



# THE JONES ACT: PROTECTIONISM V GLOBAL TRADE

## Executive Summary

United States trade policy has evolved to meet the challenges and opportunities of international markets since the nation's founding. Over the years, innovation has provided new outlets for accessing the global markets, but one law has fostered an inconsistent and inefficient standard for how goods move by water, and who carries them. The Merchant Marine Act of 1920, or The Jones Act, is a protectionist law that safeguards the domestic shipping industry from foreign competition. It was also originally intended to bolster national security by ensuring domestic sealift capability during times of war. By requiring that trade between U.S. ports be carried on a U.S.-built ship that is U.S. owned, flagged, and operated by a crew of 75 percent U.S. citizens, the trade policy bans effective competition within the United States.

Generally seen as a bastion for free markets and free trade, the U.S. maintains the world's most restrictive cabotage law, creating an inconsistent trade policy that manipulates prices and harms consumers. For almost 100 years, the Jones Act guaranteed domestic shippers a monopoly on certain trade routes and protected ship builders and crew from competition. Blocking competition, however, eliminates the incentive to innovate, lower costs, or improve standards. As a result, the cargo fleet has slowly deteriorated and become unnecessarily expensive to operate. The citizen crewing requirement alone increases the daily cost to man a Jones Act vessel by at least six times the cost of a foreign-crewed ship due to inflated wage rates. The higher costs are then incorporated into the cost of the goods being transferred, harming end-users.

In the recent federal spending bill, Congress lifted the crude oil export ban. This change was necessary to account for the rapid increase in U.S. energy production, and to assert U.S. influence in the international energy trade. Incidentally, it also highlighted the sharp contrast between the recognition that we are competing in a global economy, and outdated policies that hinder trade, like the Jones Act. The opportunity for international energy trade must be accompanied by the ability to move products competitively, which requires a revision to existing law.

U.S. island states and territories are among the most burdened by the Jones Act. Unlike the lower 48 states, that can transport products to, from, and through one another by rail, pipeline, or truck, islands, including Hawaii and Puerto Rico rely solely on cargo ships to bring food, energy products, and virtually every other good into their economy. Further, the Jones Act cabotage restriction forces foreign shippers to bypass these islands en route to the mainland U.S. ports - in order to remain in compliance with the law - where products are then offloaded and reloaded onto expensive vessels to be transported to the island at substantially higher cost to consumers.

As America finally engages the international energy market this year, leaving the Jones Act in place is counterintuitive. U.S. policy should support allowing cargo to move freely from port to port, whether domestic or foreign, to ensure U.S. consumers are not paying a premium on goods and services delivered. It should also ensure that it does not cost more to ship a product from one U.S. port to another than it costs to export the same good, which would have the perverse effect of discouraging domestic commerce.

## Introduction

The United States trade policy has been under scrutiny in recent years, as increased attention has been placed on international markets with the Trans Pacific Partnership and various trade restrictions on U.S. energy products. One of the biggest factors affecting trade, however, is in our own legal code, a century-old law that complicates the movement of goods and manipulates maritime commerce. Officially titled the Merchant Marine Act of 1920, the Jones Act (the "Act"), which was meant to protect the U.S. shipping industry, has become a hindrance to free trade due to now unnecessary and overly strict rules on transporting goods via water.

The recent increase of U.S. energy supply, and consequent realignment of U.S. energy policy serves as a perfect example of how the Act can hinder an otherwise perfect opportunity to improve the U.S. trade imbalance and generate economic growth. Congress recently repealed a decades-old ban on the export of domestic crude oil. For years, domestic energy production has been on the rise, primarily due to the combination of hydraulic fracturing technology and horizontal drilling techniques, which together have made previously inaccessible oil fields viable for production. This unexpected production led to an excess supply and consequent drop in oil prices. The call to remove this export ban was echoed by industry leaders, economists, and policy experts, and finally came to fruition in the year-end Omnibus spending bill. With this obsolete ban off the books, attention has shifted to the equally outdated Jones Act.

With the export ban newly repealed and a standing trade restriction law, these policies are now at odds with one another, creating a dichotomy in U.S. trade policy that fosters inefficiency. While Congress took a step toward global trade by lifting the export ban, it maintains a protectionist law that is counter to international trade and competition.

