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# INSIGHTS & PERSPECTIVES

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# The Macroeconomic Effects of the IRA

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Passage of the Inflation Reduction Act of 2022 (IRA) represents a watershed moment in United States climate policy. To offer perspective, MacKay Shields is publishing a series that looks at the potential impact on the environment, inflation and corporate sectors. In this piece, we look at the macroeconomic effects of the IRA, and whether it is likely to have an impact on one of its stated goals – reducing inflation.

As noted in the **climate discussion** of this series, the Inflation Reduction Act ("IRA") reestablishes the United States as a credible partner in global efforts to transition to a low carbon economy, and should result in significantly lower US greenhouse gas ("GHG") emissions in the decades ahead. But the Act is too small in size to meaningfully impact aggregate spending or savings in the economy. According to Congressional estimates, the IRA will reduce deficits by a total of $276 billion from fiscal year 2023 through 2031, or 0.1 percent of the Congressional Budget Office's estimate of cumulative nominal GDP over that timeframe.[1] Deficit reduction of that size will not move the needle on growth or inflation in a meaningful way.

The timing of tax and spending provisions can also influence the macro impacts of the IRA. First, it is worth noting that the IRA's provisions go beyond tax credits and other measures aimed at encouraging investment in and spending on clean energy. These include:

- An extension of subsidies for health insurance policies purchased on exchanges set up under the Affordable Care Act. These subsidies were set to expire at year-end, and their extension for three more years will cost the federal government close to $100 billion.
- Authorizing Medicare to negotiate prices for a limited set of prescription drugs, and also capping growth in some drug prices at the rate of inflation. These and other health care provisions are estimated to save the federal government approximately $320 billion.

The IRA achieves overall deficit reduction by offsetting the clean energy and health-related spending provisions with a 15% minimum tax on corporate book profits, increasing resources for tax enforcement by the Internal Revenue Service ("IRS"), and a 1% excise tax on corporate stock buybacks.

**CLIMATE IMPLICATIONS**

*"The IRA represents the emergence of a national climate change strategy and re-establishes the US as a credible influencer on the stage of global climate talks."*

Learn more in MacKay's IRA series from
Erin Heide, Director of Responsible Investing **[click here]**

1. Congressional Budget Office, Joint Committee on Taxation.

Thinking through the timing of the IRA's provisions, first and most importantly, deficit reduction is somewhat back-loaded. While the alternative minimum tax and 1% excise tax on buybacks go into effect next year, improved tax enforcement resulting from increased funding for the IRS will take a few years to show tangible results in terms of increased tax revenues. Similarly, the impact of climate-related tax credits on incentives, and hence business and household spending, may also take some time to gather steam, even if these credits are immediately available.

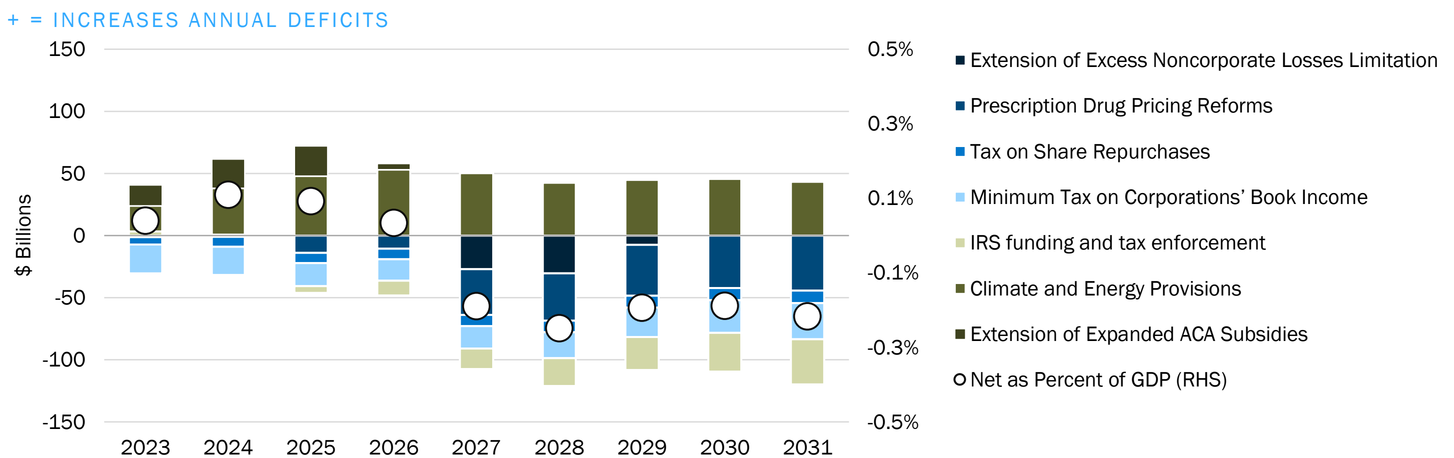
As for other provisions, authorizing Medicare to negotiate lower drug prices will lead to only very modest savings for the federal government, and will have little effect on overall inflation. For example, the Congressional Budget Office anticipates a maximum annual expenditure savings from this provision of just $25 billion in 2031, or less than 0.1 percent of estimated nominal GDP that year. One reason for this modest savings stems from the fact that negotiations for lower prices are limited to only ten drugs initially, growing to a total of sixty drugs by 2029.[2] Finally, prescription medications have just a one percent weight in the Consumer Price Index, another indicator of the limited potential impact that this provision will have on overall inflation.[3]

