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Transforming Economy

The Inflation Reduction Act: A long game

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Key Talking Points

- The recently signed Inflation Reduction Act (the "Act" or IRA) aims to reduce the budget deficit and increase investment in clean energy, helping the Fed in its fight against inflation.
- A key long-term positive of the Act is its potential to as much as double the pace of de-carbonization, while bolstering US energy security, lowering costs of traditional commodities via alternatives, and moving things forward faster.
- The IRA should help put modest downward pressure on inflation, but this is largely a medium to long-run effect. In the short term, it is not expected to provide much reprieve to the current high rates of inflation.

Once considered lifeless, the originally titled Build Back Better bill morphed into the Inflation Reduction Act (IRA) of 2022 and aims to increase investment in clean energy while also reducing the deficit, helping the Fed in its fight against inflation. On the revenue side, it includes: a 15% alternative minimum tax on "book income," increased Internal Revenue Service (IRS) enforcement, and drug pricing reforms. On the spending side, it includes new spending and tax credits to help increase renewable energy production and reduce carbon emissions and extends the existing Affordable Care Act subsidies through 2025.

In the long-run, while the IRA should help put modest downward pressure on inflation, there are likely competing effects on growth. On the one hand, increases in the corporate minimum tax rate and individual taxes should be a drag on growth. On the other hand, a reduction in government deficits should lead to more private investment; tax credits should improve productivity of clean energy; and reduction in carbon emissions are positive for long-run growth.

The Congressional Budget Office (CBO) estimates that the Act could reduce the deficit by roughly $102 billion from 2022-2031, with only a small portion of it seen in the first five years. In fact, the Act is not expected to have much of an impact on US growth or inflation overall, but there may be meaningful impact, or consequences, elsewhere.

Inflation reduction or inflation dispersion?

Rather than implying much about the level of inflation, the policies in the IRA may imply more about the level of dispersion in inflation components. Skilled vs. unskilled wages, pricing power by sector, raw materials and Producer Price Index (PPI) components are already less correlated than normal and it is possible the IRA exacerbates this, by stimulating corporate spending in certain sectors, and lowering consumer costs for health care, solar and renewables.

A key long-term positive of the IRA is its potential to as much as double the pace of de-carbonization (Exhibit 1). Corporates have earmarked capital – BofA Global Research estimates $740 billion of capex – to meet emission reduction goals over the next decade or so (see Corporate Strategies for Net Zero). The IRA tax benefits could offset >10% of that spend, where the benefit to Utilities is seemingly the largest. Moreover, the preferential rate loans to energy companies and carbon capture breaks would more than offset the tax hit. Long-term energy implications are more negative.

No near-term reprieve

In the short term, the IRA provides clarity to the clean energy industry through a 10-year extension of tax credits plus new tax credits for emerging technologies, lowering the cost and increasing projects for corporates. Long-term positives include bolstering US energy security, lowering costs of traditional commodities via alternatives, and moving things forward faster.

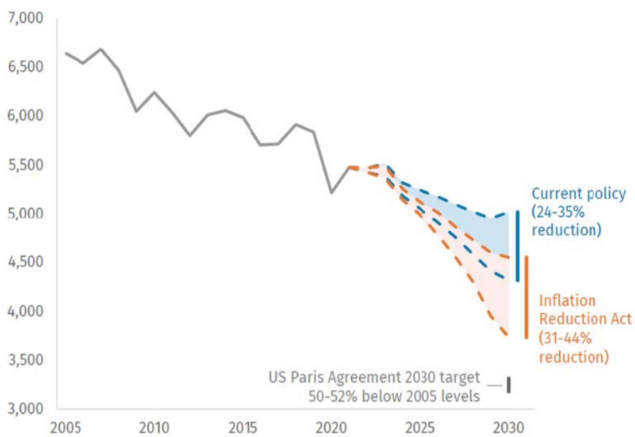
When combined with other programs (investments in offshore wind, methane reduction programs, funding for critical transmission projects, $27 billion federal investments through the Greenhouse Gas Reduction Fund) the Act has the potential to reduce US greenhouse gas emissions by >40% below 2005 levels by 2030, where the current path implies a 25% reduction. Note that the US has pledged to lower emissions by 50% to 52% as part of the Paris Agreement by 2030 (Exhibit 1).

