THE ROLE OF BUSINESS VIRTUE IN ECONOMIC DEVELOPMENT: SIX PROPOSITIONS PROVOKED IN PART BY P.T. BARNUM WITH AN EXTRAPOLATION TO THE POST-COMMUNIST EXPERIENCE

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Presented at the roundtable on "Political Economy and Socialism," Central European University, Budapest, Hungary, June 14, 2004

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This paper is in two parts. The first applies some observations by the legendary American showman, P.T. Barnum, and develops the idea that behaving virtuously in business is an innovation, the discovery and application of which substantially enhanced the economic advancement of what we now call the developed world over the last two centuries. In the second part, the ideas generated in this discussion are extrapolated to the present situation in the post-Communist, or post-Socialist, world.

I. Business virtue and economic development

The impact of the rise of business virtue upon economic development can be sketched out in six propositions.

1. Under capitalism, virtue is considerably more than its own reward.

Capitalism tends, all other things equal, systematically, though not uniformly, to reward business behavior that is honest, fair, civil, and compassionate. Such slogans as, "Honesty is the best policy; it's also the most profitable," "a happy employee is a productive employee," and "the customer is always right" are not only sound advice, but are part of a broader set of rather self-effacing moral principles that modern business has found, on average, to be wealth-enhancing in the long run. As several recent business scandals in the United States make clear, some scoundrels do become rich, even as some heavy smokers escape cancer. Nonetheless, as nonsmoking is, in general, good for your health, virtuous business behavior is, in general, good for your bottom line.[1]

Honesty. As Barnum (who never said "There's a sucker born every minute") points out, "the most difficult thing in life is to make money dishonestly" since "no man can be dishonest without soon being found out" and "when his lack of principle is discovered, nearly every avenue to success is closed against

[1] However, although honesty and the other virtues may be central to ordinary business transactions where both parties gain and where each often has a long term reputation to maintain, the acquisitive have a strong incentive to minimize the confiscation of their wealth (eg, taxes) by any means feasible. For the most part, tax evasion is probably kept in check mostly by the effective threat of detection and coercion. It should also be noted that the capitalist virtues are essentially calculated and therefore insincere: capitalism encourages people in business to be virtuous not because virtue is valued for itself, but because of acquisitiveness or greed. However, most people find it difficult to counterfeit morality, and using not much more than common sense, people very often can, at least on substantial exposure, spot pretenders. It is likely, then, that, in general, the best way to seem virtuous is actually to *be* so.

him forever." Thus, even "as a mere matter of selfishness," he concludes, "honesty is the best policy."

Fairness. Relatedly, business people who engender the reputation for being sharp operators--those who price gouge or take "unfair" advantage of a situation when the opportunity presents itself--will find others approaching them with a wariness that is not wise from an economic standpoint. As Barnum puts it succinctly, "Men who drive sharp bargains with their customers, acting as if they never expected to see them again, will not be mistaken." That is, as a general rule, one should give a sucker an even break.

Civility. Although rudeness is hardly unknown among capitalists, the system itself rewards civil behavior: in Barnum's words, "politeness and civility are the best capital ever invested in business." Customers and deal makers who are treated well will be more likely to return. And employers who are considerate and courteous to their employees will tend to find them working harder or for less money--or both. They will also be less likely to join unions, quit without warning, or steal from the company.

Compassion. It is also generally good for business to show a sense of compassion, of community responsibility, of charity, and of altruism. Barnum, none too surprisingly, had something to say on this issue: "Of course men should be charitable, because it is a duty and a pleasure. But even as a matter of policy, if you possess no higher incentive, you will find that the liberal man will command patronage, while the sordid, uncharitable miser will be avoided." Operating on this premise, he carried out his various business ventures with an eye toward what he called "profitable philanthropy" in the anticipation that the larger his reputation for liberality, "the more liberal the public would surely be to us and our enterprise."

2. It is not obvious that virtuous business behavior is profitable.

Virtuous business practices may be financially beneficial, but this reality may not be obvious to the very capitalists who stand to benefit from them. There seem to be at least four reasons for this.

1. Capitalism's image. Although capitalism is generally given credit, even by its many detractors, for generating wealth and for stimulating economic growth, it is commonly maligned for the deceit, unfairness, dishonesty, and discourtesy that are widely taken to be the normal consequences of its apparent celebration of greed. This negative image of capitalism has been propagated for centuries--perhaps forever--not only by Communists and socialists, but by the church, popular culture (including capitalist Hollywood), intellectuals, aristocrats, and often by capitalists themselves--particularly by those who have lost out in the competitive process.

2. Aversion to short term loses. To make more money in the long run very often requires making less in the short run, an important reality that has often proved difficult to grasp.[2] When a dissatisfied purchaser returns to a store, it is clearly to the retailer's short term interest to refuse to take the item back. Haggling with the customers is advantageous in the short term to retailers: they know much more about the product and are likely to be better bargainers because, unlike the average customer, they do so all the time. By putting few coals on the office fire, Scrooge saves money in the short run even though his shivering clerk is likely to be less productive as he desperately tries to warm himself on his candle. When supplies suddenly drop or demand suddenly escalates, price gouging is perfectly appropriate in the short term. And it never makes sense in the short term to give a sucker an even break.

3. Human nature. Civility and other business virtues may be admirable as well as profitable, but

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[2] On the other hand, the quest for short term gain stimulates speculation, an activity that benefits capitalism which requires that investment money generally be transferred from bad enterprises to good ones. However, speculators do worse on average than those who simply buy and hold. Thus, they effectively act as altruists--that is, they knowingly and systematically take a financial loss in order to better the economic condition of their more laid-back fellows. In an important respect, therefore, capitalism is profoundly irrational.

they are not natural to all people in all circumstances.

> Example 1: Wanamaker as shopper. The profitable, if patently absurd, business principle, "the customer is always right," is not always easy to follow. John Wanamaker, the nineteenth century retailer, recalls going to a jewelry store as a boy on Christmas eve to buy his mother a gift. He spent a long time looking at the goods on display and finally made a choice, but as the jeweler was wrapping it up, the boy changed his mind and said he would like to take another piece instead but the jeweler refused to allow him to do so. Wanamaker recalls that he was "too abashed to protest," and it seems a reasonable speculation that he never patronized that store again and has retold the story many times. The exasperated jeweler's reaction was fully human, but it was foolish business behavior.

