

Reconstruction and Reconciliation: What's Economics Got to Do With It?

by Christopher J. Coyne

Reconstruction and reconciliation are perhaps the most pressing issues of our time. The ongoing conflicts in the Middle East, as well as the many problems generated by weak, failed, and conflict-torn states in other parts of the world, are examples of situations where these topics are relevant. Reconstruction entails rebuilding, and in some cases constructing, both formal and informal institutions in weak, failed, and postwar countries. More specifically, the reconstruction process involves the restoration of physical infrastructure and facilities, minimal social services, and structural reform in the political, economic, social, and security sectors. The end goal is the establishment of liberal democratic institutions, or at least the foundations of such institutions. A liberal democracy refers to political institutions which recognizes, respects, and enforces individual and civil rights, the rule of law, and private property.¹ Typically the reconstruction process involves some array of indigenous citizens and elites as well as exogenous actors, whether they are military occupiers or international policymakers.

Reconciliation can be seen as a key aspect of the broader reconstruction process and involves individuals coming to terms with past human and civil rights abuses, oppression, and violations of the rule of law and private property. Any shift from an illiberal to a liberal regime requires some form of reconciliation between enemies. The past violations of human, civil, and property rights by certain individuals must be addressed, but when doing so, a balance of retribution and reconciliation should be established. In the absence of such an ethic of forgiveness and reconciliation, the transition toward a liberal order will be incomplete.

As the historical record indicates, policies that aim to advance reconstruction and reconciliation efforts are among the most difficult to implement.² For the most part, research regarding the issues of reconstruction and reconciliation have been limited to the disciplines of history, political science, and public policy. My primary aim in this paper is to explore the contribution that the economic way of thinking can make to this existing literature. Specifically, I examine the economic concepts of incentives, constraints, opportunity cost, institutional path dependency, and gains

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from trade in the context of reconstruction and reconciliation. In order to make this connection, I extend the “lessons learned” from the economics profession’s experience with transition economies and with the provision of monetary aid to developing countries. Additionally, I examine the economic theory of trade as one mechanism for achieving sustainable change. I believe that incorporating the economic way of thinking into the analysis of the reconstruction and reconciliation process will contribute substantially to the ongoing debate regarding the ability of governments to effectively export sustainable liberal democracy via foreign intervention.

The array of actors involved in reconstruction and reconciliation—occupiers, policymakers, indigenous citizens etc.—each have specific goals and constraints that will influence the overall success or failure of the broader effort.

When one looks at the fundamental nature of the reconstruction and reconciliation process, it becomes evident that economic issues are of central importance. That is, reconstruction and reconciliation require the creation of rules and can therefore be considered problems of political economy. A central emphasis of political economy is “the reason of rules.”³ The underlying logic is that rules provide the parameters within which individuals can carry out private activities while simultaneously establishing the scope and strength of political institutions and the activities of political agents within those institutions. For example, a key part of constructing liberal institutions is the creation of constitutional rules and binding checks and balances that are credible and sustainable. Likewise, reconciliation requires the creation of formal (codified laws) and informal (norms) rules to deal with past injustices without bankrupting the future potential of a society.

Viewed from the perspective of political economy, the reconstruction and reconciliation process can be seen as an issue of incentive compatibility. Incentives are a central concept in economics and refer to factors that influence the direction of human behavior. A core assumption of the economic way of thinking is that people behave purposefully and therefore respond to incentives. By way of example, consider the profit/loss mechanism in a market economy: the lure of profit is a positive incentive for entrepreneurs to satiate consumer wants; the possibility of a loss is a negative incentive against failing to do so.

Within the context of incentives, those directing the reconstruction and reconciliation process must establish the “rules of the game” such that there is a positive incentive for citizens to utilize, respect, and invest in liberal democratic institutions—political, economic and social—over the long run. Further, to the extent that this process involves external occupiers or policymakers, they must ensure that incentives are in place for the populace of the reconstructed country to

follow those rules once occupiers exit. In other words, occupiers must not just establish rules at “the point of a gun,” but instead ensure that those rules are durable and sustainable after the occupation ends. Absent such incentives, the reconstructed country will backslide.

