

# How do price controls impact inflation?



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This analysis was originally written in Albanian.

## Executive Summary

Like many other countries, Kosovo is also facing significant price increases this year. The decline in supply in international markets, lack of domestic manufacturing capacities, and the significant increase in demand, are among the main causes for this situation. In some countries, the inflation rate measured through several months of 2022 was the highest in the last 40 years. In Kosovo, commencing from March of this year, the inflation rate has double-digit values, and in September, this rate was 12.7%. This situation is affecting the wellbeing of citizens. For a family with a monthly income of 400 Euros, in the period September 2021-September 2022, the cost of purchasing the same food products has increased by about 28 Euros, or 17%, transport costs by about 6 Euros or 9%, means of communication by 2 Euros or 15%, etc.

This winter, challenges are expected with the supply of electricity, considering the wide gap between the generation capacities of Kosovo and the high consumption during the winter, as well as extremely high prices of imported electricity. So far, the Government interventions have mainly focused on the distribution of assistance to the categories in need, subsidizing electricity as a source leading to further price increases for other products, as well as fuel price controls, by imposing profit caps. Recently, the Government proposed a Draft Law on temporary measures on essential products in special cases of market destabilization, by which it intends to regulate the prices of other products in the basic food basket, which have recorded a significant increase. This law passed its second reading in the Assembly on 8 November 2022.

The findings of this report show that during the time of fuel price caps, a more synchronized price fluctuation is observed in retail fuels in Kosovo, and in the commodities exchange market. Meanwhile, in periods of unregulated fuel prices, one may observe an immediate tendency of fuel importing companies to increase profit margins and delay synchronization with the commodities exchange market prices.

If the inflation issue turns into a long-term issue, the price capping policy may harm the affected sectors. The Law on temporary measures on essential products in specific cases of market destabilization will affect sectors that have a combined turnover of over 1.1 billion Euros in 2021, or about 15% of GDP for that year.. Practices of other countries show that price capping as an instrument to reduce inflation is ineffective, prices tend to rise promptly as soon as such caps are removed.

The application of other forms of assistance to citizens, as proposed in the public discourse in Kosovo, which mainly envisage the lowering of tax rates or the VAT and excise tax exemption for some products, may bear a budget impact ranging between 205 and 246 million Euros in six months, or roughly 455 million Euros per year. Inadequate targeting remains one of the main issues resulting from such policies, as well as an artificial increase in consumption.

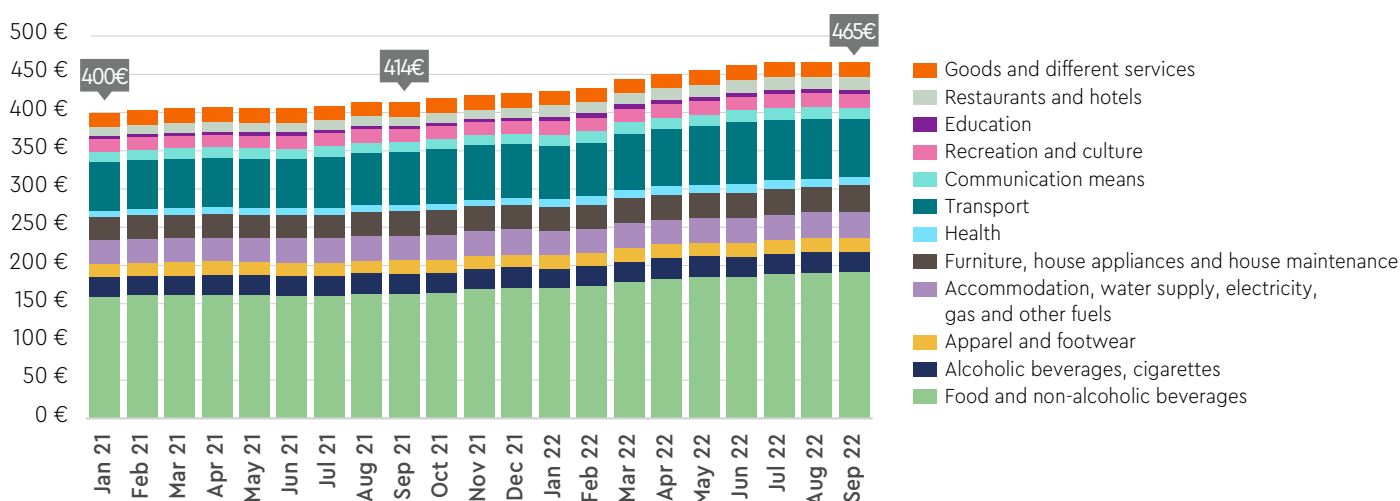
# 1. Introduction

Throughout 2022, countries, including Kosovo, have been facing significant price increases. Initially, the disruptions in the supply chain due to the pandemic, which appeared after a significant increase in demand during 2021 with the opening of economies, as well as the war in Ukraine, contributed significantly to the increase in inflation rates.<sup>1</sup> Yet, there are other events that have continuously affected the supply side, such as another 70-day lockdown in China during 2022, with the zero Covid-19 policy of the Chinese government, tensions between China and Taiwan, climate changes bringing about a decline in energy generation, etc.<sup>2</sup> In some countries, the inflation rate measured in several months of 2022 was the highest in the last 40 years.<sup>3</sup> In Kosovo, in September of this year, the inflation rate was 12.7%, while since March, inflation has recorded double-digit values.<sup>4</sup>

The global price increases mainly stem from a significant increase in the prices of electricity, oil and some essential products, such as flour, cooking oil, etc. In most cases, such increases were carried over in a chain from suppliers, retailers and service providers to consumers, bringing about numerous price hikes in the market. Such a change is also present in Kosovo, except in the case of electricity, where until now, there has been no price increase for businesses, due to the tariff subsidization by the Government, while electricity tariffs for all citizens have also been partially subsidized.

For a family with a monthly income of 400 Euro, the cost of purchasing the same food products has increased by about 28 Euros or 17% for the period September 2021-September 2022, while transport costs by about 6 Euros or 9%, the means of communication by 2 Euros or 15%, etc.<sup>5</sup> In the most developed economies, forecasts show the inflation rate in 2022 to be around 6.6%, while in developing countries such rate would be around 9.5%.<sup>6</sup>

**Figure 1.** Cost of market basket, with the same commodities in Kosovo, January 2021-September 2022



Source: GAP Institute, using KAS data

<sup>1</sup> United Nations. Global Impact of war in Ukraine on food, energy and finance systems. Source: <https://bit.ly/3S76JqH>

<sup>2</sup> Bloomberg. Source: <https://bit.ly/3fpAHIn>

<sup>3</sup> Reuters. Source: <https://reut.rs/3StHD5j>

<sup>4</sup> Kosovo Agency of Statistics. Source: <https://bit.ly/3Cw09Um>

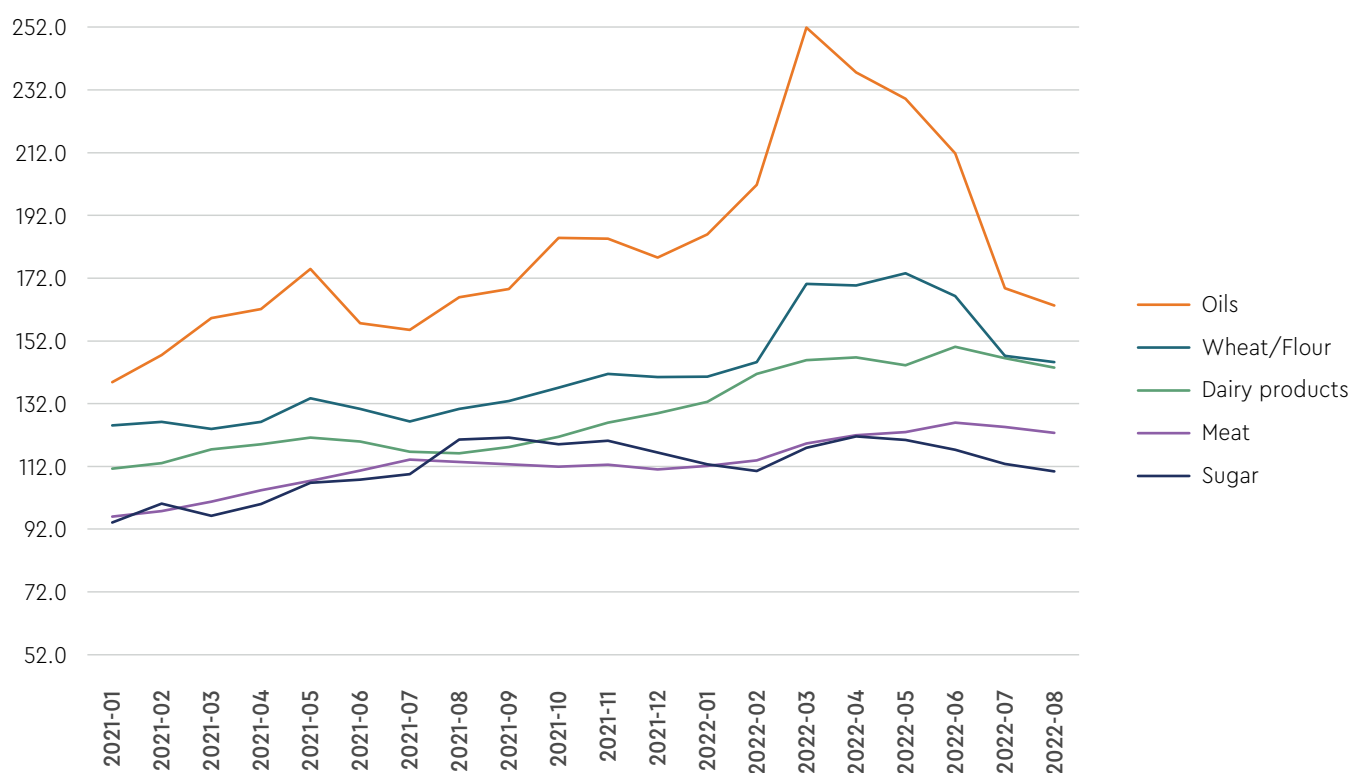
<sup>5</sup> Based on the weight of each category in the basic market basket for each year, based on the data from the Kosovo Statistics Agency (ASK).

