Policy Brief

After the German Election

What's next in EU industrial policy?

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The green and digital transformation of industry was one of the central issues in the German election campaign. However, many fundamental decisions on industrial policy can only be taken at the European level. The new German government must therefore turn its attention to Brussels as soon as possible and provide answers to specific questions: How can an investment-oriented industrial policy be organized in the single market? What European regulatory framework does the transformation of European industry to climate neutrality require? And finally, how much geopolitics can European industrial policy take?

Introduction

Industrial policy is back. During the past few years, the aim of turning into a more active industrial-policy player has become a central point on the European Union's (EU) political agenda. This same trend was also visible in the German election campaign. For years, industrial policy was often pursued, but rarely advertised as such. Now, climate change, digitization and the heated geo-economic competition with China and the USA have put the demand for strategic industrial policy in the EU back into the spotlight of the political debate. Indeed, the outgoing German Minister of Economics recently stated that the election campaign had shown that **there was finally a general agreement in Germany on the need for industrial policy.**

However, this new consensus is somewhat deceptive. The main reason why it is so easy to agree on industrial policy is that everyone understands it differently. Basically, industrial policy includes all political measures aimed at directing economic activity towards certain sectors or technologies. Those who call for more industrial policy can therefore mean tax cuts or subsidies as well as higher CO_2 prices, investments in public infrastructure or protective tariffs. Accordingly, the debate remains confusing - both in Germany and in Europe.

The new German government now needs to turn the abstract demand for industrial policy into concrete policies. In doing so, it must not to lose sight of the European dimension. First, most industrial policy decisions in the single market can only be taken at the EU level in a meaningful way. Second, in a lot of areas the EU has already put forward concrete proposals on which the next German government will have to take a position. Three areas are particularly important:

- How can an investment-oriented industrial policy be organized in the single market?
- What European regulatory framework does the decarbonization of the European industry need?
- How geopolitical should EU industrial policy be?

This policy brief briefly addresses the key issues in each area below.

1. The future of investment-oriented industrial policy in the single market.

Much of Industrial policy is about spending money. Regulatory and trade policy measures are of course part and parcel of the classical industrial policy toolbox. **The current debate, however, often focuses on direct financial support for specific sectors, technologies, or infrastructure.** There are two reasons for this. First, the decarbonization and digitalization of the European industry requires huge investments. While the private sector will need to shoulder the brunt of these expenditures, there is a growing consensus amongst European policymakers that states will need to complement these investments through the public purse. Second, China and the USA have been ramping up their spending on strategic industrial policy massively in recent years. In Europe, this is increasingly fueling concerns that the old continent could be left behind in the global race for technology leadership.

In a series of strategy papers, the European Commission has therefore recently called for Europe to become more active on the spending side of industrial policy. However, it is important to understand that doing so is extremely difficult in the European context. On the one hand, **the EU lacks money for joint spending on industrial policy at the European level.** On the other hand, unilateral industrial policy moves by individual member states poses an issue in the single market. Not all governments are equally capable of pouring large sums into industrial policy projects. Accordingly, **the role of the European Commission has traditionally been to prevent rather than to promote national industrial policy** to avoid unfair competition in the common market and limit economic divergence.

At the European level, the new German government therefore inherits a tricky situation. Without fundamental reforms, the EU itself can hardly invest in industrial policy projects on a grand scale. At the same time, simply passing the buck to member states carries the risk of political conflicts and economic divergence. The new German government therefore needs to find a fundamental position on how to proceed with European industrial policy. Two options are on the table:

- **More national industrial policy:** Without new European funding, investment-oriented industrial policy will need to be financed by member states. European state aid rules do indeed offer some room to expand national efforts. One example is the so-called **"Important Projects of Common European Interests"** (IPCEIs) framework. This framework relaxes state aid rules for private-public partnerships in multi-country projects "which make an important contribution to economic growth, jobs and the competitiveness of the EU." IPCEIs for batteries and microchips are already running, and other joint projects are in preparation. Another example is the so-called **"Carbon Contracts for Differences".** Here, governments provide companies with direct subsidies to compensate for the cost differences between conventional and climate-neutral forms of production for a certain period. The Commission has already announced that it will allow such instruments in the future, thereby significantly increasing the scope for green subsidies at the national level. Expanding national industrial-policy spending has the advantage that it can be implemented comparatively quickly. However, the approach is already causing opposition. Smaller and financially more constrained member states in particular fear a distortion of competition and oppose further relaxation. There are also concerns within the Commission. In the long term, therefore, it is unlikely that the EU's industrial policy ambitions can be realized by the member states alone.

