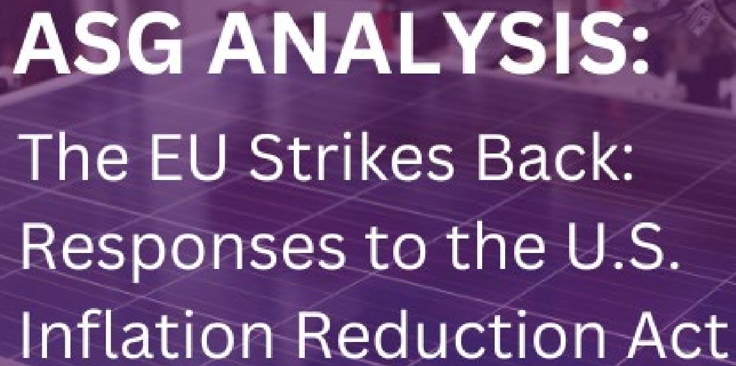

Key takeaways

- The U.S. Inflation Reduction Act (IRA) has been a wake-up call for Europe, raising alarm across the Atlantic about the law's "Buy America" provisions and the prospect of losing competitiveness against the U.S. and China on green tech.
- The European Union has sought to avoid a trade fight with the Biden administration, which European officials see as taking their concerns seriously. Talks between EU and U.S. officials to address concerns raised by the IRA have yielded some progress on car subsidies, with more possibly to come on critical minerals in the coming weeks.
- The European debate has begun shifting focus toward devising a response of its own to the IRA. The European Commission has come out with its ideas for an EU green tech industrial strategy, which will now be hotly debated by leaders in the coming months. Many details remain unresolved.
- Business should pay close attention to EU's emerging industrial strategy for green tech and be ready to come with input and constructive ideas for how the EU and the U.S. can better manage to align their respective approaches.

European reactions to the IRA

The passage of the U.S. Inflation Reduction Act in August 2022 served as a wake-up call for Europe: For the first time in more than a decade, the U.S. was taking serious domestic action on climate change, and while laudable, it was seemingly doing so at Europe's expense. The landmark legislation will spend more than $390 billion on energy and climate change over the next decade, heralding a new era of green industrial policy in the U.S. However, local content and assembly provisions of the bill, including on batteries and electric vehicles, lock out U.S. partners, including Europe, by requiring them to be made or finalized in North America.

Officials in Brussels and European capitals were caught unaware by the "Made in America" provisions, leaving them to scramble to figure out its details and possible implications.

Compounding European concerns about discriminatory provisions and their incompatibility with existing World Trade Organization (WTO) rules was a sense that it could weaken Europe at a critical moment. The energy crisis stemming from the war in Ukraine highlighted the need for a rapid transition away from fossil fuels, but high energy prices meant the industrial shift needed to produce green technology would now be significantly more costly. Coupled with rising interest rates, inflation, and stagnating industry, European officials began raising the alarms of looming "deindustrialization," saying the EU would fall behind the U.S. in a critical sector it had hoped to dominate.

While the dominant interpretation of the IRA in Europe is of concern, not all capitals reacted the same way. Some, including France, did not hesitate to cast the IRA as a threat to European sovereignty, with President Emmanuel Macron calling the IRA "aggressive" and accusing it of "fracturing" the West, and favoring a harsh "Buy European" approach as part of a response. Conversely, free-trade-oriented countries like Sweden and the Netherlands, which are wary of a slippery slope towards protectionism, prefer a more careful, liberal approach and avoiding a tit-for-tat subsidy war with the United States.

