The Goods and Services Tax and the US Federal Excise Tax: Barriers to Trucking Cabotage Reform in Canada

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PRÉCIS

La tentative récente de libéraliser l'industrie du camionnage transfrontalier au Canada et aux États-Unis s'est heurtée à deux obstacles : au Canada à la taxe sur les produits et services (TPS), et aux États-Unis à la taxe fédérale d'accise. L'objectif était de réformer les lois sur les douanes des deux pays concernant le transport entre deux points du même territoire par des camions étrangers, genre de transport qui est appelé cabotage. La tentative de réforme a échoué à cause des natures différentes des deux taxes. Le prélèvement de la TPS s'applique à la valeur des services de cabotage; si les services transfrontaliers ne sont pas terminés dans les trente jours, la taxe s'applique également à la valeur du camion étranger. Selon le point de vue de l'administration de Revenu Canada, une présence de trente jours ou plus constitue une « intégration » du camion immatriculé à l'étranger dans l'économie canadienne. Par réciprocité, la taxe d'accise américaine s'applique d'une manière similaire aux camions étrangers mais, contrairement à la TPS, la taxe américaine ne prévoit pas de crédits de taxe sur intrants. Par conséquent, les deux taxes appliquent la réciprocité en nom mais non en fait.

Afin de réactiver le processus de réforme, le gouvernement canadien doit réévaluer son traitement fiscal transfrontalier des camions étrangers. Ces camions ne sont pas une source de revenu fiscal net, mais ils sont soumis à une obligation fiscale lorsqu'ils sont utilisés pour le cabotage. Une réforme du cabotage devrait mettre fin aux trop nombreux trajets de retour à vide dans les activités de camionnage transfrontalier. Il en résulterait une utilisation plus efficace de la main-d'oeuvre et du capital dans la zone de libre échange nord-américaine.

ABSTRACT

A recent attempt to liberalize the transborder trucking industry in Canada and the United States ran afoul of Canada's goods and services tax (GST) and the United States' federal excise tax (FET). The intention was to

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reform the customs acts of both countries as they related to point-to-point domestic transport by foreign trucks, a type of transport that is called cabotage. The reform attempt failed because of the nature of the two taxes. The GST levy applies to the value of cabotage services, and if any transborder services are not completed within 30 days it applies to the value of the foreign truck as well. Revenue Canada's administrative position is that a presence of 30 days or more constitutes "integration" of the foreign-domiciled truck into the Canadian economy. As a matter of reciprocity, the FET applies in like manner to foreign trucks. Unlike the GST, however, the FET does not provide input tax credits. Thus the two taxes maintain reciprocity in name but not in effect.

In order to restart the reform process, the Canadian government must reassess its transborder tax treatment of foreign trucks. These trucks are not a source of net tax revenue, but they do face a tax compliance burden when they engage in cabotage. Cabotage reform would end the prevalence of empty backhauls as a feature of transborder trucking activities. The result would be a more efficient use of labour and capital within the North American free trade area.

INTRODUCTION

Over the past decade, Canada, the United States, and Mexico have been going through a process of trade liberalization and economic integration. This process began with the bilateral Canada-United States trade agreement (CUSTA) in 1988. It was followed, in 1994, by the multilateral North American free trade agreement (NAFTA), which included Mexico. The purpose of the agreements was to lower trade barriers and increase the flow of goods and services across the three countries' borders. What has been noticeably absent from these trade deals is coverage of the transportation sector. The omission is significant, since transportation facilitates trade and represents a transaction cost that exists irrespective of the removal of tariff barriers on goods. North America has made great strides toward becoming a free trade zone; it has yet to achieve free modes of trade that would reduce this transaction cost.

Canada's goods and services tax (GST)[1] and the United States' federal excise tax (FET)[2] have become major impediments to the achievement of free modes of trade, specifically as they apply to the transborder for-hire trucking industry. Transborder trucking accounts for about two-thirds of Canada-US trade flows and over 80 percent of US-Mexico trade flows. Trucking is an important mode of trade in North America. In 1993, interests on both sides of the Canada-US border attempted to liberalize some of the regulations that affect the transborder trucking industry; certain provisions

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[1] Parts VIII and IX of the Excise Tax Act, RSC 1985, c. E-15, as amended. Unless otherwise stated, statutory references are to the Excise Tax Act.