- **More European funding for joint projects:** Alternatively, the German government could advocate for better European funding for joint industrial policy projects. This would have two advantages. First, it would mean that not only companies in financially strong member states would benefit from government funding. Second, joint funding would **allow resources to flow to the places and projects where they can be most usefully deployed** in terms of climate protection and their macroeconomic effects. There are various options to achieve this. As part of the planned "Chips Act" to promote the microchip industry the Commission has, for example, announced a joint "European Semiconductor Fund". Details on the scope and financing of such a fund are still pending but it could set a precedent for new financing vehicles at the European level. In the future, IPCEIs could also be set up in such a way that funding is paid into a joint pot and then flows to the most promising projects in the participating member states. As the largest participant in previous IPCEIs, the German government's position on such an option would be particularly important. Finally, industrial policy provides the best illustration of why the **Recovery Instrument should be transformed into a permanent instrument of European transformation policy** in the long term.

The next German government needs to answer the fundamental question of how European it wants its industrial policy ambitions to be. Without fundamental reforms, EU-level industrial policy will remain big in ambition but meager in substance. Germany, thus, needs to take a stance on whether it wants to go national or promote common solutions for joint investments.

2. What regulatory framework does climate-neutral European industry need?

Alongside investment, market regulation is one of the most important instruments of industrial policy. In this context, setting the right framework conditions for the transformation to climate-neutral production will be a central issue of the next four years. The German election campaign witnessed some heated discussions on the right regulatory tools. However, the debates often overlooked an important truth: **the most important decisions in this regard will not be taken in Berlin, but in Brussels.** In July, the Commission proposed the „Fit for 55" package, a comprehensive set of regulatory reforms to reduce emissions in the EU by 55% from 1990 levels by 2030. The European debate on this is already in full swing and the positioning of the new German government will be a decisive factor for successful implementation in many areas. From an industrial policy perspective, three areas in particular are crucial:

- The Commission has proposed a far-reaching **reform of the European Emissions Trading System (ETS).** On the one hand, the EU wants to cut CO2 emissions for energy and industry more quickly (by 62% instead of the current 42% by 2030) and completely phase out free allowances for industry by 2036. On the other hand, the Commission is planning to introduce a **new emissions trading system for buildings and transport (ETS2)** by 2026. The proposal for the latter is based in part on the new German emissions trading system for petrol, diesel, heating oil and gas, which was introduced at the beginning of 2021. It is one of the most controversial parts of the reform package at the European level. Several large member states have expressed concerns about the social and political consequences of a sharp increase in heating and gasoline costs. The Commission proposes to use 25% of the revenues from the ETS2 for a new climate social fund that would provide member states with money to cushion the social costs of rising prices. So far, however, it has failed to convince skeptics of the new system. **The question of how an expansion and tightening of emissions trading can be organized without introducing massive economic and social hardship will be a sticking point in the upcoming elections.** The divisions between member states run deep. As discussions are already underway, the new German government will have to position itself quickly.

- The Commission wants to tighten the **CO2 reduction standards for cars.** By 2030, automakers are to reduce CO2 emissions from new cars by 60% compared to 2021. The current proposal would provide big incentives for the transformation of the European automotive industry toward climate neutrality. An EU-wide regulation would also have the advantage of circumventing legal concerns around national bans and the resulting fragmentation of the European single market. Although most member states share the proposal's goal in principle, the new, more ambitious timetable remains controversial. In addition, the question of which propulsion systems should be considered emission-free will be one of the key issues in the upcoming negotiations. The Commission's current proposal **does not include synthetic fuels** and would amount to a de-facto ban of internal combustion engines from 2035. The last German government always opposed this and was therefore repeatedly criticized for watering down European climate protection. In the coming months, the German government must develop a common position on this issue.

