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Towards a North American Cabotage Regime: A Canadian Perspective

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Abstract

Throughout the 1970s and 1980s, Canada studied the impact of its cabotage legislation thoroughly and opted to provide protection of the domestic shipping market with new legislation in 1992. This paper traces the decision-making process through this period, and the concurrent discussions within NAFTA under negotiations for liberalization of trade in services. Now that Canada has 13 years experience with the existing cabotage legislation, and has adopted a policy to promote the development of short sea shipping, this paper evaluates Canada's shipping policy options in order to identify if changes are required given the new policy environment.

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1.0 Introduction

Throughout its history, Canada has had a mixed track record in the field of maritime transport. While there have been brief periods when Canada has ranked among the leaders in maritime trade, for the most part the country has found it difficult to compete in the international shipping market. In the absence of any substantive Canadian policy initiatives to respond to these circumstances, the result has effectively been the demise of the Canadian flag deep-sea fleet (Brooks and Hodgson, 2005) in spite of efforts, in 1992, to counter the loss of shipping expertise through the establishment of International Shipping Corporations. Given its decision not to stem the decline of its deep-sea fleet after World War II, Canada's maritime efforts have been focused almost exclusively on nurturing a domestic marine transportation capacity, with a key plank in the policy being maritime cabotage.[1] It has been the traditional choice of many nations to provide some degree of economic protection for their respective cabotage trades, and Canada has been no exception.

From before Confederation in 1867, Canada has had some form of protection to reserve this domestic activity, first to British Commonwealth and more recently to Canadian-flag ships. This protection has taken two principal forms: access control based on registration and payment of duty depending on country of build. In Canada, only ships that are Canadian registered, and on which all applicable duties have been paid, have unrestricted access to engage in coasting trade activities. These restrictions were of little import in the days prior to the 1950s when national jurisdiction extended only three miles, the Great Lakes were essentially isolated, Newfoundland was not part of Canada, there was little shipping activity in the Arctic, and offshore exploration and exploitation had not been contemplated. The contraction in importance of the Commonwealth, the emergence of the OECD as an important international economic policy forum, and the extension of sovereign rights to the outer edge of the continental shelf, all served to focus attention on the expanded range and geographic scope of marine transportation and other related activities in waters under Canadian jurisdiction, prompting a series of reviews over a period of 20 years, leading to new legislation finally in 1992.

Since then, there has been substantial relaxation in maritime cabotage restrictions in the European Union, as well as review and adjustment of cabotage policies in a number of other countries, raising questions as to what constitutes Canada's best interests in the manner in which coasting trade activities should be managed today. This paper examines how Canada's domestic shipping policy choices have evolved. It endeavours to evaluate the rationale behind these policy choices and, in the light of recent policy initiatives taken by its OECD colleague States particularly in Europe, to draw conclusions as to whether these choices continue to be appropriate. In setting the stage for this evaluation, the study first takes stock of the current economic health of Canadian domestic shipping and related activities. It also examines the US cabotage regime and its impact on future Canadian policy. The re-examination of cabotage is clearly pertinent in light of the current evaluation of the potential for short sea shipping on the

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[1] In its simplest form, cabotage is defined as the movement of goods or passengers between two ports or places within the same nation. It is called coasting trade in Canada.

continent. The paper draws conclusions about the ability of short sea shipping to prosper without cabotage policy changes. It then reflects upon the potential for a NAFTA cabotage regime.

2.0 Overview of Canadian Domestic Shipping

Canada's coasting trade legislation excludes both international deep-sea and cross-border movements. It is important to note, however, that in certain specific areas such as the Great Lakes, economic conditions are such that ships used for cabotage movements may also be engaged in Canada/US import and export trade. Indeed, it would appear that domestic coasting trade accounts for less than one-half of activities of members of the Canadian Shipowners Association (CSA, a voluntary industry association), the annual reports of the CSA include statistics for both domestic and international operations and reports on them as one (Table 1). The number of ships owned by members has been declining steadily and the current number of ships is 28 percent less than it was in 1995.

Table 1

CSA Fleet, 10-Year Profile

	1995		2004	
	Ships	**GRT**	**Ships**	**GRT**
Total	**101**	**1,428, 935**	**73**	**1,154,023**
Bulkers	38	645,153	20	351,225
Self-Unloaders	30	610,011	32	651,628
Tankers	17	97,681	15	93,912
Other	11	76,090	6	57, 258

Source: Canadian Shipowners Association (2005: 15).