## History of Jones Act

The Act was implemented following World War I to protect the domestic shipbuilding industry and ensure a strong maritime fleet that would be ready for war. Marketed as a safeguard for national security, the Act evolved to promote maritime commerce and formally protect the rights of seamen, specifically relating to injury at sea.

*The act requires that vessels traveling between two U.S. ports be U.S. built, owned, flagged, and operated by a crew of 75 percent American citizens.<sup>1</sup>*

This bans cabotage, or foreign competition from bringing goods into two U.S. ports consecutively or from transporting goods within the United States. According to the World Economic Forum and the World Bank, the Jones Act represents the most restrictive cabotage law, not just among industrialized nations, but in the world.<sup>2</sup> Qualifying ships must be built in U.S. with no more than 10 percent composed of foreign material and labor. This rule seems arbitrary, but is meant to maintain quality and a robust domestic shipping industry to ensure job security. Building and safety standards are safeguarded by insulating the shipbuilding industry. Introducing competition, however, could stimulate innovation, which would drive down costs while improving the quality of the product.

Today, about six dozen Jones Act-qualified vessels are in operation, and for almost 100 years these ships have not been subject to competition or encouraged to innovate. This is not to say that these vessels are dilapidated, but because they have a monopoly on domestic trade routes, there has been no incentive to reduce costs, improve standards, or update technology. The largest lobby for maintaining the law is the shipping industry because wages and contracts are guaranteed as long as the legislation remains unchanged. Repealing the Act would remove the

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<sup>1</sup> 46 U.S.C., §§ 1-39 (1920). Print.

<sup>2</sup> World Economic Forum. (2013). Enabling Trade Valuing Growth Opportunities. Retrieved January 4, 2016, from [http://www3.weforum.org/docs/WEF\\_SCT\\_EnablingTrade\\_Report\\_2013.pdf](http://www3.weforum.org/docs/WEF_SCT_EnablingTrade_Report_2013.pdf)

U.S. shipping industry's protections from foreign competitors, but would also result in a more efficient and equitable economy. The potential loss to the shipping industry could be more than compensated for by overall growth. A full repeal may not be politically feasible, but a revision is certainly necessary.

## Economics and the Cost to Consumers

Lifting the crude oil export ban was a step in the right direction for achieving greater economic and allocative efficiency, but allowing the Jones Act to stand unaltered is incongruous. The opportunity for international energy trade must be accompanied by the ability to move products competitively. The repeal of the export ban allows the U.S. to send more light sweet crude overseas while taking in heavier, sour crude that domestic refineries are better calibrated for. With export perversions, domestic refiners are underutilized or inefficiently operated, handling crude they were not tuned to refine.<sup>3,4</sup>

Conversely, the Jones Act hinders efficiency, because imported oil must be carried on a U.S.-flag ship if it makes more than one stop along the U.S. coast. Consequently, it becomes cheaper to export and more expensive to import as a result of the vessel requirements. More than a quarter of all Jones Act-qualified ships currently make crude runs from Texas refineries to Florida or the northeast. These routes are expensive because of the high operating costs due primarily to wages.

For example, the route from Texas to Canada is significantly cheaper than to the northeast because foreign vessels are able to undertake it.<sup>5</sup> The result

is that states in New England pay a higher price for their oil than their northern neighbors pay for the same product. If left untouched, the Jones Act rewards the shipping industry to the detriment of domestic producers and consumers of petroleum products. Further, Alaska and Hawaii, along with Puerto Rico and other U.S. territories are disparately impacted because foreign ships must avoid these locations if the continental U.S. is their ultimate destination.

The cost of operating a ship for one day varies highly between a Jones Act ship and a foreign vessel. For example, ships that frequently operate between California and Alaska, unless stopping in Canada, must be U.S.-flag ships. The average daily cost for such a vessel is about \$11,500 for crewing alone, compared to about \$2,000 for a foreign-crewed.<sup>6</sup> This six fold daily rate adds to the transportation cost, which is ultimately incorporated into the cost per barrel of the product.

