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Michael Peneder*

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Amid widening gaps in innovation and productivity growth, growing geopolitical tensions, and high ambitions for green and digital transitions, industrial policy has re-emerged as a central pillar of European strategy. This paper traces its evolution from post-war sectoral interventions through decades of market-led deregulation, to the current integrated approach embodied in the EU's *Competitiveness Compass* and supporting instruments. It argues for a development perspective centred on the economy's capacity to adapt and innovate. Organised around three complementary pillars of evolutionary change, this involves fostering novelty through innovation policies, accumulating productive resources (including human capital and infrastructure) and shaping the selection environment through regulation and market integration.

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JEL Codes: L50, L52, L53, O25, O38

Key Words: Industrial policy, competitiveness, transformation, IPCEI, FDI-screening, CBAM

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1 Introduction

After a long and eventful history, European industrial policy is again facing major disruptions. Driven by far-reaching technological, geoeconomic and increasingly geopolitical changes, it has re-emerged as a defining challenge for the European Union. Having once been dismissed as an anachronism of interventionist economics, it now commands unprecedented attention from policymakers, industry leaders and academic researchers.[1] This reversal reflects the sobering realisation that the European Union is confronting a genuine **competitiveness crisis** that endangers its prosperity, technological and strategic autonomy, and security. It risks further falling behind the United States and losing ground to China in critical technologies such as semiconductors, artificial intelligence and clean energy systems, while simultaneously grappling with supply chain vulnerabilities exposed by geopolitical upheaval, energy price shocks and the economic fallout from successive crises.

Decades of soul-searching, varying in intensity and focus, have led the European Union to consolidate its approaches with the concept of an **integrated industrial policy**. This combines policies that address macroeconomic framework conditions to improve the general business environment with specific, technology- or sector-based strategic priorities. Since then, numerous new instruments have been adopted as part of an ongoing effort to expand the EU's strategic options.

In view of collapsing international rules and increasingly uninhibited geopolitics, the traditional justification for industrial policy interventions based on 'rationalities of failure', such as market, coordination and system failures, is losing much of its relevance, credibility and appeal. Instead, contemporary industrial policy should adopt an explicit **development perspective** based on the drivers of evolutionary change. Rather than attempting to correct imperfections within a hypothetical perfect state, industrial policy should be viewed as a deliberate effort to enhance an economy's capacity to adapt, innovate and evolve in response to changing opportunities and constraints (Peneder, 2017, 2024). Within this framework, industrial policy is organised around three complementary pillars: fostering novelty through innovation policies; accumulating productive resources, including human capital and infrastructure; and shaping the selection environment through regulation and market integration.

This paper is organised as follows: Section 2 develops the conceptual frame-

[1] See, for instance, Chang (2002), Bianchi and Labory (2006), Aiginger (2007), Aghion et al (2015), Juhász et al. (2022, 2024), Lee et al (2021), Kastelli et al (2023), Megyeri et al (2023), Tirole (2024), Fadinger and Steinwender (2025), Landesmann (2025), Polt (2025), Raza et al (2025), or Wanzenböck and Weber (2025).

work. It clarifies the relationship between industrial and competitiveness policies, distinguishes between structural and sectoral measures, critiques the over-reliance on heuristics of 'failure' and sets out a development oriented rationale centred on an economy's ability to evolve.

Section 3 traces the historical evolution of EU industrial policy across four distinct phases: the postwar reconstruction period; the period of market-led deregulation from the 1970s through early 2000s, during which industrial policy was largely abandoned; the gradual return to sectoral attention from the mid-2000s onward; and the current period of an increasingly comprehensive industrial policy toolbox. This historical narrative demonstrates that European industrial policy has never fully disappeared but has been continuously reframed in response to evolving challenges and demands.

Section 4 examines contemporary developments, paying particular attention to the influential reports by Letta and Draghi, and the institutional response by the EU through the *Competitiveness Compass* and the *Clean Industrial Deal*. European policy now identifies three transformative imperatives: closing the innovation gap with the United States and China; integrating decarbonisation and competitiveness; and achieving strategic autonomy while maintaining open international relationships.

Section 5 maps the contemporary policy portfolio onto the three pillars of evolutionary change and discusses three emblematic instruments in depth: *Important Projects of Common European Interest* (IPCEIs), *Foreign Direct Investment (FDI) screening*, and the *Carbon Border Adjustment Mechanism* (CBAM). This illustrates the design choices, implementation challenges, and open issues involved.

Section 6 concludes by identifying three critical obstacles to effective implementation: continued fragmentation and lack of coordination among member states, insufficient funding mechanisms, and a lack of consistency in the logic of interventions. To succeed, binding institutional mechanisms, new fiscal instruments and a deliberate embrace of the duality between competitive internal markets and managed external trade relationships are required.

2 Conception

2.1 Competitiveness and industrial policy

The term 'industrial policy' can have many different meanings. For example, Juhàsz et al (2024, p. 216) "define industrial policies as those government policies that explicitly target the transformation of the structure of economic activity in pursuit of some public goal." This corresponds to how economists generally use the term

'industry' to depict distinct branches of economic activity. Industrial policy then encompasses all deliberate interventions aimed at changing the composition of production, regardless of whether they are directed at manufacturing, tradable goods or services. If defined in this way, the European Union's *Common Agricultural Policy* (CAP) is the most comprehensive industrial policy the EU has ever enacted. There is no intention of irony in this statement. On the contrary. Arguably, this corresponds with the term's most meaningful economic use. In what follows, however, we shall designate them as either 'structural policies', if applied across different sectors, or simply 'sectoral policies', as in the case of the CAP. The reason is that, unlike in economics, the term 'industry' generally refers to **manufacturing** and related industries in the political discourse. This represents a completely different perspective, and conflating the two is a key reason why policy and economic research often fail to find common ground.

In what follows, we consider industrial policy to focus deliberately on manufacturing activities and related industries that exert a critical influence on the competitiveness of manufacturing firms, such as those involved in critical raw materials, energy, or business services. Its general aim is to enhance competitiveness, a concept that may encompass a variety of goals and ambitions. These range from reducing unit labour costs and improving trade balances, to bringing about significant economic, social, and ecological transformations. For clarity, the following definitions are applied here: *Competitiveness* is the ability of an economic system to generate high and sustainable real incomes while improving social and ecological living conditions in a continually changing environment (Peneder et al., 2025). Consequently, *competitiveness policy* is the set of public interventions that aim to foster economic development towards high and sustained living standards. This definition includes structural policies, as defined by Juhász et al. (2024), which in turn encompass industrial policies that specifically aim to enhance the competitiveness of manufacturing and related industries. **industrial policy** is thus defined as the set of public interventions designed to promote industrial development, i.e. the capacity of industry to evolve in line with a society's long-term increase in living standards, including security, resilience, and the desired social and ecological transformations.