As such, the economic way of thinking can assist in understanding if formal and informal rules provide the necessary incentives for members of the populace to engage in activities that support a self-sustaining, liberal order. In other words, economics provides the means of adjudicating between the factors and mechanisms that generate the incentive to cooperate, versus to fight. In what follows, I explore how the economic way of thinking can contribute to our understanding of the process of reconstruction and reconciliation.

ECONOMIC INSIGHTS ON THE RECONSTRUCTION PROCESS

In addition to their focus on the role of incentives, economists also focus on the role of constraints. In assuming that individuals act purposefully, economists emphasize that individuals have specific goals that they seek to achieve. The economic way of thinking indicates that the opportunities to pursue these goals are constrained by a number of factors including time, income, imperfect knowledge and information, and informal and formal rules. Given their goals and constraints, individuals pursue their desired objectives using the best options available to them at the time of action. The array of actors involved in reconstruction and reconciliation—occupiers, policymakers, indigenous citizens etc.—each have specific goals and constraints that will influence the overall success or failure of the broader effort. Let us consider some specific insights from economics as they relate to these constraints.

Insights from the Transition Experience

A wealth of relevant knowledge exists in the economics literature regarding the transition experience of former communist countries. Similar to the process of reconstruction, a central policy issue following the fall of communism was the transition from often illiberal communist regimes to liberal democratic ones. Fundamental changes in the political, economic, and social spheres were required to achieve these outcomes.

According to the economist Peter Murrell, the early economic reforms proposed for transition countries suffered from two major issues.⁴ The first issue was that reforms often neglected the nuances of the existing society and existing “rules of the game.” This issue highlights the importance of context. Prior to the collapse of communism, a social system had evolved with a unique set of customs, norms, and rules which provided an incentive for certain types of behaviors. Oftentimes, these rules operated outside the formal rules in the black market.

The second issue plaguing reforms in transitioning countries was that the reforms failed to consider whether the behavior associated with capitalist systems was the result of historical development or the result of present-day incentives.

Historical experience matters. The social system that evolved under communism could not be discarded or shifted overnight. This indicates that social structures that had developed in the communist period carried over to the transition period and served as a binding constraint on the effectiveness of transition reforms and policies. For instance, in the case of the Soviet Union, reformers knew the general characteristics of formal liberal institutions—checks and balances, rule of law and the protection of human, civil, and property rights—but were unable to generate effective change because they could not provide the informal complementary institutions (i.e., the underlying experiences, belief systems, and organizational forms) necessary for widespread acceptance and adoption of the new order.⁵

A related issue that affected economic reform during the transition period, which is equally important for reconstruction efforts, was the problem of credible commitment.⁶ For new institutions to be successfully adopted, a significant number of individuals must be confident that they are credible and legitimate. In other words, they must be confident that reconstructed institutions will be sustainable *after* the reconstruction process ends and foreign occupiers exit. The issue is one of shifting the institutional trajectory from often illiberal regimes to one that credibly supports liberal ends.

The main problem stemming from this issue of plausible commitment is that the necessary legitimacy cannot be established quickly. In short, why should citizens who were formally repressed now believe that a reconstructed government will treat them differently? Moreover, social scientists and policymakers have a poor understanding of how to design rules and institutions that are viewed as legitimate and binding by the individuals who must accept and invest in them. This is evident when one considers that historical attempts by the US to establish liberal democratic institutions abroad have produced more failures than successes.⁷

These insights from the transition experience apply beyond purely economic reforms and have important implications for reconstruction and reconciliation efforts. Formal Western style institutions require the existence of informal complementary institutions to serve as a foundation. Complementary institutions encompass informal norms and values such as trust and the related art of association, conventions, beliefs, and organizational forms which allow formal institutions to operate in the desired manner.

In order to understand the importance of complementary institutions, consider the following from Nobel Laureate economist F.A. Hayek who noted the importance of underlying beliefs and dispositions, “which in more fortunate countries have made constitutions work which did not explicitly state all that they presupposed, or which did not even exist in written form.”⁸ Hayek’s point is that a constitution is a codification of the underlying beliefs, traditions, and habits of a society and, hence, successful instruments of liberal democracies if those underlying beliefs were part of the cultural endowment in the first place. When aligned, formal and informal institutions will operate effectively, but any disjuncture between the two will result in the failure of formal institutions to operate in the desired manner. Unfortunately, policymakers and social scientists lack the knowledge of how to effectively construct

these complementary institutions where they do not already exist. Stated differently, an understanding of how to construct or impose the underlying values and belief systems required for the desired operation of formal liberal institutions does not exist.

