CONGRESSIONAL BUDGET OFFICE
U.S. Congress
Washington, DC 20515

Phillip L. Swagel, Director

August 4, 2022

Honorable Lindsey Graham
Ranking Member
Committee on the Budget
United States Senate
Washington, DC 20510

Re: Economic Analysis of Budget Reconciliation Legislation

Dear Senator:

Yesterday, the Congressional Budget Office published a cost estimate for H.R. 5376, the Inflation Reduction Act of 2022, which is the latest version of the reconciliation legislation in the Senate.[1] This letter provides answers to four questions you asked related to that bill and broader economic conditions.

Is the United States Currently in a Recession?

The U.S. economy shows signs of slowing, but whether the economy is currently in a recession is difficult to say. It is possible that, in retrospect, it will become apparent that the economy moved into recession sometime this year. However, that is not clear from data that were available at the beginning of August. Some key metrics indicate a decline in economic activity as the first half of this year progressed, whereas others indicate continued growth, though generally at a slower rate than previously.

Real gross domestic product (that is, GDP adjusted to remove the effects of inflation) and industrial production have both declined. In particular, real GDP declined by an average of 1.25 percent (at an annual rate) in the first two quarters of 2022. Industrial production grew from January to April, was essentially unchanged in May, and then declined in June.

[1] Congressional Budget Office, cost estimate for H.R. 5376, the Inflation Reduction Act of 2022 (August 3, 2022), www.cbo.gov/publication/58366.

Other key indicators of economic activity have continued to increase in the first half of 2022, though generally at a slower rate than they had previously. For instance, real gross domestic income (GDI) increased at an annual rate of 1.8 percent in the first quarter of 2022 after growing by an average rate of 6.3 percent in the second half of 2021.[2] (Second-quarter data for GDI are not yet available.) Real personal income minus transfer payments to people by federal, state, and local governments grew at an average annual rate of 0.5 percent in the first half of 2022 versus 3.1 percent in the second half of 2021. And real personal consumption expenditures grew at an average annual rate of 1.4 percent in the first half of 2022 (with somewhat slower growth in the second quarter than in the first), compared with 2.2 percent in the second half of 2021. One reason for the deceleration in personal consumption expenditures is higher inflation, which has eroded consumers' purchasing power. Another reason is that real disposable personal income has declined in the first half of 2022. Savings accumulated during the coronavirus pandemic, including from transfer payments, have continued to support consumption.

The labor market remains tight, with low unemployment and elevated job vacancies, but both measures have softened in recent months. Net gains in nonfarm payroll employment averaged 375,000 jobs per month in the second quarter of 2022 compared with 539,000 jobs, on net, added per month in the first quarter and 590,000 jobs, on net, added per month in the second half of 2021. In June 2022, the unemployment rate was 3.6 percent (unchanged since March and near its prepandemic low) and there were about 1.8 job vacancies for every unemployed worker (one of the highest readings in the near 22-year history of this series though down from its highest level of 2.0 in March).

How Would Enacting the Bill Affect Inflation in 2022 and 2023?

In calendar year 2022, enacting the bill would have a negligible effect on inflation, in CBO's assessment. In calendar year 2023, inflation would probably be between 0.1 percentage point lower and 0.1 percentage point higher under the bill than it would be under current law, CBO estimates. That range of likely outcomes reflects uncertainty about how various provisions of the bill would affect overall demand and output, the supply of labor, the persistence of disruptions in the supply of goods and services, and how the Federal Reserve would respond to offset any increase in inflationary pressure. Responsiveness to the enhancement of health insurance subsidies established by the Affordable Care Act is the most

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[2] The data on GDP and GDI are subject to revision by the Bureau of Economic Analysis.

important factor boosting inflationary pressure, and responsiveness to the new alternative minimum tax on corporations is the most important factor reducing inflationary pressure. The range applies to multiple measures of inflation: the GDP price index, the personal consumption expenditures price index, and the consumer price index for all urban consumers.

In its analysis of the inflationary effects of the bill, CBO used an approach similar to that underlying the agency's estimates of the short-term effects of legislation enacted in 2021.[3] The agency augmented its analysis to account for the effects of supply disruptions and for the amount of tightness or slack in the economy on the inflationary effects of fiscal policy.

