Central Asia Economic Paper

No. 8

May 2013

Elliott School of International Affairs
THE GEORGE WASHINGTON UNIVERSITY

Central Asia Program

Foreign Trade Effects of the Customs Union between Belarus, Kazakhstan, and Russia

Alexander Libman, and Daria Ushkalova

Alexander Libman is assistant professor at the Frankfurt School of Finance & Management and senior research fellow at the Institute of Economics of the Russian Academy of Sciences. **Daria Ushkalova** is head of a research group at Institute of Economics of the Russian Academy of Sciences.

The Customs Union (CU) created by Belarus, Kazakhstan, and Russia in 2010 constitutes a major milestone in the development of post-Soviet regional integration agreements.[1] Arguably the most important change associated with the CU is that the agreements signed within its framework, and the decisions made by its supranational institutions (the Commission of the Customs Union and—since 2012—the Eurasian Economic Commission), are perceived as binding by all members of the CU. While in the past regional integration agreements in the post-Soviet space were often revised unilaterally or simply ignored by their signatories, the CU members adhere to the commitments they make. For the last three years, the CU members have at-

Key Points

The Customs Union constitutes the first regional trade agreement in the post-Soviet space based on effective enforcement of commitments made by the member states.

However, intra-regional trade was liberalized to a great extent already before the CU came into existence.

The preliminary econometric estimations suggest that the CU had limited effect on cross-border trade: the effects were present only in particular industries.

From the descriptive data, Belarus seems to be the only winner of the CU.

tempted to resolve their disagreements within the CU framework instead of simply disregarding the CU in the decisions made by their national governments.

However, while the CU clearly constitutes a significant change in how foreign trade regulation in the post-Soviet space is set and enhances the credibility of the commitments of the member states, an equally important question is whether, and, if so, to what extent, the CU has had any effects on cross-border trade in the post-Soviet space. There is no easy answer to this. The liberalization of international trade and, particularly, the disappearance of internal customs borders makes the statistics on foreign trade for the CU countries unreliable. Further, whether the data we have actually captures the actual trade flows between the CU members is also questionable.

In spite of this, this paper attempts to gather some preliminary evidence, both descriptive and econometric, in order to characterize the possible implications of the CU for its members.

Customs Union and Common Customs Tariff

A possible causal chain of effects of the Customs Union could look as follows: due to a different decision-making mode, the regulation of foreign trade (particularly, the tariff and non-tariff barriers for both intra-regional trade and third parties, but also various customs procedures) changes, and, as a result, the trade flows change in terms of magnitude and direction. However, it stands to reason that this chain can be interrupted at any one of its steps. For example, changes in decision-making may result in regulations similar to those existing before the CU, and the new regulations may have little effect on trade. In what follows, we will consider each of the elements step by step.

To start with, one has to acknowledge that the liberalization of trade and the harmonization of customs barriers between the CU countries were relatively advanced already before the CU came into existence. This harmonization and liberalization was an outcome of previous (although less efficient) trade agreements (both multilateral and bilateral, particularly the Russia-Belarus Union and the Eurasian Economic Community), but also of the unilateral actions of individual countries. To a large extend Russia, Belarus, and Kazakhstan managed to maintain a free trade regime after the collapse of the Soviet Union, although there were numerous exceptions. The external customs tariffs of Russia and Belarus already coincided by about 95 percent when the CU was established; for Russia and Kazakhstan the degree of cohesion was lower, about 35 percent.

Nevertheless, the introduction of the CU did result in a number of substantial challenges in the regulation of foreign trade. The Common Customs Tariff (CCT) of the CU introduced in 2010 was to a great extent designed based on the Russian customs tariff of 2009, in terms of both the magnitude of tariffs as well as the classification of goods (including tariffs introduced in Russia during the economic crisis); as a result, the CCT coincided with the Russian tariff to a level of 82 percent. Still, Russia had to reduce import tariffs for about 2,000 product items and to increase tariffs for another 350 items.

