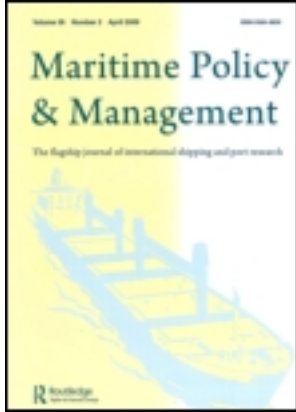


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### A ship's flag—who cares?

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## A ship's flag—who cares?

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Over 60% of ocean trade moves in ships with convenience flags, those of Liberia, Panama, Cyprus and others. Semi-detached flags of Norway, France and the UK are another of the growing devices for avoiding rich-country taxes and labour costs. Shipowners and their customers see little hope for change (taxes and labour) in their political climates at home, but they need some workable governing structure to assure safety, payment of bills, protection of the environment and decent service. It follows that all maritime nations, especially the USA and Canada, should pay more attention to the creation and observance of International Conventions.

### 1. Introduction

Cunard is in the hotel business, the US Lines are bankrupt. Shipowners in Greece, Norway, Japan and Germany rush to flag out. That means abandoning their home flags and placing their ships under convenience flags (FOCs) such as those of Liberia and Panama. These FOCs already fly on 40% of the world fleet, and their ships carry about 60% of all ocean freight. The decline of 'establishment nation' shipping flags will continue. Who should worry, and what can be done?

### 2. Convenience flags (FOCs) are cheaper and better

As a service industry shipping is judged on levels of cost and efficiency. The costs of owning and running a typical ship range from a high under the US flag of 11.4 million dollars a year to 3.6 million under the Liberian flag and lower under others (table 1).

**Table 1. Annual costs for owning and operating one bulk carrier (300 000 dwt, Seaway fitted)**

| Cost item          | Flags of        |                    |                     |
|--------------------|-----------------|--------------------|---------------------|
|                    | USA<br>(1000\$) | Canada<br>(1000\$) | Liberia<br>(1000\$) |
| Finance            | 4500            | 1596               | 1476                |
| Crew               | 2800            | 1500               | 500                 |
| Fuel               | 1200            | 1200               | 1200                |
| Stores             | 300             | 130                | 110                 |
| Maintenance/Repair | 600             | 160                | 130                 |
| Insurance          | 380             | 210                | 120                 |
| Admin/Overhead     | 240             | 70                 | 35                  |
| Taxes              | 1264            | 609                | 10                  |
| Total              | 11374           | 5475               | 3581                |

Source: Author's data bank, assuming Canadian and FOC ships built in Asia in 1983, US ship in USA, taxes figured as 50% of before tax profit of 25%. All figures in 1987 US dollars [1].

Table 2. Annual crew costs for various flags in millions of US\$.

|         |     |             |      |
|---------|-----|-------------|------|
| USA     | 2.8 | FOC/Liberia | 0.5  |
| Canada  | 1.5 | Tawain      | 0.45 |
| Japan   | 1.3 | Greece      | 0.4  |
| Norway  | 1.2 | Philippines | 0.35 |
| Belgium | 1.1 | Poland      | 0.3  |
| UK      | 0.8 | China       | 0.26 |

Source as for table 1.

In the weak 1987 open market, this ship could earn four million dollars a year. The USA ship survives because AID†, military, government financed grain/food, domestic and other cargoes are reserved, i.e. they are not able to use open markets. The Canadian ship has no chance since she has no subsidies or protective devices. A shipping company usually operates ten or more vessels. Costs for fuel, terminal and port services are constant regardless of flag. However, crew costs are a variable upon which the profits usually depend. There is an enormous spread in these (table 2).

Rich country seamen's unions claim that FOC crews are poorly paid and unskilled. This is true for marginal ships and owners under such as the Cyprus flag. However, the great mass of deep-sea commerce is carried by ships with crew costs of about a half million dollars a year. These are generally competent and well paid by the standards of the home countries of their officers and seamen. Canadian and US seamen's unions cannot compromise on deep-sea ships without weakening their case for big crews on protected Great Lakes and coastwise ships.

