Theme:

US climate policy

Finding balance between competition and EU-US cooperation

The world is divided over the IRA – which includes a historic, far-reaching USD 369 billion climate package. The US is now showing welcome, concrete leadership on the climate issue. But the IRA is also part of an industrial and trade policy that gives domestic manufacturers competitive advantages in ways that violate World Trade Organisation (WTO) rules. After extensive criticism from the European Union, the Biden administration has made minor concessions, but the package remains in force. Our conclusion is that the EU must build on its own industrial and climate policy, while striking the right balance between competition and the necessary transatlantic cooperation to avoid trade wars in a new geopolitical situation.

Since its enactment in August 2022, the US **Inflation Reduction Act (IRA)** has generated strong reactions in the EU. The package has rightly been viewed by Brussels as a set of clear, vigorous steps towards a more protectionist American industrial and trade policy, by cutting costs for US producers and developers of green energy technology. European business representatives warn of a de-industrialisation of the EU due to the current energy crisis, saying the EU may be forced into deeper cooperation and greater dependence on Eastern countries including China.

The apparent goals of the IRA and its subsidy policy are to make American green energy and technology an important future export product, reduce US dependence on other countries (increase strategic autonomy) and generate more (green) jobs at home. The EU has launched its own green policy, but it is not enough. A global race to develop green technology is welcome in the ongoing climate crisis. But if the world is now moving towards greater geoeconomic fragmentation, this decreases the chances that green technology can help solve the climate crisis.

What is the Inflation Reduction Act (IRA)?

After more than a year of internal negotiations, last August the Democrats in Congress agreed on a slimmed-down version of President Joe Biden's 2020 election promises on climate, energy, health care and taxes. A strong focus on inflation risks and public finances gave rise to its name – the Inflation Reduction Act (IRA) – which is grossly misleading. The law's overall impact on inflation is likely to be small. The reform is overfunded and will help reduce budget deficits by an estimated USD 238 billion. This is a respectable sum, but still no more than about 1 per cent of GDP, spread over a ten-year period. But because its expenditures are front-loaded and future tax revenues are uncertain, the reform may still have some positive impact on GDP in the next few years, including stimulating larger private climate investments.

The IRA represents a historic breakthrough for US climate policy. By 2030, the new law will help reduce US greenhouse gases emissions by an estimated 40 per cent – a long way towards meeting US pledges of over 50 per cent under the Paris Agreement. The comparison is based on 2005 levels, however.

The carrot, not the stick, is decisive. The law is based on the political realities of the US Congress. Lacking a qualified majority, Democrats had to take advantage of "reconciliation" rules linked to the budget process, including tax credits and direct subsidies, rather than regulations and fees. Parts of the Democratic Party are also highly dependent on protecting the oil and gas sector, and the package includes new oil and gas extraction licenses.

Green industrial policy. The IRA includes historic investments in, among other things, renewable/fossil-free energy production within mature technologies such as solar, wind and nuclear power, newer ones such as "green" hydrogen, carbon dioxide capture/storage, as well as electric vehicles, where the US has fallen behind. Last year, for example, US electric car sales accounted for about 5 per cent of the total, compared to about 10 and 20 per cent in Europe and China, respectively. The IRA reflects promises in Biden's election platform to strengthen America's industrial base, increase the number of green industrial jobs and strengthen labour. The transition will take place in a way that benefits the entire supply chain within the affected sectors.

The tax credit for the purchase of electric vehicles – USD 7,500 per light vehicle – is linked to a requirement that they must be assembled in North America and that batteries must contain a gradually rising share of components from the US or its trading partners under the US-Mexico-Canada Agreement (USMCA) and, as regards critical minerals, from countries with which the US has trade agreements. These requirements are largely aimed at reducing dependence on China in supply chains. The law establishes a cap on new electric vehicle prices (USD 55,000 for smaller and USD 80,000 for larger vehicles) and an income ceiling (USD 300,000 per household). The previous 200,000 vehicle limit per manufacturer is being scrapped, so domestic automakers such as General Motors and Tesla can again participate. The requirement for collective labour agreements is also gone. A new tax credit for used electric vehicles has been introduced. The price cap excludes many models, but Tesla recently announced price cuts on several models to qualify.

