

ESSAYS ON ENTREPRENEURSHIP AND SOCIAL CHANGE

by

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Master of Arts
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DEDICATION

To my parents, Galina and Pavel Nicoara.

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I would like to thank my family, and the many friends and colleagues who have made this possible: My parents, Galina and Pavel Nicoara, have motivated me to pursue an intellectual career. I am indebted to my mentor and dissertation advisor, Professor Peter Boettke, whose enthusiasm, guidance, and encouragements were essential to my professional achievements and to completing this dissertation. Paul Aligică, and Christopher Coyne, the members of my dissertation committee, provided insightful comments and suggestions leading me to refine my ideas and improve my arguments. I would also like to thank my friends Frédéric Sautet, Gregory Rehmke, Katrin van der Vaart, Alexander Schibuola, and Laura Grube, for their constant moral and intellectual support during difficult times. Last, but not least, I am very grateful for the financial and institutional support provided by the Mercatus Center at George Mason University and the Institute for Humane Studies. Any remaining errors are my own.

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ABSTRACT

ESSAYS ON ENTREPRENEURSHIP AND SOCIAL CHANGE

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Recently, many social scientists have turned their attention to the role that context plays in understanding real-world, dynamic phenomena such as institutional, economic, and social change. This dissertation is an effort to contribute to this growing trend of new contextual analysis. The dissertation investigates how and why the heterogeneity of, and interaction between “institutions” across societies shapes the manifestations of economic, institutional, and socio-cultural change. The research focuses on the experience with the collapse of communism and the ongoing transitions in Central and Eastern European, and Former Soviet countries.

1. INTRODUCTION

"There is a strong tendency for even the best practitioners to concentrate on the analytically interesting questions rather than on the ones that really matter for the study of real-life industries. The result is often a perfectly fascinating piece of analysis. But so long as that tendency continues, those analyses will remain merely games economists play."

--Franklin M. Fisher 1989, p. 123.

What determines change? In an age of digital innovations and colored revolutions, how does economics address modern, dynamic phenomena such as technological and social change? Franklin Fisher's quote suggests that theoretical economists are partial to questions answerable only with the standard tools of economic modeling and analysis, and tend to dismiss questions which cannot be fitted into their framework. Real-world dynamic phenomena, economic or social, in particular fall into the category of "uninteresting" questions, "hard-to-fit" into the mainstream framework of economic theorizing. Questions of institutional dynamics, like social, legal, and cultural change are left outside formal economic modeling, and are the subjects of non-mainstream analysis.

The two subjects most revealing of the weaknesses of the basic analytical tools used in microeconomic theory are institutions and equilibrium (Kreps 1990, p. 13-14). The model of perfectly competitive markets tells us that “prices matter” because we rely on the “price mechanism” to bring into equilibrium individuals’ diverse preferences (i.e. “markets clear”). The model, however, provides us only with a *closed framework* where the relevant institutions, as source of incentives, are fixed to a point in time, which limits the sphere of human action. Similarly, the weakness of the game theoretic approach in microeconomic theory is that, while it shows us that *institutions matter* and *why*, it cannot help us understand how *institutions change*, nor how existing institutions came about. In game theory, “social choice” is the outcome of rational agents interacting within a set of exogenously-given institutional arrangements. How the rules of the game in society change is left ambiguous. Some of the most interesting and relevant puzzles of the modern world are left outside of economics. The comparative static approach cannot explain market change (e.g., innovations) or social change (e.g., institutional, sociocultural, or legal change). Because individuals are endowed with unbounded rationality, and set to act within a *given* institutional framework, the analytical frameworks in economics cannot accommodate dynamic choice theories to explain innovation and social change¹. We need *truly* dynamic, context-oriented theories of economic and social choice.

¹ David Kreps observes that: “Formal choice theory has not dealt well at all with models of dynamic choice beyond the standard ‘dynamic choice equals static choice of a strategy’” (Kreps 1988, p. 198-190)

The common denominator for scholarly concerns with the mainstream theoretical economists' neglect of the mechanism of dynamic adjustment in both market and societal choice comprises the elusive notions of *entrepreneurship* and *culture*. Culture and entrepreneurship are two of the most elusive² and neglected concepts in social research and in economics in particular.

The neglect of entrepreneurship in modern economic theory has been acknowledged (Baumol 1968, Kirzner 1973, Arrow 1992), and documented as a departure from the writers in the classical tradition in the history of economic thought (Baumol 1968, Demsetz 1983, Boettke and Prychitko 1991). Numerous contributions are focused on either re-integrating the entrepreneur in price theory (Kirzner 1973, 1983, Baumol 1990, 2010), or on developing a distinct, new, scholarly field of entrepreneurship research (Shane and Venkataraman 2000, Davidsson 2003). Similarly, the work of Elinor Ostrom promotes the role of deliberate, public action as entrepreneurial action in solving “social dilemmas,” like problems of collective action, and social choice typical to economics and political science (Ostrom 1965, Ostrom 1990, Kuhnert 2001).

In parallel, a growing economics literature focuses on how and why *context matters*. This “new” approach focuses on appreciation for the role of informal, social norms, and of “culture” in problems of collective action, economic development and transition in economic history (North 1990, Williamson 2000, Djankov et al. 2003, Boettke et al. 2005). The new institutional economics field finds a defining role for

² On entrepreneurship, William Baumol famously noted that: “The entrepreneur is at the same time one of the most intriguing and one of the most elusive characters in the cast that constitutes the subject of economic analysis.” (Baumol 1968, p. 64).

culture in the broader social context, where the “culture lens” helps understand institutional diversity, embeddedness, and institutional specificity (Williamson 2000, Boettke et al. 2008). Similarly, in the political science literature, there is a growing embrace of a contextual approach to political analysis. The Oxford Handbook of Contextual Political Analysis contains a collection of interdisciplinary works on how and why the many facets of “context” matter for individual and collective decision making. In the tradition of the Bloomington School, The Framework for Institutional Analysis and Development (Ostrom 2005, Aligica and Boettke 2011, Aligica 2014) is a response to social scientists’ lack of appreciation for the diversity and heterogeneity of institutions, and the manifestation of governance both across and within societies. In light of the experience from the collapse of communism and the ongoing transitions, the question of culture dynamics in economic theory becomes ever more interesting. Is there room for an entrepreneurial-cultural theory to explain phenomena of dynamic economic and socio-cultural change?

This dissertation attempts to contribute to the growing and inter-related fields of the new institutional economics and contextual political analysis. The dissertation investigates how and why the heterogeneity of, and interaction between “institutions” across societies shapes the manifestations of economic and socio-cultural change. I investigate three cases of social and economic change, and use a contextual analytical framework that accounts for dynamic theories of institutional diversity, interdependence, and of entrepreneurship and leadership in social change. The solution I provide is twofold. First, to complement the existing narrow rational choice framework with

insights from the theory of competition and entrepreneurship (Kirzner 1973) - the notions of “*entrepreneurial alertness*” to new opportunities (Kirzner 1973, Fisher 1989), and of “*opportunity discovery*” (Kirzner 1973 1979, Shane 2001) - to help explain the driving force behind dynamic sociocultural phenomena like the Singing Revolution that led to Estonia’s independence (1991). Second, instead of assuming the relevant institutional framework, I endow individuals with *awareness of* and *alertness to* opportunities to improving or changing exiting institutions. Awareness of previously experienced institutional arrangements, for example, is conceptualized in the literature as “collective memory” (see in Goodin and Tilly 2008), and awareness of alternative institutional arrangements and their associated payoffs as experienced by other societies in the world (as the Soviet Union became more open to the outside world with Gorbachev’s policies of increased economic and political freedom, Perestroika and Glasnost).

The first chapter provides an assessment of the practical and theoretical lessons from the experience with the collapse of communism in Central and Eastern Europe and the Soviet Union. The main lesson is that to understand the differences in economic performance and social change across the former communist countries we need to account for the diversity of, and inter-dependence between the relevant societal “rules of the game” or “institutions.” Institutional diversity is based on each country’s cultural distinctiveness that ultimately impacts the rise (or decline) of reform leaders, and the success or failure of transition reforms. In the second chapter, I investigate the case of the ‘Singing Revolution’ in 1980’s Estonia, and provide a conceptual framework for interpreting peaceful social change. I explore if (and to what extent) the Estonian period

of “National Awakening” (1830’s-1860’s) and the success of the Singing Revolution (1987-1991) can be attributed to the conscious efforts of Estonia’s cultural entrepreneurs to revive and promote ancient cultural beliefs and traditions, such as the belief in self-governance and the tradition of singing, that played the role of focal points during the Singing Revolution. In the third chapter, I examine two studies of informal formation and enforcement of property rights institutions among socially distant entrepreneurs, and find that sometimes market processes may constitute the foundation for the extension of existing institutions, if not for the development of new institutions. I conclude with a final summary.

2. WHAT HAVE WE LEARNED FROM THE COLLAPSE OF COMMUNISM?

2.1 Introduction

The demise of the communist regimes in Central and Eastern Europe (1989) and the Soviet Union (1991) brought triumph to capitalism as a superior economic system for human flourishing. Ludwig Mises and Friedrich Hayek argued during The Socialist Calculation Debate (1920-1934) that under capitalism societies are able to overcome the problems of incentive incompatibility, calculation, and coordination that plagued centrally planned economies. Private property, freedom of entry and contract, and the resulting market price system provide individuals with incentives and information to recognize and realize existing gains from cooperation through trade and innovation. Leading economists were placed in a position to apply the insights of neoclassical economic theory to conduct, in fact, unique social experiments with economic reforms in transition economies. But using static/neoclassical theory to understand dynamic institutional transformations puts the role of institutions and their enforcement mechanisms into a blind spot. Transition scholars omitted that market institutions require reliable enforcement mechanisms, and that the success of the formal enforcement rules are often constrained by the pre-existing set of the informal rules (or culture).

After over twenty-five years of experience, we are today better equipped to contribute to Peter Murrell's challenging question posed at the beginning of reforms (1991) - "Can Neoclassical Economics Underpin Transition in Centrally-Planned Economies"? Murrell

concludes that standard neoclassical economics, ignorant of institutional insights, is not suited to address the institutional challenges of transition. A shaky understanding of how and why markets work, rooted in the Marxist and Keynesian models of market dynamics, has led economists and reform advisers to adopt the idea of transition as a technical problem. The focus was first on getting the economic/financial situation in order, or on “getting the prices right,” with institutional problems, although acknowledged, sidestepped. The neglected of the legal institutions and mechanisms supporting property rights led to surprise discrepancies in economic performance across the C&EE and FSU economies. The focus shifted towards “getting the institutions right.” The task of transplanting “better”, Western-style, legal-institutional systems in places where formal institutional pillars of the rule of law and constitutional democracy were weak or absent, was inevitably daunted by the complexity and dynamics of real-world social systems. The key was to focus on “getting the culture right” or to recognize the set of inherited, informal, indigenous institutions as the most important constraint of economic reforms, and therefore the actual appropriate starting point for reform design. The relevant initial conditions for the success of reforms were not economic/financial, but cultural/social as a constraint on desired legal/political reforms. Countries with a pre-existing culture favoring capitalist values, institutions and the rule of law, those with liberal-minded leadership in politics and policy, outperformed those without.

The focus on getting the economic-financial institutions right proved a myopic approach to transition reforms in retrospect as it led to a neglect of the underlying legal and political institutions with the effect of either strengthening or weakening the legitimacy of liberal economic-financial and political-legal reforms. What was missed is a subtle lesson

in *the new comparative political economy* that differences in reform outcomes are caused not by differences in the sequencing of reforms, not by the lack of foreign assistance, but by the varying degrees of compatibility or lack of thereof between formal legal rules and the informal, indigenous rules specific to each one of the societies undergoing systemic transformations (Boettke et al. 2005, Boettke et al. 2008). The informal constraints and enforcement mechanisms in use at any moment are part of a society's culture, and include informal rules like customs, norms, beliefs, civic attitudes and values. The omission of how culture matters for transition development unraveled in the form of the unexplained differences in economic performance across transition economies submitted to the same type of initial economic-financial reforms. The neoclassical transition economists took for granted the crucial mechanisms of enforcing property rights, contracts, the rule of law absent which productive and innovative entrepreneurial activity would not take place. In order for the formal/structural reforms to work, they first must be integrated within the underlying indigenous framework of informal institutions and enforcement mechanisms as basis for legitimization of liberal reform ideas, including respect for private property, freedom of contract and association, rule of law, and sound money. In order for formal structural reforms to be easily adopted by individuals in a reforming society, they must be compatible with the pre-existing, informal enforcement mechanisms indigenously in use.

a. The effectiveness of the structural adjustments is dependent on the success of the systemic adjustments.

b. The success of the systemic adjustments is constrained by culture (formal legal systems interact with informal cultural beliefs, norms, and enforcement mechanisms).

Adam Smith remarked, over a quarter of a millennium ago, that “*Little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism but peace, easy taxes, and a tolerable administration of justice: all the rest being brought about by the natural course of things.*”(Lecture in 1755)³. Entrepreneurship is natural, but in order to channel entrepreneurial activities towards the most productive and innovative ones, we need a framework of complementary formal-informal institutions and enforcement mechanisms to guarantee security of private property rights, physical, intellectual, or monetary (secured against the threat of both private and public theft). The simple demarcation of property rights does not provide sufficient incentives for a sustained dynamic and prosperous society. The effect of private property rights on development is conditional on the effectiveness of their enforcement mechanisms that guarantee protection against the possibility of any form of expropriation. Only when liberated of the threat of expropriation will individuals find it profitable to discover, exploit, and cultivate existing productive gains from trade and innovation. In other words, the economic principles that supported the set of economic and financial reforms in early transition (of stabilization, liberalization, and privatization) hold, but the welfare properties we associate with economic transactions are a function of the institutional framework within which economic life is played out (Boettke 1998, p.12). Good policies will be respected, and big bills will tend to be picked up/exploited only under an institutional infrastructure guaranteeing credible commitments on the security of profits as the property of the entrepreneurs who discover them (Kirzner and Sautet 2006, Olson 1990).

³ Quote and lecture attributed to Adam Smith by Dugald Stewart who gave a presentation to the Royal Society of Edinburgh in 1793 on the Account Of The Life And Writings Of Adam Smith LLD, Section IV, 25. <http://www.adamsmith.org/quotes>

In trying to point out the impossibility of rational economic calculation under socialism (under abolished property rights), Mises and Hayek took for almost granted the existence of a reliable legal framework to support/enforce the property rights so essential for the emergence of markets and prices. Post World War II mathematical theory took the institutional *caeteris paribus clause* regarding the background institutions further to the extreme, becoming antiseptic of institutions, change, and entrepreneurship. But in dealing with issues of development or systemic transitions, institutions become the center of the matter. Institutions structure incentives, and fundamental changes in institutions lead to fundamental changes in economic performance over time.

2.2 Survey of Thoughts on The Collapse of Communism

Today the primacy of legal and political institutions for a successful transition is becoming widely acknowledged (Snowdon 2004, 2009). The popular ideas in the profession have not always been in favor of the primacy of institutions for transition and development, and much less so in favor of the role of culture in shaping pro-development/institutional reform. Despite many breakthroughs in the growing field of institutional economics, the profession continued to operate under the influence of the Marxists and Keynesian legacies treating development and transition problems as mainly macroeconomic-financial problems requiring monetary and fiscal intervention.