The adjustment to the CTT for other members of the CU was larger: similar to Russia, Belarus had to reduce tariffs for about 2,000 product items but had to increase them for 700 items. Kazakhstan, however, had to adjust about 50 percent of its customs tariffs, increasing the tariffs for 5,000 items and reducing them for 1,130 items. As a result, Kazakhstan requested and obtained a number of exceptions, which were gradually abolished during the first years of the CU.

Furthermore, the CU heralded a number of major changes in export regulation. The most important change (and the only one we were actually able to trace if we look at the structure of international trade, as discussed below) arguably took place in 2010, when Russia abolished export duties on oil exported to Belarus. This issue had long been a major controversy in relations between these two countries. Before the CU came into existence, Russia treated differently oil exports to Belarus for domestic use, which were exempted from duties (6.3 million tons in 2010), and those bound for re-export to the EU after processing in one of two refineries in Belarus (15 million tons in 2010), which were not exempted from duties. In mid-2010, however, Russia abolished these duties after lengthy and difficult negotiations and after Belarus has ratified all other agreements of the CU; however, Belarus applied export duties on oil refinery products exported to the EU, with all payments destined to be transferred to the Russian budget.

A further major change stemmed directly from new decision-making requirements. Transferring the decision-making on customs tariffs to a supranational institution, the member states significantly increase the number of veto players in this process, decreasing the speed of decision-making. The CU implied a weighted voting procedure for most tariffs; however, to avoid any contradictions and conflicts, all adjustments to the CTT were decided by consensus of the member states. As a result, the Commission of the CU typically required about 2-3 months for a decision on a proposed amendment to the CU. Demonstrating the scope of the changes, before the CU the Russian government passed about 2-3 changes monthly to the import tariff; after the CU was established, in the first quarter of 2010 only one tariff change was agreed upon (in marked contrast to the number of proposals sent by the Russian Federation to the Commission of the CU). Weighted voting was abolished after 2012, and the newly established Eurasian Economic Commission still makes most of its decisions unanimously.

Finally, it is important to point out that some changes were caused not by the design of the CU, but rather by the gaps and deficits in it. The timeframe for designing the common norms was extremely short, and there are many procedural issues still to be resolved. To provide an example, the CU established a common mechanism of licensing and technical regulation for imports to all CU countries; however, for several goods (like alcohol and radio-electronic equipment) the licensing mechanism failed to function properly in the first two months of the CU's existence, leading to substantial difficulties for importers.

In some cases, the CU actually created new barriers which had previously not existed. For example, transit shipping to Kazakhstan via Russian territory, previously exempted from VAT, is now treated as domestic traffic and thus subject to VAT, leading to a substantial increase in costs.

Intra-regional trade in the CU

How did the change in trade regulation affect the actual trade flows? Again, it is necessary to point to the difficulties involved in collecting reliable trade data after the CU's establishment. Trade statistics in the CU are collected separately by individual member countries, which use somewhat different procedures.

In Belarus, companies are expected to declare trade transactions within the CU for statistical purposes and for the purposes of currency control; the declaration should be accompanied by the necessary primary documents (e.g. contracts, documents confirming the movement of goods, and so on). This makes data on cross-border trade relatively reliable (although it can, on the other hand, be considered as an example of indirect trade barriers). In Kazakhstan, data is collected for statistical purposes only; no primary documents should be submitted or reported to the authorities. In Russia, the declarations should include information on primary documents (e.g. contracts), but the documents themselves are not submitted to the authorities. As a result, data from Kazakhstan and Russia is likely to be substantially less reliable.[2]

First, let us consider the descriptive data on cross-border trade in the CU.[3] In 2010 the effects of the CU for Russian trade seem to have been minimal. Trade turnover between Russia and Belarus and Kazakhstan increased more slowly than trade turnover between Russia and other countries: Russian exports to the CU increased by only 10.9 percent, while Russian exports to other states grew by 34.6 percent. For Belarus, exports to Russia and Kazakhstan in 2010 increased by 44.7 percent compared with 5.7 percent to other countries.

