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# Steve Pejovich’s Insights into Property Rights, Capitalism, Socialism, and Freedom

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U pon hearing of the passing of Professor Svetozar (Steve) Pejovich on February 12, 2021, I was saddened by the loss of a great scholar from whom I’ve learned so much. Although I was not a formal student of Pejovich, he served as a source of both encouragement and intellectual inspiration. I became an “informal student” as part of my own self-study of his work when I was a graduate student at George Mason University, particularly for one of my examinations for a field of specialization in institutions and development. I recall vividly throughout my second year as a Ph.D. student not only reading and re-reading Pejovich’s work, including his classic *Journal of Economic Literature* article “Property Rights and Economic Theory: A Survey of Recent Literature” (Furubotn and Pejovich 1972), but also taking extensive notes as I read through his book *Economic Analysis of Institutions and Systems* (Pejovich 1998). All of this served me well not only for my studies and the examination but also for the returns it has yielded in my own research and teaching ever since.

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My personal recollections aside, I mention all of this to raise the following questions to honor Pejovich: First, what can we learn about pursuing scholarship and a life of the mind from reading his work? Second, what are the implications and relevance of his research on economic theory and the science of liberty for a young academic today?

### **Specialization in Production, Diversity in Consumption**

The main lesson we can learn about the pursuit of scholarship is a basic one from economics: “What is desired is *specialization in production* but *diversity in consumption*” (Hirshleifer, Glazer, and Hirshleifer 2005, 440, emphasis in original). The mark of an intellectual entrepreneur is an alertness to discover not only one’s particular area of interest but also a previously unnoticed opportunity to redirect the conversation in one’s discipline. Pejovich’s career-long pursuit of scholarship exemplifies this lesson for academic success, particularly in his seminal contributions that reintroduced the economics of property rights (Pejovich 1972) as well as its application to the field of comparative economic systems (Furubotn and Pejovich 1970; Pejovich 1971).

The focus of study and the particular debates in the field of comparative economic systems evolved over time in three phases, and Pejovich’s work can be defined by this transition. Before 1989, the core of comparative economics was an examination of the differences between capitalism and socialism in economic as well as political performance. During the 1990s and into the early 2000s, the main focus among comparative economists was the transition from socialism to capitalism. In recent years, mostly as a result of the transition experience of central and eastern Europe and particularly of China and India, a new orientation of comparative economics has emerged that focuses on the comparison of the economic effects of the various institutions of capitalism. We can understand, framed in these terms, not only how Pejovich’s work was redirected by changes in historical events but also how his unique understanding of property-rights economics influenced the changing focus of analysis in comparative economic systems.

Born in 1931 in Belgrade, Yugoslavia, Svetozar Pejovich grew up during a time when Yugoslavia transitioned from Nazi occupation to Tito’s Communist rule. This experience influenced his research in economics and the institutional underpinnings of a free society. Moreover, this hardship would benefit him greatly and in a very particular way that he could not realize before he began his Ph.D. at Georgetown University. Before pursuing his graduate studies at Georgetown, Pejovich earned an L.L.B. from the University of Belgrade, but not by choice. Though he had ambitions of going to medical school and becoming a doctor, his “bourgeois” background barred him from doing so, leaving him the possibility of studying only Roman law, which had become irrelevant and inapplicable to circumstances in Communist Yugoslavia. The genius of Pejovich, however, was to convert what seemed to be a liability

into an asset for scholarly success. His intellectual entrepreneurship came at a time when the study of property rights had reached an all-time historical low in economics. His knowledge of Roman law, a fundamental basis of which is the study of legal precedents pertaining to property rights, would serve him well and would make him one of the pioneers in reviving the economics of property rights in the second half of the twentieth century.<sup>1</sup> As Pejovich states, “Roman law provided the enduring legal and philosophical foundations for property rights, and developed a number of well-defined categories of property rights that have survived the test of time” (1998, 57). His brilliance was the subtle application of these categories of property rights to understand not only the operation of a market economy but also nonmarket decision making under socialism.

