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The Impact of Eurasian union on Business Activity: A Survey of Firms in Kazakhstan

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Abstract

In global reality Kazakhstan considers Eurasian economic integration as an important part of its global trading and economic development strategy. The paper evaluates degree of trade openness of Kazakhstan towards Eurasian Economic Union and identify whether the Union had effect on the Kazakhstani enterprises. Most of SME companies did not feel any impact on their respective business, but they still expect positive influence of integration on the economy as a whole. The analysis may be of interest to the different governments of developing economies like Kazakhstan in terms of choosing the necessary strategies. Based on the results government and Eurasian Economic Union institutions could improve policy of further integration development.

Keywords: Economic integration, Eurasian Economic Union, small and medium enterprises

Introduction

The economic interdependence of different countries, the internationalization of factors of production contributes to the development of integration processes in the world. Economic integration is a historical process occurring over many centuries. The main goal of which was building closer cooperation and interpenetration of individual national economies. Over the last decades this historically known process of economic liberalization has become a global trend, embracing an increasing number of countries. External economic liberalization means unhindered flow of goods and services, capital and information from one country to another. Trade liberalization is a common step of economy's integration into the world economy. More and more developing countries are opening their economies to take all possible advantages for economic development. Most of the world trade today is among the World Trade Organization (WTO) members. According to WTO statistics (2018) all WTO members have at least one regional trade agreement as of 2018.

Trading unions and free trading agreements are a very prominent part of our current economic landscape, and they have many important implications for all aspects of our life. This approach set the direction, goals, and the internal logic of the study, in which considerable attention is paid to the evaluation of impact of Eurasian economic integration on Kazakhstan. This study presents some findings from a survey conducted on business representatives, asking questions regarding integration effect on their businesses and their expectations.

Theoretical Background

It is commonly suggested that trade liberalization is useful both for the domestic economy and for the global economy as well. Kawai and Wignajara (2008) state that usually free trade agreements promote

trade in goods and services and investment by creating a better environment for starting business relationship between the partners. At an aggregate level, trade reforms can benefit the economies through the following channels:

- Improved resource allocation;
- Access to the best technologies, raw materials and intermediate goods;
- Economies of scale due to increased volume of production;
- Increased internal competition;
- The presence of favorable externalities, such as knowledge transfer and much more.

But there is a risk that one country might take over the whole union market, if partner countries produce the same products. Corden (1972) devoted an extensive study to the scale effect, in which he introduced two new effects, such as the "cost reduction effect" and the "trade suppression effect". To explain the new effects Corden introduced a number of assumptions: firms operating under imperfect competition face internal economies of scale and they take a given world price level. Assume there are two countries in a union and both countries are producers of a certain commodity. But after the formation of the Customs Union (CU), one of the producers (Country 1) occupies the entire union market, and the other (Country 2) ceases its production. Consequently, the average costs of the producers of the country that has occupied the entire union market will decrease. Due to specialization, the total production costs will also be reduced. This effect can be divided into two parts:

1. There is a trade creation effect that happens by replacing more expensive domestic production to cheaper imports from Country 1. All super profits are distributed in favor of the producers from Country 1 and Country 2 will not receive any gains from this trade;
2. There is a cost reduction effect that happens to Country 1 by getting domestic supply at lower production costs. Consumers of Country 1 also will not get any gains (as the price remains at the same level), all the gain will go to producers of Country 1. Country 1 receives excess profits from exports to the market of the Country 2. As a result of union, there will be cost reduction effect Country 1's producers and trade diversion loss for Country 2.

The most successful example of integration associations is the European Union (EU). According to EU timeline from website of Institute for the Study of Civil Society the beginning of the European integration process has started with the formation of the European coal and steel association in the 1950's. Six countries of Western Europe (Belgium, Germany, France, Italy, Luxembourg and the Netherlands) formed the European Economic Community, which in the next 10 years had transformed into a customs union. The seven other European countries formed the European Free Trade Association (EFTA) in 1959. In 1979, the European Monetary System was created. By 1993, the EU countries had formed a common market, and by 1999 they had created and introduced a single currency, "Euro". After the collapse of the Soviet Union, the post-Soviet countries (the Baltic countries) and the countries of Eastern Europe expressed their desire to join the European integration process. So, in 2004 the EU experienced the most significant expansion. Moreover, most EFTA countries joined the European Union, which contributed to the strengthening of its positions and the weakening of the positions of EFTA.

