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The Impact of Identity Politics on Economic Reforms in Estonia

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1. Introduction

Robert Dahl once wrote: "In liberal societies, politics is a sideshow in the great circus of life" (Dahl 1961, 305). Politics may well be a sideshow in stable societies, say, in New Haven, Connecticut, the city that provided empirical evidence for Dahl's book. But in rapidly changing societies that face concurrent economic and political transition, politics is the main show, in the center ring and under the brightest spotlight. This is not the sort of politics we know from stable societies, not the kind with well-ordered bargaining and a rational calculation of cost and benefits. The politics exercised in these societies undergoing transition operates in a completely different domain, where agents are faced with high degrees of uncertainty. They do not exploit the well-established "political opportunity structure" by considering risk-reward ratio. Uncertainty implies that they do not even know what such a structure might be. Coupled with constant change, this lack of sophistication leads agents to make decisions based on simple rules of what they consider appropriate in the given circumstances. The notion of path-dependence reveals that these early decisions will have long-term consequences. Most alarmingly for enlightened rational followers of politics, these "appropriate" rules are often based on historical legacies of troubled pasts, on exclusion rather than inclusion, and on a specific perception of identity rather than rational universal doctrines. Political decisions based on the grounds of a particular interpretation of history and identity lead to economic developments that follow – not the other way around.

However, contrary to conventional wisdom, all of this will not lead to hell on Earth. There is no reason to be deterministic in our discussion of human affairs. Perhaps it is only worth being deterministic when we consider the words of the German poet

Friedrich Hölderlin, who said: “What has always made a hell on earth has been that man has tried to make it his heaven.” In other words, being über-rational and ignoring the context within which political decisions are made offers a much straighter path to disaster than taking a humbler approach. These insights inform the research undertaken here.

By exploring the causal relationship between identity politics and economic reforms in Estonia, I demonstrate that identity politics is fundamental for explaining her successful economic reforms. The aim is not to capture all the complexities and nuances of political and economic transition in Estonia starting from the second half of the 1980s; other accounts offer a more detailed look into the entire process of transition as well as into some of its more specific aspects. I incorporate insights from two different accounts, from economic reforms and identity politics in Estonia, which in their respective extremes conflict with one another – at least on the surface. However, I argue that these two accounts can be incorporated despite their apparent inconsistencies. By relying on these secondary sources, I offer a stylized causal story in which identity politics is operationalized as an independent variable, the economic reforms as a dependent variable. The discussion is stimulated by insights found in neoinstitutionalist literature, which includes rational choice institutionalism. Such an approach may seem too simple or reductionist for a die-hard particularist, but the beauty of simplicity is clarity.

The paper starts with a discussion on the nature of economic reforms in Estonia, the main focus on privatization, trade, fiscal and monetary policy reforms in 1990s. Then it explores the causes of these reforms. This overview is followed by a brief account of the literature covering identity politics. Last but not least, the analysis part of the paper combines two accounts into one by offering a causal explanation for the economic reforms. The paper concludes by highlighting the key findings.

2. The Nature of Economic Reforms

Considering Estonia's small population of 1.3 million and the relative unimportance of this country in the broader European or world context, its economic reforms have received a surprising amount of attention. Western newspapers have published numerous and extremely positive articles about Estonia and its state of affairs. Opinion editorials and reports in the pages of The New York Times, Wall Street Journal, and the Economist – to name just a few – have highlighted the remarkable economic and technological successes of this tiny country on the shores of the Baltic (for example see Bordevich 2000, Landler 2005 and Roth 2004). One way to address the popularity of positive story-telling about Estonia would be to dismiss it as a public relations campaign, where particular Western policy wonks are eager to find empirical support for their ideas – alas, if this were the case, it would be a very successfully run campaign. However, stories focusing on eBay's $2.6 billion-purchase of the Estonia-based Internet telephony company Skype or similar news items addressing economic reforms on the pages of The New York Times have something substantive to tell (Landler 2005). Indeed, in comparison with other countries in Central Eastern Europe, Estonia's success has been phenomenal in both information technology and economic development.

Most importantly, these positive accounts have not been contained to the media and policy worlds. Scholars have drawn attention to Estonia's concurrent macro- and microeconomic reforms, which were more rapid and radical in the 1990s than anywhere else in Central and Eastern Europe (CEE) (Åslund 2001; Feldman 2003, 2006a & 2006b; Freytag 2003; Sorg and Vensel 1999; Sally and Feldmann 2001). The first gradual steps were taken in the last days of the Soviet Union: The first private bank was allowed to be formed in 1989. Price liberalization started, and the state monopoly on all trade was abolished in 1990. Once, the Soviet Union ceased to exist in 1991, the breadth and scope of economic reforms accelerated. The most important elements of these reforms took place in the areas of fiscal policy, monetary policy, privatization and trade policy. As a result of these reforms, the gross domestic product (GDP), which decreased 14.2 percent in 1992, 9 percent in 1993 and 2 percent in 1994, started to grow in 1995. With the exception of a poor performance in 1999 caused by the economic crisis in Russia, Estonia has achieved some of the most spectacular GDP growth rates in Europe between 1995 and 2005 while also maintaining low levels of inflation (See Table 1 below).

Table 1. GDP Growth (%) and Inflation(%).

Year	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**
GDP growth	**-14.2**	**-9.0**	**-2.0**	**4. 3**	**3. 9**	**10.6**	**4. 7**	**0.3**	**7. 9**	**6. 5**	**7. 2**	**6. 7**	**7. 8**	**9. 8**
Inflation	**1,076**	**89.8**	**47.7**	**29.9**	**23.1**	**11.2**	**8. 2**	**3. 3**	**4. 0**	**5. 8**	**3. 6**	**1. 3**	**3. 0**	**4. 1**

Source: Data compiled by the author on the basis of statistics from the Estonian Ministry of Foreign Affairs (available at http://www.vm.ee/estonia/kat_398/pea_172/281.html) and the Baltic Economic Indicators (available at http://www.balticsww.com/economic_stats.htm).