[2] Internal Revenue Code of 1986, chapters 31-50, as amended.

of the GST and the FET, however, caused these interests to back away. Both sides apparently concluded that the GST stood in the way of any meaningful reform of transborder trucking.[3] When the US authorities announced an intention to apply the FET in a reciprocal manner, the reform process collapsed.

This article will describe the impediment to cabotage reform that the GST and the FET have created and discuss the efficiency gains that would likely be achieved if Canada's Customs Act[4] were amended. The next section of the article discusses the existing customs regulations in the context of cabotage. The third section summarizes the set of regulations that governs the Canada-US transborder trucking industry. The fourth section discusses how this regulatory regime was to be reformed and how the GST and FET stalled those efforts. The fifth section discusses the GST's role as an impediment to reform and how application of this tax within a revised Customs Act would allow efficiency gains in transborder trucking. The final section offers some conclusions.

TRANSBORDER TRUCKING REGULATION: THE CABOTAGE ISSUE

The United States began to deregulate for-hire trucking on an interstate basis in 1980. Canada followed suit, on an interprovincial basis, in 1988. The process of intraprovincial and intrastate deregulation began in 1994. Deregulation was a national exercise that did, however, offer some new freedoms to foreign trucks operating in these jurisdictions. Essentially, deregulation meant that operating licences were no longer subject to geographical or commodity restrictions. A deregulated jurisdiction would allow any trucking firm that met minimum safety standards to enter the jurisdiction. Gone were the days when incumbent firms had the right to challenge entry to what were in essence protected segments of the for-hire trucking market.

What deregulation afforded to trucking firms on both sides of the border was the opportunity for enhanced import and export runs; that is, it liberalized the international movement of freight. Since this liberalizing process occurred in tandem with the liberalization of trade under CUSTA and NAFTA, the transborder trucking industry also reaped the benefits of greater international trade flows. Yet the ability of foreign trucking firms to move freight from point-to-point domestically was, and still is, severely restricted. In both countries, a foreign trucking firm must often turn down a domestic load that would take it from its import dropoff point to its export pickup point. Regulations that force firms to engage in empty backhauls are inefficient; they impose an underutilization of both labour and capital.

The movement of strictly domestic freight by a foreign truck is known as *cabotage*. The regulations that govern cabotage apply under the respective

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[3] "GST Wranglings Delay Cabotage Agreement" (April 1997), *Truck West* 31.

[4] RSC 1985, c. 1 (2d Supp.), as amended.

customs acts and immigration acts of Canada and the United States. The customs act in each country governs foreign tractors and trailers, which may engage in cabotage, and the immigration act governs foreign drivers, who may not.[5] The two countries introduced their respective cabotage regulations when deregulation allowed foreign trucks to carry out import and export runs. These regulations, however, are not strictly reciprocal, and the lack of reciprocity complicates transborder trucking operations.

Both countries allow two types of trucking cabotage, the "incidental move" and the "repositioning move." In an incidental cabotage move, a truck carries domestic and international freight simultaneously. US regulations require that the move be part of a "regularly scheduled" import or export run, but owing to a recent "reinterpretation" of the regulations this requirement is no longer enforced. Under Canadian regulations, the domestic freight must not exceed 30 percent of the weight and 30 percent of the value of the total load; that is, the cabotage portion of the trip must be "incidental" to the international portion. Both countries require that the cabotage pickup and delivery involve only "minor deviations" from the international route. What constitutes a minor deviation is a matter for the discretion of the border officials, since nothing is spelled out in either country's customs act. Thus any well-established import-export run used by Canadian and US truckers is a candidate for incidental-move cabotage either along the route or slightly off it. It should be noted that the opportunities for incidental cabotage are greater in the United States than they are in Canada: because the Canadian population is concentrated along the US border, Canadian trucks are more likely to penetrate deeply into the United States than US trucks are likely to penetrate deeply into Canada.

