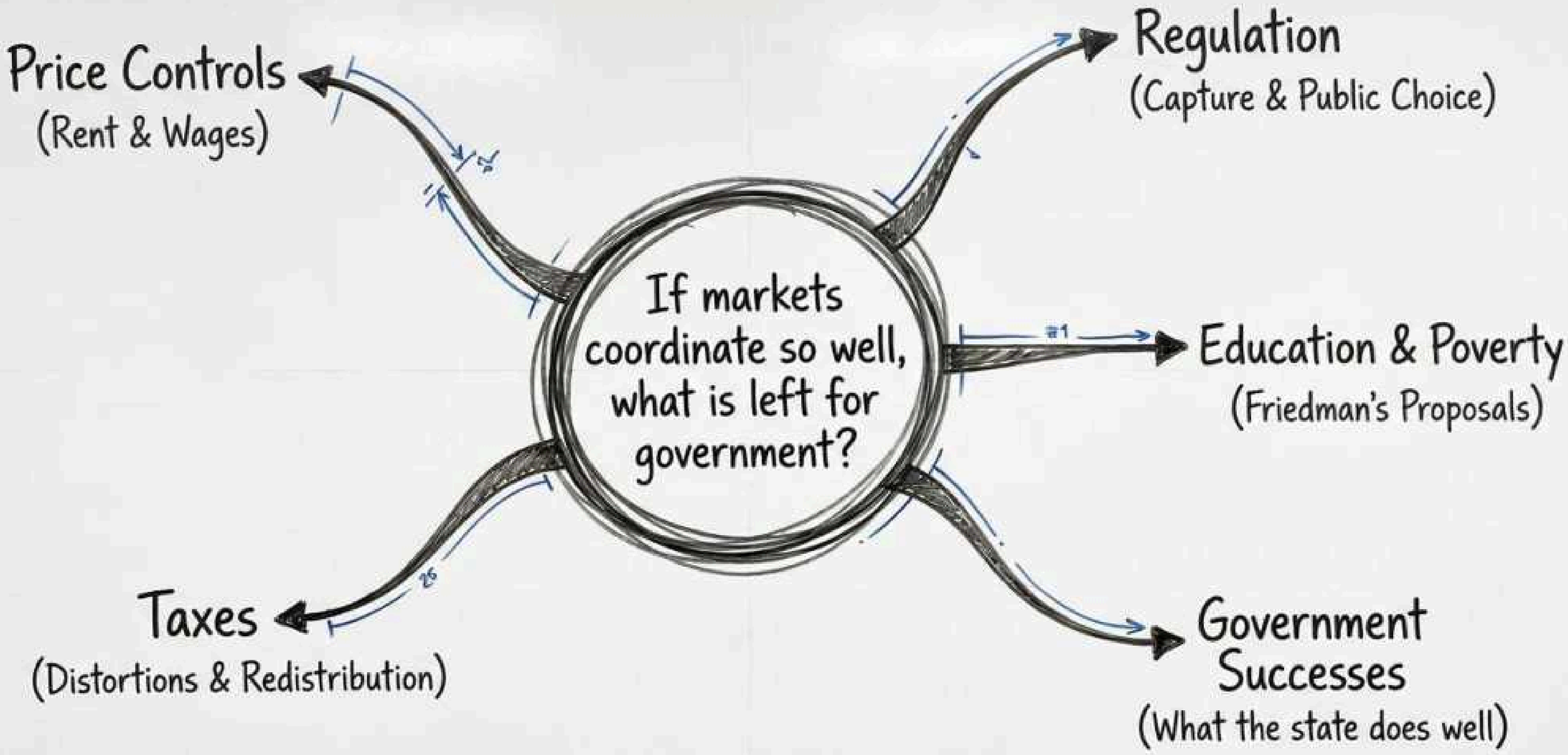
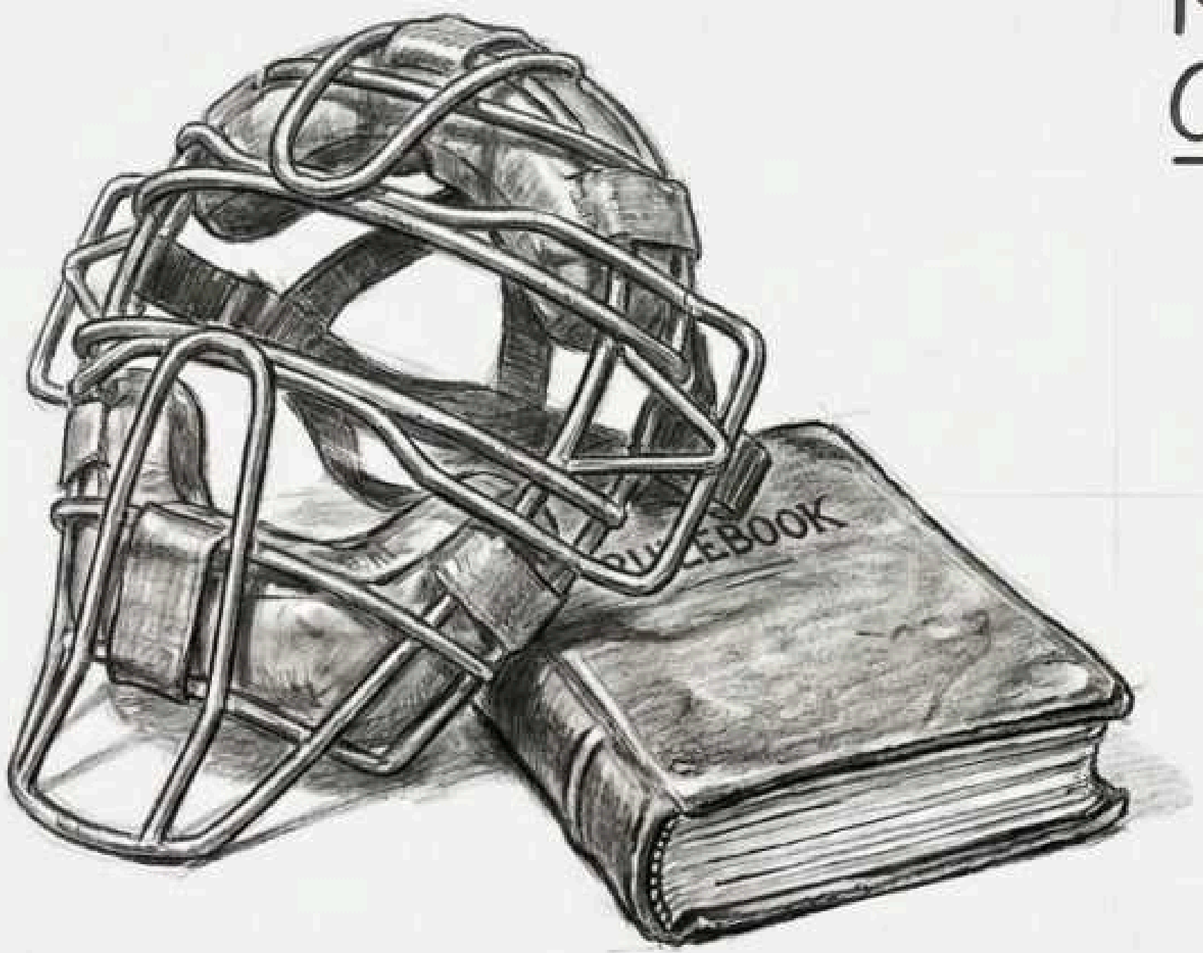
ECON 110 B / Lecture 5: The Role of Government