For shorter routes between U.S. ports, such as refineries between Texas and the northeast, up to seven dollars per barrel is added by requiring

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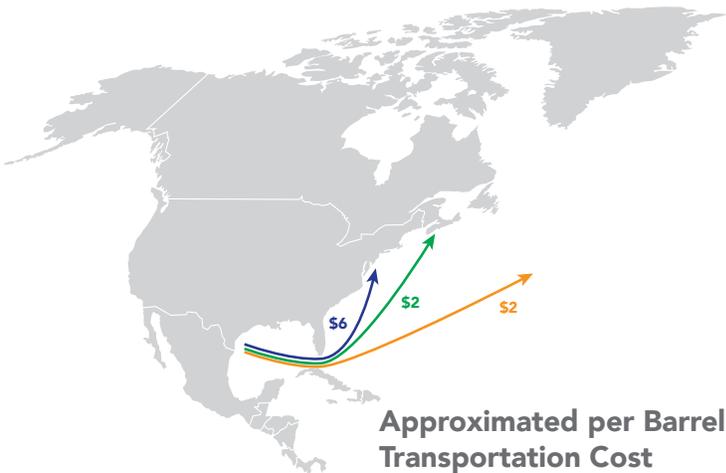
<sup>3</sup> Haun, E. (2014). Refiners Seek Jones Act Workarounds as Crude. Retrieved January 5, 2016, from <http://www.marinelink.com/news/workarounds-refiners375381.aspx>

<sup>4</sup> Kilisek, R. (2014). Jones Act Amendments Should Precede U.S. Crude Oil Exports. Retrieved January 5, 2016, from <http://breakingenergy.com/2014/02/03/jones-act-amendments-should-precede-us-crude-oil-exports/>

<sup>5</sup> Haun, E. *supra*

<sup>6</sup> Sussman, A. (2014, August 20). Refiners seek Jones Act workarounds as crude export debate heats up. Retrieved January 4, 2016, from <http://www.reuters.com/article/us-oil-shipping-jones-idU.S.KBN0GK0BT20140820>

U.S. vessels. A shipment originating in Texas and traveling to Canada, though traveling a farther distance, costs about two dollars per barrel. Similarly, the cost to export to Europe adds only about two dollars per barrel because foreign vessels with lower crewing costs can carry the products.<sup>7,8</sup> The incentive is to increase exports to Europe or Canada and not the northeast, effectively harming domestic markets by favoring international markets.



The very protectionism the Jones Act promotes for shipping creates vulnerability in domestic oil markets. By removing such obsolete protectionist legislation, the U.S. can strengthen its global position through competition and global trade. Protectionism often benefits a specific industry in the short term, but over time, incentives become warped and inefficiencies develop in other areas of the economy. Lifting the oil export ban will not immediately stimulate

the U.S. economy, but over time, it will bolster the energy sector. However, as time goes on, the inefficiency of Jones Act requirements will add up to millions in foregone economic growth, which doesn't account for the loss in potential innovation by the U.S. shipping industry.

The U.S. International Trade Commission found that in 1996, the Jones Act cost the U.S. economy an estimated \$1.3 billion.<sup>9</sup> A subsequent study revealed that the agency projected a \$656 million annual positive welfare effect for the economy if the law were repealed.<sup>10</sup> Congress must overhaul this legislation to synchronize it with contemporary economic, political, and industrial considerations. Greater latitude must be allowed to reduce the cost of compliance, and exemptions should be granted for disproportionately affected locations like islands.

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Because a permit or waiver system exists, shippers can be exempt from certain provisions of the Act. By subjecting this process to a government regulatory procedure, the industry faces business uncertainty, as companies cannot make cost, time, and other simple calculations including whether their waiver request will be accepted at all. This climate of uncertainty is detrimental to business growth and efficiency. The increased

<sup>7</sup> Holland, P. (2015, July 15). Help Puerto Rico by Repealing the Jones Act. Retrieved January 4, 2016, from <http://economics21.org/commentary/jones-act-puerto-rico-debt-crisis-anne-krueger-07-15-2015>

<sup>8</sup> National Petroleum Council. (2015). Paper #7-5 OPERATIONAL LIMITATIONS DUE TO COMPLIANCE WITH THE JONES ACT. Retrieved January 4, 2016, from [http://www.npcarcticpotentialreport.org/pdf/tp/7-5\\_Operational\\_limitations\\_Due\\_to\\_Compliance\\_with\\_Jones\\_Act.pdf](http://www.npcarcticpotentialreport.org/pdf/tp/7-5_Operational_limitations_Due_to_Compliance_with_Jones_Act.pdf)

<sup>9</sup> World Economic Forum. *supra*

<sup>10</sup> World Economic Forum. *supra*

costs to shippers manifests in higher per barrel transportation costs for both foreign shippers, who must comply with the legislation or seek costly loopholes, and for domestic shippers, who pay higher crewing costs. Revising this Act could lead to a more predictable model for shippers, allowing them to optimize their routes, lowering costs and prices for consumers.

