

Improving economic policy



EU economic policy in the wake of the IRA

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The traditional EU policy paradigm



1. A market-based model, with state intervention justified by:
 - Redistribution/social protection
 - Correction of market failures.
2. Competition within the EU is good for efficiency and growth. There is no trade-off between competition and external competitiveness. State aid rules are essential to protect competition.
3. International trade, and multilateral trade rules protecting trade, are good for the EU
4. Growth and development among EU trading partners is good for the EU.
5. EU-level regulation is feasible; EU public goods are not (fiscal constraints).

The challenge



1. Decarbonisation

- Path dependencies in innovation may justify “vertical” industrial policies

2. “Economic security” as a new objective

- Prompted by pandemic closures, use of critical raw material for leverage, gas dependency on Russia, concerns about dependency on China.

3. Economic nationalism *in advanced* [competitor?] *countries*

- Economic nationalism in the US since Trump – now Inflation Reduction Act
- Use of subsidies and other discriminatory measures in China, which is increasingly viewed as (advanced) systemic rival, rather than a developing country trying to catch up.

State intervention and economic nationalism are not the same



- Statism: state control of economic activity is necessary
 - Would be a subject of debate even in a one-country world.
- Economic nationalism: economic policies that seek to advance the interest of domestic workers/firms at the expense of foreign workers/firms.
 - Requires some state interference. But would not be an issue in a one-country world

	<i>Control of economic activity by ...</i>	
	<i>free markets</i>	<i>the state</i>
<i>Trade-offs between national and foreign economic interests are the exception</i>	Classical liberalism Modern consensus	Socialist economies
<i>Trade-offs between national and foreign economic interests are the rule</i>		Economic nationalism

Is economic nationalism ever justified?



- In countries that are *catching up*, quite possibly (Hamilton 1791, List 1841, the Japanese “developmental state” in the 1950—60s).
 - A straightforward extension of the one-country argument for subsidies.
 - Overcoming market failures due to learning by doing, scale economies or large setup costs requires discriminatory policy instruments (must only benefit those “behind”).
- In *advanced* countries? Potential justifications:
 - 1) Protect/create rents (Brander and Spencer, 1983, 1986; Gomory and Baumol 2000);
 - 2) A “good jobs externality” (Rodrik 2022)
 - 3) “Technological sovereignty” (intersection of economic nationalism with economic/national security)
- Problems
 1. Economic nationalism is never *collectively* efficient (except temporarily in developing countries)
 2. Vulnerable to special interests (rent seeking: even *nationally* inefficient)
 3. Economic nationalism and economic security could also be in conflict (when latter requires international cooperation)

The EU's emerging response

Net Zero Industry Act (NZIA), Critical Raw Materials Act (CRMA), Temporary Crisis and Transition Framework for State Aid (TCTF)



1. Create EU-level lists of strategic/critical technologies and raw materials
2. Set reshoring/self sufficiency objectives with respect to these technologies/raw materials
 - At least 40% self-sufficiency (CRMA also includes a diversification objective: max. 65% dependency on single country)
3. Ask member states to support projects that further these objectives, using
 - Acceleration of permitting
 - Stronger weighting of security/sustainability criteria in public procurement
 - State aid, within certain limits (e.g. TCTF allows matching of third-country subsidies *if project is in assisted area and/or several MS benefit*)
4. Avoid violating WTO rules
 - No local content/assembly requirements for now; no open discrimination via procurement

Problems

1. Lack of technology neutrality
 - It would be better to promote any technology/project that furthers decarbonization, resilience.
 - But this would require much stronger central governance (to get discretionary decisions right)
2. Weak instruments
 - Permitting may not be the binding constraint
 - Cannot force procurement to rank sustainability/security significantly above cost;
 - No new EU level funding
3. Protectionist in spirit if not in means (reshoring)
 - Could harm EU competitiveness, which relies on trade integration
 - Could slow decarbonization
 - Could undermine economic security based on diversification and international collaboration
4. MS-level subsidies can harm intra-EU competition and single market
5. Lacks/distracts from reforms to strengthen competitiveness more structurally

Alternative: the main ideas

Need to recognize that there could be trade-offs between growth/efficiency, decarbonization, and economic security. Select policies that minimize conflict between these objectives.

