Public Sector Practice

The Inflation Reduction Act: Here's what's in it

The Inflation Reduction Act contains $500 billion in new spending and tax breaks that aim to boost clean energy, reduce healthcare costs, and increase tax revenues.

This article is a collaborative effort by Justin Badlam, Jared Cox, Adi Kumar, Nehal Mehta, Sara O'Rourke, and Julia Silvis, representing views from McKinsey's Public Sector Practice.

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The Inflation Reduction Act of 2022 (IRA), signed into law on August 16, 2022, directs new federal spending toward reducing carbon emissions, lowering healthcare costs, funding the Internal Revenue Service, and improving taxpayer compliance.[1]

The act aims to catalyze investments in domestic manufacturing capacity, encourage procurement of critical supplies domestically or from free-trade partners, and jump-start R&D and commercialization of leading-edge technologies such as carbon capture and storage and clean hydrogen. It also allocates money directly to environmental justice priorities and requires recipients of many funding streams to demonstrate equity impacts. The Congressional Budget Office (CBO) estimates that the law will reduce budget deficits by $237 billion over the next decade.[2]

This is the third piece of legislation passed since late 2021 that seeks to improve US economic competitiveness, innovation, and industrial productivity. The Bipartisan Infrastructure Law (BIL), the CHIPS & Science Act, and IRA have partially overlapping priorities and together introduce $2 trillion in new federal spending over the next ten years.

Here's a breakdown of the IRA's major provisions—by the numbers.

The Inflation Reduction Act of 2022 is the third piece of legislation passed since late 2021 that seeks to improve US economic competitiveness, innovation, and industrial productivity.

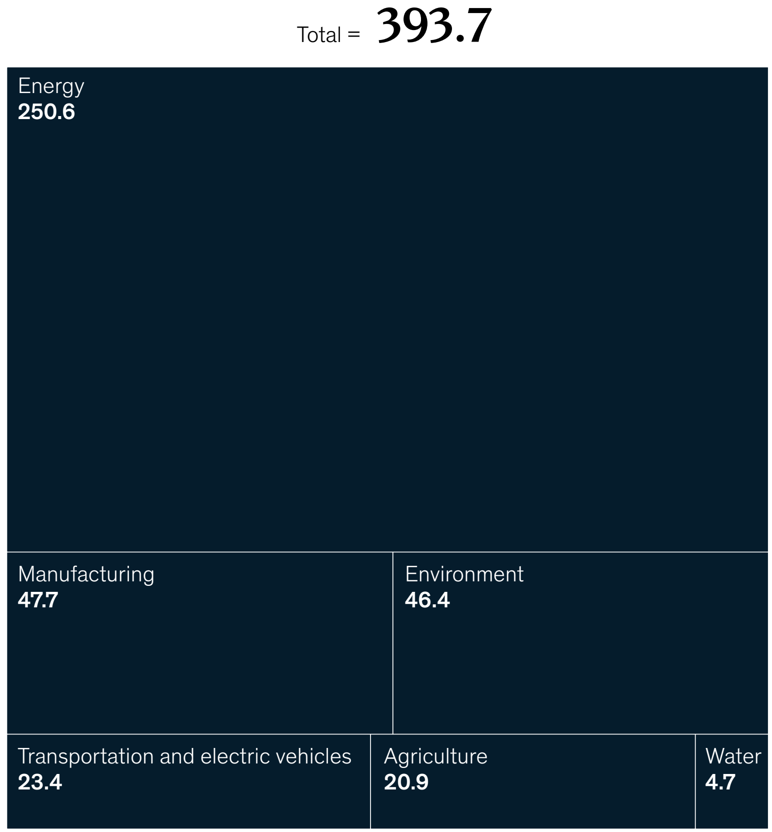
[1] H.R. 5376 - Inflation Reduction Act of 2022, Congress.gov.
[2] "Estimated budgetary effects of Public Law 117–169, to provide for reconciliation pursuant to Title II of S. Con. Res. 14," Congressional Budget Office, September 7, 2022.

