Economic Views Brief

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A look at recently passed legislation.

The CHIPS and Science Act and the Inflation Reduction Act.

Two important pieces of legislation were recently passed into law. The CHIPs Act allocates billions in federal dollars and tax incentives to domestically manufacture critical semiconductors, thus narrowing a major strategic vulnerability. The Inflation Reduction Act (IRA) is much larger and focuses on climate remediation, healthcare costs, and levies some new corporate taxes. Though each address very important long-term issues, we do not see either as having a material influence on near-term investment opportunities. Below, we provide a high-level overview of each.

Key Takeaways

- Two recently enacted laws address key long-term challenges. However, we do not see the provisions as offering material near-term investment implications.
- The CHIPS and Sciences Act looks to narrow a key U.S. long-term vulnerability – the country's heavy reliance on foreign sources for critical semiconductors.
- The Inflation Reduction Act (IRA) combines direct government spending with tax incentives to advance the transition to greener energy generation.
- In the years ahead, the IRA legislation also offers prescription drug reform to Medicare participants and institutes some new corporate taxes.

The Chips and Science Act:

This Act was signed into law by the President on Tuesday, August 9, 2022. The legislation primarily offers $52 billion in goverrnment funds to enhance U.S. research, development, and manufacturing of semiconductors. The law's purpose is to strategically strengthen the country's long-term access to semiconductors.

Today, a large percentage of these critical components are produced in Asia, including China. According to the White House, the U.S. currently produces about 10% of the world's semiconductors (and none of the market's most advanced chips) while 75% are produced in Asia. More than half of the world's most advanced chips are produced in Taiwan.

The law provides:
- $39 billion in domestic semiconductor manufacturing incentives
- $13 billion for semiconductor R&D and workforce development

Our view: The U.S. currently faces a critical strategic risk if it were to lose access to semiconductors made in Asia, particularly those made in Taiwan. It costs more to produce chips here domestically, thus the need for incentives to address this national security exposure. Many of the world's most advanced chips are designed and developed here in the U.S. but none are produced here. Intuitively, semiconductor companies benefit from this legislation. However, investors should consider that companies in the space will also need to spend substantial sums of their own investment dollars to build new facilities and run them at a higher cost of production over the long-term. Such facilities also take years to build and become operational, thus offering a lengthy potential pay-off period for investors.

The Inflation Reduction Act:

Given last minute changes to the Bill, the Congressional Budget Office (CBO) has yet to complete a full scoring of this legislation at the time of this writing. However, according to *The Wall Street Journal*, Democrats have said earlier versions would raise about $740 billion in new tax revenue and Medicare savings over 10-years, while costing about $430 billion, thus reducing the deficit by about $310 billion. Approximately $204 billion of the revenue generated is expected to come from added IRS tax enforcement, according to an earlier evaluation by the CBO.

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Overall, the law increases spending on climate remediation efforts, targets health care costs, particularly in Medicare, and boosts some corporate taxes. The president signed the legislation into law on Tuesday, August 16th, 2022.

Despite its name, the IRA offers limited inflation implications, particularly over the near-term, in our view. However, in the years ahead, the legislation sets limits on out-of-pocket drug costs for some Medicare recipients, sets a cap on insulin costs for Medicare Part D participants (at $35/month), and limits the price increases drug companies can implement on certain pharmaceuticals under Medicare. We note that Medicare could end-up shouldering more drug costs due to the end-consumer price limitations. Drug companies could also offset price constraints for drugs sold under Medicare by passing-on higher prices to private sector health plan participants.

Climate Initiatives: The law allocates about $370 billion in spending and tax credits toward advancing green energy and carbon-reduction efforts. There are too many individual climate-focused initiatives in the legislation to cover in this short overview, other than the few discussed below. However, according to the independent climate research organization, Rhodium Group, the programs in total should help put the U.S. on track to reduce 2030 greenhouse gas emissions by 31% to 44%, relative to 2005 levels. Without the legislation, the Group estimates the U.S. to be on track to reduce emissions by 24% to 35%.

Households earning up to $300,000 would receive tax credits of up to $7,500 for purchasing electric or hydrogen powered vehicles, but only up to certain vehicle price points ($55k for cars, $80k for trucks). The vehicles would also need to meet certain thresholds for U.S. domestic content, thresholds that no vehicles currently meet. The content limitations are meant to incentivize the re-shoring of battery manufacturing and the domestic development of other critical clean energy required components such as rare-earth minerals.

The legislation also provides tax credits for homeowners and builders to install more energy efficient housing materials and home heating /cooling systems. Furthermore, the law includes $60 billion over ten years to help disadvantaged communities that are disproportionally affected by climate change.

Finally, the legislation offers a tax credit that covers 30% of the investment in stand-alone energy storage, i.e., large, utility-scale batteries. Under certain criteria, the tax credit could rise to 50%, according to *The Wall Street Journal*. This is an important provision, in our view, in that it should aid in the development of the utility-scale energy storage, i.e., the type of batteries needed to balance periods of wind and solar energy generation /supply with periods of end-market demand. A similar incentive has been available for solar energy infrastructure for some time and been credited with helping expand the development of such systems and the instillation of solar power platforms, materially.