Nevertheless, it is worth keeping in mind that the success of the economic transformation cannot be explained by a few single reforms (e.g. tax reform) as some simplistic accounts often portray, but rather by the simultaneous undertaking of the whole package of economic reforms that was moved forth in the first half of the 1990s. The key elements of these reforms are outlined below.

2.1 Trade Policy

The radical liberalization of international trade is considered one of the cornerstones of Estonia's economic reform of the 1990s. In 1991, the Western markets accounted for five percent of the country's exports. By 1999, the EU alone accounted for 63 percent of Estonia's exports and 58 percent of its imports (Feldmann and Sally 2001, 10). The former Soviet Union, once the main market for Estonia's imports and exports, counted for less than one-fourth of her exports and imports in 1999. Estonia was able to rapidly integrate its economy with the West and re-orientate its trade from East to West thanks to free trade and a liberal foreign direct investment regime; this shift was accelerated by the so-called double tariffs imposed by Russia and the collapse of Russian markets.

Import quotas, a main form of trade protection until then, and most tariffs were completely abolished in 1993. In the period of 1993-1997 Estonia moved to completely unilateral free trade with zero percent tariffs on all imports, including agricultural products (Feldmann and Sally 2001). The uniqueness of this trade policy is well chracterized by the accession process to the World Trade Organization (WTO). (Estonia joined in 1999 as a *developed* country, while Slovenia, the wealthiest country in Central and Eastern Europe and at the time at least 2.5 times wealthier than Estonia, joined the WTO in 1995 as a *developing* country in order to gain concessions.) Negotiations for accession lasted four years, and were especially challenging due to Estonia's unilateral free trade regime. WTO accession normally requires binding tariffs on the levels not above pre-accession rates, which in the case of Estonia was zero. In other words, Estonia had nothing to offer other WTO members as it had abolished all forms of protectionism. However, as Estonia pursued membership in the European Union, the achieved compromise, reflective of the EU trade regime, allowed Estonia to implement average tariff bindings on industrial goods at slightly higher than six percent. In 2000, Estonia gave up its unilateral free trade policy as a result of reforms for joining the EU, and started to enforce tariffs on agricultural goods (3.3 percent, on average); industrial goods remained subject to the unilateral free trade policy until accession to the EU (Feldmann and Sally 2001). In 2004, Estonia became a member of the EU and gave up her WTO commitments to assume those of the EU.

2.2 FDI Regime

Estonia's legal framework for addressing foreign direct investment (FDI) has been liberal and non-discriminatory since the early 1990s. In general terms, foreign investors have been treated on par with domestic investors. Restrictive measures in Estonian law were only set forth for a few exceptional cases that would differentiate and discriminate investors according to their nationality, their place of residence and their location. Even more rarely have these legal provisions been applied in practice. The key restrictions on foreign capital allocation existed in the legislative acts on land privatization and regulations concerning real estate. Restricitions on foreigners buying domestic firms and real estate have been lifted. Such institutional changes have created one of the most favorable foreign investment climates in Central and Eastern Europe (Organization for Economic Cooperation and Development 2001, 1).

Foreign investors benefited more from the overall economic rule-making process than from the specific measures targeted at them. The basic elements for the implementation of rule of law were put in place in the early 1990s. The Law on Bankruptcy came into effect in 1992 (Schrader 1994, 17, Feldmann and Sally 2001, 7). The courts system was improved to enable the exercise of contractual rights (Laar 1996, 98). Certainly, the institutional changes Estonia made in the 1990s would be as complex and sophisticated as the systems operating in Western Europe. Furthermore, simple changes in formal institutions were not sufficient for changing the business environment overnight. The interactions between informal and formal rules of the game certainly undermined the impact of reforms in the legal sphere (Drechsler 1995, 113-114). Nevertheless, the Competition Act of 1998 was already in line with EU legislation, except in the area of merger control. The Estonian Competition Law became fully compatible with EU legislation in 2001 (Freytag 2003, 13).

By the beginning of this century Estonia ranked third in the CEE, behind Hungary and Czech Republic in terms of FDI per capita; FDI in relation to gross domestic investment was third, as well. By the end of 2002, the Nordic countries accounted for more than 70 percent of total FDI stock in Estonia; FDI from Sweden amounted to 41 percent, from Finland to 27 pecent of total FDI stock. Financial intermediation is the leading recipient of inward foreign direct investment which is due to the Swedish acquisition of leading Estonian banks in the second half of the 1990s and the heavy presence of other Nordic financial services companies. Strong showings in finance were followed by transport, storage, and communications, including telecommunications and electronics manufacturing (Organization for Economic Cooperation and Development 2001, 4).

2.3 Privatization

The role of foreign investments was crucial in the process of privatization because inflow of capital was combined with the inflow of expertise and technology (Organization for Economic Cooperation and Development 2001, 1-4). Small-scale privatization was kicked off in 1991 and completed by 1994. Large-scale privatization started in 1992, and most enterprises were sold by 1995 (Feldmann and Sally 2001, 7, Iwaskiw 1996, 54).

The Estonian government used a combination of privatization measures: sale for cash, vouchers, initial public offerings and restititution (for real estate and land). As a rule of thumb, a combination of cash and vouchers or only-for-cash privatization have been most successful. Legal battles concerning former owners have caused land reform and privatization to be the slowest measures. Many smaller companies that were sold for vouchers (usually to employees and managers) ended up with insufficient levels of capital. Fortunately, the Estonian privatization agency (modeled after German's Treuhand) sold significant stakes in large companies for cash. As Estonia was capital-poor in the 1990s, FDI played a fundamental role.

