## PART 4

# Macroeconomic Measurement and Basic Concepts

Chapter 14

# South Africa in Brief: Private and Public Sectors

## Learning Outcomes

- An overview of the South African population
- Some facts about SA households and SA businesses
- Why the corporate form of business organization dominates sales and profits
- The problem that arises when corporate owners (principals) and their managers (agents) have different interests
- About the economic role of government in the economy
- The categories of government spending and the sources of government revenues

In this chapter, we briefly look at the structure of the South African economy, first, in terms of the population size, distribution, etc. The next section will, for descriptive convenience, divide the economy into two sectors: the *private sector*, which includes *households* and *businesses*, and the *public sector* or simply *government*.

## Land Area and Population

South Africa's land area covers 1 209 090 km$^2$. This land area consists of nine provinces of which the Northern Cape is the largest covering almost 30 per cent of the total area and housing the smallest portion of the population (1.8 per cent) and Gauteng the smallest land area, taking up 1.4 per cent and hosting the largest portion of the population (21.4 per cent) (See more in Table 14.1.)

Table 14.2 shows the mid-year estimates for the population in 2009 by group and sex. The mid-year population is estimated at 49.32 million. African is in the majority (39.14 million) and constitutes just more than 79 per cent of the total South African population. The White population is estimated at 4.47 million, the coloured population at 4.43 million and the Indian/Asian population at 1.28 million. Fifty-two per cent (25.45 million) of the population is female.

## Private Sector

### Households as Income Receivers

The SA economy currently has about 11.2 million households. These households consist of one or more persons occupying a housing unit and are both the

| | Square km | % of Total | Population (in 000) | % of Population |
|---|---|---|---|---|
| Eastern Cape | 169 580 | 13.9 | 6 648 | 13.5 |
| Free State | 129 480 | 10.6 | 2 902 | 5.9 |
| Gauteng | 17 010 | 1.4 | 10 531 | 21.4 |
| Kwazulu Natal | 92 100 | 7.6 | 10 449 | 21.2 |
| Limpopo | 123 910 | 10.2 | 5 227 | 10.6 |
| Mpumalanga | 79 490 | 6.5 | 3 606 | 7.3 |
| Northern Cape | 361 830 | 29.7 | 1 147 | 2.3 |
| North West | 116 320 | 9.5 | 3 450 | 7.0 |
| Western Cape | 129 370 | 10.6 | 5 356 | 10.9 |
| **South Africa** | **1 219 090** | **100** | **49 320** | **100** |

*Source*: StatsSA. Census Data and Mid-year Population estimates 2009: Statistical Release P0302.

**Table 14.1** Land area and percentage of population per area

| Population Group | Male | | Female | | Total | |
|---|---|---|---|---|---|---|
| | Number | % of Male Population | Number | % of Female Population | Number | % of Total Population |
| African | 18 901 000 | 79.2 | 20 235 200 | 79.5 | 39 136 200 | 79.3 |
| Coloured | 2 137 300 | 9.0 | 2 295 800 | 9.0 | 4 433 100 | 9.0 |
| Indian/Asian | 635 700 | 2.6 | 643 400 | 2.5 | 1 279 100 | 2.6 |
| White | 2 194 700 | 9.2 | 2 277 400 | 9.0 | 4 472 100 | 9.1 |
| **Total** | **23 868 700** | **100** | **25 452 800** | **100** | **49 320 500** | **100** |

*Source*: StatsSA. Census Data and Mid-year Population estimates 2009: Statistical Release P0302.

**Table 14.2** Mid-year estimates by population group and sex

ultimate suppliers of all economic resources (land, labour, capital and entrepreneurship) *and* the major spenders in the economy. We can categorize the income received by households by how it was earned and by how it was divided among households.

## *Sources and distribution of income*

Households differ widely in terms of their main income sources across the income distribution. These sources include income from work (salaries, wages, self-employment and business income); grants and other income derived from the state social security system; capital related income; private pensions; annuities; and a sixth component, imputed rent. Only two main income types are important, i.e. income from work and social grants. Imputed income is the non-cash consumption benefit acquired either from owning durable property or from performing personal services. It consists of 'rents and wages' that one implicitly 'pays' oneself for use of one's own property and services, and is thus hard to capture.

**Functional distribution of income** The **functional distribution of income** indicates how the households' earned income is apportioned among income from work and its related categories mentioned above and income from other sources such as grants. Wages are paid to labour; rents and interest are paid to owners of property resources; and profits are paid to the owners of corporations and unincorporated businesses.

Figure 14.1 indicates that of the various sources from which households derive their income, the largest by far continues to be income from work (74 per cent), including employment, self-employment and business income. The importance of grants as a source of income among lower-income households is increasingly significant.