However the Act is unlikely to lead to much reprieve from inflation in the near term, according to BofA Global Research economists. The positive demand effect from the Act of any stimulation/brining forward of capex is likely to outweigh the impact of deficit reduction on inflation in the short-run. Increased capex may also be wage inflationary via job creation in already very tight labor markets.

As highlighted in [Corporate Strategies for Net Zero](), we noted a capex cycle is already underway, with companies representing 11% of BofA Global Research's coverage footprint aiming to achieve Net Zero during this decade, quadrupling to 41% by 2040 and further doubling to 76% by 2050. BofA Global Research US analysts estimate incremental spending for US companies (ex-Financials) of $400 billion in research and development and $740 billion in incremental capex towards carbon mitigation efforts. This spend includes investment in new energy technology, infrastructure, automobile companies shifting capacity from internal combustion engine (ICE) vehicles to electric vehicles (EVs). Corporate incentives for commercial EV / charging equipment should bolster the transition to a cleaner transportation sector and support fleet electrification for companies. This timeline is challenging, and we see more US companies falling behind rather than moving ahead of targets (Exhibit 2).

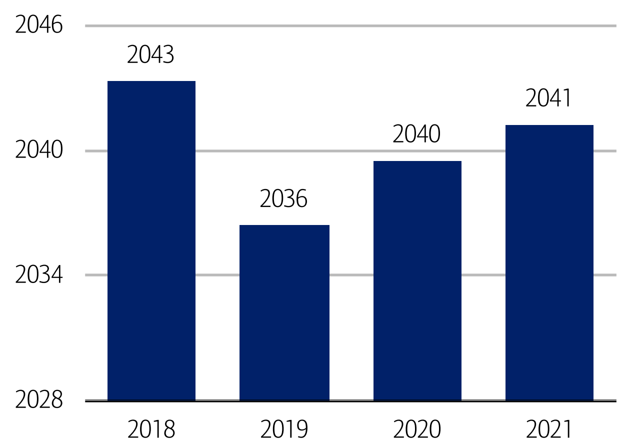
If the IRA succeeds in bringing forward capex plans, these inflationary pressures may intensify. In the longer-term positive impact of potentially less climate risk, lower oil prices and better growth should ultimately benefit corporates and consumers via margins and disposable income.

Exhibit 1: US Greenhouse Gas Emissions
Net million metric tons (mmt) CO2e



Source: Rhodium Group, (https://rhg.com/research/inflation-reduction-act/)

Exhibit 2: Companies have pushed out target dates since 2019
Average net-zero target year within S&P 500



Source: ICE Data Services, LLC, BofA US Equity & Quant Strategy

Energy Security and Domestic Manufacturing

An important piece of the IRA is funding to increase domestic manufacturing, strengthen the supply chain, and ultimately lower the cost of critical components of the clean energy transition. ESG (Environmental, Social and Governance) is a key driver for this supply chain localization and the reshoring of US manufacturing amid an increased focus on carbon emissions, the need for more transparent/less complex supply chains and workforce health/safety considerations, as mentioned in a recent Institute [publication on reshoring]().

These additions to the bill are meant to decrease reliance on imports and ensure the US can increase energy independence while lowering emissions. The package includes more than $60 billion to support on-shore clean energy manufacturing in the US. An early 2022 survey of BofA Global Research fundamental equity analysts on de-carbonization efforts suggested that corporates within the majority of sectors are employing re-shoring as a strategy to reach Net Zero – in fact, it was one of the most popular strategies across industries after enhancing energy efficiency and switching to clean energy/renewables.