A good example of the importance these transitions hold is the inflow of FDI in telecommunications, a direct result of the privatization of the incumbent telecom company and liberalization of the telecom market (OECD 2001, 2-3). In 1992, the Estonian government signed a concession agreement with *Telia* and *Sonera* of Sweden and Finland, respectively (now TeliaSonera). Both companies acquired half of 49 percent of shares in the incumbent telephone company. In 1997 the company, by then restructured into *Eesti Telekom*, offered 24 percent of the government's 51-percent stake through initial public offering (IPO) to domestic and international investors. The government still holds a 27-percent stake in the telecom company. Despite the monopoly and government ownership, the provision of leased lines and alternative infrastructure use was partially liberalized before the end of 2000. Estonia had a free market for data transmissions, Internet service providers (ISPs), and backbone service providers before the end of the monopoly on voice services (ESIS 1999a). Only a monopoly on fixed-line telephone calls was bestowed to the incumbent, *Eesti Telekom*, until the end of 2000 (World Trade Organization 1999, 11-12). The key obligation to the EU and the WTO Basic Telecom Agreement was to lift all limits on market access and national treatment by January 1, 2003, thereby ending the monopoly in the fixed-line telephony services. However, Estonia adopted its new Telecommunications Act in February 2000, which lifted the limits on market access and national treatment in the telecommunications market by January 1, 2001 – a full two years earlier than required (Commission of the European Communities 2002, 89-90). Similarly, Estonia sold many other major infrastructure companies, such as Tallinn Water Company in 2000. One major infrastructure company that has not been privatized is Estonian Energy.

2.4 Fiscal and Monetary Policy

The currency board system was introduced in 1992 – against the advice of the International Monetary Fund (Iwaskiw 1996, 41, Feldmann and Sally 2001, 6, Sorg and Vensel 1999, 14). The Estonian kroon was fixed to the German mark at 8:1 (now the kroon is linked to the euro at 15.6:1). In principle, the Estonian monetary policy has been to have *no* monetary policy, as the money supply is dependent on the amount of foreign currency and assets reserves. Estonia achieved full capital and current account convertability in 1994.

Some other significant highlights include corporate tax reforms as well as personal income tax reforms, which introduced a flat tax rate of 26 percent in 1993 (Feldmann and Sally 2001, 7, Freytag 2003, 11). By 2007 this rate of personal income tax was reduced to 22 percent. Technically speaking, there are two tax rates: People with a very small income (currently below circa EUR 1000 per year) are exempt from paying income tax. In 2005, the plan was adopted to gradually reduce Estonia's flat personal income tax rate to 20 percent by 2009. This follows the initial tax reform plan adopted in 2003. However, the initial target deadline of 2007 for tax reduction was postponed by two years. Reinvested corporate profits have not been subject to income tax since 1999 which essentially means that there is no corporate income tax (the tax rate for dividends is 10 percent).

Overall, government spending as a percentage of GDP was reduced to less than 36 percent in 1998 and has remained below 40 percent (Freytag 2003, 11). State subsidies were eliminated in the early 1990s (Feldmann and Sally 2001, 7). Since 1993 the Constitution has required the general central government budget to be balanced (Freytag 2003, 9). These factors introduced "hard budget constraints" so key to Estonia's economic success in the last decade.

All of this did not mean absolute abolishment of social spending, however. While, the radical overhaul of income taxes has made Estonia well-known in the world, the country's flat tax revolutionaries have overlooked social security and health taxes. Estonian employers are obligated to pay 20 percent for social security tax and 13 percent for health taxes, not to mention a small unemployment tax on employee salaries. Although the government does pay unemployment benefits, these amounts only add up to roughly 40-60 percent of salary, and the benefits are paid only up to 6 months after termination of employment. Most education and health care is publicly financed in Estonia. Even so, private hospitals and private educational institutions have also entered the market. A pay-as-you-go pension system remains in place, but it is important to note that in recent years two additional pillars have been added to the system in order to encourage savings. The bottom line is that Estonia has significant social spending and re-distributional policies, even if these policies are not as extensive and intensive as those found in Western Europe.

In sum, the "rather primitive market system" in Estonia and "a lack of market infrastructure" created sufficient conditions for outstanding economic performance in the 1990s (quotes from Drechsler 1995, 113-114). Once the economic recovery took off, it was also able to bear the high costs of institutional convergence with the laws of the European Union, of which Estonia became a member in 2004. Prior to the need to comply with the EU's conditionality, the radical changes in the rules of the game were quite effective and sustainable despite political fragility.

3. Some Causal Explanations for Economic Reforms

While there are numerous descriptive accounts of Estonia's economic reforms in the 1990s found in both academic literature and non-academic accounts, i.e. in policy and media reports alike, the causal relationships that led to these reforms are understudied. Nevertheless, some scholars focusing on the economic reforms have attempted to explain the factors behind rapid economic development. Broad-brush approaches outline the importance of external structural factors.

3.1 External Structural Change

The collapse of the Soviet Union in 1991 led to what Joseph Schumpeter called “[a] creative destruction” (Schumpeter 1975, 81-86). This huge structural change made possible a period of “extraordinary politics,” in the words of former Polish finance minister and current governor of the Central Bank of Poland, Leszek Balcerowics, as he described the window of opportunity utilized by radical reformers who enjoyed strong public support (Balcerowics 1995, 4, 145-165). Liuhto (1996) has pointed out structural similarities between the 1990s and the 1920s when Estonia enjoyed its first period of independence. However, opening the window of opportunity did not necessarily mean all agents seized the day. Otherwise we would not be observing the different outcomes in the various countries that were all were influenced by this structural change. Thus, structual factors are necessary but not sufficient for explaining the nature of economic reforms in Estonia.

