

THE EURASIAN CUSTOMS UNION: **Friend or Foe of the EU?**

Olga Shumylo-Tapiola

OCTOBER 2012

CARNEGIE EUROPE

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Summary

The customs union formed by Russia, Belarus, and Kazakhstan in 2010—the largest in the world by territory—is becoming very real. Though hurdles remain, member states are eliminating non-tariff barriers to trade within the union, moving toward a common external tariff, and fine-tuning a joint customs code. As the customs union's influence on the world stage and in Europe's neighborhood is likely to increase, the European Union (EU) should attempt to understand the project and find ways to protect its own interests.

Key Points

- Russia drives the union's development, but Belarus and Kazakhstan joined voluntarily and have some say.
- The Eurasian Economic Commission, the union's single regulatory body, has been declared the member states' representative in regional and global trade talks.
- Despite its achievements, the project is not yet a genuine customs union. Members erect protectionist barriers, seem reluctant to give the supranational body authority, and have allowed exemptions to the rules. Moscow must take the lead in building trust among members.
- The union agreed in principle to implement Russia's World Trade Organization commitments, but Belarus and Kazakhstan may not actually do so.
- Members promised to harmonize the union's standards with EU and international regulations. Still, local standards prevail.
- Moscow wants Ukraine to become a member, but Kyiv has to decide between the customs union and the EU.

Next Steps for the EU

The EU must overcome its fears and misperceptions. For some EU member states, the customs union is Moscow's new attempt to rebuild its empire. But this is not just a political project; the union has a practical side. The EU must accept that members were not coerced to join.

Brussels should engage with customs union staff at the technical level. The EU should educate union staff about how EU standards function to help ensure that member states comply with high international standards.

The EU should convince member states to apply EU-Russia trade commitments within the union. That would pave the way for the EU, which does not currently recognize the customs union, to negotiate trade matters with the Eurasian Economic Commission.

The EU should separate Ukraine from its relations with the customs union and reassess its policy toward the post-Soviet space. If the EU separated its geopolitical fear of losing Ukraine to Russia from its relations with the customs union, tensions between Brussels and Moscow could ease. More broadly, the EU must realize that the European model may not apply to the entire post-Soviet space.

The EU's Undesired Reality

The developments in the post-Soviet space over the past two years have ushered in a new reality for the European Union (EU). While the EU remains an attractive model and a center of gravity in the eyes of a few of its neighbors, for many others, including countries in Central Asia, Russia may be emerging as the next best thing. The customs union formed by Russia, Belarus, and Kazakhstan—the largest in the world by territory—has a chance of becoming more than just a paper tiger.

Russia has emphasized the union's purely economic rather than political nature—that it is a project of compatible and still-interdependent economies. In the spring, Moscow called on the EU to recognize the customs union and invited Brussels to deal with the Eurasian Economic Commission, the union's one regulatory body, on trade matters related to Russia.

The customs union formed by Russia, Belarus, and Kazakhstan has a chance of becoming more than just a paper tiger.

While Brussels usually encourages regional integration, it is rather cautious about these kinds of projects in its eastern neighborhood, and the debate on the customs union is only starting to take place in the EU. Brussels views the customs union as a great mystery. It is an emotional issue for some EU member states for understandable historical reasons, and a puzzle for the others. The EU is particularly concerned about the purpose of the customs union. What is the real rationale behind its creation? Is it a substantive integration project or a front behind which Russia is collecting former Soviet lands? What impact could the project have on the region and on the EU?

The project is already a reality for Brussels. While it will be a long time before the EU recognizes the customs union, if that is possible at all, the EU should make an attempt to view the project unemotionally. By putting aside historical baggage and analyzing the practical side of the customs union, the EU will be better equipped to deal with it.

What Is the Customs Union?

The integration of the post-Soviet space is an ongoing process. Since the early 1990s, Russia has pushed for various integration projects in the region.

The most inclusive in terms of participants, yet the organization requiring the loosest commitments and with the vaguest outcomes, is the Commonwealth of Independent States (CIS). Two decades after the CIS was

established, summits at the head-of-state level continue to take place. A new CIS free trade agreement was recently negotiated and is now being ratified by the national parliaments. Yet, this project is doomed to irrelevance, with many of its members opting out of this or the other CIS agreement. It was launched as part of an “amicable divorce” between the former Soviet republics to cushion their transitions to independence. As a result, it did not materialize into something meaningful. There is still no trust between CIS members, whose political, economic, and security priorities differ dramatically.

After a number of failed attempts at deeper integration,¹ three CIS members—Russia, Belarus, and Kazakhstan—managed to agree on the creation of the customs union, which was launched in January 2010. The declared goals were ambitious—to eliminate trade and non-trade barriers within the union, and to agree on the common external tariff.

The three countries signed an agreement on the creation of a common economic space that came into effect on January 1, 2012, and to date, the common economic space has seventeen agreements with 55 drafts in progress. The agreements provide the basis for free trade in services and the free movement of capital and labor; coordinate tax, monetary, and customs policies; and establish a common competition policy for the three countries.

The Rationale Behind the Customs Union

For Western observers, this customs union is a purely political initiative—Moscow’s new attempt to rebuild its empire. Some suggested that the creation of the customs union was a tactical move and a pretext to delay Moscow’s negotiations on World Trade Organization (WTO) accession. At one point, Russia proposed that the three enter the WTO as a group—that is, the customs union, not the individual countries, would join. The move caused havoc in Geneva and was ultimately rejected. Others claimed that Russia pushed for the customs union and common economic space to counterbalance the EU’s Eastern Partnership initiative launched in 2007.²

While this may partly be true, the project in reality is more complicated. It is in part a product of the geopolitical considerations of the Russian leadership and, to a degree, the two other participants. But it is also a very concrete step toward integration.

The geopolitical considerations range from personal ambitions of the countries’ leaders to very practical tactical considerations of all the three. These factors are sometimes competing, which has produced the patchy and controversial outcome to date.

Russia's Considerations

Regaining control over the neighborhood. For obvious historical and simply geographical reasons the project is very much about Russia. Moscow is indeed seeking to reestablish its control of the neighborhood. Seen from Moscow, this is a natural course of affairs, but the task is certainly controversial.

It proved difficult to gather all the countries of the post-Soviet space because many of them had already developed their own agendas. The circle of states that could be integrated into a union was thus limited to those whose leaderships had compatible agendas. Still, the way was easier than it could have been in some respects. Russia did not have much competition from the West for the region, an opportunity Moscow regretted missing.