<sup>6</sup> IMF. Source: <https://bit.ly/3dxTuAi>

Similar to 2020 and 2021, when a government intervention was sought to assist with economic recovery from the pandemic<sup>7</sup> (and such packages are still in force in Kosovo), governments' intervention has become inevitable again, this time to help overcome the situation with the increasing prices.

Prior to the rapid rise in inflation, there was a debate, initially among economists, whether there could be any inflation after the COVID-19 pandemic<sup>8</sup>, while now the debate mainly revolves around whether inflation will be temporary, whether it may have reached its peak<sup>9</sup>, or whether it will be long term. Currently, the commodities exchange market shows a decreasing trend of prices for many essential products, and their return to 2021 levels. United Nations Food and Agriculture Organization Food Price Index (abbrev: FAO) plummeted for the fifth month in a row.<sup>10</sup> For certain products, such as cooking oils, the drop in August, compared to the month of March, when the price hike was among the highest, is over 35%. However, such a trend is especially more emphasized in countries with developed manufacturing capacities, that are net exporters in one or more of the sectors driving the price crisis.<sup>11</sup>

**Figure 2.** FAO Food Price Index, 2014–2016=100



Source: FAO

Oil prices on the commodities exchange market have also fallen between March and September 2022, especially after the month of July, with a steady decline (see Figure 3). Therefore, as much as it depends on the policies undertaken by the governments, normalization of inflation also depends on the market developments themselves, be it the increase in oil production by OPEC<sup>12</sup>, end of

<sup>7</sup> Relief aid found to have contributed, to some degree, in causing inflation. See: Lawrence H. Summers, for the Washington Post, February 4, 2021. Source: <https://wapo.st/3fbHSmV>

<sup>8</sup> Ibid.

<sup>9</sup> Bloomberg. Source: <https://bloom.bg/3dFUC4V>

<sup>10</sup> Food and Veterinary Agency (abbrev. FAO). Source: <https://bit.ly/3SIWVcf>

<sup>11</sup> Project Syndicate. Source: <https://bit.ly/3DGy52F>

<sup>12</sup> English abbreviation for: Organization of the Petroleum Exporting Countries

the war in Ukraine, increase in the manufacturing of essential products by many countries at once, etc. Therefore, even the state intervention with very large packages, which may last for years and mainly target subsidization of certain categories of beneficiaries of social schemes, may prove itself inadequate. However, it remains unclear what will be the dynamics of oil prices, especially during the winter months, when the demand for heating and electricity is expected to increase significantly. The political aspects may also have a negative effect in this regard, with an observed alliance between Saudi Arabia and Russia, preventing an increase in oil production.<sup>13</sup>

However, there is a wider agreement and it remains crucial that governments change their conduct, by focusing on implementing policies that aim to reduce inflation. A high inflation rate directly affects current and long-term macroeconomic stability. However, there are different approaches in terms of the intervention. On one side there is a group of economists and countries that argue for interventions that make use of instruments affecting all citizens, such as reducing tax rates. Another group mainly focuses on the use of instruments which would drive an increased support for the most vulnerable groups, while a third group, seeks to combine the two.

So far, with direct subsidies, the Government of Kosovo has targeted only the most vulnerable groups, in addition to subsidizing electricity tariffs, which, though progressive, have benefited all consumers. According to the International Monetary Fund (IMF), when it comes to state interventions, the policies put into effect must be implemented in due time, be targeted, and temporary.<sup>14</sup> An additional argument here is that such assistance and relief for vulnerable groups do less to drive aggregate demand compared to tax relief for all citizens or price caps.<sup>15</sup>

Different countries have applied different approaches to controlling inflation. According to an IMF report, out of 130 countries surveyed, about 40 have intervened by lowering tax rates on consumption of electricity and food, 30 countries have set ceiling prices or subsidized them, 20 countries have reduced personal income tax rates, about 17 states have allocated subsidies for specific sectors, meanwhile, a smaller number of states have also allocated food coupons, put bans on the export of strategic goods, etc.<sup>16</sup>

This paper analyzes the downsides and advantages of the practice of price caps, specifically the effects of oil price regulation in Kosovo, the interventions of the Government of Kosovo thus far to combat inflation, the impact of the possible change of some tax rates, as well as it sheds light on some other policies by which the Government would encourage a shift in the electricity consumption for heating to other alternative sources. Since Kosovo does not have monetary instruments to influence the aggregate demand, the focus of this paper remains only providing a comparative overview of the options related to fiscal policies.

13 Financial Times. Source: <https://on.ft.com/3DTJFar>

14 IMF. Source: <https://bit.ly/3qZ0wj0>

15 IMF. Surging Energy Prices in Europe in the Aftermath of the War: How to Support the Vulnerable and Speed up the Transition Away from Fossil Fuels. Source: <https://bit.ly/3BAdZ7u>

16 IMF. Source: <https://bit.ly/3xliMCG>

## 2. Product Price Control

As of March 2022, the Government of Kosovo has imposed various controls on the prices of oil products from time to time. Now, through a Law on temporary measures on essential products in special cases of market destabilization, it aims to expand the market intervention by also controlling the prices of essential products, which experienced a significant price hike in recent months. The Government has adopted this law<sup>17</sup> and tabled it for a vote in the Assembly of Kosovo, without conducting public consultation procedures. Such law passed its first reading in the Assembly on 27 October 2022 and second reading on 8 November 2022.<sup>18</sup>

By this law, the Government of Kosovo intends to intervene, with temporary measures, in major cases, by regulating the quantity allowed for sale to consumers, imposing a ban on the sale of products, imposing a profit margin and consequently allowing the price caps, stipulating commodities exchange levels to be held by operators, banning exports, etc. The cases in which an intervention may be made according to this law include those with a continuous lack of essential products on the market, failure to adjust local prices with significant price fluctuations in the commodities exchange market, major gaps between local prices and those in neighboring countries and other justified cases, through executive decision. The law lists 14 groups of essential products that may be subject to price regulation, including: cereals, wheat flour, bread, rice, pasta, sunflower cooking oil, milk, kitchen salt, chicken eggs, chicken meat, crystalline sugar, personal hygiene products, firewood. However, other similar products as well, may be included through a Government decision.

Regarding the method of estimating the profit margin for operators, the law provides that such calculation should also take into consideration other custom duties costs for goods, in addition to taxation.