3.2 Conditionality of International Organizations

Nor do the constraints imposed by international organizations such as the IMF, the World Bank, the WTO and the EU offer sufficient explanation. For starters, the most important reforms were the result of bottom-up policy initiatives – not imposed in a top-down fashion by international organizations (Feldmann and Sally 2001). Second, these reforms often run contrary to the advice of international organizations and consultants by being much more radical than suggested. For instance, in the summer of 1992 the IMF actually argued against plans to introduce Estonian own currency, the *kroon,* and against the monetary policy mechanism that mimics the currency board. Nevertheless, as mentioned previously, the Estonian government proceeded with its plans, achieving the most successful currency reforms in Central and Eastern Europe. A few years later, the IMF itself began advising other CEE countries, such as Bulgaria, to adopt the currency board, as well. A similar situation occurred with tax reforms: Tom Hart, an American adviser sent to help simplify the tax system was surprised by the coalition government's plans to introduce a flat personal and corporate income tax. He argued against it for a while, pointing out that such a tax system does not even exist anywhere else – finally conceding, having seen the political determination behind the reform (Kokk 2006). Similarly, Feldmann points out that Jeffrey Sachs advised both Estonia and Slovenia on monetary policy reform but the countries chose different regimes in the end. (Feldmann 2006b, 848).

Third, Estonia did not enter the WTO before 1999, or the EU before 2004. The argument that all major economic decisions in the 1990s were made in the shadow of entry into these organizations is not supported by the evidence. For instance, unilateral free trade policy actually made it more difficult for Estonia to join the WTO and the EU. At EU entry, Estonia was forced to pay massive penalties for exceeding the limit on stored sugar. Estonia had had a free market in sugar, and sugar prices were two- to three-times lower than in the EU, which led to sugar hoarding before entry. In addition, the WTO Uruguay negotiations were not completed until 1995, and the implications for potential new members did not become clear before the second half of the 1990s. The

EU's Maastricht Treaty was signed in 1992, and the economic criteria for EU entry emerged in the 1990s. Even once the EU and WTO constraints had become clear, they did not create a straitjacket. As mentioned earlier on this paper, the Estonian government opened the telecommunications market to competition, for instance, two years before its WTO and EU commitments.

Even more significantly, the most crucial and radical of Estonia's economic reforms were realized in the first half of the 1990s, when the shadow of the EU and WTO was not yet visible. Once this shadow did in fact become visible, the concrete implications of "Europeanization" were not yet obvious. The very nature of the EU is unclear; it is more than an international organization, but falls short of being the Westphalian state, let alone a super state (Morgan 2005). More than 30 years ago, one scholar depicted the European integration project as an elephant that blind academics try to visualize by touching its different parts (Puchala 1972, 267-8). As scholarly efforts tried to get a grasp on the beast, the elephant kept growing and changing its form. Thus, the blind scholars could never clearly comprehend it. Taking this as an apt metaphor of our understanding of the so-called Europeanization process, we must admit its implications are far from certain, as has been confirmed by many empirical studies. Even those in charge are not quite sure of what it is they head. Long-time President of the European Commission Jacques Delors once called the EU an "unidentified political object" (Zielonka 2006, 4). This comment reflects the frustration experienced by policy-makers and scholars trying too capture the nature of the European Union. In a recent book, Oxford scholar Jan Zielonka offers perhaps the most helpful analogy, describing the EU as a neo-medieval empire. According to Zielonka, the EU is not "fortress Europe" but “maze Europe” (Zielonka 2006, 4) He offers a non-statist perspective, pointing out that the authority in the EU, as was the case in medieval Europe, is shared and spread; it is not uniform or exclusive. Jurisdictions are plural and overlapping. The list of similarities in this complex analogy goes on and on. The bottom line is that the EU constraints for economic reforms are much fuzzier than the uni-dimensional daily political debate often suggests.

Similarly, culture-based stories that do not offer sufficient explanation (Vadi 1999, 197-230). The first problem with approaches like this is their highly deterministic nature. Culture is a dynamic concept, and there is no question that 50 years of Soviet occupation influenced Estonian culture in diverse ways. Second, the nature of economic reforms is left completely unexplained by cultural factors, as we observe quite different economic policies and reforms in countries that are nonetheless culturally similar to Estonia.

3.3 Agency

Because the external structural change, the constraints imposed by international organizations, and culture are not sufficient for explaining the scope and nature of economic reforms, scholars and politicians have either explicitly or implicitly emphasized agency in the causal explanations for Estonia’s emergence as a market liberal phoenix rising from the Soviet dust. The most standard view is that Estonia’s new elite were eager to clean up the mess left by the Soviet Union, and thus executed radical and rapid macroeconomic and microeconomic reforms in the 1990s (Sorg and Vensel 1999, Kilvits 1999, Skolnitsky 2006). Careful versions of such accounts point out the interactions between historical legacies and strategic choices (Feldmann 2006b, Freytag 2003).

In its most optimistic versions, a few proud and youthful reformers were not only able to carry out their radical agenda(s) despite internal and external structural constraints, but also rapidly changed the domestic structures to their advantage in the era of "extraordinary politics." (Laar 1996; Laar 2002) A caricature version of this line of thinking ran in Reader's Digest, which published a story about Estonia in ten different languages; its English version appeared under the headline "The Country Run by Kids." (Bordevich 2000). Perhaps 20- or 30-year-olds are still seen as kids by the main demographic of the Reader's Digest audience in the English-speaking world, but in Estonia, these so-called kids, often bearded and bespectacled, were seen as able-bodied and responsible adults at the same table with other world leaders. One of these bearded "kids" has spent much of his time at the head of the class, having received vast attention in both academic and non-academic accounts. Recent reports in particular have spotlighted the radical reforms by former Prime Minister Mart Laar, who was 32 years old when he took office in 1992. Indeed, Laar's achievements garnered him the Milton Friedman prize, worth a half million dollars, from the Cato Institute in 2006.

All of this may sound comforting to young Estonian politicians in their 20s and 30s who walk the walk in the fragmented terrain of Estonian politics, broadly looking to follow the path taken by Laar. Nevertheless, such *leitmotiv* is incomplete at best, and sounds much like an over-stylized fishing story. Many reforms occurred under quite different governments, encompassing a hugely diverse age structure. There was little disagreement among the major political parties regarding the substantial nature of the reforms, with party views becoming divergent mainly in their assessment of the recent past and issues of nationality (Tallo 1995). Politicians' converging attitudes and beliefs in the realm of reforms made it easier to carry out the changes in the area of economy.

