

Center for the Study of Democracy

PRICE REFORM AND PRICING IN THE
TRANSITION TO MARKET ECONOMY

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1. PRICE REFORM AND PRICING IN THE TRANSITION TO MARKET ECONOMY.

1.1. The economic policy in the sphere of prices up to the beginning of the political changes in Bulgaria in November 1989.

In the years of the country's development as a socialist state and COMECON member the subject of prices and pricing used to be taboo for Bulgarian economists. Both the price reforms and the changes in the prices of specific articles were carried out under strictest secrecy. The decisions for changes in prices and price policy were made by the top hierarchy of the ruling Communist Party. For the period up to 1990 there is no available objective information on price levels and dynamics. The state authorities claimed (just like in the other socialist countries) that the economy was developing under zero inflation, which was pointed out as one of the advantages of planned over market economy.

The analysis of the actual processes developing in the Bulgarian economy, however, reveals quite different tendencies.

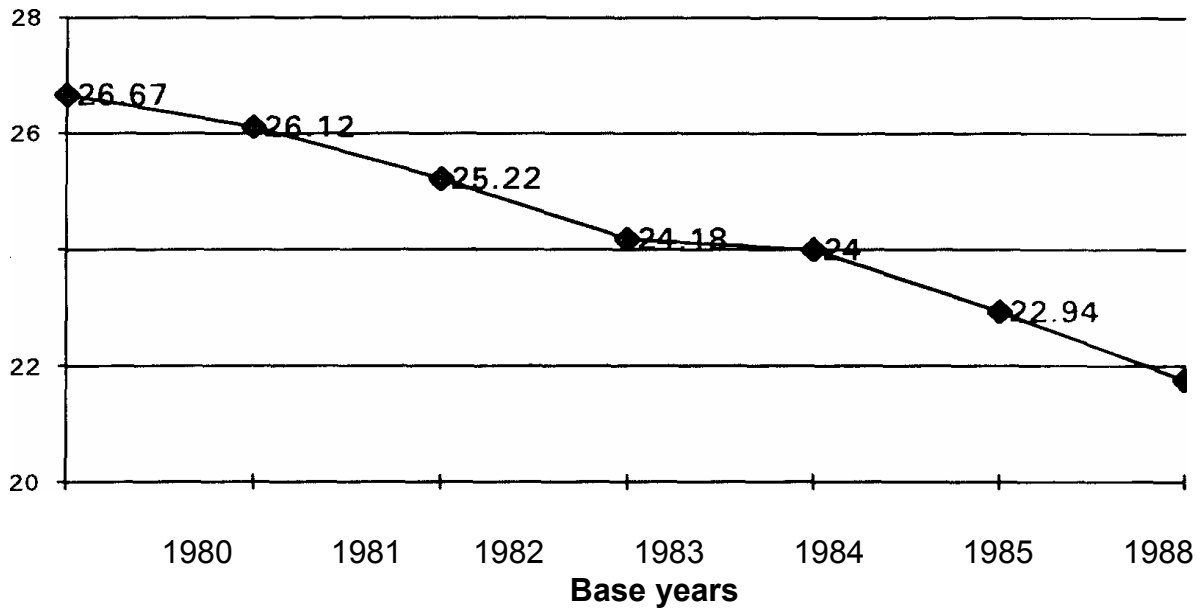
At the end of the 80s, over 95 per cent of retail prices were centrally fixed by the Committee on Prices as dictated by the Central Committee of the Communist Party and the Government. The prices of an insignificant part of goods and services - specific to a given region - were determined by special price-control authorities on local government level. The prices in all restaurants and entertainment establishments across the country, including the tourist resorts, were equally under state control.

The centralized fixing of prices, with no regard to actual production costs and conditions of supply brought with it the following negative consequences, which had to be overcome by the ongoing economic reforms:

- Continual decline in the effectiveness of the economy in macroeconomic terms. This is evident from the chart on the changing values of the national income per 100 Leva of fixed capital index (as shown on the figure). The structural, investment and price policy, which were determined subjectively, disregarding objective conditions and the country's capacity, generated a covert inflation potential. The need for new expenditures had to be met by increasingly frequent price increases. In the 60s and 70s changes in retail and wholesale prices were introduced about once in a decade, after 1975 they had to be made every two or three years, and after 1985 - annually. Nevertheless, the expenditures of the structurally unbalanced economy constantly grew, as is evident from the chart.

Each Lev of newly created value involved ever increasing costs (as shown in the table).

National Income per 100 Leva of Fixed Capital



Source: *National Institute of Statistics (NIS)*

Value Structure of the Output of Public Sector Enterprises (in %)

| Branch | Year | | 1970 | | 1980 | | 1985 | |
|--------|-------|-----------|-------|-----------|-------|-----------|------|--|
| | Costs | new value | costs | new value | costs | new value | | |
| TOTAL | 68.54 | 31.46 | 73.00 | 27.00 | 71.14 | 28.86 | | |

Leva

| | | | | | | |
|---|-------|-------|-------|-------|-------|-------|
| Production of electric and heat power | 69.29 | 30.71 | 78.56 | 21.44 | 84.88 | 15.12 |
| Ferrous metallurgy, incl. ore mining | 83.86 | 16.64 | 81.79 | 18.21 | 88.17 | 11.83 |
| Mechanical engineering, metal working, electrical and electronic industry | 59.56 | 40.44 | 69.97 | 33.03 | 65.61 | 34.39 |
| Building material industry | 65.07 | 34.93 | 79.80 | 20.20 | 76.48 | 23.52 |
| Textile industry | 65.69 | 34.31 | 69.56 | 30.44 | 71.38 | 28.62 |
| Food-processing industry | 75.99 | 23.01 | 84.92 | 15.06 | 79.76 | 20.24 |
| Agriculture | 45.09 | 54.91 | 52.69 | 47.31 | 58.63 | 41.37 |

Source: NIS

As a result of this negative tendency, the output value volumes continually increased. Manufacturing constantly required increasing capital investments while bringing in less and less fresh capital to the economy. This ultimately led to:

