A Challenge of EU Enlargement:  
Northern Cyprus  
Understanding a Small Island Economy in Isolation  

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The political division in Cyprus is one of the long standing political disputes in the world political scene for a long time. Despite various attempts by the international community, the division in the island still remains as being the Turkish side on the north and the Greek side on the south. However, international community recognises only the Greek side as the sovereign state of the island, and has kept the Turkish side under political and economic embargoes since the Turkish side unilaterally declared an independent state in 1983. With the recent admission of the Greek Cypriot government to the European Union (EU), the EU has unfortunately become a side of this international dispute. This membership has unexpectedly worsened the political dispute, and deteriorated the economic problems that the Turkish side has been encountering for a long time. Therefore EU possesses new political and economical challenges to resolve this dispute.

The political aspects of the issue have widely been examined in the international community, but its economic aspects have drawn almost no attention so far. However there exists apparent income inequality between two sides of the island, which may constitute an obstacle in reaching a peaceful settlement of the dispute in equal term. The latest effort for the resolution of the dispute was pioneered by Kofi Annan, the seventh Secretary General of the UN, and the comprehensive plan, on which had been agreed both by Turkish and Greek Cypriots, was unexpectedly declined by Greek Cypriots in the referendum on the 24th of April 2004. Despite all promises by the international community before the referendum, Turkish Cypriots still remains in isolation, and continues to struggle for existence, while Greek Cypriots were awarded with the membership of the EU. After the demise of the Annan Plan, Turkish Cypriots accordingly urged to implement appropriate policies in order to eradicate this income inequality between two communities. However such efforts first require a close examination of the unique nature of the Turkish Northern Cyprus (TNC) economy, and then sincere understanding, mostly by the EU administration, of economic challenges that the TNC economy encounters.

The Northern Cyprus economy belongs to the state, which is politically recognized only by Turkey, and has been under economic sanction for a long time. It is hence extremely dependent economy on the aid from and trade with Turkey and its financial market exhibits a complete integration with Turkish markets. With the latter feature of the economy, North Cyprus and Turkey posses a small common currency area, in which has not drawn any interest for academic examination until now. Labour market shows a dual characteristic with higher wages in the Greek side, and this wage inequality encourages many Turkish Cypriots to commute the Greek side for work. With these and similar features of the economy, North

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Cyprus provides an interesting research ground. The proposed book wishes to examine how important these country-specific features of the economy are in determining the growth prospect of a small island economy like North Cyprus. Given the existing divergence in income per capital between Greek and Turkish sides of the island, such scrutiny would particularly be crucial in finding a peaceful political solution, and, hence, we expect that our better understanding of the Northern Cypriot economy would contribute to the peaceful settlement of the dispute between two sides in the future. In order to awaken the awareness of the international community on some novel economic issues on the island rather than only politics, the proposed book is expected to be published by an international publisher, and to be distributed worldwide.

**Possible Content of the Book**

- **Introduction** by Öner Günçavdı (Istanbul Technical University).

**PART I: General Issues and the Cypriot Problems: Economics and Politics.**

- “Economic Challenges Faced by Small Island Economies: An Overview” by Clem Tisdell (University of Queensland).
- “Critical Issues in the Growth of Small States” by Robert Read¹ (Lancaster University).
- **Author(s)**², who examine the current economic disparities between two sides of the island.
- **Author(s)**³, Expected Economic Effects of the Annan Plan.
- “Required Investment for Convergence in a United Cyprus” by Özay Mehmet (Carleton University and Eastern Mediterranean University).

**PART II: Novel Nature of North Cyprus Economy**

- “Risks and Conflicts in Developing a Financial Service Market in TRNC without International Recognized Statehood” by Herbert R. Reginbogin (University of Potsdam and Lefke European University).
- “Trade Embargo and Conflict: A theoretical Analysis for the Case of North Cyprus” by Sajal Lahiri (Southern Illinois University) and M. Özgür Kayalıca (Istanbul Technical University).

