

Discuss whether electricity should be provided by the public or private sector? [15m]

Introduction

In a free market economic system, scarce resources are allocated through the price mechanism where the preferences and spending decisions of consumers and the supply decisions of businesses come together to determine equilibrium prices. The free market works through price signals. When demand is high, the potential profit from supplying to a market rises, leading to an expansion in supply (output) to meet rising demand from consumers. Day to day, the free market mechanism remains a tremendously powerful device for determining how resources are allocated among competing ends. If electricity is being provided by private firms in this manner, it is also known as being provided by the private sector.

On the other hand, should the government choose to intervene in the price mechanism largely on the grounds of wanting to change the allocation of resources and achieve what they perceive to be an improvement in economic and social welfare. Then electricity would be provided by the public sector. All governments of every political persuasion intervene in the economy to influence the allocation of scarce resources among competing uses.

In this essay we will discuss whether electricity should be provided by the public or private sector.

Electricity should be provided by the private sector.

1. Electricity is a private good.

A private good or service has 2 main characteristics:

Excludability: Consumers of electricity can be excluded from consuming the product by the seller if they are not willing or able to pay for it. For example a ticket to the theatre or a meal in a restaurant is clearly a private good. Another example is the increasing use of “pay-per-view” as a means of extracting payment from people wanting to watch exclusive coverage of sporting events on television or the payment required to travel on a toll-road or toll-bridge. Another example of a private good is the use of subscription-based services on the internet. Excludability gives the service provider (the seller) the chance to make a profit from producing and selling the product.

Rivalry: With electricity, one person’s consumption of the product reduces the amount left for others to consume and benefit from – because scarce resources are used up in producing and supplying the good or service. If you order and then enjoy a pizza from Pizza Hut, that pizza is no longer available to someone else.

2. Government intervention can prove to be ineffective, inequitable and misplaced.

(a) Political self-interest

The pursuit of self-interest amongst politicians and civil servants can often lead to a misallocation of resources.

For example decisions about where to build new roads, by-passes, schools and hospitals may be decided with at least one eye to the political consequences.

The pressures of a looming election or the influence exerted by special interest groups can foster an environment in which inappropriate spending and tax decisions are made. – e.g. boosting welfare spending in the run up to an election, or bringing forward major items of capital spending on infrastructural projects without the projects being subjected to a full and proper cost-benefit analysis to determine the likely social costs and benefits. Critics of current government policy towards tobacco taxation and advertising, and the controversial issue of genetically modified foods argue that government departments are too sensitive to political lobbying from the major corporations.

(b) Policy myopia

Critics of government intervention in the economy argue that politicians have a tendency to look for short term solutions or “quick fixes” to difficult economic problems rather than making considered analysis of long term considerations.

For example, a decision to build more roads and by-passes might simply add to the problems of traffic congestion in the long run encouraging an increase in the total number of cars on the roads.

The risk is that myopic decision-making will only provide short term relief to particular problems but does little to address structural economic problems.

Critics of government subsidies to particular industries also claim that they distort the proper functioning of markets and lead to inefficiencies in the economy. For example short term financial support to coal producers to keep open loss-making coal pits might prove to be a waste of scarce resources if the industry concerned has little realistic prospect of achieving a viable rate of return in the long run given the strength of global competition.

(c) Regulatory capture

This is when the industries under the control of a regulatory body (i.e. a government agency) appear to operate in favour of the vested interest of producers rather than consumers

Some economists argue that regulators can prevent the ability of the market to operate freely. We might find examples of this in agriculture, telecommunications, the main household utilities and in transport regulation.

For example, to what extent has the system of agricultural support known as the Common Agricultural Policy operated too much in the interests of farmers and the farming industry in general? And as a result, has the CAP worked against the long-term interest of consumers, the environment and developing countries who claim that they are being unfairly treated in world markets by the effects of import tariffs on food and export subsidies to loss-making European farmers?

(d) Government intervention and disincentive effects

Free market economists who fear government failure at every turn argue that attempts to reduce income and wealth inequalities can worsen incentives and productivity.

(e) Government intervention and evasion

A decision by the government to raise taxes on de-merit goods such as cigarettes might lead to an increase in attempted tax avoidance, tax evasion, smuggling and the development of grey markets where trade takes place between consumers and suppliers without paying tax

3. Allocative Efficiency can be achieved in private sector provision

Allocative efficiency is achieved when the value consumers place on a good or service (reflected in the price they are willing to pay) equals the cost of the resources used up in production. Condition required is that price = marginal cost. When this condition is satisfied, total economic welfare is maximised.

4. Productive Efficiency can be achieved in private sector provision

Productive efficiency refers to a firm's costs of production and can be applied both to the short and long run. It is achieved when the output is produced at minimum average total cost (AC). For example we might consider whether a business is producing close to the low point of its long run average total cost curve. When this happens the firm is exploiting most of the available economies of scale. Productive efficiency exists when producers minimise the wastage of resources in their production processes.

Why electricity should be provided by the public sector.

1. Electricity can be considered a quasi-public good. A quasi-public good is a near-public good i.e. it has many but not all the characteristics of a public good. Quasi public goods are:

Semi-non-rival: up to a point, you can produce large amounts of electricity but not small amounts of electricity therefore extra consumers initially may not exclude others.

Eventually additional consumers reduce the benefits to other users. As population increases, government have to build more power stations to meet demand.

Semi-non-excludable: it is possible but often difficult or expensive to exclude non-paying consumers. E.g. additional cost of installing meters in every home, checking of meters once in 3 months.

2. Monopoly, market failure and government intervention

The government should intervene to break up or control the potential monopoly power of firms in energy market due to the exceptionally high barriers to entry.

The main case against a monopoly is that it can earn higher profits at the expense of allocative efficiency. The monopolist will seek to extract a price from consumers that is above the cost of

resources used in making the product. And higher prices mean that consumers' needs and wants are not being satisfied, as the product is being under-consumed.

Another possible cost of monopoly power is that businesses may allow the lack of real competition to cause a rise in costs and a loss of productive efficiency. When competition is tough, businesses must keep firm control of their costs because otherwise, they risk losing market share.

Some economists go further and say that monopolists may be even less efficient because, if they believe that they have a protected market, they may be less inclined to spend money on research and improved management.

These inefficiencies can lead to a waste of scarce resources.

Conclusion

In the provision of electricity, policy makers should realize that there is often a trade-off between economic efficiency and equity. Efficiency means that all goods or services are allocated to someone (there's none left over). When a market equilibrium is efficient, there is no way to reallocate the good or service without hurting someone. Equity concerns the distribution of resources and is inevitably linked with concepts of fairness and social justice. A market may have achieved maximum efficiency but we may be concerned that the "benefits" from market activity are unfairly shared out.