The imposition of temporary measures on a series of products is a practice that has been implemented by many countries, and continues to be implemented in some of them. In the 1970s, the US had price caps for all products and wages. In some of the phases of price control implementation, the form of interventions had undergone changes and offered greater flexibility to businesses, compared to the initial stage. Such a comprehensive practice had brought about various damages to the economy, including termination of activities, lack of supply in the market, and soon after the restrictions were lifted, the inflation rate had gone up again.<sup>19</sup> On a more limited scale, Argentina implements such policies on an ongoing basis. From 2007–2015, a series of price control stages were applied in Argentina, including only the most important products of the basic food basket. On 19 October 2021, Argentina fixed the prices of 1,432 products for three months.<sup>20</sup>

Studies show that the effects of price controls were not substantial, whether in terms of full or selective price controls. In the case of Argentina, the impact on price reduction was about 0.84% in the months in which such controls were in force, while the price hike, immediately upon the removal of the measures, was over 4.9 percentage points.<sup>21</sup> According to another finding there was no

17 Government of Kosovo. Source: <https://bit.ly/3SH8uv8>

18 Assembly of Kosovo. Source: <https://bit.ly/3DwkMQJ>

19 Hugh Rockoff et al. Drastic Measures: A History of Wage and Price Controls in the United States.

Source: <https://bit.ly/3EB0QOP>

20 The Economist. Argentina's government has fixed the price of 1,432 products. 30 October 2021.

Source: <https://econ.st/3fT1RYQ>

21 Aparicio dhe Cavallo. Targeted price controls on supermarket products. Source: <https://bit.ly/3LKSKoh>

shortage in the supply of price-controlled products, except in one case, in which the government had imposed a full freeze on all consumption prices. Also, in periods of price controls, businesses increased the number of similar products on the market which were not subject to price controls, whose price they increased and tended to market them as products of better quality compared to those with controlled prices.

Kosovo has initiated such a price control measure for oil products, initially by a decision in force in the period 3 March – 31 May 2022, and which provided that the highest margin for oil wholesalers would be 4%, while for those retail ones, 6%. However, as of 27 June, the Government implemented an Administrative Instruction (AI1) that provided a more adequate monitoring of the compliance of oil suppliers and sellers, establishing a rule according to which the maximum profit cap of wholesalers was two cents, while for retailers, 12 Euro cents.<sup>22</sup> Similarly, by the end of August 2022, the Government issued a second Administrative Instruction (AI2) in a row, which set the same limits as the first one, and the same has been in force since 1 September.<sup>23</sup>

Between the periods when the Government had put in place greater regulations and monitoring of the prices of oil products, there were several periods during which the market was unregulated. Below we have analyzed the developments in oil products during the profit margin control period, since the same constitutes about 85% of the consumed amount of oil products per year in Kosovo.

**Table 1.** Decisions and Administrative Instructions in force

Period	Profit margin
3 March – 31 May	4% wholesale, 6% retail
25 June – 25 July – Administrative Instruction 1, effective implementation: 27 June – 24 July	2 Eurocent wholesale, 12 Eurocent retail
30 August – Administrative Instruction 2, effective implementation: from 1 September	2 Eurocent wholesale, 12 Eurocent retail

At the time when only the Government's decision was in force, capping the profit margin of oil wholesale sellers<sup>24</sup> to 4%, while that of retail to 6% (1 March – 31 May 2022), for the period covered by Kosovo Statistics Agency data, a synchronized movement is observed, without any expressed differences between the oil prices in the commodities exchange market and those in Kosovo. The findings of this paper show that both prices have moved in the same direction, in this case when one increased/decreased the other also increased/decreased, and that the relationship between the two variables was strong.<sup>25 26</sup>

<sup>22</sup> Office of the Prime Minister of Kosovo. AI on Price Regulation of Petroleum Products and Renewable Fuels and Other Protective Measures. Source: <https://bit.ly/3qZd6As>

<sup>23</sup> Koha.net. Source: <https://bit.ly/3Uqngrz>

<sup>24</sup> The main oil importers/suppliers in Kosovo are also among the main retailers.

<sup>25</sup> The correlation coefficient between the data sets for this period is 0.79. A correlation figure of 1 would indicate a very strong and completely positive relationship between the two variables. Even the use of lagged values for one or several days for the variable of retail prices, since and methodology for setting the price was not so strict in this monitoring period, does not produce very different results.

<sup>26</sup> The same outcome is confirmed by the t-test, the output of which shows that the hypothesis holds that the change in daily oil prices in the stock market and in Kosovo in this period differ.

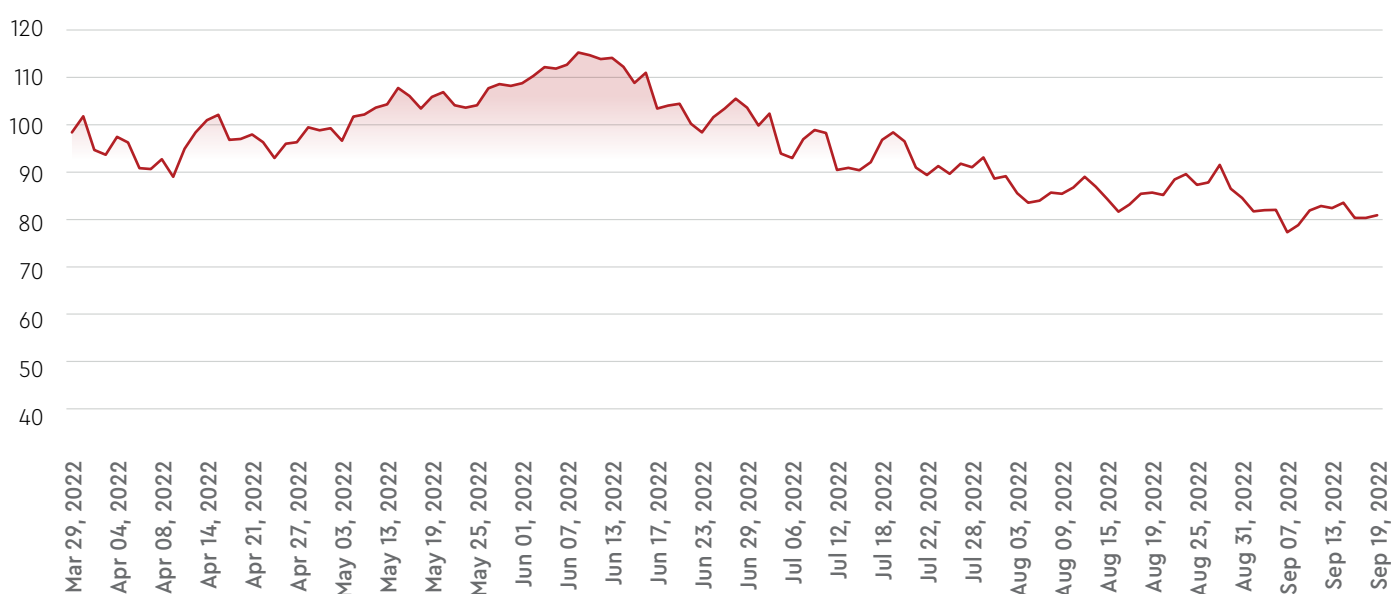


However, the data of the Kosovo Customs show that the average profit margin<sup>27</sup> of around 10.3% achieved in this period, if one compares the import price with the retail price, turns out to be higher than the limit of 6%. The reason for this is the chosen method of implementing this policy, with no strict monitoring, and it was impossible for citizens to know and report if the sale prices were not in accordance with the Government decision. Consequently, the oil companies had room to exceed the allowed profit margin rate.

Even with the entry into force of AI1, which introduced the monitoring and reporting mechanisms for the observance of the rules set forth by it, a synchronized movement of prices may be observed, but also a closer following of the stipulated margin rate. While AI1 was in force, the ceiling price of oil products was published daily to the public, and was valid at the country level. This made monitoring easier as citizens and the media could report on cases when a business went over the ceiling price set for that day. Developments in the commodities exchange market, especially between 27 June and 24 July, were characterized by a significant drop in prices, also causing the retail prices in Kosovo to fall.

An error that may be made in the interpretation of prices during this period is precisely the inference that oil prices in Kosovo have dropped significantly due to the Administrative Instruction (AI1). Based on the developments in the oil market in Kosovo in 2022, it seems that the direct impact of Administrative Instruction AI1 on the reduction of oil prices was about 6 cents per liter.<sup>28</sup> Between January-February, when there was no price ceiling, the oil companies made a profit margin of 18 cents per liter, which was lower than the margin made throughout 2021; which may be a response of oil importers, in order not to increase significantly the final retail price. The decline in oil prices in Kosovo for up to 22 cents per liter during the implementation of AI1 coincided with a steady drop in oil prices on the commodities exchange market, as seen in the figure below.