A truck may make any number of incidental cabotage moves during a given run. In the case of repositioning-move cabotage, however, only one move is allowed. A repositioning move is the carriage of solely domestic freight between the import dropoff point and the export pickup point. In order to prevent stopovers, Canada requires the US trucking firm to arrange the positioning move before it undertakes the international move. The truck may not double back along the same route to the import pickup point once it has completed the repositioning move. As well, the reposition dropoff point must be such that a straight line may be travelled between it, the import pickup point, and the international border. An example is transport of Canadian freight by a US tractor-trailer from Toronto to Winnipeg between an export run into Toronto and an import run from Winnipeg. Of course, it is usually advised that the tractor-trailer return through the same border crossing if at all possible. In the United States, the repositioning regulations force Canadian tractor-trailers to proceed

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[5] A domestic driver must be found to complete any portion of a route that involves a cabotage move. The only foreign nationals who are entitled to undertake cabotage under the immigration acts of both Canada (RSC 1985, c. I-2, as amended) and the United States (United States Code, Title 8) are those with dual citizenship or those who are at least 50 percent by-blood aboriginals.

northward—that is, outward—while they engage in this type of cabotage. This restriction has been a source of confusion in the trucking industry. Canadian carriers have complained that US carriers engage freely in "illegal" east-west cabotage, whereas they are forced to perform their cabotage in a northward direction. The lack of strict reciprocity in the letter of the two countries' regulations is the source of this confusion for Canadian carriers.

Canada's Customs Act requires a foreign tractor-trailer that enters Canada for the purpose of import-export or cabotage moves to return across the border within 30 days or forfeit its duty-free status.[6] As we shall show below, this provision plays an important role in making the GST applicable to trucking cabotage.

THE REGULATORY ENVIRONMENT

The relationship between the GST and trucking cabotage undertaken in Canada occurs within the provisions of the Customs Act of Canada. Table 1 summarizes the Canadian regulations related to cabotage. In the case of the United States, it is necessary merely to note that the allowable cabotage moves are similar to those allowed in Canada. But unilateral cabotage reform in the United States, unlike unilateral reform in Canada, would not trigger a new tax on the activity. The FET, currently at 12 percent, does not apply to any cabotage undertaken by Canadian trucking firms.

REGULATORY REFORM AND THE GST

Given the regulatory environment outlined in the previous section, let us consider the cabotage reform process that was unsuccessfully pursued some years ago by the two major trucking lobby groups in Canada and the United States. The American Trucking Association (ATA) and Canadian Trucking Alliance (CTA) began talks in 1993 in order to prepare common proposals for the liberalization of their respective governments' customs acts. The issue of the nationality of drivers was not discussed. As a NAFTA partner, Mexico would be able to opt into any bilateral agreement between Canada and the United States—provided, of course, that it granted reciprocity to its partners. Mexican immigration, however, was, and is, a sensitive political issue in the United States.[7] Thus the two organizations' decided

[6] The word "cabotage" does not appear in the Customs Act as administered by Revenue Canada. Cabotage activity is, however, duly addressed. Conveyances enter Canada as an import under tariff item 9801.10.00. It is on this basis that Revenue Canada establishes how to apply the GST to tractor-trailers. The 30-day "grace" may be extended, under extraordinary circumstances and at the full discretion of a customs official, by up to 24 months. Extraordinary circumstances include adverse weather, equipment breakdown, and legal action involving the conveyance. Revenue Canada has summarized the issue of cabotage for its customs officials under Memorandum D3-1-5.

[7] Quite apart from US concerns about Mexican immigration, trucks coming north from Mexico face intensive border inspections and hence extensive delays. NAFTA provisions required elimination of all border controls relative to trade flows between the United States' four and Mexico's six bordering states by December 1995. The entire continent

(The footnote is continued on the next page.)

Table 1 Canadian Regulations and Taxes Applicable to Trucking Cabotage

Types of cabotage move • Incidental move: domestic transport with an import-export load. • Repositioning move: solely domestic transport between an import move and an export move.	*Customs Act* • A foreign tractor-trailer is considered a temporary import. • No duty is charged during the first 30 days of cabotage activity. • The governing tariff is item number 9801.10.00.	*Immigration Act* • A foreign driver is prohibited from engaging in cabotage unless he holds dual citizenship, or is an aboriginal of at least 50 percent by blood.
Excise Tax Act • GST is payable on: (1) cabotage service, and (2) the tractor-trailer. The tractor-trailer levy occurs only once the 30-day grace on payable duties has lapsed. • The GST levy falls under the category of payable duties within the Customs Act.	*Stalled reform* • One "free" cabotage move would be allowed per import-export move whereby the tractor-trailer engaged would not be governed by the current Customs Act. • Entry of foreign equipment for up to one year with no duties.	*Reinterpretation* • All cabotage regulations remain intact. • GST levy remains intact. • Domestic transport of freight that began as international freight and has not yet reached its destination is no longer considered cabotage.

to call for a more liberal treatment of equipment but not for a more liberal treatment of drivers. By 1995, the ATA and the CTA had agreed to propose that the two governments allow one free cabotage move for every international move. They also proposed that Canada extend its 30-day duty-free period for tractors and trailers to one year.

