



# Economic Premise

75656

FEBRUARY 2013 • Number 108

## What Promises Does the Eurasian Customs Union Hold for the Future?

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*Established in 2010, the Eurasian Customs Union (ECU) carries significant economic weight as three of its member countries represent a potentially large consumer market. Drawing on existing literature that has studied the likely impacts of the ECU in Central Asia, this note discusses the ECU's pitfalls and potential benefits. After briefly describing the main features of the ECU, this note assesses whether the changes introduced after its establishment have benefitted all of its members equally, and concludes with a discussion of what will need to change to achieve the ECU's full potential. Available evidence suggests that the Russian Federation has been the main beneficiary in the short term, but that there are several benefits to be gained by other members in the medium to long term. Full realization of these benefits, however, will require political commitment and steadfast action to reduce nontariff barriers (NTBs), improve trade facilitation, and reduce the costs of trading across borders in the region.*

### What Are the Main Features of the Eurasian Customs Union?

The ECU, formed by Belarus, Kazakhstan and Russia, was established in January 2010 and is part of the Eurasian Economic Community. It carries significant economic weight, mostly because its three member countries represent a potentially large consumer market with a total population of 167 million, an estimated total gross domestic product (GDP) of US\$2 trillion, and a goods turnover of approximately US\$900 billion. Armenia, the Kyrgyz Republic, Tajikistan, and Uzbekistan are potential participants.<sup>1</sup>

Almost immediately after forming the ECU, Kazakhstan, Russia, and Belarus started applying a common external import tariff. In addition to adopting a common external tariff, internal border controls were removed, first between Russia and Belarus, and then between Kazakhstan and Russia. With a few exceptions in each of the three member countries,

the initial common external tariff schedule reflected the Russian schedule.<sup>2</sup> These exceptions are, however, expected to be removed in phases by 2015. Furthermore, the ECU has determined rules regarding sanitary and phytosanitary standards to be applied to exports and imports of goods among the three countries.

### Political economy dimensions of the ECU

The ECU is seen by many as a deliberate attempt by Russia to reintegrate the former Soviet republics under Moscow's influence and counteract the economic expansion of China and the European Union in Eurasia. The Commonwealth of Independent States (CIS) area has a somewhat limited economic importance for the Russian economy: the area accounts for less than 14 percent of Russia's trade and less than 1 percent of Russia's investments. Russia's economy is much more closely tied to the European Union (EU), its larger trading partner. However, the ECU creates an opportunity for Russia to ex-

pand its exports and its presence in Central Asia at the expense of exports from other countries, such as the European Union and China.

As argued by Wisniewska (2012) and Dragneva and Wolczuk (2012), Russia's interest in the region has been motivated mainly by political reasons. While there have been various past attempts to reintegrate the newly independent republics of the former Soviet Union, these have not been very successful. At the same time, the EU, which in the mid-2000s stepped up its engagement in the post-Soviet countries, has gradually become the synonym of modernization and governance standards in the region.<sup>3</sup> It is in that context that Russia sees the ECU as a way to compete in a domain where the EU has been dominant until now.<sup>4</sup> Russia has repeatedly reiterated the economic benefits of the ECU, which follows a rules-based regime consistent with the World Trade Organization (WTO) and has adopted modern norms and an ambitious institutional setup.

The three member states have also taken steps to embed the ECU within a broader framework for enhanced economic integration by establishing on January 1, 2012, the Single Economic Space. The legal basis of the ECU and the Single Economic Space is expected to be fully in place within three years so that the Eurasian Economic Union can be launched on January 1, 2015. The Single Economic Space envisages a common market of goods, capital and labor, and the operation of common macroeconomic competition, financial and other regulations, including harmonization of policies in areas such as energy and transport.<sup>5</sup>

### Is the ECU Benefitting All of Its Members Equally?

There are several benefits to a trade bloc that make joining appealing. Some of the most obvious ones are the removal of trade barriers and potential access to a larger consumer market. However, there are some risks too, including trade diversion and asymmetric treatment within the bloc.