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¹ He has already accepted our invitation, and I have been waiting for his abstract.
² This chapter can be written by a Greek Cypriot academician. One possible candidate is UK-based economist Professor Panicos Demetriades from University of Leicester. Another professor is the Cyprus-based Professor Panikkos Poutziouris from the CIIM-Cyprus International Institute of Management. I have already got in touch with Professor Panikkos Poutziouris, and still waiting for his response to my invitation.
³ A group of worldwide well-known economists wrote an economic report regarding the economic aspects of the Annan Plan for the Government on the Greek side of the island just before the referendum in 2004. I wish to ask one or two of these professors to write a comparative paper describing the economic situations on the island. The paper might be a brief evaluation (or even summary) of the report that they wrote before. These professors are Barry Eichengreen (Professor of Monetary Economics, University of California at Berkeley), Late Riccardo Faini (Professor of Development Economics, University of Rome), Jurgen von Hagen (Professor of Public Economics, University of Bonn) and finally Charles Wyplosz (Professor of Economics, University of Geneva). I have already got in touch with Professor Charles Wyplosz, and still waiting for his response to my invitation.
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- “Effects of Trade Barriers on a Small Country” by Benan Zeki Orbay (Istanbul Technical University).
- “Wage Setting in a Dual Labour Market with Monetary Union” by Saime Suna Kayam (Istanbul Technical University).
- Mobility of Labour and Wages in TRNC” by Mehtap Hisarcıklılar (Istanbul Technical University).
- “The Option Effects of Economic Development in North Cyprus” by Eric Li (Eastern Mediterranean University).
- “Income Inequality and Poverty in a Small Island Economy” by Raziye Selim (Istanbul Technical University) and Meltem Dayıoğlu (Middle East Technical University).
- “How Important is Tourism in Economic Growth in TRNC? Structural Changes and Inter-Sectoral Linkages” by Öner Günçavdı (Istanbul Technical University) and Suat Küçükçifçi (Istanbul Technical University).
- Conclusion by Öner Günçavdı (Istanbul Technical University).

This will be the first book examining Northern Cyprus economy, with novel empirical and theoretical tools. It would also constitute a good reference for further books in this kind with the way of analysis and the use of analytical tools. The book also aims at introducing not a political, but an economic approach to a long standing dispute in the world. With these features, the book will be the only book in the literature.

Competing Books


Our proposed book, however, differs from these books due to the country on which the book focuses, and the economic issues that the book covers, and finally due to the way of examining the economic features and problems of the economy. Also the readership of the book is expected to be wider than these existing books mainly because the Cyprus problem is well known all over the world and has expectedly a potential to attract attention of various groups of audience from the fields of economics and politics including academics and policy makers.

Likely Markets of the Book

This proposed book is expected to serve great interests of a wide range of target groups, which spans from universities to professional organizations and policy makers.

Universities in the World: This book could be used as a supplementary book in the third year undergraduate and the graduate studies in politics and economics. It would be useful for students in economics in order to understand the novel way of analysis of a small island economy in isolation with empirical and theoretical tools. It would also introduce economic issues that might have political consequences for students in politics who study this long standing political dispute in the world politics scene, and contributes to their existing knowledge on the issue with different economic approach. With these
features of the book it is also expected to be useful both for professional researchers in economics studying on small island economies and academics in political sciences studying the Cyprus issue.

**Universities in Turkey, Greece and Cyprus:** It is expected that this book would also derive demands from academics and students from the countries that already takes part of the dispute. They are 81 universities only in Turkey together with 8 universities on the island.

**Professional Organisations in the EU, the USA and in the World:** The political and economic institutions in the EU would be another target group of the book. The book serves as a very good reference for the people in these institutions who wish to understand the economic structure and problems of the Northern Cyprus economy. OECD, World Bank, IMF and people employed in these organizations are other sources of demand. Also foreign missions of different countries may show interest in this book.

**Professional Bodies in Turkey, Greece and Cyprus:** People taking part of foreign missions of Turkey, Greece and Cyprus are expected to show great interest in a book like this. This book also drives the interest of the professional bodies and policy makers in Turkey and North Cyprus.

**The Proposed Length of the Book**
The book is proposed to include 12 or 13 individual papers with approximately 20 pages each. With the inclusion of the introduction as well as other additional sections such as forewords, index and contents pages, the length would be somewhere between 300 and 350 pages.