Significant federal funding for climate efforts. The IRA directs nearly $400 billion in federal funding to clean energy, with the goal of substantially lowering the nation's carbon emissions by the end of this decade.[3] The funds will be delivered through a mix of tax incentives, grants, and loan guarantees. Clean electricity and transmission command the biggest slice, followed by clean transportation, including electric-vehicle (EV) incentives.

[3] *Preliminary report: The climate and energy impacts of the Inflation Reduction Act of 2022*, REPEAT-Rapid Energy Policy Evaluation and Analysis Toolkit, August 2022.

The Inflation Reduction Act makes investments across a wide range of sectors.

Inflation Reduction Act investments by sector, $ billion



Note: This exhibit reflects analysis of the appropriation figures contained in the Inflation Reduction Act, as well as those reported by the Congressional Budget Office and Joint Committee on Taxation. This analysis may differ from other analyses due to differences in methodology.
Source: Inflation Reduction Act of 2022, H.R. 5376, 117th Cong. (2021–22); McKinsey analysis

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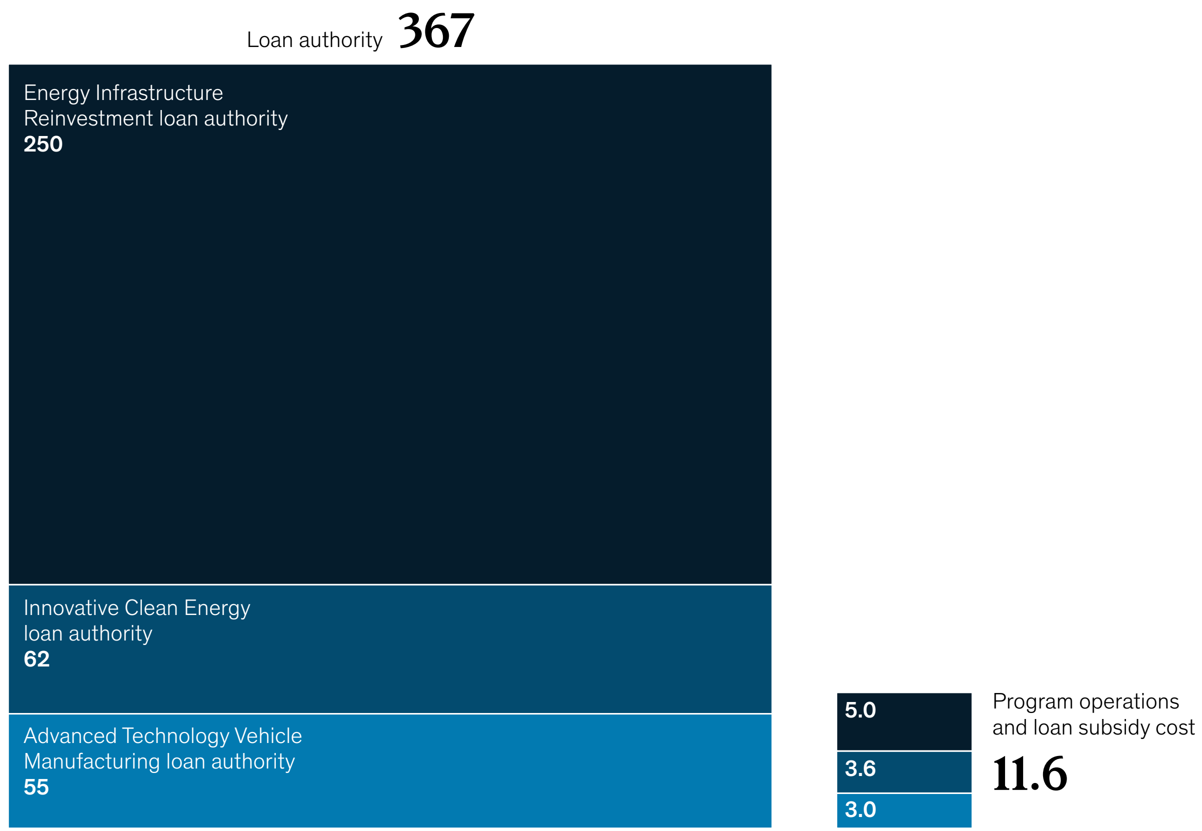
Upgrade, repurpose, or replace energy infrastructure. The US Department of Energy's Loan Program Office will receive roughly $12 billion to expand its existing loan authority by tenfold and create a new loan program capped at $250 billion to upgrade, repurpose, or replace energy infrastructure.