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In modern economics literature, the recognition of the importance of past experiences manifests itself in the concept of path dependency—the way in which institutions and beliefs developed in past periods constrain choices in the current period. In other words, past experiences will facilitate or constrain the transformation of situations of conflict into situations of cooperation in current and future periods. Nobel Laureate economist Douglass North, who is a key contributor to the path dependency literature, has emphasized that formal rules and institutions are indeed important, but they must be complemented and reinforced by informal rules and institutions in order to operate in the desired manner.⁹

The recognition of the importance of both formal and complementary informal institutions has important implications for reconstruction efforts. Policymakers and social scientists often focus on the “controllable variables” in reconstruction efforts such as troop levels, monetary aid, the timing of elections, and exit strategies.¹⁰ While these are clearly important variables, the focus on informal institutions indicates that reconstruction is not merely a technical issue.¹¹ The exact level of controllable variables employed in different reconstruction and reconciliation efforts will have drastically different outcomes because of the constraints of historical experiences and the existing endowment of skills, knowledge, beliefs etc. in the country being reconstructed. In other words, the presence of existing rules and endowments of informal knowledge and experiences will serve as hard constraints on the effectiveness of controllable variables.

To further highlight this point, consider an analogy employed by the economist Luigi Zingales. Zingales likens the situations in post-World War II Japan and Germany, typically considered examples of America’s ability to reconstruct countries along liberal lines, to a firm whose plant had been destroyed by fire.¹² Both Japan and Germany were developed and industrialized before entering World War II and, therefore, the “plant” (i.e., country) was operating at a relatively high level of productivity. While the “fire” (i.e., war) destroyed the physical plant, the skills and knowledge that generated the pre-fire level of productivity were still in place. Stated differently, the fundamental skills, knowledge, and organizational forms that had evolved prior to the fire were carried over to the reconstructed plant, allowing the firms (i.e., Japan and Germany) to eventually achieve their prior levels of productivity.

While the resources to invest in rebuilding the plant are indeed important to achieving success, it is the underlying endowment of skills and knowledge that allow the firm to be productive in the first place. Without these complementary institutions (i.e., the skills and knowledge of how to organize production activities and run the plant), the plant would be nothing but an underutilized or empty building. In the context of reconstruction, countries lacking complementary institutions to serve as a foundation for formally reconstructed institutions will fail to become sustainable liberal democracies.

This insight goes a long way in explaining the drastically different outcomes across reconstruction efforts. The main issue for policymakers is that the fundamental skills, norms, and knowledge, or “culture,” is deeply embedded in a society and cannot be easily manipulated through policy. Along these lines, Francis Fukuyama contends that democratic consolidation must take place on four levels—Ideology, Institutions, Civil Society, and Culture. Culture is the “deepest” level and therefore is “safely beyond the reach of institutional solutions, and hence of public policy.”¹³ The cultural constraint on policy indicates that those who wish to export liberal democratic institutions to other countries must consider mechanisms for first establishing the necessary complementary institutions that will allow formal institutions to “stick” and sustain over time. As it turns out, the economic way of thinking offers one potential mechanism which I will discuss in a later section.

Insights from the Development Experience

Monetary aid is a central part of most, if not all, reconstruction efforts. Research in the area of development economics and, specifically, research regarding the effectiveness of monetary aid in developing countries, is yet another area where the economic way of thinking can contribute to the process of reconstruction and reconciliation. From an economic standpoint, it is not just the total amount of aid that is important, but also how effectively aid is allocated and utilized. Economics can assist in identifying whether the incentives are in place for aid recipients to utilize aid effectively.

In his detailed analysis of foreign aid, the economist William Easterly emphasizes the dual issues of incentives and delivery mechanisms. First, statesmen and policymakers in the country receiving aid must have the incentive to utilize and disburse aid funds effectively.¹⁴ Easterly demonstrates that oftentimes the incentive structure created by the provision of foreign aid directs officials and policymakers toward unproductive activities that generate perverse outcomes and cause more harm than good.