> Example 2: Barnum's usher. One of the ushers at Barnum's Museum once told him he intended to whip a man who was in the lecture room as soon as he came out "because he said I was no gentleman." Barnum dissuaded the usher from this natural reaction by explaining to him the value of business virtue: "I cannot afford to lose a customer. If you whip him, he will never visit the Museum again, and he will induce friends to go with him to other places of amusement instead of this, and thus, you see, I should be a serious loser."

> Example 3: The appeals of egoism. "The pride of man," warns Adam Smith, "makes him love to domineer," and Smith was appalled at the tendency for high profits to "destroy that parsimony which in other circumstances is natural to the character of the merchant." People in business, particularly successful ones, can indeed become egotistic about their enterprises, not unreasonably seeing them as extensions of their personalities, and they can foolishly come to behave like despots in their self-generated and often rather petty domains. Thus, one CEO fired an executive in front of his whole company of 100, essentially sadistic behavior that may have few negative consequences for the perpetrator when he is a drill sergeant terrorizing a group of conscripted recruits, but is a distortion of sensible acquisitive behavior under capitalism. As one appalled businessman puts it pointedly, "I leave it to you to judge how this stunt would motivate the ninety-nine survivors."

> Example 4: The appeals of self-righteousness. Successful capitalists can also become superior, attributing their wealth entirely to their own skills and moral excellence. Even the mild mannered and genuinely pious John D. Rockefeller (whose immense fortune came not only from a lot of hard work, but also from some spectacular good luck) once suggested that "the failures that a man makes in his life are due almost always to some defect in his personality, some weakness of body, mind or character, will or temperament."

> Example 5: Scrooge as a natural codger. Some business people are naturally grumpy and vindictive. Scrooge, for example, is very grudging when he allows his clerk to have Christmas day off. But since he is going to do so anyway, it would be advantageous to Scrooge to tender the gift with an air of graciousness and good feeling: at no cost to Scrooge, his clerk would feel a sense of gratitude and loyalty. Scrooge seems to know this because he later recalls with considerable pleasure amiable treatment at Christmastime that he had once received from an earlier employer--treatment which was not at all expensive to the employer. Yet, presumably because of his natural grumpiness,

Scrooge is unable to bring himself to emulate such economically sensible behavior.[3]

4. The existence of plausible contrary folk-wisdom. As bleeding and the application of leeches to cleanse the body of deadly substances does have a certain rough plausibility, so it is at least plausible that wealth is best achieved by unvirtuous methods. When Napoleon pronounced that "the surest way to remain poor is to be an honest man," he was certainly subscribing to wisdom that was (and is) widely held. Indeed, when Quakers, a religious group that requires absolute honesty from its members, became rich in part because of this quality, they were regularly accused of hypocrisy. Related is the still common notion that wealth, like matter, cannot be created or destroyed, and therefore that people who become rich must necessarily do so at the expense of others.

Or there is a maxim which states, essentially, that "an unhappy employee is a productive employee" has long been accepted. Thus a prominent business writer in 1771 declared what Milton Rosenberg characterizes as the "conventional wisdom" of the time: "Every one but an idiot knows that the lower classes must be kept poor or they will never be industrious....they must (like all mankind) be in poverty or they will not work." Richard Tilly traces an "employer ideology" that was quite common in the nineteenth century: the belief among industrialists that "workers were naturally lax, undependable, opportunistic, and that only the threat of extreme poverty supplied adequate motivation to work." And Sanford Jacoby discusses the "drive system," variously common in enterprises into the twentieth century, under which it was believed that workers would produce only if they were constantly subjected to close supervision, abuse, profanity, threats, and the fear of unemployment.

3. It is very difficult to impose business virtue from above.

In attempting to account for the rise of norms appropriate for economic development, Douglass North stresses the role of formal institutions to regulate, police, and enforce contracts and agreements. He examines markets of exchange in the Middle East and North Africa where, although there are few governmental controls over the marketplace, the economy is relatively poor. North faults the consummate inefficiencies of a condition in which up to half of the labor force is engaged in the exchange process in which bargaining skills determine who prospers and in which haggling is "pervasive, strenuous, and unremitting." He finds it difficult to understand why these inefficient forms of bargaining should persist, and he suggests, that voluntary organizations should evolve "to ensure against the hazards and uncertainties of such information asymmetries." But that has not happened, he concludes, because "the fundamental underpinnings of legal institutions and judicial enforcement that would make such voluntary organizations viable and profitable" are missing.

Rosenberg and L.E. Birdzell assess essentially the same puzzle, and they too mostly stress the importance of institutions. "Somehow," they note, "appreciable numbers of people with money...must have come to believe that others...were honest, diligent, and could be trusted," and they suggest that this "business morality" may have emerged from merchant associations perhaps reinforced by the "appeal of the Reformation and its concomitant morality" or by religion more generally (though presumably not

[3] Things, actually, are a bit more complicated. Because Scrooge is naturally grumpy, sudden graciousness would probably be suspiciously (and accurately) viewed as self-interested and contrived by the clerk (or more likely by his sharper witted and sharper voiced wife). It could thus be economically counterproductive. Scrooge's convenient set of traumatic dreams, however, has the (somewhat improbable) effect of transforming his personality, and he becomes a Nice Person. Accordingly, subsequent gracious behavior will likely be accepted as genuine (because it is so), and he will profit accordingly as his employee becomes more loyal and hard-working and as business associates find more pleasure in dealing with him. Any previous success in business had presumably been due to his diligence and to his (sometimes brutal) honesty and despite his unfeeling humorlessness and disagreeableness. After his remarkable epiphany he is likely to prosper much more mightily (assuming of course that his newfound graciousness does not cause him to make foolish business decisions like giving away the store).

directly from the anti-capitalist teachings of the Catholic Church). Similarly, Alexander Gerschenkron speculates that craft guilds may have been "of considerable importance" in forming "business ethics."

But the problem is that a mechanical imposition of appropriate legal, moral, social, religious, or judicial mechanisms is unlikely to be adequate. Religions everywhere routinely prescribe moral behavior, yet the extension of this value to the business sphere is by no means obvious. North himself observes that poor countries often remain that way even when they adopt the laws and formal institutions of developed countries. And, Gerschenkron notes that governmental attempts in Russia to create guilds by fiat "could not yield the same positive results as did their spontaneous evolution in Western Europe."