Utilities

The IRA extends both the production tax credit (PTC) and investment tax credit (ITC) for clean energy projects placed in service from 2021 through 2024. Starting in 2025, the tax credits will transition from their current form to a new technology-neutral tax credit that is based on emissions. Renewable projects with zero emissions would qualify for the same PTC or ITC tax credit value as the 2021-2024 projects.

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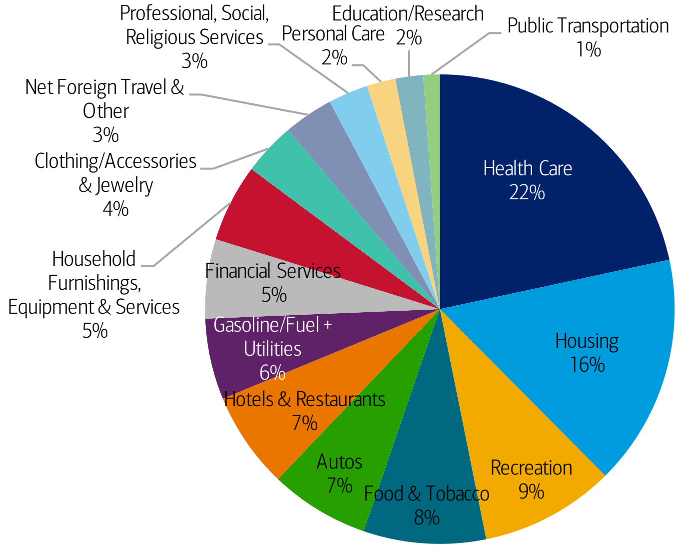
Two new tax credits are also included in the IRA – a Clean Hydrogen ITC/PTC and a Carbon Capture and Storage or Direct Air Capture Credit (CCS/DAC). These credits are available to facilities that begin construction after December 31, 2022, and through the end of 2032. Clean Hydrogen and the CCS/DAC credits help bring down the cost of these emerging technologies that are important tools for heavy industries looking to reduce their emissions.

Health Care

Key provisions in the IRA, include: 1) Medicare drug pricing reforms and negotiation authority; 2) inflationary rebates for Medicare Part B and Part D drugs; 3) Medicare Part D benefit redesign; 4) delaying the Pharmacy Benefits Manager (PBM) Rebate Rule until 2032; 5) extending Affordable Care Act (ACA) premium subsidies for three years until 2025; and 6) capping insulin out-of-pocket costs for Medicare beneficiaries at $35 per month. Note that the Medicare drug price negotiation provision will not take effect until 2026, and will only apply to 10 drugs to start, ramping up over the following years.

Health Care is roughly one-fifth of personal consumption expenditures. Lower drug costs as a result of drug pricing reforms, inflationary rebates and caps described above may be less impactful to the consumer's wallet than other components that may be positively impacted by capex, hiring, or government spending (including housing, food/restaurants, services, etc.) where we find evidence that these macro factors are inflationary.

Exhibit 3: Health Care is one-fifth of personal consumption expenditures
Share of personal consumption expenditures as of 2Q22



Source: Haver Analytics/BEA, BofA US Equity & US Quant Strategy

The bottom line

The Inflation Reduction Act, a scaled down version of the prior Build Back Better legislation that had stalled in the Senate, is focused on increased investment in clean energy, while also reducing the deficit. In the long run, the IRA should help put modest downward pressure on inflation, however, in terms of growth, there are competing effects. On the one hand, increases in the corporate minimum tax rate and individual taxes should be a drag on growth. On the other hand, a reduction in government deficits should lead to more private investment, tax credits should improve productivity of clean energy, and reduction in carbon emissions are positive for long-run growth. It's too soon to say with any certainty what the net effect will be, but estimates suggest it will likely be a small positive for growth in the long-run.

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Sources

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Disclosures