



SUSTAINABILITY OF MICROSTATES

The Case of North Cyprus

OZAY MEHMET

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Contents

List of Tables and Figures	vi
Acknowledgments	viii
Introduction	ix
1. Economic Development in North Cyprus since 1974	1
2. Economic Rationalism and Institution Building	21
3. A Development Strategy for North Cyprus	44
4. Can North Cyprus Survive as a Microstate?	59
5. Modeling Required Investment in North Cyprus	75
6. The Labor Market: Developing Skills for a Service Economy	91
7. The Construction Sector in the Post-Referendum Period <i>Ozay Mehmet, Vedat Yorucu, and Rusen Keles</i>	106
8. The Turkish Energy Corridor	117
9. Divergence or Convergence? Toward a Two-State Outcome	130
Postscript	139
Notes	141
References	149
Index	157

Tables and Figures

TABLES

1.1.	Population of North Cyprus	1
1.2.	Land Use in North Cyprus	3
1.3.	Underground Water Balance in North Cypru	4
1.4.	Gross National Product, 1977 and 1990	6
1.5.	Employment Growth, by Sector, 1982-1990	7
1.6.	Trade Redirection in North Cyprus after 1994	8
1.7.	Aggregate Investment, 2005 and 2006	10
1.8.	Turkish Aid, 1974-2005	11
1.9.	Turkish Aid as Percentage of GNP, 1977-2004	11
1.10.	Investment Incentive Program, 2001-2005	12
1.11.	Number of Promoted Projects, by Sector, 2001-2005	13
1.12.	Top 25 Promoted Projects Receiving Incentives, 2000-2005	14
1.13.	Credit Provided by the State Development Bank, by Program, 2001-2005	15
1.14.	Credit Provided by the State Development Bank, by Sector, 2001-2005	15
1.15.	Balance of Payments	17
1.16.	Summary of State Budget Balance	17
2.1.	Institution Building in North Cyprus	24
5.1.	Requirements for Reaching US\$15,000 Per Capita Income by 2011	79
5.2.	Progressive Achievement of Convergence of Incomes and Growth Rates in the URC	82

5.3.	First Stage of Convergence, 2005-2015	85
5.4.	Required Investment	87
6.1.	Descriptive Statistics of Turkish Cypriot Commuter Workers	95
6.2.	Monthly Net Take-Home Pay of Turkish Cypriot Commuter Workers, by Sector	96
6.3.	Net Pay of Turkish Cypriot Workers Compared with That of Greek Cypriot Workers	96
6.4.	Work Permit Applications, 1999-2005	99
6.5.	Descriptive Statistics of Turkish Guest Workers	100
6.6.	Monthly Net Take-Home Pay of Turkish Guest Workers, by Sector	101
6.7.	Net Pay of Turkish Guest Workers in North Cyprus Compared with Net Pay in Turkey	102

FIGURE

5.1.	The Real Estate Market	113
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Introduction

NORTH CYPRUS is a microstate with an area of 3,442 square kilometers. It shares the same potential for survival as other microstates, including Singapore, Luxembourg, and the Isle of Man, which are even smaller yet among the world's richest states.

The key argument of this book is that North Cyprus, as a microstate, possesses certain inherent comparative advantages, especially in tourism, higher education, and banking and finance, as well as other service sectors, advantages that enable it to be sustainable in a rapidly globalizing, competitive world. Service markets recognize no boundaries and thus are not constrained by diseconomies of scale that operate in the manufacture and trading of goods and commodities.

First, however, we start with the politics of the Cyprus problem.¹ Cyprus has been a divided country for almost half a century. The cornerstone of the Cyprus problem is joint sovereignty. At the time of independence in 1960, the British surrendered sovereignty not just to the Greek Cypriots but also to the Turkish Cypriots. There are five signatures on the independence documents and international agreements that created Cyprus: three guarantor powers (United Kingdom, Greece, and Turkey) plus the Turkish and Greek Cypriot communities. In other words, Cyprus was legally a bicommunal republic. But it soon became a failed state, its 1960 Constitution becoming inoperative.

Bicommunal partnership statehood failed twice, once in the December 1963 coup by EOKA² and again in April 2004 when Greek Cypriots resoundingly rejected the UN's Annan Plan. This plan was the product of forty years of UN peacemaking, backed by the European Union (EU) and the entire range of Western diplomacy. Yet soon after the Greek Cypriot rejection, the EU admitted a divided country into its midst as a full member, effectively

disowning the plan. Was this a blunder or a deliberate act? Some observers, perhaps cynically, consider the Greek Cypriot admission a calculated strategy, a political expediency designed to keep Turkey out of the EU.

Conspiracy or not, economic and social development cannot be stopped. An economic agenda must be designed and implemented to safeguard and enhance living standards. In our dynamic and energy-hungry world, strategic and geopolitical factors emerge to transform old problems. Now the creation of the Turkish Energy Corridor, from Ceyhan to Iskenderun in Turkey and from Karpiz to Erenkoy in North Cyprus, has dramatically altered the dynamics of the Cyprus problem. Oil discovery in territorial waters nearby is likely to have a far-reaching impact as well. Conflict over the control of these energy resources may even take precedence over power-sharing arrangements among the island's Turks and Greeks. Moreover, Cyprus is an arid island, and Turkish water, plenty of it available cost-effectively from a distance of under one hundred miles, is essential for the island's people. Turkey and Cyprus are, like it or not, linked in a common geopolitical destiny.

At the core of this book is an argument derived from the assumption that both ethnic communities in Cyprus are rational, to varying degrees, and that their separation stems not only from subjective emotions but also from certain objective facts rooted in *economic rationalism*. The essence of economic rationalism is *optimization of self-interest*, subject to certain constraints. In an ethnic conflict, the logic of optimization demands the balancing of competing interests to reach an agreed-on solution. This balancing is a rational choice, freely made, using cool-headed, objective analysis of losses weighed against expected payoffs. A best choice may still be feasible in Cyprus if the latest negotiations are successful in reaching a comprehensive settlement that optimizes Greek and Turkish Cypriot self-interest. In the case of failure, a second-best choice is inevitable. That is exactly what happened in the former Czechoslovakia, where a "velvet divorce" took place within the EU: both the Czech Republic and Slovakia are friendly independent countries and equal members within the Union. The same outcome might now apply in Cyprus. Or it might follow the example of Kosovo. Other second-best options must also be considered. All these options are derived from variations of economic rationalism.

The economic rationalist approach sharply contrasts with the highly emotional political, historical, cultural, or even legal approaches that have dominated the study and discussion of the Cyprus problem. Economic *rationalism* has taken a back seat in the management, or better put, mismanagement, of the Cyprus problem, resulting in a protracted conflict.³

The purpose of this book is to identify and highlight behavioral factors, primarily economic, that contributed to ethnic divergence in 1963 and again 2004; or put more positively, the book seeks to identify forces of convergence deduced from optimal human behavior known as economic rationalism. At the same, the negative forces of divergence cannot be ignored. In the end, they may well prevail because economic behavior is only part of human nature.

The book begins with a brief overview in Chapter 1 of the economic development of North Cyprus since 1974. It documents a remarkable growth, under exceptionally difficult circumstances of economic embargoes and political isolation, capped by an impressive increase in per capita income from US\$350 in 1974 to almost \$12,000 at the end of 2006.

Chapter 2 applies economic rationalism to document, in broad historical perspective, the efforts of the Turkish Cypriots since colonial days to control their own economic destiny through institution building. The institutions they built were shaped by two forces: Kemalist principles originating from Turkey and a clear desire to assert independence against a dominant Greek Cypriot presence on the island. These influences were manifested, at the beginning, against British colonial rule and, in the post-independence era, against the failure of the partnership republic created out of the ill-fated Zurich-London Agreements, which led to the 1960 Constitution.

Chapter 3 is a discussion of future development strategy for North Cyprus, whether as a separate state or in a United Republic of Cyprus (URC) as envisioned in the Annan Plan. The core of the development strategy is the idea of North Cyprus as a “developmental state” modeled on the success stories of the four Asian Tigers, some of which are microstates themselves.

Chapter 4 is a study of the economics of microstates. Some of the most prosperous states today are microstates, and the basis of their success is a service-based economy. There is no reason to doubt the sustainability of North Cyprus if the rules of efficiency and competitiveness are observed in resource allocation and if investment is managed effectively.

Chapter 5 attempts to derive the investment requirements for economic parity, or convergence, between the two ethnic communities in order to make a URC a sustainable reality as a bizonal federation. A URC is seen as a theoretical best choice, the preferred solution, a model of Turkish-Greek cooperation within the EU. However, it must be noted that the URC proposal, while accepted by the Turkish Cypriots, was overwhelmingly rejected by Greek Cypriots in the Referendum of 24 April 2004 and may fail a second time.

Regardless of the political prospects, investment is the key to nation-building, and human capital is the engine of development, representing

skills and knowledge embodied in human resources. The labor market is where human resources are utilized and full employment is realized. Chapter 6 examines the labor market in North Cyprus, in terms of both guest workers from the Turkish mainland and the movement of commuter workers from North to South Cyprus. These labor flows are examples of economic rationality at work since workers are always attracted by expectations of higher economic benefits. Of course, economic rationalism in the labor market also creates cultural, social, and economic impacts, changing the demographic landscape.

Chapter 7, adapted from an article by Vedat Yorucu and Rusen Keles, looks at the construction sector from a critical angle, questioning whether or not the post-Referendum boom in building and real estate is sustainable, especially in view of the fragile ecology of North Cyprus.

Chapter 8 is devoted to the strategic Turkish Energy Corridor, just north of the Turkish Republic of Northern Cyprus (TRNC). This corridor has emerged as a result of the start of oil exports from the port of Ceyhan at the end of the Baku-Tbilisi-Ceyhan Pipeline. Finally, Chapter 9 discusses the forces of divergence and convergence in Cyprus on the basis of best and second-best solutions.

Economic Development in North Cyprus since 1974

ECONOMIC DEVELOPMENT in North Cyprus since 1974 has been uneven, and accordingly, it is best to subdivide this period into three main stages. The first stage, 1974-90, was marked by consolidation and institution building. The second stage, 1990-2004, was a period of transformation during which the primary sector declined and the service sector emerged as the main source of gross domestic product. And the post-Annun Plan period, after 2004, featured a short-lived stage of explosive growth led by an unsustainable construction boom. In 2008 a slower and more sustainable growth pattern emerged with increasingly greater integration with the Turkish economy. As a result of the global financial crisis, 2009 has witnessed a recession, with construction at a virtual standstill, tourism down, and many small, marginal enterprises facing bankruptcy.

TABLE 1.1. Population of North Cyprus.

1975	1992	1996	2006
126,000	176,127	200,587	264,172

Source: 1975 and 1992 are from Morvardi 1993:219; 1996 and 2006 are from the Ministry of Economy and Tourism, Summer 2006:25, using data from the State Planning Office.

With a territory of 3,442 square kilometers in the eastern Mediterranean, North Cyprus is very much a microstate, defined as a country with an area less than 10,000 square kilometers (Mehmet and Tahiroglu 2002). Its 2006 population was 264,172 (Table 1.1), and it has manifested an exceptionally high growth rate of population of about 4 percent per year.

Despite this rapid population growth, North Cyprus has done remarkably

well in standard economic terms, achieving growth in per capita income from US\$350 in 1974 to almost \$12,000 by the end of 2006. A comprehensive World Bank report (2006) notes that North Cyprus has made a “remarkable achievement” (1:vii) and “significant progress in the economic and social spheres . . . despite living in isolation for almost three decades” (1:1.6:2).

North Cyprus came into existence under extraordinary circumstances when the 1960 Republic of Cyprus was violently dismantled in the Christmas 1963 onslaught on Turkish Cypriots by Greek and Greek Cypriot forces. This attack led to a period of civil war, which lasted until 1974, when the Turkish army intervened in accordance with paragraph 4 of the Treaty of Guarantee to prevent enosis (union with Greece). During the decade of civil war Turkish Cypriots survived, thanks to a high level of social capital. In this period citizen-soldiers defended their towns and villages, and the entire community depended on a variety of formal and nonformal kinds of social capital (Mehmet and Mehmet 2004).

The civil war and emergency conditions in 1974-90 influenced greatly the types and working modalities of institutions and, thus, the pattern of economic development of North Cyprus. In particular, the existential struggle created a general atmosphere of ad hoc arrangements and institutions (e.g., provisional government services in health, education, and other essential services), which subsequently had a negative impact on institutional efficiency and optimal resource allocation. Throughout this period, only Turkey came to the economic rescue with generous foreign aid to the Turkish Cypriots, who otherwise functioned under a comprehensive and devastating political and economic embargo imposed by the internationally recognized Greek Cypriot administration. The isolation of the Turkish Cypriot economy in the North was a major constraint on economic development (Plumer 2008).

ECONOMIC TAKE-OFF, DEMOGRAPHIC CHANGE, AND MARKET DEVELOPMENT, 1974-90

In the period 1974-90, North Cyprus experienced an economic take-off, as Rostow (1960) describes the term in his well-known theory of economic development. In this early period the foundations of a functioning market economy were laid, starting with demographic change and basic institutions. In 1974 North Cyprus was an agricultural economy limited by an underdeveloped modern sector and a small market that was constrained by demographic factors.

The population in 1975 was estimated to be 127,000, including some

TABLE 1.2. Land Use in North Cyprus.

TYPE	DONUMS	PERCENT OF TOTAL	YIELD/KG PER DONUM
Nonagricultural	1,067,429	43.3	
Agricultural	1,398,123	56.7	
Cereal	642,119		99.9
Citrus	54,600		4,407.0
Fruits	58,893		157.9

Source: Ministry of Agriculture and Forestry tabulated in Morvadi 1993:236-38.

Note: One donum is equal to 14,400 square feet (1,339.2 square meters).

60,000 Turkish Cypriot refugees from South Cyprus who were part of a population exchange agreement. The refugees left behind homes and property and were housed in residences abandoned by Greek Cypriots who had left the North after 1974. There was also a system of compensation of land abandoned in the South, amounting to an informal exchange of property, pending a political settlement.

Initially, the economy was in a shambles from the embargoes and civil war of the preceding decade. To boost agricultural production and stimulate industrial growth, officials organized immigration from Turkey to import agricultural and skilled workers. Production increased slowly, paralleling a demographic expansion that, in turn, enabled the growth of a domestic market. Subsequently, the economy recovered, and during the 1980s considerable economic growth was achieved. By the time of the 1992 census, the population had increased to 176,127, implying an average annual growth rate of 1.4 percent (Morvardi 1993:219).

In this period, agriculture in smallholdings was the main economic activity, accounting for the principal share of both the gross domestic product and employment. Land productivity was extremely low (Table 1.2), and dry cereal farming was the dominant type of agriculture. Rural incomes were close to poverty level, and there was extensive underemployment.

During the 1980s prices of agricultural products started rising, and this prompted significant mechanization and modernization along with the use of improved seeds and fertilizers. The number of tractors and combine harvesters in North Cyprus greatly increased, tractors by 64 percent and harvesters by 32 percent (Morvardi 1993:241). There was also considerable expansion in citrus production. The stimulus was the establishment in 1975 of Cypruvex, a company owned by Asil Nadir, a London-based Turkish Cypriot businessman

TABLE I.3. Underground Water Balance in North Cyprus, 1986 (in million cubic meters).

LOCATION	ANNUAL SUPPLY	ANNUAL CONSUMPTION	ANNUAL BALANCE
Guzelyurt	35.0	60.0	-25.0
Total	93.5	105.0	-12.0

Source: Water, Geology and Mineral Office, as tabulated in Morvardi 1993:237.

who controlled a string of multinational firms, along with aggressive export marketing through the port of Gazimagosa. Rising demand and producer prices acted as incentives, and citrus farming boomed. Cypruvex accounted for 85 percent of the citrus market, and further growth was achieved by vertical integration when Sunzest began manufacturing orange juice. Much of the economic development at this stage was through state monopolies and direct government involvement in marketing and exporting.

Citrus farming, concentrated in the Guzelyurt area, operated under a severe water supply constraint. Too many wells and excessive drawing of underground water caused increasing problems of salinization in the area. By 1987, the Guzelyurt region experienced a water deficit twice as great as that of the whole of North Cyprus, which is a water-stressed country, as can be seen from the water balances in Table I.3.

Meanwhile, nonagricultural economic activities were minimal, except for the public sector, which experienced a sudden growth. Tourism and industrial development took years to recover from the civil war. The government attempted to encourage a modest program of industrialization through industrial estates, which in the 1980s registered considerable expansion, centered on textiles and garment exports, principally to the United Kingdom. Tourism, however, depended on the development of normal air links through Turkey, owing to the Greek Cypriot embargo on air traffic with the rest of the world. As far as trade and business development were concerned, these sectors were given a major boost with a policy of early retirement from the public service.

One innovative initiative was the development of a university sector. In 1979 the state-endowed Eastern Mediterranean University was launched in Gazimagosa. It grew rapidly, reaching an enrollment of 15,000 within a decade due to excess demand for university education in Turkey. In 1994 a turning point was reached when the High Education Council of Turkey accredited higher education in North Cyprus. This decision accelerated the expansion of universities. In Lefke a second state university was launched,

along with two private universities in Nicosia, the Near East University and the Cyprus International University, as well as the Girne American University in Kyrenia. In 2004 Ankara's Middle East Technical University opened a satellite campus at Kalkanli with a projected enrollment of 6,000. Istanbul Technical University is planning to launch a similar campus in the Karpaz panhandle by the end of 2009. The economic contribution of the university sector in North Cyprus has been considerable, earning sufficient foreign exchange to finance up to a third of the trade deficit of the country.

Macrotrends

After the initial take-off stage, there was a drive toward sustained development, which was increasingly centered on the profit-driven private sector. Import-export trade expanded rapidly. The 1980s saw considerable growth, as the economy first adjusted to the shocks of the civil war, Turkish military intervention, and population exchange, and then slowly recovered and expanded. As the economy took off, there was a major secular decline in agriculture and a rapid expansion of the industrial and service sectors. Despite political challenges arising from the unresolved Cyprus problem, the economy has grown impressively since 1977 at an average annual rate of almost 6.5 percent (Table 1.4).

Sectoral Transformation

Looking at structural transformation at a sectoral level is instructive. As shown in Table 1.4, agriculture's share of GDP declined from 16.4 percent in 1977 to 9.2 percent in 1990. Construction was the fastest-growing sector, followed by trade and tourism, and transport and communication services. What is noteworthy is the large share of public service, accounting for almost one-fifth of GDP in both years. Similarly, financial institutions expanded relatively faster than industry.

Table 1.4 presents official statistics relating to employment, unemployment, and the labor force during 1982-90. Total employment grew significantly in this period, registering an overall expansion of 25.9 percent. Agricultural employment declined by 9.9 percent in line with the secular transformation of the economy. Thus, by 1990, agriculture accounted for only 26.7 percent of total employment, compared with 37.3 percent in 1982. On the other hand, industrial employment increased, notably in manufacturing, which grew by over 40 percent. The fastest growth of employment was in construction, which in 1990 accounted for 10.4 percent of total employment. The public sector was the single largest employer, accounting for better than one of every five workers in North Cyprus.

TABLE I.4. Gross National Product, in Constant 1977 Factor Cost (in millions of Turkish lira), 1977 and 1990.

SECTORS	1977		1990		PERCENT INCREASE AT 1977 CONSTANT PRICES
	PERFORMANCE	PERCENT SHARE	PERFORMANCE	PERCENT SHARE	
Agriculture	619.3	16.4	639.7	9.2	3.29
Industry	365.1	9.7	947.3	13.7	159.46
Construction	153.0	4.0	506.3	7.3	230.91
Trade & tourism	801.0	21.2	1,334.1	19.2	66.55
Transportation & communication	257.4	6.8	791.8	11.4	207.61
Financial institutions	115.5	3.1	310.0	4.5	168.63
Ownership of dwellings	355.3	9.4	337.3	5.5	-5.06
Professional services	128.1	3.4	259.3	3.7	102.42
Public service	752.7	19.9	1,278.1	18.4	69.80
Import duties	228.2	6.1	491.7	7.1	115.47
GDP at purchaser value	3,755.5	100.0	6,935.8.	100.0	83.70
Net factor income from abroad	35.0	0.9	41.6	0.6	18.85
GNP	3,810.5	100.9	6,977.4	100.6	83.11

Source: State Planning Organization, as tabulated in Dodd 1993:273.

In aggregate, the labor force (consisting of employment plus unemployment) grew by 24 percent compared with a population growth of 11.9 percent (Table I.5). In other words, the labor force grew more than twice as fast as the population, a robust reflection of economic growth in this period. Unemployment fell. However, no doubt there was considerable hidden underemployment in agriculture.

TABLE 1.5. Employment Growth, by Sector, 1982–1990.

SECTOR	EMPLOYED 1982	PERCENT SHARE OF TOTAL EMPLOYMENT	EMPLOYED 1990	PERCENT SHARE OF TOTAL EMPLOYMENT	PERCENT GROWTH 1982-90
Agriculture	21,208	37.3	19,094	26.7	-9.9
Industry	5,700	10.0	8,034	11.3	42.2
Construction	3,567	6.3	7,451	10.4	108.9
Trade & tourism	5,060	8.9	6,942	9.7	37.2
Transportation & communication	3,338	5.9	5,728	8.0	71.6
Financial institutions	1,250	2.2	1,968	2.8	57.4
Professional & other services	4,168	7.3	6,329	8.8	51.8
Public service (incl. state economic enterprises & municipalities)	12,500	22.0	15,979	22.3	27.8
Total employment (E)	56,791	100.0	71,525	100.0	25.9
Unemployed (U)	1,421		849		-40.2
Labor force (E + U)	58,212		72,374		24.0
Total population	153,239		171,469		11.9

Source: State Planning Organization, as reported in Dodd 1993:274.

TRANSFORMATION, 1990-2004

After the initial take-off in the first decade, the North Cyprus economy underwent two major kinds of transformation. First, secular decline of the primary sector progressed rapidly, leading to the emergence of a sector-oriented economy that was increasingly dependent on tourism and on an expanding export-oriented university education. Part of this service orientation reflected the expansion of small-scale, family-owned enterprises in the private sector. However, the dominance of a large, indeed excessively large, public sector was a marked feature of the economy.

Second, and at the same time, the North Cyprus economy gradually shifted away from public monopolies and government-controlled

TABLE 1.6. Trade Redirection in North Cyprus after 1994.

EXPORT TRADE			
	TOTAL NORTH CYPRUS EXPORT (MILLIONS OF US\$)	EU SHARE (%)	TURKEY'S SHARE (%)
1990	66	78.0	
1995	67	54	
2000	50	40	37
2004	62	24	47
IMPORT TRADE			
	TOTAL NORTH CYPRUS IMPORTS (MILLIONS OF US\$)	EU SHARE (%)	TURKEY'S SHARE (%)
1990	382		
1995	366		
2000	425		65
2004	853		60

Source: World Bank 2006:2:128-29.

economic enterprises toward a more private-sector-driven economy. Public monopolies, in retrospect a costly experiment influenced by Turkish etatism (Mehmet 1983), did not last long, as they clashed with the private-sector philosophy of the bulk of Turkish Cypriots (see Chapter 2). The trend toward a private-sector-driven economy accelerated especially after 2000, assisted by the provision of industrial estates and other investment incentives offered by the state (see below).

One of the most significant transformations in the North Cyprus economy in this period was a redirection of external trade from Europe to Turkey, especially since 1994, as documented in Table 1.6. The redirection of external trade was the direct result of an embargo on North Cyprus exports imposed in 1994 by the European Court of Justice on application by the South Cyprus authorities. This trade embargo, in turn, had two major impacts: it accelerated the transition of North Cyprus into a consumer society as all kinds of consumer goods flooded in from Turkey, and it created a market-driven process of economic integration with the Turkish mainland. This was an increasingly deepening kind of integration, covering imports not only of consumer (and producer) goods but also of unskilled and skilled labor for employment in such service sectors as tourism and construction.

The process of integration with Turkey is extensively discussed in the

2006 World Bank report (WBR), which evaluates it against the alternative of closer relations with the European Union. The WBR recommends that the EU “incorporate the northern part of Cyprus within its customs union.” It states:

As long as the northern part of Cyprus remains outside the Pan-European Agreement on Cumulation of Rules of Origin and EU custom territory ... benefits from liberalization will be limited at best and there will be little progress in integrating this territory into global markets. Two projects—internal reforms based on convergence to the EU and the removal of discriminatory measures—should proceed simultaneously, as the two are mutually reinforcing. Accession of the Republic of Cyprus to the EU has created the potential for improved economic growth performance for both parts of Cyprus, but this will not come by default. It calls for political action and considerable assistance to the northern part of Cyprus to converge to the *acquis*. (World Bank 2006:2:155; italics in original)

MACRODEVELOPMENT IN THE POST-REFERENDUM PERIOD

The Annan Plan, submitted to simultaneous referenda in South and North Cyprus on 24 April 2004, led to a property-driven boom in the North (see Chapter 7), thanks in large measure to its definition of property rights and its dispute-settlement provisions. Economic actors were thus enabled, for the first time, to calculate and evaluate their investment in land and economy. Private investment in housing and property development led the economy, with large inflows of foreign capital from Turkish Cypriots living abroad and from speculative investors. In this environment, public investment lagged behind in providing the necessary infrastructure that is essential for growth and sustainability as well as high productivity, performance, and employment.

In this period the investment strategy of the Turkish Republic of Northern Cyprus (TRNC) consisted of four components: (1) aggregate investment in both public and private sectors, (2) an infrastructural investment program implemented within the perspective of the economic cooperation between Turkey and the TRNC, (3) an investment incentive program administered by the State Planning Organization, and (4) an investment credit program administered by the State Development Bank.

Public Sector Investment

Table 1.7 utilizes official statistics to give a summary of aggregate investment in the TRNC in 2005 and 2006. In 2005 total investment represented

TABLE I.7. Aggregate Investment, 2005 and 2006 (in million YTL).

	2005	% GDP	2006 TARGET	% GDP
Total investment	621.6	20.5	701.2	21.6
Fixed capital expenditure	573.8	18.9	650.7	20.0
Public	185.0	6.1	210.2	6.5
Private	388.8	12.8	440.5	13.6
Change in inventories	47.8	1.6	50.5	1.6
Public	1.5	0.1	1.6	0.1
Private	46.3	1.5	48.9	1.5

Source: State Planning Organization, 2006 Program, November 2005, Table 13, p. 32.

Note: 2006 figures are targets.

20.5 percent of GDP (in current prices), of which 18.9 percent was fixed capital expenditure and 1.6 percent was change in inventory stocks.

The private sector is the locomotive of aggregate investment activity, accounting for 70 percent of total investment in 2005, the public sector providing the rest. Almost all public infrastructural investment is financed from Turkish aid, as described below. This is a major deficiency in the public finances of North Cyprus, reflecting the fact that the country has no development (i.e., capital expenditure) budget. It is likely that this deficiency is responsible, in turn, for the high level of consumerism that exists in the country, which has a chronic propensity to import luxury goods such as expensive cars.

Turkish Aid for Infrastructure

Turkish aid is vital for the economy of the TRNC. This aid stems from a series of economic cooperation agreements and protocols between the TRNC and the Turkish government, and it is administered through the Turkish Embassy in Nicosia. Utilization of Turkish aid and implementation of projects are based on close collaboration between the embassy and the TRNC Ministry of Economy and Tourism, which is responsible for macroeconomic policy, and other implementing ministries and agencies of the government.

Turkish aid is the principal source of development finance in TRNC, and it is used for both physical and social infrastructure. The former include highway and road construction, electricity, airports, sewers, dam

TABLE I.8. Turkish Aid, 1974-2005 (in millions of US\$).

PERIOD	AVERAGE ANNUAL TURKISH AID	PROJECT AID	PROJECT AID AS PERCENT OF TOTAL
1974-80	28.57	11.71	0.41
1981-85	40.8	16.6	0.41
1986-90	44.8	27.8	0.62
1991-95	69.6	28.2	0.41
1996-2000	173.0	40.4	0.23
2001-5 prelim.	317.0	73.6	0.23
TOTAL 1974-2005	3,425.99	1,014.97	0.30

Source: TC Lefkosa Buyukelciligi, Yardim Heyeti Baskanligi, Lefkosa, 2 November 2004, Ek 1/A, p. 25.

TABLE I.9. Turkish Project Aid as Percentage of GNP, 1977-2004 (in millions of US\$).

YEAR	PROJECT AID	GNP	PROJECT AID AS % OF GNP
1977	4.9	209	0.02
2000	52.7	1,040	0.05
2004 Prelim.	96.2	1,604	0.06

Source: TC Lefkosa Buyukelciligi, Yardim Heyeti Baskanligi, Lefkosa, 2 November 2004, Ek 1/A, p. 25, and Ek 3, p. 27.

construction, and water projects. The latter relate primarily to investments in education and health.

During 1974-2005 the total Turkish development assistance is estimated to be US\$3.4 billion. This works out to an annual average over 31 years of about US\$110 million, but since 1996 the figure has been rising steadily, reaching \$317 million during 2001-5 (Table I.8). Of total Turkish aid, about 30 percent, or just over \$1 billion, has been in the form of project aid (Table I.8). In the last decade there has been a major increase in the absolute amount of Turkish aid, but the proportion of project aid has declined significantly, from more than 40 percent to 23 percent.

Turkish project aid as a proportion of the TRNC's GDP has risen significantly since 1977. In 2000 it reached 5 percent, and in 2005 it was 6 percent (Table I.9). In addition to official aid, Turkey is the principal source of private sector investment, especially in tourism development (discussed below).

In 2006 there was a major increase in infrastructural investment as part of Turkish aid to the TRNC. The total aid for 2006 was 804.3 million

TABLE 1.10. Investment Incentive Program: Total Investment in Promoted Projects, 2001-2005 (in millions of YTL).

YEAR	TOTAL INVESTMENT IN PROMOTED PROJECTS
2001	58.1
2002	1,058.8
2003	181.1
2004	242.1
2005	526.1
Total	2,066.2

Source: State Planning Organization.

YTL, most of which was earmarked for physical and social infrastructural projects. Water and irrigation projects, highway construction, and electricity generation top the list of physical infrastructural projects. As for social infrastructure, the projects earmarked for 2006 included a new hospital for Gazimağusa and a new Middle East Technical University campus at Kalkanlı. Also budgeted are significant allocations for investment in municipal infrastructure.

One final word on Turkish aid: can the North Cyprus economy survive without it? The answer would have to be a conditional yes, the condition being a major tax reform in order to eliminate tax avoidance in the large informal economy. In 2006 the minister of finance announced that the informal economy might be as high as 60 percent of the total economy, reflecting a huge tax loss. If these lost taxes could be collected and mobilized into a development budget, then North Cyprus could survive without Turkish aid.

Investment Incentive Program for the Private Sector

The investment incentive program is administered by the State Planning Organization (SPO), and its purpose is to promote projects calculated to have a net benefit for the TRNC economy. The promoted projects receive a variety of incentives to attract prospective investors, domestic and foreign, especially in tourism. As can be seen from Table 1.10, the total investment in promoted projects in 2001-5 amounted to just over 2 billion YTL. During this period 233 projects were promoted under the SPO's investment incentive program. Table 1.11 provides information on the number of promoted projects by sector during 2000-5. Manufacturing and tourism are the two leading sectors in the awarding of incentives. Table 1.11 also shows that 2002

TABLE I.II. Number of Promoted Projects, by Sector, 2001-2005.

SECTOR	2001	2002	2003	2004	2005	TOTAL
Tourism	0	38	9	13	19	79
Manufacturing	1	39	24	21	26	111
Health	1	4	1	1	0	7
Education	1	8	0	0	10	19
Transport	0	3	0	0	0	3
Printing	0	1	0	0	1	2
Agriculture	0	1	2	1	0	4
Communication	0	2	0	0	0	2
Food	0	1	0	4	0	5
Trade	0	0	1	0	0	1
Total	3	97	37	40	56	233

Source: State Planning Office.

was an exceptional year in terms of the number and value of projects undertaken. Generally, the number and value of promoted projects have been on an upward trend, reflecting increasing confidence in the TRNC economy and the stimulus of the incentives available to investors.

The largest single project is in the tourism sector in the Bafra region (the Artemis hotel complex) with an investment value of 120.4 million YTL.¹ These projects have an average value of 48.4 million YTL (Table 1.12). Table 1.12 also provides information about the equity ownership of the promoted projects. There was significant foreign equity participation, mainly from Turkey, Israel, the United Kingdom, Italy, Germany, and the United States.

Investment Credit Program

The investment credit program is administered by the State Development Bank (SDB). Its purpose is to provide credit to investors undertaking projects judged to make a significant public contribution to the economic development of TRNC.

The SDB provides credit under four main programs. All these programs have been growing since 2001, but the two largest are the treasury and incentive programs. The combined cumulative total of credits provided is US\$47.185 million (Table 1.13).

Table 1.14 gives details of the SDB credits provided since 2001 by economic sector. Tourism is by far the most favored sector under the SDB credit program, followed by education and manufacturing. Health is a relatively

TABLE I.12. Top 25 Promoted Projects Receiving Incentives, 2000-2005.

RANK	EQUITY OWNERSHIP	DISTRICT	SECTOR	VALUE (MILLIONS OF YTL)
1	100% F	Iskele	Tourism	120.4
2	100% F	Iskele	Tourism	101.3
3	2% TRNC, 98% F	Girne	Tourism	96.7
4	100% TRNC	Lefkosa	Manufacturing	80.9
5	100% TRNC	Iskele	Tourism	75.7
6	100% F	Iskele	Tourism	59.8
7	100% F	Iskele	Tourism	56.6
8	100% TRNC	Girne	Tourism	55.1
9	1% TRNC, 99% F	Girne	Tourism	53.3
10	100% F	Iskele	Tourism	47.8
11	100% TRNC	Lefkosa	Education	45.4
12	100% F	Iskele	Tourism	44.9
13	100% F	Iskele	Tourism	35.5
14	51% TRNC, 49% F	Iskele	Tourism	34.9
15	100% TRNC	Girne	Tourism	33.9
16	1% TRNC, 99% F,	Lefke	Manufacturing	31.1
17	100% F	Iskele	Tourism	30.5
18	100% TR	Girne	Tourism	28.9
19	49% TRNC, 41% F	Girne	Tourism	28.6
20	10% TRNC, 90% F	Girne	Tourism	27.5
21	100% F	Girne	Tourism	27.1
22	100% F	Iskele	Tourism	25.6
23	100% F	Iskele	Tourism	24.4
24	100% F	Iskele	Tourism	22.7
25	100% F	Iskele	Tourism	22.5
Total value of investment in 2000-5 (billions of US\$)				1.211
Average size per project				48.44

Source: State Planning Office.

Note: F = foreign; TRNC = Turkish Republic of Northern Cyprus.

TABLE I.13. Credit Provided by the State Development Bank, by Program, 2001-2005 (in millions of US\$).

PROGRAM	2001	2002	2003	2004	2005	TOTAL
Incentive	0	3.894	3.524	2.217	3.553	13.188
Small and medium enterprises	3.304	0	0.067	0.037	0.962	4.37
Funded	0	1.164	3.834	2.947	1.658	9.603
Treasury	0	0	0.986	5.488	13.550	20.024
TOTAL	3.304	5.058	8.411	10.689	19.723	47.185

Source: State Development Bank.

TABLE I.14. Credit Provided by the State Development Bank, by Sector, 2001-2005 (in millions of US\$).

SECTOR	2001	2002	2003	2004	2005	TOTAL	%
Tourism	0.845	2.164	5.646	4.019	4.705	17.379	37
Manufacturing	2.450	2.014	1.287	2.421	4.168	12.34	26
Agriculture	0	0	0	0	0	0	0
Education	0.009	0.101	0.404	3.487	9.025	13.026	28
Health	0	0.779	1.059	0.761	0.347	2.946	6
Sea transport	0	0	0	0	1.463	1.463	3
Other	0	0	0.016	0	0.015	0.031	0
Total	3.304	5.058	8.411	10.689	19.723	47.185	100

Source: State Development Bank.

Note: Small discrepancies between totals here and in Table I.13 are due to rounding.

new field, as is sea transport. Projects in agriculture have not received any credit under this program.

Unsustainable Aggregate Balances

The North Cyprus economy faces two main unsustainable aggregate balances: a large trade imbalance (Table I.15) and a severe central government budget deficit (Table I.16). The external imbalance is a reflection of (1) poor export performance, owing to economic restrictions placed on North Cyprus trade by the European Court of Justice in 1994 (on Greek Cypriot application), imposing an additional 14 percent tax on third countries, and (2) the propensity of Turkish Cypriots to import luxury consumer durables, notably fashionable automobiles. The trade deficit is largely offset

by net income from services and other invisible transactions, but there is no doubt that excessive consumerism on imports needs to be curtailed. Higher ecological taxes on CO₂ emissions or luxury imports, for example, may be required to curb this kind of conspicuous consumption.

Does the large budget deficit point to long-term unsustainability for North Cyprus? The answer is no, for two reasons. In the first place, the budget deficit, at this stage of the country's development, is a reflection of the inefficiency of the tax collection system, especially owing to a large and untaxed informal economy. Given tax reform that effectively increased tax collection, it would be feasible to balance the budget. At the same time, there must be reform of public expenditures to reduce or eliminate some structural imbalances, such as excessively large public service and inordinately high transfers, including pensions and subsidies. Extensive recommendations for tax and expenditure reform are outlined in the WBR, and they deserve careful study and implementation.

Despite its rapid growth, North Cyprus is constrained by significant tax avoidance because of a large underground economy. Lack of clear and effective rules creates high transaction costs, encourages rent seeking, and in general retards economic growth. However, the North Cyprus economy is a young and dynamic economy expanding rapidly to catch up with the wealthier Greek Cypriot economy in the South, and the large budget deficit also reflects the determination of the government to build a viable economy in North Cyprus consistent with EU norms and standards.

At this stage of its development, however, subjected as it is to political isolation and trade embargoes, North Cyprus needs foreign aid and loans, hardly an uncommon feature in developing economies. As shown in Table 1.16, North Cyprus receives aid and loans from Turkey, the only country officially recognizing the TRNC, amounting to about 15 percent of GNP. This may be viewed as the cost of isolation and economic embargoes imposed on North Cyprus. These restrictions prevent the country from direct access to development assistance from international financial institutions or private capital markets, opportunities readily available to other countries.