The standard ship of the year 2000 will have few seamen aboard. In an attempt to Shipowners pay nominal taxes to FOC flag nations and usually own their vessels through separate companies in tax havens such as Bermuda and Switzerland. In addition to avoiding taxes they gain complete secrecy in the movement of their money. A Canadian task force on deep-sea shipping [2] attempted to remove the tax obstacle under the Canadian flag by proposing a category of International Shipping Corporations (ISCs) which would receive special tax treatment. Clarkson Gordon, an accounting firm, has tried to elaborate, but there is little hope. First no government can give massive tax exemption to one industry without facing 'me too' demands from other business interests. Secondly, a ship owner who has enjoyed the secrecy and other benefits of Bermuda headquarters and an FOC flag will not endure the agony of haggling with tax people, Federal, Provincial, State and local.

Many nations allow owners to build, insure, repair, store and fuel their ships wherever is cheapest and best. Some, the USA and Canada, for example, place restrictions or duties on building or repair work done overseas. Canada and the USA have their own Coast Guard ship inspection requirements which have the effect of increasing capital costs. FOCs generally rely on established international classification societies such as Lloyd's and the American Bureau of Shipping. Until recently, US ships receiving subsidy or preferences were by law built in US shipyards. Their costs are triple those in good Asian yards and building times double. This explains the high US flag finance figure in table 1.

† Agency for International Development.

Low cost crews in table 2 have in some cases been low on skills, but they seldom strike. Carefully chosen Asian officers are excellent. Though the cheapest, Chinese and Polish crews maintain their ships well. Apart from cost, many ship managers prefer crews from Asian and non-market economy countries.

### **3. Politics are difficult under establishment flags (OECD) (meaning Europe, Scandinavia, North America and Japan)**

Politics rank in importance with money. If rich country shipowners saw any hope in solving their labour and tax problems at home they would not flee to FOCs and tax havens. Because the struggles consume so much time and money, most take the easy way out. Shipping is not front-page news, and the person in the street does not know or care much about merchant marine policy. Thus big decisions are made in back rooms and through quiet discussions. Shipowners who receive subsidies and preferences prefer it that way. In open politicking they are outnumbered by their poorly organized opponents, the cargo owners. Gradually the maritime world is developing two different types of shipping politicians: one that manipulates for help at home and another that concentrates on international structures.

Every ship at sea is touched by political facts. If she is Liberian her owner has decided not to fly the flag on his passport. If built in a rich country, she enjoyed some form of subsidy. US operating differential subsidies pay mainly for crew. Cargo for Venezuela must be vetted by a complex government allocation scheme. If charts, navigation gear and crew tickets are right, she satisfies a variety of international conventions and need not worry about Port State Control. About a third of all ships at sea are owned by governments, e.g. fleets of the Russians and their affiliates, large lines such as Lloyd Brasileiro and the National Shipping Companies of Australia, India, New Zealand, France, Venezuela and Argentina. One-party governments in Africa own most of their shipping lines.

Strangely, maritime political debates do not feature labour/management differences. Most maritime lobbies (political action committees) are combinations of ship and/or yard management and labour people. The big struggles centre on three issues, namely: (1) ship versus cargo; (2) regulation versus deregulation; and (3) Government help (subsidy and protection) versus competition.

The responsibilities of shipowners are at issue in worldwide debates over the Hague, Hague-Visby and Hamburg rules. Shipowners fight for the old Hague rules which set low claim payment limits and give them broad defences, even when there is negligent navigation and mismanagement of a ship. Ship-owners are so well organized that they have prevented an updating of these archaic rules, even in the face of united efforts by cargo owners. Another issue negotiated in back rooms involves the rights of Liner Conferences or cartels. Canadian agents for European and Japanese owners have been skilled in modifying current shipping anti-trust law.

