5

The Economics of the Customs Union and Eurasian Union

Richard Pomfret

The economic analysis of a customs union is straightforward, even if the conclusions and practical application are less so. In theory, a customs union may or may not improve on the pre-union situation. In practice, customs unions based on creating a protected internal market have had a poor record in the modern global economy, while arrangements that have created more integrated internal markets while remaining open to the rest of the world have thrived. The first section of this chapter reviews the theoretical and empirical evidence in support of these statements, and the second section applies these ideas to the Belarus-Kazakhstan-Russia customs union. The third section considers the prospect for deepening the customs union into a Common Economic Space and broadening it to include new members. The final section draws conclusions.

Customs Union Theory and Evidence

Customs union theory dates from a classic work by Jacob Viner.[1] Defining a customs union as an arrangement whereby the partners have tariff-free internal trade and a common external tariff, the union will lead to increased trade among the members. Viner's crucial insight was that the increased trade has two sources. Trade is created because duty-free trade among the partners will lower prices, displacing domestic producers and increasing domestic demand. At the same time trade is diverted from lower-cost external suppliers, who still face the tariff, to internal competitors who do not. Trade creation is welfare-increasing because it represents an improved global allocation of resources,

[1] Jacob Viner, *The Customs Union Issue*, New York: Carnegie Endowment for International Peace, 1950.

while trade diversion is welfare-reducing because it distorts global production from lower- to higher-cost suppliers.

The logic of Viner's analysis is indisputable. The outcome of customs union formation is theoretically ambiguous, i.e. a customs union may or may not be an improvement over current arrangements. However, a desirable customs union is one where trade creation is greater than trade diversion, and it is not too hard to identify conditions under which this is more or less likely and hence to distinguish between welfare-improving and welfare-reducing customs unions.

The customs union in manufactured goods among the six original members of the European Economic Community was beneficial. For any manufactured good, at least one producer in the six countries would be close to the world's best, implying that there would be little trade diversion; all *ex post* empirical studies of the customs union found substantial trade creation and net economic benefits. In contrast, the accession of the United Kingdom in 1973 was not positive economically, because the UK already had low tariffs on manufactures and the main trade consequences of accession were associated with the agricultural policy, which diverted UK imports from low-cost global suppliers to higher-cost European suppliers.

The success of the European customs union led to several customs unions being created among developing countries in the 1960s, e.g. the Central American Common Market (CACM) and the East African Community (EAC). These and other similar arrangements among developing countries were signed in the context of import-substituting industrialization strategies, with the goal of reserving a larger market for internal producers. Both the CACM and EAC experienced an increase in internal trade, which could have been viewed as a successful creation of a larger market for their protected producers, but both customs unions were characterized by dissension and eventual collapse in the 1970s. The poorer less-industrialized countries (Nicaragua and Honduras, and Tanzania and Uganda) were dissatisfied that benefits were accruing disproportionately to their more industrialized partners, i.e. they were unwilling to accept trade diversion from globally efficient suppliers to the relatively efficient internal suppliers, Guatemala and Kenya.[2]

The CACM and EAC failures were typical of other integration schemes in the 1960s and 1970s based on the idea that a larger protected market would help members to industrialize. In practice, members were happy to sell their manufactures within the protected market, but were unhappy about buying their partners' manufactured goods, which were typically far from world standard in price or quality. Thus, for example, a succession of schemes within the Association of Southeast Asian Nations (ASEAN) to promote industrial projects catering to an ASEAN-wide market all foundered.

The popularity of customs unions and other regional integration schemes declined in the 1970s, but a second wave of regional integration occurred in the 1980s and early 1990s. This mainly involved high-income countries and the common feature was "deep integration," i.e. going beyond tariff elimination to facilitate trade in a more integrated internal market. The prime examples were the EC92 "single market" program, the 1987 Canada-U.S. Free Trade Agreement and the North American Free Trade Agreement (NAFTA), and the 1983 Closer Economic Relations (CER) between Australia and New Zealand. The significance of these arrangements, all of which came to be seen as successful, was their focus on trade facilitation.