In view of the strategic importance of North Cyprus to Turkey, there is no reason to expect that Turkish aid will disappear in the future. Nevertheless, it is vital for fiscal sustainability that effective reforms be undertaken toward balancing the budget by improving the efficiency of tax collection (especially by formalizing the informal economy), eliminating wasteful transfers, and reducing of the size of the public sector in relation to the population. Once the tax reform is implemented, there is no reason why, with per capita incomes of over \$15,000, North Cyprus should not achieve long-term sustainability.

TABLE I.15. Balance of Payments.

	(MILLIONS OF US\$)		
	2004	2005 (PROJECTED)	CHANGE (%)
1. Current Accounts			
1.1. External Trade			
1.1.1. Export	62.0	69.0	11.3
1.1.2. Import	853.1	1,200.0	40.7
Trade Balance	-791.1	-1,131.0	43.0
1.2. Invisible Accounts			
1.2.1. Tourism (Net)	288.3	395.4	37.1
1.2.2. Other Invisibles (Net)	488.7	652.5	33.5
Invisible Accounts Balance	777.0	1,047.9	34.9
Current Accounts Balance	-14.1	-83.1	489.4
2. Capital Movements			
2.1. Foreign Aid & Loans by Turkey	175.3	205.6	17.3
2.2. Other Capital Movements (Net)	79.4	101.7	28.1
Capital Movements Balance	254.7	307.3	20.7
Overall Balance	240.6	224.2	-6.8
3. Change in Reserves (-Increase, +Decrease)	-322.0	-215.0	-33.2
4. Net Errors and Omissions	81.4	-9.2	..
Average Foreign Exchange Rate \$: YTL	1.4281	1.3420	-6.0

Source: State Planning Office, 2006 Annual Program, Table 8.

TABLE I.16. Summary of State Budget Balance (in millions of YTL).

	2005		2006		CHANGE		
	CURRENT PRICES	GNP SHARE (%)	REAL 2005 PRICES	GNP SHARE (%)	CURRENT PRICES	REAL (%)	CURRENT (%)
Local Budget Income	994.5	32.8	1043.5	32.3	1095.6	4.9	10.2
Budget Expenses	1495.0	49.3	1545.9	47.6	1623.2	3.4	8.6
Foreign Aid and Loans	500.5	16.5	502.4	15.5	527.5	0.4	5.4

Source: State Planning Office, 2006 Program, Table 17.

Long-term sustainability will depend on two vital issues: (1) prospects of unification in a united Cyprus following a comprehensive settlement with the South, and (2) relations with the EU. Unification is treated throughout the book as the best choice. We now focus attention on relations with the EU.

NORTH CYPRUS—EUROPEAN UNION RELATIONS

Turkish Cypriot relations with the EU started in a climate of open hostility stemming from the unilateral Greek Cypriot application for accession in July 1990 by then-leader George Vasilou. TRNC president Rauf R. Denktaş regarded this application as illegal since the Constitution of 1960 prevented the original Republic of Cyprus from joining any international body in which Turkey and Greece were not members. Two years later the EU reached a favorable decision on the application (Baier-Allen 1999).

For the EU, there is no such entity as North Cyprus, and indeed, the EU differs from the UN in not recognizing that there is a Cyprus problem between Greek and Turkish Cypriots. Thus, the EU has, as a result of Greek pressure, endorsed the Greek Cypriot version of this problem from the beginning. In other words, the EU sees the Cyprus problem as essentially a secessionist movement by a rebellious Turkish Cypriot side and views the division of the island after the military intervention of 1974 as an “anomaly”; it considers the TRNC an “illegal” state under the UN Security Council Resolution of 1983.

At the same time, however, the EU began to see itself as “a catalyst” (Olgun 1999). It initially strongly endorsed the UN peacemaking efforts; it was an active partner in the Annan Plan, declaring on several occasions its preference to welcome a reunited Cyprus into the Union (Emerson and Tocci 2002). It worked very hard for the yes vote in the Referendum of 24 April 2004, making several pledges and promises to Turkish Cypriots who supported the yes side. In particular, it promised to provide financial aid, lift trade embargoes, and end their political isolation if the Turkish Cypriots voted yes.² It was assumed generally by the international community that the Greek Cypriot side would naturally vote yes (Hannay 2005, esp. 168-72), and it was a big disappointment when the then Greek Cypriot president Tassos Papadopoulos and the communist party AKEL joined in a U-turn to defeat the Annan Plan (Hannay 2005, esp. chap. 13).

Was the EU trapped by Greek cunning and blackmail? Or was Brussels a partner in crime, so to speak, aware of a sinister plot to outwit Ankara and the Turkish Cypriots all along? There can be little doubt of insincerity in EU

circles. The promises made to Turkish Cypriots for a yes vote have not been honored, especially the pledges of lifting their economic and political isolation. Thus, the Green Line Regulation (GLR), a police control on internal trade enacted just days after the Referendum, was based, in language and procedures, on the legitimacy of the Greek Cypriot government and the abnormality of North Cyprus. The GLR is nothing other than a nontariff barrier that goes against the very basis of the EU, built as it is on trade liberalization. The GLR regards the territory of North Cyprus as an “area not under the effective control of the Government.” When the EU admitted “Cyprus” as a full member, along with eastern European countries, at a special Athens celebration for the occasion, just six days after the overwhelming *oxi* (no) vote in the South, it was a total and unconditional Greek and Greek Cypriot victory. The latter’s 76 percent *oxi* was overlooked, and indeed it was rewarded with EU membership; in effect, the Greeks in the EU were given a second veto against any possible Turkish accession to the Union. The EU body of laws, *Acquis Communautaire*, was suspended in the North; Greek Cypriot authority was recognized as valid over the whole island; and Papadopoulos declared confidently that the Turkish road for EU membership “passed through Nicosia.”

When the EU, under the British presidency in 2006, finally offered to start accession talks with Turkey, “normalization” of relations between Ankara and Nicosia became a new political condition for opening EU-Turkish negotiations. Great pressure was placed on the Turkish government to extend the “Ankara Protocol” to include the Greek Cypriot-controlled Cyprus government, in effect abandoning Turkish Cypriots. That was something no Turkish government could do. Ankara reaffirmed its offer of simultaneous lifting of all trade restrictions, as promised, on Turkish and Greek Cypriots. The offer fell on deaf ears. The issue of opening Turkish ports to Greek Cypriots escalated into a crisis, and finally the EU once again rewarded the Greek Cypriot side and imposed a partial suspension of membership talks with Ankara. Several anti-Turkey members in the EU, notably France but also Germany and Austria, and more recently Sarkozy’s France, have adopted a pro-Greek Cypriot stance, blocking Turkish accession out of domestic political expediency.

Gradually, however, some improvement took place in Turkish Cypriot–EU relations. After a long delay, the financial aid package was approved and put into implementation through an EU office in North Cyprus.³ The introduction of the euro as the official currency beginning 1 January 2008 applied only in the South, as the North remained entrenched in the Turkish currency zone. While the South is an integral part of the European

monetary union, North Cyprus is similarly strengthening its integration with the Turkish economy.

Nevertheless, hopeful signs also exist as of spring 2009. The force of personalities is now on a more positive footing. February 2008 saw pro-settlement leaders in the North (Mehmet Ali Talat) and South (Demetris Christofias), and there is one last hope that a comprehensive solution of the age-old Cyprus problem may be possible. However, this problem, or rather the mistrust in Cyprus, has deep historical roots, and solutions have appeared close at hand several times in the past, only to end in frustration and bitterness. Whether the Talat-Christofias talks, generally seen as the last-ditch effort, will succeed where all else has failed, only time will tell.

Economic Rationalism and Institution Building

LONG-TERM SUSTAINABILITY requires economic rationality to ensure a productive, well-functioning market economy. Political sustainability is unattainable without a sound economic foundation. If decision makers optimize allocation of resources (both domestic and outside) and manage institutions efficiently, then there will be increasing prosperity, productive employment, and a dynamic balance between incomes and expenditures. Sustainability is ensured. Can North Cyprus achieve sustainability? Yes, because Turkish Cypriots are rational and are quite capable of making optimal decisions.¹ They have demonstrated a remarkable ability over a long period to optimize self-interest. This is especially evident through decades of institution building in North Cyprus, both economic and political.

This chapter is a historical survey of institution building in North Cyprus in accordance with rational behavior theory. However, Turkish Cypriot rationalism is colored by nationalism, an ideology imported from Kemalist Turkey. As a result, institution building in North Cyprus has created not only a market economy but also a national state, imported from modern Turkey, itself the archetype of the national state, constructed by Mustafa Kemal Ataturk in 1923 out of the ruins of the Ottoman Empire. As will be seen, in some stages economic rationalism and nationalism in North Cyprus have clashed, and the apparent contradiction here is part of the historical legacy.

ECONOMIC RATIONALISM

What is optimal and sustainable is what is efficient, productive, and generates a reward or payoff to rational actors. Optimality is grounded in a balancing of interests that creates a win-win outcome in proportion to those

interests. In a multiethnic context, for example, if economic interests are equal, optimality would mean a level playing field with economic parity as the expected outcome. If there is no economic parity between the Turkish and Greek Cypriots, it is difficult to have a just and lasting solution to the Cyprus problem, even with the best constitution or legal guarantees. Inequality in ownership and control of economic assets would imply political and constitutional inequality, posing a threat in a partnership state.

We can define economic parity more precisely as equal per capita income for each and every Cypriot, whether Turk or Greek. In 1960, when the partnership republic was established, it was not optimal for the two ethnic communities in Cyprus because the equilibrium the republic represented matched external interests more than the internal distribution of economic assets in the island. The 1960 republic was unsustainable because the Turkish Cypriots' share of the economy was a mere 5 percent in contrast to about 20 percent of the population and 30 percent of the constitutional power. Economic facts on the ground simply did not match the demographic landscape and the constitutional power sharing.

By 2005, the Turkish Cypriot share of the island economy had doubled to about 10-12 percent, which means the economic disparity is approximately 10:1 in favor of the Greek Cypriots. Under economic parity, the Turkish Cypriot share of income would be equal to its population share, that is, 25 to 30 percent. With identical per capita incomes, there would be equal tax burdens and balanced budgeting without Greek Cypriots having to subsidize Turkish Cypriots in a new partnership state. Only then would there be the economic equality to make political equality a reality in a new partnership state, one that would be workable and lasting, that is to say, optimal.

Unfortunately, economic rationalism in ethnic conflict—the balancing of the costs and benefits of ethnic conflict from the perspective of economic self-interest, or trading gains and losses objectively (for example, land for power sharing)—has not been much utilized in the Cyprus conflict. This conflict has been dominated by lawyers, legal experts, and political scientists. While lawyers look for the magic wand in constitution making, political scientists dwell on the politics of identity and ethnicity. Seeing the Cyprus conflict exclusively as a contest of ethnonationalism (or as a case of competing national states) is counterproductive. The nationalist rivalry produces an unfortunate bias because the economic rationalism of balancing mutual gains is subordinated to divisive emotionalism nurtured by hatred and hostility. In this negative environment new states are not born, they die.

For example, political scientist Niyazi Kizilyurek (2005) attributes the death of the unborn United Republic of Cyprus to the lack of a common

ethnic identity in Cyprus. He argues that both ethnic communities in the island prefer, for historical reasons, to identify themselves externally. The Greek Cypriots yearn for enosis, union with Greece, basing this on an idealistic construction of a common cultural and religious identity with the wider Hellenism. The Turkish Cypriots, similarly, feel by blood and racial ties to be part of the Anatolian Turkish identity, rejecting “Cypriotness” as an artificial construct.

Kizilyurek’s argument is persuasive and is in line with popular sentiment. In an age of ethnonationalism, these arguments carry weight, especially among proponents of the nation-state. Even in Europe, and the West generally, after a decade of technologically driven globalization, it seems that nationalism is resurgent, and so Kizilyurek’s views appear also to be consistent with global trends.

However, the argument is no more than half the truth. It is an emotional and subjective argument. As such, Kizilyurek’s reasoning misses the rational roots of ethnic separatism in Cyprus.

Ethnic separatism in Cyprus stems from objective, rational factors, not the politics of personality.² In particular, on the Turkish Cypriot side a major factor for separatism lies in economic vulnerability. The fear of economic insecurity via domination by the more powerful Greek Cypriots has always driven the desire of Turkish Cypriots to be masters of their own destiny. Kizilyurek is not unaware of these economic factors, but he chooses to ignore them, focusing exclusively on subjective and emotional explanations. In the process, his otherwise impressive study tends to be polemical, blaming leaders and political figures for subjective reasons.

The Turkish Cypriot “insecurity” manifested itself, at least at the outset, in negative terms, that is, in the desire to lessen or remove the economic disadvantage relative to the economically more powerful Greek Cypriot side. How and why institution building was chosen is not always easy to discover, but what is clear is that in almost all cases, institutional innovation was a response to Greek Cypriot domination played out in a generally hostile British environment. Interestingly enough, political institution building came later, well after the mobilization of elites and the grass roots for financial, social, and economic institutions.

Institution building is a complex and difficult process, time-consuming and patient work. It demands considerable voluntarism and committed leaders and is driven by rationalism and nationalism. North Cyprus finally emerged as a nation after 1974 thanks to the solid institution building that had been going on since the early part of the twentieth century. Without these institutions, there was little hope of surviving the devastating

TABLE 2.1. Institution Building in North Cyprus, by Approximate Date of Establishment.

INSTITUTION	DATE
Control of Evkaf	1950s
Banking	1901
Cooperatives	1950s
Trade unions	1920s
Chamber of Commerce	1958
National Party, FTTT campaign	1950s

embargoes imposed by the ultranationalist regime of Archbishop Makarios III on the Turkish Cypriots, whose only sin was to refuse the archbishop's constitutional amendments, designed to reduce them to second-class citizens. Table 2.1 summarizes the institution building in North Cyprus surveyed here.

Turkish Cypriot institution building did not occur in a vacuum. It paralleled similar developments among Greek Cypriots. Indeed, many of the Turkish Cypriot institutions in the prewar era had started jointly at the outset, but ethnonationalism, primarily on the part of the Greek Cypriots, caused ethnic separation, in some cases well before the EOKA violence that erupted in the mid-1950s. For this reason, and to the extent that such ethnonationalism still dominates today, economic rationalism may lead not to the best choice but to the second-best solution in Cyprus. Thus, if the Greek Cypriots objectively determine that it is preferable to have two states in Cyprus rather than share power equally in a federal system such as the United Republic of Cyprus (URC),³ then mutual self-interest may lead to a peaceful divorce (as in the former Czechoslovakia). That, however, is a long way off because economic rationalism deserves to be given a chance to promote a solution.

In the context of the Cyprus issue, economic rationalism suggests it is in the interest of everyone, Cypriots and interested outside parties, to seek an optimal solution on the basis of land for power sharing. The Greek Cypriots want land, now controlled by Turkish Cypriots, who, in principle, are willing to trade it for political and economic empowerment in a new partnership state with the Greek Cypriots. This, in turn, requires eliminating the existing economic and political disadvantages of the Turkish Cypriots as quickly as possible. In this sense, embargoes on North Cyprus hurt the Greek Cypriots no less than the Turkish Cypriots. The longer the Turkish Cypriots suffer losses from political isolation and economic barriers to free

trade, the longer it will take to achieve economic parity and, hence, to attain a stable and lasting settlement of the Cyprus problem. It is far more rational instead to help overcome the historic “insecurity” of Turkish Cypriots by bolstering their economic, social, and political institutions within a United Republic of Cyprus and to actively promote the achievement, as soon as possible, of economic parity between the island’s two ethnic groups.

A historical appreciation of the Turkish Cypriot institutions that are critical in their economic development is essential, and we now focus attention on how these institutions came about in the first place. As a background, however, it is instructive to examine the long and divisive struggle over the control of British Evkaf, the Islamic trust organization, that was very much regarded as the symbol of Turkish Cypriot underdevelopment during the 1950s.

TURKISH CYPRIOT ECONOMIC UNDERDEVELOPMENT: THE BITTER FIGHT OVER BRITISH EVKAF

Let us start with two quotations to document Turkish Cypriot economic insecurity, one from an official document in 1963 and the second from a recent survey of Turkish Cypriot university students in 2002. The first one, quoted by Kizilyurek (2005:43), is a document drafted by the Turkish Cypriot leadership in the early 1960s, bemoaning the structural weakness of the Turkish Cypriot economy at the start of the independent Republic of Cyprus (ROC 1960), established under the London-Zurich Agreements. It points out, in several paragraphs, that “under this (ROC 1960) regime, the already weak Turkish Cypriot economy is condemned to gradually erode away.... Lack of financial resources and economic constraints are so grave that our separate community status (entrenched in ROC 1960) is bound to be obliterated within a very short space of time.”

The second quotation is from a survey of Turkish Cypriot university students in the period leading up to the referendum on the Annan Plan (Mehmet and Mehmet 2004:307). It must be noted that these students were generally pro-reunification in Cyprus on the basis of the Annan Plan. This particular student was pessimistic about the consequences of reunification: “They [Greek Cypriots] will ultimately kill us slowly, not by war, but through their economic power. If they take this area [Famagusta], they won’t let us live here.”

What are the roots of this economic insecurity? They lie in the history of British colonialism, 1878-1960. When the British took over the island from

the Ottomans, Turkish Cypriot identity was Muslim. Parallel with the decline and death of the Ottoman Empire, the “Sick Man of Europe,” Turkish Cypriots were expected to wither away from neglect and underdevelopment, the British more or less facilitating the enosis aspirations of the fellow Christian (Greek Cypriot) millet on the island. The Turkish Cypriots, however, refused to die, reawakened by Turkish nationalism shaped by Mustafa Kemal Atatürk, and they used nationalism for economic and social development. As we see below, they were successful in this venture to a remarkable extent, despite serious internal and external obstacles.

The real origins of the economic and political awakening of the Turkish Cypriots lie in the British colonial policy of “divide and rule.” This awakening was not easy; it occasioned a long and bitter fight among the elites of the time, involving Dr. Fazıl Kucuk, İhsan Ali,⁴ Necati Özkan, and others (Ali 1978). Until the 1930s, British colonialism in Cyprus was generally pro-Christian. In the postwar period, and especially after the Greek Cypriots resorted to violence and terror (e.g., in 1931 and after Makarios and Colonel Georgios Grivas planned and launched EOKA),⁵ British colonial policy became more sympathetic to the economic and social plight of the Turkish Cypriots. This sympathy, however, was always subordinate to overriding British interests. British interests often clashed with Turkish Cypriot aspirations, and the Turkish Cypriots fought hard for every concession, as demonstrated by struggles in the 1940s and 1950s over the wresting of the Muslim Endowment Organization, *Evkaf*, from colonial control; securing the independence of the chief religious officer, or *muftu*; enacting Kemalist reforms in education and civil marriage; and replacing polygamy with modern family law.⁶ Turkish Cypriots, from the very outset, responded to Kemalist reforms wholeheartedly, sometimes implementing them ahead of the mainlanders (see Tahiroğlu 2002).

The first major colonial initiative for Turkish Cypriots, launched in 1943, was the sponsorship and support of an ethnic organization in Lefkosa, KATAK (Kıbrıs Adası Türk Azınlık Kurumu; Turkish Minority Association of the Island of Cyprus), which established a network of Turkish organizations in the cities and towns of the island to articulate the educational, cultural, and social problems of the community. KATAK sparked a fierce leadership struggle involving such figures as Necati Özkan, İhsan Ali, and Faiz Kaymak, each espousing a different vision of economic and social development. Finally, after intense in-fighting that lasted well into the 1950s, the nationalists, dedicated to Kemalist principles⁷ and led by the popular, chain-smoking, Swiss-trained physician Dr. Fazıl Kucuk,⁸ editor of the influential daily *Halkın Sesi*, carried the day. Kucuk prevailed over not only

his secular opponents but also the Islamist Sheik Nazim, who argued for Islamic rather than national/secular salvation as the development path for Turkish Cypriots.

A major colonial initiative took place in 1948, when the Commission on Turkish Cypriot Affairs was established by the colonial administration. It was ably led by Justice Mehmet Zeka⁹ and vigorously supported by the young British-trained lawyer Rauf R. Denктаş, who was destined to have a decisive role in the evolution of the Cyprus problem. The commission worked diligently, traveling all over the island, collecting evidence, and documenting in pitiful detail the lack of basic human services for the Turkish Cypriots, including education, health, and welfare. It produced an influential report.

One of the chief concerns of the commission was the reform of Evkaf, the single biggest landowning organization in the Turkish Cypriot community. It had huge revenues from rents and farm income that were collected in trust and intended for religious and social charitable expenses, principally mosques, schools, and hospitals, for the benefit of the Turkish Cypriot community, in memory of the pious donors who set up trusts and bequests, called *vakf*, in accordance with the fifth pillar of Islam. Colonial rule frustrated the intent of the deceased while also frustrating the economic and social development of the Turkish community.¹⁰ At that time Evkaf was under British colonial control, though nominally administered by Turkish Cypriots, such as Sir Mehmet Munir, appointed to serve not the community but the colonial masters. For his loyal service, he was titled by the British monarch.

British Evkaf¹¹ was managed in total disregard of Turkish Cypriot interest. Revenues benefited the British first and foremost. Trust lands ended up in Greek Cypriot hands, in violation of the sacred Muslim law of trusts and endowments. In the end, at the time of the 1960 London-Zurich Agreements, the British were obliged to acknowledge the wrongs committed by British Evkaf, and the governor of Cyprus, Sir Hugh Foot, wrote a letter to Fazil Kucuk and Rauf R. Denктаş, informing them “that the Government of the United Kingdom of Great Britain and Northern Ireland have decided to make available the sum of 1,500,000 lira by way of grant to the Turkish community.”¹² Although this grant exempted the British from further claims by Turkish Cypriots, it was merely financial aid, not compensation. It did not extinguish Evkaf’s right to claim land that fraudulently ended up in Greek Cypriot hands, such as Maras, which was, and may still be, *vakfland*.

British Evkaf was profitable though ill-administered. It generated surplus revenue that served British interests as part of a deflationary monetary

policy intended to extract surplus from colonies.¹³ During 1938-48, for instance, Evkaf expenditure was kept to a minimum while increasing annual revenues were transferred to accumulate at the British-controlled Osmanli Bank,¹⁴ at zero percent interest.¹⁵ Meanwhile, clerics on the payroll of Evkaf were underpaid, and the Turkish Cypriots suffered from lack of schooling, hospital care, and social services. Ahmet Mithat Berberoglu, a young attorney at the time, expressed the sentiment of his generation: “a [colonial] administration [of Evkaf] that denies the entitlement of the Turkish [Cypriot] community is contrary to the principles of justice and fairness.”¹⁶

Although the commission recommended immediate transfer of Evkaf’s control to the Turkish Cypriot community to finance its economic and social development, this was achieved only in 1956 and only after intense, often bitter struggles against colonial administrators.¹⁷ This struggle, in an unintended way, helped to galvanize the Turkish community around Kemalist nationalism, greatly assisting the emerging leadership of Dr. Fazil Kucuk and Rauf R. Denктаş.

THE ESTABLISHMENT OF THE TURKISH BANK

Turkish Cypriots have long been aware of the importance of economic and financial institutions in their struggle to control their own destiny. At every stage, leaders and progressive-minded figures emerged to launch pioneering institutions for the economic development of the community.

A notable case in point is the creation of the Turkish Bank in 1901, when Ottoman influence prevailed, the Kemalist Revolution was yet to be born, and Islamic values dominated.¹⁸ This case is significant because no economy can be put on a sustainable footing without banking and financial institutions to provide credit and finance for growth and expansion.

In keeping with the values and customs of the day, the original name of the Turkish Bank was something quite different. It was the Muslim Savings Chest of Nicosia, a remarkable initiative of progressive businessmen of the day, led by the reform-minded mufti Hafız Ziyai Efendi. The idea was to raise, by a modest subscription of one shilling per person, a reserve fund to provide loans to traders and businessmen as a means of improving the Turkish Cypriot economy, dominated at the time by small-scale trading. It functioned on a largely voluntary self-help basis until 1922. During this time the colonial government attempted to merge the Chest into a single colonial banking institution called the Bank of Cyprus. It was to include the senior bank at the time, the Imperial Ottoman Bank (a British institution despite its name), the Bank of Athens branch in Limassol, and the newly formed

Greek Cypriot cooperative saving banks (Jenness 1962:169). The colonial attempt was successfully resisted, and the Chest retained its autonomy and Turkish Cypriot character.

In 1922 the colonial administration introduced a new limited companies law. As a result, in 1925 the Chest was registered under a new name, the Muslim Savings Bank of Nicosia, and it expanded its working capital by issuing shares with a par value of five pounds. It continued to expand as the import and export trade grew, but after the Wall Street crash in 1929, Cyprus suffered a major economic dislocation along with the rest of the world. Despite this setback, the Muslim Savings Bank of Nicosia continued operations. In 1938 an important step toward modern banking was taken with the dispatch of manager-designate Ibrahim Orhan to a practical training course at the Is Bank in Istanbul.

During the Second World War the colonial government attempted to consolidate four small banks in the island under one name, the Bank of Cyprus, which, of course, would become a Greek Cypriot-dominated bank. The proposal was, therefore, rejected by the Turkish Bank, and the colonial authorities were obliged to respect its mission of serving the Turkish Cypriot community. In 1943 the bank took the more appropriate name of the Turkish Bank of Nicosia Ltd, with an expanded capital of 80,000 pounds and authorization to undertake all types of banking services. But the Turkish Bank was small compared with the amalgamated Greek Cypriot banks under the name Bank of Cyprus Ltd, which was financially supported not only by the Greek Orthodox Church but also by Greek Cypriot businessmen, including those living and working overseas.

Until 1955 the Turkish Bank concentrated its banking on financial intermediation for the relatively small Turkish Cypriot trade sector, typically providing letters of credit and short-term lending for import-export businesses. The loan business for housing and education also expanded. As the volume of banking grew, the bank's capital expanded, reaching 200,000 pounds, and for the first time, branches were opened in Famagusta, Larnaca, Limassol, and Paphos. After the start of the EOKA violence, the separation of economies became more and more obvious and the bank's role reflected this new reality. The most difficult times were the decade of embargoes and blockade beginning in 1963. But even then the bank managed not only to survive but to grow. For example, connections between the Turkish Cypriot businessmen on the island and those in London expanded, and accordingly, the bank opened its first overseas branch in England in 1974 and one in Istanbul in 1982.

Thus, from its humble beginnings slightly more than a century ago, the Turkish Bank Ltd has become a success story. It is a highly profitable,

multinational bank with headquarters in Nicosia. In keeping with the dynamics of modern, global banking, it has had to transform itself to adjust to growth and competition in a constantly changing world. Its success is also a testimony to the ability of Turkish Cypriots to create and manage financial institutions through difficult times

THE ORIGINS OF THE COOPERATIVE MOVEMENT IN NORTH CYPRUS

In most cases of institution building in colonial Cyprus, at the beginning there was unified (intercommunal) establishment, with Greek and Turkish Cypriots participating in the same initiative. This is true for the cooperative movement, for trade unions, and for municipalities. Ethnic separation of these institutions owes its origin to the EOKA violence of the 1950s.¹⁹ In other words, the creation of separate economies in Cyprus is the direct result of Greek Cypriot ultranationalism, especially when it took a drastic turn toward violence and, in the process, forced the two communities to break apart.

The cooperative movement in Cyprus is one of the most successful cases in the world, owing to its inherent democratic organization and operation (Mehmet 1986b). Originally, the cooperatives were able to function efficiently at zero profit, returning operating surplus revenues to farmer-members, who thus were rewarded for their support and membership. In Africa and elsewhere in developing countries, cooperatives failed, generally because corrupt leaders in charge simply pocketed surplus revenues rather than reward the farmer-members.

Cypriot cooperatives emerged out of the severe indebtedness of farmers and rural communities, as result of the world economic depression in the aftermath of the stock market crash of 1929. Both Greek and Turkish communities suffered badly, especially vine growers in the Limassol and Paphos districts,²⁰ and it is to the credit of the British colonial administrators that they worked diligently to introduce the Rochdale principles of the British cooperative movement to the island. Small savings and credit unions enabled farmers in particular to practice self-help through microcredit, providing finance for agricultural producers. The growth of export-oriented agriculture, especially in potatoes and citrus fruits, owes its success to the cooperative movement.

The cooperative experiment worked well in Cyprus in the 1940s and 1950s, thanks to the dedication of men such as Ragib Kenan and his co-workers. As a small boy growing up in the village of Minareli Koy, I remember vividly the introduction of savings to us primary schoolchildren, one or

two piasters at a time, in thrift boxes donated to us for the purpose through the good offices of men such as Ragib Kenan.

Mehmet Hasguler (1996:20), who has written comprehensively about cooperatives in Cyprus, notes that originally Turkish and Greek cooperatives were “under one roof.” In 1959, however, under the Zurich-London Agreements and in accordance with constitutional provisions, the basic law of cooperatives was amended to provide for ethnic separation.

The Turkish Cypriot Cooperative movement began very modestly in poultry farming, thanks to Kenan’s personal dynamism, but it expanded rapidly in urban and rural areas. Initially, it was limited to encouraging thrift through credit unions, but soon it grew into producer cooperatives for farmers, building on the accomplishments of the Turkish Cypriot Farmer Organizations started a decade earlier by Mehmet Kemal Deniz (Demiryurek 2005). Its rapid growth is testimony to the economic rationalism of the Turkish Cypriot community, reflecting the fact that, given good management, peasants and workers alike respond positively to incentives.

Subsequently, the cooperative movement expanded into the growth of consumer cooperatives. Thus, according to Hasguler (1996), in 1959 there were a total of 196 cooperatives of various types, the majority (129) being credit unions. A person could become a member by buying a single share at a nominal fee of one or two shillings. By 1974, despite severe economic embargoes imposed by the Makarios regime on the Turkish Cypriots, the number of cooperatives had risen to 347, increasing to 412 by 1985 (Hasguler 1996:22-23). Part of this growth was the result of statism, or more specifically the state monopoly system, then much in vogue in North Cyprus. Over time, and with the proliferation of market competition, consumer cooperatives, such as PEYAK, became increasingly inefficient owing to excess staffing and stiff price competition from private firms. PEYAK was obliged to close down in 1999 after accumulating huge operating losses.

Overall, the cooperative movement among Turkish Cypriots is a success story. What started as a social movement to encourage thrift and rural microcredit more than fifty years ago has resulted in some of the biggest and most successful banks, notably the Limassol Cooperative Bank, AS Bank, and Central Cooperative Bank, now operating as fully fledged banks playing vital roles in the economic development of North Cyprus.

THE TURKISH CYPRIOT TRADE UNION MOVEMENT

At the beginning, economic rationalism created solidarity among the Turkish and Greek Cypriot workers of the island. Commonality of interest

emerged out of trade unionism, which is almost a century old in what was colonial Cyprus. Its origins go back to the copper mining of the American-owned Cyprus Mining Corporation (CMC) in the 1920s. CMC later expanded into the colonial railway system, which operated from 1905 to 1951, and the manufacturing and industrial sectors.

In early trade unionism, worker solidarity trumped ethnicity. Thus, Turkish Cypriots joined forces with Greek Cypriot workers for a common cause, fighting and striking together for better wages and working conditions. They labored together in unsafe workplaces and died together: for example, eight Turkish Cypriot miners and three Greek Cypriots perished in a landslide in the Karadag mine, causing the first strike of CMC, by some two thousand workers in 1936.²¹

Joint unionism, however, did not last long. The primary reason was the enosis campaign of the Greek Cypriots, which accelerated toward end of the Second World War (Vamaya 1997:17). Although some Turkish Cypriots remained dues-paying members of the right-wing PEO, and a few stayed with the Communist AKEL, in 1942 a new Turkish Workers Union was established, under the leadership of Niyazi Dagli, when a group of twelve carpenters left the joint union in protest of the enosis declaration made by the Greek Cypriot union leaders. This marked the start of ethnic separation in the labor movement in Cyprus. Two years later, and from same motivation, hundreds of Turkish Cypriots left PEO and joined forces with thirteen other Turkish workers' unions from all the major cities of the island, establishing on 1 August 1945 a federation of Turkish Cypriot Workers (An 2005:12-13). It immediately won the support of Dr. Fazil Kucuk, chairman of the National Party and publisher of the influential daily *Halkin Sesi* (*People's Voice*). The movement was also endorsed strongly by Mehmet Kemal Deniz, secretary-general of the Association of Turkish Cypriot Farmers and publisher of the daily *Ates* (*Fire*), dedicated to the economic progress of Turkish Cypriot artisans, workers, and farmers, whom Deniz regarded as the backbone of the community (Demiryurek 2005:86-93).

The ethnic separation of the labor movement became inflamed as the enosis campaign intensified. Thus, in the AKEL Congress of 18-20 August 1945, enosis was the first item on the agenda (An 2005:17), reflecting the co-optation of the Greek Cypriot labor movement by the ultranationalists. In 1955 the EOKA campaign of terror and violence began, and as the violence turned increasingly intercommunal and first Volkan and later the TMT (Turkish Resistance Movement) evolved to resist EOKA attacks on Turkish Cypriots, the Turkish Cypriot labor movement began to show signs of disunity. While the majority remained steadfast in solidarity with the

nationalist leadership, for some Turkish Cypriot workers economic interest prevailed; AKEL attempted to take advantage of this division by establishing a Turkish wing for its political action (An 2005:91-92). By 1959-60, however, it was clear that ethnic separation had become an accomplished fact enshrined in the 1960 London-Zurich Agreements and the 1960 Constitution of the new republic.

The Partnership Republic met the aspirations of a handful of idealists. Some activists on the left, notably Hasmet Gurkan and Ayhan Hikmet, championed social justice and labor rights after the establishment of the republic (An 2005:145), while political dissidents such as Dr. Ihsan Ali from Paphos preached the unrealistic idea of a common Cypriot identity. The partnership republic, however, was doomed. It did not last three full years and died a victim of the Akritas Plan, launched on Christmas 1963. Thereafter, the labor movement in the Greek Cypriot community, in particular AKEL, became an increasingly political actor, assuming a kingmaker role in the Greek Cypriot presidential elections. On the Turkish Cypriot side, the movement adjusted to going it alone and gained strength as the voice of Turkish Cypriot workers in the North, playing a crucial role in the victory of the CTP (the Republican Turkish Party), which ultimately came to power in 2004, staying on until its defeat in April 2009.

Political awakening in North Cyprus came rather late, well after the creation of economic and social institutions. Political development was actually a postwar phenomenon, but when it emerged it was comprehensive, covering all groups of Turkish Cypriots—workers, farmers, and villagers as well as urban elites. Much of the political development was inspired by leaders such as Dr. Fazil Kucuk and Rauf Denктаş. Their nationalism was a direct response to the increasing threat of Greek ethnonationalism, but indirectly it was also encouraged and supported, despite colonial obstacles, by Ankara, the seat of Turkish national ideology.

THE “FROM TURK TO TURK” CAMPAIGN

“From Turk to Turk” (FTTT; or “Turkish Self-Reliance”) was one of the earliest mass mobilization movements for the economic empowerment of the Turkish Cypriot community. It was organized in 1958, shortly after Denктаş’s resignation as assistant attorney in the colonial government to start full-time political activity, heading the newly created Federation of Turkish Cypriot Organizations. At the same time, the colonial administration encouraged the separation of municipalities in major cities in response to growing EOKA terrorism.²² By 1956-57, EOKA had turned increasingly

against the Turkish Cypriots, thus initiating intercommunal strife. In response, not wishing to stay defenseless against EOKA attacks, the Turkish Cypriots created Volkan, which was later replaced by the better-organized TMT (Gazioglu 2000:5-17; Drusotis 2005: 210-13).

The FTTT campaign was an idealistic program of modernization and economic self-reliance that under normal times would most likely have failed. It succeeded, as we see below, primarily because of EOKA violence, for nothing galvanizes a vulnerable community so much as a common threat. The campaign had limited funds and overambitious aims. It sought to modernize the status of women by promoting European dress in place of the old Muslim headwear (decades ahead of Turkey), and it encouraged the use of Turkish words rather than a mixture of Greek and Turkish, imposing a small monetary penalty for infractions, which was generally disliked. The campaign was led by the nationalist youth movement, which had limited experience. Denktaş actively supported the movement, comparing it with the Israeli model of an economic miracle in the Sinai desert at the time (Gazioglu 2000:168-69).

FTTT's greatest impact was in the development of a parallel, separate Turkish Cypriot economy. Most likely it would gradually have withered away had it not been for the EOKA reign of terror, which led to ethnic separation. Turkish Cypriots in cities and villages were pushed by this terror toward self-reliance far more powerfully than they were pulled by the ideology of their leaders to actively support the new Turkish Cypriot trade and industry. Within a short time, new enterprises emerged, typically small-scale, ranging from the manufacture of cigarettes, cheese, bread, textiles, and soft drinks to small business development. Until then there was a single market, and the Turkish Cypriot consumers did their shopping in Greek Cypriot stores. The few Turkish Cypriot traders usually bought wholesale from the larger Greek Cypriot businesses and retailed at cost plus a commission, resulting in uncompetitive prices. In short, these were dependent businesses that had no long-term viability. Left untouched, they could not have survived. What ensured their survival was the EOKA violence, not market forces. In other words, the ethnic division of what had been, until that point, a single market dominated by Greek Cypriots was the direct result of EOKA.

Of course, finance played a critical role in the emergence of a separate Turkish Cypriot market. In particular, the cooperative and the Turkish banks provided commercial credit, as did the newly Turkish Cypriot-controlled Evkaf. Investment funds and technical assistance also came from Turkey (Gazioglu 2000:165-79), which opened branch banks on the island.

Within a short time, and thanks to the growth of Turkish Cypriot trade and industry, the FTTT was followed by the establishment of a Turkish Cypriot Chamber of Commerce (see below), a movement initiated by the well-known bookseller Kemal Rustem.

The FTTT was not without its critics. Dr. Ihsan Ali, the physician from Paphos who believed in a single Cypriot state under Greek Cypriot hegemony and was a close confidant of Makarios, condemned the boycotting of Greek Cypriot stores and argued that the only impact of the FTTT was to make a few Turkish Cypriot businessmen rich (Ali 1978:20). Kizilyurek (2005:72), years later, believed that the FTTT was designed to promote *taksim* (partition) and that it marked the start of ethnic division in Cyprus. These views are not supported by the actual chain of events.