According to the Canadian Transportation Agency (2006), there are no Canadian registered ships operating in exclusively non-cabotage trades. The conditions imposed on Canadian flag vessels are sufficiently onerous that they are simply not competitive against foreign flag vessels. It should be noted that some of the largest CSA companies have offshore subsidiaries and operate foreign flag vessels globally through these subsidiaries. Canadian owners in international shipping activities prefer to choose a foreign flag, with 57.6 percent of the Canadian-owned fleet registered under foreign registry; the US percentage is even higher at 77.8% (UNCTAD, 2005: 33). The Canadian register constitutes 0.3 percent of the world deadweight tonnage as of December 31, 2004, while the US flag fleet is a key global player with 5.3% of the world fleet; the Canadian-registered fleet is only 6.5% the size of the US-registered fleet, while the Mexican fleet is smaller still at 2.8% the size of the US fleet (UNCTAD, 2005: Annex IIIb).

The Canadian registered fleet, therefore, exists primarily to service domestic shipping and is comprised of a smaller number of vessels than might be expected from the global statistics (Table 2). Canada's coasting trade is quite diverse, with four principal regions of activity,

namely the East and West Coasts, the Arctic, and the Great Lakes/St. Lawrence River system, and each region has quite a different profile of activity. **East Coast** domestic shipping activity consists of important container movements (both domestic and feeder shipments), domestic movements of refined petroleum products and coal, ferry services, and a significant level of offshore support and community re-supply. **West Coast** services are provided predominantly by quite specialized tug/barge operations; cargoes are dominated by forest products, but also include aggregates, cement, chemicals and petroleum products. The West Coast is also home to a large fleet of passenger ferries and the coast is also a popular venue for large cruise ships, virtually all of which are foreign flag and generally operate without invoking Canada's coasting trade regime. In the **Arctic**, the principal activities generating shipping activity include community re-supply, oil and gas exploration, exploitation of various mineral and oil deposits in the High Arctic, and grain movements out of Churchill. The seasonal nature of shipping in the Arctic presents particularly challenging problems for ship operators, since there is insufficient domestic business elsewhere to keep a specialized (ice-capable) ship economically operating year round. However, once duty is paid, the ship is severely impeded from competing for business internationally.

An understanding of shipping patterns in **The Great Lakes/St. Lawrence River** region is rendered more complex by the significant level of international shipping activity, involving both cross lake movements and international voyages into and out of the Lakes. There is, of course, unrestricted foreign flag access to international movements in this sector. As already noted, the Canadian Great Lakes cabotage fleets are also regularly used on Canada/US cross-lake movements of cargoes such as coal, iron ore, cement, and limestone. In some respects, Great Lakes shipping is quite technologically advanced, illustrated by the innovative concept of the self-unloader. In other respects, it is technologically backward with a rapidly aging fleet in significant need of replacement. The problems generated by a slow but steady contraction in demand over the last two decades on the Great Lakes has been exacerbated by the introduction of Coast Guard charges and the continuing high cost of other service support charges (Seaway, pilotage, etc.).

The Canadian fleet has fallen on hard times; it is old and requires substantial investment. In 2000, there were nine members in the CSA; by 2006, there were seven. Three companies dominate the fleet—Seaway Marine Transport, The CSL Group Inc. and Groupe Desgagnés Inc. In recent years, there is a new type of member. To illustrate, Rigel Shipping Canada Inc. was added as a member of the CSA in 2002; it is a Canadian domiciled and registered ship chartering and operating company, a subsidiary of Rigel Schiffahrts GmbH of Bremen, Germany, specifically established to provide high quality petroleum and chemical tanker shipping services to the Canadian petroleum and petrochemical industries. Rigel provides an excellent example of the transformation of a foreign owner to "Canadian" for the purposes of participating in the coasting trade (a strategy we will return to later).

Table 2

The Canadian Registered Fleet, 2006

Self-Propelled Ships of 1,000 Gross Tons and Over	Number	Gross Tons
Ferry Passenger	21	74,901
Tugs/Offshore Supply	55	126,906
Tankers	460	3,865,147
Barges	23	52,983
Cargo Vessels	84	1,227,252
Research and Survey	1	3,545
Dredges	7	12,359

Source: Canadian Transportation Agency (2006). Canadian Vessel Information System, http://www.cta-otc.gc.ca/marine/index_e.html, accessed 3 May 2006.