EU-U.S. discussions on the IRA

As the dust settled from the initial shock, the EU abandoned more aggressive options, including issuing a WTO complaint or launching a full-scale trade dispute with Washington, which would threaten to undermine cooperation on Ukraine and in the U.S.-EU Trade and Technology Council (TTC). Instead, the EU opted to first set up a high-level dialogue with U.S. officials on including European goods in some of the subsidies. European interlocutors perceive the Biden administration as understanding and keen to show goodwill despite the limitations of the IRA text. Talks have already yielded some results on commercial car tax credits, with hopes that early successes can be extended to critical minerals for batteries. The current plan is to begin winding down the task force following the release of U.S. Department of the Treasury's implementing guidance, expected in March.

Due to this recent incremental progress in talks, the EU has shifted the emphasis to crafting its own response, even at the encouragement of U.S. officials who noted the best response to tackle climate change would be for Europe to come up with its own package. However, crafting a response is likely to fall prey to complicated EU political dynamics, likely setting up intense discussions between European leaders over the coming months. **Businesses should keep a close eye on these negotiations, as they will likely shape the future of European industrial policy and trans-Atlantic alignment on renewable energy.**

Crafting a European response

Unlike the landmark EU responses to the pandemic, the war in Ukraine, and the energy crisis, a response to the U.S. IRA is arguably even less politically straightforward, cutting straight into longtime debates on the nature of the European Single Market and fiscal integration. If the EU is forged in crisis, then a response is currently shaped by different member state assessments of what the crisis is and what the response can be. While there is growing agreement among EU leaders that a green industrial strategy of its own is warranted – lest the EU risk losing competitiveness – there is still no consensus on how ambitious and far-reaching such a plan should be.

EU leaders and ministers have called for responses, ranging from vague statements to concrete proposals. As with all EU-level proposals, the first concrete word goes to the European Commission, in consultation with member states. On February 1, Commission President Ursula von der Leyen launched a compromise-heavy package titled the "Green Deal Industrial Plan" that combines several plans already in the works with some new ones. The plan includes:

- A **Net-Zero Industry Act,** which would empower the Commission to set industrial capacity goals, study green technology value chains, and create standards for market design across Europe. The Act would also create one-stop-shops in each member state to support investors in green technologies and create clear deadlines for permitting;
- A **reform of the electricity market**, which was already slated for Q1 of 2023;
- A **Temporary Crisis and Transition Framework** that would expand current relaxed state-aid rules to allow member states to subsidize all renewable technologies, eliminate the need for open tenders for emerging green tech, and increase the funding threshold for review by the Commission. Most importantly, it would allow member states to subsidize the manufacturing of renewable tech for the first time, including through IRA-like tax credits, and allow "matching" the subsidies non-EU countries give to companies;
- **New guidelines for existing EU funding** that would encourage member states and the EU to speed up and increase investment in renewables.
- A new **Sovereignty Fund** to be proposed under the midterm review of the EU's 7-year budget in Q2 of 2023, which would redirect unused existing EU funds towards green technology and digital projects;
- A **Critical Raw Materials Act** that promotes production of critical materials, reduces regulatory barriers for their extraction and recycling, and support R&D initiatives, which is already planned to be released in March; and
- A new **Critical Raw Materials Club** between countries, building on existing international partnerships and negotiating new partnerships with other countries to reduce dependence on a single supplier and create more predictable markets.

The proposal is designed to complement existing European Green Deal and RePowerEU plans, focusing on bolstering Europe's green tech sector. While this initial proposal doubtlessly would represent progress toward making Europe more competitive, it is notably less ambitious than what some capitals would have preferred, and success is far from guaranteed.

Implications and political dynamics

While much of the Commission's proposal is uncontroversial, subsidizing green industry could upend the EU's fragile redistribution framework, where wealthy Northern and Western European countries redirect funds to the South and East. Loosening subsidy rules would likely result in Franco-German domination due to having both the fiscal space and industrial base. Already, France and Germany used 80 percent of pandemic-era state-aid loosening, raising fears that a new slew of subsidies would only further widen gaps within the EU. Even the proposed Sovereignty Fund to offset these differences would likely mean a tricky tradeoff between earmarking funds for less industrialized EU member states, that may remain unused, and redistributing Covid-19 recovery funds already allocated to the South and East back to the more industrialized member states.