1. Horizontal (single market) reform is at least as important as new vertical policies
 - Improves growth/efficiency and resilience without harming decarbonization
2. Economic security needs to be better defined and measured not solely on existing trade patterns but taking elasticity of supply and demand to price shocks into account.
3. Economic nationalism hurts decarbonisation, growth, and broader EU foreign policy interest. Stay away from it, unless narrowly justified by a security argument.
4. Vertical industrial policy is needed, but must
 - Promote sustainability/resilience objectives, not specific technologies.
 - Protect competition and the single market

This requires a strong EU-level governance and EU-level funding.

Alternative: specifics

(Tagliapietra, Veugelers and Zettelmeyer, June 2023)



1. Single market reforms: a new push
 - Capital markets union; electricity market reform; alignment of clean tech regulation; skills
2. A “rebooted” NZIA, mainly to coordinate Member States
 - Drop technology list and 40% self-sufficiency targets
 - Replace by performance indicators focused on investment supporting decarbonisation
 - Stronger use of procurement, with EU-level financial incentives
 - A strong EU-level governance structure that coordinates national-level policy, monitors KPIs and policy interventions, and administers financial incentives
3. An EU “ARPA” for EU-level support of clean tech innovation and deployment
 - Frontier technology only
 - But along the entire “technology readiness” cycle (i.e. also commercialisation)
 - Aligned with governance of NZIA



Body

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Thank you

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Backup slides

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Recent policies/legislation in the US and the EU cannot be motivated without invoking economic nationalism



Body

Economy	Measure	Motive		
		Externalities related to decarbonisation	Resilience/ Security*	Economic Nationalism**
United States	IRA	Yes	Yes	Yes
European Union	TCTF State Aid	Not much	Not much	Yes
	Net-Zero Industrial Act	Not much	Not much	Yes
	Critical Raw Materials Act	Not much	Yes	Yes

* Increasing domestic resilience to external shocks, including geopolitical shocks

** Economic policies that seek to advance the interests of domestic producers/workers at the expense of the interests of foreign producers/workers.

Recommendations vs. EU response: summary



Recommendation	EU response (Net Zero Industry Act, extension of Temporary State Aid Framework, Critical Raw Materials Act)
Don't break WTO rules	Ok, we try not to
Don't loosen State Aid Rules	Loosen, but fairly narrowly. Only for net zero industry, up to ceilings, unless response to subsidy outside the EU, and only for state of the art tech
Don't mimic IRA subsidies	Ok, unless they are needed to keep industry here, via state aid (see above)
Improve competitiveness in general: regulation, green procurement, skills	Only for net-zero industry (clean tech) projects
Improve competitiveness in general: energy, banking + CMU	Nah—business as usual. Sure, we are trying some of this, but not accelerated due to IRA or other competitive threats.
Trade policy response at several levels	Negotiate exemption to domestic content requirements with the US
Competition-friendly EU-level subsidy instrument	Maybe part of "Sovereignty Fund", but for medium term
[didn't even think of this; if we had, it would have been a no-no]	Formulate a quantitative import substitution targets for net zero industry, critical raw materials.

When are subsidies justified?

1. Economic Theory: to correct market failures
 - a. (Positive) externalities (social return of investment > private return)
 - b. (Large) initial fixed costs of production (including cost of initial learning-by-doing)
 - c. Scale economies
 - a. justifies subsidizing certain activities (R&D, clean energy). b. and c. may justify subsidizing investment and/or initial production.
2. EU Law (and EU Commission practice) in effect internalizes this theory.
 - Article 107 TFEU: “any aid granted by a Member State ... which distorts competition by favouring the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market”
 - But allows exceptions, including: “ ... to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest”
 - In practice, economic benefits must be justified with market failures. Trade-off

What can happen if one loosens state aid rules



Total state aid disbursed in 2020 compared to total aid disbursed in 2019
(aid content, % of GDP)

