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Inflation Reduction Act: What's In A Name?

A long negotiation cycle yields green investment, a smaller deficit and higher corporate taxes.

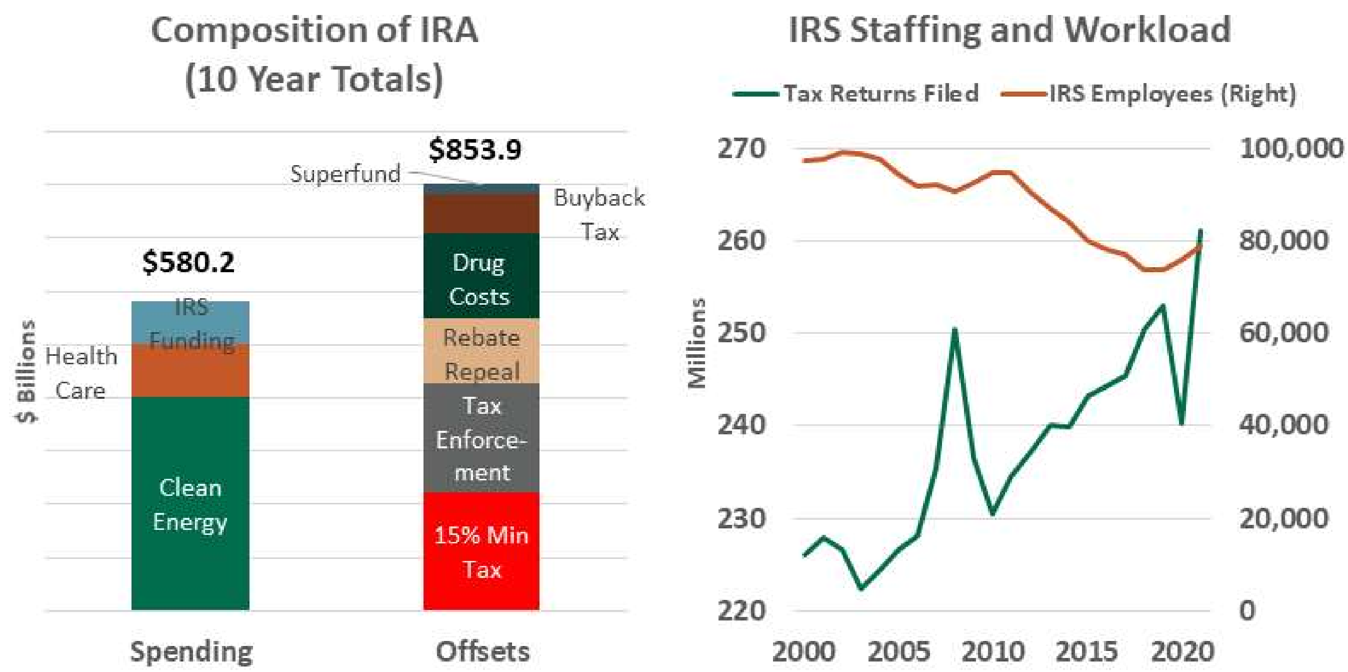
By Ryan James Boyle

Last year ended with a legislative surprise. After an interval of elevated government spending, the Build Back Better plan collapsed in the Senate. At the time, we speculated that **the era of the open checkbook was over**. Slow news from Capitol Hill through the first seven months of this year gave us no reason to expect a revival.

Then, earlier this month, Senate Democrats agreed upon a narrower reconciliation spending bill, passed with a filibuster-proof simple majority. The "Inflation Reduction Act" (or IRA—more on that name later) likely represents a concluding step in an expansive era for government spending.

Totaling $401 billion, green funding is the largest and broadest segment of the bill. This allocation will create new subsidies for household purchases of more efficient appliances, electric vehicles (EVs) and solar panels. It will also support research and investment in renewable energy generation and upgrades to the nation's electric grids.

The bill also funds healthcare subsidies, to the tune of $98 billion. This allocation will serve primarily to limit cost increases for Affordable Care Act enrollees and Medicare recipients. Though not a direct outlay, starting in 2026, Medicare will be empowered to directly negotiate the prices of the most commonly-used drugs and limit price increases to no greater than the broader rate of inflation.



