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Black • Calitz • Steenekamp

5th Edition

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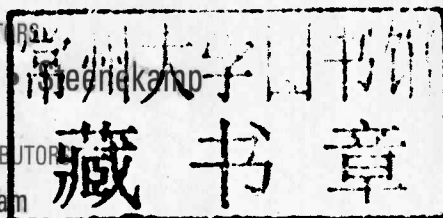
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Dedication

In memory of Daantjie Franzsen (1918-2008)

The leadership of Franzsen spanned more than half a century as teacher, researcher, policy adviser, and commissioner in the field of economics. He inspired many students of economics, influenced many decisions and decision-makers, and knowingly and unknowingly shaped the views of many ordinary people and officials in government and business in South Africa.

Born in 1918 and educated at the University of Stellenbosch, Daniel Gerhardus Franzsen was Professor of Economics at the Universities of Pretoria and Stellenbosch. He was Deputy Governor of the South African Reserve Bank, Chairperson of the Commission of Inquiry into Fiscal and Monetary Policy in South Africa (1967-1969), Chairperson and member of various other commissions and committees, Economic Advisor to the Minister of Finance, President of the Economic Society of South Africa, and author of many scientific books and articles.

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Preface

Public Economics provides a comprehensive introduction to the study of public economics within a South African as well as an African context. In this book, theory is explained with reference to several important institutions, practices and examples. The aim is to equip the student with basic analytical skills and to demonstrate the application of these to practical issues.

Our emphasis is on developing the student's understanding of the theoretical issues pertaining to the role of government in a mixed economy, as it translates into expenditure on government functions. These functions are then financed by means of various taxes and loans. The conceptual framework for the book is that of a medium-sized, open developing economy, exposed to the forces of democratisation and globalisation. Many textbooks offer public economics as a study in applied microeconomics. Although this book follows the same approach to a large extent, fiscal policy is discussed in terms of both its macro- and microeconomic dimensions.

Fourth edition

In the fourth edition we maintain the approach followed in previous editions, which includes several cross-references to, and examples from countries making up the African region generally and Southern Africa in particular. The increased level of interaction and economic cooperation between the latter countries, and across the African continent as a whole, makes it almost impossible to look at the role of government and public policy in isolation. We cannot ignore the many economic spillover effects – both positive and negative – within our region; nor should we miss the opportunity to learn from one another by adopting a more integrated

regional approach. In view of the interrelatedness of the economies of Southern African and other African countries as well as cultural and historical links between them, students from these countries should therefore also find the contents of the book accessible and relevant. We hope that the book will enable African students to have greater appreciation for the broader economic environment in which they operate.

As the book deals with constantly changing policy and analytical issues, we updated the material in this edition by using the latest relevant figures and information as provided in the March 2008 issue of the Quarterly Bulletin of the South African Reserve Bank and the 2008 Budget of the South African Government.

This edition of *Public Economics* is the product of a long process of discussions and deliberations amongst ourselves and colleagues, and students who have used the earlier editions. We are grateful to them, and also to our co-contributors, for the efforts they have put into the edition. A special word of thanks is due to our colleagues at Oxford University Press Southern Africa: Astrid Meyer (Development Editor), Meryl Abrahams (Editor) and Nicola van Rhyn (Project Manager), as well as to Mthunzi Nxawe (the former Education Publisher) for their strategic contributions, technical proficiency and, above all, patience.

Fifth edition

Much has happened since the time we started work on the previous edition of *Public Economics*. We have witnessed a major global recession in 2007–2009, several natural disasters and, more recently, widespread social unrest in the Middle East and certain North African countries. These developments have

had significant implications for the conduct of fiscal policy, with banks and even governments being bailed out and international aid and additional defence spending putting strain on fiscal budgets generally. If anything, these crises have highlighted the importance of the subject matter covered in this book.

Throughout this new edition we have updated all the statistical information and also included the results of relevant research that has been undertaken over the past five years and earlier. In Part 1, for example, we have added a critique of the concept of market failure; reported on estimates of the size and composition of alcohol-related externalities; provided a critique of Pigouvian tax hikes on tobacco and alcohol products; expanded the sections on emission fees and cap-and-trade policies; added a new section on the regulation of natural monopolies; and expanded the section on rent-seeking by including a brief analysis of corruption. Similarly, an updated version of Chapter 14 has been brought forward and included as Chapter 8 in Part 2 dealing with *public expenditure*; while some recent applications of cost-benefit analysis have also been included in the final chapter of Part 2.