Inflation Reduction Act allocations to the US Department of Energy provide credit subsidy to allow for direct loans and loan guarantees.

Inflation Reduction Act funding for Department of Energy Loan Program Office, $ billion



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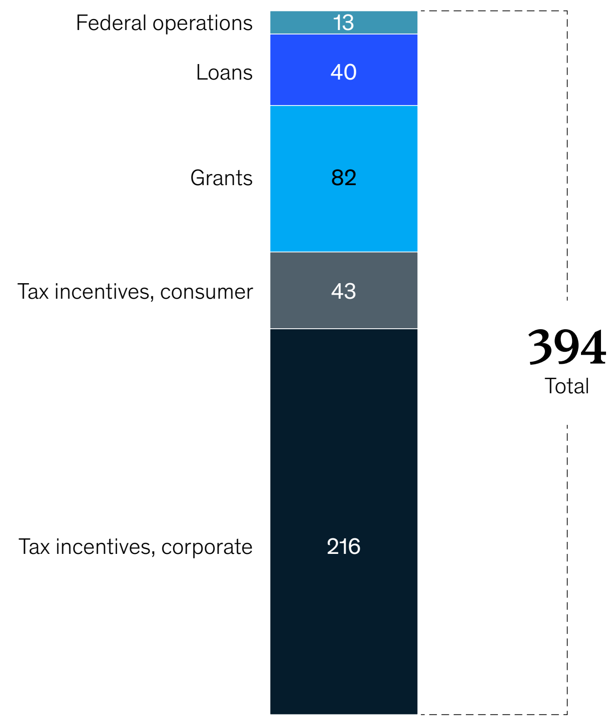
Provide incentives for private investment.
The majority of the $394 billion in energy and climate funding is in the form of tax credits. Corporations are the biggest recipient, with an estimated $216 billion worth of tax credits. These are designed to catalyze private investment in clean energy, transport, and manufacturing. Many of the tax incentives in the bill are direct pay, meaning that an entity can claim the full amount even if its tax liability is less than the credit.

Corporations, individuals, and state and local governments are all eligible to receive funding in the energy portion of the Inflation Reduction Act.

Energy and climate change funding in the Inflation Reduction Act, $ billion



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Consumer incentives. Some $43 billion in IRA tax credits aim to lower emissions by making EVs, energy-efficient appliances, rooftop solar panels, geothermal heating, and home batteries more affordable. Starting in 2023, qualifying EVs will be eligible for a tax credit of up to $7,500 and $4,000 for new and used vehicles, respectively. Qualifying home improvements will be eligible for a tax credit of up to 30 percent of the total cost, capped at $1,200 per year. For heat pumps, the credit is capped at $2,000 per year.[4]

The Inflation Reduction Act reforms energy tax incentives through a mix of extensions, modifications, and new programs over the next ten years.

Selected tax credit modifications in the Inflation Reduction Act,[1]

$2,000

per year consumer tax credit for the purchase of heat pumps, heat pump water heaters, biomass stoves, and boilers *(25C, nonbusiness energy property credit)*

$30

per MWh for zero carbon electricity generation placed into service after 2024; reduces to $23 in 2034 and $15 in 2035 *(45D, production tax credit; 45Y, clean electricity)*

$15

per MWh for power produced at a qualifying nuclear facility *(45U, nuclear production tax credit)*

$4,000

per vehicle consumer tax credit for used electric vehicles (EVs) *(36E, used EV tax credit; 30D, clean vehicle credit)*

$1.75

per gallon for production or mixture of sustainable aviation fuel; credit runs 2023–24 *(40B, aviation; 45Z, renewable fuels credit)*

$3

per kilogram for the production of qualified clean hydrogen *(45V, clean hydrogen tax credit)*