There is a significant difference in the economic development of EU member countries, which caused the emergence of crisis situations, such as the crisis in Greece. The EU is both an economic and a political union. The consequences of political decisions like the crisis with refugees from the Middle East and North Africa, relationships with Russia and Turkey, were the reason for the split within the organization. As a result of this split UK held a referendum, at which residents voted for the country's withdrawal from the EU. In general, economic integration in Europe has had a positive impact on regional trade. Despite this, the EU maintains separate protectionist measures aimed at protecting the domestic market.

Table 1: History of EU integration

Year	EU	EFTA
1951	Belgium, France, Germany, Italy, Luxembourg, Netherlands established the European Coal and Steel Community (ECSC)	
1959		Austria, Denmark, Norway, Portugal, Sweden, Switzerland and the UK – established a European Free Trade Association (EFTA)
1961		Associated membership of Finland. The EFTA Consultative Committee is established
1968	Formation of the Customs Union	
1970		Accession of Iceland
1972		The exit of Denmark and the UK to join European Economic Community (EEC)
1973	Joining Denmark, Ireland and the United Kingdom	Establishment of the EU-EFTA FTA
Creation EU-EFTA		
1979	Creation of the European Monetary System	
1981	Accession of Greece as 10 th member	
1985		Portugal's exit, full membership of Finland
1986	Accession of Portugal and Spain	
1991		Accession of Liechtenstein
1993	Formation of the common market	
1994	Establishment of the European Monetary Institute (EMI)	
1995	Accession of Austria, Finland and Sweden	The exit of Austria, Finland and Sweden to join EU
1998	Establishment of the European Central Bank (ECB)	
1999	Creation and introduction of the single currency Euro, official in 11 out of 15 Euro States	Austria, Denmark, Norway, Portugal, Sweden, Switzerland, United Kingdom
2004	Accession of Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland and Slovenia	Associated membership of Finland
2007	Accession of Bulgaria and Romania	Accession of Iceland
2011	Accession of Estonia	
2013	Accession of Croatia	The exit of Denmark and the UK
2016	The referendum in the UK on membership in the EU, in which the victory was won by supporters of Brexit	Establishment of the EU-EFTA FTA

Source: Authors based on data from EFTA and Institute for the Study of Civil Society websites

Sapir (1998) states that formation of preferential trade agreements (PTA), or deepening of existing PTA, leads to deviation of trade and investments and to “domino effect”. This deviation generates political forces in third countries (not participating in the PTA), which creates “pressure to join”. Pressure increases with the growth of the size of the trade block, and the size of the trade block depends on the number of countries participating in it. Thus, the block will receive various requests for accession from countries that have not previously shown any interest in membership. The country's position on regional

integration is balancing on the interests of supporters and opponents of integration. Supporters are domestic firms exporting to the regional bloc or to markets of potential PTA partners. Since the firms of the third country start to be discriminated against, their incomes are starting to decline. Representatives of such firms are beginning to actively work to exert pressure on the state, so that it pursues an integration policy. Excessive pressure on the part of exporters can lead to a country joining this bloc, which leads to expansion of the bloc and increases costs for third country firms. The whole process leads to a second round of integration of political activity, which can further expand the bloc. If the trade bloc is really open, then the process of its expansion will stop only when the third countries provide very high resistance. For example, as EU was enlarging Switzerland and Norway resisted to join the union. If the bloc is not completely open, the process of its expansion will stop only when the bloc members refuse to accept new countries whose membership will bring big costs (EU and Turkey). If the block is completely closed, then all requests will be rejected (the case of NAFTA). There are vivid examples of evidence of the validity of the "Domino Theory". The US trade partners were apprehensive about the beginning of trade negotiations between the US and Mexico. Preferential access for Mexico could squeeze the producers of other countries and reject investments in the direction of Mexico. The first "domino effect" was the reduction of tariffs between Canada and Mexico. Canada tried to reduce the likelihood of trade deviation by lowering the tariffs that it considered optimal prior to the negotiations between Mexico and the United States. "Domino effect" would become wider if NAFTA was open for expansion. Nevertheless, virtually all countries of the Americas came up with the initiative to establish an FTA with the United States. Moreover, in the book by Bhagwati et al (1999) it is written that representatives of 26 countries signed a framework agreement within the framework of the American Initiative, which required reducing barriers to US investment in exchange for a promise of close trade cooperation with the US in the future. This agreement shows one more "domino effect", manifested in the liberalization of investments. The "domino effect" can also be observed using the example of MERCOSUR. The formation of MERCOSUR had a significant impact on trade flows. From 1990 to 1995 the internal trade of MERCOSUR grew by 27% per year, while foreign trade increased by only 7.5%. If before Chile and Bolivia were not showing any interest in the organization, afterwards they expressed desire to participate in this trade bloc. Chile became an associate member in October 1996, Bolivia followed suit and signed a similar agreement in December 1996. The "domino effect" can be clearly seen in the example of European integration, when the number of EFTA members that joined the EU decreased significantly over time (table 1). However, Baldwin assumes (1997) many countries in the European integration pursued geopolitical goals rather than economic. These countries include Austria, Finland, as well as the countries of the former Soviet Union and the socialist bloc.