Second, such explanations do not supply the reasons for why agents made the decisions they did. Simply being young does not grant the ability to carry out free market reforms. Third, the superhero cape of youth does not tell us why these specific politicians were elected to office. In sum, external structural change, constraints imposed by international organizations and accounts focusing on culture and agency all offer insufficient explanations for understanding the causes of economic reforms.

4. Literature on Nationalism

Scholars writing on nationalism and ethnicity issues have taken a more skeptical view of developments in Estonia than scholars who focus on economic reforms (Andersen 1999, Kolsto 2002, Laitin 1998, Smith 2002, Vogt 2004, 243-246). Some have published devastating critiques, labeling Estonia's political system an "ethnocracy" (Yiftachel 2006, 31-35, Melvin 2000, Karlsson 2002, 186) or "ethnic democracy" (Hughes 2005, 739-740, Smith 1996). A review of academic journals shows that issues of nationalism often overshadow discussions of economic reforms. Or economic policy is bluntly seen as a tool for the nationalist purposes (Andersen 1999). In these accounts 'Laar the libertarian' becomes 'Laar the nationalist.' An exaggerated symbiosis of the two stories can lead to a view of Estonia as an ethnocracy run by kids.

On the surface, there seems to be an inherent conflict between economic and nationalist accounts. Nationalism in post-socialism seems so barbaric and irrational. The

Caucausus and the former Yugoslavia provide plenty of support. Contrary to this, the agency-based accounts on the Estonian economic revival tell a story of rational men seeing the light at the end of the long tunnel of post-socialist transition. It is a dialectic story of struggle between two forces. In the end, rationalism comes out the winner, and with the help of international organizations, such as the European Union, the Council of Europe and the OCSE, irrational nationalism is forever put to rest or significantly curtailed. The dialectic might sound plausible were it not for the nationalists and economic reformers being the same individuals. Dual identities should be left to fairytales, where warted toads are free to turn into princesses and handsome men become vampires.

Nevertheless, several bleak accounts on the nature of nationalism in Estonia are a broad-brush normative exercise that somewhat violently groups Estonia together with other accounts of nationalism (for example see Yiftachel 2006, 31-35, Andersen 1999). Andersen (1999) suggest that economic reforms benefited Estonians at the expense of Russians but he focuses on restitution and some aspects of privatization, not on the entire package of economic reforms. Furthermore, his research has not been able to subject normative biases to a thorough methodological examination (Kaplan 2001, 157). Fundamentally, in these broad normative sweeps, many important elements are neglected. Empirical evidence suggests that, while in government, nationalists were also the most supportive of the liberal economic reforms. This co-existence runs counter to standard logic that would suggest political nationalism easily spills over into the economic sphere. It was already Gustav von Schmöller, an adviser to German Chancellor Bismarck in the 19th century, who not only not noticed the connection between economic protectionism and nationalism but also encouraged it as an effective policy tool. Schmöller saw in his essay on *The Mercantile System and Its Historical Significance* in 1884 Adam Smith's concept of mercantilism as an attempt to achieve a favorable balance of trade as too narrow (Robbins 1998, 47-48). For Schmöller, favorable trade balance was a tool for building a powerful nation-state. Ever since the days of Schmöller, when we speak of nationalism we automatically conjure a negative connection between the political and economic spheres. Of course, both the 19th and 20th centuries offered plenty of evidence to support such a view. However, the interactions do not inevitably have to work out as such. Adam Smith was to some extent a nationalist albeit one of mild degree, a sort of "civic nationalist" perhaps. He praised the benefits of free trade, but this view did not stop him seeing the Navigation Acts, instituted by mercantilists in the 17th century, as necessary restrictions on the freedom of commerce for the purposes of national security (Smith 1904, IV.2.30). After all, Smith wrote that "the act of navigation is, perhaps, the wisest of all the commercial regulations of England" (Smith 1904, IV.2.30) In keeping with the perspective of Smith rather than that of Schmöller, the discussion below sees the nationalistic aspects and liberal economic policies in Estonia as not only consistent but mutually re-enforcing, as well.

5. Identity Politics as a Cause of Economic Reforms

The accounts on nationalism discussed above offer inspiration for constructing an independent variable in explaining the outcome in terms of a dependent variable, i.e. the nature of economic reforms. In this sense, nationalism and radical economic reforms actually represent two sides of the same coin.

5.1. Identity politics

I elaborated on the dependent variable above. The independent variable "identity politics" uses the term identity loosely and sees it as ultimately related to nationalism. I recognize that nationalism and identity can be different concepts. Nationalism is a political concept, while identity is cultural (Vogt 2004, 214-215). However, John Breuilly's restrictive definition of nationalism and identity is not helpful because the two overlap when cultural identity is a springboard for political mobilization (Smith 1998, 89-90).. Furthermore, nationalism is often about preserving the cultural identity (Smith 1998, 89-90). This happened in Estonia where identity can be defined as "…about belonging, about the values that individuals share with other individuals..." (Schouls 2003, 1). Estonian identity can be seen as a host of cultural practices of which most important part is language and endures resistance to outside forces once these forces become perceived as a threat to survival of this identity. The representation of this identity is not always formalized but can be highly tacit. The desire to preserve this identity led to a political mobilization. Since I take a benign view of the nature of this nationalism, I would see it as more inclusive rather than more exclusive (Vogt 2004, 215). In addition, I do not think that this nationalism it is beyond rational analysis (Smith 1998, 89-90). We are not dealing with "animal spirits" here. Essentially, my argument is that identity-based politics led to the undertaking of radical economic reforms and because of the path-dependent process that unfolded as a result the radical economic reforms became mutually re-enforcing in Estonia.