In sum, the precarious economic circumstances faced by the domestic shipping industry, including the offshore oil and gas sector, have changed little since the Canadian Shipowners Association (2000: 6) made this observation:

> *Canada's domestic marine industry faces severe challenges. Unless a marine policy environment which supports industry growth, reinvestment and innovation is developed and implemented, the industry will cease to be a competitive option for shippers.*

The industry has survived on finding market niches and exploiting them. As will be seen, there is little incentive to change existing ways of doing business, and the protected market is both a blessing and a barrier to change. The next section details how Canada's marine cabotage policy got to where it is today.

3.0 The Evolution of Canada's Coasting Trade Policy

The origins of Canada's coasting trade policy may ultimately be traced back to the *Treaty of Paris, 1763*, which provided Britain with virtually undisputed control of maritime commerce. While restrictions on coasting trade within the United Kingdom were lifted in 1854, similar restrictions remained in place in most British colonies, including Canada (Government of Canada, 1957: 7). The *British North America Act*, passed in 1867, provided the Parliament of Canada with authority over navigation and shipping, but any Canadian legislation could not be inconsistent with UK law. This did not change until the *Canada Shipping Act* was enacted in 1934 and came into force in 1936. This new legislation meant that, for the first time, shipping law was fully under Canadian jurisdiction. However, the *1931 Merchant Shipping Agreement* continued the provisions favouring British shipping and requiring non-British ships to pay duty in order to gain access to the coasting trade.

The fast approaching opening of the St. Lawrence Seaway in 1959 led to the establishment, on 1 March 1955, of a Royal Commission (called the Spence Commission, Government of Canada, 1957) charged with examining the relationship of the coasting trade to shipping and shipbuilding, and to domestic and international trade, with a particular focus on the probable effects of the opening of the Seaway. The Spence Commission was also charged with examining the need to adjust relevant policies or to prescribe particular conditions.

3.1 The Report of the Spence Commission

The report of the Spence Commission examined the merits of restricting the coasting trade to vessels registered in Canada. The main argument for restriction of registry was to the effect that Canadian registered ships best served the public interest, but faced elimination by lower cost UK registered ships (Government of Canada, 1957: 109). After extensive analysis, the report concluded that "restriction of the coasting trade to vessels registered in Canada would be detrimental to the public interest, whether the restriction applied generally or to only a particular part of Canada" (Government of Canada, 1957: 139).

The Commission also examined the merits of lifting the current coasting trade restrictions so as to allow ships of all flags (not just Commonwealth) access to Canada's domestic transportation. It concluded that this would not be desirable since the competition provided by Commonwealth, and in particular UK, ships was sufficient, and foreign flag participation would impair its access to allied shipping services in the event of hostilities.

The remainder of the report was devoted to considering the shipbuilding and repairing industry in Canada. It pointed out that the imposition of a 25% tariff afforded no protection against UK shipbuilding competition, since any ship built in the UK was able to enter duty-free. Thus, the only effect of the duty was to protect UK shipbuilding against its foreign competition!

Ultimately, after a huge analytical undertaking, the Spence Commission recommended no change in the coasting trade regime of the day, based primarily on the conclusion that the main source of alternatives to Canadian ships was the UK, and that unrestricted access to UK shipping was desirable for a number of reasons.

3.2 The MacPherson Royal Commission

Some two years after the completion of the Spence Commission, the MacPherson Royal Commission was established and tasked with examining the full range of Canadian transportation issues. While the stimulus for this Royal Commission stemmed from issues in relation to rail and truck competition, it offered principles that were expected to govern all modes.

The report ultimately led to the *National Transportation Act 1967* (NTA). This Act called for the Canadian transport system to be economic, efficient and adequate, and set out certain key principles to guide the achievement of this goal. These included the promotion of free competition between modes, and the obligation on all modes to bear a "fair proportion" of the costs of services provided to them. Despite significant changes in Canadian transportation generally and marine transportation in particular, the principles enunciated in the NTA continue, with only modest adjustment, to guide transportation policy in Canada today.

While it might be expected that the combination of Spence and MacPherson Commissions would guide cabotage policy in Canada for the next decade at least, the growing stature of the OECD, commencement of operations of the St. Lawrence Seaway, the emergence of containerization, rapid expansion of offshore exploration/exploitation activities and the entry into force of the *UN Convention on the Continental Shelf* led to the initiation of a further inquiry, the 1970 Darling Report.

3.3 The Darling Report

While the Spence Commission (1957) has no subsequent counterpart that matches it for depth and comprehensiveness, Darling (1970) has provided the foundation for domestic shipping policy since. Darling observed that the Spence Commission had taken the position that any action that would restrict competition or raise costs of shipping in Canada would be on balance harmful to the economy.[2] Darling (1970: 3) argued instead that policy for coasting trade should be considered in the same way as for any other Canadian industry.

