A EUROPEAN RESILIENCE AND COMPETITIVENESS AGENDA: REINFORCING THE EU INDUSTRIAL BASE, RELAUNCHING COMPETITIVENESS

Italian views on the EU response to the Inflation Reduction Act (IRA) and the need for a full-fledged European Industrial Policy

The European economy is facing a dual challenge. The Inflation Reduction Act is by and large in line with European goals – encouraging the production of green technologies. However, it can result in a competitive advantage prompting many European firms to move their operations overseas. This compounds the problem of high energy prices, that put our companies at a competitive disadvantage vis-à-vis their American and worldwide competitors. The combined effect of these factors seriously risks undermining the European industrial system.

The Union must react cohesively to these dangers. The European Council shall provide a sense of direction and reassure the European citizens, the business environment and the markets, allowing Member States and European Institutions to work intensively, in the next weeks, to identify the most exposed sectors and the fields in which proactivity is needed.

In carrying out this process, **we should start by acknowledging the link between economy and security**. The Covid-19 pandemic, the Russian aggression to Ukraine, the increase of energy cost and general inflation have exposed our potential weaknesses. The fragility of global value chains emerged, with a number of ramifications which continue to impact on the EU manufacturing system and on citizens. The process of de-industrialization in Europe has accelerated further. More recently, a number of EU companies are considering delocalisation as a mean to benefit from lower energy prices and a wider array of subsidies. In the absence of an immediate industrial policy response, this can turn into a serious threat to the survival of the European manufacturing landscape.

Loosening the State aid Temporary Crisis and Transition Framework is not the answer, since it would entail a risk of fragmentation of the internal market. More than 77% of the State aid approved under the current scheme is concentrated in 2 Member States and this imbalance could further increase should we give free rein to national Governments, since not all Member States have the same fiscal space for providing State aid.

This would jeopardize the unity of Europe in the very moment we need to tackle together the challenges ahead of us.

Lastly, we also need to better understand the impact of the IRA on our European industrial sector before finalizing the EU response, both in terms of state aid framework and use of national and European funds.

Hence, the decision on the 'Temporary Crisis and Transitional Framework' should be discussed together with other relevant topics affecting the future European integration and the public intervention in the economy as far as investments are concerned.

All the challenges that we are facing should be addressed in a wider context. We cannot politically accept to go ahead with a piecemeal approach moving forward on one topic without a clear and coherent progress on the other challenges.

In order to reinforce our economic resilience and relaunch our competitiveness, we need a comprehensive industrial, economic and trade policy. A policy aimed at bolstering our industrial base, fostering sustainable growth and preserving the level playing field at the international level, without falling into the protectionist trap, which in the end would result in a zero sum game.

Below are some thoughts, and policy suggestions, from an Italian perspective.

a) Mitigate the IRA's impact through dialogue with the USA

The high road to address the IRA's impact on the European industry is the **transatlantic dialogue**. This dialogue has been honed by the coordination on sanctions against Russia. We should pursue the same approach on IRA, looking for constructive solutions.

From a trade policy angle, we look forward to EU-US task force set up to address critical IRA-related issues. The Trade and Technology Council is another essential platform in articulating a transatlantic dialogue on IRA.

Predictably, we will face mounting pressures to adopt defensive measures to counter the IRA effects. All the more pressing as the US legislation on IRA will enter into force as early as March 1st. In processing these requests, we shall keep in mind the need to avoid triggering a trade war with the United States. An outcome that would be extremely negative for all parties involved. For this reason, any defensive measure should be regarded as a last resort, to be adopted in compliance with WTO rules and after having tried the path of dialogue. In this respect, we note that the EU-US IRA task force is starting to bear some fruit, however limited. A positive transatlantic agenda remains the lodestar of our relations.

b) Addressing the key issue: the loss of competitiveness of the European industrial system

Europe needs a healthy, vibrant industry, for social, economic and security reasons. If we want to avoid being sidelined in the global race for competitiveness and innovation, we need to address the structural factors that risk hamstringing our industrial base. Particularly relevant, in this respect, are the technological lags accumulated by Europe in key economic sectors and the European dependence on raw materials and energy sources.

We need to act, swiftly, at national and European level, to maintain, foster and upgrade the EU industrial capability, thwarting delocalization, boosting economic security in strategic sectors, with a view also to enhance industrial co-operation with neighboring Third countries.