**The personal distribution of income** The **personal distribution of income** indicates how the nation's money income is divided among individual households. In South Africa 10 per cent of the population continues to earn more than 50 per cent of household income in the country, the poorest 40 per cent of the population accounts for less than 7 per cent of household income, with the poorest 20 per cent accounting for less than 1.5 per cent of income (based on income

| | Rand per Household 12-Month Period | % of Total |
|---|---|---|
| Food and non-alcoholic beverages | 8 105 | 14.4 |
| Alcoholic beverages and tobacco | 647 | 1.2 |
| Clothing and footwear | 2 781 | 5.0 |
| Housing, water, electricity, gas and other fuels | 13 245 | 23.6 |
| Furnishings, household equipment and routine maintenance of the house | 3 868 | 6.9 |
| Health | 933 | 1.7 |
| Transport | 11 180 | 19.9 |
| Communication | 1 969 | 3.5 |
| Recreation and culture | 2 582 | 4.6 |
| Education | 1 356 | 2.4 |
| Restaurants and hotels | 1 232 | 2.2 |
| Miscellaneous goods and services | 8 081 | 14.4 |
| Other unclassified expenses | 172 | 0.3 |
| **Total** | **56 152** | **100** |

*Source*: StatsSA.

**Table 14.3** Distribution of household consumption expenditure

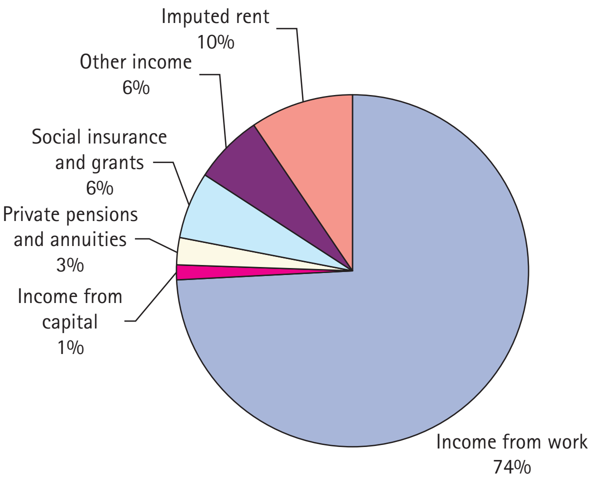


**Figure 14.1 Percentage components of household income**

*Source*: StatsSA: Income and Household survey.

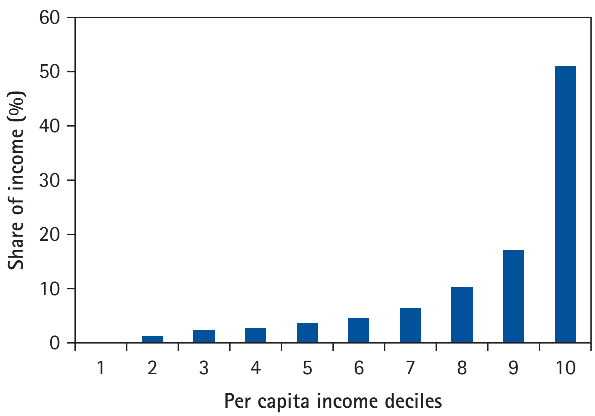


**Figure 14.2 The personal distribution of income among households' income across deciles**

Personal income is unequally distributed in South Africa, with the top 10 per cent of households receiving more than half of the total income.

from work and social grants). Figure 14.2 shows this distribution of income across deciles.[1]

## Households as Spenders

How do households dispose of their income? Part of it flows to government as taxes (R68.7 billion from their income in 2005/06; 7.4 per cent of their total income of R929.2 billion) which left them with a disposable income of R860.5 billion for that period.

[1] Deciles divide the South African population into ten equal groups of 10 per cent with the decile 1 group the lowest per capita income earners and decile 10 the highest.

This disposable income is used for personal consumption expenditures.

### *Personal consumption expenditure*

Table 14.3 shows the composition of expenditure showing expenditure by group as a percentage of total household consumption expenditure. It is important to note that no two households consume in the precisely the same way; the table only represents an average expenditure pattern for households.

Apart from the miscellaneous goods and services category (which includes insurance) the three expenditure groups that are clearly dominant are housing, water, electricity, gas and other fuels (23.6 per cent of the total), transport (19.9 per cent) and food and non-alcoholic beverages (14.4 per cent). Together these three categories accounted for approximately 60 per cent of consumption expenditure for the period 2005/06.

Income is an important determinant of expenditure patterns. Typically, low-income earners have expenditure patterns that are very different from those of high-income earners. Low-income earners allocated a considerably higher proportion of their expenditure to food and non-alcoholic beverages, clothing and footwear than high-income households did.

Figure 14.3 shows how South African consumers in 2009 divided their expenditure among durable goods, semi-durable, non-durable goods and services. Seven per cent of consumer expenditure is on **durable goods** – products that have expected lives of three years or more. Such goods include automobiles, furniture and personal computers. Nine per cent is spent on semi-durable goods which include commodities like clothing and footwear, products that have lives of less than three years. Another 40 per cent of consumer expenditure is on **non-durable goods;** included are such goods as food, clothing and fuel. About 44 per cent of consumer expenditure is on **services** – the work done for consumers by lawyers, barbers, doctors, lodging personnel, and so on. This high percentage is the reason for classifying South Africa almost as a *service-oriented economy*.