Darling re-examined the impact of the *British Commonwealth Merchant Shipping Agreement*. The scope of study was constrained to an examination of the nature and degree of the protection to be afforded to Canada's maritime cabotage activities, and was not intended to explore whether there were alternatives to restricted access and imposition of duty that might better achieve Canada's shipping policy objectives. This is important because the merit of the provision of aid to maritime transport services through alternative support mechanisms (rather than in the form of protection through access and duty controls) has not been examined at any time since the earlier Spence Commission.

The foundation of Darling's recommendations was to retain protection as the essential mechanism, and that application of the protection envelope should extend to the edge of the continental shelf. All coasting trade activities should be reserved to Canadian ships, with the definition of 'coasting trade' extended to cover such activities as dredging, salvage, seismographic vessels, supply and support ships, and extending application to the Canadian continental shelf. While he supported the need for a waiver system, he concluded that the issuance of permits should be directed as much as possible and practicable toward replacing foreign vessels with Canadian equivalents.

> *One such means might be to permit Canadian ships to take a foreign registry for either short or extended periods with the right to return to Canadian registry to participate in the coasting trade or other marine activity. This might require us to find our own "Liberia" in the form of a Commonwealth country with which special arrangements could be made.* (Darling, 1970: 222)

Such an approach could, Darling believed, result in a pool of Canadian-built and owned ships (manned with Canadian officers, if practicable) on the high seas, which could then be drawn upon for work in Canadian domestic trades as required. However, he did not address how

[2] Darling (1970: 2). This claim was not actually quite correct since Spence had talked in terms of harmful to the 'public interest.'

such vessels, if built in Canada or duty-paid, and with operations taxed in Canada, might be able to compete effectively in international shipping markets.

3.4 Two Decades of Limited Change

A lengthy period now began in which efforts were directed at implementing the recommendations of the Darling Report, but it would be another 20 years before this was actually achieved! In the meantime, efforts were directed at streamlining the temporary entry process. Efforts to introduce change often emerged as controversial and were withdrawn. In 1979, a major roadblock was removed when all parties to the *British Commonwealth Merchant Shipping Agreement* agreed to withdraw, and the Agreement became defunct. After the release of Transport Canada (1982), the last substantive review of Canada's coasting trade policy, Canada entered a period when the government turned its attention to the development and implementation of transportation deregulation in the country.

Despite the strong deregulatory thrust of *Freedom to Move* (Transport Canada, 1985), it is interesting to note that there is little in the way of analysis of deregulatory options for marine cabotage in this document and the recommendations confirmed the largely protectionist policy already in place.

The outcome of the *Freedom to Move* initiative was a new *National Transportation Act* (NTA) in 1987. Section 3 of the NTA includes the goal to promoting competition "both within and among" modes and also stressed competition and market forces as "the prime agents in providing viable and effective transportation services" but did not differentiate between domestic and international competition. This introduces an important anomaly in the marine mode, since imposition of conditions to achieve a 'level playing field' in competition with other domestic modes precludes the provision of a level playing field in relation to international competition.[3]

3.5 The Coasting Trade Act

Finally in 1992, over 20 years after Darling (1970), the *Coasting Trade Act* came into force. It essentially implemented his recommendations, including removal of the concept of a 'British' ship, thus reserving the coasting trade to Canadian flag, duty paid ships.

With the coming into force of the *Coasting Trade Act*, domestic shipping policy analysis effectively ceased. The marine mode received somewhat limited attention in the review of the Canada Transportation Act in 2001, but the two recommendations made by the Panel were critical to Canada's relationship with the US. The first was to reaffirm the desirability of pursuing a more liberalized approach to domestic shipping with the United States (PWGSC, 2001: 146, Recommendation 8.4), and the second was to stress once more the desirability of removing the import duty on foreign-built ships (PWGSC, 2001: 147, Recommendation 8.5). Despite the excellent opportunity provided in the review terms of reference for the *Canada Marine Act* (*CMA*) Review Panel to make observations on other issues beyond amendments to

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[3] While substantial attention in the 1970s and 1980s was focused on Canada's deep-sea shipping policy (Brooks and Hodgson, 2005), Canada continued to maintain a firewall between domestic and international shipping.

the *CMA*, this Panel (Transport Canada, 2003) chose not to make any such observations on coasting trade policy or accept the opportunity granted to it by the CTA Review Panel report.