The customs union is also very much about the economy.³ Putin's Russia can survive if its resources—both natural and human—are limitless, something the customs union could potentially offer. Moscow does not have a grand plan to rebuild the production lines that once existed in the post-Soviet space. Rather, Russia's desire to improve the cohesion of its neighborhood, expand its own rules of the game, and gain access to neighbors' resources drives this integration project forward. It is more about a wider exchange of commodities than a new economic model.⁴ At the practical level, Russia seeks to limit the reexport of cheaper goods from the EU and China through Belarus and Kazakhstan, controlling exports of raw materials to the EU via Belarus, and getting better market access from Minsk and Astana.

An equal partner. The customs union is, however, more than just a fight for resources. It is meant to have an impact on Russia's global stance. Moscow secretly admires the EU, and the idea of building the Eurasian project on the basis of the European experience demonstrates that admiration.

In addition, Russia wants to be recognized as an equal partner by Brussels. To officials in Moscow (not only Putin), the customs union is a precondition for such a recognition. Moscow projects its own way of doing business onto the European model, thinking that a country can only be seen as equal to the EU if it controls its own neighborhood. And even further, Russia believes that Brussels is more likely to entertain the idea of a free trade area from Lisbon to Vladivostok that was proposed by Putin if it is negotiating with another bloc.

Counterbalancing China. The customs union is also about Russia's quest for an economic presence that can act as a counterweight to a rising Asia. Despite Beijing's status as Moscow's ally, Russia is uncomfortable with China's rise and growing presence in Central Asia. The customs union is thus a way to protect Russia from China with a buffer of friendly countries (now Kazakhstan with Kyrgyzstan and Tajikistan to potentially follow) and to improve Russia's declining appeal in Central Asia by granting these countries better access to markets.

Russia wants to be recognized as an equal partner by Brussels.

As it is with the EU, Russia is driven by its own misperception of China. Moscow cannot believe that China is pragmatically seeking natural resources in Central Asia without any interest in dominating the region or exporting its economic model there. The customs union is thus a way to counterbalance China, even if for the wrong reasons.

Considerations in Belarus and Kazakhstan

Many in the West prefer to see Russia as having coerced other countries to participate in the customs union. While Russia may indeed be attempting to coerce Ukraine into participating, Belarus and Kazakhstan joined the union essentially voluntarily. Minsk has had quite close ties with Russia since 1996, when a customs union between the two countries was first formed, and Astana never hid its interest in Eurasian integration.

The union of three is thus more than a Russian game. Both countries are still run by politicians of the old order, with Aleksandr Lukashenka of Belarus in power for more than a decade and Nursultan Nazarbaev of Kazakhstan at the helm since the country's independence. Therefore, their motivation to get closer to Russia is primarily shaped by “the class solidarity of post-Soviet elites” who feel comfortable copying Moscow.⁵ Undoubtedly, both leaders hope for more equality within the union and expect Russia to change, but they clearly know what they signed up for.

In the end, their decision to join was purely political. There were hardly any ex ante estimates of the costs and benefits of the entire project and of its impact on individual members. Russia's promises of significant increases in trade flows and a \$16 billion gain in the first five years—thanks to the elimination of customs duties and cheap gas—were largely pulled out of thin air.

For Lukashenka, the customs union is a way to help ensure the survival of his regime. In part, he may have been worried that Russia would reinstate a customs regime if Belarus did not join the customs union, as Moscow threatened to do. Yet, Lukashenka's need for financial support to restore his social contract with people that had been undermined by the economic crisis was the main driver of Belarus's decision. Lacking support from the International Monetary Fund and the EU, Lukashenka was forced to seek Russia's financial intervention.

For Lukashenka, the customs union is a way to help ensure the survival of his regime.

For Kazakhstan, the story is more complicated. Nazarbaev is quite comfortable in Kazakhstan. When the time comes, he is likely to pass the mantle of the presidency to his daughter. The resource-rich Kazakh economy is doing quite well, with the population largely supporting Nazarbaev's policies. For him, the decision to join the customs union was driven by the ambition to be remembered as the father of this project. Indeed, he was the first to coin the term “Eurasian union” back in 1994. In addition, Nazarbaev also sought

to counterbalance China, whose presence and influence in Kazakhstan has grown in recent years.

There was little economic rationale behind Kazakhstan's membership. The country's elite and businesspeople voiced their concerns before the launch of the union, though few listened. Nazarbaev pushed for the country's entry, justifying it by the possibility of greater market access in Russia, a large influx of Russian and Belarusian business thanks to the better business climate in Kazakhstan, larger budget revenues as a result, and better transit routes for Kazakh exports to the EU.