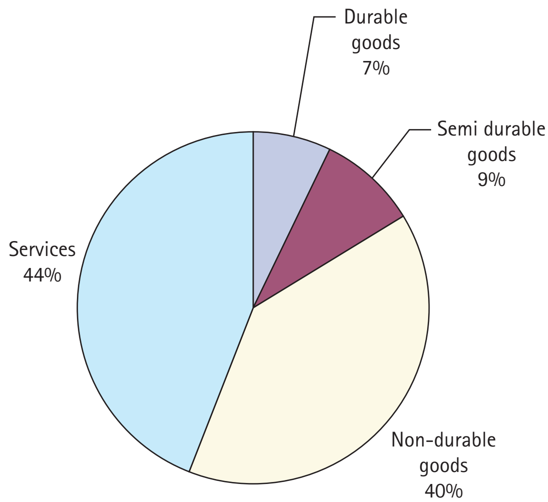


**Figure 14.3 The composition of consumer expenditure, 2009**

Consumers divide their spending among durable goods (goods that have expected lives of three years or more), semi-durable goods, non-durable goods and services. About 44 per cent of consumer spending is for services.

*Source*: South African Reserve Bank: Quarterly Bulletin March 2010.

## Quick Review 14.1

- The functional distribution of income indicates how income is apportioned among wages, rents, interest and profits.
- Wages and salaries are the major component of the functional distribution of income. The personal distribution of income reveals considerable inequality.
- More than 90 per cent of household income is consumed; the rest is saved or paid in taxes.
- Consumer spending is directed to durable goods, semi-durable goods, non-durable goods and services, with nearly 44 per cent going to services.

## The Business Population

Businesses constitute the second major part of the private sector. It will be useful to distinguish between a plant, a firm and an industry:

- A **plant** is a physical establishment – a factory, farm, mine, store or warehouse – that performs one or more functions in fabricating and distributing goods and services.
- A **firm** is a business organization that owns and operates plants. Some firms operate only one plant, but many own and operate several.
- An **industry** is a group of firms that produce the same, or similar, products.

The organizational structures of firms are often complex and varied. *Multiplant firms* may be organized horizontally, with several plants performing much the same function. Examples are the multiple bottling plants of South African Breweries and the many individual Pick and Pay stores. Firms may also be *vertically integrated*, meaning they own plants that perform different functions in the various stages of the production process; for example, organizations such as

Sasol who produce fuel from coal, produce gas as well as fertilizer for the agricultural sector. Some firms are *conglomerates*, so named because they have plants that produce products in several industries. For example, Tiger Brands makes not only breakfast cereals (Oats and Weet Bix) but also soft drinks (Grapetizers and Energade), baby food (Purity), rice (Tastic), sweets (Liquorice All Sorts and Beacon chocolates), canned food (jam and fish) and many more.

### *Legal forms of businesses*

The business population is extremely diverse, ranging from giant companies such as Anglo American, with a turnover in 2007 of R500 billion and thousands of employees, to neighbourhood specialty shops with one or two employees and sales of only R500 to R1000 per day. There are four major legal forms of businesses:

1. A **sole proprietorship** is a business owned and operated by one person. Usually, the proprietor (the owner) personally supervises its operation. A sole proprietor has no limited liability for the owner, and it is therefore important to note that the business liability includes the owner's own personal assets.
2. The **partnership** form of business organization is a natural outgrowth of the sole proprietorship. In a partnership, two or more individuals (the partners) agree to own and operate a business together. Usually they pool their financial resources and business skills. Consequently, they share the risks and the profits or losses.
3. A **closed corporation** (cc) is a legal entity similar to a company with its own legal requirements regarding bookkeeping and responsibilities to members etc. The owners of a closed corporation are called members and do not hold shares in the entity. Members' interest is expressed as a percentage of the entity; the minimum number of members allowed is one and the maximum 10. This is a common form of business entity for smaller businesses.
4. A private or public **company** is a legal creation that can acquire resources, own assets, produce and sell products, incur debts, extend credit, sue and be sued, and perform the functions of any other type of enterprise. A company is distinct and separate from the individual stockholders who own it. The number of shareholders in a private company is restricted to 50 while a public company has no limitations. Hired CEOs run most companies.

**Advantages of companies** Certain advantages of the corporate form of business enterprise have catapulted it into a dominant sales and profit position in South Africa. A company structure is by far the most effective form of business organization for raising money to finance the expansion of its facilities and capabilities. Companies employs unique methods of finance – the selling of stocks (equity financing) and bonds (debt financing) – that enable them to pool the financial resources of large numbers of people.