- Chronic deficit of goods and widening disproportion between supply and demand in macroeconomic terms. Despite the frequent price increases in the 80s and the overfulfilment of the planned indices in value, the deficit of goods in the domestic market persistently increased. Thus, for instance, whereas the average world growth in agricultural output was 13 per cent for the period 1981-1985, in Bulgaria it was merely 4 per cent, even though purchase prices were raised by an average of 50 per cent in 1980 and about 30 per cent in 1983. Since the planned indices were recorded by value, the rate of income increase surpassed the growth in output. The disproportion between the money and goods supply in the domestic market was widening and the deficit was drawing near a critical point - in the first year of the political changes it became necessary to introduce a rationing system for distribution of staple goods. In the same year the correlation between the money supply and the gross domestic product reached 106%. In the other East-European countries it varied between 33 and 76 per cent. The huge mass of hot money without any equivalent in goods caused inflation to turn from creeping to galloping, reaching a monthly rate of over 10% in 1990. The enormous inflation accumulated over the last decade of totalitarian planned economy undermined the progress of the radical economic reform.
- A great many enterprises and entire branches of the economy became loss-making. In the 70s and 80s the term "loss-making enterprise" became permanently established in the economic terminology of socialist economy. The number of enterprises operating

with a "planned loss" - e.g. a loss approved by the planning authorities - constantly increased. The existence of entire branches came to depend solely on the extended state subsidies. Even though the amount of these subsidies was kept secret, it is known that in 1987-1988 the sum of the subsidies exceeded 6 billion Leva - e.g. about one fifth of the gross domestic product.

- The predominance of monopoly prices and the lack of competition in the domestic market. In the course of decades the system of prices and pricing helped reinforce the monopolistic positions in the domestic market of some state-owned enterprises and structures, whose operation and output were the object of wide dissatisfaction among all consumers. Through prices, they were nevertheless tolerated as they constituted a stable source of revenues for the state budget.
- Another important negative consequence of centralized planning and management of the economy consisted in an adverse budgetary policy, when the basic functions of the state budget in fact became the redistribution of funds from successfully operating to loss-making enterprises, and covering the budget deficit by raising prices and printing money. The transition to market economy called for fundamental changes in the functions and principles of forming the state budget.

2. THE LIBERALIZATION OF PRICES - ONSET OF THE REFORM.

As a result of these factors, which were characteristic of centralized planned economy and particularly pronounced in Bulgaria due to the lack of a significant private sector as had been preserved in Poland, Hungary, GDR, and Czechoslovakia, the economic reform in Bulgaria began with a liberalization of prices and dismantling of the monopolistic structures in industry and the services. The shock liberalization of prices was the only way to a speedy overcoming of the huge disproportion between the supply and demand. It is our view that if the liberalization of prices had begun already in the first year of the reform - 1990, their rise might have been more moderate and would not have had such a strong negative impact on the standard of living of the population. Unfortunately, the liberalization of 40 per cent of the prices of goods and services included in the government's program was not introduced and that for purely political reasons, as the government of the ruling Communist Party was driven by populist considerations. In February 1991 the first government with the participation of ministers from outside the Communist Party undertook a liberalization of about 80 per cent of the prices of goods and services. Within a month following the liberalization of prices, inflation, measured through the consumer price index, reached 222.9 per cent. Only a group of 14 essential goods and services, among which fuels and electric power, as well as certain staple foods, remained under state control.

Following the initial price shock, the general price level began declining and reached a mere 2.5% in April. Price dynamics in the months preceding and following the price shock can be examined in the table below:

Consumer Price Indices in the End of 1990 and Beginning of 1991

| Month | Months serving as a base | | | | | | | |
|-------------|--------------------------|-------|------|------|------|------|------|------|
| | 1990 | | | | 1991 | | | |
| | Sep. | Oct. | Nov. | Dec. | Jan. | Feb. | Mar. | Apr. |
| 1990 | | | | | | | | |
| September | 100.0 | | | | | | | |
| October | 104.1 | 100.0 | | | | | | |

| | | | | | | | | |
|-------------|-------|-------|-------|-------|-------|-------|-------|-------|
| November | 109.2 | 104.9 | 100.0 | | | | | |
| December | 120.5 | 115.8 | 110.4 | 100.0 | | | | |
| 1991 | | | | | | | | |
| January | 136.9 | 131.5 | 125.4 | 113.6 | 100.0 | | | |
| February | 305.1 | 293.1 | 279.5 | 253.2 | 222.9 | 100.0 | | |
| March | 459.2 | 441.1 | 420.6 | 381.1 | 335.5 | 150.5 | 100.0 | |
| April | 470.7 | 452.1 | 431.1 | 390.6 | 343.9 | 154.3 | 102.5 | 100.0 |

Source: NIS

2.1. The role of changes in credit policy and the interest rate.

The financial stabilization and the curbing of the hyperinflation on a macroeconomic level were achieved in 1991 not only through the liberalization of the prices of goods and services, but of credits as well. The basic interest rate in the country prior to the reform was 2 per cent, with commercial banks having the right, under certain conditions, to raise it by an additional 2 points. The transition to a new economic system, as well as the huge mass of hot money in the economy necessitated taking up a more realistic credit price, as a first step towards introducing a market interest rate. The basic interest rate was repeatedly raised with the aim of keeping up with inflation as far as possible and attracting the free capital of the enterprises and the population into the banks. A term was set, within which the population could pay off their housing credits with the former interest rates. These measures led to a drastic "cooling off" of the money turnover and prevented hyperinflation. Within the first few months of 1991 alone the population paid off consumer credits amounting to 2.3 billion Leva (a sum exceeding the gross domestic product by 13%).

One shortcoming of the reform at that stage can be found in the failure to liberalize fuel and energy prices. The analyses of this stage of the reform often reach the conclusion that the liberalization of prices should have been preceded by demonopolization and starting of the privatization process. However, this could unfortunately not have been achieved for objective reasons. In the first place, the laws on privatization, restitution, protection of competition had not been passed by parliament. Secondly, the situation in the domestic market was critical - the acute deficit of goods imposed the use of a rationing system for the distribution of essential goods. The liberalization of prices helped restore the balance between the supply and demand within a mere few months. This could of course only be achieved at the cost of a drop in the living standard of the population, but on the other hand prevented hyperinflation and the wild expansion of the black market. For the first time in many years citizens were given a real incentive to earn more money as the market offered goods which used to be extremely difficult to obtain or totally unfamiliar in Bulgaria.