Among developing countries the most active regional cooperation in the 1990s was within the forum of Asia-Pacific Economic Cooperation (APEC). The underlying concept of APEC was open regionalism, by which members reduced barriers to internal trade without discriminating against non-members. Major successes were the unilateral tariff reduction by many East Asian economies (China, Thailand, Philippines, etc.), which would have been harder to implement without a (vague) promise of reciprocity. The significant reduction in

[2] In both cases the catalyst for formal collapse was a military conflict (the 1970 "soccer war" between El Salvador and Honduras, and the Tanzanian invasion of Uganda in 1979 to depose Idi Amin), but the underlying tensions centred on dissatisfaction with the distribution of benefits had already undermined the customs unions. See Richard Pomfret, *The Economics of Regional Trading Agreements*, Ocford: Oxford University Press, 2001.

trade costs introduced on a non-discriminatory basis by the leading ASEAN economies was also in keeping with the idea of open regionalism.[3]

What lessons can be drawn from the theory and evidence of customs unions? Customs unions may or may not be an improvement over the current situation. A customs union is most likely to fail when its main consequence is trade diversion, and this is most likely when the union involves countries that are not from the world's leading trading nations and is predicated on the assumption that a larger market will promote members' economic development. A customs union is most likely to succeed when it has low external trade barriers and promotes market integration by lowering trade costs. The success story is the European Union (EU), which has low external tariffs and, especially within Schengenland and the Eurozone, highly integrated internal markets. A similar conclusion about beneficial trade facilitation could be drawn from nineteenth century customs unions that promoted internal market integration (the USA, Canada, Italy, Germany, or Australia), although these were associated with political union rather than driven by economic efficiency arguments and often had high external trade barriers. From a broader perspective, a customs union is inferior to non-discriminatory trade liberalization, which delivers trade creation without trade diversion, and hence is unlikely to harm third countries.

Customs Union between Belarus, Kazakhstan, and Russia

The establishment of a customs union between Belarus, Kazakhstan, and Russia was rapid. The customs union agreement was signed in November 2009, and a common external tariff and customs code established in 2010. In July 2011 customs controls at the members' common borders were abolished. The common external tariff was weighted towards the Russian tariff, which had little impact on Belarus,[4] but led to significant increases in Kazakhstan's tariffs. Russia kept 82 percent of its customs tariffs unchanged and lowered 14 percent and in-

[3] Richard Pomfret and Patricia Sourdin, "Have Asian Trade Agreements reduced Trade Costs?," *Journal of Asian Economics*, vol. 20 no. 3, 2009, pp. 255-68.

[4] Irina Tochitskaya, "The Customs Union between Belarus, Kazakhstan, and Russia: An Overview of Economic Implications for Belarus", *CASE Network Studies and Analyses*, no. 405, 2010, http://www.case-research.eu/upload/publikacja_plik/32701553_CNSA_405.pdf.

creased 4 percent of its tariffs; the corresponding shares for Kazakhstan were 45 percent, 10 percent, and 45 percent.[5]

Among economists, expectations were of negative welfare consequences for Kazakhstan. Raising the external tariff while allowing duty-free imports from Russia was a recipe for trade destruction and trade diversion, and a simple but plausible model by Tumbarello estimated substantial welfare loss for Kazakhstan.[6] Moreover, the negative trade impact is likely to be exacerbated by administrative changes and increased non-tariff barriers which will further reduce trade with non-members, e.g. newly designed sanitary and phytosanitary (SPS) rules make it harder for the Kyrgyz Republic to export its farm products to Kazakhstan[7] and tighter controls on the customs union's external borders will discourage informal, or currently poorly monitored, imports into Kazakhstan from the Kyrgyz Republic and China.[8] CAREC reports that, while average border-

---

[5] Alexander Libman and Evgeny Vinokurov, *Holding-together Regionalism: Twenty years of post-Soviet integration*, Basingstoke: Palgrave Macmillan, 2012, p. 49.

