

Department of Applied Economics
University of Cambridge



The Contribution of the Foreign
Shipping Community to the UK Economy and the
Economic Effects of a Change
to the Taxation of the Foreign
Shipping Community.

A Report for the Baltic Exchange

by Cliff Pratten

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**The Contribution of the Foreign Shipping Community
to the UK Economy and the Economic Effects of a Change
to the Taxation of Members of the Foreign Shipping Community**

Executive Summary

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Executive Summary

1. This report updates a study made in 1997. The purposes of the original study, which was commissioned by the Baltic Exchange, were to quantify the contribution of the foreign shipping community to the UK economy and to assess the economic effects of a change in the taxation of members of the foreign shipping community. Members of the foreign shipping community are *shipowners* who are domiciled overseas but are resident in the UK, and shipowners who are domiciled overseas and have agencies in London.¹
2. The shipping industry is international and segmented and the segments which are the focus of this study, tankers and dry bulk cargo carriers, are highly competitive.
3. The fleet owned by families with a member resident in London, the fleet at risk from a change in the taxation of members of the foreign shipping community, now totals about 100m. dwt, more than 1,100 ships, and represents, of the order of, 15 per cent of the world fleet at the end of 2002. Greek shipowners account for 70 per cent of the fleet at risk. For comparison, 9m. dwt of ships of the same class are registered in the UK, less than one tenth of the ships operated by the foreign shipping community.
4. London is the leading world commercial shipping centre for fixing charters and the purchase and sale of ships. London's pre-eminence rests on the location in and around the City of London of the largest concentration of *shipowners*, agents

¹ The definition of shipowners used for the purposes of this study is given on page 1 of the report.

and brokers, in the world. A comprehensive range of commercial shipping services, including banking, legal and accountancy services, is available in London and there is competition among many independent firms to provide services efficiently and effectively. Most of the shipowners present or represented in London are members of the foreign shipping community. During the 1990s the competitive advantages of the London shipping market were eroded by the concentration of the growth of demand for shipping in the Far East, the improvements in communications and the development of Piraeus as a commercial shipping centre. Nevertheless, London has retained its share of the market for maritime services.

5. The shipping industry has unique features for tax purposes. An international study of the taxation of shipping concluded that in many countries it is possible to operate as shipowners without being subject to ordinary taxation. This has two implications for the shipping industry:

- the expected long run gross return on investment in shipping is likely to be forced down to the post-tax return on alternative investments in equities and gilts. (The low actual returns on shipowning since 1973 support this conclusion)
- any shipowners operating in the tanker and dry bulk carrier markets who are subject to significant taxation would be at a competitive disadvantage and, in time, would be forced out of the industry.

A number of governments, including that in the UK, have recognised the

exceptional features of the shipping industry and introduced special tax provisions for companies that operate ships.

6. A UK domiciled shipowner who *controls* a shipping company resident overseas is liable to UK taxation on its profits, whether or not these are remitted to the UK. In contrast, a shipowner who is domiciled abroad but resident in the UK is liable for UK taxes on his earned and investment income and capital gains *remitted to the UK*, but is not liable to UK taxation on profits which are earned by companies, including shipping companies, registered and resident overseas and which are not remitted to the UK. Where a shipping company controlled from overseas has an agency or broking business in the UK, the current position is that only the profits relating to the agency or broking business are subject to UK taxation. At times in the past, there has been uncertainty about the taxation of agency companies.
7. The introduction from 1st January 2000 of a tonnage tax for UK companies operating ships has reduced the taxes paid by shipowners. However, it has not affected the position of most members of the foreign shipping community. They operate single ship companies. One purpose of this arrangement is to avoid, where possible, the chance of one ship being arrested to provide security in respect of a liability related to another ship owned by the same company (for example, a liability caused by an accident at sea or an oil spillage). Also, many of the ships operated by the foreign shipping community are not managed (as defined in the relevant legislation) from the UK, a pre-condition for being able to opt for the tonnage tax.

8. Many members of the foreign shipping community would leave the UK if the UK tax regime were changed in such a way as to make members of the foreign shipping community liable to substantial taxes, or to tax agencies in respect of the profits of their overseas shipowning principals' operating companies, or to tax members of the foreign shipping community domiciled overseas but resident in the UK on their investment income which is not remitted to the UK. There are three reasons for this conclusion:

- shipowners who pay taxes are not competitive in the tanker and dry cargo trades and in the long run would be forced out of the business
- shipowners have the option of easily moving to countries where their shipping operations would not be subject to tax. (This option is not available to most other businessmen who operate factories, offices, restaurants, etc.)
- shipowners reluctance to *disclose* information about their families' financial arrangements, which would be onerous.

Neither the introduction of the tonnage tax, nor the tax concessions for capital gains on the realisation of business assets introduced by the UK government since 1998 change these conclusions. Exposing the foreign shipping community to taxes on their income and capital gains from their shipping and other business interests and investments would seriously weaken their competitiveness in the shipping market.

9. Assuming that *all* the foreign shipping community at risk from a change in taxation withdrew from the UK, took *all* of their business with them and they

cease to use London brokers and insurance underwriters, UK P & I Clubs, etc., the economic consequences would be:

- the loss of £375m. of maritime service earnings. (Total UK maritime service earnings were £945m. in 2000 (BI(2001))). This would be a significant loss at a time when the UK current balance of payments deficit represents two per cent of GDP.
- the loss of more than a third of London's tanker chartering business and 40 per cent of its dry bulk carrier business.
- the loss of 4,500 jobs with most of this reduction in employment concentrated in the City
- a reduction, *not an increase*, in tax revenue of about £125m. a year and this reduction would not be offset by any significant cuts in public expenditure
- large adverse effects on the London shipping business and the City firms in the legal and accountancy professions which specialise in work related to the shipping business.

10. What would happen in practice if the UK tax regime were changed is considered in Chapter 6 of the report. In the event, the withdrawal of foreign shipowners could have disproportionately large adverse effects for London shipbrokers and the London shipping market could lose critical mass. Also, any change in the taxation of people who are resident in, but who are not domiciled in the UK, could have substantial adverse effects in other sectors of the UK economy and the City. Foreign shipowners are only a very small fraction of the people who would

be affected by the changes. The effects on the City of a change of tax regime could be serious, particularly if, as in 2002, the City is already under pressure for other reasons.

