ECONOMIC SCENE

Legal reform is what the old Soviet bloc needs to put it on the path to growth.

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THE transition from Communism to a free-market economy is like changing the engine on an airplane while it is still flying," Gerard Roland of the University of California at Berkeley explained at a conference here. The challenge is to feed, clothe and house people -- and maintain their support for reform -- while overhauling the system of production and distribution.

The most striking lesson of transition has been that all the former Soviet bloc countries took a steep nose dive after gaining political and economic freedom around 1989; only now are the more successful ones surpassing the meager level of output they had at the twilight of Communism. Economists at the Center for Economic Research and Graduate Education conference chalked up the slow progress primarily to underdevelopment and inadequate enforcement of commercial laws, and lack of encouragement of private start-up companies.

In the Czech Republic, for example, which embraced free-market reforms as vigorously as any country did, gross national product was down 13 percent four years after the Velvet Revolution. Just as the country dug its way out of this depression, it was hit by a recession, from which it has only recently recovered. Russia, the basket case of transition, had a protracted 45 percent fall in output.

Even the bright lights, Poland and Hungary, have yet to begin to narrow the gap with the West. The gross domestic product per capita in Poland, Hungary and the Czech Republic is still less than a quarter of that in Western Europe.

The downturn in Central and Eastern Europe that followed the introduction of markets and privatization of state-owned businesses took economists by surprise. Permitting free markets to allocate goods and services was supposed to improve the efficiency of production, not cause a depression.

Moreover, West Germany and Japan enjoyed rapid and sustained growth after their capital stocks were destroyed in World War II. Economists attributed their success to a well-educated and highly motivated work force. Because Central Europe has relatively well-educated populations who historically had a strong work ethic, many economists -- myself included -- predicted in the early 1990's that the region would quickly narrow the gap with Western Europe.

So what went wrong?

One possibility is that the data are misleading. Under Communism, output was overreported to exaggerate growth; under capitalism it is underreported to avoid taxes. Additionally, official inflation figures -- which showed rapid price inflation when prices were liberalized -- may overstate the true rise in the cost of living because new goods became available and quality improved. Although these factors undoubtedly have merit, they cannot explain the slow growth since the early 1990's.

Perhaps most important, the public believes that the transition has moved slowly. Opinion surveys show that Central and Eastern Europeans increasingly believe the economic transformation has gone badly. Interviews with workers and shoppers at Staromestska Trznice, a middle-scale grocery store in central Prague, reinforced this view. Typical of many people we interviewed, Kveta Vlckova, 45, a co-owner of a small novelty shop, said that 10 years ago she expected the Czech Republic to be like Germany or Britain by now, but it is not close to any country in Western Europe yet.

Jan Svejnar of the University of Michigan says the high-profile debate over whether former Soviet bloc countries should pursue a "big bang" or gradual approach to reform turned out to be a distraction. All countries moved quickly to liberalize prices, stabilize the macroeconomy and privatize state-owned enterprises. But Professor Svejnar says most countries moved too slowly to overhaul legal and regulatory institutions.

"The overall experience suggests that rapid mass privatization, in the absence of a strong legal system, has negative effects on performance," he said, "while the absence of rapid privatization may not detract from growth if the countries expose the state-owned enterprises to relatively hard budget constraints and world competition, and if they create new private firms."

Privatization alone is insufficient. The legal system must protect property rights and allow them to be transferred with minimal transaction costs. Central and Eastern European governments have failed to establish a well-functioning, modern legal system. Instead, many adopted portions of their pre-Communist civil law codes.

In the Czech Republic, for example, until recently borrowers had the right to control a bank's disposition of their collateral if they defaulted. Banks subsidized failing companies. Not surprisingly, many banks failed when the state stopped bailing them out. Foreign banks now own most Czech banks. A similar situation arose in Poland, Hungary and the Baltic States.

Fortunately, the prospect of joining the European Union is inducing Central European governments to reform their legal and regulatory systems, which may explain why their performance has been much better than that of the former Soviet states.

Some economists argue that it was necessary to privatize state assets rapidly before beginning legal and institutional reforms to make the reform process irreversible and prevent the Communists from seizing power again. This argument would be more persuasive had some countries come closer to returning to central planning. Furthermore, quick privatization often led to a class of inside managers who stripped assets and blocked reforms.

In retrospect, Hungary's sequencing of reforms has worked well: it privatized a small number of companies to establish their value and raise revenue, encouraged new entrants who could absorb workers laid off from state-owned enterprises and established a viable legal system before embarking on mass privatization.

The Hungarian economist Janos Kornai has argued that the transition will end when the Communist Party has lost its power, the private sector accounts for most of G.D.P. and the free market coordinates economic activity. By this definition, transition ended in Central Europe about five years ago.

Professor Svejnar, on the other hand, says transition will end when countries establish a functioning market system that generates rapid, sustained growth that enables them to interact with the West without major protection.

Kveta Vlckova had a simpler definition in mind. "It will take decades for transition to end and the Czech Republic to catch up to Western Europe," she said. But she hastened to add, "I think we will get there."