For Kazakhstan, exports to Belarus increased by a factor of more than five (this was due to oil supplies to Belarus in the first half of 2010, when Russian export duties were still in effect) and to Russia by 21.5 percent, while total exports increased by 39.5 percent. For 2011, Russian exports to the CU countries increased twice as fast as exports to other countries—by 38.2 percent to Belarus, 40.2 percent to Kazakhstan, and 18 percent to other countries. As a result, by 2012 the share of the CU in the total foreign trade of Russia increased from 7.2 (2010) to 8.3 percent.

There was little change in terms of commodity structure. For Kazakhstan in 2011 exports to Russia increased by 62 percent as opposed to a 46.5 percent increase in total exports; exports to Belarus declined three-fold, suggesting that the growth of 2010 was an outlier (furthermore, after Russia abolished the export duties for oil, the export of oil from Kazakhstan to Belarus decreased dramatically).[4]

As for Belarus, its exports in 2011 increased by 39.9 percent to Russia and 35.5 percent to Kazakhstan, but the growth of the intra-regional trade was much slower than the growth of trade with other parties: the share of Russia in the geographic structure of Belarus exports actually declined from 40 percent in 2010 to 30 percent at the beginning of 2012.

Interestingly, one the major effects of the CU was a rapid growth of exports from Belarus to the European Union (EU). The reasons for this development are straightforward: because customs duties for oil exports were abolished, Belarus enjoys a major advantage in importing oil from Russia, processing it using its two large refineries and exporting it to the EU. Thus, somewhat counter-intuitively, for Belarus decreasing intra-regional trade is a significant outcome of *highly successful* regional integration within the CU, which has allowed the country to use its advantages of industrial capacity (refineries) and geographic location to the full.

At the same time, Belarus has increased its exports of agricultural products and machinery to CU countries. For example, in the first quarter of 2011, compared to the first quarter of 2010, the export of truck tractors from Belarus to Kazakhstan increased by 15 times, meat and meat products by a factor of 3.9, and footwear by 3.5. Thus, Belarus seems to gain substantially from the CU both in terms of both its exports and imports.

The effects for Kazakhstan are much more ambiguous—the major change observed so far has been the growth in the share of raw materials (other than food) and mineral fuel in Kazakhstan's exports to Russia and Belarus (from 39.1 percent in 2009 to 41.5 percent at the end of 2010 for raw materials, and from practically zero in 2010 to 25 percent in 2011 for fuel). There is no evidence that Kazakhstan can gain by re-exporting products of the CU to third countries or by increasing the exports of its machinery. On the contrary, Kazakhstan is still the major recipient of Chinese imports and the gateway for Chinese goods entering the CU market.

Econometric analysis

Descriptive statistics may provide a misleading impression of the effects of the CU for its member countries, since they cannot separate the effects of the CU from other factors influencing foreign trade. Thus, it is reasonable to complement them by means of econometric analysis. A number of papers have already attempted to assess the impact of the CU on the trade relations between the member countries.[5] In this section we complement this literature by using a difference-in-difference approach. The advantage of this way of studying the consequences of the CU is that we can isolate a possible effect of the CU from other contemporaneous factors which could have influenced the development of cross-border trade.[6]

The results of the estimations are, unfortunately, ambiguous and depend upon the particular control group we chose to compare the CU countries with. We either find no significant effect of the CU, or establish that the CU does have a positive and significant effect on trade, but it disappears if we exclude from regressions the year 2011 or trade between Russia and Belarus. Thus, strictly speaking, the only real effect of the CU we were able to find was that of the increase of Russia-Belarus trade in 2011. Furthermore, in this case, the placebo test (that is, a counterfactual test looking at whether the CU countries were different from the control group already before the CU was established) is insignificant in the main specification, but it is significant if we use clustered standard errors; hence, even the Belarus effect is in question.

The result becomes more interesting if we re-estimate the CU effects for individual industries from the SITC classification separately from each other. One can show that the CU had a significant effect only for two industries: fuel and, in some specifications, for alcohol and tobacco. Therefore we are forced to conclude that the results of the CU we observed were driven merely by the Russian fuel exports to Belarus—again, we possibly see the already mentioned effect of abolishing export duties. As for alcohol and tobacco, the effect could have been driven by the growing export of Belarusian beer to Russia (which gained in competitiveness due to the devaluation of the Belarusian ruble, as well as lower excise duties; both regulations have little to do with the CU, although could be of significance for the Common Economic Space, which is currently under development); it could have also been an effect of disruptions of import of alcohol from outside the CU in the first months of its existence, but the data do not allow a clear conclusion in this respect.