In conclusion, with the closure of Canadian maritime cabotage to all but Canadian ships, albeit with a waiver provision, and with the maintenance of a duty payment on (most) imported ships, and a duty-based fee for temporary entry, Canada has essentially reconfirmed the same protectionist philosophy that has existed ever since Canada inherited its coasting trade regime from Britain. This policy direction is significantly at odds with the trends that have occurred in Europe and with its environment where international and domestic shipping are able to support each other through adverse business cycles. We now examine the policy approaches of other major shipping competitors.

4.0 Cabotage Policy Elsewhere

4.1 US Cabotage Policy

US cabotage is protected for US flag vessels under Chapters 24 and 27 of the US *Merchant Marine Act of 1920* (the *Jones Act*). The Act states that cargo may not be transported between two US ports unless it is transported by vessels built and registered in the US, owned by citizens of the US and manned by a US crew. The Act also covers a variety of other maritime issues, including harbour dredging, compensation to seamen, and government loan guarantees to shipbuilders.

Protection of coasting trade is contrary to the overall liberalized trade intentions of the two primary trade agreements that Canada has negotiated with the United States, the *Canada US Trade Agreement* and the *North American Free Trade Agreement*. In both negotiations, the US was not prepared to relax the regime it had in place. The US Maritime Administration defends its protectionist stance with the argument that "cabotage restrictions are more common than many believe" (US MARAD, 2001). While many countries do impose cabotage restrictions, the scope of US restrictions is almost certainly unparalleled.

Since these two agreements were negotiated, there have been one or two glimmers of hope for those interested in the removal or rationalization of cabotage within the NAFTA area. One is the recent interest expressed by the three NAFTA countries in the development of short sea shipping, and the memorandum[4] they signed to collaborate on examining the future potential of this alternative to all-land transportation. Another is the waiver of Jones Act regulations in the wake of Hurricane Katrina for disaster response purposes. However, enthusiasm must be tempered by the clear expression to date on the part of Mexican officials that cabotage rules afford Mexican nationals an opportunity to rebuild their small domestic fleet for short sea purposes, and by US labour that the Jones Act is sacrosanct.

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4 *Memorandum of Cooperation on Sharing Short Sea Shipping Information and Experience between the Transportation Authorities of Canada, Mexico and the United States of America*, signed November 6, 2003.

4.2 Cabotage in Europe

The vision embodied in the Cockfield Report (Commission of the European Communities, 1985: 30) was for a Single European Market in maritime transport services; this required a strategy for the phasing out of restrictions in order to make the European shipping industry internally fair and externally competitive against other flags (Brooks and Button, 1992). While the plan took longer than expected to implement, today any EU flag ship that is eligible to engage in its own coasting trade is able to engage in coasting trade activities in any other EU State. Several States (notably the UK and Norway) have no restrictions on the use of ships of any flag in their cabotage trades. It should be noted, however, that the relaxed restrictions on the registration of vessels engaged in maritime cabotage do not preclude the imposition of requirements in relation to crew and the location of the ownership of the vessel in question.

The current state of maritime cabotage policy in Europe has its origins in the discussions leading up to the promulgation of Council Regulation 4055/86, one of a package of four maritime regulations addressing the freedom to provide international maritime services. While cabotage was an important part of the early negotiations in this package, it was ultimately lifted out of the discussions because of the significant political sensitivity that emerged. This subsequently led to a specific, concerted focus and effort on cabotage policy, which some six years later resulted in Council Regulation 3577/92, and the principal provision in this regulation, Article 1:

> *As from January 1, 1993, freedom to provide maritime transport services within a Member State (maritime cabotage) shall apply to Community shipowners who have their ships registered in, and flying the flag of, a Member State, provided that these ships comply with all conditions for carrying out cabotage in that Member State.*

The regulation provided for a gradual phasing in for sensitive areas (for example, Greek island cabotage), and for safeguard measures should some significant commercial disruption arise.

The process of monitoring implementation resulted in four commission reports, the fourth of which (Commission of the European Communities, 2002) advised that, as of January 1, 1999, the liberalization of cabotage services in Europe was virtually complete. The report observed that the liberalization of services since January 1, 1999, had not resulted in any significant increase in traffic or penetration of national markets by vessels flying foreign flags and that the quality of services had increased.

Of equal importance is the fact that the large majority of European States also offer important fiscal aid, usually in the form of a 'tonnage tax,' which effectively reduces corporate taxation to levels approaching zero, as well as varying degrees of relief from income tax for seafarers. This State aid, formally endorsed as EU-wide policy, has the important effect of reducing or removing any differential in the cost of conducting operations between the domestic and the international sector, thus facilitating the comparatively unrestricted movement of ships from one sector to the other. Such circumstances are in sharp contrast to the substantial 'firewall' between domestic and international sectors that exists in Canada.