Companies provide **limited liability** to owners (stockholders), who risk only what they paid for their stock. Their personal assets are not at stake if the corporation defaults on its debts. Creditors can sue the corporation as a legal entity but cannot sue the owners of the corporation as individuals.

Because of their ability to attract financial capital, successful companies can easily expand the scope of their operations and realise the benefits of expansion. For example, they can take advantage of mass-production technologies and division of labour. A corporation can hire specialists in production, accounting and marketing functions, and thus improve efficiency.

Unlike sole proprietorships and partnerships, companies and closed corporations have a life independent of their owners and officers. As a legal entity, they are immortal. The transfer of corporate ownership through inheritance or the sale of stock does not disrupt the continuity of the company. Corporations have permanence that lends itself to long-range planning and growth. This permanence and growth explains why virtually all the nation's largest business enterprises are big corporations.

**The principal–agent problem** Many of the world's corporations are extremely large. That is also the case in South Africa; among South African top companies are SAB Miller, Sasol, Sanlam, AngloGold and Impala Platinum, each making profits of more than R7 billion annually. This is still small if we compare that with the sales of US-based ExxonMobil who sold R2 296 billion of goods in 2005.

But large size creates a potential problem. In sole proprietorships and partnerships, the owners of the real and financial assets of the firm enjoy direct control of those assets. But ownership of a large company is spread over tens or hundreds of thousands of stockholders. The owners of a company usually do not manage it – they hire others to do so.

That practice can create a **principal–agent problem**. The *principals* are the stockholders who own the corporation and who hire executives as their *agents* to run the business on their behalf. But the interests of these managers (the agents) and the wishes of the owners (the principals) do not always coincide. The owners typically want maximum company profit and stock price. However, the agent may want the power, prestige and pay that often accompany control over a large enterprise, independent of its profitability and stock price.

O14.1
Principal–agent problem

So a conflict of interest may develop. For example, executives may build expensive office buildings, enjoy excessive perks such as corporate jets, and pay too much to acquire other corporations. Consequently, the firm's costs will be excessive, and the firm will fail to maximize profit and the stock price for the owners. (Key Question 4)

### Quick Review 14.2

- A plant is a physical establishment that contributes to the production of goods and services; a firm is a business organization that owns and operates plants; plants may be arranged horizontally, be vertically integrated and/or take on a conglomerate form.
- The major advantages of companies are their ability to raise financial capital, the limited liability they bestow on owners and their continuing life beyond the life of their owners and managers.
- The principal–agent problem is the conflict of interest that may occur when agents (executives) pursue their own objectives to the detriment of the principals' (stockholders') goals.

## The Public Sector: Government's Role

The economic activities of the *public sector* – federal, state and local government – are extensive. We begin by discussing the economic functions of governments. What is government's role in the economy?

### Providing the Legal Structure

Government provides the legal framework and the services needed for a market economy to operate effectively. The legal framework sets the legal status of business enterprises, ensures the rights of private ownership, and allows the making and enforcement of contracts. Government also establishes the legal 'rules of the game' that control relationships among businesses, resource suppliers and consumers. Discrete units of government referee economic relationships, seek out foul play, and impose penalties.

Government intervention is presumed to improve the allocation of resources. By supplying a medium of exchange, ensuring product quality, defining ownership rights and enforcing contracts, the government increases the volume and safety of exchange. This widens the market and fosters greater specialization in the use of property and human resources. Such specialization promotes a more efficient allocation of resources.

Like the optimal amount of any 'good', the optimal amount of regulation is that at which the marginal benefit and marginal cost are equal. Thus, there can be either too little regulation (MB exceeds MC) or too much regulation (MB is less than MC). The task is deciding on the right amount.

### Maintaining Competition

Competition is the basic regulatory mechanism in the market system. It is the force that subjects producers and resource suppliers to the dictates of consumer sovereignty. With competition, buyers are the boss, the market is their agent and businesses are their servants.

It is a different story where a single seller – a **monopoly** – controls an industry. By controlling supply, a monopolist can charge a higher-than-competitive price. Producer sovereignty then supplants consumer sovereignty. In South Africa the government attempts to control the creation of monopoly powers through the efforts of the Competition Commission.

The new South African government signalled its intention to review the South African competition law regime in the White Paper on Reconstruction and Development in 1994. A fundamental principle of competition policy and law in South Africa thus is the need to balance economic efficiency with socio-economic equity and development. This led to a new Competition Act in 1998. The stated purpose of the Competition Act, 1998 (Act No. 89 of 1998) is to promote and maintain competition in South Africa in order to achieve the following objectives:

- To promote the efficiency, adaptability and development of the economy
- To provide consumers with competitive prices and product choices
- To promote employment and advance the social and economic welfare of South Africans
- To expand opportunities for South African participation in world markets and recognize the role of foreign competition in the Republic
- To ensure that small and medium-sized enterprises have an equitable opportunity to participate in the economy
- To promote a greater spread of ownership, in particular to increase the ownership stakes of historically disadvantaged persons

Three institutions are created in terms of the Act to achieve the above objectives:

1 The Competition Commission
2 The Competition Tribunal
3 The Competition Appeal Court

A few industries are natural monopolies – industries in which technology is such that only a single seller can achieve the lowest possible costs. In some cases government has allowed these monopolies to exist but has also created public commissions to regulate their prices and set their service standards. Examples of *regulated monopolies* are Eskom, Telkom and railway services Transnet.

