global level or in the single market?

On the 9th of March, the Commission relaxed its state aid rules to allow for green tech investments. **The new rules will apply until the end of 2025 and allow Member States to subsidize the production of strategic equipment such as solar panels, batteries, heat pumps and key components related to critical raw materials**. Furthermore, governments can, in "exceptional cases", surpass the maximum of support, to match state aid from third countries if "there is a risk of investments being diverted away from Europe".

Prior to that, President von der Leyen defended that the EU needs to strive for a "level playing field in the global competition as well as a level playing field within the Single Market". However, considering the heavy subsidies of both US and China, is it possible for the EU to remain competitive at the global level while preserving the level playing field of the Single Market?

It is not the first time that the EU relaxes state aid rules. COVID-19 and the economic consequences of the Russian invasion of Ukraine led the Commission to loosen rules under the temporary crisis framework. However, the relaxation of state rules was not used by Member States in an equal way. In a letter sent to EU Finance Ministers, Executive Vice President Margrethe Vestager stressed that **53% of the 672 billion euros of state aid** approved under the temporary framework went to Germany, whereas France was responsible for 24% of the state aid. As the overwhelming majority of EU countries have seriously constrained fiscal space and limited scale, it is challenging for them to fully benefit from loose state aid rules. Consequently, if under more lenient rules the bulk of state aid remains heavily concentrated in Germany in France, the remaining Member States are likely to find it difficult to compete within the single market.

However, if the rules do not allow states to properly fund clean tech industries, Europe might not be able to compete internationally. Therefore, **there is a clear trade-off between striving for a European Industry that can be competitive worldwide and ensuring that there is fair competition within the single market**.

To try to solve this trade-off, **the Commission hinted to the creation of a new European Sovereignty Fund**, even if its details are yet to be known. In fact, considering the fiscal space and scale asymmetries within the EU, a common budget is needed to rebalance the scales. The new European Sovereignty Fund could facilitate the funding of investments in more fiscally constrained Member States. In addition, existing initiatives including REPowerEU, InvestEU and the Innovation Fund could also be reframed to make sure that the clean tech transition does not leave anyone behind.

Trade policy: what does "ambitious trade agenda" mean?

At the time of the presentation of the Green Deal Industrial Plan, President Ursula von der Leyen said that one of its pillars will be an "ambitious trade agenda". **The Commission President defended a "positive" trade policy, and aimed at concluding agreements with Mexico, Chile, New Zealand and Australia, make progresses with India and Indonesia, and restart talks with Mercosur**.

While seeking additional free trade agreements, the Commission presented the Net Zero Industry Act (NZIA) on the 16th of March, a new regulatory framework that includes several protectionist provisions.

As trade policy is classically intertwined with industrial policy, it is impossible to understand what is an "ambitious trade agenda" without analysing the underlying industrial strategy.

Industrial policy: green and geopolitical protectionism?

In a time where the classical WTO consensus seems to no longer be appropriate to tackle environmental challenges, there is a new fashion of protectionism: green and geopolitical protectionism. The press release of the NZIA was revealing of this new form of protectionism by clearly emphasizing in its title that this act was aimed to "making the EU the home of clean technologies and green jobs". The language is evident: the NZIA has a green imperative and, simultaneously, is intended to make the EU the "home" of clean industry and green jobs. In particular, it seeks to ensure that at least 40% of the EU's demand for clean tech is produced inside of the bloc until 2030. This will help the EU to achieve its climate objectives of 2030 and to speed up the climate neutrality (the so-called "net-zero" emissions by 2050), reaffirming the "Green" part of the Green Deal Industrial Plan. However, how these objectives are pursued is also important. As stated by the Commission, the NZIA will aim to boost "the competitiveness of EU industry" and create "quality jobs", stressing the "Industrial" part of the Green Deal Industrial Plan.

Last but not least, it will support "the EU's efforts to become energy independent", highlighting the bloc's recent geopolitical lessons withdrawn from the ongoing war in Ukraine.

The proposal is fully aligned with von der Leyen's famous promise of a "Geopolitical Commission". It states that "net-zero energy technologies are at the centre of strong geostrategic interests and at the core of the global technological race". Instead of referring to third countries, it mentions directly to both allies and rivals, and leaves the idea that all should be treated equally as "competitors". The proposal refers to the American IRA, but also to the plans of Japan, India, the United Kingdom, and Canada.