2.2. Liberalization of foreign trade and foreign exchange regulations.

The liberalization of prices was introduced concurrently with a liberalization of foreign trade regulations and the foreign exchange market in the country.

The liberalization of the foreign exchange and the foreign trade regulations carried out in 1991 and the following years involved the following:

- Substitution of the centrally fixed exchange rate of the Lev against convertible currencies, which only used to be modified in the beginning of the established planning periods, for

a floating exchange rate, set by the Central Bank simply as a guideline, with commercial banks having the right to negotiate different exchange rates in their transactions. At first the Central Bank used to fix that rate on the basis of the foreign currency supply and demand on the currency sale auctions, and from the beginning of 1992 - on the basis of foreign currency supply and demand in the foreign exchange market, in which the newly created private exchange offices and brokerage and finance houses participated along with the banks.

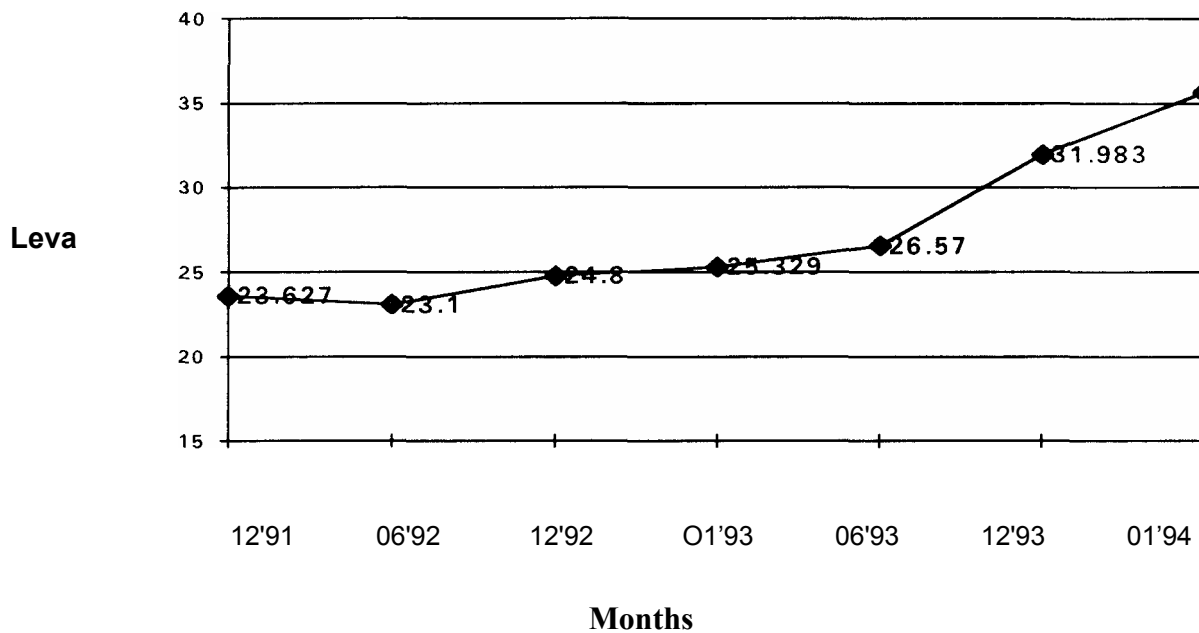
- Universal right of all Bulgarian citizens to own foreign currency and trade with it within the limits set by the state.
- Right of Bulgarian private companies to engage in foreign trade operations, which finally put an end to the decade-long state monopoly in the sphere of foreign trade.
- Development of the banking sector and a financial market and admission of private capitals into those spheres.

2.3. Principal changes and characteristics of the system of prices and pricing

These consequential changes in the economic conditions had a substantial impact on the price level and the system of pricing, which could be summarized as follows:

- Opening up of the domestic price system to prices in the international market and making it dependent on those prices. The considerable import of goods, as well as the introduction of more adequate exchange rate of the Lev against convertible currencies made the Bulgarian economy more sensitive to the fluctuations in the prices of goods and raw materials in the international market. There began a rapid shrinking of the disproportions in the system of pricing which used to be characteristic of the centralized economy and led to imbalance of supply and demand. Thus, for instance, prior to the reform there used to exist a number of manufactures using imported raw materials which needed large subsidies from the budget as the planning authorities maintained low prices of these raw materials, far below the actual prices in the international market, in order to demonstrate the high efficiency of the respective enterprises. The opening up of the domestic price system to the international market became an important economic precondition for the development of market economy, because it led to a more adequate correlation between costs and prices. One of the major shortcomings of the former price system was indeed the discrepancy between prices and the costs they are based on, as the system relied on the subsidies to cover the losses and the influence of supply and demand on prices was completely ignored.
- Appearance of strong economic interdependence between prices and market conditions, above all supply and demand, allowing for competition through prices. The rapidly developing private sector managed to make the most of this. The state-owned enterprises, accustomed to centrally fixed prices, found it more difficult to adjust to the new conditions and began losing clients to private companies. Dependence of the price levels in the domestic market on the exchange rate of the Lev against convertible currencies and more specifically, the US Dollar. Due to the fall in output in the country and the loss of traditional links with goods suppliers from the former socialist countries, there was a reorientation of the import of goods, raw materials and technologies from the ruble to the dollar sphere. This was also prompted by the transition to payments in US Dollars among the former socialist countries following the dissolution of the COMECON. As the Bulgarian economy is strongly dependent on the import of fuels and energy sources, the Lev-Dollar exchange rate turned into one of the principal factors determining the level and dynamics of prices in the domestic market. The chart below displays the fluctuations of the Lev-Dollar exchange rate:

Average Monthly Exchange Rate (Lev for USD 1.00)