A few other considerations bear mentioning. As we discussed in part one of this series, through its energy provisions the IRA certainly has the potential to lower US GHG emissions. However, it is unclear whether this will meaningfully reduce the longer-term costs and price pressures associated with climate change. Climate change is a complex global issue and it is challenging to see how this single piece of legislation can have a material impact on the trajectory of global emissions in the years ahead. Of course, if the IRA represents a permanent shift in how US government policy will be used to transition to a low carbon economy, it could have a positive impact on other countries' commitment to the same outcome. But this effect is too uncertain and long-term to include in an assessment of the IRA's impact on inflationary aspects of climate change over the medium term.

In addition, to secure the support of Senator Manchin for the IRA, the Democratic leadership in Congress and President Biden agreed to put forward a package of energy-related permitting reforms. These reforms would be aimed at speeding up the "time to market" of any investments in fossil fuels infrastructure, including pipelines and export facilities. While it is unclear if passage can be secured, and how the

FIGURE 1: ESTIMATED DEFICIT / SAVINGS OF IRA PROVISIONS AND NET DEFICIT IMPACT

+ = INCREASES ANNUAL DEFICITS




Source: Congressional Budget Office, Penn Wharton Budget Model.

2. The drug price negotiation program also phases in very slowly. For the first ten drugs that will first be identified for inclusion in the program, negotiations will begin in October 2023, with negotiated prices coming into effect only in 2026.
3. The act also provides for inflationary rebates for certain medications, which will result in additional Medicare cost savings. But the Congressional Budget Office also anticipates that the inflation-rebate and drug price negotiation provisions would lead to offsetting actions by pharmaceutical companies, namely, an increase in launch prices for new drugs relative to what those new prices would otherwise have been. See Congressional Budget Office, letter to Representative Jason Smith, August 4, 2022.

implementing legislation will be written, it is possible that any such legislation could lead to increased investment in the oil and gas sector, resulting in greater supply and lower energy costs for households and businesses in the years ahead. Clearly this is uncertain ground, but bears close monitoring, not least because of the longer-term disinflationary impact that such legislation could have.

Finally, it should be noted that monetary policy would be used to offset any impact of the IRA on the overall price level in the years ahead. If, for example, the IRA's tax credits lead to inflationary pressure via clean energy investment and hiring, the Federal Reserve would lean against this impulse with tighter policy. Alternatively, down the road, higher effective corporate tax rates and deficit reduction could prove to be a larger-than-expected disinflationary force. In this event, all else being equal the Federal Reserve would lean towards an easier monetary policy stance to boost the rate of inflation back to the central bank's two percent objective.

In conclusion, the IRA represents a watershed event in US efforts to transition to a low carbon economy, and stands a good chance of putting the US on a lower path of carbon emissions in the years ahead. Still, the overall size of the legislation, including its deficit reduction, is modest relative to the size of the US economy, and as a result is likely to have limited impact on aggregate demand and inflation in the years ahead, despite the Act's branding. Its impact on energy transition costs is also unclear – the Act's incentives may speed up the energy transition, putting pressure on resources in the economy, including labor. On the other hand, the IRA's various tax credits may serve to lower the costs of a transition that has already been underway. Finally, the timing of the various provisions, the extent to which its "carrots" meaningfully impact investment in clean energy, as well as the impact of potential permitting legislation, all add uncertainty as to the macroeconomic effects.

None of this is meant as a criticism of the IRA. In fact, quite the opposite. After the excessive amount of stimulus (and inflation) that resulted from the American Rescue Plan, it's refreshing to see Congress and the administration craft legislation that attempts to address important long-term health care and climate change issues in a manner that does not further add to deficits and price pressures.

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