**Figure 3.** Oil index on the commodities exchange market (28 March = 100)

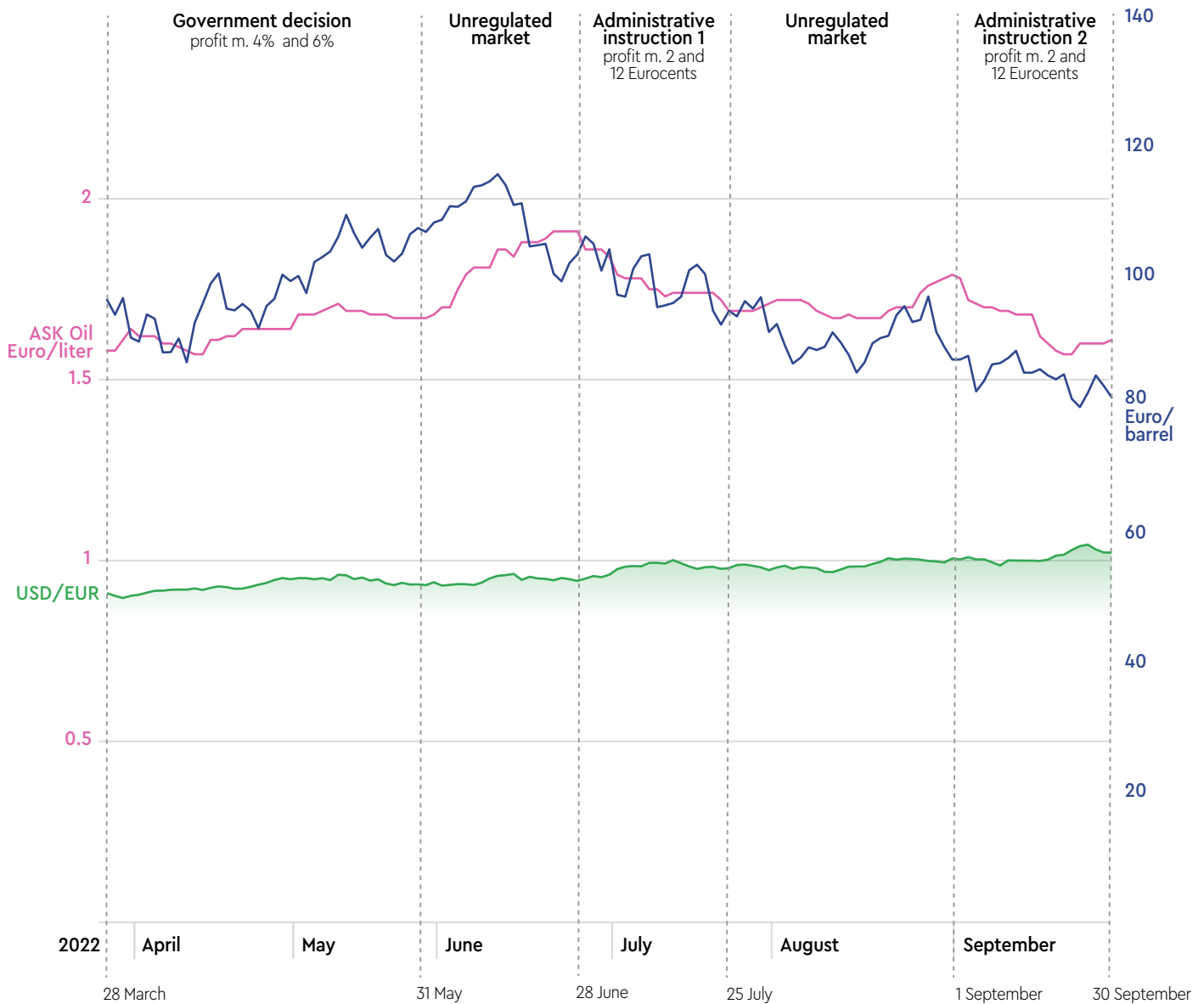


<sup>27</sup> The method of calculating the margin in this case includes the difference between the average retail price and the supply price, based on the data of the Kosovo Customs. The value of goods presented by the Kosovo Customs includes the cost of transportation, as the largest cost, so the margin calculated in this form only fails to include other expenses of oil importers for customs clearance or any administrative expenses. As such, the difference between the retail and the supply price, that includes the value of the goods, the cost of transport, tax duties (customs and excise) is a very approximate indicator of the actual profit margin.

<sup>28</sup> Usually the comparisons in this report are made with retailers' margin and not the supply margin, since the main importers in Kosovo also operate the key retail points.

However, a more in-depth market monitoring by the institutions, made the price fluctuations in the commodities exchange market to be reflected much faster in our market, as showcased by the correlation coefficient between domestic and international oil prices.<sup>29 30</sup>

**Figure 4.** Fluctuation of retail oil prices in Kosovo and crude oil on the commodities exchange market, 28 March – 19 September 2022



Source: GAP Institute, using KAS data and Yahoo

Also, the findings show that by the end of the implementation period of the Government's decision, the average profit margin had risen from 16 to 18 cents per liter. Similarly, upon the expiry of the AI<sub>1</sub>, the profit margin had risen from 15 to 18 cents per liter. Even the correlation between oil prices on the commodities exchange market and in Kosovo, in unregulated periods, turns out to be negative or very low. Thus, in any period when there was no price control regulation in place, the tendency was for the profit margin to rise immediately.

— USD/EUR (left)  
— ASK oil (left)  
— Oil (right)

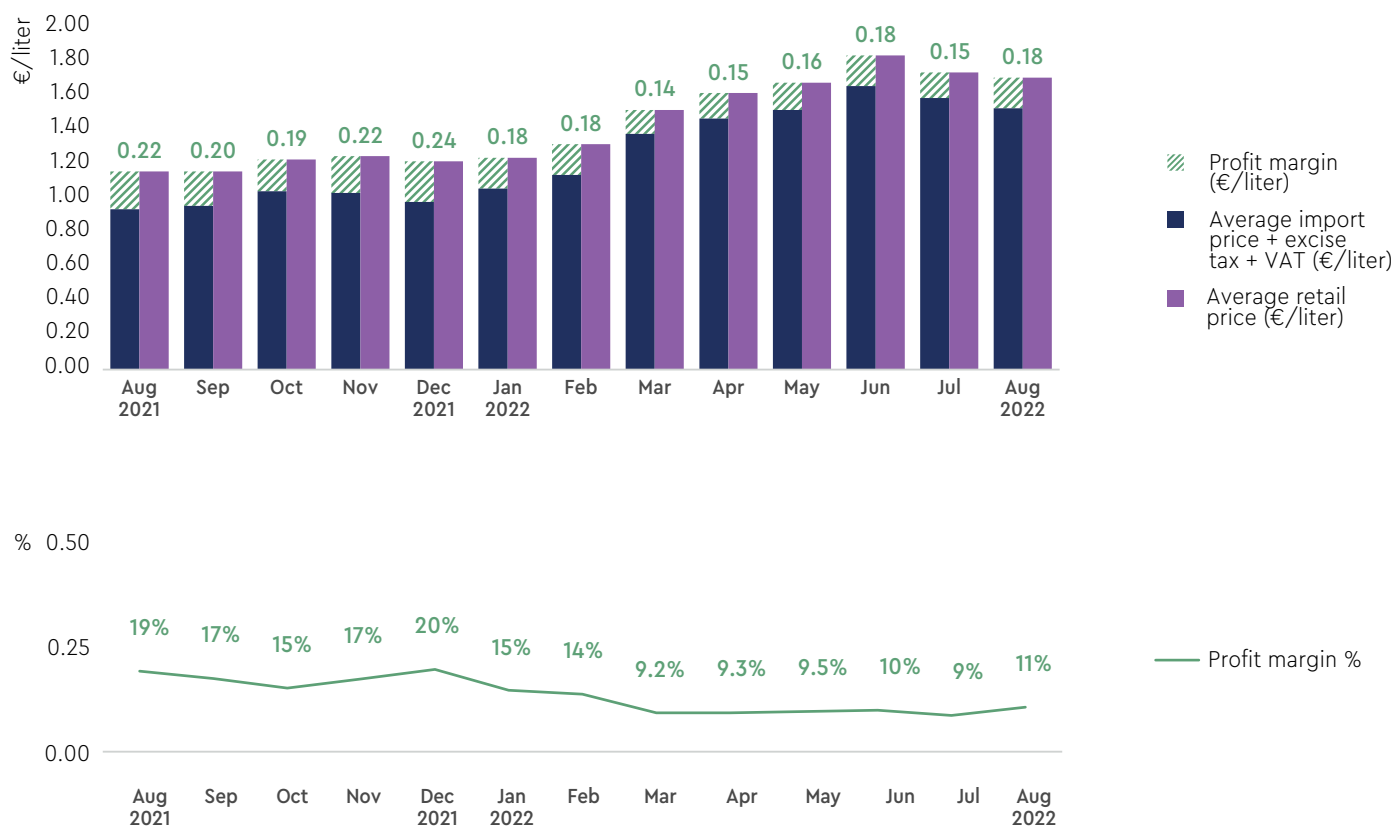
<sup>29</sup> The correlation coefficient in this case was 0.67, although for this measurement, there was a smaller number of observations available, compared to the period of the price controls decision.

<sup>30</sup> Similarly, the t-test, presented in Table 10 in the complaint, shows that it cannot be proven statistically that the fluctuations in the daily prices of oil in the stock market and those in Kosovo differ.