## Redistributing Income

The market system is impersonal and may distribute income more inequitably than society desires. It yields very large incomes to those whose labour, by virtue of inherent ability and acquired education and skills, commands high wages. Similarly, those who, through hard work or inheritance, possess valuable capital and land, receive large property incomes.

But many other members of society have less productive ability, have received only modest amounts of education and training, and have accumulated or inherited no property resources. Moreover, some of the aged, the physically and mentally disabled, and the poorly educated earn small incomes or, like the unemployed, no income at all. Thus society chooses to redistribute a part of total income through a variety of government policies and programmes. They are:

- *Transfer payments*. Transfer payments, for example, in the form of welfare payments, provide relief to the destitute, the dependent, the disabled and older citizens; through the Unemployment Insurance Fund (UIF) unemployment compensation payments provide aid to the unemployed.
- *Market intervention*. Government also alters the distribution of income through market intervention, that is, by acting to modify the prices that are or would be established by market forces. Providing subsidies to some manufacturers to assist them to be competitive or to be able to sell their products at a more affordable price.
- *Taxation*. Government uses progressive personal income tax to take a larger proportion of the income of the rich than of the poor, thus narrowing the after-tax income difference between high-income and low-income earners.

The *extent* to which government should redistribute income is subject to lively debate. Redistribution involves both benefits and costs. The alleged benefits are greater 'fairness' or 'economic justice'; the alleged costs are reduced incentives to work, save, invest and produce, and therefore a loss of total output and income.

## Reallocating Resources

*Market failure* occurs when the competitive market system (1) produces the 'wrong' amounts of certain goods and services or (2) fails to allocate any resources whatsoever to the production of certain goods and services whose output is economically justified. The first type of failure results from what economists call *externalities* or *spillovers*, and the second type involves *public goods*. Both kinds of market failure can be corrected by government action.

### *Externalities*

**O14.2**
Externalities

When we say that competitive markets automatically bring about the efficient use of resources, we assume that all the benefits and costs for each product are fully reflected in the market demand and supply curves. That is not always the case. In some markets certain benefits or costs may escape the buyer or seller.

An **externality** occurs when some of the costs or the benefits of a good are passed on to or 'spill over to' someone other than the immediate buyer or seller.

Such spillovers are called externalities, because they are benefits or costs that accrue to some third party that is *external* to the market transaction.

**Negative externalities** Production or consumption costs inflicted on a third party without compensation are called **negative externalities**. Environmental pollution is an example. When a chemical manufacturer or a meat-packing plant dumps its waste into a lake or river, swimmers, fishers and boaters – and perhaps those who drink the water – suffer external costs. When a petroleum refinery pollutes the air with smoke, or a paper mill creates obnoxious odours, the community experiences external costs for which it is not compensated.

**Positive externalities** Sometimes externalities appear as benefits to other producers or consumers. These uncompensated spillovers accruing to third parties or the community at large are called **positive externalities**. Immunization against measles and polio results in direct benefits to the immediate consumer of those vaccines. But it also results in widespread substantial external benefits to the entire community.

Education is another example of positive externalities. Education benefits individual consumers; better-educated people generally achieve higher incomes than less well educated people. But education also provides benefits to society, in the form of a more versatile and more productive labour force, on the one hand, and smaller outlays for crime prevention, law enforcement and welfare programmes, on the other.

### *Public goods and services*

Certain goods called *private goods* are produced through the competitive market system. Examples are the wide variety of items sold in stores. Private goods have two characteristics – *rivalry* and *excludability*. 'Rivalry' means that when one person buys and consumes a product, it is not available for purchase and consumption by another person. What Joan gets, Jan cannot have. *Excludability* means that buyers who are willing and able to pay the market price for the product obtain its benefits, but those unable or unwilling to pay that price do not. This characteristic enables profitable production by a private firm.

Certain other goods and services called **public goods** have the opposite characteristics – *non-rivalry* and *non-excludability*. Everyone can simultaneously obtain the benefit from a public good such as a global positioning system, national defence, street lighting and environmental protection. One person's benefit does not reduce the benefit available to others. More important, there is no effective way of excluding individuals from the benefit of the good once it comes into existence. The inability to exclude creates a **free-rider problem**, in which people can receive benefits from a public good without contributing to its costs. The free-rider problem makes the good unprofitable to provide by a private firm.