11. Since 1998 the UK government has recognised the importance of the role of entrepreneurs for the performance of the economy by introducing a special low rate of tax on capital gains on business assets. It has also recognised the exceptional position of shipowners competing with owners who pay little or no tax by introducing the tonnage tax. The foreign shipowners resident in London are entrepreneurs who contribute to the strength of the London maritime service trades. There is, therefore, a strong case for continuing the present friendly and helpful tax regime that applies to them and it would be consistent to do so. The alternative of attempting to subject their operations to taxes would be counter-productive. In practice, tax revenue would be reduced and the London maritime service trades, the world leaders, would be weakened and, perhaps, in time, undermined by the loss of the foreign shipping community and their business.

Chapter 1. Introduction

The Purposes of the Study

The purposes of the study were to quantify the contribution of the foreign shipping community to the UK economy and to assess the economic effects of a change in the taxation of members of the foreign shipping community. Members of the foreign shipping community are *shipowners* who are domiciled overseas but are resident in the UK, and shipowners who are domiciled overseas and have agencies in London. The term shipowners is defined *for the purposes of this study* as parties involved in the management and/or operation of ships and/or who may, or may not, have a beneficial interest in the ownership of ships.

Background

London is the leading world *commercial* shipping centre for fixing charters for ships and the purchase and sale of ships. London's pre-eminence rests on the concentration in and around the City of London of the largest concentration of *shipowners*, agents and brokers, in the world. Historically, London's position was built on trade with the Empire and British shipowners but since 1939 the UK's share of world trade and the fleet owned by companies and individuals *domiciled* in the UK has shrunk. The place of UK shipowners in the market for tankers and dry bulk carriers and for buying and selling ships has been taken by the foreign shipping community resident but not domiciled in the UK, particularly the London Greek shipping community.

London's leading position in commercial shipping is supported by the near universal use of the English language in the global shipping industry, the in-depth expertise in law, insurance, banking and accounting available in London, London's

reputation for fair dealing and effectiveness and its working time zone which overlaps with the Pacific working time zone early in the day and with New York in the afternoon. Also, shipbrokers, insurance brokers and underwriters, bankers and lawyers in the City have established good working relationships with the Greek and other foreign shipowners.

The Industry

The shipping industry is a segmented global industry. The markets for tankers and dry bulk cargo carriers, which are the main segments of the shipping market for which charters are arranged, are highly competitive. There are more than 1,000 separate owners of dry cargo vessels. Similarly there are more than five hundred separate tanker owners but for tankers the leading oil companies are important charterers. There are few barriers to entry, particularly in the dry cargo trades. A new shipowner *with knowledge of the industry*² can start with a single second-hand vessel; if the vessel is relatively old, the capital cost will be low and access to other inputs, finance, insurance, crews and repairs, is not restricted³. However, the regulatory framework for tankers and the concentration of charterers may operate to hinder entry in that segment of the market. Also, the leading charterers of tankers and many charterers of dry cargo vessels set high standards for the ships they are willing to charter, in terms of the *reputations* of the shipowners, the age and maintenance of the ships and the training of the crews, to protect their own reputations in the event of an accident.

² A new entrant needs to have knowledge of the industry or he has to hire someone with the expertise.

³ In practice, a new entrant without a reputation in the industry may have to pay higher insurance and P and I premiums.

The low barriers to entry imply that the economies of scale for shipowning are limited. Although there are economies of scale related to the size of vessels, the size of the largest ship is small relative to the total cargoes carried on the main routes. There may be some small economies for operating a fleet of five or perhaps twenty tankers or bulk cargo ships, through spreading the costs of administration and management.⁴ There are other segments of the shipping market where there are barriers to entry - liners, ferries, gas carriers and container vessels. In these trades incumbents have advantages - goodwill, reputation and written down infrastructure investments. Put another way, the capital required to enter many parts of these trades is much greater than for acquiring a second-hand tanker or bulk carrier. There is some short term chartering of liners and container ships, but liner and container ship operators own most of the ships they operate, or have ships on long term - bareboat - charters.

The markets for chartering tankers and bulk carriers are competitive and contestable, but, when a charterer sets about chartering a ship to meet his requirements to move a specific cargo, he sometimes faces a limited choice, as few as one or two ships, because of the need to charter a ship of the required size which is available at or near the port for loading the cargo at a certain time.

Freight rates and prices for second hand ships are highly volatile. Apart from operating his ships efficiently, a shipowner has to *time* perceptively the chartering of his ships and the purchase and sale of ships to be successful.

⁴ A shipowner with one or two ships may be able to obtain these economies by employing a company which provides the services for a number of shipowners.

The industry is international. An owner may reside in one country (such as the UK), and obtain loans from an American bank to finance the purchase of his ship, while the technical management of the ship is organised elsewhere (for example, in Piraeus). The ship may be registered in, say, Panama, the company which owns the ship may be incorporated in Bermuda, charters for it may be negotiated in London, and it may carry cargoes between ports in Australia and Japan.

2. The Foreign Shipping Community

The Greek Shipowners

In terms of tonnage, nearly twenty per cent of the world fleet of tankers and dry bulk carriers is owned by Greek shipowners. The development of the Greek fleet since the beginning of the nineteenth century has been described by Gelina Harlaftis (1996). The history of family firms, their growth and fragmentation and the continuous entry of new Greek firms has some similarities with the history of UK industrial districts analysed by Marshall (1920) and modern Italian industrial districts described by Pyke, Becattini, & Sengenberger (1990) which since 1960 have been relatively successful in the textile, clothing and leather goods industries. The competitive strengths of the Greek shipowners have been their knowledge and understanding of the shipping industry obtained from association with the industry over many years with, until recently, each generation obtaining experience of operating ships at sea. Also, shipowning is a prestigious activity among the Greek community, perhaps reflecting the past success of Greek shipowners, and this encourages successive generations to enter the industry.