Even if the correct incentives are in place, many underdeveloped, weak and failed states lack the delivery mechanisms to allocate aid effectively.¹⁵ For instance, feedback loops that provide information of accountability and the effective allocation of resources are typically absent or lacking in scope. As such, even if the right incentives are in place, getting the aid to those who need it most presents an additional problem.

Country	Approximate year of onset of state failure	Time under IMF programs in preceding 10 years (%)
Afghanistan	1977	46
Angola	1981	0
Burundi	1995	62
Liberia	1986	70
Sierra Leone	1990	59
Somalia	1991	74
Sudan	1986	58
Zaire	1991	73
Average		55
Average for developing countries 1970-90		20

TABLE 1: ALL EIGHT CASES OF STATE COLLAPSE WORLDWIDE AS OF 1990 AND PRIOR IMF PROGRAMS¹⁶

Mainly due to the issues raised by Easterly, one should not expect monetary aid in itself to be a catalyst for sustainable political, economic, and social change in illiberal states. Indeed, the evidence seems to indicate that monetary aid is largely ineffective in overcoming the major problems in weak and failed states. A brief review of the performance of aid in those countries that experienced complete state failure seems to support the claim regarding the ineffectiveness of aid in generating sustainable change.

As Table 1 illustrates, engaging in programs of the International Monetary Fund (IMF) for an extended period of time correlates with a greater risk of complete state collapse. Of course, this says nothing about causation, and the magnitude of the effect of IMF programs relative to state collapse is unclear. Nonetheless, it is safe to conclude that the general problems of incentives and the lack of information related to the dispersal of aid played some role in the ineffectiveness of the IMF programs. As this data indicates, there is no reason to believe that monetary aid is a suitable mechanism for generating widespread sustainable change toward liberal democratic institutions. Instead, spending significant time in an IMF program is associated with a higher likelihood of complete state collapse.¹⁷

Within this context, another important insight from economics is that policymakers must be careful not to fall prey to the “nirvana fallacy.” In its simplest form, the nirvana fallacy indicates that it is incorrect to hold the view that the “grass is greener on the other side” by assuming that government intervention is preferable to the status quo. In the context of reconstruction, a nirvana fallacy occurs when it

is assumed that, in the face of a weak, failed, or illiberal government, external policymakers or occupiers can provide a better outcome relative to what would exist in the absence of those efforts.¹⁸ This is not to say that the provision of aid can never have beneficial effects, but neither can it be assumed that they *will* yield beneficial outcomes.

Consider also that there are many historical cases where monetary aid has been given to illiberal regimes generating the unintended consequence of strengthening those very regimes, as well as increasing dependence on aid. Somalia is one example. Prior to the collapse of Siad Barre's regime in 1991, foreign aid accounted for 70 percent of Somalia's budget, which allowed the regime to continue to function and repress a large part of the Somali population.¹⁹ In addition to propping up the brutal Barre regime, the aid created what James Buchanan, a Nobel Laureate economist, called the "Samaritan's Dilemma." In providing assistance, the "Samaritan" who provides the aid shifts the incentives facing those receiving aid, and in doing so, provides a disincentive to save and invest while providing a positive incentive to become dependent on aid.²⁰ In the case of Somalia, while the intention of those providing aid may have been to better the situation of Somali citizens, the aid had the negative, unintended consequence of creating a dependency that actually made the shift toward self-sustaining liberal institutions that much more difficult in later years.

For example, the expectation of aid is at least partially responsible for the conflict that has occurred in the capital city of Mogadishu. As Karin von Hippel notes,

*Many Somalis erroneously believe that a restored central government, based in Mogadishu, will once again cause the foreign aid floodgates to open at similar levels to those prior to state collapse. Mogadishu therefore remains the most hotly contested piece of real estate in the country[...].*²¹

This expectation that control of Mogadishu will also yield foreign aid, as it did in the past, has increased the payoff to engaging in conflict to gain control of the capital city. Similar logic extends beyond the case of Somalia to aid provided to other weak and failing states. The important point is that the tools of economics are critical in understanding the incentives created by efforts—whether military occupation, aid, or some mix of the two—to reconstruct foreign countries. Neglecting the insights provided by the economic way of thinking is likely to produce wrongheaded policies, which will often generate perverse outcomes.