## Exceptions and Waivers

U.S. Customs and Border Patrol has direct administrative oversight of the Jones Act, and is responsible for enforcing its provisions and granting waivers.

*U.S. Customs and Border Protection (Customs) has direct responsibility for enforcing the Jones Act and may grant waivers of the U.S.-flag, U.S.-build or U.S.-ownership requirements only in the interest of national defense.<sup>11</sup>*

There is a formal process for granting waivers, but also loopholes to get around compliance. Certain shippers can acquire waivers to permit certain types of trade, though these are inconsistently distributed and must serve a compelling national security, emergency, or strategic interest justification.

Outside of the formal waiver process, it is not uncommon for foreign vessels to travel between Alaska and California, making a quick stop in British Columbia to avoid the U.S. port repetition. This allows a vessel that does not meet Jones Act standards to avoid a waiver and still transport goods between U.S. ports. Requiring foreign ships to take such steps causes inefficiency by costing the shipper more time and money, ultimately delaying the delivery and increasing the cost of any product.

No such loophole exists for Hawaii, meaning any ship leaving the U.S. west coast must be a Jones Act-qualified vessel to stop in Hawaii, and any ship coming out of the Asian Pacific must choose

between Hawaii and the U.S. mainland because of the multiple stop rule for foreign vessels. The result is that consumer goods of all kinds are artificially more expensive in Hawaii due to the cost to transport products to the island. One major exception exists in the Jones Act for the U.S. Virgin Islands, which should serve as a model for all islands. Because islands are geographically disadvantaged, this legislation has virtually no benefit but a substantial opportunity for harm.

## An Analysis of Puerto Rico

The Jones Act, officially the Merchant Marine Act of 1920, should not be confused with the Jones-Shafroth Act of 1917, which granted U.S. citizenship to Puerto Ricans. In light of the Jones-Shafroth Act, however, Puerto Ricans are considered U.S. citizens and the island is a U.S. territory. The relationship the island has with the U.S. is not all beneficial, however. Puerto Rico is not eligible for Chapter 9 of the U.S. Bankruptcy Code and is restricted by all Jones Act shipping requirements. As an island, Puerto Rico is disproportionately affected by the Jones Act because it relies solely on marine transports for goods, whereas the continental U.S. has alternatives such as pipeline, rail, or freight trucks.

According to a 2013 U.S. Government Accountability Office (GAO) report, trade between the mainland and Puerto Rico occurs on a weekly schedule, utilizing four Jones Act container ships. The report acknowledges, "some vessels are operating beyond their expected useful service life".<sup>12</sup> The GAO goes on to detail the difference in costs for domestic and foreign shippers, noting that even on longer routes, foreign vessels frequently maintain lower operating costs. Finally, the study found that some shippers have reported a lack of qualified bulk cargo vessels. The ultimate conclusion of the report is that there are too many factors affecting prices and economic trends to attribute a significant blame to the Jones Act and that the effects of modifying the Act are uncertain.

<sup>11</sup> MARAD. (n.d.). Maritime Administration News Release. Retrieved January 4, 2016, from [http://www.marad.dot.gov/search/jones act/](http://www.marad.dot.gov/search/jones%20act/)

<sup>12</sup> GAO. (2013). PUERTO RICO Characteristics of the Island's Maritime Trade and Potential Effects of Modifying the Jones Act. Retrieved January 4, 2016, from <http://www.gao.gov/assets/660/653046.pdf>

The U.S. Department of Transportation has agreed with the findings of the GAO, stating that the Jones Act presents complex and multifaceted issues.<sup>13</sup>

The complexity of the issue alone should encourage revision, rather than serve as an excuse to avoid the problem altogether. Further, the GAO report identifies multiple problems that exist in the trade route, all of which are in some way related to Jones Act requirements, but because the relationship cannot be completely vetted, the agency determined that the cabotage law should not be altered. The last justification for avoiding a revision to the law was that any amendments or repeals could potentially harm the industry the Act was made to protect, but this is precisely the reason to modify it. The Act is outdated, a product of the early twentieth century, and is no longer beneficial to the macro economy of the U.S. in a global trade market.