2.2.1 Lessons from Western Scholars and Practitioners

In the aftermath of the collapse of communism and the Soviet Union, the Western economists' prime concern was for getting the speed or sequencing of economic reforms right rather than with getting the institutions right. The biggest question at the beginning of

transition was choosing between a gradual and a radical reform plan (Murrell 1992). The gradualists feared the possible costly social effects of rapid reforms. The shock therapists feared the likely countervailing political effects of gradual reforms. The costs of a radical (“big bang”) transformation were social revolt due to decreases in the quality of life and security. Among the most feared cost of gradualism was the high probability of reversibility of reforms by old elites given enough time to resist. The test of time brought into light Russia’s persistent failure to perform relative to its Central European stellar counterparts, Poland, Hungary, and the Czech Republic. Unlike the C&EE performers, not only did Russia’s economy lag significantly behind throughout the 1990’s but was also followed by a stock market crash in 1998. Russia’s experience did not provide a resolution between the two popular camps. The main divergences were (a) on the proper pacing of reforms (i.e. big bang vs. gradual), and (b) on the origin of reformers and reform resources (i.e. not enough foreign assistance vs. too much foreign assistance). Promoter of the gradual approach to transition and development reforms, Joseph Stiglitz, argued that the problems with Russia’s transition were due to market failures exacerbated by the shock therapy approach (Stiglitz 2002). He denounced the top-down Western intervention in Russia through the International Monetary Fund and the World Bank as faulty, and ideologically driven. Stiglitz saw capital controls, taxation, and sequenced, *local, state-led privatization and legal reforms* as the proper alternative as demonstrated by Russia’s economic growth during Putin’s administration (Stiglitz 2003). Jeffrey Sachs, practitioner of the shock therapy approach to reforms, argued that unlike his success in Poland, his efforts in Russia have

failed because the type of social, and legal/political difficulties in Russia required a *significant assistance strategy* that has not been provided by the West (Sachs 2012).

Both Stiglitz and Sachs, while acknowledging the importance of local institutions for development and a successful transition, favor the approach of manipulating local legal institutions from above. Both are highly critical of the loans-for-shares privatization method of Russia's most valuable assets and enterprises, which they believe is what caused Russia becoming a crony oligarchy. By focusing either on the method of privatization, and/or on the magnitude or source of assistance with reforms instead of on and the cause of weaknesses of the legal framework within which that privatization method took its effects, Sachs and Stiglitz neglect an important distinction in applied political economy between two levels of analysis: one focused on *the rules within rules* (like policies), and one on *the rules above other rules* (like constitutions) made by James Buchanan.

Other practitioners of transition reforms expressed more confidence in capitalism and its positive spontaneous long run effects on the formal-informal institutional dynamics. Anders Aslund believes that capitalism can solve the ethical problems of the rise of oligarchies in Russia, Ukraine, and Kazakhstan, stating that we need to "make a deal with the oligarchs and preach capitalism" as in the end more growth and development is achieved by this form of privatization do state assets then by non-privatization (Aslund 2005, p.15). He also supports the idea that the generalized wealth-effects created by oligarchs, increase the local demand for improvements in the state of the rule of law, by reforming the legal-judicial system from partial and corrupt to impartial and reliable. Andrei Sheilfer thinks that having faith in the long run effect of liberalized markets and capitalism is one of the lessons

from the experience with transition that can be useful to other countries undergoing market reforms (Shleifer 2012).

All the problems of transition can be traced back to initial or persisting weaknesses in the former communist countries legal and political systems. The importance of establishing or restoring the formal rule of law institutions is what contemporary economists in the West and the C&EE countries have been aware of from the beginning, but with a few exceptions, the interaction between the formal and the informal, indigenous rules or cultural institutions was entirely missed (e.g. Pejovich 2003, Boettke et al. 2005).

2.2.2 Lessons from Eastern Scholars and Practitioners

In an interview with Brian Snowdon on “Globalization, Development, and Transition,” Harvard economist of Hungarian origin, Janos Kornai, expressed that the severity of the 1990’s recession can be attributed to “an institutional vacuum” that took economists by surprise. Western-based economists, advisers of transition reforms in Russia, in Kornai’s view, paid little attention to reforming or creating credible institutions that guaranteed a secure legal framework⁴ within which vibrant productive entrepreneurial activities of all forms and sizes could spontaneously emerge (Snowdon 2009, p.323-324). He argues that Western-based economists-advisers of transition needed to look beyond the narrow neoclassical economic theory and the top-down approach of the ‘Washington Consensus’ in order to provide effective advice (p. 324). For Kornai, the most appropriate conclusion

⁴ A reinforcement of Kornai’s earlier position on the primacy of institutions securing property rights to consider in transition reform strategies, in his essay on “Ten Years After ‘The Road To A Free Economy’: The Author’s Self-Evaluation” (2000), where he states similarly that “Private ownership has to be guaranteed security. Institutions have to be founded that enforce the fulfillment of private contracts. (p 6)”

about the experience with transition reforms is not any specific or tangible lesson but a general lesson of the importance of giving priority to getting the legal framework right:

“Every sphere of the transformation—the political process, the business world, or the arts and sciences—requires an adequate legal or legislative background. Lack of it will only lead to trouble and conflicts, a lesson learned from bitter experience in places where much has already happened on the way to a transition to a market economy. [...] Whatever non-legal field they are working in, they should not forget to clarify the legislative and judicial branches of government and take account of their complexity when pacing the changes.”

(Kornai 2004, p.13-14)

As a lesson from the C&EE experience useful for Cuba’s transition in 1997, in Kornai’s view, establishment of the rule of law is possible by “creating a state of law” which “entails enacting modern, constitutional civil and penal codes to enforce private contracts. It calls for a range of special laws that regulate business activity in a market-compatible way, along with the provinces, rights, and obligations of various state authorities. Parallel with the legislative activity, an independent judiciary has to be established. There have to be guarantees that the police and law enforcement systems do not abuse their powers. Everyone must be held accountable, and no one—a party or authority or the state itself—can be above the law (Sajó 1998 and 2002).” (2004, p.13)

In his work, Kornai shows appreciation for the role of social capital in development and institutional change. Together with Western colleagues, Kornai understands that a) there exist informal indigenous social systems (such as systems of social trust, trust between individuals, and between individuals civilians and state representatives) which b) have a

dynamics of their own, such that c) any successful reform schemes must align the new set of incentives from reformed formal institutions with those of the (pre-) existing informal cultural/social institutions (Kornai et al. 2004, Kornai et al. 2005).

In his 2001 essay on “The Post-Communist Transition: Some Lessons”, Polish economist, and Minister of Finance, Leszek Balcerowicz, famous for implementing the first radical set of economic reforms in Central Europe, “The Balcerowicz Plan”, identified two basic types of reforms that all post-communist economies needed to undertake at the beginning of transition: “exceptionally comprehensive liberalisation and the vast programme of building or restructuring of institutions conducive to, or required by, free society and a stable and dynamic market economy” (Balcerowicz, 2001, p.53). These two distinct, yet interdependent kinds of reforms correspond to Balcerowicz’s two main stylized sets of institutional legacies characteristic of all socialist systems (p. 30). The first set, broadly defined as economic institutional legacies, comprised institutions of economic and individual control, or institutions restricting individuals’ economic freedoms, such as laws prohibiting private property, freedom of association, contract, and trade, the freedom to a monetary system, and political freedoms. The second set of institutional legacies formed the realm of legal and political institutions established to enforce the first (i.e., rules about prosecutions and sanctions).

What this literature is still missing is the importance of cultivating an underlying public morality favorable to capitalist values and attitudes in society that may help alleviate the cultural/social constraints on transition efforts in Russia, and the Former Soviet Republics (FSRs).

2.3 The Interaction Theory of Transition Dynamics

The conjecture that development is not a technical problem but a cultural one is at best only partially appreciated in comparative political economy today (Boettke et al 2005). Our theory builds on many interrelated works on the impact of culture on economic development (Boettke 1995, Boettke et al. 2008), culture as the main generator of transaction costs of transition (Pejovich 2003), and the moral and spiritual components of culture as the underlying drivers of legitimization of reforms (Boettke 2010). We also bring the idea on the importance of institutional leadership in times of rapid change (Ackerman 1992) in light of the experience with transition. We argue that differences in indigenous cultures, assumed reform leadership, and the existing, inherited climate of public morality explain the puzzling differences in the economic and democratic performance across C&EE and the FSR's under analysis.

Unlike Stiglitz and Sachs, we argue that the problems of economic performance in Russia and the FSR relative to Central East and Eastern European countries are *not* due to a “social shock” of the shock therapy approach to economic/financial reforms (privatization, liberalization, stabilization) but because market reforms in Russia and the FSRs were not compatible with the existing culture – the basis for appropriate political/legal reforms (rule of law institutions: independent judicial frameworks, courts, new constitutions). As Milton Friedman admitted, privatization is useless without a functioning rule of law. The market-preserving function of credible rule of law institutions validates the incentives to enterprise and innovate induced by a system of property rights, freedom of contract, and entry. No one today would undermine the gradualists' observation of Russia's path dependent culture evolved unfavorably towards capitalist values that contributed to the differences in results

with transition across post-communist countries. Attempts to reform the system from within, equivalent of a gradual approach, as advocated by gradualists (Stiglitz 2002), have already been tried unsuccessfully in Russia in the past. In Soviet Russia, Lenin's New Economic Policy (NEP), and Gorbachev's Perestroika are two examples of attempted gradual economic reforms (Boettke 1993, 2001). Both failed to spur productivity and entrepreneurship due to inherent economic and political inconsistencies. They failed not because the entrepreneurial profit incentives under NEP and Perestroika, respectively, were nullified by the threat of expropriation by the Soviet state where the Communist Party was above the law. As entrepreneurs, Russians' estimations of opportunity costs, and their calculations of estimated profit and loss, were impacted by the high risk of public predation by the Communist elites. Absent rule of law during pre-Soviet and Soviet era, as reflected in weak public and political support for the rule of law in today's Russia explains reformers' failure to implement shock therapy reforms at the beginning of transition as successfully as they were implemented in the Czech Republic.

We argue that provided constitutionally-backed rule of law to restrain political activism towards exacerbation of those "imperfect" inherited systems of beliefs, the benefits of adopting capitalist cultural-moral values and beliefs, like the virtues of the honest profit-making class (the productive and innovative entrepreneurs), can be cultivated in time, by learning from experience, from comparison with other system provided freedom of information, trade, and travel. Societies can become "civilized" in the spirit of capitalist values (Williamson 2012, Boettke 2010). Moreover, unlike the CE&E reformers, Russia and the FSRs lacked leadership over promotion of neoliberal, free-market ideas in politics and

economic policy-making. Russia and the FSRs did not have the type of intellectual-political leadership to push economic/financial and legal/political reforms through strong political activism to persuade the public of the welfare benefits of capitalist system and adherence to rule of law, negotiation with the incumbent elites.

2.3.1 Culture Matters

The road to a successful transition from “a shortage economy” to “an innovative economy” is an indigenous one, supported by pivotal people promoters of liberal ideas at pivotal times and by a culture and public morality that extends respect and admiration to any one ordinary member driven by productive entrepreneurial-innovative ideas in their society.

A nation’s economic performance is shaped by the prevailing rules of the game (enforced incentive-generating constraints) within which its citizens act and interact over time (Baumol 1990, Boettke 1995, North 1997, North 2005). Why then do we not see poor countries adopting growth-promoting rules of the game? The notions of *path dependence* and *lock-in* tell us only that history matters. Understanding the *how* institutional *path dependence* matters should be the focus of reformers preoccupied with finding ways to alter the economic performance of transition economies as quickly and as effectively as possible (North 1997, p.16). A country’s experience with historical-political events is imprinted in its culture, which in turn explains the diversity of institutional contexts, and therefore the corresponding differences in development and economic performance across countries at any point in time (Boettke 1995, 2001, Boettke et al. 2008). The fuzzy, informal, indigenous institutions (and their enforcement mechanisms) interact with the set of written, formal political and legal institutions to form the institutional infrastructure in a modern society

(Boettke 1994). Depending on their degree of compatibility or complementarity, the vector of development/transition and corresponding economic performance resulting from the interaction between the social-cultural, the legal-political, and the economic-financial institutions, may point either upwards (development and growth), or downwards (decline and stagnation). The success of a transition or development process is a function of this *interaction* between the proposed formal (*de jure*) and pre-existing informal (*de facto*) rules of the game in society (Boettke 1995, Pejovich 2003, Boettke et al. 2008). In Figure 1, we present a useful analogy of *the theorem of institutional interaction*. The three-legged bar stool where the legs supporting the top represent the three key types of institutions: economic institutions, political-legal institutions, and cultural-social institutions, while the top represents a country's success during transition and its corresponding economic performance (i.e. slow or rapid growth, largely innovative or imitative, with frequent economic crises vs. sustained booming markets).

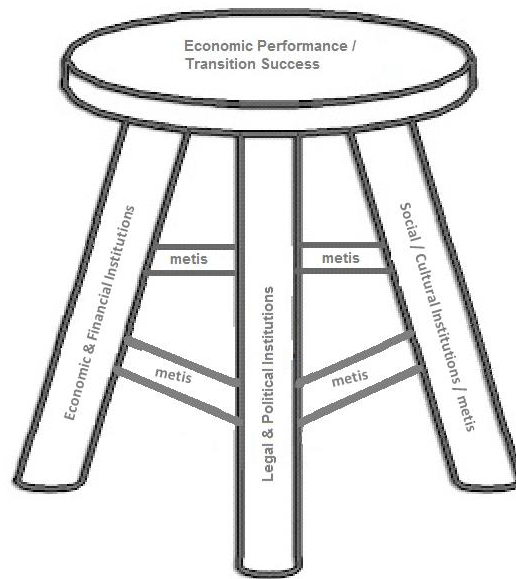


Figure 1 - The Bar Stool Analogy for Cross-Institutional Interaction and Economic Performance in Transition

Transition scholars' mistake was to ignore the role of culture, its specificity, and interactive dynamics with formal institutional changes. Many of the former communist societies have retained their pre-Soviet cultural heritage. Unluckily for those societies dominated by the Russian culture, cultural attitudes and beliefs beneficial for capitalism have been lost, or have been consistently discouraged from taking roots as studied in Russia's history and ethnography (Pipes 2006, Procaccia 2007). The variety of cultural legacies across the former Soviet republics and satellite states provide one of the key insights into the puzzle of the uneven results with the same transition reforms.

All the costly lessons from the collapse of communism and the post-communist transition can be traced back to an overemphasis of "getting the economic-financial

institutions right” and an under-emphasis of, ultimately neglect for, “getting the legal and cultural institutions right” both in our theorizing, and in practical policy-institutional solutions. As practitioners of transition reform plans, we have focused too much on the ways to solve economic-financial problems during transition, and omitted from our view that the stability and credibility of the economic-financial institutions themselves is supported by how compatible are the desired formal legal-political institutions with the inherited informal social/cultural institutions prevalent in a country. Introducing property rights, contract and rule of law institutions in countries where history has wiped out the cultural memory of respect for the rule of law, and appreciation for the activity of the productive and innovative class of the society, will fail to induce the spontaneous manifestation of mutually beneficial exchanges as predicted by standard articulations of the welfare theorems in neoclassical textbooks. Where formal institutions of the rule of law are weakened or ignored by an unsupportive culture, existing Smithian gains from trade, including Schumpeterian gains from innovation, will tend to *not* be exploited.

Exchange does not occur in a vacuum. Economics is not a “science of exchanges”⁵, but a science of exchanges within institutional systems (or structures of incentives generating information, and processes of discovery of gains from trade and innovation ultimately responsible for the path of economic growth. Economic history research shows that modern societies have flourished under systems of credible property rights institutions, freedom of contract, entry and competition (North and Thomas 1971, Rosenberg and

⁵ Quote by A. S. Bolles, “The definition to which economic writers have yielded a more general assent than to any other...is “the science of exchanges.” (1878), cited in Kirzner’s *The Economic Point of View* (Kirzner 1960, p.76)

Birdzell 1986, Acemoglu and Robinson 2011), and within cultural-moral attitudes of praise and admiration towards the productive and innovative entrepreneurs in society (McCloskey 2010, Mokyr 2009).

Applied to the lessons learned from the collapse of communism, economists' lack of attention to the legal/political and cultural/social pillars when theorizing about and in designing transition programs has naturally unraveled over time in the uneven levels of economic progress across transitioning countries of Central Europe, South-East Europe, Russia and Central Asia.

On one side, for a long time the idea that institutions matter has been neglected in economics for its simplicity. Ronald Coase remarked that he thought his major contributions were about "stating the obvious" (Roberts 2012). And it is only years after the collapse of communism that Ludwig von Mises is acknowledged as famous for pointing out since the early years of Soviet socialism that property rights institutions and money make all the difference across alternative economic systems (Phelps 2013).

