Pinnacle of the big Eurasian game

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The day is drawing nearer when the Treaty on the Eurasian Economic Union (EAU) is scheduled to be signed—29 May 2014—and so is the pinnacle of the big integration game in the former Soviet Union (FSU). Apparently, the debate between the Eurasian partners concerning political and economic issues will continue even after the agreement has been signed, the more so because a full-scale common market based on the achievement of "four freedoms" (free movement of goods, services, workforce and capital) with no exceptions and exemptions will not be launched starting 2015. However, the EAU Treaty cements the system of decision-making within the Union and fixes the basic economic rules of the game, thus identifying the balance between costs and benefits of each party for the short- and medium term, therefore so much is at stake now.

Eurasian integration as a breakthrough stage

Unlike previous FSU integration initiatives that proved ineffective, the Customs Union (CU), Eurasian Economic Community (EurAsEC) and the Common Economic Space (CES) turned out to be operational institutions, albeit with numerous exclusions from the principles of free trade. Unlike their less successful integration predecessors in the region, the CU and CES commitments are put not only on paper, but also in practice. As of today, Belarus, Russia and Kazakhstan apply unified rates of customs duties to third countries, have eliminated many non-tariff trade barriers and are working hard to unify standards and norms in various areas, have lifted bans on labor migration and are making arrangements for the coordination of their macroeconomic and agro-industrial policies.

Moreover, each participant in the Eurasian integration is ready to make concessions in order to ultimately reach a consensus. On the one hand, the Belarusian authorities made an unpopular move when they increased the customs import duty on foreign vehicles. Kazakhstan increased its original national customs tariff rates by more than a half to meet its CU obligations. The tighter controls on the external customs border of the CU member-states resulted in a significant reduction in the smuggling of Chinese-made goods from Kyrgyzstan, which entailed a rise in prices of some categories of goods (clothes, electronics, and household appliances) for consumers in Kazakhstan. On the other hand, Russia made steps to meet halfway with Minsk and Astana when it agreed to adopt tariffs that protect the key productions of its partners in their markets. As a result, in practice, the share of the Russian tariff in the context of the rates agreed in the CU framework turned out to be lower than it had been theoretically predicted and expected based on the assumption that Russia is a much bigger market than its CU partners.

Judging by the results of the summit of the Supreme Eurasian Economic Commission, which took place on 29 April 2014, Russia has no plans to establish a single market (which envisages single import and export duties) for oil and oil products starting 2015. However, given the consent of the parties to sign the EAU Treaty in late May and the principled position of President Lukashenka, who raised the rates ahead of the summit (saying "if we are not ready now, then let us sign the deal in 10 years"), one could expect that Russia would either increase the oil rent for Belarus or propose another mechanism to subsidize its ally based on an individual bilateral arrangement.

Russia's plans became clear on 9 May—in 2015, it will not collect about half of the total volume of the export duties on oil products; i.e. subsidies will increase by approximately USD 1.5 billion. It cannot be ruled out that starting 2017 Belarus will be enabled to keep the entire amount of the export duties applied to oil products produced from Russian duty-free oil (estimated at approximately USD 3.5 billion). Moreover, it was reported back in April that Russia would provide 23 million tons of crude oil to Belarus in 2014, exactly the amount that Belarus had requested. Furthermore, it was declared that Belarus would receive a USD 2 billion Russian loan to shore up its gold and foreign exchange reserves as early as May 2014. It became obvious that Russia is ready to subsidize the Belarusian economy and provide political support for Lukashenka ahead of the 2015 presidential election. A serious economic crisis in a partner country would affect the image and progress of the Eurasian integration, and Russia is not interested in such a scenario. Minsk must have also promised the Kremlin to meet halfway in the talks over the creation of joint ventures. It is also possible that shareholdings in Belarusian oil refineries will in mid-term be sold to Russian businesses.

Benefits of the regional economic integration

How do/will the Customs Union, Common Economic Space and the anticipated Eurasian Economic Union contribute to the economic growth and improvements in living standards in the EAU member-states?