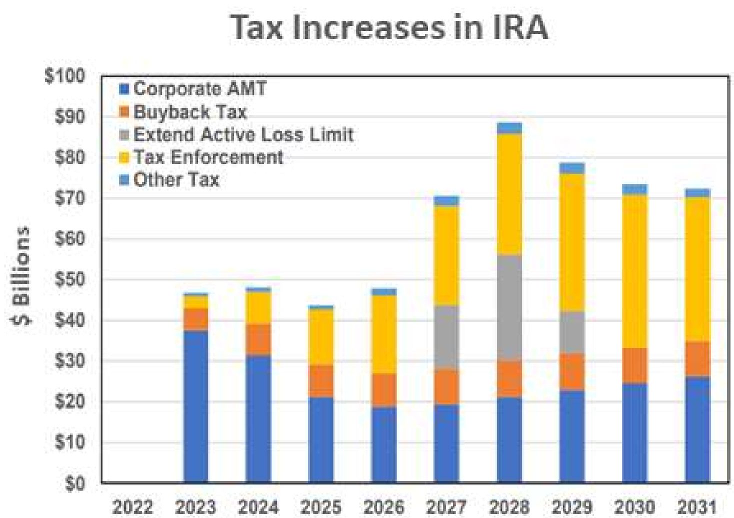
Sources: CBO, JCT, IRS, Haver Analytics

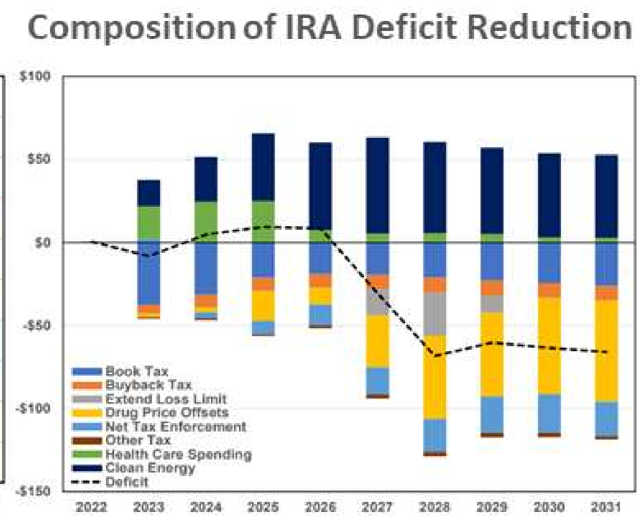
Finally, the Internal Revenue Service will receive an additional $80 billion to modernize and enhance enforcement. Taxes are always a contentious topic, but the IRS' **backlog** of over a year of returns and **inability to audit complex returns** are evidence of prolonged neglect. Projecting the return on this investment is difficult: The IRS has estimated the tax gap (the difference between taxes fairly owed and taxes paid) in a tremendous range of **$441 billion to $1 trillion** annually. Greater capacity to scrutinize complex returns will generate more tax revenue, while merely increasing the perceived risk of an audit will deter potential fraud. The Congressional Budget Office (CBO) estimates a yield of $200 billion in additional tax revenue over ten years.

Improving tax collection and lowering healthcare expenditures are not the only way the bill is paid for. The IRA levies a new 15% minimum tax on corporate book income, for companies with earnings in excess of $1 billion. This will weigh particularly on the manufacturing, finance and technology sectors, and may prove unproductive as firms have **flexibility** in reporting financial statement income. The bill also levies a new 1% tax on companies that execute stock buybacks, starting in 2023. Buybacks indirectly provide a return to investors by lifting share prices, but because they do not have a cash flow like dividends, they do not currently have any tax treatment.

Greater tax enforcement is likely to have a positive return on investment.

Taken together, the new revenues are forecast to substantially exceed the new spending, and the provisions of this bill will reduce the deficit. The CBO's initial **estimates** total over a $300 billion deficit reduction over 10 years. With the CBO recently reaffirming its projections for the national debt to rise from 100% today to **185% of gross domestic product in 30 years**, today's fiscal restraint can help limit future harm.





Sources: CBO, JCT, Piper Sandler

We do not think "Inflation Reduction Act" is an appropriate title for a bill that brings more spending. Consumer stimulus payments in the COVID downturn sparked additional activity that contributed to inflation. None of the measures in the IRA are likely to have that same inflationary effect. Though the bill will not increase inflation, it is too optimistic to call it a reduction.

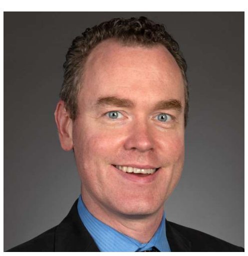
Healthcare subsidies will not lower the cost of health insurance, but will prevent an inflationary jump in prices that **would have happened** without legislative action. Households shopping for new cooktops, furnaces and water heaters will find that tax credits make greener choices more affordable, but these are infrequent purchases and thus a small part of the inflation basket. Large tax credits for electric vehicles ($7,500 for purchasing new or $4,000 for a used car) will encourage adoption by reducing EVs' cost premium. However, the IRA has limitations on the availability of these subsidies: Currently, **only 21 vehicles** assembled in North America qualify for them. From 2025 onward, EVs must contain batteries made in North America or an allied nation. With mineral extraction and battery production concentrated in China, none of today's vehicles meet that standard. More domestic production will be necessary.

Over the long run, investments in green energy stand to lower costs to consumers. Renewable power sources like wind and solar farms have very low operational costs, but bringing those projects online takes years. Research into new technology may yield climate and cost dividends in decades to come.

The IRA is likely to be the last big fiscal bill for some time.

The IRA looks to be Congress' last authorization of new spending before November's midterm elections. Historical precedent and current polling suggest the majority party will lose control of at least one chamber of Congress. Even if Democrats beat the odds and retain both chambers, they have not signaled intentions for more spending plans. Sensitivity to inflation remains high, and President Biden's other fiscal proposals are contentious, even within his own party.

This summer's heatwaves supported the case for climate investment. And discussion of federal taxation and spending can make any of us feel hot under the collar. But it appears higher temperatures had one upside: they helped to thaw a frozen Congress.



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