#### Potential economic benefits of greater trade integration

In its recent 2012 *Transition Report*, the EBRD identifies some likely short- and long-term impacts of increased regional economic integration that the ECU can bring about. These benefits are grouped in the following six categories:

- (i) Lower tariffs and the removal of NTBs should increase trade and enhance consumer choice.
- (ii) Producers within a regional integration grouping, including the ECU, can benefit from increased market size.
- (iii) Exporting within a regional area may serve as a first step toward the expansion of exports worldwide.
- (iv) Countries within a regional integration area can build cross-border production chains by leveraging each other's comparative advantages and subsequently exporting the finished product outside that area.

- (v) Deeper regional integration can help member countries strengthen their economic and political institutions.
- (vi) Integration can encourage the liberalization of service markets.

#### A common tariff with unequal consequences

Despite these potential benefits, there are some risks to joining a trade bloc that have become a concern in the context of the ECU. The first of these concerns is that a relative change in tariff barriers can divert trade from more efficient external exporters to less efficient ones.<sup>6</sup> As argued by Tarr (2012), since the common external tariff was in essence a reflection of the import duties adopted by Russia, the ECU did not have much of an impact on tariffs there. The big change took place in Kazakhstan, where the tariff structure was much lower than in Russia before the country joined the ECU. The World Bank (2012) estimates that as a result of implementing the common external tariff of the ECU, with a few exceptions, the tariffs of Kazakhstan have increased from an average of 6.7 percent to 11.1 percent on an unweighted basis, and 5.3 percent to 9.5 percent on trade-weighted basis.

The direct impact of a higher external tariff on Kazakhstan and Belarus was felt, for example, in the form of a substantial increase in the imports from Russia and the displacement of imports from the EU and China. In that context, Tarr (2012) argues that Russia benefitted by expanding its exports, even if they were not competitive, while Kazakhstan and Belarus were deprived from importing higher quality goods from Europe. Isakova and Plekhanov (2012) estimate that Kazakhstan's imports from China saw an even more significant decline in response to the higher ECU external import tariff. This is also a view shared by the EBRD (2012, 70), which recognizes that:

To date, the Customs Union appears to have had tariff-related trade creation effects only for Russia, as reduction in external tariffs have been associated with higher imports from selected trade partners outside the Union.

#### Three scenarios for the future

In a recent report, the World Bank (2012) arrived at similar results by estimating a 57-sector computable general equilibrium (CGE) model for the case of Kazakhstan. The Bank's assessment indicates that not only has the ECU benefitted Russia the most, but also that Kazakhstan has experienced losses in real income, wages, and returns on capital as an immediate result of the ECU, while the expected easing of NTBs and improvements in trade facilitation remain a distant objective. Nonetheless, the report simulates the expected impacts of three possible scenarios: (i) a baseline scenario to estimate the impact of what has actually been implemented as a result of the introduction of the ECU; (ii) a pessimistic outlook scenario, which assumes that Kazakhstan will fully implement the common external tariff by

eliminating the remaining exceptions, but does not realize any reduction of its trade facilitation costs or reductions in NTBs; and (iii) an optimistic outlook scenario, where it is assumed that Kazakhstan fully implements the common external tariff and that trade facilitation costs and NTBs are substantially reduced in the ECU.

In the baseline scenario, with the tariff changes that took place with the ECU, the average tariff rate in Kazakhstan increases by 78 percent, imposing a higher cost to import from outside the ECU and the CIS, and diverting trade to these regions. This increases import costs for businesses and consumers, and under the tariff umbrella, resources are shifted to areas of inefficient production. Under these circumstances, Kazakhstan loses about 0.2 percent in real income per year as a result of participation in the ECU, and real wages are depressed by 0.5 percent while the real return on capital in Kazakhstan drops by 0.6 percent. Kazakhstan also trades less with the rest of the world, resulting in less imported technology from the more technologically advanced EU, which is likely to lead to a loss in productivity gains in the long run. The pessimistic scenario is in essence very close to the baseline, because Kazakhstan is expected to lose about 0.3 percent a year in real income, with similar impacts as in the baseline in regards to real wages and returns on capital.