Key inputs into the analysis of inflation were the effects of the bill on overall demand for goods and services. In the short term, changes in fiscal policies affect the economy primarily by influencing the demand for goods and services by consumers, businesses, and governments, which leads to changes in output. Factors increasing overall demand push inflation up and those decreasing overall demand push inflation down. To estimate the effects of changes in federal spending and revenues on overall demand and output, CBO considered evidence about the effects of similar policies in the past and used results produced by macroeconomic models.[4]

CBO expects different provisions of the legislation to affect overall demand and output differently.[5] For example, provisions that directly increase government purchases of goods and services would add to overall demand on a dollar-for-dollar basis. Increases in financial support to people, such as through enhanced health insurance subsidies, would boost spending more among lower-income people than among higher-income people, partly because lower-income households typically consume a higher fraction of their additional disposable income than higher-income households do. Thus, financial assistance to lower-income households would boost the overall demand for goods and services more than financial assistance to higher-income households would. Changes to business taxes that affect after-tax profits on past investments—as opposed to the return on new

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[3] See Congressional Budget Office, *Additional Information About the Updated Budget and Economic Outlook: 2021 to 2031* (July 2021), Appendix B, www.cbo.gov/publication/57263.

[4] For further discussion, see Congressional Budget Office, *The Effects of Pandemic-Related Legislation on Output* (September 2020), www.cbo.gov/publication/56537.

[5] For additional discussion, see John Seliski and others, *Key Methods That CBO Used to Estimate the Effects of Pandemic-Related Legislation on Output*, Working Paper 2020-07 (Congressional Budget Office, October 2020), www.cbo.gov/publication/56612.

investments—would have relatively small effects on overall demand, in CBO's assessment.

CBO used its estimates of the bill's net effects on the deficit as the starting point for its analysis of overall effects on demand (see Table 1). The enhanced health insurance subsidies and energy-related subsidies were the largest contributors to increases in the deficit. The new alternative minimum tax on corporations was the largest contributor to reductions in the deficit. For each dollar change in the deficit, the increases in subsidies would probably have larger effects on overall demand (boosting it) than the increases in revenues (which would reduce overall demand). Those factors could contribute to the effects on output and inflation being positive even when the overall deficit was reduced.

Table 1.

Net Increases and Decreases (-) in the Deficit From the Inflation Reduction Act of 2022

Billions of Dollars	**Fiscal Year 2023**	**Fiscal Year 2024**
Title I.		
A. Tax Provisions	-54	-46
A. Internal Revenue Service Funding	5	4
B. Prescription Drug Pricing	-3	-2
C. Affordable Care Act Subsidies	20	22
D. Energy Security	12	14
Titles II.-VIII.	3	10
Total	**-18**	**3**
Memorandum: Deficit Effects From Higher Revenues Resulting From Increased Funding for the Internal Revenue Service (Not included above)	-3	-8

Data source: Congressional Budget Office.

The estimated budgetary effects are of H.R. 5376, as amended in the nature of a substitute (ERN22335) and posted on the website of the Senate Majority Leader on July 27, 2022. Components may not sum to totals because of rounding.

The budgetary effects in fiscal years 2023 and 2024 informed CBO's analysis of the economic effects in calendar year 2023. The analysis included the effects on the deficit from higher revenues resulting from increased funding for the Internal Revenue Service. Under guidelines agreed to by the legislative and executive branches, those effects are not included in the total line from CBO's cost estimate reporting the net effect on the deficit. Thus, the effects shown in the memorandum are additional. Those revenues constitute a shift in resources from the private sector to the government that would reduce demand and thus reduce inflationary pressure.

Enacting the bill would also reduce some businesses' incentives to invest through changes in the after-tax return on private investment, pushing down output and inflation. (See the answer to the fourth question in this letter for further discussion.) In addition, enacting the bill would reduce the incentives of some people to work, mainly because of the enhanced health insurance subsidies, pushing down output and pushing up inflation.

