

## **The island economy**

*Understanding the complex relationship between the private and public sector by Bill Wright*

Imagine a tiny island nation with exactly 100 households; a combination of singles, couples, young families and multi-generational families. Each household had exactly one working person (in which context, gender is irrelevant). And each household owned a similar chunk of island land.

The island was about ten miles from its nearest neighbour, a much larger friendly nation with a well developed economy. Which was appreciated in terms of opportunities to sell island products, and for procuring goods and services that were not available locally on the island. Significantly this included medical services and schools which were not yet available on the island.

Given that the island was peaceful, fertile, enjoyed a healthy year-round climate and was blessed with plenty of natural resources, finding a source of reasonable income for each islander was not difficult.

The political culture of the island was inspired by fundamental democratic principles. A governing council of 12 (unpaid) 'elders' was elected by everyone over the age of 21. And given the small population, significant policy decisions could also be subject to referenda - and so the elders were not empowered or expected to take many decisions themselves except for the mundane. Which was all fairly straightforward, especially as there was no council budget to spend. The council also acted as the judicial authority, dispensing justice whenever disputes arose between islanders.

Everyone on the island made their own money and spent it exactly as they pleased. The majority of islanders were farmers and fishermen. There were also small numbers of skilled tradesmen and traders such as builders, plumbers, electricians, blacksmiths, mechanics, carpenters, store owners and two innkeepers. But no doctors or teachers. Except for a retiree teacher that offered professional tuition to the children of the most affluent families. All the other young children were home-schooled.

Everyone worked for themselves and, although incomes varied to some extent as would be natural, the average islander generated \$10,000 p.a. Which for most was more than adequate to meet all the regular annual needs of their household.

And because of this positive factor, things began to change across the island.

The youngest of the 12 elders found herself performing a far greater share of all the regular, administrative tasks than any of the other eleven. Which meant she did not have as much time to spend working in her regular day job. Which she and her family felt was unfair, and she raised it at the next meeting.

Arguing that if the island nation wanted her to carry on dealing with all the admin work, then she required some form of regular remuneration to compensate her for all the time spent. This proposal was widely acknowledged all around the island as reasonable.

After due consideration, the other 11 elders proposed to the population that she be appointed into a full-time role entitled 'Island Administrator' on a salary of \$10,000: the national average. This caused plenty of debate in terms of the salary level and how the money to pay her was to be raised. Many of the farmers and fishermen argued that as the job involved little more than 'paperwork' the salary did not merit the island average. Others argued that, unlike their own jobs, she would enjoy unparalleled income security and should accept a lower salary. Many agreed and went further suggesting there should be an open competition for such a desirable salaried role. But in the end the 'young elder' was confirmed into the role.

The arguments continued when it came to the method of raising the \$10,000 through taxes. Inevitably the higher earners advocated a flat tax of \$100 per year per working person whilst the lower earners pushed for a proportional 1% income tax.

Finally, the island went with the latter proposal because many of the very lowest earners were simply refusing to contribute \$100. And so the island appointed their first public servant.

But not the last.

Because at the next meeting, the Island Administrator pointed out that in her opinion it was unfair that only the 'children of the wealthy' could benefit from a formal primary education courtesy of the resident tutor. This view was warmly supported by numerous families, all of whom quite naturally wanted the best start in life for their children.

The Administrator proposed that the island should open its own primary school open to all and appoint two of their number as full-time teachers, one of whom would serve as Head. Enthusiasm for the project dipped slightly when the issue of cost was discussed. It would mean that the income tax rate would have to go up to 3.5%. But the motion was carried because in theory every single family on the island might benefit.

'Hang on a moment,' muttered one of the islanders. 'It seems we are now reduced to just 97 tax contributors.'

'Not at all!' replied the Administrator. 'This is the beauty of the public sector. All three of us on the public payroll will pay exactly the same rate of income tax as everyone else. We will all contribute equally.'

It was hard to argue with that logic. The motion was carried and not long after, the island had a decent little primary school up and running, and open to all. A source of much civic pride.

And at the next council meeting, another exciting proposal was tabled: the island could and should have its own Doctor. One of the islanders should be selected, trained up overseas and a small surgery building established for the benefit of all.

This was an intoxicating thought for a nation long accustomed to a lack of basic medical care – only the richest families could afford to travel to the neighbouring state for treatment. The Administrator also proposed that the Doctor be supported by a Nurse, also to be one of the indigenous Islanders. Given the high level of professional expertise required, the Doctor’s salary would also have to reflect this.

Much discussion took place and afterwards the basic income tax rate was raised to 10%. The island would now have five public servants but as the Administrator never tired of pointing out, everyone paid the same 10% income tax.