Proposals to issue new debt to fund state aid will also divide member state opinions. The traditionally “frugal” group – the Netherlands, Austria, Denmark, Sweden, and Finland, along with Belgium, the Czech Republic, Slovakia, Estonia, and Ireland – have already declared their opposition to new joint borrowing, noting that it would be countercyclical to borrow during a period of inflation and high interest rates. France and Spain have presented a common front, reiterating their long-standing desire for EU fiscal policy, rooted (in the French case) in ideals about “European sovereignty” driven by industrial policy and common debt. The German position is still somewhat unclear, as the government is mired on infighting between parties and personalities. Long-standing fiscal hawk and current finance minister, Christian Lindner, has outright ruled out common debt, adding fuel to the fire of a tense Franco-German relationship.

Despite these unresolved issues, there appears to be a growing alignment between the Commission, Germany, and France behind the scenes. Tense debates between EU leaders around a new common borrowing package could be back on the table later in the summer as part of broader EU budget debates.

The biggest question is whether any of this will work. It will be difficult for the EU to match the scale and ambition of the IRA, especially without joint borrowing. Loosening state-aid rules and providing funding for subsidies still doesn’t answer how the money will be spent, which will still be up to member states. While the U.S. has created large, uncapped tax credits focusing on both investment and production, the EU can at best permit member states to create their own.

The scope and implementation of the proposals must also be proportionate to the underlying challenges. Competing will take more than matching the size of the IRA, it will also require Europe to reduce the effect of high interest rates, comparatively high energy prices, and tighter regulations. Mimicking the U.S. model of broad swaths of spending is unlikely to work in Europe, increasing the likelihood of more targeted projects and lots of compromises between approaches. The EU will also need to think about how it can effectively leverage its extensive web of climate change regulation already in place, with initiatives like the Emissions Trading Scheme to incentives for R&D, as it now embarks on green industrial policy.

As the debates continue over the coming weeks and months, business will likely have opportunities to shape the conversation.

As the debates continue over the coming weeks and months, business will likely have opportunities to shape the conversation, especially by discussing ways to build trans-Atlantic investment on renewables and green tech, taking advantage of the IRA, the EU’s plans, and the clean energy agenda in the TTC. Stakeholders will need strong examples to keep cooperation open on both sides. One potential fruitful model for avoiding a subsidy war is the close coordination between the EU and the U.S. on semiconductor subsidies over the past year. The next TTC meeting planned in the resource-rich northern Sweden in May could also provide a good opportunity for the EU and the U.S. to demonstrate progress on critical minerals and battery cooperation.

Next steps

While the Commission has released its proposal, the specifics will need to be fleshed out. So far, proposals are vague, requiring significant tinkering by EU member states, likely in one or more all-night European Council meetings with heads of government in the next several months,

starting with the February 9-10 meeting. In charge of preparing these upcoming European Council meetings is the rotating Swedish Presidency which is keen to avoid a weakening of the Single Market or paving the way for protectionism and rather seeks to set an example about the importance of openness toward key trade partners such as the United States.

EU officials will continue their talks with the Biden administration, although any outcomes are unlikely to stop the EU from pushing through its own plan. French Finance Minister Bruno Le Maire and German Economy and Climate Minister Robert Habeck will both travel to Washington, D.C. in early February to conduct their own talks with the U.S. government. As long as both sides can avoid a major clash over the dispute, trans-Atlantic relations are likely to remain about the same as they have been for the past year: warm in spirit and strong on cooperation on Ukraine but with the need to deliver more on the trade and technology agenda.

About ASG

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ASG's Europe & Eurasia has extensive experience helping clients navigate markets across the European Union and beyond. For questions or to arrange a follow-up conversation please contact Pablo Rasmussen or Erik Brattberg.