First, the elimination of customs stations between the countries in question expedites commodity flows and cuts costs in mutual trade, because an additional day of delay in the delivery of goods results in an increase in their prices by several percentage points. The abolition of non-tariff barriers in the form of sanitary and phytosanitary norms applicable to foods and crops and technical barriers in trade facilitates the work of exporters, which would otherwise have to pay additional charges for additional certification procedures or bribes for the successful qualification of the delivered goods. Further, some goods traded between the CES member-states should become cheaper as a result of the unification of rail transportation tariffs.

Second, a deeper economic integration is capable of initiating a series of positive structural economic benefits, including a more effective use of labor and capital, production cooperation and increase in return rates due to collaboration in research and development. For instance, Russia is planning to promote cooperation ties with Belarus in the automotive industry, defense and space sectors, and telecommunications. The two countries also negotiate five joint ventures—between MAZ and KAMAZ, Grodno Azot and Gazprom, Peleng and Roscosmos, Integral and Ruselectronics, and MZKT and Rostec. Russia and Kazakhstan are planning to pursue integration projects in ferrous and non-ferrous metals industries, nuclear and aerospace sectors. To successfully compete with the world's leading producers in foreign markets, manufacturers need to be consolidated, merged or ousted from the market. Agreements in the framework of the CES and the EAU Treaty envision the equal access of companies and other economic entities to the services provided by monopolies in the energy sector, transportation and other areas, which is expected to foster competition and partially demonopolize markets.

Third, in a longer term, institutional economic effects are supposed to come into play, such as enhanced competitiveness of the economies and companies, and equalized social and economic development of the regions and member-states of the Eurasian integration project. The increased competition with foreign markers, which will be granted equal access to the operation in the local market, will encourage modernization.

While we can already observe the positive impact of the elimination of non-tariff barriers in the cross-country trade between the Eurasian troika member-states, the question remains whether the three countries will continue to sincerely meet the commitments fixed on paper, i.e. to ensure free movement of goods and services and equal terms and conditions for investment while refraining from any new non-tariff barriers and offering transparent tendering terms inviting companies from the partner countries to make their bids. In conditions of the dampened economic growth in Russia and Belarus, the Eurasian economies might introduce protectionist practices and stimulate import substitution, including for goods from the CES partner countries, in order to use their national companies to their capacity. Another decisive factor is the effectiveness of the EAU's supranational bodies, which will supervise the situation in the sectors under their control, specifically, whether these supranational authorities will be able to make decisions binding on the national institutions.

Eurasian integration and Belarus's long-term national interests

While acknowledging the potential positive economic impact of the Eurasian integration on the Belarusian economy, one should not overemphasize its benefits from the point of view of Belarus's long-term national interests. The Eurasian integration pegs Belarus to Russia, both institutionally and economically, even tighter than before, and isolates it from the integration processes with the European Union.

First, the European integration is based on the principles of freedom, democracy, respect for human rights and fundamental freedoms, as well as the rule of law, which is clearly stipulated in the Treaty on European Union (TEU). The integration with the European Union envisages not only a reform of economic institutions, but also the liberalization of political institutions. Unlike the EU, the Eurasian Union is in reality an association of authoritarian countries with no rule of law and free and fair elections[1], despite the formal commitment to democratic principles stated in the respective national constitutions. A typical example of the existing problems with electoral democracy in the three "Eurasian" countries is the fact that Aliaksandr Lukashenka, Vladimir Putin and Nursultan Nazarbayev have served as heads of state for a total of 58 years.

Second, the engagement in the European integration is built on the support and promotion of cultural diversity (which is crucially important for Belarus, given the fact that the national language is being driven out of public life), as well as respect for sovereignty and territorial integrity. At the same time, Russia neglects these principles with respect to the countries that prefer the European integration option to the Eurasian integration project (Moldova and Ukraine). Given the heavy dependence of the Belarusian economy on Russia, the involvement of Belarus in the Eurasian integration raises a sensitive rhetorical question: will Belarus ever be able to withdraw from this process, and what consequences would such a move have for Belarus?

