CHAPTER X

PUBLIC UTILITIES—REGULATION BY TAXATION

The following thoughts are prompted by a desire to make some contribution, however small, to the elucidation of a problem that to-day is clamouring for solution. The chapter is a first essay at the subject and contains tentative views as well as settled opinions.

In this country of ours, in the last half century, have grown up new and great public utility undertakings, some of which in a short generation have taken on stupendous proportions. Their nature is neither wholly public nor wholly private, but partakes in differing ratio of both, and is best described as quasi-public.

Ownership or Regulation

It is admitted that one of two things must come, viz., either these public utilities must be owned by the public, or they must be regulated by law.

Public ownership, it is objected, may be all right under comparatively pure civic conditions, as in Switzerland or in Glasgow, but public ownership is not safe where there is graft. Of taxation it can be asserted that it is likely to be safe and sane, graft or no graft.

Thus a conservative public hesitates to accept public ownership as the right way out, for a country so young and expanding as ours, until a higher standard of civic virtue and administrative capacity is attained, prefer-
ring to endure the ills of monopoly rather than hazard what seems a gigantic experiment. Yet, considering the great advance already made by the city and state of New York* in the regulation of public utilities, it is difficult to believe that the people will not hold fast to what they have now obtained.

For one I do not incline to ownership, though I do not pretend to be wise enough to reach a sure decision. Fortunately, it does not appear to me immediately necessary to make such choice. There is one good way easily open for its determination, viz., the comparative test of time. That the employment of taxation, as one instrument ready-made and close at hand, is wise, I have not a doubt.

The astonishing thing is that economists, legislators, and newspapers, in their opposition to ownership of certain monopolies, do not more prominently suggest and discuss, even if they are not ready to advocate, the compromise alternative to ownership. How else can the opposition to public ownership head off its coming better than by advocating taxation in its stead, and why not be as persistent in experiments of taxation as of ownership, thus contributing to the only possible solution — experimental test and demonstration — the survival of the fittest? The true system when found will be the one that bears the supreme test of furnishing a maximum service at a minimum cost.

Legislature or Commission

If, in the course of events, it should appear that public regulation is preferred to public ownership, and there-

*See Reports of Public Service Commission, First and Second Districts, for the six months ending December 31, 1907.
fore should have the right of way, so to speak, in public consideration, then the next question is:

Shall it be regulation by Legislature or regulation by Commission?

The Legislature

Considerable effort has been recently directed, notably in the mooted question of the New Haven and Boston & Maine merger, along the line of regulation by legislation, but it must be admitted that at best legislative regulation, being uninformed and uninspired, cannot be otherwise than arbitrary, unaccommodating, undiscriminating.

Perhaps no better preparation can be made for treating the problem than to endeavour to define to ourselves as clearly as possible the nature of the task proposed.

What are some of the matters for which regulation, wisely or unwisely, is invoked? First and indispensable are public audit and public inspection; the questions of the capitalisation of franchises, and the capitalisation of earnings, which may or may not be made subject to a general law: then follow the problems of mergers, absorptions, extensions, connections, common use of tracks, and pooling; the question of rates and rebates, standard of equipment, strikes and wages; exploitation of every kind, including the pocketing or sequestration of valuable franchises or patents; the vicious insurance plan of control of stock to secure control of salaries; the just attribution of dividends to capital and profits to skill; valuation of property; valuation of franchises; and lastly, like the speed governor on the engine, taxation of the franchise.

To frame a creditable statute to cover all these par-
ticular features would be an all engrossing occupation for legislators. To make a specific law for each class and case would seem to be an impossible undertaking. The Legislature of Massachusetts, which ranks high in intelligence, alertness, and honesty, is to-day struggling with the New Haven and Boston & Maine merger, and I venture to say that not a single legislator feels himself competent to the the task. If all similar questions required the action of the legislature, what would become of the docket and the time of legislators?