Tharakan (2002) also suggests that driving forces of Preferential Trade Agreements (PTA) are rarely purely economic. According to him, the European Coal and Steel Community was created to prevent armed conflicts. Currently, the EU actively invites other countries / blocs to form new Regional Trade Agreements (RTAs), while supporting the WTO. Moreover, the EU has a complex "web" of PTA, which includes the Single Market, the Customs Union, the FTA, the Cooperation and Partnership Agreements, non-reciprocal contractual preferences, and non-reciprocal autonomous preferences. This situation is due to historical reasons and the geopolitical interests of the EU member countries. The Generalized System of Preferences (GSP), which the EU and other developed countries provide to developing countries, is very often limited to those products for which developing countries have a comparative advantage. For example, the EU provides very limited preferences for textiles and clothing. Even though multilateral agreements on textile fibers and other quantitative restrictions are being eliminated, the EU is trying to use anti-dumping measures to restrict imports. Agricultural products are completely excluded from preferences. It should be remembered that preferences are offered in the form of privileges; they are not regulated by the WTO and can be withdrawn at any time. In their paper Valliant and Ons (2002) studied the consequences of creating an FTA between the two blocks and grouped them as follows:

1. Trading opportunities - corresponded to a potential increase in South American / EU exports due to easier access to EU / South American markets;
2. Trade threats - corresponded to defensive actions on the part of regional import substitution sectors facing a potential shift from regional exports.

The idea of the study was to identify the interests of supporters and opponents of integration. So, according to the results of their model, the ideal list of exceptions for each partner should be based on the index of the comparative advantage of the other partner. For example, the likelihood that Chile's agreement with the EU poses a threat to Chile was low. Consequently, this agreement will not be subject to resistance from Chile's regional trading partners. The case of the Andean community is different from that of Chile. Its members are not guaranteed to increase exports to the EU, but the agreement creates a threat to individual sectors. Thus, the political pressure of the lobbying groups and the resistance of the relevant sectors are expected in this direction. The EU agreement with MERCOSUR is a rather complicated situation, as it leads to both the creation and the rejection of trade. In particular, there are threats to the agriculture of Argentina and Uruguay, as well as the undermining of MERCOSUR's domestic trade through the substitution of Brazilian manufactured goods for European goods.

Antonio Bojanic (2012) finds a positive relationship between economic growth and trade openness for Bolivia. The author analysed the 70 year long data from 1940 and 2010, and the results show that there is indeed a long-run equilibrium relationship between economic growth and trade openness, and that trade liberalization caused economic growth in the country.

Current global processes lead to a need of assessing the appropriateness of the chosen development strategy of Kazakhstan by determining its place in the global and regional processes in Eurasia. The concept of forming the Eurasian Union was discussed since 1994. Tang (2000) states it was going to be based on a voluntary, equitable integration, joint political and economic development of the post-Soviet states, and the entrance of Commonwealth of Independent States (here and after CIS) countries to a leading position in global economy. That concept presents the principles, objectives and mechanism of formation of the Eurasian Union. It provides the establishment of a number of coordinating supranational institutions and sets out the basic directions of cooperation – in the following spheres: the economy, science, culture, education, environment and defense. The current and future perspectives of the EAEU were considered by Khitakhunov et al. (2017).

