



# REPORT ON THE ECONOMIC SITUATION

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## The European response to the US Inflation Reduction Act

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There was a lot of concern in Europe when the US passed the Inflation Reduction Act (IRA) in the summer of 2022. It provides for EUR 369 billion in subsidies to promote climate protection in the US over the next ten years. The European Union (EU) is concerned that this will cause a lot of problems, specifically if industrial value creation moves away from Europe as a result of the IRA. Several companies have already announced that they will be reviewing their investments plans in the Eurozone. The EU Commission responded swiftly and announced that it would ease the subsidy rules for the domestic market, allowing member states to pay higher subsidies to companies. Moreover, the Commission is also working on a sovereignty fund for its own industrial policy projects - possibly financed with new EU debt. The subsidy race has started. What should we think about that?

First, the nervousness in the EU is exaggerated. The IRA volume is about half of the Next Generation EU (NGEU) programme, which was passed during the COVID-19 crisis and which was financed with special EU bonds. NGEU had a volume of EUR 750 billion using the prices at the time, which means that the number is much higher now. Until 2026, the funds from NGEU are supposed to be used for climate protection and digitisation, and now also for defence projects. Therefore the US is following the EU's subsidy policy. However, IRA and NGEU are different in that the projects supported by IRA must be mainly from US production. It includes a Local Content clause. Ministers Habeck and Le Maire are trying to negotiate some relief in this context.

Just how restrictive the Local Content clause will be will depend on other factors too. Second, value chains are globally optimised. This applies not just to the European economies but also to the US economy. Companies will not change their value chains just like that. Therefore, intermediary products from European production will continue to be used to a certain extent.

Third, the easing of the subsidy rules as envisioned

by the EU has a negative impact on the EU domestic market. Already now, the subsidy volumes of Germany and France are much larger than those of the other member states. This creates distortions in the domestic market and the competitive environment. Most recently, Italy, whose industrial portion of value creation is higher than in France, has demanded compensation (e.g. in the form of relaxed fiscal rules), in that subsidies to Italian industry are not applied against indebtedness.

Fourth, a debt-financed European sovereignty fund is a very tricky concept. NGEU was designed as a one-time emergency measure, and it was only deemed constitutional by the Federal Constitutional Court as a temporary measure. With a new debt-financed fund, the EU would have greatly overstepped its jurisdiction. This would only be made possible by a change in the Basic Law, which would have to be preceded by changes to the EU agreements. There is no obvious willingness for that anywhere in the EU.

Moreover, a debt-financed EU fund creates the wrong incentives for national fiscal policy. Member states must consolidate their budgets. Additional EU programmes would not only tie up more funds but would also create the leeway for structural additional expenditures in other areas, which are difficult to correct.

Therefore entering into a subsidy race with the US is not a good idea. It is becoming increasingly evident that the failure to complete the Transatlantic free trade agreement TTIP was a big mistake. The task now is to gather up the debris and use it to develop a concept for smaller trade agreements with the US - and then hopefully without the dreadful discussion about chlorinated chicken.

Sincerely yours

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