Towards the end of the nineteenth century Greek shipowners began to set up offices in London and this movement continued until the post-war period. Members of the Greek families have resided in the UK for long periods without losing their overseas domicile for tax purposes. In addition to the London Greek shipowners⁵, other Greek shipowners have agency or broking companies in London⁶.

⁵ Shipowners who have traditionally had a presence in London.

⁶ Shipowners who have more recently opened agency companies in London.

The 'agency companies' range from companies which carry out many of the functions associated with managing and operating ships to agency companies which fix charters after referring to more senior managers resident outside the UK and do not manage ships. Senior members of the families usually manage the London agencies. Apart from arranging charters, these managers are responsible for sorting out problems such as delays to ships and dealing with the media in the event of accidents such as an oil spillage. Although certain Greek shipowners have moved from London to Piraeus in recent years, many Greek families maintain a presence in London.

An estimate made by a knowledgeable Greek shipowner was that Greek shipowners resident in London, or resident overseas with an agency in London which was managed by a member of the family, control about fifty per cent of the total Greek fleet excluding coastal shipping, ferries and liners - of the order of 850 ships, about 70m. dwt of shipping, and, in terms of tonnage, 10 per cent of the world tanker and bulk carrier fleets of ships over 1,000 tons. Without carrying out a detailed enquiry into the residence of shipowners, it is not possible to make precise estimates of the ships owned by Greek shipowners with members of families managing their London agency companies, but information obtained from other members of the shipping community for the 1997 enquiry and for this follow-up survey supported the estimates, and members of the shipping community with whom we discussed the estimates were comfortable with them. Although there are many independent Greek shipowners the pattern of ownership is skewed. Twenty Greek families control as much as a half of the 70m. dwt of shipping.

As already noted, the 'timing' of chartering ships is an important element in the success of shipping firms. An advantage of London is that it has the greatest

concentration of *information* about the charter market. Shipowners resident in London also have ease of contact with brokers, insurers, lawyers and other experts. Other critical decisions for shipowners are whether to buy and sell ships and the timing of these decisions. Effectiveness in picking the tops and troughs of the shipping cycle requires judgement, knowledge of the shipping cycle and experience.

It is generally agreed that since 1980 the newer Greek shipowners based in Greece have been more successful than the Greek shipowners traditionally based in London in expanding their fleets. Whether this is attributable to their being willing to take more risks than the more *mature* London Greek firms is not clear, but there is an important implication of the difference in performance: the location of family members in London appears not to be a necessary condition for the success of family shipping firms. This may reflect the improvement in communications and ease and speed of travelling compared to the position in, say, 1960. Furthermore, the expansion of the shipping business and the expanded infrastructure in Piraeus, together with the support for the shipping industry provided by the Greek government, have made Piraeus and the surrounding area a more attractive location for shipowners.

Other Members of the Foreign Shipping Community

In addition to Greek shipowners, shipowners, including owners of some large fleets, who are domiciled in Norway, other Scandinavian countries, the Middle East, Hong Kong, India and Eastern Europe, are resident in the UK or have agency companies or managers or employ service companies in the UK. Recently, the fleet controlled from London by Russian owners has increased and Italian owners have moved to London. An estimate made in 2002 by a major London broker showed 16.5m. dwt of shipping owned

by non Greek foreign shipowners, including corporate owners, resident in the UK. However, certain of these shipowners are not at risk from a change in UK taxation of the foreign shipping community. In addition to the non Greek foreign shipowners listed as resident in the UK, there are non Greek shipowners with agency companies or managers in the UK. Here the focus is on the size of the non Greek fleet which would be affected by a change in the tax status of members of the foreign shipping community, shipowners domiciled overseas but resident in the UK or with agency companies managed by members of the families in the UK. Estimation of the size of this fleet is difficult because shipowners do not publish information about their places of domicile and residence. The estimate of the fleet owned by non Greek foreign shipowners resident in the UK reported earlier in this paragraph, information obtained from a firm of advisers to shipowners and assessments made by other industry experts who were interviewed suggest that it could be of the order of 30m. dwt, five per cent of the world fleet of tankers and bulk carriers, and equivalent to about 40 per cent of the Greek fleet at risk. An estimate reported in *British Invisibles* (1996) that ‘the presence of Far East owners, Russians, Norwegians and Americans may together generate as much business as the Greeks’ indicates a larger fleet. As for Greek shipowners, the pattern of ownership among the non Greek shipowners is skewed with a small number of families and groups of shipowners controlling much of the tonnage.

The Fleet at Risk

Combining the estimates of the Greek and non Greek fleets at risk from a change to the taxation of the foreign shipping community gives a total of 100m. dwt of shipping, more than 1,100 ships, equivalent to, of the order of, 15 per cent of the total world fleet

and with a gross value of about \$20bn. The total, 100m. dwt of tankers and bulk carriers controlled by the foreign shipping community, at risk from a change in the UK tax regime, compares to the fleet registered in the UK, 9m. dwt. Thirty families and groups of shipowners control about half the total fleet at risk.

3. Maritime Services and the City of London

The Baltic Exchange

The Baltic Exchange has retained its historic position as an important part of the City of London. Traditionally shipowners, brokers and representatives of charterers (oil companies, grain traders, etc) met face to face at the Baltic Exchange to arrange charters for ships and cargoes. Nowadays, most of the business is conducted by electronic communications, rather than face to face at the Baltic Exchange, but the close proximity in the City of London of shipowners and brokers facilitates frequent meetings and opportunities to meet to deal with any problems which arise.

The principal business of members of the Baltic Exchange is to arrange charters for ships. The freight or hire specified in the charter can vary from less than £100,000 to more than £10m. The Baltic Exchange has estimated that there are around 2,000 shipbrokers working for shipbroking firms in London.⁷ Some firms of brokers specialise in finding ships for charterers, others in finding charterers for shipowners and many operate for both shipowners and charterers. Similarly, there are brokers who specialise in buying and selling ships but other firms of brokers combine this type of business with chartering ships, though they may have separate departments for the two activities. Some brokers specialise in arranging charters for tankers or bulk carriers while some of the smaller firms specialise in arranging charters for a limited size range of cargo ships or types of cargo. Brokers charge commissions of 1¼ per cent of the value of the charter and this is paid by the shipowner to the broker. Sometimes, the charterer will also receive a percentage commission paid by the shipowner to provide remuneration for the

⁷ Source 'The Baltic Exchange', a brochure published by the Baltic Exchange.

chartering office. The Baltic Exchange estimates that as much as 50 per cent of the world tanker chartering business and 30 per cent of the world dry bulk chartering business is arranged in London⁸. A broker estimated that ‘over 50 per cent of the world’s sales and purchases of ships is arranged through the London market.’ Greek owners are particularly active in this market. In the first half of 2002 they have bought a third of all the ships sold (Clarkson Research).