On the other side, the study of institutions has been neglected because of their complexity. The idea that culture alters the path of transition and development, for example, is still relatively novel. New research on transition economies suggests that the chemistry between the (newly-introduced) formal and the (pre-existing) informal institutions in transition economies determine the economic success or failure across reforming transition and developing countries. The more compatible are the reforms (the formal) with the local culture (the informal), the higher is the chance of success of transition as translated in economic performance (North 1990, Boettke 1995, Pejovich 2003, Boettke et al. 2008). As

Pejovich (2003) points out, culture interacts with formal institutions in a way that either increases or decreases the costs with transition. These are the “transaction costs of transition” associated with learning about the local structures of incentives (in order to make adequate adaptations of reforms), understanding how to approach indigenous resistance to reforms, including the effort of negotiating with the existing interest groups, and persuading and informing an electorate with a “Soviet-type mentality,” and an acquired “sense of belonging” about the welfare benefits and virtues of the capitalist system and the rule of law.

Culture interacts with legal institutions the most. It is the link between prior beliefs about what is just, ethical, moral, and attitudes towards what is thought of as not just, ethical, moral and the new formal legal frameworks with their own new constraints and enforcement of what is just.

2.3.2 Public Leadership Matters

In a lecture at The UNU World Institute for Economic Research Institute in 1997, Douglass North conceded that our limited understanding of the transition problem was in part due to lack of advanced research in constitutional political economy in transition countries at that time: *“The interface between economics and politics is still in a primitive state in our theories, but its development is essential if we are to implement policies consistent with intentions”* (North 1997, p.16). James Buchanan and Vincent Ostrom promoted the idea of “constitutional craftsmanship” and the role of classical liberal elites in advancing (through academic writing, involvement in journalistic and media debates, political activism) liberal policies and institutions based on the ideas of economic and

personal freedom, rule of law, and constitutional democracy. The serial revolutions preceding the retreat of communism in Central and Eastern Europe and the Soviet Union provided the opportunity for the new elites to craft new constitutional frameworks that would set a new directions for future economic, political, and legal policies. Bruce Ackerman famously advanced the thesis of “constitutional moments” which he defined as “short windows of opportunity,” in the aftermath of a successful revolution, that “generate a political constellation that allows for mobilization for deep and broad support for a liberal constitution.” (Ackerman 1992, p.3). Without strong leadership to take advantage of “the opportunity for constitutionalizing liberal revolution”, Ackerman insists, “[the constitutional moment] may be entirely missed.” For Ackerman, the strategic role of liberal political activists during constitutional moments trumps the role of economic and political reformers because “constructing a liberal market economy, let alone a civil society, requires decades, perhaps generations, and the project can be easily undermined without the timely adoption of an appropriate constitutional framework.” While agreeing with Ackerman on the primacy of leadership in crafting new constitutional frameworks, we believe that analogous strategic action in the realm of economic policy can set a country on a faster track towards success. It was crucial for the local political and institutional entrepreneurs to recognize and act in a timely manner to grasp the opportunity to advance liberal agendas in politics and in policy making. Leadership of pivotal people at pivotal times (pre-, during, and post establishment of a liberal constitution) in promoting liberal economic and political reforms in countries undergoing system transformations mattered. Poland is a great example because its key political and institutional entrepreneurs are well acknowledged in the world and in the

literature. The constitutional leadership of Lech Walesa of the liberal Solidarity movement, in the aftermath of the Polish Revolution, was akin to that of George Washington at the time of America's Constitutional Convention (Ackerman, p. 48). For post-constitutional reform, consider the leadership of Leszek Balcerowicz in Poland's economic reform programs. As an institutional entrepreneur with economic scholarship and appreciation for classical liberalism and classical liberal thinkers, Balcerowicz recognized the niche window of opportunity for advancing liberal market reforms post-revolutionary Poland which he called a period of "extraordinary politics," when the Polish society was more inclined to accept drastic proposal of system change, and the opposing older elites were not given enough reaction time to organize and plan an opposition (Balcerowicz 1995).

Moral and intellectual integrity and reputation of the reform leaders added to the credibility of reforms, as did their risking their lives fighting adverse interest groups to promote a set of institutional and policy changes based on ideas they believed conducted to prosperity, better quality of life as persuaded by the works of F. A. Hayek and Milton Friedman. The added credibility of reforms carried forward by leaders in Central Europe and Baltics have increased the percentage of other political actors, interest groups, and voters buying into reform, the success of reforms. The pivotal role of the local actors in the advancement of classical liberal (also called "neoliberal") ideas in Central and Eastern European countries contributed, for example, to strengthening the credibility of the promised benefits of an economic reform like the flat tax, which may have led to its widespread adoption, as researched by Evans and Aligica (2009). The case of Poland is outstanding but followed in close degrees by the Central European and the Baltic countries

where leadership over the implementation of “shock therapy” reforms, both in politics and in the economy, shortened the period and scope of possible institutional frictions.

Ultimately, leadership reduced the possible negative effects of a prolonged situation of uncertainty on people’s hopes and expectations about the promised benefits of capitalism for the quality of their lives during the critical first stage of transition.

By contrast, countries like Russia and the FSRs, lacked credible and sustained constitutional leadership. Frequent changes in the ruling elites, lack of the rule of law, broken promises, and continued delay in seeing improvements in their quality of life has turned Eastern societies against capitalism, and in favor of new Communist factions and leaders. Path dependency in Russia’s politics of “broken promises” was caused by the ruling elite’s repeated breaches of promised reforms under Russia’s weak or non-existent democracy and rule of law institutions (Boettke 2001).

2.3.3 Public Morality Matters

The prevailing public morality is another important factor that has only recently started to be appreciated in the literature on transition. We believe that a successful transformation toward constitutional democratic governance and a capitalist system is conditioned by the compatibility of the pre-existing cultural foundations of a society with sentiments of appreciation for capitalism, and the rule of law. The cultural foundations of capitalism and the rule of law form a nation’s *social capital* the source of private order based on informal constraints and their enforcement mechanisms supportive of property rights, honest profit making, individualism, and the rule of law.

Theorizing about the importance of *social capital* goes at least as far back as Adam Smith's Theory of Moral Sentiments (TMS) and includes philosophical and economic analyses of the role of the informal institutions (i.e., the informal "rules of the game" and their enforcement mechanisms as dictated by the set of indigenous beliefs, customs, moral codes and attitudes) in economic performance (North 2005, Leeson 2007, Tabellini 2010, Williamson 2009). Elements of social capital like trust, tolerance, and respect, serve two main functions: a) to "bond" or strengthen trust and cooperation in personal relationships between socially-close groups like families and friends, and b) to "bridge" or foster trust and cooperation in impersonal relationships between socially-distant groups (Leeson 2005, Boettke 2010). Cultural elements and systems, including language, religion, may serve not only a *bonding function* promoting greater social cohesion for individuals of a certain group, but also a *bridging function* promoting trust, and openness for cooperation and trade with strangers. Some of the most studied informal institutions with cooperative properties are the institutions founded on religious beliefs. Religion is an important source of social capital supportive of capitalist virtues. As research shows, adherence to common religious beliefs signals trustworthiness among socially-distant traders which leads to avoidance of conflict, and the exploitation of mutually beneficial transactions (Chew and Greer 1997, Leeson 2005, Williamson 2010, Tabellini 2010).

By providing the moral foundations for most societies of the world, it forms the *spiritual part of the wider whole of the social capital* of a society. Churches, or worship houses foster the *spiritual capital* of a society by deepening trust within existing networks and by extending trust in social interactions with socially-distant groups (Putnam 2000,

Sacerdote and Glaeser 2002). We also familiarized by now with the idea that some religions are more propitious for capitalism and economic growth than other religions (Weber 1930). Even among Christianities, some are based on beliefs more supportive of markets and the rule of law than are others, more attendance than others, and more acceptance of other religions than others. Barro and McCleary's empirical analysis supports that "religion affects economic outcomes mainly by fostering religious beliefs that influence traits such as thrift, work ethic, honesty, and openness to strangers" (2003, p. 23), and that church attendance, unlike religiosity, implies a blockage of resources towards unproductive activities (p.37). They further find that the more diverse and pluralistic a nation in its religions, the more tolerant and respectful its members. Mutual tolerance and respect promote trust and cooperation across spiritually distant groups, and are therefore two important traits of capitalist societies. By contrast, in nations with monopolized religion markets, or with "state religion", where there is a co-dependent relationship between the state and the Church powers (e.g. in Russia and other predominantly Eastern Orthodox countries), the spiritual capital is manipulated, and adverse to openness to strangers (Barro and McCleary 2003). This finding is helpful in understanding the classification of societies, made by Douglass North, John Wallis, and Barry Weingast, into "open access orders" and "closed access orders" (North et al. 2010).

Spiritual capital is important in the study of processes of transition to capitalism in C&EE and FSU countries because a constitutional-democratic process relies on ideas favored by the general public. The set of favored ideas in society matter because they legitimize the *public capital* or the constitutional and policy frameworks within which social

interaction takes place (Boettke 2005). The informal, spiritual capital may enhance the *civilizing effect* of a capitalist system (Williamson 2010), and contribute to a *modern growth effect* when the spiritual capital extends entrepreneurial liberties and confers dignity to the ordinary people (McCloskey 2011).

2.4 The Interaction Theory: Examples of How The Legs of The Bar Stool Work

Studies on the differences between the historical and political paths of the post-communist countries (Pop-Eleches 2007) support our interaction thesis of transition in C&EE, and the FSU. Successful transition economies benefited from their pre-existing culture, dominated by capitalist values and attitudes including individualism, self-determination, strong work ethic, honesty, and respect for religious pluralism/tolerance (Gorodchinenko and Roland 2011, Pejovich 2003). Eastern European scholars and practitioners of transition reform plans, acknowledge that leadership in politics and policy at the beginning of transition also mattered (Balcerowicz, 2001, Klaus 2013). By contrary, lack of cultural support of a liberal leadership, and a system of anti-capitalist beliefs persisted in the transition lagers: Russia and many of the Former Soviet Republics today.

2.4.1 Success Stories: The Central European, and Baltic Countries

The Central European and the Baltic countries are acknowledged success stories of the ongoing experience with post-communist transition reforms (Balcerowicz 2002, Aslund 2012). Poland, Hungary, the Czech Republic, and the Baltic states have excelled at establishing market economies, and working democracies with rule of law.

One of the initial contributing factors in their success was their geographical and cultural proximity with Western Europe with which they shared common pro-capitalist cultural characteristics advantageous for their transition. In fact, Western economic advisers (who were called to advise the new governments in charge of reforming their countries' economic systems) motivated their going forward with the "top-down Western-style" economic reforms based on the Western origins of the pre-Soviet institutions of Central Europe and the Baltic countries. In Poland, in particular, what legitimized the shock therapy market reforms was the slogan, "A Return to Europe", of the Polish pro-independence liberal revolution (Aslund 2012, Sachs 1994).

According to anthropologists, the three Baltic countries are modern nations with truly indigenous roots. Hiden and Salmon (1994) note that "They have lived there far longer than any of the peoples who have ruled over them since the middle ages – whether Scandinavians, Germans, Poles, or Russians." Moreover, "The native inhabitants of the three present-day republics of Estonia, Latvia and Lithuania are directly descendent from the tribes who settled on the Eastern shore of the Baltic some 4000 years ago." (Hiden and Salmon 1994, p 9). Perhaps, as I argue in chapter two, their direct descent from the original inhabitants of the Baltic region favored the societies of present day Estonia, Latvia, and Lithuania to preserve the memory of their pre-Soviet, ancient cultures of free, and self-governing tribes, which played a key role in their peaceful social change movements (i.e. in the Singing Revolution of 1987-1991), and successful transitions to capitalism, liberal democracies, and the rule of law. Given their ancient cultures based on values of self-governance and individual freedom, during the period of transition reforms, the Baltics

benefited from a greater compatibility between their pre-existing cultural (informal) values and beliefs, and the new formal economic and political reforms based on capitalist institutions, and liberal democratic values. This favorable interaction between their pre-existing culture of self-governance and individual freedom, and the legal-political, and economic reforms resulted in their superior performance during throughout the transition. Moreover, as I find out in Estonia's case, ancient folklore promoted leadership over good, responsible governance. Leadership mattered in Estonia, as it did in Poland, Hungary, and the Czech Republic, in particular. The manifestation of political and policy leadership promoting of neoliberal ideas conduced to reform success, and further cultivation of classical liberal beliefs, market values, entrepreneurship-promoting attitudes and public morality in society.

2.4.2 Failures: The Russian Federation

In 2005, Vishny and Shleifer's analysis of economic data on post-Soviet transition led them to pronounce Russia "a typical middle-income capitalist democracy," or "a normal country" unlike most of the non-reforming countries of East and Central Asia, part of the enduring Community of Independent States (CIS) today (Shleifer and Vishny 2005). Similarly, according to World Bank economists' latest calculations, Russia is more than a middle-income economy it is a "high-income economy" in line with enduring Western developed, capitalist economies like The United States, and The United Kingdom, and the performing countries of the former communist space, the Central and Baltic European countries (Table 1).

Table 1 Income Groups, World Bank Country Classification (GNI per capita 2013)

“Developing economies”			“Developed economies”
Low-income (\$1,035 or less)	Lower-middle- income (\$1,036 to \$4,085)	Upper-middle-income (\$4,086 to \$12,615)	High-income (\$12,616 or more)
Kyrgyz Republic	Armenia	Azerbaijan	Czech Republic
Tajikistan	Georgia	Belarus	Estonia
	Moldova	Bulgaria	Latvia
	Ukraine	Hungary	Lithuania
	Uzbekistan	Kazakhstan	Poland
		Romania	Russian Federation
		Turkmenistan	Slovak Republic

Source: The World Bank Country Classification 2013 <http://data.worldbank.org/about/country-classifications/country-and-lending-groups>.

A more qualitative look at Russia’s economic-entrepreneurial environment today reveals flaws in the above optimistic research findings about Russia. As Leeson and Trumbull show, the relevant group of countries to compare Russia’s performance over the last decades with is not the entire world, but the other former-socialist countries embarked in transition to capitalism at the beginning of the 21st century (Leeson and Trumbull 2005). First, if we look at the progression of PPP-adjusted measures of GDP per capita over time, Russia’s economy belongs with the group of average reformers of the C&EE countries, Romania and Bulgaria, and below the performance of worldwide average economies, like Mexico or Argentina. Second, when comparing the progress with democracy and governance reforms across the former-communist countries in the same group, by indicators of judicial framework and independence, rule of law, and freedom of the press, the Russian Federation ranks as a non-reformer, in other Former Soviet Republics (Aslund 2007, 2012). Forth, Russia persistently ranked at the bottom of the Heritage Foundation’s Indexes of

Economic Freedom, of the past two decades, as a “repressed” environment in terms of investment freedom. Similarly, survey data gathered by the Global Entrepreneurship Monitor (GEM) shows that the intention of the Russian people to start a business in the last ten years has been extremely low relative to that expressed in other countries (Table 2). Only 2.2% of Russians intended to enterprise in their own home country in 2012, and by World Bank and OECD estimates, Russia has not been an attractive destination for foreign entrepreneurs either as the net inflows of foreign direct investments in Russia have decreased steadily over the last five years from 4.50 to 2.5 percent of GDP. At the same time, the GEM reports also show that the majority of Russians do perceive entrepreneurship as a desirable career choice, there being very little variation in this GEM index internationally (Table 2), suggests that despite the limited freedom to enterprise, significant positive attitudes towards entrepreneurship have prevailed among Russians after the collapse much like, even more than in many of the developed societies today, including the U.S., U.K, Sweden, and the stars of transition, the C&EE and Baltic countries (Table 2). Russians are normal people as they respond to the incentives of their perceived entrepreneurial profits abundant under capitalism, but the threat of future expropriation under the institutional environment within which the exploitation of their discovered profits must take place is disincentive.