2.2 Rationalities of 'failure'

Traditional economic rationales for industrial policy draw on theories of **market failure** (Bator, 1958) to advocate public intervention. These theories encompass various types of market frictions and distortions that prevent the optimal allocation of scarce resources. Common examples include external effects, information asymmetry,

public goods, common pool resources, or market power. These rationales provide a solid foundation for many particular policies, such as innovation and technology policy, competition policy and the provision of public infrastructure. They clearly matter also for industrial policy, which spans all these domains. However, when the primary objective shifts from market efficiency to industrial development, the focus will inevitably change.

Industrial policy thus invokes additional rationales that reflect its deliberate development perspective. The most common reference is to **coordination failure**, where firms could collectively achieve better outcomes through coordinated action but fail to do so. For instance, this applies when the wait-and-see attitude of individual market participants impedes the diffusion of new technologies or complementary investments in supply chain development. Juhász et al. (2024, p. 217) thereby highlight increasing returns as the cause of multiple equilibria, in which policy interventions may foster the transition from suboptimal to superior configurations. The classic *infant industry* argument is a prime example, where learning by doing generates dynamic increasing returns and average costs decrease as production increases. A situation like this can justify temporary protection, which enables domestic firms to achieve economies of scale and develop competitive capabilities.

The notion of 'failure' has led to the identification of numerous additional heuristics for public intervention. For instance, *system failure* emphasises the lack of coherence in the institutional setup (Smith, 2000). Another example is *strategic failure* in policymaking (Cowling and Tomlinson, 2000, 2011). Similarly, economists use the heuristic of 'failure' to reject industrial policy. They refer to **government failure** when they identify agency problems and the risk of dominant business interests capturing public resources and regulations (Tullock, 1967; Krueger, 1974).

All these rationales raise valid and important points. Government failure, as well as market failure, is ubiquitous. And economists know that. Stigler described the idea of an omnipotent state as an "article of almost desperate faith", while Samuelson highlighted the knife-edge conditions required for perfect market equilibrium: "the elementary consideration that a line is infinitely thinner than a plane would make it a miracle for these conditions to be met" (Stigler and Samuelson, 1963, p. 4; p. 26). To better align our analysis with actual policymaking, we should seriously question our over-reliance on such **rationalities of failure**, and our habit of accepting hypothetical perfect states as the definitive benchmark for public intervention. In dynamic and open systems, the normative benchmark of a hypothetical perfect state is ill-defined, making the heuristic of failure a poor foundation for intervention (Peneder, 2017). Instead, industrial policy requires dynamic reasoning that starts with its development objectives rather than the failures it aims to correct.

2.3 Ability to evolve

By emphasising the need to provide *activity-specific public inputs*, Juhász et al. (2024) take an important step away from conventional rationalities of failure towards an explicit development perspective. It highlights that public investments, such as those in infrastructure or education and professional training, are often location- and sector-specific and an important means to strengthen the competitive advantage of particular industrial clusters (Porter, 1990).

As defined in the previous section, competitiveness policy aims to foster economic development, which is tantamount to the objective of enabling and molding evolutionary change. Starting from fundamental relationship between the micro, meso and macro levels of economic activity (Dopfer et al, 2004; Lipsey et al, 2005), aggregate populations evolve through structural changes in favor of more productive activities, and thereby raise the average ability to alter the given material constraints. Competitiveness policy therefore must be tightly embedded in a multi-layer system of enterprise, industrial and general framework policies.

Combining the target levels and system functions of economic development, one can organize a fairly comprehensive variety of different public interventions into a concise typology of competitiveness policies (Peneder, 2024). At each target level, concrete policies aim to serve one or more of the following basic system functions:

i *Innovation* sustains the requisite variety for evolutionary change and development. This includes a system's ability to adapt to changing environments and crises (i.e. resilience). Areas of public intervention encompass research, technology, and start-up policies.

ii The accumulation of *productive resources*. Common examples involve subsidies for investment or technology diffusion, as well as the public provision of general and sector-specific inputs (infrastructure, education, etc.).

iii Shaping the *selection environment*. Examples range from antitrust and trade policy to economic integration (the Single Market), as well as environmental, social, labour or specific product regulations.

Many of the policies derived from this evolutionary perspective can also be inferred using the traditional rationales of market failure, coordination failure, and so on. Due to the ubiquity of 'failure', these justifications are indeed like sturdy old shoes that neither wear out nor ever fit comfortably. One explanation for this 'uncomfortable fit' is that economic efficiency is difficult to define within the context of multiple, often path-dependent, trajectories of industrial development. A second, more practical reason is that public officials tend to see their role as facilitating growth and structural change, rather than addressing hypothetical efficiency gaps.

Figure 1: Rethinking the logic of intervention

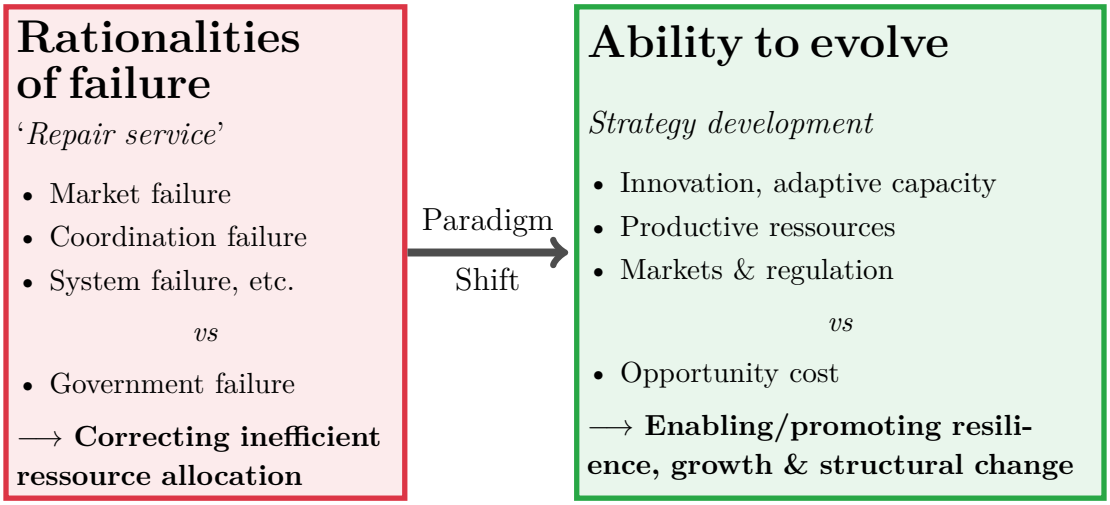


Figure 1 summarises the key components of a strategic development paradigm to industrial policy that shifts the focus from established rationales of failure to fostering an economy's capacity to adapt, innovate and evolve. It arguably reflects many of the factors that have contributed to the success of Asian economies such as Japan, South Korea and China in the past. The practical needs and considerations involved in implementing industrial policy will lead European initiatives down a corresponding path. The main conclusion of this section is that European policymakers should consciously adopt this approach in order to promote shared perspectives and coordinated action.

