

The Eurasian Customs Union: The economics and the politics

by Iana Dreyer and Nicu Popescu

Long ignored by the West, the Eurasian Customs Union (consisting of Russia, Belarus and Kazakhstan) has recently been brought into the international limelight. The project – an attempt by the Kremlin to create a rival to the European Union and its Eastern Partnership project – attracted attention when Moscow, with its characteristic bluntness, began to pressure Armenia, Georgia, Moldova and Ukraine to join the grouping and drop their plans to sign Association Agreements with the EU. Although Russia has not succeeded in convincing all these states to join, it managed to do so with Armenia in September 2013, and the political tussle over the issue with Ukraine played a central role in triggering the country's current crisis.

The Eurasian Customs Union came into force in 2010 and is expected to become a fully-fledged 'Eurasian Union' in 2015. Previous Russian-led attempts to create trading zones and customs unions among members of the Commonwealth of Independent States (CIS) ran into the sand. But will this one fare differently? In a region where border management practices and bureaucracies are notoriously inefficient, the union already works reasonably well. That said, the project has inherent economic and political flaws that could yet cause it to derail. In the meantime, the EU and its partners can work together to ensure that, in implementing

the customs union, Russia at least abides by World Trade Organisation (WTO) rules and respects its members' and neighbours' political sovereignty.

The contours of the plan

The Eurasian Union is still work in progress, but its template – at first glance – looks strikingly similar to that of the European Union. Within the customs union, most internal trade has been liberalised (bar certain sectors like sugar, tobacco, alcohol or rice) and since July 2011, border controls between its members have largely disappeared. Conversely, controls were stepped up on the borders with direct neighbours in the CIS which opted to stay out of the union.

Members established a common external trade tariff in January 2010 and about 85% of import duties are now harmonised. Kazakhstan, initially the most economically liberal among the three members, had to raise around half of its tariffs in order to become part of the grouping and its average applied rate nearly doubled from 6.5% to 12.1%.

Since 2012, the customs union has been run by a 'Eurasian Economic Commission', which is expected to become the centrepiece of the eventual

Eurasian Union. This body sets key rules for the customs union and is tasked with handling Russia's trade relations with third countries and relations with the World Trade Organization (WTO) on behalf of all three partners. Designed with the hope of eventually guaranteeing the free movement of capital and labour, the Eurasian Union is expected to have a say in the macroeconomic, financial, competition and energy policies of its members. The Commission is also in charge of harmonising the bloc's technical and sanitary standards, as the absence of shared and mutually recognised standards has proven to be a major obstacle to further economic integration.

Yet there are significant differences when compared with the EU. First, whereas the EU is mostly a union of middle-size and small countries, the Eurasian Union is much less balanced in its composition. Russia's dominance of the customs union is overwhelming, accounting for 86% of the bloc's GDP and 84% of its population. The same figures for Kazakhstan and Belarus are 8% and 10% and 5% and 5% respectively.

Second, whereas the EU has attracted many applicants with the prospects of membership, the Eurasian Union is expanding mostly through a combination of Russian subsidies and coercion. Moscow is pressing for other members of the CIS to join the bloc, and while Armenia and Kyrgyzstan have agreed to join in principle, Ukraine, even under President Yanukovich, has firmly resisted Russian advances.

Do customs unions work?

A customs union is a form of regional free trade area (FTA) which seeks to liberalise trade exclusively among its members. Customs unions involve, on top of an FTA, a common external tariff and, by extension, a common external trade policy. They are easier to administer than FTAs because there is no need to agree on rules of origin for traded products. Customs union members, however, cannot pursue their own tariff or trade policies with third parties. This restriction on national sovereignty is often difficult to accept and partly explains why customs unions are rather uncommon – as opposed to classic FTAs.

History is full of failed customs unions, and the only fully-fledged and well-functioning customs union in the world today is the EU. Other customs unions are either incomplete or plagued by political frictions among members over the distribution of costs and benefits of the arrangement: the

EU-Turkey customs union, established in the mid-1990s, excludes agricultural products; Mercosur – founded by Brazil, Argentina, Paraguay and Uruguay in 1991 – has failed to establish a common external tariff (to avoid reversals in trade liberalisation) and avert political tensions; and an East African Customs Union collapsed in 1978, with the ensuing closure of borders contributing to subsequent regional military confrontations.

Customs union projects are rarely market-liberal in their economic outlook. This explains their frequent failure, as protectionist policies raise political tensions over the redistribution of rents while failing to raise prosperity. Such unions tend to succeed if underpinned by a wider political project and genuine willingness by its members to relinquish their trade policy autonomy as part of a broader transfer of political sovereignty. The German *Zollunion* of 1834 for example, prepared the ground for the unification of Germany forty years later – although neither the Prussian-led state that emerged nor its trade policies were liberal.