Shipowners use other services available in the City. Insurance brokers, underwriters and companies earn substantial commissions and premiums from marine business. P&I Clubs, which are mutual associations of shipowners which underwrite a range of risks involving liabilities to third parties for shipowners, also receive premiums from shipowners. Certain banks in London have special departments for lending and providing other banking services to shipowners. Shipping is an important source of business for some firms of solicitors and accountants and barristers in the City.

The City

As the move towards global markets has gathered pace since 1980, the City has emerged as one of the most internationally competitive sectors of the UK economy. While segments of manufacturing industry have declined or even vanished, the City has been competitive internationally and been able to expand its international business while paying high salaries to many participants. The shipping market has participated in this success and has contributed substantially to it. The Baltic Exchange has retained its dominant share of the world markets for chartering and the purchase and the sale of ships. It has been estimated that UK financial institutions predominantly based in the

⁸ Source: ‘The Baltic Exchange’, a brochure published by the Baltic Exchange.

City earned a net £18bn. through overseas transactions in 1999 (British Invisibles (2000)) and that the contribution of maritime services £948m. (BI (2001)).⁹

The Competitiveness of the City

The competitiveness of the City is based on the accumulated knowledge, expertise and skill of the firms and individuals who make up the City. One source of competitive advantage is that London has the highest concentration of financial and commercial firms in the world, which is a legacy of Britain's historic role in the development of world trade.

There are, however, new challenges to the City's position:

- the boom at the turn of the millennium in mergers and acquisitions and the funding of high tech ventures and companies has burst. These were very profitable activities for the City.
- the City is handicapped by the UK opt-out from European monetary union (EMU) and the Euro at a time of rapid realignment of financial markets and institutions within Europe. (Already the UK has lost the race to host the European Central Bank)
- while the City has kept abreast of the telecommunications revolution and competition has forced down the costs of telecommunications for City firms, the improvements in the speed and global comprehensiveness of communications and reductions in the costs of communications have damped down the advantages of location in the City

⁹ The estimated contribution excludes the contribution from the UK-owned fleet.

- the costs of operating in the City are formidable; salaries and rents are higher than in many locations and the appreciation of sterling since the beginning of 1996 has raised this cost handicap
- the introduction of the Euro has eliminated foreign exchange trading in the currencies of members, a useful source of business for London in the past (London is the leading foreign exchange trading centre)
- City firms, like many manufacturing companies, have been acquired by overseas owners. Expatriate managers play an important part in managing and operating these firms and maintaining their international competitiveness. A change in the UK tax status of managers not domiciled in the UK but resident here could make it difficult for overseas firms to send managers to London and could weaken the competitiveness of the City.

The Competitiveness of the London Shipping Market

Success leads to success for markets. A market which has a large share of a category of transactions has advantages because of the quantity of *information* available and perhaps benefits from economies of scale for arranging and processing of transactions. It is a paradox that London retains the advantages of scale in the shipping market in spite of the diminished role of UK firms and sterling in world trade and the eclipse of UK domiciled shipowners in the tanker and bulk carrier trades. One important explanation for the paradox is the remarkable *combination* of many competing shipbrokers who, nevertheless, share information. Another explanation is the presence of the foreign shipping community, which provides the London shipping market with the largest concentration of ships available for charter in the world. The London shipping

community acknowledges the *loyalty* of foreign, particularly the London Greek Community, to the Baltic Exchange, to London insurance brokers and to other London firms providing services to shipowners. Apart from BP and, perhaps, Shell, few large scale *charterers* operate their main business from the UK and have no reason to be particularly loyal to the London market.

The presence of shipowners in London is an important source of expertise and information. At present Greek shipowners are Chairmen of the UK based P&I clubs and are active in other shipping institutions. They provide the views of *shipowners* and this perspective would not be available if they were to leave London.

Although the London shipping community has maintained its position in the global industry so far, its position is now less secure. Greek shipowners are the London shipping market's single most important source of business; already there has been some drift of London Greek shipowners to Piraeus and other locations, many of the new Greek shipowners have not set up offices in London and there has been a marked shift in the location of some aspects of the operational management of Greek owned ships to Piraeus. Many Greek families have moved the technical aspects of management - crewing, organising bunkering and repairs, etc - to offices in Piraeus. Lower costs for staff, office space and overheads in Piraeus have been the incentives for these moves. The improvements in telecommunications and air travel which have reduced the advantages of a permanent presence in London and concern about the future tax position of agency companies in London have also been factors.

The Baltic Exchange, in conjunction with other providers of maritime services in London, operates a promotion programme in the UK and overseas and makes every

effort to maintain London's pre-eminent position. Nevertheless, the position of the London shipping market is now viewed as precarious by some participants. The growth of demand for shipping in the future is expected to be concentrated in the Far East, and Singapore, Hong Kong and other countries are likely to attract more commercial shipping business. Within Europe, London has certainly maintained its position as the leading commercial shipping centre, but, if it lost its foreign shipowners, it could well lose that position and the advantages of scale which go with it.