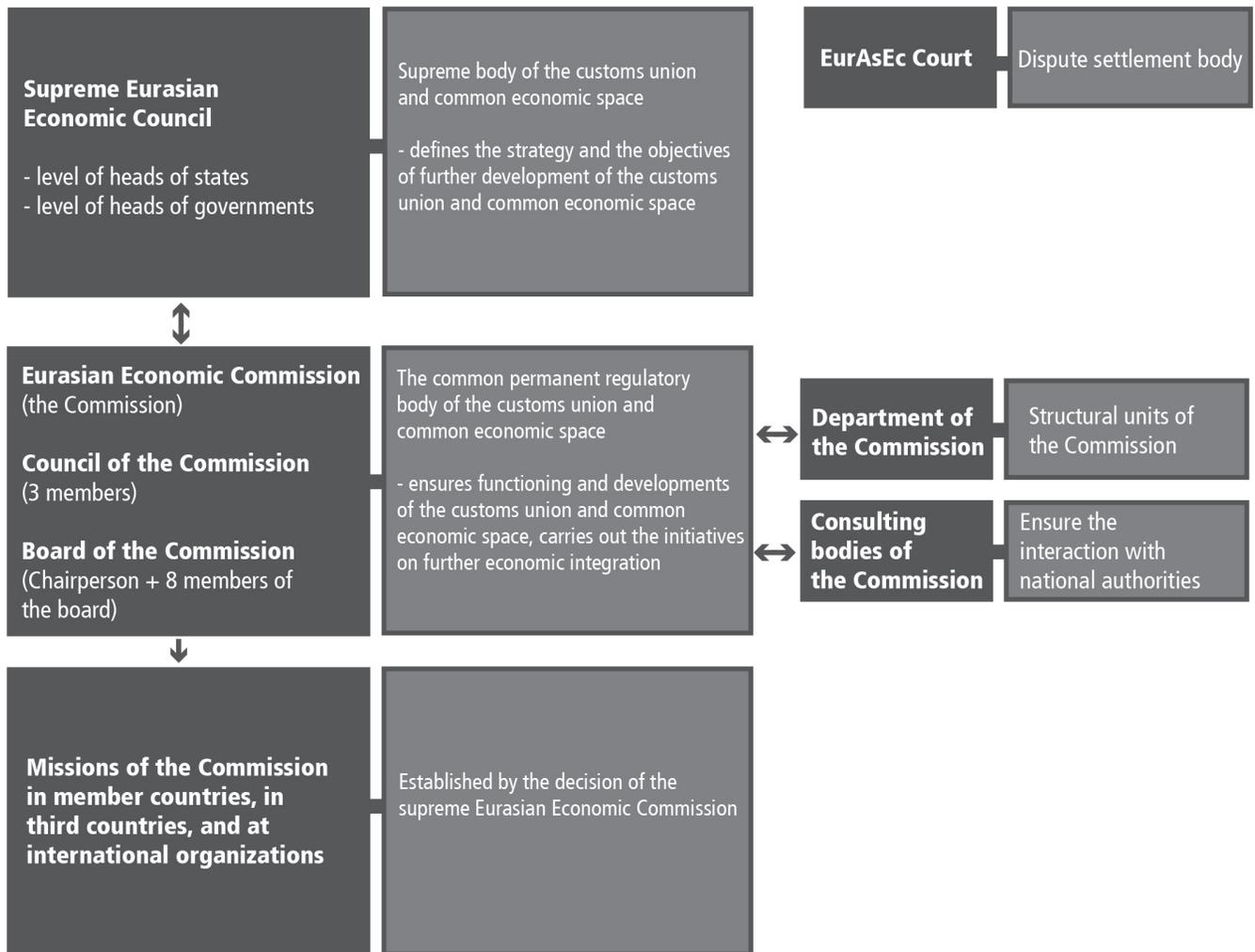
Integration in Practice

The Supranational Authority

The experience of previous integration attempts in the post-Soviet space suggests that supranational bodies exist on paper, but in reality, the show is run by the leaders of member states. That was the case with both the CIS and the Eurasian Economic Community. This time the story seems to be different.

In November 2011, the Supreme Eurasian Economic Council, made up of the heads of state from Russia, Kazakhstan, and Belarus, signed a treaty on the creation of the regulatory body of the customs union and the common economic space, the Eurasian Economic Commission (see figure 1). It replaced a somewhat consultative commission of the customs union and started functioning in February 2012.

Figure 1. Bodies of the Customs Union and Common Economic Space



The new commission is responsible for the implementation of the agreements within the customs union and common economic space and for the evolution of these two projects. Its operations are governed by its foundational treaty, the international agreements that form the legal base of the customs union and common economic space, and decisions of the Supreme Eurasian Economic Council. The commission is now based in Moscow; however, there are discussions about relocating it to Astana.

The commission is made up of two bodies—the council of the commission (*Sovet komissii*) consisting of three representatives, one for each member of the customs union, and the board of the commission (*Kollegia komissii*) with nine people (a chairperson and eight members). The position of the head of the council was given to the Belarusian deputy prime minister, Sergei Rumas. Russia is represented in the council by its vice prime minister, Ihor Shuvalov.

The seats on the board are equally divided between the ministers of the three countries with Russia's former minister of industries and trade, Victor Khristenko, holding the position of chairman.

The commission is seen as the union's ministry, and its decisions are to be made independently from the national governments. The members of its council and board as well as the commission's staff are fully employed by the commission and do not serve their national governments. The members of the commission are not permitted to receive instructions from their national capitals.

The decisionmaking process is quite simply constructed. Departments analyze the proposals of legislative change within their competency and submit them for the comments of member states. The commission has 23 departments that are responsible for a range of issues, from trade policy and technical regulations to macroeconomic, competition, energy, transport, currency, and migration policies, the protection of intellectual property, and financial market regulation. After it is reviewed by the appropriate department, the proposal is submitted to the board of the commission and to its council. The most important—typically political—decisions are approved by the Supreme Eurasian Economic Council.

Once the Supreme Council approves a decision, it becomes legally binding for all members of the customs union. Decisions at the council level are made by consensus with each country having one vote. This distinguishes the commission from its predecessor, the Customs Union Commission, in which decisions were made by a two-thirds vote, with Russia holding 57 percent and Belarus and Kazakhstan 21.5 percent of votes.

To date, the commission employs around 1,000 staff members relocated from the Customs Union Commission and delegated from the three member states' national agencies. The commission is expected to grow in size so that it can handle the full range of competences, but whether the countries will get an equal number of positions within the commission or whether they are divided on a proportional basis is unclear. Plans will solidify after the agency is fully staffed.

This has not all worked out in practice. The commission is facing a number of problems, including a lack of authority within the customs union, which may be worked out over time as the body grows and develops. The leadership of the member states still guides the decisionmaking process within the union, with decisions made to accommodate the needs or fears of the countries (for example, decisions on exemptions from intra-union trade or on the speed of further deepening of the union are initiated and taken by the leadership of the three countries, not the commission). The Eurasian Economic Commission is along for the ride. This may well change if the political will for integration prevails over the national interests of all three states. Russia's acceptance of the commission as an authority within the union will thus be crucial. The staff

of the commission will also have to rise above the national interests of the countries they represent.

On a more technical level, the creation of the commission is contributing to brain drain in the member countries. It attracts the best and the brightest minds from state capitals—highly respected professionals (for instance, Russia’s team that negotiated the country’s accession to WTO, which happened in August 2012). These individuals differ significantly from their predecessors, who looked more like members of a retirement club. How the countries fill the gap in their state institutions remains an open question.

The recognition of the commission outside the union is a more complicated story. For the commission to become an actor on a wider stage, the customs union should be recognized at least by the WTO. This will require at minimum the accession of both Belarus and Kazakhstan to the WTO. While Kazakhstan may become a WTO member in 2013 according to optimistic estimates, Belarus is not even close. Both countries agreed to be guided by WTO rules when they signed the treaty governing the customs union’s functions in the framework of a multilateral trade system in May 2011. This means that Russia’s WTO accession commitments and WTO regulations will become an integral part of the legal framework of the customs union. The Eurasian Economic Commission may thus gain its credibility from the EU (that may translate into some form of recognition) if it ensures full implementation of WTO commitments through the entire customs union.

Steps Toward Trade and Economic Integration

The three countries have taken a number of practical steps toward the creation of the customs union and common economic space. However, the results of the first two years are mixed. According to one Western economist, the customs union “still cannot claim at the present time to be a customs union in the textbook/Treaty of Rome sense.”⁶ National interests and protection mechanisms prevail. The degree of integration remains low and the convergence of standards incomplete.

