The Eurasian Customs Union among Russia, Belarus and Kazakhstan: Can It Succeed Where Its Predecessor Failed?

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November, 2012

In 2010, Russia, Belarus and Kazakhstan formed the Eurasian Customs Union and imposed the Russian tariff as the common external tariff of the Customs Union. This resulted in almost doubling the external average tariff of the more liberal Kazakhstan. Russia has benefited from additional exports to Kazakhstan under the protection of the higher tariffs in Kazakhstan. However, estimates reveal that the tariff changes have resulted in substantial transfers from Kazakhstan to Russia since importers in Kazakhstan now purchase lower quality or higher priced Russian imports which are protected under the tariff umbrella of the common external tariff. Transfers from the Central Asian countries to Russia were the reason the Eurasian Economic Community (known as EurAsEC) failed, so this bodes badly for the ultimate success of the Eurasian Customs Union. What is different, however, is that the Eurasian Customs Union and its associated Common Economic Space aim to reduce non-tariff barriers and improve trade facilitation, and also to allow the free movement of capital and labor, liberalize services, and harmonize some regulations. Estimates by my colleagues and I show that if substantial progress could be made in trade facilitation and reducing non-tariff barriers, this could make the Customs Union positive for Kazakhstan and other potential Central Asian members. Unfortunately, so far the Customs Union has made these matters worse. On the other hand, Russia's accession to the World Trade Organization will eventually substantially reduce the transfers from Kazakhstan to Russia, but this will need a strong political commitment from Russia which we have not yet seen. If that Russian political leadership is forthcoming, the Eurasian Customs Union could nonetheless succeed where its predecessor has failed.

In January 2010, Russia, Belarus and Kazakhstan formed the Eurasian Customs Union. Two years later, the three countries agreed to even closer economic ties, by signing the agreement to form a "common economic space." Regarding tariffs, the key change was that the three countries agreed to apply the tariff schedule of the Customs Union as their common external tariff for third countries. With few exceptions, the initial common external tariff schedule was the Russian tariff schedule. Kazakhstan negotiated exceptions from the common external tariffs for slightly more than 400 tariff lines, but was scheduled to phase out the exceptions over a period of five years (World Bank, 2012). In addition, the members agreed to have the Customs Union determine the rules regarding sanitary and phyto-sanitary standards (SPS) and standards on good. Fearing transshipment of goods from China through Kazakhstan and from the European Union through Belarus, Russia negotiated and achieved agreement on stricter controls on the origin of imports from countries outside of the Customs Union. The common economic space (CES) stipulates that, in principle, there will be free movement of labor and capital among the countries, there will be liberalization of services on the CES and coordination of some regulatory policies such as competition policy.

In February 2012, the Eurasian Economic Commission began functioning. It is intended to act as the regulatory authority for the Customs Union in a manner similar to the European Commission for the European Union.

The Economics of Tariff Changes — Gains for Russia and Losses for Kazakhstan

Some proponents of the Eurasian Customs Union have argued that as a result of the Customs Union firms in the three countries will have improved market access through having tariff free access to the markets in all three countries. Prior to 2010, however, along with other countries in the Commonwealth of Independent States (CIS), the three countries had agreements in place that stipulated free trade in goods among them. Thus, the Customs Union could not provide improved market access due to reducing tariffs on goods circulating among the three countries.

Since the common external tariff was essentially the Russian tariff, there was little change in incentives regarding tariffs in Russia. The big change occurred in Kazakhstan, who had a much lower tariff structure than Russia prior to implementing the Customs Union tariff. Despite the exemptions, Kazakhstan almost doubled its tariffs in the first year of the Customs Union (see World Bank, 2012). The increase in tariffs on many items which were not produced in Kazakhstan but produced in Russia, led to a substantial increase in imports from Russia and displacement of imports from Europe. Many of Russia's manufacturing firms, which were not competitive in Kazakhstan prior to the Customs Union, were now able to expand sales to the Kazakhstani market. This represents gains for Russian industry. Given the deeper manufacturing base in Russia compared with most of the CIS countries and the resulting uneven benefits of the common external tariff in favor of Russia, acceptance of the common external tariff has been a fundamental negotiating position of Russia regarding acceptance of members in the Customs Union.

Some cite the expanded Russian exports in Kazakhstan as evidence of success of the Customs Union. But the displacement of European imports, to higher priced or lower quality imports from Russia, represents a substantial transfer of income from Kazakhstan to Russia and is an example of what economists call "trade diversion". Moreover, it is the reason the World Bank (2012) has evaluated the tariff changes of the Customs Union as a loss of real income for Kazakhstan.

Furthermore, the three countries together (and even a broader collection of CIS countries) constitute too small a market to erect tariff walls against external competition. They would lose the benefits of importing technology from advanced countries and would rely on high priced production from within the Customs Union. Some would argue that there are political benefits of trade to be taken into account, but experience has shown that when a customs union is inefficient and the benefits and the costs of the customs union are very unequal, the customs union can inflame conflicts (see Schiff and Winters, 2003, 194-195).

Non-Tariff Barriers — Extremely Costly Methods of Regulating Standards Worsened by the Customs Union

Non-tariff barriers, in the form of sanitary and phyto-sanitary (SPS) conditions on food and agricultural products and technical barriers to trade (TBTs) on goods, are a very significant problem of the Customs Union. There are standards based trade disputes between Belarus and Russia on several products, including milk, meat, buses, pipes and beer (see Petrovskaya, 2012). Anecdotal evidence indicates that Kazakhstani exporters complain bitterly regarding the use by the Russian authorities of SPS and TBTs measures, either to extract payments or for protection.