5.2 Rationality and Dynamics of Change

Douglass North has critiqued that neoclassical economics is bad at explaining dynamics of change (North 2005). Indeed, the view of rational man calculating costs and benefits focuses on comparative statics. However, there is nothing static about the rapidly changing transition society. Perfect rational calculation as articulated by neoclassical economics was not an option for agents facing constant change and a high degree of uncertainty. Uncertainty and risk are fundamentally different (Keynes 1936; Knight 1921). Uncertainty implies that the role of rational calculation and bargaining based on consideration of risk is significantly reduced (March and Olsen 1998). In stable societies "known unknowns" can play a much more important role than in rapidly changing societies, where "unknown unknowns" dominate. In light of uncertainty and constant change, we should see the rationality of agents in Estonia as highly "bounded" or "adaptive" (see Simon 1955 for the discussion of "bounded rationality" and Mueller 1986 for "adaptive rationality"). Furthermore, since the rational calculation does not provide a formula for action for agents faced with uncertainty, the agent will follow "the logic of appropriateness" instead of "the logic of consequences" that rationalist calculation would require (March and Olsen 1998). The role of mental models and ideologies of agents becomes essential in influencing institutional change (North and Denzau 1994).

5.3 Critical Juncture

Following this train of thought, integrating identity into the picture enables us to explain why radical economic reforms occurred in Estonia. Identity provides glue in the form of the logic of appropriateness, which binds agents together as they deal with uncertainty. Under certain conditions identity can provide an informal institutional framework that allows overcoming commitment problems (Greif 1993). Even more importantly, what has been perceived as identity politics was not actually a barbaric and irrational force in this context; rather, it should be analyzed in the context of "bounded rationality" and seen as a behavior deemed appropriate by the agents. Procedurally speaking, the appropriateness of the behavior was not even in reference to the identity – the appropriateness was in regarded restoring the Republic of Estonia on the basis of the republic that had *de facto* existed in the current territory of Estonia between 1918 and 1940. (It existed *de jure* throughout the Soviet occupation.) Restoration of the republic was the "critical juncture" for the path-dependent process that followed (see Geddes 2006, 140, for the discussion of path-dependency and critical juncture). After the occurrence of the juncture in 1991, any political agency had to be understood within these constraints because, as the notion of path-dependency implies, there were increasing returns present. Hence, this institutional change alters the incentive structure and preferences of all agents (see Thelen and Steinmo 1992 on how institutions modify preferences).

5.4 The Road Not Taken

The path chosen or "The Road Not Taken" as Robert Frost put it in one of his poems in the past will lead to a different reactions towards the same structural changes (e.g. collapse of the USSR) or the same set of interests (e.g. business groups interested in freer trade with Russia) (March and Olsen 1989). Prior to the critical juncture, there were two choices: Restore the Republic of Estonia or create a new republic. In an attempt to offer a simplistic aggregate story, the academic literature that sees the Popular Front movements in the three Baltic states as the main force for independence in the late 1980s and early 1990s ignores the differences among the Baltic states (see Melvin 2000 as an example). For instance, the relative importance of the Popular Front was greater in Lithuania than in

Estonia. In the second half of the 1980s two political movements occurred in Estonia. (Technically, there was a third one called InterFront, which supported the status quo (Melvin 2000, 137). However, its role in the political debate was marginal as its aims were unrealistic.) One movement, headed by the reformist-minded high government officials of the Estonian Soviet Socialist Republic, was the Popular Front for the support of Gorbachev's *perestroika* and *glasnost*. The movement grew out of the concerns about the environmental and economic issues. Its initial aim was greater autonomy for Estonia within the USSR – not full independence (Andersen 1999, 95-103). For instance, its main early policy declarations by its future leaders published in 1987 called for economic self-government for Estonia but stopped short of calling for full political sovereignty. One of the four signatories of the document was Siim Kallas, the current commissioner of the European Union.

The other movement was made up of many small organizations clustered around what was called the Congress of Estonia (Andersen 1999, 104). They were small dissident groups, new political parties such as the Nationalist Independence Party and Christian Democrats, the Association Res Publica for young intellectuals, and the organization Geneva-49 which organized resistance against the mandatory Soviet military service. This Congress of Estonia-centred movement supported the restoration of the Republic of Estonia.

5.5 From Cooperation to Coordination

Interactions between the two movements are easily demonstrated using the prisoner's dilemma game. Having played the one-shot prisoner's dilemma game and ended up in suboptimal Nash equilibrium several times, the incentives for cooperation grew.

Meanwhile, the prison guard became weaker and weaker, adding additional risks regarding credible commitment for rewarding non-cooperation.

Table 2: Cooperation Game: Prisoner's Dilemma

	Cooperate	Defect
Cooperate	3, 3	4, 1
Defect	1, 4	**2,2**

Payoffs: (Popular Front, Congress of Estonia)

Even though the activities of the independence movement were notoriously suppressed by the Soviet security forces in the early phases, the movement gained momentum and wide-spread support as the Soviet Union continued to disintegrate. Ultimately, the idea of restoring the republic on the basis of historical continuity trumped the idea that evolved from a greater autonomy to establishing a new republic (Andersen 1999, 105). The historical evolution of these two movements represents the main divisions in the daily politics that continue even today. Nevertheless, the new rules of the game that emerged by restoring the republic constrained all the political actors, regardless of their political views in the 1990s. Indeed, many Popular Front leaders became strong supporters of restoring Estonian independence and affiliated themselves with the organizations in the independence movement. In 1993, a new political party called the Center Party was formed on the basis of the Popular Front; it was essentially committed to the new rules of the game, despite its political rhetoric and policy proposals in daily politics that ran counter to several implications of these rules. Hence, interactions between these two movements evolved to a new level, which can be viewed as a coordination game, such as the Battle of Sexes. Two movements may have had some different preferences which are expressed in the relative degrees of continuity of the republic rather than a stark choice between continuity and discontinuity. Both movements realized that they are better off with each other than on their own.