Table 2 Entrepreneurial Intentions, and Perception of Entrepreneurship as a Desirable Career Choice in C&EE and FSU (2002-2012)

	Intention to start a business within the next three years (%)			Positive attitudes towards entrepreneurship as a desirable career choice (%)			
	2002	2008	2012	2002	2008	2012	
Chile	34.2	29.5	43.1	Japan	34	26	30
Romania	-	8.5	27	Hungary	-	48	41
Latvia	-	6.6	21.9	Germany	55	56	49
Poland	2.2	-	21.6	Slovak Republic	-	-	50
China	27.5	-	20.4	United Kingdom	51	52	50
Mexico	23.2	25.6	18.4	Slovenia	59	58	53
Lithuania	-	-	18	Estonia	-	-	55
France	3	12.7	17.3	Mexico	-	66	56
Estonia	-	-	16.4	Israel	-	56	59
Slovenia	9	7.3	13.2	Latvia	-	75	60
Hungary	5.9	6.2	13	Russia	-	60	60
Israel	14.4	14.2	12.8	Lithuania	-	-	63
United States of America	9.2	6.9	12.5	United States of America	63	63	-
Slovak Republic	-	-	11.8	France	46	63	65
Sweden	12.5	-	11	Poland	-	-	68
United Kingdom	4.2	5.3	9.5	Chile	85	80	70
Denmark	6.2	5.5	6.6	Romania	-	-	71
Germany	4.5	4.2	6	China	73	-	72
Japan	0.9	3.8	2.5	Denmark	51	57	-
Russia	2.5	3.1	2.2	Sweden	52	-	-

Source: Global Entrepreneurship Monitor 2002-2012, percentages of 18-64 populations.

Our theory suggests that understanding cross-country transitional paths requires understanding differences in culture, and how cultural institutions interact with legal, political and economic-financial reforms. The main argument is that variations in institutional path dependence, or the specificity of cultural paths, determine the differences in economic performance across the target former communist countries. Russia's relative economic underdevelopment is due its anti-capitalist and weak rule of law cultural legacy as

reflected in the prevailing post-Soviet informal institutions largely adverse to capitalist attitudes, values, and virtues. The prolonged exposure to Soviet authoritarianism and the highly hierarchical political system has damaged the “good”, pre-Soviet, market-promoting informal institutional system of respect for private property and rule of law that started to take roots at the beginning of the nineteenth century.

Could Russia’s institutional, and therefore economic, “non-normalcy” today be due to its “backwards” culture inherited from its past? Chirot (1991), Pipes (1999, 2006), Obolonsky (2005), and Procaccia (2007) discuss how history and politics have modeled Russia’s informal institutions into a “system against individuality” as manifested in its culture, and morality altered by centuries of soviet-style authoritarianism and the monopolized-politicized market of religion due to the marriage between the Russian Church and Government. Political morality replaced market morality, collectivist mentality replaced individualism, and preference for an authoritarian political regime is stronger than preference for a rule of law regime. Instead of personal responsibility, individualism, strong work ethic, dignity for the entrepreneurial class, Russia’s culture encourages shirking, collectivism, poor work ethic, and dignity for the politically and militarily powerful class (the bureaucrats).

Russia’s political history has put a negative imprint on Russia’s cultural institutions (rules, norms, beliefs, morals, traditions). The so called “conservative mentality” of the Russian people (as expressed through prevailing attitudes, beliefs, values) can be traced back to their repeated experiences with authoritarian political regimes (Pipes 2006), with the

Soviet regime being the most oppressive, and damaging to Russians' cultural consciousness of all (Oblonosky 2005).

The rule of law has been persistently undermined in Russia's history by succeeding authoritarian regimes. Russian law, politics and culture are especially hard to disentangle; it is "by long tradition" that "the Russian society is authoritarian and hierarchical" (Procaccia 2007, p. 96). The long history of authoritarianism, as pictured in Russia's biblical iconography and law is claimed in the central tenant of Russia's culture responsible for the failure of contract in contemporary Russia (p.96). Unlike in innovative societies, where dignity is conferred to any ordinary people who join entrepreneurial-innovative value-creating class, in Russian society dignity has traditionally been perceived as conferred by rank. Unlike in constitutional democracies, where authority emanates from the supremacy of common general norms, in Russia authority emanates from the supremacy of men (p.107). In Roman Catholic societies, we can find the allegorical depiction of the Divine Providence - the source of authority of the iconic figure of Pope Urban VIII – surrounded by a swarm of bees, sending a message of confusion, and the need for validity. In Russian Orthodox societies, we find allegorical depictions of Russian St. George as deriving his authority from "the very spheres from an intrinsically wholesome world where everyone and everything has its proper place" (pp.128-29). The Western ideas of a constitutional order and the rule of law had no match in Russian Orthodox iconography.

Soviet-times slogans perpetuated in Russia today, signal attitudes, norms, ethics, morals, and beliefs detrimental to capitalism. Russia lacks the basic pro-capitalist cultural personal-moral-ethical pillars we find in Western developed societies. The notorious slogan

dating back to the Gulag Archipelago, that “everybody can be replaced,” and the Marxist-Leninist “From each according to their abilities, to each according to their needs” combined gave Russians clear incentives to hide and (or) debase their true abilities, to shirk, and lie about their true opinions, and governance preferences (Kuran 1997) for fear and lack of competitive reward for their efforts.

The Soviet police state and communist economic system have discouraged Russians from pursuing and expressing their own individuality, creativity, entrepreneurial initiative, and talents. Under severe political, economic, and cultural oppression, the Soviet people have lived a lie, hiding their pre-existing culture and their true beliefs, and pretending to adhere to the propagandistically forced Soviet culture and false system of beliefs. There was little room for a work ethic, appreciation for a system of private property and freedom to enterprise to develop. And despite the weak legal system and the limited economic in post-Soviet Russia, as revealed in world development and transition reports, there is still a chance for a culture of market-friendly values and beliefs to develop even to present day. This chance is severely stifled by Russia’s authoritarian political regime, which manipulates the Russian individuals’ access to worldwide information on differences in the quality of institutional and cultural institutions across nations. By manipulating the local media (including media, and press censorship), the Russian government maintains its power at the societal cost of evolution towards learning and adoption of superior market-supporting culture and civilization.

2.5 Transitional Political Economy: Past, Present, and Future

The collapse of communism placed neoclassical economists in the world in a position to engineer the transformation of the former-communist countries from socialist to capitalist, from authoritarian to constitutionally-democratic. The lessons learned revealed the inadequacy of the mainstream neoclassical economic models in explaining differences in economic growth and development in the world.

What the 22-year-long feed-back data from our experience with transition reforms revealed is the rediscovery of economics as a lesson in humility over the complexity and diversity of institutional systems at glance. The difficult task of (re-) designing the complex, path dependent systems of the former communist societies in transition to capitalism has been captured in varied creative metaphors like “rebuilding the ship at sea” (Elster et al.1998), or “changing the engines of a plane in motion” (Roland 2008). Translated the metaphors tells us that a) there exist informal institutional indigenous systems which b) have a dynamics of their own, such that c) any reform schemes must align their incentives with those of the (pre) existing institutions. There is a knowledge problem in the planning of economic and institutional change sustainable and compatible with the pre-existing local incentives. The knowledge of the already existing cultural-social technologies on one hand, and the knowledge problem in devising a (new) formal set of technologies to match the pre-existing one, on the other hand, as well as with beneficial outcomes of the dynamics of the cultural/informal and the new/formal social technologies over time (Eggertsson 2005, 2010). The path to a successful transition to a market economy and a system of rule of law is an indigenous one. The complexity and specificity of institutions should inform the transition

reform community to (1) adjust the scope of their designed programs downwards, and (2) change their approach from foreign to indigenous, from centralized to decentralized.

The idea that alternative institutional arrangements lead to different economic and social outcomes is not novel. The works of Mises and Hayek showed that some institutional environments are clearly more conducive to economic learning (through discovery and exploitation of mutual gains from trade) than others (Mises 1920s, Hayek 1930s). In capitalist societies, individuals operate within institutional environments conducive to the discovery and transmission of the relevant information, and here mutual economic learning is decentralized. By contrast, in socialist societies, individuals are forced to operate within institutional environments in which the discovery and transmission of the relevant economic information is muted, and learning is centralized. Open, competitive markets, not central governments, are able to solve the problems of violence, scarcity and technological backwardness. More recent research shows that institutional environments are formed of both formal and informal institutions, and it is the latter that the former rely for their proper functioning. Only the societies with a mix of formal and informal institutions congruently fostering respect for markets and the rule of law will see the manifestation of productive entrepreneurship and innovation (Boettke 1995, Boettke 2001, Pejovich 2003, Boettke et al. 2008, La Porta et al. 2008). The experience with communism, its collapse, and the post-communist transition tells us that the insights about the primacy of institutions have been mostly ignored or misunderstood with unfortunate to disastrous consequences for development across the former communist countries of the CEE and Central Asia from past to present. During transition, attention to the role of institutions was undermined in favor of

mimicking the economic-financial outcomes in nations with stable, good institutional frameworks. A subtle lesson has been missed: that of the specificity of legal and moral institutional frameworks because of the spontaneous, tacit nature of the indigenous cultural institutions.

With the collapse of communism (1989), over 23 years ago (1991-2014), the countries of the Former Soviet Union, and its Central-Eastern and South-Eastern European satellite states have embarked on a series of reforms aimed at aiding in their transformation to capitalism. The source of advice or inspiration for the institutional transformation came from Western, neoclassical liberal economic ideas. The mainstream approach to economic theory and policy of the West, at the beginning of the twentieth century, was dominated by Samuelsonian neoclassical economics ignorant (or even dismissive) of the epistemological-institutional insights of the Austrian Economics (forgotten with the rise of post-WWII mathematical approach in mainstream economics) and the New Institutional Economics (still in its infancy at the beginning of transition). So was the advice from the Western economists involved in transition.

One important breakthrough was the lesson of the false model of “piecemeal institutional change” from the realization that institutions are entangled as part of a global integrated complex system (e.g. Kornai introduces the congruence among economic institutions for the allocation of resources in the Soviet-type economy, and Boettke advances a game theoretic public/rational choice explanation for why Lenin’s New Economic Policy and Gorbachev’s Perestroika failed). The entanglement of systems of institutions within the global institutional framework guiding behavior in a society creates a

unique institutional mix that is responsible for the economic trajectory of its economy over time. To use the taxonomy of institutions in relation to development in Acemoglu and Robinson (2013): when *extractive institutions* prevail, productive entrepreneurs and innovator retreat, and economies stagnate and lag in economic performance as a result; when, on the contrary, the rule of law, and *inclusive institutions* dominate, productive entrepreneurship and innovation spurs growth performance as a result.

Balcerowicz advances a theory of “tacit political pacts” to explain the non-violent transitions out of communist regimes in the CEE and the FSU republics. The gradual introduction of the ideas of radical political and economic changes through Gorbachev’s Perestroika and Glasnost has provided the context for implicit negotiations between old communist elites and the new democratic regimes in which the later are promised radical economic and political changes in return for physical safety and freedom of the first: “Peaceful negotiations would never have taken place (or, had they taken place, they would never have borne fruit) had the Soviet threat not been gradually eliminated by Gorbachev’s glasnost and perestroika. These negotiated changes were not always based on an explicit political pact and entailed a large element of surprise for all the main actors. However, they would not have come about if the members of the old elite had felt physically threatened or even if they had not believed that they would be free to seek favorable positions in whatever new system emerged. In this sense one can speak of *tacit political pacts*.” (Balcerowicz 2001 p.25, emphasis added)

In the 10-years aftermath with transition reforms, Balcerowicz’s focus is on the difference between two types of reforms “economic” and “political”, where the economic

reforms comprise privatization, liberalization, and macroeconomic stabilization, while political reforms refer mainly to democratization. But discussions on the importance of the rule of law become inevitable as economic changes depend on political and legal changes. Balcerowicz's assessment legal change comes through changes in political institutions: "the efficiency and fairness of the justice system are fundamentally important in terms of limiting the arbitrary power of the state as well as in the enforcement of property rights and contracts, and thus in longer-run economic development." (p.26).

Many of the mistakes and lessons learned by the Western economic advisers and reformers during transition can be traced back in great part to the general neglect of an institutional perspective imported and spread in the East based on inadequate models of economic and institutional change under the noble cause of aiding these countries in their transition to capitalist systems. Institutional revelations of key economists involved in transition theorizing and the practice have grown over time, fact reflected in many successive assessments of the lessons learned from the collapse of communism and the experience with reforms over the past 25 years. Once we take into account the epistemic-institutional/cultural insights, we are able to provide a consistent explanation for many of the "puzzles" on the list of key lessons learned common to many transition economists. For example, regime uncertainty theory, and path dependence explain the surprising slump in output at the beginning of transition that still appears in the top of the "lessons learned" by leading transition practitioners like Anders Aslund (2012), and Andrei Shleifer (2012).

The sub-field of transitional political economy emerged as a result of the intellectual stocktaking in the fields of comparative political economy and development economics

prompted by the collapse of communism in the late 1980's, early 1990's (Boettke et al. 2005). The ongoing experience with transition reforms started in 1991 has made transition scholars and reform practitioners change the focus of their studies and the reform strategies pursued from (1) getting the prices right, to (2) getting the institutions right, and (3) getting the culture right. In 1991, the focus of reforms was on getting the prices right through (a) microeconomic policies of market/price liberalization and privatization of state assets and state-owned enterprises, and (b) macroeconomic policies of inflation stabilization, and monetary/fiscal responsibility. Empirically however, over a decade of little sign of convergence in the development paths across the CEE and FSU economies required to look elsewhere for reliable answers. The macroeconomic-oriented troika of liberalization, privatization, and stabilization reforms proved an insufficient prescription for the economies with weak democracies like Russia and Central Asia, where authoritarianism replaced the basic intuitions of the rule of law. It is true that the initial imbalanced macroeconomic situation - of a sharp slump in output, a rise in inflation, and fiscal imbalance - was a common characteristic across all the former communist economies in the group. However, the initial conditions of their institutional frameworks were not. The failed shock therapy reforms in weak democracies of the FSU revealed that legal institutions matter. The focus shifted on getting the legal institutions right, and on adequate institutional design. However, the inadequacies of the model of "piecemeal institutional change" unraveled with the realization that our idea of "institutions" is too narrow, and that we need to consider both the formal and the informal dimensions of the complex, integrated institutional systems in former Soviet countries. For example, Janos Kornai and Peter Boettke challenged the myth

of a “pure Soviet-type economy” by pointing out that the congruence between the formal and informal institutions was key for the functioning of the allocation of resources throughout the Soviet era (Kornai 1995, Boettke 1998, 2001), and that de facto the Soviet Union belongs in the class of “mixed economies”.

Getting the legal institutions right required a better appreciation for the scope and diversity of the relevant institutions. Svetozar Pejovich makes a useful distinction between the *de jure* (formal, written) and the *de facto* (informal, tacit) dimensions of the institutional frameworks relevant for guiding the behavior of individuals in society. Institutional frameworks go beyond the *de jure* – the formal, written rules, codes, and their enforcement mechanisms, into the realm of the informal, the realm of a society’s culture. In fact, as research shows, the informal, cultural, or *de facto* institutions in society are at the core of the entire relevant institutional matrix. They represent the embeddedness level in socio-economic analysis (Williamson 2000), and are seen as the slowest to change (Williamson 2000, Roland 2012). The most embedded of informal institutions are identified in the path dependence literature of social change as *metis* – the most stable and “sticky” of institutions (Boettke et al. 2008). According to this literature, *metis* is the link between the past and the present, the impact of history and past politics on the perceived, prevailing structure of incentives today. The success of transition reforms depends on the effect of the interaction between the pre-existing *metis* and the newly introduced policies and formal institutional changes (Pejovich 2003, Boettke et al. 2008). The problem of getting the institutions right soon became a problem of getting the culture right.

Adam Smith (1776) observed that cooperation and economic growth comes naturally “Little else is requisite to carry a state to the highest degree of opulence from the lowest form of barbarism, but peace, easy taxes and a tolerable administration of justice; all the rest being brought about by the natural course of things” as long as basic institutions of property rights and rule of law are in place. Yet the majority of economists today perpetuate the Keynesian ideas of macroeconomic policies and institutional engineering are equal to the Marxists-Leninist ideas of social and economic engineering. The project of transforming the former communist economies has to be completely rethought. This rethinking must take place in light of insights from new institutional economics to help rule of law and pro-capitalist sentiments emerge from the bottom up.