Another possible potential danger to the London shipping market can be seen from comparisons with the investment management industry. Both the equity market and the shipping market are *efficient* markets - there are many well informed participants and prices incorporate the expected effects of all the information which exists. It is argued that there is no advantage to be gained by hiring an investment manager to play the stock market and that investors should invest in tracker funds instead to economise on management fees.¹⁰ The parallel implication for the shipping market is that it could be efficient for participants to avoid the costs of a presence in London and fix charters without access to as much information as is available in London. However, there are significant differences between the equity and shipping markets. As noted earlier, in the case of shipping there may be very few ships of the required size available at a specific port for charter, and charter-parties are far more complex and distinctive than contracts

¹⁰ Some participants in the equity market may get new information sooner or be able to analyse its impact quicker or more skilfully than other investors and get a return for these skills.

to buy and sell shares. The complexity of charter-parties is indicated by the average number of charters each shipbroker completes; very approximately, fifty a year.¹¹

There are some advantages for shipowners in having face to face meetings with charterers which are easier if both parties are resident in the same city. From discussions with charterers it is clear that they have a preference, other things being equal, for dealing with shipowners they know. Being able to trust the shipowner is important because of the complexity of charters. However, only 20 to 25 per cent of the charters fixed in London are arranged with charterers resident in the UK.¹²

¹¹ Based on estimates obtained from shipbrokers.

¹² Estimate provided by a shipbroker.

4. Taxation of the Shipping Industry

Unique Features of the Industry

The shipping industry has unique features for tax purposes. A ship on the high seas, unlike a factory or office where work is performed, does not have an obvious place of residence for tax purposes. The 'flag' flown identifies the country of registration, but many countries where ships are registered levy low or negligible charges and taxes. The special features of the shipping industry for tax purposes has been recognised by many governments, including the UK government, that have introduced unique tax arrangements for taxing ownership of ships.

International Taxation of Shipping

A recent Norwegian study (Knudson (1997)) concluded that in seven of the countries studied 'it is possible to operate as shipowners without being subject to ordinary taxation', though 'the use of foreign (open) registries may be a condition, and sometimes foreigners have better tax free facilities than national citizens'. In the other three countries, Denmark, Norway and Sweden 'during weak market conditions... liberal deductions before arriving at taxable income may effectively remove most tax'. Knudson concluded that: 'shipping companies which do not pay normal tax on profits dominate supply'.

UK Taxation of Shipping

During the 1980s and 1990s, the UK tax system was designed to be *neutral* between industries and there were no special rules for shipowners. However, the UK tax rules for people resident in but *not* domiciled in the UK have had, and still have, important effects. In brief, a shipowner who is domiciled abroad but resident in the UK

is liable to tax on his earned and investment income and capital gains received in the UK but is not liable to UK taxation on profits which are earned by companies, including shipping companies, registered and resident overseas and which are not remitted to the UK. Like other residents who are not domiciled in the UK, shipowners are not taxed on their investment income or capital gains, *which are not remitted to the UK*. A UK domiciled shipowner who *controlled* a shipping company resident overseas would be liable to UK taxation on its profits whether or not these were remitted.

The Tonnage Tax

From 1st January, 2000 an important change was made to the taxation of UK companies that operate ships. Shipowners were given the option of their tax assessments being related to the tonnage of their fleets instead of their profits. In effect, the taxation of a ship of 25,000 gross tons was pegged at about £30,000 a year.

These helpful changes did not eliminate the handicap faced by shipowners domiciled in the UK. The new regime only applies to vessels that are strategically and commercially managed in the UK and there are strings attached involving the provision of training. One way of dealing with the instability of the shipping industry and to take advantage of the volatility of freight rates and values of ships is to move resources in and out of the industry. In the words of Frank Tsao, a successful Asian shipowner: ‘ The trick is simply to make sure you supplement the (family) shipping business (with interests) in other market sectors’. The tonnage tax does not affect the taxation of investment income or income from non-shipping interests. UK domiciled shipowners are subject to taxation on dividends and interest from investments and capital gains on their non-shipping interests whether, or not, these are remitted to the UK. This would be a

very serious handicap if it were ever applied to the foreign shipping community.

Agencies

Some shipowners not domiciled in the UK have agency and/or broking companies in the UK. Any profits of non-UK companies could be subject to UK taxation through the UK agent, if there were significant economic activity in the UK which contributed to the making of profits for the non-resident companies. Whether there is significant economic activity is determined by 'an examination of all the relevant facts including such matters as where negotiations relating to potential cargo contracts are handled, where the contracts on behalf of the principal are concluded and the extent to which other operations on behalf of the principal are carried on (in the UK). In general, if the agency company is performing a full brokering service, then, whether or not it carries on other activities for the principal, it will be hard to avoid the conclusion that it is carrying on part of the principal's trade. If an agent is carrying on part of his principal's trade, it will be a matter for determination how much of the principal's own profit is attributable to the UK agency. It would be rare for all the profits to be attributed to the UK as there will usually be economic activity in the principal's own country of residence or elsewhere. Another factor to take into account will be where the economic risks are borne. But, in general, there will be some part of the non-resident's profit potentially assessable to UK corporation tax even where the agent is being remunerated on arm's length terms.'¹³ (The quotations are from a letter from the International Division of The Inland Revenue to The Baltic Exchange dated 8th July 1997).

¹³ 'In cases involving agents for non-residents there are two distinct assessments. The first assessment is on the agent in respect of his own profits and the second assessment (usually sent to the UK agent) is on the non-resident's profits ... In practice, where the

The Effects of the Tax Treatment of Shipping

The Effects on the Returns from Shipping

Mayr and McGrath (1997) have shown that differences in taxation are ‘the major source of international variation in the cost structures of tramp shipowners and that it can significantly increase the total cost and reduce the realised return on shipping investment’. Greece, Norway and Hong Kong where taxes are minimal are, together with the UK, the countries of residence of shipowners owning the world's largest fleets of ships for charter on the open market. Effectively, shipowners resident in these countries do not pay significant taxes on their shipping operations; provided, in the case of residents of the UK, they are not domiciled in the UK. Shipowners in many other countries are not subject to significant levels of taxation. As most ships are operated by shipowners who do not pay taxes, it follows that in the long run the return on investments in shipping will be forced down to equate the *gross* return on investment in shipping with the *post-tax* return on alternative investment in equities and gilts. (Returns on shipping and equities include risk premia).

