

CHAPTER 3

The Economics of Clubs

Introduction

Although individual motivations may vary, people join together to form collective organizations because they believe that greater benefits are available to them through collective action than when they act alone. People might desire collective action to control negative externalities or to encourage the production of positive externalities and public goods. The motivation for collective action is to do things that benefit the people in the collective organization. Although this may seem too obvious to state, it is worth a remark because it provides a way to evaluate the results of collective action. Collective action is successful to the extent that it improves the welfare of those who participate in it.¹

The evaluation of any grouping—economic, social, or political—begins with a branch of economic theory known as the theory of “clubs.” There have been over a hundred individual contributions to club theory since the seminal 1965 paper by James Buchanan.² Yet the fundamental lesson, captured in the quote above, remains constant: if a grouping is voluntary, participants must benefit individually, or else the collective disintegrates.

Individual members assess the costs and benefits of joining a collective effort. The sum of these individual decisions dictates whether a grouping is successful or not. Clubs are no different from other goods. Their viability depends on meeting demand from consumers, whether they be governments, firms, or citizens. Despite this singular conclusion, many different clubs exist at many different levels, from small voluntary cooperatives to large intergovernmental institutions. This variety exists because different

sized clubs have different characteristics that make them amenable to groupings of different sizes.

The essential element of club theory is that any collective endeavor requires two conditions to be satisfied. First, the club must be self-sustaining. More technically, the additional benefit each member receives from joining equals the cost to the club of allowing another member. Second, the club must provide benefits for each of its members. That is, each member must see an incentive to join a club even if it causes the club to become larger and more costly. This basic conclusion has remained unchanged in over a hundred theoretical contributions since it was first presented in the original Buchanan paper.

Club theory has been applied to a wide range of contexts, including military alliances, international organizations, cross-border infrastructure, and services. This chapter will explore some basic concepts of club theory and offer a number of lessons for the design of club goods in the Pacific region.³ The chapter will conclude with a historical overview of clubs in the Pacific.

Club Theory in the Pacific Country Context

A number of theoretical adjustments are needed to draw useful lessons for Pacific regionalism from a standard club theory, as outlined in Appendix 5.

The theory needs to be adjusted for the following facts:

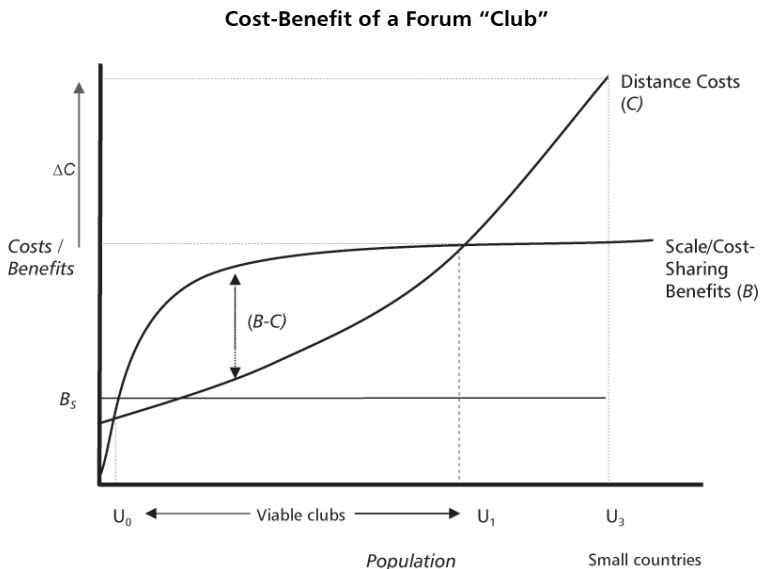
- club members in the Pacific are countries, not private individuals;
- while potential congestion costs of clubs are important, costs of overcoming distance arguably matter more for the Forum membership; and
- there is a high degree of diversity of incomes and socioeconomic characteristics among Pacific countries.