Another finding, similar to the case of Argentina, when targeted price controls were imposed, was that there was no record of lack of supply of oil products in Kosovo.

In addition, during this period oil prices in Kosovo were negatively impacted by the devaluation of Euro against the US dollar, by over 10%, since oil is quoted in dollars. Therefore, this aggravated the situation even more, as such a sudden increase is a major blow to the cost part of the product and directly affects the final price etc.

**Figure 5.** Average profit margin of oil suppliers



Source: GAP Institute, using KAS and Kosovo Customs data

As a practice in Kosovo, the use of ceilings on oil prices has mainly brought the effect of reducing the price to the level of the ceiling margin, as stipulated by the adopted rules. The increase in the number of products with controlled prices, including other products from the basic consumption basket, is expected to have the same developments. The negative effect of such measures is largely influenced by their time period of application, namely how long the Government intends to use it as an instrument, as well as the duration of inflation. The price caps on essential food products and oil in Kosovo affect a market which in 2021 had a turnover of over 1.1 billion Euros, or about 15% of the Gross Annual Product of that year.<sup>31</sup> As pressure on the cost side increases, especially for small businesses with a stipulated profit margin, price controls may cause some businesses to wind down. Similarly, upon the imposition of price controls in other countries, trends have been observed to decrease the quality of products with capped prices, a drastic decrease in manufacturing when profits are low, but such sectors may be rather important sectors for the economy, as is the case with the decline of meat production in America in the 70s etc.<sup>32</sup>

<sup>31</sup> Calculation of the GAP Institute, from the open data of the Kosovo Customs.

<sup>32</sup> Hugh Rockoff et al. Drastic Measures: A History of Wage and Price Controls in the United States.

Source: <https://bit.ly/3EB0QOP>

In some countries, such as France, Australia, Great Britain, etc., in order to preempt the possibility of state intervention, either in prices or by increasing tax rates, but also in order to help citizens, practices have been observed according to which larger supermarket chains have voluntarily set ceiling prices for hundreds of essential products, or the best-selling products, in various months. Similarly, they also make efforts to reduce prices for many products, thereby affecting their own profit margin.<sup>33</sup>

### 3. Kosovo Government Interventions to Combat Inflation

In order to mitigate the effects of inflation, the Government of Kosovo has intervened with two larger packages, mainly targeting the families and citizens most affected by the crisis. The Government's first package was worth 100 million Euros. Its main measures provided for one-off payment of 100 Euros to all private and public sector employees with gross monthly salaries of up to 1,000 Euros, 100 Euros for students and pensioners, double social assistance payments for the month of April, as well as a distribution of food packages. Social assistance payments were doubled earlier for the months of November and December 2021, precisely due to the increase in the cost of living.<sup>34</sup> In addition to this package, a considerable increase was made also in subsidies for key agricultural crops, which are also among the main sources of the current global price crisis, as well as the oil subsidies for farmers at the amount of 36 cents per liter.<sup>35</sup>

This September, the Government presented a second counter-inflation package, with a target value of 150 million. This package foresaw one-off allocation of 100 Euros to pensioners, 100 Euros to students for the month of November, and double social assistance payments for one month. Meanwhile, a monthly allowance of 50 Euros is allocated to public sector employees until the end of the year, and a one-off supplement of 100 Euros for employees of public enterprises. For private sector employees, the Government undertakes to cover a subsidy of salary increases in the first three months, for up to 50%, or a maximum of 100 Euros.<sup>36</sup> However, this amount also includes measures to encourage electricity savings and compensation for the inflation rates, within the public sector capital projects.

#### — 3.1 Government Measures for Electricity

There are also some additional measures taken by the Government to prevent major hikes in electricity prices, and the share of the energy component in citizens' expenses. Initially, in February of this year, the Government pledged 90 million Euros in subsidies for electricity tariffs, so that they would not change for businesses, while the price increase for households would be phased, while certain levels of consumption, had no increase in tariffs, even for this category. The government also allocated around 30 million Euros to the Kosovo Electricity Corporation (KEK) to import electricity.<sup>37</sup>

Also, in September 2022, the Government of Kosovo rendered a decision aiming to reduce energy costs in public institutions, requiring a lower utilization

<sup>33</sup> Reuters and Retail Wire. Source: <https://reut.rs/3S94JOW> and <https://bit.ly/3S8EKac>

<sup>34</sup> Office of the Prime Minister of Kosovo. Source: <https://bit.ly/3yIu7sV>

<sup>35</sup> Kallxo.com. Source: <https://bit.ly/3MkeNlN>

<sup>36</sup> Office of the Prime Minister of Kosovo. Source: <https://bit.ly/3Cf1bUi>

<sup>37</sup> Kallxo.com. Source: <https://bit.ly/3V8o2cl>

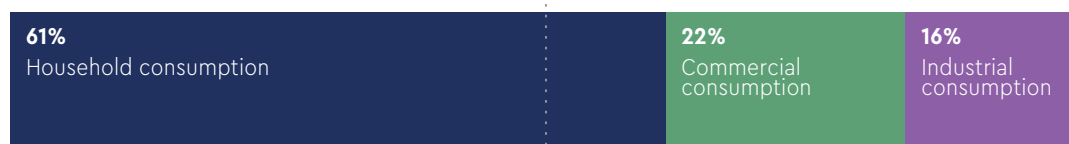
of air conditioners, replacement of inefficient light bulbs with efficient ones, heating of premises during the winter at a maximum of 19 degrees etc.<sup>38</sup> Similar decisions would have been appropriate much earlier also for the private sector, with higher electricity consumption, as done in various countries in Europe, including the time schedules in which company signs and ads may be kept on.

Within the framework of the second counter-inflation package, a subsidy of 20% of electricity bills was foreseen, in case the consumption for that month decreased by 10% compared to the previous year.<sup>39</sup> Meanwhile, in September this year, the Government also rendered a decision on a temporary ban on export and re-export of wood products as fuel.<sup>40</sup>

On 6 October 2022, the Ministry of Economy (ME) introduced a measure amounting to 6 million Euros, under which citizens would be subsidized to purchase efficient appliances, such as heat pumps, but also other appliances operating with other inputs, including pellet, wood and briquette.<sup>41</sup> This public call was closed only six days later, as the ME informed that 5.992 potential beneficiaries had applied within this period, and the allocated budget would not suffice for other applicants.<sup>42</sup> Considering that the residential sector in Kosovo, consumes over 61% of the electricity consumed during the year<sup>43</sup>, such an amount is insufficient to significantly affect consumption, and the exclusion of support for home insulation makes the effect of this measure even more limited.

In recent years, due to low electricity prices, many families have resorted to using electricity as the only source for heating. In addition, only 17% of houses in Kosovo, are estimated to have adequate wall and roof insulation.<sup>44</sup> Therefore, this sector has the greatest potential for electricity saving. This is confirmed by the fact that the peak time of electricity consumption is at night, when the manufacturing sectors are almost completely closed.

**Figure 6.** Electricity demand from the total electricity billed



Source: GAP Institute, using ERO data

In crises like this, with the increase in the electricity prices and in some essential products, country interventions have strived to target the source of the crisis. This is mainly related to the increase of domestic production capacities, such as electricity, but also other basic food products. Through a package aimed to reduce inflation, United States of America, are subsidizing use of renewable energy sources, either through installation of solar panels by families and businesses, the installation of heat pumps, installation of 120 thousand wind turbines, etc.<sup>45</sup>

Major challenges are expected ahead of the winter in terms of electricity supply in Kosovo. The consumption charts during winter in Kosovo significantly