That leaves one important question to be resolved. When markets are functioning reasonably well, the requirement to prove the existence of genuine market failures can act as an effective safeguard against unwarranted government intervention. However, it is important to understand that the principle of opportunity cost provides a more fundamental and comprehensive criterion that encompasses the various instances of market failure while remaining consistent with our approach. If private markets are more efficient at accomplishing a certain task, governments should save their scarce resources for other value-creating activities. The opportunity cost principle therefore implies that governments must strategically prioritise public interventions according to their anticipated benefits and costs.

3 Historical devolopment

3.1 Postwar reconstruction

The history of industrial policy in the European Union is long and marked by significant changes and reversals. From the outset of the European project, industrial policy was of considerable importance, as demonstrated by the establishment of the European Coal and Steel Community (ECSC) in 1951. In addition to concerns about the mutual control of military goods, attempts were made to secure the supply of coal and steel within the Community by introducing joint investment quotas, regulating prices, and removing internal customs duties and external trade restrictions. Similarly, EURATOM was established in 1957 to coordinate and monitor the civil use of nuclear energy and nuclear research across Europe. Conversely, the main aim of establishing the European Economic Community (EEC) in the same year was to promote the free movement of people, capital and goods, and to implement a common trade regime within the framework of the Common Market. However, the responsibility for industrial policy largely remained with individual nation states, who made ample use of it.

Sectoral targets generally flourished during the period of **industrial reconstruction** after the Second World War, as governments had established firm control over various sectors of the economy and capital stocks were depleted (Grabas and Nuetzenadel, 2014). The main instruments used to encourage investment, rebuild production capacity and expand output were public ownership, subsidies, regulation of the credit and bond markets, and business-friendly sector regulations.

3.2 Demise and collapse

The situation changed when the reconstruction boom ended, resulting in substantial **excess capacity** in targeted industries such as steel and shipbuilding. Industrial policy was held responsible for delaying the necessary structural adjustments. Beyond mere 'government failure', industrial policy was caught in a strategic *prisoner's dilemma*. Nations would have been better off coordinating the reduction of oversized sectors, thus shortening the crisis and reducing its cost. However, lacking transnational coordination, the dominant strategy for individual countries was to continue supporting their industries. The result was widespread and costly subsidies for oversized operations, and a slow overall adjustment.

The growing cost of targeted sector interventions made industrial policy increasingly unpopular during the crises of the 1970s. In the 1980s, this issue fuelled intense ideological debates about the appropriate role of government versus markets.

In light of governments' inability to manage the necessary restructuring of industry, free competition on liberalised markets became the obvious means to implement required reforms. Momentum shifted towards **pro-market reforms** focusing on the deregulation and privatisation of target sectors. Clearly intended to make them more productive, these reforms must also be considered an industrial policy. The pro-market agenda found its most important realisation in the Single European Act of 1986. While 'old' industrial policy disappeared from the agenda, the completion of the Single European Market came to be regarded as the EU's most significant industrial policy, promoting competitiveness through much-needed reforms of the overall framework conditions. When the EU formally adopted industrial policy as one of its responsibilities in the Treaty of Maastricht in 1992, it was deemed to be 'horizontal' in nature.

3.3 Return of industrial policy

Amid mounting competitive pressure from China[2] and other emerging economies, attention eventually returned to the sector level. First, it dawned that horizontal policies affect industries differently. They are therefore not neutral, but strategic instruments to foster structural change towards desired activities. Next, it became clear that many horizontal measures had to be adapted to the specific context of an industry when they were implemented. These arguments blurred the strict boundaries between vertical and horizontal policies, which had previously been heavily charged with ideological preconceptions. In response to these learnings, the European Commission (2005) conceived an **integrated industrial policy** which continued to emphasise horizontal measures, but combined them with the tailoring of sector-specific regulations and framework conditions (Allen et al., 2006).[3]

In 2009, the European Commission took the next step towards strategic priorities by introducing the concept of **Key Enabling Technologies** (KETs). Classified as systemically relevant, KETs were considered particularly significant for Europe's future prosperity due to their potential for value creation and their wide range of applications. They developed into an important tool for managing European research and industrial policy. The current *Horizon Europe* programme (2021–2027) for funding research and innovation prioritises the following six KETs:[4]

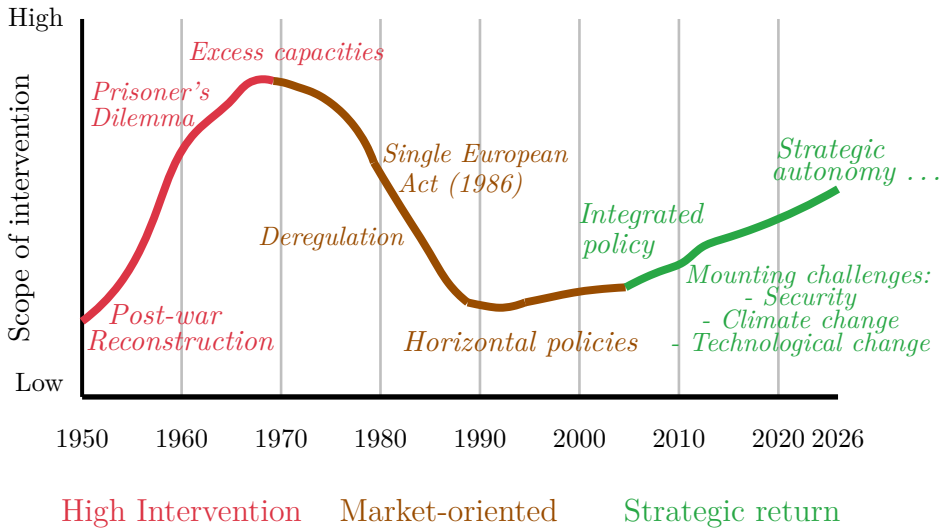
– Advanced Manufacturing

[2]See, e.g., Friesenbichler et al (2024).
[3]https: COM(2005) 474.
[4]https: COM(2009) 512.