2.6 Conclusion

“The Great Economic Transformation” (Kornai 2006) of the former socialist economies depended crucially on institutional change focused on strengthening or building market-preserving institutions (e.g. rule of law institutions, impartial courts, liberal constitutions, federalism within the larger EU space). A strong rule of law fosters the incentives for productive entrepreneurship, and innovation. In weak post-socialist democracies, the new political elites thrived from campaigns of instigation of the public against prominent entrepreneurs thus eroding public support for capitalist institutions and policies. But establishing the institutions of the rule of law anew is a cultural challenge, not a technical issue of transplant of formal legal institutions.

Transition from “a shortage economy” to “an innovative economy” is an indigenous one supported by a liberal public morality, and pivotal people with pivotal liberal ideas, at moments of constitutional redefinition. The fact that radical plans of free-market reforms have succeeded in Poland and other CEE geographically and culturally closer to Western Europe is not a demonstration that “economics can be put to the service of humanity” in a mechanistic way as transition and development economists Jeffrey Sachs (Sachs 1994) have argued and applied. The scholarly consensus on the problems of transition and development is increasingly appreciative of the complexity and specificity of institutions which should from now on inform the transition reform community of the need to change their approach from top-down and foreign-led to bottom-up and locally/indigenously-informed.

To stress the importance of understanding informal institutions, Douglass North often makes the point that a diligent adviser of economic reforms in developing nations must “soak themselves in” the indigenous culture for at least six months in order to be able to give informed advice that takes account of the informal institutions guiding behavior that might conflict with his theory acquiring the local knowledge of norms, etc., and even then, the success of us as external planners is not guaranteed. The pretense of knowledge that has dominated the attitude of mathematical economists since WWII carried on in post-communists modeling of transition, and that was detrimental to the economies of in planning intuitional and economic transitions.

By corroborating insights from the literature on lessons learned from the collapse of communism from the past two decades, we find that:

1. Transition problems can be imputed to a neglect of the role of cultural/social institutions
2. The neglect of culture was caused by an overemphasis on the formal institutions over the informal, cultural institutions as the basis of a nation's morality capital legitimizing the public capital and the direction of the formal legal/political institutions, and the economic/financial policies.
3. The role of liberal leadership and ideas is underappreciated.

What we hope to show is that the biggest lesson is one of humility about the extent to which the standard body of economics can aid our understanding of reforming countries and the adequate policies and institutions that best promote markets, productive entrepreneurship, and growth. We find that insights from new institutional economics filled in the analytical gap in neoclassical economics and revealed three main insights into what contributes to a successful transition: leadership matters, as do the underlying culture, and the moral fabric specific to each society undergoing institutional and economic transformations.

The lesson from the collapse of communism is that flourishing markets - where individuals are able to recognize and bet on small and grand entrepreneurial ideas depend - on a formal-informal institutional environment, which not only minimizes threats of arbitrary predation, but also morally praises individuals for their productive and creative-innovative entrepreneurial contributions to society. The road of a successful transition from "a shortage economy" to "an innovative economy" is an indigenous one, supported by pivotal people promoters of pivotal (liberal) ideas through bold political activism at pivotal

times. Positive societal attitudes and sentiments towards entrepreneurship and innovation do *matter*. A pre-existing moral-cultural context of informal norms, attitudes and beliefs favorable for the innovating class also contributed to success. Access to information through freedom of media, freedom of trade and competition can help “civilize society” to adopt informal institutions favorable to a capitalist system.

3. THE ROLE OF CULTURAL ENTREPRENEURSHIP IN ESTONIA'S 'SINGING REVOLUTION'

3.1 Introduction

The series of “Singing Revolutions” in the former Soviet Baltic republics are well known for their non-violent, cultural characteristics in the history preceding the collapse of communism and the Soviet Union at the end of the twentieth century. Yet, the economics and political science literature on revolutions is dominated by analyses geared to show why in repressed societies revolutions should fail rather than explaining the successful ones. Collective action problems plague large groups of individuals even if they would jointly benefit from it (Olson 1971 p.2). The rationality assumption of standard rational choice theory provides a concentrated benefits, dispersed costs explanation for to explain social and institutional change (Tullock 1967), and incentives for each individual to free ride on the participation and/or leadership moves of others (Hardin). Under this approach, historically, small, rebellious groups were able to overcome the incentive problems by devised institutional solutions (Leeson 2007), while larger demonstrations required leadership to spark the wider support of masses (Kuran 1989).

How does the literature factor in the role of culture in revolutions? Culture is perceived as a transaction cost of successful development and transition reforms (Pejovich 2003, Boettke et al. 2007). The interdependent legal and political system

transitions are particularly constrained by the indigenous culture, with which they must be compatible in order to be successfully adopted (Boettke et al. 2007, Eggertsson 2005). I argue in favor of a paradigm shift in our thinking about the role of culture and the cognitive/rationality assumptions of the agents participating in the democratic process from standard rational choice to a multidisciplinary approach, from passive (reactive) to active (entrepreneurial) participants able to recognize windows of opportunity within which to act on their true constitutional preferences, and to work within epistemic communities to anticipate and devise solutions for problems of collective action like governance (Ostrom 1997). Culture is the object of study of a multitude of interrelated social sciences including economics, sociology, anthropology, political science, and cultural and complexity studies. In this line of research, I argue that instead of *either* rational choice *or* cultural explanations of revolutionary phenomena, like the Singing Revolution, there is added scientific value to research on the economics of revolutions by integrating cultural insights from a diversity of fields.

To illustrate how an entrepreneurial-institutional approach to social change enriches our understanding of the successful Estonian revolution, I explore Estonia's system of ancient cultural beliefs. The Estonian ancient heroic epic, "Kalevipoeg", is a piece of cultural heritage that illustrates how cultural beliefs persisted, and contributes contributed to Estonia's moment of "national awakening," and the successful corresponding revolution, and independence struggle. In a dynamic framework, the ancient culture curators as entrepreneurs facilitated social change manifested in a nation-wide "cultural awakening". The story of Kalevipoeg stuck to the hearts of minds of the

Estonian people because they resonated with pre-existing indigenous beliefs about self-governance. History reveals the importance of complementing the standard rational choice analytical framework with insights from cultural and entrepreneurship studies to better explain phenomena of social and institutional change.

The underlying theme of this paper is the neglect of the human element, “agency”, in economic theory, and how it is reflected in economic analyses non-market decision making, such as the collective action problems faced by potential protesters, or revolutionaries.

3.2 The Estonian Singing Revolution: History, Culture, and Politics

The “Singing Revolution” is the title given to a series of peaceful mass demonstrations featuring spontaneous, pro-independence singing in Estonia starting in 1987 that led to increased political protests against the Soviet regime, and finally to Estonia gaining its independence from the Soviet Union in 1991, and the withdrawal of the last Russian troops from Estonian territory in 1994. The Estonian singing demonstrations started during Mikhail Gorbachev’s policies of freedom of political expression, “Glasnost”, and intensified in the summer of 1980, eventually assembling over 300,000⁶ Estonians at the annual Song Festival in Tallinn to sing Estonian national hymns, and songs for independence that were strictly forbidden under the Soviet regime.

3.2.1 Estonia’s Singing Culture

Singing has been a defining characteristic of Estonia’s culture since before the Soviet era. The tradition of singing of popular religious and patriotic Estonian songs thrives as a result of a large portion of younger population practicing singing generation

⁶ Circa a quarter of the entire Estonian population in 1989 (1, 565, 662 Est. <http://www.stat.ee/62931>).

after generation. According to Statistics Estonia, the most active practitioners of amateur cultural activities in Estonia are the 10–24-year-old young people, among whom singing is the most popular activity. According to the Time Use Survey, 83% of the 10–24-year-olds were involved in some amateur cultural activity in 2010. Among the 25–64-year-olds there were 74% of those practicing some kind of amateur cultural activity and, among persons aged 65 or older the respective proportion was 56%.

As a tradition that persisted to present day, Estonia's culture of singing goes back to at least 1869, during the rule of the Russian Empire, when Estonian journalist and poet, Johann Voldemar Jannsen, first established The Estonian Song Festival in Tartu. He also wrote the lyrics of the "Mu isamaa, mu õnn ja rõõm ("My Fatherland, My Happiness and Joy") a popular, folkloric song later adopted as the national anthem of Estonia. By composing the nation song, and by establishing the Annual Song Festival, Johann Voldemar Jannsen is credited with fostering The Estonian National Awakening that led to the Estonian "Singing Revolution" and independence from Moscow.

Jannsen was not alone in his endeavors to foster the cultural grounds conducive to creation of an Estonian national identity. The period known as the "national awakening" started in the early nineteenth century in a series of coordinated, private initiatives that led to the realization of a unified Estonian cultural identity (Iwaskiw et al. 1996). The Society of Estonian Literati (SEL), the oldest scholarly organization, founded in 1838 at the University of Tartu by a group of indigenous Estonians and Estophile Baltic German intellectuals, took credit for uncovering Estonia's ancient cultural roots. The purpose of the Learned Society was to do research, develop, and disseminate Estonia's history and

culture from Antiquity to present, including its language, literature, and folklore. The leading indigenous figures were Friedrich Robert Faehlmann, Alexander Friedrich von Hueck and Dietrich Hienrich Jürgenson. The the society published its works in yearbooks, bibliographies and Proceedings.

Friedrich Robert Faehlmann, an Estonian physician, folklore expert and linguistic scholar, made key steps to the restoration of the Estonian Ancient cultural heritage. He was the first to research Estonia's ancient folklore, and to compile Estonia's ancient heroic epic *Kalevipoeg* (Kalev's Son) the source of stories and lyrics for Estonia's singing tradition. Faehlmann dies at the age of 51, in 1850, however, leaving behind "only bits and pieces of his ongoing efforts" as accounted by comparative mythologist of Estonian origin, Jaan Puhvel (2003). Faehlmann death, coupled with the immediately preceding publication of the Finish Kalevala in 1849, prompted the Estonian Learned Society to commission his close friend, Estonian poet Friedrich Kreuzwald, to complete the literary task. As Puhvel states, however, Kreutzwald's task required more than a work of "restoration" of existing folkloric material because "he had no lays to work with, only prose sagas and interspersable lyric pieces." To complete the epic, Kreuzwald "took considerable liberties which detracted somewhat from the final result," and that "Only about twelve percent is from original folksongs." (Puhvel 2003).

3.2.2 "Kalevipoeg": Estonia's Ancient Epic Narrative of a Society of Free and Responsible Individuals

The first version of Friedrich Kreutzwald's heroic poem *Kalevipoeg* was published in the Learned Society's *Proceedings* between 1857 and 1861. The epic was rapidly disseminated, and adopted by the indigenous population, and is considered to

present day *the* fundamental Estonian heroic epic, and a reservoir for ancient, Pre-Soviet indigenous values, norms, and beliefs (Kruks 2003).

Latvian sociologist Sergei Kruks considers literary epics “as conscious attempts to invent a tradition of self-identification in the framework of the emerging ‘nations’ in the 19th century,” and provides a comparative analysis of the cultural messages contained in the old texts of Kalevipoeg by contrasting it with those of its Latvian counterpart (Kruks 2003). Starting from the assumption that the logic of epic stories, epic narratives is to present us with contexts for interpreting which values, actions or behaviors are moral, socially acceptable, and which are not, Kruks proceeds to read the verses of Kalevipoeg and derive the central message encompassed therein.

The Estonian narrative describes the formation and development of Kalevipoeg, the hero, and how he tests his limits and corrects his behavior according to the existing social norms. We learn of the following ancient personal, inter-personal, and governance values in circulation in Estonia through the epic of Kalevipoeg and the songs derived from its text:

Optimistic and constructive attitude towards failure

Yet, dear brothers, no regret can stem from this voyage. Knowledge must be held as higher than a silver treasure, more precious than heaps of gold! Thus on our errand route, on our delusive pasture path, we found many truthful tidings: that the wide world has no end; that Taara, in his wisdom, fixed no limit anywhere, set no impassable barriers. (Kreutzwald 1982: 212; Song XVI)

Humility and knowledge accumulation

*“On turning back man has more wisdom/ than he had upon departing.”
(Kreutzwald 1982: 212; Song XVI)*

Entrepreneurship (as risk taking)

*Don't throw today's chores onto tomorrow's peg!
Each day has its own burdens, each hour its own demands,
its pressing weight of worry, its own needs calling.
If you want to try your luck and see a profit in your work,
then don't waste time — hesitate no longer!
(Kreutzwald 1982: 43; Song III)*

The role of social feedback for good governance

*I'll be sure to find some kinsmen, acquaintances in Lapland, old friends from
the isle who'll put me on the path, direct me toward the right trail.
(Kreutzwald 1982: 200; Song XVI)*

Cooperation through communication: Language and singing skills

By Kruks' interpretation, "The external help and advice are highly appreciated and repaid in kind. Communication with helpers requires the language skills. Kalevipoeg talks and sings, he even seeks a discursive resolution to a conflict."

Responsibility for own actions

*The spilling of innocent blood passes judgment on you;
blood strives for blood's wages, death brings forth more death:
you cannot clear your sword from having gashed faultless flesh.
(Kreutzwald 1982: 115; Song IX)*

Freedom of choice

Military defeat is represented as an unintended by-effect of the aspiration for knowledge and natural human curiosity. Kalevipoeg had exchanged the book of precious wisdom for the satisfaction of his curiosity to find the Edge of the Earth. Kalevipoeg accepts the freedom to make decisions and to act, and he is ready to account for his actions.

Hope for the future

Where decrees were also fixed and the law clearly laid down, revealed to the king and proclaimed to his people. More precious than gold or silver, the shackled book contained the very liberty of old days, freedom for Estonia's sons — a poor man's finest treasure.
(Kreutzwald 1982: 250; Song XIX)

Responsible collective action

What are the young men doing then? Are there no brave ones growing, no strong men rising to form a shield for the old ones and grant the aged peace?
(Kreutzwald 1982: 251; Song XIX)

A society of equal, capable, and responsible beings

*What are the young men doing then?
Are there no brave ones growing,
no strong men rising to form a shield
for the old ones and grant the aged peace?*
(Kreutzwald 1982: 251; Song XIX)

The end of the epic expresses the hope that one day the hero will be resurrected.

Kalevipoeg is treated just as one among others.

*But one day an age will dawn
when all spills, at both their ends,
will burst forth into flame;
and this stark fire will sever
the vice of stone from Kalevipoeg's hand.
Then the son of Kalev will come home —
to bring his children happiness
and build Estonia's life anew.*
(Kreutzwald 1982: 266; Song XX)

Here Kruks notes that “Kalevipoeg's death is not an impasse for the people, because the function of a ‘hero’ is just to incarnate the qualities worthy of identification with. Any man able to prove his skills and competence can take up the position of the hero.”

The message of Estonia's oldest epic is ultimately one of self-governance as a superior mode of social organization. Kalevipoeg encourages personal responsibility, collective action, and risk taking as essential for development. The message in Estonia's folklore is one of desire for a self-governing society of equals, capable of socially responsible actions, of learning from mistakes, and self-actualization.

3.2.3 The Political Context of the Singing Revolution: 'Glasnost', and the Theory of Preference Falsification in Soviet Estonia

The theory of *preference falsification* and numerous accounts of its prevalence during the communist and Soviet regimes is an indication that in practice, Soviet societies adhered to two different, parallel institutional systems, one formal and militarily imposed, and one informal, self-enforced. Estonia's case gives cultural weight to Timur Kuran's theory of a preference falsification phenomenon. Preference falsification and tacit collective choice seem to have a basis in Estonia's medieval cultural institutions. Estonians believe that patience is a weapon and caution a virtue, "*their hero is the shrewd old barn keeper who sits by the fire, waits, watches, and acts only when the time is right*" ("The Singing Revolution" 2009). Inherent in Estonians' culture is a common identity, and their folkloric songs reflected what institutions they found valuable, their indigenously-approved institutions based on their actual political preferences. The choir platform as a revolutionary instrument provided Estonians with an opportunity for a synchronized (thus, anonymous) expression of their actual constitutional preferences.