Source: *Bulgarian National Bank (BNB)*

In the same period, inflation (measured through the consumer price index) considerably exceeded the devaluation of the Lev. The economic policy of the National Bank was oriented towards curbing inflation and stabilizing the internal foreign exchange market, in order to guarantee the supply of imported raw materials and equipment to the enterprises. The maintenance of an "expensive Lev" was one of the factors influencing inflation and was relatively easy to achieve - by intervention of the National Bank in the inter-bank exchange market and sale of the necessary amounts of currency when the exchange rate of the Dollar began rising. This policy had a positive effect on the formation of the private sector and its development. It was also an encouraging signal to foreign investors. In the end of 1992, however, and in 1993, it turned into a factor impeding the increase in exports

as exporters had no interest in selling for convertible currency. In two years manufacturers' costs in the national currency had risen to an extent when they could not be covered by revenues from sales in the international market. There appeared a paradox. A number of goods imported from other countries proved to be cheaper than the same goods produced by Bulgarian manufacturers. As a result, the import of goods began growing at a much faster rate than exports. The foreign trade deficit increased more than ten times in a single year and reached USD 420 million in 1993. Obviously, in the presence of such a tendency the Central Bank had to give up its firm support for the Lev in order to stimulate exports. The withdrawal of the National Bank from the inter-bank exchange market and its non-intervention at the sharp rise of the Dollar led to a considerable devaluation of the Lev in 1994. For the period January-April it reached 160%, significantly surpassing inflation, which was 41% in the same period. These figures could be compared with the data for 1992 and 1993. In the first year the devaluation of the Lev barely reached 5%, whereas inflation, measured through the consumer price index, was 79%. In the next year of the reform -1993 - the devaluation of the Lev was about 20%, while inflation reached 64%. The dramatic rise of the Dollar in early 1994 cannot be accounted for solely by the change in the policy of the National Bank regarding the stability of the Bulgarian currency. There are a number of other reasons, most notably, the inefficiency of the economy, which was not in a position to meet its own needs for convertible currency. The statistical data on the financial state of the industrial enterprises indicate that a considerable part of the foreign currency revenues serve to cover the important liabilities to the banks and other creditors. The liquidity ratio, measured as the correlation between the sum of the company's cash, receivables and securities and its current liabilities, reveals extremely limited possibilities of the enterprises to secure payments to creditors and suppliers. On average for the industry as a whole, the ability to pay off the interests on drawn credits is 68% - e.g. the enterprises are able to cover 68% of the interests they owe. The situation of the enterprises in agriculture is even worse - they are in a position to cover barely 5% of the owed interests.

The high interest rate is used by the Central Bank as a means to limit the rise of inflation, but for many of the enterprises it makes it impossible to invest in modernization or meet the need for capitals. Under the conditions of centralized planned economy the enterprises used to transfer their circulating capital to the state and received (by decision of the state authorities) funds for investments, reconstruction, modernization, and other needs. At the outset of the reform the enterprises in fact found themselves without any funds of their own at their disposal. This, as well as the fast rise in prices generated the need for large sums to buy raw materials and maintain the equipment and facilities. The rapidly increasing interest rates put the enterprises in a difficult financial situation. The level of the interest rate also affected the price level of the output. Even today the price system frequently proves to be stuck in this vicious circle. The Central Bank raises interest rates in order to restrict inflation and stabilize the Lev, prices in the domestic market rise sharply due to the need to pay the higher interests. As a result, the competitiveness of Bulgarian goods in the international market decreases due to their high prices and this restricts the possibilities for export of goods. In its turn, the inflow of foreign currency to the country declines and the demand increases, which leads to another rise in the exchange rate of the Dollar. Experience to date has shown that the sole intervention of the Central Bank in the foreign exchange and financial market is not in itself in a position to regulate the processes on a macroeconomic level. Without resorting to the other mechanisms of economic policy it is impossible to achieve lasting positive results.

The data in the table below reveal the strong dependence of the enterprises on credit resources:

Dependence on Creditors

| Branch | Credits (million Leva) | Net liquid assets (million Leva) | Ratio of dependence on creditors |
|--|-------------------------------|---|---|
| Industry | 70087.4 | 320971.3 | 0.22 |
| By branches: | | | |
| Power supply and mining | 1696.1 | 126614.0 | 0.01 |
| Ferrous metallurgy, incl. ore mining | 7303.1 | 4517.8 | 1.62 |
| Non-ferrous metallurgy | 1505.6 | 15495.1 | 0.10 |
| Mechanical engineering and metal working | 17517.7 | 44352.4 | 0.39 |
| Electrical and electronic industry | 9371.1 | 16633.9 | 0.56 |
| Chemical and petroleum refining industry | 9637.9 | 47651.8 | 0.20 |
| Timber industry | 1342.9 | 5683.9 | 0.24 |
| Wood-pulp and paper industry | 1286.5 | 1598.2 | 0.80 |
| Textile industry | 3403.9 | 11152.3 | 0.31 |
| Leather and footwear industry | 703.5 | 1829.5 | 0.38 |
| Printing industry | 48.5 | 1315.9 | 0.04 |
| Food industry | 13020.1 | 30624.1 | 0.43 |
| Construction | 1798.0 | 20687.0 | 0.09 |
| Agriculture | 6710.7 | 36266.2 | 0.19 |
| Transport | 3418.3 | 30422.4 | 0.11 |
| Communications | 306.4 | 8229.3 | 0.04 |

Source: NIS

In the private enterprises the correlation between capital and credits is also quite unfavorable. In 1993 it was approximately 1:1. In the private companies in the sphere of trade, credits exceed capital 2.67 times. In industry, where the relative share of private enterprises is about 17 per cent of the total number of industrial enterprises, the capital makes up a mere 30 per cent.

The general state of the economy produces a number of factors accounting for the rise in price levels. They are the following:

- the enterprises are incurring losses while the possibilities for covering those losses by their own capital are becoming increasingly limited;
- the relative share of credits in the capital of the enterprises is increasing, and so is the impact of interests on their profitability;
- the purchase power of the enterprises is decreasing and production capacity is not used to the full;
- the pursued policy of reassessment of the assets of the enterprises in the course of the last two years has made it impossible to pay the respective real estate taxes and to make depreciation allowances to the amount fixed by the state;
- financial discipline is growing slack, payments among partners are being delayed and the velocity of money is continually falling.

All of these setbacks in the sphere of the economy are causing a constant rise in prices in order to cover the shortage of capital on all levels and in all branches and activities. The fact that Bulgaria is not attracting enough "fresh money" as a consequence of the unsettled question of its foreign debt, which amounts to over USD 12 billion, with payments having been suspended since 1990, further aggravates this negative tendency.

