30/01/2023

A NEW EU SOVEREIGNTY FUND: A BOGUS GOOD IDEA?

Climate Action Network (CAN) Europe is Europe's leading NGO coalition fighting dangerous climate change. With over 185 member organisations active in 38 European countries, representing over 1,700 NGOs and more than 40 million citizens, CAN Europe promotes sustainable climate, energy and development policies throughout Europe.

Introduction

In reaction to the Inflation Reduction Act in the United States (IRA), the European Commission announced an upcoming Net Zero Industry Act and a loosening of the State aid framework. It would establish new goals for European cleantech projects until the end of the decade, with particular emphasis on the wind, heat pumps, solar, clean hydrogen, and energy storage industries. For European businesses to remain competitive in light of the subsidies for the US economy and to avoid a relocalisation of private investments in so-called green economic activities towards the United States, the Commission is expected to propose a relaxation of state aid rules as well as a new European sovereignty fund.

The relaxation of state aid rules will allow Member States who have sufficient resources, to offer tax breaks for green industry. So far, most state aid to companies has been allocated by Germany and France and a number of Member States do not have the financial resources to massively support their private sector. Therefore, in order to protect fair competition within the internal market, a new EU fund is being proposed to support industries in countries which don't have the fiscal space to provide state aid to businesses. The details of how such a sovereignty fund would work and how it would be funded are still being debated, while some Member States have been reacting negatively to what is being proposed.

The problem with the approach that is being proposed is that it is completely one-sided: it suggests that through the mere provision of additional subsidies to industries, the latter would transition to sustainable practices, while ignoring the crucial role of regulation to align incentives, the roll-out of existing technologies (e.g. heat pumps and rooftop solar, transport infrastructure), as well as the additional public investment support needed on the demand side, including households.

Indeed, successfully greening our industry requires first and foremost an adequate regulatory framework, providing necessary *sticks* to the *carrots* of public subsidies. Progress there is far too slow, from shifting private investments away from damaging economic activities to banning fossil fuel subsidies, from robust corporate accountability rules to ensure companies don't damage climate and the environment to green progressive taxation, from products eco-design rules to setting reduction targets for resource and energy consumption. Even worse: for the moment, massive subsidies are provided to carbon intensive industries without the necessary safeguards and rules to ensure they deliver on social and environmental objectives.

It is clear that there is a huge investment gap for climate action (mitigation and adaptation) and the just transformation of our economies. It has been assessed at 520 bn euros a year till 2030 by the European Commission for the EU as whole, while a CAN Europe report has estimated investment needs and investment gaps for 8 individual Member States, pointing that the investments mobilised to this date via EU funds are insufficient to fill investment needs for ambitious National Energy and Climate Plans[1]. While private investments will dominate, public finance will be needed in particular for investments that private investors are not considering attractive enough, because they don't generate a rapid and high enough financial return. It will also be the case of the investments needed to make the transition just, such as supporting low-income households to shift to renewable energy, ensuring effective public transport in remote areas where it can't necessarily be financially profitable, or re-skilling and up-skilling workers who will need to transition to new green jobs. From this point of view, mobilising additional public finance for the green transition is necessary. However, the sovereignty fund pitched at the moment in European circles fails to respond to the need of mobilising and targeting scarce public financial resources adequately. It is also highly problematic for the following reasons:

The principle of such a fund: is there a need to hand more public funds to large European industries?

The announcement of a new EU sovereignty fund and relaxation of state aid rules seems a thoughtless reaction to US IRA - but the IRA may well be a pretext for some to push their existing agenda to fund large European companies. **Are the amounts mobilised by the IRA higher than existing public subsidies to the European industry?** Existing subsidies to European industry are significant: these include Emissions Trading System (ETS) free allowances, tax breaks on capital investments, and investment support schemes through EU instruments such as the Innovation Fund - often in disregard of the polluter pays principle. Most

[1] CAN Europe (2022). The contribution of EU spending plans to ambitious NECPs: Comparing funds mobilised vs. climate investment needs to 2030 https://caneurope.org/content/uploads/2022/08/Final-report_UNIFY_EU-FUNDS.pdf

of these subsidies to industries have come with little or no climate, environmental or social conditionality[2]. Further, EU industries have ample financial capacity to invest in greening their operations on their own. The IRA amount - less than 400 bl USD, is marginal compared to the US economy. **Are private investors indeed leaving the EU as a result of the IRA?** There is never just one factor that causes investment locations to erode, and the effects of the Act have reportedly been wildly exaggerated by the media and politicians.[3] And **are subsidies for businesses the only way to keep our industries competitive**, or does this raise more fundamental questions about the adequacy of trade liberalisation at all costs and about the role and scope of public finance?

Fundamental questions about the design and governance of a new EU sovereignty fund

CAN Europe has fundamental questions about the design and governance of a new EU sovereignty fund, and proposals regarding a new climate fund aiming to address the public investment gap for climate, and just transition spending. Lessons from previous funds such as the RRF and cohesion policy funds need to be learned for building any effective new EU financial instruments.