[6] Patrizia Tumbarello, Regional Trade Integration and WTO Accession: Which is the right sequencing? An application to the CIS, *IMF Working Paper WP/05/94*, 2005. Early post-2010 empirical studies such as Isakova and Plekhanov, Mogilevskii and the World Bank had too little data to draw convincing empirical conclusions. Mogilevskii (p. 22) emphasizes the number of contemporary exogenous shocks that obscure identification of pure customs union effects. See Asel Isakova and Alexander Plekhanov, "Customs Union and Kazakhstan's Imports," CASE Research Network Studies and Analyses No. 442, Center for Social and Economic Research, Warsaw, 2012; Roman Mogilevskii, "Customs Union of Belarus, Kazakhstan and Russia: Trade Creation and Trade Diversion in Central Asia in 2010-2011," University of Central Asia Institute of Public Policy and Administration, Working Paper No.12, 2012; World Bank, *Assessment of the Costs and Benefits of the Customs Union for Kazakhstan*, *Report 65977-KZ*, Washington D.C.: World Bank, 2012.

[7] Nuritdin Djamankulov, *SPS Regulations and Access of Kyrgyz Goods to the Customs Union*, USAID Regional Trade Liberalization and Customs Project (USAID Contract No.: 176-C-00-07-00011-08), Bishkek, 2011.

[8] Roman Mogilevskii, "Re-export Activities in Kyrgyzstan: Issues and Prospects," University of Central Asia Institute of Public Policy and Administration, Working Paper No.9, 2012. Silitski argues that the main reason for Russia promoting the customs union was to control imports from the EU and China, which were evading tariffs, taxes and other restrictions by routing via Belarus and Kazakhstan respectively. See Vitali Silitski, "The 2010 Russia-Belarus-Kazakhstan Customs Union: A Classic Case of *Prinuzhdenie k Druzhbe* Friendship Enforcement," PONARS Eurasia Policy Memo No. 110, 2012, available at http://www.gwu.edu/~ieresgwu/assets/docs/pepm_110.pdf). Laruelle and Peyrouse (p. 44) highlight the drastic effect of the customs union on the Kyrgyz Republic's role as a platform for re-exporting Chinese goods and claim that the number of Kyrgyz wholesale traders fell by 70-80% in 2010-11. Marlène Laruelle and Sébastien Peyrouse, "Regional Or-

crossing time for trucks leaving Kazakhstan for Russia fell from 7.7 hours in 2011 to 2.9 hours in 2012, the average border-crossing time for trucks entering Kazakhstan from outside the customs union increased from 8.6 to 21.5 hours, with "waiting in queue" the biggest part.[9]

Why did Kazakhstan take this step when economic studies suggested that the customs union would yield negative returns to Kazakhstan? Mogilevskii highlights the immediate increase in tariff revenue, by at least USD1.4 billion in 2011.[10] Laruelle and Peyrouse see the empirical literature as indicating potential short-run benefits for Kazakhstan, but a long-term negative impact as foreign investment, technology and knowledge transfer flows decline.[11] The EBRD study is more agnostic—small negative short-term effects on Kazakhstan, but uncertain long-term effects—perhaps suggesting that forming the customs union was a political, rather than economic, decision.[12]

The negative economic effects will be reduced as Russia implements its WTO accession commitments, effectively lowering the customs union's common external tariff and liberalizing Russia's domestic market. When Russia joined the WTO in 2012, its commitments included substantial tariff reductions (to an average tariff of 8 percent by 2020), elimination of some non-tariff barriers to trade, and written clarification of other non-tariff measures that affect trade.[13]

---

ganisations in Central Asia: Patterns of Interaction, Dilemmas of Efficiency," University of Central Asia Institute of Public Policy and Administration Working Paper No.10, 2012.

[9] CAREC, *Corridor Performance Measurement and Monitoring Annual Report 2012*, pp. 38-39, http://cfcfa.net/cpmm/cpmm-annual-and-quarterly-reports/2012-annual-report/.

[10] Mogilevskii, "Customs Union of Belarus, Kazakhstan and Russia," p. 33.

[11] Laruelle and Peyrouse, "Regional Organisations in Central Asia" pp. 44-45.

[12] Asel Isakova, Zsoka Koczan, and Alexander Plekhanov, *How much do Tariffs Matter? Evidence from the Customs Union of Belarus, Kazakhstan, and Russia*, London: European Bank for Reconstruction and Development, Working Paper no. 154, 2013.