The FTTT campaign was a defensive strategy, not proactive, shaped primarily by increasing intercommunal violence initiated by the Greek Cypriot leadership. Political agendas such as *taksim* (first proposed by the British) came in response to EOKA's *enosis* campaign. It is doubtful if the FTTT would ever have been launched but for EOKA terror in the name of *enosis*. As such, it marked a watershed in the creation of two economies in Cyprus. The driver in this economic separation was the EOKA violence. For, in an atmosphere of terror and violence increasingly directed at the Turkish Cypriots, how could business carry on as usual? In other words, economic necessity, rather than some Turkish or British hidden plan, ignited and nurtured economic separation on the island in the final years of colonialism.

The growing economic and ethnic separation did not, of course, bode well for the post-1960 independence and the partnership republic born out of the London-Zurich Agreements. The new constitution had no option but to acknowledge and indeed augment the economic and political separation that had been growing since 1955, when the EOKA terror started. The separation of municipalities as well as ethnic quotas were now entrenched in the constitution. But this did not stop Makarios, now president, from trying to undo the separation, culminating on 29 November 1963 in his thirteen-point proposal (Clerides 1989:1:176-93) to Dr. Kucuk, the vice-president, for the wholesale constitutional abolition of all Turkish Cypriot rights in favor of a unified state under Greek Cypriot hegemony.

THE CREATION OF THE TURKISH CYPRIOT CHAMBER OF COMMERCE

Traditionally, Turkish Cypriots had a disdain for private business. In the Ottoman period they preferred landowning and farming. Trade and commerce on the island was controlled by foreigners in association with Greek

Cypriots and Armenians (Jeness 1962). In this sense, Ottoman Cyprus mirrored the economic domination of non-Muslim millets across the entire Ottoman Empire. During British rule, as the numbers of qualified Turkish Cypriots expanded, they looked for government jobs, since even a lowly clerical job in the colonial bureaucracy was held in higher esteem than a career in business (Deniz in Demiryurek 2005:97-98). After 1946 this traditional attitude began to change, but as we have seen, the real push for commercial development among the Turkish Cypriots was the EOKA terror campaign.

By 1958, when the From Turk to Turk campaign was launched, there were enough Turkish Cypriot firms and businesses that it was felt necessary to organize them under one roof. This led to the establishment in December 1958 of the Turkish Cypriot Chamber of Commerce (TCCC). The move was led by bookseller Kemal Rustem, actively supported by the leadership of Kucuk and Denктаş. Rustem became TCCC's first president.

Initially, there was opposition to the TCCC from the colonial administration about what was perceived as the economic separation of the two communities. However, the intensifying EOKA violence made the evolution of two separate ethnic markets as well as separate municipalities in Cyprus inevitable. Of course, the leadership of Kucuk and Denктаş played a vital role as well. By April 1959, Governor Sir Hugh Foot and colonial undersecretary John Reddaway adopted a more constructive attitude toward the formal recognition of the new Turkish Cypriot Chamber of Commerce. The colonial government was encouraged in this direction by the positive reports of political rapprochement between the Turkish and Greek governments, which finally resulted in the London-Zurich Agreements and independence in 1960. On 14 May 1959 Reddaway informed Rustem and his associates of the formal registration of the Turkish Chamber of Commerce by the colonial government (Gazioglu 2000:179-80). This move was vigorously opposed by Greek Cypriot political figures and the Greek Cypriot press on the grounds that it was economic taksim (Gazioglu 2000:180).

The new Chamber of Commerce quickly appealed to and was granted technical support from the Turkish government. Shortly after its establishment, a technical delegation came from the Turkish Chambers of Commerce and prepared a report for the Turkish Ministry of Commerce, recommending a number of actions to be launched by the Turkish government in support of the economic development of the Turkish Cypriots: (1) more frequent shipping from Turkey to Cyprus in order to expand the import-export business; (2) investment in industrial projects benefiting the Turkish Cypriot economy, (3) provision of credit at low interest to boost Turkish

Cypriot enterprise, and (4) provision of housing credit in order to expand real estate development among Turkish Cypriots (Gazioglu 2000:189-90).

By this time, the London-Zurich Agreements had become a reality, and an important level of political and economic separation in Cyprus had been entrenched in the new constitution. Thus, separate municipalities, communal chambers, voting rights, and veto powers were part of the constitution. Makarios was obliged to swallow these hard pills as part of the independence package, giving up enosis, only because rejection would bring about partition (Drusotis 2005:chap. 8). But shortly after independence, he changed course once again and worked to negate Turkish Cypriot rights, implementing the genocidal Akritas Plan to exterminate the Turkish Cypriots. In the ensuing civil war during the decade of 1964-74, the Makarios regime imposed a system of economic embargoes on the Turkish Cypriots, a policy that had the effect of creating a totally separate Turkish Cypriot market. Thus, Makarios unwittingly contributed to the economic self-reliance of the Turkish Cypriot community. At the same time, sheer necessity helped Turkish Cypriot businesses to grow in number and experience, and as they progressed, so did the Turkish Chamber of Commerce.

THE FREE-ENTERPRISE MODEL VERSUS TURKISH STATISM

In the early 1960s Turkish Cypriot economic thinking was dominated by two opposing schools of thought: the free-enterprise economics of Adam Smith, espoused by a small group of economists educated in England, and a much larger group of returning graduates from Turkey schooled on statism, then the dominant economic philosophy in Turkey. The former group, which included Ozalp Sarica, Nail Asaf, and myself,²³ collectively believed that the development budget of the new partnership republic could be used for the economic development of Turkish Cypriots. Sarica concentrated on monetary policy, Asaf worked on project preparation, and I focused on manpower planning and educational reform to increase the quantity and quality of skilled and educated Turkish Cypriots to work with Greek Cypriots in the public and private sectors for the common good.

By contrast, graduates who returned from studies in Turkey were generally in favor of state intervention and public control of the economy, trying to establish state monopolies and bureaucratic control of new and feeble enterprises. In the 1960s, and especially in the aftermath of the first military coup, which installed Ismet Inonu in power, Turkey adopted statism in a vigorous way, creating a new and powerful State Planning Organization in charge of comprehensive economic planning. SPO sent personnel and

missions to Cyprus to spearhead similar action there. These statist views found fertile ground in the Turkish Cypriot Communal Chamber, headed by Denктаş, who was actively supported by lawyers and physicians, such as Burhan Nalbantoglu, almost all educated in Turkey. Subsequently, during 1964-67, Denктаş was in exile in Ankara at the very height of statism.²⁴ Turkish financial aid was modeled and channeled to Turkish Cypriots to institutionalize statism within a top-heavy, uncompetitive, and centralized framework (Plumer 2008).

Much of the Turkish aid in the years following Turkish military intervention in 1974 was used to build an uncompetitive statist model in North Cyprus, especially with the establishment in the late 1960s of ETI (Endustri, Ticaret ve Isletmecilik) as a state monopoly, directed by Sarica. The free-enterprise model lost out, and some British-trained economists in fact played key roles in the implementation of statism in 1970s and 1980s. Statism was further strengthened with the creation in the late 1960s of the Turkish Cypriot SPO. As in Turkey, statism created state monopolies, and bureaucrats became businessmen. In 1976 the strong Cyprus pound was replaced by the weak and inflation-prone Turkish lira at a fixed exchange of 36 TL = 1 CYP, resulting in great losses for small savers and depositors and capital gains for influential figures. A top-heavy bureaucracy was built, rent-seeking behavior was encouraged,²⁵ and private sector development was delayed. The oversized and overpaid bureaucracy, costly social transfers, and subsidy programs of today are the legacy of this period and philosophy.

Even more unfortunate was the dominance of lawyers and physicians in charge of the economic vision of the Turkish Cypriots. It must be said, however, that the Turkish Cypriot community has been fortunate in producing several first-rate lawyers, not only in Rauf Denктаş but also such notables as Osman Orek, Munir Ertekun (Ertekun 1984), and Zaim Necatigil (Necatigil 1993). Yet the legal mindset is fundamentally at variance with economic rationalism.²⁶ Whereas the economist seeks paths for ethnic conflict resolution through trade-offs and balancing of interests, working with budgets and economic power sharing, the lawyer uses persuasive legal arguments and precedents to seek a win-lose (or zero-sum) outcome. In other words, in the legal approach there is no room for compromise, whereas the economist believes that without concessions no settlement is possible.

The lawyers have dominated the Turkish Cypriot case against the Greek Cypriot quest for enosis. The "national cause" (*milli dava*) was defined primarily, or almost entirely, in legalistic terms, as a legal claim. It was defended by the leadership on the grounds of justice, and it was argued in the world court of public opinion as a sacred cause. Thus, the emphasis from the

outset was placed on legal arguments, crafted and led by lawyers, assisted by historians. Legal arguments and historical evidence fed a public relations campaign at home and abroad in which reporters, especially foreign, became the critical intermediaries intended to win world public opinion over to the “national cause.”

The negative side of this approach is that economic rationalism has been underused by the Turkish Cypriots. Economic rationalism is valid both as a strategy in articulating and defending its case and as a means of promoting economic development. The “national cause” mentality has been biased, if not distorted. The economic card has not been ignored, but it has taken a back seat to the political agenda of safeguarding Turkish Cypriot identity through nationalism alone. Yet at every stage where economic rationalism did manifest itself in the Turkish Cypriot community, it played a critical, but nevertheless subordinate, role in facilitating economic institution building. In the longer term, these institutions have served as a critical investment in the survival of the Turkish Cypriot community, providing the vital infrastructure. These institutions could have played a more constructive and efficient role in economic development if the Turkish Cypriot leadership had been friendlier toward economic rationalism, especially after Turkey under Prime Minister Ozal changed course beginning in 1980 in favor of a more competitive economy.

BALANCING ECONOMIC RATIONALISM AND NATIONALISM

While building economic institutions to facilitate economic development, Turkish Cypriots, at least since the 1940s, have opted for nationalism as their primary ideology. Both Kucuk and Denктаş, for example, followed Kemalism to counter Greek Cypriot ethnonationalism. Kucuk was the first national leader, supported ably by a cadre of like-minded nationalists that included not only Denктаş but also dedicated lawyers (e.g., Osman Orek, Umit Suleyman, Ahmet Berberoglu), who rejected the minority status of the Turkish Cypriots and effectively utilized Kemalism to mobilize and modernize the Turkish Cypriots around a “national cause” that emphasized “blood and flag,” to paraphrase Kizilyurek (2005:48). There were others as well, such as Ragib Kenan, Kemal Deniz, and Mehmet Zeka, who laid the groundwork for economic, social, legal, and in particular educational reforms in colonial times. To their credit, these reformers concentrated on building a modern, secular society with a modern educational system, using textbooks and teachers imported from Turkey. Thus, they unintentionally began creating human capital, well before the concept was even coined.

North Cyprus, with a 110 percent literacy rate,²⁷ is among the most highly educated countries in the world. It is not by accident that in 2005 the only sector in which North Cyprus led the South was the university sector, providing the country with a large economic return in valuable foreign exchange equaling the contribution of the tourism sector.

The Greek Cypriot educational system, by comparison, is archaic and ultranationalist.²⁸ To make matters worse, it has been reinforced by a strong church indoctrination that is equally anti-Turkish. During Ottoman rule the head of the church was the *ethnarc*, leader of the Greek Orthodox millet on the island. This office had major political significance. It provided for self-government and kept the two ethnic communities apart, living side by side but culturally at loggerheads, with education and religion as forces of disunity. Equally important, this tradition of the political role of the church has remained a dominant feature of Greek Cypriot community.

As a result, schooling has not been a unifying force in Cyprus and it cannot be said to produce rationalism. Rather, it has served ethnonationalism. As far as the Turkish Cypriots have been concerned, economic development has lagged behind nationalism. Why that should be so is perhaps understandable: Turkish Cypriot nationalism, in a large measure, has been a response to Greek Cypriot nationalism. Its construction on the Kemalist model was secular and rational, but at the same time it has been reactive in the sense of opposing something perceived as a threat to its identity and survival.

Economic rationalism, or the pursuit of economic development, is proactive, aiming at the betterment of well-being through purposeful action. The institutions built (such as the Turkish Bank, the cooperatives, and the Chamber of Commerce) all aim at economic rationalism. Given efficiency and good management by a developmentally minded government, these and similar institutions are the instruments for implementing economic rationalism.

Can economic rationalism help unite the island today? The optimistic answer must be yes, but history cannot be undone. Certain realities must be taken as given. First and foremost, there is the fact of demographic separation and the existence of two economies on the island. The bizonality and bicommunality principles embedded in the UN Peace Plan, known popularly as the Annan Plan, based on some forty years of peacemaking, are intended to ensure this demographic and economic separation. If this fact is accepted as the point of departure by the two Cypriot ethnic communities, then subsequent positive steps can be taken, especially learning from other multiethnic federal states in the world. Turkish and Greek Cypriots have

lived as separated communities, side by side, for over half a century, each governing itself as best as it could.

Rational behavior demands that neither side accept an outcome that would make it worse off. The outcome must be optimal (win-win) or it will fail. Accordingly, joint gains of settlement must be identified and emphasized, such as joint-venture business projects in tourism or industry, mutually beneficial water imports from Turkey, and on a larger regional scale, Greek-Turkish-Cypriot cooperative projects in the eastern Mediterranean. Joint gains are greatest in the business arena, and perhaps the most effective potential role in the identification and capture of these gains lies with members of the Turkish and Greek Cypriot Chambers of Commerce.²⁹

A positive part of economic rational behavior is that it is ahistorical. This does not mean that history is unimportant or irrelevant. Rather, it means that in the calculation of costs and payoffs, one must be progressive and forward-looking. Put differently, it is impossible to turn the clock back to 1974 or 1963. This fact is recognized in the idea of bizonality and bicommunality enshrined in UN resolutions, which means ethnic and physical separation. Such separation must be viable in the short run and in the long run. Accordingly, economic viability must be constructed in terms of bizonal and bicomunal federalism.

Economic viability is built on productivity that generates sufficient value-added for the Turkish Cypriots to catch up with Greek Cypriots and realize economic parity in the shortest timeframe possible. Significantly, productivity is a key element of the February 1977 guidelines agreed on by Denktaş and Makarios.³⁰ Productivity in North Cyprus needs a precise definition. It rests on two economic pillars: (1) Turkish Cypriot demographic majority, and (2) Turkish Cypriot majority ownership of land. These two conditions in the North match similar conditions among Greek Cypriots in the South. Collectively, these two conditions ensure that market forces in the North are strong enough to generate sufficient income for economic convergence to happen and achieve income parity between the two communities.

To its merit, both these principles are recognized and enshrined in the Annan Plan, which otherwise suffers from major shortcomings, to be discussed later. Article 10 of the plan sets up a Property Board for settlement of property claims and makes a clear distinction between *ownership* and *use* of property. There is an explicit attempt in law to balance the claims of former owners with the rights of current users, along with the principle of bizonality. Dispossessed property is not subject to wholesale and unconditional return to the former owners. Rather, former owners are provided with

incentives to opt for compensation, leases, or exchanges. Only one-third of previously Greek Cypriot-owned lands are to be reinstated; the rest of the cases are to be settled with long-term leases or compensation for the owners. The deeper logic of the plan on property rights is consistent with economic rationalism, realizing that ownership is by no means the only attribute of land, nor is reinstatement of (former) ownership the sole remedy. After decades of dispossession and use by current users, land, like everything else, may be improved or changed in a basic way, and avoidance of costly disruption is the fair thing to do. The Property Board may therefore settle property claims on the basis of compensation more often than reinstatement.

As for bizonality, it would imply that without Turkish majority land-ownership in the North, bizonality would be meaningless. Put differently, if Greek Cypriots were to own the majority of land in the North, then industrial or regional development policy necessary for the productive use of the land would lie beyond the control of the Turkish Cypriot state. Building and operating hotels and factories, or indeed, any construction, would be at the mercy of the majority landowners. As a result, the productivity or economic viability of North Cyprus would be imperiled.

The danger of majority Greek Cypriot property ownership in the North can easily be overcome under the rules of bizonality and thanks to the one-third reinstatement formula in the Annan Plan. This is a sound formula on economic grounds because it recognizes the rights of the current users/owners and bases financial compensation of former owners in the future productivity of the land, more precisely in the future profits realized by the current users/owners.

On this basis, we can evaluate the case of reopening Marash/Varosha for economic development. This ghost town, formerly a flourishing Greek Cypriot tourist town of 40,000 inhabitants on disputed land,³¹ is now controlled by the Turkish army, which occupied it in 1974. The town is a huge economic loss as trees grow in the streets, and vacant houses, shops, and huge hotels are derelict and in need of major reconstruction. There is no reason why the Turkish Cypriot authorities, in collaboration with the Turkish government, cannot take the necessary initiative to invite willing Greek Cypriots to come and reopen this town for business, with the proviso that all the required permits must be obtained from the relevant Turkish Cypriot authorities. These permits are the lifeblood of bizonality, making it function for mutual economic advantage.

Reopening Marash/Varosha would be a huge economic step forward. A rebuilding boom would immediately create large numbers of productive jobs. Restarting businesses would generate income on a tremendous scale,

creating tax revenues for government authorities and stimulating regional development. Gradually, as the mutual economic gains of the economic stimulus in Marash/Varosha lead to (at least de facto) political cooperation between the North and South, the port of Famagusta could be declared a free port and operated as such. That is what happened in the wake of the relaxation of the Green Line restrictions when in April 2003 the Turkish Cypriot authorities unilaterally decided to allow individuals to cross from one part of the island to the other. As a result, cross-border trade and movement of people expanded, generating economic gain for both sides.

Overall, the URC model of bizonality and the Annan Plan on which it rests offer a rational way to unite the island. Given goodwill, the plan had the potential for a solid economic foundation to strengthen bizonality through economic power sharing. Each state in the URC should have the capacity to generate sufficient financial resources to achieve roughly comparable living standards for its citizens so that there is economic parity on the island. Political equality and power sharing alone are not enough. Bizonality must become a living reality, a functional, efficient system on a united island.

Economic rationalism demands that North Cyprus is developed to the same level as the South. Economic parity is necessary not only for reasons of external competitiveness in a globalized economy but for the politics of survival in a microstate. Economics and politics must be harnessed in a carefully designed development strategy to ensure sustainability. That is the topic of the next chapter.

A Development Strategy for North Cyprus

ECONOMIC RATIONALISM, and the institutions it promotes, must be mobilized as an economic development strategy both for competitiveness in the marketplace and for the political capability of controlling one's destiny. United or divided, Turkish Cypriots, as rational decision makers, have the potential to achieve as much in the marketplace as the Greek Cypriots or other success-oriented people.

Designing and implementing a development strategy is not the same as planned development, a sort of mandatory state control of resource allocation, something that was fashionable in the 1960s and 1970s. Development strategy is rather a rule-based, private-sector-led development carried out by a pro-development government through enabling legislation.

In this chapter our examination of "developmental strategy" has two parts, one based on a search for a suitable model and the other looking back in time to the recent past. First, we explore the Asian "developmental state" model to identify guidelines that might be useful for a microstate such as North Cyprus. Second, we examine the provisions of the Annan Plan in terms of their adequacy for promoting a sustainable economy in North Cyprus as part of a future United Republic of Cyprus.

A MODEL TO FOLLOW: THE ASIAN "DEVELOPMENTAL STATE"

Perhaps the most relevant model of development for North Cyprus is the Asian developmental state. Singapore, for example, is even smaller than North Cyprus in terms of area. Learning from the Asian Tigers (Singapore, Hong Kong, Taiwan, and South Korea) is a useful exercise in economic rationalism. These newly industrialized countries (NICs) emerged from poverty to prosperity within a relatively short timeframe of two decades,

1960-80. How did they do it? They did it by transforming nationalism into the logic of economic development, known as the “developmental state” (Onis 1981)—in short, economic rationalism. Political leaders in these states saw salvation in rapid economic development, as a means of both securing legitimacy for the regime and gaining popularity by forging partnerships with the business community, trade unions, and other civil organizations. Thus, when Singapore was thrown out of the Malaysian Federation in 1965, its leader, Lee Kwan Yew, who had risen to leadership from the ranks of the trade union movement, chose the path of rapid economic development to forge ahead of Malaysia. Similarly, when General Chiang Kai-shek escaped to Taiwan (then called Formosa) in 1947, he chose the path of economic development. In South Korea and Hong Kong we find similar expressions.

In the Asian NICs, education was the engine of development. Education was utilized as an instrument for both nationalism and human capital. Top priority was assigned to vocational education and training to produce skilled workers (blue-collar workers) and entrepreneurs for industrialization. Education for nationalism was given lower priority. Vocational and technical institutes rather than academic schools were built, and the private sector was mobilized for national economic development. In return for state support to industry, the political leadership demanded that firms and industries become globally competitive on the basis of labor-intensive, export-oriented industries and services.¹ At the same time, these export-oriented industries created large-scale productive jobs not only for young graduates but also for agricultural laborers displaced by the application of modern farm technologies. However, there was no massive rural-to-urban migration as happened in other developing countries. Most of the new export-oriented industries were established in rural areas. This facilitated the relatively costless and speedy redeployment of displaced farm labor in new industrial jobs.

The single major lesson to be learned from the Asian Tigers’ success story is the feasibility of the growth with equity (GwE) model of economic development within a relatively short timeframe of twenty years. Under the GwE model, the state enabled the private sector (1) to become globally competitive by adopting export orientation and (2) to create productive jobs in export industries to maximize employment. With expanding jobs, labor income as a proportion of national income increased, thereby improving income distribution. Thus, not only was rapid growth achieved, but this growth process resulted in more equitable distribution. In turn, the legitimacy of the state was enhanced in the eyes of the people.²

The GwE model became envy of the world until the 1997 Asian currency collapse. These countries survived this currency crisis and have continued to

forge ahead with their GwE model. Now a second generation of NICs has emerged, such as Malaysia, Thailand, Indonesia, and the Philippines.³

There are, to be sure, significant differences between North Cyprus and the Asian Tigers, such as location and an authoritarian history. For one thing, all these Asian Tigers have a significant Chinese entrepreneurial class. But the success of the GwE model is not simply due to Chinese business ethics. If that were the case, China itself should have been far ahead of the Asian Tigers. The GwE success was fundamentally the result of a dynamic state, one in which the political leadership deliberately chose the path of a developmental state.

NORTH CYPRUS AS A DEVELOPMENTAL STATE

North Cyprus has some important similarities with the Asian Tigers. Like them, North Cyprus is a small economy, and like Singapore and Hong Kong in particular it has been emphasizing service-oriented exports. Small island economies and microstates are among the most prosperous states in the world (Mehmet and Tahiroglu 2002), disproving the earlier presumption that the smallness of an economy is an economic disadvantage, creating diseconomies of scale. While this argument may be valid for industrial products, it does not seem to be legitimate for service sectors, especially export-oriented sectors that are globally competitive in terms of price and environmental quality.

North Cyprus possesses some unique environmental and natural advantages. Not surprisingly, the development of the tourism and higher education sectors are collectively the dynamo of North Cyprus. But North Cyprus to date has been a national state nurtured on nationalism. It needs to become a development state guided by economic rationalism. What are the preconditions for North Cyprus to become a developmental state?

First and foremost, there must be a megaproject focused on improving and enhancing infrastructure, both physical and social. In the past, North Cyprus has not given much attention to infrastructural development, with the important exception of higher education. The country has not even had a development budget and has relied on Turkish aid, which, although generous, has been inadequate, especially in the most recent economic boom. Thus, out of a total of US\$3.4 billion Turkish aid during 1977-2005, infrastructural project aid has amounted to only 30 percent, or just over US\$1 billion. Indeed, the proportion of infrastructural project aid from Turkey has actually declined since 2005, even though total Turkish aid has increased.⁴ This implies that increased Turkish aid has been used for relatively

unproductive military expenditure and consumption-related budgetary expenditures. The World Bank report of 2006, discussed in Chapter 1, has been harshly critical of such Turkish aid.

As a result, North Cyprus is seriously lacking in electricity supply, telecommunications, highways, port facilities, and water, as well as human capital, especially in terms of skilled and technical workers. Without such infrastructure, it is impossible to develop the economy and achieve the growth targets in the tourism and export-oriented sectors. It is, therefore, imperative that North Cyprus adopts a development budget, under the authority of the minister responsible for economic development, and use this instrument for macroeconomic policy and investment strategy in a developmental state.

Efficient management of macroeconomic policy and investment entails five important areas of public policy. First, a critically important lesson from the Asian Tigers is that economic development must become the overriding objective of government, any government, led by a president fully committed to economic development. To this end, it is desirable to have a superbody, a Presidential Economic Council,⁵ with the minister in charge of the economy or the development budget as secretary-general for macroeconomic policy. The aim of macroeconomic policy must be maximum sustainable growth with equity (GwE).

Second, GwE means that growth must benefit all segments of society, not just the privileged. To this end, all existing subsidy schemes and social transfers will need to be reevaluated on the basis of productivity, and all unproductive ones channeled into productive investment. The investment share of GDP should, at the first opportunity, be raised to 30 percent, and economic performance judged not only in terms of efficiency gains but also in terms of its positive impact on income distribution in accordance with GwE.

Third, all Ministries, ex officio members of the Presidential Economic Council, and all departments of the state must be mobilized to achieve GwE. There must be rapid growth, but as income grows it must be distributed more equitably. To ensure this, educational restructuring is essential to give more emphasis on skill development in technical and vocational education so as to develop the necessary human capital. Greater investment is required to expand the supply of middle-level occupations, especially the technician level, designed for the tourism and service sectors, which are the leading sectors of the economy. This requires the establishment of polytechnics and vocational institutes as an alternative career path for young people who currently have no place but the university after graduation from

secondary school. In an increasingly open and competitive North-South interaction in Cyprus, there is an ever present risk that more and more skilled workers will migrate South, pulled by higher wages there, their places being filled by lesser-trained workers imported from Turkey.

Fourth, if North Cyprus is to become a developmental state, there must be a closer partnership between the government and the private sector, the locomotive of the economy. This partnership must cover not only industrial, regional, and employment strategy but also environmental protection. Government must encourage innovation and R&D expenditure by creating technology parks and providing credit for small and medium-sized firms for market development, but in return it must demand greater corporate responsibility in terms of competitiveness, higher environmental standards, and more productive jobs, especially for young workers.

Finally, higher standards and quality must be vigorously pursued in all sectors, but in tourism and higher education in particular, since these are operating in highly competitive global markets. When foreigners visit Singapore, Hong Kong, and Taiwan, they marvel at the cleanliness, discipline, and orderliness of society. Everything works efficiently. Shopping malls, parks, and hotels are spotless, and respect for the environment, ranging from waste management to traffic control, is evident everywhere. The same must be true in North Cyprus, with visible cleanliness of the environment and protection of the ecosystem, the rich flora and fauna, included.

A word on environmental protection is in order because development must be sustainable in terms of the environment as well. North Cyprus possesses some unique natural features, which are national assets as valuable as our historical heritage. Equity demands fairness not only to the present but also to future generations. Accordingly, economic growth must be harmonized with environmental protection. There should be a powerful land zoning regulation, properly supervised and scrupulously implemented. Tourism development must not damage the beaches or the green and scenic vistas of the mountain ranges, and the unique flora and fauna should be safeguarded no less than the historic sites.

In the final analysis, North Cyprus as a developmental state must put its economic house in order first, reforming its public sector and scaling down its excessive and inefficient subsidies and social transfers, replacing them with a more productive investment and growth strategy based on a productive collaboration between the state and the private sector. Achieving economic parity with the South would make settlement of the Cyprus problem more feasible because it would be less costly all around. If economic rationalism prevailed in the North and South alike, Greek Cypriot leadership

would adopt a more constructive position at home and abroad, especially at the EU. It would cooperate in lifting trade embargoes on the North and would facilitate, rather than obstruct, free trade between the North and the rest of the world. Such a constructive approach would promote convergence rather than divergence.

DEVELOPMENT STRATEGY OF THE ANNAN PLAN, 2004

The Annan Plan, submitted in separate referenda in North and South Cyprus on 24 April 2004, contained significant elements of a development strategy within a United Republic of Cyprus as well as in the republic's two constituent states. Although this plan was not accepted in the South, it was endorsed by a commanding two-thirds majority in the North. The plan, for the first time, gave some degree of international legitimacy to North Cyprus, and any future settlement between the North and the South will be based largely on its provisions. More specifically, the plan provided some vital elements of economic policy, which must be carefully examined for future development strategy. Accordingly, it is useful to consider the Annan Plan's provisions, in both positive and negative terms, and ask the following question: Can North Cyprus still emerge as a developmental state within the URC as envisaged in the Annan Plan, or some negotiated variation of it?

The economic provisions in the Annan Plan are inadequate. The plan aims at economic convergence, but it fails to define what this means, and more significantly, it fails to specify policy tools with which convergence can be promoted. The plan details political power-sharing arrangements and provides elaborate rules and procedures for property claims, but surprisingly, it ignores economic power sharing. This is such a serious omission that the economic viability of the URC is threatened. In a future revision, if and when the URC is seriously taken up, the omissions and weaknesses of the plan's economic aspects must be remedied to put the URC on a solid economic foundation. It is instructive to list some of the plan's more important economic faults.

(1) Indirect tax revenues and transfers in the plan mean that the Turkish Cypriot state subsidizes the federal government in the first year to the tune of 15 million Cyprus pounds (CYP), because what it sends to the federal government (108 million CYP) is far greater than what it receives back (93 million CYP). Of course, Turkish Cypriots would work in the federal civil service, and their salaries may offset the subsidy, but in principle, in federal states the economically weaker state should be the net gainer from fiscal transfers.

(2) The Annan Plan generates a large fiscal surplus for the federal government. In the first year, a budget surplus of CYP 200 million was planned, and the plan is silent on how the surplus is to be used. George Vasiliou (2003) was quick to recalculate the Annan Plan figures and make new assumptions. Under the Vasiliou scenario, these surpluses would be returned to the Greek Cypriot state. This, together with the deficit for the Turkish Cypriot state noted above, means that the economically weaker state is further hurt in order to reward the economically stronger. This serious error must be rectified to strengthen the bizonality of the URC (see below).

(3) The Vasiliou amendment would leave the federal government fiscally strapped with no resources left for macroeconomic policy assigned to the federal government under Article 14 and elsewhere in the plan. For example, Article 52 explicitly recognizes the big economic gap between the North and the South, but it makes no provision for its elimination through the fastest possible convergence of two economies in terms of per capita incomes and growth rates. In other words, the plan is silent on how economic parity is to be achieved to ensure the sustainability and stability of the URC.

(4) The plan's provisions with respect to land are quite reasonable, recognizing the fundamental distinction between economic use and legal ownership rights. But it is silent on provisions for financing land claims. Only one-third of former Greek Cypriot land is to be reinstated, while the rest is to be compensated or leased on a long-term basis. This is a fair way to balance the rights of the current users of the property against the rights of the legal owners, acknowledging the investment and improvement that have gone into land abandoned some forty years ago. However, the plan provides no financial resources for compensation or settlement of land claims.

(5) Similarly, the cost of resettlement is not addressed. Although the plan explicitly recognizes that there will be large numbers of persons to be relocated, there is no clear financial provision for housing, rehabilitation, and resettlement. Economic and common sense suggest that there can be no dispossession of current occupiers unless their needs and rights in terms of housing and livelihood are met first. Only then can there be room for any transfer or reinstatement of land or real estate.

However, the most important omission in the plan is with respect to bizonality, one of the two cornerstones of the URC. Bizonality is defined in the plan on the basis of an ambiguous boundary. Moreover, the plan contains no provision for implementing a development strategy in the two zones. Without adequate financial resources, it is impossible to undertake economic development. Political responsibility must be matched by adequate budgeting and tax revenues. Similarly, without adequate resources

to back it, bizonality in the URC (like the British Evkaf) can be starved of funding, becoming an empty shell and unable to promote economic and social development.

How can this potentially disastrous prospect be avoided? In well-run federations, as well as in the EU, financially stronger states pay a proportionally higher financial contribution to the federal authority, which then transfers funds to the lagging states in the form of solidarity payments to create common prosperity. In Canada such equalization payments are designed to ensure that all Canadians, from coast to coast, enjoy broadly comparable standards of living (see Mehmet 1992). In the EU an elaborate array of measures such as structural funds, regional funds, and social funds all work as fiscal transfers to enable the weaker regions to catch up with the more prosperous ones.

In the URC, if economic rationalism is to have a role, similar fiscal arrangements would have to be instituted. Ideally, the constitution would contain clauses mandating economic parity and charging federal macroeconomic policy as the instrument for achieving this policy as soon as possible.

The most efficient manner in which federal macroeconomic policy can become an instrument of convergence is through a federal investment strategy. In this strategy, a certain percentage of annual investment expenditure is earmarked for capital projects in North Cyprus (roads, telecommunications, water projects, harbors), projects that in the plan are to be federally (i.e., jointly and cooperatively) administered. Enabling this strategy would necessitate a development budget in North Cyprus into which federal fiscal transfers are to go for implementation of infrastructure projects.

Greek Cypriots may refuse to accept any responsibility for the transfer of funds from the South to the North. That would be unfortunate, as it would prevent the gradual emergence of solidarity arising from common citizenship in the URC. However, if necessary, other, external sources could be found, such as the EU and Turkey.

CAN BIZONALITY WORK IN A UNITED CYPRUS?

If a new partnership state were possible in Cyprus, then fiscal federalism would be an essential policy instrument. In successful federal states, such as Canada, fiscal federalism is a well-developed system of transferring large amounts of funds from rich to poor regions through the federal government. In this framework, given goodwill to make fiscal federalism work, the truly partnership URC would be a first-choice option, an island of peace and friendship, a model of Turkish-Greek cooperation within an EU in which

all Turks and Greeks are equal citizens enjoying common citizenship and comparable living standards.

In this spirit, the positive way to unify Cyprus within a URC is economic rationalism dedicated to making bizonality work. In particular, federal macroeconomic policy must be managed to promote and sustain economic parity. There are a number of critical preconditions for this objective, two of which are already accomplished facts, namely, demographic separation and separate but efficient economies in the North and South. Let's discuss these in turn in a little more detail.

The separation of the two ethnic communities, as agreed in Vienna by the leaders of the North and the South in 1975, is the foundation of the bizonal URC. Ethnic separation provides the opportunity for the expression of cultural identities in Cyprus, each one jealous of its historical heritage. One cannot dominate the other, and it must be a cardinal duty of the federal government to ensure that such domination does not occur. It would be courting disaster and renewed intercommunal fighting to undo this fact. The URC must be a multiethnic state within the EU, each ethnic group secure of its survival. Bizonality (or living side by side) is the formula for ensuring the survival of separate ethnic communities in Cyprus. Fortunately, the Annan Plan and UN resolutions clearly recognize bizonality. However, the Annan Plan is weak in economic power sharing and in particular in detailing how economic policy can be harnessed to make bizonality work.

This is where the second pillar of Cyprus reality must be recognized and built on to protect and enhance Turkish Cypriot economic security. In the last forty years two separate economies have emerged, the one in the South enjoying international interaction, but the one in the North functioning largely in isolation and with only indirect and costly participation in world trade. Despite these economic disadvantages, it is remarkable how resilient the North Cyprus economy has been, especially since 2003, when per capita income rose sharply from under US\$5,000 to over \$12,000 at the end of 2007. At present trends, it is anticipated to reach \$15,000 by 2010, well on the way to achieving economic convergence with the South, where the comparable figures stood at around \$18,000. Income convergence means achievement of economic parity, that is, 100 percent equalization of per capita incomes in the South and North. Convergence cannot and should not be taken to mean economic domination of one side by the other. Such an outcome must be guarded against by the federal government through careful and creative management of macroeconomic policy. Efficient and competitive business enterprises in the North and South must coexist and prosper side by side under the same rules.

Given successful convergence in terms of prosperity, it would be feasible to establish a bicomunal and bizonal URC. But extreme care must be taken to safeguard not only political equality but also economic equality. Without the latter, the former would be meaningless and the political architecture would, as in the 1960 Republic of Cyprus, end up as another failed state.

In the final analysis, the URC must be built on making living side by side a viable, sustainable foundation of the new and vigorous state. The best guarantee of the viability and sustainability of the URC lies in the efficiency gains and trade creation that a settlement in Cyprus will bring about. Tourism will flourish in the North and South, investment will accelerate in industry and commerce, and the entire eastern Mediterranean region, inclusive of a united Cyprus as well as Turkey and Greece, all of them EU members, will prosper. In short, the URC can be a “win-win” for all because that is the only way it can last. If one side attempts to crush the other, as in a zero-sum game, then such a URC will face the same fate as the 1960 Constitution.

THE URC, POWER SHARING, AND THE GREEK CYPRIOTS

The URC proposal failed because it was rejected by Greek Cypriots. In the future the Greek Cypriot side may again reject sharing sovereignty and power with Turkish Cypriots.

The key reason is that in 2004 the Greek Cypriots were acting emotionally rather than rationally. In the future the URC or its replacement may be rejected on the basis of more rational reasons. On the eve of the Referendum, Greek Cypriot leader Tassos Papadopoulos wept on television, pleading with his fellow Greek Cypriots not to kill the “beloved Republic of Cyprus,” the Greek Cypriot-controlled government. His emotionalism carried the day. And there was a second wave of emotionalism: the last-minute rejection of the Annan Plan by AKEL, the party of social justice, priding itself on a presumed solidarity of the working classes. Moreover, when one examines the age composition of those participating in the resounding *oxi* (no) vote, any rational observer is bound to be disappointed to discover that the rejection was strongest among the younger generation of Greek Cypriots,⁶ clearly an outcome of the ultranationalist education system.

Accordingly, it is a fair question to inquire whether or not Greek Cypriots exhibit economic rationalism. Is it reasonable for Greek Cypriots to reject cooperation with Turkish Cypriot authorities when criminals escape across the border or when there is a common threat of pandemic

caused by infected migrating birds? Are the Greek Cypriots ever willing to share economic power and prosperity with the Turkish Cypriots? What would happen if a second referendum was also rejected in the South? All the economic rationalism among the Turkish Cypriots may come to nothing if it is not matched by the same on the other side.

Of course, there can be no doubt that in private terms, most Greek Cypriots are rational, fully capable of maximizing self-interest. After all, they are the wealthiest group on the island. However, in terms of public rationality, or when it comes to optimizing collective interest with Turkish Cypriots, there clearly is an existential problem arising from the difficulty of accepting the existence of the Turkish Cypriots. Thus, the EOKA and enosis campaigns were started as if there were no Turkish Cypriots on the island. Even now, the Greek Cypriot leadership cannot accept Turkish Cypriots as the other party in the Cyprus conflict, believing that it can solve the problem with Ankara on its own. The roots of this attitude lie in emotionalism and a certain degree of irrationality.