When dishonest business practices are common, courts or regulatory systems will be swamped. Moreover, it is difficult to see how such business-enhancing virtues as civility and compassion and to a degree fairness (courts are likely to find it difficult to assure that suckers always get an even break) could be enforced by formal institutions in any case.

4. Virtuous business behavior is best developed as a business innovation.

Virtuous business behavior is, on balance and in the long run, profitable (proposition 1). Therefore, it can emerge from normal competitive activity. But since the value of such behavior is not obvious (proposition 2), it is necessary for a business innovator to discover its economic value and then to act upon this important discovery. Others, out of competitive pressures, will then tend to imitate, and virtue-enforcing institutions will subsequently arise.

North argues that, because of the absence of legal institutions and judicial enforcement in the bazaar he examines, "there is no incentive to alter the system." But there *is* such an incentive. Those who behave in a virtuous manner will, in general and on average and in the long run, profit from this behavior. What seems to be missing is not incentives or formal morality-enforcing institutions, but rather the realization by people doing business that honest, fair, civil, and compassionate dealing will be profitable.

What is required, therefore, is *enlightened* self-interest. Benjamin Franklin once observed that "Tricks and treachery are the practice of fools that have not wit enough to be honest." That is, because it is not intuitively obvious, it takes *wit* to discover that virtuous business behavior is economically sensible.

I propose, therefore, the following model:

1) A business comes to the (non-obvious and difficult) realization that honest, fair, civil, and compassionate dealing is the best way to profit.

2) Shattering tradition, it innovates and happily finds it enjoys a competitive advantage (that is, there is no collective action problem).

3) Its competitors, noticing the success of the innovator, follow suit (or decline by failing to do so).

4) Virtuous business behavior becomes the norm.

5) Concerned that business is given a bad name by the relatively few who still engage in (economically foolish) dishonest, unfair, uncivil, and uncompassionate business practices, the dominating businesses form associations and work with the government to force miscreants to shape up. That is, *effective institutions are more nearly the result of virtuous norms than the cause of them.*

5. Virtuous business behavior leads to economic growth.

Policies like price controls or confiscatory taxes will cramp economic activity and hinder economic growth, as economists point out all the time. But so will unvirtuous business behavior. When people generally expect to be treated dishonestly, unfairly, or discourteously in business they will simply tend to avoid making transactions, and hence there will be less wealth and growth because there will be less economic activity.

Therefore, all other things equal, places where these business virtues flourish will be more prosperous than places where they don't. And, indeed, that seems to be substantially the case. As Max Weber once pointed out: "The universal reign of absolute unscrupulousness in the pursuit of selfish interests by the making of money has been a specific characteristic of precisely those countries whose bourgeois-capitalistic development...has remained backward."

> Example 1: Southern Italy. In a southern Italian town visited in the 1950s by Edward Banfield, "An employer who can get away with it is almost sure to cheat his employees," and relations with employees were accordingly poisoned by "anxiety, suspicion, and hate." The result of this condition is that the economic development of the whole area suffers: often, he found, peasants prefer to go it alone on small uneconomic holdings rather than work a larger unit on shares, an arrangement which would be more profitable but which would "necessitate getting along with a landlord."
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> Example 2: Haggling as lying. Robert Frank notes that the art of bargaining is in large part the art of "sending misleading messages." But to mislead is to lie: Bill Clinton eventually allowed as how he had "misled people" when he had forcefully declared that he "never had sexual relations with that woman," but most people took this to be an admission that he had lied, not simply "misled." That bargaining is a form of lying is neatly indicated in this fanciful exchange penned in 1727 by Daniel Defoe:
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> > *Lady*. I like that colour and the figure well enough, but I don't like the silk, there no substance in it.
> > *Mercer*. Indeed, Madam, your Ladyship lies, 'tis a very substantial silk.
> > *Lady*. No, no, you lie indeed, Sir, 'tis good for nothing, 'twill do no service.
> > *Mercer*. Pray, Madam, feel how heavy 'tis; you will find 'tis a lie; the very weight of it may satisfy you that you lie, indeed, Madam.
> > *Lady*. Come, come, show me a better; I am sure you have better.
> > *Mercer*. Indeed, Madam, your Ladyship lies; I may show you more pieces, but I cannot show you a better; there is not a better piece of silk of that sort in London, Madam.
> > *Lady*. O fie! You lie, indeed, Sir; why it is not in grain.
> > *Mercer*. Your ladyship lies, upon my word, Madam; 'tis in grain, indeed, and as fine as can be died.
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> There are eerie reflections of Defoe in an article about training schools recently set up by the automobile industry, a rare retail business that still haggles with customers. When salespeople are asked, "All buyers are--what?" they instantly reply, "liars!" The article observes, "Once the negotiating begins, so does the lying...every customer suspects the salesman of being slime." And indeed, car salesmen consistently receive the lowest ratings for "honesty and ethical standards" in polls--this despite the fact that surveys also indicate that Americans are overwhelmingly pleased with the cars they have purchased.
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> The problem in all this is that most people do not like to lie, and the number who enjoy being lied to is, of course, even smaller. To the degree that people don't like to receive (or send) misleading messages, then, they will be disinclined to deal at all, and economic development will therefore be hampered.

As business virtue rises, therefore, the sheer pain of doing business is reduced--effectively transaction costs are lowered. As a result, people more and more overcome their traditional, well-founded aversion and cheerfully do business with virtuous enterprises with the result that economic activity increases overall and the general economy grows.

North stresses "evolutionary theory" and "path dependence," the notion that current developments are the result of forces set in motion long ago in the society. By contrast, the explanation for economic development I am suggesting stresses innovation: the grasping of the idea that honesty, fairness, civility, and compassion furnish a competitive advantage. Economies prosper when that visceral emotion is given free play and when that idea is seized and then imitated.

It seems to me, then, that Montesquieu is quite correct when he proclaims, "it is almost a general rule that wherever manners are gentle, there is commerce," but that he exaggerates when he adds, "and wherever there is commerce, manners are gentle." Similarly, Adam Smith seems in error when he argues that "Whenever commerce is introduced into any country probity and punctuality always accompany it. These virtues in a rude and barbarous country are almost unknown" or when he insists that "when the greater part of people are merchants they always bring probity and punctuality into fashion, and these, therefore, are the principal virtues of a commercial nation." The same problem exists when James Q. Wilson suggests that capitalism fosters "a reasonable concern for the opinions of others," or when Daniel Klein concludes that "commerce elevates manners and probity," or when an eighteenth-century Scottish historian contends that commerce "softens and polishes the manners of men."

