The Customs Union Between Russia, Belarus and Kazakhstan: Some Evidence from the New Tariff Rates and Trade Flows

Arevik Mkrtchyan, European University Institute
October, 2013

This brief addresses the Customs Union between Russia, Belarus and Kazakhstan that was established in 2010. It argues that the external tariff schedule reflects a compromise between the interests of its members rather than simple expansion of Russian influence on the CU partners, and that the reduction in trade costs due to elimination of internal borders, benefits both the members of the CU and their external trade partners. Moreover, the impact of alleviated non-tariff trade costs on trade flows is strong and significant, while the tariff impact is insignificant for all members.

The Customs Union (CU) between Russia, Belarus and Kazakhstan is a rare political success in the otherwise rather mixed re-integration experience within the CIS region. In its current form, the CU provides for a common external tariff among its member states and the removal of their internal customs posts. Analysts in the East and West alike tend to portray the CU as largely a geopolitical project. However, there is disagreement about its future impact: some view it as an instrument for further regional unification and ultimately economic development; others fear that the CU will lead to more protectionism and perpetuate an inefficient economic structure inherited from the Soviet times. Clearly, which scenario will play out depends crucially on how the external tariff is set and how internal trade facilitation is addressed.

The evidence on the CU's tariff rates appears to be mixed. Established in 2010 by Russia, Belarus and Kazakhstan, the CU harmonized more than 85% of tariff lines at the outset. This meant, on average, small external tariff declines for Russia and Belarus, but lead to profound tariff increases for Kazakhstan (from an average of 6.5% in 2009 to 10.3% in 2010).

Moreover, Shepotylo (2011) found that the common tariff was to a large extent influenced by Russian tariff rates, which would support the idea that the CU is simply an expansion of Russia's influence onto the member states. Gnutzmann and Mkrtchyan (2013) study of the common tariff determination in the CU, however, suggests that the process was more complicated than that. As mentioned above, already by 2010, 85% of tariff lines were harmonized between all member states. On the other hand, this success is partly because tariff policies were similar between the countries even before formation of the CU: 44% of the now-harmonized tariffs were at the same level in all three states by 2009. For Russia and Belarus, the tariff agreement in 2009 actually rose to 84%.

Second, further inspection of the tariffs that were harmonized after the creation of the CU shows that Kazakhstan had a significant impact on the setting of new tariff rates, and especially so in the case of specific (that is, per unit of quantity) tariffs that are typically more protectionist. In particular, Russian-specific tariffs averaged 29% in 2009 and fell to 23.5% in 2010, representing a significant drop, while Kazakh-specific tariffs went up from 14% to 22% during the same time period. This demonstrates that the common external tariff for the most protected goods was a compromised choice. Ad valorem (that is, value-based) tariffs have a much lower average rate, and were much more heavily influenced by Russian rates (as an indicator, Russian average ad valorem tariff rate was 8.8% in 2009 and only slightly lower – 8.1% in 2010). It follows that the rise in the specific tariff rate of Kazakhstan can explain almost all the increase in the average rate, but precisely these tariffs were set as a compromise.

This mixture of influences in the setting of new tariff rates would suggest that there might be strategic thinking involved in the formation of the CU rather than a simple expansion of one country's policies into the others.

Gnutzmann and Mkrtchyan (2013) consider a standard oligopolistic model of trade bloc formation with political economy motivations in order to bring a theoretical explanation behind the observed tariff changes. They derive an estimable equation of the common external tariff as a function of individual country tariff rates before and after the formation of the CU. Converting the specific tariffs into their ad valorem equivalents, they obtain that the common tariff in a CU can be presented as a linear combination of individual member-state tariffs and a sector-specific fixed effect, with the weights of individual tariffs proportional to member states' share in the CU economy.

Thus, the theoretical prediction involves conducting a linear estimation of the CU tariff as a function of individual past tariffs. We would expect the ratio of weights of individual past tariffs of Russia, Belarus and Kazakhstan to be equal to 85/5/10 respectively based on the ratio of their economies' sizes. This would suggest that the new tariff rates are a simple, and straightforward, weighted average of the member states tariffs. Instead, the empirically estimated weight of Russia's tariff rate is lower than the theoretically predicted one in all considered specifications, indicating certain concessions offered by Russia to its partners, and in particular, to Kazakhstan. Namely, various estimation strategies suggest that the new tariff rates could be explained by past individual tariffs with a ratio of weights equal to around 67/11/21 for Russia, Belarus and Kazakhstan, respectively.