Friedman, Free Markets, and the State



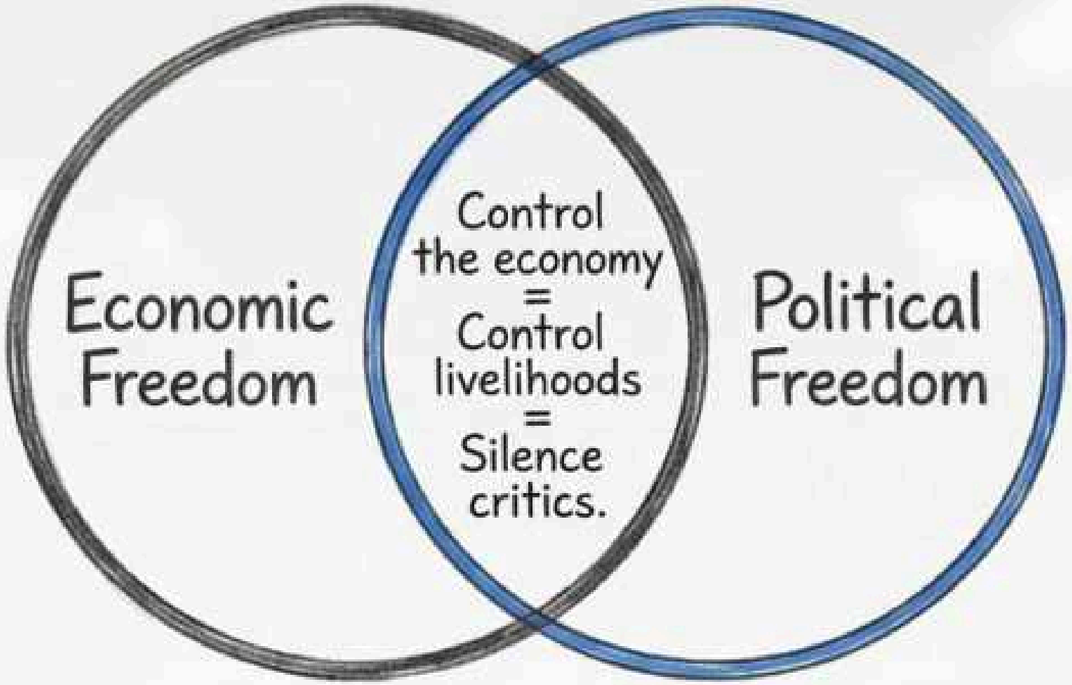

Price Controls
(Rent & Wages)
Regulation
(Capture & Public Choice)
If markets coordinate so well, what is left for government?
Education & Poverty
(Friedman's Proposals)
Taxes
(Distortions & Redistribution)
Government Successes
(What the state does well)



Milton Friedman: Capitalism and Freedom (1962)

The Government's Role:

- Rule-maker & Umpire
- Prevent Force and Fraud
- Enforce Contracts
- Manage Money Supply
- Handle Spillovers (Externalities)
- Protect the Vulnerable (Children and those unable to decide for themselves)



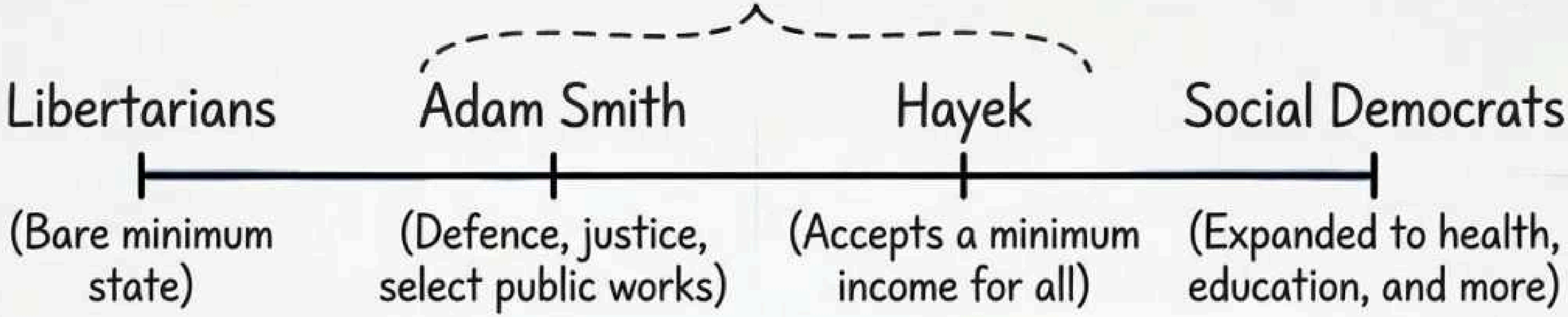


"There is no such thing as a free lunch."

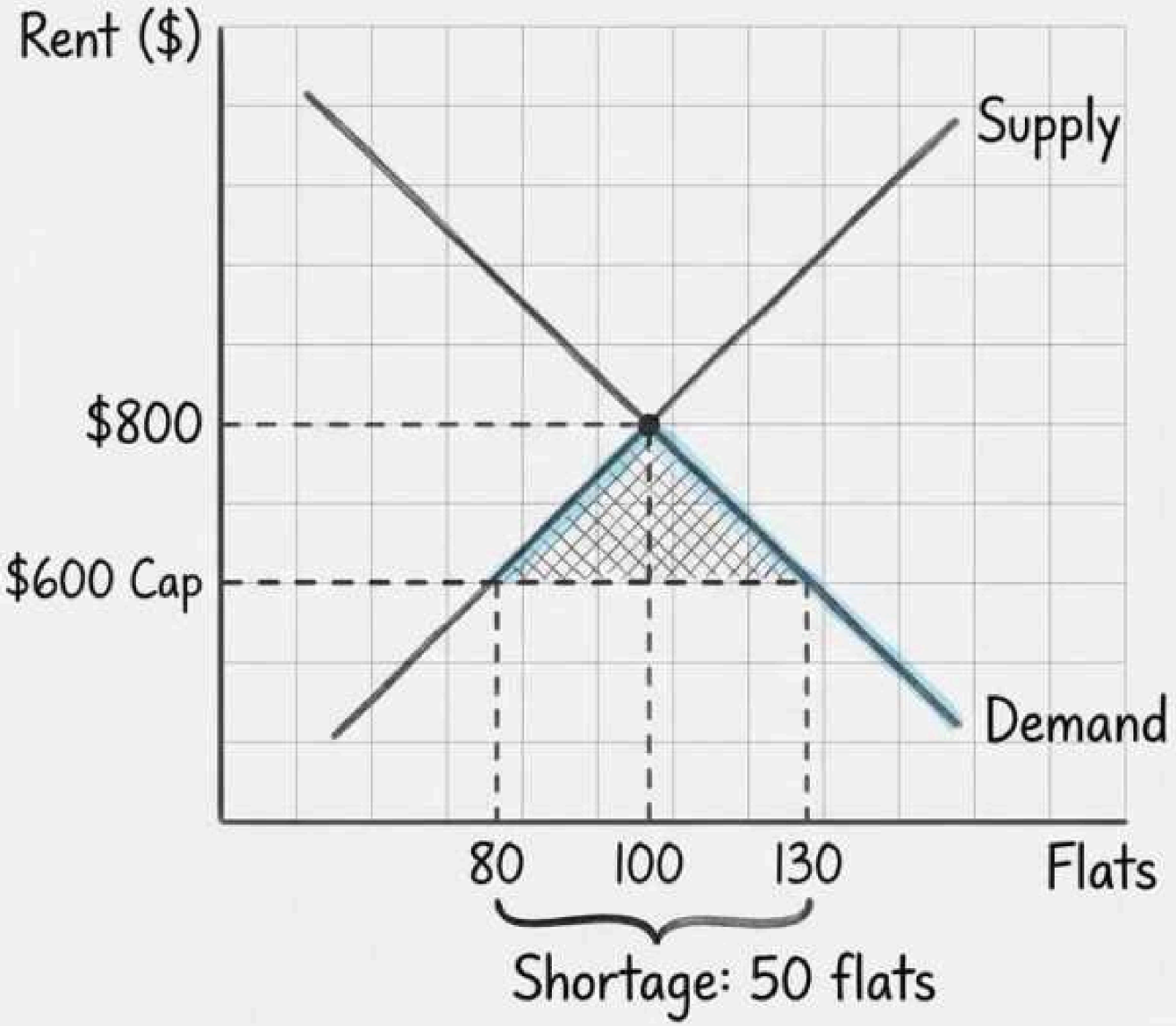
— Free to Choose (1980)