The Greek Cypriots' irrationality originates from two fundamental myths. The first myth is that there exists only *one people* (i.e., Greek Cypriots) in Cyprus,⁷ and the second is that Cyprus, as geography, is sacred and indivisibly Greek. These two myths form the bedrock of Greek Cypriot worldview, shaped by a deep-rooted, distorted understanding of culture and history. It gives rise to a highly emotional brand of political and legal mindset, shaped not by Greek Cypriots' own self-interest but by an externally driven ideology.⁸ Thus, a strong majority of Greek Cypriots accept as dogma the enosis ideology as ethically good and heroic, an ideology nurtured for decades by a cultural tradition shaped by church indoctrination and a dysfunctional education system. This distorted cultural tradition promotes a set of dogmas and taboos intended to demonize everything Turkish. It rejects Turkish Cypriots' reality and views Turkish Cypriot rights as something unimaginable, despite the fact that they are enshrined in the 1960 Constitution and subsequent UN resolutions stating that Cyprus is a homeland for both communities and that this problem is not a majority-minority dispute.

After 1974, and especially after the establishment in 1983 of the Turkish Republic of North Cyprus, many Greek Cypriots came to see Turkish Cypriots as "traitors" who collaborated with the "invading" Turkish Army that humiliated them and dispossessed them of their homes and property. Obsessed with their own suffering, the Greek Cypriots have acquired a "victim" mentality, objectifying their condition as "refugees in our homeland," a condition generated not by any fault of themselves but by external

conspirators such as the American CIA, Turkish “barbarism,” or British “divide and rule.”⁹ At the same time, this Greek Cypriot mind assumes away, as if psychology could replace reality, Turkish Cypriot suffering and humiliation during the period 1964-74—this psychological trick in no way diminishing, of course, Turkish Cypriot rights and claims. One psychoanalyst has argued that Greeks collectively suffer from a historic “inability to mourn over Constantinople” (Volkan and Itzkowitz 1994, esp. chap. 4), and this profoundly distorts their view of everything Turkish. The Greek Cypriot irrationality when it comes to Turks can sometimes border on paranoia, generating a form self-delusion that, unfortunately, crosses over into the domain of politics.

Accordingly, the Greek Cypriot cultural tradition creates a second source of irrationality, this one manifested on the political plane. The political perception of most Greek Cypriots is such that they could not possibly see the state of Cyprus as anything but exclusively Greek Cypriot. The current “Republic of Cyprus,” which is wholly Greek Cypriot, is seen as the source of all legality in Cyprus, and hence any authority or institution in the Turkish Cypriot North is, by definition, “illegal.” The Turkish Cypriot state is “pseudo”; universities in North Cyprus are “illegal”; banks, hotels, farms, and companies are “theft” because they occupy Greek Cypriot property. Turkish Cypriots simply have no rights, no ownership: they do not even have the right to exist!

The Greek Cypriots, at least a significant percentage of them, live in the past, educated and brought up on an idealized Hellenistic heritage, a legacy cherished as glorious and as a pure monopoly of Greek Cypriots. In the modern manifestation of this view, Greek Cypriots see themselves as the rightful inheritors of Byzantium, violently destroyed in 1453 by the Ottoman Turks, who in 1571 also conquered Cyprus, and once again in 1974 the Turkish army “invaded” the island. Accordingly, for Greek Cypriots, everything Turkish is “impure,” “barbaric,” or “inhuman.” Turkish Cypriots, by historical association, are part of the “enemy” of Hellenism, of which the Greek Cypriots are an integral part. In this idealized historical construction, any political equality and power sharing with the Turkish Cypriots is unimaginable; for example, a confederation is viewed as “anathema” (Calotychos 1998:11). Emotionally, therefore, the Greek Cypriot finds comfort in hiding behind self-deluding myths when referring to the Turkish Cypriot North as a “pseudo-state” or as “areas beyond government (i.e., Greek Cypriot) control.”

These two sources of irrational behavior create circular or self-serving reasoning. For example, most Greek Cypriots argue that the Turkish

Cypriots are “poor” and would make a burdensome partner in a federation, but at the same time they resist any attempt to lift embargoes and trade restrictions imposed on the North that would allow the Turkish Cypriots to eliminate their relative poverty. Lifting embargoes, these Greek Cypriots claim, would empower the partitionist sentiments among the Turkish Cypriots; yet Greek Cypriots flatly refuse power sharing with the Turkish Cypriots. Likewise, the Greek Cypriots are inclined to differentiate between mainlanders (or “settlers” from Turkey), at whom they direct venomous hate, and Turkish Cypriots, for whom they declare friendship, yet since Christmas 1963 they have missed no opportunity to treat Turkish Cypriots as second-class citizens (see Chapter 4, for example). So much insincerity can have one message: Greek Cypriots have little or no wish for any cooperative or partnership solution with Turkish Cypriots.

If Greek Cypriots had it their way, the ideal solution for them would be to control the whole island with no concessions at all for Turkish Cypriots. This clearly is not possible because of certain realities on the ground. Like it or not, more than one-third of the island is under Turkish control and the Turkish Cypriots have nowhere else to go. Twice before (in 1964 and 1974) Greek Cypriot irrationality blew up into violence, bringing untold misery to all Cypriots, and future irrationality spilling into yet further violence may prove even costlier.

Landownership or property rights lie at core of the Cyprus problem. It is a complex issue involving reinstatement of and compensation for Greek Cypriot property in the North and Turkish Cypriot property in the South. By definition, land claims are extremely emotional, reflecting birthrights and homeland attachments, but at the same time, property represents economic value. In economic theory, land is one of the primary factors of production. Land here represents value, not only as a stock (i.e., as in an asset stemming from ownership) but also as a flow arising from use-value in production regardless of ownership. For example, a farmer creates value-added from his labor on a farm quite apart from the fact that the owner of the farm may be an absentee landlord. And if a piece of real estate owned by a Greek Cypriot and worth \$1 million contains an investment by current Turkish Cypriot users worth \$100 million, such as buildings belonging to a university or a hotel, surely the claim of the former cannot ignore the rights of the current investor.

The land issue in Cyprus is a political matter requiring an ultimate balancing of Turkish and Greek Cypriot claims. In other words, the land issue cannot be solved simply by legal redress, as in the Loizidou case.¹⁰ There are far too many individual cases that would take hundreds of years

to resolve, and even then an enforcement formula is required to translate legal decisions into reality. If Greek Cypriots, acting irrationally, believe they can use force again at some future date in order to take possession of land while denying Turkish Cypriot rights, they will have to fight not only the Turkish Cypriots but almost certainly the Turkish army as well. The irrational Greek Cypriot, in short, is faced with a dilemma: for most Greek Cypriots, Turkish Cypriots are the “enemy” who betrayed them and brought in, or at least cooperated with, the hated Turkish army. Should they share power with Turkish Cypriots in a new URC or risk it all by resorting to force, once again, for a total win?

In the end, the Greek Cypriots may be obliged to replace emotionalism with economic rationalism to solve the land issue. A rational basis for settlement of the Cyprus problem is the “land for sovereignty sharing” formula. This formula, detailed in the Annan Plan, allows the two sides to optimize their counterclaims objectively by balancing their respective interests in a federation. In private land claims, the Greek Cypriots may now be able to exchange land with Turkish Cypriots in similar situations, obtain compensation, or, in some cases, obtain reinstatement of their property rights through the Land Commission created in North Cyprus in the aftermath of the ongoing Orams case and similar pending cases.¹¹ The European Court of Justice has recognized that this commission is the first point of recourse for Greek Cypriots pressing their property claims, and an increasing number of Greek Cypriots have started to apply to the commission. As of March 2008, there are some six hundred such applications before the commission, which has already delivered judgment in some thirty cases, many times ruling in favor of Greek Cypriot claimants.

Beyond land claims, a URC is almost certain to bring huge efficiency gains and trade-creation benefits for both communities. Tourism will flourish in the North and South, investment will flow into a reunited Cyprus, and a Cyprus freed of the burden of nonsettlement will reap huge benefits as a Singapore of the eastern Mediterranean. Indeed, this region will become prosperous once Turkey joins the EU as a full member like Greece, Cyprus, and all other member states.

But economic rationalism may not overcome Greek Cypriot ethnonationalism. For these nationalists, power sharing in a URC with Turkish Cypriots may be out of the question. It might be unacceptable, worse than a second-best outcome. Even if no subsidy of the Turkish Cypriot state was involved, to these nationalists the idea of a Turkish Cypriot president of a URC might be anathema, over and above the heavy toll of administering a partnership state, with constant conflict over finances, jobs, and foreign

affairs, problems that are fairly normal in federations. Accordingly, and somewhat irrationally, the Greek Cypriot majority may reject the URC a second time. In that eventuality a peaceful divorce of the Czechoslovakian type would be inevitable. That would mean agreeing to a two-state solution on the island with a treaty of friendship and cooperation.

THE WAY AHEAD

As we have seen in this chapter and the previous one, Turkish Cypriots have reaped some benefits by acting according to economic rationalism. First and foremost, in the postwar period Turkish Cypriots have been well served by a series of progressive leaders who recognized the importance of institution building as a means of grassroots mobilization. Village cooperatives and farmer organizations, no less than banks and financial institutions, have enabled the Turkish Cypriots to make some critical rational choices while also creating a valuable stock of social capital (Mehmet and Mehmet 2004). Second, social capital formation helped the Turkish Cypriots survive and flourish during the EOKA years, which brought about the physical separation of the two ethnic communities on the island. Third, thanks to a secular system of education modeled on Atatürk's modern principles, Turkish Cypriots were successful in striking a reasonably good balance between economic rationalism and modern Turkish nationalism. The close attachment to Turkish nationalism opened the door to Turkish aid, not just in financial and material terms but in the summer of 1974 in terms of military intervention and the creation of a national state in North Cyprus.

Now, after almost four decades of existence, North Cyprus is confronting the challenge of sustainability. The critical factor in the emergence of Turkish Cypriot identity and survival is the small geographic size of the territory it controls. Physical compactness is not an obstacle to survival; indeed, given the proximity to the Turkish mainland, it is an advantage, as demonstrated in the next chapter, which deals with the economics of size. Thus, in the end, geography rather than history may be the real trump card of the Turkish Cypriots.

Can North Cyprus Survive as a Microstate?

Some of the richest countries in the world today are microstates, including Singapore, Luxembourg, Barbados, and the Isle of Man. Each has a unique comparative advantage, but all are based on service economies and demonstrate a high level of sustainability in the competitive world economy. Given efficiency in resource allocation and effective management, North Cyprus, like other successful microstates, can survive on its own. However, this is a second-best option. The best solution, as argued earlier, would be a united Cyprus, a theoretically ideal outcome, a true partnership state of Greek and Turkish Cypriots, equally prosperous citizens within EU, inclusive of Turkey and Greece. If, however, that option is not feasible for political or cultural reasons, then permanent partition must be accepted even if it is second best.

In classical economics, the smallness of a country has been something of a paradox. On the one hand, there is a dominant presumption that a small market creates diseconomies of scale and results in excessively high unit costs. Accordingly, the sustainability of small states, especially mini- or microstates, is questionable. In the classical view (Robinson 1960), the smaller the population of a state, the smaller its domestic market and ultimately the greater the likelihood of its demise.

But the classical view is not the only rationalization on size in standard economics. In pure trade theory, for example, there is a well-known theorem that argues in terms of “the importance of being unimportant,” that is, that small trading countries can benefit from being small precisely because, as price takers, they can maximize gains of trade if and when they specialize and exchange according to comparative advantage (Salvatore 1995:43 and 64-65). This approach appears to contradict the diseconomies argument, and it is a fair question to ask which view is valid.

The second view is gaining ground as international trade shifts from goods to services, suggesting that small states may develop comparative advantages in such sectors as tourism, financial services, and specialized education on the way to sustainability. These new comparative advantages of mini- or microstates also appear to be in accordance with the new "cluster theory" of regional development, reviewed below (Dunning 1999; Birkinshaw and Hood 1997; Markusen and Gray 1999).

A related theory is Paul Krugman's (1991, 1995) "location" or "localization" theory, the study of the location of economic activity, especially its central-place theory, which argues that an industry is located in a central location to serve a hinterland surrounding it. The central place may be a manufacturing industry while the hinterland is an agricultural periphery that provides both the market and the primary resources for the center's industrial activity, enabling its growth on the basis of economies of scale. The implication is that the central-peripheral roles are determined by spatial or geographic characteristics (such as good climate, natural harbor, proximity to a market or natural resource such as a mine), conferring comparative advantages that lead to special "niches" in the central place. These advantages lead to economic growth in proportion to the creation of economies of scale in the central place, attracting related industries and services through linkages and interdependencies.

What exactly is the central-place location? It does not need to be a metropolitan, urban center within a country. It may be an island microstate surrounded by larger countries. The case of Singapore illustrates the theory. Singapore, the central place, is a small island state surrounded by much larger neighbors Malaysia and Indonesia, which make up its periphery. The dynamo here is the central place in the microstate of Singapore. That is precisely the logic of the growth triangle (see Lee Tsao 1992; Thant and Tang 1996), an international region of prosperity spilling outward from Singapore to the surrounding hinterland in neighboring Malaysia and Indonesia. In brief, central-place location theory provides a theoretical justification for the survival or sustainability of microstates that possess certain locational advantages capable of generating economies of scale and stimulating economic growth. Services, unlike manufacturing, recognize no borders. Thus, size ceases to be a constraining factor when states specialize in services, especially export-oriented services such as banking and finance, higher education, and tourism.

Empirically, too, there is growing evidence in support of the sustainability of microstates. For example, according to the World Bank, the richest country in the world (Luxembourg) is one of the smallest, and moreover,

four other microstates (Bermuda, Singapore, Hong Kong, and Brunei) have per capita income levels that exceed even the high-income countries' average (Mehmet and Tahiroglu 2002). There are no fewer than thirty microstates in the world, that is, states smaller than 10,000 square kilometers.

This suggests that smallness of a state in area and population, far from being a constraint on economic growth and development, may in fact be a source of comparative advantage. Specifically, smallness may be more than compensated by certain unique characteristics possessed by microstates. Evidence from the performance of microstates such as Singapore suggests that export-oriented services tend to represent such uniqueness and, therefore, a basis for a potential comparative advantage in line with the modern "cluster" theory of regional development. Thus, on theoretical as well as empirical grounds, the viability and survival of microstates can no longer be dismissed out of hand.

A THEORY OF SERVICE-ORIENTED EXPORTS IN MICROSTATES

When a microstate specializes and trades in service-oriented exports, such as tourism and higher education, it is as if the demographic base of the microstate is enlarged, thereby extending the size of the market and expanding effective demand. For example, if the initial population of a microstate is 250,000, but it hosts 520,000 tourists a year with an average stay of two weeks, and in addition this state attracts 30,000 foreign students annually, the effective demand is increased by 50,000 $[(520,000/26) + 30,000]$, or by 20 percent. Thus, the effective size of the market is 300,000, and there is a significant gain in purchasing power generated by the additional demand for goods and services. In some microstates the volume of tourism or other service-oriented sectors may run into millions of persons, pushing effective demand well beyond what is indicated by the initial population.

The upshot of this logic is that the classic diseconomies-of-scale argument is rendered invalid or at least undermined sufficiently by specialization and trade in service-oriented exports. Put differently, microstates can enlarge the extent of the market and acquire or create new comparative advantages in niche sectors specializing and trading in services for export. The development of such niche sectors requires creative government policy to exploit the special characteristics of microstates, as the survey below indicates.

THE SPECIAL CHARACTERISTICS OF MICROSTATES
AND THE "CLUSTER" THEORY

Interest in small economies did not flourish until the late twentieth century, one of the first instances of the use of the term "microstate" occurring in a title published in 1985 (Dommen and Hein 1985). Several economic and political factors, including a new tide of ethnonationalism, decentralization, and secession, have resulted in the disintegration of multiethnic states into smaller units. In some cases, disintegration has occurred peacefully (e.g., former Czechoslovakia), but more often it has erupted into conflict and violence (e.g., Yugoslavia), creating small states without formal international recognition, at least at the beginning. Bartman (1998) estimates that currently there are in excess of thirty microstates in the world, which can be described as "states in waiting," that is, *de facto* states lacking formal recognition.

As stated before, here we define microstates simply as those states with an area of less than 10,000 square kilometers. Admittedly, this criterion is different from the conventional one of measuring the size of states on the basis of population to determine the size of domestic market. I prefer geographic area, as it more closely relates to the natural resource endowments and location of states, and as such determines the climatic and geostrategic significance that, in turn, may generate comparative advantages in such service sectors as tourism, defense, financial, and specialized education.

"CLUSTER" THEORY OF REGIONAL DEVELOPMENT

How can a region, a distinct geographic area such as a microstate, prosper? One of the most interesting explanations of this question is the modern "cluster" theory formulated by trade specialists and economic geographers. John Dunning (1999), a leading trade specialist, has identified six clusters to explain how a region may plan its development. What are these six clusters?

The first is the hub. In this cluster a flagship, the hub, generates a number of suppliers and consumers, the spokes. Examples are the Boeing complex near Seattle and the Toyota complex around Tokyo. This central hub operates as the business nerve center for the creation of backward and forward linkages and networks, constituting the wider cluster.

The second type of cluster is characterized by the concentration of firms, suppliers, and competitors in a geographically proximate area, all using a common pool of natural resources and infrastructural facilities such as transportation networks. Examples of this kind of cluster are the Swiss watch industry, centered in Geneva, and the Portuguese cork industry.

The third kind of cluster involves institution building, usually based on strategic partnerships between community, educational, and government agencies as major stakeholders in a given region. The development of Boston and California's Silicon Valley as knowledge-based clusters was sparked by this kind of intent to build new institutions and capacity.

The fourth type of cluster is the government-sponsored regional development project. Examples include the development of a new national city such as Brasilia or Canberra, and the concentration of growth poles in a depressed region, such as the Mirabel airport in Quebec.

The fifth kind of cluster is the export processing zone or special economic area, built by government or business leaders to attract investment into a given region and launch it as a growth pole. Some of the most successful examples of this kind of cluster include the growth triangle centered on Batam Island, involving international cooperation between Malaysia, Singapore, and Indonesia. The Chinese economic processing zones and special economic areas are also notable cases in point.

The sixth type of cluster is the specialized technology park or innovation center. It is intended to stimulate innovation and research and development by attracting scientists, technologists, and knowledge workers. Examples include the technoparks and innovation centers in Boston and in Menlo Park, California.

What these clusters illustrate is the strategic role of state-led development. An interventionist developmental state (Wade 1990; Onis 1991) can succeed, with appropriate policy incentives and rewards, in launching and initiating rapid and sustained development. We now examine how this can be done, using a sectoral framework.

SECTORAL ANALYSIS

Some small economies, such as Singapore and Hong Kong, are first and foremost *service centers*, providing banking, financial, and trading services not only for their own export-oriented industries but also for neighboring countries' industries. Hong Kong's role as China's trading window on the world, and Singapore's similar intermediary role for Malaysia and Indonesia, is deeply rooted in the history and economic development of those countries. Exploiting this historical legacy, governments in these small economies have also been able to transform these states into major tourist attractions. Additionally, Hong Kong and Singapore have managed to develop a secondary source of comparative advantage in the rapidly expanding tourism of the Asian Pacific (Bar-On 1999).¹ These small countries emerged

as regional hubs for airlines and the multinational hotel and tourism industry, while playing a pioneering role in the design and marketing of circuit tourism, linking their own attractions with those of such other exotic destinations as Bali and Bangkok (Hall and Page 1996). Small island economies in the Pacific, such as the Northern Mariana Islands, which have virtually nothing else to develop, have also capitalized on their favorable climatic and locational advantages to launch tourism-based sustainable development (Kakazu 1994:chap. 4).

The development of the tourism sector has been a boon for small economies in other parts of the world as well. Indeed, in some cases, tourism has been the sole source of comparative advantage of small island economies. One of the most successful cases of rapid development and prosperity through tourism is Bermuda. It emerged as *tourism center*, exploiting its favorable climate and location. Bermuda, unlike Singapore and Hong Kong, lacks a regional trading link or industrial capacity. Yet it has capitalized on its relative proximity to the rich markets in North America to gain a strong, possibly the strongest, comparative advantage in tourism in the Caribbean. By comparison, other Caribbean islands, endowed with similar climatic and locational advantages, have failed to achieve the impressive income gain of Bermuda and are still bedeviled by problems of serious poverty and underdevelopment (Gafar 1998; Ashley, Boyd, and Good 2000). As well, tourism in Caribbean nations suffers from foreign control that results in a low multiplier at home and a “leakage” of tourism spending that can run as high as 75 percent. This foreign control is represented by imported skilled labor, franchise royalties, and management fees paid to foreign hotel companies, advertisers, and promoters, and commissions paid to foreign travel agencies and tour operators (Patullo 1996).

In other sectors, the growth of banking and financial services has been noteworthy. Offshore banking units, now called international banking units, and/or international business companies (formerly offshore companies) have become a growth industry in a number of microstates, thanks to their strategic location combined with enabling state legislation. Notable in this category are Bahrain, Bermuda, Malta, Jersey, the Isle of Man, and Cyprus (Bowe et al. 1998). Highly liberalized financial sectors have been a major attraction in the emergence of these microstates as offshore financial centers. Bahrain, in the oil-rich Persian Gulf, is a typical case: in the aftermath of the quadrupling of oil prices in 1973-74, it managed to emerge as the “financial centre for the Middle East” (Bowe et al. 1998:134). Taking advantage of a convenient time zone, located between those of Europe and the Middle East, and a liberal policy environment, this small state now boasts

an estimated 47 international banking units, which collectively represent the third largest employer in the state and contribute 16 percent of its GNP. However, sometimes there may be social costs attached to offshore banking centers. Thus, where loose regulatory standards or inadequate supervisory controls exist, these centers may operate as magnets for illicit transactions and money laundering. As a result, the social costs of criminality and the loss of reputation must be measured against any benefits.

Small economies, especially islands, may also possess great strategic significance. They can serve as military bases, offering sites for radar installations, for nuclear testing, or for landing and refueling aircraft. Perhaps the classic case of an island of great military significance is Cuba, which was the focus of the 1962 missile crisis. The Falkland Islands played a similar role in the war between England and Argentina. The islands of French Polynesia and the Marshall Islands have been used as sites for atomic or nuclear weapon testing. In addition, islands such as those of Hawaii are significant landing and refueling stops for trans-Pacific air traffic.

All these qualities reveal comparative advantages that yield revenue flows from, for example, foreign aid or payment of fees for services rendered. These are incomes earned from "invisible strategic service" (Poirine 1999:831). In fact, it has been found that "small island countries with a population of less than 1 million receive on average nine times more aid per capita than do less-developed" states, and this is valid even when "their average per capita GNP is much higher" (Poirine 1999:832).

THE ROLE OF THE STATE

The enabling role of the state is critical in the identification and exploitation of comparative advantage in small economies. This has been especially demonstrated in the case of the Asian Tigers (Wade 1990; Onis 1991). Given their lack of rich natural resources, these economies possess limited options for development and also suffer from the small size of their home markets. As a result, they typically have to develop innovative policies and approaches to generate potential comparative advantages (PCAs). Often this is a long-term development strategy requiring substantial investment in building capacities and skills to exploit PCAs.

PCAs may exist in a wide range of service sectors such as offshore banking, tourism, travel, communications, and strategic fields. In all cases, the exploitation of PCAs relies not only on enabling legislation but also on the availability of specific (i.e., risk-taking) types of people with the dynamism and skills to capitalize on the limited potential that exists for economic development.

The role of human capital formation in microstates is of special importance. Human capital formation (i.e., skills and education) is subject to the well-known “market failure” problem: because it is risky, it makes poor collateral to qualify for private loans in capital markets. Consequently, banks and financial institutions normally refuse to provide long-term loans to individuals who would otherwise be willing to finance their own human capital formation but lack the personal funds. This is a serious constraint on human resource development in developing countries, particularly those with inadequate financial deepening.

Thus, the early stages of economic development are marked by an underinvestment in private human capital formation by private investors. The result is a serious deficit in entrepreneurial skills and trained and educated workers in precisely those sectors in which a country may possess potential comparative advantages. This “market failure” problem is especially limiting in small economies that, as noted above, also suffer from certain structural constraints.

The major policy implication of all this is state intervention to “govern the market” (Wade 1990), in particular the labor market: major investment in human capital formation, particularly in small economies, is best initiated by the state, using public tax revenue. Public investment in human capital formation has several integral parts. A typical mix includes:

- (1) Social infrastructural development (academic schools, vocational training centers, technical institutes, special incubators, industrial R&D parks, etc.)
- (2) Scholarships, student loans, and other incentives for students in designated skill areas
- (3) Business loans and credits following graduation in order to promote small business development
- (4) Technical support, such as marketing and publicity, to facilitate sustained growth

An active labor market policy, as discussed in the preceding chapter, is supported empirically by the success stories from East Asia. The small economies of Singapore and Hong Kong provided ample support for heavy human capital investments by the state in the early stages of sustained development. This is a key lesson emerging from the East Asian “miracle growth” model (Campos and Root 1996; Green et al. 1999). A further important

aspect of public human capital formation suggested by the Asian model is that it not only contributes to sustained growth but also promotes equity. We now turn to an extended discussion of this important topic in the case of service- and export-oriented small economies.

SOCIAL JUSTICE IN MICROSTATES

The relatively small populations of microstates implies that these states can achieve growth with equity (GwE) faster. The GwE model was discussed briefly in the previous chapter. In this model the state plays a vanguard role in the promotion of economic development policies that deliberately maximize growth performance at the same time as they promote greater income distribution.

A key precondition is a development-minded government (Onis 1991) that emphasizes the growth of export-oriented service sectors. Service sectors, by definition, are labor-intensive, and their expansion promotes GNP growth with a rising wage share of income. When there is GwE, relative poverty declines. By the same token, productive employment creation tends to reduce absolute poverty.

The experience of the East Asian Tigers (Tan 1992; World Bank 1993), of which Singapore may be taken as typical, is very instructive of the potential GwE in microstates. In the first phase of Singapore's industrialization drive (1966-78), the labor market was characterized by excess labor, and a "cheap labor policy" was followed. But real wages rose nevertheless, owing to subsidized public services such as low-rent housing and transport. This contributed toward social justice, as reflected in steadily declining relative poverty during a period of stable nominal wages. After the late 1970s, when full employment was achieved, the government adopted wage and labor market policies that had the effect of not just ensuring continuous growth of GNP but further strengthening social justice. Thus, the wage share of income rose as a result of an expansionary wage policy implemented by a wage council system organized on a tripartite, democratic basis. In addition, the government implemented a Skill Development Fund (SDF) designed to upgrade and expand the skilled workforce. The SDF, financed by a 2 percent payroll tax collected by employers, invested in raising the productivity of Singaporean workers with a wide range of on-the-job and institutional training programs (Selvaratnam 1994).

Singapore is notable also for its innovative approach to the development of *sustainable tourism*, a labor-intensive method of generating new comparative advantage in an export-oriented service sector. Thus, the Singapore

River cleanup project, which began in 1977, was an urban development scheme with multiple aims: to eradicate pollution of the river, to resettle some 26,000 families and 5,000 street-cooking food hawkers, and to improve the physical environment, converting the rundown area into a major tourism center. The project, completed within ten years, has been a major success on both growth and equity criteria (Ling 1992). Sustainable tourism in the area now thrives year round, and festivals, carnivals, and night markets are major attractions along the river. High-income employment opportunities have replaced low-productivity cottage industries in a polluted environment. This particular project is a good example of Singapore's success in promoting social justice while also achieving sustained growth of income.

THE CASE OF THE TRNC

The TRNC, with an area of 3,442 square kilometers and a population of about 265,000 as of 2006, possesses several of the features of microstates outlined earlier. The economy of this young state, which came into being in 1974, is subject to an economic and political embargo imposed by the internationally recognized South Cyprus, controlled by Greek Cypriots. The embargo has pushed North Cyprus into a close tie with Turkey. As a result, imports and exports of goods that formerly flowed to and from Europe have been diverted to Turkey. Turkish goods are cheaper, and as a result of this trade diversion, North Cyprus has acquired a cost advantage relative to South Cyprus in several important sectors, such as wholesale and retail trade. Closer economic ties with Turkey have conferred comparative advantage on service sectors such as tourism and construction that now depend on cheap labor imports from the Turkish mainland, replacing the Turkish Cypriot commuter workers who work for higher wages in the South (see Chapter 5). In the case of the higher education sector, Turkish students unable to attend universities at home have come to North Cyprus, enabling the emergence of a brand-new specialized service export sector.

There have been some negative effects of closer ties with Turkey as well. The use of the Turkish lira has imported inflation and caused periodic financial crises. Since 2003, however, this particular instability has been overcome. Before the Annan Plan, the economic embargo and political non-recognition had slowed the rate of growth of the TRNC economy (Wilson 1992). In 1994, for example, the European Court of Justice, on an appeal by the Greek Cypriot party, imposed a total trade ban on agricultural and textile exports from North Cyprus, arguing that the court recognizes only the Greek Cypriot state as the legal authority in the island. The loss of the

export market disrupted the thriving citrus and manufacturing sectors of North Cyprus. The trade deficit ballooned, and trade was increasingly diverted to Turkey, the only country recognizing the Turkish Cypriots' rights and claims.

Despite these difficulties, however, and especially after the opening of the North-South border for movement of persons and some trade in April 2003, the TRNC economy has managed to achieve an impressive growth. Per capita income, which was US\$3,750 in 1997, almost trebled by early 2007, reaching just over \$12,000. This achievement was largely driven by the private sector. Public investment has lagged behind this rapid growth, except in one sector, higher education. Six new universities (three private and three public) have been established, all using English as the language of instruction. As seen below, these public/private investments have paid off handsomely, although they showed their impact after a time lag. The university sector has been a dynamic "growth pole" and has emerged as an export-oriented leading sector (see below).

However, this has not been an easy achievement; it has required significant and painful structural transformation of the entire economy. The economy of North Cyprus, like that of other microstates, has experienced difficult "trial and error" efforts to achieve sustainable development. In the initial stage of its economic take-off after 1974, the focus of public investment policy was the creation of "state economic enterprises" (SEEs) in agriculture, manufacturing, and tourism. The SEE focus resulted in over-employment, especially in the public sector, which emerged by 1997 as the largest sector, slightly ahead of agriculture.

More recently, and as in other microstates, development policies in North Cyprus have attempted to shift the economic base from primary to secondary and ultimately to tertiary sectors. In the tertiary sector, tourism and higher education have been emphasized. Indeed, the higher education sector has emerged as a "cluster" or "growth pole."

Universities as Growth Centers

The evolution and rapid growth of universities in North Cyprus has been the major force in the transformation of the economy from a traditional agrarian base to export-oriented services. The Eastern Mediterranean University (EMU) in Gazimagosa, home of North Cyprus's sole deep-sea harbor, pioneered university growth on the eastern coast of the island. The EMU, which opened its doors as a state institution in 1979, transformed Gazimagosa into a university town.² Its formation was stimulated by excess demand for university education in mainland Turkey, just fifty miles to the

north, coupled with the necessary cooperation between the Turkish and TRNC governments. In its first decade the EMU's enrollment rose sharply, from less than a thousand to over seven thousand, of which 75 percent were Turkish students from the mainland, where there is a perennial shortage of university openings.

The rapid expansion of the EMU had a dramatic impact, causing a multiplier effect. It spawned the growth of several private, profit-oriented universities located in the four major urban centers of North Cyprus. These five universities became a major source of foreign exchange earnings. At the start of the 1999 academic year, the combined enrollment of the five universities then in operation approached 20,000, of whom 30 percent came from North Cyprus, 63 percent from Turkey, and the remaining 7 percent from 53 countries in Asia, Africa, Europe, and North America. With the establishment of an offshore campus of Ankara's Middle East Technical University in 2006, there are six universities in North Cyprus. Total enrollment in the six has more than doubled to about 50,000, with the share of Turkish students declining and that of international students from the Middle East, Africa, and the Balkans rising steadily.

The economic impact of this rapid university growth has been quite impressive. Overseas students, spending on the average about US\$15,000 annually for tuition and living expenses, are effectively long-term tourists. Even if we do not consider the income multiplier effects, the estimated contribution of the university sector to the GDP of North Cyprus finances about one-third of the trade deficit. As recently as 1987, the comparable ratio was only 1.8 percent of this deficit.

The research and publication performance of the EMU compares favorably with that of the leading Turkish universities, especially in social and administrative sciences, particularly when the relative youth of EMU is remembered. Clearly, universities in North Cyprus have to raise the quality of teaching as well as research as they strive to attain international standards. But it is evident that the TRNC has made significant progress in this export-oriented sector.

Economic Equity

On the equity side, the development policies of the TRNC have been on the whole quite successful. Overemployment in the public sector is costly, but it has had the positive effect of promoting a more balanced distribution of income, especially as almost every household has at least one member working as a public servant. Such public goods as education and health are heavily subsidized, with free education up to the age of 15 and

free hospitalization available for low-income individuals. In terms of social policy, while there is as yet no unemployment insurance, there is a generous social security system providing for old-age pensions and a superannuation scheme for the working population. Absolute poverty, defined as an income of less than \$2 per day, is virtually nonexistent.

The social benefits can be exemplified in terms of the United Nations Development Programme's Human Development Index (HDI) (UNDP 1999). The HDI is computed on the basis of three indicators: (1) a life expectancy index, measuring life expectancy at birth, (2) an adult literacy index, based on a weighted average of adult literacy rate and the combined gross enrollment rate in the age bracket 6-17, and (3) adjusted real GDP per capita on a purchasing power parity basis.

On the basis of official figures from the TRNC State Planning Organization for all the relevant indicators, we have estimated that the HDI for North Cyprus in 1997 is 0.82. This places North Cyprus among the top, in the high human development category, in the UNDP rankings. The HDI index for South Cyprus is 0.87, for Greece it is 0.86, and for Turkey it is 0.73 (UNDP 1999:164-65).

The evidence reviewed and discussed here suggests that the small size of a country need not be a constraint on growth and equity in development. Indeed, sustainability depends increasingly on new potential comparative advantages not traditionally recognized by classical and neoclassical economists working from the perspective of diseconomies of scale. The classic diseconomies argument may be valid for goods and manufactures, but it may be invalid in the new and emerging field of trade in specialized services. The cluster theory reviewed here offers some possibilities for exploiting potential comparative advantages in export-oriented service sectors, in particular higher education and tourism.

OTHER SOURCES OF COMPARATIVE ADVANTAGE THE "DAY AFTER":
PEACE DIVIDEND, WATER, AND THE EU

Especially in the event of a comprehensive settlement of the Cyprus problem, North Cyprus—indeed, the whole island—can expect to realize significant other comparative advantages. A recent study (Mullen et al. 2008) argues that in the first year following a settlement, Cyprus will experience trade creation parallel to that of the peace and reconciliation era in Turkey and Greece, where since 2003 commercial trade and tourism have exploded from virtually nothing to over \$2 billion and are expected to increase to over \$5 billion within a few years. The peace dividend for each family in Cyprus,

according to this study, is 5,500 euro annually at the beginning, and it is expected to rise. A similar study (Mehmet et al. 2008) has estimated that in the event of a settlement, tourism revenues will expand by about 30 percent in the North and by about 15 percent in the South, representing an annual sum of \$300 million for the island economy, one-third of which is expected to occur in the North.

North Cyprus will also gain from trade creation and free trade access with the EU and world economy. In addition to benefiting from the EU's structural and regional development funds, it will enjoy international recognition and will be an EU territory in fact and in law, with the *acquis communautaire* applicable as in the South. In particular, the Green Line Regulation, in effect a nontariff barrier put into force at the time of Greek Cypriot accession very much on Greek Cypriot terms, will be lifted, and foreign investment and island-wide trade will begin. Prices and costs will converge, as will incomes, but of course, the latter will take a few more years while prices and costs can be expected to equalize much faster, owing to competitive market forces.

Imported water for United Cyprus will be major and demonstrable advantage of settlement. The whole island is currently facing a water shortage, and unless some cost-effective solution is found quickly, the competitiveness of the tourism industry as well as other key sectors, including agriculture and industry, may be threatened. To make matters worse, with global warming a reality, the water shortage will almost certainly intensify.

What, if any, are the economically feasible long-term remedies? Currently, there are two alternatives: desalination of seawater and importation of freshwater. According to the latest comparative cost figures, desalination of seawater is about 67 eurocents per cubic meter.³ On the other hand, the cost of shipping water from Greece by tanker is considerably higher, at 5 euros per cubic meter, a figure that is almost certain to increase owing to rising oil prices.

These alternatives are, simply put, not viable options for solving the island's immediate water shortage while maintaining cost-competitive tourism and industrial sectors. Nor can these technologies offer a long-term sustainable solution for the island, North and South.

The long-term solution is Turkish water. It is available for less than US\$0.20 per cubic meter, possibly even cost-free initially as a contribution to peace building in Cyprus, providing, of course, the obvious political obstacles are removed.

Where is the potential Turkish water for import to the island? Several sources are available, depending on the technology of large-scale water

transport. At Manavgat, near the major vacation spot of Antalya, the Turkish government has already completed two loading terminals. Originally, Turkey was to sell up to 100 million cubic meters of water annually to Israel. Turkey wanted to charge US\$0.18 per cubic meter, Israel offered \$0.08, and then, due to a change of government, the deal fell apart. But there is no reason, except politics, why this export facility cannot be exploited now for the benefit of the people of Cyprus.

Manavgat is not the only source of Turkish water. Farther east, near Anamour, the Dragor River flows into the Mediterranean, and in the same region there is also the Goksu River, which issues in the Toros Mountains. The Turkish government has given the large pipeline company Alarko Holding an \$8.5 million contract to carry out an engineering feasibility study for an undersea suspended pipeline to deliver Turkish water to North Cyprus. Until such a project becomes reality, it may be necessary to ship Turkish water to the island by tanker, if, of course, the political obstacles can be cleared.

An experimental project to ship Turkish water by large balloons, pulled by tugboats operating between Anamour and Guzelyurt, failed for technical and operational reasons. Nevertheless, in a few years' time Turkish water will come to Cyprus. The critical question now is, can it be developed jointly for the benefit of all the peoples of Cyprus? Common sense and solid economics say yes. It is to be hoped that politics will agree.

CONCLUSION

The advantages enumerated in the previous section are contingent benefits, that is, realizable in the event of a political settlement of the Cyprus problem. If, however, no such settlement is feasible, there is no reason why North Cyprus, as argued above, cannot go it alone as a service economy, specializing in high-quality products in tourism, higher education, and other services.