### *Quasi-public goods*

The government provides many goods that fit the economist's definition of a public good. However, it also provides other goods and services that could be produced and delivered in such a way that exclusion would be possible. Such goods, called **quasi-public goods**, include education, streets and highways, police and fire protection, libraries and museums, preventive medicine and sewage disposal. They could all be priced and provided by private firms through the market system. But, as we noted earlier, because they all have substantial positive externalities, they would be underproduced by the market system. Therefore, government often provides them to avoid the underallocation of resources that would otherwise occur.

## The Reallocation Process

How are resources reallocated from the production of private goods to the production of public and quasi-public goods? If the resources of the economy are fully employed, government must free up resources from the production of private goods and make them available for producing public and quasi-public goods. It does so by reducing private demand for them. And it does that by levying taxes on households and businesses, taking some of their income out of the circular flow. With lower incomes and hence less purchasing power, households and businesses must curtail their consumption and investment spending. As a result, the private demand for goods and services declines, as does the private demand for resources. So by diverting purchasing power from private spenders to government, taxes remove resources from private use.

Government then spends the tax proceeds to provide public and quasi-public goods and services. Taxation releases resources from the production of private consumer goods (food, clothing, television sets) and private investment goods (printing presses, boxcars, warehouses). Government shifts those resources to the production of public and quasi-public goods (post offices, submarines, parks), changing the composition of the economy's total output.

## Promoting Stability

An economy's level of output depends on its level of total spending relative to its production capacity. When the level of total spending matches the economy's

## Consider This . . .

### Street Entertainers

Street entertainers are often found in tourist areas of major cities. Some entertainers are highly creative and talented; others 'need more practice'. But, regardless of talent level, these entertainers illuminate the concepts of free-riders and public goods.


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Most street entertainers have a hard time earning a living from their activities (unless event organizers pay them) because they have no way of excluding non-payers from the benefits of their entertainment. They essentially are providing public, not private, goods and must rely on voluntary payments.

The result is a significant free-rider problem. Only a few in the audience put money in the container or instrument case, and many who do so contribute only token amounts. The rest are free-riders who obtain the benefits of the street entertainment and retain their money for purchases that *they* initiate.

Street entertainers are acutely aware of the free-rider problem, and some have found creative ways to lessen it. For example, some entertainers involve the audience directly in the act. This usually creates a greater sense of audience willingness (or obligation) to contribute money at the end of the performance.

'Pay for performance' is another creative approach to lessening the free-rider problem. A good example is the street entertainer painted up to look like a statue. When people drop coins into the container, the 'statue' makes a slight movement. The greater the contributions, the greater the movement. But these human 'statues' still face a free-rider problem: non-payers also get to enjoy the acts.

Finally, because talented street entertainers create a festive street environment, cities or retailers sometimes hire them to perform. The 'free entertainment' attracts crowds of shoppers, who buy goods from nearby retailers. In these instances the cities or retailers use tax revenue or commercial funds to pay the entertainers, in the former case validating them as public goods.

## Quick Review 14.3

- Government enhances the operation of the market system by providing an appropriate legal foundation and promoting competition.
- Transfer payments, direct market intervention, and taxation are among the ways in which government can lessen income inequality.
- Government can correct for the over-allocation of resources associated with negative externalities through legislation or taxes; it can offset the under-allocation of resources associated with positive externalities by granting government subsidies.
- Government provides certain public goods for which there is non-rivalry in consumption and non-excludability of benefits; government also provides many quasi-public goods because of their large external benefits.
- To try to stabilize the economy, the government can adjust its spending and tax revenues and the nation's central bank can take monetary actions that lower or increase interest rates.

production capacity, human and property resources are fully employed and prices in general are stable. But sometimes total spending is either inadequate or excessive and the result is either unemployment or inflation. Government promotes stability by addressing these two problems:

1 *Unemployment*. When private-sector spending is too low, government may try to augment it so that total spending – private plus public – is sufficient to achieve full employment. It does this by increasing government spending or by lowering taxes to stimulate private spending. Also, the Reserve Bank takes actions to lower interest rates, thereby stimulating private borrowing and spending.
2 *Inflation*. Inflation is a general increase in the level of prices. Prices of goods and services rise when spenders try to buy more than the economy's capacity to produce. When total spending is excessive and becomes inflationary, government may try to reduce total spending by cutting its own expenditure or by raising taxes to curtail private spending. The Reserve Bank may also take actions to increase interest rates to reduce private borrowing and spending.

## Government's Role: A Qualification

Government does not have an easy task in performing the aforementioned economic functions. In a democracy, government undertakes its economic role in the context of politics. To serve the public, politicians need to get elected. To stay elected, officials (presidents, ministers, representatives, mayors, council members, school board members) need to satisfy the voting public. At best the political realities complicate government's role in the economy; at worst, they produce undesirable economic outcomes.

