



Centre for Economic  
and Financial Research  
at New Economic School

#37

December 2012



# **The Eurasian Customs Union among Russia, Belarus and Kazakhstan: Can it succeed where its predecessor failed?**

David G. Tarr

CEFIR Policy Paper series

## **The Eurasian Customs Union among Russia, Belarus and Kazakhstan:**

### **Can it succeed where its predecessor failed?**

**David G. Tarr**

**Adjunct Professor of Economics  
New Economic School, Moscow**

**Abstract:** 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. But estimates reveal that the tariff changes resulted in substantial transfers from Kazakhstan to Russia as importers in Kazakhstan now purchase lower quality or higher priced Russian imports that 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. But Russia's accession to the World Trade Organization will eventually substantially reduce the transfers from Kazakhstan to Russia. Progress with non-tariff barriers and trade facilitation, however, will take a strong political commitment from Russia which we have not yet seen. But if that Russian political leadership is forthcoming, the Eurasian Customs Union could succeed where its predecessor failed.

## **The Eurasian Customs Union: Can it succeed where its Predecessor Failed?**

In January 2010, Russia, Belarus and Kazakhstan formed the Eurasian Customs Union. In January 2012, the three countries agreed to even closer economic ties, by signing the agreement to form a “common economic space.” Their earlier effort at a Customs Union failed due to high transfers from Kazakhstan and the other Central Asian member countries to Russia; unfortunately, the current Customs Union imposes a tariff structure that repeats that mistake. But Russian WTO accession will substantially reduce those transfers, and the present Customs Union is charged with reducing non-tariff barriers among the member countries and hopes to improve trade facilitation. So far, the Customs Union has moved backwards on non-tariff barriers and trade facilitation. It will take strong political will and leadership from Russia to make the required progress in non-tariff barriers and trade facilitation to avoid a repeat of the failure of its predecessor customs union.

### **What is the Eurasian Customs Union**

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.

## **Economics of the Tariff Changes—Gains for Russia and Losses for Kazakhstan**

Some proponents of the Eurasian Customs Union argue 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. But prior to 2010, 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 allowed Kazakhstan on a transition basis, Kazakhstan almost doubled its tariffs in the first year of the Customs Union by imposing the common external tariff (see Jondosov and Sabyrova, 2011; and World Bank, 2012). The increase in tariffs on many items not produced in Kazakhstan, but produced in Russia, led to a substantial increase in imports from Russia and displacement of imports from Europe. From Russia's perspective, the Customs Union does represent an expansion of the market. Many of its manufacturing firms that were not competitive in Kazakhstan with the low tariffs of Kazakhstan prior to the Customs Union; but they were able to expand sales to the Kazakhstani market under the tariff umbrella. This represents gains for Russian industry. Given the deeper manufacturing base in Russia compared with most countries of the CIS, 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 in Kazakhstan, under the tariff umbrella of the common external tariff, by higher priced or lower quality imports (including lower tech goods that reduce access to modern Western technologies) from Russia represents a substantial transfer of income from Kazakhstan to Russia, and is an example of what economists call "trade diversion." It is the reason that the World Bank (2012) has evaluated the tariff changes of the Customs Union as a loss of real income for Kazakhstan.

Further, 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.

### **Political Consequences of the Customs Union—Large Transfers Lead to Tensions and Conflict**

Some would argue that there are political benefits of trade to be taken into account. The European Union has shown that despite a long history of wars, the increased interdependence of France and Germany due to increased trade now makes it appear inconceivable that they would engage in hostilities. But 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. Schiff and Winters (2003, 194-195) have effectively argued that a clear example of how integration can inflame conflict is the civil war of the United States. The United States constituted a customs union among the states. In the 1800s, the North produced manufactures that were sold to the South and the South produced cotton that was exported to Europe. In 1828, Congress passed the “Tariff of Abominations” that resulted in a massive transfer of income from the South to the North. South Carolina threatened to secede and Federal troops were sent to South Carolina; but Congress reduced the tariffs before fighting ensued. In 1860, however, tariffs were raised again and this time Congress did not back down. Adams (1993) concludes that the high tariffs were as important as slavery in driving the South to secede from the Union and initiate the civil war. Another example is the East African Customs Union. Kenya was seen as the country with the relatively advanced base in manufactures that resulted in transfers from Tanzania and Uganda to Kenya. The customs union collapsed in 1978 with the closing of borders among the countries. This led to tensions and contributed to the conflict between Tanzania and Uganda in 1979. On the other hand, the success of the European Union in promoting peace in the region is partly explained by a strategy of avoiding policies that create transfers large enough to trigger conflicts.

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

Non-tariff barriers are a significant problem in the Customs Union. International evidence shows that command and control barriers, such as quotas and licenses, have become much less important as instruments of protection in world trade. They have been replaced by sanitary and phyto-sanitary (SPS) conditions on food and agricultural products and technical barriers to trade (TBTs) on goods. In the case of the Eurasian Customs Union and the CIS, SPS conditions and TBTs are even more important than in other regions of the world. 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 from them 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 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 based on the Soviet system of standards regulation. There are reportedly about 20,000 standards that apply in the Customs Union. Standards in the three countries remain dominated by Soviet style standards, known as GOST: 62 percent of the standards are GOST standards; 23 percent are Russian; and 14.5 percent are Belorussian.<sup>1</sup> Lacking a market to control quality, GOST standards controlled the quality of a product, even when there was no health or safety issue. That is, mandatory technical regulations were employed where market economies allow voluntary standards to apply. Even the process under which the product was produced was controlled in many cases. This regulatory system makes innovation and adaptation 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. This overly mandatory regulatory system is a bigger problem than a trade problem as it impacts virtually all producers, regardless of the destination of the product. Legislation in both Russia and Kazakhstan calls for conversion to a system of voluntary standards, and there is a desire to move to a system of voluntary standards where no health and

---

<sup>1</sup> See Shymulo-Tapiola (2012) and [www.minpromtorg.ru/industry/metrology/59](http://www.minpromtorg.ru/industry/metrology/59).

safety problem exists; 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 get agreement from the Customs Union, and 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. And even in the European Union, they 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.