**Time Plan of the Project:** It is expected to be received the completed papers by 30 September 2008.

**Possible Referees**

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ABSTRACTS

Economic Challenges Faced by Small Island Economies:
An Overview
By Clem Tisdell,

As pointed out in this article, small island economies are diverse in their nature and in the challenges they face. A taxonomy of these economies is provided. The overview takes account of small island economies that are satellites of large countries as well as those which are independent nation states. Nevertheless, the emphasis here is on small island economies that are remote from central economies or disadvantaged in other ways. These include many island nations in the Pacific and elsewhere. Such economies suffer from diseconomies of scale in economic activity, are prone to imperfect market competition, and experience high transport and trading costs for a variety of reasons which are outlined. The gravitational pull of stronger central economies and central places favours net out migration from these economies, particularly a brain drain, as well as net private capital outflows. These tendencies often stifle local economic development. Such economies frequently depend on aid from foreign or central places for maintaining the levels of income of their inhabitants; income levels which in many cases are relatively low. Income levels may be precarious in such economies because they are vulnerable to variations in economic, natural and political forces. They usually lack diversity in their natural resources and in their exports. A natural disaster can devastate their whole island economy so that little resilience remains to deal with the disaster by relying on the island’s own resources. Whether or not such economies are particularly prone to political disturbances is unclear, but when such disturbances occur they tend to impoverish those areas because net migration and net capital outflows increase and inbound tourism (which is often an important source of income for such economies) dwindles. The environmental situation facing small island economies varies. Some have undergone rapid urbanisation and centralization of their populations and this has caused significant pollution problems and water availability problems. Furthermore, some are at considerable risk from climate change. Increased urbanisation of such economies usually increases their economic vulnerability because it is normally associated with greater dependence on international market exchange and results in increasing urban-bias in politics.

Required Investment for Convergence in a United Cyprus
By Ozay Mehmet,

This paper forecasts from a Harrod-Domar Model through to 2025 the volume of required investment for 100% convergence of incomes per capita and of growth rates between North and South parts under two alternative scenarios. The first (the best case scenario) is based on power sharing in a federal Cyprus, bizonal and bicommmunal as outlined in the UN Peace Settlement called the Annan Plan. In such a reunited Cyprus federal macroeconomic policy in general, and fiscal transfers for capital investment, are seen as the key policy instruments of managed convergence, or the necessary condition of stability and sustainability of the Cypriot
federalism. However, this first-best scenario may not be attainable owing to the reluctance of Greek Cypriot side to share power with the Turkish Cypriots in Northern Cyprus. Accordingly, a Two-State Solution is assumed in an alternative scenario in which the required investment in Northern Cyprus is assumed to originate principally from Turkey with which there is already a growing economic integration as a result of (1) trade divergence from Europe to the Turkish mainland, and (2) labour market convergence with unlimited inflow of cheap labour imported from Southern Turkey.

**Risks and Conflicts in Developing a Financial Service Market in TNC Without International Recognized Statehood?**

By Herbert R. Reginbogin

The paper attempts to define the different risks and conflicts with the emergence of a dynamic financial service industry on the island of TNC and to identify the proximate terms that reputable firms are prepared to accept to participate in an emerging financial service industry located in the TNC. It considers the key driving elements of comparable historical cases like South Africa and Taiwan based on literature about their growing financial service industry at a time they were boycotted by members of the international community.

In 1974, Turkey began its occupation of a portion of the island of Cyprus over the objection of Greece. This was done for the expressed purpose of protecting the Turkish minority just after the Greek Cypriots staged an unsuccessful coup that would have unified Cyprus and Greece. This was nevertheless an illegal occupation, because the UN Charter prohibition on the use or threat of force in international relations. In 1997, the UN Security Council vowed an end to the occupation – a predicament that remains unresolved.

In 2007 the challenges and opportunities facing the TNC to develop a financial service industry to attract corporate capital from mainland Turkey and abroad have major obstacles to overcome. In preparing this paper, a link between interviews with directors of major international hedge funds or other financial global players and the comparative analysis about the financial risks in similar countries without statehood during the Cold War, will provide major insight into the practical steps to be considered to attract managerial support from the financial community to support this feasibility study of establishing a financial service industry on the island of TNC.