Third, there is another important question, namely, how successful can Belarus be in modernizing its economy, developing its non-resource sectors of the economy and increasing added value of its export supplies in partnership with Russia (which lags behind Europe in its technological advancement)? In the long term, the integration with the European Union could provide stronger economic growth and improvements in living standards of the population than the anticipated economic impact of the Eurasian integration.

[1] Based on The Democracy Index compiled by the British research center The Economist Intelligence Unit, Russia, Belarus and Kazakhstan have ranks 122, 141 and 143 of the 167 analyzed nations. See http://pages.eiu.com/rs/eiu2/images/Democracy-Index-2012.pdf

Key discrepancies: energy and competition policy

Back in February 2014, the website of the Ministry of Economic Development of the Russian Federation posted the text of the functional part of the Treaty on the Eurasian Economic Union; and in April 2014, the combined draft of the sections of the functional part and exhibits were made public on more than five hundred pages. The draft institutional version of the Treaty is still unavailable to the broad public. It is known for certain that the EAU will not be a full-fledged political union, because the presidents of Belarus and Kazakhstan disagree in principle to lose political sovereignty.

A remarkable fact is that even in the existing system of decision-making within the CES the Russian side does not enjoy a priority status despite its economic dominance. The Supreme Eurasian Economic Council is the body responsible for overall political management. The Council and Board of the Eurasian Economic Commission, the CES's supranational body, are formed based on the balance of representation, meaning the equal number of members representing each party, and approve decisions either unanimously or by a majority vote. Russian used to have 57% of votes in the CU Commission, and Belarus and Kazakhstan used to split the remaining 43% of votes in two equal halves (and decisions were approved by a 2/3 majority vote). It looks like Russia agreed on the "one country–one vote" pattern in order to encourage Ukraine to eventually join the Eurasian community thus allaying fears of Russia's monopoly in the Eurasian institutions. However, as a result of the recent political events, it is highly unlikely that Ukraine will ever accede to the EAU. The decision-making system in the EAU supranational bodies will probably look like the one effective in the CES.

The most significant economic provisions governing the operation of the EAU are listed in more than 30 Exhibits to the Treaty. The Protocol on the procedure for the organization, management, operation and development of the common markets for oil and oil products seems to have the most inconsistencies. This is hardly a surprise, because the essential financial gain of both Belarus and Kazakhstan, along with the political benefits of the Eurasian integration for both Lukashenka and Nazarbayev (a better chance to "bribe" voters), stem from the beneficial agreements concerning the export, import and transportation of energy resources. Judging by the latest draft Treaty on the EAU, besides the oil sector, the partners find it the hardest to agree on the rules of access to the services provided by the natural monopolies in natural gas transportation by pipeline systems, as well as the general competition and concerted transport policies.

Essence of the oil card

According to a current agreement between Belarus and Russia, Minsk harmonizes the rates of its export duties applied to oil and oil products up to the Russian level, currently at approximately USD 400 per ton. Belarus receives Russian crude oil on a duty-free basis within an agreed quota (20.9 million tons in 2013 and 23 million tons in 2014) and returns the duty applied to the export of the oil products refined from Russian crude (USD 3.5 million annually) back to the Russian budget. Duty-free oil supplies are translated into about USD 5 billion worth of subsidies annually for the Belarusian budget. In Kazakhstan, the rate of the export duty on oil that exporters pay to the national budget stands at mere USD 80 per ton, as long as an increase in the rate would turn oil export into a loss-making business in Kazakhstan.

The most profitable version of the EAU Treaty for Belarus and Kazakhstan would be the one stipulating that Russia should not only stop collecting the export duties on the oil products refined from Russian crude, but also lift all limitations on the supplies of duty-free oil to Belarus and allow Kazakhstan to supply its crude oil to Belarus via the territory of Russia at Russia's domestic rates. If Belarus were also allowed to set its own, lower export duty on oil, Minsk would reap additional benefits, while Russia would have to pay additional costs, because Russian companies would prefer to export oil via its Eurasian partner countries. Deputy Minister of Finance of Russia Sergey Shatalov said that such a combination would result in a fivefold increase in Russia's combined subsidy to Belarus and Kazakhstan, to an estimated USD 30 billion annually.