[13] WTO accession commitments go beyond tariffs and NTBs. The *Final Report* on Russia's accession contains 758 pages, excluding the specific commitments on goods and services, which are in annexes, and it includes, *inter alia*, rules for the treatment of foreign investors, constraints on trade-distorting (amber box) agriculture subsidies, and rules on intellectual property, public procurement and foreign trade regime transparency. Shepotylo and Tarr calculated that in 2020 after the transition period Russia's weighted average bound tariff will be 8.2% and the applied tariff 7.6%. (Oleksandr Shepotylo and David Tarr, *Impact of WTO Accession and the Customs Union on the Bound and Applied Tariff Rates of the Russian Federation*, Policy Research Working Paper 6161, 2012, World Bank.) However, some of Russia's actions towards trade with Ukraine in 2013 were contrary to obliga-

All of these policies will be implemented *de facto* as changes in the Customs Union's common external commercial policy. With the 2020 external trade policies, the customs union is likely to be less harmful to Kazakhstan than what has been suggested by estimates made before Russia's WTO accession. If the net outcome is of market integration with lower transactions costs and external tariffs that do not discriminate greatly against non-members, then the net welfare effect could be positive.[14]

Nevertheless, the long-term net benefits remain uncertain. Economic theory is clear that a customs union is a second-best arrangement, which may or may not improve over the preceding tariff-ridden situation, but which is inferior to non-discriminatory trade liberalization.[15] The argument that a customs union is necessary for a small economy to achieve economies of scale is false, because with open trade policies the world is the market. The scale economy argument is belied by the success of the relatively small first generation new industrializing economies (Hong Kong, Singapore, Taiwan and South Korea), and the dismal performance of the most populous countries as long as they sheltered their producers from global competition (rapid growth in China, India and Brazil dates from the major opening up of their economies in 1978/9, 1991, and 1995 respectively). There may be dynamic gains from regional market integration, but these are uncertain and unproven. The empirical evidence shows that customs unions and free trade areas have been harmful when they have erected a wall around a protected market, but sometimes beneficial when they have low external protection and focus on integrating the internal market by trade-facilitating measures.[16]

---

tions towards a fellow WTO member, raising questions about Russia's commitment to WTO obligations.

[14] Vinokurov champions the desirability of this type of "open regionalism." Yevgeny Vinokurov, "Pragmatic Eurasianism: Prospects for Eurasian integration," *Russia in Global Affairs*, vol. 11 no. 2, 2013, pp. 87-96. However, after Russia's restrictions in 2013 on trade with Ukraine, a fellow WTO signatory, the reliability of Russia's commitments is in doubt.

[15] As with any change in trade flows, there will be gainers as well as losers (e.g. the Russian firms who displace non-member exports to Kazakhstan are beneficiaries), but the global welfare effect of trade diversion is negative and the combined losses to the displaced non-member supplier and to Kazakhstani consumers outweigh the gains.

[16] Richard Pomfret, *The Economics of Regional Trading Arrangements,* Oxford: Oxford University Press, 2001.

From Customs Union to Common Economic Space

In January 2012, the creation of a Common Economic Space (CES) began. The aims of the CES include creation of a common market in goods, services, labor and capital; coordination of monetary, financial and tax policies; development of unified transport, energy and information systems; and unification of systems of state support for innovation and priority sectoral development. In July 2012 the Eurasian Economic Commission (EEC), a supranational executive body comprising deputy prime ministers, was established. The CES is a step beyond a customs union, and the consequences of creating an integrated economic space are more far-reaching and at this stage difficult to evaluate.

How far will creation of a common economic space go? Widening and deepening are on the horizon. The Kyrgyz Republic and Tajikistan, both members of EurAsEc, are the most likely new members of the CES, and a steering committee for integrating the Kyrgyz Republic into the customs union already meets (a road map was approved at the EEC's October 2013 summit, although reconciling Kyrgyz WTO commitments with the external tariff of the customs union is a major obstacle).[17] The sixth EurAsEc member, Armenia, signed a road map at the December 2013 EEC council meeting, with the goal of joining the CES in January 2015, although Armenia faces similar issues to the Kyrgyz Republic.[18] Moldova and Ukraine are more distant, and more challenging, future members.