**Trade Embargos and Conflict: A Theoretical Analysis for the Case of Cyprus**

By Sajal Lahiri and Özgür Kayalıca

In this paper we propose to develop a theoretical model of international trade and conflict with stylised facts from the conflict in Cyprus. To be specific, we consider a four country trade-theoretic model where two of the countries – Northern (Turkish) and Southern (Greek) Cyprus – are in a conflict (cold war) situation, with both countries allocating a part of the resources (labour) away from productive activities to activities relating to (cold) war. The levels of these non-productive activities are determined endogenously in a Nash game. The fourth country, which is the rest of the world, has imposed trade embargo on one of the warring countries, namely Northern Cyprus. The third country (Turkey) has a good relationship with Northern Cyprus, and most of Northern Cyprus’s exports are sent via Turkey to avoid embargo. This costs substantial transportation costs. The same applies to imports from the rest of the world. There are some goods, however, that cannot pass as Turkey’s product and these can only be consumed in Northern Cyprus and Turkey.

The labour markets in the two warring countries and Turkey are also linked. We assume that there is unemployment in Turkey, and an excess demand for unskilled labour In Southern Cyprus. This excess demand of unskilled labour is met by temporary migration from Northern Cyprus (of Northern Cyprus citizens only) where the unskilled wage rate is lower than that in Southern Cyprus. Wage rate in Northern Cyprus is assumed to be higher than that in Turkey, but legal migration from Turkey to Northern Cyprus is only allowed to a limited degree. However, there is some amount of illegal immigration from Turkey to Northern Cyprus, with a probability of getting caught and paying a penalty. Within this framework, the paper would examine the effect of a relaxation of trade embargo – characterized by a reduction in transportation costs for exports from, and imports into, Northern Cyprus on the levels of conflict and welfare in both northern and southern Cyprus. We shall also examine the effect of foreign aid from Turkey to Northern Cyprus on the welfare levels in the two parts of Cyprus and in Turkey.

**Effects of Trade Barriers on a Small Country**

By Benan Zeki Orbay

Small countries always face with various difficulties in trading with other countries. In general, efficiency problems are the culprit of these difficulties. However, in the case of Republic of Northern Cyprus, there are more serious political difficulties preventing direct trade relationship of this country. Northern Cyprus can only perform trade with the other countries through Turkey except some special cases. Clearly, this situation creates an additional inefficiency for this country.
In this study, we aim to model these political barriers using a three-country model, namely, Northern Cyprus, Turkey and another foreign country and investigate the welfare effects of trade on Northern Cyprus under these barriers. As stated, goods can not be directly sold to the foreign countries from Northern Cyprus. For this reason, we assume in our model that a manufacturer firm from Northern Cyprus sells its product to a distributor located in Turkey and that distributor decides what portion of Cyprus originated good to sell in Turkey and what portion to export to the foreign country. We assume that in the first stage, the selling price of the Cypriot firm’s product to the distributor is determined through a bargaining process. In the second stage, the distributor sells this product in Turkey where it competes with the other n firms and also exports to the other country again competing with the same n manufacturers from Turkey. There is a transportation cost to sell the product from Turkey to the foreign country. We compute the equilibrium of this model and compare it with the situation of free trade between the Northern Cyprus and the foreign country. This comparison shows us the extent of the welfare loss of Northern Cyprus caused by these political barriers and moreover, helps us to determine the factors effecting this welfare loss, such as the level of transportation cost, the relative sizes of the foreign country and Turkey’s market, efficiency of the Cypriot firm and etc.

In the second part of the study, using a similar model, we investigate how imports from the foreign country through a distributor from Turkey affect the welfare level in of Northern Cyprus. Finally, we compare the total welfare levels from trade including both exports and imports with barriers and without barriers to understand the extent of the loss better.