Costs and Benefits of Joining a Pacific Forum “Club”

The trade-off between costs and benefits when joining a Forum “club” are shown in the figure on next page. This graph has four features.

- The horizontal axis ranks countries in decreasing order of population size. Thus larger Pacific countries (Australia, PNG, New Zealand, Fiji Islands) are on the left-hand side of the horizontal axis, and the smaller countries (Niue, Nauru, Tuvalu, Palau) are on the right-hand side.

- While congestion costs for Forum clubs are possible—especially if there is a significant expansion in membership—it is unlikely that congestion will be a major constraint. The high cost of shipping goods, services, and people across the region—the so-called diseconomies of isolation—are a much more relevant constraint for Pacific clubs.⁴ These costs are denoted by the C curve in the figure. Given that travel between even the large Forum countries is costly, the diseconomies of isolation are significant even when the number of countries is small. These diseconomies increase exponentially as the smaller and more remote countries are included.⁵
- The benefits of collective action (economies of scale) are shown by curve (B). When large countries join together to produce a club good, there is a large initial increase in scale benefits. As smaller and smaller countries join, these scale benefits remain positive but diminish until they are virtually flat as the club incorporates the smallest countries.
- Any country wishing to join a regional club will incur costs in switching from national to regional goods. These forgone benefits potentially include the economic benefits of trading in sovereignty-related services (finance centers, flags of convenience, and passports), the political benefits of homogeneous societies (ethnicity, etc.), and the benefits of autonomous policy making and implementation. All of these costs, denoted by B_s , can be considered one-off and are irrespective of the size of the regional club.



The optimal size of a club is found by the optimal balance between the economies of scale and the diseconomies of isolation, at the intersection of the B and C curves. Interestingly, there are two optimal club sizes, U_0 and U_1 . At U_0 , there is a low cost of provision as only large countries are members. However, the corresponding benefits are also low. At U_1 , more countries mean higher costs. The benefits are also higher, however. In between U_0 and U_1 lies a spectrum of viable clubs where the net benefits of collective action are still positive. The basic lesson here is that several clubs of different sizes are possible, but the trade-off remains the same.

If the Forum membership decides to include all members (that is, increase membership size to U_3), inevitably the diseconomies of isolation will be higher than the economies of scale. This implies that a transfer will be required, from an external source such as a donor. This transfer is denoted by ΔC .

How do the benefits of sovereignty fit into the picture? These benefits vary for each country and are denoted for a representative country in the figure by B_s . At the outset (U_0) the club may be attractive but its benefits low. Thus sovereignty remains the most rational choice. As the club grows in size, its net benefits provide a stronger and stronger pull until they rise above the benefits of sovereignty. At that point, a country should elect to join the club.

Heterogeneous Clubs

An important aspect not explicitly included in the figure is the question of financing—who pays for the club good? In a standard club theory, the collective good is financed by equal, lump-sum contributions. What happens when users are not homogenous?

The Pacific Islands Forum clearly constitutes a heterogeneous club, with a wide diversity in incomes. The decision of whether a club is attractive to a given country thus depends crucially on whether the country is a net donor or a net recipient. Donor countries, such as Australia and New Zealand, are assumed to be large enough to not require the club good. However, as a donor they shoulder the costs of the collective good, and as more and more remote countries are joined together, the cost of maintaining the club rises sharply. Thus the decision to join, for a donor country, depends on the benefits they derive (however indirectly) from funding the club good, balanced against the costs of funding the good plus the

sovereignty they must forego to join the club. For recipient countries, such as the FICs, the situation is much different. Once the club's scale benefits rise above sovereignty benefits, there will always be positive demand from recipient countries, since the recipient countries do not shoulder any of the costs of the club good.