Participation in integration unions is foreign policy priority for the strategy of Kazakhstan. Great opportunities to expand its capabilities are available in the deepening integration of Kazakhstan in the framework of regional integration. A main goal of integration is to achieve economic stability, progress and military-political security in the region. Evolution of economic integration process is shown in a Table 2.

Table 2: Evolution of Eurasian Economic Union

Eurasian Economic community	EurAsEC (2000-2014)	free trade area	no barriers between trading countries,	Belarus, Kazakhstan, Kyrgyzstan, Russia, Tadjikistan
Eurasian Customs Union	EACU (2010)	customs union	no customs are levied inside the union , imposing a common external tariff on all goods entering the union	Armenia, Belarus, Kazakhstan, Russia
Eurasian Economic Space	EES (2012)	single market	the free movement of persons, goods, services and capital	Armenia, Belarus, Kazakhstan, Kyrgyzstan, Russia
Eurasian Economic	EEU (2015)	single market	the free movement of goods, capital, services and people and provides for	Armenia, Belarus,

Union			common policies in macroeconomic sphere, transport, industry and agriculture, competition and antitrust regulation.	Kazakhstan, Kyrgyzstan, Russia
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Source: Authors based on data from Eurasian Commission website

As we can see from table 2 EurAsEC is an example of free trade area including a group of countries that agree to gradually eliminate trade barriers (quota, tariffs) between themselves. Each member country retains the right to charge its own external tariff towards other non-member countries. In trade relations between members, there may be free trade in some products, and some protection in other products.

Theoretically, reforms with respect to the liberalization of international trade can affect (positively or negatively) individual local firms in following ways:

- By increasing competition: reducing import tariffs, quotas and other non-tariff barriers leads to an increase in external competition in the domestic market, and it is expected that this will lead to inefficient / unproductive local firms trying increase their productivity. The openness of the economy to international trade is also seen as an increase in the size of the enterprise (that is, the effectiveness of the scale), as local firms gain access to efficient technologies, experience in effective management, organization and production methods;
- By reducing production costs from cheaper imported resources: local firms benefit from lower production costs, which allows them to compete more effectively with imports in domestic markets and export markets;
- Increasing export opportunities: reducing or eliminating customs barriers open up new export opportunities for domestic firms;

Thus, the liberalization of international trade, which increases external competition in the domestic market, may be detrimental to some inefficient or uncompetitive SMEs, while benefiting other effective or competitive SMEs.

Research Methods

The approach based on the Degree of Trade Openness describes what changes might happen with respect to the degree of openness of a country towards member countries of economic union. If a country's trade increases with its Union member countries after integration, then it means that the country is using its resources more efficiently and gets benefits from participating in the union. The data in the country's openness and its trade balance with respect to the Union show how the country's trade results within the Union has changed overall as an effect of integration. The degree of is calculated using the country's export, its imports and the sum of the two. Mathematically, the rate of the openness is calculated with a simple equation:

$$DTO_x = \frac{\text{Exports of Kazakhstan to EAEU in year } t}{\text{Total Exports of Kazakhstan in year } t} \quad (1)$$

$$DTO_m = \frac{\text{Imports of Kazakhstan to EAEU in year } t}{\text{Total Imports of Kazakhstan in year } t} \quad (2)$$

Comparing the change in the two measures for the pre- and post-integration periods, we can determine whether the trade sector in Kazakhstan has overall benefited or has performed worse in the aftermath of integration.

Table 3: Kazakhstan to EAEU degree of trade openness ratio

	2011	2012	2013	2014	2015	2016	2017
DTOt	19.6%	18.7%	19.2%	18.3%	21.3%	22.2%	22.4%
DTOx	9.0%	7.9%	7.8%	9.0%	11.1%	10.7%	10.6%
DTOm	43.8%	38.9%	39.0%	36.2%	36.7%	38.9%	41.8%

Source: Authors based on data from Agency of Kazakhstan of Statistics

Calculated openness ratios are presented in table 3 and graphed in figure 1. In the case of exports, Kazakhstan’s openness toward its union partners tended to decrease steadily from 2011 to 2014 during Customs Union period, before picking up again in 2015 when EAEU came into force. On the imports side, the openness measure generally fluctuated from 2011 to 2017, with a slight increase starting from 2015 as a result of EAEU. The overall DTO based on total trade (export plus import) shows constant trend in trade among Kazakhstan and its union member countries.