Note: Every benefit has a cost somewhere.

Most real economies lie in between.



Millbrook Rent Control (Price Ceiling)



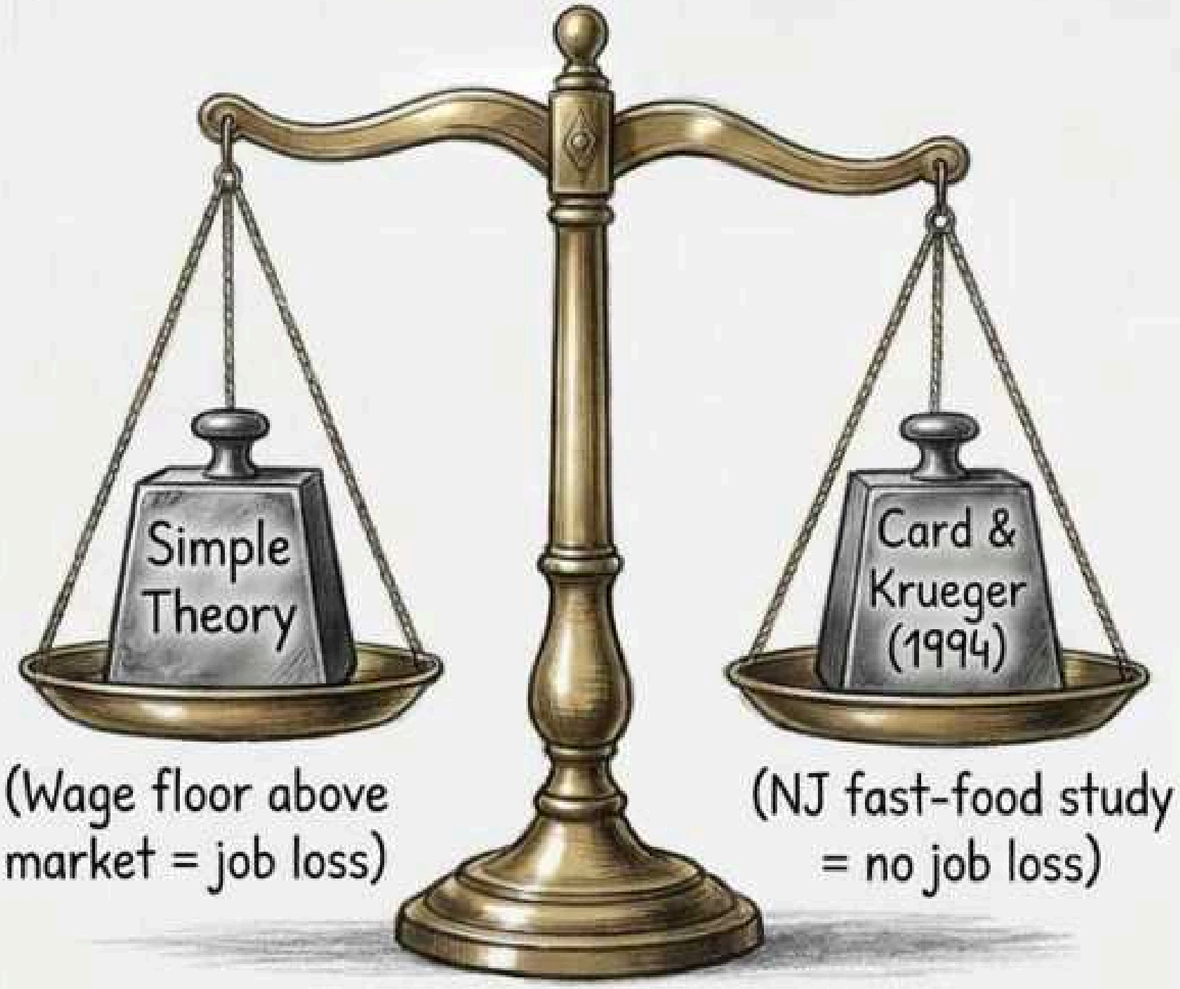
The Trade-off:

Reduces overall quantity and quality of housing vs. protects sitting tenants from displacement.

The Minimum Wage (Price Floor)