The rise in prices is shown in the table below:

General Consumer Price Indices by Months

(based on a market basket of 1,700 items, under observation by the National Institute of Statistics)

| Month | Months serving as a base | | | | | | | | | | | | |
|---------|--------------------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| | 12'92 | 1'93 | 2'93 | 3'93 | 4'93 | 5'93 | 6'93 | 7'93 | 8'93 | 9'93 | 10'93 | 11'93 | 12'93 |
| Dec.'92 | 100.0 | | | | | | | | | | | | |
| Jan.'93 | 106.9 | 100.0 | | | | | | | | | | | |
| Feb. | 112.0 | 104.7 | 100.0 | | | | | | | | | | |
| Mar. | 118.2 | 110.6 | 105.6 | 100.0 | | | | | | | | | |
| Apr. | 122.8 | 114.9 | 109.7 | 103.9 | 100.0 | | | | | | | | |
| May | 129.3 | 121.0 | 115.5 | 109.4 | 105.3 | 100.0 | | | | | | | |
| Jun. | 134.6 | 125.9 | 120.2 | 113.9 | 109.6 | 104.1 | 100.0 | | | | | | |
| Jul. | 135.9 | 127.1 | 121.4 | 115.0 | 110.7 | 105.1 | 101.0 | 100.0 | | | | | |
| Aug. | 139.4 | 130.4 | 124.5 | 117.9 | 113.5 | 107.8 | 103.5 | 102.6 | 100.0 | | | | |
| Sep. | 144.7 | 135.4 | 129.3 | 122.4 | 117.8 | 111.9 | 107.5 | 106.5 | 103.8 | 100.0 | | | |
| Oct. | 150.8 | 141.1 | 134.7 | 127.6 | 122.8 | 116.6 | 112.0 | 111.0 | 108.2 | 104.6 | 100.0 | | |
| Nov. | 157.7 | 147.5 | 140.8 | 133.4 | 128.4 | 121.9 | 117.1 | 116.0 | 113.1 | 109.0 | 104.6 | 100.0 | |
| Dec. | 163.9 | 153.3 | 146.3 | 138.6 | 133.4 | 126.7 | 121.7 | 120.6 | 117.6 | 113.2 | 108.7 | 103.9 | 100.0 |
| Jan.'94 | 170.0 | 159.0 | 151.9 | 143.9 | 138.4 | 131.5 | 126.3 | 121.1 | 122.0 | 117.5 | 112.7 | 107.8 | 103.8 |
| Feb. | 177.8 | 166.3 | 158.8 | 150.4 | 144.8 | 137.5 | 132.1 | 130.8 | 127.5 | 122.8 | 117.9 | 112.8 | 108.5 |
| Mar. | 191.0 | 178.7 | 170.6 | 161.6 | 155.5 | 147.7 | 141.9 | 140.6 | 137.0 | 132.0 | 126.7 | 121.2 | 116.6 |
| Apr. | 232.5 | 217.4 | 207.6 | 196.7 | 189.3 | 179.8 | 172.7 | 171.0 | 166.8 | 160.6 | 154.1 | 147.4 | 141.9 |

Source: NIS

The following table shows the rise in some of the main prices under government control (of energy, fuels, and postal services):

Base Inflation (Consumer Price Index) and Prices under Control

| | General consumer price index (Mar. 1991=100) | Energy price index (1991=100) | Liquid fuel and liquefied hydro-carbonic gas price index (1991=100) | Postal service price index (1991=100) |
|-------------|---|--------------------------------------|--|--|
| 1992 | | | | |
| 1'92 | 155.48 | 170.23 | 167.23 | 100.00 |
| 2'92 | 164.48 | 170.23 | 180.62 | 100.00 |
| 3'92 | 170.96 | 170.23 | 172.43 | 100.00 |
| 4'92 | 176.45 | 170.23 | 169.83 | 100.00 |
| 5'92 | 197.50 | 228.27 | 177.90 | 366.42 |
| 6'92 | 208.87 | 230.73 | 190.57 | 371.55 |
| 7'92 | 214.74 | 230.73 | 198.95 | 371.55 |
| 8'92 | 217.26 | 231.06 | 188.50 | 371.55 |
| 9'92 | 224.62 | 230.65 | 180.51 | 371.55 |
| 10'92 | 238.59 | 230.47 | 183.38 | 371.55 |
| 11'92 | 254.63 | 231.18 | 183.57 | 371.55 |
| 12'92 | 266.26 | 231.18 | 183.39 | 371.55 |

| 1993 | | | | |
|-------------|--------|--------|--------|--------|
| 1'93 | 284.61 | 269.44 | 184.30 | 371.55 |
| 2'93 | 298.10 | 271.07 | 217.64 | 371.55 |
| 3'93 | 314.70 | 271.07 | 247.97 | 371.55 |
| 4'93 | 327.01 | 271.07 | 259.28 | 371.55 |
| 5'93 | 344.34 | 406.77 | 271.28 | 371.55 |
| 6'93 | 358.42 | 406.77 | 266.98 | 860.56 |
| 7'93 | 361.86 | 406.77 | 255.80 | 860.56 |
| 8'93 | 371.09 | 406.86 | 269.41 | 860.56 |
| 9'93 | 385.30 | 406.86 | 281.94 | 860.56 |
| 10'93 | 401.53 | 406.86 | 283.34 | 860.56 |
| 11'93 | 419.79 | 407.90 | 306.47 | 860.56 |
| 12'93 | 436.25 | 407.93 | 305.24 | 860.56 |
| 1994 | | | | |
| 1'94 | 452.70 | 407.82 | 295.64 | 860.56 |
| 2'94 | 473.36 | 407.82 | 327.13 | 860.56 |

Source: Agency for Economic Programming and Development

The basic inflation indices (column 1) have been calculated by isolating from the general consumer price index: controlled foods, electric and heat power, liquid fuels, postal telegraph and telephone services, railway transport, medications (since 1993), passenger bus transport (since 1994) and drinking water for the population (since 1994).

The analysis of the available statistical information on prices indicates that, although under state control, the level of electric power and fuel prices strongly affects the prices of goods and services in the domestic market. This influence was particularly pronounced in the first 4 months of 1994, when fuel prices began rising at a monthly rate of about 10% due to the steep rise of the US Dollar in that period. The available statistical data does not allow to make a factorial analysis of the influence of energy and fuel prices on the general price level in the country, but, by estimates of the National Commission on Prices, a 1% rise in the price of electric power and fuels brings about an increase in the general index of 0.18-0.26 per cent.