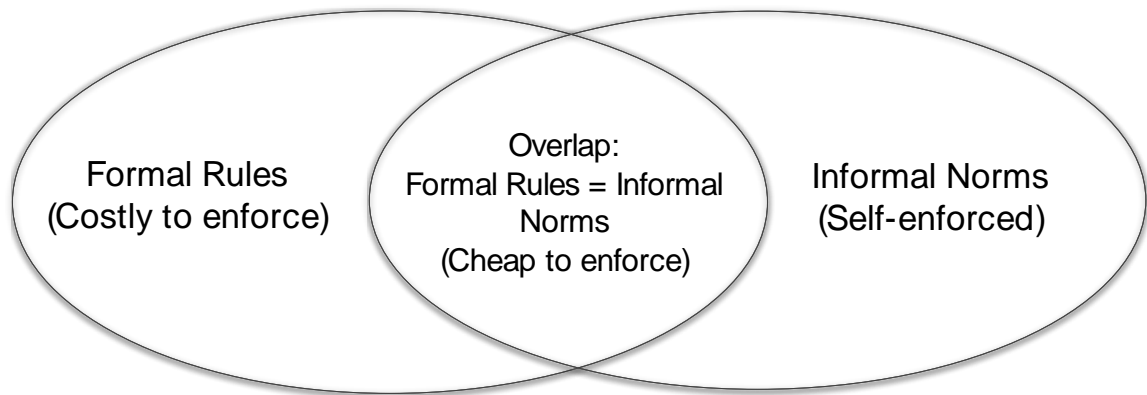


Figure 2 The Relationship Between Formal and Informal Institutions in Society (Sautet 2005, p.5)

To better appreciate the phenomenon of preference falsification in practice, consider Sautet’s illustration (Figure 2) of the relationship between the formal and the informal dimensions of the relevant rules of the game, or “institutions,” and the cost of their enforcement in society (Sautet 2005).

3.3 Rational Choice, Game Theory, and the Static Solutions to the Problems of Revolution

For a pure rational choice analyst, the Estonian “Singing Revolution” is a case where the indigenous culture helped solved the typical problems of collective action. The culture of singing played a role in increasing the payoffs of individuals participating in spontaneous, mass anti-Soviet protests, and in the Singing Revolution. The pre-Soviet indigenous culture eliminated the problems of participation and coordination, and legitimized the creation of a liberal Estonian constitution during independence. The Estonians’ tradition of singing lowered the transaction costs of mass singing during the Tallinn Song Festival - window of opportunity for expression of participants’ *true* constitutional preferences. It helped overcome the participation problem, the context of

the singing arena fostering spontaneous singing and thereby anonymity of the “first mover” and eliminated the first mover problem by eliminating the necessity for a first mover (the conductor was forced to continue conducting by the Soviet authorities themselves). The festival arena fostered, moreover, participants’ anonymity and their assurance of a tacit, binding singing agreement.

Game theory can serve as a helpful heuristic in the question of why the Singing Revolution occurred. The use of game theory to complement a rational choice analysis of collective action problems is popular especially in comparative politics. The *n-person assurance game* (or “tipping game”), for example, illustrates how an appropriate change in the structure of incentives leads to the cooperative equilibrium in a case of prisoner’s dilemma (Little 1993, Peterssen 1999). Under the *n-person assurance game*, the underlying logic is that an individual will act only if a certain “threshold” of other agents will act as well (Sen 1967; Shelling 1985, Peterssen 1999). The “participation threshold” in the case of a revolution is the percentage level of participation by a reference group that triggers reciprocation by the individual (Peterssen 1999). The *n-person assurance game* has been used in the past to explain revolutions against communist regimes in Eastern Europe (Goldstone 1994, Kuran 1991, 1995, Karklins and Peterssen 1993, Bunce and Chong; Lohman 1992). However, this literature deals only with violent revolutions.

Applied to Estonia’s non-violent revolution, the assurance game helps us illustrate the economic calculations by an individual choir singer, and how the non-violent, cooperative equilibrium of the singing revolution was reached. An individual choir singer’s expected payoff of obeying or disobeying the Soviet rules of singing exclusively

Soviet propaganda songs at the Tallinn Song Festival in 1988 is expressed in the following equations. Equation (1) expresses the expected payoff of disobeying the Soviet rules, and switch to singing Estonian patriotic songs along with the rest of the thousands singers on the platform. Equation (2) expresses the expected payoff of obeying the Soviet orders even when the rest of the singers disobeyed.

$$E(M) = \rho\alpha - (1 - \rho)\varphi \quad (1)$$

$$E(A) = (\rho - \rho_i)\alpha \quad (2)$$

Where ρ is the probability the Singing Revolution is successful when all singers at the Song Festival disobey the authorities by singing Estonian songs instead of continuing to sing songs of Soviet propaganda, and where $\rho \in [0, 1]$. α is each singer's private payoff of gaining independence from the Soviet Union, and where $\alpha > 0$. If the singing revolution fails, the Soviet authorities may persecute and imprison the rebellious singer and his family (a private cost φ , where $\varphi > 0$). In equation (2) the cost term from (1) is absent since this equation considers the singer's expected payoff of obeying the Soviet rules.

		Choir Singer A	
		Disobey (Sing Estonian songs)	Obey (Sing Soviet Songs)
Choir Singer B	Disobey (Sing Estonian songs)	α	σ
	Obey (Sing Soviet Songs)	ω	σ

Figure 3 The Tallinn Song Festival Choir Singers' Assurance Game

The role of the pre-Soviet culture in this assurance game, increases the level of reciprocity in participation from other fellow singers, and leads to the cooperative Pure-Strategy Nash Equilibrium, in which the payoffs of the singing revolutionaries are maximized.

Moreover, the context of freedom of speech and political expression provided by the implementation of “Glasnost” has decreased the costs of revolutionary participation, and leadership. Moreover, the use of singing and the Tallinn Festival Arena as shelling points solved the problem of protest coordination, and of achieving anonymity of the prime singers-protesters. The arena provided grounds for an increasing threshold of numbers for the anonymity of the revolutionaries to step up and carry their sung protests. The conductor of the choir could be considered as “the prime mover” since his role in coordinating the force of singing is crucial. Accounts tell that even if the Soviets used the tradition of the festival for Soviet propaganda instead, they were forced to allow the conductor to guide the spontaneous, unison singing of thousands of choir singers, of Estonian patriotic and religious songs, in essence an expression of opposition to the Soviet regime, and a clear demand for independence and change.

The problem with the rational choice, game theoretic explanation of the Singing Revolution is that it is no explanation at all. By treating changes in culture, the informal structure of beliefs, as exogenous, the framework remains static. It only describes the equilibrium outcomes before and after the change, without explaining. In our case, it omits *the who* made social change possible in 1800’s Estonia. The standard rational choice approach omits the human element in sociocultural change.

3.4 A Dynamic Theory of Socio-Cultural Choice: The Role of Cultural Entrepreneurs in Estonia's Singing Revolution

“It is patent that dynamic choice is of crucial importance in many important economic (and other) decisions... Formal choice theory has not dealt well at all with models of dynamic choice beyond the standard ‘dynamic choice equals static choice of a strategy.’” (Kreps 1988, p.198-190)

The problems of dynamic market choice and competition faced by the standard neoclassical economic theory spill over into rational choice analyses of dynamic sociocultural choice. As Kreps point out, comparative statics cannot explain change, neither of the market kind, nor (I would argue that even less so) of any non-market kind (e.g., institutional, sociocultural, or legal). What we need is a dynamic theory of change. Extending the existing theory of competition and entrepreneurship (Kirzner 1973), we can complement the narrow rational choice framework to help explain dynamic sociocultural phenomena like the Estonian Cultural Awakening and the subsequent Singing Revolution that led to Estonia's independence. The solution out of the comparative statics trap is to reintroduce the active, entrepreneurial human element into economic theory, by recourse to entrepreneurial-institutional individualism as opposed to conforming to an atomistic definition of methodological individualism (Buchanan 1999, Boettke 1996).

The biggest shortcoming of the rationality assumption in orthodox neoclassical economics is that it disables explanations of various dynamic phenomena in society (North 1990, 2005, and North and Denzau 1994). Social change is a particular nebula for standard economic theorists. Given an uncertain, constantly changing, “non-ergodic” world, North asks: “How well do we understand reality? How do beliefs get formed?”

Whose beliefs matter and how do individual beliefs aggregate into belief systems? How do they change? What is the relationship between beliefs and institutions? How do institutions change? And perhaps most fundamental of all, what is the essential nature of the process [of economic change] itself?” (p.5). Like sociologists, Douglass North appears inclined in his writings to accept an evolutionary theory of social change. Social norms, beliefs, values, “cultures” change over time by an evolutionary mechanism, through learning and adapting from experience (North 2005). An evolutionary perspective on social change, however, disarms even theorists like North from exploring the possibility and validity of alternative, dynamic theories. If evolution must take its course first in order for the prevailing societal system of beliefs to change, then like evolution, we must take social change as exogenous, i.e. *given*. The culture of a society, as defined by North, is “the cumulative structure of rules and norms (and beliefs) that we *inherit* from the past that shape our present and influence our future” (North 2005, p.5, emphasis added). In this paper, I argue that although an evolutionary theory of social change in Estonia may perfectly hold, it omits from the view the role of the Estonian cultural entrepreneurs who deliberately attempted and succeeded to steer the course of Estonia’s cultural “evolution” towards a re-actualization of ancient indigenous beliefs of self-governance and personal responsibility. History reveals the key role of the Estonian indigenous *epistemic community* of the early nineteenth century, represented by the members of Estonian Learned Society, and its/their role in discovering, designing, and disseminating the relevant knowledge of the *cultural commons* in society.

An alternative, entrepreneurial-institutional approach to rationality complements the standard neoclassical framework, and helps explain the social change phenomenon that helped Estonians overcome the problems of revolution, and reinstate self-governance.

3.4.1 Institutional Disequilibrium, Entrepreneurial Social Change, and Revolution

From Samuelson's famous illustration of a society's production possibilities frontier (PPF), we learn that a society's choice of optimal production level on its PPF varies with the "quantitative and qualitative resources of the economy in question and the technological efficiency with which they are used" (Samuelson 1948, p.18). The more fundamental question in economics, however, is what determines changes in the PPF itself? For a long time, the old growth theorists' biggest revelation was that growth is a result of exogenous changes in resource availability and technological change. Unsatisfied with a "no explanation" exogenous explanation, the new research in growth theory showed that technological change is a function of the institutional makeup of a society: better institutions cause increases in PPF and the corresponding combinations of optimal production levels. Extending the relevance of institutions in macroeconomics to the problems of developed and developing nations, Shleifer et al. develop a framework for understanding social choice, where an Institutional Possibilities Frontier (IPF) captures a society's optimal choice of institutions as a tradeoff between the extremes of dictatorship and disorder (Shleifer et al. 2005). The problem in their framework is one of

static choice, however. There is no explanation for the adjustment between chosen social orders.

As I have argued, standard economic tools of analysis exclude the dynamic role of entrepreneurs in coordinating markets, and society. The existence of multiple equilibriums, as predicted by standard game theoretic analysis, betrays a state of *de facto* disequilibrium. Living under the military oppression of communist dictatorships did not stop or a sub-culture in a state of continuous change, and self-reinvention. Using the opportunity discovery theory of entrepreneurship advanced by Israel Kirzner and promoted by Scott Shane, we define cultural entrepreneurs as arbitrageurs of sociocultural beliefs. Boettke and Coyne illustrate the importance of the human element in a society's choice of optimal production in Figure 5, showing that economic coordination does not occur mechanically, but it is carried on by active entrepreneurs who discover opportunities to trade and innovate, and in the process their function is to increase the level of coordination (equilibration) in a previous greater state of dis-coordination (disequilibrium).

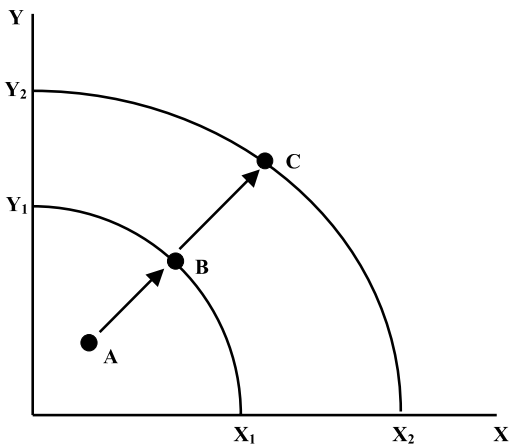


Figure 4 Kirznerian (A to B), and Schumpeterian (B to C) entrepreneurship on a diagram of the Production Possibilities Frontier (Source: Boettke&Coyne 2003, p. 157)

In addition to “market entrepreneurship,” they introduce, and define the notions of “institutional entrepreneurship,” and “social entrepreneurship” (Boettke and Coyne 2003).

3.4.2 Cultural Entrepreneurs: The Human Elements behind Estonia’s Period of “Cultural Awakening”

Toivo Raun, historian of Estonia and the Estonian people, attribute its national awakening to the Society of Estonian Literati (SEL). Founded in 1831, the SEL started as a group of local and Germanic Estophiles enthusiasts, promoters of educational literature in Estonia, but quickly expanded its broader cultural aspirations to include the popularization of written Estonian folklore and music, and the establishment of cultural centers, song festivals, and a museum in Tartu (Raun 2001, p. 75). Their efforts were later paralleled by an emergence of civic organizations for the development of Estonian music, theater, and art. The first all–Estonian song festivals organized by SEL members in 1869 in Tartu became a tradition, and it set the start of an indigenous musical culture in

Estonia. Mass participation in numerous song festivals grew rapidly over time, in particular as “antidotes to the pessimism occasioned by Russification” in 1890 (Raun p.76), and the later Soviet regime.

While the process of mass adoption of the Estonian folklore and culture of singing can be described as spontaneous, leading to an “awakening” of shared sentiments of socio-cultural and national identity,

How can economics account for the activity of cultural leadership of The Society of Estonian Literati?

Culture and entrepreneurship are two of the most elusive⁷ and neglected concepts in social research in general, and in economics in particular. The neglect of entrepreneurship as the driving human element in standard economic analysis has been long acknowledged (Baumol 1968, Kirzner 1973, Arrow 1992) and documented in the history of economic thought (Baumol 1968, Demsetz 1983, Boettke & Prychitko 1991). Numerous contributions are either towards re-integrating the entrepreneur in economic theory (Kirzner 1973, 1983, Baumol 1990, 2010), or part of a distinct, new, scholarly field (Shane and Venkataraman 2000, Davidsson 2003). Similarly, the framework for institutional analysis and development (Ostrom 2005, Aligica&Boettke 2011) is a response to the neglect of the role of deliberate, entrepreneurial action in solving problems of collective action and social choice typical to economics and political science (Ostrom 1965, Kuhnert 2001). As a growing literature focuses on a “new” approach that

⁷ William Baumol famously noted that: “The entrepreneur is at the same time one of the most intriguing and one of the most elusive characters in the cast that constitutes the subject of economic analysis.” (Baumol 1968, p. 64).

includes an appreciation for the role of informal, social institutions, and “culture” in problems of economic development and transition throughout economic history (North 1990, Williamson 2000, Djankov et al. 2003, Boettke et al. 2005), the question of culture dynamics becomes ever more relevant. Is there room for an entrepreneurial dimension of a phenomenon of socio-cultural change? In this section, I use insights from both the field of entrepreneurship studies on one side, and from the new, culture-based approach in economics on the other side, to provide a more integrated framework for interpreting the Estonian Singing Revolution. Mainly, I draw on the literature that focuses on *the function of entrepreneurship in society* (Kirzner 1973 , Davidsson 2003), and on “culture as the set of informal rules of the game a society inherits from the past that guide the behavior its individuals in the present” (North 1990, 2005). My idea is that the manifestation of deliberate activities of cultural leadership in 1980’s Estonia corresponds in theory with *cultural entrepreneurship* that attributes the

Entrepreneurship theory allows us to consider cultural leadership a form of entrepreneurship, specifically *cultural entrepreneurship*. One of the most theoretically rigorous definitions of entrepreneurship in the economics literature is by Israel Kirzner (1973), who defines entrepreneurship as an act of arbitrage, and an entrepreneur “an arbitrageur” (1973). It follows that *cultural entrepreneurship* is the entrepreneurial act of discovery and exploitation of existing, yet previously unnoticed, opportunities to advance valued cultural commons in society. Evidence that the Estonia’s cultural entrepreneurs were *alert* to discovering and exploiting opportunities to bridge the gap between forgotten, yet pre-existing culture (i.e., the ancient Estonian beliefs, norms,

customs/traditions, values) and the growing demand for a unified national identity comes from an Estonian Literati Society's member, along the lines "Let's give Estonians what they want" (Raun 1991, 2001).