Enacting the bill would affect economic activity and inflation beyond 2023. CBO has not evaluated those effects.

What Is the Highest Amount of Income That People Qualifying for Expanded Health Insurance Subsidies Would Earn?

The answer to your question depends on people's age and geographic location, and the number of enrollees in the family. On the basis of nationwide average premiums projected for 2023 under the bill, CBO estimates the following:

- A 64-year-old would receive a premium tax credit if his or her income did not exceed $163,700 in that year.
- A 21-year-old would receive a premium tax credit if his or her income did not exceed $54,600.
- A family of four consisting of individuals ages 50, 50, 21, and 21 would receive a premium tax credit if their household income was no greater than $304,100.
- A younger family of four, consisting of people ages 24, 24, 5, and 5, would receive a premium tax credit if the household's income was no more than $192,700.

Premium tax credits are used to lower people's out-of-pocket monthly premium contributions for health insurance obtained through the marketplaces established by the Affordable Care Act. The amount of the credit is calculated as the difference between the benchmark premium for health insurance (that is, the premium for the second-lowest-cost silver plan available in a region) for the individual or family and a specified maximum contribution, expressed as a percentage of modified adjusted gross income. Those benchmark premiums are also a function of age, geographic location, and the number of enrollees. For example, the premium for a 64-year-old is three times that for a 21-year-old in most states. The premium tax credit is thus correspondingly larger for older people than for younger people.

The likelihood that the benchmark premium will exceed a person's maximum contribution—and that the person will therefore receive a premium tax credit—declines at higher income levels. For those whose income is above 400 percent of the federal poverty guideline, or $54,400 for a single person in 2023, their maximum contribution would be 8.5 percent of income through 2025 under the bill.

This analysis is based on nationwide average premiums. For people living in states with premiums that are above or below the average, the income at which they would no longer be eligible for a premium tax credit would be higher or lower.

What Effect Would a New Alternative Minimum Tax on Corporations Have on Business Investment and GDP?

Section 10101 of H.R. 5376 would increase taxes on corporations by imposing a new alternative minimum tax equal to 15 percent of income reported on financial statements by certain large corporations—specifically, those whose adjusted financial statement income exceeds $1 billion. The staff of the Joint Committee on Taxation (JCT) estimates that the provision would increase federal revenues by $313.1 billion over the 2023–2031 period (with $96.6 billion of that amount being generated in fiscal years 2023 and 2024). JCT has projected that approximately 150 corporations would be subject to the new tax each year and that just under half of the revenues would come from the manufacturing sector.[6]

In CBO's assessment, the proposed new corporate minimum tax would reduce the incentive for those large corporations to invest, primarily by limiting the tax benefit of accelerated depreciation and by decreasing the after-tax return on their new investment. According to the generally accepted accounting principles that are used for preparing financial statements, firms must deduct the cost of investments over the full useful life of the asset. In contrast, various provisions of the tax code—including "bonus" depreciation—allow firms to deduct investment expenses more quickly, increasing the tax benefit of those deductions and the expected after-tax return on the investments. By setting a new minimum tax, section 10101 would limit the tax benefit of accelerated depreciation for affected corporations and, all else being equal, reduce their business investment.

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[6] See Thomas A. Barthold, Joint Committee on Taxation, letter to the Honorable Ron Wyden, Senate Committee on Finance (August 1, 2022), https://tinyurl.com/4z5wtn7t.

The provision would also affect private investment by increasing federal revenues and, all else being equal, by reducing the federal deficit and the amount of federal debt. Less government borrowing would increase the amount of funds available for private investment and put downward pressure on interest rates, which would have a positive effect on business investment, in CBO's view.

The net effect on business investment, and hence on GDP, would depend on the relative magnitudes of the direct incentive effect and the indirect effect resulting from the change in the federal budget deficit. Additionally, the net effect would depend on overall economic conditions.

Other provisions of the Inflation Reduction Act would also affect incentives to invest. Thus, the legislation's overall impact on business investment and GDP would differ from that of just this provision considered by itself.

I hope that this information is useful to you.

Sincerely,

Phillip L. Swagel
Director

cc: Honorable Bernie Sanders
Chairman