The US and Canadian Coast Guards have regulations more strict than those of Lloyd's, and the American Bureau of Shipping and the other respected international ship classification societies. These can add millions to the capital cost of a ship. Intermodal container shipping received a boost when the US Shipping Act of 1984 allowed The American President Lines to quote rates and issue bills of lading on through shipments between Asia and points anywhere in the USA. Similar green lights will come more slowly in the European Common Market.

Most public of all are appeals for subsidy and protection. The US Merchant Marine Act of 1936 established differential payments to equalize US and foreign costs for ship

operations and construction. At that time the differences in both categories were about 30%. Today (per table 1) the differences are 300%. The medicine has made the patient much worse. Similar stories can be told in Brazil, India, France, Australia and New Zealand. After World War II, there were two dozen solid US Flag shipping companies. Today only six survive.

Everywhere budget-conscious governments are cutting back on ship and yard subsidies. Retreating maritime lobbies base their pleas on three issues: (1) their national economies; (2) defence; and (3) pride in the flag. Only the third has merit. Countless impartial studies [3] have established that a national shipping line that requires subsidy and protection is a net minus factor in the balance of payments account. This is true mainly because rates are increased and services decreased to protect the home flag, and the cargo owners suffer.

Merchant marines have always been seen as the 'fourth arm' of defence. However the realities of modern warfare have driven shipping and the military far apart. Supertankers, big bulk carriers and containerships do not fit the needs of today's war plans. The merchant ship of the future will carry less than 16, mostly officers and trainees. In the event of a war, these will stay abroad. Shipping is no longer a training ground for the Navy. As in the last war, crews must come from small craft (fishing, tugs, pleasure boats, etc.) and through training.

One magic move might evade political obstacles. Semi-detached flags offer shipowners in England, Norway and France a chance still to fly the home banner without rewriting tax and labour laws. In France, for example, starting in June 1986, bulk carriers could be registered in the Antarctic territory of the Kerguelen Islands and employ crews three quarters composed of foreign nationals, but with at least four French officers. Playing political games with merchant ship flags is not new. At the start of World War II, President Roosevelt used Liberian and Panama flags to assist the Allies before the American people were prepared to declare war. The Liberian flag looks a bit like the US flag, and Liberia was a virtual USA colony during the days of Presidents Tubman and Tolbert. Flags of the Dutch Antilles have been a handy compromise for some Benelux shipowners. In today's Persian Gulf fighting, President Reagan arranged cosmetic adjustments to put 10 Kuwaiti tankers under the US flag.

Norway promotes their Oslo-based Norwegian International Ship's Register with no nationality requirements on manning or equity capital. But Norwegian owner, Erling Naess, originator of the idea, has elected to keep his base in Bermuda. These semi-detached flags are compromises which may stem or speed up the flood of flagging out. It is too soon to tell. They do have one great virtue in that they tend to carry over the international convention ratifications of their parent nations.

We have argued that OECD shipowners must either fly convenience flags or obtain help from their governments in the form of tax exemptions, subsidies and protection. We will argue that cargo owners care more about rate and service levels than they do about flags. Obtaining government assistance has proved expensive, time consuming and, in the end, self defeating. Thus if they opt for FOCS, shipowners have a large stake in making the international all flag system as good as possible.

#### **4. An international political structure exists for all flags**

A ship under the Cyprus flag does not pay much attention to her national safety rules. Some flags are more insurable than others as shown by the loss figures given in table 3.

Since flag states like Panama and Liberia do not entirely supervise their fleets, there must be a structure that does. The international trading community must somehow

Table 3. Percentage of fleets totally lost (per annum, 1975 to 1985 averaged).

|         |      |
|---------|------|
| Malta   | 4.86 |
| Cyprus  | 1.59 |
| Greece  | 0.88 |
| Panama  | 0.81 |
| Liberia | 0.40 |
| UK      | 0.20 |
| Japan   | 0.12 |
| USA     | 0.10 |
| Norway  | 0.02 |

Source: The International Shipping Federation (1987) [4].

have a substitute for the fading influence of individual rich country flag states. Those who care most about this are the customers, owners of cargoes increasingly carried by FOC ships.