– Advanced Materials
– Life-science Technologies
– Micro-/nano-electronics, photonics
– Artificial intelligence
– Security and connectivity technologies

When the European Commission elevated industrial policy to one of the flagship initiatives of its Horizon 2020 strategy in 2010,[5] it essentially continued its integrated approach, but with a bolder sectoral focus. Two years later, the European Commission set the infamous goal of active **reindustrialisation** as part of an update to this strategy.[6] The aim was to increase the share of manufacturing in total value added to 20% by 2020. This target dominated the European industrial policy debate for many years. In fact, the proportion of value added by manufacturing increased from 15.3% in 2012 to 16.2% in 2023.[7]

Figure 2: Stylized timeline of EU Industrial Policy



NB: The line shown indicates general trends. It does not represent the scale or scope of interventions quantitatively.

[5]https: COM(2010) 2020.
[6]https: COM(2012) 582.
[7]Peneder and Streicher (2018) provide a critical empirical assessment and present a new method for identifying the sources of structural changes based on global value chain data.

Figure 2 illustrates the evolution of EU industrial policy, distinguishing three broad historical phases characterised by critical turning points and policy shifts. These reflect competing paradigms and responses to structural crises. The post-war consensus on sectoral intervention collapsed under the weight of excess capacities and the systemic failure of policies to correct them (the prisoner's dilemma). Market fundamentalism won the intellectual debate and dominated for about three decades. However, it proved insufficient to address mounting technological, ecological, and geopolitical challenges. Contemporary competitiveness policy sees the reintegration of sectoral and horizontal instruments, driven by multiple external pressures and the aspiration towards strategic autonomy.

4 Current developments

4.1 New challenges

The European Commission presented a new industrial policy strategy in 2020, focusing on three overarching objectives: competitiveness, ecological transformation and digitalisation.[8] In addition to the numerous specific plans and suggested policy measures for individual sectors, the realignment of the overarching goals is particularly noteworthy. Against the backdrop of perceived asymmetries in international competition, concerns about Europe's technological and economic sovereignty have come to the fore.[9] But alongside this unusually defensive goal, the European Union has sought to take on more offensive challenges in the context of an aspired **twin transition**: it aimed to play a leading role in global digitalisation and to become climate-neutral by 2050.

The first year of implementing the new industrial strategy was marked by the outbreak of the **COVID-19 pandemic**, which required extensive public aid and special programmes to support the European economy. The most significant development was the EU's *Recovery and Resilience Facility* (RRF), coupled with the national recovery and resilience plans of individual Member States.[10] This combined an immediate response to the crisis with long-term strategic goals by financing investments in the green and digital transformation. The RRF came into force in February 2021 for a limited period. This exemption from the ban on debt financing allowed the European Commission to raise up to €750 billion on the capital market by issuing bonds on behalf of the European Union. These funds were then distributed

[8]https: COM(2020) 102.

[9]See Edler et al. (2020), Janger (2024) or Reiner and Stölllinger (2025).

[10]https: RRF

to the member states, partly in the form of loans and partly as non-repayable grants, subject to minimum quotas. At least 37 per cent of the funds had to be allocated to climate-related measures and at least 20 per cent to digitalisation. All member states must have implemented the milestones and targets agreed in their recovery and resilience plans by August 2026. Repayment of the bonds is to be made from the EU budget, starting in 2028 and to be completed by 2058 at the latest.

Also due to the pandemic, the European Commission felt compelled to update its industrial strategy after just one year.[11] In support of its vision of **open strategic autonomy**, the EU further advocated new coordination mechanisms to enhance crisis resilience and strategic sovereignty while remaining open to international trade and investment. The aim is to reduce dependence on imports from highly concentrated suppliers outside the EU in product groups that are important for public safety, healthcare or critical supply chains. If it is not possible to sufficiently diversify supply relationships, it considers strategic stockpiling, encouraging international manufacturers to locate in the EU, or developing its own production to be effective ways of achieving this goal. Since then, the EU has adopted several specialised instruments to address some of the most pressing challenges:

- The *European Chips Act* of 2023, for instance, aims to boost Europe's market share in semiconductor production from under 10 per cent to 20 per cent by 2030 by promoting R&D and offering state aid exemptions (Dachs, 2023).
- The *Critical Raw Materials Act* (CRMA) sets similarly ambitious targets for developing European capacities regarding critical raw materials.
- The *REPowerEU* plan, updated in 2025, provides a comprehensive roadmap to end dependence on Russian energy imports by 2027.

Although these and other programmes set ambitious goals, the limited additional funding that the EU can raise to support them casts doubt on their overall coherence and chances of success.

4.2 The EU Competitiveness Compass

Two influential reports, both offering very **sobering diagnoses** of European competitiveness, have shaped the most recent debate on European industrial policy. Enrico Letta's report (2024) focuses on strengthening the EU's Single Market to improve industrial competitiveness. He emphasises the need to unify the fragmented internal market so that European companies can grow more quickly and compete

[11] https: Strategy Update

globally. He also calls for the implementation of a genuine capital markets union to mobilise private savings for the necessary investments. Many of these issues are also addressed in Mario Draghi's report (2024). Like Letta, Draghi calls for massive additional investment in research and development, digitalisation, education and infrastructure, as well as reducing energy costs and administrative burdens. Both authors emphasise the importance of completing the *Capital Markets Union* as a mechanism for financing large-scale investments. While Letta wants to oblige member states to contribute more national funds to EU-wide initiatives, Draghi advocates joint borrowing through EU bonds.

A critical point is that both reports view competition policy in the context of strict **merger controls** as an obstacle to scaling up European companies with a global presence. The idea that reducing competition through strategic consolidation could make European companies more competitive in the global market goes against the empirical evidence of successful industrial policies in Asia (Aghion et al., 2015; Lee et al., 2021).[12] Consistent with the evolutionary rationale of industrial policy in Section 2, these have repeatedly fostered industrial development and global competitiveness through a highly selective competitive environment in the domestic market.

Both reports significantly influenced the priorities of the European Commission. In January 2025, the Commission presented the **Competitiveness Compass**, a five-year framework for its activities which established competitiveness as the overarching principle for EU action. While competitiveness is still understood to include social and environmental dimensions, economic considerations clearly take precedence. The growing importance of security policy concerns reinforces this trend. The Compass essentially follows the Draghi Report, positing three **transformative imperatives** for Europe. The first of these is to close the innovation gap with the US and China, as well as the associated lag in productivity growth. This is to be achieved by removing structural barriers and boosting the economy. The second imperative is a roadmap for decarbonisation and competitiveness that treats both as integrated goals to be pursued jointly. The third imperative emphasises the goal of open strategic autonomy in order to reduce existing dependencies and increase security.