There is clearly plenty of commerce in the bazaar North discusses, but little probity, gentleness, or soft and polished manners. That is, the virtues do not follow automatically from commerce; it is quite possible to have commerce that is also rude and barbarous. These areas are not "barbarous" or "backward" because they lack commerce or trade. Rather, they are "barbarous" or "backward"--that is, relatively poor--because commerce is being carried out without the capitalist virtues.

6. The west's prosperity was substantially caused by a rise of business virtue.

Virtuous business behavior, of course, is not *sufficient* for economic development. Inept government policies, religious prescriptions (like a bias against usury), or detrimental social attitudes (like laziness or endemic distrust or the conventional acceptance of the notion that prices should be set by custom or tradition) will discourage business and entrepreneurship and hamper growth no matter how honest or fair or civil or compassionate the business norms. But it seems likely that business virtue is important to economic development, and it would be useful to trace its rise and acceptance.

In 1962, Alexander Gerschenkron noted that "a sociology of business honesty still remains to be written," a condition that seems still substantially to hold. It is difficult to capture a rise of business virtue with any sort of precision, but there are a number of sources of evidence to suggest that it rose substantially over the last two centuries in the west. This rise in virtue coincided with remarkable economic development and was probably important to that development.

1. Content analysis. It is possible to find at least occasional explicit acknowledgment of the value of the capitalist virtues--particularly of honesty--before the nineteenth century. The phrase "honesty is the best policy" (meaning that it is the most profitable) seems to have a fairly long lineage: it is often credited to Cervantes (1547-1616), and in 1727, Daniel Defoe (who had been a businessman for decades before he became a novelist--indeed, invented the novel--with *Robinson Crusoe* in 1719) does chance to observe that "An honest tradesman is a jewel indeed, and...is valued wherever he is found." In his farewell address of 1796, George Washington said, "I hold the maxim no less applicable to public than to private affairs, that honesty is the best policy." Though, of course, other ex-Generals, like Napoleon, subscribed to the opposite maxim.

Even if the capitalists of his era were not systematically writing about it, Adam Smith did detect probity and a gentleness of manner as common characteristics at least of the commerce in his neighborhood. The Quakers brought virtue to business early on, though they were virtuous for religious reasons, not economic ones. As early as 1748 Benjamin Franklin stressed the economic value of honesty in enhancing one's ability to obtain loans, and there have long been informal reputational mechanisms like guilds and systems of merchant law for policing honesty among business people.

Undoubtedly some capitalists have long understood the value of virtuous behavior and did not bother to articulate the practice into an explicit business principle because it was second nature. At the same time, however, those business books that did exist were often filled with the kind of wisdom discussed earlier: that workers would only produce if they were constantly on the verge of starvation.

At any rate, as elaborated, self-conscious principles, the ideas that honesty and especially fair dealing, civility, and compassion bring wealth--notions commonly found in contemporary books on business--seem to have been generally discovered, or at least to have been made clearly explicit, only in the nineteenth century or so. In fact, P.T. Barnum's mid-century tract, "The Art of Money-Getting," is the earliest publication I have been able to find in which the profitability of virtuous business behavior--particularly of fairness, civility, and compassion--is clearly, specifically, and extensively laid out.

This rather remarkable silence suggests that the explicit discovery and the conscious application of the capitalist virtues to actual business behavior may be fairly recent.

2. The research of Richard Tilly. Although difficult to chart precisely or to quantify, Tilly finds that honesty in business affairs grew notably during the nineteenth century in Britain and Germany. Entrepreneurs, he notes, increasingly came to view "individual transactions as links in a larger chain of profitable business ventures, as building blocks in a long-run process of capital accumulation" rather than as "one-time opportunities to be exploited to the utmost." He notes, for example, that, even though business activities were expanding greatly, there was no rise in the number of complaints about breaches of contract or fraud. Indeed, the business done by Prussian Banks expanded by 563 percent over a 40 year period, while their bad debts accounts declined by 20 percent. He also traces the dawning awareness by industrial entrepreneurs of a connection between peaceful industrial relations and high labor productivity, a realization that made them "increasingly willing to deal with their workers as economic partners who had the right to fair and honest treatment." This rise of business virtue, then, seems to have been strongly associated with economic development: "business honesty and capital accumulation," observes Tilly, "go hand in hand." And, it is "in economically underdeveloped countries of the twentieth century," he suggests, that "one can observe low standards of business morality reminiscent of Europe's backward areas of the eighteenth and nineteenth centuries."

3. The observations of Alfred Marshall. Writing in 1890, economist Alfred Marshall could see the rise of virtue happening. He noted that the quickly-developing modern economy "has undoubtedly given new openings for dishonesty in trade." New ways "of making things appear other than they are" had been discovered, and "the producer is now far removed from the ultimate consumer" and thus "his wrong doings are not visited with the prompt and sharp punishment which falls on the head of a person who, being bound to live and die in his native village, plays a dishonest trick on one of his neighbors."[4] However, although "the opportunities for knavery are certainly more numerous than they were...there is no reason for thinking that men avail themselves of a larger proportion of such opportunities than they used to do. On the contrary, modern methods of trade imply habits of trustfulness on the one side and power of resisting temptation to dishonesty on the other, which to do exist among a backward people." It is among

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[4] Marshall assumes business practices would be more honest in small communities, as does North when he suggests that transaction costs in a village would be comparatively low because "trade exists within a dense social network." However, Barnum's recollection of business in the early part of the century stresses that "sharp trades" and "dishonest tricks and unprincipled deceptions" occurred both in the cities and in the country at that time.

races "who have none of the originating power of the modern business man," suggests Marshall, that "there will be found many who show an evil sagacity in driving a hard bargain." In my opinion, of course, the modern economy was developing precisely *because* habits of trust had been developed, not, as Marshall suggests, the other way around.