¶ 5.7





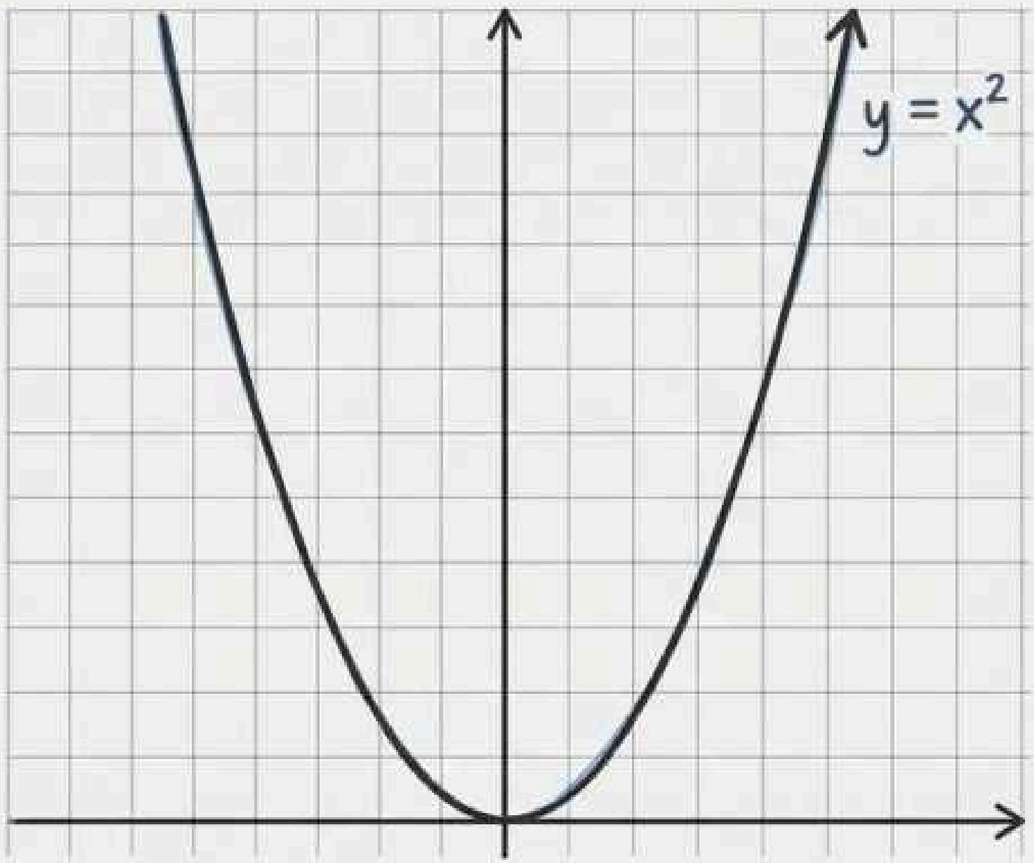
(Wage floor above market = job loss)

(NJ fast-food study = no job loss)

Economists remain divided; the impact depends entirely on how high the floor is set.

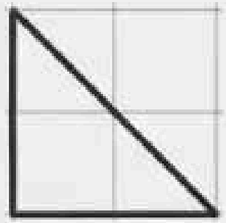
Deadweight Loss: Damage grows faster than the rate.

¶ 5.8

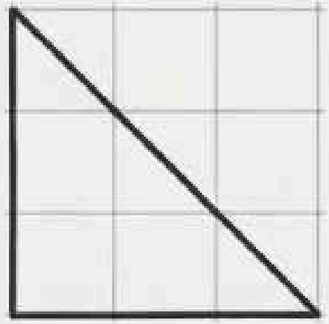




10% tax = 1 unit loss (1^2)



20% tax = 4 unit loss (2^2)



30% tax = 9 unit loss (3^2)

Tripling the rate multiplies the loss by nine. This is the economist's case for broad, low-rate taxes.

Arthur Okun's Leaky Bucket

¶ 5.9



$100 (Taken from the Rich)

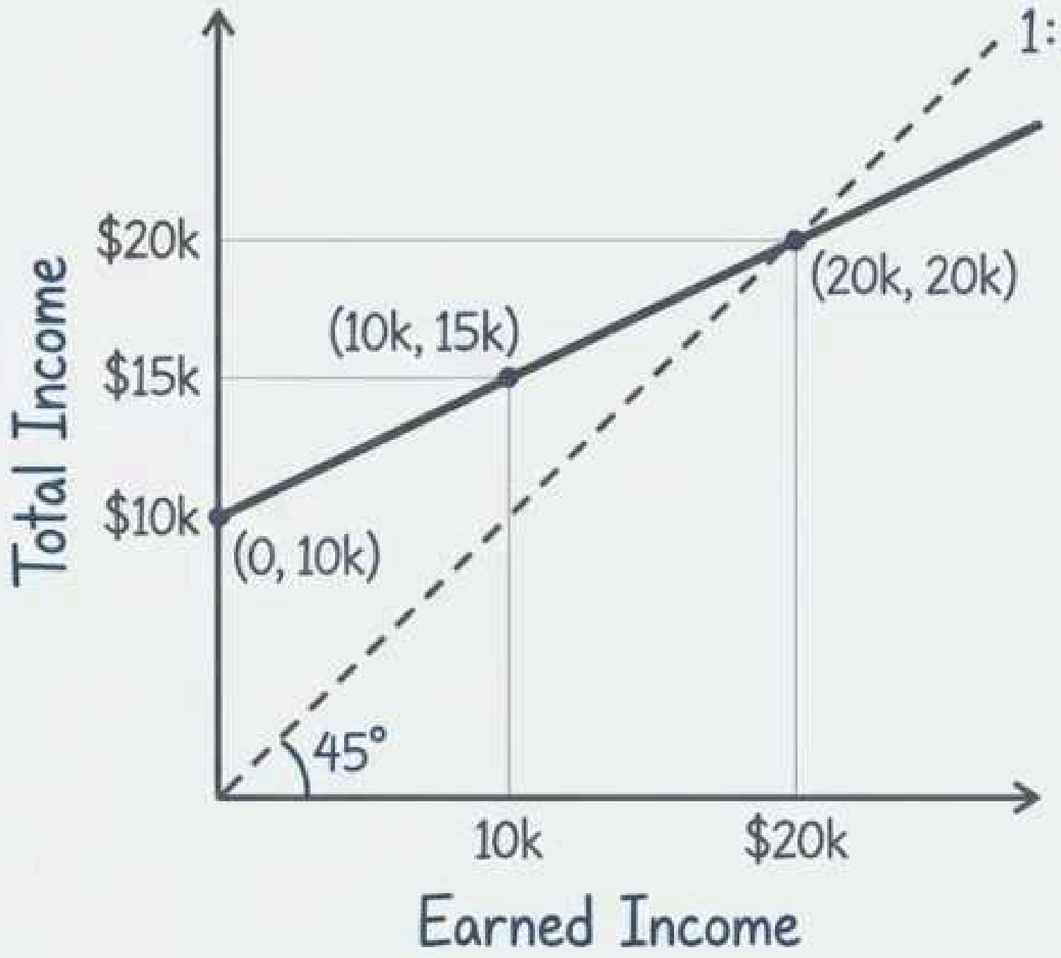
$20 (Lost to costs & distorted behaviour)

$80 (Arrives to the Poor)

Whether the water is worth carrying is a question of values.
Economists differ on how big the leak is.