At the next meeting similar arguments were advanced for the appointment of a sheriff, court clerk, teaching assistant, social worker, garbage collector, road maintenance engineer, health visitor and a town clerk. And just a year later the number of public servants on the island had grown to 20 including a ferry captain who was tasked to provide a free ferry service for everyone. Which was fine in principle but very difficult to operate in practice because demand for the free service was practically insatiable. And by now the average salary of the 20 public sector workers was \$9000 and the national tax rate had climbed to 20%.

This hike started to cause consternation, not least amongst the lowest earning islanders who claimed they simply could not afford it – and many suggested that it would be fairer if the higher earners should be asked to pay a higher proportion.

After considerable research and analysis, the Administrator proposed a new progressive tax policy.

No one would pay any tax on the first \$5000 earned in a year, then everyone would pay 25% on the next \$5,000 and finally 55% on any earnings above \$10,000. This new tax policy would meet all the costs of the public sector. The proposal was eventually ratified by the entire island including the support of the public servants because most were not in the higher income bracket and stood to gain handsomely from the concept.

The Administrator’s calculations were as follows:

#### PUBLIC SECTOR EXPENSES

Public employees	Average salary	Public payroll	Tax payable (25% band)	Net cost to island
20	\$9,000	\$180,000	\$20,000	<b>\$160,000</b>

## INCOME TAX PROJECTIONS

Number of other islanders	Average salary	Lower personal tax contribution (25%)	Higher personal tax contribution (55%)	Annual Tax receipts
40	\$5,000	\$0	\$0	\$0
20	\$10,000	\$1,250	\$0	\$25,000
20	\$20,000	\$1,250	\$5,500	\$135,000
			<b>TOTAL</b>	<b>\$160,000</b>

Aside from the 20 prosperous islanders that earned more than \$10,000 (each earning an average of \$20,000) this was a very popular tax policy across the island. The Administrator was congratulated widely on her innovative and progressive thinking.

And by the following year the number of public sector employees had risen further to 25 and the average public sector salary had crept up to \$10,000. But as the 'public servants' were always quick to point out, everyone on the island was all subject to exactly the same income tax regime. But a growing number of the self-employed islanders were responding to this by pointing out that no other class of people enjoyed such high job security and a guaranteed annual income every year.

And then it all started to unravel.

Due to the improved education system, a child of one of the prosperous families could work with Excel spreadsheets as well as - if not better than - the Administrator, and one evening over supper calmly stated 'Dad, do you realise your higher tax rate this year is probably going to be 87.5%?'

A remark met with utter incredulity by the father until the child produced the following spreadsheet modelled on the work of the Administrator:

## PUBLIC SECTOR EXPENSES

Public employees	Average salary	Public payroll	Tax payable (25% band)	Net cost to island
25	\$10,000	\$250,000	\$31,250	<b>\$218,750</b>

## INCOME TAX PROJECTIONS EXCLUDING HIGHER BAND CONTRIBUTION

Number of other islanders	Average salary	Lower personal tax contribution (25%)	Annual Tax receipts
40	\$5,000	\$0	\$0
15	\$10,000	\$1,250	\$18,750
20	\$20,000	\$1,250	\$25,000
		TOTAL	<b>\$43,750</b>

THEREFORE, IF THE SHORTFALL OF \$175,000 IS RECOVERED THROUGH THE HIGHER TAX BAND THE HIGHER RATE WILL HAVE TO RISE TO 87.5% - PROOF:

Number of other islanders	Average salary	Lower personal tax contribution (25%)	Higher personal tax contribution (87.5%)	Annual Tax receipts
40	\$5,000	\$0	\$0	\$0
15	\$10,000	\$1,250	\$0	\$18,750
20	\$20,000	\$1,250	\$8,750	\$200,000
			TOTAL	<b>\$218,750</b>

In a state of shock her father checked the spreadsheet line by line for errors but found none. At which point he turned to his wife and said 'If this is how they plan to tax us, we are moving off this island as soon as we can and I expect at least ten other families like us will do exactly the same. Whatever is the point of working so hard if we only get to keep a fraction of our earnings?'

'I agree completely,' said his wife, 'But wait a moment, you could decide to stop working so hard and make quite sure our annual income never exceeds \$10,000. Let the other fools pay the top rate.'

*And the key morals of this island story?*

The public sector simply cannot *exist* unless paid for in taxes by sufficient numbers of workers in the private sector. And once an imbalance starts to develop, Governments need to intervene rapidly before the high earners/high contributors decide to relocate to more equitable fiscal regimes. Because once gone they may never come back.

Alternatively, they might well decide to stop creating wealth (and employment for others) because it simply does not make sense to them any longer.

Bill Wright, April 2020