

# Turning Shipwrights into Masons: How tariff walls have hurt Canadian shipping

Stephen Kymlicka

Senior Policy Analyst, Atlantic Institute for Market Studies

## In Brief

Canada was once a great shipbuilding nation. Yet despite having one of the highest tariffs in the world, there remain a paucity of viable bidders on the new Canadian supply ships. What happened? This commentary shows the full-spectrum acknowledgement that the tariff is ineffective and that the tariff, in fact, hurts Canadian shipping; the very customers that might purchase services from the shipyards.

## Introduction

It's a great time in Canada to be in shipbuilding. Right? On Monday, June 26th, Canada's defence minister, Gordon O'Connor, announced a multi-billion investment in three new supply ships for Canada's navy. Given Canada's illustrious maritime history, you would think that there would be many places that could build these ships. You would be wrong. Only a handful of shipyards and four groups meet federal qualifications for bidding on the work: Irving Shipbuilding has capabilities in Halifax, NS and Lévis, QC, SNC Lavalin ProFac Inc. would use a shipyard in Victoria, B.C., and both ThyssenKrupp Marine Systems AG and BAE Systems Ltd. plan to use shipyards in Newfoundland.<sup>1</sup>

## How did we get here?

Many of the answers can be found in the AIMS publication [The Jones Act under NAFTA and Its Effects on the Canadian](#)

[Shipbuilding Industry](#) by Dr. Mary R. Brooks. Many of the problems sound very familiar: Canadian shipbuilding suffered from a lack of world-class productivity in an environment of government subsidies, tariff walls, non-tariff cabotage barriers and, in the 1980s, uncompetitive government borrowing rates. As the domestic market shrank, Canada looked abroad and found it could not compete in a highly competitive world market. It was the beginning of the end.

Government protectionism has reduced the necessity to be competitive. This is best exemplified in the U.S. where over 70% of shipbuilding revenues are derived from the military.

### United States Industrial Productivity<sup>2</sup>

	1977-1998 annualized labour productivity gains	1998 ratio of value added to payroll
Shipbuilding	1.7%	1.59
Aircraft assembly	3.0%	2.50
Auto assembly	3.9%	3.57

The least protected auto sector produced the greatest gains. By comparison, between 1980-1985 labour productivity gains for Canadian shipbuilding were 1.3%<sup>3</sup> while Japanese productivity increased by 13.9% and Korean productivity increased by 24%.<sup>4</sup>

<sup>1</sup> Murray Brewster, CNEWS, 2006, <http://cnews.canoe.ca/CNEWS/Politics/2006/06/25/1652765-cp.html>

<sup>2</sup> Derived from U.S. Department of Commerce, [National Security Assessment of the U.S. Shipbuilding and Repair Industry](http://www.bis.doc.gov/DefenseIndustrialBasePrograms/OSIES/DefMarketResearchRpts/shipbuilding_and_repair.pdf), 2001, [http://www.bis.doc.gov/DefenseIndustrialBasePrograms/OSIES/DefMarketResearchRpts/shipbuilding\\_and\\_repair.pdf](http://www.bis.doc.gov/DefenseIndustrialBasePrograms/OSIES/DefMarketResearchRpts/shipbuilding_and_repair.pdf)

<sup>3</sup> Economic Council of Canada, 1998, quoted in Brooks

<sup>4</sup> Derived using GT data from Dr. Phil Koenig, [Current Directions in Asian Shipbuilding Technology](http://www.nsrp.org/st2003/presentations/koenig.pdf), 2003, <http://www.nsrp.org/st2003/presentations/koenig.pdf>

Other countries have engaged (and continue to engage) in subsidies to encourage domestic purchase. However, subsidies alone fail to explain why Japan, Korea and China now build over 81% of the world's merchant fleet. More competitive wages, attention to leading edge technology, training of qualified marine engineers and an understanding of niche markets are all critical to their export success. In fairness however, competitive factors are insufficient to explain how Korea tripled their shipbuilding capacity between 1997 and 1999,<sup>5</sup> a period when there was a surplus in world-wide shipbuilding capacity of 20%-30%,<sup>6</sup> and simultaneously dropped the price of Panamax container carriers by 30%!