Friedman's Negative Income Tax

Threshold = $20,000 | Rate = 50%

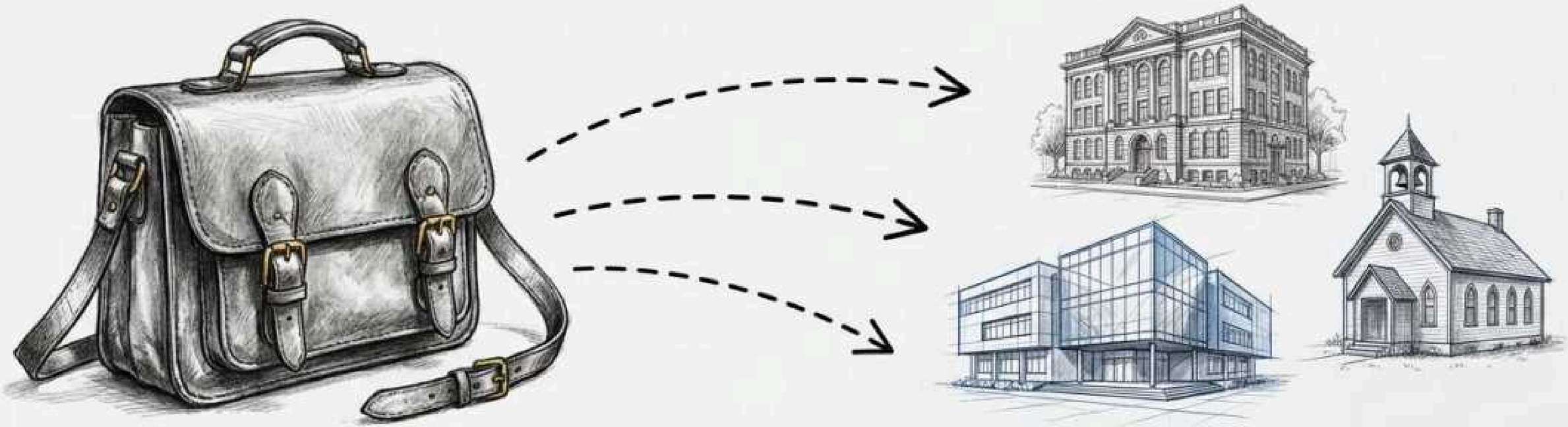


Earn $0 →	Receive $10,000
Earn $10,000 →	Receive $5,000 more
Earn $20,000 →	Receive $0

Key Insight: Income always rises when people work more; aid does not distort prices.

School Vouchers (Friedman, 1955)

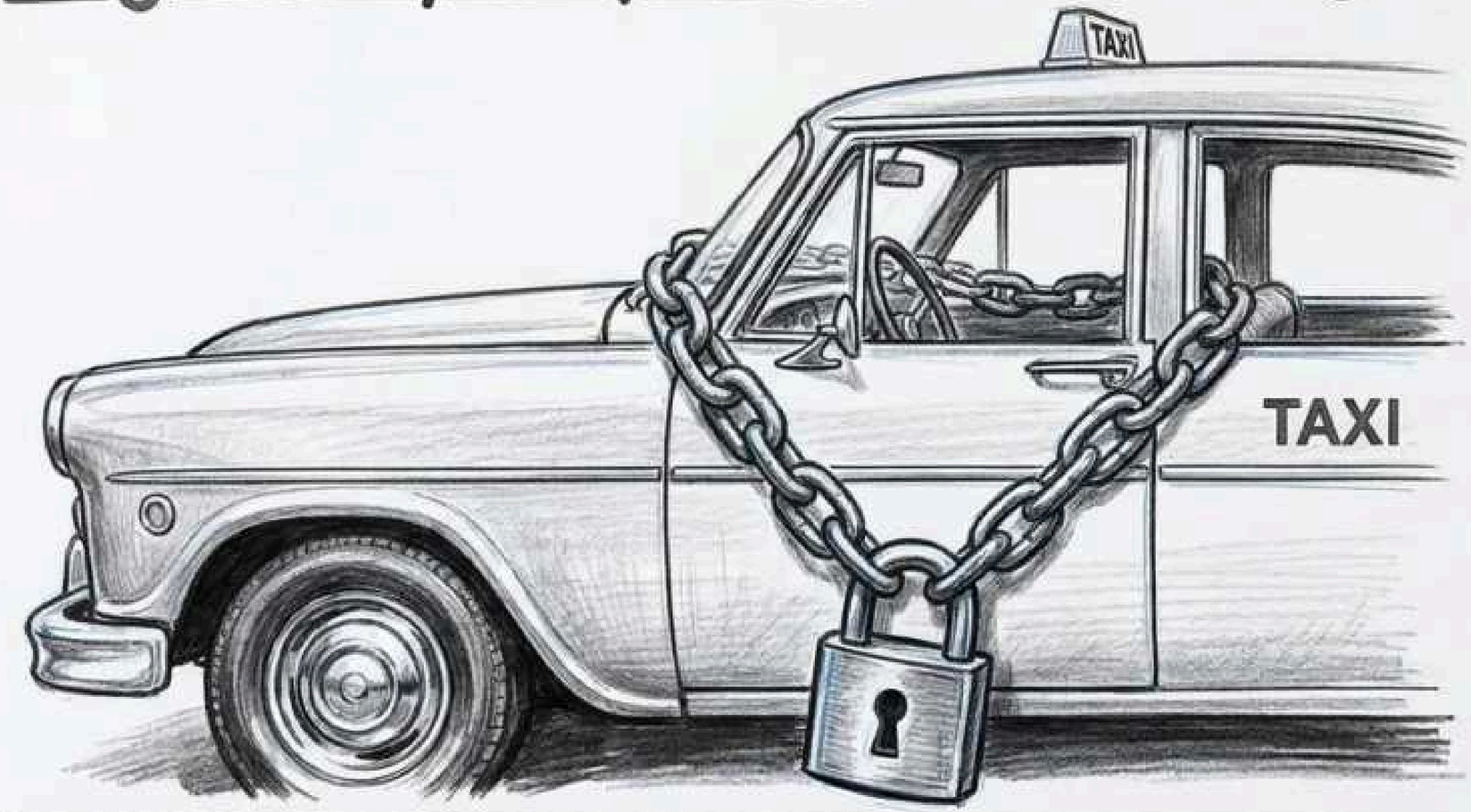
Core Mechanic: Money follows the child.



Pros	Cons (Critics)
Competition pushes schools to improve.	Risks increasing segregation, letting schools pick the easiest pupils, and draining public schools. (Evidence from trials remains mixed).

Regulatory Capture (George Stigler, 1971)

¶ 5.12



Core Concept

Regulation is often sought by the industry itself to protect against competition (e.g., taxi licences blocking newcomers).

The Test Question: Does the rule serve the public, or the regulated?

Public Choice Economics (Buchanan & Tullock)

Premise: Politicians and officials respond to incentives like everyone else.



Concentrated Benefits.

A $50M subsidy = $50,000 each to 1,000 farmers (Strong incentive to lobby).

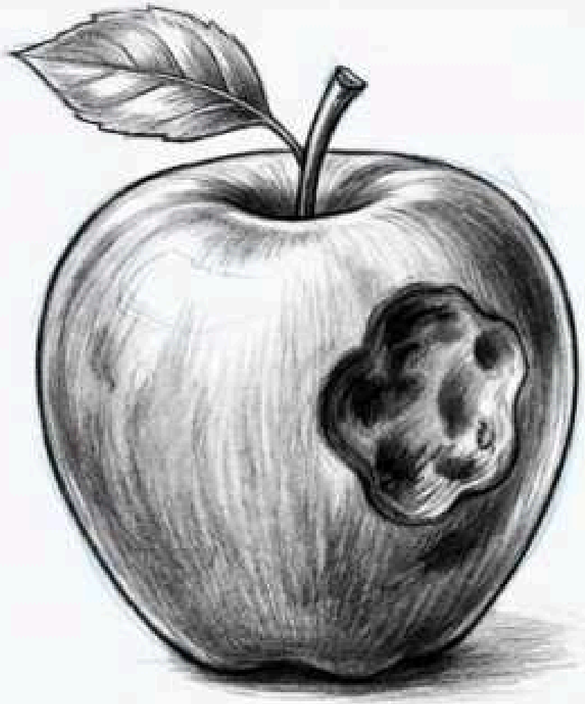


Spread Costs.