The following table contains data on the level and dynamics of prices by groups of goods and services:

Consumer Price Indices by Months in 1994

| Consumer groups | Chain Indices (preceding month=100) | | | | Base Indices (Dec.1993=100) | | | |
|------------------------|--|------------|------------|------------|------------------------------------|------------|------------|------------|
| | Jan | Feb | Mar | Apr | Jan | Feb | Mar | Apr |
| Total | 103.8 | 104.8 | 107.5 | 121.7 | 103.8 | 108.5 | 116.6 | 141.9 |
| Foods | 102.6 | 105.8 | 107.7 | 125.6 | 102.6 | 108.5 | 116.9 | 146.8 |
| Alcoholic beverages | 105.3 | 103.0 | 104.4 | 119.1 | 105.3 | 108.5 | 113.3 | 135.0 |
| Tobacco products | 103.8 | 103.7 | 123.7 | 115.2 | 103.8 | 107.7 | 133.2 | 153.4 |
| Housing | 108.7 | 101.8 | 104.8 | 122.4 | 108.7 | 110.6 | 115.9 | 141.9 |

| | | | | | | | | |
|------------------------------|-------|-------|-------|-------|-------|-------|-------|-------|
| Electric and heat power | 100.1 | 100.0 | 100.6 | 125.5 | 100.1 | 100.2 | 100.8 | 126.5 |
| Furniture | 106.7 | 103.4 | 105.5 | 116.2 | 106.7 | 110.3 | 116.4 | 135.2 |
| Clothing, shoes, accessories | 105.9 | 101.5 | 105.0 | 114.3 | 105.9 | 107.5 | 112.9 | 129.0 |
| Hygiene and health care | 106.6 | 105.0 | 108.3 | 112.7 | 106.6 | 112.0 | 121.3 | 136.8 |
| Education and leisure | 106.7 | 109.8 | 110.2 | 114.9 | 106.7 | 117.1 | 129.1 | 148.4 |
| Transport and communications | 102.8 | 105.1 | 110.1 | 121.8 | 102.8 | 108.1 | 118.9 | 144.9 |
| Other expenses | 102.2 | 102.4 | 101.7 | 108.8 | 102.2 | 104.6 | 106.4 | 115.8 |

Source: NIS

3. LEGISLATIVE ACTS AND REGULATIONS CONCERNING PRICING AND PRICE CONTROL.

The first document regulating activities related to prices and pricing under the new conditions, was the Regulation on Price Control of Goods and Services and Protection of Consumer Interests, endorsed in March 1991. It was adopted on the basis of Decree 56 on economic activity and was aimed at preventing the illegal rise in prices due to abuse of the monopolistic positions of some producers, limitation of competition, unfair competition, and other unlawful actions. The Regulation contains the principles, rules and criteria for establishing the improper rise in the prices of goods and services both of producers with monopolistic positions in the domestic market, and of goods, which are of particular importance to consumption. The Regulation specifies the conditions and manner of exercising supervision and control over prices, as well as the prerogatives of the government and the official bodies authorized by it to secure the protection of competition in the sphere of prices and consumer interests. According to the Regulation, prices have been fixed improperly and the subsequent proceeds are subject to expropriation to the benefit of the state budget in the following cases:

- When a seller sets different prices for different customers on goods having the same characteristics under equal production conditions;
- Setting prices higher than the Lev equivalent of the export price of the respective goods or, in the cases when the particular item is not exported - prices exceeding production costs by more than 20%;
- Selling products of lower quality at prices for higher quality established according to the requirements of Bulgarian standards;
- Charging prices higher than the list prices or higher than the fixed prices established by the Council of Ministers (where relevant), or in violation of stipulated pricing rules (if such have been established by the respective state authorities);
- Charging prices which do not conform to the list prices quoted to customers in terms of warranty and other sale conditions;
- Effecting sales to customers who have been attracted at the expense of competitors as a result of unfair treatment of the latter, at prices higher than those listed;
- Sale of goods and services at prices higher than the fixed maximum prices (if such prices have been fixed for the respective goods or services).

The Regulation for Price Control of Goods and Services and Protection of Consumer

Interests (RPC) fixed the maximum allowed retail surcharges so as to avoid arbitrary overpricing by brokers and retailers. For bread, milk and meat products this surcharge could not exceed 6 per cent, and for the other essential goods specified in an appendix to the Regulation - 8 per cent. According to the Regulation, this surcharge is applied to the value of the goods, formed by the buying price plus turnover tax and freight charges. As of April 1, 1994 the turnover tax has been replaced by value added tax.

According to RPC, control over the prices of products produced by monopolist companies in the domestic market (according to the Competition Law, those which hold more than 35% of the domestic market of a given item or service) is carried out by the National Commission on Prices at the Council of Ministers, and with respect to companies with a monopolistic position on a specific local market - by the authorities at the respective municipal councils.

The Regulation requires the Central Statistical Direction (later transformed into National Institute of Statistics) to summarize the information on prices, and the 28 regional statistical services in the larger towns - to collect and summarize the information on price levels and dynamics, inflation, and the subsistence minimum. Subsequently, with a number of other additional regulations of the government, the functions of the National Institute of Statistics were specified and extended. Besides the state authorities on price control and information, there are other authorities active in this sphere, which will be considered in the last part of the present paper.

Should an unlawful rise in prices by one or several of the criteria established in RPC be established, the price control authorities may:

1. Stop sales at such prices until they are brought in conformity with the requirements of the Regulation and the other existing stipulations in this sphere;
2. Propose to the Council of Ministers measures for countering negative tendencies towards rising price levels, such as:
 - introduction of maximum prices of certain goods and services;
 - establishing new procedures for fixing the prices of certain goods and services of particular importance to consumption in the domestic market;
 - introduction of restrictive profit margins for retailers and wholesalers, or producers;
 - others.
3. Ordain the payment to the state budget of double the size of the illegally realized revenues from raising prices above the officially established ones. In case of recurring or major violations, the entire sales revenue from the goods sold or the provided services is appropriated to the benefit of the state. The violators are required to reimburse the surcharges to the wronged natural and legal persons, and if the latter are unknown the sums are paid to the state budget. These regulations were part of the country's legislation even before 1990 and are not covered by RPC.
4. Violations related to unlawful raising of prices of goods and services are considered penal offenses and are prosecuted under the Administrative Violations and Penalties Law and the Anti-Speculation Law.