Comparative advantage means producing a good or service at lower cost than your closest competitor, regardless of economic size. In the case of North Cyprus, smallness seems to be more than compensated by two specific comparative advantages, both emerging from economic ties with Turkey. The first is on the supply side of the market, the second on the demand side. First, close economic ties with Turkey have permitted cheap imports of labor inputs, consumer goods (especially in retail services), and durable and intermediate goods (cars, appliances, and construction materials), giving Turkish Cypriot firms a competitive advantage over their Greek

Cypriot counterparts. Second, large numbers of Turkish students and tourists (as well as investors) have enabled the growth of cost-competitive higher education and tourism sectors in the North. None of these comparative advantages are likely to disappear in the foreseeable future; indeed, as Turkey's economy becomes stronger, so will that of North Cyprus.

Investment and competitiveness are the two preconditions of sustainability. To the degree that North Cyprus is able to offer the world market competitive products in services, its survival, like that of Singapore and the Isle of Man, is guaranteed. It must, however, manage investment in growth according to the rules of efficiency. Modeling investment is a technical task. It is explained in detail in the next chapter

Modeling Required Investment in North Cyprus

THE SUSTAINABILITY of a microstate requires a steady and well-managed investment climate to fuel its growth and competitiveness. In North Cyprus these objectives can be recast as *convergence*, that is, achieving economic parity with the South. This chapter extends the argument of economic rationalism to modeling the investment required in North Cyprus to achieve parity with the South on the basis of the Harrod-Domar (H-D) Model. This model is especially suited for a program of capital expenditure focused on public infrastructural projects covering both physical and social infrastructure. Physical infrastructure refers to projects in power, telecommunications, highways, ports, and so on, while social infrastructure is centered on skilled worker development through human capital formation, primarily, but not entirely, in the public sector. The H-D Model also estimates private investment, seen as the economic driver of growth. Public investments are complementary, enabling the more critical profit-oriented investment in the private sector.

WHY THE H-D MODEL?

The Harrod-Domar Model is a physical capital formation model fit for an economy in the early stages of development or suffering from chronic shortage in physical infrastructure (Sen 1970).¹ That is because growth is dependent purely on capital, K , which in the original specification of the model is defined as purely physical capital. Nowadays, unlike in the 1940s, when the model was formulated, K is defined not only in physical but in human capital as well. There is no recognition of human capital in either the Harrod or the Domar formulation. In the traditional production function,

$$Y = F(K),$$

income, Y , is solely a function of physical capital, K , as if no other factor of production existed. However, in an economy in which infrastructure is a key constraint on growth (such as North Cyprus), the Harrod-Domar Model is justifiable. As for human capital, developed through investment in social infrastructure, this can easily be accommodated within the model, especially by assuming that it can be developed in higher education or the private sector. Once required investment is determined, it is allocated among projects to be funded on the basis of priority rankings. At this stage human capital requirements can be estimated at the project level.

A second major clarification is in order in the Harrod-Domar Model. This relates to the role of the financial sector. The model assumes equilibrium between aggregate savings, S , and investment, I . This equilibrium ensures that the savers, principally households, put their excess disposable income in deposit accounts in a well-functioning banking sector that channels savings into investment.² Savings may be partly domestic and partly foreign (in the case of North Cyprus, foreign savings are Turkish official transfers). In other words,

$$I = S = S_d + S_f$$

The subscripts d and f refer, respectively, to domestic and foreign sources of savings.

The Harrod-Domar Model has the advantage of simplicity because the key formula focuses attention on the most critical variables, that is,

$$g = s/v,$$

where g is the desired aggregate growth rate, s is the aggregate saving rate consisting of both domestic and foreign, and $v = \text{ICOR}$, the incremental capital-output ratio,³ or dK/dY . If, in addition to availability of K , the capital markets work efficiently as noted above so that aggregate savings are effectively mobilized into investment, then the desired growth rate, g , becomes a positive function of the savings rate, s , which is the investment ratio, that is, $s = I/Y$.

It is evident that a growth-stimulating environment exists today in North Cyprus in the aftermath of the UN Referendum in April 2004, for two major reasons. First, the definition of property rights in the Annan Plan spelled out for the first time the parameters of a key issue of the final

political settlement. Whatever the nature of this settlement, if it ever occurs, the property claims will be roughly what is provided in the plan. The second reason has to do with macroeconomic stability in Turkey, where interest rates have sharply declined to eliminate savings in high-yielding Turkish treasury bonds or speculative financial deals through shaky banks. This macroeconomic stability, along with enhanced legality in the aftermath of the Annan Plan, has brought about a behavioral transformation among Turkish Cypriots. Now a great deal of aggregate savings are being channeled into economic development, especially in residential construction, trade, and tourism. Financial aid from Turkey has assisted major projects in electricity, energy, telecommunications, harbors, highways, and other forms of physical infrastructure. Rapidly rising incomes have created an upsurge in demand for automobiles, at a rate far in excess of the expansion of highways, resulting in overcrowding and congestion, especially in urban centers.

However, the small size of the North Cyprus economy can be an economic advantage, overcoming supply (infrastructural) bottlenecks rather quickly. Given the injection of external investment resources for capital expenditure projects, it is highly feasible to achieve sustained growth and bring about 100 percent convergence of incomes between North and South on the island in a relatively short period of time, ten to fifteen years. The main precondition is that there should be faster and sustained growth in the North to catch up to the income level of the South. Thus, economic parity is critical for reunification and the sustainability of a comprehensive settlement.

Several scenarios of the model are presented in the discussion below. The first one assumes that in time a United Republic of Cyprus or similar outcome will emerge, updating what was proposed in the Annan Plan. The second one assumes that a two-state solution will be reached and that North Cyprus will determine its economic development independently. And the third one assumes that a settlement is not feasible anytime soon, owing to the great economic disparity between the Turkish and Greek Cypriot communities. Technically, the specification of the model, and hence the required investment in the North, differs little between these political scenarios, the major difference being that in the URC scenario, North Cyprus receives federal capital expenditures from the federal budget as part of a macroeconomic policy called “managed convergence” (see below). In the second and third scenarios these federal fiscal transfers come from alternate sources such as Turkey and other investors.

REACHING \$15,000 PER CAPITA INCOME IN FIVE YEARS

The difficulty with economic convergence is that a comprehensive settlement based on the Annan Plan seems distant, owing to the reluctance of the Greek Cypriot side to share power with the economically weaker Turkish Cypriot side. On the basis of economic rationalism, Greek Cypriot reluctance is quite understandable. For one thing, why should the Greek Cypriots form a partnership state requiring a substantial subsidy for a roughly comparable living standard in the North and South? Even if the Greek Cypriots did not end up paying the subsidy themselves (Turkey or others such as the EU may end up funding it), the politics of the partnership state could be bogged down by constant disputes over Greek and Turkish Cypriot differences in macroeconomic policy or other aspects of federalism. Moreover, what incentives do the Greek Cypriots have to share the benefits of EU membership with the Turkish Cypriots, given that they alone enjoy all these benefits at the present time? The rational course of action in this situation is for the Turkish Cypriots to push through reform of their economy and state for speedy economic convergence, that is, eliminating the income disparity between the North and South as quickly as possible.

The timing of a comprehensive settlement in Cyprus makes a vital difference in the economic strategy of North Cyprus. Thus, if settlement occurs by 2015, full economic convergence may well be an accomplished fact by then, meaning that the focus of such a settlement would be to graft political equality on an already accomplished economic equality. In that case, political equality would rest on the equality of two peoples, two founding states, as equal stakeholders, not the soft equality envisaged in the Annan Plan. On the other hand, if a political settlement is achieved relatively quickly, say by 2010, then the function of the federal economic policy of the URC must be to promote and sustain economic convergence. Under any scenario, the most appropriate economic policy for North Cyprus is to become a developmental state, with the government of the day (whether parliamentary or presidential) dedicated to a clear economic program and good government and focused on the elimination of disparity in per capita income between Greek Cypriots and Turkish Cypriots as soon as possible.

This is best achieved by means of a policy of a clear economic targeting, such as US\$15,000 per capita income of Turkish Cypriots by 2011. Once such a target is determined, the vital question that arises is, what savings and investment are required to achieve this target? Table 5.1 provides the detailed answer.

Table 5.1 is simply an economic simulation exercise based on certain assumptions to guide economic policy. There are two key assumptions in

TABLE 5.1. Requirements for Reaching US\$15,000 per Capita Income in North Cyprus by 2011.

VARIABLE	PARAMETER ANNUAL AVERAGE, 2005-2011	2005	2011
Income/capita	1.07	10,250	15,382
Greek Cypriot Income/capita	1.03	19,000	22,686
Turkish Cypriot/Greek Cypriot (%)		0.53	0.68
Marginal propensity to save (mpc)	0.8		
Private savings (%)	0.17		
Public savings (%)	0.03		
Foreign investment	0.08		
Total Investment Required (millions of US\$)		659	
Private sector	0.6	395	989
Public sector	0.4	254	555
ICOR	4		

the table: (1) that the aggregate investment/GDP ratio will increase from the current level of 20 percent to 28 percent, and (2) that capital efficiency will increase so that incremental capital (ICOR) will decline to 4, so that an average annual growth rate of GDP of 7 percent can be maintained.

The implications of this investment strategy need to be elaborated. In order to achieve a 28 percent investment ratio, savings in both the private and public sectors must be significantly raised (i.e., the marginal propensity to consume must be reduced from its current level of 80 percent), and foreign investment inflow (principally from Turkey but also direct foreign investment) must increase. As well, capital efficiency in North Cyprus must be improved significantly with an emphasis on efficiency and good government, so that ICOR falls to 4 from its current estimated level of 4.5 to 5.

If these assumptions are realized, the rewards are impressive. By 2011, per capita income in North Cyprus will exceed US\$15,000 and the disparity between Greek and Turkish Cypriots will be greatly narrowed. Here, too, there is a significant underlying assumption. How fast will the economy in South Cyprus grow? An average of 3 percent per annum is assumed, for two reasons. First, as a mature economy it has a slower growth potential

than the North. Second, after entering the EU, the economy experienced a moderate contraction owing to a higher cost of living due to the elimination of subsidies and money-laundering activities and to the generally stricter EU norms and standards.

MAKING THE URC WORK THROUGH FEDERAL MACROECONOMIC POLICY

By 2011, according to projections in Table 5.1, income per capita in North Cyprus will reach 68 percent of that of South Cyprus, and it therefore it will be feasible to enter a partnership in the URC as proposed in the Annan Plan or an enhanced version of it. On the other hand, establishing a URC may mean the end of Turkish aid, and accordingly, it is vital that the URC be created with a solid economic foundation in order to provide federal fiscal transfers to North Cyprus to achieve 100 percent convergence in incomes and growth rates. This is essential for stability and sustainability of the URC; in other words, it is in the common interest of both communities.

This key requirement can be stated differently: constitution making for political equality is not enough for a stable, sustainable settlement. The best solution must also specify and provide conditions for economic convergence.⁴ Without economic parity, political equality written into the constitution is meaningless and transitory.

The aim of federal macroeconomic policy within a possible URC can be stated as follows:

- (1) A sustainable “best” settlement in Cyprus, based on a URC, requires not only political equality but economic equality or full parity through economic convergence.
- (2) Full economic parity must be achieved either prior to a settlement by raising per capita income of Turkish Cypriots to the level of that of Greek Cypriots or through managed convergence within a relatively short time by a federal government fully committed to economic and political equality.
- (3) Prior to a settlement, North Cyprus must become a development state to commence the task of income parity with the South, giving top priority to economic development with this ultimate aim in mind.
- (4) Economic rationalism suggests that it would be in the interests of all, Greek Cypriots no less than Turkish Cypriots, as well as the UN and especially the

EU, to cooperate jointly to aid North Cyprus as a developmental state and bring about economic parity in Cyprus in the shortest timeframe possible.

Accordingly, we begin by constructing a macroeconomic model in order to estimate the magnitude of investment required for the achievement of economic parity, called *managed convergence in a federal URC*, as soon as possible.

TARGET: LEVELING THE ECONOMIC FIELD,
OR ACHIEVING 100 PERCENT INCOME CONVERGENCE

The overall policy target in a possible URC of the economic model constructed here is economic parity, or 100 percent convergence of per capita incomes in the North and South of Cyprus, as soon as possible. However, convergence of incomes is not enough; at the same time, growth rates must be equalized for macroeconomic stability. Otherwise, once achieved, convergence will bring about a reversal of disparities, that is, Turkish Cypriot incomes will surpass those of Greek Cypriots, an outcome equally undesirable. Accordingly, a macroeconomic policy of 100 percent convergence implies a deliberate and carefully crafted federal policy to ensure stability and sustainability.

In the model, the difference in per capita income in the South, Y_g , and in the North, Y_t , is $\Delta(Y_g - Y_t)$. The reduction of this disparity to 0 is a key objective of federal macroeconomic policy of *managed convergence* in a future URC, by an agreed-on date such as 2020:

$$\Delta(Y_g - Y_t) = 0.$$

Under such a federal macroeconomic policy, two specific targets of convergence are actively pursued: (1) 100 percent income parity and (2) equalization of growth rates in the North and South. Both these policy targets are essential for macroeconomic stability. Therefore, as Turkish Cypriots approach the Greek Cypriot per capita income, the economic growth rate in the North must slow down and convergence be held at 3 percent to maintain a common macroeconomic policy. Otherwise, the disparities will be reversed and cause instability.

Table 5.2 provides the details of the progressive achievement of these twin policy targets during the ten years from 2012 to 2021. At the outset of the URC, we project that per capita income in South Cyprus will be US\$23,367 and will reach \$27,089 by 2018, given a growth rate of 3 percent.

TABLE 5.2. Progressive Achievement of Convergence of Incomes and Growth Rates in the URC.

	PERIOD 2012-18	PERIOD 2019-20	PERIOD 2021 AND BEYOND
South Cyprus			
Income/capita (US\$) at start:	23,367	27,902	30,489+
at end:	27,089	29,601	
Annual growth rate	3%	3%	3%
North Cyprus			
Income/capita (US\$) at start:	16,305	28,293	30,307+
at end:	26,838	29,425	
Annual growth rate	6%	4%	3%

During this period the North Cyprus economy will grow at 6 percent, or double the rate in the South, in order to catch up. This comparatively rapid growth is to be pursued by a deliberate macroeconomic policy, in particular an investment strategy as outlined below. As Turkish Cypriot per capita income approaches the Greek Cypriot level, the growth rate in the North is deliberately slowed to 4 percent during 2019-20 and then to an island-wide 3 percent from 2021 on, when incomes fully converge. From this date onward, the objective of federal macroeconomic policy becomes one of maintaining common prosperity on the basis of a unified and stable macroeconomy.

Required Investment for Convergence

Given the target of 100 percent convergence, we need a policy instrument to achieve this goal. The required investment for capital expenditure is such an instrument. It acts as the catalyst for a higher growth rate in North Cyprus. In the model it is assumed that the North will grow from 2006 to 2015 at 6 percent per year, or twice the steady state growth rate of the more mature South, that is, 3 percent. In other words, the North has the potential to grow twice as fast. A faster growth rate than the average 6 percent would require an extremely high investment/GNP ratio. Even a 6 percent growth rate implies a heavy investment burden, as it would require no less than a 27 percent investment/GNP ratio, at an average annual investment through 2015 of US\$583.2 million.

The model assumes that the private sector will be the dynamo of the

economy in the North. Thus, of the required total annual investment of \$582.3 million, the majority, \$348.4 million, or 60 percent, is planned as private sector investment prompted by the prospect of a political settlement (a figure the Turkish business community believes may be understated).⁵ Significantly, since the Referendum on 24 April 2004, private investment has exceeded this amount.⁶ The remaining 40 percent, or \$232.9 million, will be in the public sector: public infrastructural investment for modernization and upgrading basic facilities to international standards (in harbors, airports, roads, power, telecommunications) and human capital formation for training in the required skills.

Feasibility of Planned Investment

How feasible are these investment requirements? In particular, is the 27 percent investment/GNP ratio projected in the model above achievable? According to the State Planning Organization, the aggregate investment/GNP ratio in 2005 was 20.5 percent, consisting of 18.9 percent fixed capital expenditure plus 1.6 percent as change in inventories. The private sector share was 14.3 percent, the balance of 5.2 percent being the public sector share.⁷ The ratio was projected to increase to 21.6 percent in 2006.

There are two significant dimensions in the figures above. The first is the fact that investment in North Cyprus is indeed private sector driven, and the second is the shortfall in public sector investment, especially fixed capital expenditure representing investment in infrastructural facilities. The latter is, in fact, financed almost entirely from Turkish aid. Put differently, this underinvestment in public infrastructure is a reflection of the existing bottlenecks experienced in the supply of electricity as well as in the availability of other basic infrastructural facilities, such as roads and water as well as social infrastructure in skill development.

How can public sector underinvestment be remedied? In the event of a settlement based on the establishment of a URC, it is important that provision is made for federal fiscal transfers to the North Cyprus development budget, as argued above. In our model we have assumed that a significant percentage of required public investment, \$91 million, or 20 percent, will be in the form of federal transfers for capital expenditure in North Cyprus. Another way of looking at this federal fiscal transfer is as a dividend for settlement. This dividend is part of a strategy of convergence between the North and South intended to promote economic reunification. It is best implemented as *managed convergence*, that is, an integral part of a federal macroeconomic policy jointly managed by Greek and Turkish Cypriots as equal cofounders of the URC. Although it is conceivable that

in a laissez-faire free market environment (i.e., unmanaged convergence, as preferred in Greek Cypriot circles—see, for example, Eichengreen et al. 2004) some economic convergence will indeed take place, there are two major weaknesses of the laissez-faire strategy. First, it runs the risk of making Turkish Cypriots second-class citizens,⁸ and it may be slow,⁹ and second, these facts will generate friction, undermining the capacity of the federal government to be a meaningful stakeholder in promoting and maintaining the sustainability of the federation.

Given strategic injections of investment in the public sector of the North Cyprus economy, stocks of physical capital can be upgraded and augmented to desired levels of growth to achieve convergence of uniform prosperity for all citizens in North and South Cyprus. Accordingly, it is assumed here that those well-meaning external sources and organizations, in particular the European Union and USAID (in addition to Turkey), with a stake in the eventual resolution of the Cyprus issue will be forthcoming with some of the required injection of investment funds in the North to promote convergence. In fact, aid coordination offices have been set up by these agencies in the North to facilitate such aid inflows.

Time Path of Convergence

The time path for the convergence scenario in the model has four stages, all to be carefully monitored and managed by federal macroeconomic policymakers in the URC to achieve the desired policy targets of equalizing per capita incomes and growth rates in Cyprus. The first stage of managed convergence is 2015, when a cumulative sum of about US\$1 billion is to be transferred from the federal budget to the Turkish constituent state investment budget to work as a catalyst in an investment program including both public and private capital expenditure. These annual federal transfers are amortized over 20 years and calculated as $1/20$ of the difference in per capita incomes aggregated for the total Turkish Cypriot population, taken to be 190,000 in 2005. It is important to emphasize that these funds are *not* for consumption but for public sector projects for high-value social and physical infrastructure.¹⁰ By the end of this period, the Turkish Cypriot per capita income, which is estimated to be only 37.5 percent of the Greek Cypriot level in 2005, rises to 82 percent. The relevant figures are summarized in Table 5.3.

Despite the failure of the Referendum in April 2004, early indicators suggest a faster rate of economic convergence than projected. By 2006, per capita income in North Cyprus had exceeded US\$10,000, and an explosive construction-led investment boom had generated a growth rate in excess of

TABLE 5.3. First Stage of Convergence, 2005-2015.

	2005	RATIO OF TURKISH CYPRIOT/GREEK CYPRIOT INCOME, 2005	2015	RATIO OF TURKISH CYPRIOT/GREEK CYPRIOT INCOME, 2015
Greek Cypriot income per capita (US\$)	16,000		21,502.66	
Turkish Cypriot income per capita (US\$)	6,000	0.375	17,602.29	0.81861
Difference	10,000		3,900.37	
Federal Fiscal Transfers (millions of US\$)	95		1,000.2	

15 percent. It is evident, however, that this boom is not sustainable, partly due to environmental limits, but primarily owing to infrastructural constraints, especially in the availability of electricity, telecommunications, highways, and water. The issue of sustainable growth, with special reference to the construction sector, is discussed in detail in Chapter 7. It is doubtful that a rate of growth in excess of 6 percent can be sustained for much longer unless a dramatic increase in the investment/GDP ratio occurred.

The second stage of managed convergence in a future federal Cyprus is from 2016 to 2020, when a further investment of approximately \$260 million is transferred from the federal budget to the Turkish Cypriot development budget, a cumulated sum of \$1,259.7 million. In this period 97 percent convergence is achieved, and the growth rate in the Turkish Cypriot state declines to 5 percent. This reduced growth rate discloses the important fact that under the macroeconomic policy of managed convergence, both per capita incomes and growth rates must be equalized. Relying on market forces alone cannot bring such a desirable outcome, implying that federal macroeconomic policy management under a *laissez-faire* regime would be unfeasible. As a result of growth and progress toward convergence, the population in the Turkish Cypriot state increases modestly in the second stage to 200,000. Indeed, by 2016 it can be expected that Turkey will become a full member of the EU and the inflow of Turkish economic migrants to North Cyprus will be maintained as part of an active labor market policy, specifically as part of an official guest-worker scheme designed to regulate the inflow of workers strictly in accordance with the economy's requirements (see Chapter 6).

Assuming successful implementation of the managed convergence strategy, in the third stage federal transfers to the Turkish Cypriot investment budget are eliminated by 2020. At this stage, Turkish Cypriot per capita income will approximate 98 percent of Greek Cypriot income. The remaining small gap will vanish to zero owing to a slightly higher growth rate in the Turkish Cypriot state, 4 percent versus 3 percent in the Greek Cypriot state. At this stage, management of the aggregate growth rate becomes vital for macroeconomic stability and for ensuring that incomes remain equalized for all Cypriots.

Under our scenario, full convergence between North and South Cyprus would be achieved by 2025. At the end of 2025, per capita income in all of Cyprus would be around US\$29,000 and the growth rate island-wide would be a steady 3 percent. An island-wide macroeconomic policy would then become the norm on a common playing field, but beforehand, income inequality had ruled out such a possibility. Once 100 percent convergence is thus achieved, any disparities between the economies of the North and South would be eradicated and economic sustainability on a level playing field in a federal Cyprus would be safeguarded due to a uniform annual growth rate of 3 percent. Of course, continuation of a managed macroeconomic policy beyond 2025 is necessitated by the need to ensure overall prosperity and stability in the URC.

Derivation of Required Investment in the First Ten Years, 2005-15

Now we focus on the derivation of the required investment to achieve the target of 100 percent convergence. This is provided, for illustration purposes, in this second component of the Harrod-Domar Model, covering the first ten years, 2005 to 2015:

$$I = gY^*v$$

where I = the required investment, g = the growth rate, y = per capita income, and v = ICOR taken as 4.5, a rather high figure reflecting relatively inefficient capital utilization in North Cyprus owing to economic and political isolation.¹¹ The figures also reflect an interesting implied investment multiplier of 0.48 in 2005, declining further to 2015. The low multiplier stems from the service-oriented character of the North Cyprus economy and an underdeveloped manufacturing sector, in part due to trade embargoes that have resulted in economic isolation. Export earnings from services, such as higher education and tourism, which will become the economic dynamo of North Cyprus economy, provide the finance for this high trade import

TABLE 5.4. Required Investment (10 YR 2005–2015 only), Based on the Harrod-Domar Model ($I = gY^*v$).

	PARAMETER	2005 (US\$ MILLIONS)	2010 (US\$ MILLIONS)	2015 (US\$ MILLIONS)	CUMULATIVE TOTAL (US\$ BILLIONS)
Total investment		307.8	566.7	903.0	6.5
Private investment	0.6	184.68	340.0	541.8	3.8
Public investment	0.4	123.12	226.7	361.2	2.6
Federal Fiscal Transfer (FT)		95.0	95.0	74.1	1.0
Balance from other sources		28.1	131.7	287.1	1.6
FT as % of total investment		0.31	0.17	0.08	
Implied multiplier		0.48	0.4	0.3	
ICOR ^a	4.5				

^aIncremental capital output ratio.

dependence. In other words, the investment multiplier is low because of high import leakage, both for consumption and for producer goods.

The last column of Table 5.4 gives the cumulated sums of required investment for convergence during the ten years 2005–15. Under our assumptions, a total cumulative sum of \$US6.5 billion is the projected investment requirement, consisting of \$3.8 billion in private and \$2.6 billion in public capital expenditures earmarked for essential infrastructure projects. Of this last figure, \$1.0 billion represents the federal transfers expected to work as a catalyst, as argued above, the balance coming from other sources such as Turkey.

Before concluding, we must note that technical assistance for North Cyprus is as important as financial resources. It took South Cyprus more than ten years of hard bargaining with the EU before accession. North Cyprus was outside this process. After decades of isolation and embargoes, Turkish Cypriots need technical help in project preparation and implementation, capacity development, and financial management. In addition, federalism can work in a URC only if technical assistance from friendly donors is forthcoming. The fact is that federalism is not in the Cypriots' historical memory. Neither the Greek Cypriots nor the Turkish Cypriots (and indeed the same applies for Greece and Turkey) have any knowledge of how

federations work. Therefore, much external technical aid will be needed. These matters have not been emphasized here, but their vital role in the successful implementation of managed convergence cannot be overstated.

Sensitivity Analysis with the Harrod-Domar Model

Sensitivity analysis is a technique for determining the impact of a given change on a projected value. It deals with the question, what if? That is, what will happen if the growth rate in North Cyprus turns out to be greater than the assumed 6 percent? What if the ICOR value is not 4.5 but 4? Sensitivity analysis is a useful test of the robustness of our estimations and projections.

When assumptions in the base case are altered, alternative results naturally occur, and these can be evaluated according to whether they are sustainable or realistic. For example, if the growth rate is raised from 6 percent to 7 percent, other things remaining the same, the volume of required investment will be an annual average of \$707.5 million and the investment/GDP ratio will be 31.5 percent, rising further with every percentage point increase. In general, an investment/GNP ratio of over 30 percent is unsupported as it implies that almost one-third of national income is channeled into investment. Of course, for a short time (such a year or two), large injections of foreign funds may enable such growth rates, but over a ten- or fifteen-year period, that is not feasible. For one thing, it is likely the economy will get overheated from inflationary pressures due to bottlenecks arising from a lack of necessary inputs.

One interesting sensitivity test we performed was to combine a 7 percent growth rate with a higher efficiency in the utilization of physical capital, that is, to use a lower ICOR. Thus, when $ICOR = 4$, a 7 percent growth rate can be achieved with only a 28 percent investment/GDP ratio and a required average annual investment of \$628.9 million, owing to higher national income. What this particular scenario implies is that if physical capital in North Cyprus could be used more efficiently (e.g., if electricity generation could use cost-saving modern technology), then a faster rate of growth and earlier convergence would be realized with a more affordable investment effort than otherwise.

One further sensitivity test we carried out involved a higher starting per capita income in North Cyprus at the time of a comprehensive peace settlement to establish a URC. In the original base case, an initial disparity of US\$16,000 against \$6,000 was used. But in view of faster convergence after the Referendum, per capita income in North Cyprus increased impressively to around US\$9,000 at the end of 2005 and approached \$12,000 at the end of 2007, thanks to an unexpectedly large inflow of direct foreign investment

in tourism-related real estate. Therefore, given a Greek Cypriot/Turkish Cypriot income disparity of 2:1, keeping everything else same in the base case would produce two significant conclusions: (1) average annual required investment would be \$708.4 million and the investment/GNP ratio would be 27 percent, but (2) 100 percent convergence would be achieved in 2018, a full five years sooner than before.

Admittedly, these are ambitious projections and targets, requiring a huge economic sacrifice on the part of Turkish Cypriots to undertake the required investment to catch up with the income levels of South Cyprus and make a political settlement sustainable. In this challenge they will naturally require financial and technical support from the international community as well as Turkey. Most significantly, goodwill and cooperation will have to come from the Greek Cypriot side. The reward, however, is worth it. Future generations of Cypriots, the children and grandchildren of the present generation, will reap the dividends of the required investment computed above in terms of a stable and prosperous united country.

WHAT IF A UNITED CYPRUS IS NOT ACHIEVABLE? THE NEXT BEST ALTERNATIVE

The most drastic sensitivity analysis involves nonsettlement, or a two-state solution. One thing is certain: continuation of the status quo—keeping North Cyprus in a state of limbo under political and economic isolation—is not acceptable. North Cyprus, as a microstate, does have alternatives.

It is no secret that the Greek Cypriot side has always wished for a unitary state under its own (majority) control, arguing that in Cyprus there is only one people (Greek Cypriot) and a minority (Turkish Cypriot). During the Annan Plan negotiations, the Greek Cypriot side argued strongly for this option, equating a URC with a Greek Cypriot-dominated URC.¹² In the event of a nonsettlement, two options exist. Either there is a mutual divorce à la Czechoslovakia, whereby one or the other side in Cyprus finds a URC based on political and economic equality too costly and prefers an amicable two-state solution, or there is gradual recognition of the Turkish Republic of Northern Cyprus in the international community. There is also the possibility of continuation of the status quo, however unacceptable or costly this might be. This would clearly be an inferior solution.

Under both options the choice for North Cyprus in terms of economic development policy is quite clear. It must continue forward along the path of a *developmental state* (as argued in Chapter 3), delivering economic and social development as the key function of the government, implementing

the investment strategy outlined in the Harrod-Domar Model above. The federal transfers for capital expenditure assumed to originate from the URC federal budget would be either replaced with the North's own resources or supplemented by transfers from Turkey and other friendly countries.

Why is the status quo costly for both sides? The explanation rests on the fact that in a regional context the economic forces favor the Turkish side, not the Turkish Cypriots alone but Turkey, barely fifty miles to the north, especially after the emergence of the Turkish Energy Corridor (see Chapter 8). Economic integration with the Turkish mainland, documented in the next chapter, is already under way.

One of the most important types of economic integration now going on between North Cyprus and Turkey involves labor market flows. Prompted by higher earnings, large numbers of Turkish workers are coming to work in North Cyprus. This type of economic migration is commonly found elsewhere in the world. In the case of North Cyprus, it is facilitated by close proximity and customs union agreements between Turkey and the TRNC. The next chapter discusses labor market processes and flows, including Turkish guest workers in North Cyprus.

The Labor Market: Developing Skills for a Service Economy

RAPID AND sustained growth requires not only physical infrastructure but also high-quality, skilled human resources. This, in turn, implies large-scale investment in human capital development, primarily in state-provided polytechnics and technical/vocational schools. If tourism and related service sectors are to be the locomotive of the North Cyprus economy, skill development must be designed with care to match the personnel requirements of these sectors. This requires an action plan or labor market policy deliberately designed and implemented by the Department of Labor to ensure efficient human resource development and allocation.

What is the current labor market situation in North Cyprus? It is largely a free and flexible market. Although there is a high literacy rate thanks to a good education system, there is underinvestment in technical and vocational training. With relatively few technical/vocational schools, there is an inadequate supply of skilled workers, especially technicians, clearly well below the capacity required for high and sustained growth. The traditional manner for skill development is on-the-job (informal) training whereby a young person picks up whatever skills he or she can by experience and observation. Employers, especially investors from Turkey, rely on imports of Turkish workers, often ignoring the local availability of qualified workers.

At the same time, North Cyprus has a large number of commuter workers who travel daily to higher-paying jobs in the South. Is this a case of “brain drain,” depleting North Cyprus of its valuable high-level human capital, or is it rather an intricate substitution process in the labor market whereby Turkish migrant workers simply replace Turkish Cypriot commuter workers going south? Whatever the answer might be, the labor market in North Cyprus is a sophisticated process requiring careful management by the government to ensure stable growth. Moreover, in the event

of a political settlement, labor market convergence will be a critical factor within the macroeconomic policy management, requiring a delicate balancing of inflows and outflows of labor across borders.

Two recent labor market surveys were carried by a team of researchers from the Eastern Mediterranean University (Mehmet et al. 2007) to determine how the labor market flows and real wages are operating in the status quo of a divided Cyprus. One was a commuter worker survey of Turkish Cypriots working in the South, and the other was a guest worker survey of migrant workers entering the North Cyprus labor market from Turkey. Both categories of workers are “economic migrants” who are motivated by economic gain. The key research question was to determine whether labor market convergence is occurring to facilitate a future United Republic of Cyprus as envisaged in the UN Peace Plan or whether it is forcing Turkish Cypriots into second-class status in a Cyprus dominated by Greek Cypriots.

The chapter is analytical, empirical, and policy-oriented. First, these two patterns of mobility and migration¹ are analyzed, using standard economic theory of rational migration. Second, an empirical evaluation uses special survey findings along with relevant official statistics. Finally, some policy implications for labor market convergence are highlighted.

MOBILITY IN NORTH CYPRUS: TWO KINDS OF ECONOMIC MIGRATION

Although small, with just over 82,000 workers (Ministry of Economy and Tourism 2005),² the North Cyprus labor market reveals two significant and interesting types of mobility. One is international, flowing from low-wage, labor-surplus regions of southern Turkey, just seventy miles away across the Mediterranean; the other is internal, across the Green Line, as Turkish Cypriots commute daily to the South for higher-paying jobs. Both types of labor mobility represent economic migrants carrying out rational behavior shaped by market forces.³

MODELING ECONOMIC MIGRATION

The modern microeconomic theory of rational migration was pioneered by human capital theorists such as Theodore Schultz and his academic team from the University of Chicago in the 1960s (see, for example, Schultz 1961). In this theory, migration is a rational decision by an individual who is maximizing self-interest. Migration is a careful investment decision, comparable to the acquisition of skills and technical know-how, leading to a more efficient labor market process and hence a more rewarding employment for the

worker concerned. In terms of macroeconomics, rational migration results in efficiency gains due to more productive utilization of human resources.

Following in the footsteps of Schultz, Larry Sjaastad (1962) introduced the investment model of rational migration in the early 1960s. In the following decade, and against the background of growing interest in the huge internal migration in the Third World, the rational migration model was further expanded and enriched by the economist Michael Todaro (1969), who treated the case of migration from rural to urban labor markets in developing countries.

Rational migration occurs when certain conditions exist: (1) freedom of movement, (2) no exit or entry barriers, and (3) adequate labor market information. In pure theory, these conditions are known as “perfect market” conditions. In practice, the first two are administrative or political conditions that must be provided. Beyond these two, there must be adequate and reliable information about job opportunities, wages, and working conditions for meaningful comparisons between jobs in the original location and in new destinations.

Rational migration occurs internationally, regionally, or within a country, as in interstate or rural-urban migration. In all cases, migrants behave rationally to better their working conditions. In other words, job seekers change their employment location in search of higher-paying jobs, *ceteris paribus*.⁴ Accordingly, and most simply put:

$$Exp \Delta Y = prob * [Y_1 - Y_0] - T \quad (1)$$

where *prob* = probability of getting a job, $1 > prob > 0$; *Exp Y* = additional expected income from migration, Y_1 = income at the destination, Y_0 = income at the origin, and T = transportation cost from the origin to a destination.

What is critical in eq. (1) is the probabilistic role of expectations on the part of migrants, which center on the *ceteris paribus* conditions. Expectations vis-à-vis jobs in the new location are an exercise in risk taking, with a certain level of probability of success (when *prob* = 1) or failure (when *prob* = 0). In this framework, economic migrants compare incomes at the two locations and they move if and when they believe their move will make them better off, expecting that *prob* > 1. But believing is *ex ante*, and the reality may turn out differently, in terms of not only wages but working conditions or other aspects of the jobs they obtain. Thus, the validity of the theory is an empirical question and requires empirical application.

The necessary condition for rational migration to occur is that it should be profitable:

$$\text{Exp } \Delta Y > 0. \quad (2)$$

Otherwise, migration will not pay, and the decision to relocate will end in disappointment. There are several reasons for this negative outcome, one major factor being the fact that $T > (Y_1 - Y_0)$, and if migration incurs significant psychic or adjustment costs in the destination labor market, most notably prolonged unemployment or language or racial barriers.

Eq. (1) is simple because it excludes the fact that economic migration can be long-term or lifelong, as when migrants relocate permanently, as opposed to short-term or transitory. In the case of permanent relocation, although the same investment decision occurs, the benefits and costs of migration are calculated in terms of present values, using a private discount rate that reflects the personal rate of time preference. This last variable is a subjective assessment reflecting the psychic value of migration, that is, loss of family and friends in the original location and adjustment problems encountered in the new location.

LABOR MARKET CONVERGENCE: COMMUTER WORKERS IN CYPRUS

Here we analyze statistics relating to wages, social security, and working conditions of Turkish Cypriot commuter workers in the South. These statistics are derived from a special random survey ($N = 301$) conducted in November 2005. It is estimated that there are 5,000 to 6,000 such workers. Accordingly, the sample size of 300 was determined to achieve minimum 5 percent coverage, and direct enumeration was chosen for data collection from commuters at the border "gates" in order to ensure accuracy and representativeness.

First, we provide some descriptive statistics about the 301 commuter workers (Table 6.1). The average age was 36 years, with a minimum of 15 and a maximum of 64 years. Only 8.3 percent were female; accordingly, the survey findings are focused entirely on male workers.

Generally, the education level of commuter workers was fairly low, with 3 out of 4 having no more than elementary schooling, only 22.3 percent having high school, and only 4 percent possessing university-level education. Thus, the majority of commuter workers in the South are low-skilled rather than highly qualified manpower. It disproves the fear in some quarters of a large volume of human capital loss to the South.

Nearly 3 out of 4 (70.8%) were married. Most of the commuter workers (53.2%) lived in the Famagusta region, with a further 19.6 percent from Iskele. For the Nicosia district, the figure is 22.9 percent, perhaps reflecting

TABLE 6.1. Descriptive Statistics of Turkish Cypriot Commuter Workers.

1. Average age: 36 yrs
2. Gender: 91.7% male
3. Highest level of education:
74.7% elementary
22.3% secondary
4% university
4. Marital status: 70.8% married
5. Home district:
53.2% Famagusta
22.9% Nicosia
19.6% Iskele
2.3% Guzelyurt
2% Kyrenia
6. Worked for over 2 yrs: 59.1%
7. Paid weekly: 95%
8. What benefits have you received:
None yet: 95.7%
Unemployment: 1%
Health/medical: 2%
9. Travel to work daily:
In own or shared car: 95.3%
Going 0-20 miles: 56.8%
More than 20 miles: 43.2%
Paying for travel > 3 CYP: 86%

the existence of a large industrial zone and better job opportunities there. Elsewhere the numbers are small: 2.3 percent from Guzelyurt and 2.0 percent from Kyrenia; clearly, the distance traveled to a border gate is a factor.

