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The Grace Richardson Fund
New Free Market Policy Solutions for 21st Century Challenges

Clean Tax Cuts for Green Bonds – Charrette Summary

Columbia University, New York, NY – March 6th, 2017

Clean Tax Cuts (CTCs) for qualified green bonds will be a new class of policy proposal designed to stimulate investment in and demand for clean technologies and solutions simultaneously by reducing investment tax rates on - and ultimately the cost of capital and outputs for – initiatives that deploy them. It provides a framework to align conservative and progressive interests on energy, environmental protection, and economic growth by marrying two proven concepts: the green bond market and municipal bond tax abatement.

Green bonds have already proven to be an effective instrument for channeling investor funds into clean technologies. They represent a burgeoning market that has seen dramatic growth since their debut in 2007. The global value of green bonds issued last year rose to a record $93.4 billion, up over 3,500% from 2012's $2.6 billion. Moody's Investor Services suggests that green bond issues could more than double again in 2017, to $206 billion. Although the standards and definitions for green bonds are still being established, this designation helps reduce the costs of matching interested buyer and sellers. Green bonds are used for projects in a variety of sectors and are therefore an effective focal point for CTC. Applying CTC to green bonds promises accelerated, broad-scale impact with targeted simplicity.

The established market of municipal bonds represents a successful experiment in mobilizing large amounts of low-cost capital for public benefit. Adopting strategies similar to the municipal bond tax abatement model is the simplest, most impactful solution: by cutting tax rates paid on interest earned from green bonds, CTC will lower the cost of capital for investors, thus making qualified projects more attractive. Because the target technologies and initiatives are typically capital intensive, lowering the cost of capital significantly lowers the levelized cost of production, be it for electricity, cars or wind turbines. Cheaper solutions will open up larger potential investor and consumer markets in tandem, and translate into accelerated deployment of clean technologies.

Thus, tax-free corporate green bonds create a new class of security, which simultaneously increase both supply and demand for clean solutions. Blending characteristics of tax free munis ($3.7 trillion market) and higher yield taxable corporate bonds ($35 trillion market) the potential appeal to investors and issuers - even those with no interest in sustainability - appears straightforward. These bonds offer lowest cost of debt for issuers, and potentially the highest tax-free return for investors. The market potential could be large.

There are many potential ways to design CTC mechanisms, but using them to accelerate the supply of capital holds significant potential impact across a broad swath of sectors. Green bonds are a similarly broad, flexible investment vehicles for the same purpose, and marrying the two offers a powerful tool for mobilizing cheaper capital where it is needed.

One caveat: The green bond market succeeds because participants, not governments, define it. To preserve that, the IRS or SEC cannot become arbiters of impact, complexifying issuance and putting tax exemption at risk by a prospective impact requirement. That could make returns uncertain, chilling the market, which thrives on economic freedom, low costs and low risk returns. So CTC for bonds must be based on assets with pre-certified impact, to keep issuance simple, returns predictable, and avoid ill-advised bureaucratic interference.

The proposals presented below were challenged to be simple, practical, and effective; generate broad appeal and bipartisan support; and be hard to game but easy to administer.

1. Proposal 1: Tax-Exempt Emission Reduction Bonds (ERBs)

Similar to favorable tax treatment given to municipal bonds for large-scale assets deemed to be in the public interest, ERBs would eliminate federal taxes on interest income from bonds or loans invested in projects and assets that meet the test of being an emissions-free energy generator, thus rewarding investments in clean energy infrastructure like wind, solar, nuclear and geothermal projects. Pre-certified technologies installed and put into service would qualify for the 100% tax cut exemption on all loan or bond debt interest. The current ITC/PTC could be eliminated or reduced to help fund this tax cut, which should assist in the scoring as projects migrate from one regime to another.

This approach sets a clear, understandable qualification threshold, avoiding contentious arguments about ambiguous impacts that might chill market participation.

2. Proposal 2: Tax-Exempt Clean Asset Bonds (CABs)

ERBs could be expanded to include any desirable asset class with known impact. CABs are privately issued tax-exempt green bonds, where the underlying assets pre-qualify as "clean" without need for agency (SEC, IRS, etc.) impact assessment, by virtue of pre-certified ability to reduce waste, inefficiency and externalities. Assets support a quantifiable benefit, or are certified by an external standard such as ENERGY STAR or CAFE. CABs could finance:

- Renewable and other low or zero emission energy infrastructure projects (ERBs)
- Electric or PEH private vehicles, service fleets, and public transportation
- Energy storage, batteries, and fuel cells; smart grids and transmission
- Green buildings and energy efficiency equipment (eg. ENERGY STAR loans and MBS)
- Oil & Gas, industrial, community waste reduction, monitoring and recycling systems
- CCUS, Air Capture, and downstream captured carbon product manufacture
- Factories, manufacture, construction, installation and operation for all the above

This proposal also builds on the muni bond model to lower cost of capital, while keeping corporate issuance simple, and returns predictable. Projects financed by qualified bonds would voluntarily transition from the existing system of tax credits to clean tax cuts. Qualified projects might be allowed to claim both credits and CTC for a short transition period, after which they would be required to pick one or the other.

More fully described in the Columbia charrette report, CABs create a new class of security, the tax-free corporate green bond. These should be extremely attractive to both issuers and investors, for they would offer the lowest cost of debt for issuers, and the highest tax-free return for investors – a better deal for both issuers and investors than anything else they can get. CABs should appeal to legislators as well,. Tax-free debt leverage would not only stimulate job-creating capital flows, but higher profits (and tax revenues) on the equity side. Which need not be tax-free. 25% or 50% reduction on equity side tax rates would strongly incent decision making while allowing for significant dynamic revenue effects and scoring.

__Note:__ This document compiles policy ideas from many sources for further discussion and consideration. Inclusion here does not imply that any CTC working group participant endorses any specific proposal as public policy.