Wage-Setting in a Dual Labour Market with Monetary Union

By Saime S. Kayam

Wages in Turkey (TR) and Northern Cyprus (NC) are quite different. In NC workers and civil servants get higher wages than their counterparts in TR, a relatively wealthier economy. The political problems in NC have led to a dependent economy on the island. The nature of economic activity and the embargo enacted since 1994 have increased the dependency on TR more in the last decade. This has literally led TR and NC to become a two-region dual economy.

This study will be merging two strands of literature i.e., dual economy from economic geography literature and monetary union-wage bargaining interaction literature to analyse the effects of monetary union and deficit financing in a dual economy with difference in wage-setting. The monetary union literature will allow us to model -probably the most important issue in terms of dependency of NC on TR- the absence of individual NC currency. This causes some of the policies, which may have adverse effects on the NC’ economy, to be easily adopted by TR governments. The similarity between the relationship of NC-TR and a monetary union ends where the second or smaller economy (NC) has no say in policy measures. Hence, the TR-NC relationship can be modelled as a dual economy structure with TR constituting the wealthier/developed region and NC the less developed part.

Features of the labour markets determine the wages in different parts of the dual economy. In NC, most of the workers are employed in services sector and approx. 1/5 th in public service. However, in TR, the economy is vast with lots of sectors both public and private, different levels of skill intensity and many regions. Although services sector employs a large part of the labour force in TR, public services remain below 1/10 th. Therefore, to reflect the difference in labour market conditions we make a conjecture that wage determination in NC is conducted with reference to centralized-bargaining and that decentralized bargaining sets the wages in TR.

Hence, difference in wage-setting procedures causes a dual labour market.

In order to incorporate monetary dependence into the analysis, we let the central banks decide on the economic policy measures, in this case the inflation rate. However, absence of a national NC currency means the Turkish central bank has to decide on the inflation rate. Two different scenarios can be visualized: the TR central bank determines the inflation rate considering the wages in TR only or by taking the wages in NC into consideration as well. In order to compensate for the losses that might be endured by the government in NC, TR can finance the budget deficit of NC. Therefore, TR central bank also needs to consider the burden of this financing issue.

Mobility of Labour and Wages in the TNC

By Mehtap Hisarcıklılar

With this study, we aim to examine the labour mobility in the Turkish Northern Cyprus (TNC). This is a very interesting case as while people in Turkey are migrating to work in the TNC, some TNC citizens are crossing to the Southern part of the island for work. According to the 2006 Population and Housing Unit Census results, which is conducted by the State Planning Organisation (SPO) of the TNC, 27% of 256,644 people living in this part of the island are the citizens of the Turkish Republic, the number including workers as well university students residing in TNC. Also, the results of the 2004 Household Labour Force Survey, conducted by the same organization, indicate that 5.3% of the employed population in TNC is working in the Southern part of the island. In this study, we will define the characteristics of these groups and test for the existence of a dual structure in the labour market for the two cases mentioned above.

The dual labour market theory divides the economy into two parts, called the “primary” and “secondary” sectors, where the primary sector offers stable jobs, good working conditions and higher promotion possibilities.
while the secondary sector offers unstable jobs, worse working conditions and poor promotion possibilities. One characteristic of dualism in the labour market is existence of different structures in two sectors in question. The other characteristic of duality is that the labour market outcome in the secondary sector is independent of the level of human capital accumulation whereas the human capital accumulation has a significant role in the primary sector.

Existence of a duality in the labour market could be tested using mainly two approaches: The first, and most widely applied approach, is examining the differences in wage determination while the second approach concentrates on the job turnover. The methodology that will be followed in the empirical part of this study will be based on the wage setting. It involves two steps. In the first step, we will test for the existence of two different wage structures. If the wage structures are different, then the second step aims to find out whether this difference could be attributed to the existence of primary and secondary sectors and if so, which market structure is primary and which one is secondary.

First we will examine the issue of Turkish workers immigrating to the TNC. People immigrate for better working opportunities and for a higher pay, but this have an impact on the welfare and labour market outcomes in the receiving economy. In this step, we will examine the duality comparing the wage structures of people migrating to TNC from Turkey with TNC citizens working in the North. As a second task, we will examine the workers crossing to the South and compare their wage structure with TNC citizens working in the North. Putting forward the differences or similarities in the payment structures of both parts of the island will signal whether or not the labour markets are in convergence and are ready for a possible union.