The Commission

The already established trend toward regulation by national or state commission, to which it is proposed that the exercise of regulative governmental power shall be delegated, brings us to a consideration somewhat in detail of the reasons for, and the possibilities of, the commission idea as applied to the regulation, under statute, of special franchises or public utilities, either by rate making, by taxation, or by any other means whatsoever.

Mr. Henry Clews voices a pregnant truth when he says that a large part of the gross evils in trusts and syndicates and public service corporations are traceable to the fact that "legislatures have not kept pace with national progress." Similarly, President Woodrow Wilson of Princeton University, says:

The corporation lawyers of this country know what is going on; the legislators do not. I want to say to all corporation lawyers, "if you would save the corporation, you will come out from cover and tell the legislators what is needed. You know what is needed; they don't. By telling them you will save the corporation. If you don't you will have the mob at its doors in a decade."
In these public service corporations the public is a recognised partner, holding, through the franchise, perhaps a minor interest, possibly a major interest. The private interest in these partnerships is administered by men skilful, alert, of life-long experience, masters of their art. Of the public's interest, which has too long or too often been that of a silent partner, the Legislature is the constitutional representative. But legislative bodies, by reason of the method of their selection, their short terms, and by their limited and varied experience, are disqualified to cope directly with the specialised ability and experience of the private administration. Consequently the question has already arisen and is being answered, viz., why should not the interest of the people, the State, in the co-partnership, be represented by the ablest men whom the President, or the Governor, can secure at adequate salaries, constituting permanent commissions — men who shall learn to know what is needed without asking corporation lawyers, who shall become as competent in their distinct sphere of regulation, including the field of taxation, as are the Hills, Harri-mans, Mellens, and Tuttles in what should be their own sole province of railway administration — commissions whose duty shall be to ascertain the facts, to frame the argument for the people's side — to defend the rights of the public against aggression, now inseparable from the situation, and to render a decision which shall stand as the verdict of the people's representatives. Not until some such harmonising agency is employed can it be possible for these great corporations and the people to get their respective rights without wrong to the one or the other.
The great lack to-day is not so much in the general wisdom and honest intention of the people or their representatives as it is a lack of understanding of certain general principles of simple application; the longer this understanding is deferred the harder the problem becomes.

The President of Princeton says also:

We have, in fact, turned from legal regulation to executive regulation. We have turned from law to personal power.

But what we are here considering is legal regulation, executive regulation under law. What is needed is a Legislature to make wise general regulative laws, courts to interpret them, and a competent executive agency to administer them.

Regulation by Rates, or by Taxation, or by Both

Granting the probable establishment of the commission method, the endeavour of this chapter is to bring to the front, in the railroad and other public utility problems, the factor of taxation: not taxation for revenue; not taxation of future franchises or their capitalised earnings; but taxation of franchises already granted and exploited and capitalised, together with earnings already capitalised—taxation of present franchise earnings to bring them into the public treasury, instead of leaving them in private hands; not the taxation of the earnings of industry, but the appropriation by taxation of the dividends that are earned by the public; to the end that the profit of "operation" shall go to skill and enterprise, and the profits of the franchise shall go to the people.

If there is one problem, National and state, that
to-day towers above all the rest, it is the problem of railway regulation. The avowed aim of what is known as the New York Ford Amendment is to facilitate the raising of revenue. It contains no suggestion of possible extension to include the far higher and more difficult function of regulation. There are those who believe that the vexatious perplexities of this, as of all other public franchise problems, will prove more amenable to the correcting tendencies of taxation than to any other agency. Legislative regulation is, at best, clumsy and intermittent, often amounting to a weak confession that hostility of interests cannot be converted into harmony. Taxation is neither of these, but is elastic, self-adjustable, and self-operative. The best hope of any graft extermination must reside in taxation — the taxation of special privilege. Would any one maintain that change for the worse is possible in American graft of to-day? Is the public graft of a corporate city worse than the private graft of all its constituent citizens? Are not the people the victims in either case, and cannot graft be resisted more concretely and thus more effectively by the arm of a strong individual executive than by the slower instrumentalities of public administration?

