The Inflation Reduction Act: Incentivizing Sustainability

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Key Takeaways

- The Inflation Reduction Act (IRA) earmarks nearly $370B in tax incentives towards climate change action, the largest commitment in U.S. history
- Tax incentives lower the cost of transitioning to clean energy and are projected to instigate demand, drive investment, and encourage innovation in the U.S. green technology industry
- Under the IRA, companies and investors can financially benefit from taking action to advance sustainability and environmental justice

Background and Overview

Hailed as the most ambitious climate legislation in American history, the Inflation Reduction Act (IRA), passed by the Biden administration in August 2022, earmarked nearly $370B in tax incentives towards decarbonization and climate change resilience. In addition to decreasing the cost of clean energy, the Act was designed to advance environmental justice for disadvantaged communities, which have historically shouldered an outsized share of the burden associated with climate change. Altogether, the passage of the IRA enables the US to reduce emissions by 40% by 2030, bringing the country closer to its 50-52% reduction goal by 2030; prior to the IRA's enactment, the US was only on track to hit 25-30% reduction. Enablement, however, is mostly symbolic if companies do not evaluate the Act's provisions and how to integrate them into their overall corporate strategies around climate change.

The tax incentives for businesses to decarbonize their operations, innovate in the green tech space, and invest in clean energy projects in historically disadvantaged communities are a necessary step towards reframing the narrative around the financial benefits of sustainability. While the transition to clean energy is typically viewed as more costly, the IRA decreases cost and expands accessibility around decarbonization for smaller businesses, communities, and individuals. As such, the IRA is expected to increase the demand and stimulate innovation around clean technologies such as low-carbon materials, electric vehicles (EVs), and renewable energies.

The IRA is centered around four primary goals:

1. Reducing pollution
2. Improving clean transit
3. Making clean energy more affordable
4. Strengthening climate change resilience

Each of these goals is set to tackle climate change from multiple angles. Under the IRA, tax credits are made available for the next decade for various investments such as pollution monitoring and carbon removal technologies, solar and wind production subsidies, EV purchases for small businesses, and funding for climate-resilient affordable housing. The Act introduced a plethora of opportunities for companies to drive clean energy development at scale and the tax credits are designed to financially incentivize companies to reduce emissions, improve energy efficiency, and stimulate job growth. Notably, tax credits are payable to non-tax paying entities such as non-profits, municipalities, or tribes, allowing them to finance sustainability projects more easily in comparison to earlier versions of climate-related tax credits. These credits are increased for projects that employ individuals in well-paying jobs or are located in or directly benefit disadvantaged communities.

To further redress historical environmental discrimination against disadvantaged communities, the Act establishes Climate and Environmental Justice Block Grants to support community-led projects; invests in pollution monitoring near industrial facilities and public schools; provides substantial bonus credits for clean energy development in lower-income communities; encourages climate resiliency projects in Tribal and Native Hawaiian communities; and expands access to affordable, clean energy in Tribal nations. The many environmental justice initiatives created by the IRA are closely tied to financial incentives that should push developers to integrate community interests into their clean energy projects.

Business Impact

The IRA will reduce the "green premium" across various American industries – in particular, some of the largest impacts will be felt in the manufacturing sector. The Act focuses on domesticating supply chains to ease U.S. reliance on foreign exports and decrease the cost of EVs. To promote domestic EV manufacturing and demand, the IRA provides tax credits for both manufacturers and consumers if such vehicles use batteries with minerals that have been extracted or processed in the US or any of its free trade agreement (FTA) partners. Against the backdrop of seemingly perpetual global supply chain disruptions, the IRA sets manufacturers up to benefit from the production of clean transport financially and operationally.

The commercial real estate industry also stands to gain from certain IRA provisions. Tax deductions are available to developers of energy-efficient commercial buildings, and they increase proportionally in size with higher levels of energy efficiency achieved. Further, aiming to stimulate job growth and offset job losses from the fossil fuel sector, these tax benefits are set to increase fivefold for developers that meet the IRA's wage and apprenticeship requirements. Developers can also receive tax credits for setting up EV charging stations in disadvantaged communities, if again, prevailing labor requirements are satisfied.

For private equity firms, the Act creates a pathway for clean energy and energy transition investments. By decreasing the financial risk associated with investing in green technologies, the Act provides more certainty for the renewable energy sector. Again, projects around emerging technologies such as carbon capture or clean hydrogen are eligible for direct cash payments rather than tax incentives for the first five years of development, opening investment up to a wider range of non-tax paying partners. The tax credits themselves are more easily transferable, which is predicted to increase the inflow of capital from foreign investors. While these technologies and their potential to replace traditional energy sources have been growing slowly, the financial incentives for these projects under the IRA are projected to spur innovation and expedite development significantly.

These examples only scratch the surface of the positive impact the IRA is positioned to have on climate, communities, and businesses if companies choose to take meaningful action. For the many U.S. companies with net zero emissions targets, the IRA has the primary benefit of decreasing the cost of achieving existing goals. In addition to advantageous financing, buy-in should increase around the idea that sustainability can serve as a revenue growth opportunity – the IRA will only spur demand for clean energy, and business leaders would be remiss not to pull such a lever. As companies weigh up the costs and benefits of decarbonization against corporate strategy and shareholder interests, the $370B made available by the Act can serve as a push towards real action around sustainability.

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