In the optimistic scenario, the Bank makes an optimistic assessment of how much the ECU may lower trade facilitation costs to trade and how much Kazakhstan can benefit from a reduction in NTBs. Lower trade facilitation costs and NTBs both save resources and thus reduce the costs of importing and exporting. Under these circumstances, the estimated impact is an increase in real income by about 1.5 percent of consumption per year. The reduced trade facilitation costs would represent about 93 percent of the gain in consumption. In this scenario, the gains from the reduced NTBs roughly offset the losses from the full implementation of the common external tariff.<sup>7</sup>

### What Will Need to Change to Ensure Realization of the Full Potential of the ECU?

Previous attempts at regional integration in Central Asia have failed and the success of the ECU is not guaranteed. A number of difficulties that stood in the way of success in the past remain prevalent today and may even have been exacerbated. These include NTBs, trade facilitation, and border crossing problems. What needs to be done, and what needs to be tackled first to ensure ECU success?

#### Address NTBs first

Available evidence seems to suggest that in order for the ECU to benefit all of its members, it will be essential for them to work together to reduce trade facilitation and border crossing costs as well as NTBs. Among the most important issues are

licensing or quotas on imports or exports; state control or monopoly control of imports or exports; state subsidies on production or exports; and technical regulations, including sanitary and phytosanitary (SPS) measures that may be barriers to trade. Although the challenge of addressing the standards problems and other NTBs is very large (box 1), reduction of NTBs could potentially bring substantial benefits to ECU member countries. In the case of the ECU and the CIS, Tarr (2012) argues that SPS conditions and technical barriers to trade are even more important than in other regions of the world.

Evidence from the 2009 round of the Business Environment and Enterprise Performance Survey that was concluded just before the ECU was established suggests that improvements are needed in customs procedures in the region. As reported by the EBRD 2012 *Transition Report*, approximately 30 percent of the firms in Belarus, Kazakhstan, and Russia that traded across borders viewed these procedures as a serious problem, while only around 10 percent did so in the new EU member states. The EBRD argues that a number of important NTBs within the Single Economic Space have yet to

#### Box 1. Two Weights and Two Measures

Russia requires many imported products to have a certificate of conformity issued by its Federal Agency for Technical Regulation and Metrology. Russia does not recognize internationally accepted certified products and undertakes their testing and mandatory certification in accordance with Russian standards. Certificates of product conformity issued in Kazakhstan for Kazakhstani exporters will often not be recognized in Russia. Further, producers in Kazakhstan often have to produce to one standard for the domestic market, another standard for exports to Russia, and potentially other standards for other markets, raising their production costs. Finally, some Kazakhstani food exporters have reported situations in which they were required to pay Russian agencies for inspections of their facilities, under threat of denial of market access, and they have alleged that the inspection fees appeared excessive.

Although Kazakhstan has also formally announced its intention to convert to EU standards, the country has a mix of standards including domestic, GOST,<sup>a</sup> EU, and international standards. GOST standards, however, still dominate. Kazakhstan and the other members of the ECU maintain their own lists of goods subject to mandatory regulation. The integration of these lists was still very limited as of 2011. Thus, those importing into Kazakhstan also face problems. Kazakhstani businessmen allege that the problems are less severe for imports into Kazakhstan than for their exports to Russia, but nonetheless, they raise the costs of importing into Kazakhstan, which raises the costs of doing business in Kazakhstan.

Source: World Bank 2012.

a. GOST refers to a set of technical standards maintained by the Euro-Asian Council for Standardization, Metrology and Certification (EASC).

be fully removed. In particular, technical and sanitary regulations need to be harmonized, and, in many cases, firms are still subject to national-level inspection and certification of their produce. In addition, the legal regime governing imports into the ECU, which is underpinned by national and supranational legislation, is complicated and may entail increased compliance costs. Furthermore, there is a clear need to reduce NTBs for export and import trade between ECU members and other countries.

### **Lower the cost of trading across borders**

According to the World Bank 2013 Doing Business Survey,<sup>8</sup> the three members of the ECU are ranked in the bottom third when it comes to trading across borders, with Kazakhstan ranked 182<sup>nd</sup>, Russia 162<sup>nd</sup>, and Belarus 151<sup>st</sup> in the world out of 185 countries. These rankings are due mainly to high costs (measured in U.S. dollars per container), the time it takes to export and import (measured in days), and also the large number of necessary documents. In the case of Kazakhstan, the higher border costs are partially the result of the natural geographic disadvantage of being both landlocked and far from the major markets of the world, notably the EU. On the other hand, the higher costs are also partially the result of weak institutions. However, the poor score of the three countries on the number of documents required for importing and exporting, which may also reflect red tape in the acquisition of documents, is unrelated to geography and can potentially be improved by a better institutional framework.