4. Notable changes in specific business practices. Since the mid-nineteenth century or so there has been a clear rise in certain business practices that are generally considered to be fair and virtuous. Among these are the refund of cash or the exchange of bad merchandise to disappointed buyers, concentrated efforts to train employees to be polite and to make the shopping experience more pleasant and unpressured, and the introduction of fixed prices as well as brand labels and other guarantees of quality,

Similarly, there has clearly been a pronounced decline in the employer ideology that workers must be dealt with harshly, even brutally, to keep them productive. This approach seems substantially to have been enhanced by the experiments at the Hawthorne Works of Western Electric in the 1920s that systematically suggested that higher employee morale led to greater and more efficient production--observations that came as a revelation to many business people at the time. By 1996, when strikes in the United States dropped to a 50-year low, corporate officials credited the phenomenon to "increased employer-employee team-work" and to the fact that management had learned to treat workers with more respect.

There has also been an obvious rise in policing institutions over the last century or so. Concentrated efforts by businesses to establish agencies to deal with industry-embarrassing and therefore profit-harming fraud and misrepresentation began in the United States only about 100 years ago: Underwriter's Laboratories, for example, was not founded until 1901, the Better Business Bureau not until 1912. Tilly finds that "established business leaders played a dominant role in the deliberations and negotiations that produced legal codification of business norms" but also that the legalization of behavioral norms took place precisely when the norms had already become widely accepted. For example, fraud and dishonest practices by the larger German merchant houses in wholesale trade had become quite rare because they were "'monitored' (or controlled) by competition," and the problem then became to extend these practices to the smaller firms which were often "devoid of any solid mercantile tradition" and had "no reputation to lose."

As this last comment suggests, bigness probably paid a role in all this. As businesses become large, they are likely to have longer term perspectives, to have more reputation to lose, and to become impatient with deceptions that sacrifice steady accumulations for quick gains. But it seems likely they did not come to these perspectives because they were big, but rather that they became big because they held them from the start.

Example 1: Wanamaker as seller. Judging from Wanamaker's recollections, American business practices in the 1860s were quite similar to those discussed by North for the Middle East and North Africa:

> The law of trading was then the law of the jungle, take care of number one. The rules of the game were: don't pay the first price asked; look out for yourself in bargaining; haggle and beat the seller as hard as you can....And when a thing was once sold--no returns....Schools in stores for training employees were unknown.

Shattering this ill-tempered tradition with its high transaction costs--a tradition that probably goes back to the origins of commerce--Wanamaker consciously set out to provide "a service exactly opposite to the ancient custom that 'the customer must look out for himself.'" To begin with, he applied set prices--called "one-price" since the same price was paid by all buyers. He was not the first to set prices, and there were advantages to setting prices other than customer satisfaction: a business did not have to rely on an employee's bargaining ability, one could hire fewer and less expensive sales clerks, and the process was less time-consuming. However, Wanamaker went further and combined this with a money-back offer which essentially guaranteed a low price. In addition, he carefully trained his employees. They were told to "place yourself in the customer's place and give such service as you would like to have given you were you buying instead of selling," and, when customers come back with goods to return, to "be, if possible, more agreeable than if they had come to make other purchases." The approach proved, in the words of business historian Joseph Appel, "sound not only in morals, but in economics as well." Wanamaker became rich, his success was imitated by his competitors, a retailing revolution took place, customers became much happier to part with their money, and the economy prospered. And, indeed, countries that have given up haggling at the retail level are also among the most prosperous. But the revolution took an innovator--someone had to realize that "ancient custom" was dictating a foolish way to do business, then to devise an effective alternative that sacrificed short-term advantage for long-term gain, and finally to demonstrate that it would work in practice.

<u>Example 2. Barnum's circus</u>. Before Barnum, circuses were very often run by fly-by-night cheats: ticket takers would regularly short-change customers; pickpockets, working on a commission, would roam the grounds; "Monday men" would steal the wash from clotheslines or burglarize homes when the citizenry was at the performance or watching the circus parade; shows would be frauds; games would be fixed. Quick profits were made this way, but soon the entire industry was on the verge of extinction because its customers, through experience, were no longer foolish enough to attend. Barnum was one of those circus innovators who changed all that. He used honest ticket takers, hired private detectives to police pickpockets, and spent a lot of time and money creating what he (with characteristic understatement) called, "The Greatest Show on Earth." Whether customers always fully agreed with that representation, they did find the show, and the whole experience of attending the circus, enjoyable, and they were happy to come back year after year. Accordingly, Barnum and such like-minded circus managers as the Ringling Brothers, applying their "Sunday School" approach to business, soon became far richer than the cheats who had preceded them.[5] By 1910, virtuous circuses like Barnum's had come to dominate the industry. Concerned that business on the road was being harmed by bad business practices that still persisted, they met to establish by agreement that the generally profitable "Sunday School" approach should dominate.

In attempting to explain why Western economies developed so prodigiously and unprecedentedly over the last couple of centuries, economic historians almost invariably stress innovation as part of this process. Rosenberg, for example, concludes that "economic growth is, in many important respects a learning process whereby the human factor acquires new skills, aptitudes, capabilities, and aspirations," improvements "which typically escape the scrutiny of the economic theorist."

Technological innovations have clearly been important in this process, as have management

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[5] Management guru Peter Drucker argues that integrity, his one "absolute requirement" of a manager, "is not something a man can acquire; if he does not bring it to the job, he will never have it." Nonetheless, it does seem possible to learn to appreciate the economic value of honesty. Barnum found that the colorful "humbugs" of his early career "ended in disaster and reduced myself and family to the pinching income of $4 per week." The fortune he acquired later, he points out, "was accumulated almost wholly from enterprises which were undoubtedly legitimate."

innovations in accounting, organization, and responsibility sharing. But the recognition of the economic value of business virtue seems to have been one of these innovations.

It might be interesting to speculate about what would happen if the process were to be reversed. How much money would L.L. Bean lose if rumors spread that it had been cheating its customers? How long would a successful restaurant remain that way if it began to treat its customers with rudeness and contempt? How much damage to productivity would there be if a company's management decided to rely entirely on profanity and threats of unemployment to get its workers to put out? How would an established business fare if it were systematically to lie to its clients? How many patrons would continue to attend The Greatest Show On Earth if it routinely short-changed them? The answers to questions like these may suggest the magnitude of the importance of business virtue to economic development.

II. Extrapolating to post-Communism

Extrapolating these propositions to the post-Communist experience leads to a set of observations.

1. The importance of a long-term perspective

For virtue to be rationally pursued, it is vital that people in business have a long-term perspective. If one is concerned only about short-term gain, then lying, cheating, unfairness, deception, fraud, intimidation--indeed, outright stealing--become sensible behavior patterns. During much of the 1990s, the instability in many post-Communist countries, certainly including Russia, made long-term planning so uncertain that the most reasonable approach in business often was, essentially, to take the money and run.