Note: This exhibit reflects the key statutory requirements for the cited tax provisions contained in the tax provisions in the Inflation Reduction Act, as well as those reported by the Congressional Budget Office and Joint Committee on Taxation. This analysis may differ from other analyses due to differences in methodology.
[1]Entities may need to meet certain domestic sourcing and procurement targets as well as prevailing wage/apprenticeship requirements.
Source: Inflation Reduction Act of 2022, H.R. 5376, 117th Cong. (2021–22)

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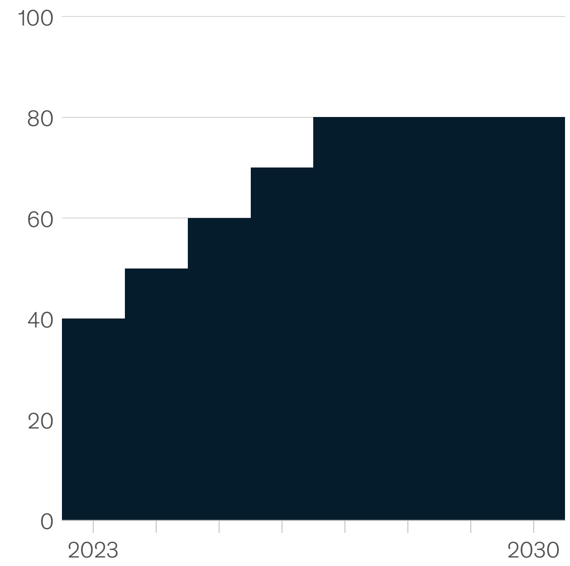
[3] If a homeowner installs a heat pump to heat/cool the entire home, the cap is increased to $2,000 for that one item. See Rocky Mengle, “Save more on green home improvements under the Inflation Reduction Act,” *Kiplinger*, updated September 2022.

Strings attached. To help build stronger, more diverse science, technology, engineering, and math (STEM) talent pipelines, manufacturing facilities are only eligible for full IRA tax credits if they meet prevailing wage and apprenticeship requirements. Many IRA tax incentives also contain scaling domestic-production or domestic-procurement requirements. For example, to unlock the full EV consumer credit, a scaling percentage of critical minerals in the battery must have been recycled in North America or been extracted or processed in a country that has a free-trade agreement with the United States. The battery must have also been manufactured or assembled in North America.

The Inflation Reduction Act includes a modified tax credit for electric vehicles and batteries—including new content requirements.

Share of critical minerals for EV battery production extracted or processed in a country with FTA with US,[1] %



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[1]A free-trade agreement with US is required for tax credit qualification for electric-vehicle battery production; alternatively, critical minerals that have been recycled in North America also qualify.
Source: Congressional Research Service; Inflation Reduction Act of 2022, H.R. 5376, 117th Cong. (2021–22)