In the political context, over-regulation can occur in some cases; under-regulation, in others. Income can be redistributed to such an extent that incentives to work, save and invest suffer. Some public goods and quasi-public goods can be produced not because their benefits exceed their costs but because their benefits accrue to firms located in areas served by powerful elected officials. Inefficiency can easily creep into government activities because of the lack of a profit incentive to hold down costs. Policies to correct negative externalities can be politically blocked by the very parties that are producing the spillovers. In short, the economic role of government, although critical to a well-functioning economy, is not always perfectly carried out.

## Government Finance

How large is the SA public sector? What are the main expenditure categories of national government? How are these expenditures financed?

### Government Purchases and Transfers

We can get an idea of the size of government's economic role by examining government purchases of goods and services and government transfer payments. There is a significant difference between these two kinds of outlays:

1 **Government purchases** are *exhaustive*; the products purchased directly absorb (require the use of) resources and are part of the domestic output. For example, the purchase of a missile absorbs the labour of physicists and engineers along with steel, explosives and a host of other inputs.
2 **Transfer payments** are *non-exhaustive*; they do not directly absorb resources or create output. Welfare payments to the disabled and elderly, for example, are transfer payments. Their key characteristic is that recipients make no current contribution to domestic output in return for them.

### A Budget Overview

Let us look separately at each of the government expenditures and taxes in South Africa. Figures 14.4 and 14.5 tell the story for the 2010/11 budget year.

#### *Expenditures*

Three areas of federal spending stand out: (1) education, (2) social protection and (3) health. The *social protection* category includes the many income-maintenance programmes for the aged, persons with disabilities or handicaps, the unemployed, the retired and families with no breadwinner. *Health* reflects the cost of government health programmes.

#### *Revenues*

The revenue side of Fig. 14.5 shows that **personal income tax**, **value-added tax** (VAT), and **company tax** are the basic revenue sources, accounting respectively for 35, 25 and 23 cents of each rand collected.

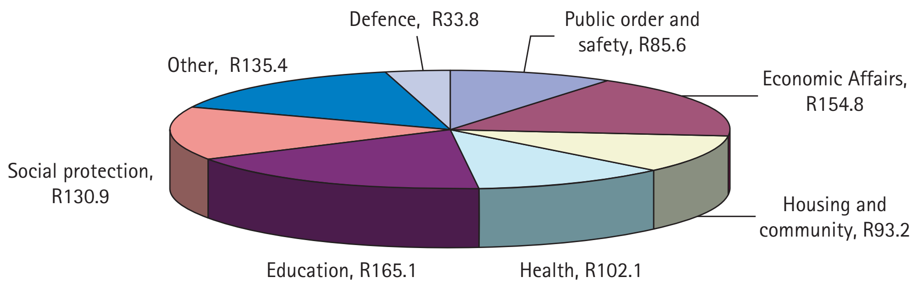


**Figure 14.4 Government expenditures, 2010/11 (R billions)**

Expenditures are dominated by spending for pensions and income security, health and education.

*Source*: SA budget 2010/11: www.treasury.gov.za.

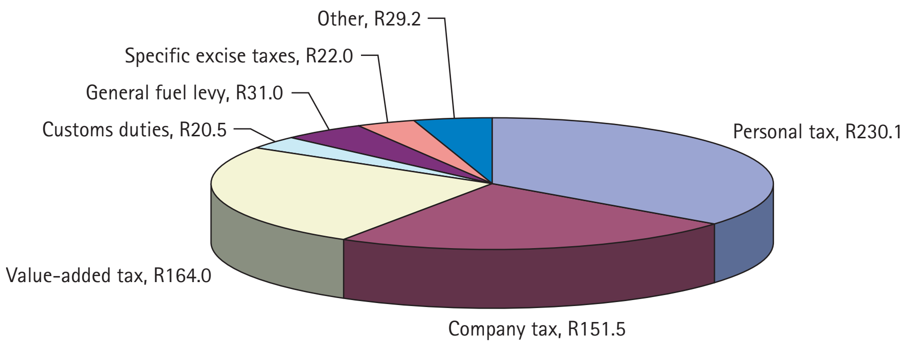


**Figure 14.5 Government tax revenues, 2010/11 (R billions)**

Personal taxpayers contribute 35 per cent of the total tax revenue and the second-largest contribution comes from value-added tax (25 per cent). The R318 billion difference between expenditures and revenues reflects a budget deficit.

*Source*: SA budget 2010/2011: www.treasury.gov.za.

# Last Word

## 2010 – Ke Nako

During the 2010 FIFA World Cup South Africans were excited about hosting one of the world's greatest sporting events.

Preparation for the event started in 2004 and gradually the country's roads, transport, stadiums and buildings received a facelift. This massive construction work resulted in a number of jobs being created and this boosted the economy. Estimations were made and over 130 000 jobs were created in building the stadiums alone, contributing R2 billion to low-income households.

Our country has now 10 world-class sport stadiums, allowing us to hold other big sporting events in the future. Private business in partnership with the government contributed all to the success of the massive operation.