Table 3. Coordination Game: The Battle of Sexes

	More Continuity	Less Continuity
More Continuity	**4, 3**	1, 1
Less Continuity	2, 2	**3,4**

Payoffs: (Popular Front, Congress of Estonia)

5.6 The Citizenship Law

Both the most important aspect of these new rules as well as the differences of the two movements can be found in the area of identity politics. Restoration of the Republic of Estonia meant that pre-World War II citizens and their descendants automatically became citizens. Most Estonians qualified for citizenship, even though some Estonians who had lived in the Soviet Union during the interwar period did not automatically qualify. Most of the Russian-speaking population, which had grown to 35 percent since totaling 8 percent in the interwar period, did not qualify automatically (Hughes 2005, 744). This group had to apply for citizenship and meet a number of prerequisites, including the most contested: some basic knowledge of the Estonian language. The Center Party campaigned for the so-called “zero-citizenship” law, which would have granted all inhabitants immediate citizenship. However, this proposal did not sit well with the electorate as a whole, and thus parties with a tougher stance on citizenship requirements dominated the politics, as was well-demonstrated by the first presidential elections. Candidate Rein Taagepera, a professor of political science at the University of California Irvine, placed last in the presidential race. Taagepera supported the zero-citizenship law.

The new citizenship law of February 1992 and the victory of its strong supporters in the Fall of the 1992 parliamentary elections led to the decline of economic relations with Russia. These relations were further weakened by the passing of the Law on Aliens in 1993 (Melvin 2000, 138). Russian president Boris Yeltsin was highly critical of these new laws but Russia did complete the withdrawal of ex-Soviet troops in 1994. However, scholars who have merely focused on the gap between political actions and rhetoric in Russia's foreign policy toward Estonia have often ignored its foreign economic policy. Upset by the exclusion of the Russian-speaking population in Estonia, Russia imposed economic sanctions on Estonia in 1994. Most notorious of these sanctions were trade restrictions on Estonian exports, a tactic that became widely known as "double tariffs." The imposition of such high transaction costs on Estonian exports actually had a negative boomerang effect on Russia's policy goals. First, it weakened the interests of groups who traded with Russia. These groups collapsed or reoriented their exports to the West. Hence, Russia's policy reduced the interest groups supporting close relations with Russia, including Estonia's Russian-speaking population, which held the comparative advantage in economic relations with Russia. Second, the high transaction costs imposed by the most influential trading partner created incentives for Estonian politicians to radically reform the economy and open it up completely in order to ensure rapid integration into the world economy. In other words, a gradual and smooth economic transition was no longer an option.

5.7 Constraints on Agency

The process-tracing as articulated above went beyond mere acknowledgment of the co-existence of nationalism and liberal economic policies; the nature of identity politics and how it was played out in Estonia limited the menu of choices available to Estonian politicians. This, in turn, led to the radical nature of economic reforms in the 1990s. Such a view implies that agency is analyzed within the given constraints. The high-degree of fragmentation of daily Estonian politics was a third-order problem, because support for radical economic reforms was broad-based beyond any set of political parties and their leaders (Tallo 1995, Andersen 1999, 246-248). Furthermore, despite division among the Estonian population, the identity of politicians and key decision-makers provided informal constraints and secured the trust of the population during the times of high uncertainty. All key decision-makers, regardless of party affiliation, were Estonian, because only the small proportion of Russian-speaking populations could effectively participate in the national politics due the constraints imposed by the citizenship law.

Non-citizens were able to participate in the municipal election but, because Estonia is a unitary state, local politics does not assume the importance it would in more decentralized states. The effectiveness of participation by the Russian-speaking population in both municipal and national elections was seriously hindered by the groups' ability to overcome collective action dilemmas. Their party landscape was too fragmented, with several small Russian parties essentially competing for the same votes.

Meanwhile, several corruption scandals in municipal politics undermined the legitimacy of these parties and portrayed their leaders as being more concerned with their personal well-being than with that of their Russian-speaking constituency. In addition, the populist Center Party, run by the charismatic Edgar Savisaar, formerly the leader of the Popular Front, proved more effective in capturing the votes of the Russian-speaking electorate than the parties that were supposedly formed specifically to represent these interests. Russian parties effectively disappeared from the Estonian political scene by the turn of this century. Those leaders who still had enough credibility joined other parties, some siding on the Left and others on the Right of the political spectrum.

5.8 A Broad Consensus

Despite this consolidation and the integration of Russian politicians into what could be called mainstream politics, the Estonian political scene remained quite fragmented throughout the 1990s and remains so today. This case of fragmented politics implies that the governments are extremely fragile, as well. It is frequently pointed out that Mart Laar was Estonia's longest-serving prime minister. This fact although interesting is no more than mere trivia. A "long" time in Estonia is actually very short in the comparative perspective. Laar was prime minister from 1992 to1994 and from 1999 to 2002. Nevertheless, despite the fragmentation of Estonia's political landscape, substantial economic reforms have been executed and economic indicators have shown constant improvement. These points all work to signify broad support for the *zeitgeist* of economic reforms and caution against overemphasis of the role played by some governments over that of others.

The monetary reform, in which the currency board was introduced on the basis of ideas taken from the Austrian School of Economics, was put in place several months before Laar took office. The reform and introduction of Estonia's own currency was carried out despite the advice of the International Monetary Fund. The move to unilateral free trade was completed in 1997 by political forces that had strong ex-Communist elements and included strong agricultural interests, based on the party headed by ex-directors of collective farms. Nevertheless, this government did not substantially change any of the economic policies, and continued with the unilateral free trade policy – including complete free trade in agriculture. Even more importantly, many politicians of the governing coalition in the period 1995-1999 were closer in views to those of the Popular Front than to the more nationalist independence movement five years earlier. Between 1995 and 1997 the coalition included the Center Party; former Popular Front leader Edgar Savisaar served as a cabinet minister. However, they did not change the citizenship law and maintained the economic policies of previous government (Andersen 1999, 247).