38 Government of Kosovo. Decision no. 28/96. Source: <https://bit.ly/3qYo3Cp>

39 Office of the Prime Minister of Kosovo. Source: <https://bit.ly/3Cf1bUi>

40 Government of Kosovo. Decision no. 06/97. Source: <https://bit.ly/3BXOUFO>

41 Ministry of Economy. Source: <https://bit.ly/3e9Dfd0>

42 ME official Facebook page, October 12, 2022. Source: <https://bit.ly/3yAZwYe>

43 Energy Regulatory Office. Annual Report 2021. Source: <https://bit.ly/3qZGQxe>

44 RIT Center for Energy and Natural Resources. Energy consumption and Potentials for Energy Efficiency

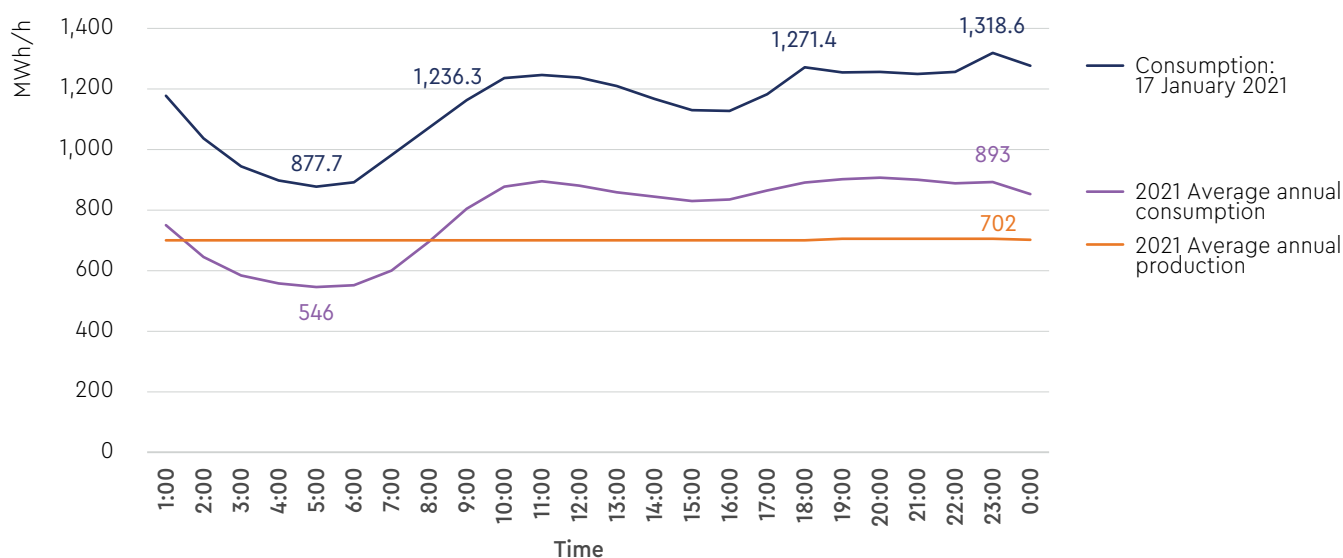
Implementation: Analyzing Low Income, Low Service Areas of Kosovo – Final Report. Source: <https://bit.ly/3MEmi6y>

45 The White House. Source: <https://bit.ly/3COLX6s>

differ from the annual average, where consumption remains high, primarily throughout the day (see Figure 7). The major discrepancy between electricity consumption and generation during the winter will render it very difficult to cover the total consumption. Differences of up to 600 MWh/h between the demand for consumption and generation, for periods of more than eight hours during the day, are almost unattainable to import, considering the enormous prices of electricity in the markets, where in some cases, futures and forwards have reached up to 1,050 Euros/MWh.<sup>46</sup>

On the other hand, when it comes to subsidizing energy prices one of the issues relates to the fact that they artificially maintain high consumption rates.<sup>47</sup> Despite a positive effect of the progressive nature of tariffs in reducing consumption, the threshold of up to 800 kWh for households has not undergone changes in tariffs, and it remains very high, as during the winter, only 31% of households spend over 600 kWh per month.<sup>48</sup> In addition to finding opportunities to substitute electricity consumption and in addition to the incentives of the Government to save electricity, similar to other countries, the increase in consumption and high import prices will bring about the pressure to increase electricity tariffs. If this happens, then one effect of such new tariffs would also entail reduction of electricity consumption.

**Figure 7.** Electricity consumption and generation in Kosovo, hourly, 2021



Source: GAP Institute, using KOSTT data

In addition to addressing the short-term issues caused by high inflation, the Government should also aim to address the internal causes of such a high inflation rate. It has been stated above that the countries with greater domestic generation capacities are experiencing lower inflation rates. At this point, government policies for the development of industries and domestic production are very important, since at this point, inflation in Kosovo reaches a very high point of imported inflation. Similarly, in the area of energy, it is important to take strategic steps to increase energy generation capacities, and prioritize investments in energy efficiency, especially in the household sector, where energy losses due to poor insulation of houses are abundant. Nevertheless, Kosovo has not taken any major initiatives in this regard, and it has yet to adopt the new Energy Strategy 2022–2031.

<sup>46</sup> Reuters. Source: <https://reut.rs/3LwKyrD>

<sup>47</sup> IMF. Source: <https://bit.ly/3R89fvG>

<sup>48</sup> ERO. Consultative report: Review of the tariff structure for regulated household consumers served under USS. Source: <https://bit.ly/3Mip95H>

### 3.2 Another (Additional) Option: Reduction of VAT Rate, Excise Duty and Subsidies

What can often be heard in the public debate in Kosovo, is that apart from the Government interventions so far, which have been mainly through subsidies, tax reliefs should also be designed. In some cases, some political parties have found adequate intervention through tax breaks and more inclusive policies.<sup>49</sup>

Undertaking such alternative policies which would include tax relief in energy and food products would bear additional budgetary costs of around 246 million Euros in six months, or around 455 million Euros per year. If such an intervention would only last for a period of six months, it would result in a cost of approximately 7.7% of the annual expenditures of the Government during 2022, or around 8.3% of the annual expenditures of the projected budget for the year 2023; in this case, such measures would be implemented as of next year.

**Table 2.** Budgetary impact of some tax relief measures

	Budgetary cost for a six month period	Budgetary cost for one year
Cutting VAT rate in half and suspending the excise duty on oil, gasoline and gas	150–170 million Euros	320 million Euros
VAT exemption on pellet	600–700 thousand Euros	1.2 million Euros
VAT exemption on electricity bills	25–35 million Euros	58 million Euros
VAT and customs tax exemption for imported food products	Min. 30–40 million Euros	75 million Euros
<b>Total budget impact</b>	<b>205–246 million Euros</b>	<b>455 million Euros</b>

Source: Estimates of the GAP Institute, based on the budget revenues structure for these categories, throughout 2021

In terms of using tax rates as instruments to mitigate price increases, the most frequent cases implemented by European countries appear to be those of rate reductions for electricity and oil products used for heating. This is due to the fact that in many countries, gas is the main source of heating and, to a lesser extent, electricity. Meanwhile, it is the opposite in Kosovo, especially in recent years, where due to low electricity tariffs, the use of electricity for heating has increased drastically. Government intervention in the electricity sector, in this period, is considered to be decisive, taking into account the indirect impacts of this product. Most of the states that have lowered tax rates on energy products have done so for a specific period of time, usually for a period of 6 to 9 months. Germany reduced the VAT on gas from 19% to 7%; Slovenia has reduced the VAT on gas, electricity and heating fuel from 22% to 5%; Belgium lowered VAT on electricity, gas and heating from 21 to 6%; Spain had VAT reduction for domestically generated electricity from 21 to 10%; Turkey lowered VAT on domestically produced electricity from 18 to 8%, etc. (see Table 1 in the Annex). In the case of Kosovo, the Government has chosen the direct subsidization of electricity tariffs, allocating around 90 million Euros from the budget. This has resulted in the lower rate increase than the price dynamics in this sector. Specifically, the subsidization resulted in no increase in tariffs for businesses at all, which to some extent has also influenced a lower trend in the price increase of other products in the market. Similarly, tariffs for domestic consumers were partially subsidized.

<sup>49</sup> Koha.net. PDK with five proposals for exiting the economic crisis. Source: <https://bit.ly/3SVI0aI>. Avdullah Hoti, MP from LDK. Source: <https://bit.ly/3SSDE2G>



Countries such as Germany and Great Britain have also directly subsidized citizens with lump-sum amounts. Germany has allocated 300 Euros to students and pensioners, while Great Britain is giving each family a discount on electricity bills at the amount of 400 pounds.<sup>50</sup>

From approximately 2.2 billion in budget revenues it had in 2021, not including other budget receipts from loans, Kosovo collects around 1 billion Euros or 48% of revenues from VAT, and around 500 million Euros or 23% from excise duty. Meanwhile, due to the increase in inflation, the performance of budget revenues is much better this year. Only between January and August 2022, VAT revenues reached 75% of the total VAT collected in 2021, while the amount collected in corporate income tax was exceeded by 8%, around 67% of the excise tax, etc.<sup>51</sup>

### 3.3 Proposed Tax Breaks for Oil and Energy Products

In many European countries, gas turns out to be the main source of heating. Also, unlike Kosovo, where the excise rate of 15 cents per liter has an impact on the price almost similar to the 18% VAT rate, in some European countries such as Germany, Luxembourg, Belgium, etc., the excise rate for gas used for heating (below 7 cents per liter) turns out to be much lower than the VAT rate. Therefore, even the removal of VAT on gas in these countries, which is being observed as a practice this year, provides a greater impact. As for the gas imported into Kosovo, according to the legislation in force, the gas used for manufacturing is exempt from excise duty, while gas for heating and cooking is not. Based on Kosovo Customs data, in terms of gas imported during 2021, excise duty was paid for around 21 million cubic meters, amounting to around 3.2 million Euros, and around 2.9 million Euros were paid in the form of VAT. Temporary tax exemptions in relation to gas would have a positive impact as they would relieve, to some extent, the demand for energy, specifically for cooking and for heating. This measure would not have a high budgetary impact.