It will be profitable, in approaching the problem, to analyse in our own minds what is meant by the phrases public utilities, quasi-public corporations, semi-public functions. We mean, do we not, that a part is public business and a part is private business; that one part of their capital is public, another part private; that one part of their function is public and one part individual; that one part of their value rests on franchise, the other part on equipment and operation?
REGULATION OF PUBLIC UTILITIES

The sensible question at once suggests itself: If these constituent parts can be separated, why not treat them separately? Why, in order to control the public agency, is it necessary to assume control over the private agency? Why not, through taxation, assume gradually the public's right to the franchise, and let improvement and operation remain in private hands? Or, if we are not quite sure that it is wise to take over both, why not take the franchise first, and observe the effect? And even if we are persuaded that it is wise to take both, why not take them over in the natural order, one at a time — the franchise first? How better can the municipality learn to "run" its own utilities than by first learning to regulate them?

The all important preparatory step must be to separate as distinctly as possible regulative functions from administrative functions, so that the commission may not meddle with administration further than to set such limits, not fixed by statute, as bound the public's right.

The following tentative classification is offered:

REGULATIVE

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<th>Audit</th>
<th>Rebates</th>
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<td>Capitalisation of earnings</td>
<td>Standard of equipment</td>
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<tr>
<td>Capitalisation of franchises</td>
<td>Stock control of salaries</td>
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<td>Exploitation of every kind</td>
<td>Stock watering</td>
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<td>Inspection</td>
<td>Taxation of the franchise</td>
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<tr>
<td>Reduction of earnings</td>
<td>Valuation of franchises</td>
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<tr>
<td>Rate of taxation</td>
<td>Valuation of property</td>
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ADMINISTRATIVE

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<tr>
<th>Absorptions</th>
<th>Pooling</th>
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<tr>
<td>Common use of tracks</td>
<td>Rate Making</td>
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<td>Connections</td>
<td>Strikes</td>
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<td>Extensions</td>
<td>Wages</td>
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<td>Mergers</td>
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Most of the things set down under the head of "Regulative" clearly belong there. The regulative reduction of earnings would involve a reduction of rates in general, but the original making of specific rates would seem to fall inevitably within the province of administration, while questions of absorption, common use of tracks, connections, extensions, mergers, pooling, strikes, and wages would naturally range themselves under the same head; and so, too, it is respectfully submitted, the most effective, definite, and delicate (because flexible) regulation possible is through the agency of a franchise tax, which can be made to extract annually from the corporation that part of its profits directly contributed by the public, leaving all its improvements—in other words, its plant, the capital devoted to its industry—free of taxation.

The natural operation of such a system would be to leave to the corporation only such profits as are due to capital and industry actually involved, and thus to reduce capital stock to a fair market value, tending to reduce present overcapitalisation, as is now being effected in the City of New York.

The trend of such taxation would be to destroy the motive for exploitation, by appropriating, through taxation, the public's share of the profits, thus tending to take public utilities out of politics. Taxation would thus be, as it were, the vital nexus between public and private interest, extracting annually a profit already accrued to the franchise alone, and operating like a board of equalisation between the corporation and the state. When this point is reached, regulation and administration will no more think of exploiting each other than would individual partners in a
business firm. Clearly, the advantage, if it be an advantage, temporary or permanent, of regulation over public ownership, is the relief of the public from the details and responsibilities of administration.

The State of New York has a Public Utilities Commission already installed by way of example, and has paved the way with an enabling statute to aid in the process of valuation for purposes of taxation of those public assets to which the public may rightfully lay claim.

The Ford Law for the Taxation of Special Franchises, now in operation in the State of New York, was enacted in 1899. It was amended at a special session called by Governor Roosevelt, and, after five or six years' contest, was sustained by the Court of Appeals of the State of New York, and by the Supreme Court of the United States.