All of these points indicate constraints on the agency. On the one hand, the politicians realized that changing the citizenship law would equal political suicide, since most Estonians would not support such a change. On the other hand, they were then forced to share the economic vision – even if their electoral rhetoric often suggested otherwise. This balancing act could have been thrown off by granting citizenship to the majority of Estonia's Russian population. The social and economic background of the Russian-speaking population differed significantly from that of the rest of the population. The Russian-speaking population had been brought into Estonia under Soviet relocation programs as factory workers for heavy industry. Hence, granting Russian-speaking population citizenship would have decreased electoral support for radical economic reforms, if not perpetuated the status quo. However, this was a gamble that even politicians with an ex-Communist past either did not want to take, were afraid to take or could not take. For instance, Tiit Vähi, prime minister of the governing coalition of 1995-1997, had also been Prime Minister in 1992 during the introduction of the currency board system. The much heralded flat income tax that Estonia introduced in the early 1993 has not been seriously challenged by any political parties. The Center Party, one of the most popular parties, has long expressed intentions to replace the flat tax with progressive income tax rates, but since they are not able to attract more than 30 percent of the vote and all other parties are opposed to the idea, it counts as mere rhetoric. Nevertheless, such rhetoric constantly helps the party get elected. This should not be read to imply voters for the party are irrational; rather, their rationality is constrained by imperfect information. From the perspective of rational choice, it can be rational for individuals to vote a certain way when they have imperfect information or are simply misled (Brunk 1980).

It should be noted that these examples are not given to undermine the crucial role played by Laar's first government but to point out that the pursuit of market-oriented economic policy has been constant and is broad-based in Estonia, despite the concurrent political fragmentation. Of course, unanimous consensus is certainly not always reached in economic issues. But as Robert Dahl has pointed out, consensus is not a static but "a process of interchange among politicians, political stratum and a great bulk of population" (Dahl 1961, 307). The imperfect information in voting was crucial in other ways, too. Issues related to identity and interpretation of recent history were the main matter of debate and disagreements. In the first half of the 1990s, identity questions also helped implement economic reforms by diverting attention away from the actual economic issues. The political parties that formed Prime Minister Laar's coalition government were not elected in the first free parliamentary elections in 1992 precisely because they promised radical economic reforms.

Table 4. Timing of Most Significant Economic Reforms, the Nature of Governing Coalition and Their Position on the Citizenship Law.

Time	Economic Reform(s)	Governing coalition	Position on citizenship law
1992 June	The Currency Board	Tiit Vahi, economic pragmatists, ex-communists, affiliated with the Popular Front	Liberal
1992-93	Simpification of tax system Introduction of Flat Income Tax in 1993	Tiit Vahi, economic pragmatists, ex-communists, affiliated with the Popular Front. Mart Laar, Nationalist, Free-Market Coalition, (outgrown from pro-independence movement).	Until September 1992 - Liberal After September 1992 Traditionalist
1992-1997	Trade liberalization that culminates in introducing unilateral free trade by 1997 (including agriculture).	1992-1994 Nationalist Free Market Coalition Under Mart Laar. 1994-1995 Nationalist Free Market Coalition under Andres Tarand. 1995-1997 Tiit Vahi, economic pragmatists, ex-communists, affiliated with the Popular Front	1992-1995 Traditionalist 1995-1997 Liberal.
1992-1995	Large-Scale privatization	Starts in 1992 under Tiit Vahi, economic pragmatists, ex-communists, affiliated with the Popular Front. 1992-1994 Nationalist Free Market Coalition Under Mart Laar. 1994-1995 Nationalist Free Market Coalition under Andres Tarand.	Until September 1992 – Liberal. 1992-1995 Traditionalist.

Laar's party was elected as a moderate Estonian nationalist party promising a clear-cut break from the Soviet past. Economic issues were only part of the Soviet heritage with which the government had to deal, and at least in the world of Estonian politics, one of the least controversial ones. However, once the increasing returns of these reforms kicked in and new interests emerged, it became much easier to gain wide support for continuing with along the path of reforms. Establishment of the Reform Party in 1995 is proof in the pudding. The party was led by Siim Kallas, a former governor of the central bank during the successful implementation of the currency reform and one of the authors of the 1987 economic autonomy plan within the USSR . It was a market liberal party that focused primarily on economic issues.

In sum, this discussion demonstrated how identity politics that stemmed from the restoration of Estonian independence by imposing constraints on reformers led to a radical path to transforming Estonia's economy.

6. Conclusion

For those who organize human affairs into neat compartments labeled "political" and "economic" and for those who believe in economic supremacy over politics, the arguments that claim causes of economic reforms can be found in identity politics may sound reminiscent of the following quote from Hamlet: "By indirection, find direction out" (Shakespeare 2003, Act II, Scene I). But just as scenes from Hamlet may be relatable to our understanding of the human world, so too has this research demonstrated that the role played by identity politics is essential for understanding the radical nature of Estonian economic reforms and their timing.

The research has connected that which for many has previously seemed unconnected by incorporating existing academic literature on Estonian economic reforms and identity politics. Following the ideas of the neo-institutionalist school of thought, the convergence of interests of different political movements around the principle of national independence based on historical continuity and the subsequent restoration of the Republic of Estonia provided a critical juncture for the path-dependent process that was to unfold. This decision, by providing increasing returns for most of the important agents, also limited the menu of choices available for future decisions. The most important outcome of this process was the Law on Citizenship, which led to a series of events tipped by economic sanctions being imposed by Estonia's then main trading partner, Russia. Contrary to expected policy change, Russia shot herself in the foot as the inevitability of carrying out radical economic reforms in order to integrate rapidly into the West gained wide-spread political support in Estonia.

This research contributes to the literature on the political and economic transitions in Central and Eastern Europe. By analyzing the role of agency within structural and cultural constraints, it improved our understanding of agent autonomy under constraints and a high degree of uncertainty. Since the study at hand is of a single country based on secondary sources, the future research could build on these findings by incorporating more countries for comparative purposes and relying more on primary sources, such as archive documents and elite interviewing.

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