With that tumultuous decade behind us, things seem generally to be improving in this regard. Concerns about Yugoslavia-like violence, so common in the early 1990s, have faded, and there may be a growing sense that the basic system that exists now will, for better or worse, still be there years from now: things may be messy, but they are unlikely to blow up or to change fundamentally in the next years. This outlook may furnish a degree of predictability and stability that permits long-term planning increasingly to become a reasonable business perspective.

2. The need for acquisitiveness, ambition, entrepreneurship

In the immediate wake of the collapse of Communism, many analysts argued that the potential for economic development in the post-Communist countries was severely limited because over its 40 or 70 year reign Communism had systematically stifled the entrepreneurial spirit--people expected everything to be furnished them and had lost the capacity to work. For some people--particularly those over 40--there may have been something to this anticipation. The experience of the 1990s, however, suggests that there has been plenty of entrepreneurial spirit within the societies--particularly among the young. Admittedly, this spirit has frequently expressed itself in ingenious manipulations of the system in order to steal from the government or to engage in outright, albeit organized, crime. But the capacity is clearly there for a significant chunk of the population.

Some entrepreneurial people were systematically discouraged under Communism and dropped out, but others decided to work the system. In an age in which individual entrepreneurs are systematically rewarded, therefore, we would expect many who were excluded from the old Communist system to rise, but also many to come from within it. Thus it is not surprising to find that many top managers in the private sector used to be directors of socialist enterprises. Although the perception is that the old Communists are still running the system and thus that nothing has really changed, in fact everything has.

In any developing economy, the numbers of people actually engaged in entrepreneurial, risk-acceptant behavior does not need to be large. The post-Communist states seem to have an adequate supply of such people. What is required is that their energies be channeled in a direction that is economically beneficial for the entire society.

Nor does successful capitalism require that people generally understand the economic form. In polls conducted in 1990, the residents of capitalist New York tended to agree with those in still-Communist Moscow that it is "unfair" for an entrepreneur to raise prices merely because demand increases, and New Yorkers were, if anything, *less* tolerant of economic inequality, *more* distrustful of "speculators," and *less* appreciative of the importance of material incentives. And, although the overwhelming majority of economists insist otherwise, generous portions of the public in capitalist America continue to maintain that downsizing is bad for the economy, that foreign trade agreements only cost domestic jobs, and that gasoline prices result mainly from the quest for profits by Big Oil rather than from the normal play of supply and demand. However, such faulty popular perspectives do not seem to have notably hampered the fundamental workings of capitalism at least in advanced capitalist democracies of late. Although there probably ought to be *some* guiding minds at work for capitalism to be properly instituted and maintained, it does not appear necessary for people in general fully to appreciate them, or even to believe in them, for them to work.

3. The capacity for trust, honesty, and civility

Communism was notable for the mendacity and incivility it inspired among the population. Governmental officials routinely lied to the public while members of the public responded in kind, and interpersonal relations, particularly among strangers, were very often laced with stylized misdirection and deception. And, because the monopolistic economic system would not allow prices to rise when demand outstripped supply, clerks and officials tended to ration by incivility as customers essentially became supplicants--a phenomenon that is not exactly unknown in the West when the same basic parameters prevail as in passport offices or drivers license bureaus.

As the Polish sociologists Mira Marody and Piotr Sztompka have observed, however, under Communism there was actually a curious contradictory duality between the public and the private (or perhaps better, personal) spheres for most people. The public sphere may have been characterized by mendacity, deception, laziness, cynicism, rudeness, social helplessness, mediocrity, and a devaluation of work, but the private sphere--which extended far beyond the immediate family--was characterized by risk-taking, resourcefulness, initiative, civility, self-fulfillment, considerateness, and appreciation of work. Stealing from the state was accepted; stealing from a private individual was not. Cheating on a university exam was accepted, even lauded; cheating in a personal relationship was not. Among "us" there was civility and honesty; between "them" and "us" mendacity and incivility. Thus, honesty, fairness, civility, compassion, and initiative were not stamped out, but simply restricted to the private sphere.[6]

In the post-Communist states private attitudes should freely find application in the business sphere (neither exactly public nor exactly private) because the private values will be rewarded there. Old habits may still dominate relations between the individual and the state--as, to a lesser extent, they also do in the West. But as the capitalist sphere expands, relations between the individual and the state become a decreasingly important element of life.

Thus, it is not necessary for old habits to be unlearned. Rather, one preexisting set of habits and perspectives may gradually (or perhaps suddenly) become eclipsed by the other preexisting set.[7] All this

[6] Contrary to Robert Putnam's concern, then, the social atmosphere does not appear really to resemble that of economically backward areas like southern Italy.

[7] A student who visited the Soviet Union came back with all the usual tales about the rampant discourtesy so characteristic of government stores. When asked about the private markets, she observed that the people there were, by contrast, wonderfully warm and friendly. The sellers there, she said, were "just like Americans." Actually, they were just behaving like sensible capitalists.

could make economic development comparatively easy. It would hardly require decades of pain, trauma, uncertainty, and effort.[8]

It may be that within certain substantially self-isolated groups--Chechens and Gypsies perhaps--expansion of private civilities will be difficult. But among most it may not be very hard to pull off: McDonald's does seem to have been able to teach its people to smile at customers. Indeed, my experience suggests that the expansion could be quite easy, that dishonest and uncivil behavior is quite superficial. I have been led in the streets of both Bucharest and Moscow by guides who needed repeatedly to ask for directions. Although the general street demeanor of people on those cities is brusque and distant--even by the standards of Manhattan--I was impressed by how thoroughly this could be broken down when one simply asked strangers for assistance. In each case, my guides were greeted with consummate civility and attentiveness: with rare exceptions, the strangers stopped, listened carefully, and tendered detailed (and usually correct) advice.

The capacity for trust, honesty, and civility clearly is there. Expanding it to more distant interpersonal relationships should not prove terribly difficult.

4. Fostering virtue as an innovation

If the propositions in Part I of this paper are correct, virtuous business behavior can emerge and be advanced on its own through competitive pressures once its value has been grasped. There seem to be two methods by which this process can be enhanced in the post-Communist countries.