By 1997, however, this modest reform process had come to a stop. The obstacles were the GST and the FET. The Canadian government indicated that it would not exempt US trucking firms from a GST levy on their cabotage activities within Canada. According to Revenue Canada—the GST's administrator—the GST applied to trucking cabotage, under the Excise Tax Act, in two ways. First, the tax applied to the value of the service rendered. Second, it applied to the full market value of the US equipment used in cabotage. In the opinion of Revenue Canada, tractors and trailers that remained in Canada for more than 30 days would be "integrated" into the Canadian economy, just as any other import would be, and would therefore become subject to the GST. The tax would likely be assessed as a one-time levy at the border on a tax base of around $500,000 per tractor-trailer. US truckers would, however, be able to claim input tax credits against both the levies on their services and the levies on their equipment.

[7] Continued . . .
was to be opened up by the end of 2000. But political considerations—the protection of US highways from potentially unsafe vehicles and pressure from the Teamsters' lobby—have delayed implementation of these provisions. Needless to say, Mexican officials feel that the objections raised by the United States are unwarranted.

The US Treasury Department's response to Revenue Canada's ruling was to subject Canadian equipment, in like manner, to the FET. Since the FET applies at the retail level, it does not apply to cabotage undertaken by Canadian truckers. On the other hand, since the FET applies at the retail level, no input credits may be claimed against it. By virtue of being subject to the FET, therefore, Canadian equipment used for cabotage in the United States would become both integrated into the US economy and resident in the United States, whereas US equipment subject to the GST would be integrated into the Canadian economy without becoming actually resident in Canada. Thus the US action was reciprocal in intention but not in effect.

The argument over the application of federal taxation forced both governments to abandon any formal revisions to their customs acts. Clearly, Canadian truckers lost more by the failure of the reform process than did US truckers, since Canadian truckers who undertook cabotage would receive no FET relief but their US counterparts would receive GST relief. To date, the Department of Finance—the authority that administers the Excise Tax Act—has given no sign of being willing to extend the GST exemption to tractor-trailers. A letter to the authors from the minister of finance states that "the [Excise Tax] Act does not provide any GST relief for U.S. trucks engaging in cabotage activities."[8] Furthermore, the deputy minister of national revenue, in another letter, states the following:

> To ensure equitable tax treatment with domestic products, all imported goods are subject to the GST unless there are specific legislative provisions that allow for relief from the tax. In this regard, the Excise Tax Act does not provide any relief from the GST on importation of conveyances and transportation equipment to be used specifically for [cabotage]. No exemptions or rebates are therefore available in relation to the GST that is properly payable on these imported supplies.[9]

A zero-rated good or service under the GST is one for which the vendor may claim a credit for GST paid on input purchases but need not charge GST on sale of the good or service. International freight transportation services (both inbound and outbound) are zero-rated under part VII of schedule VI of the Excise Tax Act. Even domestic freight transportation is zero-rated when it is a domestic portion of a continuous outbound movement of freight (that is, an export run as defined in section 7 of the Act). Technically, the value of the transportation service must be $5 or more and the shipper must provide the carrier with a "declaration in prescribed form" that the freight is intended to be an export (sections 6 and 7). The value of any import that is not a zero-rated item in Canada is subject to GST, but the import's transportation service is itself zero-rated (section 8). Moreover, any domestic portion of the transportation service is also zero-rated if the carrier can demonstrate that the service is part of a

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[8] June 6, 1997.

[9] May 6, 1997.

continuous inbound movement of freight (section 10). A waybill or housebill that indicates origin and destination is useful evidence for this purpose, whereas the carrier's bill of lading may merely indicate the first dropoff point in Canada and not the freight's offshore origin.

Point-to-point domestic transport that is part of either an export run or an import run is zero-rated because the domestic run is in fact interlined with the international run and all interlining services are zero-rated (section 11, subsection 1(2)).[10] Section 11 treats interlining as a contract between carriers rather than as a solicitation of services by the shipper. If the freight transported is strictly domestic but interlining takes place between origin and destination, only the final carrier, the carrier that settles the freight bill with the shipper, is required to charge GST on the service. Strictly domestic transport is subject to the GST.