By comparison, the U.S. accounts for only 1% of new construction of the world's commercial fleet while Germany, Poland and Italy command about 3% each; Canada accounts for 0.03%.<sup>7</sup> Worse, the U.S. 1% is almost exclusively small domestic traffic (e.g. river barges). Orders for U.S. merchant ships over 1,000 gross tons went from 41 in 1973 to 0 (none!) in 1983.<sup>8</sup> In 2001, the U.S. Department of Commerce concluded that "the U.S. commercial shipbuilding industry is generally not internationally competitive."<sup>9</sup>

### What is the cost?

The cost can not be measured by the size of the shipbuilding subsidy alone. Canadian cabotage restrictions require a Canadian-flagged vessel for domestic traffic. This means a Canadian-made vessel (or a non-NAFTA vessel that has paid a 25% tariff),<sup>10</sup> crewed with Canadian citizens and maintained by Canadian shipyards. These burdens can close to double

the operating cost of a ship - costs that are passed along to the consumer.<sup>11</sup>

Furthermore, the tariff stifles Canadian shipping. On one hand, Canadian ships remain too expensive;<sup>12</sup> on this even the Marine Workers Federation agrees: "Our 25 percent tariff on imported ships... is one of the highest in the world-- but it has not been of significant assistance in winning new work for Canadian shipyards."<sup>13</sup> On the other hand, financing rules frustrate foreign purchases. For example, banks will not include the 25% in their financing coverage. To quote Vice-Admiral and Past-President of the Canadian Shipbuilders Association, Peter Cairns, "one may put together a good technical proposal at an excellent price, but unless the deal is attractively financed, it is unlikely to be consummated."<sup>14</sup>

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competitive."*



### What can be done?

The important thing to realize is that Canada does not have, nor can it realistically develop, the capacity to build large ships.

*The contested market in which Canada's shipyards compete becomes vessels for coastal and regional transport (including the feeding of the larger intercontinental vessels), specialized vessels (e.g., research, icebreaking), local ferries and fishing vessels. These vessels make up a very small percentage of the total world order book, and an even smaller part of the world fleet. [Brooks]*

<sup>5</sup> Allen Walker, "South Korean Shipbuilding Pricing Policies, Impact on the World Shipbuilding Market," a presentation at Shipbuilding Decisions '99, available at: <http://www.marinelog.com/DOCS/MMKor.html>

<sup>6</sup> Koenig, 2003

<sup>7</sup> U.S. Department of Commerce, 2001

<sup>8</sup> Congressional Budget Office (1984), quoted in Brooks

<sup>9</sup> U.S. Department of Commerce, 2001

<sup>10</sup> Also exempt are other countries with which Canada has a free trade agreement (e.g. Israel and Chile).

<sup>11</sup> Using a U.S. example from the Congressional Budget Office, quoted in Brooks.

<sup>12</sup> This remains the principle reason why Canadian shipbuilders have not profited from the removal of the U.S. tariff under NAFTA, although ownership, crewing and maintenance restrictions also apply. However under NAFTA, Canadian shipbuilders have profited from increased levels of Canadian maintenance allowed on U.S. flagged ships. See comments by Andrew McArthur of Irving Shipbuilding before the Nova Scotia Standing Committee on Economic Development: [http://www.gov.ns.ca/legislature/hansard/comm/ed/ed\\_2003apr15.htm](http://www.gov.ns.ca/legislature/hansard/comm/ed/ed_2003apr15.htm)

<sup>13</sup> Marine Workers Federation 1997 policy statement on shipbuilding, <http://staging-caw-ca.inf.ca/campaigns&issues/ongoingcampaigns/shipbuilding/revivingpolicydocument.asp>

<sup>14</sup> Quoted in House committee on Industry, Productivity and Innovation Report, 2000, Chapter 16 (Shipbuilding) <http://cmte.parl.gc.ca/cmte/CommitteePublication.aspx?COM=160&Lang=1&SourceId=36373>