#### 4.1. *Who cares?*

##### 4.1.1. *The shipper/cargo owner*

The wrecks of the *Arrow* and the *Amoco Cadiz* taught oil companies a lesson. Old-time traffic managers cared mostly about the lowest rate. Now they know that any ship that they own or charter can put them in trouble financially and in the public eye. They care about the skills of the officers, and the standards of owners and managers. Charters and contracts of affreightment were once made in the bar at India House or over festive lunches in London. Now decisions are made by directors of distribution, computer-loving specialists who factor in inventory, insurance and all other related costs. Shipper decisions are scientific, hard-nosed and with little thought about flag sentiments. Behind the large corporations are the farmers, miners and factory workers—workers who should care most, but are poorly organized. Large shippers such as DuPont, Krupp, Shell and the aluminum companies are active in the International Chamber of Commerce division that promotes maritime issues. They also are heard in maritime convention bodies such as the International Maritime Committee.

##### 4.1.2. *Those who serve the industry*

Officers, seamen, banks, shipyards, insurers, attorneys, stevedores, ports, ship chandlers and oil companies—the list is long. Ships are moving objects, and some shipowners dislike paying bills. When the us Lines round-the-world service went bankrupt owing over a billion dollars, the creditors' list read like a 'who's who' of the maritime world. These care about the flag and who lies behind it. They must have some system for collecting their bills.

##### 4.1.3. *The environment*

Ships once routinely flushed their tanks at sea and blew their stacks in port. Public outcries over oil pollution and dumping at sea have forced a painful review of international maritime law. Oil companies once thought that they could limit exposure by incorporating ships separately in tax havens and flying FOC flags. Now they understand that a coherent set of international conventions must function regardless of flag.

#### 4.1.4. *Shipowners*

Ships today are owned by banks, oil companies, real-estate developers, steel mills, pension funds and insurance companies. Many of these lack understanding of the maritime world. For this reason they care more than most about a rational system.

#### 4.2. *Organizations and fora*

The courts of Malta, Liberia, Cyprus and Panama will not be trusted to decide important maritime cases. Schoolchildren are taught that a ship is an extension of the nation whose flag she flies. This, however, means little in selecting a forum for settling disputes or debating new arrangements. There are four widely different types of international control systems.

##### 4.2.1. *Maritime courts*

Until three or four centuries ago, the *Lex Mercatoria*, of which maritime law was a major part, extended beyond the boundaries of individual nations, being based as it was on such universally accepted edicts as the *Roles of Oleron* and the *Consolato del Mare*.

A truly international law would avoid conflict of laws and a truly international maritime law would avoid conflict of maritime laws. This was true up to the sixteenth century.....

WILLIAM TETLEY, QC [5]

Most shipping nations have maritime courts, and there are commonly accepted ground rules. These courts respect the substantive law of a nation where a contract is made. After a collision, courts everywhere will apply the substantive law of the nation where the event occurred. Always, however, the procedural laws of the forum (where the trial is) are applied.

There are many exceptions. Few nations exactly agree on what is procedural. Questions of public policy (often regarding seamen's wages) are decided by the forum. Courts are not kind to a manipulator who manoeuvres to evade one set of laws for another. Whenever possible British courts favour shipowners and USA courts look after cargo owners. In France, Quebec and New Orleans, Civil Codes (of Napoleonic origin) are harder on shipowners who pollute.

Against this confusing background International Conventions have been devised to create order.

