Part Four

Multinational Corporations, Corrupt Dictators, and U.S. Military Power

by Mason Gaffney

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Tax Subsidies of Beneficiaries

Since income attributable to military subsidies may add to tax returns, the social cost of subsidies *could* be reduced by the recouped taxes. In fact, the subsidy to offshore resource owners is augmented by preferential tax treatment, nowadays realistically called "tax subsidy." Some preferential treatment applies to minerals as such rather than overseas property as such, but I shall take as a standard of reference the treatment given to domestic wage earners, not to domestic oil exploration. This is because so many of the benefits of military spending go to owners of mineral reserves.

In a nutshell, the Treasury shares the costs of overseas investors without sharing in the resulting income. It is a very powerful combination. Some particulars follow.

Expensing intangibles

Most exploration outlays, the "intangible" part, may be written off as current expense. It should of course be capitalized instead and written off very, very slowly as the value of the as-yet-unextracted residual deposit declines. No write-off at all should be allowed until production begins. On the contrary, the reserve usually appreciates and an ideal income tax would take a share of this increment. The first few years of production reduce value little or none, and write off should be equally slow.

Expensing of capital outlays is in fact full exemption from income tax, even without other privileges. The Treasury puts up of the capital, where *t* is the tax rate. Any tax revenue it gets later is just a return on this investment of other taxpayers' money. Since cartels tend to explore to preempt long before use, the

Treasury has a long wait and a low rate of return. The cartel benefits from the preemption which taxpayers thus help finance. [xviii]

Exemption of accrual

Minerals appreciate between discovery and use. Offshore, where tenures are turbulent and cartels preempt, the period is long and appreciation great. This accrual of value is never taxed, not even after it has occurred and been realized in cash, although tax neutrality would call for taxation of current accruals much earlier, as they occurred. Some say that taxation of production income is sufficient, and taxation of prior accruals would be double taxation. They are wrong.

Let V_0 be the value of a mineral deposit in place in year zero, the date production begins. The cash flow imputable to the deposit must cover recovery of V_0 plus interest on the unrecovered value over life—say, 30 years. Only the interest element is taxable income. V_0 is fully deductible at the least. (In practice, much more is deducted under percentage depletion based on wellhead value and posted price.) [xix]

Tax-depletion of V recognizes it as an asset of value that the owner possesses in year zero. How could the owner have acquired wealth of V_0 without receiving any income? He couldn't. Accrual from discovery value up to V_0 is a separate income, above and beyond the interest on V_0 received later.

On domestic minerals the local property tax, where applied, is a means to tax accruals during the ripening years. Value tends to rise along a compound interest curve. That means current accrual is a percentage of value already accrued. The *ad valorem* property tax is also a percentage of accrued value, and hence of income currently accruing.

In practice in the United States, ripening minerals are the most underassessed form of property, which is quite a distinction considering the notorious underassessment of other forms of property. Still, they do pay something and are vulnerable to paying many times more. Under salt water, on the other hand, they pay none whatever. Nor are there property taxes of any account in most of our client nations. That is one of the rewards for being a cacique.

Percentage depletion

As to Federal income taxes, accrual is exempt because it is not treated as income, but V_0 is deductible as "depletion." Only in practice, one deducts more by taking percentage depletion, which is not limited to V_0. First, percentage depletion is based on wellhead value, which includes lifting costs (also separately deductible). Second, it is a fixed percentage of wellhead value so long as the well shall yield. Third, it is often based on "posted" prices, in excess of market value. It can hardly fail to exceed V_0.

Unrepatriated income

A foreign-chartered corporation, even though fully owned by U.S. nationals or corporations, is not taxable by the United States on income from sources outside the United States. Thus U.S. corporations set up foreign subsidiaries to receive income from foreign holdings. The income is not taxable until and unless repatriated (Krause and Dam 1964, 6-9). Since taxes deferred are taxes partially denied, this deferral is of great value at the least. It is an interest-free loan.

And some income need never be repatriated. Thus a foreign subsidiary might reinvest undistributed profits for 25 years as the permanent capital of a foreign operation. Then it may pay dividends earned by capital thus accumulated.
The dividends would be taxed, but they would be income earned by the undistributed profits. The latter themselves would never be taxed. All the capital value of foreign subsidiaries above the cumulated value of capital exported from the United States represents prior income that has not been taxed.