This bill did not "prescribe any specific method of assessment," but simply "added certain items to the prescribed classes of real property, full provision for the assessment and taxation of which was already provided for by other laws in force."*

An essential provision of the original bill was set forth in the following lines: "The terms, 'land,' 'real estate,' and 'real property,' as used in this chapter, include the land itself above and under water, all buildings and other articles and structures, sub-structures and superstructures, erected upon, under or above, or affixed to the same; all wharves and piers, including the value of the right to collect wharfage, cranage, or dockage thereon; all bridges, all telegraph lines, wires, poles, and appurtenances upon, above, and under ground; all surface, under ground, and elevated

*"The Ford Bill," Municipal Affairs, June 1899, New York Reform Club,
railroads, all railroad structures, substructures, and superstructures, tracks and the iron thereon; branches, switches, and other fixtures permitted or authorised to be made, laid, or placed in, upon, above, or under any public or private road, street, or ground; all mains, pipes, and tanks laid or placed in, upon, above, or under any public or private street, or place for conducting steam, heat, water, oil, electricity, or any property, substance, or product capable of transportation or conveyance therein or that is protected thereby; all trees and underwood growing upon land, and all mines, minerals, quarries, and fossils in and under the same, except mines belonging to the state."

What is known as the Ford amendment was an addition of seven lines to the above section further elaborating the legal definition of "land" in the following words:

Including the value of all franchises, rights, authority, or permission to construct, maintain, or operate, in, under, above, upon, or through, any streets, highways, or public places; any mains, pipes, tanks, conduits, or wires, with their appurtenances, for conducting water, steam, heat, light, power, gas, oil, or other substance or electricity for telegraphic, telephonic, or other purposes.

These seven lines are a clear and concise restatement of the legal meaning of the term "land" as including the recognised "rights and privileges thereto pertaining." It is this definition for purposes of taxation that is the basis of the few words of argument which I have to offer. It is interesting, because, with the sanction of the highest courts of the state and Nation, it defines a public franchise as "land," a public franchise value as "land value."

It is evident that the public can reap its franchise
benefit either in lower fares or in franchise taxes.
It may be assumed that the gross amount of the
benefit is the same whichever way it is distributed.
If the franchise is taxed, the benefit is distributed
immediately among all the people. If rates are re-
duced, would not the benefit, while going immediately
to the patrons of the road, likewise be ultimately dif-
fused among all the people?

If the above analysis be correct, it follows that
the question of method is one, not of justice, but of
expediency, and it is submitted that, on the ground of
expediency, the taxation method is preferable by
reason of its greater simplicity.

A too frequent change in schedule rates is at
least inconvenient. This disadvantage finds illustration
in the contrasted conditions of 1907 and 1908. By
hard times and greatly reduced business, the railroads
now seek to justify either a reduction of wages or a
paradoxical advance of rates, in place of the reduction
usually resulting from dull business.

It is at this point that taxation offers itself, like the
"ratchet" or the "follower" in the machine, to "take
up the slack" be it more or less from year to year.

Under the system here considered, in which regula-
tion is supplemented by taxation, instead of a legisla-
tive reduction of rates once in every five, ten, or twenty-
five years, in the face of a formidable lobby, there would
be a periodical but not too frequent general readjust-
ment of rates, which presumably must be high enough
to include dividends on capital actually employed;
there would be an annual flexible regulation of the tax
based upon the net earnings of the previous year, in
the light of an honest, expert, and inquisitorial public
inspection and accounting. This tax would appropriate to the public such net earnings (barring a liberal surplus), leaving the industry itself free from tax. Such regulation would seem to promise all the benefits which could be claimed for public ownership without the dangers which would attend that policy. It may be that the management and the commission could be merged into a holding company, which would become, to all intents and purposes, a public commission with all the benefits of actual municipal ownership.