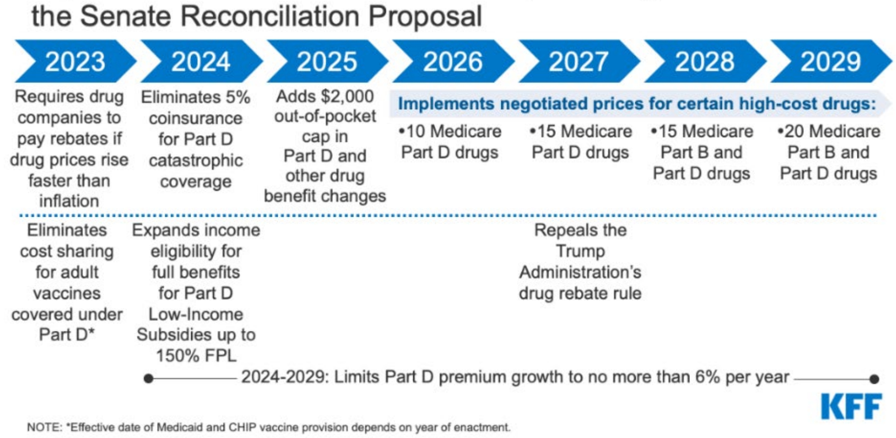
Health Care: The law's health care provisions seek to lower drug prices, particularly for seniors, and provide premium subsidies for Affordable Care Act (ACA) health insurance plans. According to *The Wall Street Journal*, about 13 million ACA plan participants were set to see a notable increase in monthly premium costs late this year due to the expiration of previously enacted funding. Overall, the legislation allocates about $64 billion toward ACA subsidies covering the next three years.

The legislation enables Medicare to negotiate some drug prices beginning in 2026. Currently, however, it's not clear which drugs. Additionally, out of pocket prescription drug costs for Medicare recipients would be capped at $2,000 by 2025. Further, drug makers would be restricted from raising drug prices beyond the rate of inflation on a limited number of drugs under Medicare plans beginning in 2023.

The graphic at right is sourced from the Keiser Family Foundation and reflects details as known on August 8th. It should NOT be considered a full representation of all IRA provisions related to health care.

Figure 1

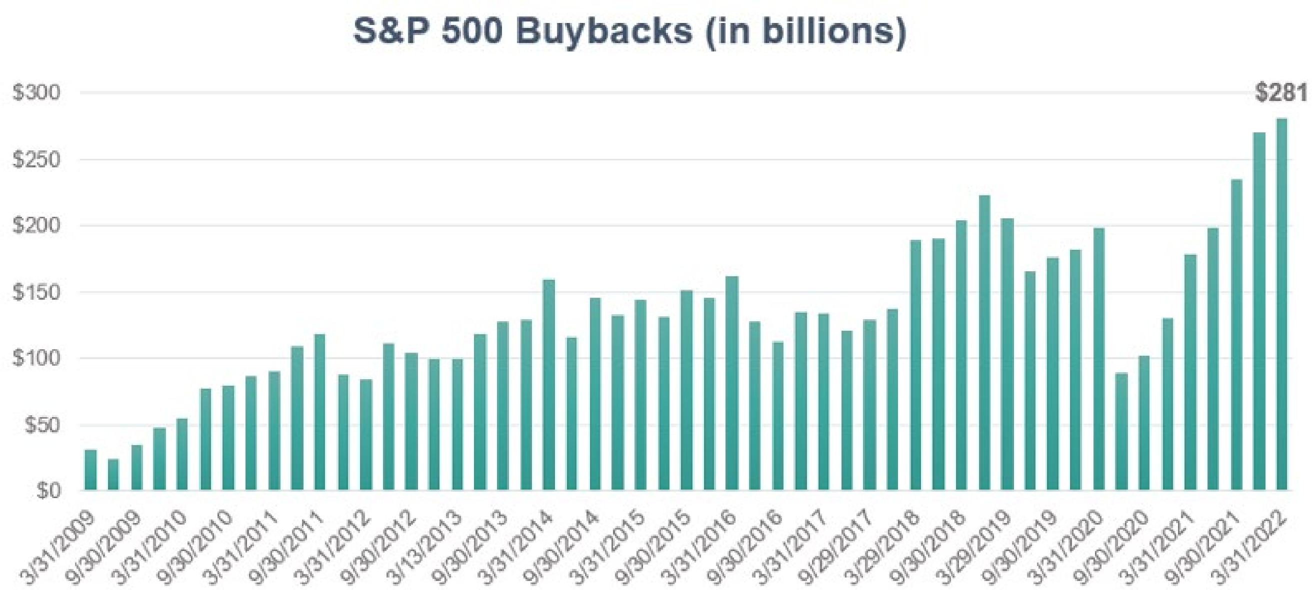
Implementation Timeline of the Prescription Drug Provisions in the Senate Reconciliation Proposal



<u>Taxes and Tax collections:</u> More money for the IRS: One of the largest direct allotments under the law is an added $80 billion (over 10 years) for the Internal Revenue Service (IRS). The funding is targeted at strengthening tax enforcement on upper income taxpayers and those that utilize “pass-through” tax structures for income tax reporting.

<u>A 15% minimum corporate tax rate.</u> The legislation sets a minimum corporate tax rate of 15% on corporate book profits. According to The Joint Committee on Taxation (JCT), this provision would generate approximately $222 billion in tax revenue over the 2022 through 2031 period, or about $22 billion per year.

The legislation also implements <u>a 1% excise tax on net corporate stock buybacks</u> (net of shares issued to employees). The JCT estimates this provision would produce revenue of about $74 billion over a 10-year period, or about $7.4 billion /year on average. Overall, we do not see this added cost as likely to have a material influence on corporate buyback activity.



Source: S&P Dow Jones Indices and American Enterprise Investment Services Inc.

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