- Finally, the Commission is proposing a **carbon border adjustment mechanism.** The mechanism is to be introduced in 2026 and should reflect prices from the ETS. It would initially affect the cement, iron, steel, aluminum, fertilizer and electricity sectors. **During the election campaign, the proposal was supported by the SPD, CDU, the Greens and the FDP.** Criticism, on the other hand, has come mainly from non-European trading partners. While the U.S. government, for example, has expressed interest in introducing its own border adjustment in cooperation with the EU, China and many developing countries criticized the proposal as introducing new and unfair trade restrictions. The success of the reform will depend primarily on its design. The French government would like to reach a political agreement among the member states during its Council presidency in the first half of 2022. The new German government thus needs a clear position on the concrete implementation of the proposal by then.

3. How geopolitical should European industrial policy be?

Industrial policy is first and foremost economic policy. However, not only since the beginning of the pandemic geopolitics are increasingly also influencing the debate. The European Commission and a number of member states see industrial policy as a **key instrument for strengthening "European sovereignty" and "open strategic autonomy".** What exactly this means often remains unclear. However, the geopoliticization of industrial policy raises a number of questions to which the new German government must provide answers. Two of them are particularly pressing:

- The outgoing German government was a strong proponent of the idea that **European competition policy** must be adopted to reflect the new geopolitical realities. Since the planned merger of Siemens' and Alstom's train divisions in 2019 failed because of a Commission veto, Germany has joined France, Italy and Poland in pushing for reforms of EU competition law that would facilitate the creation of "European champions". According to this idea, Europe needs large companies in key sectors that can compete internationally with the big rivals from China and the United States. The argument is controversial. **Economically, there is little to suggest that a targeted relaxation of merger rules would benefit the productivity of European industry in the long term.** In fact, market concentration has increased continuously within the EU in recent years. The negative consequences for innovation, prices and wage shares are well documented. Moreover, the Commission in particular is opposing any politicization of European competition policy. The fact that the topic nevertheless remains on the agenda was recently demonstrated by the heated debate on the possible takeover of chip manufacturer ARM by the U.S. Nvidia Group. The Commission plans to present a revision of its competition rules in 2022. The new German government must therefore decide quickly on whether it wants to keep up the political pressures introduced by its predecessors.

- Since the pandemic, there has also been intense debate about the extent to which industrial policy should **reduce strategic dependencies.** With supply chain security becoming a key issue in the global crisis, the Commission has started a review of products for which the EU relies heavily on imports from a few third countries. More extensive analyses are currently underway in the area of key technologies. The next German government must ask itself how it intends to deal with the results of these analyses. In many cases, it will come down to diversifying import sources. However, where this is not possible, **parts of the Commission and partners such as France are pushing to build up targeted production capacities** in Europe. With the aforementioned Chips Act, for example, the Commission wants to reduce the EU's dependence on semiconductor imports. Amongst other measures the plan is to offfer big subsidies to foreign chipmakers to lure them into opening up new fabs on the continent. The outgoing German government has supported this plan. Critics, on the other hand, fear that the EU is throwing itself into a hopeless subsidy race for a sector that is already being courted with a lot of money in the U.S. and Asia. **In any case, it is clear that strategic autonomy is a costly goal, especially in the realm of technology.** Alongside the many other priorities of industrial policy, the next German government will have to decide how much weight it wants to put behind it.

Conclusion: Time for a Europeanization of the industrial policy debate

After an election campaign in which industrial policy issues were discussed primarily through a national lens, **the incoming German government must now urgently turn its focus towards the European dimension of the issue.** In terms of investment volume, financing, regulation and strategic orientation, fundamental issues are on the table on which a clear German position is needed. The next German government will not have a long grace period. Answers will be needed in Brussels by the start of the French Council Presidency that is in the first half of the next year at the latest.

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