There are also ways to repatriate funds advantageously. One is a distribution in complete liquidation, taxable at reduced capital-gains rates (Krause and Dam 1964, 21). Another is a dividend disguised as an upstream long-term loan, tax-free (Krause and Dam 1964, 20). Use of foreign subsidiaries is less common in oil than manufacturing (Richman 1963, 116). The branch form lets them use the U.S. percentage depletion allowance to better advantage (Krause and Dam 1964, 13). A consolidated income statement lets them expense foreign intangible capital investments in exploration and development against current domestic income (Richman 1963, 52).

Under section 931 of the code, investors in U.S. possessions and Puerto Rico enjoy the same benefits as foreign corporations (Janke 1960, 51). The resulting flow of capital to Puerto Rico is large. The Virgin Islands are another beneficiary. A key refinery there adds to the insular empire of Jersey.

Foreign tax credit

U.S. corporations owning foreign branches or subsidiaries may deduct foreign taxes, not from their taxable income, but from their tax. [xx] This "Foreign Tax Credit" dates from 1918 (the year Dinsmore Ely "invested" his life for his country). Until 1954, the credit was limited to the U.S. tax due from the taxing country; since then all foreign source income may be aggregated, and the only limit is the total U.S. tax liability.

This privilege is reserved to those owning 10% or more of the stock in the foreign corporation. (Before 1951 it was 5%.) Small shareholders pay on the regular basis.

Foreign hosts have responded to this opportunity by renaming their royalty payments as "taxes," eliminating any burden on the royalty payer. In 1949, Aramco paid $48 million in U.S. income taxes. In 1950, King Ibn Saud keyed in with the U.S. law. "Taxes" on oil companies (Aramco being the only one) replaced "royalties." In 1950, Aramco's U.S. taxes were $200,000 (a decline of more than 99%). In 1955, Aramco grossed $724 millions, paid $272 millions to Saud, netted $272 millions itself, and paid no U.S. tax at all (Engler 1961, 223-24, citing U.S. FTC 1952, 128). Today there is great concern over increased demands on U.S.-based mineral holders abroad. But the added burden falls on the general U.S. taxpayer. The companies simply reduce their other taxes by the amount of the increase abroad.

An added wrinkle is the "Tax Sparing" treaty. Under this agreement, by treaty, a foreign host may lower taxes on a U.S. corporation, but the U.S. Treasury will let the corporation deduct the unpaid or "spared" foreign taxes from its U.S. tax (Richman 1963, 55; Mikesell 1957, 56). So far no such treaties have been executed, however.

Other special benefits

FOREIGN AID. Foreign taxes are not entirely painless. Most of the large oil firms have reduced their U.S. taxes to near zero, and they could easily find they lacked any more taxes to offset. Besides, a double-bolted door is safer than a single. So U.S. firms benefit from U.S. aid to their host caciques because it reduces the need for (and is implicitly conditional on not) taxing the U.S. firms heavily. Actually, we should view the two together: the Foreign Tax Credit is a form of aid, and aid is a form of tax relief, and both are part of an overall policy calculated to minimize tax burdens on U.S.-based corporations owning resources and enjoying our military umbrella overseas.

DEVALUATION INCREMENT. A large bonus to holders of offshore resources came from dollar devaluation. Since devaluation was accelerated by capital outflow and domestic deficits, and preferential tax treatment of offshore resources raises both, devaluation is a kind of surtax on domestic capital vis-^-vis offshore capital.

SELECTION OF TAX DOMICILE. Corporations subject to multiple tax rates on different stages of vertically integrated operations have become skilled at shifting profits to the stage of lower tax rate by rigging posted prices and other prices used for internal accounting. Multinationals have added options among the various countries they inhabit, which of course they use to lower their overall tax liability. The usual pattern is one of shifting profits to the extractive or shipping stage. In international affairs, that means shifting them overseas.

WESTERN HEMISPHERE PREFERENCE. “Western Hemisphere Trade Corporations” pay a reduced rate of 34% on profit (Krause and Dam 1964, 7-8; Richman 1963, 53-4). This is obviously a way of encouraging corporations to “invest” in Latin America, which the U.S. has considered in its sphere of influence since the Monroe Doctrine was promulgated.