3.1. Prices under government control. Types of prices and control mechanisms.

The regulation of the price level of certain staple goods in the early stages of the reform deserves special attention. According to RPC these are the following goods:

GOODS WHOSE RETAIL PRICES ARE UNDER GOVERNMENT CONTROL

1. Wheat flour (type 500).
2. Dobrudza and Stara Zagora bread.
3. Meat with bones:
 - pork;
 - veal;
 - lamb;
 - chicken.
4. Meat products:
 - Veal Cold Cut;
 - scalded sausage Strandza;
 - Hamburg Cold Cut;
 - blood sausage.
5. Milk, 3% fat.
6. Yoghurt in 0.5 kg cartons.
7. White cow's cheese.
8. Vitosha cheese.
9. Refined sugar in 1 kg packages.
10. Sunflower oil in 1 liter bottles.
11. Macaroni in 0.5 kg packages.
12. Transport fares:
 - motor transport;
 - railway transport.

The price restrictions on these specific items are politically rather than economically motivated. Control over the prices of these goods has a strong social impact as they are traditional staples in the diet of Bulgarians. Controlling the level of these particular prices is of great importance in the initial stage of the reform when, as a consequence of the liberalization of prices, the standard of living of the population suffered a severe shock. In practice, control over the level of these prices is exercised through the introduction of forecast prices. This term denotes the prices calculated by the National Commission on Prices at the Council of Ministers. In the second half of each month, on the basis of information on the level and dynamics of the prices of these goods in the previous month and the tendencies concerning inflation, the Dollar's exchange rate, the interest rate and other factors influencing production costs, the Commission calculates the expected (forecast) prices of the goods included in the RPC appendix, which are then officially announced as an acceptable price level. The producers, wholesalers and retailers selling their goods and services at prices lower or equal to the government's forecast prices are not penalized by the price control authorities. Selling at prices higher than the forecast ones is subject to penalties. This type of prices are not of particular economic value as they involve excessive averaging out of the particular components forming the price. They practically do not differ from the term "maximum prices", familiar from the practice of pricing. The only difference is that maximum prices are obtained by calculating certain actual costs, while in the case of forecast prices, all expenses constitute forecast values. From this point of view they cannot be accepted as sufficiently objective by the participants in the buying and selling operations in the domestic market. The term "forecast prices" did

not manage to establish itself in the practice of price control in Bulgaria due to the very provisional character of this type of prices. A great many of the penalized violators successfully appealed in court against the penalties imposed by the price control authorities, refuting the validity of these prices.

Another reason why forecast prices failed to play the role of a deterring factor with respect to the rise in the prices of the goods and services included in the list is found in the poor financial discipline characteristic of the transition to market economy. Transactions frequently take place without the necessary accounting records and documents, payments are made in cash, rather than through banker's orders and this makes it difficult for price control authorities to determine the buying price and the actual profit margin of the retailer or wholesaler.

Since June 5, 1991 the Government has introduced maximum prices of liquid fuels and liquefied hydrocarbonic gas on the basis of their mean international prices and the Lev's exchange rate for the period between the 15th and the 25th of the previous month. The decree (1106 of 1991) introducing these maximum prices requires the National Commission on Prices to set the allowed profit margins and maximum prices for each subsequent month by the 28th of the previous month. Another decree (18 of 1991) of the beginning of the year introduced fixed prices on electric and heat power, and coal. Prices for the general public differed from those paid by companies with a view to stimulating the effective use of energy sources. The differences in the price levels for industrial purposes and for the general public are shown in the table below:

| Item | Measure | Companies | General Public |
|----------------|------------------|-----------|----------------|
| Electric power | per thousand kWh | 461 | 284 |
| Heat power | per gigacal | 281 | 85 |
| Coal | per ton | 485 | 375 |

Source: National Commission on Prices

According to this decree, imported coal was to be sold at calculative prices when used for industrial purposes.

Maintaining fixed prices on energy sources was meant to keep the price levels of goods and services under government control. The differentiated prices by periods and type of energy source were to be coordinated with the National Commission on Prices. This failed to provide a viable check on the rise in prices for the following reasons:

- Energy and fuel prices are a major but not the only price-forming factor;
- Faced with fixed prices on energy sources and climbing production costs, power suppliers were put in a difficult financial situation and this caused constant social tension and strikes in this important branch of the economy;
- The price control authorities do not have at their disposal sufficient staff and means to secure systematic control over all enterprises. Retailers were not required to use cash-registers until late 1993.
- Applying different principles of pricing for domestic and imported coal also allowed certain companies to engage in unlawful operations.

3.2. Indirect control over price level and dynamics.

State control over price levels was equally exercised through regulating the import and export of certain goods. Thus, for instance, due to the lower prices of wheat in the country, in August 1991 the Government banned the export of wheat so as to avoid buying higher priced wheat in the international market in case of a deficit arising in the domestic market. Similar measures were taken with respect mainly to agricultural products and raw materials, medications, timber, and other commodities with strongly differentiated prices on the domestic and the international market. The regulation of prices did not only rely on direct, but likewise on indirect means - by measures intended to spur production. In 1991, for instance, the Government set up a Grain Fund with the aim of effecting state regulation of the production, buying and selling of bread-corn and fodder grain and to maintain a stable price level of grain. Providing funds for building up and reconstruction of small bakeries, meat and milk-processing enterprises from the Small Enterprise state fund at the Ministry of Industry was another indirect way of influencing price levels and dynamics. There are a number of other similar examples, but on the whole the use of economic mechanisms and means of influencing price levels and dynamics has clearly been quite inadequate. There have predominated administrative measures of setting maximum or fixed prices which, due to the high inflation, failed to provide an effective barrier to the rise in prices and constantly need to be readjusted.

To protect the interests of agricultural producers, with Decree 64 of April 17, 1992, the Council of Ministers introduced minimum purchase prices on certain essential agricultural products, such as wheat, milk, pork, chicken, and lamb. A subsequent Decree 219 of 1992 included some medications in the list of goods and services under government control.