---

[17] According to the WTO, 30% of Kyrgyz duties align with those of the customs union, 21% can be realigned without violating WTO commitments, and 49% would require renegotiation of WTO terms (and potentially compensation to affected WTO members) before they could be aligned. WTO, *Trade Policy Review The Kyrgyz Republic,* Geneva: World Trade Organization, 2013.

[18] A report by the Eurasian Development Bank acknowledges that upon accession Armenia would need to "improve the level of protection" and that this will conflict with WTO commitments; EDB, *Armenia and the Customs Union: Impact of Accession*, EDB Centre for Integration Studies, Eurasian Development Bank, Saint Petersburg, 2014, summary at http://www.eabr.org/e/research/centreCIS/projectsandreportsCIS/project20/ (accessed January 15, 2014). The report predicts a four percentage point increase in Armenia's growth rate after accession, with half of this coming from lower oil and gas prices and most of the rest from increased foreign investment, including a Russia-Iran railroad that would bring Georgia into the CES circle. These are not effects of the customs union, but rather the side-payments to encourage Armenian accession by offsetting the trade destruction and trade diversion resulting from higher tariffs and discrimination in favor of customs union trade. The CES would also help Armenian migrant workers, whose numbers in Russia are larger than the Kyrgyz although remittances are a smaller share of Armenia's GDP.

These potential new members are all in the WTO. If Kazakhstan finalizes its own WTO accession, this could reinforce steps towards an open rather than an exclusionary regionalism. The beyond-trade aspects of the CES could be especially valuable for the poorer Central Asian countries; both the Kyrgyz Republic and Tajikistan would benefit from regularization of the status of migrant workers and resolution of issues such as those of workers' pension rights and access to health and other social services, as well as from improved north-south transport corridors.[19] However, restrictions on member countries' economic links with non-members, notably China, could have seriously negative welfare effects.

Conclusions

Beyond debates about the economic impact, the customs union is clearly part of a geopolitical struggle in which Russia is trying to re-establish hegemony over at least part of the old Soviet Union. The challenges to this vision are China's burgeoning economic influence in Central Asia, which has firm foundations in comparative advantage and will be difficult (but not impossible) to limit by policy instruments, and the EU's attempts to bring western CIS countries into its own sphere of special trade relations.[20] For Kazakhstan, and future CES members, the scenarios are either an economic-welfare-reducing closed regionalism or a more open regionalism. The former is unlikely to be sustainable in the long-run, although it is salutary to recall that both the EAC and CACM func-

[19] The current CES Agreements on labor migration reduce the number of documents required by migrant workers, increase the timeframe for registration and permissible period of uninterrupted stay, grant social rights to the migrant's family (especially in education), and provide guarantees about information availability to migrants. EDB concludes that a key accession issue for the Kyrgyz Republic is to ensure that these conditions apply to new entrants creating something similar to Schengenland. (EDB, *Labor Migration and Human Capital of Kyrgyzstan: Impact of the Customs Union*, EDB Centre for Integration Studies, Eurasian Development Bank, Saint Petersburg, 2013). Another EDB report argues that the origin countries also need to adopt policies that reduce the demand for emigration. (EDB, *Economic Impact of Tajikistan's Accession to the Customs Union and Single Economic Space*, EDB Centre for Integration Studies, Eurasian Development Bank, Saint Petersburg, 2013.)

[20] Other non-members such as Uzbekistan are likely to suffer from trade diversion. The economic impact will be minor, but there may be other dimensions if Russia is signaling abandonment of its neutral role as an honest broker and allying itself with the Kyrgyz Republic and Tajikistan in their water disputes with Uzbekistan. Uzbekistan's 2012 withdrawal from the CSTO was an indicator of deteriorating relations with Russia.

tioned for over a decade before their terminal illness. An open regionalism in which market forces drive economic relations will be more economically beneficial, but in such a setting Russia's economic significance in the region will continue to decline.