Finally, although Mutual Recognition Agreements are required for significant progress, the “National Quality Infrastructure” will need to be developed in all three countries. That is, facilities such as laboratories, testing and metrology facilities will need to be developed and mutually recognized to allow the implementation of MRAs. This is a non-trivial investment.

### **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 exporters and importers operating in the three countries. But Russia’s concerns regarding transshipment have led to an opposite impact on trade with third countries, i.e., the costs of trading with countries outside of the Customs Union have increased. Participation in international production chains has become a key feature of modern international production and trade. If goods can’t 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).<sup>2</sup> 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 with 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.

## **Customs Union Implications for the entry of Kazakhstan into the WTO—Surmountable Complications**

Prior to joining the Customs Union, Kazakhstan had signed bilateral market access agreements with many of the WTO members on its Working Party on WTO accession,<sup>3</sup> and had committed to lower tariffs than the tariffs of the Customs Union on many tariff lines. Thus, to join the Customs Union, Kazakhstan would have to exceed its bound tariff level on many tariff lines. This may require "compensation" from the Customs Union in the form of lowering the common external tariff to provide offsetting market access. Shepotylo and I (forthcoming) have estimated, however, that there are about 1,500 tariff lines where the applied tariff rate of Russia is below its final bound rate. Consequently, Russia should be able to agree to lower the bound tariffs of the Customs Union to pay "compensation" to the WTO members for Kazakhstan applying higher tariffs than its commitments, without actually having to lower any applied tariffs in Russia.

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

---

<sup>2</sup> 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.

<sup>3</sup> As of October 2012, it had reportedly signed bilateral market access agreements with all members of its Working Party except one.



In 1996, the same three countries formed a customs union; they were joined by Kyrgyzstan in 1996, later by Tajikistan and still later by Uzbekistan in 2005. As Michalopoulos and I (1997) anticipated, the earlier Customs Union failed because it imposed large costs on the Central Asian countries, who 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.<sup>4</sup> 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 and includes "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 is 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.

### References

- Adams, Charles, (1993), *For Good and Evil: The Impact of Taxes on the Course of Civilization*, Lanham, Md.: Madison Books.
- Grossman, Gene and Elhanan Helpman, "The Politics of Free-Trade Agreements," *The American Economic Review*, Vol. 85, 4:667-690, 1995.
- Jandosov, Oraz ,and Lyaziza Sabyrova (2011), "Indicative tariff protection level in Kazakhstan: before and after the customs union (part I)," Rakurs Discussion Paper 5.3. March.

---

<sup>4</sup>Russian tariffs fall more on an un-weighted average basis than they do on a weighted average basis. See Shepotylo and Tarr (forthcoming).

- Michalopoulos, Constantine and David G. Tarr (1997), "The Economics of Customs Unions in the Commonwealth of Independent States," *Post-Soviet Geography and Economics*, Vol. 38, No. 3, 125-143.
- Petrovskaya, Galina (2012), "Belarus, Rossia, Ukraina. Obrechennyenatorgovyekonflikty" (Belarus, Russia, Ukraine. Doomed for trade conflicts), Deutsche Welle, June 14. [www.dw.de/dw/article/0,,16023176,00.html](http://www.dw.de/dw/article/0,,16023176,00.html).
- Schiff, Maurice and L. Alan Winters (2003), *Regional Integration and Development*, Washington DC: World Bank and Oxford University Press.
- Shepotylo, Oleksandr (2011), "Calculation of the tariff rates of Kazakhstan before and after the imposition of the customs union common external tariff in 2010." Available as part of World Bank (2012).
- Shepotylo, Oleksandr, and David G. Tarr (2008), "Specific tariffs, tariff simplification and the structure of import tariffs in Russia: 2001–2005," *Eastern European Economics*, 46(5):49–58.
- Shepotylo, Oleksandr, and David G. Tarr (forthcoming), "Impact of WTO Accession on the Bound and Applied Tariff Rates of Russia," *Eastern European Economics*.
- Shymulo-Tapiola, Olga (2012), "The Eurasian Customs Union: Friend or Foe of the EU?" The Carnegie Papers, Carnegie Endowment for International Peace, October. Available at: [www.CarnegieEurope.eu](http://www.CarnegieEurope.eu),
- Irina Tochitskaya (2010), "The Customs Union between Belarus, Kazakhstan and Russia: An Overview of Economic Implications for Belarus," paper no 405/2010, Case-Network. Available at: [www.caseresearch.eu/sites/default/files/publications/32701553\\_CNESA\\_405\\_0.pdf](http://www.caseresearch.eu/sites/default/files/publications/32701553_CNESA_405_0.pdf).
- World Bank (2012), *Assessment of Costs and Benefits of the Customs Union for Kazakhstan*, Report Number 65977-KZ, Washington DC, January 3, 2012. Available at: <http://documents.worldbank.org/curated/en/2012/01/15647043/assessment-costs-benefits-customs-union-kazakhstan>