1. Intra-Union (Free) Trade

Turnover increase: Intra-union trade is certainly on the uptick. According to reports of the Eurasian Economic Commission, trade within the union amounted to \$62.7 billion in 2011, which meant a 32 percent increase over the previous year.⁷ In the first quarter of 2012, the turnover increased by 17.6 percent in comparison to the same period in 2011, rising to \$16.5 billion.⁸

Russia’s share of trade is still higher than that of the two other countries, constituting about two-thirds of intra-union trade. This is because of Russia’s energy resources, which constitute about 45 percent of intra-union trade. Belarus engages in the most intra-union trade, while Russia and Kazakhstan continue focusing on trade with CIS, European, and Chinese markets.

Uncertainties of trade conditions: The tariffs imposed on intra-union trade are not enforced by any contracts—that is, the tariffs are not determined by the WTO and thus can be changed at the discretion of any member. Moscow insisted that free trade within the union be limited to goods produced by its members only, suspecting that Belarus would resell goods from the EU and Kazakhstan from China. Limitations on trade in goods originating in third countries are in place, but it is not clear how the regulations will be enforced with no borders between the union’s members.

Trade wars: Intra-union trade is not free from mutual distrust and disagreements, especially between Russia and Belarus. These two are engaged in trade wars over various types of products—from milk to meat, beer, buses, pipes, and even toothpaste tubes.⁹

Russia cites free economic zones and poor sanitary standards in Belarus as reasons for restricting exports from the country. These problems may go away since Belarus will have to eliminate free economic zones by 2017 to comply with common-economic-space agreements, and sanitary (SPS) standards are to be made uniform within the union at some stage.

Local observers insist that Russia is attempting to gain access to Belarus’s strategic industries or to make Lukashenka more amenable to Russia’s positions on other matters. When it comes to free trade in services—a new source of trade wars between Russia and Belarus—the dispute is clearly about economic interests and Minsk’s fear of stronger competitor. This was clear when Belarus denied the Russian aviation company Aeroflot’s attempt to increase the number of flights from Minsk.

2. Common External Tariff

With the 2007 Harmonized System of goods classification as a base, a common external tariff (CET) schedule among Russia, Belarus, and Kazakhstan was launched in January 2010. As confirmed by Russian officials, the CET was largely based on Russia’s pre-WTO external tariffs and thus had little impact on Moscow. Russia increased rates for 14 percent of its tariff lines (on meat products, yeast, and some clothing and accessories), and decreased rates for 4 percent of the customs duties (mainly for fruit concentrates, baby food, materials for photography, wool fabrics, pharmaceutical substances, parts of footwear, and electromechanical appliances).¹⁰

It also had a limited impact on Belarus’s tariffs due to the country’s already-high degree of tariff harmonization with Russia. Minsk increased 7 percent of tariffs (largely for meat products, metals, and motor cars) and decreased 18 percent of tariffs (primarily for apparel, footwear, mechanical appliances, and pharmaceutical substances).¹¹

Kazakhstan was affected most, with its tariff rates approximately doubling in recent years. Forty-five percent of its customs duties went up (motor vehicles, clothing, fur, forestry products, furniture, and more) and only 10 percent decreased. The variance of the tariffs also substantially increased.¹²

Some tariffs within the customs union are still not harmonized. While Minsk and Moscow do not enjoy any exemptions from the CET, Kazakhstan continues using its own tariffs for 88 positions (409 product lines) and applies reduced customs duties for the goods it imports. It will have such freedom for up to five years.¹³ Furthermore, customs union members can still grant additional tariff exemptions and impose national export and import bans with the consent of the rest of the members and the Eurasian Economic Commission.

Yet, this is just the beginning of the CET saga. Russia's accession to the WTO has already brought changes to the CET. On July 20, the Eurasian Economic Commission announced that it had completed the revision of the CET according to Russia's commitments. The document still includes 120 exemptions for Belarus and Kazakhstan, and the transition periods for them are not clarified.¹⁴

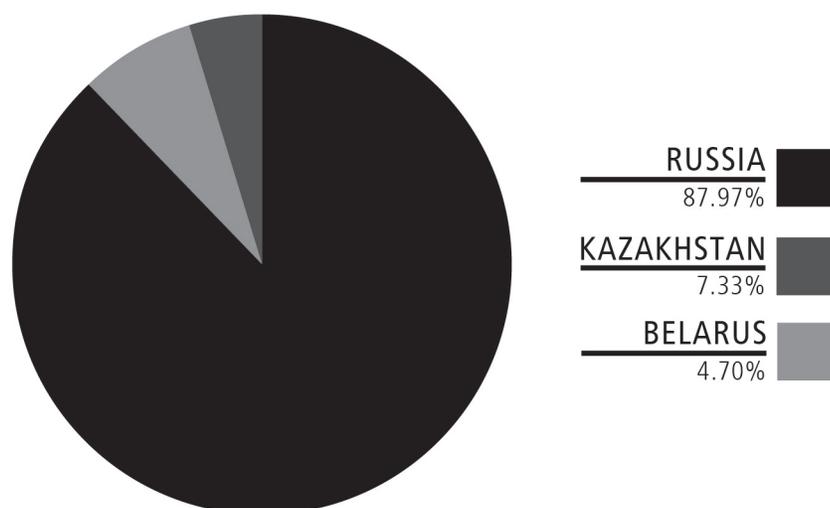
The post-accession period is a test for the customs union. It is not certain that Belarus and Kazakhstan will comply with Russia's WTO commitments. Time will also tell whether Kazakhstan renegotiates its own WTO accession commitments without causing too much trouble for itself—as these commitments will have to be in compliance with the current CET of the customs union.

3. The Customs Code and Revenues

The customs union's Customs Code was adopted in July 2010 and entered into force a year later. The document regulates customs procedures and the control of and payments for goods crossing over the external borders of the customs union.¹⁵ Despite the fact that the code is relatively new, it is now being modified by the Eurasian Economic Commission in consultation with all three member governments. A package of about 700 amendments to simplify customs procedures is under discussion.¹⁶ The commission is also planning to completely redraft the current code in 2013 to further simplify the procedures and to eliminate references to national regulations.¹⁷

Moscow, Minsk, and Astana had a heated debate on the distribution of customs revenues as they are a significant part of all three countries' budget revenues. The countries agreed to consolidate the revenues in one account and distribute 87.97 percent to Russia, 7.33 percent to Kazakhstan, and 4.70 percent to Belarus (see figure 2).