The data shows that overall trade among Kazakhstan and EAEU member countries increased. Thus these positive results encouraged to look into the effect of integration on Kazakhstani enterprises directly.

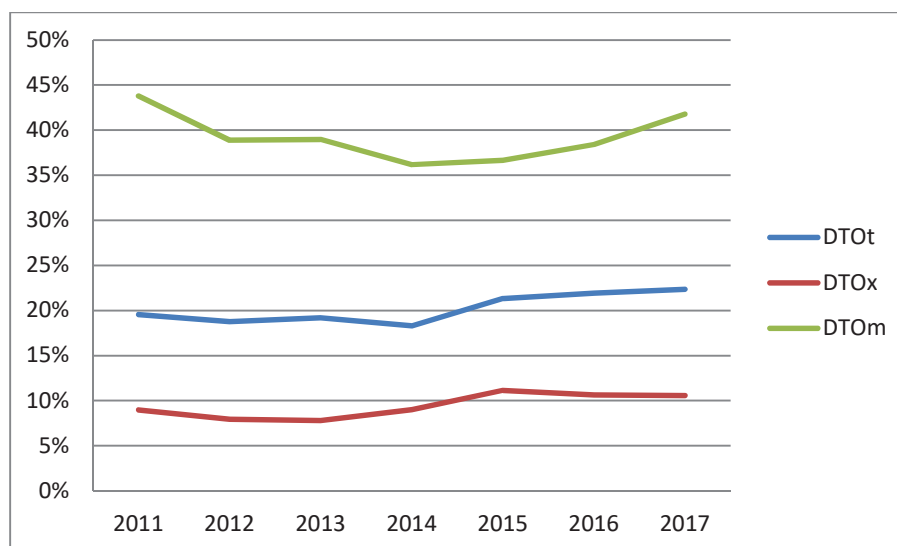


Fig. 1: Degree of Kazakhstan’s trade openness 2011 -2017

The next methodology used is survey of companies. According to Ritchie & Spencer (2002) the survey is a methodology, where a sample of subject is drawn from a population or firms and studied to make inferences about the population and firms. Indeed, a group of companies operating in Kazakhstan was approached for defining the effect of EAEU on their activity. This method is an efficient mechanism for data collection.

In late 2017, a survey of the business community of the Kazakhstan was undertaken in order to analyse the actual and perceived effects of Eurasian economic integration on local businesses. The 115 firms that comprised the survey sample were operating in different sectors, mostly, retail trade, services, construction and other sectors (see figure 1).

With regard to age of firms, young enterprises that started after EAEU came into force accounted for 37% of the survey sample (31 firms) while the other firms had different level of experience (84 firms), amongst which 34% were 3-10 years of experience and 38% 10-20 years of experience.

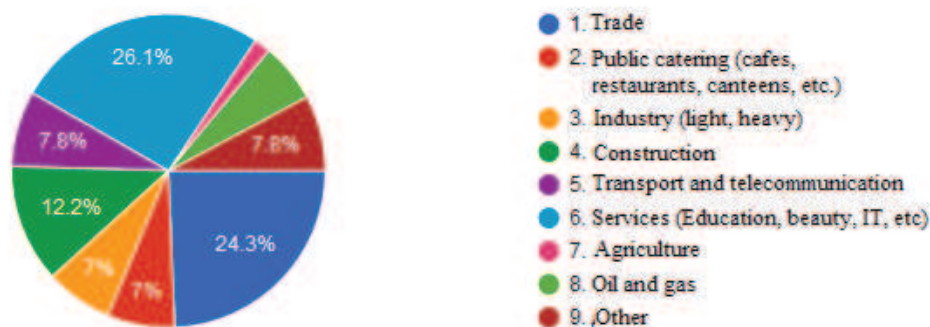


Fig. 2: Operating Sector of surveyed firms

Calculated according to the number of permanent employees, very small enterprises (less than 10 permanent employees) accounted for 41% of the survey sample, small enterprises (50 or fewer permanent employees) for 32%, and medium enterprises (between 50 and 250 permanent employees) for 25%. Although, in general, small and medium size firms have a smaller comparative advantage in using FTAs, but they are more flexible to adapt to any external changes in business environment. The survey was done among small and medium firms, because they may have a higher proportion of their products produced for export and enjoy better market access due to their specialized business relations with trade partners.

