



Policy Brief

Decarbonisation and the Carbon Tax in the Context of the Green Transition in Kosovo

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INTRODUCTION

Climate change and its environmental degradation have prompted developed countries to launch a global initiative to limit global warming to 1.5°C above pre-industrial levels, with a highly ambitious target of net zero greenhouse gas emissions by 2050. In this context, Europe has become a global leader in efforts to address and mitigate the consequences of climate change. In this regard, the focus is on ambitious initiatives related to the decarbonisation of technological processes in the manufacturing industries and other economic sectors. With a strong commitment to transitioning to cleaner and more sustainable energy sources, European countries have embarked on a transformative journey that not only addresses the urgent issue of global warming but also serves as an inspiring example for the rest of the world to follow. Therefore, the European Union (EU) has pledged to significantly reduce greenhouse gas emissions, reduce dependence on fossil fuels, and multiply the share of renewable energy in their energy mix.

Fiscal instruments through the carbon tax have been one of the earliest policies used by various countries around the world in their efforts to reduce carbon emissions. It is worth noting that Scandinavian countries have applied carbon taxes since the early 1990s. Currently, around 40 different countries apply a carbon tax, with the highest rate being in Uruguay, at around 137 USD per ton of carbon emitted. In the Western Balkans, currently only Bosnia and Herzegovina, Montenegro, and Albania have implemented various measures in the form of taxes, mainly on fossil fuels. According to the Energy Strategy of the Republic of Kosovo¹ 2022-2031, Kosovo will make preparations for the establishment of a carbon pricing system by 2025. The anticipated revenues from carbon taxation, according to this strategy, are planned to create a fund that will promote investments in renewable energy sources, support consumers in need, and other measures aimed at a just transition.

A key pillar of Europe's decarbonisation strategy has been the rapid expansion of renewable energy sources. Wind, solar energy, and hydropower plants have shown extraordinary growth, with countries investing in large-scale projects and stimulating the deployment of clean technologies. Additionally, significant steps have been taken towards decarbonisation goals in energy efficiency and energy storage. Europe has now become a hub for innovation in renewable resources, driving advancements in offshore wind farms and solar energy storage. Furthermore, building renovation programs, stricter energy efficiency standards for appliances, and initiatives promoting sustainable transport have been implemented across the continent. These efforts not only reduce emissions but also result in significant cost savings for businesses and households.

SYSTEMS AND MECHANISMS FOR CARBON TAXATION

Europe's unwavering commitment to decarbonisation serves as a beacon of hope in the global fight against climate change. Through ambitious goals and collaborative efforts, European countries are making significant strides toward a greener and more sustainable future. As Europe continues to lead by example, it inspires other countries around the world to prioritize decarbonisation, creating a path toward a better planet for future generations.

In this regard, the EU has already put in place mechanisms to directly influence emissions reductions through disincentive schemes for industries that emit large amounts of carbon. The EU Emissions Trading System (EU ETS) is a market-based mechanism implemented by the EU to reduce greenhouse gas emissions and combat climate change. It is the largest emissions trading system

¹This designation is without prejudice to positions on status, and is in line with UNSC 1244/1999 and the ICJ Opinion on the Kosovo Declaration of Independence.

in the world and covers various industries, including energy production, manufacturing industries, and aviation. The EU ETS operates on the ‘cap and trade’ principle. According to this principle, a cap is set on the total amount of greenhouse gas emissions that participating industries are allowed to emit. This cap is gradually reduced over time to meet emission reduction targets. Within the system, emission allowances are distributed to companies, with each representing the right to emit one ton of CO₂ or its equivalent. These allowances can be bought, sold, or freely traded among participants.

Companies that can reduce their emissions below their allocated allowances can sell the surplus to those who exceed their limits. In this way, it creates financial incentives for companies to invest in cleaner technologies, energy efficiency measures, or compensatory projects and international carbon loans (e.g., investment in environmental projects anywhere in the world). The goal is to encourage emission reductions in the most cost-effective way by allowing the market to determine the carbon price.

The EU continues to refine and strengthen the ETS as part of its broader climate and energy policies. To address the issue of carbon leakage, the EU has also launched the so-called Carbon Border Adjustment Mechanism (CBAM), through which it aims to establish a fair price for the carbon emitted during the production of carbon-intensive goods entering the EU and to encourage cleaner industrial production in non-EU countries. The gradual introduction of CBAM aligns with the gradual phasing out of free allowance allocations under the ETS to support the decarbonisation of the EU industry. CBAM will be applied in its transitional phase starting on October 1, 2023, and will end on December 31, 2025. The set of rules and reporting requirements for emissions under CBAM will be further specified in an implementing act to be approved by the Commission after consultation with the CBAM Committee, composed of experts from the EU-27.

CBAM will initially be applied to imports of certain goods, whose production is carbon-intensive and also poses high risk of carbon leakage: cement, iron and steel, aluminium, synthetic fertilizers, electricity, and hydrogen. Since Kosovo, along with all Western Balkan economies, is part of the EU's trade arrangements, the functioning of such mechanisms will also have implications for industries that already have exposure in export markets within the EU. In the first phase, cement production, processing of various iron products, and electricity production will be affected in Kosovo. Although the current exposure of products from the aforementioned sectors is not very large, the list of goods included in this mechanism will be expanded in the future to cover the entire industrial sector. It should also be emphasized that during the transitional phase, local businesses that export goods from the sectors included in the list will be required to report the amount of carbon emitted from the production process for the quantity exported to the EU. Since about 2/3 of carbon emissions in Kosovo come from the Kosovo A and B power plants, and since the majority of the industry is supplied with electricity from these two power plants, the source of electricity will be the main factor influencing the potential decline in the competitiveness of Kosovo's industry in EU export markets.

CONCLUDING REMARKS

Given the ambitious targets that Kosovo has undertaken with the Green Agenda for the Western Balkans, decarbonizing the economy will be one of the most complex challenges in implementing the commitments outlined in this Agenda. While some countries in the region have made progress in implementing measures aimed at reducing greenhouse gas emissions, Kosovo still lacks a clear strategy on how its economy will achieve environmental neutrality from its economic activities. Furthermore, the lack of adequate frameworks and technical expertise within the institutions further complicates the implementation of obligations related to addressing the challenges in the process of decarbonizing the economy.

However, the government, specifically the relevant ministries, should urgently strengthen their capacities and actively engage in accelerating the implementation of commitments related to decarbonisation within the framework of the Green Agenda.

In the following, some recommendations are presented based on the assessment of the current state, regarding the obligations for decarbonizing the economy:

- The government of Kosovo should urgently begin preparing the legal infrastructure for the introduction of the carbon tax and create fiscal incentives for the use of 'green' technologies, including fully electric means of transport.
- Considering the measures taken by the EU through carbon taxation mechanisms and the potential implications these may have on the economies of the EU's trade partners, it is crucial that, at this stage, serious preparations begin for a clear strategy that, in addition to decarbonizing the energy sector, also includes alleviating measures for the industrial sector aimed at increasing energy efficiency, as well as supporting investments that aim to gradually reduce dependence on energy sources from fossil fuels.
- Institutional support and technical assistance should be offered – even through the engagement of external expertise – to businesses that will be subject to the measures from CBAM regarding the assessment and reporting of emissions from their production processes starting in October of this year.