First, Western businesses are likely generally to provide beneficial models of behavior, and therefore their proliferation is to be encouraged. Applying conventional Western standards of honestly, fairness, civility, and employee and customer satisfaction, such businesses are likely to cause local businesses to follow suit--or to go out of business.[9] Thus, for example, McDonald's in Moscow has already inspired a borscht-and-blini imitator which, like McDonald's, sells fresh ingredients and fast and pleasant service in a clean environment. Says the marketing director of the Moscow McDonald's, "I really see it not so much as competition as the acceptance of our way of doing business. They have seen what we can do and I hope they will learn from it." Similarly, there are reports that Russian oil barons are beginning to see the economic value of transparency and reliability as they brush up against Western businesses and seek Western investment.

Second, it seems possible that there could be benefit in systematic propaganda touting the economic value of virtuous business practices. Material like that is routinely found in Western how-to-do-it business books like those on excellence by Thomas J. Peters (though, of course, it is almost never found in movies put out by capitalist Hollywood). Since, as noted in Part I, there has long been conventional imagery and folk-wisdom to the contrary (both in the East and in the West), the process is by

[8] Opportunities for honest business abound in these areas. Going back to Communist days, it has been common for automobile mechanics to cheat their customers: an automobile brought in for repairs would be fixed, but the mechanic at the same time would remove good parts from the car, replacing them with inferior (thought still functional) ones. The result, however, is not that mechanics become rich. Rather, the customers do everything to repair their cars themselves; where possible, they even take their cars to western capitalist countries, preferring to spend much more money, and hard currency, to be sure that they get an honest repair job. Thus an honest repair business--which, precisely because of its honesty, can charge higher prices--can prosper. A few years ago a resident of Warsaw complained to me about the difficulty of getting repairs done competently and honestly there. When I suggested there must be some competent and honest repair businesses, she observed, "Yes. But they have so much business, you have to wait for months."

[9] This process may resemble the adjustments to traditional arrangements that occurred when Japan, China, and Korea were confronted with Western capitalism.

no means sure fire, but efforts could be made to spread the word--like Barnum did in 19th century America.

5. Developing the private enforcement of business virtue

Once businesses have discovered the economic value of virtuous business behavior, they will have an incentive to police their individual economic sectors because unvirtuous behavior by some businesses causes people to be wary of dealing with all businesses in the sector. Policing and informational organizations like the Better Business Bureau, the Advertising Council, and the Chamber of Commerce might be set up and developed. Similarly private firms may find profit in supplying advisory information as have businesses like Underwriter's Lab, *Good Housekeeping*, *Consumer Reports*, and some newspapers in the United States.

In addition, business organizations that facilitate reputational gossip can be of value. These would include trade associations as well as groups like Kiwanas, Rotary, and Lions.

6. Government as a problem

Confiscatory and arbitrary taxation policies can have many detrimental effects on economic development, and, as Timothy Frye has pointed out, one of these is to penalize transparency and honesty. The problem is, however, neither new nor unique, and it has often been found the developed West. As Rosenberg and Birdzell point out, for centuries predatory taxation policies by rulers caused businesses to engage in routine and ingenious tax evasion and to hold wealth as much as possible in mobile and concealable form. Nor has it completely been eliminated: some friends of mine recently sought to buy a pizza business in Rochester, NY, and found they were never told how much money a business actually took in, only the amount reported on tax returns.

Overregulation and corruption, as Djandov et al. have observed, can have a similar effect by greatly restricting entry--or, worst of all, effectively limiting it to manipulatory, bribing, or criminal enterprises. It is vital for virtuous businesses to be able to enter the market as freely as possible.

7. Government as a solution

"Little else," Adam Smith once said, "is requisite to carry a state to the highest degree of opulence from the lowest barbarism, but peace, easy taxes, and tolerable administration of justice." Following Smith, many have argued that a viable judicial system is important for the development of capitalism, particularly as the ultimate arbiter of contracts and property rights and as final recourse against fraud.

As suggested in Part I, however, governmental and legal structures to enforce contracts and property rights and to provide redress against dishonest business practices came relatively late in the development process. For the most part, European states mainly absorbed pre-existing commercial and merchant law into their evolving legal systems. And, as Rosenberg and Birdzell suggest, this did not come about even in advanced England until late in the eighteenth century after a great deal of commercial expansion had already taken place: an effective court system did not *cause* commerce but rather was "a response to the expansion of commerce;" as such it (merely) "added to the ability to predict the behavior of others." Similarly, Robert Ellickson notes that law often "is not central to the maintenance of social order," but rather that informal group norms do the job. Or, as Adam Smith observes, "commerce and manufactures gradually introduced order and good government," not the other way around.

In general, appropriate norms cannot be effectively superimposed upon a business system that is dishonest or unfair because that would require policing just about everyone--a hopeless administrative task. That is, a system in which nearly everyone is a crook simply cannot be policed--even by a Hobbesian Leviathan. Government and legal structures become effective mainly when business practices are already honest and fair so that the relatively few miscreants could be readily identified and prosecuted.

There is, of course, obvious economic benefit when contracts can be guaranteed and when fair courts can act as final arbitrator in disputes. However, although the United States has such a system, the process of taking somebody to court--especially when the system is swamped with criminal (especially drug) cases--can be extremely expensive and time-consuming. As a result, if there is even a small chance the courts will be required to make a deal work, the deal will probably not be consummated in the first place. A fair and reliable judicial system facilitates capitalism and may be useful as an accepted ultimate arbitrator, but it is a clumsy and costly expedient. (And, as noted in Part I, it is unlikely in any case to be able to do much to enforce such important business-enhancing qualities as civility, compassion, and, often, fairness.)

Daniel Klein observes that "the simple explanation for integrity would seem to be that agreements are enforced by court and constable." However, "everyday experience and numerous scholarly studies suggest that official contract enforcement is often costly and impractical, yet promises usually work out nonetheless." For example, in his study of actual business behavior, Stewart Macaulay found that only five of the twelve purchasing agents and only two of the ten sales managers he interviewed "had ever been involved in even a negotiation concerning a contract dispute where both sides were represented by lawyers," and *none* had ever "been involved in a case that went to trial." Instead, he found that "disputes are frequently settled without reference to the contract or potential or actual legal sanctions." Indeed, "there is a hesitancy to speak of legal rights or even to threaten to sue." As one respondent put it, "You don't read legalistic contract clauses at each other if you ever want to do business again. One doesn't run to lawyers if he wants to stay in business because one must behave decently." In this regard, "holding a customer to the letter of a contract is bad for 'customer relations.' Suing a customer who is not bankrupt and might reorder again is poor strategy."