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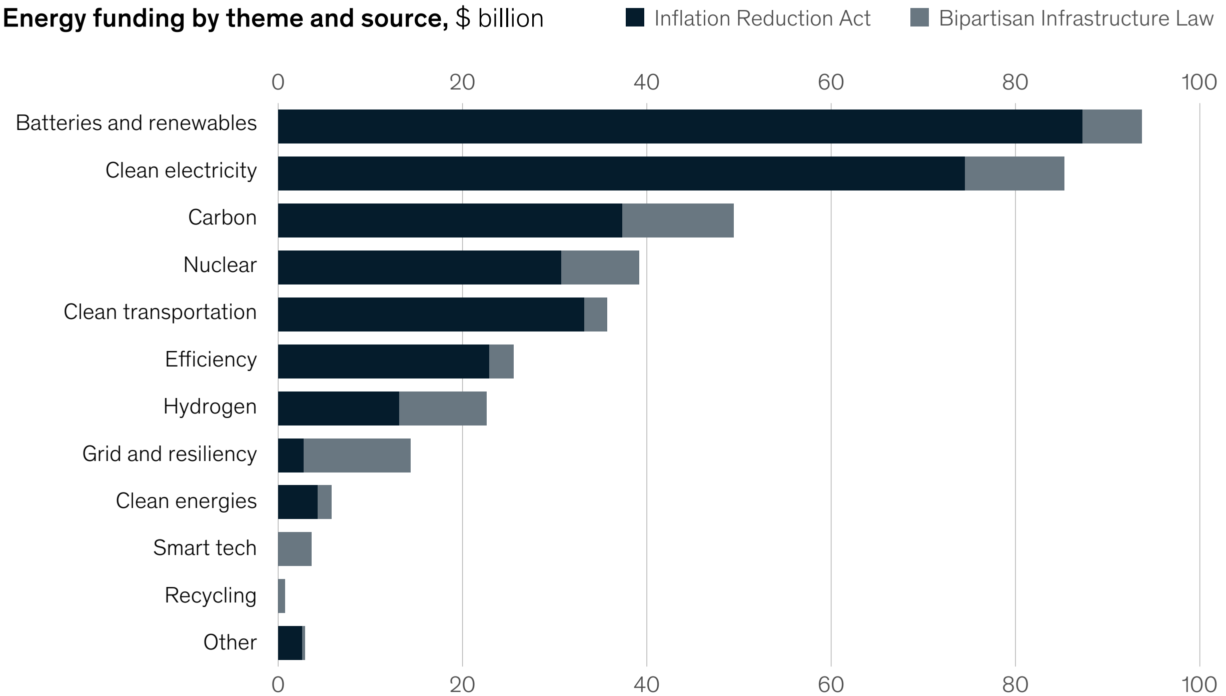
Compliment and amplify. The IRA's clean-energy tax credits and product credits could catalyze and potentially amplify the $70 billion in clean-energy technology and demonstration projects funded under the BIL. The two acts together mount an estimated $370 billion in federal funding over the next five to ten years to facilitate the clean-energy transition.

Energy funding from the Bipartisan Infrastructure Law and the Inflation Reduction Act spans major funding themes, totaling $370 billion.

Energy funding by theme and source, $ billion



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Source: Inflation Reduction Act of 2022, H.R. 5376, 117th Cong. (2021–22); Infrastructure Investment and Jobs Act, H.R. 3684, 117th Cong. (2021–22)

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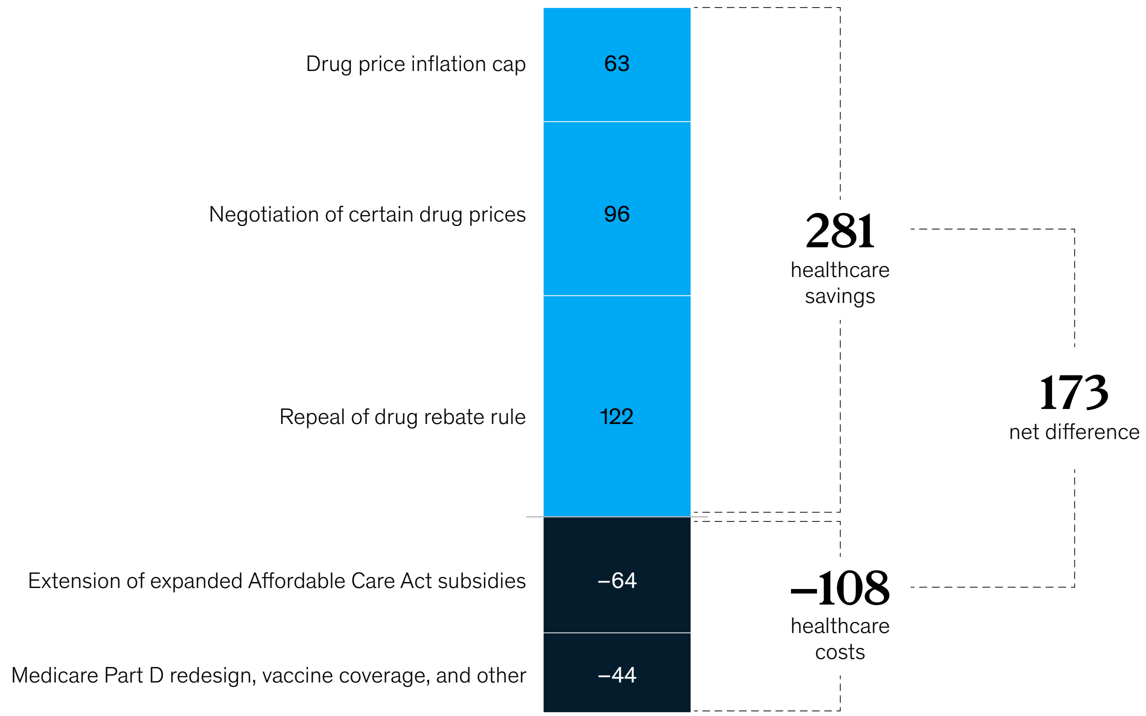
Lowering healthcare costs. The IRA seeks to lower prescription drug costs by allowing Medicare to negotiate prices with drug companies, put an inflation cap on drug prices, and lower out-of-pocket expenses for Medicare recipients. It also extends Affordable Care Act (ACA) subsidies for three years. Together, the CBO estimates these measures will save the federal government $173 billion through 2031.