It is difficult to test this theoretical expectation by comparing actual returns for shipowning for several reasons: many shipowners do not publish their financial results and the industry is subject to short and long term fluctuations in returns which make for difficulties in identifying the returns for shipowning. Certain governments provide

parties are connected, the Inland Revenue may agree to the non-resident's profit being built into the agency fee structure so that only one assessment is necessary. If the principal is a resident of a country which has a double taxation agreement with the UK then the terms of that agreement must be taken into account. This may restrict UK taxing rights’. Special protection for agents from assessments on behalf of non-resident principals is given to certain categories of agents including brokers. However, it appears that ‘the typical agency shipping company regularly acting for associates overseas is unlikely to enjoy this protection.’

subsidies for the construction of new ships or financing the purchase of new ships which affect the investment returns for some owners. However, it is clear that the average returns on investment in shipping since 1973 have been low and this supports the view that in the long term the tax free regime for shipping results in lower prices for charters rather than inflated post-tax returns for shipowners.

Martin Stopford (1991), using a set of hypothetical assumptions, has calculated that the average gross return for shipowning for bulk carriers between 1971 and 1990 was nine per cent per annum in nominal terms compared to the return on equities over the same period of eleven per cent. He pointed to the greater volatility of returns for shipowning and the implication that the risk premium for shipowning should be higher than for equities. Stopford chose to calculate the return on the ownership of dry bulk carriers after commenting that the return on investment in very large tankers ‘was certainly strongly negative’ over the fifteen year period starting in 1973. Since 1990 the returns from shipping have remained low. There have been brief periods of high freight rates and hence profitability, as in the year 2000, but many shipowners have had to re-equip their fleets.

The risk premium associated with a risky financial asset is defined to be the difference between the expected return on the asset, conditional on all available information, and the return on a riskless asset. Taking gilts as a less risky asset, the risk premium for holding equities has historically been substantial, of the order of six per cent depending on the period selected. As the yield on gilts has been volatile reflecting changing expectations about the future rate of inflation and as investments in gilts provided negative real returns during the 1970s, the justification for such a large risk

premium is uncertain. The historic difference in returns may reflect faulty expectations of investors rather than conscious assessments of greater risks of investment in equities by investors. One interpretation of the increase in equity prices and buoyant returns on equities during the 1980s and 1990s is that the risk premium has substantially reduced. This reason for rising equity prices has run its course, and future returns on equities are expected to be lower.

The riskiness of an investment is usually measured by the standard deviation of the daily, monthly or annual returns on the security relative to its trend price. Martin Stopford has compared the volatility of the returns on shipowning and equities and has shown that the volatility of the returns on shipowning is greater which suggests that the risk premium for shipowning should also be greater. As noted above, his calculations indicate that the actual gross returns on shipowning have been lower than the after tax returns on equities which suggests that the returns, after allowing for the higher risk premium on shipping, have been substantially lower than the returns on equities.¹⁴

¹⁴ A qualification to this conclusion is that investors have a limited choice of inflation-proofed assets and an alternative to equities, even if volatile, could be attractive if the fluctuations were not closely related to those for equities. However, some of the periods of lowest returns on shipping have approximately coincided with low returns on equities.

The Effects of Taxation for Shipowners who are Subject to Taxes

It follows from the supply of shipping being dominated by shipowners who do not pay taxes that a shipowner subject to significant taxation would be at a competitive disadvantage and would in time be forced out of such a competitive industry as shipping. The taxation of UK domiciled shipowners has contributed to the withering of the British tanker and dry bulk cargo fleets prior to the introduction of the tonnage tax. The rundown of the fleet owned by US domiciled shipowners after the US tax rules were changed circa 1961 to tax shipowners is often used to illustrate the importance of taxation for the competitiveness of shipowners and the effects of taxing profits on investments in shipping. Knudson (1997) reports that in Norway ‘following general tax reform effective from 1992 (which) curtailed former liberal income deductions, several shipowners ... moved’. Prior to the introduction of the UK tonnage tax, a small UK based shipping company, Carisbrooke Shipping Plc, reported that it was selling its two new ships to a Dutch Investment Fund and commented: ‘The tax incentives available to Dutch private investors allow them to make attractive returns while maintaining a relatively low level of gearing in the venture.’ Since the introduction of the tonnage tax there has been an increase in the tonnage registered in the UK.

The Effects of a Change in the UK Tax Rules

If the rules of domicile for tax purposes, or the tax status of people resident in the UK but not domiciled here, or the taxation of agency companies were changed, the effects would depend on the precise changes made and the circumstances of shipowners. However, any substantial increase in the taxes paid by people domiciled overseas but resident in the UK, or the taxes paid by agencies in respect of the profits of their overseas

shipowning principals' operating companies would have dramatic consequences for the overseas shipping community in the UK. Many foreign shipowners would withdraw from the UK. There are three reasons for this conclusion.

- as reported earlier, shipowners who pay taxes are not competitive in the tanker and dry cargo trades and in the long run would be forced out of the business.
- shipowners have the option of easily moving to countries where their shipping operations would not be subject to tax. (This option is not available to most other businessmen who operate factories, offices, restaurants, etc.)
- the need to *disclose* information about their families' financial arrangements, which would be onerous.

It may be argued that a change in the tax rules would not be disruptive because the taxation of shipping has been made bearable by the introduction of the tonnage tax. For the reasons given earlier this conclusion would not be valid for most members of the foreign shipping community. Alternatively, it might be suggested that the capital allowances available to UK companies for ships, 25 per cent of the initial cost in the first year and 25 per cent of the reducing balance in subsequent years, are generous and that a shipping company based in the UK which is increasing its fleet and acquires new tonnage can avoid taxes by setting the capital allowances against its profits. (Generally, the expected life of ships varies up to twenty-five years). Capital allowances are, however, only useful for shipping companies such as P&O and some smaller UK shipping companies which have diversified and which can, in practice, set capital allowances for ships against taxable profits on other activities.

Changing the tax status of people who are not domiciled in the UK to tax them on their earned and investment income and capital gains not repatriated to the UK would not necessarily result in the taxation of the profits from shipowning. Nevertheless, it is claimed by shipowners who would be affected by this change that they would withdraw from the UK. This would apply to shipowners resident, but not at present domiciled in the UK, and to other overseas shipowners with agency companies in the UK managed by members of their families and to shipowners with agency companies in London which are likely to be subject to detailed Inland Revenue investigation to determine whether and to what extent the offshore managers and shipowners could be subjected to UK taxation.