1. **Genuine green activities:** Any new EU fund must support genuinely green activities and avoid greenwashing. Uncompromised, science-based do no significant harm (DNSH) criteria[4] needs to be applied to all the funds, and under no circumstance should additional funding be made available for fossil gas, nuclear or hydrogen not made with renewables.

2. **Green conditionality:** Public and private companies benefitting from "green" investments under the new EU fund should divest from climate and environmentally harmful activities, which includes accelerating the shift to renewable energy sources. This requires significant regulatory reforms at the macro level as well as robust prerequisites at the micro level. Among others, governments should end both explicit and implicit (e.g. free ETS allowances) fossil fuel subsidies for these companies as a precondition for accessing more public funds.

3. **Social conditionality:** Provisions must be included in the law establishing a new climate fund to ensure that taxpayers obtain social and environmental returns from the

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[2] See for instance: WWF (2022). Where did all the money go? How EU Member States spent their ETS revenues https://wwfeu.awsassets.panda.org/downloads/ets_revenues_report_2022___web___final.pdf
[3] The German Economic Institute, Jan. 2023, https://www.atlantik-bruecke.org/en/schadet-der-us-inflation-reduction-act-der-deutschen-wirtschaft/
[4] For science-based criteria against a greenwashed taxonomy see: https://www.greenwashed.net/

companies receiving the subsidies[5]. Conditions such as gender equality in recipients' operations, respect for collective bargaining, participation of workers as shareholders to move towards alternative business models, prioritisation of social and environmental goals in companies' operations, a ban on dividend payments while a company is in receipt of state aid, and a requirement that a proportion of the profits should be distributed to workers and reinvested in greening the company's operations.

4. **Beneficiaries of the fund:** Announcements so far suggest that a new fund would only provide subsidies to the private sector, disproportionately targeting the supply base with no provisions for supporting households or the roll-out of existing technologies. No resources would be dedicated to support investments in the public sector infrastructure such as public transport, including public services which are the only way to make the transition socially just and inclusive. Transferring resources from public to private hands at a time when income and wealth inequalities keep increasing, is the best recipe for a failed just transition and a distrust in the capacity of our political institutions to shape an economy that works for all.

5. **The role of public finance:** There is significant climate and environmental investment needed for typical *public goods* that are either underfinanced or not financed at all, by the private sector. Conversely, there are major doubts that transferring more public resources to corporations with large profits (and consequently large investment capabilities) would provide genuine additionality and value for money. Finally, it remains unclear whether the provision of subsidies to private sector companies would differentiate between large corporations and SMEs; indeed, while the former do not have a problem of access to finance (no "market failure") the latter often do. An indiscriminate channelling of resources would risk wasting scarce public resources in investments with little additionality (investments that could have happened anyway without public support).

6. **Democracy and ownership:** Participation by civil society organisations, unions, local authorities to plan the funding allocation is key for ownership and success. Reports that the sovereignty fund could be a top-down scheme eluding national governments and local authorities, with the European Commission directly allocating subsidies to businesses, are very worrying from that perspective. The capacity of public administrations to manage funds from the EU budget or the recovery and resilience facility is insufficient in a number of Member States. The implementation of projects is consequently too slow, which translates into a low absorption of funds. This capacity issue needs being addressed rather than circumvented. Human resources need being strengthened, and expertise built where needed. The EU needs to support the strengthening of the capacity of national public institutions in charge of administering the

[5] M. Mazzucato (2021) . Mission Economy A moonshot guide to changing capitalism. Penguin Allen Lane

EU funds - including for ensuring the proper implementation of DNSH criteria, for enforcing the rule of law and for avoiding corruption.

7. **Avoiding adverse impacts in the global south:** with the finalisation of the EU carbon border adjustment mechanism and the introduction of the US Inflation Reduction Act, recent climate and trade policy is putting nascent green industry and industries needing support for just transition in the Global South at further disadvantage. Additional public subsidies to European businesses will only widen the gap in a race they can't win, since Global South governments do not have the capacity to provide similar support to industries at this scale. The EU should scale up climate finance and technology transfer to developing countries in line with equity, and international trade (WTO) rules should be reformed to ensure that economies of the global south are able to pursue industrial policies that are aligned with decarbonisation targets.

Conclusion

To conclude, the EU will need a new EU fund for climate, but the use of public resources at the EU or national level should primarily target crucial components of the green transition that private finance is failing to invest in. **The indiscriminate supply-side approach currently proposed by the European Commission should be urgently reconsidered to ensure that EU funds provide genuine additionality for the achievement of ambitious Green Deal targets**. At the same time, the EU's regulatory framework should be reformed for aligning private investments with ambitious climate and environmental targets, beyond the mere *disclosure* of impacts as is currently the case under the Corporate Social Responsibility Directive and the EU Taxonomy Directive.

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