ECONOMIC INSIGHTS ON THE RECONCILIATION PROCESS

The economic way of thinking can also assist both policymakers and social scientists in understanding the process of reconciliation. In many cases the success of reconstruction efforts requires the development of an ethic of forgiveness that provides the incentive for citizens to move forward and make the necessary investment in liberal democratic institutions. For instance, as noted earlier, the issue

of credible commitment is central in any reconstruction. The problem of transitional justice magnifies this problem. In many illiberal societies, citizens were repressed and suffered grave injustices. As such, citizens will tend not to trust the new government based on historical experiences with repression.

Within this context, rules must develop that simultaneously signal a break from the past *and* a credible commitment that those rules will be followed in the future. For obvious reasons, achieving this task is one of the most difficult policy achievements. The tools of economics can assist in identifying some of the central issues involved in developing an ethic of reconciliation that is effective and credible.

The tools of economics are critical in understanding the incentives created by efforts—whether military occupation, aid, or some mix of the two—to reconstruct foreign countries.

For instance, a key issue in the process of reconciliation is determining how much justice to pursue. At one extreme, the decision not to pursue any level of justice will fail to generate a sufficient break from the past, and those who have suffered past injustices and harms may refuse to participate in the new order. In such an instance, reconstructed institutions will lack legitimacy because they will be associated with the former illiberal regime. On the other hand, pursuing total justice can bankrupt the future of a society. Investing an abundance of resources in transitional justice can erode the ability of the system of exchange and production to serve as a basis for peaceful social interaction and cooperation in the future.

At a minimum, the economic way of thinking highlights that there is an opportunity cost to investing resources in the pursuit of justice and reconciliation. The notion of opportunity cost is used by economists in reference to the next best alternative opportunity that is forgone by pursuing some activity. In the context of reconciliation, resources allocated to the pursuit of justice cannot be allocated to other activities. A society that allocates a substantial amount of resources to rectifying past injustices trades off the use of those same resources for other activities that may allow a society to move on. To be clear, this is not to say that justice should not be pursued at all, but rather to recognize the inherent trade-off involved.

To further understand how the pursuit of justice and reconciliation can bankrupt the future of a society, consider the issue of determining just retribution. Principles of restitution often stress that in the face of criminal destruction or confiscation of property, the victim should be made whole through compensation for the full value of the property. However, serious problems come to the forefront with the passage of time, because just compensation will require some form of time discounting. For instance, the economist Tyler Cowen has pointed out how the attempt to right past injustices by a restitution principle, using basic compounding techniques, can quickly lead to financial claims that consume a significant portion of

the output of an economy.²² In order to understand this point, consider the following example provided by Cowen,

Consider the loss of a billion dollars worth of resources in the past. At a one percent rate of compounding, for a loss suffered one hundred years ago, positive compounding suggests a reward of 2.7 billion dollars rather than one billion. For a loss suffered two hundred years ago, compounding increases the reward to 7.3 billion dollars. At a three percent rate of compounding, the awards jump to 19.2 billion dollars and 369.4 billion dollars respectively. At a five percent rate of compounding, the sums raise to 131.5 and 17.3 trillion dollars.²³

As this example illustrates, when positive compounding is employed to determine retribution for victims, and the decedents of victims, the result can be a significant claim on current and future output. Restitution can bankrupt a society because these high levels of retribution prevent a society from realizing the gains from production and exchange that would have occurred absent the need to pay retribution. Stated differently, high levels of restitution can potentially slow, or altogether prevent, a society from breaking from the past and moving forward. Of course the magnitude of restitution depends on how far in the past the wrong occurred, as well as the rate of compounding used in the calculation.

Finding an acceptable solution to this issue requires knowledge of history, philosophy, and political theory; however, the tools of economics are also of utmost importance in considering different proposals for retribution. Specifically, economics can assist in identifying the relevant tradeoffs and costs associated with different options for seeking justice and retribution. As discussed, depending on the relevant time frame and rate of compounding, the costs of carrying out justice and retribution may quickly outweigh the associated benefits. Economics alone cannot solve this issue, but the economic way of thinking is one important input for determining a recipe for reconciliation around an ethic conducive to sustainable liberal democratic institutions.

