Focus Questions
- What goods will be produced in a free enterprise economy?
- Who decides what goods will be produced in a free enterprise economy?
- For whom will goods be produced in a free enterprise economy?
- What are five major features of free enterprise?
- What is the circular flow of economic activity?

Key Terms
private property
public property
household
circular flow of economic activity

How Does Free Enterprise Answer the Three Economic Questions?

You read about the three key economic questions that every economic system must answer in Chapter 2. Now let’s look at how these questions are answered in a free enterprise economy.

What Goods Will Be Produced?

In a free enterprise economy, business firms will produce the goods that consumers want to buy. For example, suppose consumers are willing and able to buy goods A, B, and C at a price and quantity that will earn profits for business firms. Also suppose that consumers are either unwilling or unable to buy goods D, E, and F at a price and quantity that will result in profits for the businesses that produce the goods. Business firms will produce goods A, B, and C, but they will not produce D, E, or F.

Example: In the United States, General Motors and Ford Motor Company decide what style and make of cars they will produce. Each company bases its production on what it thinks the car-buying public wants to buy.

How Will TheseGoods Be Produced?

The individuals who own and manage the business firms decide how goods will be produced. For example, if the owners and managers of an automobile company want to use robots to produce cars, then they will purchase the robots and produce cars with them. If a company prefers that its secretaries use computers produced by Apple instead of computers produced by Hewlett-Packard, the secretaries will use computers produced by Apple.

For Whom Will the Goods Be Produced?

In a free enterprise economy, goods are produced for those people who are willing and able to buy them. Notice that it takes both willingness to buy and the ability to buy. A person has the ability to buy a
$25,000 car if that person has $25,000 to spend, but if the same person is unwilling to spend $25,000 for the car, he or she will not purchase the car. Also, no purchase will occur if a person has the willingness to buy something but is unable to do so. For example, Shelly may be willing to spend $800 to buy a computer but may currently be unable to do so because she does not have the money.

**QUESTION:** Aren’t some goods and services produced in a free enterprise economy that we would be better off not producing? Harmful products, such as pornography and drugs; and showy, unnecessary products like a $20,000 watch, or a $1 million diamond ring, or a solid gold faucet for the bathroom? Should these goods and services be produced?

**ANSWER:** Probably everyone can find some good or service produced, bought, and sold in a free enterprise economy that he or she thinks we would be better off without. Some people dislike hip-hop and think the country would be better without it; some people think that big Hummers on the road are something we would be better off without. The free enterprise economic system doesn’t really make value judgments; it simply produces goods and services that individuals (maybe not all individuals) want to buy. Look at it this way. You might be in favor of free speech, but still not like everything that people say. Similarly, you might be in favor of free enterprise, but still not like everything that people produce, sell, and buy.

### Five Features of Free Enterprise

Five major features or characteristics define free enterprise: private property, choice, voluntary exchange, competition, and economic incentives. (See Exhibit 3-1.)

![Exhibit 3-1](image)

Economic systems are often defined by their characteristics. Five characteristics that define free enterprise are private property, choice (or freedom to choose), voluntary exchange, competition, and economic incentives.

#### Private Property

Any good—such as a car, house, factory, or piece of machinery—that is owned by an individual or a business is referred to as **private property**. Any good that is owned by the government—such as the Statue of Liberty—is referred to as **public property**. Under free enterprise, individuals and businesses have the right to own property. Furthermore, they may own as much property as they are willing and able to purchase, and they may sell whatever property they own.

The right to own private property is not, however, absolute in all cases. Suppose the government wants to run a new road through the private property of some homeowners. The government offers to buy the property from the homeowners, but a few owners refuse to sell. What happens next? Generally, under the right of **eminent domain**, the government can take ownership of the land even without the consent of the owner. In such cases the government will compensate owners for the loss of their land.

- **private property** Any good that is owned by an individual or a business.
- **public property** Any good that is owned by the government.
She argued that the ruling favors the most powerful and influential in society and leaves small property owners with little recourse. She stated that the “spector of condemnation hangs over all property. Nothing is to prevent the State from replacing any Motel 6 with a Ritz-Carlton, any home with a shopping mall, or any farm with a factory.”

**Choice (or Freedom to Choose)**

Choice is a key element of free enterprise. Workers have the right to choose what work they will do and for whom they will work. Businesses have the right to choose the products they will produce and offer for sale. Buyers have the right to choose the products they will buy.