Another decree of the Council of Ministers of 1994 set fixed prices on imported and domestically produced cigarettes. Essentially, this constituted an anti-dumping measure with respect to the import of cigarettes, as certain companies were importing large quantities of cigarettes without paying the sums required under the Turnover Tax and Excise Duty Law. This was in fact a matter of large-scale smuggling operations, all while Bulgaria is a tobacco and cigarette producer and the local producers are having serious problems in selling their output. Minimum tobacco purchase prices were introduced under pressure from tobacco producers, allowing them to cover their costs for the 1994 crop.

Price level and dynamics in the country were seriously affected by the introduction of value-added tax as of April 1, 1994. This tax replaced the former turnover tax.

The turnover tax with its two levels of 10% and 22% was replaced by a value-added tax of 18%. The expectations that the introduction of VAT would not have a serious impact on price levels of goods and services proved unjustified. The legislation on VAT, based on the related legislation in the countries of Western Europe, provided for much stricter control as compared to the turnover tax which so many companies in fact managed to evade. For this reason, following the introduction of VAT there occurred the most important price increase ever since 1991. The monthly inflation measured through the consumer price index in the month of April reached 21.7%. This is due to the combined effect of the spectacular climb of the Dollar in the first few months of the year when it reached a record high since the outset of the reforms, the severe depression in manufacturing and the political instability in the country. It does appear that neither tax authorities, nor the public in general were quite ready for the introduction of VAT. Textually, the law itself is not as exhaustive and clear-cut as the legislations of the West-European countries it has been borrowed from, which necessitates constant clarifications by the Ministry of Finance. This complicates the implementation of the law and impedes the work of tax control authorities.

Even if rather limited, the practice on the implementation of the law so far has made it possible to outline its major drawbacks:

1) In the countries with considerable experience in the implementation of such a law, the principle has been adopted that along the entire chain of producers, wholesalers and retailers, the only one not subject to taxation under this law is the final private customer, who, however, pays to all the participants along the chain their due payments to the budget. In Bulgaria there are no clear-cut provisions concerning those subject to taxation under the VAT law. A complex system has been adopted for calculating the amount of VAT owed through the use of tax credit and deductions of the VAT paid for the used services and goods in the fiscal period. Certain businesses with an annual turnover below 1.5 million Leva are free not to register for VAT payment.

2) There is a possibility for certain companies not to pay any taxes at all on the value added because the turnover tax has been abolished, and, if they are not registered, they are not required to pay VAT either.

3) In fact the only guarantee relied on is the economic interest of companies to register for payment of VAT, but this does not correspond to actual economic conditions in the country: lack of well-established tax administration structures; lack of qualified staff; inadequate business competence and experience of part of the companies; weak familiarity of the public with the essence, purpose, and functions of the value-added tax, etc.

As a result of these deficiencies, the introduction of the value-added tax led to an initial significant rise in the prices above all of the basic foods, on which turnover tax used to be 10% or was not levied at all (in the case of bread, for instance).

There is no sufficiently reliable statistical information on manufacturers' wholesale prices and this makes it difficult to forecast how they will be affected by VAT in the near future in the rapidly changing economic situation.

4. THE INSTITUTIONAL FRAMEWORK OF ACTIVITIES RELATED TO PRICES AND PRICING.

Prior to the outset of the reform, the state authorities on prices were the following:

- Chief Direction on Prices (CDP) at the Ministry of Finances;
- The ministries and other state institutions with respect to the goods and services produced within their respective systems;
- Specialized departments on prices at the district, city, and municipal councils;
- Chief Inspection on Trade and Services at the Ministry of Trade and Services.

After the merger of the Ministry of Foreign Economic Relations and the Ministry of Trade in 1990, the Chief Inspection on Trade and Services was abolished.

Following the liberalization of prices in 1991, the ministries were also discharged of their functions related to prices and pricing.

Presently the main state authority implementing the state policy in the sphere of prices and pricing is the National Commission on Prices at the Council of Ministers. It took over the functions of the Chief Direction on Prices, active in 1990. The National Commission on

Prices determines the methodology of calculating maximum and fixed prices of goods and services, exercises control over prices and pricing, and coordinates the activities of the other state authorities in this sphere. The National Commission on Prices considers all matters related to the government's policy in the sphere of prices and pricing and prepares the government's decisions. The functions of the municipal councils in the sphere of prices and pricing are largely reduced to exercising control over the proper implementation of the legislation and regulations enacted by the state authorities.

In carrying out their control activities, the National Commission on Prices and the specialized authorities at the district and municipal councils are entitled:

- To require the relevant accounting documents related to prices and explanations from natural and legal persons;
- To have free access to all ministries, institutions, organizations and companies when carrying out their duties, and to attend meetings of their boards of directors and other managing bodies in relation with the inspections;
- To engage specialists whenever the inspection requires specific expertise; the experts may be from outside the system of state price-control authorities.

The decisions of the price-control authorities are not definitive. It is possible to appeal against them in court. Experience has shown that in most cases the companies do exercise their right to appeal in court.

Public opinion exerts serious pressure for tighter control over prices and pricing. Manufacturers, on the other hand, are opposed to interventions in their activities. At present a balance is being sought between centralism and decentralizing in the fixing of prices of goods and services and policy-making in the sphere of prices.

Trade unions are very active in the sphere of prices. They have their own authorities and organizations collecting and analyzing information on prices, inflation, the cost of living and the subsistence minimum. It is on the basis of this information that they formulate their demands before the government for income compensations. A National Council for Trilateral Partnership has been created and is currently operating in the country. It involves the participation of the largest trade unions in Bulgaria protecting the interests of employees and workers in the private and public sectors, the government, represented by the deputy prime minister who is responsible for social policy, and representatives of employer organizations – the Union for Entrepreneurial Initiative of Citizens, Bulgarian Business Chamber, and the Bulgarian Trade and Industrial Chamber.

There also exists a Union of Consumers, which is a voluntary non-profit organization. Its activities, similarly to those in other European countries, involve protecting consumer interests and collecting information on violations of the existing legislative acts and regulations on prices. The structures of the Union are as yet not fully developed due to its limited financial resources.