In order to support the three imperatives, the Compass has defined **five horizontal drivers** designed to strengthen competitiveness across all sectors. First, the focus is on reducing administrative burdens. Second, the completion of the European Single Market is prioritised, particularly the capital markets union. Third, closely linked to this is the financing of extensive investment projects through a

[12]There is extensive economic literature on the relationship between industrial policy and competition. Other recent examples include Tirole (2024), Hottenrott et al. (2025), Schnitzer and Weber (2025), Wu (2025), or Duso and Peitz (2026).

planned savings and investment union and a reformed EU budget with a new European competitiveness fund. The EU Startup and Scale-up Strategy,[13] presented in 2025, addresses venture financing, which is particularly important for closing the innovation and productivity growth gap.[14] The fourth horizontal action line addresses workforce skills, employment and social fairness. Fifth, a new coordination instrument for competitiveness has been announced to improve EU governance and enhance the coordination of competitiveness strategies among its member states.

A key component of this strategy is the introduction of **omnibus packages**, which aim to simplify and reduce the bureaucracy associated with European regulations. Rather than adopting many small individual amendments separately, the European Commission is combining various legal provisions from different policy areas into bundled reform packages. One focus is on harmonising reporting requirements. Rather than collecting data and preparing reports separately for each regulation, companies should only have to do so once. The aim is to create a uniform structure that integrates the requirements of various directives. The first omnibus package, published in February 2025, aims to simplify sustainability reporting and due diligence obligations in supply chains.[15] A second package deals with simplifying EU investment programmes, while a third package addresses the CAP. Further omnibus packages are planned.

In February 2025, this was followed by the **Clean Industrial Deal**. Treating decarbonisation and competitiveness as integrated components of a single growth strategy, it comprises six priorities: an affordable energy plan, financing the transition, the circular economy, international partnerships, lead markets for green technologies and the need for skilled workers. In June 2025, the new *Clean Industry State Aid Framework* (CISAF) was adopted to provide member states with tools to support strategic industries in renewable energy, decarbonisation and clean technologies. Additionally, plans were announced for a €100 billion *Industrial Decarbonisation Bank*.

Alongside the Clean Industrial Deal, the Commission adopted further sector-specific action plans, some of which replace or update previous activities. These relate to the steel industry, automotive sector, chemical industry, biotechnology, space travel, artificial intelligence and quantum technology. Due to growing geopolitical tensions, military security has become the most urgent task. The **European Defence Readiness Roadmap 2030**, presented in October 2025, aims to address critical shortcomings in Europe's defence capabilities and bolster the European defence industry. It is linked to an EU-wide defence industrialisation plan that prioritises

[13]https: EU start-up & scale-up strategy

[14]See also Peneder and Resch (2021).

[15]See, e.g., Felbermayr et al (2025).

artificial intelligence, drones, space systems and ammunition production. The plan also envisages the creation of military mobility zones similar to Schengen to enable troops to move more quickly.

In March 2026, the European Commission presented two new proposals in line with the Competitiveness Compass. To begin with, the **Industrial Accelerator Act** (IAA) specifically targets energy-intensive industries, producers of net-zero technologies and the automotive sector.[16] When it comes to political messaging, the proposal revisits the contentious goal of achieving a 20% share of manufacturing in GDP (this time by 2035). Substance-wise, the Act intends to introduce a voluntary low-carbon label for industrial products, streamline the permitting process for decarbonisation projects, and designate 'industrial acceleration areas' to encourage the spatial clustering of activities. There will be tighter conditions for inward FDIs (e.g. relating to technology transfer, local workforces and joint ventures), and mandatory local content rules ('Made in Europe') shall apply to public procurement and funding.

Finally, the European Commission presented its *EU.Inc* proposal as part of the **28th regime**, which should enable businesses to exploit the benefits of the Single Market more effectively.[17] It will allow firms, particularly those with high innovation and growth ambitions, to operate under a single, harmonised EU framework, rather than having to navigate 27 distinct national legal systems with their own corporate laws. The EU Inc. aims to simplify the corporate legal shell, enabling founders to incorporate within 48 hours, digitally, for under €100, with harmonized procedures for raising capital, attracting talent through standardized employee stock options, and managing corporate events such as share transfers and simplified insolvency. Despite this notable progress, the standard legal form of EU companies alone cannot resolve continued fragmentation across the 27 national legal systems and cultures. Without prior harmonisation of critical policy domains such as taxation, labour law and dispute resolution, individual member states clearly have many reasons to oppose the creation of opportunities for regulatory arbitrage.

In conclusion, mounting challenges have led to a significant expansion in the scope of European industrial policy initiatives since the influential Letta and Draghi reports in 2024 (Table 1). The comprehensive ambition of these initiatives, coupled with the potential for coordination problems, increases structural complexity. Overall, contemporary EU policy demonstrates an unprecedented commitment to large-scale, targeted public investment to address the triple challenges of technological change, the green transition, and fostering geopolitical resilience through increased defence capabilities.

[16] https: IAA.
[17] https: EU.Inc.

Table 1: Selected EU industrial policy initiatives since 2020

Date	**Initiative**	**Short description**
March 2020	*New Industrial Strategy for Europe*	Prioritises technological/economic sovereignty plus twin transition: digitalisation& ecological transformation.
February 2021	*Recovery and Resilience Facility*	Temporary debt-financing, combining crisis response with twin transition; repayment via EU budget (2028–2058).
May 2021	*Update of EU Industrial Strategy*	Added emphasis on coordination mechanism to enhance crisis resilience and strategic sovereignty.
May 2022	*REPowerEU*	Roadmap to end dependence on Russian energy imports by 2027. Update in May 2025.
September 2023	*European Chips Act*	Aims for EU market share of 20% by 2030, e.g. through R&D promotion and state aid exemptions.
May 2024	*Critical Raw Materials Act*	Sets targets for European capacities in critical raw materials essential for energy transition and innovation.
April 2024	*Letta's Report*	Focus on strengthening the EU's Single Market for industrial competitiveness.
September 2024	*Draghi's Report*	Diagnoses competitiveness crisis; calls for massive additional investments.
October 2025	*Defence Readiness Roadmap*	EU-wide defence industrialisation, e.g. AI, drones, space, ammunition production.
January 2025	*Competitiveness Compass*	5-year framework; 3 imperatives: closing the innovation gap, decarbonisation, open strategic autonomy.
February 2025	*Clean Industrial Deal*	6 priorities: energy, finance, circular economy, international partners, green tech, labour skills.
February 2025	*Omnibus Packages*	Simplify and reduce bureaucracy by bundling legal provisions.
May 2025	*Startup and Scale-up Strategy*	Mobilize venture finance, e.g. by regulatory reform or preferential tax treatment.
June 2025	*Clean Industry State Aid Framework*	Support strategic industries in renewable energy, decarbonisation, and clean tech.
March 2026	*Industrial Accelerator Act (IAA)*	Targets energy-intensive, net-zero technology, and automotive sectors, e.g. by local content rules (*Made in Europe*).
March 2026	*28th Regime*	Enable businesses to operate under single harmonised EU framework, e.g. by simplified corporate legal shell (*EU.Inc*).