Healthcare provisions in the Inflation Reduction Act are expected to net $173 billion in savings, largely through price negotiation and cost caps.

Inflation Reduction Act healthcare provisions, $ billion



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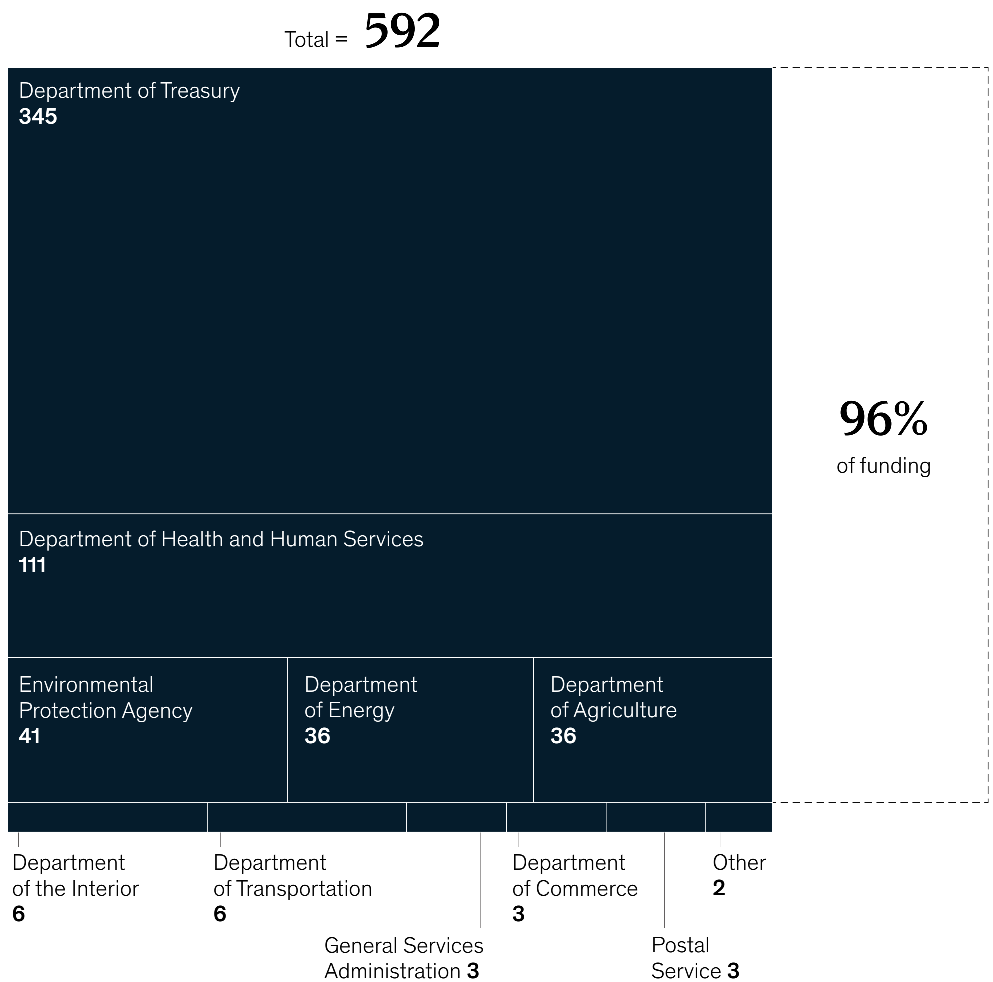
Many agencies. IRA funds will flow through more than a dozen federal agencies. The US Treasury Department is expected to handle the lion's share—more than $250 billion—given the prevalence of tax credits in the law. More than $100 billion worth of subsidies to extend ACA coverage fall to the US Department of Health and Human Services. The Departments of Agriculture and Energy, as well as the Environmental Protection Agency, will receive $120 billion combined to bolster climate, environmental justice, conservation, and resilience programs.