4.3 Cabotage In Australia and New Zealand

Australia's coasting trade is governed by *The Navigation Act 1912*. The Act provides, in Section 7, sub-paragraph (1), a definition of coasting trade, which also provides for a number of circumstances where such carriage is not deemed to be coasting trade, including, for example, international cargo on through bills of lading, or passengers on through tickets to/from overseas. The Act also provides for certain trades to be exempt, including trades between the mainland and certain island territories, and also passenger cruise liners operating in coastal passenger trades (other than between Victoria and Tasmania). Ships may engage in the coasting trade by being issued with either a licence or a permit (Government of Australia, 1998). It is important to note that nothing in the Act differentiates an Australian flag ship from any other ship.

A ship qualifies for the issuance of a licence if the seafarers on board are paid in accordance with prevailing Australian rates and conditions, and the ship is not in receipt, nor has it been in receipt, of a subsidy from a foreign government. It should be noted that there is no discretion in this matter if the conditions are met, and thus no barriers to reputable foreign shipowners. Nor are there any duty payments. Unlicensed ships may engage in the coasting trade on being granted either a Single Voyage Permit (SVP) or a Continuous Voyage Permit (CVP) upon payment of a nominal fee.

As this cabotage regime differs considerably from others, the question becomes: Does it work? The Independent Review of Australian Shipping (2003: 2) made the observation that "the coastal shipping industry in Australia is in a confused and confusing situation." The Review concluded that if Australia was to retain a viable shipping industry, it had to undergo significant change.

> *If all sectors are unanimous on a single issue, it is the need for Government to enunciate a clear, certain and consistent policy towards the industry, and for regulatory activities to be carried out in a consistent way.* (Independent Review of Australian Shipping, 2003: 20)

The statement most frequently made by Australian operators was: "we can compete if the playing field is level, but we cannot compete if the field is tilted in favour of foreign operators who have different tax rules and different crew costs (Independent Review of Australian Shipping, 2003: 21)." The Review then pressed for the introduction of a tonnage tax system, similar to that adopted by a number of countries, observing that, where such an initiative had been applied, it had led to a revitalized shipping industry (Independent Review of Australian Shipping, 2003: 34).

Turning to **New Zealand**, the provisions governing maritime cabotage are laid out in Section 198 of the *Maritime Transport Act 1994*. Coastal shipping control is not economically highly significant and its administration is comparatively straightforward. It may be viewed as protected in that no ship is permitted to carry coastal cargo unless it is either a New Zealand flag ship, or a foreign ship that has either loaded or unloaded international cargo or passengers at a port in New Zealand, or will do so before departing from such a port. There is no Ministerial discretion with this provision; however, the Minister may authorize the carriage of coastal cargo by 'any other ship' under such conditions as the Minister considers appropriate. There are no New Zealand ships in international trades, and the comparatively small scale of New Zealand's

coasting trade (New Zealand Ministry of Transport, 2002: 12), makes it unlikely that it can offer much in the way of solutions for Canada.

5.0 Other Cabotage Studies

For an issue of protectionism in a global environment of freer trade, there is surprisingly little written in the academic literature on maritime cabotage. Like this paper to this point, Sheridan (1995) is of historical interest. One of the few papers available is Francois *et al*. (1996); they concluded, based on the first two (USITC, 1991, 1995) of the four studies undertaken by the US International Trade Commission, that US cabotage legislation, the *Jones Act,* imposes substantial costs on US consumers and taxpayers.

On the other hand, there is a growing interest in short sea shipping, a development that may or may not be impeded by cabotage regulation depending on the region. Paixão and Marlow (2002) noted that short sea shipping is recognized as having the advantages of being highly energy efficient, while producing lower levels of air pollution, and having lower fatality rates than road. Saldanha and Gray (2002) explored the problems of encouraging modal switching while Peeters *et al*. (1995) viewed short sea shipping as an area where governments might help fund innovation. In all, these authors indicated that building a business case for maritime cabotage was difficult.

In summary, we conclude that cabotage policy is under scrutiny by established maritime States, and this situation offers compelling arguments for Canada to examine the merits of following suit.