Naturally, such a move by the Russian side would be too big a concession, especially now that Russia seeks to keep the energy infrastructure under its sole control and given the ongoing recession in the Russian economy. In case Belarus and Kazakhstan should stick to their position of principle, Russia has prepared a counter-proposal codenamed "a big tax maneuver". In order not to allow "leaks" of its oil via Belarus and Kazakhstan, Moscow suggests cutting its export duty on oil and oil products to the level effective in Kazakhstan while making up for the losses of the national budget through increases in the mineral extraction tax. Essentially, in response to the proposal by Belarus and Kazakhstan to establish a "real" single market, Russia threatened to implement the model of an even more full-fledged common market. Such a scenario envisages the unification of not only import duties, but also export duties, which would be distributed between all the partners of the economic union proportionally to their exports.

It is the consequences of the "big tax maneuver" outlined by the Russian side that must have discouraged the Eurasian partners, which gave their tentative agreement to create a common market for oil and oil products subject to a 10-year transition period. First, the drastic changes in the taxation system in the oil and oil-processing sectors would pose risks to the Russian oil and chemical sector and the Russian budget. Second, if Russia raises its mineral extraction tax rates, oil prices will rise as well, thus making the Belarusian oil refineries less profitable, maybe even loss-making. Furthermore, the "big tax maneuver" would entail a significant increase in prices of automotive fuel in the markets of the Eurasian partner countries. Therefore, Russia made an effective counter-argument to Belarus's liberal point regarding the development of a full-fledged single market with no exceptions and exemptions, and the Eurasian partners had to comply. Nevertheless, it had to meet halfway with Lukashenka ahead of the upcoming presidential election by consenting to collect only half of the total amount of the export duties on refined oil starting 2015.

Bilateral bonus in exchange for the absence of the single oil market

For Lukashenka, who makes the key decisions concerning Belarus's political and economic development, the success or failure of the Eurasian agreements determines his own success at the presidential election, not even the 2015 election, but rather the 2020 election. Even if the results of the Eurasian negotiations prove to be unsatisfactory for the Belarusian ruling elite, the segmented and passive opposition forces will hardly have a chance to put an end to his 20-year tenure in 2015. Further, Lukashenka successfully plays the card of the situation in the region in connection with the Ukrainian developments, thus maintaining and even boosting his rating.

It follows from the statement by the Chairman of the Board of the Eurasian Economic Commission, Viktor Khristenko, which was made following the meeting of the Supreme Eurasian Economic Council on 29 April 2014, that the common market for oil and oil products would not become operational starting 2015, while the transition period in that sector would take up to ten years. This evidence points to the fact that the Belarusian authorities have not managed to have the most favorable version of the EAU Treaty. However, the agreement concerning the 23 million tons of duty-free oil in 2014 and transfer of just one half of the total amount of the export duties on refined oil should be considered Lukashenka's achievement. Along with the USD 2 billion loan from Russia, this will help stabilize the economic situation in the country ahead of the presidential campaign of 2015. Moscow's consent in principle to offer Belarus an even higher rent from the processing of Russian crude will increase the likelihood of Lukashenka's staying in power for at least another decade (based on the best-case election scenario in 2020), with all the benefits and disadvantages of the existing Belarusian political and economic system that come with it.

The principal conclusion of the Eurasian summit of 29 April 2014 and the bilateral agreements that followed is that the EAU Treaty will be signed as scheduled, and Moscow is ready to provide a bilateral financial bonus to Belarus with its expanding foreign trade imbalance. Incidentally, Minsk managed to procure such a bonus even before it signed the EAU Treaty. Russia is interested in the further use of the oil sector as leverage to keep the Belarusian authorities under pressure, including during the talks over the creation of joint ventures in manufacturing industry and increase in the share of Russian capital in the Belarusian oil refineries.