This donor-recipient relationship modifies the conclusion of basic club theory in one important aspect: higher-using members no longer pay the highest rates of toll. In fact, the poorest countries (those least able to pay) will be most likely to make use of the club. This cost asymmetry can undermine decisions about how best to use club resources. The basic formulation, where each member pays in proportion to the amount of use of the club good, ensures that their decision to join is closely linked to a rational assessment of individual needs vis-à-vis the benefits of the club. If, however, a donor member is subsidizing (completely or even partially) the club good, there is a strong—even rational—incentive for a recipient country to join the club even if it does not require its services. While a larger club may be desirable, it intuitively increases costs for the donor, and increases congestion costs among the club membership.

Clearly, developing a toll system that more closely reflects economic costs would constrain this excess demand, but it is also likely to induce exit of marginal users from the club. This implies that the design of club goods—the incentives for members to join, and the way in which they work together—is essential, especially where membership is very heterogeneous.

Historical Overview of Five Pacific Island Clubs

How has this analysis of club theory played itself out historically in the Pacific region? Over the last 30 years there have been numerous examples of both successful and unsuccessful “clubs.” Some have been created voluntarily in the postindependence era, and others unintentionally by metropolitan powers as decolonization ebbed in the last quarter of the 20th century.

What is fascinating about the diverse clubs is that some have proven remarkably durable and sustainable, while others have been sources of instability. The experience of Pacific countries as colonial constructs that crossed widely different groups (ethnicity, politics, geography) is mixed. Some, despite occasional separatist rumblings, have stayed together, while others have failed. Some of the postindependence voluntary clubs formed

by sovereign Pacific states have remained durable. A review of both experiences will be useful as lessons learned may well instruct consideration of options for a new type of Pacific regionalism.

If one considers a democratic state as a “club,” that club is held together because the advantages of membership stem from the net economic benefits that are accrued to each citizen, and to powerful groups in each country. When a group of citizens feels they are not benefiting from membership of a particular club, they may well attempt to exit the club. As long as membership of a club is based on voluntary agreement, not coercion, there may be no significant exit costs for a group to leave and form a separate entity. In reality, of course, many democratic nation-states are reluctant to allow separation of a group, particularly when the nation-state feels that allowing separation will provide a precedent for further separatist movements, or when the nation-state gains significantly from economic activity in the territory seeking sovereignty. In such cases, sovereignty—or “exit from the club”—can be associated with very high costs, often in the form of armed conflict.

At independence in the Pacific, a number of sovereign “clubs” were created with the support, recognition, and aid of the international community. These were frequently subeconomic in size, with the added disadvantage of physical dispersion of small populations and isolation from major markets. In the most disadvantaged of these nation-states, even aid and trade preferences were insufficient to induce competitive economies. Whatever benefits derived from the global economy came in large measure from remittances, aid, and migration, and from the trade in sovereignty-related services such as finance centers, flags of convenience, and philatelic sales.

Ethnic diversity does not necessarily create the preconditions for the appearance of separatist movements. There have been numerous historical examples in the Pacific and elsewhere where ethnically diverse “clubs” have managed to stay together successfully and flourish. The lessons of success and failure in the Pacific are telling and instructive for those seeking to build a durable regionalism that goes beyond the regional cooperation of the past three decades. In the examples below, diversity, especially ethnic diversity, is a given. What is not a given is the economic benefits of voluntary association in one or other club.

Kiribati and Tuvalu

This is perhaps one of the most interesting historical club experiences in the Pacific. While it is an example of an unsuccessful colonial club, the lessons derived for modern attempts at deepening regional integration could not be greater. Near the end of the colonial era in the late 1970s, present-day Tuvalu was the Ellice Islands part of a British dependency called the Gilbert and Ellice Islands Colony (GEIC). The Ellice Islands were Polynesian. While this made them distinct from the Gilbertese population, such diversity was not uncommon among other Pacific countries. In 1975, however, the Ellice Islands decided to separate from the GEIC prior to independence. The division was achieved amicably through a vote of the population and no serious conflict, armed or otherwise, occurred during the separation.