Against this challenging background, the proposal emphasizes that "Europe is currently a net importer of net-zero energy industries, with about one-quarter of electric cars and batteries, and nearly all solar PV modules and fuel cells imported, mostly from China". It adds that in solar photovoltaic technologies the EU dependency exceeds 90%. In this context, **the NZIA puts forward the target of ensuring that at least 40% of the EU's demand for clean tech is produced inside of the bloc until 2030**. Thus, to achieve the goal of "Open Strategic Autonomy", defended by President von der Leyen since the start of her mandate, it is necessary to increase the share of EU production on clean tech. For that, the EU **will necessarily seek an import substitution strategy in the old protectionist fashion but with an important twist: a green and geopolitical protectionism.**

To achieve the 40% target of European clean tech production the regulation proposes:

- **Streamlining administrative and permit-granting processes for clean tech;**
- **Priority of investments to Net-Zero Strategic Projects** (i.e. projects that increase the production capacity of the Union of clean tech from with the EU "heavily depends on imports coming from a single third country" and/or improve the Union's net-zero industry supply chain);
- **Priority of investments to Co2 storage projects**;
- **State-intervention to guarantee market access to clean tech, including through procurement and auctions**. Public authorities should "create and maintain a stable public demand for net-zero technologies that will make it economically attractive" for the private sector;
- **State-intervention to subsidize private demand of consumers of specific clean tech products**;
- **Measures to foster innovation, enhance skills and creates a new Net-Zero Europe Platform** that will set Net-Zero Industrial Partnerships to improve coordination across Member States.

The NZIA's geopolitical objectives are complemented with the reform of the [electricity market design] and, especially, with the Commission's proposal for a [European Critical Raw Materials Act] (CRMA), that seeks to increase EU's autonomy in terms of the necessary raw materials for the development of the clean technologies.

The import substitution recipe of the NZIA is replicated in the CRMA by setting up clear targets for 2030. By that time, at least **10% of strategic raw materials consumed should be extracted inside the EU and at least 40% of them should be processed within the Union**. Furthermore, **not more than 65% of each critical raw material should be from a single country**.

As stated above, both the NZIA and the CRMA, set clear protectionist targets and create a number of incentives to achieve them. However, **an important distinction is the lack of "firing power" of the two EU acts as well as the other elements of the Green Industrial Plan when compared to the $369 billion in investments from the IRA**. Thus, **a challenge for the Commission will be to integrate current and future funding instruments within this new strategy** and, in parallel, **incentivize Member States to adhere to these geopolitical and green goals**.

Future of EU-US relations: cooperation in times of green and geopolitical protectionism?

Protectionism, in the traditional mercantilist perspective, is often seen as a "zero sum game" where a nation tries to increase its exports and decrease imports (maximizing the trade balance). Nevertheless, the green and geopolitical protectionism is more nuanced and, when it comes to EU-US relations, should recognize that both sides of the Atlantic have common interests concerning green policies and geopolitics. **Thus, for the future, the EU and the US should cooperate to make sure that parallel efforts to address climate and geopolitical goals are mutually reenforcing**. A way to do so, is to allow companies from Europe to be eligible to benefit from certain fiscal incentives, and vice-versa. In fact, the visit of President von der Leyen to the White House on the 10th of March proved that this can be the start of a new form of EU-US cooperation. In the aftermath of the meeting with President Joe Biden, the President of the Commission [announced] that both sides would work on reaching an agreement so that European electric vehicles and critical raw materials sourced or processed in the union could have access to the American market and fiscal incentives.

To sum up, **both the EU and the US should not deter from continuing to use their respective industrial policies to achieve their common geopolitical and green ambitions but, simultaneously, cooperate to safeguard the protection of their shared interests**.

This is a paradigm shift where new policy goals rooted in geopolitical and green ambitions create the necessity for a strategic interventionist approach. On one hand, geopolitical concerns may protect the EU and the US from dependencies vis-à-vis China both in the clean tech of the future and also in the critical raw materials that are needed for the climate transition. On the other, climate considerations will accelerate the green transition and better protect the world against climate change. In the end, "**we are all protectionists" but we subscribe to a new type of green and geopolitical protectionism**.