ECONOMIC INSIGHTS ON MECHANISMS OF SUSTAINABLE CHANGE

As previously stated, complementary institutions are necessary foundations for formal institutions. Absent the required complementary norms, belief systems and organizational forms, formal institutions will be dysfunctional and fail to operate in the desired manner. A central issue facing policymakers and social scientists is how to export these complementary institutions where they do not already exist. The economic analysis of international trade can contribute to finding a solution.

Economists rarely disagree regarding the economic benefits of free trade. As the economists David Dollar and Aart Kraay write,

Openness to international trade accelerates development: this is one of the most widely held beliefs in the economics profession, one of the few things on which Nobel prize winners on both the left and the right agree.²⁴

Indeed, the economic impact of free trade on wealth is significant. William Cline estimates that worldwide free trade could help 500 million people escape poverty while simultaneously injecting \$200 billion annually into developing nations.²⁵ This indicates that the US can utilize its global economic status and trade policy to influence development and change abroad.²⁶ Moreover, it is important to realize that the benefits of trade extend beyond purely economic ones.

In addition to the economic benefits of free trade, economists have also emphasized cultural benefits. For instance, Tyler Cowen analyzes the impact of globalization on culture and concludes that free trade not only makes societies better off in terms of increases in wealth, but also in terms of the array of cultural products available to consumers.²⁷ Cowen's core argument is that cross-cultural trade has the dual effect of allowing cultures to simultaneously maintain and develop certain aspects of their unique identities, while partially merging with other cultures and becoming similar in other aspects. In other words, the impact of globalization on culture is not an all-or-nothing proposition, whereby a culture must either remain isolated or be destroyed. Instead, while globalization admittedly destroys certain aspects of culture, it simultaneously allows other aspects of culture to grow and flourish.

To illuminate this point, Cowen cites the restaurant market. On the one hand, chain restaurants (i.e., McDonald's) continue to increase their overall market share in the global marketplace, which tends to make cultures more homogenous. However, the overall increase in dining has simultaneously increased the number of ethnic and niche restaurants that are able to remain profitable in the broader restaurant market, which has made the options available in the overall restaurant market more diverse and heterogeneous.²⁸ While one can find a McDonald's restaurant in many places around the world, many ethnic and niche restaurants are available as well. Cowen's reasoning can be extended across cultural products and includes not just physical goods and services, but also intangible things such as values, ideas, and other informal, complementary institutions. As in the restaurant market, cross-cultural trade has the dual effect of making intangibles more similar and homogenous in some respects, while causing intangibles to be more diverse and heterogeneous in others.

It is important to note that the material gains from exchange and the intangibles produced by cross-cultural trade are not necessarily mutually exclusive. For instance, the economist Benjamin Friedman has recently explored the implications of economic growth or stagnation for the moral character of a country. He concludes:

Economic growth—meaning a rise in standard of living for the clear majority of citizens—more often than not fosters greater opportunity, tolerance of diversity, social mobility, commitment to fairness, and dedication to democracy. ²⁹

In short, increases in material wealth provide individuals with the ability to pursue other, often intangible, ends, and influences other, often non-economic, aspects of society.

To return to the central dilemma of how to export the required complementary institutions where they do not already exist, it is my contention that a commitment to free trade on the part of the US can be viewed as one mechanism of change to establish the foundation for formal, liberal institutions. Societies tend to become more similar, at least in their awareness of others outside their borders, as they become aware of and integrate the ideas, values, organizational forms, and practices of others. A commitment to free trade is not a panacea, but it is one important tool for spreading the awareness of formal and informal Western institutions.

Although much more can be done, US policymakers have realized the benefits from free trade as they relate to economic development and social change. For instance, in May 2003, President Bush announced an initiative to establish a free trade area between the US and Middle East over the next decade. In their simplest form, free trade agreements (FTAs) attempt to eliminate barriers to trade—quotas, tariffs, etc.—between parties in the agreement. The specific dynamics of each FTA varies depending on how it is written and what goods, services, and barriers it covers. However, while the specifics vary, FTAs typically phase out barriers to trade while establishing some basic agreement on standards regarding a variety of issues, such as labor and the environment. Since 2003, steps have been taken to meet President Bush's FTA goal through the negotiation and signing of Free Trade Agreements with Bahrain and Morocco. Furthermore, negotiations with Oman regarding an FTA were concluded in September 2005. Therefore, the growth of FTA frequency shows that they are believed to serve economic development and social change.