5 Policy instruments

Industrial policy has always spanned various domains of public intervention. In addition, over the past years the scope and diversity of instruments has expanded significantly in response to evolving objectives. These encompass not only productivity, innovation, trade and regional development, but also sustainability, resilience, supply chain security and European defence capabilities. This section provides a brief overview of the range of available tools and highlights three examples of particular interest.

5.1 The policy portfolio

As previously mentioned, the ubiquitous nature of the rationalities of failure implies that any policy in support of the aforementioned goals could be justified by some kind of market, coordination or system failures. Alternatively, in this section the focus is on the system's ability to adapt and evolve in response to new challenges and constraints, such as economic crises, aspired social and ecological transformations, or geopolitical conflict. According to the dynamic rationale of Section 2.3, the overall portfolio of instruments can be organised along the **three pillars** of evolutionary change (novelty, accumulation, and selection). Table 2 provides selected examples of instruments that address different tasks and system functions from an integrated perspective.

The first pillar is **innovation**, a fundamental 'imperative' of the EU's industrial policy. This reflects the widespread recognition that technological advances and the creation of new knowledge are the main drivers of long-term economic growth, international competitiveness, and successful green, digital or defence-related transformations. *R&D tax credits, subsidies and grants* are among the most common policy tools aimed at encouraging private investment in innovation. In addition, *intellectual property rights* incentivise R&D by granting inventors temporary exclusive rights to appropriate the returns from their innovations (Peneder et al., 2020). Supporting *entrepreneurship* and *start-ups* is another way to sustain business dynamism by encouraging new market entries. Instruments include business incubators and accelerators, and encouraging the supply of *venture capital* through regulatory reforms, preferential tax treatment or the allocation of public funds. Finally, governments may offer tax credits, grants or subsidised consultancy services to encourage the *adoption of new technology*. This is an important driver of both productivity growth and the aspired ecological transformation, e.g. in favour of energy-saving technologies.[18]

[18] See, e.g., Arvanitis et al. (2017), Peneder et al. (2022).

Table 2: Integrated Industrial Policy: system functions and policy instruments

System functions	**Targeted policies, e.g.**
Innovation	R&D tax credits, subsidies and grants Intellectual property rights (e.g. patents) Support for entrepreneurship and business formation Venture capital (regulation, taxes and public funds) Technology adoption (credits and grants; services)
Ressources	Skilled labour and workforce development Physical infrastructure (e.g., energy, transport, communication) Access to finance (deep and integrated capital markets) Strategic reserves, commodity market stabilisation State-owned enterprises (SOEs)
Markets & Regulation	Integration (Single Market, EU.Inc, trade agreements) Tariffs and other trade barriers, export credit Competition policy, antitrust Standards, product market regulations, etc. Public procurement

Beyond supporting innovation, industrial policy involves a wide range of measures aimed at improving the availability and quality of **productive resources**, such as human capital, physical infrastructure and financial capital. This second pillar involves the public provision of specific inputs for prioritised sectors and activities (Juhász et al., 2024). Demographic trends imply that shortages of *skilled labour* will continue to be a most critical constraint. Deliberate policies need to align public and private investments in education and training more closely with industrial policy objectives. Likewise, investments in physical *infrastructure* may be deliberately targeted towards a prioritised cluster of activities. Policies designed to improve *access to finance* (e.g. grants, loans, guarantees and public-private partnerships) can lower the cost of capital for targeted private-sector activities. To this end, specialised development banks may be able to offer greater operational flexibility and autonomy than traditional government agencies. *Strategic reserves* address vulnerabilities in supply chains and mitigate the economic disruption caused by extreme fluctuations in commodity prices. Examples include petroleum, natural gas, food and pharmaceuticals. Recent crises and growing geopolitical tensions suggest extending the instrument to critical minerals essential for the energy transition, technological innovation and defence. Another means by which governments can deploy capital towards industrial policy objectives is through *state-owned enterprises* (SOEs) and holding companies. The degree of policy intervention depends on the specific governance structures in place. These must strike a delicate balance between operational autonomy for the portfolio companies and the accountability and transparency needed to ensure that public resources are used for legitimate purposes.

The third pillar focuses on the factors shaping the broader institutional context of **markets and regulation** in which firms decide to invest or innovate. Policy instruments affect market integration, the intensity of competition, and the regulatory requirements with which firms must comply. They establish the broader institutional framework that also impacts the returns on productive investments versus rent-seeking behaviour. The aim is to align individual choices and actions with societal norms, objectives, and constraints. The completion of the European *Single Market* is a prime example of an area in which manufacturing industries could greatly benefit from the full integration and harmonisation of capital, business services, raw materials and defence procurement markets across the entire EU. The EU's growing network of international partnerships and *trade agreements*, including those recently signed with Australia, India and Mercosur, aims to capitalise on larger market opportunities for European businesses and consumers. They also serve broader geopolitical purposes, such as forming coalitions against rising protectionism, ensuring supply chain resilience, and promoting sustainable development

norms. Export credit is a tool that alleviates financing constraints, which would otherwise limit firms' ability to access international markets. By contrast, *tariffs* and other trade barriers are intended to restrict imports, thereby raising domestic prices and increasing the profits of protected producers, but they also risk inefficient resource allocation and retaliation from trading partners. *Regulations and standards* are designed to guide economic activities in line with societal objectives and the perceived constraints of human (inter)action, such as environmental sustainability, public health, consumer protection and fair market competition. By enforcing compliance and structuring incentives, they reshape the selection environment and coordinate expectations. Finally, *procurement* policies operate on the demand side, using public funds to stimulate demand for products from specific industries or producers. These policies can employ explicit preferences for procured goods to fulfil specific requirements regarding content or origin (*Made in Europe*), or more subtle mechanisms, such as technical specifications, that favour particular suppliers or domestic producers. As they involve a high degree of intervention, any benefits in terms of industrial development goals must be weighed carefully against the economic cost of distorting the competitive allocation of available resources.

The EU's industrial policy **competencies** are divided between exclusive powers of the Union, shared competencies and areas where member states retain principal authority. This creates a complex institutional landscape which has evolved significantly in recent years. Fundamentally, the EU has exclusive control over external trade relationships and competitive market rules, while member states have primary authority over domestic industrial support. However, this is always subject to EU state aid rules to ensure that national measures do not distort competition within the Single Market.

5.2 Selected examples

This section briefly highlights three notable examples of new or substantially enhanced instruments in the EU's policy portfolio. The first example of *Important Projects of Common European Interest* (IPCEI) directly relates to our first pillar of industrial development, addressing the European innovation gap in key high-technology areas. The second example addresses the inflow and control of productive resources in the form of foreign direct investments (*FDI-screening*). The third example of a *Carbon Border Adjustment Mechanism* (CBAM) involves the introduction of targeted import tariffs to ensure fair competition, while directing domestic businesses towards reducing their carbon emissions.