If the Customs Union could make substantial progress on reducing these barriers, it would be a significant accomplishment. My colleagues and I have estimated that progress on the non-tariff barriers and trade facilitation could outweigh the negative impact of the tariff changes for Kazakhstan (see World Bank, 2012). Unfortunately, so far the Customs Union has taken a step backward on both non-tariff barriers and trade facilitation.

A big problem in reducing standards as a non-tariff barrier is that standards regulation, in all three countries, is still primarily based on the Soviet system. As a holdover from the Soviet era, mandatory technical regulations are employed where market economies allow voluntary standards to apply. This regulatory system makes innovation and adaption to the needs of the market very costly as firms must negotiate with regulators when they want to change a product or how it is produced. Legislation in both Russia and Kazakhstan calls for conversion to a system of voluntary standards, but this is happening too slowly in all three countries. The problem is that the Customs Union has worsened the situation. Technical regulations are now decided at the level of the Customs Union, so firms that previously negotiated with their national standards authority, have had to now get agreement from the Customs Union. This has reportedly caused further delays, impeding innovation and the ability of firms to meet the demands of the market.

A second problem with efforts to reduce the non-tariff barriers is that the Customs Union is trying to harmonize standards of the three countries by producing mandatory technical regulations. The alternative is to use Mutual Recognition Agreements (MRAs). Experience has shown that no customs union has been able to broadly harmonize standards based on mandatory technical regulations, with the exception of the European Union. In fact, even in the European Union, they have had to use MRAs and only harmonized technical regulations after decades of work. While each member of the Customs Union is expected to create a system of mutual recognition of certificates of conformity, these certificates are not presently recognized in the other countries of the Customs Union. There is little hope for a significant reduction in standards of non-tariff barriers unless the system of mutual recognition is more widely recognized and adopted.

Trade Facilitation — Participation in International Production Chains Made More Difficult by the Customs Union

Customs posts between the member countries have been removed and this has reduced trade costs for both exporters and importers in the three countries. Russia's concerns regarding transshipment have, however, led to an opposite impact on trade with third countries, i.e., the costs of trading with countries outside the Customs Union have increased. Participation in international production chains has become a key feature of modern international production and trade. If goods cannot move easily in and out of the country, multinational firms will look to other countries to make their foreign direct investment and for international production sharing. Addressing this significant problem will take a change of emphasis on the part of Russia.

Russian WTO Accession — Liberalization That Will Significantly Reduce Transfers to Russia

It has apparently been agreed by the Customs Union members that the common external tariff of the Customs Union will change to accommodate Russia's WTO commitments. As a result, the applied un-weighted average tariff will fall in stages from 10.9 percent in 2012 to 7.9 percent by the year 2020 (see Shepotylo and Tarr, forthcoming).[1] This will have the effect of lowering the trade diversion costs of Kazakhstan. In addition, the Customs Union will be expected to adapt its rules on standards to conform to commitments Russia made as part of its WTO accession commitments. In the case of Belarus, it remains to be seen if it will implement the changes, as this will increase competition for its industries.

Conclusion — the Need to Russia to Exercise Political Leadership for Standards and Trade Facilitation Reform for Success of the Customs Union

In 1996, the same three countries formed a customs union. Later the same year, they were joined by Kyrgyzstan, then by Tajikistan and in 2005 by Uzbekistan. As Michalopoulos and I (1997) anticipated, the earlier Customs Union failed because it imposed large costs on the Central Asian countries, which had to buy either lower quality (including lower tech goods) or higher priced Russian manufactured goods under the tariff umbrella. The present Customs Union also started with the Russian tariff, which protects Russian industry and suffers from the same problem that led to the failure of the earlier Customs Union. Nonetheless, the present Customs Union could succeed. Crucially, due to Russia's accession to the WTO, the tariff of the Customs Union will fall by about 40 to 50 percent.[2] This will make the Customs Union a more open Customs Union, very significantly reduce the transfers from Kazakhstan to Russia, and thereby reduce the pressures from producers and consumers in Kazakhstan on their government to depart from enforcement of the tariffs of the Customs Union. Further, the present Customs Union aims to reduce non-tariff barriers and improve trade facilitation, as well as it has "deep integration" on its agenda, i.e., services liberalization, the free movement of labor and capital and some regulatory harmonization. Although, to date, the Customs Union has moved backwards on non-tariff barriers and trade facilitation, one could optimistically hope for substantial progress. In the important area of non-tariff barriers, given the common history of Soviet mandatory standards, Russia will have to take the lead in moving the Customs Union toward a system of voluntary standards where no health and safety issue are involved, and toward a system of mutual recognition agreements and away from commonly negotiated technical regulations. On trade facilitation, Russia will have to reverse its pressure and find a way to allow the freer movement of goods with third countries while addressing its transshipment concerns.

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[1] The final "bound rate" of Russia is higher at 8.6 percent on an un-weighted average basis; but there are about 1,500 tariff lines where the applied rate of Russia is below the bound rate. The applied weighted average tariff will fall from 9.3 percent in 2012 to 5.8 percent in 2020.

[2] Russian tariffs fall more on an un-weighted average basis than they do on a weighted average basis. See Shepotylo and Tarr (forthcoming).

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