Table 3: Age and size of surveyed firms

	Age						Size				
	<1y	1-3y	3-5y	5-10y	10-15y	15-20 y	<10	<25	<50	<100	<250
NB of firms	11	20	11	28	17	26	47	21	16	13	16
Share in %	10%	17%	10%	24%	15%	23%	41%	18%	14%	11%	14%

Source: Authors based on data from Agency of Kazakhstan of Statistics

The representative of firms were asked whether new markets were opened in the member countries, whether it became easier to buy intermediary goods from member countries, if number of business partners increased and if the competition of goods and services from the following countries disturb your business. The climate of opinion is quite clear as regards of Russia. About a half of the respondents agree that starting business relationships with Russian companies became easier, and more opportunities have opened. But for most they are skeptical about effect from countries Belarus, Kyrgyz Republic and Armenia. So far the respondents did not notice any improvements. It is expected, because the share of trade with these countries is relatively small in comparison to other countries.

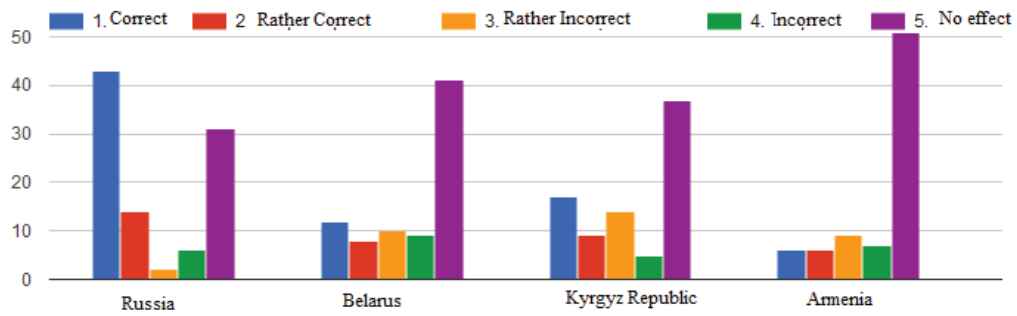


Fig. 3: New foreign markets opened in the countries listed below

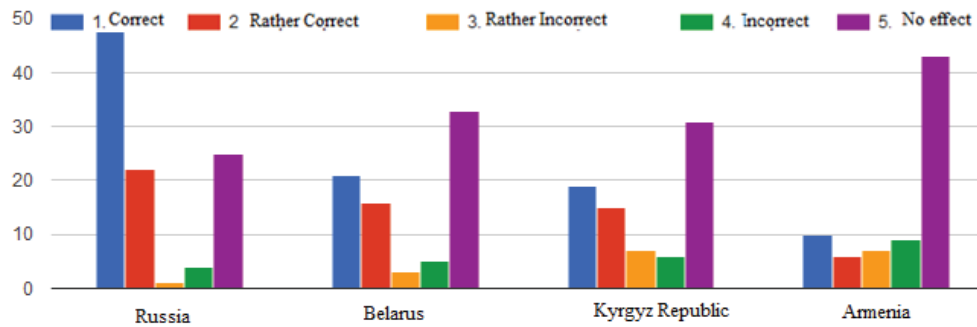


Fig. 4: The procurement of intermediary goods improved from the following countries