To achieve these goals, we should focus on the **following lines of action:**

i) <u>Supporting and accelerating a sustainable green and energy transition</u>:

Decarbonization entails not only the need to speed up the adjustment in the energy mix, but also the industrial and technological transformation of entire economic sectors. Therefore, the regulatory framework and the trajectory of our effort aimed at reducing pollution should take into account the important of preserving the competitiveness of our industry.

ii) Accompanying the digital transition:

An inclusive and digital transition is a prerequisite to foster our industrial competitiveness. Bearing that in mind, EU legislation should support the creation of related infrastructures, the development of digital skills and a widespread promotion of digital services both in the public and the private sector.

iii) Fostering research, innovation and human capital empowerment:

We will not be able to ensure Europe's resilience and competitiveness without adequate investments in high-risk research projects, which would result in cutting-edge technologies to be transferred to the business sector. We need the development of innovation ecosystems that encourage the emergence of start-ups and the co-operation between business and research as well as the upskilling and re-skilling of the labor force as appropriate.

iv) Developing strategic sectors

To move towards strategic autonomy and economic security, Europe should focus its future industrial policy actions towards specific key sectors: semiconductors, raw materials, energy, defense and aerospace, bio and high-tech tools. Upgrading these sectors will prevent further delocalization processes and will make our industries competitive, while preserving the efficiency of global value chains. The development of strategic sectors should be done within a pan-European strategy, in a WTO-compatible way and consistent with the green transition process. Strengthening IPCEI instrument and exploring the possibility to finance the development of strategic sectors through new EU funding instruments is a fundamental European priority.

This ambitious resilience and competitiveness agenda can be carried out only through a comprehensive approach. The next sections will examine possible initiatives in the domain of State aid and EU financing.

c) The revision of the state aid rules

Streamlining State aid rules is one of the elements to be taken into consideration. Administrative simplification is necessary to expedite and facilitate approval procedures that are currently too long and burdensome. In particular, **a simpler and faster state aid framework** with a fast track for notification and approval for strategic projects, including IPCEI, is needed.

Changes to the "temporary framework" should also aim at facilitating a rapid implementation of the investments under the NRRPs through a simplification of state aid rules for projects already planned. Also, the temporary adjustment of the State aid framework applicable to measures contained in the NRRPs should remain in place for the whole duration of the Recovery and Resilience Facility, currently until 2026.

Another possible change could consist in simplifying the state aid regime for public guarantees allowing ex-ante clearance in terms of targeted sectors, tenor, and remuneration of the guarantees, which will incorporate the cost of the risk of the transactions.

However, **streamlining the EU rules on State aid shall not turn into a "free pass" for all,** which would give a competitive advantage to Member states with greater fiscal leeway or more opportunities to underwrite debt on advantageous terms. This would only trigger a subsidy race within the EU and lead to a fragmentation of the Single Market.

A policy of simplification and flexibility is needed, but it has to be proportionate, evidence-based and targeted. In particular, targeting is crucial to interfere as little as possible in the market dynamics and avoid squandering public resources. Therefore, we should make sure we avoid generic and indiscriminate subsidies. We should narrow down the sectors to be supported, taking into account national specificities and developing shared analysis. It is therefore of the utmost importance that the upcoming proposals on the State aid rules adequately heed the national contributions to the consultation launched by the Commission. In this respect, the choice of the legal instrument, i.e. a regulation, is key to allow a debate between Member States in the Council.

d) Reforming the European economic governance

To preserve a level playing field for business across Europe, the decision on the 'Temporary Crisis and Transition Framework' should be discussed together with other relevant topics in the domain of European economic governance.

The March EUCO could focus on both topics, providing the EU institution and Member States with sufficient leeway for an impact assessment.

Updated common fiscal rules should account for the conspicuous **investments** that Member States will have to make in the coming years to sustain the green and digital transitions and to foster competitiveness in leading sectors. A system of common fiscal rules that encourages public investment, both with regard to promoting strategic investments and improving growth potential, could be one of the key elements of the new Stability and Growth Pact.

The discussion of the future of the **European economic governance** should also address the missing piece of the Economic and Monetary Union: the creation of a central fiscal capacity. A demarche that can be undertaken, more than twenty years after the launch of the Euro, building on the positive experience of Next Generation EU.

e) Financing strategic projects, stimulating the competitiveness of the European Industry

To limit the distortive effect of State aids, an ambitious resilience and competitiveness agenda cannot hinge exclusively on national resources. It needs to **pool together different forms of private and public investments, both at national and EU level.**

In the short-term it is essential to ensure a proper leeway for re-prioritizing investments under the NRRPs and cohesion policies that can no longer be implemented due to fundamental changes of circumstances and allow the reallocation of funds already available, as needed to provide timely and targeted support in strategic areas.

The MFF mid-term revision will provide us with an opportunity to screen existing EU funds, and examine whether some of them should be reoriented, or better funded, in order to foster competitiveness. In this context, we also need to consider carefully which role can be played by all EU/Euro area Institutions (namely the ESM and EIB).

The real game changer would be creating European funds aimed at financing strategic projects, stimulating the competitiveness of the European industry and making up for unbalances created by foreign subsidies and/or distortions in the raw materials and energy markets.