When assessing the response of foreign shipowners, the concentration of ownership is significant. Thirty families and groups of shipowners control about half the 100m. dwt fleet at risk. It would not require a large exodus to significantly reduce the London fleet operated by the Greek and other foreign shipowners who are resident in the UK but domiciled overseas or who have agency companies in the UK managed by members of the families. Also, the family members at present in charge of the London agencies are senior members of the shipowning families and the members of the families which own large fleets are likely to have significant investment portfolios apart from their shipowning interests. Shipowners would, of course, have the option of retaining London agency offices with limited functions manned by non-family members which they could visit occasionally, but this would not be an attractive option.

It follows that a change in the tax rules to make shipowners liable for substantial amounts of individual and corporate taxes would cause members of the foreign shipping

community to leave London and would *not* in the long term result in any extra tax revenue for the UK. In practice, tax revenue would be *reduced* as explained in Chapter 5.

Entrepreneurs

The UK government has recognised the importance of entrepreneurs for the performance of the economy. Among the steps taken to promote enterprise and reward risk-taking the government has reformed the capital gains tax and made special provisions for business assets. These reforms have reduced the effective rate of tax on capital gains from business assets to 10% and many entrepreneurs can take their income as capital gains thus avoiding income tax. The reforms discriminate between shareholders and taxpayers.

The foreign shipping community are the entrepreneurs of the shipping industry. It is noteworthy that the son of a Greek shipowner, Stelios Haji-Ioannou, is one of *Britain's* best known entrepreneurs. The present tax arrangements discriminate between domiciled and non-domiciled residents of the UK. The discrimination can be justified, like the discrimination in favour of business assets, as a support for entrepreneurs.

Tax Rules

If the UK were to change its tax rules affecting residents not domiciled in the UK, without introducing special rules for shipowners, the London Shipping market would be in a similar position to the Ford Motor Company while Henry Ford insisted that customers could have any colour of car they wanted: 'as long as it's black'. From 1923, the Ford Motor Company rapidly lost its share of the market and had to abandon its policy. It is noteworthy that the Ford Motor Company recovered after it changed its policy and provided a choice of colours, but it is very doubtful if a subsequent change of

policy by the UK government could reverse the effects of a policy to tax the foreign shipping community once members of that community had left London; the costs and disruption would be too great and there would be the possibility of another erratic reversal of policy in the future.

The UK has a reputation for the stability of its tax regime for people domiciled overseas and resident in the UK. The stability of a tax regime is an important consideration for shipowners contemplating moving to a country. In addition to the effects of a change to the tax regime on the existing members of the foreign shipping community, it would inhibit new Greek and other foreign shipowners moving to London in the future.

5. The Contribution of the Foreign Shipping Community to the UK Economy

The Alternative Position

In this chapter the contribution of the foreign shipping community to the UK economy is quantified in terms of its impact on:

- employment
- the output of the economy, GDP
- service sector foreign exchange earnings
- net tax revenue

In order to estimate the size of these effects it is necessary to identify the alternative position - what would happen if the foreign shipping community withdrew from London. Initially it is *assumed* that all the foreign shipping community at risk from a change in the tax regime leave the UK and take *all* their business with them, they cease to use London brokers and insurance underwriters, UK P & I Clubs, etc. and that there are no other changes. The reality of these assumptions is examined in Chapter 6.

The Effects

Table 5.1 lists the effects of the withdrawal of the foreign shipping community. To estimate the effects it was assumed that all the Greek and other shipowners resident in London and all the shipowners resident overseas with agency companies in London which were managed by members of the families had withdrawn from London and taken their business with them. These shipowners account for approximately fifteen per cent of the world fleet of tankers and bulk cargo vessels in 2002. The effects would not apply

Table 5.1 The Effects of the Hypothetical Withdrawal from London of the Foreign Shipping Community in 2002⁽¹⁾

Effects on:	Size of the Effect
Employment (employees)	-4500
GDP (£m.) ⁽²⁾	-390
Balance of Payments (£m.)	-375
Net tax revenue (£m.)	-125

⁽¹⁾ It is assumed that the foreign shipping community take all their business with them and cease to use London brokers and insurance underwriters, P&I Clubs, etc.

⁽²⁾ It is assumed that GDP is determined by aggregate demand and that the withdrawal of foreign shipowners would reduce demand. In time some of the resources, including labour and office space, would be re-employed reducing the estimated effect on GDP.

evenly to all shipbrokers, insurance brokers and underwriters and P&I Clubs because some of these firms and clubs are much more dependent on the foreign shipping community which would be affected by a change in the tax regime than others.

London brokers have a 50 per cent share of the world tanker chartering market and 30 per cent of the dry bulk chartering business worldwide. Allowing for ships which are not available for charter, about one third of the total, which are used by the shipowners such as oil companies and are rarely put out to charter, the loss of 15 per cent of the world fleet would represent more than one third of London's tanker chartering business and 40 per cent of its dry bulk carrier business.

The estimates shown in Table 5.1 are based on the estimates made for the original study by the author in 1997 and estimates of the contribution of maritime services to the

UK economy to the year 2000 (BI (2001)).

The estimates in Table 5.1 show the magnitude of the effects on the economy if the shipowners at risk from a change in the tax rules left the UK and withdrew all their business from London. In relation to the macroeconomy the effects are not large, the loss of employment would be less than 0.02 per cent of the UK labour force. In relation to the balance of payments the loss would be more significant as most of the revenue foregone would, in effect, be lost overseas service earnings equivalent to 0.2 per cent of the UK's exports of goods and services. There are three further important points to note about the effects of a change in the tax status of shipowners domiciled overseas but resident in the UK which led to them withdrawing their business from the UK. It would:

- result in the loss of 4,500 jobs with most of this reduction concentrated in the City. (The loss of employment would not be limited to shipping professionals but would include secretarial/administrative and accounting staff). The total of jobs lost represents one-third of the 13,800 employees in maritime services in 2000, (BI (2001)).
- *reduce*, not increase, tax revenue by about £125m. and this reduction would *not* be offset by a significant cut in public expenditure
- have large adverse effects on the London shipping business and the firms in the legal and accountancy professions which specialise in work related to the shipping business.