In Part 3 we applied the theory of tax incidence to the taxation of tobacco and alcohol consumption, revealing some important policy implications; extended the calculation of the excess burden by introducing the efficiency-loss ratio as a means of minimising tax inefficiencies; added a section on the neoclassical treatment of optimal tax evasion; analysed the effect of personal income tax on the supply of labour; extended the discussion of tax incentives aimed at promoting FDI by analysing tax holidays and taxable and non-taxable cash grants; added a new section on two important alternatives to the comprehensive income tax system, i.e. the flat rate and dual income tax systems; and included an extended discussion of tax reform in the last chapter of Part 3.

Part 4 on fiscal policy had to be substantially revised in light of the global financial crisis, with a new section entitled 'The great recession: new fiscal activism in practice' being added to Chapter 15. The section on 'fiscal rules versus discretion' was likewise updated and extended to include a discussion of the role played by fiscal councils. Finally, in Part 5 we have extended the sections dealing with fiscal federalism and also added new material to sections focusing on conditional grants and local government financing.

As before we would like to thank our colleagues at Oxford University Press for the important contributions they have made to the fifth edition. We are especially grateful to Astrid Meyer (Commissioning Editor), Ilka Lane (Development Editor) and Nicola van Rhyn (Project Manager).

Plan and outline of this book

We have three objectives with this book:

- To provide students with an opportunity to study public economics with reference to South African and African institutions and practices.
- To teach public economics as a field representing the dynamic interaction and tension between macro- and microeconomic considerations.
- To explain public economics with reference to the enormous challenges posed by recent constitutional changes in the region and the re-integration of individual countries into the global economy.

The book is divided into five main parts.

Part 1 contains a theoretical perspective on the **role of government** in the economy. We begin in Chapter 1 with an introduction to the study field of public economics, and we also discuss the nature of the public sector in South Africa. It includes a discussion of the political and institutional context within which the public sector conducts its



business as well as a brief overview of the major views of the role of government in the economy. In Chapter 2 we explain the rationale for the role of government in the economy in terms of market failure, and distinguish between the allocative, distributive, and stabilisation roles of government. The next two chapters (3 and 4) examine the different dimensions of the government's allocative role, focusing on the nature of public goods, externalities, and imperfect competition. Chapter 3 includes a section on 'regional and global public goods', and also has a section on global warming as an example of a major negative 'global' externality. Chapter 4 contains an extended discussion of privatisation and regulation, and also provides an overview of several high profile cases of collusion being investigated and acted upon by the South African competition policy authorities. Inequality as a type of market failure is the focus of Chapter 5, which also examines the criteria for government intervention. We also briefly discuss results from 'experimental economics' which question the validity of the 'self-interest hypothesis'. Chapter 6 discusses the institutions and mechanisms of public (or social) choice and examines their efficiency and equity properties.

In **Part 2**, which deals with **public expenditure**, we first discuss the phenomenon of public expenditure growth in South Africa (Chapter 7) with reference to international experience. Theories of expenditure growth are studied with a view to determining their explanatory value for South Africa. We also study the positive impact of public expenditure on economic growth, with reference to both Keynesian economics and new growth theory. This chapter includes a discussion of the role of infrastructure investment in lowering production costs and 'crowding-in' private investment. Chapter 8 deals with fiscal and social policy issues pertaining to poverty, socio-economic development, and the distribution of income in Southern Africa. This is not such

an unusual theme for a textbook on public economics if one considers the importance of these issues to developing countries in Africa, as well as the amount of time spent by politicians and government officials in finding solutions to the challenges. These issues cannot be dealt with by public administrators, sociologists, political scientists, and engineers alone. An analysis of spending patterns in respect of various social services is also included in this chapter. Chapter 9 focuses on expenditure efficiency and the nature and use of cost-benefit analysis.

A major part of this book is devoted to **taxation (Part 3)**. In Chapter 10 we focus on the principles of taxation and equity. Tax efficiency and related aspects of tax reform form the main focus of Chapter 11; this chapter also includes a new and extended treatment of tax competition and harmonisation within a regional context. In the next three chapters we analyse different types of taxes, placing the emphasis on both theory and the South African and Southern African experience: taxes on income (in which a new section has been included which analyses the impact of a selective tax on interest income) (Chapter 12); taxation of wealth (including a more detailed treatment of property taxation) (Chapter 13); and taxes on goods and services (Chapter 14).