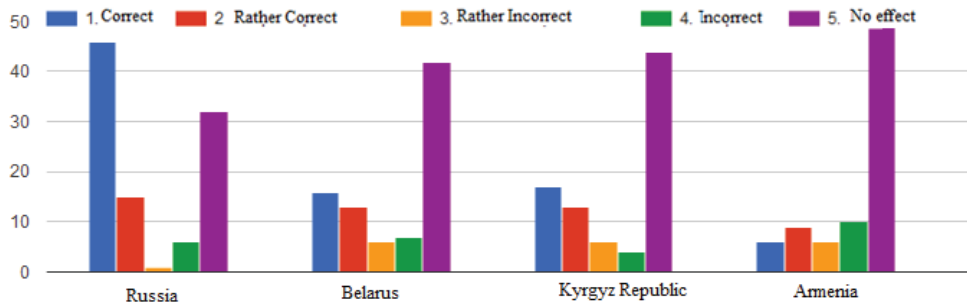


Fig. 5: Number of business partners increased from the following countries

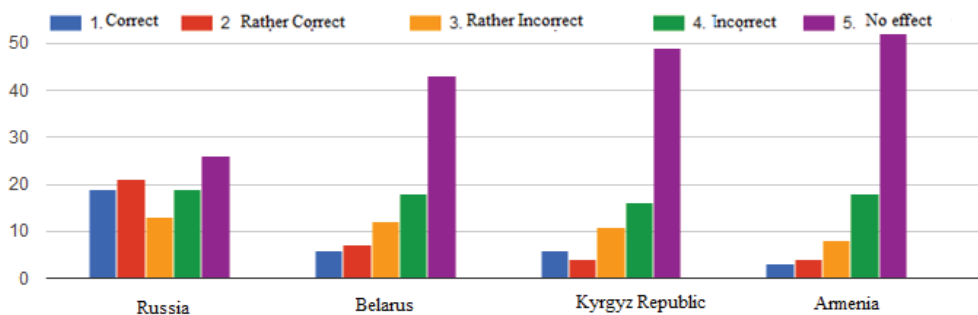


Fig. 6: The competition of goods and services from the following countries disturb your business

Although some companies estimate that possible new competitors could even represent a potential threat to their existence, most companies feel assured of competition especially from Belarus, Kyrgyz Republic and Armenia.

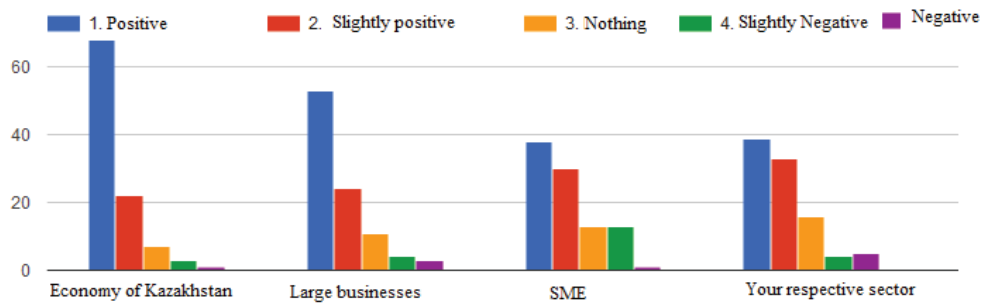


Fig. 7: Firms' expectations of integration effect on respective fields

The participants in the survey are for the most optimistic: more than 60% expect positive impact of Eurasian economic integration on the economy of Kazakhstan. They also anticipate improvements in business environment for large business as well as for small and medium enterprises, about 46% and 33% respectively.

Unfortunately majority of the all respondent companies state that they haven't noticed any effect of integration on their business activity. Only 33% of executives shared their positive or negative experiences aftermath of economic integration.

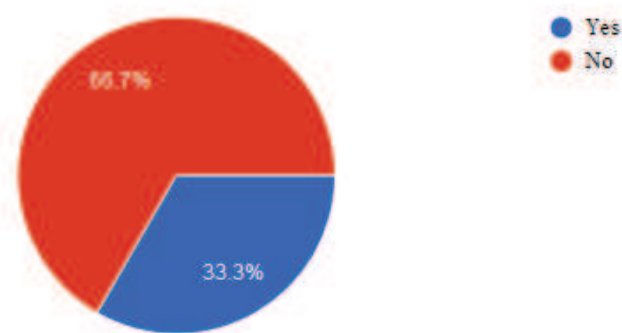


Fig. 8: Impact of integration on respective businesses of respondent firms

Conclusion

Although the integration process on post-soviet space has a long history, the Eurasian Economic Union is a relatively young institution. Thus it may be too early to calculate the effects of integration on country's economy. To identify the current direction and situation, this paper provides the following results.

1. The share of total trade among Kazakhstan and EAEU member countries has increased since 2015, that shows that countries using this the opportunity of non tariff trade for their benefit. The degree of trade openness based on imports has increased from 36.2% in pre-integration period to 41.8% in 2017 after EAEU came into force. The degree of trade openness based on exports has increased from 9% in pre-integration period to 10.6% in 2017 after EAEU came into force.
2. Unfortunately majority of the all respondent companies state that they haven't noticed any effect of integration on their business activity. Only 33% of executives shared their positive or negative experiences aftermath of economic integration.
3. Firms expect positive impact of integration on economy and business in future.

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