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THE EU AND THE INFLATION REDUCTION ACT: HOW TO RESPOND?

What is the Inflation Reduction Act?

In August 2022, the US Congress passed the Inflation Reduction Act ("IRA"), which was hailed as the biggest US effort to combat climate change to date. It stands as President Biden's flagship legislative achievement, and includes investment of $370 billion over a decade in renewable energy and other efforts to cut emissions. Much of this investment is in the form of tax credits to businesses making investments in clean energy, or consumers buying electric vehicles ("EVs") and making home improvements.

What are the EU's concerns?

The EU has expressed deep concern about the tax credits and subsidies on offer in the IRA, with one Dutch MEP describing the bloc as being *"in panic mode"*. It has two main concerns about the IRA –

1. A breach of World Trade Organization ("**WTO**") rules
2. The US is "poaching" investment from the EU.

A breach of WTO rules?

In comments made to the US Treasury in November 2022, the European Commission ("**Commission**"), alleged that the IRA "*contains provisions with clearly discriminatory domestic content requirements, in breach of WTO rules*", warning that tensions created by the discriminatory rules "could lead to reciprocal or retaliatory measures".[1]

This is because many of the benefits on offer in the IRA have conditions attached. For example, only EVs assembled in the US, Canada or Mexico can benefit from a tax credit of up to $7,500, and the critical minerals in them must be sourced from the US, or a country with which the US has a free trade agreement. This excludes European-assembled EVs from the tax credit, significantly reducing their competitiveness on the US market.

The Commission set out its complaints in detail in its comments and identified five specific IRA tax credits which it alleges breach WTO rules. Four of these five are tax credits for renewable energy investment and production, and the manufacture of equipment such as wind turbines and solar panels. They are partially conditioned on the use of US steel and iron. The fifth is the EV tax credit, mentioned above.

The Commission alleges that these domestic content requirements clearly breach the national treatment requirements of the WTO, under which imported products must be treated no less favourably than domestically produced ones under local regulations and tax rules. Border measures such as tariffs are excluded from the scope of the national treatment principle as they only apply to imported products and are dealt with separately. The Commission also claims that these requirements violate the WTO's Agreement on Subsidies and Countervailing Measures, and the Agreement on Trade-Related Investment Measures.

While there is no suggestion yet that the EU is considering initiating a complaint against the US before the WTO, the Commission has begun discussions with the US regarding its concerns. This has secured some concessions for the EU, which reached an agreement with the US in December 2022 to allow EVs assembled outside of North America to benefit from tax credits if they are leased, rather than sold.

[1] Regulations.gov

Investment poaching fears

The EU's second set of concerns around poaching is arguably a larger and, for the EU, a much thornier one. As the EU sees it, the extensive tax credits offered by the IRA, as well as further tax breaks and support which state and local governments grant, are diverting investment by European companies from Europe to the US.

This concern has been raised by several countries and the French and German economy ministers made a joint trip in February 2023 to Washington DC to raise their concerns about the IRA, including poaching.

There is a growing body of evidence that green investment is being redirected from Europe to the US. For example, press reports indicate that Norwegian battery company, Freyr, is investing $2.6 billion in Georgia after receiving over $600 million in subsidies from the IRA as well as the state and county governments. Similarly, an Irish low-carbon cement producer, Ecocem, is doubling its planned $120 million investment in California following the passage of the IRA, as it reorients investment to the US and away from France, according to its founder.

Certain US states have been particularly active in their bids to attract European investment, with Michigan, Georgia and Ohio sending trade delegations to tour Europe in recent months, and the governors of Michigan, Illinois and Georgia attending the World Economic Forum in Davos in January 2023. The CEO of a Swiss solar company has warned that *"[i]f the EU does not come up with something similar [to the IRA] then we may continue growing … in the US … as opposed to continuing to invest in Europe."*[2] Indeed, the numbers seem to support this – according to the American Clean Power Association, as of November 2022, at least 20 new or expanded clean energy projects have been announced since the passage of the IRA, with over half coming from non-US companies.[3]

How will the EU respond?

The EU is currently considering how to respond to the challenges the IRA poses for European industry and investment. There are, broadly speaking, two main camps:

1. those who favour relaxing state aid rules for green projects and allowing individual member states to invest.
2. those who favour a common EU-wide approach to enable smaller countries to make adequate investments.[4]

Relaxing state aid rules

The EU cannot replicate the US's simple and straightforward tax credit approach, as there are no EU taxes against which to offset. Hence, a relaxation of state aid rules would allow member states to grant tax credits themselves. France and Germany are the main proponents of loosening state aid rules. However, many other member states are deeply concerned about this, fearing that France and Germany would unleash an avalanche of subsidies. These fears are not unfounded, as these two countries accounted for 77% of all state aid spending made under relaxed Covid-related rules.[5] A group of 11 smaller, northern and eastern member states have sent the Commission a letter urging "great caution" in relaxing state aid rules, citing the fragmentation of the internal market, harmful subsidy races and the weakening of regional development.[6]

Common EU-wide approach

Some southern member states favour further common borrowing to create a common fund to address the imbalances which could be created by looser state aid rules. However, northern states like Germany, the Netherlands and Sweden fiercely oppose further common borrowing.

Meanwhile, Italy is pushing for a reallocation of unspent money from the €800 billion Covid recovery fund, in return for a relaxation of state aid rules. This is unsurprising given that Italy is entitled to 25 per cent of this fund and has yet to spend well over half of its allocation.

The bloc is hoping to reach an agreement in time for the next European Council summit in late March 2023. Given all the conflicting positions, it is difficult to predict where it will go from here. However, we suggest some possible options below:

- A relaxation of state aid rules could create huge potential for investment in clean energy and critical minerals capacity in the EU, particularly in France and Germany.
- If Italy is successful in its bid to repurpose Covid recovery funds, there are significant opportunities to develop the country's power transmission infrastructure.

[2] US touts Biden green subsidies to lure clean tech from Europe | Financial Times (ft.com)

[3] Clean Energy Investing In America Report | ACP (cleanpower.org)

[4] COM_2023_62_2_EN_ACT_A Green Deal Industrial Plan for the Net-Zero Age.pdf (europa.eu)

[5] State_aid_decisions_TF_and_107_2b_107_3b_107_3c.pdf (europa.eu)

[6] Eleven EU countries urge 'great caution' in loosening state aid rules – EURACTIV.com

- Finally, Sweden could emerge as a key location in Europe's green supply chains as the continent's biggest source of rare earth metals, following a discovery of major reserves announced in January 2023.[7]

What about the UK?

The IRA does not appear to have solicited as much consternation in the UK as it has in the EU. While International Trade Secretary, Kemi Badenoch, has joined the EU in raising concerns about how the IRA will cause economic harm and impact global supply chains, there has been little sign of the UK engaging in high level discussion with the US. This is despite calls from the UK car industry for the UK government to try to secure similar concessions on EVs to those obtained by the EU. In addition, there does not appear to be the appetite in London to respond with a similar package of investment and subsidies as there is in some quarters in Brussels. The concern is that as the US, China and the EU increase the level of subsidies and incentives on offer for clean energy, the UK risks being left behind.

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[7] Sweden announces discovery of Europe's biggest deposit of rare earth metals – EURACTIV.com