Another way to look at cultural entrepreneurs is as a category of institutional entrepreneurs. Institutional entrepreneurs are defined in sociology as institutional arbitrageurs by DiMaggio (1988, p.14) who states "new institutions arise when organized actors with sufficient resources see in them an opportunity to realize interests that they value highly". While institutional entrepreneurs innovate institutions in general, cultural entrepreneurs innovate cultural, informal institutions in particular. I find that the most integrated look at cultural entrepreneurship is by acknowledging that it serves all the functions of three distinct, yet interrelated types of entrepreneurship conceptualized in social sciences: social entrepreneurship, institutional entrepreneurship, and public entrepreneurship⁸. I illustrate cultural entrepreneurship at the intersection of the three types of entrepreneurship in Figure 5.

⁸ For a synthesis of the market, social, and institutional types of entrepreneurship in the literature, see Boettke and Coyne (2003). For the use of the concept of "public entrepreneurship" (as differentiated from political entrepreneurship), see Ostrom (1965). For a conceptualization of "constitutional entrepreneurship" based on Ostrom's concept of public entrepreneurship, see Khunert (2002).

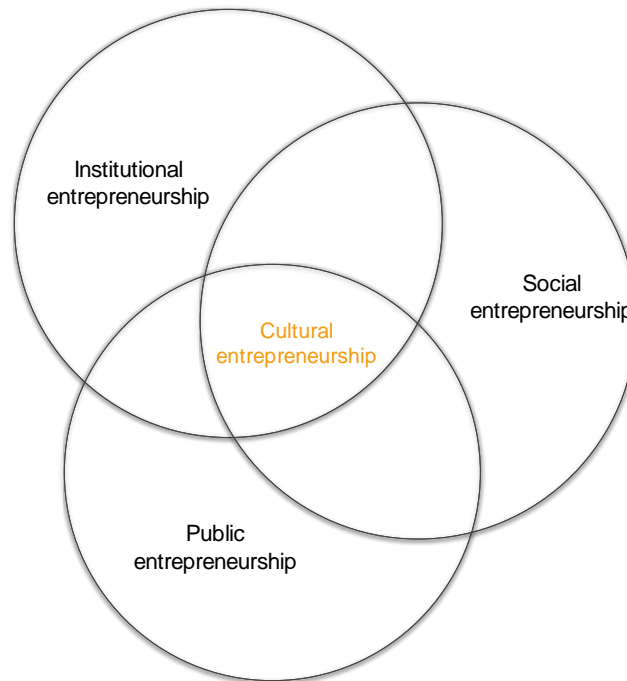


Figure 5 Cultural entrepreneurship in relation to social, institutional, and public entrepreneurship.

The Estonian Kalevipoeg is a piece of cultural heritage in the form of heroic epic poetry that contributed to Estonia’s moment of "cultural awakening," and the successful revolution, and independence struggle. In a dynamic framework, Friedrich Kreutzwald and his predecessors represent the cultural entrepreneurs, the driving forces who facilitated the Estonian moment of sociocultural change or “cultural awakening”.

3.5 Conclusion

The Estonian “Singing Revolution” was a spectacular case of successful collective action of hundreds of thousands of Estonians singing folkloric, patriotic songs with the goal of demanding independence from the Soviet Union in the late 1980’s. Exploring the “Singing Revolution” as a case study, I find that its success is attributable

to Estonia's pre-Soviet culture of self-governance and personal responsibility. However, careful historical and ethnographic research revealed the role of the members of Estonia's Learned Society in reviving and promoting Estonia's ancient cultural beliefs at the beginning of 1800's, the beginning of Estonia's Age of Cultural Awakening that led to the perpetuation of Estonia's culture of singing and the ultimately to the Singing Revolution and independence. The entrepreneurial activity of the members of the Estonian Learned Society is a historical fact that calls for a switch to an entrepreneurial-institutional notion of rationality in economic theory. Estonia's cultural entrepreneurs induced social change by fostering the development and preservation of Estonia's pre-Soviet culture that ultimately conducted to the Singing Revolution.

The Estonian heroic epic Kalevipoeg is a piece of cultural heritage in the form of heroic epic poetry that contributed to Estonia's moment of "cultural awakening," and the successful corresponding revolution, and independence struggle. In a dynamic framework, Friedrich Kreutzwald and his predecessors represent the cultural entrepreneurs, the driving forces to facilitate the Estonian moment of sociocultural change, or "cultural awakening".

The story of Kalevipoeg stuck to the hearts of minds of the Finnish and Estonian people because they resonated with pre-existing indigenous beliefs about freedom of choice and self-governance.

4. SUBORDINATE MARKET PROCESSES IN ALTERNATIVE GOVERNANCE SOLUTIONS

4.1 Introduction

Is there a scientific basis for the idea of market-based governance solutions?

When it comes to the economics of institutions (their emergence, adoption, and development), or the fields of new institutional economics, law and economics, and the economics of anarchy, most economists are rather skeptical about the idea of markets generating institutions and mechanisms for their enforcement (Buchanan 2011, Boettke 2011). Apart from a few economists who recognize the importance of achieving a more robust theorizing about the institutions within which exchange takes place (Wagner 2010, Boettke 2011), in general economists tend to assume market institutions as given (Alchian 1965, Kirzner 2000), or take institutions as exogenous, rather than explain their emergence from within individuals' exchange relations. Most importantly, economists today seem to reject a market-based generation of the "rules of the game over property rights"⁹, for example. In theorizing about the institutions within which exchanges takes place, they tend to adopt a pessimistic view about the idea of marketable institutions by pointing out externalities and incentives problems analogous in the provision of public goods (Buchanan 2011, Kirzner 2000). Price theories take market institutions as primordial and given, and therefore seem to imply that there is no prospect for a workable

⁹ To which I will refer from now on as "property rights institutions".

price system to signal rule preferences in a society. Their focus is instead on the study and design of endogenous mechanisms of *collective rule making* and *not* on the study of endogenous *market-process-based* mechanisms of *rule formation*. James M. Buchanan, for instance, has argued that a market solution for the choice of an institutional framework is hard to imagine in practice, because the very role of institutions in a society implies their non-excludable “public goods” nature:

Embodiment of a recognition that the rules or constraints on the operation of markets are best classified as “public goods” in the Samuelson taxonomy, while at the same time general agreement on the collective provision and dimensional characteristics of such goods is relatively more attainable than like agreement on post-rule allocation distribution of value, does not give economists license to claim that efficient rules are generated as if by magic from within-market behavior. The “invisible hand,” even as properly interpreted, remains inoperative at the level of choices among rules. Far-seeing entrepreneurs cannot expect to secure differential rents, at least to the same degree as those promised by exchanges in partitionable goods. (Buchanan, 2011, p.9)

For Buchanan, the non-rivalrous nature attributed to institutions prevents entrepreneurial market processes of profit and loss from taking place, which implies that institutions cannot be submitted for evaluation to any market efficiency criteria like clearly priced commodities can. Therefore, for Buchanan institutions are rather the product of a pre-constitutional collective choice, than the result of spontaneous market forces.

Similarly, for Israel M. Kirzner institutions are established and evolve over time out of actors’ interacting ethical perceptions. Kirzner strictly disapproves of associating the words “market” and “process” with institutions formation and development:

These limits on the market are imposed by its institutional prerequisites. Without these institutional prerequisites—primarily, private property rights and freedom and enforceability of contract—the market cannot operate. It follows that those institutions cannot be created by the market itself. The institutions upon which the market must depend must have been created or have evolved through processes

different from those spontaneous coordinative processes which we have seen to constitute the essence of the market's operation. It can in fact be shown not only that, of course, we cannot, without a market, rely on spontaneous market processes of coordination to establish the institutions needed for the market to operate, but also that we cannot rely upon *any* spontaneous social forces to foster those institutions. So that these institutional requirements for the market constitute what we have termed the "outer limits" to the market. They mark out the boundaries beyond which any coordinative processes (such as those generating the sets of mutually reinforcing expectations which constitute the system of property rights) must necessarily be of a non-market character. (Kirzner, 2000, p. 83)

In his shared skepticism with Buchanan, Kirzner turns to the idea that institutions are rather "nonmarketgenerated" (2000, p.86), than market-based, spontaneously-generated. In his entrepreneurship theory, Kirzner assumes a given institutional framework (Kirzner 1978, 1983, 2000) and insists that a rigorous or "pure" theory of entrepreneurship necessitates a pre-existing framework of market institutions, without which spontaneous entrepreneurial processes are not possible.

Other economists, like Hayek (1960), and later Boettke and Coyne (2009), have argued that existing informal institutions and enforcement mechanisms may be neither collectively-made, nor market-supplied, and that they seem instead generated spontaneously outside a price system "out of human action, but not human design". Peter T. Leeson's research area was defined by Peter J. Boettke for example, as "the economics of endogenous rule formation" (2011). Boettke and Leeson have contributed with theoretical advancements to this field by introducing the concepts of informal "protective institutions", or "the protective entrepreneurship tier" that supports "the productive entrepreneurship tier" in a society where formal institutions are weak or absent (Boettke and Leeson 2009). Likewise, Avinash K. Dixit defines his own research area as "the

economics of lawlessness” (2004); research focused on the study of “alternative institutions that support economic activity when a government is unable or unwilling to provide adequate protection to property rights and enforcement of contracts through the machinery of state law” (2004, p.vii). The work of Dixit and Leeson in particular is focused on historical and more contemporary case studies illustrating that informal property rights institutions are formed endogenously, through a variety private mechanisms of social cooperation that are the realm of “non-market decision making”.

It seems that the underlying wisdom in this incipient literature on endogenous informal institutions formation is in line with Buchanan and Kirzner’s skepticism over the ability of markets to supply institutions. Contrary to this conventional wisdom confirmed in the Buchanan-Kirzner conundrum, there is reason to be more optimistic about the potential of markets to support and generate “rules of the game”. In this paper, I suggest that a market process-based analytical framework is applicable to theorizing about endogenous property rights institutions. I make a claim over the plausibility of market-based emergence and development of institutions. I intend to demonstrate the case for market-based emergence or extension of institutions by analyzing two separate case studies of informal property rights institutions through the entrepreneurial market process framework¹⁰. I find out that through this framework, the two cases of informal property rights institutions enforcement mechanisms can be viewed as market-process-based and driven. I claim contrary to the Buchanan-Kirzner conundrum that we can count

¹⁰ I consider (and therefore use in this paper) “the Austrian entrepreneurial market process framework” interchangeable with “the neo-Mengerian program for economic theory” as defined by Richard E. Wagner (2010).

on an entrepreneurial market process framework to theorize about property rights formation, enforcement, and development. My argument is that a solution out of the conundrum is possible in those cases where the required “entrepreneurial process” in the activity of an “institutional entrepreneur” can be subordinated to the entrepreneurial process of his activity as a “market entrepreneur”¹¹. In other words, in cases where the formation of institutions is connected to or dependent on the success of an activity based on prices, able to undergoes the profit and loss mechanism, then the market process natural in the latter can be indirectly imputed on the first. An activity of institutional entrepreneurship also undergoes an entrepreneurial process by virtue of it being interconnected with an activity of market entrepreneurship

The rest of this paper is organized as follows: in Section 2, I discuss existing non-market-based theories of emergent endogenous informal property rights institutions. In Section 3 I propose instead an alternative, entrepreneurial market process perspective (model) on emergent informal property rights institutions. In Sections 4 and 5, I apply the entrepreneurial market process-based framework of analysis to two select studies of endogenous informal property rights institutions from the existing literature. I then follow with as summary of my findings, implications for further research, and conclusions in Section 6.

4.2 Informal Property Rights Institutions: Conventional Approaches

¹¹ The literature on the distinction between “institutional entrepreneurship” and “market entrepreneurship” is summarized and elaborated on in Boettke and Coyne (2009).

New institutional economist Douglas C. North defines institutions as “the rules of the game in a society; [...] the humanly-devised constraints that structure human interaction [...] made up of formal constraints (rules, laws, constitutions), informal constraints (norms of behavior, conventions, and self imposed codes of conduct), and their enforcement characteristics” (1993). By North’s definition, property rights institutions are the rules of the game over property rights. More precisely, property rights are the formal or informal institutions that establish and enforce property rights. Entrepreneurs, from small local arbitrageurs operating in their local marketplace to large multinational corporations, will hold back from committing their resources if they do not trust in the institutions meant to preserve their property. Research in the field of informal governance reveals that heterogeneous societies with weak or absent formal property rights institutions have exhibited the practice of alternative, informal forms of institutions that establish and guarantee the protection of their property from exchange (Friedman 1979, Greif 1989, 1997, Dixit 2004, Leeson 2005a 2005b, 2006, 2008, 2009). Moreover, analyses of present-day trade outcomes and relations also reveal modern traders’ (i.e. firms, local and global corporations) reliance of alternative property rights and enforcement institutions (Dixit 2004, Rauch and Watson 2005, Rauch 2007). Among the types of informal property rights institutions and their enforcement mechanisms explored by the new institutional economists above for example are community-enforced property rights institutions based on social distance-reducing mechanisms, such as ex-ante signaling of credibility and trust, ex-post validation of reputational capital, and internal ostracism and exclusion.

The evidence of such practices of alternative protective institutions suggests that it is not the “legal property rights” (formal or de jure rights), but the “economic property rights”¹² (informal or de facto rights) that are in fact important for the achievement of the cooperative equilibriums in a society. Alternative property rights institutions emerge in a context of absent or misaligned formal (de jure) property rights with the informal (de facto) economic property rights (Boettke et al., 2008). The actual formation, extension and development of informal property rights institutions is currently modeled in the literature as based on individuals’ non-market-based choices. The theoretical explanations of such non-market informal institutional mechanisms vary from social distance-reducing mechanisms, such as ex-ante signaling of credibility and trust, multilateral internal ostracism and exclusion, a “small world”, and “spin-off entrepreneurship” theories, as well as theories of ex-post validation of reputational capital. Although, implicit in these theories is the manifestation of individuals’ entrepreneurial actions, none of the theoretical explanations provided by new institutional economics researcher however, makes an explicit case for a market-based, entrepreneurial process foundation of their property rights enforcement theory. Thus, this literature seems to reinforce the fundamental criticisms made by Buchanan and Kirzner vis-à-vis workable markets for institutions. In the following section I present my theoretical claims on why the entrepreneurial market process framework is applicable and appropriate to cases of emergence or extension of informal property rights institutions.

¹² Note, as a matter of methodology, the meaning of “property rights” I adopt in this paper is the one defined by Armen A. Alchian (1965, 1987, i.e. the economic origin of the rights of individuals over the use of resources) or “economic property rights”, as distinguished from “legal property rights” (i.e. the rights assigned by the state to individuals) by Yoram Barzel (1997); distinction also implicit in Ronald H. Coase (1960).

4.3 Informal Property Rights Institutions: A Market Process Approach

[A]cting man really does try to construct his picture of the future to correspond to the truth as it will be realized... He is thus motivated to bring about correspondence between the envisaged and the realized futures. (Kirzner 1982, p.149, emphasis in original)

James Buchanan and Israel Kirzner have advanced an important challenge for an entrepreneurial market process perspective on institutions formation and development. Their combined arguments result in a dead end for a research program researching the emergence of institutions from a market process perspective. To paraphrase both Kirzner and Buchanan in a sentence, the benefits of the “invisible hand” of markets are limited only to priced commodities, which can only emerge based on a pre-existing set of market institutions that allow for entrepreneurial profit and loss calculations in the first place. The major shortcoming both economists identify in an activity aimed at arbitraging over institutions is the absence of prices, or of a profit and loss mechanism, and therefore the absence of the essential “entrepreneurial process”¹³ that would legitimize the application of the entrepreneurial market process framework to explaining institutions, their formation and development.