The proposal to establish **a European sovereignty fund**, targeted towards the most strategic sectors of the EU economy, is a step in the right direction. Thanks to spillover effects, all Member States could benefit from this tool. Furthermore, through better coordination of national investment policies, it would be possible to implement systematically Europe-wide priorities. The Important Projects of Common European Interest demonstrate the value and potential of a European dimension in the development of sophisticated and cutting-edge technologies.

This sectoral fund – however useful to spur EU competitiveness –- would leave unaddressed the short-term level playing field conundrum, though. In order to provide relief to the European productive system and put European companies on the same footing as their subsidized international competitors we need a horizontal **initiative to support the EU competitiveness.**

In engineering this new tool, we should draw inspiration from the mechanism we have been experiencing, successfully, during the pandemic. Next Generation EU and SURE have already demonstrated that market borrowing to finance European programs is not only feasible, but also efficient. If we act together and speak with one voice, we are stronger, capable to optimize our resources and able to generate positive spillovers.

We are aware of the reluctance of some partners towards instruments involving a certain degree of common funding. Yet, the alternative is decidedly worse given the limits, contradictions and dangers of a strategy based on granting state aid on a purely national basis. Only through a purely European mechanism can the public support to economic competitiveness be reconciled with the integrity of the common market.

The creation of innovative financing instruments will be of fundamental importance in the coming months: we should face the debate with a constructive spirit, and without ideological prejudices.

f) Pursuing strategic autonomy through resilient value chains and trade agreements

Our resilience and competitiveness agenda should also have an external prong.

Strengthening energy security, reshoring production of semi-conductors (EU Chips Act), securing sourcing of lithium for batteries and rare earth for electronics (upcoming Critical raw material act) were all mentioned in September 2022 by President Ursula von der Leyen as fundamental short-term objectives of the EU industrial policy. Those objectives need now to be operationalized and framed within a broader industrial strategy.

The main objective of a new, assertive, industrial policy should be to uphold a competitive European industrial base, which is able to guarantee the security of supplies, export capability and job creation. This can only be pursued by strengthening European economic security and by **ensuring the resilience of the national and European value chains,** both cornerstones of the EU strategic autonomy.

To pursue these goals we need Europe-wide **investments aimed at reducing our strategic dependencies**. A promising example of this approach is the Chips Act, which aims to reduce the Union's dependence on imported semiconductors.

We also need to invest in **critical infrastructures** within the Union and with our partners. Major infrastructure projects should be revamped, particularly with regard to the completion of the TEN-T networks; connectivity with third countries developed, building on the logic of Global Gateway.

Trade policy will be an important enabler of this strategy. The extension and further diversification of the EU's trade and investments agreements network is urgently needed to reduce European dependencies in strategic sectors and to open new supply sources and export markets for our industries. In this regard, we look with interest at the global diversification strategies of critical raw materials proposed by the Critical Raw Materials Act, in a crucial sector for the defense of national energy supply.

g) Leveling the playing field

In parallel, the EU should **increase its capacity to level the playing field** and enforce its rights, including autonomously where needed.

Some key instruments, like the EU Investment Screening, the International Procurement Instrument, and the Regulation on Foreign Subsidies distorting the internal market have already been finalized. However, the Investment Screening Regulation, which will hopefully be reinforced in an upcoming revision, only tackles inward investments in EU strategic sectors. We invite the Commission to consider also the issue of outbound investments limited in strategic sectors.

In addition, autonomous measures on investments would need to be coupled with other measures. On top of traditional trade policy and trade defense instruments (antidumping, anti-subsidy, safeguards, and trade enforcement regulation), the EU is on its way to put in place new tools, notably the Anti-Coercion Instrument and a package of "autonomous measures". The first one is key to counter third countries' interference in legitimate sovereign choices of the EU and its Member States. By the same token, the new "autonomous measures" - aimed at restricting the placing on the EU market of goods produced in illegally deforested areas or exploiting forced labor – as well as the new Carbon Adjustment Mechanism imposing the same carbon price paid by European companies on imported goods, will implement a more sustainable level playing field.

These are all key policy tools that, while reaffirming the EU principles and stance on human rights, environment and climate, will contribute to re-establishing the level playing field with our trade partners, in line with the path traced by the EU Communication on the Trade Policy review in February 2021. Close cooperation with partners, the USA being a crucial one, will be important in supporting multilateralism and the rules-based international order and face current geopolitical challenges.

***

The above listed policy suggestions have different time horizons. Some can be quickly implemented, others will take longer, and the correct sequencing is key. However, it is essential that the European Council sends a clear signal of commitment, to reassure businesses and citizens, identifying a path that allows the EU to tackle the challenges ahead, boost its competitiveness and safeguard its very own economic fabric.