##### 4.2.2. *International conventions*

In September 1910 in Brussels, two historic agreements were drafted, one on collisions and one on salvage. Since then, often in Belgium, many good Conventions have been drafted and ratified to cover Carriage of Goods at Sea (Hague Rules), Limitation of Shipowners Liability, Sovereign Immunity and Pollution. In 1948, The International Maritime Consultative Organization (IMCO) now known as IMO, an agency of the United Nations began studying and drafting conventions. These activities seldom drew distinctions between flags. They were mainly to solve technical, legal and operating problems, not political or economic ones. About 1960 another UN agency, the United Nations Committee on Trade and Development (UNCTAD [6]) began to develop conventions that were intended to promote the shipping flags of Third World nations. This effort was part of the UNCTAD mission to create 'A New World Economic Order'. Naturally the shipping establishment (OECD, known at the UN as Group B) resisted. The

struggle raised questions about the purposes of an International Convention. In a Meredith Memorial Lecture at McGill University on 27 September 1986, Professor William Tetley, QC provided an answer as follows:

What is the purpose of an international convention? Why attempt to adopt such a convention? In other words what are the advantages of an international convention over individual national laws adopted by individual nations?

Perhaps the answer may be summarized in three principles; (1) Uniformity of Law, (2) Certainty of Law, and (3) Justice, or a just solution to the problems requiring resolution...

Judged by these standards, UNCTAD's conventions fail. Their masterpiece is called a Code of Conduct for Liner Conferences. Adopted in 1974, this entered into force in 1983. It is a long confusing document which, without exactly saying so, allocates general cargo shipments on a 40-40-20 basis. That means that every nation must be allowed to carry under its flag 40% of its conference liner general cargo while allowing outsiders to carry 20%. Most Third World countries supported it as did Russia and the other non-market nations (Group D). The latter proceeded to ignore it in their own shipping arrangements. Many Latin American nations, Brazil, for example, supported the Code but continued as before to demand 50% for their flags. Many of the Group B establishment countries have adopted it, but under the 'Brussels Compromise' made an exception of trade with Group B nations. Thus in practice the Code only applies to conference trades to and from certain Third World (Group of 77) nations, about 15% of all general cargo movements.

It may not be fair to judge the Code by the Tetley standards, since, apart from the title, it has little to do with law or justice. It is a political and economic effort.

UNCTAD's other major effort has been a 'Convention on Conditions for Registration of Ships' adopted on 7 February 1986, but not yet (or likely in the near future to be) in force. This began as an attempt to phase out FOCS, and in the process to promote the Third World fleet of bulk carriers and tankers. After seven years of expensive emotional meetings the UNCTAD staff realizes that eliminating FOCS will not help the Group of 77 developing nations. Thus a convention has emerged which tries to set standards for convenience flags. While the objective is good, the document has few friends. Labour interests in rich and poor nations, dream of eliminating FOCS because of the crew cost in table 2. They reject the final document because it accepts and legitimizes FOCS. Russia, China and the Comecon countries have never hesitated to employ FOC vessels. They seem to have lost interest in the struggle to eliminate them. The establishment Group B nations are unhappy about the whole effort, especially the attempt to create a 'Genuine Link' between flag and the ownership/management of ships.

Even UNCTAD's worst enemies must admit that the link between flag and owner must have some substance. Otherwise the flag is a meaningless decoration and an invitation to abuse crews and customers. Having this in mind, cargo owners enter ship markets with care, especially when they are offered a ship with a high risk flag (see table 3).

#### 4.2.3. *The market*

The Baltic Exchange may not seem like a regulatory forum, but it functions as one. Important charterers such as Shell Krupp, Esso, Cargill and the steel companies pick and choose in one of the purest of free markets. They avoid ships and owners with poor records for safety, bill paying or abuse of seamen. In this they are aided by a flood of computerized marine credit analysts such as Marine Reporting Co. and TSA Marine in Oxford, UK.