What is the status of cabotage under the Excise Tax Act? Since cabotage is strictly point-to-point domestic movement of domestic freight, a GST levy applies. The charge to the shipper whose domestic freight is either a part of the freight in an incidental cabotage move or the whole of the freight in a repositioning cabotage move will include the GST. As we shall discuss below, however, the Customs Act has recently been reinterpreted to expand the definition of international freight.

The GST levy on cabotage applies, in effect, to both the marginal cost of the service (that is, the line haul costs) and the fixed cost of the service (that is, the value of the tractor-trailer), and input tax credits are applicable to both costs. The Customs Act defines a foreign tractor-trailer that is engaged in cabotage as an import during its duration in Canada, and the Excise Tax Act makes the GST applicable to imports. The foreign equipment, however, is eligible for an input tax credit, since it is the means by which a commercial activity (cabotage) subject to GST is undertaken.

Obviously, US equipment purchased by a US trucking firm in the United States is not subject to GST at the time of purchase, whereas Canadian equipment purchased by Canadian truckers is. The input tax credit claimable on cabotage service offers relief to US truckers who purchase inputs such as fuel, tires, or maintenance services while in Canada, though of course the trucker has no incentive to charge the GST on the service if no such inputs are ever purchased. In the case of equipment, the incentives are different. If a US trucker engages in cabotage activities or any other activities that require a stay in Canada of more than 30 days, the GST levy on equipment will apply. To obtain an input tax credit and recover the tax paid, the US trucker would have to register for the GST and file a GST return.

[10] An owner-operator provides service as an agent of the for-hire carrier, and since it is the latter that is responsible for billing the shipper the owner-operator is treated as a zero-rated interliner. Thus an owner-operator does not collect GST on his service to the for-hire carrier but has an incentive to register for the GST in order to claim input tax credits.

The GST may create cash-flow problems for small US trucking firms; nevertheless, relief from the GST, in the form of credits, is available. Canadian trucking firms that operate in the United States have no such consolation, since Revenue Canada's administrative position that the presence in Canada of foreign equipment for more than 30 days triggers the GST has led the United States to reciprocally invoke the FET, for which no credits are available. The problem is that the two taxes are not, in fact, reciprocal in their treatment of the equipment. Thus Revenue Canada's administrative position has frustrated a serious attempt to create a truly continental trucking fleet. If it is possible to extend the duty-free period for the foreign equipment under the Customs Act, it should also be possible to delay the GST trigger on that equipment. Since the Department of Finance has the legislative authority to carry out this change, it bears the primary responsibility for the present state of affairs.

What has been achieved in place of reform is an agreement to reinterpret the existing cabotage regulations. Origin-destination of the cargo, as determined by the bill of lading, is now the criterion for cabotage, instead of the nationality of the tractor-trailer used in the transport. Thus point-to-point movement of goods by a foreign driver and tractor-trailer will not be considered cabotage if all of the goods carried are international. And goods that cross the border to be dropped off at an intermediate point are still considered international until they reach their final destination. The repositioning cabotage move in the United States must still be northward to Canada, but the words "regularly scheduled" will not be enforced. It is now a viable option for a Canadian carrier to pick up US freight and interline it with a Mexican carrier on the US side of the border. A point-to-point move of this kind is not illegal—and now not even cabotage—since the freight is technically international on the basis of its bill of lading. This development bodes well for the results of current research into the viability of north-south trade corridors.[11] Of course, complete removal of all cabotage regulations should be the true goal of trade and transport rationalization in North America.

Under this new interpretation of the customs regulations, the GST is still applicable in the manner outlined above. The FET remains non-applicable to any cabotage undertaken by Canadian truckers, since the tax is applied at the retail level. The intention to apply the FET to Canadian equipment that undertook cabotage was a response to the expansion of the GST tax base that was expected to occur if reform became a reality.

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[11] There are several proposed north-south trade corridors, and all of them are striving for viability on the basis of agreements that may be struck among their participating jurisdictions. Thus far, agreements have been sought on the issues of truck weights and configurations; taxes are a federal issue beyond the participating jurisdictions' scope. One proposed corridor is the Mid-Continent Trade Corridor, which proceeds from Manitoba along Interstate 29 through Texas and into Mexico. The Rocky Mountain Trade Corridor and the Eastern Border Transportation Coalition are two regional initiatives that do not focus on any particular north-south interstate.