Although I acknowledge the Buchanan-Kirzner arguments against an entrepreneurial theory of institutions, I claim that a solution out of the Buchanan-Kirzner conundrum is possible in those cases where the required “entrepreneurial process” in the activity of an “institutional entrepreneur” can be subordinated to the entrepreneurial

¹³ It is Kirzner’s argument (based on Mises 1949) that while all human action is entrepreneurial, the absence of prices in some entrepreneurial activities prevents a learning process from happening. Without prices, the entrepreneurial process of knowledge communication through the profit/loss mechanism necessary for plan coordination with other actors in the economy is not possible. (Kirzner, 1973, p. 223).

process of his activity as a “market entrepreneur”¹⁴. In other words, in cases where the formation of institutions is connected to, or dependent on, the success of an activity based on prices, which undergoes the market profit and loss mechanism, then the subordinate market process in the later can be imputed on the the first. An act of institutional entrepreneurship undergoes a process by its interconnectedness with an activity of pure market entrepreneurship.

In my proposed theoretical solution to the Buchanan-Kirzner conundrum, an institutional entrepreneurial process can be viewed as an implicit process, subordinate to the demand-versus-supply process working towards equilibration on the associated markets for goods or services. Absent a commonly agreed upon system of property rights and their enforcement, the discovery of profitable arbitrage opportunities on the market for goods necessarily reveals a concomitant discovery of a way to secure the property rights over the speculated profits to be obtained from exploiting those market profit opportunities. The two cognitive processes are inseparable and reinforce each other. Moreover, from this broadened theoretical perspective, without factoring in the necessary alertness to discovering an idea of how to achieve inclusion in a stranger group’s institutional system, alertness to existing gains from exchange with the stranger group is likely to lose force. The entangled, double cognitive process at work provides an explanation for the reality of widespread and constantly increasing trade among strangers and across socially distant groups in the absence of strong formal property rights systems. It is markets for goods that validate the indirect implicit markets for institutions (i.e. the

¹⁴ The literature on the distinction between “institutional entrepreneurship” and “market entrepreneurship” is summarized and elaborated on in Boettke and Coyne (2003).

entrepreneurial actions taken towards the extension of the property rights institutions, within which those goods exchanges take place, over both parties engaged in a specific market trade).

To sum up the broader entrepreneurial market process framework that I propose as a solution to the emergence and/or extension of informal property rights institutions, while I agree with Henry Ford, for example, who says that “You can’t build a reputation on what you are going to do”¹⁵, I maintain my theoretical assertion that one can nonetheless signal her future reputation, your trustworthiness, or your type. The act of signaling your future reputation is in itself an entrepreneurial one and it is attached to the entrepreneurial market process of your intended underlying exchanges with a stranger party. Kirzner’s entrepreneurial market process theory can be applied towards active acts of bidding on profits from formation of (or extension of) discovered (or existing) informal property rights institutions. Consequently, the phenomenon of increasing institutional spans over regions is a result of entrepreneurial action and process. Finally, this solution to the Buchanan-Kirzner challenge is based on a broader perspective on Kirzner’s own ideas. Acting man, from a broader entrepreneurial market process perspective, can use markets to benefit from an existing property rights regime or to influence the realization of an envisaged type of property rights institutional regime.

4.4 Application 1: From Relation-Based to (Entrepreneurial) Profit-Motivated Governance or Contract Enforcement Theories to Explain the Chinese Informal Investment Climate

¹⁵ As quoted in MacLeod 2007, p. 615.

In “Lawlessness and Economics”, Avinash Dixit (2004) models a mechanism of informal, relation-based contract enforcement based on the information flow from the repeated play of geographically and socioeconomically distant traders. In Dixit’s model, honesty prevails among randomly matched traders for shorter distances, and cheating prevails for longer distances. The analysis shows that the extent of honesty decreases as the number of traders in the economy increases. The result is unfavorable for optimists of informal enforcement institutions: the relation-based contract enforcement mechanism breaks down as economies grow larger. The theory suggests that informal governance is limited to small economies, and the prospect for large economies is somber: absent effective formal governance, per capita economic growth will stall in expanding informal economies. Yet, current empirical research challenges Dixit’s analysis. In his review of Dixit’s book, James E. Rauch notes that, if we compare investments in China and Russia, for example, it appears that the limits of informal contract enforcement in Dixit’s model do not hold in most of the countries, as results from the cross-country empirical analysis in Rodrik, Subramanian, and Trebbi (2002) also show. Unlike Russian investors, Chinese investors appear to enjoy the protective benefits of the existing informal property rights institutional system, despite operating within the second largest economy in the world, and lacking the option of formal protective property rights institutions (due to China’s socialist legal system).

One way to explain the phenomenon of extended trade in China, Rauch elaborates, is to resort on the “small world” network theory, or a version of the “six degrees of separation” phenomenon, according to which “there is a remarkably short

number of steps between a given individual and a random stranger via individuals who know each other” (Rauch, 2007, p. 484). Using the insights of the “small world” network theory formalized by Duncan J. Watts and Steven H. Strogatz (1967), and his own theory on “Cluster and Bridges in Networks of Entrepreneurs” (Rauch and Watson, 2005), Rauch provides an improvement to Dixit’s model which permits him to explain the case of the extended informal property protecting institutions in China. Rauch’s explanation for the emergence of a small world network system of trust in China is based on local entrepreneurs’ “tendency to spin off from “mother firms” so that each mother firm gives rise to a cluster of entrepreneurs who know each other needs and capabilities.” Crucial in this model are the cross-cluster links based on successful business relationships that firms (entrepreneurs) initiate and cultivate in response to discovered gains from cross-cluster trade.

What Rauch seems to put forth from a market process view, is a twist in the nature of informal governance theory of Dixit from *relation-based* to *profit-based*. The profit-based theory of informal institutional emergence developed by Rauch is, I argue, an *entrepreneurial* one, and therefore compatible with the (Austrian) dynamic and entrepreneurial, rather than (Walrasian) comparative statics, analytical framework. From an Austrian market-process theoretical perspective, in reality, the process of matching traders from distant clusters is never automatic. Before a local trader approaches another trader from a distant network of entrepreneurial clusters about forming a trading partnership or for simple exchange, she first must perceive that doing so might be profitable. The action of reaching out to distant traders is itself entrepreneurial and entails

a pre-ceding “eureka moment” – a cognitive moment of discovery of a means to exploit and keep the profits from a future trade or business partnership. How to present yourself, what negotiation and business etiquette techniques to use and how to persuade a distant trade partner of your trustworthiness, are all entrepreneurial actions.

The challenge is to show that the entrepreneurial idea of establishing cross-cluster partnerships also entails a process, and pass the Buchanan-Kirzner profit and loss requirement. I suggest that, if we consider the entrepreneurial discovery of a signaling method to achieve contract enforcement as subordinate to the discovery of the profit opportunity from the main entrepreneurial activity – the cross-cluster trade with goods or services – than the implicit entrepreneurial process in the signaling activity is also subordinate to the main process of the actual market activity. The signaling activity, by deduction is *profit-motivated*, and therefore also *entrepreneurial* and market-based. The implicit institutional entrepreneurial activity aiming at achieving contract enforcement and preservation of property rights is, in this light, entangled with the market entrepreneurial activity and process aiming at exploiting the monetary profits from the novel trade partnership. Therefore, a market for informal institutions, although subordinate to the market for goods or services, exists. In my view, the Austrian market process framework and Rauch’s theory of cross-cluster spin-off entrepreneurial ventures provide a dynamic market-based theory for the phenomenon of functional informal property rights institutions, or governance institutions, contract enforcement mechanisms in large, extended economies like China.

4.5 Application 2: A Entrepreneurial Market Process Perspective on Endogenous Property Rights Formation in the Context of Trade among Ethnically-Distant African Tribes

The well-known weaknesses in their formal institutional systems make African countries particularly propitious environments for the emergence of alternative forms of property rights. In the works of Peter T. Leeson, informal self-enforcing institutional arrangements are the explanation for how relative cooperation and peace was possible among the socially heterogeneous African groups. Signaling was the main informal mechanism identified by Leeson to play a key role in the expansion of the level of cooperation and trade among African groups of different ethnicities (Leeson 2005a, 2005b, 2006, 2008). In his theory, the signaling mechanism contributed to the formation of the institution of trust. The institution of trust is foundational for a credible trade relationship to emerge. It guarantees commitment to the terms of exchange. It guarantees that private property rights will be respected by the stranger party reaching out for gains from trade with a socially-distant group. However, Leeson only implicitly applies the (Austrian) entrepreneurial process framework to explain the endogenous formation of property rights institutions that sustain cooperation in Africa. Only in essence, his theoretical model recognizes the entrepreneurial aspect in the choices of the African traders establishing trade relationships among themselves. The set of choices individuals have to signal their trustworthiness is not given, as it would be from a comparative statics framework, but it is entrepreneurially discovered:

... the framework presented here provides an alternative to the conventional approach to homogeneity in the self-enforcement literature, which treats social distance as fixed and exogenously determined. In contrast, my analysis views social distance as endogenous to the choices of actors who may manipulate social

distance for their purposes. It therefore helps to explain why we often observe individuals adopting the behaviors and customs of those with whom they desire to interact and why individuals typically trust those who are like them over certain dimensions more than they trust those who are not. (Leeson 2008, p.24)

...by adopting the practices, customs, or beliefs of outsiders, we are able to signal our credibility, which builds trust between otherwise heterogeneous individuals and enables interaction despite the absence of formal enforcement. (Leeson 2005b, p. 3)

In a (Walrasian) comparative static framework, the means to signal credibility in order to exploit the gains from trade are given. All rational choosers need to do is optimize among those given signaling means (i.e. by adopting the set of given practices, customs, or beliefs) to achieve cooperation and trade. Implicitly, the institutional choice set is also given. All exchange does is activate automatically the optimal property rights institution - the institution of trust and the associated ex-post reputation in this case.

Consequently, the dynamic market process framework is more appropriate for theorizing about the endogenous property rights formation and enforcement in African trade. In this case too it can be showed that the institutional entrepreneurship entails both entrepreneurial action and an entrepreneurial process. The challenge, again, is to answer the question of how is an entrepreneurial market process here possible without an actual market for those property rights institutions. The entrepreneurial process is a learning market process based on calculations of profit and loss. It is a process of discovery of profitable opportunities validated (or invalidated) by markets through the profit and loss feedback mechanism. In this case study, the socially distant individuals are primarily motivated by the discovered profits from the trade with goods, not the trade with institutions that would protect their property rights over the goods to be exchanged.

To overcome the Buchanan-Kirzner challenge in this case study is to consider, again, the process of property rights formation as subordinate to the market process undergone by the main entrepreneurial activity - the trade with goods. In the light of the entrepreneurial process framework, the profit and loss calculations concerning Africans' signaling activity – an implicit investment in the desired property rights institutions – are subordinate to the profit and loss calculations concerning the actual exchange of goods or services. African traders' betting on property rights institutions occurs simultaneously and inseparable from their betting on the monetary profit from trade with actual priced commodities.

4.6 Conclusion

The current consensus between scholars under the broader umbrella of the law and economics field (i.e. the new institutional economics, constitutional economics, and anarchism) on one side, and scholars of the Austrian entrepreneurial market process field, on the other side, rejects any theoretical foundation for the idea of a market for institutions or the idea of “institutional entrepreneurship”. The existing models rely on non-market-based explanations for the emergence and development of the “rules of the game”, or institutions in a society. The Buchanan-Kirzner arguments against the possibility of marketable institutions pose the most notable current challenge to market-based theorizing about institutions, which reinforces the non-market foundations in these models. At the core of the Buchanan-Kirzner challenge is the impossibility of an “entrepreneurial process” of profit and loss accounting to occur due to the inexistence of

primordial property rights institutions essential in supporting a price system to guide acts of institutional entrepreneurship.

While I acknowledge the Buchanan-Kirzner arguments against an entrepreneurial theory of institutions, I argue in this paper that a theoretical solution for this Buchanan-Kirzner conundrum is possible in those cases where the required “entrepreneurial process” in the activity of an “institutional entrepreneur” can be perceived as subordinated to the entrepreneurial process of his activity as a “market entrepreneur”. Mainly, in cases where the formation of institutions can be track to as connected to or dependent on the profit and loss feedback mechanism of an activity based on market prices, then the market process natural in the latter can be indirectly imputed on the first.

Through an Austrian market process lens, an activity of institutional entrepreneurship also undergoes an entrepreneurial process by virtue of it being interconnected with an activity of market entrepreneurship. Two theoretical claims can be made based on applying the Austrian market process framework to explaining phenomena of institutional entrepreneurship: 1) a stronger claim maintaining that an entrepreneurial market process for the formation of property rights institutions in a trade relationship is possible even in the absence of some underlying system of property rights guiding the main market entrepreneurial activity to which the first is linked, and 2) a weaker claim maintaining that that an entrepreneurial market process for the emergence of property rights institutions in a trade relationship is possible only for the *extension* of the existing underlying system of property rights guiding the main market entrepreneurial activity to which the first is linked.

My examination of two studies of informal formation and enforcement of property rights institutions among socially-distant entrepreneurs point to the weaker, the second theoretical claim of a possible entrepreneurial process in an attempt to succeed in extending (or adopting) an already existing set of property rights institutions governing exchange in among a potential group of traders. My findings imply that as far as informal property rights institutions go, there are cases when markets represent the foundation for their provision, or at the very least for their extension.

The scientific prospects of the realm of applications of the resulting broader Austrian entrepreneurial market process framework are especially promising for scholars working at the intersection of the Austrian market process theories with constitutional economics theories, and new institutional economics, and anarchism theories.

5. CONCLUDING SUMMARY

A recent trend across social sciences emphasizes the role played by “context” in understanding real-world, dynamic phenomena such as institutional, economic, and social change. This dissertation is an effort to contribute to this growing trend of contextual economic and political analysis. The dissertation investigates how and why the specificity of, and interaction between “institutions” across societies shapes the manifestations of economic and socio-cultural change. The first chapter is an assessment of the practical and theoretical lessons from the experience with the collapse of communism in Central and Eastern Europe and the Soviet Union. The main lesson is that to understand the differences in entrepreneurial performance and social change across the former communist countries we need to account for the diversity in societal “rules of the game” or “institutions.” Institutional diversity is based on each country’s cultural distinctiveness that ultimately impacts the rise (or decline) of reform leaders, productive entrepreneurs, and ultimately the success or failure of transition reforms. In the second chapter, I investigate the case of the ‘Singing Revolution’ in 1980’s Estonia, and provide a conceptual framework for interpreting peaceful social change. I explore if (and to what extent) the Estonian period of “National Awakening” (1830’s-1860’s) and the success of the Singing Revolution (1987-1991) can be attributed to the entrepreneurial efforts of Estonia’s cultural leaders to revive and promote ancient cultural beliefs and traditions,

such as the belief in self-governance and the tradition of singing, that played the role of focal points during the Singing Revolution. In the last chapter, I examine two studies of informal formation and enforcement of property rights institutions among socially distant entrepreneurs, and find that sometimes market processes may constitute the foundation for the extension of existing institutions, if not for the development of new institutions.

Simply acknowledging that context matters - a breakthrough in recent economics and other social sciences - is not sufficient for understanding how and why economic and social change happen. The uneven dynamics of the institutional and economic transitions in the Central and Eastern European and the Former Soviet countries channeled the focus of research towards the variety and specificity of the indigenous cultures across. It is a mistake to neglect the cultural aspects of context in favor of pre-conceived, formal institutional models, disembodied from the existing local knowledge, norms, and historical-political heritage.

That market institutions, like formal property rights, matter, and are desirable in society, we have learned from the collapse of communism. But, that the informal, cultural institutions matter more because of their impact on the success of proposed, formal, property rights-preserving, legal-political institutions (like the rule of law and credible constitutions), we have only been able to appreciate during transition reforms. The unfolding of the experiments with reforms in a variety of contexts drew attention not only upon how context impacts individual and collective decision making, but also to how and why, with their entrepreneurial alertness to opportunities to improve their social climates, individuals and their communities were able to overcome problems of leadership, and

participation in collective action, and succeeded to better shape the contexts of their future lives.

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