Many preferences overlap, and are alternative rather than additive. No doubt there are others not listed. DISC treatment, recently enacted, could develop into a new preference luring capital offshore. The important thing is the availability of many options and lines of defense for overseas investors avoiding taxation.

The Interest Equalization Tax of 1963 appears to be an exception. This tax applies a higher rate to foreign source income. However, it applies only to portfolio investments, not equities. It is the equities that gain primarily from military spending. For them, tax preference is the rule. Portfolios are the small man’s foreign investment. Interest equalization used them to take the heat off the larger investor; the latter could continue to buy abroad in anticipation of dollar devaluation.

Enactment and acceptance of these preferences have moved under high phrases like Postwar Recovery, Reconstruction, Economics of Freedom, promoting Free Trade, Economic Development, Take-off, and sharing with the world’s poor. We have shared, but not with the poor. We have arrived at total failure to recoup from the major beneficiaries of military spending.

Domestic Beneficiaries:
Military Contractors and Others

Not all of the benefits of military action overseas go to the companies that gain control of resources overseas.
There is another class of beneficiaries within the domestic economy: the companies that supply the

military with equipment.

It was once said that what is good for General Motors is good for the country. The same would presumably apply to General Dynamics and other military contractors. According to that story, we all benefit from defense contracts because they boost aggregate demand. If the idea ever fit the facts, it does not now. Defense spending comes either from taxes, reducing other spending on consumption or investment; from new borrowing, reducing other investment; or from new money, which is either another form of debt instrument or, more likely, raises prices. In the world of inflation with-unemployment, all the old knee-jerks must go. Military spending does not increase aggregate spending much; and there is no longer any gain from increasing spending, as such, anyway.

Benefits to contractors are partial. They are taken from others. Particular firms and regions gain; others lose. The gainers are vocal and organized into weapons constituencies. The care and feeding of Lockheed shareholders and employees has become an end in itself, as much as a means to defend the nation. AID has become part of the farm price support program designed to make U.S. consumers pay more for cotton, wheat, rice and milk. Ernest Fitzgerald, the Pentagon cost analyst who revealed the C-5A cargo aircraft cost overrun, becomes a pariah and is fired. Mendel Rivers' indifferent district around Charleston becomes a major arsenal of the nation. Scores of generals retire into the waiting arms of contractors they have been dealing with. Caciques grow wealthy overnight, Saigon being more typical than exceptional. Senator Allen Ellender of the Appropriations Committee sees that Food for Peace money is used to buy unwanted, overpriced U.S. rice for export to Southeast Asia, which remains a rice surplus area in spite of the war (*Newsweek* 1970).

If in this there is a net benefit to the nation, it must be that those who gain are more meritorious than those who lose. The most evident distinction between military contractors and other businesses is that the former are larger. Influence goes with size. In addition, government purchasing agents ease their workload by buying from a few huge suppliers rather than from many small ones.

Public business is not very public, so various estimates of concentration vary, but all are impressive. The Joint Economic Committee said five firms got 25% of military prime contracts in 1964 (Magdoff, 192, citing JEC 1964, 11). William Baldwin said the top 50 got 66% (Philips 1969, 179). For 1969, Kaufman (1970, 41) presents a lower figure, 68% to the top 100. I do not know if this reflects a drop in concentration or a difference of sources and definitions. The point here is that all sources indicate extreme concentration.

There were instances during World War II of the use of war contracts to foster competition, as in aluminum. Those days are gone. And the power is overriding: procurement policy is legally superior to antitrust policy (Kefauver 1965, 230-31, citing Gray 1963, 149).

The choicer plums are more concentrated. R&D contracts, where the contractor may keep patent rights as a fringe benefit, went 80% to the top 100 in 1959 (Kefauver 1965, 229, citing testimony of Dr. Richard J. Barber, JEC 1962, 861).

In addition, regions of heavy dependence on defense contracts and military bases are above average in concentration. In the United States, Hawaii tops both lists: it is most dependent of all states on military spending, and its ownership of land and business is the most concentrated of any state. Southern California ranks high in both departments, too. But nothing matches the dependence of overseas oil on military procurement. We have seen that offshore DOD oil procurement runs around 4% of domestic use. Imports run 12.5% of domestic use. Thus the military adds very roughly a third to U.S. demand for overseas oil—and who knows how much more if we had data on jet fuel used in contract troop ferrying, etc.? And nothing matches the concentration of the benefits in the hands of the richest people in the world.