The Inflation Reduction Act (IRA). USD billion

Increased revenue and savings		**738**
Reform of drug prices, etc.		281
15 per cent minimum corporate tax		222
Strengthening tax collection		101
Tax on share buy-backs		74
Miscellaneous		60
Increased investments*		**499**
Energy security and climate policy		369
Clean energy tax credit	161	
Lowering emissions	40	
Clean fuel and vehicle tax credit	36	
Component, battery etc. tax credit	37	
Energy efficient housing etc. tax credit	37	
Conservation, research, etc.	49	
Health care subsidies		108
Government deficit reduction		**238**

Source: Committee for a Responsible Federal Budget (CRFB) and Congressional Budget Office (CBO).
* Including loan guarantees

The EU's late awakening and frustration

Europe's reaction to the IRA appears to have been delayed, even though Biden signed the bill in August. This was probably because of two other acute crises: the Ukraine war and the energy crisis. But in recent months, the EU has become more vocal, persuading Washington to re-adjust some details of the IRA package. But our conclusion is that positive effects of these changes on EU industry are barely measurable.

Brussels' main criticism of the IRA is that it links extensive climate subsidies with, among other things, demands for domestic production. This criticism refers both to US government tax credits and to the package's direct financial subsidies to manufacturers. Trade experts agree with the EU that the IRA in its current form, including large subsidies, obviously violates WTO national equal treatment rule. The subsidies are clearly targeted to the vehicle industry, which is crucial to the EU economy, making these subsidies especially troubling. The tax credits offered to buyers of vehicles assembled in the US, Canada and Mexico are equivalent to an indirect 15 per cent import duty on vehicles from the EU. This has prompted several EU companies to consider moving production to North America to benefit from the IRA.

The IRA has some similarities with the EU's European Green Deal and the green investments made possible through Next Generation EU. The combined efforts of the EU and the US mean that two of the world's major economic players are investing heavily to slow down the climate crisis. However, there is a risk that this race will occur at the cost of increased protectionism and a risk of poorer resource allocation and less innovative power.

Late in 2022, **the European Commission announced two proposals** that represent a counteroffensive to US industrial policy: 1) a new EU government fund to subsidise companies' transition to climate-neutral operations; 2) a review of the EU framework for state aid to industry. The Commission intends to unveil a proposal for the new fund by this summer. The money in this fund will go to industries and green projects of common interest to the EU. As the proposal looks today, the money will come from a re-allocation of funds within existing budgets. In the short term, the Commission wants to increase the funds that are already available – and can be expanded – within the framework of -RepowerEU, the EU's plan for saving energy, producing cleaner energy and diversifying EU energy supplies. RepowerEU now has funds totalling about EUR 245 billion. Additional funds may be obtained from such sources as the European Investment Bank (EIB) and various private initiatives.

A review of the regulations regarding state aid is also among the Commission's priorities. The goal is to have a state aid policy that is "bigger, faster and simpler" than today's regulations. The Commission is expected to submit proposals in January, leading to a discussion of these issues at the EU summit on February 9-10. Among the ideas being considered is that state aid in a given country should also be allowed to take global conditions into account, not just developments among the EU's 27 member states. However, new crisis funds and more flexible state aid rules are controversial issues not only for EU countries, but also for the rest of the world.

Europe's energy insecurity a major problem

The EU energy crisis is another risk factor that may persuade manufacturers to relocate to countries like the US. Predictable energy supplies and prices are critical factors for industrial operations in Europe, which must meanwhile undergo a clean energy transition. The unpredictability of the Ukraine war and Moscow, a vulnerable energy infrastructure and increased political intervention are contributing to greater energy insecurity – in a situation where new green technologies must be developed and electrification must be implemented. If the EU cannot offer such predictability, there are reasons for companies to consider moving to the US or Asia.

The EU and the US established a joint working group last autumn (the EU-US Inflation Reduction Act Task Force) to devise solutions. Just before the end of 2022, the US announced that it had changed its tax deduction guidelines so that privately leased cars would meet the same conditions as commercial vehicles, which need not be assembled in North America. However, the European Commission would like to see more easing for electric vehicles owned by private individuals. The EU also wants the US to review the requirements that battery components must originate from the US or its trading partners (a field in which the US and EU currently has no trade agreement).

Balancing collaboration and competition

Because of the new domestic political situation in the US after last autumn's mid-term elections – with a Republican majority in the House of Representatives – the potential for major amendments to the IRA must be regarded as very limited. The most likely scenario is that the IRA package will not change, and the law will thus act as a magnet to attract companies from other countries.

The need for continued good transatlantic relations in an increasingly strained geopolitical situation means that it is now up to the EU to increase its competitiveness and attractiveness. But achieving maximum global exchanges of green technology and transition strategies will require coordination of climate, industrial and trade policies to ensure that industrial subsidies and domestic production rules lead to the right balance between competition and collaboration, without strengthening protectionism.