However, in terms of tax exemptions for other oil products, the budgetary impact would be very high. Specifically, for products such as oil and gasoline, in 2021, Kosovo's revenues from VAT reached around 112 million Euros, while from excise duty around 283 million Euros. In total, the revenues from these two categories reached over 395 million Euros, or about 18.1% of Kosovo's budget revenues for that year. If the VAT rate on oil products were to decrease from 18 to 8%, and the excise duty on oil would be suspended, this would have an impact on budget revenues of around 150–170 million Euros in six months, or around 300–320 million Euros per year.

**Table 3.** Amount of tax dues paid for oil products, 2021

2021	Quantity	Value of Goods	Excise Duty	VAT tax
Oil	728,616,744	€ 320,461,969	€ 251,651,166	€ 100,952,532
Gasoline	81,438,918	€ 37,123,767	€ 31,129,135	€ 12,239,506
Gas	49,928,215	€ 14,226,317	€ 3,187,588	€ 3,130,783
Total	859,983,877	€ 371,812,053	€ 285,967,889	€ 116,322,822

Source: GAP Institute, using Kosovo Customs data

Also, the Government took a decision on the temporary ban on the export and re-export of wood products as fuel, with the main goal of banning the export of

<sup>50</sup> Government of the United Kingdom. Source: <https://bit.ly/3Snk51H>

<sup>51</sup> Ministry of Finance, Labor and Transfers (MFPT). Time series. Source: <https://bit.ly/3sFK75K>



pellet fuel.<sup>52</sup> Based on Kosovo Customs data for 2021, if the Government were to encourage a group of citizens to move away from the consumption of electricity for heating to the use of pellet, the impact on the Government's revenues from VAT, since excise duty is not applied, would amount to approximately 600 thousand Euros in six months or around 1.2 million Euros per year. However, such a policy would only be effective if the reduction in excise duty and/or VAT would not reflect directly on the sales price.

**Table 4.** Amount of tax dues paid – pellet fuel for heating and cooking, 2021

	Value of Goods	Net weight	Excise Duty	VAT tax
Pellet	€ 6,426,500.48	47,552,734.00	€ 0.00	€ 1,156,770.28

Source: GAP Institute, using Kosovo Customs data

Similarly, there have been proposals for VAT exemption on energy bills. Out of the revenues allowed for KESCO, that charges the end consumers, based on the revenues allowed, the amount paid by citizens in the form of VAT on electricity bills per year tends to reach around 58 million Euros. Out of all the countries in Europe that have introduced VAT reliefs, most of them applied a 50 to 75% reduction of the current rates. In a similar case, the budgetary impact of the reduction of VAT in electricity bills in Kosovo from 8% to 0% for one year would therefore amount to approximately 25–35 million Euros in six months, or around 58 million Euros per year.

### 3.4 Proposed Tax Breaks for Food Products

Additionally, when it comes to importing the food products<sup>53</sup>, throughout 2021 Kosovo collected about 104 million Euros in VAT, and about 18 million Euros in customs tax. Any intervention in reducing the rates in these categories, if the VAT rates are cut in half from 18 to 8% or 8 to 0%, as well as if the customs tax is removed, could have a budget impact of at least 30–40 million Euros in six months or about 75 million Euros per year.

**Table 5.** Amount of tax dues paid for food products, 2021

2021	Quantity	Value of Goods	Customs Duty	Excise Duty	VAT
HS Code 01-21	12,492,529	€ 738,913,379	€ 17,791,346	€ 0	€ 104,333,347

Source: GAP Institute, using Kosovo Customs data

If the above listed tax exemptions would be applied, their budget impact would amount to around 225–266 million Euros for six months, in case the decision was temporary as in other countries, or around 480 million Euros per year. However, such wide practices, that do not target vulnerable groups, increase consumption artificially. Consequently, the aid effect also decreases.

In addition, during this period, an increase in the minimum wage was also suggested<sup>54</sup>, which though proposed by the Government as an adequate policy in this period of inflation, has not yet passed the second reading in the Assembly. A proposal was also made to allow the withdrawal of funds from the Pension Trust.<sup>55</sup>

<sup>52</sup> Government of Kosovo. Decision no. 06/97. Source: <https://bit.ly/3BXOUFO>

<sup>53</sup> The main food products in the nomenclature of the Integrated Tariffs of Kosovo (TARIK) are classified in codes 01 to 21.

<sup>54</sup> Avdullah Hoti. Former prime minister and current member of the Assembly of Kosovo from the ranks of the Democratic League of Kosovo. Source: <https://bit.ly/3SSDE2G>

<sup>55</sup> Koha.net. PDK with five proposals to exit the economic crisis. Source: <https://bit.ly/3SVl0aI>

## Conclusion

The significant increase in prices is weighing down on the well-being of families in Kosovo. In the coming months, the supply of electricity will be challenging for Kosovo, taking into account the insufficient generation capacities of Kosovo and the high import prices. When it comes to the created situation, the Government of Kosovo has undertaken several measures, by intervening through financial packages, which are mainly intended to help those citizens affected the most by the crisis, or even with other measures intended to encourage electricity savings. Simultaneously, the Government has intervened initially by capping the prices of oil products, by establishing ceiling profit margins for oil sellers, and now, it also proposed a law to regulate a larger number of basic basket products.

The practices of other countries with controlled oil prices, including the case of Kosovo, show that the effect of price controls is limited only to the period when the Government's rules for price control are in force. Meanwhile, using price caps as an instrument to reduce inflation has shown to be ineffective, since upon removal of such caps, prices tend to rise promptly. However, in the event that inflation is structural in the economy and does endure, such policies may hurt the regulated sectors, either by influencing the reduction of manufacturing, business closures, the decline in the quality of products, etc. Therefore, although the price controls will be temporary, it is important for the Government to engage in continuous analyses on the potential damages caused by price controls in the affected sectors. In addition, there is another risk with price controls, that market demand remains artificially high due to cheaper prices, versus that of a free and unrestricted market, in which prices are automatically adjusted by the level of market demand and supply. In addition to the Government's current measures to help the citizens most affected by high inflation, it is appropriate to adopt the new minimum wage rate, which would affect approximately 106,000 private sector employees. At the same time, the Government must design and implement sustainable policies to increase domestic manufacturing in order to reduce dependence on import, and thereby exposure to imported inflation.

In addition to the decision of the Ministry of Economy to save electricity in the public sector and to encourage households to save electricity, the Government should take decisions to save electricity in the private sector as well, following the good practices of other countries. The government should continue to allocate funds for initiatives that support the improved efficiency in energy consumption in homes, knowing that over 61% of the electricity billed during the year was consumed by families (households). The lack of such programs from 2021, that signaled a deteriorating electricity situation in 2022, made Kosovo fail to properly target one of the main causes of high electricity consumption during the winter. Moreover, taking into account the importance for the displacement of the heating sources and the small budgetary impact, the Government should consider tax relief in gas and pellet, the prices of which are expected to be controlled with the new law, which also renders the tax exemption easily effective. Similarly, the Government should strive to address the source of the crisis, which in the field of energy means building new generation capacities. A step in this direction would include the adoption and implementation of the new Energy Strategy 2022–2031.

# Annex

**Table 1.** State intervention through tax rates to relieve the increase in the cost of living for citizens

Country	Description	Old rate	Current rate	Time of application
Germany	VAT lowered on gas	19%	7%	From 1 October 2022 to 31 March 2024
Luxembourg	VAT reduction on oil used for agricultural and horticultural work, as well as for industrial oil:  VAT lowered for fuel	17%	14%	6 May 2022 – end of July 2022
Slovenia	VAT reduction on gas, electricity and heating fuel bills	22%	5%	Confirmed from 1 September 2022 to 31 May 2023
Cyprus	Zero-rate VAT on gasoline, energy and electricity	19%	0%	14 July 2022 until the end of the year
Belgium	VAT reduction on electricity, gas and heating	21%	6%	Initially from 1 April to 30 June 2022, then a new decision extended the period from 1 July to 31 December 2022;  Initially from 1 April to 30 September 2022, then a new decision extended the period until 31 December 2022.
Spain	Temporary VAT reduction for domestically produced electricity	21%	10%	Initially from June to 31 December 2021, then extended for the first time until April 2022, only to be extended again until June 2022
Estonia	VAT reduction for gasoline, diesel and gas for heating	20%	5%	From 30 April 2022 – xxxx
Netherlands	VAT reduction on energy (natural gas, electricity and central heating)	21%	9%	1 July 2022 – 31 December 2022
Italy	VAT reduction on natural gas	10%	5%	Initially October – December 2021, then with a second decision, extended until December 31, 2022
Ireland	VAT reduction for gas and energy bills	13.50%	9%	1 May 2022 – 31 October 2022
Poland	VAT reduction on coal, heating oil, diesel fuel and LPG gas for heating	23%	8%	1 February 2022 – 31 July 2022
North Macedonia	1. VAT reduction on basic food 2. VAT reduction on fuels 3. VAT reduction on electricity	1. 5% 2. 18% 3. 18%	1. 0% 2. 10% 3. 5% ; 10%	1. From 17 March to 31 May 2022; 2. From 12 March to 31 May 2022; 3. 5% until 31 December, then 10% for the first half of 2023, to return to the standard rate again.