Figure 2. The Distribution of Customs Revenues Among Customs Union Countries



Source: <http://www.tsouz.ru/Pages/Default.aspx>

Russia's oil and oil products received special treatment. Belarus and Kazakhstan agreed that 100 percent of the export revenue for crude oil supplied by Russia and that they refine and sell would be returned to Moscow.

4. Trade Facilitation

Borders. According to official information from Moscow, the borders between the customs union members have been eliminated. As of July 2011, customs regulation takes place at the external borders of the union. The parties are working to establish an electronic system that connects their individual customs services and duties. The system is expected to be in place in 2013.¹⁸

However, the process is not without difficulties. Belarus has accused Russia of reestablishing customs control zones, for example, at the former customs crossing near Smolensk.¹⁹ Belarus and Kazakhstan also complain about Russia's style of management of a single border and the pressure that Moscow applies to these countries to make them open up their borders—for example, their customs services—to scrutiny. Their trade operators also complain about unfair treatment of their goods by Russian customs authorities along the external borders.²⁰

Elimination of non-tariff barriers to trade. The three member states agreed to unify their technical standards, make the standards voluntary, and bring them in line with European and international standards. The agreement on the common principles and rules of technical regulation was signed by the heads of the three states in November 2010 and later ratified by the national parliaments. The countries agreed on a strategy for the development of a common system of technical regulation and the application of SPS measures of the

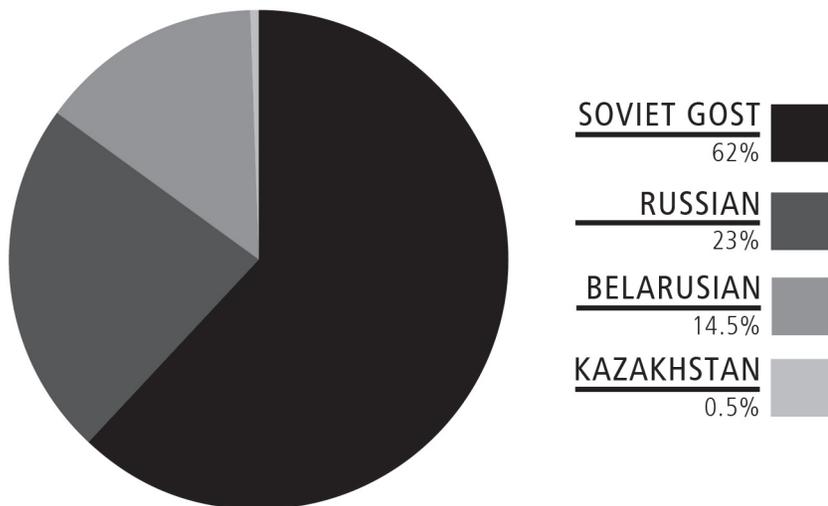
customs union for 2011–2015, and established a schedule for the development of 38 technical regulations of high priority.

While the new regulations at the customs-union level will be adopted, states are expected to eliminate the use of national regulations and to stop developing new national regulations. The members of the customs union are also expected to create a system of mutual recognition of certificates of conformity, but those certificates still differ depending on the member state.

However, the implementation of these measures is slow. Diverging technical regulations, including SPS standards, remain the biggest barrier to intra-union trade and enable the union's members to engage in trade wars with one another.

At the moment, there are about 20,000 standards that apply to the customs union territory. Despite the declared intentions to convert them into EU and international standards, they remain heavily dominated by those developed by the Soviet Union (referred to as GOSTs, they account for 62 percent of standards), followed by Russian (23 percent) and Belarusian (14.5 percent) standards.

Figure 3. Standards in the Customs Union



Source: www.minpromtorg.gov.ru/industry/metrology/59

Despite the agreed standard base, the application of some common regulations—for instance, regulations governing automobile and aviation gasoline, marine fuel, jet fuel, heating oil, the safety of machinery and equipment, low voltage equipment, and equipment for use in hazardous environments—is delayed until December 2012 or February 2013.²¹ The members of the customs union have only just started debating the impact of the introduction of these regulations on businesses.

Thus, countries still apply their own standards and do not recognize each others' certificates of conformity. To achieve progress on the elimination of non-tariff barriers within the union, Russia's political commitment will

first and foremost be required, in addition to the commitment of significant resources and time by all three members of the union.

Costs and Benefits for the Customs Union Members

The creation of the customs union did not seem to be based on an ex ante cost and benefit analysis, which is confirmed by the lack of in-depth studies on the subject before 2010. The implications of the union are starting to become clear, yet it is too early to see comprehensive results. It is possible, however, to discuss immediate gains or losses, as well as the fears and hopes of the customs union members regarding the project.

Immediate Gains and Losses

Thus far, Russia has enjoyed an increase in trade flows within the union that resulted in bigger budget revenues. Otherwise, Moscow's primary gains are in the security sphere, as controlling—or at least attempting to control—the external borders of the union brings greater order to the area.

Belarus mainly saw gains from Moscow's financial contributions, but the direct effect of the customs union remains unclear. Minsk benefited from the protection afforded its producers because of the higher external tariff, but that gain is marginal.

Kazakhstan's participation in the customs union does not appear to be a rational choice. The country has a rather liberal economy with a good amount of foreign direct investment and an orientation toward both CIS and non-CIS markets, so it seems to be an immediate loser given the price hike and inflation that followed the creation of the customs union.

Future Hopes

Russia expects to increase trade primarily with Kazakhstan (because the Belarusian market is largely open to Russia already) and to gain better market access for its producers. The costs of business are also expected to go down due to a decrease in transaction costs following the full cancellation of customs controls along Russia's borders with Belarus and Kazakhstan. Last but not least, gains should result from planned infrastructure improvements that will increase connectivity between the countries and improve transit speed through Russian territory.

Belarus may potentially benefit from protecting goods producers with the higher import duties that will be applied to Western—hence more competitive—products. The Belarusian government may also enjoy increased revenue from the higher customs duties within the CET zone. At the same time, its

trade with non-CIS countries should not decrease by more than 10 percent.²² However, this may eventually change as Russia (and consequently the rest of the customs union member states) will begin decreasing the duties applied to goods following its WTO accession. Belarus expects to gain from its potential as a transit country, yet it remains to be seen whether the transport routes between Minsk and Astana will improve to allow that.