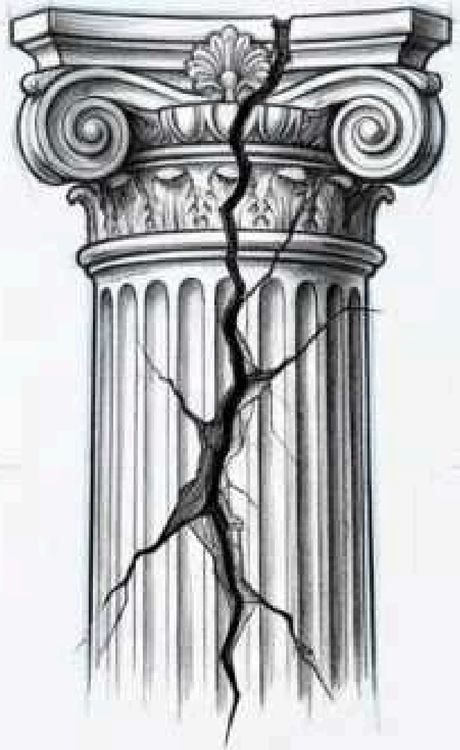
Over 100M taxpayers, it costs $0.50 each (Little reason to resist).

The Nirvana Fallacy (Harold Demsetz)

¶ 5.14



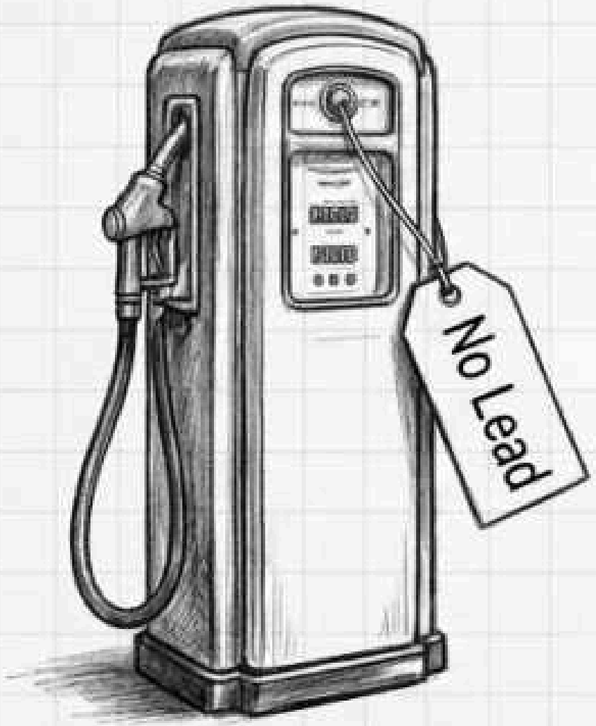
Imperfect Market



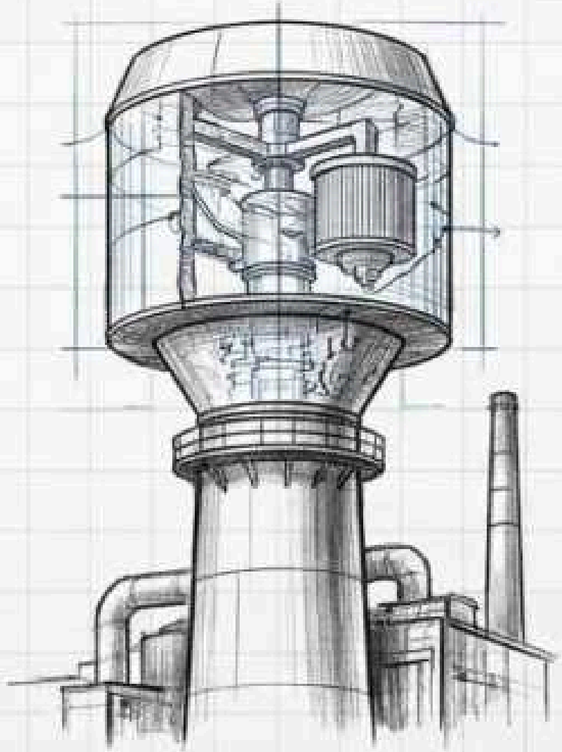
Imperfect Government

Core Lesson: Do not compare imperfect markets to perfect governments, or the reverse. Fair comparison sets real markets against real governments, case by case.

Government Successes



Removed lead from petrol.



1990 Sulphur Dioxide trading scheme (cut acid rain efficiently using a market mechanism).



Vaccination campaigns, clean water, safe food.

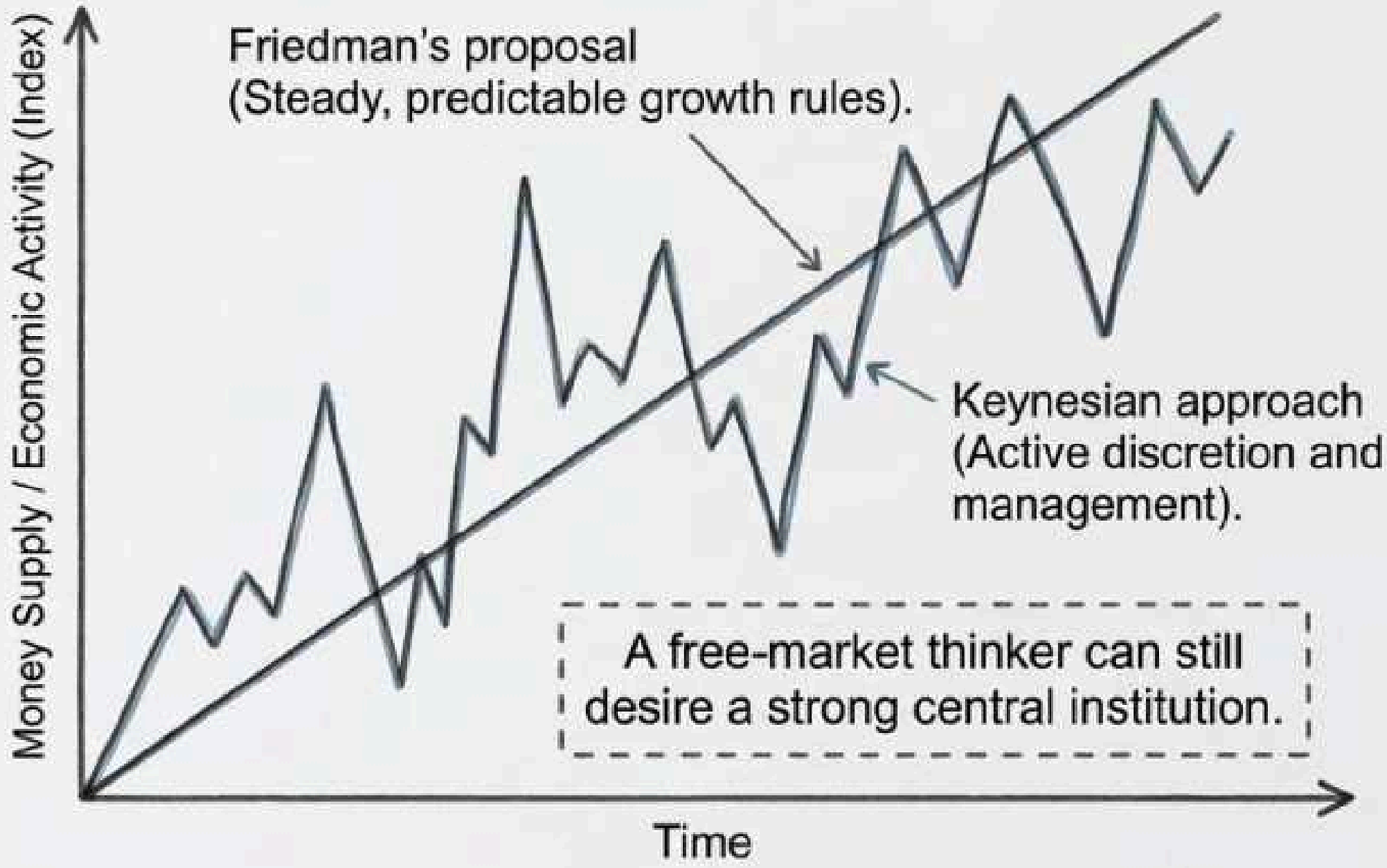
Active government works, especially where it uses incentives.