Similar to the emphasis on free trade through FTAs, unilateral reductions in barriers to US markets also have some precedent. In May 2003, senators Max Baucus and John McCain introduced the Middle East Trade and Engagement Act to create a trade preference program for countries in the Middle East. The proposed bill would have allowed the president to implement unilateral reductions in barriers to US markets for countries in the Middle East that met certain requirements. While the proposed bill was never enacted into law, the proposal indicates that the use of trade policy as a tool for generating change has some foundation in current practice.

Similarly, under the Generalized System of Preferences (GSP) program instituted in 1976, the US provides preferential duty-free treatment for several thousand products, from over a hundred designated countries and territories. The underlying logic of the GSP program is that lesser developed countries benefit from free access to US markets. In other words, the GSP program illustrates that policymakers recognize the benefits of free trade with lesser-developed countries. The economic and cultural benefits from free trade become clear only through economic analysis, again highlighting the importance of economics in understanding how to generate sustainable social change.

CONCLUSION

I have discussed only a few insights from the economic way of thinking that are directly applicable to reconstruction and reconciliation. Policymakers and social

scientists involved in these efforts have a large number of tools at their disposal. It is my contention that the economic way of thinking has been largely neglected and should be added to this toolkit. Basic economic concepts such as incentives, constraints, opportunity cost, institutional path dependency, time discounting, and gains from trade can provide important insights into the process of reconstruction and reconciliation. In sum, the key insights of the economic way of thinking on the topics of reconstruction and reconciliation are as follows:

1. *Policymakers and social scientists suffer from a knowledge problem*—While the general characteristics of liberal democracies are well known, policymakers and social scientists lack the knowledge of how to construct these liberal institutions where they do not already exist. This is evidenced by the fact that the historical record of US reconstruction efforts shows more failures than successes. Where failure has occurred, it is not necessarily due to a clear end-goal, but instead to a lack of knowledge of how to achieve the desired end.
2. *Context matters*—Focus is often placed on the controllable variables (i.e., troop levels, timing of elections, monetary aid, planning and exit strategy, etc.) involved in the reconstruction process. While important, the effectiveness of these variables is constrained by uncontrollable variables such as historical experiences and culture. These uncontrollable variables serve as a constraint on the effectiveness of variables that can be controlled, and limit what can be achieved.
3. *Incentives and allocation mechanisms matter*—While monetary aid is an important aspect of the broader reconstruction process, it will be ineffective in the absence of the proper incentives and feedback mechanisms. Recipients of aid must have the incentive to use aid to improve their position and become self-sustaining instead of becoming dependent on continued aid. Further, there must be feedback loops, including mechanisms of accountability for ensuring that aid is utilized effectively. Typically the countries most in need of aid are also those most lacking regarding incentives and allocation mechanisms. Policymakers lack an effective solution to these issues.
4. *Reconciliation must take place with an eye toward the future*—The emergence of an ethic of forgiveness and reconciliation is often critical for the long-term sustainability of a society where past harms and abuses have taken place. However, when considering the calculation of restitution, it is critical to recognize the associated trade-offs. At some point, the payment of restitution consumes such a significant portion of current and future output that it will bankrupt the society in question.
5. *A commitment to free trade is an alternative means of political, economic and social change*—Sustainable change toward liberal democracy requires certain complementary institutions to serve as a foundation. Efforts to impose liberal democratic institutions via military occupation suffer from the knowledge problem of how to construct these complementary institutions

where they do not already exist. A commitment to free trade provides an alternative and is a means of engaging in economic and cultural exchange with trading partners around the world. Free exchange allows for the imitation of both formal and informal institutions, providing the potential for social change through peaceful interaction.

Economics alone may not be able to provide an answer to all the questions and issues associated with reconstruction and reconciliation. However, the economic way of thinking can complement other tools and contribute substantially to our understanding of not only the different outcomes of past reconstruction efforts, but also the limitations of our knowledge of how to establish liberal democratic institutions where they do not already exist.

Notes

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