The EU has managed to avoid the pitfalls of other customs unions. It is part of an 'ever closer union' designed to consolidate a liberal political and market order on the European continent, for the sake of which member states have agreed to relinquish part of their national sovereignty gradually and voluntarily. Apart from certain sectors (such as agriculture), the European customs union can be said to be fairly liberal by international standards.

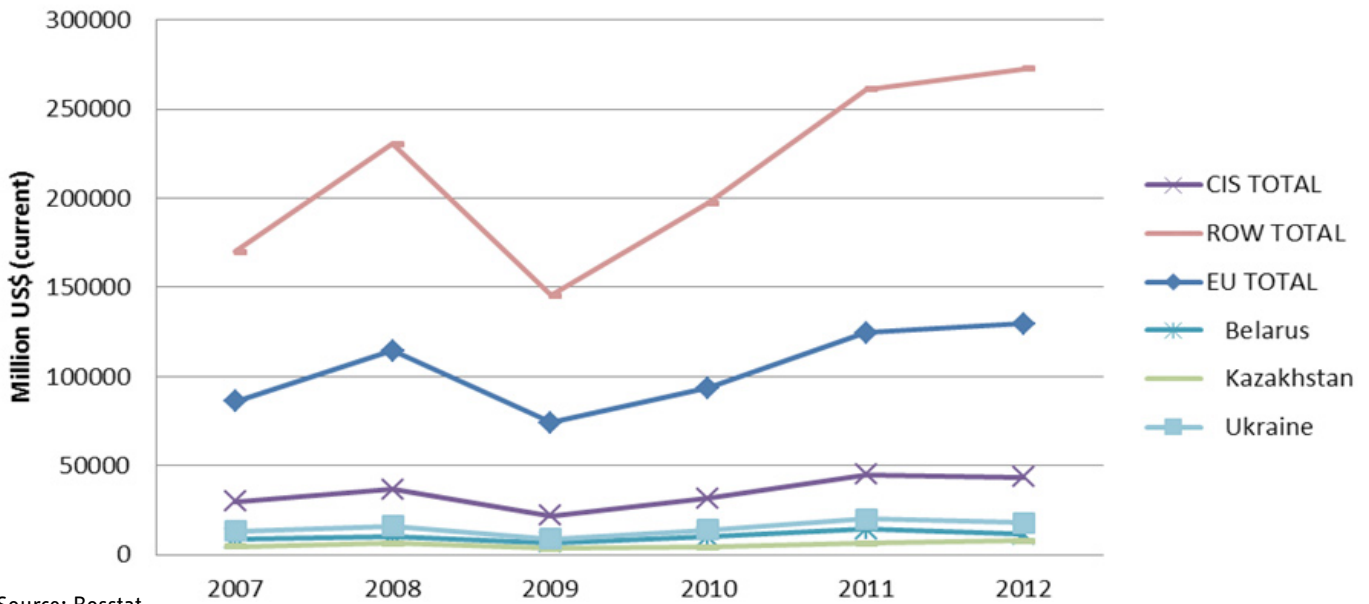
The economic effects of FTAs are two-fold. On the one hand, FTAs *create* trade, because they offer a bigger market for producers, thus generating economies of scale. On the other hand, FTAs also *divert* trade. Since there is a preference for trade with partners from within the zone, less efficient and more expensive producers can be propped up to the detriment of more competitive ones from outside, thus harming consumers and reducing economic gains.

Trade economists consider that, in order for trade creation in FTAs to outweigh inevitable trade diversion, liberalisation among members must cover (close to) all areas of trade. Trade barriers towards non-members should not be raised, and 'behind-the-border' barriers to commerce (such as trade restrictive application of technical standards) reduced.

FTAs work out best when its members are already reasonably wealthy or when their economies are complementary, as found in so-called 'North



Russian imports 2007-2012



Source: Rosstat

South' FTAs (e.g. NAFTA involving Mexico plus the US and Canada). These allow the poorer country to attract investment, improve productivity and access a major wealthy market. FTAs exclusively between poorer countries, however, tend to exacerbate differences in wealth among their members, frequently spurring internal political tensions.

Customs unions often initially raise the average levels of trade protection of their members *vis-à-vis* the outside world. Yet as the EU has demonstrated, this problem can be addressed. Partly because its trading partners feared a 'fortress Europe' when the customs union was set up in the 1960s (and the Single Market in the late 1980s), EU integration was accompanied by the reduction of trade barriers during global trade liberalisation rounds in the GATT (now WTO). When the EU expanded to include states in southern and eastern Europe, new members – as a general rule – were required to reduce tariffs in order to match those of the EU. This decision has both benefited their economies and contained political grievances over trade diversion with non-EU trading partners.

For its part, the WTO regulates FTAs. It says that FTAs should liberalise 'substantially all trade', and that 'the purpose of a customs union or of a free-trade area should be to facilitate trade between the constituent territories and not to raise barriers to the trade of other(s)'. The WTO foresees a mechanism for members to negotiate 'compensations' – either tariff reductions or money – if a country decides to increase its tariffs above the level it has 'bound' them in the WTO. This also applies to countries that join a customs union and, as a consequence, have to raise import duties.