#### 4.2.4. Others

Shipping is blessed with many outfits that function as regulators. Annoyed by the slowness of courts, disputants turn to arbitration in London or New York. The International Transport Workers Federation (ITF), a London-based labour organization, monitors FOC ships all over the world. When they detect that a crew has been abused, they detain their ship. Left-wing waterfront workers in Australia, France and New Zealand help them as do waterfront churchmen of all denominations. The ITF issues 'blue cards' to approved FOC ships. A ship with such a card can trade anywhere and is worth more on the Baltic. Lloyd's Register and the American Bureau of Shipping are classification societies that can in their inspection procedures influence a ship's value. Port State Control is a recent device intended to discipline shipowners who fail to maintain ships or pay bills. These are samples drawn from a long list.

### 5. Conclusion

To tell the truth, everybody cares about their flag and ships. Canadians do not like the idea of a zero deep-sea fleet. The British shipping press bemoans the Red Ensign's decline. Americans worry when 'Old Glory' is artificially planted on a dozen Kuwaiti tankers. Twenty years ago the Canadian government gave two ships to the Caribbean West Indies. They were poorly designed, politically managed and great money losers. But on any beach in Tobago, St Lucia or Barbados you could hear local people say proudly: 'those are *our* ships'.

On the other hand a farmer in Iowa has reason to complain when he loses business because a merchant marine second mate earns over a hundred thousand dollars for six months at sea.

Tax havens bother people. Some Norwegians criticize their countrymen who have fled to tropical islands. Why should one industry be tax free while others carry the load?

It will take a generation to sort this out. Rich countries will wind up with ships run like jumbo jet freight planes, just a few officers aboard. These may be stockholders in the owning company, and their wives and children may join them at sea. Less rich countries will have less automation and larger crews doing maintenance at sea. No one will pay more than a half million dollars a year (1987 US\$) for a crew. Somehow a way will be found to tax the industry.

In the meantime everyone should care about the painful process of creating order, about Professor Tetley's uniformity, certainty and justice in a political system for all flags. This is painful because it takes years of meetings and patient persuasion to draft a good convention and longer to get it ratified and in force. France, England and her FOC satellites have good records in this regard. Canada and the USA do not.

### Notes

1. Transmode Consultants Inc. (21 St Clair Avenue, Suite 1001, Toronto, Ontario, M4T 1L9, Canada) is a research group in which the author is a director. They and the author keep and daily upgrade data banks on ship and port types worldwide. Table 1 assumes no subsidies or favourable financing, i.e. it covers pure costs.
2. The Task Force on Deep Sea Shipping Report was prepared for the Canadian Minister of Transport in April 1985. Its membership included four prominent Canadian shipowners, and they concluded that there are not enough economic benefits to warrant a Canadian flag deep-sea subsidy/protection programme.

3. A 1984 US Congressional Budget Office study considered proposals to require that some USA bulk cargo exports be moved on US flag ships. Their conclusions were similar to those of the Canadian Task force. Quietly the World Bank has been saying the same things to its clients. Recently UNCTAD feasibility studies for Third World shipping aspirants have followed suit.
4. The International Shipping Federation in London publishes and updates a comprehensive Guide to International Ship Registers.
5. *Maritime Liens and Claims* by WILLIAM TETLEY, QC, published by Business Law Communications Ltd of 53 Fleet Street, London, UK. The quotation is from page 522 at the start of his chapter on Conflict of Maritime Laws (Choice of Law). Professor Tetley teaches the course at McGill Law School for which this paper was prepared.
6. Sr Juan E. Oribe Stemmer, of Roque Graseras 680, Montevideo, Uruguay, provides an interesting account of the early political jockeying between IMCO, the shipping establishment, and the Third World on the scope of IMCO conventions. He notes that there is no rule against IMO (then IMCO) involvement in economic matters and that they are not easy to separate from technical ones. His paper is entitled A new economic order for postwar shipping and the liner conference system. The International Maritime Conference, 1948, and is published in *Maritime Policy and Management* (1987), 14, 5-26.