In South Africa the debate on fiscal policy and the role of government in the economy has been strongly influenced by two seemingly opposing forces. On the one hand, there are severe demands on the fiscus to deal with poverty, unemployment, and the high degree of inequality in the region. On the other hand, severe constraints are imposed on the fiscus by the need to maintain macroeconomic stability and at the same time to promote sustained economic growth within a very competitive global economy.

In **Part 4 (fiscal and social policy)** we capture this debate. We spell out the development of policies at the macroeconomic level, as well as sectoral policies (sometimes



referred to as social policies in books on public policy, for example, with regard to welfare and housing). Chapter 15 (fiscal policy and the national budget) and Chapter 16 (public debt) are particularly pertinent to the second objective of this book, namely to highlight the dynamic interaction and tension between macro- and microeconomic considerations. Chapter 15 has been largely re-written and now includes a discussion of the evolution of views on the macroeconomic role of fiscal policy, focusing on the distinction between the Keynesian and structural approaches and the choice between discretionary and rules-based fiscal regimes. As in the fourth edition, this chapter closes with an overview of fiscal reforms in sub-Saharan Africa. Chapter 16 deals with theories of public debt and includes several sections on public debt management.

The last part (**Part 5**) deals with **intergovernmental fiscal relations**. In the sole chapter of this part (Chapter 17), we discuss the theoretical issues pertaining to fiscal federalism. We focus specifically on the structure of government as embodied in the constitution and the implications for inter-governmental fiscal relations in South Africa.

How to use this book

As lecturers at both residential and distance-learning universities, we share among us a great deal of research and practical experience in different aspects of public economics and fiscal policy. We have therefore designed this book with different kinds of students in mind: students at distance-learning universities who will have a fairly self-contained text that the lecturer can supplement with further explanations and tutorial exercises; residential students who will be able to study on their own, leaving lecturers time to analyse and debate topical issues, discuss the self-assessment exercises, and explain the more difficult material; postgraduate students who are completing a course in public economics for the first time and need to do self-study in

order to digest more advanced material; and postgraduate working students who did not complete an undergraduate course in public economics but who need to acquire this knowledge for non-degree purposes in order to advance their careers.

The material contained in this book may be more than can be digested in a semester course at undergraduate level. If public economics is presented as a theoretical course in applied microeconomics, the focus could be on Parts 1, 2, and 3 and Chapter 16. If the course designer requires a good mix of theory and practice, Parts 4 and 5 are a must, and one could then scale down by omitting Chapter 9. The material can therefore be adapted to suit specific courses.

Our educational approach is fairly straightforward. We explain public economics to students with a basic understanding of macroeconomics and microeconomics at the undergraduate level. We make extensive use of diagrams and some basic algebra. Each chapter begins with an aim and a number of study objectives or learning outcomes. The student should use these to maintain a focus on what is essential in the chapter. We highlight important concepts in bold in the text and list them (together with page references) at the end of each chapter. Each chapter also contains a list of self-assessment exercises at the end that the student can complete to test his or her understanding of the material. A comprehensive literature list is included at the end of the book, containing sources consulted and references that the serious reader may wish to consult.

Throughout the book we have tried to present factual information about public economics in Southern Africa and other African countries in relation to theory and international experience, rather than as separate and dull descriptions of statistical trends and superficial features. We trust that this will enhance the relevance of both empirical observation and theoretical understanding.

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PART

1

Perspectives on
the role of
government in
the economy

Chapter ONE

Estian Calitz

The public sector in the economy

The aim of this chapter is to demarcate the study field of public economics with reference to key issues and fiscal challenges facing the South African economy and the Southern African region in general. The role of government is fairly similar across the region, and in the sections and chapters that follow we describe the nature of the South African public sector against the backdrop of the theory of public economics and contemporary views on the role of government in the economy. We also consider the interaction between the public, household, and private (business) sectors of the economy.

Once you have studied this chapter, you should be able to:

- ▶ give a brief overview of different views of the role of government in the economy
- ▶ list key issues confronting Southern African governments regarding their role in the economy
- ▶ distinguish between the main institutional categories of the public sector
- ▶ discuss the salient features of and trends in the size and composition of the South African public sector
- ▶ discuss various aspects of the relationship between the public sector and the rest of the economy.