CUSTOMS ACT REFORM AND EFFICIENCY GAINS IN TRUCKING ACTIVITY

The United States and Australia are the only Organisation for Economic Co-operation and Development (OECD) countries that do not maintain a value-added tax (VAT). As we mentioned above, the US federal excise tax applies at the retail level and therefore does not act reciprocally with the GST in regard to cabotage activity. Given this state of affairs, it would be in the interest of Canada's trade with its NAFTA partner to amend the Customs Act in order to extend the period of duty-free status for transportation equipment engaged in cabotage and thus avoid a GST levy on this equipment. This section examines the gains that an amendment to this effect would likely achieve.

The arguments in favour of a VAT such as the GST over a retail sales tax are well known.[12] A VAT applies to all levels of production and is thus harder to avoid. Furthermore, producers at intermediate stages of a final good's production have an incentive to register for the VAT. It is in their interest to prove that they paid the VAT on their purchased inputs, since by doing so they can remit the VAT on the sale price net of a credit claimed against the VAT paid on their inputs and thereby reduce the net tax burden on their sale price. The result is that the government collects revenue at every stage in which value is added, whereas under a retail sales tax a complete loss in revenue occurs if the retailer declines (knowingly or unknowingly) to charge it.[13]

In the case of trucking cabotage in Canada, however, the usual motive for compliance with the GST may not apply. If a US trucker purchases his operational inputs (such as fuel and maintenance) in the United States, as he is likely to do, he will have no GST input tax credit to claim and therefore no incentive to charge GST on the cabotage service.[14] In the

[12] See, for example, John F. Due, "The Choice Between a Value-Added Tax and a Retail Sales Tax," in *Proceedings of the Thirty-Seventh Tax Conference*, 1985 Conference Report (Toronto: Canadian Tax Foundation, 1986), 16:1-10; Wayne R. Thirsk, "The Value-Added Tax in Canada: Saviour or Siren Song?" (1987), vol. 13, no. 3 *Canadian Public Policy* 259-83; and John Whalley and Deborah Fretz, *The Economics of the Goods and Services Tax*, Canadian Tax Paper no. 88 (Toronto: Canadian Tax Foundation, 1990).

[13] Since evasion is easier under a retail sales tax than it is under a VAT, the exchange of a retail tax for a VAT with the same tax rate would theoretically generate more revenue for the government. Of course, since the incentive to evade is weaker under a VAT, governments can set VAT rates that are higher than the rates they could set under a retail sales tax.

[14] There is an interesting parallel between provincial retail sales taxes and the GST. Quebec operates a 15 percent harmonized sales tax (HST) that levies a provincial tax of 7.5 percent on the price plus GST of 7 percent; the result is a combined tax of 15.025 percent. There is no input tax credit for the provincial portion of HST levied on input purchases of trucking firms that are not domiciled in Quebec. Furthermore, the Atlantic provinces' 15 percent HST is charged on goods shipped to destinations within the Atlantic provinces. If the destination is outside the HST jurisdiction, only the GST is charged. Because all sales taxes in Canada operate under the destination principle, exports are zero-rated—no tax is levied but credits are claimable against any inputs that included GST in their prices. A

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absence of the incentive provided by input credits, a US trucker might very well evade compliance with the GST, especially if he is not already a GST registrant, since if he did not comply he would simply remit the same amount of tax as he collected. Evasion of this kind is especially likely if US trucking firms find that a GST charge on cabotage service begets a further GST levy on the full value of the tractor-trailer when the cabotage activity is claimed at the border; that is, the firm would incur an additional compliance burden in terms of the time spent in waiting for the input tax credit refund.[15] Indeed, only the largest US trucking firms would find compliance an affordable exercise.

Thus the current GST regime serves to reduce trucking cabotage activity in Canada and may also drive some of it underground. In either case, the government loses legitimate revenue from a value-added service. Although it is true that the tractor-trailer has a 30-day duty-free status, it must be kept in mind that the US driver cannot undertake the cabotage move. If the US driver is laid over, he has to be picked up, which may add an extra leg to the haul. And on this extra haul the truck cannot be loaded with either domestic freight, since only one repositioning move is allowed while the truck is in Canada, or international freight, since a completed repositioning move cannot include doubling back. An empty haul adds time and money costs.[16] Moreover, in order to minimize customs delays and provide the necessary verifications, it is often necessary to have the original US driver take the truck back into the United States. In this environment, only incidental cabotage appears viable, yet most of the cabotage opportunities in Canada occur in the form of east-west repositioning runs.

