Clean Tax Cuts for the Automobile Industry – Proposal Summaries

The automobile industry offers potentially one of the simplest, highest impact targets for the application of Clean Tax Cuts (CTC). That is so because the industry enjoys some of the clearest, best understood and reported metrics for efficiency, but also faces challenges. So concluded participants of the first CTC charrette convened at Columbia University, September 2016. When discussing areas where CTC might work well, SASB analyst David Parham pointed out that Corporate Average Fuel Economy (CAFE) standards provide "existing well-defined metrics" that could be used to set tax rates to advantage and accelerate the deployment of cleaner fleets.

Thanks to CAFE, we know the average vehicle fleet emissions for every automobile manufacturer.[1] It would be a simple matter to take that number, and turn it into a tax rate: the lower the fleet emissions, the lower the tax rate. If applied to all capital taxes (corporate income tax as well as taxes paid by investors on capital gains, dividends and interest) that would provide a very powerful mechanism to drive the automobile industry ever-cleaner. Firms with cleaner fleets would decrease taxes, lower cost of capital, and increase returns, gaining significant competitive advantages over less efficient firms. Since every board member, executive and employee all have stock packages, the value of which increases as taxes go down, CTC applied to all capital taxes presents a powerful point of leverage to incent and align corporate behavior and culture, at every level, with the goal of reducing waste and inefficiency.

Intrigued by these observations from the first CTC charrette, R Street Institute undertook a new policy study (no. 90, March 2017) exploring the possibility of CTC replacing the existing "trilateral" regulatory approach where automakers are subject to a bewildering and costly array of conflicting regulations from three agencies: "the EPA, the California Air Resources Board (CARB) and the National Highway Traffic Safety Administration (NHTSA), which oversees CAFE."

In the study, "Replacing Fuel Economy Rules With Clean Tax Cuts," R Street Senior Fellow Ian Adams recommended replacing the current tripartite regulatory regime with a single regulator overseeing a CTC reward-based system for "both vehicle emissions and fuel economy by [setting] a single vehicle efficiency target that achieves both… The regulator would evaluate firms' fleet performance relative to the target, an assessment that would be keyed to cuts in marginal rates assessed for taxes on capital, including the corporate income tax paid by the automaker and the dividend, capital gains, estate and earned interest taxes paid by its shareholders and bondholders. Fleets that are more efficient would receive larger tax cuts. The cleaner the fleet, the lower the tax burden associated with the firm."

In general, the R Street study found that CTCs "increase both the supply of, and demand for, cleaner products by lowering" their cost. CTCs "establish[] positive feed-back loops that help the market for cleaner activities become more attractive." In doing so, CTCs "replace costly regulatory structures and overly complex subsidies and credits with a flexible and streamlined system. It would remove punitive regulations that punish problematic behavior and instead

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[1] CAFE provides mechanisms to adjust that for vehicle footprint, to avoid discriminating against vehicles that have greater carrying capacity.

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.

erect a system to reward favorable behavior, which offers the additional benefit of encouraging "over-compliance" as a competitive advantage.

With respect to the automobile industry in particular, Adams observed "The chief advantage of clean tax cuts over the existing rules governing fuel economy and emissions is the flexibility they offer automakers to determine which emissions reductions strategies are efficient. [] A supply-side approach to regulating fuel economy and emissions would, rather than setting a regulatory benchmark that functions as a *de facto* ceiling, offer concrete advantages to firms that opt to excel beyond the target. Firms that opted for fleets that are more efficient could see the cost of developing platforms, powertrains and the "hard" parts of vehicles drop, thanks to their lower tax rates. This would allow them to add more high-margin discretionary content to their vehicles.[59] On the showroom floor, vehicles from manufacturers with efficient fleets would be better equipped than similarly priced vehicles from manufacturers with less-efficient fleets and higher tax rates." Or more efficient firms "could simply offer similarly equipped vehicles to consumers at a lower price. Manufacturers with more efficient fleets also likely would enjoy better margins, offering them greater flexibility about how they choose to position themselves in the market."

The R Street study concludes: "Encouraging automakers to explore greater fuel efficiency through a supply-side approach that reduces taxes on capital is an attractive approach. The impact on automakers would be to lower their cost of capital by increasing returns for investors. This, in turn, provides incentives for investment in more fuel-efficient firms… If they operate as designed, and spur more growth and investment in the affected firms, CTCs could even pay for themselves. CTCs could reduce emissions while freeing up capital for innovation…. Crucially, by focusing on supply [and on reducing cost of capital] CTCs could prevent price from being a barrier to the adoption of newer and more efficient vehicles – a critical step toward a more efficient fleet and better environmental outcomes than we see today."

In addition to the above approach, the March 6 charrette at Columbia University exploring the application of CTCs to green bonds suggested some additional options for the automobile industry. Clean Asset Bonds (CABs) would be privately issued green bonds granted municipal bond-like tax exemption, because the underlying assets deliver or support a known, quantifiable public environmental or health benefit, or are impact-certified by an external standard such as ENERGY STAR or CAFE. These qualify as "clean," and merit tax-exemption, without further external assessment (or any need to involve the SEC or Treasury as arbiters of impact, which should be avoided) by virtue of proven ability to reduce waste, inefficiency and negative externalities.

Relevant to the automobile sector, CABs could finance the manufacture of electric and hybrid vehicles, and components thereof, or other kinds of low emission vehicles, the purchase and operation of high-efficiency service fleets, public EV charging infrastructure, as well as mass transportation alternatives. This mechanism would enable even a firm with an inefficient fleet to access lower cost capital when attempting to increase fleet efficiency. Indeed, any automobile firm would be able to finance higher fleet efficiency at a lower cost of capital than anything else they could invest in. The two CTC mechanisms could work well, side-by-side, and provide a promising model for other industries.