Furthermore existing government supports are insufficient to maintain its paltry share of the international market. Again quoting Peter Cairns:

*I acknowledge that the federal government does give limited assistance to the industry. You are familiar with the 25% tariff on non-NAFTA vessels, the requirement to replace and repair government vessels in Canada, assisted rationalization, accelerated CCA, R&D credits and EDC funding. These are useful measures and important to the industry, but they are not effective in today's competitive market.*<sup>15</sup>

The traditional view is that North America can justify higher costs with the best infrastructure with the best trained workers. In fact, it is South Korea's ability to place half of their maritime engineering graduates in their shipyards that has allowed South Korea to capture the lucrative customization market and relegate the previous market leader, Japan, to pre-formatted ships.<sup>16</sup> Nonetheless, Canada remains competitive in some key component technologies. This is most clearly seen by the fact that manufacturing value-add now comprises 70% of the Canadian shipbuilding industry.<sup>17</sup>

### Concluding Thoughts

The current program dearly costs Canadians. Brooks recommends the 25% tariff be phased out. Brooks also recommends a commercial regional seas strategy complementing an external security perimeter as a rationale for the mutual removal of Canada/U.S. cabotage legislation. This would

open each country's domestic market to the ships and crews of the other; a benefit to shipping companies on both sides of the border.

The bottom line is that the tariff wall is constricting our shipping industry, an industry where traditional Canadian market strengths of logistics, marketing and financing are some of the best in the world. Worse, this huge wall can not save our shipbuilding industry. Canada has protected an ever-decreasing

set of niche products and vessels; and now Canadian shipbuilding has largely dissolved into myth. Massive infrastructure, overcapacity and cut-throat subsidy competition are the reasons why there are only four bidders; and the situation is not likely to improve. In fact, if short-term political pork-barrelling through use of the national security exemption<sup>18</sup> undermines sound business practices, Canada's shipbuilding industry is likely to

suffer. There has been a useful rationalization of Canada's shipbuilding capacity - many shipyards, including the Saint John Shipyard, the major winner in the last major defence project,<sup>19</sup> no longer exist. This is a benefit to the small industry that remains, and trying to change it for short-term political reasons would disrupt the whole industry all over again.

There are Canadian niche successes, especially as they related to component parts and maintenance; however the broad supports now in place for Canadian shipbuilding protect a phantom industry while hurting very real Canadian businesses and consumers. Mr. Harper, tear down this wall!

*“The tariff wall is constricting our shipping industry, an industry where traditional Canadian market strengths of logistics, marketing and financing are some of the best in the world.”*



<sup>15</sup> Ibid.

<sup>16</sup> Moon Ihlwan, "Korea's Shipbuilding Industry Sails Ahead", May 15, 2006, <http://uk.biz.yahoo.com/15052006/244/korea-s-shipbuilding-industry-sails-ahead.html>

<sup>17</sup> 2001 data cited in Industry Canada, Interim Evaluation of the Structured Financing Facility, 2004, [http://www.ic.gc.ca/cmb/welcomeic.nsf/vRTF/AuditVerificationOct2005/\\$file/EvaluationStructureredFinancingFacility.pdf](http://www.ic.gc.ca/cmb/welcomeic.nsf/vRTF/AuditVerificationOct2005/$file/EvaluationStructureredFinancingFacility.pdf)

<sup>18</sup> Daniel Leblanc, "Ottawa overrides its controls on contracts," August 8, 2006, Globe and Mail

<sup>19</sup> Saint John built nine of the twelve frigates in the \$6.2 billion Canadian Patrol Frigate program. Lauzon (now part of Lévis) built the other three.



Atlantic Institute for Market Studies

2000 Barrington St., Ste. 1006 Cogswell Tower,  
Halifax NS B3J 3K1  
phone: (902) 429-1143 fax: (902) 425-1393  
E-Mail: [aims@aims.ca](mailto:aims@aims.ca) <http://www.aims.ca>