Another interesting finding from examining tariff changes is that, after controlling for past individual tariffs, there is a large heterogeneity between sectors. Sectors, which had more protection in one of the countries, were also more likely to have a higher tariff in the CU than predicted by that country's weight. In particular, after controlling for the individual past tariff weights and sector dummies, having highest tariff rate among the members is a significant determinant of the CU tariff; the share of the respective member state increases by an extra 17% in the weights ratio. This effect can be explained with the same oligopolistic competition model used to explain presence of production asymmetries, since a customs union creates incentives for a mutual protectionism effect: each member country receives protection for its own industries in the partner countries in return for accepting tariffs that also protect the partners' key industries in its own market. A customs union thus leads to higher external tariffs than a free-trade area or unilateral policy. Indeed most of the tariff increases between 2009 and 2010 took place precisely in sectors that were more protected in some of the member states than in the other.

The changes in the tariff policy, the elimination of border controls, and other alterations that came about with the CU translate into changes in trade patterns. While Russia is a prime exporter to the CU partners, the reverse is not true. This pattern prompted concerns of trade diversion towards Russia (Tarr, 2012). See Isakova and Plekhanov (2012) for supporting evidence for this (the case of Kazakhstan's imports from China in 2010).

On the other hand, the elimination of borders could work in the opposite direction by opening the Kazakh market to firms from external countries that, before the CU, were only serving the larger Russian market. Gnutzmann and Mkrtchyan (2013) show that the change in tariffs had a small impact on trade flows, while the elimination of borders had a positive and significantly larger influence. This impact of elimination of customs checks is not observed in the trade flows of 2010 (customs posts between Kazakhstan and Russia were taken down only in July 2011) and the tariff impact dominated. The overall impact of the CU, after the 2011 trade flows have been taken into account, is estimated to not only have benefited most of the members, but also to have had a positive impact on the main external trading partners: EU, China, US and an FTA partner Ukraine.

Further research could focus on the impact on small peripheral economies, like Kyrgyzstan, that are not likely to gain from access to the larger common market but which, prior to the CU, enjoyed easy customs access to the Kazakh market. The quick calls of Kyrgyzstan (by the acting prime minister in October 2011) to join the CU suggest that it faced higher trade barriers as a result of the creation of the CU.

There are also some broader policy implications related to the global trade networks. The members of the ECU rank near the bottom of World Bank's Trading Across Borders index, hinting at large trade costs on top of formal tariffs. The removal of the last internal customs posts – effective of July 2011 – may thus explain trade gains. By creating a larger common market for operating firms, it also gives rise to the potential for integrated supply chains in the CU area. This may in fact already be happening; a recent newspaper article (Bradsher, July 2013) discusses the rise of transit rail freight from China to Europe. After elimination of internal borders, it became economically viable to instead send trains through Kazakhstan, Russia and finally Belarus.

This brief discussed the evidence that suggests that – contrary to the common belief –the CU tariffs are far from entirely driven by Russian interests. Moreover, Russia's influence is estimated to be below the level predicted by a standard economic model. Furthermore, the estimations suggest that the CU members' political interests of protecting certain sectors have spilt over on the partners. Analysis of the trade flows, however, showed that these changes did not matter for trade flows as much as the changes in the non-tariff trade costs, brought by eliminating internal customs checks. What is more, the CU may bring a number of indirect benefits to its members. For example, it may enhance Kazakhstan's bargaining power during the WTO accession by allowing referrals to existing CU commitments. The immediate activation of Kazakhstan's negotiation process following the conclusion of the Russian negotiations suggests this may very well be the case

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Arevik Mkrtchyan

European University Institute
Visiting Researcher at CEFIR
Arevik.Mkrtchuan@eui.eu
http://www.eui.eu/Personal/Researchers/Mkrtchyan/

Arevik Mkrtchyan is a PhD candidate in Economics at the European University Institute in Florence, Italy. She is currently visiting CEFIR in Moscow, Russia.

Mkrtchyan's research interests are Microeconomics and International Trade, and she is currently doing work on Preferential Trade Agreements.