6. The Economic Effects of a Change in the Tax Status of the Foreign Shipping Community

What Would Happen in Practice?

In practice, the effects of a change in the tax status of UK resident shipowners who are domiciled overseas would depend upon the precise nature of the changes to the rules and the enticements (tax and otherwise) offered by other countries. They would vary for different shipowners and would be spread out in time. Many countries, including the UK, have introduced special, more friendly, tax regimes for shipowners. An attractive feature for shipowners of the arrangements introduced in the Netherlands is that the new tax reliefs are guaranteed for ten years, providing shipowners with a *stable* tax environment. The competitive scramble by Vancouver, Singapore and other countries to attract Hong Kong shipowners before the hand-over to China indicates the scope for competition to attract shipowners.

In the long term, for the reasons described in Chapter 4, shipowners could not pay substantial taxes and remain in the tanker and bulk carrier trades and many shipowners would leave the UK. One option for those affected by a change in tax status would be to move to Greece, Monaco, or other low tax location with attractive facilities and carry on as before using London shipbrokers and insurance brokers. *Some* brokers, including brokers who presently act for Greek shipowners based in Piraeus without London agencies, take the view that this would be the effect. They believe charterers already in London would stay, that shipowners need to come to the London brokers for information and that London brokers would fix charters for shipowners and charterers with *both* parties based overseas.

Managers of P&I Clubs take the view that their business would not be much affected by the country of residence of shipowners; many Greek shipowners based in Piraeus without London agencies are already members. Similarly, London insurance brokers and underwriters and solicitors would expect to retain a significant share of the foreign shipowners' business because of their reputation, knowledge and experience, the depth of the London insurance market and the widespread use of English law for settling disputes. The argument about the improvement in communications operates in both directions, shipowners who leave London will be able to keep in contact with London shipbrokers and insurance brokers.

Another scenario is that the foreign shipowners who withdraw from London concentrate in Piraeus where the infrastructure has been built up and where they would be welcomed, or elsewhere depending on the tax regime and any incentives offered. In contrast to their present practices, the foreign shipowners would not feel any particular 'loyalty' to the London shipping market and it would no longer be in their interests to promote London as a commercial shipping centre. At first they would continue to do business with their contacts in London but they would, in time, make new arrangements.

More generally, a shock to participants in a market is likely to make them re-examine assumptions and conventions which they have taken for granted for many years. A change in tax rules would act as a shock and precipitate changes. This 'shock' effect could be particularly significant as the advantages of a presence in the London shipping market have already weakened. It would not be surprising if the owners affected by a change in tax status thoroughly tested alternative arrangements by, for example, seeking to fix charters direct with charterers, particularly the majority of

charterers who are not based in London. Greek shipowners based in Greece without an agency company in London were estimated by one broker to place only 25 per cent of their business through London brokers. If they leave London, the shipowners may deal with insurers direct and cut out the London brokers.

In the event, the withdrawal of foreign shipowners could have disproportionate results for shipbrokers. Effectively, London shipbrokers would lose their local shipowners, more than a quarter of their business, and thereafter would be dealing for the most part with overseas shipowners *and* charterers. The loss of Greek business would be particularly disruptive because the Greek shipowners are, on average, disproportionately active in the short term charter market and in buying and selling ships. They provide the London market with depth and liquidity and are innovative. Also, the average size of the fleet of ships at risk from a change to the tax status of members of the foreign shipping community is larger than the average for all ships chartered in London. Given the brokers' practice of charging percentage fees, charters for larger ships tend to be the more profitable business for brokers: the loss of this business would therefore have a particularly adverse effect for brokers. One broker summed up the position with the comment: 'The Greeks are vital for the business'. These effects would be exacerbated in time by the absence of shipowners including new and dynamic shipowners, moving to London.

In time the brokers would lose business and the loss would be cumulative; as the relative advantages of London were eroded, more shipowners and charterers would question their presence in London and leave. London would lose its competitive advantage - particularly access to more information and knowledge about the shipping

business than is available in any other centre - provided by the presence of the foreign shipping community and the scale of business conducted in London. Some of the insurance business would drift away from London and insurance brokers and P&I Clubs at present operating in the UK would relocate more of their operations overseas. An insurance broker suggested that he would lose some of the business he now obtains from Greek shipowners based in Greece if the foreign shipping community withdrew from London. The viability of firms and organisations in London which collect and publish information and provide other support services would be threatened by the erosion of business. The London shipping market would lose 'critical mass', the flow of information and knowledge and availability of experience of the shipping business would dwindle and this process could be speeded up by Piraeus simultaneously gaining critical mass. In time Piraeus could take over from London as the *European* commercial shipping centre.

Conclusion

Changes to the existing approach to the taxation of people not domiciled in the UK, which would lead to the withdrawal of foreign shipowners from London, would weaken the position of shipbrokers and other London businesses specialising in work related to the shipping industry. If this occurs at a time when the City is under pressure for other reasons, as in 2002, the effects would be serious. Also, there could be substantial adverse effects in other sectors of the UK economy and City from any change in the taxation of residents who are not domiciled in the UK. The UK and London would be less attractive locations for potential entrepreneurs and employees from overseas with

expertise and skills. Foreign shipowners are only a very small fraction of the people who would be affected by the changes.

Since 1998 the UK government has recognised the importance of the role of entrepreneurs for the performance of the economy by introducing a special low rate of tax on capital gains on business assets. It has also recognised the exceptional position of shipowners competing with owners who pay little or no tax by introducing the tonnage tax. The foreign shipowners resident in London are entrepreneurs who contribute to the strength of the London maritime service trades. There is, therefore, a strong case for continuing the present friendly and helpful tax regime that applies to them. This would be consistent with the government's fiscal innovations to support entrepreneurs and shipowners. The alternative of attempting to subject the operations of the foreign shipping community to UK taxes would be counter-productive. In practice, tax revenue would be reduced and the London maritime service trades, the world leaders, would be weakened and, perhaps, in time, undermined by the loss of the foreign shipping community and their business.

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