Government contributed a total of R33 billion to the World Cup and South Africans will hopefully continue to reap the benefits long after Zakuni, the official mascot for the World Cup, danced his last dance on

11 July during the final. Spending was carefully monitored so that no public resources were unaccounted for or wasted. Almost R13 billion was spent on upgrading transport systems across the country and major cities now have new systems like the Bus Rapid Transport System and of course the Gautrain. A further R1.3 billion was spent on safety and security, which assisted the SAPS in making the tournament safe for everyone.

The World Cup will always be a defining moment in South Africa's history and all the role players were involved.

## Summary


1. The distribution of income shows how society's total income is divided among wages, rents, interest and profit; the personal distribution of income shows how total income is divided among individual households.
2. Households use all their income to pay personal taxes, for saving, and to buy consumer goods. Nearly 45 per cent of their consumption expenditures are for services.
3. Sole proprietorships are firms owned and usually operated by single individuals. Partnerships are firms owned and usually operated by just a handful of individuals. Corporations – the dominant form of business organization – are legal entities, distinct and separate from the individuals who own them. They often have thousands, or even millions, of owners – the stockholders.
4. Companies finance their operations and purchases of new plant and equipment partly through the issuance of stocks and bonds. Stocks are ownership shares of a corporation, and bonds are promises to repay a loan, usually at a set rate of interest.
5. A principal–agent problem may occur in corporations when the agents (managers) hired to represent the interests of the principals (stockholders) pursue their own objectives to the detriment of the objectives of the principals.
6. Government improves the operation of the market system by (a) providing an appropriate legal and social framework and (b) acting to maintain competition.
7. Government alters the distribution of income through the tax-transfer system and through market intervention.
8. Externalities, or spillovers, cause the equilibrium output of certain goods to vary from the socially efficient output. Negative externalities result in an over-allocation of resources, which can be corrected by legislation or by specific taxes. Positive externalities are accompanied by an under-allocation of resources, which can be corrected by government subsidies to consumers or producers.
9. Only government is willing to provide public goods, which can be consumed by all simultaneously (non-rivalry) and entail benefits from which non-paying consumers (free-riders) cannot be excluded (non-excludability). Because doing so is not profitable, private firms will not produce public goods. Quasi-public goods have some of the characteristics of public goods and some of the characteristics of private goods; government provides them because the private sector would under-allocate resources to their production.
10. To try to stabilize the economy, the government adjusts its spending and taxes, and the central bank uses monetary actions to alter interest rates.
11. The main categories of government spending are pensions and income security, education and health. Revenues come primarily from personal income taxes, company profits and VAT.

## Key Terms and Concepts

functional distribution of income
personal distribution of income
durable goods
non-durable goods
services
plant
firm
industry
sole proprietorship
partnership
closed corporation
company
limited liability
principal–agent problem
monopoly
externality
negative externalities
positive externalities
public goods
free-rider problem
quasi-public goods
government purchases
transfer payments
personal income tax
company tax
value-added tax

## Study Questions

1. Assume that the five residents of Edenville receive incomes of R50, R75, R125, R250 and R500. Present the resulting distribution of income as a graph similar to Fig. 14.2. Compare the incomes of the lowest fifth and the highest fifth of the income receivers.
2. Distinguish between a plant, a firm and an industry.
3. What are the four major legal forms of business organization? Which form is the most prevalent in terms of numbers? Why do you think that is so? Which form is dominant in terms of total sales? What major advantages of this form of business organization gave rise to its dominance?
4. KEY QUESTION: What is the principal–agent problem as it relates to managers and stockholders? How did firms try to solve it in the 1990s? In what way did the 'solution' backfire on some firms?
5. Identify and briefly describe the main economic functions of government. What function do you think is the most controversial? Explain why.
6. What divergences arise between equilibrium output and efficient output when (a) negative externalities and (b) positive externalities are present? How might government correct these divergences? Cite an example (other than the text examples) of an external cost and an external benefit.
7. What are the two characteristics of public goods? Explain the significance of each for public provision as opposed to private provision. What is the free-rider problem as it relates to public goods? Is US border patrol a public good or a private good? Why? How about satellite television? Explain.
8. Use the distinction between the characteristics of private and public goods to determine whether the following should be produced through the market system or provided by government: (a) French fries, (b) airport screening, (c) court systems, (d) mail delivery and (e) medical care. State why you answered as you did in each case.
9. Use the circular flow diagram to show how each of the following government actions simultaneously affects the allocation of resources and the distribution of income:
   a. The construction of a new high school
   b. A 2-percentage-point reduction in the corporate income tax
   c. An expansion of pre-school programmes for disadvantaged children
   d. The levying of an excise tax on polluters
10. What do economists mean when they say government purchases are 'exhaustive' expenditures whereas government transfer payments are 'non-exhaustive' expenditures? Cite an example of a government purchase and a government transfer payment.
11. What is the most important source of revenue and the major type of expenditure at the national government level?
12. LAST WORD: Explain how South Africa can benefit from and event such as the FIFA World Cup tournament in 2010.