Important Projects of Common European Interest (IPCEI)

IPCEIs constitute an exception to European state aid law, promoting large-scale projects of particular strategic importance to the European Union.[19] Although the legal instrument for overseeing significant European projects had initially been established in the EEC Treaty of 1957, it remained largely unused and fragmented across various documents. In 2014 the European Commission consolidated these regulations in a comprehensive communication, thereby paving the way for their systematic implementation within an integrated European strategy.[20] Since their launch in 2018, IPCEIs have evolved from an *ad hoc* mechanism into a structured framework for coordinating pan-European innovation in high-tech sectors, also aligned with the objectives of the green and digital transformations. Established in 2023, the Joint European Forum for IPCEI (JEF-IPCEI) formalised coordination mechanisms, including workstreams dedicated to the identification, design, assessment and implementation of projects.

The European Commission is responsible for reviewing, approving and monitoring the implementation of projects, while financing is primarily provided by the member states and companies involved. Projects must meet various criteria. These include participation by several member states, significant contributions to overarching European objectives, evidence of market or system failure, and a focus on fundamental product or process innovations. Since the first IPCEI communication in 2014, the European Commission has approved a total of eleven integrated IPCEIs across various sectors, including microelectronics, batteries, hydrogen, cloud infrastructure and services, health, and specialised AI projects. Five additional IPCEI candidates in biotechnologies, critical raw materials, autonomous vehicles, artificial intelligence, and advanced semiconductors have entered design phases as of late 2025.

Further reforms are needed to improve governance and transparency, and to consolidate funding mechanisms. In particular, introducing a common EU funding mechanism alongside national contributions would reduce fiscal disparities between member states and enhance the EU's capacity to advance its strategic priorities. Further reforms should define transparent methods for sectoral prioritisation and include the introduction of standardised evaluation frameworks. Finally, the announced competitiveness coordination tool will offer an opportunity to streamline administrative processes and integrate IPCEIs more effectively within the overall institutional framework.

[19] See, e.g., Polt et al. (2021).

[20] https: IPCEI.

FDI screening and control

FDI screening mechanisms are designed to control the inflow of foreign direct investments. The rationale originates in concerns about national security and strategic autonomy that may justify restrictions on foreign ownership or control of companies operating in sensitive sectors or with access to critical technologies. Investment screening has expanded substantially in recent years, with countries including the United States, the United Kingdom, Australia, Canada, Japan and South Korea implementing or substantially strengthening their regimes. Such regimes typically require government approval for foreign investments in designated sensitive sectors or impose a review of transactions when foreign investors seek to acquire controlling interests in domestic companies. The proliferation of investment screening mechanisms reflects heightened geopolitical tensions and the realisation that foreign direct investment can be used by other governments to gain control of critical technologies or infrastructure.

Given its traditional focus on the Single Market, free capital flows and rules-based foreign relations, the EU was reluctant to adopt such an instrument. However, amid mounting pressure, the European Commission established a general framework for reviewing foreign direct investments classified as posing a risk to security or public order as part of an update to its industrial policy strategy in 2017. In 2019, corresponding legislation was enacted to give member states greater legal assurance and flexibility in reviewing and, if necessary, prohibiting hostile corporate takeovers from third countries outside the EU, the EEA or Switzerland. Since then, the introduction of screening mechanisms has developed into a comprehensive system. By the beginning of 2026, all EU member states shall have an operational or imminent national FDI screening mechanism in place.

The 2019 EU regulation only established a minimum consensus on basic principles, leaving individual member states free to decide on implementation and specific details. This has resulted in significant national differences and a fragmented regulatory environment for investment controls across Europe. In December 2025, the European Union reached a political agreement on revising FDI screening with the aim of achieving far-reaching harmonisation of the rules, in order to overcome this fragmentation.[21] Member states will still be able to expand their systems beyond the minimum requirements. However, the new minimum requirements will reduce regulatory fragmentation and increase predictability for investors.

[21]https: FDI-screening.

Carbon Border Adjustment Mechanism (CBAM)

The EU's objective of climate neutrality by 2050 requires a pricing system for greenhouse gas emissions that reflects the polluter-pays principle. The lack of a globally uniform price on emissions at their source leads to distorted comparative advantages in international trade and increases the risk of *carbon leakage*, i.e. the relocation of emission intensive production to areas outside the EU. The EU's *Carbon Border Adjustment Mechanism* (CBAM) is a regulatory instrument designed to prevent carbon leakage by placing a carbon price on imports of carbon-intensive goods. It aims for fair competition between EU and non-EU producers by ensuring that they face the same carbon costs. CBAM applies to goods such as cement, iron and steel, aluminium, fertilisers, electricity and hydrogen. These sectors account for around 50% of emissions within the EU Emissions Trading Scheme (ETS).

The European Commission proposed CBAM in July 2021 as part of the European Green Deal, and the regulation was officially adopted in October 2023. The beginning of 2026 marks the transition from a two-year transitional phase involving only reporting obligations, to a binding regulatory phase with a concrete pricing mechanism for carbon emissions from selected imported goods. The transitional phase allowed regulatory bodies to collect data and firms to adapt to the reporting requirements. Throughout 2024 and 2025, the European Commission published extensive additional legislation to operationalise the technical requirements of CBAM. This included methods for calculating emissions, verification standards, customs procedures, and certificate pricing mechanisms. The 2025 omnibus package introduced a *de minimis* exemption threshold of 50 tonnes per year. This is expected to exempt around 182,000 importers, primarily small and medium-sized enterprises, while still covering over 99% of embedded emissions. At the beginning of 2026 more than 4,100 economic operators had obtained authorised declarant status. The purchase of certificates will begin in February 2027.

The complexity of the required regulation can be inferred from two critical design problems yet to be resolved. First, downstream industries using carbon-intensive inputs covered by CBAM and the EU ETS may face significantly higher costs than their non-EU competitors. To mitigate this problem, the European Commission has proposed to extend the scope of CBAM by 2028 to include around 180 downstream steel and aluminium products. Second, when European producers export to third countries without comparable carbon pricing and border adjustments, they must bear the full cost of EU ETS allowances, whereas their non-EU competitors face no such charges. To ensure fair competition and avoid carbon leakage, the system should reimburse the carbon prices incurred in domestic production for exports to third countries not covered by a similar mechanism.