Another distinction of military contractors is their non-competitive nature. They operate on cost-plus. They indulge a gold-plated Cadillac syndrome among procurers, so a new aircraft carrier costs $1 billion, and the P-15 Air Force fighters, now in development, will cost $10 million each, or 100 times more than the P-47 of World War II (*BW* 1972). Service bureaucrats do not spend as though they were concerned about national security: they buy one weapon for the price of five, or fifty. Pentagon procurers give advance commitments to production of new weapons without having competitive prototypes. Overhead on idle capacity is passed along in costs (*BW* 1972). Control is weak and costs escalate wildly. Congressmen and Presidential candidates use their clout to prevent closings of unneeded bases. Retiring procurement officers move into high positions with contractors. A 1969 check found 2,122 "former top military men working in industry" for the 100 largest defense contractors (*BW* 1971h).

An ominous aspect of military spending is its use to suppress critics and reward the faithful. Congressman Edward Hebert of Louisiana, Chairman of the House Armed Services Committee, "has launched a battle to keep the military services from sending officers to study at universities that have barred ROTC." "Harvard," Hebert says, "is the No. 1 target• . They fight the military more than anyone else." A Committee report says, "It is morally wrong for the military to spend dollars sending students to a particular university which has chosen not to cooperate with the military services" (*Washington Post*, 19 February 1972). "Citing possible loss of $16 million in NASA and Defense Department-research funds, Stanford University President Richard W. Lyman yesterday (3/8/72) rejected the 8-to-1 recommendation of a student-faculty committee to bar military recruiters from the campus placement center" (Washington Post, 9 March 1972).

Several universities with contracts to advise abroad have done little to dispel a hypothesis that they are used by the CIA, and that this influence may reach back into academic programs and personnel decisions.

It would appear, then, that the net effect of military contracting is to concentrate wealth and power, and destroy the free market system. Military contracting has proved to be cor
rupting, wasteful, inefficient, antidemocratic and anti-competitive. This is incongruous with the alleged goal of promoting a free world.

[xviii] Editor's note: An example may help. Let us suppose Exxon sends a team of geologists to Rondonia to explore for oil. After $5 million in exploration costs that are not directly attributable to equipment (thus making them "intangible"), they estimate they have found oil with a net value of $100 million (after drilling expenses) in today's market. They will not drill for twenty years, however. The tax laws allow Exxon to subtract that $5 million from current income, thus reducing their tax liability by "t" (the marginal tax rate) times $5 million. If the marginal tax rate is 30%, that means Exxon has received a de facto "grant" of $1.5 million from the government. If Exxon can receive a 10% rate of return on that $1.5 million for 20 years (when the oil is actually extracted), the value of this year's tax gift will grow to approximately $10 million (or 1.5 times 1.10 to the 20th power).

[xix] Editor's note: It is now 20 years after the exploration and discovery in the previous footnote. The $100 million value has now grown to $300 million. (If its value in the ground had not grown faster than the real rate of interest, it would have been in Exxon's interest to extract the oil, sell it and reinvest elsewhere.) So V_0 is $300 million. Even as 3.3% of the deposit is extracted the first year, the remaining oil increases in value. So the sale price must be higher than $300 million divided by 30 years or $10 million per year. It must also incorporate the interest that could have been collected by pumping the oil, selling it, and putting the money in the bank. The base value of $10 million per year is not taxable because it is regarded as a reduction in Exxon's asset value. Thus, only the imputed interest on the remaining oil is taxable. Gaffney's point is that the growth of value from $100 million at discovery to $300 million when extraction begins is also income that should be taxed, but it isn't. He further explains that the property tax is an ideal way to tax that growth of value as it occurs, but most LDCs have low property tax rates or none at all.

[xx] It is a little better yet. The income taxable by the U.S. is figured after the foreign tax, while the foreign tax is based on income before tax and is then allowed as a credit against this smaller U.S. liability. Sounds bewildering, but bewilderment is a vital technique of privilege.