By way of illustration, let it be supposed that a number of railway experts (not exploiters) have formed a company to take over the franchise and operation of a great railway. Although small holders of stock, these men naturally become the salaried officers and managers of the business.

Under what must amount to a municipal guarantee of dividends (out of profits in good years, or out of surplus in bad years), the promise of a low market rate suffices to attract ample funds from the sale of capital stock, and the corporation is established as a going concern.

Let it be further assumed that taxation has been operative, say, for a generation; that it has gradually recovered to the public the value of the franchise by a process so tentative and even cautious as to make "grim financial disaster" impossible. Let it be next assumed that, as a result, the triple concurrent agencies, "private ownership," "public regulation," and "taxation of franchise," are now in mutual and harmonious control of the situation, from which speculation and exploitation will have been eliminated as superfluous.
The problem of government regulation will be to harmonise the three interests of capital, management, and the public; a fair profit to capital; fair rewards for skill and enterprise in management; a fair return to the public for franchise privileges.

Capital: A fair rate of return to capital invested in railways is the market rate of interest upon investments of equal security, as fixed in competitive industries, and this is all that capital (minus speculation) demands.

When the public thus asserts its rights and enforces them, it must, of course, first guarantee dividends to the stockholders, whose property rights would otherwise be imperilled.

Capital does not run the road, and hence it is not entitled to unusual profits due to the risks of an established business. Reduction of rates and taxation of franchise will have squeezed the water from the stock, and actual capital, as determined by the commission valuation, will get its “fair profit” in dividends, and profits will go to skill and enterprise, where they properly belong. The claim that a higher rate of dividend should be paid to capital on account of skill and enterprise in management is a vicious one, arising from the attribution to one factor of what clearly belongs to an entirely distinct one.

Management: The administration of the business of the public service corporation would be, as now, in the hands of agents, superintendents, and managing directors, who would profit by salaries in proportion to their skill and brains, from $1,000 to $50,000, a year. It is these men who run the road now, and it is their concern to deserve profits by so doing. "Traffic men,
as a whole, keen, adroit, and sensitive to every change in the industrial world, would turn to with their magnificent forces and abilities and work with the commission instead of against it." Skill and enterprise, and public exigency, instead of selfishness and greed, would provide the initiative for legitimate extension and development.

The Public: Its concern is to reap from its own business, delegated to private hands, a fair return, whether it be by lower rates or higher taxation. The public utilities commission, composed of men of good judgment and incorruptible honesty, its functions being supervisory rather than managerial, will fix upon a fair capitalisation, and will determine when and what gross reduction in current or accumulated earnings the administration should proceed to effect through the reduction of specific rates. By the municipalisation of the franchise the main motive for "stock watering and corporation wrecking" or for "underpaid or overworked employees or false economies" will be destroyed. Whatever "rebates," "stock watering," and "corporation wrecking" survive the assumption of the franchise by taxation, the commission will prevent under statute. The value of the franchise will be gradually absorbed through reduction of rates, leaving, however, a substantial margin as the best possible index and basis for taxation and regulation. This marginal surplus would serve the purpose of equalising conditions from year to year, bridging over lean financial periods, and thus securing more fully the stability of the fair profits to capital invested.

To sum up, it is my contention that, with railways privately owned, publicly regulated, and taxed approxi-
mately to the value of their franchises, public audit will increasingly protect both public and stockholder; public inspection will keep up the standard of the service; capital will get its interest; managerial skill and enterprise will get its compensation; the public will get its low rates and taxes. It will, therefore, appear, that franchise taxation is proposed not as a sole solution of the railway problem, but as a flexible, practicable, speedy supplement to the necessarily more rigid policy of regulation.

The people should have the benefit of monopoly, and how can this benefit be better secured to the people than by charging the corporation a fair price for what the people do for it, leaving the corporation free to prosecute its private business in its own way?