Virtually every good, from food to energy products to construction material is inflated for Puerto Ricans because of the higher transportation costs associated with U.S.-flag ships crewed by U.S. citizens. The price per gallon of gasoline is 15 cents higher because of transportation costs than it would be in the absence of Jones Act requirements.<sup>14</sup> For a small island with a struggling economy and devastating debt crisis, Puerto Rico cannot afford to continue to abide by the Jones Act.

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In 2010 the University of Puerto Rico conducted a study, which concluded that the island economy loses approximately \$537 million annually as a result of the Jones Act. Year after year, the losses to the Puerto Rican economy compound while the government’s debt increases. The Federal Reserve Bank of New York examined the issue and found that Puerto Rico’s economy suffers from relatively high cost of doing business. Much of this cost is related to the transportation of goods

to the island. The New York Fed recommended that a temporary exemption be granted to Puerto Rico in order to alleviate the pressures from shipping costs and to test the theory that the Jones Act is having a detrimental impact.<sup>15</sup>

Similarly, Hawaii has the highest cost of living and the highest energy prices in the Union.<sup>16</sup> These substantial costs are directly attributable to expensive transportation costs, which are intimately associated with the Jones Act. Ultimately, consumers would benefit from a reform, repeal, or exemption of the Jones

Act because the price of goods would fall due to the reduced cost of shipping. As Patrick Holland observed, the U.S. Virgin Islands received an exemption in 1992 and “predictably, the cost of shipping goods to the Virgin Islands from the mainland is now nearly half that of shipping to Puerto Rico.”

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<sup>13</sup> GAO. *supra*

<sup>14</sup> Holland. *supra*

<sup>15</sup> Federal Reserve Bank of New York. (2012). Report on the Competitiveness of Puerto Rico’s Economy. Retrieved January 4, 2016, from <https://www.newyorkfed.org/regional/puertorico/recommendations.html>

<sup>16</sup> Holland. *supra*

## Conclusion and Recommendation

The economic climate and the scope of international trade have changed drastically since the implementation of the Jones Act in 1920. The underlying catalyst for the Jones Act was twentieth century warfare and insulation of the shipping industry in the U.S., two concepts that no longer apply to the present day. Therefore, attempting to do businesses in the 21st century based on regulations from the early 20th century is simply a roadmap to failure.

For years the Jones Act has inflated marine transportation costs while thwarting international competition. Areas with no alternatives for transportation find themselves dependent on high-cost U.S. barges for all of their goods. Islands like Hawaii and Puerto Rico have lost potentially billions of dollars over the years, as U.S. ships with a monopoly on trade routes become costlier. This lack of competition has fostered complacency in the shipping industry, unchallenged by competition with no incentive to innovate. Furthermore, with the repeal of the oil export ban, permitting the Jones Act to remain in its current state causes an absolute misalignment of goals and highlights to the world the inconsistency in U.S. trade policy.

What is most needed, if not a complete repeal of the Jones Act, is a revision that creates a consistent policy on the domestic level as well as at the micro level, such as all U.S. islands having the same status and less restrictive rules to encourage competition. This could take the form of lowering the percentage of crew that must be U.S. citizens, allowing foreign built vessels, or even increasing the port calls to no more than two, which would allow short routes like Alaska to California and alleviate some of the costs for islands.

As America finally engages the international energy market this year, it is counterintuitive that protectionist legislation such as the Jones Act still stands, making the cost of domestic trade more expensive. The future holds new and untapped prospects for trade, innovation, and economic stimulus, but the best way to optimize that opportunity is ensuring that U.S. trade policy is overly consistent and equipped to deal with current global trade requirements. Step one was repealing the crude oil export ban, step two needs to follow in haste, revising a law that increases costs, encourages inefficiency, dampens innovation, kills competition, and penalizes island economies.

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