The great majority of commuter workers have been working in the South for at least 2 years. In fact, 59.1 percent have worked there for more than 2 years, a further 26.6 percent for 1-2 years, 6.3 percent for 6-12 months, and 8.0 percent for less than 6 months.

The typical form of pay was weekly (95%), providing further evidence of the generally low level of commuter workers. Only 5 percent were paid monthly. The average net take-home pay (after deductions for income tax⁵ and social security) was CYP 648.5 per month, the maximum (in the case of one person who owned a business) being CYP 1,200 per month, the minimum being CYP 220.

Table 6.2 summarizes monthly net take-home pay of Turkish Cypriot commuter workers, by sector. The mean and the maxima and minima around the mean are shown to give a sense of the range, which seems to be

TABLE 6.2. Monthly Net Take-Home Pay of Turkish Cypriot Commuter Workers, by Sector, 2005 (in CYP).

SECTOR	FREQUENCY	MINIMUM	MAXIMUM	MEAN
Manufacturing	137	240	3,400	697.46
Services	72	310	1,200	697.23
Construction	92	220	780	537.35
All workers in all sectors	301	220	3,400	648.47

TABLE 6.3. Net Pay of Turkish Cypriot Workers Compared with That of Greek Cypriot Workers, 2005.

	FREQUENCY	PERCENT	CUMULATIVE %
The same	92	30.6	30.6
< 25%	155	51.5	82.1
< 25-50%	45	15.0	97.0
< 50%	3	1.0	96.0
> GC workers	6	2.0	100
Total	301	100.0	

quite large. Pay levels vary by industrial sector. They are virtually the same (at an average of CYP 697 per month) and highest in manufacturing and services, with construction significantly behind at CYP 537.35. There is a wide variation between maxima and minima, although the manufacturing maximum is distorted by the fact that it refers to one entrepreneur who owns a factory.

Table 6.3 compares net pay with the pay of Greek Cypriot workers in the same industrial sector with similar job skills or experience, as reported by commuter workers. Overall, 30.6 percent of respondents reported being paid the same wages as their Greek Cypriot counterparts, while twice as many reported inferior or lower pay. Interestingly, 2 percent of respondents reported higher levels of pay.

When 2 out of 3 workers report inferior pay relative to comparable workers, there is serious wage discrimination against Turkish Cypriots working in the South. Such a labor market cannot be working as a tool of convergence, promoting wage equalization as predicted by theory. This is especially disturbing if ethnicity is the basis of wage discrimination.

Our statistics suggest an average discrimination ratio ranging from 25 to 50 percent, the average probably being around one-third, a high ratio of

wage discrimination. Wage discrimination in this case means inferior pay for the same work performed by comparable Greek Cypriot workers.

Wage discrimination reported here is from the perspective of commuter workers. For objectivity, it needs to be verified by Greek Cypriot sources. Our study was designed to obtain “reference group” net pay directly from Greek Cypriot sources, but our Greek Cypriot partners have so far not been able to provide this vital piece of information.

Relying on our findings, we underline the fact that reported wage discrimination is based on the perceptions of commuter workers alone. According to these workers, the presence of wage discrimination is widespread and is substantiated by individual observations given to enumerators during the survey and reported below.

Despite the presence of wage discrimination, Turkish Cypriot commuter workers in the South are better paid than before they started work in the South. Thus, 93.0 percent reported a significant increase in their pay in the South compared with previous earnings in the North, the majority reporting up to 25 percent higher pay. Moreover, there are psychic benefits that make wage discrimination tolerable. The most significant is the fact that commuter workers return home daily, enjoying the comfort of their homes and families in the North, implying that physical separation of the two ethnic communities on the island is a “compensating benefit.”

Convergence is a good outcome because it creates efficiency gains. The individual workers and employers gain, as does the economy. When economic migration takes place, wages gradually tend to converge between the original and new labor markets. The convergence process continues until finally, in the long run and with continued free movement of labor and perfect information, they equalize, save for transport cost. This is a desirable outcome because convergence brings about efficiency gains, allocating labor in the most productive employment. In terms of macroeconomics, labor market convergence promotes equalized wages, with workers of equal skill and productivity earning equal wages and having equal working rights under social security regulations.⁶

One efficiency gain of labor market convergence is the ultimate elimination of labor market discrimination. For if such discrimination exists in the receiving labor market (say because employers have religious or ethnic preference), then wages will not converge and there will be lost potential output with lower per capita income as the result. These are ideal conditions; they may not prevail in reality. We now discuss this topic.

Barriers to Convergence: Labor Market Discrimination

Labor market discrimination refers to the underpayment of groups of equally qualified workers in given jobs or industries in comparison with a reference group. This discrimination may be based on gender, race, or ethnicity. In the case of Cyprus, for example, Turkish Cypriot workers in the South may be subjected to ethnic discrimination even when they are just as qualified or skilled as their Greek Cypriot counterparts. This problem is an empirical issue and can be verified and studied through a special survey of concerned workers, discussed below.

When discrimination prevails, it reduces the efficiency of the labor market process, causing loss of potential output. In addition, there are indirect costs stemming from worker resentment, absenteeism, and dissatisfaction. In short, workers, firms, and governments all pay the direct and indirect costs of discrimination.

Barriers to Convergence: In-Migration from Turkey

The second barrier to labor market convergence is excessive or unregulated migration of labor into North Cyprus from Turkey. Higher wages in North Cyprus are attractive for these Turkish mainlander workers, and given relatively free entry, they enter the North Cyprus labor market in such sectors as construction and services. While these workers help reduce the cost of construction, they also have negative effects. Thus, they effectively cancel out the progress toward labor market convergence between North and South Cyprus by perpetuating lower wages and incomes in the North.

TURKISH GUEST WORKERS IN NORTH CYPRUS

Between 1999 and 2003 the number of guest workers staying in North Cyprus for the duration of their work permits varied between 5,000 and 6,500 per year, including seasonal agricultural workers employed in the citrus harvest and forestry. However, the exact figure of foreign workers is unknown due to large numbers of illegal workers entering North Cyprus without any passport formality, typically as tourists. By 2004, there was a general perception of an excessive inflow of Turkish migrants against a background of economic boom.

This led the government to introduce a new immigration policy, including a new guest-worker scheme requiring all migrant workers to obtain work permits and become guest workers. Guest workers differ from commuter workers going to the South. Guest workers are temporary, noncitizen workers, and by the terms of their work permits they are expected to return

TABLE 6.4. Work Permit Applications, 1999-2005

YEAR	TOTAL	NEW	EXTENSION
1999	5,828	4,156	1,672
2000	6,113	4,611	1,502
2001	5,311	3,924	1,387
2002	5,828	3,521	2,307
2003	6,498	4,124	2,374
2004	12,429	9,656	2,773
2005	46,010	38,464	7,546

Source: Department of Labor, Lefkosa.

to Turkey at the termination of the permits, although a good number marry and stay.

In 2004 the numbers of guest workers increased to 12,429, but the big increase occurred in 2005, when total guest worker applications jumped to 46,010, of which 38,464 were new registrations and 7,546 were extensions.⁷ The relevant data are given in Table 6.4, which also shows figures for earlier years.

The new guest-worker scheme went into force on 1 November 2005. After that date any unregistered migrant worker was subject to a penalty. Moreover, it was the responsibility of the employer to apply to the Department of Labor to get a preliminary work permit before the guest workers entered the country.

In January 2006 we conducted a random survey of 308 Turkish guest workers in the North Cyprus labor market. According to Immigration Office records, completed work permits totaled 10,353 out of 46,010 work permit applications (May–October 2005). The sample size of 308 achieved a minimum 3 percent coverage, ensuring accuracy and representativeness.

The average age of the 308 guest workers was 30 years, with a minimum of 17 and maximum of 52 years; 20 percent were female (Table 6.5). Generally, their education level was fairly low, 4 percent having no education, 1 out of 2 having no more than elementary schooling, 35 percent having completed secondary schooling, and only 7.5 percent possessing university-level education. Thus, the majority of guest workers in the North are low-skilled, confirming the general perception that low-cost immigrant workers displace relatively expensive local workers.

Nearly half (45.5%) were married. Most (47.4%) came from the southern coast of Turkey, reflecting the importance of proximity and transportation cost. For Turkey's large industrial zones with better job opportunities

TABLE 6.5. Descriptive Statistics of Turkish Guest Workers.

1. Average age: 30 yrs
2. Gender: 79.5% male
3. Highest level of education:
52.9% elementary
14% junior secondary
21.1% secondary
7.5% university
4. Marital status: 45.5% married
5. Home region:
37% South East Anatolia
28.2% Eagen
12% Interior Anatolia
10.4% Mediterranean
6.5% Black Sea
0.6% East Anatolia
6. Worked for over 1 yr: 63.3%
7. With their families: 20%
8. Do not plan to go back: 51.6%
9. Transportation to North Cyprus
Sea: 74.7%
Air: 25.3%
10. Transportation cost: > 250 YTL
11. Type of payment
Weekly: 28.9%
Monthly: 68.8%
12. Commuting costs > 2 CYP: 31.8%
13. Unskilled workers: 55.5%

in the Aegean region and Inner Anatolia, the figures are 28.2 percent and 12 percent, respectively, perhaps reflecting the pulling effect of North Cyprus's higher wages. The numbers are small for other regions such as Eastern Anatolia and the Black Sea, clearly indicating the effect of the distance to North Cyprus.

More than half the guest workers (51.6%) have no intention of going back to Turkey, and for a further 38 percent the return decision depends on available opportunities. About 20 percent came to North Cyprus with their families. The majority (63.31%) have been working in North Cyprus for more than 1 year.

The typical form of pay (68.8%) was monthly. The average net take-home pay (after deductions for income tax and social security)⁸ was YTL 1,041.9 per month, the maximum being YTL 5,500 per month, the minimum being YTL 450.⁹

TABLE 6.6. Monthly Net Take-Home Pay of Turkish Guest Workers, by Sector (in YTL).

SECTOR	FREQUENCY	MINIMUM	MAXIMUM	MEAN
Construction	32	720	1,600	995.3
Manufacturing	87	450	2,000	1,018.6
Tourism	87	619	5,500	1,253.6
Services	99	450	1,800	886.1
Agriculture	2	800	1,040	920
All workers in all sectors	307	450	5,500	1,041.9

Table 6.6 summarizes monthly net take-home pay of Turkish guest workers, by sector. The mean and the maxima and minima around the mean are shown to give a sense of the range, which seems to be quite large. Pay levels vary by sector and are highest in tourism and manufacturing, with construction slightly behind. There is a wide variation between maxima and minima; the maximum is distorted by the fact that it refers to one exceptional entrepreneur from Turkey who owns a factory, restaurant, and construction company.

Table 6.7 compares the net pay of Turkish guest workers in North Cyprus with their net pay in Turkey prior to migration. Two of every five guest workers reported an increase in pay of 50 percent or more compared with their previous earnings in Turkey. A further 25 percent reported higher pay in the range of 25-50 percent. In total, virtually 90 percent reported a significant pay increase in North Cyprus compared with their previous earnings in Turkey.

Our survey of Turkish workers in North Cyprus revealed some significant findings. First of all, the level of education of Turkish Cypriot commuter workers in the South and those coming from Turkey are similar, suggesting that there is no loss of human capital in North Cyprus. Put differently, this fact implies that net migration creates a monetary net gain for the country, helping to offset the large trade imbalance. Second, the Turkish migrants tend to concentrate in two sectors: construction and tourism. In the former sector these lower-wage workers help keep housing prices lower and the inflation rate less than otherwise would be the case. In the tourism sector, where wages of Turkish workers are higher than those of construction workers, there is no reason for these imports because, especially in terms of white-collar, front-office jobs, there seem to be adequate local workers. It appears, therefore, that Turkish hotel owners tend to encourage an excessive inflow of migrant workers, something that a well-regulated guest-worker scheme in North Cyprus ought to control, as discussed below.

TABLE 6.7. Net Pay of Turkish Guest Workers in North Cyprus Compared with Net Pay in Turkey.

	FREQUENCY	PERCENT	CUMULATIVE %
The same	14	4.5	4.5
> 25%	78	25.3	29.8
> 25-50%	117	38	67.8
> 50%	4	1.4	68.2
Higher	67	21.8	90.6
Lower	11	3.6	94.2
Did not work before	17	5.5	100
Total	308	100.0	

AN ACTIVE LABOR MARKET POLICY:
ANALYTICAL PRINCIPLES AND EU PERSPECTIVES

From the perspective of labor market policy, the inflow of workers from Turkey must be closely monitored as part of the managed convergence policy discussed in the previous chapter. An unregulated inflow of labor clearly runs the risk of slowing down convergence of per capita incomes between North and South. Accordingly, labor market convergence needs to be viewed as an integral component of macroeconomic policy, implemented vigorously by the Department of Labor. In the event of a political settlement on the basis of a United Republic of Cyprus at some future date, labor market convergence would be tied to an active labor market policy as discussed below, benefiting from the vast EU experience in this field.

An active labor market policy is a "managed labor market" directed by deliberate policy intervention in order to avoid social external costs created by free and unimpeded labor migration. A managed labor market is now an essential part of the European Union, as discussed below, where employment policy and monitoring of labor markets are integral to macroeconomic policy management.¹⁰ The same should apply in a possible future federal Cyprus.

Unlimited labor imports from Turkey would, for the foreseeable future, prevent labor market convergence between North and South Cyprus. Unregulated migration would also entail significant social costs in the form of criminal migrants and financial drains on housing, educational, and health services. In view of these social externalities, North Cyprus authorities have

introduced a guest-worker scheme to regulate the labor inflow from Turkey. This scheme is a first step that is required for labor market convergence between South and North Cyprus. However, by itself it is not enough; it must be applied efficiently within the framework of an active labor market policy, which is itself a component of managed macroeconomic convergence, a topic discussed in Chapter 5. The experience of the EU in this area is a good model for the URC, and accordingly, it is briefly analyzed here.

Management of migration as a component of an active labor-market policy is the opposite of an unmanaged labor market in which entry and exit are entirely unregulated. Such free labor mobility would be desirable as a long-run objective on a “level playing field,” that is, when there is no structural unemployment between the sending and the receiving labor markets and no significant institutional (security and social service) costs. If the social costs of incoming migrants more than offset any benefits of lower wages that some employers may derive, then regulated migration is required as an external control mechanism of active labor market policy.

The EU has its Schengen system of migration management (see Monar 2004), part of a common immigration policy that entails an elaborate cross-border police system and administrative control in the name of public safety and security, using sophisticated computer-based information technology. Managed migration is a response to the fact that in recent years, several EU countries (especially Portugal, Spain, Italy, France, and Belgium) have been faced with high and persistent unemployment,¹¹ apparently reflecting rigidities arising from unionism and strong customary beliefs. As a result, migration management is a key component of labor market policy. In the EU’s post-2004 enlargement process this managed migration policy has become even more significant.

Over and beyond the external control mechanism, there is an internal dimension of an active labor market policy intended to enhance labor market efficiency. In EU governance, the Directorate General for Employment, Social Affairs, and Equal Opportunities aims to make Europe the world’s “most competitive and dynamic knowledge-based economy.”¹² Several EU countries, including Spain, Portugal, and Ireland, have benefited from major funding under the European Social Fund as well as Regional and Structural Funds to undertake large-scale investments in technical and vocational training, skill upgrading, and mobility programs in line with human capital theory.¹³ Retraining of structurally unemployed workers is an important element of active labor market policy. In the case of skill upgrading (for already-employed workers), these training programs are typically financed from a payroll tax collected from employers for a skill development

fund,¹⁴ originally designed and applied in Singapore in the 1970s as part of that nation's drive for full employment.¹⁵ But in the case of structurally unemployed workers or new entrants into the labor market, these training costs are usually borne by governments from tax revenue.

Of course, now that Turkey has started accession talks with the EU, in the long run free labor migration from Turkey to North Cyprus may be an agreed-on outcome, in which case full convergence between North and South Cyprus and Turkey at a common wage may become a reality. That, however, must be viewed as achievable only after several decades.

In the meantime, North Cyprus needs to reform its labor market policy by harmonizing its laws with EU standards, upgrading the technical capacity of its inspectors and other staff, and most importantly designing and implementing various skill training programs to expand the supply of trained workers with certified skills. In turn, the EU must offer technical and funding support to help North Cyprus achieve this kind of labor market reform.

Realistically, labor market convergence with South Cyprus can become a reality only if labor laws and the social security system in North Cyprus are reformed and harmonized with EU standards. If and when this is achieved, labor market convergence on a level playing field becomes feasible, ensuring equal treatment of all Cypriot workers regardless of ethnicity, gender, or language. In short, if a United Republic of Cyprus is established, labor market convergence must be managed by means of an active labor market policy, as part and parcel of managed macroeconomic policy aimed at stability while also increasing the supply of trained workers essential for a fully employed, efficient labor market.

In the event of having to go it alone, North Cyprus would still need an active labor market policy for labor market efficiency. In the first place, imported labor from Turkey needs to be harmonized with the skill requirements of North Cyprus, guest workers supplementing, rather than replacing, local qualified workers. In addition, the influx of excess workers and their families is likely to generate social and cultural problems, intensifying the resentment that always exists between newcomers and local residents. For the Greek Cypriots, the presence of Turkish citizens or settlers in Cyprus represents the Turkification of the island, something they naturally have resisted. The counterpoint to Turkification is the labor market discrimination against commuter workers in the South, which we documented above. No sustainable labor market convergence can occur under either of these situations, and only effective and equitable policies can overcome such dangers.

In the past, when large numbers of Turkish workers came, many brought their families. Most worked for low wages in the construction sector (discussed in the next chapter), able to afford only minimal rents in poor districts. This led to the “ghettoization” of the cores of cities and towns (e.g., the walled part of Nicosia), forced down rents and the quality of housing, and created tension and conflict in inner-city schools due to the large numbers of children of working Turkish parents. Overall, only effective labor market policy can overcome such issues.

Imported labor gravitates to such sectors as construction where there is easy entry and steady demand for unskilled as well as skilled workers. The construction sector in North Cyprus exploded immediately after the Referendum, accelerating the inflow of Turkish workers. The next chapter takes a close look at this phenomenon, examining the economic determinants of the construction boom and in particular questioning its environmental sustainability. In view of the unique and fragile ecology of North Cyprus, it is desirable to strike a dynamic balance between rapid economic growth and environmental protection.

The Construction Sector in the Post-Referendum Period

Ozay Mehmet, Vedat Yorucu, and Rusen Keles

THE APRIL 2004 Referendum on the Annan Peace Plan led to a construction boom in TRNC because of a widespread expectation that a comprehensive political settlement would stimulate prices and profits. These expectations, in a large part driven by speculative demand for real estate, caused growth of over 30 percent in just one year, from 2004 to 2005. This type of explosive growth is clearly unsustainable and can only be expected to encounter serious ecological and structural limits. A more reasonable growth rate is both desirable and inevitable.

This chapter uses a macroeconomic framework to analyze the principal causes and impacts of the construction sector on the economy of the Turkish Republic of Northern Cyprus, particularly in terms of income and employment. Given that the TRNC possesses a unique and rare ecosystem in the eastern Mediterranean, the chapter devotes special attention to the environmental impacts of the construction boom, highlighting environmental costs and deficiencies in land zoning regulations. Pollution and unplanned urbanization are also discussed, and the urgent need for rigorous environmental legislation, especially at the local level, is emphasized.

Research on the construction sector of North Cyprus has rarely been done, although since the mid-1990s there has been an explosion in the building of apartments, especially in the high-density tourist regions of Kyrenia and Famagusta, raising serious environmental concerns and creating infrastructural bottlenecks. The surge in construction activity has created structural imbalances for the TRNC economy in general and urban planning challenges in particular. The fact is that urban planning and environmental protection were not taken into consideration by policymakers before the onset of the construction boom. Government authorities

naively assumed that construction-led growth would not cause any serious problems. Now it may be too late to arrest, let alone reverse, the process.

EXPLAINING THE CONSTRUCTION BOOM: THE ANNAN PLAN

The UN Peace Plan, popularly known as the Annan Plan, was the first evidence of international legality in North Cyprus, in particular with respect to property claims. After several revisions following complex rounds of negotiations, the final version of the plan was released on 31 March 2004 and submitted for separate referenda on both sides of Cyprus on 24 April 2004. It was approved by the Turkish Cypriots, who voted 65 percent in favor, but it was resoundingly rejected by 76 percent of the Greek Cypriots.

Investors in general, and those in real estate in particular, need a clear legal framework to realize expected returns. This is what the Annan Plan provided because one of its most significant provisions relates to the settlement of property claims in the North and South. For the first time since 1974, when Greek Cypriots left their property in the North and Turkish Cypriots left theirs in the South, these counter property claims are defined and codified for settlement. Specifically, Article 10(4) sets up an independent and impartial Property Board, consisting of Greek Cypriot, Turkish Cypriot, and international jurists, to arbitrate and determine property claims within a prescribed timeframe. The rights of owners and current users are carefully balanced. Article 10(3b) states that one-third of the value and one-third of the area of total property ownership is to be reinstated to original owners, while the rest will be dealt with through compensation, long-term leases, or other mutually agreeable formulas.

The Annan Plan had a major impact on the property market in the North, primarily because it defined property rights and protected the rights of current users and investors in addition to the rights of owners. It led directly to a huge investment in real estate, driven partly by domestic demand and partly by foreign demand. In turn, there has been a construction boom, covering all subsectors of construction (residential, commercial, and industrial), but notably in tourism-related building.

The Annan Plan also covers, in a limited manner, environmental policy. Although this is primarily a federal responsibility, the states play a significant role in such areas as land zoning, building permits, and land registration. Part IV, Article 16(3b) of the plan emphasizes the environmental protection and use and conservation of energy in the URC. The federal and constituent states are expected to cooperate, coordinate, and harmonize their policies and legislation, including through cooperation agreements, common standards, and regular consultations.

THE DEVELOPMENT OF THE HOUSING CONSTRUCTION SECTOR

The development of air transportation since 1968 facilitated the arrival of mass tourism on the island, which led to a boost in the construction sector, especially in the most popular tourist areas such as Varosha (near Famagusta) and Kyrenia. During the same period migration increased from the neighboring rural areas toward urban and tourist regions, creating an extra need for homes to accommodate the growing workforce in tourism and related industries. At this stage, growth in construction was driven principally by residential building. However, this early trend slowed after the 1974 Greek military coup and the Turkish intervention, and then stagnated until the early 1980s. During the late 1970s Turkish settlers from Eastern Anatolia came to the island, and the population of North Cyprus started to increase rapidly, causing an expansion in housing construction. In this period Greek Cypriot and Turkish Cypriot authorities cooperated in the construction of a joint sewage and drainage system in the divided capital city of Nicosia, financed by the United Nations Development Programme (UNDP). This was the first intercommunal program, which brought the two communities somewhat closer after 1974. There was an increasing population movement from rural areas to Nicosia, and Turkish settlers moved into the depopulated villages, where they repaired and restored abandoned Greek buildings or in some cases constructed new ones to replace those beyond repair.

In the mid-1980s the university sector began to expand in the TRNC, stimulated by excess demand for higher education in Turkey. The Eastern Mediterranean University was established in Famagusta in 1986, followed by the Girne American University in Kyrenia, the International American University in Kyrenia, Lefke University in Lefke, and the Near East University and Cyprus International University in Nicosia. In 2002, 27,748 students were studying and more than 3,000 employees were working at these universities (State Planning Organization 2002). Growth in the university sector occasioned a major construction boom, centered on institutional and related residential and commercial building. Thus, the university sector in North Cyprus acted as a growth pole, triggering construction in all the regions where these campuses were located.

By the end of the 1990s, the nature of the construction activity shifted toward public infrastructural projects. Various highway construction projects were completed with financial aid from Turkey, including new expressways connecting Nicosia with Famagusta, Kyrenia, and Guzelyurt. These highways expanded the size of the internal market and accelerated industrial and commercial expansion, especially stimulating the growth and development of industrial complexes.

Industrial growth, in turn, further stimulated residential construction. Bayramoglu (1997) notes that 89 percent of total construction in Nicosia, 84 percent in Famagusta, and 92 percent in Kyrenia was residential; 8 percent in Nicosia and Famagusta and 7 percent in Kyrenia was commercial. The remainder was industrial. The statistics for Nicosia are very similar to those for the whole of the TRNC.¹

THE DETERMINANTS OF INCREASED VOLUME OF CONSTRUCTION

The construction sector has achieved sustainable growth during the last two decades with increasing employment opportunities and rising share of gross domestic product. Despite all the economic embargoes and political isolation of TRNC, the construction sector grew enormously in terms of the number of contractors operating in the TRNC, and related sectors expanded noticeably as part of the multiplier impact of construction investment. For example, the transportation, trade and commerce, and manufacturing sectors all benefited from the growth in construction and contributed to further development of the real economy.

We now briefly discuss the major determinants of increased construction volume. The average annual growth rate of population between 1980 and 2002 was 1.66 percent. However, the average annual growth rate of total construction, in terms of the number of buildings, was 6.68 percent and in terms of square meters 6.91 percent. The TRNC experienced high inflation during the two decades ending in 2002, yet even during this inflationary period the construction boom continued. During this period the cost of building per square meter grew at an average of 53.99 percent annually.²

What is noteworthy in these figures is the similarity of two alternate growth indicators: the average annual growth in numbers of buildings constructed and the average growth of construction volume measured in square meters of floor area. However, when population growth (1.668%) is contrasted with construction volume (6.68%), an anomaly is observed in that the latter far exceeds the former, suggesting unplanned excess building, or “dead capital.”

In addition to the demographic determinants discussed above, there are financial, political, and social factors explaining the trend in construction volume in the TRNC. Before 2002, inflationary expectations, devaluations in the Turkish lira (the currency of the TRNC), the establishment of new universities, the policy of early retirement among public servants, high gratuity compensations (policies used by the TRNC authorities to boost private-sector growth), and offshore banking, perhaps even money laundering, all

reinforced each other to generate the rapid construction volume observed. As far as the political determinants are concerned, the list includes the following: political unrecognition of TRNC, a crisis in the banking sector in Turkey, and beginning in November 2002, proximity talks between the two communities of Cyprus under the auspices of UN Secretary-General Kofi Annan, culminating in the 2004 Referenda.

Foreign demand for real estate in North Cyprus has also been influenced by political expectations. According to the official statistics of the Ministry of Interior for 2004, 2,467 donums of land were purchased by 2,743 nonresidents since 1974.³ Ozgan (2004) estimates that there are five thousand foreign residents in Kyrenia alone, receiving services provided by that municipality. The Annan Plan stimulated foreign demand for real estate. The pledges of European Union diplomats to end the isolation of the Turkish Cypriots have also contributed to boosting demand for real estate in the TRNC. One trend in the post–Annan Plan period was the movement to North Cyprus of European citizens who sold property they possessed earlier in the South, evidently taking advantage of huge price differentials.

The import volume of construction materials is a significant indicator of construction volume. During 2004 the input materials imported for the construction sector, such as steel, concrete, and lumber, increased significantly. For example, in just one year, from 2003 to 2004, the imports of steel materials increased from US\$11.39 million to \$36.77 million (222.8% increase), concrete imports increased from \$6.82 million to \$19.68 million (188.6% increase), and lumber imports increased from \$5.18 million to \$11.39 million (119.9% increase) (State Planning Organization 2004). These trends accelerated in subsequent periods.

Speculative demand also played a significant role. Ben (2004) points out that the Annan Plan not only increased the demand for construction volume but also attracted the interest of speculators looking for a quick windfall in the land and real estate market in North Cyprus. This trend pushed construction prices up along with wages. It is rumored that Greek Cypriots are purchasing properties in the North through intermediaries. Proxy purchases of land through British or other foreign nationals may be occurring in anticipation of a political settlement in the due course of time.

A PRICE MODEL FOR THE TRNC REAL ESTATE MARKET

We now utilize all these variables in a simple aggregate (macroeconomic) model of the real estate market with reference to North Cyprus after the Annan Plan. The dependent variable is P , price of real estate, as a

function (f) of aggregate demand (AD) and aggregate supply (AS).

$$P = f(AD, AS)$$

Aggregate demand for real estate is a function of investment while aggregate supply is a function of landownership as determined by title.

$$AD = f(I)$$

$$AS = f(T_d)$$

$$I = I_d + I_f$$

$$I_d = I_d(R) + I_d(S) + I_d(O) + I_d(L)$$

Investment consists of domestic investment, I_d , and foreign investment, I_f . Domestic investment has several determinants, of which the interest rate, R , set by monetary policy, is perhaps the most significant. In North Cyprus, where the Turkish lira is the currency in use, monetary policy is designed by the Turkish central bank in Ankara. Favorable monetary policy developments in Turkey since 2005 have reduced interest rates sharply along with price stability. These developments, in turn, have positively impacted investment behavior in North Cyprus, shifting investors away from financial securities to property investments. The cost of borrowing money from the commercial banks became cheaper, and this also encouraged investors to invest in real estate.

$I_d(S)$ is the investment based on speculative demand, which heated up the investment climate in North Cyprus. Turkish investors were interested in the tourism sector, particularly in the building of hotels and casinos. Many foreigners living in the South sold their properties at a high price and bought new ones in the North for much less. This situation created speculation on the value of properties, driving up prices. Tudor (2004) examined speculative land transactions based on information gathered from real estate agents in the TRNC. He concluded that the boom was fueled by expectations that EU membership for Cyprus will push up prices, offering good returns for those who buy now and squeezing out latecomers. Tudor reported that the vast majority of buyers are British, many having old colonial links to Cyprus. Many of these expatriates are realizing big capital gains on existing homes and have freed up cash to enjoy in retirement.

$I_d(O)$ is the investment based on the ethnic affiliation of the original

owner of the existing title deeds. In the property market of North Cyprus, Turkish title deeds have the highest value. Foreign-owned title deeds, Greek title deeds (exchanged properties), state-owned title deeds, and religious-owned title deeds (church property and the Turkish Trust) have varying price ranges according to the value of the property and the guarantee of future exchange possibilities as explained in the Annan Plan, Article 10 (3b, 3d, 3e). $I_d(L)$ is the price of the investment determined by location and productivity. A piece of land near the coast with infrastructure costs more than the one in a rural area without infrastructure and public utilities.

$$I_f = I_f(P_g, Y_f)$$

I_f is foreign investment, originating partly from non-Cypriots (including those formerly residing on the Greek side) and partly from Cypriots who live abroad, particularly in London, Canada, Australia, and Turkey. Many Cypriots who had lived abroad for years started to return home (reverse migration) after the Annan Plan, triggering land sales in 2003 and 2004.

$$T_d = (T_{t,1} + T_{t,2}) + (G_{t,1} + G_{t,2}) + (F_{t,1} + F_{t,2}) + (S_{t,1} + S_{t,2}) + (R_{t,1} + R_{t,2})$$

Aggregate supply is a function of ownership of land as determined by land title (T_d). T_t stands for Turkish title deed, G_t stands for Greek title deed, F_t stands for foreign title deed, S_t stands for state title deed, and R_t stands for religious title deed, while t corresponds to 1 for the pre-Annan period and 2 for the post-Annan period.

The price shows the relationship between AS and AD before the Annan Plan (t_0) and after the Annan Plan (t_1). During the pre-Annan period (t_0), the equilibrium price is determined at point “a,” where initially $AS = AD$ at price level P_1 (Figure 5.1). When the Annan Plan was released, an increase in property investments shifted the AD curve to the right (AD_1 to AD_2) and a new equilibrium occurred at point “b.” At this point, prices rose dramatically and reached level P_2 . The Annan Plan offered hope to the current users that they would be able to claim the original title deeds once a political settlement was reached.

The Annan Plan created a new property market. On the supply side, it increased the availability of usable land based on the ethnic affiliation of the original owners of the title deeds. Accordingly, the AS curve is rotated toward the right (AS_1 to AS_2), and new equilibrium is obtained at point “c,” where $AS_2 = AD_2$ at price level P_3 . During the post-Annan period (t_1), the price, which had risen from P_1 to P_2 , fell from P_2 to P_3 . On balance, P_3 is higher than the initial equilibrium price level P_1 .

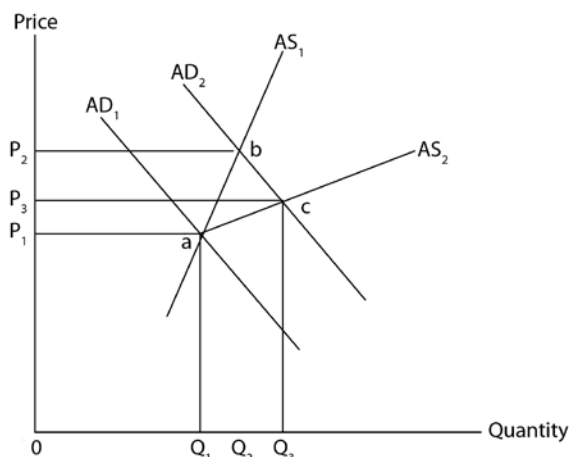


FIGURE 5.1. The Real Estate Market.

POLICY IMPLICATIONS OF THE MODEL

This theoretical model can be utilized for an evaluation of the North Cyprus real estate market from a policy perspective. There is little doubt that policy variables are significant independent variables in modeling real estate growth. Generally, for a more comprehensive impact study of the construction sector, an up-to-date input-output table is necessary, something not currently available for TRNC, the last such table being over a decade old. In the development of such a table, it is beneficial to examine the experience of neighboring Mediterranean countries, including studies by Bon, Birgonul, and Ozdogan (1999), Pietroforte, Bon, and Gregori (2000), and Pietroforte and Bon (1999). In the absence of input-output tables, it may be useful to utilize available official statistics, which throw light on inter-industry transactions between the construction sector and the rest of the economy.

Monetary policy, specifically the interest rate and conditions in the credit market, have significant impacts on the construction sector. During 2000 there was a major banking crisis in Turkey and in North Cyprus, which had a negative impact on the economy in general and construction activity in particular. Economic instability continued into 2001, when a massive (almost 100%) devaluation of the Turkish lira occurred. This caused an economic dislocation in the TRNC economy, resulting in a contraction of 5.4 percent. As for developments in the trade and service sector during 2002-4, it is evident that TRNC has managed to acquire a comparative advantage in services and has emerged as a competitive tourism destination. The most significant growth in the TRNC economy in this period was in the

service sector. Since 2002, as expectations grew for a political settlement, the overall economy has expanded very rapidly, with the GDP growing more than 10 percent per year. The growth in the construction sector was 30.8 percent (with 1977 prices) after 2003, which was greater than trade and the other service sectors but is surely not sustainable.

ENVIRONMENTAL SUSTAINABILITY

The major aim of public policy for the construction sector is to maximize net public benefit, especially in terms of urban growth. The challenge, of course, is in defining what constitutes public benefit. The opinions of economists, urban planners, sociologists, and other related specialists are far from uniform on the question of public benefit. There are those who believe that the construction sector is an engine of economic growth (Turin 1978; Bon 1992) and contributes to public welfare. This group takes a positive view of construction in economic development and urbanization. On the other hand, there are those who place high social value on environmental protection and quality, recognizing that unplanned urban growth creates social costs such as congestion, pollution, and higher rents (Mehmet 1995a; Panayotou 2001). These costs include inflationary trends in rents and land prices, air and water pollution, insufficiency of infrastructure such as sewers and waste disposal capacity, traffic congestion, and dwindling green space and fertile agricultural land.

In the past, construction in North Cyprus expanded in a largely unplanned manner, and insufficient attention was paid to safeguarding public benefits and in particular protecting the environment. In recent years, especially as a result of explosive construction growth, the country has begun to encounter physical and environmental limits, with numerous types of social costs emerging, ranging from automobile congestion on roads causing high mortality from traffic accidents to deforestation and the destruction of unique shorelines.

The central implementing agency in environmental protection is the Urban Planning Department, which is in charge of approving blueprints and building plans. The approval process is through a joint body composed of representatives of the central government and municipalities. This structure is far too cumbersome and slow, and therefore is in need of a major restructuring, especially in titling procedures. Reform is also required to empower local authorities to have more say in the design, approval, and implementation stages of construction plans. The principle of subsidiarity, so effectively utilized in the European Union, needs to be balanced with the

principle of efficiency in public services in order to ensure that the planning system approximates European norms of local democracy.

Although the present construction policy framework does not allow municipalities to prepare their own plans, they nevertheless use their powers of planning controls extensively. Centralization of planning powers does not constitute a major problem for the time being, in view of the fact that the country is small. But in the future, with further urbanization and increasing environmental costs, pressures for greater local democracy will intensify.

Internationally, the concept of “sustainable development” has become a model that tries to satisfy the needs of society without compromising the ability of future generations to meet their own needs. Sustainable development also means creating harmony between economics and the environment and calling on the poor and rich countries to come together to plan development in cooperation.

TRNC possesses a unique ecology and many rare natural resources. Unplanned construction growth is a threat to the rich and diverse flora and fauna. Urban development and land zoning regulations must protect these scarce natural assets. Articles 37 and 38 of the Annan Plan, dealing with the protection of land and sea, mention that there are rules to protect the excessive use of those natural resources. For example, only state buildings for emergency public use can be constructed within 100 meters of the coastline. Yet even those buildings must not harm the natural beauty, which is defined in the law.

All these limitations have the same purpose of protecting the environment while sustaining economic development. However, some private and public construction has disregarded these rules, causing serious problems with regard to the environment. Pollution has affected the water, air, land, and “visual aesthetics” of the TRNC.

TRNC’s “Law of Environment,” numbered 21/1997, recognizes the principle of “sustainable development.” The essence of this law is that whoever pollutes has to pay for it. The principle of sustainable development involves development and investment plans that are designed to combine economic growth and environmental protection.

Lately, the TRNC authorities have started to take the environment seriously and have adopted new measures to guide land zoning and urban development within the framework of sustainable development. The TRNC has a very old and structured urban planning history that goes back to British administration and even earlier. These old rules and regulations are being updated with master plans so that the public’s health, security, and comfort are all reasonably maintained. There is no doubt that residential

and commercial construction provides a great many economic and developmental benefits. But individuals who own land or homes must take responsibility for social benefits as well, including the protection and development of environmental values and natural resources, not only for the people of today but also for future generations. The real difficulty here is to balance the relationship between ethical responsibility and rent-seeking activity. When individuals themselves cannot achieve this balance, then it is necessary to install a strict legal system.