Kazakhstan is likely to gain from better access to Russia's markets. According to the World Bank, Kazakhstan will only be able to cover its costs of membership in the customs union and increase gains if the three countries move toward completely removing non-trade barriers and unify their technical standards, including SPS. The introduction of international and European norms is likely to benefit Kazakhstan, but that is not the case now, with the Soviet GOSTs forming the basis for the customs union's standards.²³

Future Fears and Costs

Russia expects to see a number of negative consequences resulting from the customs union, including losses caused by the distribution of customs revenues among all members of the union. Despite all the precautions taken, Moscow remains concerned about the possible consequences of goods being reexported from third countries through the territory of Belarus and Kazakhstan. Public opinion in Russia favors the reunification of the former Soviet republics, yet people are concerned that Moscow will end up providing continuous subsidies to other members of the union.

Public opinion in Russia favors the reunification of the former Soviet republics, yet people are concerned that Moscow will end up providing continuous subsidies to other members of the union.

Minsk may have to pay for the introduction of new technical standards, including SPS measures, envisioned as part of the common economic space, but the costs have not yet been estimated. Minsk hopes to attract a greater amount of foreign direct investment, but membership in the customs union is unlikely to bring more of that type of investment to Belarus. Foreign investors will be more comfortable dealing with the two larger and more liberal members of the union. Though Belarus is likely to benefit from duty-free Russian crude oil that it gets for domestic consumption, it will not be able to capitalize on the portion of oil that is refined for further export because Minsk agreed to return 100 percent of its revenues from such operations to the Russian budget.

Despite recent difficulties, Kazakhstan remains optimistic about its future within the customs union, at least publicly. Perhaps the only concern that is voiced by the administration about the future is that multinationals seeking easier access to Kazakh markets may try to use Russian businesses as a back-door entry point.

Kazakhstan clearly loses as a result of the CET because it had to increase about 45 percent of its external tariffs to conform to the standard. The

situation may change after Russia's accession to the WTO and further revision and lowering of the customs tariffs of the entire customs union. For Kazakhstan, however, that process brings additional complications, as the country will have to adjust its own WTO accession commitments to the new CET of the union. That will have attendant costs and require time, and may result in the delay of WTO membership.

Incumbent and Future Challenges

Economic Disparities and Diverging Goals

The customs union is initially suffering from the disproportionate size of the three countries' economies. For instance, the Belarusian economy is 40 times smaller than that of Russia. The countries also have different domestic goals, with Kazakhstan seeking to liberalize and modernize while Russia and Belarus are still very much attached to natural resources and state protectionism.

Lack of Trust and Protectionism

The atmosphere within the union is tense. The members still do not trust each other. Some say that the customs union is moving forward with the help of blackmail and manipulation, and not just from Russia. Each state has put protectionist measures in place. A picture from the Kazakh business newspaper *Kapital* is a good example of how the customs union is seen in Astana.²⁴ The union is depicted as a traditional Russian house (*izbushka*), and Kazakhstan is placed in a doghouse nearby.

The Implementation of Existing Commitments

The biggest challenge the customs union faces is implementation of existing commitments. Eliminating protectionist measures within the union and unifying technical standards will be the number-one priority. Implementing regulations that permit the free movement of services and capital will be task number two. However, it remains to be seen whether the leadership of the three countries will be able to strike a balance between national and common interests. It is also unclear whether Minsk, Moscow, and Astana will manage to implement in three or five years what took the EU three or even five decades to accomplish. Only time will tell whether the Eurasian Economic Commission will establish its authority and effectively implement existing commitments across the union. It is not certain that the countries will be able to afford the unification of standards or the creation of new agencies, such as mutually recognized laboratories or joint customs forces.

Recognition by the West

Recognition of the customs union by the West will be a difficult issue. Obtaining it will only be possible if the members of the union succeed in implementing their declared commitments. If the bickering within the union continues and if Russia continues dominating the group or hiding behind the customs union to avoid its international commitments, the initiative will never be accepted as a serious player in the international arena.

Russia's WTO Membership

How Moscow implements its WTO commitments will have an impact on the underdeveloped Russian industries, which seem to be unprepared for the WTO despite almost two decades of talks. The effects on Belarus and Kazakhstan are difficult to measure, as it is not clear whether these two will implement Russia's WTO commitments.

Further Deepening

Another challenge for the customs union is its further deepening. The members of the union adopted a significant number of regulations aiming at a very high level of integration within just a few years. Western economists have warned against such a rushed effort, suggesting that rapid implementation may result in shocks to the three countries' economies. However, for political analysts, it looks as if Moscow is trying to lock in Belarus and Kazakhstan rather than allowing a natural course of affairs to play out.

So far, Belarus and Kazakhstan have managed to block Moscow's suggestion to move to the third integration step—a Eurasian Economic Union that would be based on EurAsEc and the customs union. Astana and Minsk argued that they wanted to move deliberately and allow their economies to adjust to the changes that had already been agreed upon. The countries have not agreed on what to call such a new organization, how its various bodies would be financed, and what role potential members Kyrgyzstan and Tajikistan would play. In reality, opposing this move could be a survival instinct of the Kazakh and Belarusian leadership, or in the end simply rational thinking.

Recently, President Nazarbaev coined a possible name for a joint currency—*jevraz*. However, the debates go no further than that, as the countries, mainly Belarus and Kazakhstan, are not ready for such a move, and the currency issue is not on the top of Russia's list of priorities.

Further Widening

The question of the customs union widening is an additional challenge. Moscow, not Minsk or Astana, has put the idea forward and extended invitations to potential entrants. Membership is said to be a voluntary decision of the third countries, and the precondition for joining is the adoption of the

entire customs union and common economic space's legal framework prior to accession.

Invitations were sent to all CIS countries. The number of studies that are conducted by international financial organizations, which demonstrate the countries that are interested in joining the union, and by Russian research institutes, which reveal the countries Moscow hopes will become members, provides some insight into which countries are expected to join. Yet, there seems to be no clear map of the future borders of the customs union.

Kyrgyzstan and Tajikistan. Both countries, currently members of EurAsEc, aspire to be part of the union. The creation of the union affected their economies, and according to World Bank calculations, their membership may mean more gains than losses for the potential members at least in the short term. For Russia the accession of these two would also play out well. Kyrgyzstan's membership may help diminish the level of shuttle trade in goods coming from China because Russia hopes to have control over Kyrgyz borders. Tajikistan's membership may help build a sanitary zone with Afghanistan, a source of drug trafficking to Russia, and Moscow's growing security concern due to the withdrawal of the U.S. troops in 2014.

Uzbekistan and Turkmenistan. Neither country is interested in joining the customs union. Uzbekistan resists membership for fear that the union will grow beyond the economic interests and turn into a political union. For oil-rich Turkmenistan, the project does not seem interesting from an economic point of view.