So far, progress on defining common technical regulations and SPS conditions throughout the ECU has been very slow. But if progress could be made in this area, it would lead to substantial benefits in terms of reduced production costs for exports and imports. In sum, the ECU could lower border costs by: (i) eliminating trade borders within the union, (ii) reducing the number of documents required for importing and exporting and the difficulty in obtaining the documents, and (iii) reducing corruption on the roads within the ECU.

### **Expect the most from WTO accession**

Both Russia and Kazakhstan can expect to reap substantial gains from their cumulative commitments for WTO accession. Jensen, Rutherford, and Tarr (2007) estimated Russia's gains from WTO accession in the medium term of about 3.3 percent per year of the value of its GDP, or more than 7 percent of Russia's consumption. In the long term, when the positive impact on the investment climate is incorporated, the gains should increase to about 11 percent per year of the value of Russia's GDP. Further research by Rutherford and Tarr (2010) showed that virtually all households and regions would gain, but the regions that will gain the most are those that are most successful at attracting foreign direct investment and creating a good investment climate. Research on Kazakhstan by Jensen and Tarr (2008) shows that Kazakh-

stan would likely reap similar gains from WTO accession, about 6.7 percent of GDP in the medium term. For both Russia and Kazakhstan, liberalization of barriers to foreign investment in business services, which contributes to the competitiveness and productivity of Russian and Kazakhstani manufacturing, is the major source of gains from WTO accession.

## **Conclusion**

At this stage, while the ECU and Single Economic Space arrangements are certainly steps in the right direction, there is still a long road of reform, institutional change, and political commitment ahead. The multiple, positive impacts of increased trade integration that can potentially benefit ECU members will only materialize with meaningful improvements on NTBs and the development of market-oriented institutions to pave the way for improvement in the business environment and trade facilitation in the region.

Russia's recent WTO accession is likely to play a positive role in this context. Russia's accession has the potential to significantly boost the positive impacts of the ECU in the region. Most importantly, as a result of Russia's accession, the ECU tariff is expected to fall by about 40 to 50 percent. This will reduce significantly the transfers from Kazakhstan to Russia and lower the trade diversion costs for Kazakhstan. In addition, the ECU will be expected to adapt its rules on standards to conform to commitments Russia made as part of its WTO accession agreement.

Looking forward, besides addressing NTBs and border issues, ECU members should look for opportunities farther east. The World Bank is conducting research that will shed light on important factors that could help ECU members move in that direction. The forthcoming flagship report on Eurasian growth and the Country Economic Memorandum for Kazakhstan will assess, for example, what types of products ECU members would be most competitive on; what markets they should consider joining or gaining access to; whether they have the right endowments to be competitive with new products and in new markets; and, most importantly, whether they have the right set of institutions to succeed.

## **About the Author**

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## Notes

1. See Krotov (2012) for a detailed discussion of the ECU's administration system.
2. According to Wisniewska (2012, 1), the common import tariff introduced by the ECU coincides 80 percent with the import duties that were in force in Russia at the time of the ECU's inception.
3. For a discussion of the European economic model, see Gill and Raiser (2012).
4. See Dragneva and Wolczuk (2012) for a political economy analysis of the EU governance model and its approach to Russia.
5. See EBRD (2012) for an assessment of the ECU and details about the creation of the Single Economic Space.
6. See Venables (2003) for a discussion of aspects related to trade diversion.
7. These findings are similar to those presented by Jandosov and Sabyrova (2011) in an analysis of pre- and post-ECU tariff rates in Kazakhstan. Jandosov and Sabyrova find that the tariffs in Kazakhstan approximately doubled in 2011, and that tariff variations increased substantially after the creation of the ECU.
8. See <http://doingbusiness.org/rankings>.

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