If the GST issue were resolved through an extension of duty-free status for the tractor-trailer, it would then be possible to re-examine the cabotage regulations on both sides of the border. Freedom to engage in cabotage without having to satisfy customs officials as to the nature of the domestic

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shipment that is moved by a truck in order to be interlined—even on the Canadian side of the border—has a zero rate assessed. This arrangement makes Canada's exports more price-competitive.

[15] Other incentives to evade the GST are covered in Peter S. Spiro, "Evidence of a Post-GST Increase in the Underground Economy" (1993), vol. 41, no. 2 *Canadian Tax Journal* 247-58.

[16] The reinterpretation of Canada's Customs Act by both Canadian and US border officials began on December 1, 1997. The new system is still in its infancy. One of the reinterpretations within the Act that may inadvertently test the limits of the 30-day grace period is the new allowance for trailer-spotting. Trailer-spotting involves either (1) the dropping-off of a trailer in a yard so that the tractor can move a pre-loaded trailer or (2) the movement of an empty trailer from yard to yard. Previously, trailer-spotting itself fell under the cabotage regulations. Under the new interpretation, a foreign trailer, if spotted in a yard for more than 30 days, would become eligible for a GST levy on its value if it were subsequently used for cabotage purposes. Increasing ease of trailer-spotting makes this outcome more likely, especially given that foreign trucking firms are operating increasingly large fleets.

point-to-point transport route and immigration officials as to the status of the driver would reduce administrative costs for foreign trucking firms. If the existing restrictions on cabotage were removed, Canadian trucking firms would be able to engage in east-west repositioning moves in the United States instead of always having to proceed northward. US trucking firms would no longer have to ensure that incidental cabotage freight did not exceed the 30 percent of the weight and 30 percent of the value of the total load. Trucking firms in both countries would no longer face restrictions as to the number and duration of cabotage activities.

The filling of empty backhauls would obviously produce efficiency gains for trucking firms. Broader social gains would arise in the form of a fall in freight rates over routes previously barred to cabotage. To put the matter simply, a fronthaul and a backhaul (whether loaded or empty) constitute the joint supply that accounts for the truck's round trip. By definition, the demand for fronthauling exceeds the demand for backhauling. The costs of a round trip, however, are not necessarily separable into a fronthaul cost and a backhaul cost. The fronthaul cost is made up of the loaded-fronthaul costs plus the non-separable empty-backhaul costs. The loaded-backhaul cost, however, exists independently, and under the present regime it includes the costs of complying with the cabotage regulations. Under cabotage reform, therefore, the loaded backhaul cost should decline. Thus the optimal freight rate for a backhaul would be less than the rate for a fronthaul.[17] Further efficiency gains would arise from the fact that the opening of previously closed domestic backhaul markets for foreign trucks would increase the competition faced by domestic trucking firms.

The GST and the FET, by creating a barrier to cabotage reform, create a barrier to these potential efficiency gains. If market freight rates on a given run that is not amenable to cabotage are higher than they would be if cabotage were possible, it would appear that the GST revenue from each haul of a given freight load on that run is higher as well.[18] This analysis, however, makes the mistake of looking at a run in isolation, when in fact it is supplied jointly with another run. If cabotage reform were to eliminate all empty backhauls in the transborder trucking industry,

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[17] For a complete model of trucking cabotage, see Darren Prokop, "The Canada-US Transborder Trucking Industry: Regulation, Competitiveness and Cabotage Issues" (PhD dissertation, University of Manitoba, 1998). The seminal article on joint supply is Paul A. Samuelson, "Contrast Between Welfare Conditions for Joint Supply and for Public Goods" (February 1969), 51 *Review of Economics and Statistics* 26-30. For a discussion of joint supply in a trucking context, see John Richard Felton, "The Impact of Rate Regulation Upon ICC-Regulated Truck Back Hauls" (September 1981), 15 *Journal of Transport Economics and Policy* 253-67. The theory of joint supply implies that if the drop in loaded backhaul costs were reasonably large fronthaul freight rates would fall as well. Thus cabotage reform would have positive spillovers into other markets.