### Property Rights Are *Perceived* Social Relationships

To understand the importance and continuing relevance of Pejovich’s contributions to economic theory—namely, why property rights matter—it is first important to contextualize the state of economics at the time of his early career. Neoclassical economics was marked by an increasing tendency toward mathematical formalism and thus by a turn away from institutional analysis by the mid-twentieth century. The consequence of this tendency is that “neoclassical economics is silent about both the effects of alternative rules on the agents’ costs of acquiring the knowledge required to make optimal choices and the effects of new knowledge on prevailing rules” (Pejovich 1998, 6). Thus, Pejovich argued that “a theory of economic systems developed around the concept of property rights would assure us of much deeper and fuller understanding of the organization of production and distribution in various countries” (1969, 155).

“*Property rights,*” according to Pejovich, “*are relations among individuals that arise from the existence of scarce goods and pertain to their use*” (1998, 57, emphasis in original; see also Pejovich 1969, 156, and Furubotn and Pejovich 1972, 1139). Their existence does not imply an absence of social conflict over the assignment of resources. Rather, the omnipresence of scarcity implies social conflict over the allocation of resources. Private-property rights provide the institutional framework that allows individuals to *learn* how to compete for goods and resources in a peaceful and productive manner. To understand the patterns of de facto exchange and production within a particular economic system, one must first understand that the “prevailing institutions” of a particular economic system “are the aggregation of property rights that individuals have” and that “competition is carried by out by means of institutions, the critical function of which is to reduce the costs of exchange and production”

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1. See the Liberty Fund DVD *A Conversation with Steve Pejovich*, Intellectual Portrait Series, March 2010, 52 min.

(Pejovich 1998, 57, 32). Given that competition is a “*knowledge-creating process*” (Pejovich 1998, 32, emphasis in original), property rights not only provide incentives to exchange but also generate knowledge in the form of profit-and-loss signals, the appropriation of which creates a tendency toward an allocation of resources to their most-valued uses (Furubotn and Pejovich 1972, 1138). Moreover, what choices are *perceived* to be available to the individual are structured by property rights. For example, the incentive to discover the opportunity to exchange rental rights over one’s house implies not only that rental rights are respected by the landlord but also that the landlord bears the benefits and costs of his or her decision making. Knowledge of this profit opportunity, in turn, will be reflected into the value of the house through competitive bidding by prospective buyers. Thus, “the set of various property rights held over resources enters into the utility function of a decision-maker” (Furubotn and Pejovich 1972, 1139). The difference between capitalist and socialist systems in economic performance, therefore, is based neither on the degree of benevolence or malevolence on the part of decision makers governing the system or acting within the system nor on the existence or absence of profit opportunities in the system but upon what individuals identify as relevant knowledge available to them and how they *learn* to achieve their goals, given the prevailing structure of property rights.

One of Pejovich’s fundamental contributions to comparative economic systems is the application of property-rights analysis to socialism, specifically as it manifested itself under labor-managed firms in Yugoslavia (Furubotn and Pejovich 1970; Pejovich 1966). Compared to capitalist systems, socialist systems’ inherent inability to deliver economic prosperity and human flourishing, according to Pejovich, can be understood by distinguishing the particular attributes of property rights in each of these systems as the ability to use, exclude, and exchange resources. Though indeed each attribute is distinct, they are not mutually exclusive of each other. The ability to use a good, for example, implies a particular ability to use resources to define and enforce one’s property rights in such a way that an individual excluding others becomes the focal point of decision making. The individual is using the good in such a way that ties consequences to his or her actions. Moreover, the ability to exchange implies a particular ability to use a good or service by transferring title over a particular good or service. It is the ability to exchange and assign residual claimancy to a decision maker that fundamentally distinguishes private property from other forms of property (Furubotn and Pejovich 1972, 1154).