Five US government agencies account for 96 percent of the Inflation Reduction Act funding.

Inflation Reduction Act funding by government agency,[1] $ billion



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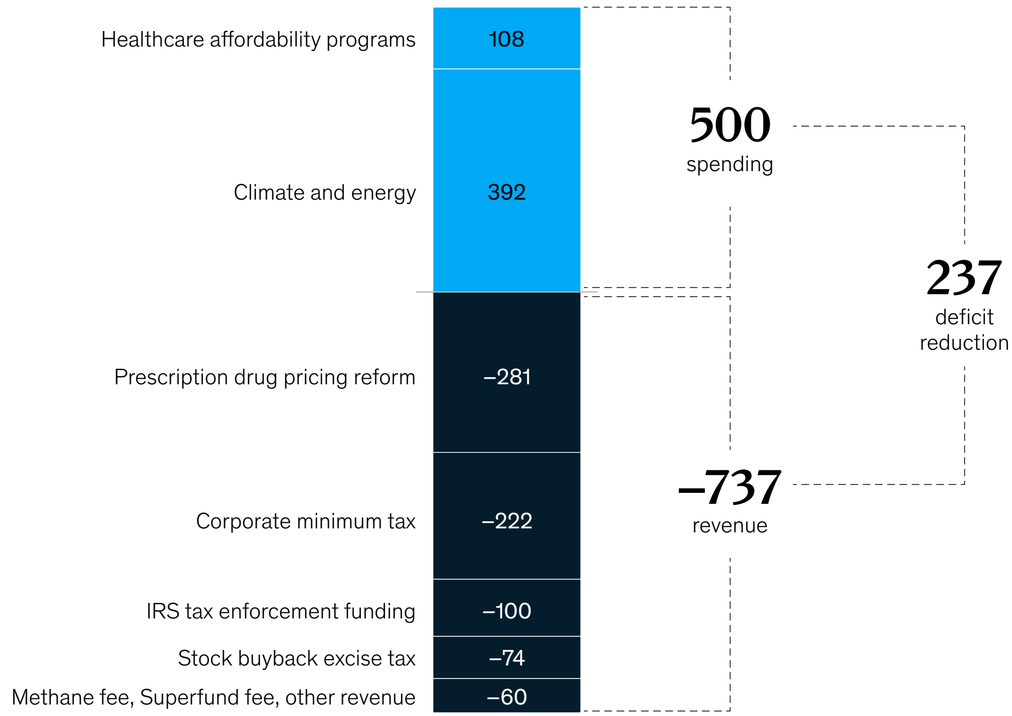
Raising revenue. Much of the new spending in the IRA is designed to be offset by measures to increase government revenues. The act raises the minimum tax on large corporations to 15 percent, imposes a 1 percent excise tax on stock buybacks, and provides new funding to enhance IRS collection and enforcement. Combined with savings from the healthcare initiatives, the CBO estimates the IRA will lower government deficits by $237 billion over the next ten years.

An estimated $500 billion in new spending and tax credits for clean energy and healthcare will yield $237 billion in deficit savings.

Inflation Reduction Act provisions, $ billion



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