Principally, then, people in American business rely on trust and reputation to make deals happen. A spectacular case in point would be the agreements between Standard Oil and the railroads in the nineteenth century. Of enormous economic consequence to both parties, they were mostly sealed simply with a handshake. In the end, Macaulay is able to find remarkably few reasons for written contracts to exist at all, and many of these are essentially extra-legal. He points out that contracts sometimes serve as a useful communication and clarification device, particularly when the issue at hand is complex and likely to take place over a long period of time, and they are often mainly put together because they are required by the federal government or by a lender of money or for the convenience of outside lawyers who are obsessed with avoiding "any possible legal difficulty" and demand a formal contract because it makes their job easier in the (highly unlikely) event that a future dispute will have to be settled in court or by legal pressure.[10]

It is surely desirable to have enforceable antifraud legislation, but it is worth noting that the buyer must still be wary of fraud even in the United States with its highly developed and substantially incorruptible court system. A consumer who has been cheated can report the fraud to the authorities and the cheater may perhaps eventually be put in jail. But as a practical matter the swindled have very little chance of ever getting their money back--by the time the swindler is caught, the money is likely to be long

[10] Actually, where trust has arduously, and profitably, been built up, efforts to further guarantee honesty by mechanical legalistic devices could be counterproductive, even in the consumer field. Suppose, for example, the successful mail-order merchant, L.L. Bean, were to attempt to enhance its reputation for business integrity by establishing a policing organization in cooperation with a governmental agency that would guarantee that any customer cheated by the company would receive quick and full recompense. It seems likely that this innovation would actually lower concern about the company's integrity, and it would almost certainly reduce sales. It is sounder business for Bean to rely simply on its reputation for honesty even though this is secured by nothing grander than its appreciation for the fact that that reputation is money in the bank.

gone. Moreover, a huge portion of transactions do not involve enough money to make a civil suit a sensible recourse--and, of course, many agile swindlers will wisely keep their fraudulent profit per sucker low enough to make sure of that.

And, as the experience of contemporary China demonstrates, if other conditions are appropriate, a great deal of economic development and investment is possible even when a commercial legal system can scarcely be said to exist. The process, however, does tend to put a premium on informal contacts with government officials, and there tends to be an emphasis on shorter-term investments and transactions.

What is mainly needed for an effective regulatory, legal, and court system to emerge, it appears, is the development of such business norms as honesty, integrity, fairness, and reliability. It is the central message of this paper that, because those adhering to the norms have a competitive advantage in the long run, the norms tend to emerge naturally out of normal competition when an innovator grasps the economic benefit of such virtues and demonstrates their advantage by putting them into practice. Governments beneficially get into the act only later.

8. A second European miracle?

Economic historian E. L. Jones has applied the word, "miracle," to describe the unprecedentedly massive economic development that began a few centuries ago in Europe, a process that soon came to distinguish that continent (and its spinoffs) from the rest of the world. It may be a bit extravagent to use the same word to describe the general (though not unrelieved) success the European post-Communist states have had in making the transition to capitalist democracy. But it may not be too far off the mark, either.

In the early 1990s it was commonly argued, in the words of a Czech entrepreneur, "We are fighting a deformation of the human mind. During 40 years of the totalitarian regime people have formed the opinion that all private businessmen are thieves trying to get money without doing any work." And in 1992 Sovietologist Stephen Cohen gloomily argued that "Any hope for real markets and real democracy in Russia is a matter of a generation." These concerns, it seems, have been substantially exaggerated: the results suggest either that minds were not permanently deformed in Europe by the Communist experience, that whatever deformation took place is rather readily overcome, or that any such deformation is essentially irrelevant.

Moreover, the process was totally unprecedented and completely unstudied. As Lawrence Summers observes, the death of Communism caught the economics profession utterly unprepared: although there had been quite a few studies at that point about the transition of market economies to controlled or command economies, "there was not a single book or article on the problem of transforming an economy from the communist to a market system." Indeed, the word, "privatization," had only been recently coined in connection with Margaret Thatcher's relatively modest efforts in the 1980s to denationalize comparatively small portions of the British economy. In the space of a very few years, Hungary alone privatized more enterprises than had been privatized previously in the entire history of the human race, and country after country built banking systems in less time than it takes to train a bank examiner in the United States.

The experience in many of the European post-Communist countries suggests that democracy as a form of government and capitalism as an economic form are really quite simple, even natural, and, unless obstructed by thugs with guns, they can form quite easily and quickly without any special development, prerequisites, or preparation. It seems to me that democracy is fundamentally about leaving people free to complain, and that capitalism is fundamentally about leaving people free to be greedy. Neither emotional quality, it seems, can easily be stifled and neither is terribly difficult to inspire.

It also suggests that continued discussion about "transition" could be dangerous because the word suggests that the post-Communist countries are still moving toward future institutional patterns which will somehow be crucially different from the ones that prevail today. This can inspire or reinforce a short-term perspective, something that is undesirable from either a political or an economic standpoint.

By contrast, it seems to me that most of the post-Communist countries of central and eastern Europe have essentially completed their transition to democracy and capitalism: what they now have is, pretty much, it. They are already full-fledged democracies if we use as models real Western countries (as opposed to some sort of vaporous ideal), and by most realistic standards they have already substantially achieved the kind of capitalism found in the West where governments still control and regulate much of the economy. And, like their Western counterparts, people have come to take freedom for granted and have quickly learned to seize their new opportunities to complain.

There will, of course, be continued political and economic change in these countries and some of this will be quite important. Politicians will come and go; some parties will fall and others will rise in voter favor; constitutional and legal structures will undergo development; controversial issues will emerge and decline; new businesses will rise and others will go bankrupt; economic structures will be reshaped and refined; trade patterns will change; governmental subsidies will be increased and decreased; tax laws will be altered. But, barring some sort of violent upheaval, the time of fundamental change is substantially over: further developments will take place in environments which are essentially democratic and capitalistic. The societies may become more or less efficient, humane, responsive, productive, corrupt, civil, or effective, but these changes will probably have to come about within (or despite) the present political and economic framework, not through further fundamental institutional transformation.

But it seems sensible now to decrease the talk of "transition" and to put a quiet, dignified end to the new field of transitology. In most of Europe, post-Communism is already over.

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