In the case of labor-managed firms in Communist Yugoslavia, workers could not sell their claims of ownership over a firm’s capital stock and therefore liquidate its value in money; workers possessed only the ability to use the capital stock within the firm and to exclude others from their income in the form of wages, both monetary and nonmonetary (i.e., leisure). Under such a property-rights arrangement, the inability to exchange precluded the possibility of economically calculating and pricing the overall value of the capital stock, let alone assessing the value of a work-

er's particular share. Given the impossibility of learning how much their share of capital is worth and of appropriating its value through sale, monitoring and reinvestment of the capital stock become a concentrated cost to a particular worker but a dispersed benefit to the other workers in the firm, whereas appropriating returns from the capital stock in the form of wages is a concentrated benefit but a dispersed cost to the other workers of the labor-managed firm. The overall tendency is one of shorter time horizons, less specialization in capital reinvestment and monitoring, limited technological innovation (Pejovich 1996), and an overall reduction in labor productivity.

The implication of Pejovich's analysis of firms under central planning is that economic transition requires fundamentally a credible commitment to *institutional transition* of the rules of the game (Pejovich 2005). Changing the players without changing the rules will not change the game being played. Simply changing the name of the game from "socialism" to "capitalism" will not generate outcomes consistent with a market economy properly understood as an institutional system of private property and freedom of contract under the rule of law. "To reform an economy," Pejovich states, "means to introduce a change in the quality of contractual agreements" (1969, 157). Thus, economic and political transition to a market economy "means institutional restructuring" (Pejovich 2003, 348). Given that property rights are a *perceived* set of social relationships regarding the ability to exercise choices over goods and services, this implies that not only institutions but also culture matter for economic transition. Economic transition requires both an institutional transition and an institutional transition that creates an alignment between de jure property rights and de facto rights. This "interaction thesis" (Pejovich 1997, 1999) implies that formal rules that are in harmony with informal rules will reduce the transaction costs of economic transition, specifically those pertaining to the definition and exchange of property rights, whereas conflict between formal and informal rules will raise transaction costs and dissipate wealth due to uncertainty over property rights (Pejovich 2003, 349).

The central lesson is that understanding human interaction at a particular time and place requires detailed historical and institutional details, such that economists must not only specialize in the production of sound economic reasoning but also diversify in their "consumption" of law, history, ethnography, and sociology to evaluate what are *perceived* to be de facto property rights by actors on the ground and whether de jure property rights align with de facto property rights or not.

### **Classical Liberalism and Private Property: Why Socialism Can Never Be Democratic**

Though socialist systems collapsed in central and eastern Europe in the 1990s, Pejovich warned that the idea of socialism was not yet buried. He argued that in the tran-

sition from classical socialism (i.e., state ownership of the means of the production), a new form of socialism has emerged in North America and Europe under the guise of liberalism, which he dubbed “liberal socialism” (Pejovich 2018).

This new manifestation of socialism accepts the notion of private property but with increasing control of the means of production via redistributive policies, labor-market rigidities, price controls, and so on. Pejovich’s implicit argument is that the fundamental similarities between classical socialism and liberal socialism, both distinguished from classical liberalism, are: (1) the rejection of the rule of law; (2) the assumption that the market ought to serve a social function or a common end for society, whether that be equality, justice, or fairness as conceived by the political and intellectual elite; and (3) the process by which a distribution of wealth emerges can be modified without affecting the pricing process and the direction of productive efforts.

Herein lies the fundamental lesson that we can draw from Pejovich that is particularly relevant to the rising appeal of socialism today. Socialism can be neither liberal nor democratic because (1) the right to private property is a social liability, not a private privilege, and (2) the essence of classical liberalism is the denial of all legal and political privileges. The conflation of property with privileges conflates the physical assignment of a good with *the assignment of consequences of one’s choices exercised over that good*, the latter of which is the fundamental purpose of private property—namely, to tie consequences to one’s action. However, socialism in any form implies, by definition, that a ruling elite, whether autocratic or democratically elected, has the privilege to intervene in the allocation of resources without bearing the full consequences of their decision making. Such a lack of accountability to the demands of one’s constituency is, by implication, also inherently undemocratic.

I have been very fortunate to learn all of these lessons from Professor Pejovich. He embodied the best of what it means to be a scholar and a teacher. He was an original and cogent scholar, an outstanding teacher of sound economic reasoning, and a warm-hearted human being, supportive of anyone curious to learn from his ideas. The relevance of his ideas for economic theory and the institutional underpinnings of a market economy will and *must* continue for generations to come if we wish to enjoy the fruits of a free society.

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