Rapid urban development after 2004 caused extensive environmental deterioration. As a result, the government has updated and supplemented earlier master plans for Kyrenia and Nicosia with a new set of environmental regulations. The first decree was adopted by the Council of Ministers in August 2004 (Official Gazette, TRNC 2004). It is designed to protect the fragile ecology of the Karpaz Peninsula. The second decree concerns the Tatlisu-Buyukkonuk region of Karpaz (Official Gazette, TRNC 2005a), designated a special coastal zone. In both decrees strict rules are provided for the development of coastlines, farmland, forestry, national parks, natural and archaeological sites, ecotourism, and population centers. The third decree concerns the Akdeniz section of Kyrenia (Official Gazette, TRNC 2005b). It provides detailed planning and construction standards similar to those of the other two decrees.

Environmental protection is every citizen's responsibility. Sustainable construction in TRNC, as elsewhere, depends on such human factors as the quality of regulators and the vigilance of the citizens as much as the written laws. Rules and decrees are essential for enhancing the efficiency of implementation by central and local authorities to reconcile construction growth with environmental standards in the public interest, but at the same time increased public consciousness about the environment, through formal and informal educational channels, is vital.

North Cyprus has a unique and fragile ecology. Its coastline is still largely virgin land, and its mountains and waters contain some flora and fauna not found elsewhere in the world. Its territorial waters have recently emerged as critical areas in the global search for oil, and its sea-lanes are now important energy routes. The Ceyhan-Iskenderun oil terminal is situated just miles away, and the volume of tanker traffic has increased rapidly. The prospect of environmental disaster in the ocean around North Cyprus is now a distinct possibility, and an early warning system for protecting the environment is no longer a luxury. The next chapter discusses these issues and challenges and offers a system of joint management of the Turkish Energy Corridor.

The Turkish Energy Corridor

NORTH CYPRUS and Turkey have become players in the European energy market. They control the Turkish Energy Corridor (TEC), covering the territorial waters between southern Turkey and the entire length of the North Cyprus coastline. This strategic fact is slowly but surely altering the nature of the Cyprus problem; it is transforming this problem from a struggle over power sharing between the Greeks and Turks of the island into a contest over territorial waters, international tanker shipping, and, of course, under-sea oil and mineral exploration. In turn, these factors affect the security and foreign relations of North Cyprus.

In short, North Cyprus is acquiring a new geopolitical importance that enhances its sustainability in terms of regional and global energy security. In the globalizing world, sustainability will require not only a well-functioning market economy but also a strategic and effective capability in foreign relations. Insofar as North Cyprus is concerned, defense cooperation with Turkey is desirable both for energy security and for environmental protection, as discussed below (see the concluding paragraph of Chapter 9). By virtue of its location, North Cyprus will play a more active role in the regional energy context. Increasingly, its territory will influence the energy security of the West, especially the EU markets. This region is rich in energy resources, but the Middle East is volatile, and the Turkish Energy Corridor shares some of the characteristics of the Straits of Hormuz. As European energy dependency undergoes a transformation, with alternatives to Russian sources on the agenda, North Cyprus needs to formulate an active policy in this field based on new developments. What are these new developments? What responses are required? How and what new policies need to be developed and implemented? These are the questions addressed in this chapter.

On 15 June 2006 the Baku-Tbilisi-Ceyhan Pipeline (BTC) officially went into operation, loading tankers at Iskenderun for delivery to European and world markets. As a consequence, the economic and strategic importance of the sea-lanes between southern Turkey and the TRNC has increased immeasurably. These sea-lanes, called here the Turkish Energy Corridor, require administration and protection for normal and safe operations.

The TEC brings several important advantages for the TRNC as well as for Turkey. The economic and strategic value of land bordering this energy corridor is immediately enhanced. In the near and medium term, the administration of the energy corridor will require joint policy development, in particular the setting up by Turkey and the TRNC of a Joint Authority (JA), modeled on the U.S.-Canada St. Lawrence Seaway Authority, to administer normal daily operations, to establish an early warning system (EWS), and to finance these operations from a system of user fees, making the TEC self-sufficient. In addition, a preventative environmental protection regime is required to ensure safe passage in the corridor. In the longer term, as Iskenderun becomes the Rotterdam of eastern Mediterranean, the TRNC may expect to realize future economic benefits consistent with the growth pole theory, through ship building and tourism development in Karpaz. All these advantages are explored here.

Against these advantages, the BTC operations raise serious security threats from potential terrorist attacks against tankers or pipelines. The eastern Mediterranean is a high-risk region, and such acts of terror or sabotage cannot be ruled out. An even greater threat is the prospect of major oil spills and environmental disasters that would destroy rich, tourist regions in the area. An EWS is indispensable to warn against and prepare for these dangers.

DEFINING AN OPTIMAL POLICY FRAMEWORK IN THE CASE OF THE BTC

What is an optimal policy framework? It is a deliberate policy designed and implemented to deal comprehensively with and maximize national interest in the event of an unexpected environmental disaster, such as an oil spill, that has serious ecological, economic, social, and geopolitical repercussions. In other words, an optimal policy framework is, first, comprehensive in scope, ranging from the establishment of an early warning systems of monitoring and surveillance to the provision of financial contingency plans to deal effectively and efficiently with the massive costs of damage and pollution; and, second, represents a set of policies and institutions with a clear intent of asserting the national interest of the affected states, that is, Turkey and the TRNC.

In terms of policy development, it is important to start with an economic impact analysis of environmental disasters as a prelude to designing a practical EWS. How an EWS should be financed is a key issue in such a design. But first, a word needs to be said about the international legal status of the issue at hand.

The Law of the Sea and the TEC

What are the relevant provisions of the Law of the Sea Convention in the case of the TEC? Turkey is not a signatory power in this convention, and the TRNC is not a recognized state. They must therefore operate on the basis of the principle of necessity, keeping in mind the relevant provisions of international law in optimal policy development for the management of the TEC. We examine this matter below. Turkish national interest must be given top priority, including the issue of “flag of convenience” (FOC). First, however, the area of concern needs to be defined and specified.

Setting Boundaries of the Area of Concern

The first task in formulating an optimal policy framework for the transportation of BTCP oil is the delineation of the area of concern in the affected territorial waters. The task of boundary setting is a technical job and should be done by experts in cartography and marine law and practice.

However, the task here is relatively straightforward given the cardinal fact that this case involves two friendly countries, Turkey and the TRNC. And roughly speaking, the areas of concern are the waters, including the sea-lanes used by tankers transporting BTCP oil, bounded by the southern coastline of Turkey and, in North Cyprus, extending from the tip of the Karpaz Peninsula to the westernmost point of the TRNC.

For all these reasons, it is appropriate to call the sea-lanes used for transporting BTCP oil the TEC. This is the usage adopted in this chapter.

Managing the TEC

Development of optimal policy that is both environmentally sound and in the best interest of Turkey and the TRNC must be jointly done with professional expertise. An interdisciplinary task force is essential, including ecologists, cartographers, international lawyers, economists, security and intelligence experts, and public administration specialists.

Institutional Arrangements for an Early Warning System

Caution must be exercised in institution building. It is not advisable to set up, especially up front, costly and elaborate institutions for the

implementation of any agreed-on optimal policy for the TEC between the TRNC and Turkish governments. At the outset and for some time to come, learning by doing would maximize flexibility and adaptability to emerging circumstances. Accordingly, it is argued here that for purposes of the BTCP, the region of concern must be clearly defined and policy must be formulated, at least at the outset, in a highly flexible manner.

Within this compact and flexible policy development, the binational nature of the TEC should be borne in mind. In other words, these two countries should set up whatever policy and institutional arrangements suit them best exclusively between the two of them. In doing this a good model to follow is the binational St. Lawrence Seaway Authority, established cooperatively between Canada and the United States in 1954. Taking this as a model, Turkey and the TRNC may establish a Joint Authority (to be named more appropriately in due course) for the administration of the TEC, including an early warning system for environmental monitoring and safety.

Like natural disasters such as earthquakes and floods, oil spills and other environmental hazards are inevitable. In the TEC it is simply a question of when these hazards and disasters will take place, giving rise to environmental damage that carries heavy social costs. The rational action by Turkey and the TRNC is to initiate policy intervention ahead of time (a) to minimize these environmental costs when they do occur, and (b) to offset the damage and return to the regime that existed prior to the damage as quickly as possible.

The central focus of such a policy intervention is most likely the design and implementation of an early warning system, administered by a Joint Authority set up by Turkey and TRNC. However, there are some technical issues, involving environmental risk assessments (ERA) and benefit-cost appraisals (BCA),¹ which must first be resolved before such a body is set up to manage EWS. What should be the terms of reference (TOR) of the JA? How should the JA be financed? If, as is most logical, by means of a user fee, what should be the rate of this fee? How should it be collected and by whom?

The JA and EWS must be self-financed, that is, they should not be a tax burden on Turkey and the TRNC but rather run by revenue generated from the normal operation of the TEC. Self-financing must be safeguarded by a user fee. Determining what the user fee should be is a technical issue requiring ERA and BCA. The first step in optimal policy development for setting up the EWS is to become familiar with the basic elements of ERA and BCA.

ERA is essentially a probability calculation based on estimating the chances of a specific (unnatural) event happening randomly. In the case of the TEC, ERA is focused on determining the probability that a tanker

accident in the corridor will cause an oil spill. Managing preparedness for unnatural events is similar to the task of insurance companies in determining their premium rates. Once the probability factor of a likely oil spill or tanker accident is computed as a result of ERA, it can be utilized for determining the user fee to finance an EWS.

A BCA is a related but quite separate technical work. It is focused not on accidents and disasters but rather on normal (natural) operation, or in technical terminology, on steady-state costs and benefits. In the case of the TEC, a BCA exercise would be useful to determine the normal maintenance and operational costs and benefits of administering the corridor, including the EWS. The benefits include direct benefits (e.g., employment income, revenue generation from tolls and user fees), while the costs include direct costs (e.g., repair and maintenance, wages, fuel). In addition to direct benefits and costs, there are indirect impacts (external benefits and costs) from normal operations, but generally these are elusive and difficult to quantify. They relate to pollution of air and water on the external cost side, and income and employment gains in upstream and downstream economic activities on the benefit side. For purposes of the JA policy, it is best to set the tariff for user fees with the intention of generating a small surplus over and above steady-state costs of operations and maintenance. In carrying out the BCA it would, therefore, be desirable to examine how user fees in similar projects elsewhere in the world are set and determine a per mile or per ton user fee.

Essential Implications of ERA and BCA

Below is a summary of the essential implications of ERA and BCA as they apply to the case of BTCP to guide policy development by Turkey and the TRNC:

- (1) It is important for Turkey and the TRNC to distinguish between two kinds of benefits and costs of the TEC that must be measured, one relating to the normal, steady-state operation of the corridor, the second relating to accidents and unnatural events in the corridor.
- (2) Under steady-state operation, the TEC must be self-financed from revenues generated from user fees. These user fees should be determined on the basis of a carefully conducted BCA. The BCA must include the cost of EWS and its management jointly by Turkey and the TRNC.
- (3) In the case of accidents and disasters in the TEC, especially oil spills, the cost must be borne by the shipping companies concerned. It is up to Turkey

and the TRNC to so manage the corridor to ensure that tankers have adequate insurance to pay for these unnatural costs, as in the case of the *Exxon Valdez* in Alaska, one of the most damaging oil spills to date. It devastated the marine ecosystem and large tracts of fragile coastline, and caused billions of dollars of damage. The cleanup costs were borne by Exxon (Owen et al. 1995).

- (4) The operation of the EWS jointly by Turkey and the TRNC must include the estimation and use of risk probability factors determined in ERA of a tanker accident causing an oil spill in the TEC. This factor depends on a number of variables, including (a) size and load of the tanker, (b) weather conditions and time of the year, and (c) age and seaworthiness of the tanker. Accordingly, the EWS management and monitoring by Turkey and the TRNC must incorporate the regulation of these variables.
- (5) It is important for Turkey and the TRNC to have a clear idea of the implicit *divergence* between environmental costs of the BTRP and its benefits. In other words, Turkey and the TRNC must take the initiative to protect their own interests through optimum policy development and implementation. Without such a policy, the benefits of the security of the corridor will accrue to shipping companies and tankers while the costs will fall on Turkish and Turkish Cypriot citizens.
- (6) *Externalities* deserve special attention. Environmental costs in the case of the BCTP will be largely social external costs, damaging coastlines in Turkey and the TRNC, or more specifically cities and industries therein. Under no circumstances should these costs be borne by the citizens of Turkey and the TRNC.
- (7) The benefits of a cheaper and safer energy corridor will largely accrue to private (foreign) actors such as tankers and shipping companies in pursuit of private benefit in the form of economic gain.
- (8) It is therefore only logical and equitable that these private actors should be required to pay a user fee for the safe and secure operation of the TEC.

BENEFITS OF THE BTCP FOR NORTH CYPRUS

The shipment of BCTP oil to world markets from the Iskenderun terminal has created an energy corridor between the coastline of TRNC and

southern Turkey, greatly increasing the strategic, political, and economic value of the territory. This section identifies and discusses these benefits and advantages for the TRNC, along with the optimal policy framework for implementation and management.

The Contingency Value of the TEC

The TEC is a major joint resource for Turkey and the TRNC, each side needing the other for the realization of immense benefits, in both the short and long term. Turkey alone cannot exploit this resource; it needs the TRNC's cooperation, and likewise, the TRNC needs Turkey for obvious political and economic reasons. The optimal policy is active and close cooperation between the two countries in all phases of the management of the corridor.

Given such cooperation and joint management of the TEC, and judging by similar corridors such as the Persian Gulf, the TRNC and Turkey stand to derive several comparative advantages from this corridor, the two most important being (1) its safety and security and (2) a shorter distance to European markets. These advantages imply significant economic gains for energy-consuming countries in Europe and the West, in particular lower shipping costs and secure delivery. For example, BTCP offers an alternative route for Russian energy supplies to European markets.

Safety and security should not be provided by the Turkish and TRNC coastguards for free. That would amount to subsidizing the supply of energy for the consuming countries in Europe and the West. This relative security is especially important in the light of the fighting in the Middle East in 2006 over Lebanon, which significantly raised the price of oil, enhancing the value of Turkey and the TRNC as "guardians" of the delivery of BTCP oil.

However, this "value" is not a directly quantifiable economic value. It is mostly an indirect contingency value, in the nature of an externality, partly expressed as higher Turkish and Turkish Cypriot prestige and partly an implicit subjective (rather than market-determined objective) value. For example, BP and other stakeholders in BTCP may "appreciate" or "take note" of security provided by Turkish and Turkish Cypriot authorities, but it is up to these authorities to use their leverage and convert "appreciation" into cash or market-determined value. Thus, if the cost of security services rendered by the Turkish and Turkish Cypriot militaries can be converted into "fee for service" and collected by shipping companies, then these contingency values may be transformed into income generation. This ability to generate income depends on diplomatic and political skill.

The fact that the TEC shortens the distance to European and Western

markets, a direct cost saving for shipping companies, provides a second and reinforcing argument for a user cost as fee for service, essential for a self-financed BTCP Joint Authority to be established by Turkey and TRNC (see below). Here, of course, there are several key questions: What should be the rate of the fee? How should it be collected? And of course, who should collect the fee? Where will the revenue collected go?

The Joint Authority for TEC

All these questions justify the establishment of a special-purpose, autonomous Joint Authority between the Turkish and TRNC governments to manage and monitor the TEC to ensure its safety and security. These two governments would determine the terms of reference of this JA on the basis of a shared jurisdiction and the closest possible coordination in policy implementation. The JA would be a binational, autonomous body set up under national legislation in both countries, partly coordinating existing functions (e.g., meteorological service, marine radio, port authority services) and partly assuming direct service delivery (e.g., emergency search and rescue, toll collection, and coastline development projects). In the case of the TRNC, there is already the Directorate of North Cyprus Coastal Security and Shipping Rescue and the North Cyprus Coastal Radio, as well as the Department of Meteorology and the Harbor Authority of the Ministry of Communication. In Turkey there are no doubt even more of these relevant bodies.

If successfully introduced and established as part of its TORs, the JA would collect user fees from shipping companies using the TEC and administer its safe operation on a self-financing basis. Thus, it would provide security for the TEC without requiring any subsidy from or tax burden on Turkey or the TRNC.

A Possible Model from Canada and the United States: The St. Lawrence Seaway Authority

In terms of the administration of the JA, the U.S.-Canada Joint Authority for the St. Lawrence Seaway is a good model for Turkey and the TRNC.² Started jointly by an international agreement in 1954 between the United States and Canada, which financed the entire cost, the St. Lawrence Seaway is reportedly the world's most comprehensive inland navigation system, providing 40,000 jobs and annual personal income of US\$2 billion to workers in both countries. The volume of cargo handling is 50 million tons a year, and in addition, the seaway provides electricity generation; both of these are important income-generation activities. The seaway also serves,

directly and indirectly, a wide range of industries along the coastline in both countries, in particular tourism, especially around such well-known sites as Niagara Falls, on the U.S.-Canada border, and the Thousand Islands region between Montreal, Quebec, and Kingston, Ontario.

Passage of ships and boats through the St. Lawrence Seaway is subject to an elaborate and costly system of user fees, called the tariff of tolls. Because of the binational nature of the seaway, a U.S. agency, the St. Lawrence Seaway Development Corporation, and the St. Lawrence Seaway Management Corporation of Canada are charged jointly with the responsibility of setting the tariff rates and collecting the toll revenues. These tariffs and tolls can be quite heavy. Even pleasure craft are subject to them; for example, in the 2005 navigation season, the tariff per pleasure craft was set at US\$25 or C\$30.³ The revenues, however, are sufficient for operation and administration of the seaway without any subsidy from the two governments concerned. Indeed, the seaway is a major source of economic development and sustainability for the bordering states along its extensive shoreline.

The Benefits of the Early Warning System

The most obvious method of ensuring the safe and secure operation of the TEC is to create and manage an EWS as part of the terms of reference of the proposed JA. These systems are now being introduced in several parts of the world to safeguard against environmental and natural disasters, such as floods, volcanic eruptions, and the Asian tsunami of 2004-5.⁴

In the case of the BTCPC project, Turkey and TRNC should set up an EWS system as soon as possible. An EWS would involve surveillance and monitoring throughout the entire length and width of the TEC with the latest, state-of-the-art technology and skilled manpower, civilian and military, to guard against natural and man-made risks.

Natural disasters, due to stormy seas, for example, may lead to major or minor oil spills, causing environmental damage and destroying tourist facilities in such areas as Antalya or Girne. Or large-scale pollution may follow acts of terrorism, sabotage, or simply tanker collisions or accidents. An EWS that checked the seaworthiness of tankers and supervised their cargo on the basis of international standards would minimize, but most likely would not be able to eliminate, the risks of such disasters. In addition, the EWS would provide emergency action in accidents or storms when urgent remedies are required to minimize these costly environmental damages.

We understand that a station for EWS-type operations is under construction at Kantara in Karpaz. A similar station at Kurucam, west of Girne and the nearest point on TRNC soil to the Turkish coast, would be an ideal

surveillance center for the western parts of the TEC. Beyond these surveillance stations, it is essential to provide coast guard search-and-rescue services to deal with marine accidents and other emergencies that are bound to happen.

Setting up and implementing an EWS should not be a free service. Such a service is costly to establish because it involves obtaining and installing modern technology and hiring well-trained personnel to use it around the clock. Who will pay the costs of technology, monitoring, and personnel?

Shipping Toll Charges, User Fees, and a Special Fund for Steady-State Operation

Shipping services involve complex technical operations requiring significant financial and human resources. The cost of these resources is best recovered under the formula of fee for service, or user fees. This is the case for other, similar bodies, such as the St. Lawrence Seaway Authority, proposed as the model for the BCTP. In other words, the shipping companies using the TEC must be charged a fee for the EWS. This fee should be collected by the proposed JA set up by Turkey and TRNC to cover normal, steady-state operation of the energy corridor.

The justification for a user fee was discussed earlier in the section on environmental costs and benefits, where it was pointed out that the social costs of oil spills for coastline states (i.e., Turkey and the TRNC) exceed private costs (to shipping companies). If unchecked, shipping companies would simply walk away from oil spills, leaving cleanup and other environmental costs to coastline states and their citizens. An effective monitoring system administered by a JA that supervises safety and administers the EWS system, under normal conditions, represents the steady-state management of the TEC.

There would be economies of scale if the financing and administration of the EWS were integrated as a component of the steady-state operation of the BTCP by the JA. The TOR of the JA must be solidly based on self-financing principles. Accordingly, a special fund might be set up for collecting the user fee for the EWS and covering the normal, steady-state expenses of the JA for the TEC. Of course, the fund and all financial activities of the JA must be independently audited according to accepted international accounting standards to ensure integrity; an independent board separate from the day-to-day operations of the JA could administer the fund as a trust.

The implementation of JA and the fund, as proposed above, are major policy initiatives. It is up to Turkey and the TRNC to set up these institutions, administer the JA, determine its TOR, and charge a user fee for the fund. So long as the Cyprus problem remains unresolved, these initiatives

must be done through quiet diplomacy by Ankara and Nicosia in a creative and flexible way within the limits of international law.

Growth-Pole Benefits of the Ceyhan-Iskenderun Hub

There are also medium- and longer-term advantages of the BTCP for the TRNC. In the medium term the Ceyhan-Iskenderun basin will become an energy terminal or hub, a sort of Rotterdam of the eastern Mediterranean. Rotterdam's annual handling capacity is 134 million tons, and by 2010 Iskenderun's alone is planned to reach 160 million tons.⁵ In particular, the TRNC's Karpaz Peninsula has the potential to become a center of shipping and marine services and tourism, as explained below.

What is the nature of these longer-term benefits? They can be predicted on the basis of the well-known economic theory of the growth pole, discussed in Chapter 4. According to this theory, Iskenderun will become a hub, constantly expanding by attracting the growth of related industries connected to the energy sector. These related industries fall into two categories of services for shipping and tanker traffic: (1) downstream services covering maintenance and repair and (2) upstream operations ranging from banking and insurance to hotels and restaurants. Guzelyali Harbor in Karpaz is regarded as ideal for the former category of services. It is estimated that these upstream and downstream services may provide up to two thousand new jobs for skilled and technical workers in North Cyprus. Additionally, as economic growth gathers speed, the population of Iskenderun will expand, requiring more schooling, healthcare, and social and physical infrastructure.

Indeed, the growth pole theory predicts that these dynamic growth effects may spill across international borders. These spill-over effects are noticeable in several parts of the world. One international example is Singapore's Growth Triangle (Thant and Tang 1996), whose rapid growth spilled into the neighboring state of Johor in Malaysia and the Indonesian province of Riau, creating ever-expanding waves of economic expansion, raising incomes, and providing employment for local populations. Singapore, an economic dynamo with limited land, provided the capital and entrepreneurial skills, while Johor and Riau provided the land for this impressive Growth Triangle, which has brought prosperity and jobs for the three countries involved.

Looking at prospects of the BCTP at the port of Iskenderun, Turkey, we can make predictions based on the growth pole theory. The region around Iskenderun in Hatay province to Ceyhan and Mersin in the Adana province will grow, and land prices will rise in tandem with business investment. This will stimulate demand for skilled workers of all kinds, and urban prices (especially rents) will rise.

Some of these future investments may be directed to North Cyprus, depending on relative land values and other determinants of private investment. At this stage, land in Karpaz will become even more valuable for related investment. In addition to private investment, there are possibilities of public investment, especially in the provision of ship building. In the shorter term the most likely sectors to experience growth, thanks to the BTCP project, are tourism and shipping, especially in the Karpaz Peninsula.

Flag of Convenience Shipping

In regard to shipping in the TEC, there is a serious conflict of interest between Turkish and Greek Cypriot shipping interests, centered on whether Limassol or Iskenderun will emerge as the regional hub. Greek Cypriots have the third-largest flag of convenience (FOC) shipping business in the world, generating some 250 million Cyprus pounds of annual revenue, and they want to cash in on the BTC tanker business.⁶ It is estimated by the Turkish Cypriot Chamber of Commerce that FOC shipping by Greek Cypriots would earn up to US\$2 billion annually (or 50% of total tanker business) from the TEC. Limassol, the major port in South Cyprus, is losing FOC business from being kept out of Turkish ports. Lack of international recognition rules out TRNC as an alternative point of FOC registration, but there is no reason why Turkey cannot provide these shipping services.

There is a political problem here that needs to be faced. Should Turkey open its ports to Greek Cypriots (as demanded by the EU), not only TRNC but also Turkish shipping will suffer a severe economic loss; indeed, the vision of a future Rotterdam will suffer a setback. For this reason, Ankara's current policy of linking opening Turkish ports to the lifting of the economic isolation of the TRNC is a justified policy and should be strictly observed in order to maintain a level playing field.

Freshwater Transportation

A significant potential exists for the freshwater market in the arid Middle East, especially in Israel, Jordan, and Palestine. Turkey is ideally suited for exporting large volumes of freshwater to this area from the Manavgat terminal (already built) if long-term price contracts can be negotiated, which, of course, requires a peace agreement in the Middle East. While a land-based pipeline through Syria is an option, especially in the event of peace, a maritime pipeline through Karpaz is also a possibility, as is tanker transportation. Tanker transport would also allow freshwater to be imported into North as well as South Cyprus, especially if and when the Cyprus problem is settled.⁷

Natural Gas Pipeline

Similar prospects exist in the case of natural gas delivery to the port of Iskenderun. Initially, Russian gas, through the Samsun-Yumurtalik pipeline, and later on Egyptian gas, is on the agenda. The TRNC may benefit from cheaper gas imports. Additionally, it will also benefit if and when a maritime pipeline is constructed through Karpaz, linking Turkey and Middle Eastern markets and sources.

UNDERSEA RESOURCES, LAW OF THE SEA
AND THE ZONE OF ECONOMIC INTEREST

Articles 55, 56, and 57 of the UN Convention of the Sea (which Turkey and the United States did not sign)⁸ define, regulate, and empower coastline states to declare an exclusive economic zone (EEZ) for up to 200 nautical miles. Since Turkey is not a signatory to this convention, it is unlikely to take advantage of this power. Canada and other countries have done so under a variety of justifications such as depletion of fish stocks and environmental considerations. As a result, a new governance order is evolving centered on the EEZ regime (Ebbin 2005). Closer to home, South Cyprus and Egypt have signed an agreement for joint exploration for oil in eastern Mediterranean waters.⁹ This activity needs to be closely watched by the TRNC and Turkish authorities, not only for reasons of vested interest but also for future policy development. Exactly what kind of policy might be developed for joint exploration and development of marine and undersea resources is unknown at this stage, but monitoring of similar activities in the region will surely provide options.

Not being a signatory does not mean, however, that Turkey and the TRNC cannot undertake joint action for the exploration and development of marine resources under the sea between the two countries. For example, they can jointly create a zone of economic interest for oil exploration. Syria, which has expressed an interest in such exploration,¹⁰ may be invited to join these efforts under appropriate conditions. In the meantime, however, a more flexible regime may be more appropriate for the TEC. In this flexible format, Turkey and TRNC may jointly opt for a *de facto* regime, while silently acting in conformity with the provisions of the Law of the Sea, pending any legal declaration at a more appropriate time. The exploitation of undersea resources (including oil) is a long-term advantage that must await future political developments.

Divergence or Convergence?

Toward a Two-State Outcome

WILL THE two ethnic identities in Cyprus successfully redefine joint sovereignty and agree to live together? Or will the effort fail one last time, and if so, can the two sides live in peace side by side? The answer depends on whether the forces of convergence or divergence, especially in the marketplace, prevail in the end to produce a win-win outcome.

As of 2008, Cyprus remained divided. With the replacement of the Papadopoulos regime in the South with the more pro-settlement Christofias regime, there appears to be a last-chance opportunity for a comprehensive settlement of the age-old Cyprus problem. Only time will tell whether the market forces of convergence will overcome the deep-rooted historical and emotional forces of divergence and bring about a sharing of power and sovereignty between the Turkish and Greek Cypriots.

In this book we set out to examine the Cyprus problem from an economic perspective. We argued that the optimization of self-interest on the part of the two ethnic communities may show a way toward reunification of the island on the basis of land for power sharing, the best solution. However, a second-best solution may be preferred if the costs of the best solution turn out to be too high for one or the other side. In that eventuality, South and North Cyprus may choose to opt for a “peaceful divorce,” as the next, or second-best, option, within an EU that, it is hoped, also includes Turkey as a member.

Whether or not there is an eventual political settlement, North Cyprus must become as rich as the South, regardless of its small size. Economic success is a precondition for both the best and the second-best solutions. The book has discussed the economics of North Cyprus as a microstate, arguing that small size is no barrier to survival or prosperity, providing such a state specializes in efficient and high-quality services, as in the successful cases of

Singapore, Luxembourg, Hong Kong, and Barbados, among others. This means making investment in the development of export-oriented service industries a top priority. The book also utilized an economic model to specify the investment requirements, highlighting in particular the need for skilled human capital formation and sustainable construction in North Cyprus to safeguard environmentally sound economic growth for convergence, or economic equality, under the UN's URC proposal. We now conclude with a discussion of the forces of convergence and divergence.

When all is said and done, economic rationalism may lead to an impasse in Cyprus. The parties may rationally determine that they are better off apart than united. In other words, reunification may not be feasible simply because the forces of divergence, lying deep in the collective (historical) memories and (future) aspirations of the island's two ethnic communities, may be stronger than the forces of convergence. Indeed, Chapter 6, on labor market forces, suggested that the forces of divergence may be stronger and that over time the Turkification of North Cyprus may occur as a counterpoint to the discrimination faced in the South by Turkish Cypriot commuter workers. This raises a dangerous implication: even if there is a "forced" settlement arranged by pro-settlement political leaders, especially one built on an unbalanced power sharing in economics and politics, it, like the 1960 Constitution, may be short-lived.

Accordingly, and as a second-best option, the two-state solution must be considered. A state in the North and one in the South would be created by mutual consent and would live side by side as good neighbors. In that eventuality, several common issues, including outstanding landownership in both parts of the island, policing the border, and joint management of the environment, may be cooperatively resolved on an ad hoc basis or some other agreed modality.

The Cyprus problem cannot remain unresolved forever. Since it has not been settled in almost half a century, then reluctantly, the parties may have to agree to disagree. They may be obliged to conclude that the forces of divergence are greater than the forces of convergence. What are the forces of divergence in contemporary Cyprus? Cypriots of both major ethnic groups must face history and accept certain facts, however bitter. That is the necessary precondition for any reconciliation and peaceful coexistence.

First and foremost, in Cyprus the Greek Cypriots have been proactive, assuming the initiative for enosis, EOKA, and the taking the Cyprus problem to the UN in 1955 and now to the EU, where the Greek side feels itself strong as a result of the absence of the Turkish side. After more than forty years of UN peacemaking, the Greek Cypriot initiative at the UN ended in

failure, culminating in the rejection of the Annan Plan in the 24 April 2004 Referendum, and the Greeks simply altered course and pinned their hopes on the EU. Here they are bound to fail yet again: the Greeks' expectation of winning a solution at the EU on Greek Cypriot terms will not happen,¹ and there are early signs of this fact.²

The fundamental fact is that the Greek Cypriots have always acted unilaterally, without showing any sensitivity for the Turkish Cypriots' concerns.³ Accordingly, the Turkish Cypriots have resisted each and every one of these initiatives, and this opposition has been solid, from the top political elite to the bottom of the grassroots, involving workers and farmers as well as the educated middle class. In this sense, the Cyprus problem is a real Greek tragedy in which the protagonist has been the Greek Cypriots, seeking a suicidal end by violence, generating only counterviolence from the antagonist, the Turkish Cypriots. In this violent ethnic contest, the rationality of mutual self-interest has given way to the emotionalism of short-sighted ethnonationalism, both sides losing out in an unwinnable wargame.

Second, in its post-1974 manifestation, the Greek tragedy of Cyprus has revealed itself as a "victim" mindset in the Greek Cypriot soul, a refugee in one's homeland, while the Turkish Cypriots, finally enjoying a measure of economic and political security in the North behind a Green Line actively defended by Turkish soldiers, are seriously hoping for a new partnership state with the Greek Cypriots. Sadly, the victim mentality is self-centered; it is insensitive to earlier suffering that the Greek Cypriot state inflicted on its Turkish Cypriot citizens. Nor does this mindset seem ready to accept that the Cyprus of forty years ago no longer exists. It wishes against all hope that the clock be put back to 1974 so Greek Cypriot property owners can reclaim their land and property and at the same time get rid of the Turkish soldiers and settlers. The fact that Greek Cypriots have managed to get into the EU is only a partial reward for them, unlikely to satisfy their political ambitions even in the short term. Indeed, in the longer term it may make matters worse unless Turkey is able to become a full member. Following Greek Cypriot accession, the EU has emerged as a biased (pro-Greek) actor in the Cyprus problem. Some key EU members have hidden their opposition to Turkey's accession behind the Greek Cypriots, and it is highly doubtful that the EU will become an honest broker, playing the "catalyst" role it claimed for itself at the time of the Annan Plan.

Third, and sadly, however, this hope for peace and reconciliation among ordinary people, especially the young, looks dim. The formula for peace is "land for power sharing" in a URC as proposed in the Annan Plan. But within a decade there will be no more undeveloped land to trade. What

was once owned by the Greek Cypriots, and potentially is available for a land-for-peace deal, may be no more, just as in the case of Palestinians who wish to reclaim lands in Israel which they left behind in 1948. Like it or not, possession is nine-tenths of the law, and it is unlikely that the remaining one-tenth will trump the rest. As the Orams case indicates,⁴ the land issue is too complex to be solved on Greek Cypriot terms alone by the European courts, ignoring Turkish interests. The creation of the Land Commission in the North is a direct result of these legal recourses taken by the Greek Cypriots. In effect, Europe is telling the Greek Cypriots to try to settle their property disputes with the Turkish Cypriots first, no doubt taking a cue from the Annan Plan.

Accordingly, economic rationalism indicates that an enhanced Annan Plan will be the foundation in a future second—and last—chance to settle the Cyprus problem. The URC proposal, a one-state solution and a partnership federal state, may yet save the day in Cyprus and produce a bizonal, bicom-munal settlement. The replacement of the ultranationalist Papadopoulos regime in February 2008 by the more pro-settlement Christofias regime is a hopeful sign, but the deeper historical and emotional forces of divergence in Cyprus may, at the end of the day, prevail. Economic rationalism suggests a URC as the best option, but the stability requirements of this option also impose rigorous preconditions that may ultimately be too costly. What are these preconditions?

Two kinds of equality are essential in any eventual one-state solution in Cyprus: political and economic. One alone is not enough for a just and lasting solution. The former ensures a fifty-fifty power sharing; the latter safeguards shared prosperity with comparable standards of living and without first-class/second-class discrimination. The federal government is the critical custodian in a URC to protect and sustain these two kinds of equality.

Ensuring political equality is complex yet, amazingly, is the easier task, achievable through federal constitution writing. Sustaining economic equality, once achieved in a federation, is far more costly and difficult, as it requires goodwill, a willingness to share power, and a commitment to carry out constant and deliberate management.⁵ The bedrock of federalism is economic and political equality achieved and sustained through the macroeconomics of managed convergence. Economic equality must be actively nourished by political equality.

The major obstacle to federalism in Cyprus is the lack of unity between the two sides on what “federalism” is all about. There is little understanding and experience of how it should be managed. There is hardly any serious theoretical or empirical work on federalism.⁶ The Greek Cypriots view

“federalism,” originally defined in the Denkraş-Makarios-Kyrianou high-level agreements of 1977-79, in terms of a strong central government under effective Greek Cypriot domination. The Turkish Cypriot side insists on a loose confederation of two equal partners.

In this climate the prospects for success cannot be rated very high, even if a political compromise could be reached. And even if “political equality” could be achieved on paper, it may remain a dead letter, similar to the 1960 Constitution. Without economic equality, nourished by fiscal federalism, political equality is meaningless and unworkable. Political equality can be agreed on by political leaders, but economic equality takes time and investment. Attaining economic equality in a future URC to avoid the fate of the 1960 Constitution is a big challenge.

There is more: economic parity as a vision for the future is only the initial necessary condition for stability; there must be further safeguards to ensure the preservation of initial conditions. In a viable URC, a truly fifty-fifty partnership, the federal state must be the arbiter and sustainer of economic equality, and the role of federal macroeconomic policy in particular should be permanent economic convergence. That is to say, the sufficient condition of a lasting URC is not only the achievement but the maintenance of economic parity for all citizens, so everyone has an equal stake in the stability and survival of the URC. The federal government must *always* be neutral. It cannot be perceived as the agent or instrument of one ethnic group; it must be scrupulously impartial and evenhanded at the beginning and at all times. Otherwise, federal policy making will be like a soccer match refereed by a crooked referee and played on an uneven field. This is a recipe for disaster.

Given a federal government with integrity, the power sharing of the two states must parallel the economic and financial resources. This is essential for making bizonality work. In each state, revenues and expenditures, including investment in the public sector, must match political competencies to deliver approximately comparable standards of living in all parts of the union. This is the logic of economic rationalism. If implemented, it can yield the dividends of shared prosperity and lasting peace and harmony on an island that has been divided and torn by conflict for too long.

Admittedly, these are very difficult conditions to meet. They require above all good faith and a genuine desire to make the URC work. If one or both parties do not wish to enter the URC in good faith and remain fully committed to making it work, then it is preferable to agree to disagree, to seek a peaceful divorce and live side by side in two separate states as good neighbors, almost certainly within the EU on some agreed basis. After all, except for the period 1960-63, Greek and Turkish Cypriots have never

experienced joint rule. This short experience ended in disaster. Moreover, neither the Greek nor the Turkish Cypriots have any knowledge of how federalism works. In short, at the end of the day, the forces of divergence may be stronger than those of convergence.

A historical summary may be in order at this point to see how strong and deep-rooted the “forces of divergence” are. During the four centuries of Ottoman rule, the two communities lived generally in peace, thanks to the millet system of ethnic self-government, side by side, each as a distinct *cemaat* (ethnic community), never as one people. Religion, culture, and language were the dominant facts of Ottoman life, and trade, largely in foreign hands, did not bring the two *cemaat* closer, even in times of prosperity. Thus, in the decades prior to 1878, when the British replaced the Ottomans as rulers of Cyprus, the economy of island prospered rapidly, external trade tripled in value (Jenness 1962:115), and yet the British quickly discovered that the Greek Cypriot delegates in the ruling council acted from ethnic sentiment, voting “as a solid bloc” (Jenness 1962:121), not as representatives of special interests for the general good of the island. The origin of colonial “divide and rule” resided in the fact that the British rulers had to give in to either the Greek Cypriot bloc or the Turkish Cypriot one to get any action approved. When such support was not forthcoming, the British ruled by executive decree without attaining any consent from the islanders.