Azerbaijan. Azerbaijan is a desirable candidate for the customs union. Russia's quest for Azeri participation is driven by energy interests. Gaining a degree of control over Baku will lead to an even-stronger Russian energy monopoly in the region. Yet, well endowed with natural resources, Baku is among the least interested in joining the project.

Moscow keeps nudging Baku to join the union through formal and informal channels. Azerbaijan is engaged in talks on a new agreement with the EU, but the EU is not seen as a threat to Moscow because Baku is not going to embrace the EU's economic governance model or strive for especially deep integration with Europe. To achieve its goal, however, Russia may seek to use the Nagorno-Karabakh conflict to its advantage.

Armenia. Armenia is not a priority when it comes to customs union enlargement. With its leadership closely aligned with Moscow, Armenia did not encounter any immediate pressure to join the union. The pressure started to increase only after Armenia expressed interest in signing a deep and comprehensive free trade agreement with the EU.

Over the last few months, a number of high-ranking Russian officials visited Yerevan to remind the Armenian leadership about the invitation to join the customs union. The local media has been discussing the possibility of Armenia joining the customs union, citing possibly cheaper gas and loans

from Russia as justification for such a choice. However, according to local observers, the Armenian government is not falling for the offer and is continuing talks with the EU.

Russian threats are—at least for the moment—unlikely to change the Armenian leadership’s mind. What may change it, however, is the EU’s pro-Azerbaijan stance on the Nagorno-Karabakh conflict according to local experts.

Moldova. Moldova is not on Moscow’s list of priorities, as it lacks natural resources and much of its labor force is already working in Russia. While quickly moving closer to the EU, Moldova does not indicate any interest in the customs union. Moscow understands that the move toward the EU is irreversible under the current Moldovan leadership, so it only reminds Moldova about the customs union’s existence on an ad hoc basis and does not apply serious systematic pressure on Chisinau.

The Kremlin may have a chance if the 2014 parliamentary elections in Moldova bring the Communist Party back to power. Yet that is not the safest bet. The Communists may well change their position once in power. It was the Communist president Vladimir Voronin who began Moldova’s integration with the EU and kept the country away from full membership in EurAsEc. Moldova’s weak points are the issues of the breakaway territory Transnistria, the autonomous region Gagauzia, and the city of Bălți, whose leadership publicly aligns with Moscow, which may be used to push Chisinau into the customs union.

Ukraine. While the resistance of others disappoints Russia, the Kremlin is very eager to convince Ukraine to become a customs union member. The country has been invited to join all post-Soviet integration projects, with little success. Kyiv never became a full member of the CIS and remained an observer in EurAsEc while focusing on free trade with the organization’s members.

The door to the customs union is open for Ukraine, with both former Russian president Dmitry Medvedev and the incumbent president, Vladimir Putin, extending an invitation. Russia’s push for Ukraine’s membership in the customs union began to intensify after the 2010 Ukrainian presidential election that brought to power Victor Yanukovich, who was seen as pro-Russian. The pressure grew stronger when Yanukovich declined Moscow’s invitation to join and proceeded with Association Agreement talks with the EU.

Moscow used sticks and carrots to attempt to convince Ukraine to join. The country was promised cheaper Russian gas that alone should result in gains of about \$10 billion within the first few years and more than \$1 trillion over the next twenty years.²⁵ The country’s gross domestic product should grow by 7 percent within the first few years of accession due to better market access. Rumor also has it that then prime minister Putin promised to pay the fines WTO members would charge Ukraine after the country significantly hiked its customs tariffs as part of the customs union agreement. Lastly, Ukraine was promised a stronger negotiating position vis-à-vis the EU.

As much as the Ukrainian leadership needs cheaper gas from Russia, it has not yet made any moves toward the customs union. The formula of “3+1” cooperation (that is, allowing free trade without exemptions between Ukraine and the customs union members) coined by President Yanukovich was an attempt to buy time and hide from Moscow’s overtures. This proposal was not even considered in Moscow, as multi-speed integration is not an option within the customs union according to President Putin.

Russia’s offer does not satisfy the Ukrainian leadership. Yanukovich does not believe that Moscow will follow through on its commitments and provide cheaper gas. He also fears losing control over Ukraine if he succumbs to Russia’s pressure, and that his family’s and oligarchs’ business ventures may suffer from harsh competition with Russian businesses. Local economists also raised concern about the possible negative consequences of customs union membership for Ukraine’s WTO commitments. Russia, they claim, will likely not be there to hold Ukraine’s hand when it faces angry WTO members and their fines. Moscow also will not come to help deal with the shocks experienced by the Ukrainian economy due to the significant increases in export duties that would come along with adopting the customs union’s CET.

Moscow is unlikely to put too much pressure on Ukraine to join the customs union now. Russia may try to use the 2015 Ukrainian presidential election to convince Yanukovich to join the customs union by offering loans and cheaper gas to tame unhappy voters. Yet, the Kremlin does not need to look like a villain to the West by coercing Kyiv to join the union. Russia’s cards—cheaper gas and loans—are on the table. It will be up to the Ukrainian leadership to make a voluntary decision.

It looks as if Ukraine is to be a defining factor in the limits and direction of the customs union. If Ukraine decides to join, not only will it cause havoc within the European Union, but it will also mean that the post-Soviet economic model has been cemented in the region. If Ukraine opts out by signing an Association Agreement with the EU, some in Moscow suggest that the customs union may redirect its focus toward the Asia-Pacific and start afresh.

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Conclusions and Recommendations for the EU

The customs union of Russia, Belarus, and Kazakhstan clearly differs from its predecessors because of a number of real integration milestones it has achieved over a short period of time. However, this is still a top-down project with the leaders of the three countries running the show and the bureaucracy catching

up. The project also lacks the trust of its members and is often confronted by their sabotage.

Participation in the union is based on a voluntary decision of each of its members. The choice, however, is primarily driven by personal ambitions of the countries' leadership rather than economics. It is result of a mix of geopolitical thinking and practical measures. The project is very much led by Moscow, though other members have their say in some matters, such as the speed of integration.

The customs union does not yet fully meet the classic textbook criteria. Its members employ protection mechanisms against each other and allow exemptions, mainly for Kazakhstan. The credibility of this project is easily undermined by incidents between Moscow and Minsk, like the one over oil export duties in 2011. The initial interest in eliminating the barriers is apparent, at least on the side of Belarus and Kazakhstan, but it will take Russia's political will to make this project a reality.