6 Conclusions and perspective

European industrial policy has undergone fundamental changes, evolving from post-war sector-specific intervention, through a period of market-led deregulation, to an integrated approach enabling the progressive expansion of the range of available policy instruments. The historical trajectory reveals that industrial policy has been continuously reframed in response to new challenges, ranging from growing competition with emerging economies to climate neutrality, technological sovereignty and defence capabilities. The current EU industrial **policy framework** is set out in the 2025 Competitiveness Compass. It posits three imperatives: closing the innovation gap; treating decarbonisation and competitiveness as integrated objectives; and achieving strategic autonomy while maintaining international openness. Recent EU initiatives, including the European Chips Act, the Critical Raw Materials Act, FDI screening mechanisms and plans for the defence industry, demonstrate the deliberate integration of multiple societal objectives, such as prosperity, ecological transformation and security, within a comprehensive approach that combines horizontal framework conditions and targeted sectoral interventions.

Even though the EU's industrial policy has evolved considerably over the past years, the challenges have escalated even faster. To keep up, the EU must urgently address the **gaps** and **inconsistencies** of its current system. Three factors are among the most prevalent obstacles to further progress:

1. The major barrier holding the EU back from realising its full potential is continued **fragmentation** and **lack of coordination**. Member states persistently diverge on priorities and resist measures requiring genuine integration, including the announced European Savings and Investment Union. Overcoming this requires binding institutional mechanisms to commit member states to coordinated action and enforcement procedures rather than relying on voluntary cooperation. The proposed *28th regime*, which offers companies the option of EU-wide legal registration, well illustrates the apparent limitations in the EU's ability to overcome such barriers. Whether *EU.Inc* can ever offer a unified framework that extends beyond the limited reach of the current proposal will critically determine its actual impact. Without the prior harmonisation of certain minimum standards in critical policy domains such as taxation, labour law or dispute resolution, individual member states will clearly oppose the creation of opportunities for regulatory arbitrage.

2. The second major obstacle is the **funding gap** caused by inadequate financing mechanisms. While the Draghi report demands annual investments of 750-800 billion Euro until 2030, the EU possesses only fragmented financing instruments that are incapable of mobilising resources on this scale. The EU clearly needs to increase

its fiscal space, but member states remain divided over whether to issue common EU debt or rely exclusively on national contributions and the mobilisation of private capital. The RRF will expire in 2026, further exacerbating the projected funding shortfall. Being part of the next Multiannual Financial Framework (MFF), the proposed new European Competitiveness Fund is unlikely to receive sufficient funding.[22] By offering a single portal and a standardised application process, another goal is to reduce administrative burdens and facilitate coordination with regard to technologies that are critical to European strategic autonomy.

3. Third, EU industrial policy still struggles to establish a consistent logic of intervention. This is evident, for example, in the disparity between official commitments to promoting competition and free markets, and the increasing demand for protective policies. The idea of an **open strategic autonomy**, which aims to combine targeted interventions with a fundamentally competitive approach, is increasingly at risk of yielding to blunt protectionism. Once again, the latter will come to dominate EU industrial policy if current campaigns for 'Made in Europe' and 'European Champions' result in the weakening of European competition rules, merger control, or standards of public procurement and trade. There can be no doubt, that the shifting geopolitical landscapes have altered the rules of international relations (Hinz et al, 2025). Where trade is not open to fair competition, it must be managed, since power relations rather than economic efficiency determine who earns rents and gets the jobs. However, increasing protectionism will result in lower economic efficiency, suggesting that current trends may not endure indefinitely. A competitive internal market that is open to trade with like-minded international partners is the best training ground for all actors to ensure and promote future European competitiveness. European industrial policy should deliberately embrace this duality of open markets and managed trade relationships. Understanding the differences between them helps prevent anti-competitive behaviour in managed markets from becoming the norm and spreading to markets that are still open and competitive.

Also there should be no doubt that industrial policy is here to stay, and the portfolio of available tools will continue to grow. In the past, traditional notions of 'failure' have been used to develop a comprehensive structure of valuable theoretical insights and **rationales for public intervention**. However, these rest on fragile foundations when the focus shifts from economic efficiency to industrial development. Recurrent crises and geopolitical conflicts have highlighted the importance of dynamic capabilities, which encompass own innovation and a system's capacity to

[22]https: EU Competitiveness Fund. The current proposal consolidates 14 fragmented funding programmes within an indicative budget of around 234 billion euros for the period from 2028 to 2034 (EUC, 2025, Chapter 1, Article 4, p. 39).

adapt to changing environments. The latter boils down to concerns about European resilience. Clearly, the system's capacity to evolve is more significant with regard to the objective of strategic autonomy than any notion of allocative efficiency. One can foresee that the accumulating structure of new challenges and policy tools will eventually cause an already weak theoretical basis to collapse. As a consequence, the relevance of analytical economic reasoning to policymaking will further diminish. Given the enormous amount of public resources involved, the extent and variety of potential impacts, and the significant risk of unintended consequences, one must not eschew the search for a solid theoretical basis of such interventions. To provide policymakers with better guidance, the rationales of industrial policy should be rebuilt from the ground up and adopt a deliberate development perspective. One promising avenue is to reframe industrial policy as competitiveness policy aimed at enhancing industry's ability to evolve by adapting to changing external constraints and actively shaping its environment.

As European industrial policy itself continues to evolve, the EU must **demonstrate confidence** in its undeniable strengths and develop them further. In addition to the well-known advantages, such as the size and purchasing power of its Single Market, the high average standard of living, and its clusters of excellence in scientific research and advanced manufacturing, three factors should be noted. First, the EU's *rules-based* and open governance model, founded on democratic institutions, is an important asset in promoting trust among investors and global partners. To establish diverse, resilient global value chains based on voluntary partnerships rather than coercion or restriction, it is crucial that the EU continues to emphasise multilateral cooperation, binding international agreements and transparent regulatory frameworks. Second, the EU's *institutional diversity*, which encompasses 27 distinct national legal systems and regulatory approaches, enables it to process vastly more information about what works in complex domains like regulatory design, education systems, innovation policy, or industrial strategy than would be possible otherwise. Provided that member states are committed to the collective goals of European sovereignty, competitiveness and industrial development, EU policy can leverage this diversity as a natural laboratory for experimentation and learning. This involves scaling up successful policies across the continent while respecting subsidiarity and local autonomy. Finally, mounting *external pressure* tends to weaken the salience of national identity politics and to encourage collective action. This radically changes the dynamics of EU decision-making and accelerates European integration. One example are the EU's unprecedented defence spending commitments, which have overcome historical fiscal constraints and spill over into other areas, including fiscal, industrial and institutional reforms.

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Additional sources

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- "Which EU countries have not yet adopted the foreign direct investment (FDI) screening mechanism?"
- "How did the IPCEI initiative come about? Is there a direct link or advance notice from one of the EU's general strategy documents?"
- "What does the EU's Omnibus Package mean? Where does the name come from? Which steps have already been taken, and which are in preparation or planned?"

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