In short, *Cypriot-ness*, or a common Cypriot identity, has never existed as a fact,⁷ but this has not prevented Greek Cypriots from using the term to exclude Turkish Cypriots as non-Cypriots. For example, former Greek Cypriot leader George Vasiliou has audaciously stated that Turkish Cypriots are no more than four-hundred-year-old guests on the island. The rare voices championing the inclusive Cypriot identity, such as Dr. Ihsan Ali, who believed in a Greek-dominated Cyprus, were unrealistic preachers in the desert with no more than marginal impact on either community. As far as the Turkish Cypriots of his generation were concerned, Ihsan Ali, while respected for his charitable contributions in his hometown, remained a pathetic figure to the end; he was unable to come to terms with the post-Kemalist Turkish identity being shaped during his lifetime. His opposition to those who did, notably Dr. Fazil Kucuk, and his subsequent collaboration with the Makarios regime sealed his failure as a leader of his community.

After the Ottoman era, the two ethnic communities continued to live side by side, each governing itself according to time-honored custom. The British colonial administrators, by and large, respected this ethnic divide and built their administration on it. Whenever economic interest pulled the two ethnic communities together to form joint organizations or movements,

for example in trade unions, farmer associations, or cooperatives, these intercommunal efforts were short-lived.⁸ Political division emerged quickly, most notably as a result of the Greek Cypriots' ambition for enosis, later spilling into EOKA violence, and these intercommunal efforts ended in failure, as did the short-lived 1980 partnership republic.

In British Cyprus, from the grass roots up, ethnic separation was always a fact of life, and it became stronger after EOKA violence opened a new chapter on the island in 1955. However, even before, the roots of separation were there. In mixed villages the two communities lived in separate quarters and had different schools and village administration, and intermarriage was virtually unheard-of.⁹ Interethnic conflicts emerged after 1821, when Greece gained independence from the Ottoman Empire and the enosis campaign was started by the church and in the schools (see Oberling 1982). When the enosis struggle turned violent in a major way first in 1931 and especially after 1955, ethnic separation became inevitable and permanent. Workers broke ranks and created ethnic unions, farmers and cooperatives were reorganized along ethnic lines, and the British authorities officially endorsed separate municipalities and chambers of commerce.

Objectively, therefore, history does not support the idea of a joint, shared government in Cyprus. Making federalism work, as in the United Republic of Cyprus proposal in the Annan Plan, would require a superhuman effort in power sharing. The idea merely reflected the wish of the international community that on a small island, strategically located, having two independent states is undesirable. But the wish of the island's ethnic groups is, like it or not, for separation, and it is not in keeping with democracy and freedom to force people into an identity they reject. In the postmodern world, it would, of course, be a wonderful achievement if federalism (or more appropriately confederalism) were to succeed (as it has done to a remarkable degree in Europe), and it just might do so if the EU were to utilize its considerable incentives to equalize the playing field between the Turks and Greeks in the eastern Mediterranean. The state of the Ankara-Athens axis is always the vital determinant of the health of ethnic relations in Cyprus.

The opposite case must also be considered. If a voluntary marriage is not feasible between the Turks and Greeks of Cyprus, the logic of economic rationalism, or mutual interest, strongly implies that the two ethnic communities should have two states in Cyprus, diverging rather than converging. In this case the two ethnic communities would live side by side peacefully as good neighbors, each having its own government and tied by a treaty of friendship and cooperation, most likely within an EU that included as

well all three guarantor powers (the United Kingdom, Greece, and Turkey). Under the terms of such a treaty, and with incentives and standards provided within the EU, as in the Czechoslovakian and Kosovo cases, common problems (e.g., the environment and water shortages) could be resolved by mutual agreement, while the Turks and Greeks enjoy equal rights as EU citizens.

There is also a further, negative, possible outcome that could emerge from the status quo. It would lead to permanent partition of the island, with Papadopoulos's "osmosis" plan as possibly the most effective causal factor. The historical evidence outlined in this book clearly demonstrates that the "osmosis" idea is unrealistic because it is a complete misreading of Turkish Cypriot sentiment and aspirations. There is simply no chance of Turkish Cypriots melting away or reaching a crisis point at which they become an undefined minority within the existing Greek Cypriot state. The suffering and isolation of the period 1964-74 is clear testimony to that. Now, with the impressive gain in political and economic development achieved since 1974, they will not give up what they have accomplished.

"Osmosis" is also a total misreading of the wider Turkish national interest. Ankara will simply not allow itself to be surrounded by hostile territorial waters. This is valid not only for strategic reasons but increasingly for safeguarding the Turkish Energy Corridor, as discussed in Chapter 8. In the February 2006 presidential elections, Papadopoulos was deservedly humiliated, going down to defeat in the preliminary round. The new Greek Cypriot leader, Dimitris Christofias, a Communist trade unionist, appears more flexible, but whether or not he can make the necessary compromises over power sharing and co-ownership of the island with Turkish Cypriots in order to achieve a double yes vote in a future referendum is difficult to say.

What is especially problematical is the position of the European Union. In the past, the EU has declared itself in favor of a comprehensive settlement on the island based on the Annan Plan. Following the plan's rejection by the Greek Cypriots, the EU went ahead and admitted a divided country as a full member, in effect giving the Greek side another veto. It is virtually impossible that this veto can be overcome or canceled to accommodate a potential settlement acceptable to both ethnic sides in the island, as well as Turkey, one of the guarantors of Cyprus. Turkey has its own EU aspirations, and as of 2008, it is most unlikely that these aspirations will be fulfilled.

So what is the most likely scenario? As of 2008, there is a last chance of a negotiated comprehensive settlement of the Cyprus problem through the Talat-Christofias talks. However, there are also deep historical and emotional forces of divergence at work, and a third rejection is very possible.

If a future UN plan for a URC also ends up in failure, then the two ethnic identities in Cyprus will live not together in one citizenship, but side by side, and gradual recognition of North Cyprus will be inevitable. Its sustainability will, in fact, grow over time as more and more qualified Turks come to the island from Anatolia as a result of trade and labor market integration, intermarry, and settle on the island. Economic integration over the next half century may easily transform the Turkish population into the majority ethnic group on the island. All these possibilities, however, are speculative. One thing, though, is certain: both Turks and Greeks in Cyprus can look forward to increasing prosperity, united or divided. A Cypriot treaty of peace and friendship within the two zones of the island would be strengthened if it paralleled similar security arrangements with Greece (for the South) and Turkey (in the North). An integral part of such security arrangements between North Cyprus and Turkey would be the payment of an annual rent for Turkish military bases in the North in lieu of aid.

Postscript

At the beginning of this book, the Cyprus problem was described as one centered on sovereignty sharing between the island's Greeks and Turks. This remains the stumbling block in any future settlement. In 2008, talks for a comprehensive settlement resumed, between Dimitris Christofias, president in the South, and Mehmet Ali Talat, president in the North. Promisingly, the leaders agreed, in principle, on the need for a single sovereignty and single citizenship in a future federal Cyprus that will be bizonal and bicomunal. The real challenge is defining the terms of bizonal and bicomunal federalism in a post-Annan framework that would be acceptable to both sides in a simultaneous future referendum.

Only time will tell whether or not the Talat-Christofias talks, generally regarded as a last-ditch effort, will succeed. Federalism is nothing else if not sharing sovereignty and power in a multiethnic country. There is no reason, given goodwill, that federalism cannot succeed in a new, united Cyprus within the EU, itself perhaps the most innovative and successful postmodern federal experiment. However, whether sufficient goodwill exists among the people of Cyprus, or internationally, most vitally at the EU, only time will tell.

As this book went to press, a major legal decision was rendered at the European Court of Justice (ECJ) which is expected to have far-reaching consequences for the Cyprus problem. This is the judgment on the Orams case, a dispute mentioned several times in this book. At the end of April 2009 the ECJ, with a Greek judge presiding, ruled against the Orams family, the current owner of a property in North Cyprus, and in favor of a pre-1974 owner. If confirmed and enforced, this ruling would effectively undermine the Annan Plan, specifically the bizonality principle. At a minimum the ECJ ruling nullifies the right of current users, a key provision of the Annan Plan,

by declaring the unconditional supremacy of former Greek Cypriot property ownership in the North. Significantly, there is no mention of Turkish property left behind in the South. Nor is there any reference to the population exchange agreement of 1975, under the terms of which Greek Cypriots moved to the South and Turkish Cypriots moved to the North.

In the short term, the ECJ has put the Talat-Christofias talks in a serious impasse. It has also undermined the UN-sponsored peacemaking efforts. Talat has charged that the ECJ has “torpedoed” the ongoing talks. Thus, if the ECJ ruling is to prevail, what is the point of carrying on with these talks? The ECJ has tied the hands not only of Talat but equally of Christofias. If EU law is to be upheld, politicians and diplomats must stand down. Thus, a fundamental question has emerged: is the Cyprus problem to be ultimately decided by European courts or by politicians in Cyprus and through international diplomacy?

It is difficult at this stage to give any answers to these questions. One thing, however, can safely be stated: the EU membership of “Cyprus” in 2004, prior to a political settlement, complicated the Cyprus problem. The ECJ ruling on the *Orams* case may be the final blow for a political solution.

Notes

INTRODUCTION

1. For a recent study of the Cyprus problem, especially from a legal angle, see Hakki 2007. See also Sozen 2008.
2. EOKA (in English, the National Organization of Cypriot Fighters) was a guerrilla group that fought the British for independence and violently advocated union with Greece (enosis). For an unusually balanced historical account by an investigative reporter, see Drusotis 2005.
3. If Turkey were to pay rent for military bases in North Cyprus, as argued in Chapter 9, Turkish aid might be offset accordingly.
4. For a wide range of issues from a Canadian federalist perspective, see Salem 1992.

CHAPTER 1. ECONOMIC DEVELOPMENT IN NORTH CYPRUS SINCE 1974

1. This region is designated as a new tourism center with several new hotels and a large yacht marina.
2. When the financial aid of 259 million euros from the EU to Turkish Cypriots was finally approved and implemented, the Greek Cypriot authorities, under the Papadopoulos regime, quickly challenged its implementation through the European courts, an action that the subsequent Christofias regime has endorsed. The trade embargoes, including direct flights to Ercan, remain in force due to the EU's deference to Greek Cypriot authority. In the legal arena, major private actions, notably the Orams case, are pending. This case seeks to dispossess, under EU law, the British owner of previously Greek Cypriot property in the North. Interestingly, the EU has suspended its own law, the *Acquis Communautaire*, in the North, even though the accession in 2004 covers the whole island.
3. Within a year of its operations, however, the Greek Cypriot side legally challenged the implementation policy of this office, and its future is uncertain.

CHAPTER 2. ECONOMIC RATIONALISM AND INSTITUTION BUILDING

1. Rational behavior is the basic assumption in modern economic theory, as explained in any introductory text on microeconomics (e.g., Parkin 2008).
2. For example, for a long time, it was widely assumed by observers that Turkish Cypriot leader Rauf Denktaş was the obstacle to a settlement in Cyprus. David Hannay, for example, states the general misperception: “Successive UN negotiators, including two UN secretaries-general—Perez de Cuellar . . . and Boutros Ghali—had despaired at Denktash’s inflexibility from which [they] had effectively concluded that he was not interested in a settlement” (see Hannay 2005:55). After the election of Mehmet Ali Talat as president of the TRNC in 2005, it became evident that the inherent complexities of the Cyprus problem are far more powerful than force of personality.
3. See Lordos 2004:17–18, which reports that young Greek Cypriots, those aged 18 to 24, prefer a two-state solution to a federation with the Turkish Cypriots. A good part of the problem is that federalism is little understood among the two peoples on the island, elites as well as ordinary citizens.
4. Ali was a physician from Paphos with leadership aspirations who believed in a unitary Greek Cypriot–controlled state. He lost out early in the 1940s to the nationalist Dr. Fazil Kucuk. In the late 1960s, when the 1960 republic was destroyed and the island became a de facto Greek Cypriot state, Ali became a close friend and adviser of Archbishop Makarios, sharing many of the latter’s beliefs.
5. Drusotis 2005 is a remarkable account of the bloody campaigns of terror and violence among various cliques of Greeks, originating in the Greek Civil War (1944–48) and subsequently transferred to Cyprus by Grivas, with Makarios’s blessing, to attempt to achieve enosis by force. It was a campaign that completely ignored the Turkish Cypriots, assuming naively that they would not be dragged into the EOKA violence or would not oppose enosis.
6. For contemporary articles in dailies such as *Soz*, *Istiklal*, and *Halkin Sesi* on all these topics, see Dogasal and Tekakpinar 1991.
7. Turkish Cypriots consider themselves an integral part of the Anatolian Turkish nation and have embraced Kemalist reforms from the beginning.
8. Dogasal and Tekakpinar 1991 document the life and struggles of Kucuk through newspaper articles.
9. Zeka Bey (Sir Zeka), as he was respectfully known, eventually became the chief justice of the island, respected by Greeks and Turks alike. See Fedai 2002.
10. In the words of a contemporary intellectual, Ferruh Halluma, “Just as in Italy all roads lead to Rome, for us Turkish (Cypriot) community, every development path goes to Evkaf. Our middle schools are directed from this centre, our hungry imams open their hands to this source. Our decrepit mosques wait for funding from here. The massive revenues from Evkaf lands flow here.” *Halkin Sesi*, 24 May 1953, quoted in Dogasal and Tekakpinar 1991:509.
11. This term is chosen to emphasize the British control of the institution.
12. See the original documents in Altan 2003:559–61. This work is a rich archival source on the loss of Turkish lands to Greek Cypriots. Also see Dogasal and Tekakpinar 1991, esp. 470–73, for numerous articles in contemporary dailies about the many cases of fraudulent land transfers from British Evkaf (e.g., the 12,086-donum Afendrika

- Estate in Karpaz administered by Evkaf in trust for Hala Sultan Tekke) to Greek Cypriots or the Greek Cypriot church.
13. In the 1930s the British carried out the same monetary policy (of generating surplus from local revenue) in British Malaya. See Mehmet 1978:96-101.
 14. In 1936 this amount was 6,935 sterling pounds, rising to 46,691 pounds in 1947. See the full set of figures in Gazioglu 2000:148-49.
 15. This was a major complaint highlighted by the commission in its report. See Dogasal and Tekakpinar 1991:448.
 16. Quoted in Dogasal and Tekakpinar 1991:477.
 17. For a detailed history of this struggle, see Dogasal and Tekakpinar 2000, especially vol. 2. Significantly, after the establishment of the TRNC, Evkaf created the Vafklar Bank, one of the leading banks in North Cyprus.
 18. Except as otherwise noted, the information on the bank was provided by Yenil Musannif, general manager of the Turkish Bank, in an interview on 12 May 2005. This assistance is gratefully acknowledged.
 19. One important exception to this generalization is the case of the Turkish Cypriot Farmers Association, which started under the same roof with the Greek Cypriots in 1940 but became separate in 1943. The leader of this movement was Mehmet Kemal Deniz, who attributed the separation, in an article in the Turkish daily *Hursoz*, to ethnic slurs by Greek Cypriots. See Demiryurek 2005:17.
 20. In 1904 the district commissioner of Paphos launched village cooperative saving banks. See Jenness 1962:169.
 21. These historical details are from Varnava 1997:11. I thank Hasan Felek of Dev-Is for bringing this valuable book to my attention.
 22. See the conversation of John Reddaway, the colonial undersecretary, with Dr. Ihsan Ali at the start of 1959 (Ali 1978:30-31).
 23. Sarica was vice-governor of the Central Bank, Asaf was an adviser to Vice President Fazil Kucuk, and I (the first Turkish Cypriot to be educated at the London School of Economics) was an economist at the Economic Planning Commission. For a fuller discussion of economic policymaking in this period, see Plumer 2008.
 24. See the details of his secret landing in Karpaz and his meeting with Clerides on behalf of Makarios in Clerides (1989:2:200-205).
 25. For a case study of rent seeking, see Mehmet 1994.
 26. There were exceptions. A noted lawyer who differed with the leadership on economic policy was Mithat Berberoglu, the founder of an opposition party that evolved into the present CTP.
 27. The excess over 100 percent reflects large numbers of over-school age “students” from Turkey.
 28. The dysfunctional Greek Cypriot education deserves some elaboration based on expert opinion. Pierre Oberling (1982:chap. 2, esp. p. 16) provides one of the most informative accounts of how ethnonationalist Greek Cypriot education brainwashes young minds to spread hatred of everything Turkish. The same point is made by Rebecca Bryant (1998:66).
 29. One noteworthy initiative in this direction was the bicomunal Economic Forum started by Erdil Nami, the former president of the Turkish Cypriot Chamber of Commerce, and Constantinos Lordos, a prominent Greek Cypriot businessman.

However, the forum, which was active in the period leading to the 24 April 2004 Referenda, seems to have declined following the no vote in the South.

30. For a personal account, see Denктаş 1988:83.
31. Much of Marash/Varosha is vakfland that ended up during colonial times in Greek Cypriot hands through fraudulent transfers. See Altan 2003.

CHAPTER 3. A DEVELOPMENT STRATEGY FOR NORTH CYPRUS

1. For greater detail on this development strategy, see Mehmet 1988:chap. 2.
2. For an excellent book on the GwE model, see Campos and Root 1996.
3. For a case study, see Mehmet 1986a.
4. These figures are taken from TC Lefkosa Buyukelciligi 2004. For a detailed discussion of this topic, see Chapter 1.
5. This system may require a constitutional amendment to initiate a presidential system in North Cyprus, although such an economic council should also be feasible under the existing parliamentary system and within the existing powers of the president.
6. See the survey results reported in Lordos 2004 based on findings soon after the 2004 Referendum.
7. As in the title of Calotychos 1998: *Cyprus and Its People* (not *Peoples*).
8. For a revealing discussion of the lack of self-interest among Greek Cypriots, see the article “Self-Interest and the Politics of the Possible,” *Sunday Mail*, 19 February 2006.
9. See in particular Vangelis Calotychos’s introduction and the writings of Peter Loizos in Calotychos 1998.
10. For a legal assessment of this landmark case, see Necatigil 1999.
11. The British High Court judgment can be found at www.cyprus44/property/orams-judgement.pfd.

CHAPTER 4. CAN NORTH CYPRUS SURVIVE AS A MICROSTATE?

1. With the end of colonial rule, Hong Kong is now an administrative region of the People’s Republic of China, but it has an autonomous government.
2. The opening of the Middle East Technical University campus at Kalkanli near Guzelyurt in 2005 is the most recent example of a regional growth center. This campus is expected to accommodate six thousand students and, at that capacity, will uplift the economy of the entire western region of the country.
3. See “Topic: Water from Turkey: It Makes Economic Sense,” *Cyprus Today*, 26 April–2 May 2008, p. 18.

CHAPTER 5. MODELING REQUIRED INVESTMENT IN NORTH CYPRUS

1. The H-D Model was developed by British economist Sir Roy F. Harrod and his American counterpart Evsey Domar independently in the 1940s to guide European post-war reconstruction. Subsequently, it was introduced to the Third World, where its performance was far less effective. See Mehmet 1995b.
2. In North Cyprus the banking system is a free market, but officially it operates within

- the Turkish currency zone. After 2002 a high level of monetary stability was achieved, considerably improving the investment climate.
3. ICOR is a measure of productivity of capital, i.e., how efficiently capital is utilized. The higher this efficiency, the lower is ICOR. In North Cyprus, ICOR = 4.5, reflecting relatively low K productivity.
 4. There is a large volume of work on convergence, which can be defined in numerous ways. For a comprehensive survey, see Islam 2003. For an application to Cyprus, see Demetriades, Fethi, and Fethi 2002.
 5. As declared in a working seminar at the Turkish Chamber of Commerce at the time of the Annan Plan negotiations.
 6. In the tourism sector, for example, current investment by private investors exceeds \$500 million. But of course, our investment planning is an average for a 10-year period.
 7. See Devlet Planlama Orgutu 2005:Table 13:32.
 8. See the next chapter on labor market convergence.
 9. Eichengreen et al. (2004) predict that in a laissez-faire environment Turkish Cypriot per capita income will be only 60 percent of the Greek Cypriots' level in 2020.
 10. In a more elaborate version of the model, three major groups of infrastructural projects have been identified and pre-feasibility benefit-cost analyses done. They are (1) doubling capacity in higher education to 60,000 students by 2025, (2) vocational and technical polytechnic schools for skill training and upgrading especially for small and medium enterprises, and (3) physical infrastructural projects such as electrical power, harbor modernization, civil aviation, roads and highways, and telecommunications.
 11. The assumption here is a constant ICOR, more justifiable than a positive technical change or a declining capital-output ratio, which would suggest a quicker, that is, a more optimistic, rate of convergence than the one indicated here.
 12. This view was clearly evident in a background paper presented by the Greek Cypriot side at the Technical Committee negotiations on the Annan Plan in early 2004 (Eichengreen et al. 2004). See also the Turkish Cypriot response to this document (Turkish Cypriot Reply 2004).

CHAPTER 6. THE LABOR MARKET: DEVELOPING SKILLS FOR A SERVICE ECONOMY

1. These two terms are used interchangeably. Economists prefer *mobility* whereas sociologists use *migration*.
2. Ministry of Economy and Tourism, *TRNC Quarterly Economic Review* No. 1 (Fall 2005), Table 7, p. 13.
3. Economic migration is a global phenomenon, and there is a large literature on the subject. See Mehmet et al. 1999.
4. Other things being equal; for example, all necessary information about working conditions is available.
5. No income tax is payable on incomes of less than CYP 10,000 annually.
6. In line with the principle of equal pay for work of equal value enshrined in international labor standards formulated by the International Labor Organization.
7. Information gathered from the TRNC Labor and Immigration Offices.

8. For 2005, no income tax was payable on annual incomes of less than YTL 8,640.
9. US\$1 = YTL 1.34 in 2005.
10. See OECD Employment Outlook 2005, esp. chap. 4, “Labour Market Programmes and Activation Strategies: Evaluating the Impacts,” at http://www.oecd.org/document/1/0,2340,en_201185_34855489_1_1_1_1_00.html. See also Monar 2004 and the EU’s own sources cited in notes 12 and 13.
11. By contrast, unemployment has declined in some countries (e.g., Ireland). See Saint-Paul 2004.
12. http://europa.eu.int/comm/dgs/employment_social/index_en.htm, Mission Statement.
13. http://europa.eu.int/comm/employment_social/esf/en/public/broschure/brochen.thm.
14. E.g., the British industrial training system.
15. For a brief account of the Singapore Skill Development Fund, see Mehmet 1988:15.

CHAPTER 7. THE CONSTRUCTION SECTOR IN THE POST-REFERENDUM PERIOD

1. Building Construction and Parcel Statistics, TRNC Prime Ministry, State Planning Organization, Statistics and Research Department, 2002.
2. All calculations are made by the authors from data collected by the State Planning Organization, Nicosia.
3. One donum is equal to 14,400 square feet or 1,339.2 square meters.

CHAPTER 8. THE TURKISH ENERGY CORRIDOR

1. On ERA and environmental impact assessment, see Dixon, Scura and Carpenter, 1994. For a concise introduction to BCA, see Belli 1996, esp. chap. 6.
2. Jean-Paul Rodrigue, The St. Lawrence Seaway and Regional Development, <http://people.hofstra.edu/geotrans/eng/ch7en/appl7en/ch7a2en.html>.
3. For more details, see <http://www.epa.gov/fedrgstr/EPA-IMPACT/2005/May?Day-17/19799.htm>.
4. See the Humanitarian Early Warning Service (www.hewswb.org).
5. This estimate consists of daily delivery of 1.5 million barrels of BTC oil, 1.5 million barrels of Kerkuk-Yumurtalik oil, plus 1.5 million barrels Samsun-Ceyhan natural gas, or a total of 4.5 million tons. Assuming a normal year of operation of 250 days and 7 barrels per ton, these figures imply a total capacity of 160 million tons, well ahead of Rotterdam. These figures are the estimates of M. Rende, of the Energy Division of the Foreign Ministry, Ankara, supplied on 25 July 2006.
6. This, by the way, is a major motivation behind South Cyprus’s desire to gain access to Turkish ports under the EU’s Additional Protocol.
7. See the last section of Chapter 4. For earlier studies on this subject, see Brooks and Mehmet 2000, especially chap. 7.
8. Exclusive Economic Zone (EEZ), Part V, Art. 55: Specific Legal Regime; Art. 56: Rights, Jurisdiction and Duties of Coastal States; Art. 57: Breadth of EEZ http://www.un.org/depts/los/convention_agreements/texts/unclos/part5.htm.

9. Information obtained from Mr. Ulu, of the Turkish Petroleum Partnership Ltd, Ankara, 26 July 2007.
10. Information obtained from M. Rende, of the Turkish Foreign Ministry, Ankara, 25 July 2007.

CHAPTER 9. DIVERGENCE OR CONVERGENCE? TOWARD A TWO-STATE OUTCOME

1. See the interesting article by Kosta Pavlowitch, “A Growing Malaise,” *Cyprus Mail*, 1 January 2006.
2. For example, the Arestis case, decided on 22 December 2005 at the European Court of Human Rights, rejected compensation and redirected Greek Cypriots seeking “local remedy” to the newly created Turkish Cypriot Land Claims Commission. This landmark decision blocks Greek Cypriot attempts to exploit the EU legal card, at the same time opening the door for legitimizing Turkish Cypriot authority in the North along the lines of the property claims provisions of the Annan Plan. For a discussion of the complexities of this case, see Simon Bahcheli, “The Varosha Riddle,” *Cyprus Mail*, 1 January 2006.
3. Drusotis (2005) makes this point abundantly clear.
4. The Orams case involves a British family that owns a house in the North claimed by a Greek Cypriot. The Greek Cypriot has argued, before British and EU courts, that the original property should be restored by demolishing the house the Oramses built on the property, which they bought from a Turkish owner who was issued a title by North Cyprus authorities. EU law, however, is suspended in the North.
5. Canada may be cited as an example of the complexity and difficulty of sustaining federalism. After almost 140 years of almost superhuman efforts to sustain the Canadian Confederation, the risk of Quebec’s separation has not diminished.
6. Only one book (Theophanous 1996) is available from the Greek Cypriot side, and it argues for a unitary, Greek Cypriot state. None exists on the Turkish Cypriot side, except my own article in Salem 1992:169–90, which takes Canadian confederalism as the model. Fiscal federalism is not entrenched in the URC proposal, which also lacks a dispute-settlement mechanism.
7. Kizilyurek 2005 is a recent and comprehensive testimony to this fact.
8. The same thing occurred in sports in 1955–56, when Turkish soccer teams ceased to play in the Greek Cypriot–dominated federation.
9. The number of mixed Turkish Cypriot and Greek Cypriot villages declined during the British colonial period. In 1859 there were 234 mixed villages, in 1931 there were 202, and in 1960, at the time of independence, there were only 102. See Atakol 2003:97.

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Index

Numbers in italics indicate tables.

- agriculture: and cooperatives, 30, 31;
decline of, 5; mechanization and
modernization of, 3
- AKEL: opposition of, to Annan Plan, 18,
53; and ethnic separation of labor
movement, 32
- Akritas Plan, 37
- Ali, Ihsan, 26, 136
- Annan Plan, ix; bicommunality in, 40;
deficiencies of developmental strategy
in, 49–51; and EU role in referendum
on, 18; impact on construction boom,
107; and real estate market, 112; rejected
by Greeks, xi
- Asaf, Nail, and free-enterprise model, 37
- Asian Tigers, as models of developmental
state, 44–46
- Ataturk, Mustafa Kemal, and Turkish
nationalism, 21, 26
- Baku-Tblisi-Ceyhan Pipeline (BTCO):
benefits of, for North Cyprus, 118,
122–29; policy framework for, 118–22;
and Turkish Energy Corridor, 18
- banking and finance, ix; in colonial era,
28–30, 31; in microstates, 64; and
separate economy, 34–35
- Berberoglu, Ahmet Mithat, 28
- Bermuda, and tourism, 64
- bicommunality and bizonality: in Annan
Plan, 50; feasibility of, in united Cyprus,
50, 51–53, and history of Cyprus, ix
- Britain: and colonial administration of
Cyprus, 25–28; and recognition of
Turkish Cypriot Chamber of
Commerce, 36
- British Evkaf. *See* Evkaf
- central-place theory, and microstates,
60–62
- Christofias, Demetris, and settlement
talks, 20, 130, 137
- cluster theory, and microstates, 60, 62–63
- construction: Annan Plan impact on,
107–9; determinants of increase in,
109–10; employment in, 7; and envi-
ronmental sustainability, 114–16
- consumerism, excessive, as problem in
North Cyprus, 10, 16, 79
- convergence, forces of, 130, 131, 135–36.
See also divergence, forces of; economic
parity
- cooperatives, and institution building,
30–31
- Cypriot identity, ethnic divisions in, 23,
135–36
- Cyprus, under British colonialism,
25–28. *See also* Cyprus, unification of;

- Greek Cyprus; North Cyprus (region); Republic of Cyprus; Turkish Republic of Northern Cyprus (government); United Republic of Cyprus
- Cyprus, unification of: economic parity as precondition for, xi, 22, 24–25, 52, 78–81, 135; and federalism, 49–52, 78, 87–88, 133–36, 141; Greek Cypriot version of, 22, 54–56, 78. *See also* United Republic of Cyprus
- Dagli, Niyazi, 32
- Deniz, Mehmet Kemal, 31, 32
- Denktaş, Rauf R., 27, 28, 36; and Cyprus EU membership, 18
- developmental state: characteristics of, 44–46; North Cyprus as, 46–49
- divergence, forces of, 130, 131, 135–37, 139–40. *See also* embargo; EOKA; ethnic violence; identity
- economic parity: in Annan Plan, 49–50, 51; and Harrod-Domar model, 88–89; investment needed to achieve, 82–84, 86–88; labor market barriers to, 98; and managed convergence, 77, 78–80; as precondition for united Cyprus, xi, 22, 24–25, 52, 78–81, 134; time path of, 84–85
- economic rationalism theory, x, 21–25, 58; as basis for unification, 39–43
- education: and ethnonationalism in Greek Cyprus system, 40, 54; and human capital, xi, xii, 39–40; vocational, in developmental state, 45. *See also* higher education
- embargo of North Cyprus, 2, 24–25, 37, 141n2; impact on tourism, 4; impact on trade, 8, 15–16
- energy resources. *See* Turkish Energy Corridor.
- enosis, 2, 32, 54; Turkish Cypriot legal case against, 38–39
- environmental protection: in Annan Plan, 107; and construction, 114–16; and government-private partnership, 48; and sustainability, 107; and Turkish Energy Corridor, 117, 118–22, 129; in two-state solution, 131
- EOKA, ix, 30, 32–33, 34–35, 131
- ethnic violence, 22, 37, 136. *See also* Akritas Plan; EOKA
- European Court of Justice: 1994 embargo imposed by, 8, 15; and Ormas case, 139–40
- European Union (EU): admission of Cyprus to, ix–x; and benefits of membership for North Cyprus, 71; and labor market policies, 102–4; and North Cyprus, 80; and potential investment in North Cyprus, 84; and relations with North Cyprus, 18–20, 84; and Turkey, x, 19, 85, 132
- Evkaf: British control of, 25–28; Turkish-Cypriot control of, 34
- federalism, Cypriot lack of experience with, 133–34, 136
- Foot, Hugh, 27, 36
- “From Turk to Turk” campaign, and economic development, 33–35
- Greek Cyprus, x; dominant position of, 22; and economic convergence, 81–82, 84–86; and economic rationalism, 48–49, 53, 57, 58; and ethnic violence, 22, 26, 27, 132 (*see also* Akritas Plan; EOKA); and federalism, 133–34; and Orams case, 133; and rejection of Annan Plan, 53, 78, 89; sources of irrationality, 54–56; and wage discrimination, 97, 98
- Green Line, 19
- growth-pole theory, and Turkish Energy Corridor, 127–28
- Gurkan, Hasmet, 33
- Harrod-Domar Model, and investment needed in North Cyprus, 75–80, 88–89
- higher education, ix, 7, 12; and construction of universities, 108; importance of, to North Cyprus development, 4–5, 68,

- 69–70, 71. *See also* education; human capital
- Hikmet, Ayhan, 33
- human capital, 47–48; in EU labor market management, 103, 104; and labor migration, 101; public investment for, 66, 67. *See also* education: human capital; higher education: importance of, to North Cyprus development; labor development theories, 59–63; sectoral analysis of, 63–65; viability of, ix, 65–67
- Munhir, Mehmet, 27
- Muslim Endowment Organization. *See* Evkaf
- Nadir, Asil, 3
- nationalism, 21, 22–23, 24
- Nazim, Sheik, 27
- North Cyprus: consolidation and institution building, 1, 2–7, 23–25, 28–37; construction boom, 1, 9; as developmental state, 79; economic development in post-referendum period, 9–18; emergence of service economy, 1, 5, 7–9; and excessive consumerism, 10, 16, 79; potential benefits for, of settlement of Cyprus problem, 71–73; support for separation, 23; Turkish assistance to, 8, 10–12, 16, 34, 36–37, 46–47; viability of, as microstate, 68–78. *See also* embargo of North Cyprus; Turkish Republic of North Cyprus
- Orams case. *See* property rights: and Orams case
- Ozkan, Necati, 26
- Papadopoulos, Tassos, 18, 53, 137
- parity, economic. *See* economic parity
- peace dividend, for North Cyprus, 71–73
- private sector investment: incentives for, 12–15; versus consumerism, 10
- property rights: in Annan Plan, 50, 76, 112; and construction boom, 107; Greek Cypriots and, 57; as key to unification, 3, 41–42; and land for power sharing, 132–33; and Orams case, 139–40, 141n2
- rational behavior theory; undermined by nationalism, 21, 22–23, 24
- real estate market: price model for, 110–12; policies for, 113–14; impact of ethnicity on, 111–12; and Annan Plan, 112. *See also* property rights
- Reddaway, John, 36
- 69–70, 71. *See also* education; human capital
- Hikmet, Ayhan, 33
- human capital, 47–48; in EU labor market management, 103, 104; and labor migration, 101; public investment for, 66, 67. *See also* education: human capital; higher education: importance of, to North Cyprus development; labor
- import-export trade, 5
- industrial development, 4, 5, 108
- infrastructure, 86, 87; federal support for, in URC, 51; in HD model, 76, 77, 78; investment incentives for, 9; Turkish aid for, 10–12, 46, 77, 86
- Islam, and Turkish Cypriots, 27
- KATAK (Kibris Adasi Turk Azinlik Kurumu), 26
- Kaymak, Faiz, 26
- Keles, Rusen, xii
- Kemalism, 39
- Kenan, Ragib, 30, 31
- Kizilyurek, Niyazi, 22–23
- Kucuk, Fazil, 26, 27, 28, 32, 36, 135
- labor and labor market: and commuter workers, 91, 92, 94–98, 104; ethnicity, 31–33; and EU policies as model, 102–4; growth of, 5–6, 7; in microstates, 67; and rational migration, 92–4; and Turkish Energy Corridor, 127; Turkish immigrants in, 3, 90, 91, 92, 98–101, 102; and unions, 31–33
- land claims. *See* property rights
- “land for power sharing,” 132–33. *See also* property rights
- London-Zurich Agreements (1960), 27; and separatism, 37
- Markarios, Archbishop, 24, 37
- Mehmet, Ozay, and free-enterprise model, 37
- microstates, 130–31; defined, 1; and

- Republic of Cyprus, 2; Greek domination of, 25. *See also* Greek Cyprus
- Rustem, Kemal, 36
- Sarica, Ozalp, and free-enterprise model, 37
- Schultz, Theodore, 92
- service economy, and microstates, xi, 61–62, 63
- shipping, and Turkish Energy Corridor, 127, 128
- Singapore: and central-place theory, 61–62; and sustainable tourism, 67–68
- Sjaastad, Larry, 93
- social justice: in microstates, 67–68; in North Cyprus, 70–71
- St. Lawrence Seaway, as model for Turkish Energy Corridor, 124–25
- statism, as early model for North Cyprus economy, 37–38
- Talat, Mahmet Ali, 20, 137, 139
- Talat-Christofias talks, 137, 139, 140
- taxation: inefficiencies in, undercut North Cyprus economy, 12, 16; inequity of, in Annan Plan, 49
- Todaro, Michael, 93
- tourism, 48; and benefits of Cyprus settlement, 71–72; and construction boom, 108; and microstates, 63–64, 67–68; in North Cyprus economy, 7, 12–15
- Turkey: and EU membership, 19, 104, 132, 137; importation of water from, 4, 72–73, 128–29; loans to North Cyprus from, 16; and military intervention in North Cyprus, 2, 5, 18; support of, for North Cyprus infrastructure, 10–12, 36–37; and trade with North Cyprus, 8, 34, 68–69
- Turkish Bank, success of, 28–30
- Turkish Cypriot Chamber of Commerce, 35–37, 38
- Turkish Cyprus. *See* North Cyprus; Turkish Republic of North Cyprus
- Turkish Energy Corridor, 137; and benefit-cost appraisals, 120–22; benefits of, for North Cyprus, 122–29; and coastal zone exploitation, 129; early warning system for, 119–20, 121, 122, 125–26; and environmental risk assessment, 120, 121–22; joint management of, 124–25; and operational funding, 126–27; value of, for Turkey and North Cyprus, 123–24
- Turkish Republic of North Cyprus (TRNC): budget deficit, 16; environmental regulations, 115–16; and guest worker policy of, 98–101; investment programs of, 9–15; State Development Bank, 14; State Planning Organization, 12. *See also* North Cyprus
- two-state solution, 80, 89–90; examples of, x; reasons for, 131, 134–35, 136–37, 138; as second-best outcome for Cyprus, 24, 77
- unions. *See* labor and labor markets: and unions
- United Nations, ix. *See also* Annan Plan
- United Republic of Cyprus (URP): as best outcome for Cyprus, xi, 24–25, 43, 77; and economic parity, 135–36; and federal transfers to North Cyprus, 83–84, 89; and forces of divergence, 134–35; and power sharing, 133–34
- Vasiliou, Geroge, 136; and Cyprus EU membership, 18
- water: access to, improved by Turkish Energy Corridor, 128–29; imported from Turkey, 4, 72–73
- women: and “From Turk to Turk” campaign, 34; in labor force, 94, 99
- Yorucu, Vedat, xii
- Zeka, Mehmet, 27