

EC1B5 | Chapter 8

Why Isn't the Whole World Developed?

Additional Practice Questions:

Book Question 3

In 1974, Cyprus got divided into two parts, the Northern part that got invaded by Turkey and the Southern part that is internationally recognized and a member of the European Union.

The Southern or the Greek Cypriot part has a free-market economy mostly based on services, especially the tourism industry, it was affected by the Greek crisis but has since recovered at a fast pace registering a 4 percent growth rate in 2018 and continuing at a healthy pace. Whereas, the Turkish Cypriot part, which also has a big services sector but depends on agriculture as well, has a GDP per capita around half of the Southern part and gets extensive financial help from Turkey. Based on the information given in the question and your own research, do you think the case of Cyprus is similar to the case of Germany and of Korea when each of these countries got divided?

Answer:

Answers should be along the lines of:

The case of Cyprus is about a country that got split into two parts with a resulting big difference in economic performance. Even if Cyprus does not represent a pure natural experiment (because in natural experiments, the geography and culture should be more or less identical, while the institutions are the only different factor) it's still similar to the cases of East and West Germany and of North and South Korea. Indeed, Cyprus did not start as a unified body of culture and beliefs – after gaining independence from Great Britain, there were always political instabilities and intercommunal violence between the Greek Cypriot majority and the Turkish Cypriots. This eventually led to a coup and then to Turkey taking over Northern Cyprus and declaring that part independent, though only recognized by Turkey. However, what accounts for the differences in economic performance and standards of living between the two parts following this division and what serves as the key explanation for the divergence in growth paths, is the difference in economic and political institutions.

Sources: <https://fas.org/sgp/crs/row/IF10749.pdf>, <https://www.cyprusprofile.com/page/economy>, <http://txs.it/docs/hm2gd3.php?9e5fe6=cyprus-gdp-by-sector>; retrieval Date: August 9, 2020.

Book Question 3

Suppose the country of Temria has an abundance of oil and gas. These natural resources were discovered about 40 years ago. Before this discovery was made, the country was a middle-income country with relatively productive industrial and service sectors. However, with exceptional profits due to its efficient extraction of oil and gas, the country gained access to a huge amount of capital. Since Temria is a democracy where people prefer planning ahead, this capital was reinvested into improving education and research and development. Now, due to sound planning, Temria is one of the richest countries in the world. Using the information given, distinguish between the fundamental and proximate causes of prosperity (or its absence) in Temria.

Answer:

The proximate causes of prosperity are high levels of factors such as physical capital, human capital, and technology, which result in a high level of GDP per capita. The underlying factors that explain the proximate causes of prosperity are known as the fundamental causes of prosperity. In other words, fundamental causes explain why some countries have accumulated more physical capital, invested more in human capital, and developed and adopted better technologies than other countries. In the case of Temria, three of the proximate causes for prosperity that could be cited are the following:

- The oil extraction process is efficient and waste is presumably not tolerated.
- Earnings from the oil sector are reinvested into education and R&D that can make growth sustainable.
- The local industry has not been destroyed by capital flowing into the oil and gas sector instead of traditional industries, keeping the growth balanced.

The fundamental causes that could explain the proximate causes are as follows:

- From the given information, it seems that Temria's government and people prefer planning ahead as opposed to spending wealth just to buy expensive cars and build "prestige investments."
- There was a relatively developed industry in the country, and instead of letting all resources go into the oil sector, the extra inflow of capital was used to regain a competitive edge in the traditional industry in the country.

Book Question 4

Look at the following map of Nogales, a twin city that is divided by the U.S. border.



One part of Nogales lies in the United States, in Arizona, and the other part lies in Sonora, Mexico. Life in Nogales, Mexico is very different from life in Nogales, Arizona. The average income in Nogales, Mexico is about one-third the average income in Nogales, Arizona. Education levels, life expectancy, and health conditions are better in Nogales, Arizona than in Nogales, Mexico. Unlike the city in Arizona, Nogales in Mexico has only recently adopted political reforms, bringing it closer to functioning as a democracy. Crime rates are also lower in Nogales, Arizona than in Nogales, Mexico. Since both cities are located so close to each other, they share similar geographical conditions and climate. The inhabitants of both cities also share a common ancestry and enjoy the

same types of food and music. Based on this information and your own research, what factors do you think can explain why Nogales, Arizona is so much more prosperous than Nogales, Mexico?

Answer:

One of the obvious reasons for the difference in prosperity between the two cities divided by the border is the border itself. Nogales, Arizona, is a part of the United States, which has very different institutions compared to those in Mexico. The United States generally has inclusive economic institutions that promote economic activity and development. U.S. citizens can take part in elections that allow them to elect their government democratically and hold it responsible for its actions. Much of the important infrastructure, as well as key public services, are provided by the government. Economic institutions encourage employers in the United States to invest in technology, hire the best talent, and contribute to economic growth in the country. Citizens acquire education and are free to work in occupations to which they are best suited.

Unlike the United States, Mexico does not have many of these inclusive institutions; even where they are present, they are often incomplete or compromised by political factors. It is these institutional factors that could explain why life is so different for people who live in two areas that are otherwise very similar.

Map credit: http://www.nytimes.com/2012/02/26/travel/nogales-mexico-a-few-steps-and-a-whole-world-away.html?_r=0

Adapted from: *Why Nations Fail: The Origins of Power, Prosperity and Poverty* (James A. Robinson, Daron Acemoglu).

Book Question 10

The process of Schumpeter's creative destruction creates winners and losers in economies. What are some of the options to limit the negative effects on the losers? Why is it imperative to minimize these negative effects?

Answer:

The process that Schumpeter called "creative destruction," which is fundamental to growth, is one that inevitably creates winners and losers in an economy. As new technologies replace older ones, new businesses and new sectors replace existing firms and sectors. Likewise, skills consistent with the new technologies are in higher demand, which results in a disproportionate increase in the rewards to the people possessing those skills.

It should be noted that those who are losers are people and that some may not be able to change the way they operate/live/work without outside assistance. This means that retraining and assistance programs should be provided for those who would not be able to change on their own. If people are left to the forces of the market, they could be dissatisfied with how things have turned out for them in their career and could be radicalized and participate in violent action against their compatriots.