Russian trade and the Customs Union

Like other customs unions, the Eurasian Union is underpinned by a wider political vision. Championed by the Kremlin, this vision seeks to establish a new centre of power in an increasingly multipolar world. But the other customs union members do not wholeheartedly share Moscow's stance and are wary of its dominance of the bloc. At this stage, it is a union of three post-Soviet authoritarian regimes, and those countries with more open political systems in the region have resisted Russian pressure to participate. In addition to the weakness of the political legitimacy of the project, its underlying economic vision is not liberal, with Russia having raised protection levels since the onset of the global financial crisis in 2008, and forced the other members to raise their tariffs.

Although the Eurasian Union is incomplete, compared to previous Russian-led regional trade initiatives, it is, however, the most effective attempt to date. At any rate, internal trade tensions have not disappeared, and Moscow has not fully given up on the idea of introducing occasional trade barriers (for example on milk products from Belarus).

The 'deep integration' dimension of the union remains somewhat unclear. The process of harmonising technical standards has been extremely slow and there is no mutual recognition of members' differing standards. Moreover, the prospects of establishing the free movement of labour are uncertain, with over 80% of Russians currently in favour of curbing migration through the introduction of visas for Central Asians.

It is worth noting that tighter border controls with non-customs union members after 2011 led to a dramatic reduction of imports from Russia's neighbours. According to the data from Russia's statistical agency (Rosstat), imports in 2012 from Azerbaijan declined by 1.4%, from Kyrgyzstan by 33.4%, from Tajikistan by 24.2%, from Uzbekistan by 25.1%, and from Ukraine by 10.7%.

Due to previous liberalisation efforts, the market access exporters in Kazakhstan and Belarus have gained has been limited, and there has been no trade growth within the zone that is directly linked to the customs area. But there have been measurable, if limited, signs of trade diversion to the detriment of Kazakhstan. For example, Astana is now importing more expensive cars from Russia and reducing imports of more competitive German, Japanese, and Korean vehicles, effectively amounting to the transferring of economic rents to Moscow's automobile sector. As for Belarus, its economy has largely retained its Soviet-era structures, and while this will not change as a result of the union, Russian state-backed companies will be in a better position to get hold of the country's economic assets.

The Eurasian Union is unlikely to bring long-term economic benefits to its members. Its member states are neither wealthy nor are their economies complementary. As a result, political tensions over transfers of wealth can be expected. Russia's economy is not developed enough to play the positive role that the US and Canada played for Mexico in NAFTA, or the Western European economies for the new EU members of central and eastern Europe.

Several studies on the countries of the former Soviet Union have shown that they have more to gain by integrating with the outside world than with each other. Applying WTO rules on services liberalisation, investment, intellectual property, government procurement, and technical standard recognition (among others) would be a more effective way of helping the current members of the union to modernise and diversify their economies.

Most economists agree that the Eurasian Customs Union could bring greater benefits to its members were its trade regime more open than it is today. In other words, both politically and economically, the Eurasian Union is a ghost of the past. Yet it can now no longer be ignored, and must be dealt with in an appropriate manner.

Outlook and implications

Relations between the customs union and the WTO remain hazy. Russia has been a member since 2012 and has been slow in delivering on its commitments to the organisation. What is more, Moscow's WTO partners are wary of recognising the customs union as the sole representative of Kazakhstan and Belarus. If Kyrgyzstan and Armenia join the union, other WTO members will also claim compensation.

It is also not guaranteed that the union will gain any more members. Even Kyrgyzstan and Armenia are having second thoughts as they gauge the potential consequences of joining: the loss of their political autonomy, the economic costs of more protectionism, and the impact this could have on their economic and political relations with other WTO members and/or neighbours – not least China. Further integration within the union may also be hindered by Russia's military intervention in Ukraine, with other post-Soviet states (including union members like Kazakhstan) deeply unsettled by Moscow's aggressive behaviour.

For most trade partners of those states in the customs union, what matters most is avoiding discrimination against their products as a result of greater customs controls. Encouraging Russia to liberalise its tariffs and services should also be on the agenda of its major Western and Asian trading partners. And ensuring that Kazakhstan (and perhaps one day even Belarus) can join the WTO should remain a priority.

Russia's behaviour in the context of the customs union may also have to be monitored in order to ensure its compliance with WTO rules. Moscow's recourse to trade blockades against countries unwilling to join the Union – like those against Ukraine in 2013 – are contrary to the spirit and the letter of the WTO. And if Russia raises tariffs against Ukraine if/when Kiev joins the planned Deep and Comprehensive Free Trade Agreement with the EU, as Moscow has threatened to, such action would be in breach of its commitments to the WTO. Moscow's trading partners should not hesitate to launch WTO procedures to tackle trade diversion and should provide technical assistance (with regard to WTO dispute settlements) to any of their eastern partners who suffer as a result of Russian trade sanctions.

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