What is instructive and important is that Tuvalu's separation broke up one subeconomic and very remote unit, the Gilbert and Ellice group, into two even smaller and remote units. This occurred first by its separation from the GEIC in 1975, and was confirmed by Tuvalu's independence in 1978. Tuvalu's independence had always appeared from an economic point of view as irrational because it was clear that Tuvalu would never be sufficiently large to be a viable economic entity. However, with the benefit of hindsight and some understanding of "clubs," Tuvalu's independence was indeed rational. Furthermore, on a net basis this decision was beneficial to not only the political classes in Tuvalu, but to the population as a whole. Tuvalu had a choice of staying in a club that would nonetheless be subeconomic in size, or gaining the sovereignty benefits of forming a club that was even more subeconomic. In the language of economics, the benefits of sovereignty were greater than the cost of the diseconomies of scale associated with that sovereignty.

In retrospect, Tuvalu chose wisely. The commercial value of sovereignty has provided considerable economic benefits—e.g., the sale of its ".tv" domain name, philatelic sales, and fees from fishing fleet access to tuna resources in its exclusive economic zone. Perhaps the most significant benefit has been aid levels that would otherwise not be available to a group of outer islands. Tuvalu, like many smaller Pacific countries, has little else in terms of tradable resources and remains understandably reluctant to sacrifice the commercial aspects of sovereignty. However, there is a slightly larger lesson to be learned from the history of the dissolution of the GEIC than just the economic benefits of sovereignty.

The language of physics rather than economics can better explain the dissolution of the GEIC. While the Gilbert Islands, or Kiribati, is large relative to Tuvalu, its basic economic and political magnetism was not such that it could overcome the twin centrifugal forces of Tuvaluan ethnicity and the economic benefits of sovereignty. Had Kiribati been considerably larger and the pool of economic benefits from club membership been significant for Tuvalu, then these centripetal forces may well have overcome the twin effects of ethnicity and the benefits of sovereignty. This was not the case.

There was, however, another factor that must be considered in properly understanding the economics of the breakup of the Gilbert and Ellice “club.” As we shall see below, one of the significant benefits of being part of a larger club stems from the economic benefits of being able to move to a much larger unit and seek gainful employment. It is this source of magnetism that has been one of the main reasons why so many ethnically diverse entities have not broken up. However, Tarawa (the Kiribati capital), as any Tuvaluan would have reasonably calculated at the time of independence, was unlikely to become the source of the gainful employment and opportunities that are found in such places as Suva, Auckland, Sydney, or Honolulu.

Fiji Islands and Rotuma

The relationship between Rotuma and the Fiji Islands is in many ways historically similar to that which existed between Kiribati and Tuvalu. Rotuma, like the Lau group of islands, is Polynesian. Unlike the Lau group, it was not traditionally or ethnically part of the Fiji Islands. Rotuma was part of the Fiji Islands for the convenience of the British colonial administration in Suva. Rotuma, however, despite sporadic secessionist rumblings both before and after the 1987 coups, has never seriously sought independence from the Fiji Islands.

Why has the experience been so different from that of Tuvalu? First, like the Tuvaluans, the Rotumans and Lauans were among the most educated groups in Fiji Islands. Both before and after independence, they have played key roles in the public service. This would intuitively bring pressure for secession. Secondly, Suva has always been an economic magnet for Rotumans, with some 70% of the population living on the main islands of Vitu Levu and Vanua Levu, and only 2,600 living on the island of Rotuma itself. Tarawa was similarly a magnet for Tuvaluans in the days of the GEIC, as Tarawa was the seat of government and the Tuvaluans dominated GEIC civil service. The difference lies in the nature of the magnetism. For

Rotumans in the Fiji Islands, there is the additional pull of nonpublic sector economic benefits that were unavailable to the Tuvaluans in the old GEIC, where the civil service was the largest employer. Independence from the Fiji Islands would have cut Rotuma off from that pool of economic benefits that accrue to a population from movement to a relative metropolis such as Suva.