Customs union members seem set to achieve in just a few years what took the EU five decades. The process of the elimination of non-tariff barriers to trade has begun. The countries are moving toward a single set of customs regulations for the external border of the union, and a joint customs code is in place. However, full implementation may be hampered by national interests and fear of competition from Russia.

The Eurasian Economic Commission, a single regulator, is functioning, modeled on the European Commission with the best staff from the three countries' capitals employed there. The commission is to represent Russia, Kazakhstan, and Belarus on matters of trade in regional and global talks, yet it remains to be seen whether the union members grant the commission the authority it in theory has and whether the commission can make all of them abide by the joint rules.

The customs union is said to be based on the European experience as well as EU and international standards. This may be the case if one looks at the titles of the stages of integration, but the project does not yet feel European. It is more about protectionism than liberalization, especially for rather liberal Kazakhstan; it is about continued dependence on natural resources or their transit than on modernization. The customs union very much looks backward, with old Soviet standards prevailing.

The road to a comprehensive customs union and common economic space will not be easy. The countries will have to deal with large disparities in the size of their economies and with diverging national interests, and learn how to build trust within the union, with Russia setting an example as the biggest—and thus more controversial—partner. The implementation will remain a problem from the perspective of both political will and capacity within the Eurasian Economic Commission and national institutions.

While the trade flow between the three increased over the last two years, the full spectrum of the costs and benefits of integration efforts remains to be seen. It is clear that all three will benefit from deeper integration, especially when it comes to the elimination of non-tariff barriers to trade and if the union's standards are eventually harmonized with European and international standards.

The widening of the customs union will remain an open question with Russia alone extending invitations to potential members. However, Moscow may revisit the direction of the customs union if Ukraine, the main missing piece of the puzzle, does not fall for the offer of cheaper gas and refuses to join. Kyrgyzstan and Tajikistan are likely to join, and the door for the remaining CIS members will be kept open without too much pressure from Moscow, at least for the next few years.

With all its difficulties, the customs union of Russia, Belarus, and Kazakhstan is more real than many in the EU expected it to be. There are a number of steps the EU should take in response to learn to live with this developing union.

1. The EU must deal with its own fears and misperceptions about the customs union.

Naturally yet unfortunately, the EU may struggle to see the reality of the customs union, as some members are overtaken by their historical baggage. The risk is that the EU may focus on finding proof of fears or reasons to resist engaging with the customs union. There will be a number of academic and policy papers produced within the EU to confirm those fears. However, little information will come from people on the ground because local analysis on the subject is seldom translated into English, let alone other EU languages.

The EU will have to deal with the fact that for some of its members, the customs union brings back memories of the Cold War. The EU's concern that the project is still very much about politics has to be revised. As the analysis of the customs union reveals, the project does have a practical side, and the ball will keep rolling toward integration. The EU will also have to accept that the customs union is too heavily dominated by one country—Russia. However, contrary to the EU's belief that members were coerced into participating, Belarus and Kazakhstan joined the union quite voluntarily, and they have some, albeit limited, say in the way the customs union develops.

2. The EU should engage with the customs union staff at the technical level.

The European business community is concerned about the declared plans to deepen the union because of the uncertainty surrounding the future rules of the game. What makes the situation even more complicated is that

the new reality is not static. The EU will have to learn how to deal with a moving target. Russia became a WTO member in August 2012, and the application of WTO norms will soon begin. In parallel, the members of the union will be moving toward deeper relations within the common economic space. The union may enlarge to Kyrgyzstan, which is a WTO member, and Tajikistan, a non-member.

At the moment, the EU is neither willing nor able to recognize the customs union as a regional entity. Formally, it is impossible as two out of three of the union's participants (Belarus and Kazakhstan) remain outside of the WTO. Astana may join in a few years, but Minsk's WTO prospects remain bleak. The EU can only hope that both countries will voluntarily follow WTO standards, as there is no mechanism to hold them accountable.

Engagement with the Eurasian Economic Commission as a representative of the unrecognized customs union is thus also difficult for the EU. Still, the EU cannot ignore these developments. At the technical level, it should help commission staff understand how EU standards function, since the customs union has agreed to move toward those regulations. The EU should try to engage with the Commission to help solve problems that may arise if Russia does not implement its WTO commitments.

3. The EU must solve the practical problems created by the customs union for EU-Russian relations.

The creation of the customs union has already posed practical dilemmas for the EU, such as the issue of the EU's negotiations on a new agreement with Russia. These talks are currently on hold. Since the power to negotiate trade arrangements was handed over to the Eurasian Economic Commission, the Russian government cannot engage in such negotiations with the EU.

The EU, in turn, cannot negotiate the trade aspects of the bilateral agreement with a supranational body that it does not formally recognize. At the moment, the European Commission's mandate is limited to talks with the Russian government. The Eurasian Economic Commission can thus only be invited to negotiations as an observer. However, if Russia, Belarus, and Kazakhstan implement Moscow's WTO commitments over time and also agree to apply Russia-EU commitments within the customs union, the EU should look into revising the mandate.

At the moment, the EU is neither willing nor able to recognize the customs union as a regional entity.

4. The EU has to separate the issue of Ukraine from its relations with the Customs Union and assess the relevance of its own policy toward the post-Soviet space.

The EU is concerned about the appearance of new dividing lines in Europe potentially caused by the creation of the customs union and its further enlargement.

The EU will thus face certain long-term strategic challenges related to the customs union: Belarus and the much bigger Ukraine, and perhaps the EU's whole policy toward the east. The EU will have to find a way to engage with the customs union—knowing that Belarus, which is currently facing restrictive EU measures because of its poor democratic record, may benefit.

The EU will also have to decide whether to continue its geopolitical competition with Russia over Kyiv, a struggle that Brussels may be neither willing nor able to win. Separating the geopolitical debate about losing Ukraine to Russia from the EU's relations with the customs union could ease tensions between Brussels and Moscow. It could also help Ukraine finally make a voluntary choice.

Brussels will have to come to see that its model—however attractive for the Central European and Baltic states—may not be applicable for the post-Soviet space, with the exception of Moldova and perhaps Georgia. With some countries moving toward the customs union with Russia and others continuing their balancing act between east and west, the EU may need to start thinking about a Eurasian policy.

Taking these steps will not be easy. Yet, they seem to be unavoidable for the EU.

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From 2006 to 2010 Shumylo-Tapiola participated in the development of the European Commission's Deep and Comprehensive Free Trade Area formula (DCFTA), leading a team of Ukrainian experts to assess the impact of the future EU-Ukraine DCFTA and the readiness of the Ukrainian government to implement the EU-Ukraine Association Agenda.

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