Managing the Money Supply

¶ 5.16

Friedman & Schwartz (1963) argued the Fed worsened the Great Depression by letting the money supply shrink.





The Safety Net & The Nordic Model

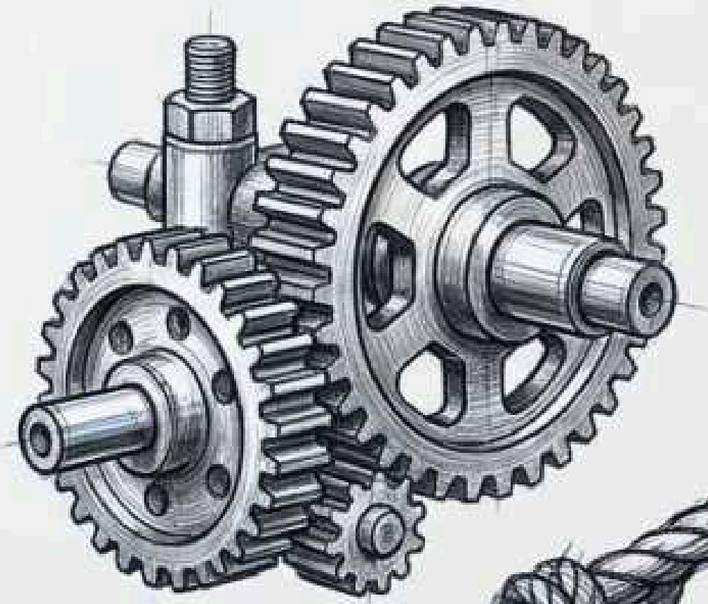
¶ 5.17

Both Hayek and Friedman supported a safety net.



The Nordic Proof: High taxes and generous welfare can successfully coexist with open trade and secure property rights.

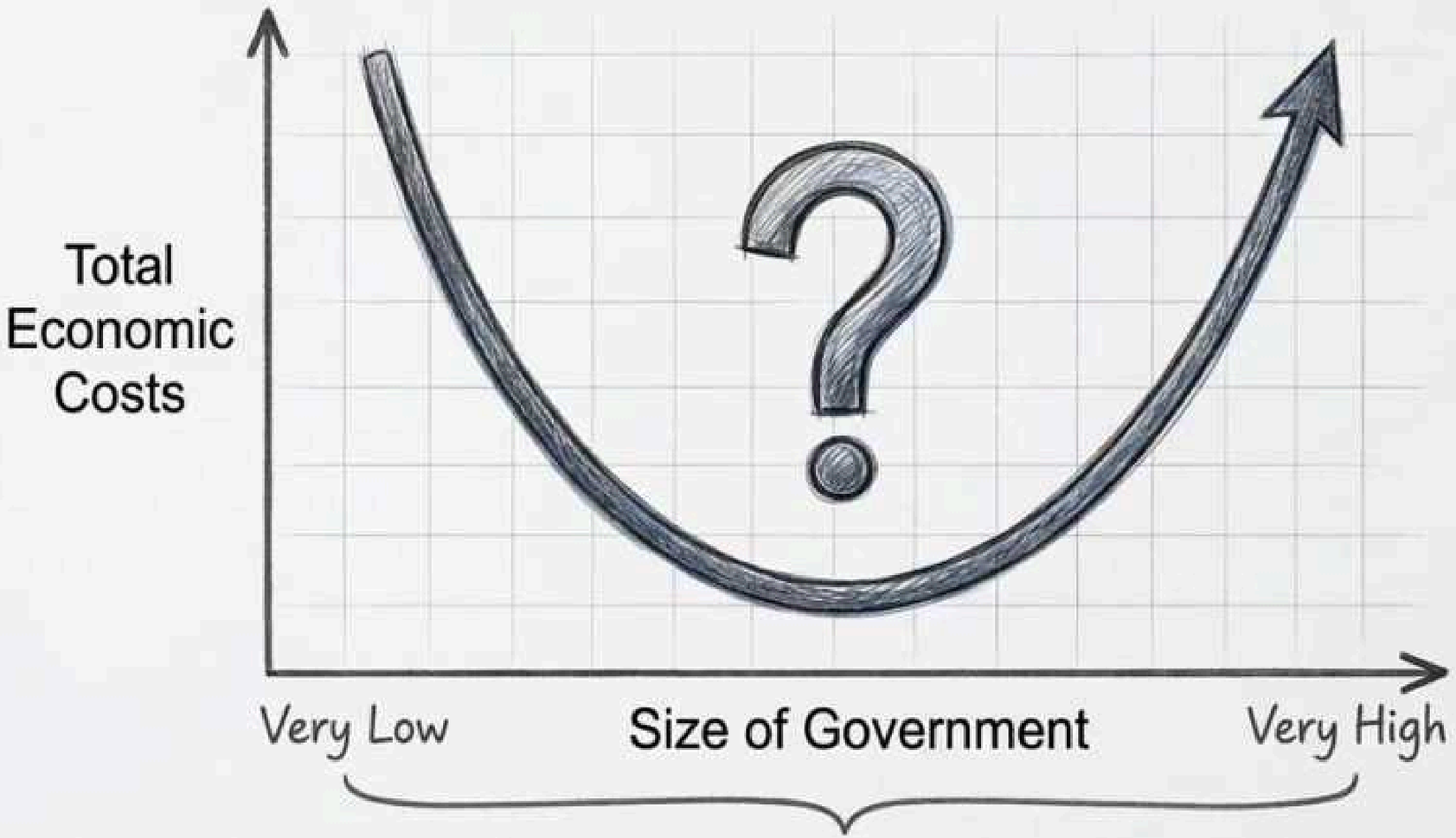
The Free-Market Response: Design is everything—how benefits are paid, and what incentives they leave intact.





How Big Should Government Be?