Another significant example of the principles applying between Rotuma and Fiji Islands occurs between the two small islands of Rennell and Bellona in Solomon Islands. Rennell and Belona are Polynesian islands in the very heart of Melanesia. Once again ethnic differences have been present, but the small economic opportunities (compared with, say, Nauru) on these two tiny islands never made an economic case for separation viable. Indeed the presence of a large part of the Polynesian population at White River (the outskirts of the capital Honiara) means that, in the language of physics, Honiara had sufficient economic magnetism to keep ethnically diverse groups in one club.

Cook Islands, New Zealand, and Niue

Perhaps one of the most important examples of a stable club where there is no intention or real movement toward exit is the agreements of free association that exist between both Niue and the Cook Islands, and New Zealand. The residents of both island groups are Polynesian, and Cook Islanders are related to the Maori. The agreements provide the two island groups with relative autonomy in all areas except foreign policy and defense. The most significant economic benefit that accrues to Niue and the Cook Islands is that their inhabitants remain New Zealand citizens with the right of residence in New Zealand and, by extension, in Australia.

This arrangement has meant that the vast majority of both islands' population live in New Zealand. The free movement of people between Cook Islands and New Zealand has been an important safety valve for the former when it faced serious retrenchment in the public service in the late 1990s. Migration allowed Cook Islands to remain politically stable in the face of economic hardship.

The islands' relationship with New Zealand also brings practical problems. Depopulation stemming from unfettered migration has brought both Niue and some of the outer Cook Islands to the very edge of economic viability as sovereign entities. This, too, is an important lesson for a sustainable path to development of a region with limited economic

opportunities. If Pacific countries form clubs with much larger economic entities, they need to ensure that while movement of persons strengthens the relationship between them, dysfunctional and unsustainable relationships that result in depopulation are avoided.

Pacific Islands Forum

One of the most successful and enduring “clubs” formed voluntarily by sovereign Pacific countries, together with Australia and New Zealand, has been the Pacific Islands Forum. While obviously not a sovereign entity, it has been a strongly supported “club” since its creation in the wake of French nuclear testing in the Pacific in the late 1960s and early 1970s, when the newly independent states were unable to discuss these issues in the context of the South Pacific Commission. The Forum has endured over a period of 34 years as a club of sovereign states that, by and large, has not interfered directly with the sovereignty of its members. Agreements are generally exhortatory in nature.

In large measure the funding of the regular budget of the Forum has been based on a formula that is related to GDP. Consequently, the bulk of financial responsibility for funding the organization has been left to Australia and New Zealand. FICs have shown a reluctance to bear a greater cost of the Forum, and other regional organizations.

Forum activities are currently in the areas of political and legal affairs, trade relations, and economic affairs. It is in the area of trade negotiations that the Forum has played a vital role in establishing a path to regional integration. It has also handled negotiations of Economic Partnership Agreements with the European Union. At another level, the Forum now has representative trade missions in Auckland, Sydney, Beijing, Tokyo, and Geneva. The first four of these are purely commercial in nature, while the office in Geneva exists due to the absence of diplomatic representation of any FIC at the World Trade Organization.

Forum activities have expanded over time to include those that complement the sovereign activities of its members. The Forum-endorsed Regional Assistance Mission to Solomon Islands, for example, was done with agreement of Solomon Islands.

The lessons of the Forum as a club for Pacific regionalism are that it has succeeded to the extent that it has complemented sovereignty of its

members. In other words, the political costs imposed have been low. At no point has the Pacific put its members to the test of imposing sanctions for failure to abide by agreed principles in the way of the Commonwealth's Harare Declaration. Thus the durability of the Forum to this point rests in its consensual approach that offers no substantive challenge to its members, and very low operating costs for FICs. Whether such a voluntary and consensual approach to regionalism can be sustained in the longer term remains to be seen. This is the subject of the following chapter of this report.

Summary: The Lessons of Club Theory for the Pacific

Several important lessons for Pacific regionalism can be drawn from the preceding analysis.