6.0 Revisiting Canada's Coasting Trade

The fact that Mexico and the US, Canada's largest trading partner, are unlikely to change their approaches to cabotage in the short term is a complication of substantial proportion to any recommendations for change in the North American context. Canada's fundamental policy position with respect to cabotage has changed surprisingly little since Confederation in 1867, even though international trade policies and perspectives have evolved significantly. Thus, despite the fact that Canada has generally supported a substantial shift towards the concept of free trade in goods and selected services, it has chosen to maintain a markedly protectionist stance in relation to coasting trade. The degree of this protection, employing both access control and tariff mechanisms, is now much greater than that prevailing in Europe and, among developed maritime States outside of North America. It appears to be only exceeded by the cabotage regime of the United States. In the light of these widely contrasting approaches to cabotage activities, it is clear that Canada's current regulatory regime merits review.

The present cabotage regime has effectively constructed a barrier between domestic and international operations, to the point where ships positioned and qualified to operate in one regime are unable to participate in the other. This concept is workable so long as the domestic regime is large and stable enough to sustain healthy commercial operations. However, this does not appear to be the case. The contraction and turbulence in demand for cargo movements, the very modest growth in offshore oil and gas activity, and the challenge of seasonal operation in many parts of Canada's waters, raise doubts as to whether such an independent domestic regime

can continue to be economically sustainable in the long term. Beyond providing artificial protection for hard-pressed and expensive domestic fleets, there is virtually no evidence that the present regulatory regime is providing an optimum environment to encourage domestic shipping operations.

We count ourselves among the growing number of policy analysts who believe that there are fundamental flaws in the rationale for application of a 25 percent duty payment on imported ships. It is of no help to the shipbuilding industry, a fact borne out by the near total absence of shipbuilding orders (Brooks, 2005). The facts that Canada is the only developed country that still applies such a tariff, and that such application has come under criticism from Canada's OECD colleagues (OECD, 2001), only strengthen the arguments for its discontinuance.

Under NAFTA, the 25% tariff does not apply to US-built ships; with the recent increase in the value of the Canadian dollar, Canadian operators may well find it cheaper to build in the US. This also applies to Mexico, Chile, Costa Rica, Israel, and the Caribbean, thus introducing a policy anomaly not unlike that which prevailed under the *British Commonwealth Merchant Shipping Agreement*.

Not only has the tariff been of no value to the shipbuilding industry, it has given rise to some serious issues for ship operators, including the additional financing burden imposed on ship operators by the existing tariff situation; banks are unwilling to view the 25% tariff as part of the purchase price of the vessel, and so there is no bank financing available to support acquisition of a foreign flag vessel. Thus the 25% tariff on an imported vessel must come from the retained earnings or the acquisition year's cash flow, with a chilling impact on new ship investment or capital replacement. No other transportation mode is required to pay anything like the level of import duty for the foreign acquisition of capital assets. It would be both inappropriate and unfair to effect an immediate full removal. Instead, a transitional phase, or tax credit equivalent, would need to be designed to provide for gradual adjustment to any new regime.

As for access controls, this is a more complex issue. While removal of the tariff would bring some relief to the capital cost of operating Canadian ships, there remain important cost differentials in relation to such aspects as corporate taxation and crewing costs that would continue to inhibit the ability of Canadian ships to compete with their international counterparts. Indeed, the situation that would then prevail would not be dissimilar to that of Australia, where, despite the absence of a tariff and a temporary entry regime that functions reasonably satisfactorily for shippers, Australian ship operators continue to face significant challenges. We conclude that the Australian approach does not appear to offer an attractive alternative for Canada.

Maintaining the status quo is also not an attractive choice. In short, if Canada cannot see its way to examining alternative approaches that allow for a relaxation in access controls, and therefore an increased facility for ships to move into and out of the Canadian coasting trade, it could legitimately be argued that, at least for the marine transportation sector, it would be best to stick with the present waiver process. On the other hand, it should be noted that the waiver process does not work well in relation to the complex technology and long lead times in decision-making that characterize the needs of the offshore oil and gas industry. Thus, for this

latter sector, streamlining of the temporary entry process would certainly appear to merit substantial further examination.

The OECD has made clear that it would like to see Canada and others follow the initiatives adopted by the EU (OECD, 2001). Canada should be open to this encouragement. Of course, similar to the EU, any selective relaxation of access controls would need to be accompanied by an appropriate fiscal regime and other State aid similar to that provided to other States in the liberalized regime. As with the removal of the 25% tariff, considerable care would be required in gradually liberalizing access to ensure full reciprocity of terms and conditions.