¶ 5.18



Core Insight:

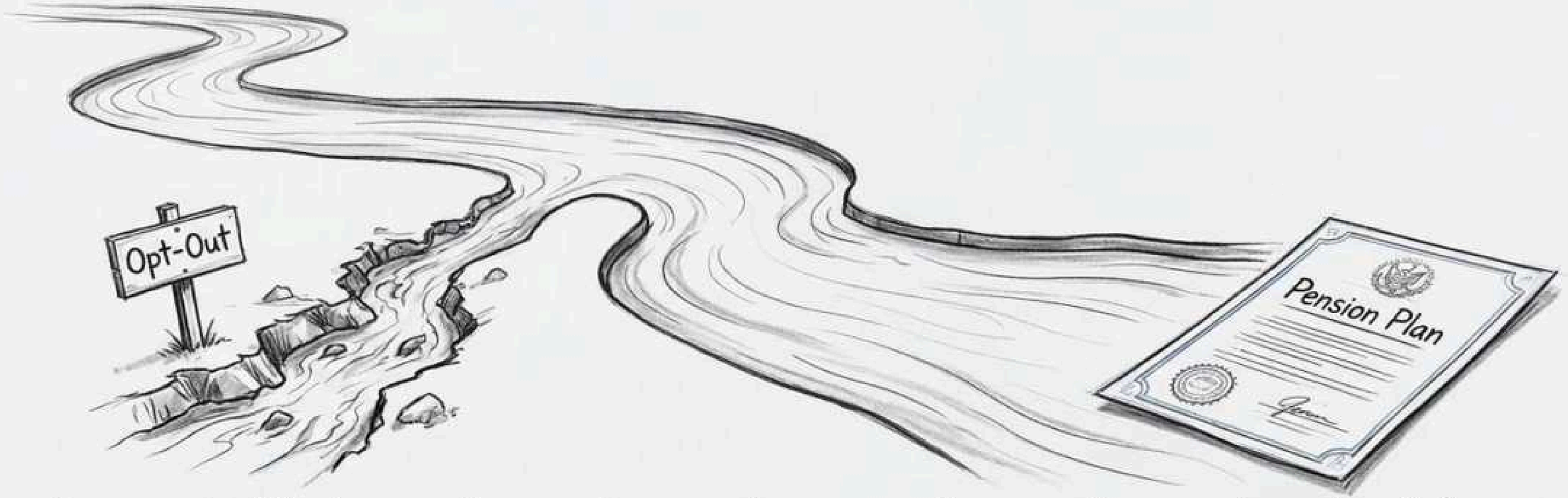
Economists have found no single ideal size.

Very low taxes and very high taxes both carry costs.

Context matters: The optimal point is disputed and depends entirely on what the money buys (e.g., spending on roads/schools vs. subsidies for a declining industry).

Nudges & Behavioral Economics (Thaler & Sunstein)

¶ 5.19

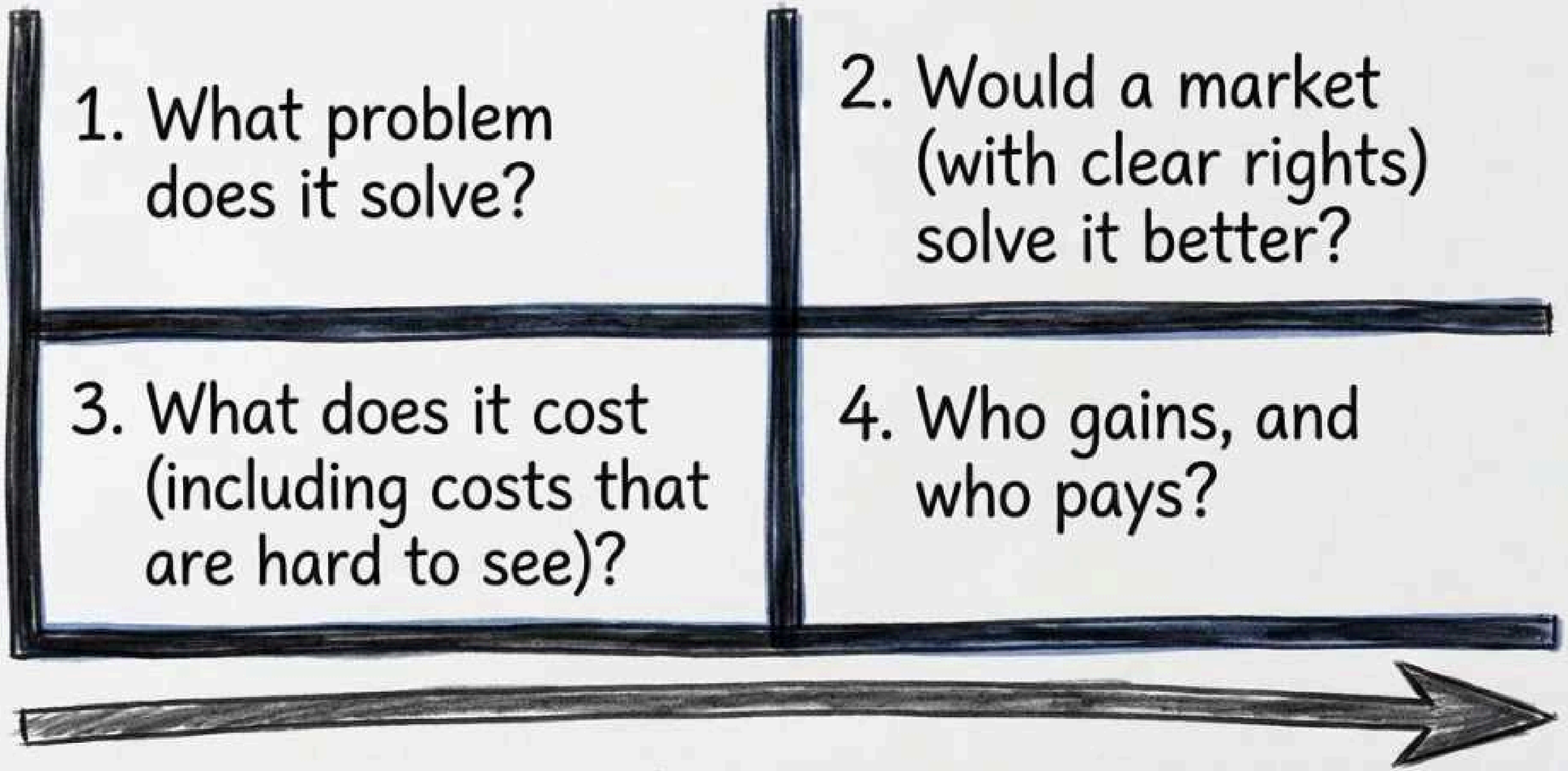


Concept: Nudging steers choices (e.g., enrolling workers automatically) while keeping the opt-out open.

The Debate: Paternalism vs. Freedom. Does this respect choice by keeping it open, or quietly erode it by exploiting inertia?

The Evaluation Framework

¶ 5.20



Asking these questions forces the argument into the open.

The Lecture Question



Lecture 6: Market Limits

Next Time: We examine the limits of free markets,
and the critiques that deserve a serious answer.