Intervene regionally only where there are significant economies of scale, and avoid interventions where there are significant costs associated with isolation. Given the high fixed costs of setting up regional goods and the high variable costs of servicing remote countries, the diseconomies of distance begin to increase exponentially once provision is moved outside a small circle of closely grouped countries. This implies that the universe of club goods that are sustainable for the Forum membership is quite limited. Given that many Pacific countries are small and isolated, only club goods that yield large-scale benefits, or enjoy low distance costs, will be viable without extensive external assistance. This is especially important if the club is to be voluntary—does not impose high costs, either in terms of the sacrifice of sovereign rights or direct financial costs.

Intervene regionally only where there are significant net benefits over and above national provision. In order for a "club" to remain together, the pool of economic benefits must be of a sufficient order of magnitude to overcome the possible forces of dissolution that stem from the economic benefits of sovereignty. To form clubs with small economic benefits is likely to prove unsustainable. This is especially relevant given that sovereignty is currently the main source of economic and political benefit for many smaller countries in the Pacific.

In the face of high isolation costs, subregional provision may prove optimal. It is worth reiterating that every regional club good has its own

cost and benefit structure. For any club good, distance costs of provision are sensitive to its location. Scale benefits, on the other hand, are sensitive to its institutional structure. Given the high diseconomies of isolation in the Pacific, it may prove optimal to break up a larger regional club good into a number of smaller, subregional clubs. While subregional provision may prove optimal to overcome isolation costs, there will be a corresponding loss of benefits as regional goods are broken up into smaller components and the potential for economies of scale is reduced. Likewise, the fixed costs will likely be higher as a number of duplicative institutions will need to be set up on a subregional basis (with possibly an additional regional good to coordinate the subregional bodies). These costs of subregionalism will have to be weighed against potential benefits.

In many cases, special initiatives are essential to assure services are provided to the smallest and poorest states. This will occur for two reasons. First, specific financing arrangements may be necessary to preserve the solvency of regional goods. The capacity weaknesses in many FICs are such that simply pooling together existing capacity will not generate enough scale to provide adequate service throughout the Forum membership. Unless these marginal countries are in a position to provide significant resources to underwrite the expansion of the club and absorb the additional diseconomies of distance, some form of additional financing will undoubtedly be required. This may take the form of external donor aid, or increased access fees for existing larger members. Second, it may be necessary to provide smaller countries with an incentive to join regional arrangements. If there are high barriers to membership—or, conversely, the benefits of sovereignty are particularly high—then some form of specific arrangements will be required to overcome smaller countries' resistance to joining a regional club.

The history of Forum “clubs” reflects many of these important lessons, and has shown that **between Forum members, historically the strongest association arrangements have been based on the movement of people.** Furthermore, the most durable diverse “clubs” are ones where a significant portion of the population of a particular group live in the territory of another. It is the movement of people that taps into the pool of economic benefits through opportunities for club members and remittances for those who have not moved. While movement of persons has been essential to cement relationships in diverse clubs in the Pacific, unfettered and unlimited movement can result in a dysfunctional relationship, where smaller constituents of the group become depopulated.

ENDNOTES

- 1 Holcombe, R. 2004. A Theory of Collective Action. Unpublished manuscript.
- 2 Buchanan 1965. For a survey of subsequent contributions see Sandler and Tschirhart (1980), and Sandler and Tschirhart (1997).
- 3 Only the elements of club theory relevant to Pacific regionalism will be explored. For further information, see the surveys listed above. See Appendix 5: Club Theory—Basic Concepts and Conclusions and a Technical Summary.
- 4 In this report "distance costs" and "diseconomies of isolation" are used interchangeably.
- 5 Remoteness here is assumed to be a function of traveling costs, which are in turn assumed to be inversely proportional to population. This is potentially problematic in the Pacific context, where remoteness is a fluid concept, incorporating distance from major hubs and the cyclical business fortunes of the region's transportation sector.