Pursuit of such an approach would give rise to certain ancillary policy issues. Among these is the concept of modal "neutrality" (the construction of a level playing field among domestic modes), which has been a cornerstone of Canadian transportation policy since the late 1960s. The construction of this level domestic field gives rise to an uneven playing field in the international sector, and precipitates the need for the artificial barrier between domestic and international shipping operations, which in turn gives rise to serious difficulties for the marine mode. Modal neutrality is not viewed as a key principle by other OECD States, which tend to regard the marine mode as in need of special considerations. The manner in which domestic "neutrality" is applied to the marine mode needs to be revisited.

Finally, Brooks and Frost (2004: 404) note:

> *There is also the issue of a level playing field between Canada and the U.S.; currently, the regulations are sufficiently different that the crewing and country of build provisions need to be more closely examined.*

There are those that might argue that Canada should not enter into agreements for liberalized trade conditions with Europe until or unless such conditions are put in place in North America. While this argument is in theory attractive, it risks becoming a recipe for policy gridlock. Canada has sought, through various trade in services negotiations over the last 15 years or so, to achieve some relaxation in the maritime cabotage regime in NAFTA and through the World Trade Organization. However, such efforts have to date been unproductive, and there are many who are of the opinion that there is virtually no prospect of any change in the cabotage regimes in North America in the foreseeable future.

On the other hand, there are those who would argue that the US desire to progress towards a secure North American perimeter and the new policy momentum generated by the potential for expanded short sea opportunities may introduce some flexibility south of the border. These are still quite tenuous policy thrusts, and it is important that Canada's cabotage policy not be held hostage indefinitely to intransigence in US domestic shipping policy. The Jones Act dictates a unique situation and our research has not uncovered transferable lessons from elsewhere. A unilateral relaxation of the rules by Canada is simply not appropriate. Therefore, Canada will have to decide, in pursuing relaxation of US regulations, whether a continued regime of protection, albeit in a larger market, would be more attractive than seeking more liberalized approaches with other markets. As no research has been done on trilateral cabotage, this provides a starting point for a new research agenda.

We envisage a structured research program. A side-by-side analysis of the current state of play is merely a start to evaluating the baseline differences between cabotage regimes. Country of build provisions, crewing, taxation, and fiscal support are, of course, on the "must review" list. The appropriateness of modal equity as a Canadian policy objective also needs examination. In addition, the potential common waiver options and flag scenarios need to be developed, including the concept of a "NAFTA flag" not unlike the Euro flag (that was examined and rejected as unacceptable by the EU Member States). It would be useful to evaluate the concept of bilateral relaxation with other liberalized, developed country trading partners, not unlike the liberalization recently undertaken by Canada with the UK in the air transport market. Finally, the research program needs to have a plan for consultation with industry on all aspects of any proposed changes so that the full impact of the policy can be determined. While it would be best to do such work under the umbrella of the *Memorandum of Cooperation*, it is necessary to do the research with or without full cooperation from Canada's NAFTA partners.

7.0 Final Comments

In summary, the record shows that, in relation to maritime cabotage, Canada has pursued a virtually unbroken policy of protection. The nearest that Canada has ever come to adopting a more liberalized regime was probably at the time of the Spence Commission. However, this brief endeavour to pursue a more relaxed cabotage regime was quickly reversed by Howard Darling, and by the modal symmetry expectations of the *1967 National Transportation Act*. Since the early 1970s, Canada has only chosen to expand, in terms of both activity and geographic scope, the definition of coasting trade and, hence, the associated protective regime. It is our conclusion that the course of action best suited for Canada's current position is one with four action items:

Immediately implement a plan to remove the 25% duty on the importation of foreign-built ships, the removal to include a phase-in period or a transition plan so that those who recently invested in ships are not unduly penalized.

Adopt a more liberalized access regime with like-minded States (e.g., European Union).

Investigate more liberalized access for NAFTA-flagged vessels as long as reciprocity is on the table. The Canadian government needs to invest in research to determine if the development of NAFTA cabotage or a NAFTA flag will damage Canada's beneficial owners of foreign flag shipping. Such work might take place under the umbrella of the *Memorandum of Cooperation*.

Provide the domestic shipping industry with fiscal and other aid (e.g. tonnage tax opportunities and relief for seafarer income tax, when, for example, engaged in international trade, including foreign cabotage), in line with equivalent measures adopted in much of the European Union.

The authors believe that the process of discussion and debate, leading to adoption of some or all of the suggested courses of action, needs to commence without delay. Within the North American economic space, the political reality is that further amendment to NAFTA is unlikely, but both the *Memorandum of Cooperation* and the *Security and Prosperity Partnership* signed in 2005 with the US and Mexico offer avenues for the development of change.

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