[18] Apart from the zero-rating of international and interlining transportation activities, higher freight rates lead to higher prices on final goods. Consequently, because the GST is an ad valorem tax, an increase in freight rates would increase the per unit tax bite on those goods.

the theory of joint supply[19] would indicate (1) an increase in, and equating of, both fronthaul and backhaul quantities and (2) an increase in the industry's joint revenue from the fronthaul and the backhaul, provided that the joint demand curve is price elastic.[20] The second point implies that GST revenue would unequivocally increase as empty backhauls were eliminated. This outcome cannot be demonstrated a priori,[21] but nonetheless the trucking industry would experience efficiency gains that, given Canada's interest in NAFTA, should take precedence over any loss of GST revenue.[22]

CONCLUSIONS

This article has described the net effects that are likely to occur when a domestic tax is applied to international transportation. In Canada, the service of cabotage is taxed, and if the tractor-trailer remains in Canada for more than 30 days the fixed value of the tractor-trailer is taxed as well. The latter levy applies because under the Customs Act the tractor-trailer becomes an import after the 30-day grace period. By claiming input tax credits, US truckers can claim a refund of the GST levies on both cabotage and equipment, but this process imposes a compliance burden on

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[19] Supra footnote 17.

[20] Prokop, supra footnote 17, develops a summed demand curve for fronthaul and backhaul demands with empty backhauls in existence. A comparison of this curve with the joint demand curve, which by definition allows for no empty backhauls, allows one to make suppositions about industry revenue. Technically, if the drop in the sum of the fronthaul cost and the loaded backhaul cost occurs along the price-elastic region of the joint demand curve, then joint industry revenue will rise under cabotage reform.

[21] One may hold the view that demand for freight transport by mode is price-inelastic because (1) transportation of freight is a derived demand and (2) freight rates are a relatively small component of the final price of many transported goods. Intermodal competition, however, has increased modal substitutability and led to more price-elastic demand estimates for freight transport. For a survey of the empirical literature, see Tae Hoon Oum, W. Waters II, and Jong-Say Yong, "Concepts of Price Elasticities of Transport Demand and Recent Empirical Estimates: An Interpretative Survey" (May 1992), 26 *Journal of Transport Economics and Policy* 139-54 and 164-69. Another issue is the status of the backhaul under increased competition. Certainly, under perfect competition, US and Canadian truckers would rationalize their freight runs in a way that resulted in their facing the same fronthaul and backhaul directions (Alfred E. Kahn, *The Economics of Regulation: Principles and Institutions*, vol. II (New York: John Wiley & Sons, 1971)). However, as long as (1) cabotage is seen as secondary to both import-export runs and domestic runs and (2) the two countries maintain different business practices, a rationalization of this kind will remain difficult to achieve. Cabotage reform alone is not enough to eliminate the effect of the international border on transborder trucking activities.

[22] Admittedly, this statement assumes that the government would prefer industrial expansion over sales tax revenue. Certainly industrial expansion would increase the personal and corporate income tax bases. No aggregate measure of cabotage-related revenues for trucking activity in Canada is readily available. Statistics Canada's *Trucking in Canada* (catalogue no. 53-222) for 1990-91 did publish total revenue from international sources and revenue derived from US interlining. Subtraction of the interlining revenue from the total international revenue would give US-generated Canadian revenues, or in other words Canadian cabotage revenues payable to US trucking firms. In subsequent years, however, *Trucking in Canada* has omitted the interlining component.

them: they must register for the GST, file for input tax credits, and await the credit refund. The situation of Canadian truckers is even more onerous, since the US government has responded to the application of the GST to US trucks by making the FET—for which no input credits, and therefore no refunds, are available—applicable to Canadian trucks. If cabotage reform is desirable and the United States' use of the FET is undesirable, it is up to Canada to change the situation. The Customs Act must be amended to extend the grace period for US equipment in Canada.

The GST and the cabotage regulations make trucking cabotage in Canada narrow in scope and small in quantity. The fact that under the Customs Act foreign equipment can be "integrated" into the Canadian economy without becoming resident in Canada raises the issue of what constitutes a true import. The failure of the reform efforts by the national trucking associations in Canada and the United States highlights the problems that have arisen because tax policy has taken precedence over the need to rationalize the transborder trucking industry in the face of increased north-south trade flows. If the Customs Act were properly amended to allow for an extension of duty-free status for US equipment, cabotage reform efforts could begin anew.