The Option Effect of Economic Development in North Cyprus

By Eric Li

The economic development of North Cyprus faces a number of significant hurdles, which are largely related to the uncertain nature of its future geo-political status. In this paper, we utilise the recent advances in real option analysis to show that any foreign investment in North Cyprus must not only pass the conventional cost-benefit analysis, but also overcome a significant mark-up (option value) in net benefit before it can profitably go ahead. Hence, the presence of wide-spread under-investment in the small-island economy, especially in infrastructure such as electricity and water supply. As long as foreign investors are holding this development option, they will adopt a wait and see attitude towards North Cyprus. Potential investors could stand to lose a large amount of initial capital outlay if political situation were to deteriorate. The ability to avoid this has an intrinsic value (option value), which must be overcome by any profitable investment. On the other hand, by not investing today, potential investors lose the immediate benefits of investment projects (periodic cash inflows from sales, etc.) and the upside in their investment value should there be a satisfactory political resolution. As with financial call options, an increase in the volatility of the underlying instrument (i.e., political situation) raises the value of the option, making foreign investors more reluctant. On the contrary, an increase in the rate of return of the underlying instrument (i.e., business profits) suppresses the value of the option, thereby enticing investors who fear missing out on profitable business ventures. This partially explains the current "property boom" in North Cyprus. The paper closes by examining policy implications due to the presence of this investment option.

Income Inequality and Poverty in a Small Country: North Cyprus

By Raziye Selim and Meltem Dayoğlu

The Turkish Republic of North Cyprus (TRNC) is a small island economy that is not politically recognized - except by Turkey - and faces an economic embargo. Due in part to the external restrictions on the economy, its growth performance has been poor and erratic. However, in parallel to the developments in the political arena, economic activity has recently picked up due mainly to the massive construction activity that transformed the island’s physical space. The other sector that benefited from this has been business and personal services with the result that sectoral income distribution shifted in favour of construction and services and against agriculture and manufacturing. An important feature that distinguishes the labour market in North Cyprus is the size of the public sector. However, despite the heavy role of the government and trade unions, income inequality is rather high; the Gini coefficient is recorded at 0.377 in 1998.

This study aims to analyze income inequality and poverty in North Cyprus, with a view of explaining the potential factors that give rise to high earnings and income inequality in a rather small and almost, closed economy. Furthermore, to see how the effect of the recent political and economic changes has impacted the income distribution, the change in the distribution over time is also examined. Such an investigation has not been attempted before for North Cyprus. For these purposes we use the 1998-1999 Household Consumption Expenditures and Income Distribution Surveys conducted by State Planning Organization of North Cyprus. We analyze earnings and income distribution using the common income inequality measures namely the Gini coefficient and coefficient of variation as well as poverty measures such as head-count ratio, poverty gap ratio and Foster-Greer-Thorbecke poverty index. We also use multivariate analysis to identify the factors that give rise to inequality in North Cyprus.
How important is Tourism in Economic Growth in TRNC? Structural Changes and Inter-Sectoral Linkages

By Öner Günsavdı and Suat Küçükçifçi

The Turkish Northern Cyprus (TNC) deals with being a small island economy without having politically been recognised by international community. Political constraints such as trade embargoes intensify the existing economic disadvantages of being a small island. The country has very limited natural resources and a very small domestic market, and shows great dependency on Turkey. The tourism sector is the leading sector in the TNC economy that generates the growth prospects for other sectors in the economy. The aim of this research is empirically to examine the importance of the tourism sector, and to investigate to what extent economic growth in the tourism sector can be accounted for the growth performance of other sectors in the economy. In doing so, we employ an input-output model, in which sectoral interlinkages can be defined. Our research uses input-output tables of TNC economy, and analyses the importance of tourism sector using a hypothetical situation where tourism sector provide no input for the use of other sector and final demand. Therefore, we can examine the changes in the total production in the economy. Through such a sensitivity analyses, we are able to investigate the extent of which other sectors rely on the production of the tourism sector.