Certainly, the econometric results we base our discussion on should not be treated as unambiguous evidence. Particularly, the lack of data for Russia-Kazakhstan trade in 2011 makes our estimate of the CU effects for these countries questionable; one could debate the quality of the data for 2010 as well.[7] Furthermore, one has to recall that there were a number of exceptions in effect for Kazakhstan in 2010, which could have biased the behavior of private actors.

And, of course, CU is not only about trade. Indeed, one often debated aspect of the CU is whether it will lead to intensified interjurisdictional competition and higher mobility of capital (here Kazakhstan is mentioned as a possible winner, although much more careful investigations are required). Notwithstanding this, the effects of the CU for trade have, at least in the first years of its existence, been relatively small—that is, if present at all. Also, our results may be debatable from the econometric point of view. But at least our preliminary findings indicate that the effects of the CU should not be exaggerated.

Conclusion

The CU created by Belarus, Kazakhstan, and Russia has had important effects in terms of both significant adjustments of trade tariffs (for Kazakhstan) and a change in the decision-making structure. However, in evaluating the CU, one should also take into account that foreign trade between countries had already been liberalized and customs tariffs partly harmonized well before the CU came into effect. Our preliminary estimations suggest that the CU had little effect on the trade patterns of its members. Despite this, it would appear that it is Belarus that has gained most from the CU, principally on account of its ability to increase its export of oil products to the EU after Russia abolished its customs duties. For Kazakhstan, meanwhile, the quality of data at our disposal is rather poor, making it nearly impossible to establish any effects of the CU on trade.

---

[1] The CU was established on January 1, 2010, when the Common Customs Tariff entered into force. The internal customs controls were abolished on June 1, 2010 for Russia and Kazakhstan and July 6, 2010 for Belarus.

[2] We should point out that this system existed in 2010-2011—that is, the period investigated here. Currently there is an effort toward making statistics more reliable and ensuring comparability of data across countries. Still, as of 2012, there were major discrepancies in statistical data on the same trade flows published by different countries, implying that the problem of statistical quality has not been resolved.

[3] Comtrade data is used throughout the rest of the paper unless otherwise indicated.

[4] As reported by the National Statistical Agency of Kazakhstan.

[5] Asel Isakova, Koczan, Zsoka, and Alexander Plekhanov, "How Much Do Tariffs Matter? Evidence from the Customs Union of Belarus, Kazakhstan and Russia," *EBRD Working Paper* No. 154, 2013; Vasily Astrov, Peter Havlik, and Olga Pindyuk, "Trade Integration in the CIS: Alternate Options, Economic Effects and Policy Implications for Belarus, Kazakhstan, Russia and Ukraine," *WIIW Research Report* No. 381, 2013; Asel Isakova, and Alexander Plekhanov, "Custom Union and Kazakhstan's Imports," *CASE Network Studies and Analyses* No. 442, 2012.

[6] Details on the methodology of analysis and econometric tables can be downloaded from https://sites.google.com/site/libmanalexander/u.pdf?attredirects=0&d=1.

[7] There are reasons to claim that the industry-level trade data for 2010 in Comtrade contain only information before June 2010: then, actually, our estimations cannot capture CU effect for Kazakhstan at all. It remains to be seen how the dilemma between the need to abolish internal barriers for trade and to provide reliable information on intra-regional trade will be resolved.

The Central Asia Program at the George Washington University aims to promote high-quality academic research on contemporary Central Asia, and to become an interface for the policy, academic, diplomatic, and business communities. It calls for a multidisciplinary approach and provides a platform for different, and even sometimes contradictory, points of view on contemporary Central Asia. The CAP strives to bring together counterparts from the United States, Europe, Russia, Asia, and Central Asia by promoting various forms of interaction and initiating joint projects.

More on www.centralasiaprogram.org