Country	Description	Old rate	Current rate	Time of application
Romania	VAT reduction on domestic heating energy	19%	5%	Valid between November 2021 and March 2022
Turkey	VAT reduction on domestically generated electricity	18%	8%	28 February 2022- xx

Source: VAT calc (<https://bit.ly/3QP9HzF>)

**Table 2.** Correlation between oil prices in the commodities exchange market and those in Kosovo

Period and measures	Measures	Correlation
3 March – 31 May	Government Decision	0.79
1 June – 24 June	Unregulated	-0.43
27 June – 24 July	AI 1	0.67
25 July – 31 August	Unregulated	0.18
As of 1 September	AI 2	0.62

**Table 3.** Main categories of budget revenues, 2019-August 2022

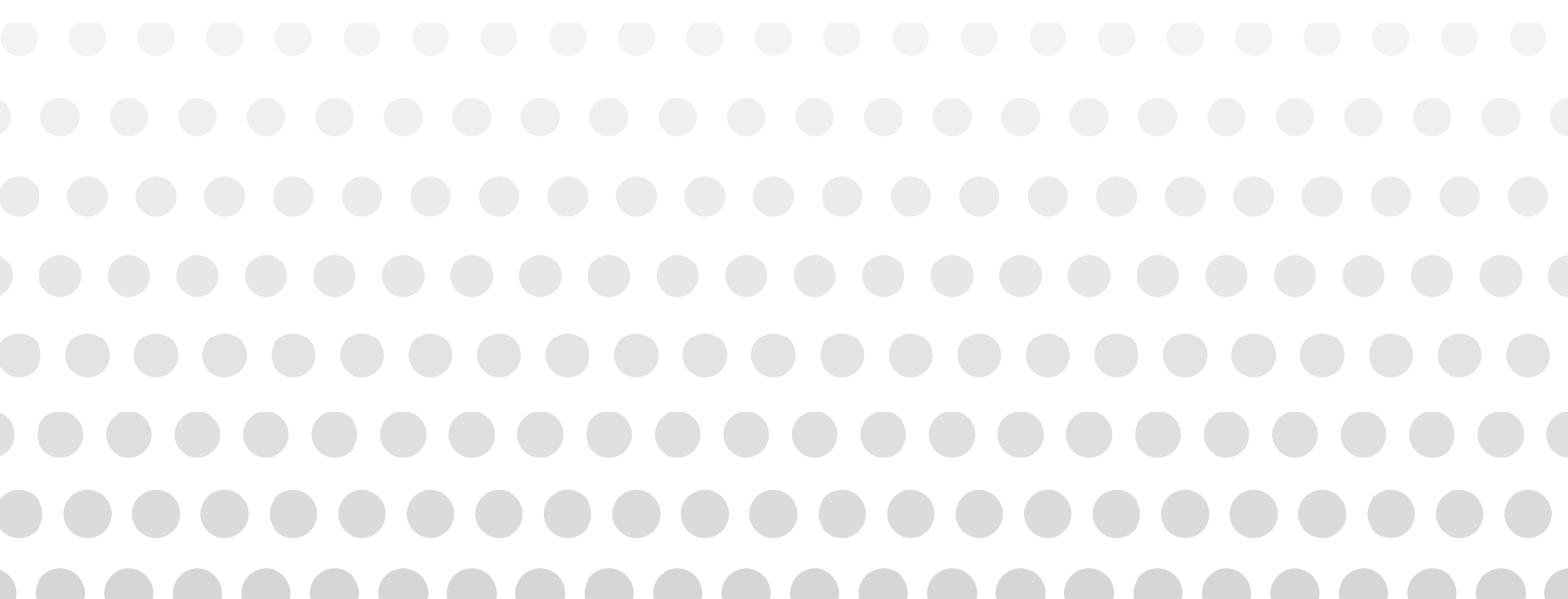
	2019	In %	2020	In %	2021	In %	January – August 2022	In %	Jan-August 2022/2021, in %
VAT	€ 845.647	44.8%	€ 770.145	44.7%	€ 1,038,218	47.5%	€ 782.521	48.1%	75%
Excise tax	€ 435.496	23.1%	€ 398.072	23.1%	€ 501.295	23.0%	€ 335.242	20.6%	67%
Personal Income Tax	€ 165.616	8.8%	€ 157.966	9.2%	€ 189.521	8.7%	€ 141.775	7.6%	75%
Corporate Income Tax	€ 94.593	5.0%	€ 85.279	5.0%	€ 113.946	5.2%	€ 123.555	8.7%	108%
Customs Duties	€ 130.325	6.9%	€ 101.618	5.9%	€ 124.606	5.7%	€ 83.595	5.1%	67%
Property Tax	€ 27.277	1.4%	€ 22.707	1.3%	€ 36.258	1.7%	€ 24.616	1.5%	68%

Source: GAP Institute, using MFLT data

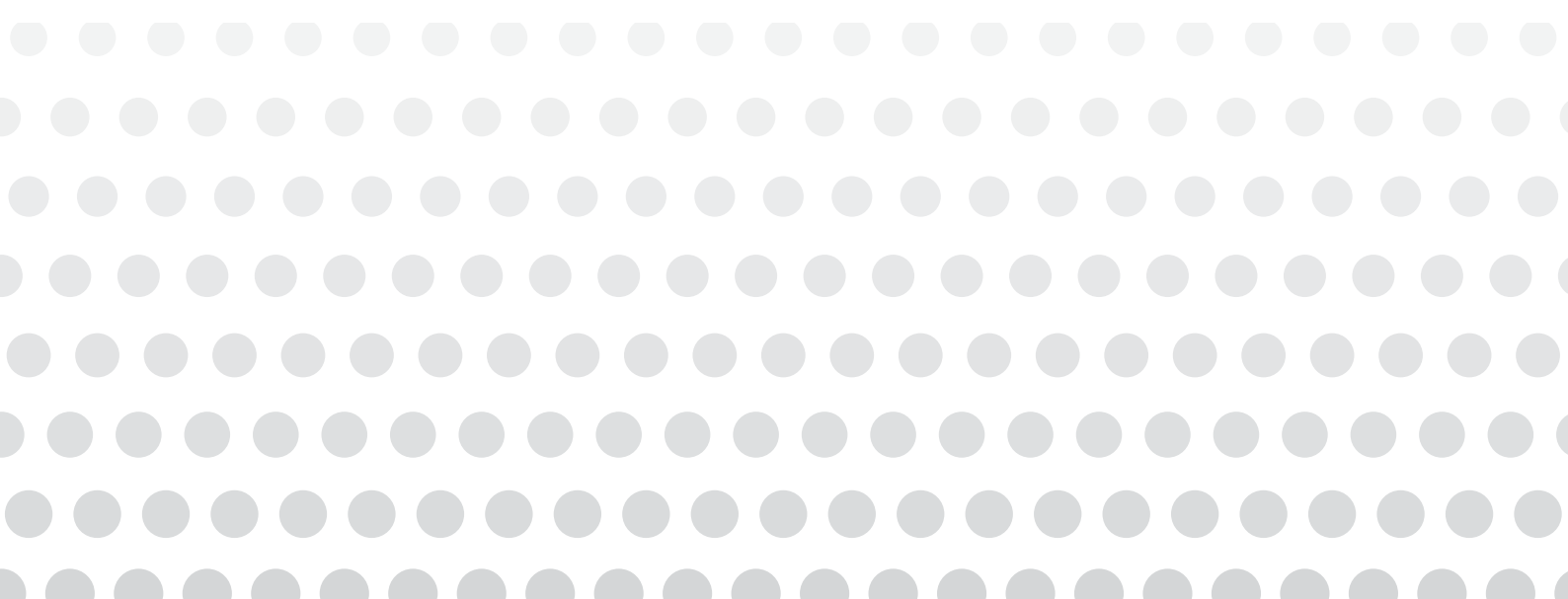




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