**Example:** Morgan, living in a free enterprise economy, wants to buy some vitamins, tofu, barbells, and a classic novel by William Faulkner. Ashley, also living in a free enterprise economy, wants to buy a CD by 50 Cent, a tattoo of an eagle, a book by Ayn Rand, and a motorcycle. Both Morgan and Ashley can buy what they want in a free enterprise economy.

**Voluntary Exchange**

In free enterprise, individuals have the right to make exchanges or trades they believe will make them better off. For example, suppose Mei has $10, Michael has a book, and they trade. We conclude that Mei believes she is better off having the book than the $10, and Michael believes he is better off having the $10 than the book. Individuals make themselves better off by entering into exchanges—by trading what they value less for what they value more.

**Competition**

Under free enterprise, individuals are free to compete with others. Suppose you live in a town with five bakeries. You think you would like to open your own bakery and compete for customers with the other five bakeries. In a free enterprise system, no person or law stops you.

As a consumer living in a free enterprise system, you are likely to benefit from com-
petition between sellers. You will probably have a bigger selection of products from which to choose, and sellers will compete with each other for your dollars by increasing the quality of the goods they sell, offering lower prices, providing better service, and so on. Although consumers in a free enterprise system may still have justified consumer complaints, the system usually provides major advantages. It may also have some disadvantages, which may or may not be present in other economic systems.

As a worker in a free enterprise economy, you may benefit from competition in another way. The competition between employers for your labor services will often result in your earning a higher wage or income than you would without competition. For example, suppose you are an accountant working for one of the five accountancy firms in town. A person opens up another accountancy firm and wants you to come to work for her. How might she get you to quit your present job and come to her firm? She may offer you a higher income than you are currently earning.

Economic Incentives

As we learned in Chapter 1, an incentive is something that encourages or motivates a person toward action. Under free enterprise, money acts as an incentive to produce. If you produce goods and services that people are willing and able to buy, you receive money in return. As you learned in Chapter 2, Adam Smith wrote about the usefulness of economic (or monetary) incentives in a free enterprise economy. He explained that business owners are interested in making themselves better off. This desire to earn an income strongly motivates them to produce for others.

Laws, Institutions, and Regulations

A free enterprise economy (such as the U.S. economy) does not operate in a vacuum. Free enterprise operates in countries, which have different systems of laws, institutions, and regulations. What a particular country’s legal system permits and prohibits affects the “economic climate” of that country and determines, to a large degree, how free enterprise operates in that country.

Legal systems and institutions can either help or hinder free enterprise. For example, imagine a country in which the banking sector is somewhat undeveloped, and private property is not viewed as important. In this country the free enterprise system would have a difficult time operating (and doing what it does well). In a country such as the United States, however, laws have been developed to regulate banking and protect private property, which helps promote free enterprise.

As you read along in this text, you will learn how some of the institutions and laws in the United States influence the economy. For example, the last section of this chapter introduces you to government’s role in free enterprise; Chapter 8 discusses antitrust laws; Chapter 9 describes certain business regulations; and Chapter 10 examines the banking system.
The circular flow of economic activity shows the relationships between different economic groups. For example, in this circular flow diagram we see that households buy goods from businesses and sell resources to businesses. We see that both businesses and households pay taxes to government and receive benefits from government.

### The Circular Flow

Much of what characterizes a free enterprise economy has to do with how the key economic sectors—government, businesses, and households—deal with each other. Does government play a big role in the economy, or a small role? Are businesses free to produce what they want? What goods do businesses produce in order to sell to the household sector?

### A Snapshot of an Economy

A picture of what an economy can look like in action might help us answer these questions. Look at Exhibit 3-2, which shows the circular flow of economic activity in the U.S. economy. The picture shows who the key players are in the economy, the relationships they have with each other, and the ways in which they interact. At first sight, it simply looks like a picture with lines going every which way, but those lines tell a story.

1. As mentioned above, it is customary to think of an economy as composed of businesses, government, and households. In the exhibit, businesses, government, and households are visually represented in the center of the diagram.
2. An economic relationship exists between businesses and households. Businesses sell goods and services to households (purple arrow), for which households must make monetary payments (blue arrow). For example, a consumer decides to buy a sofa from a furniture company.
3. Businesses and households have another economic relationship: individuals in households sell resources (such as their labor services) to business firms (red arrow), and in return, businesses pay individuals for these resources (green arrow). For example, a business pays a worker a day’s wage.
4. Both businesses and households have a certain economic relationship with the government. Households pay taxes to the government (yellow arrow) and in
return receive certain goods and services (gray arrow). For example, the government provides individuals with roads, schools, and national defense. The same kind of relationship holds between businesses and the government: businesses pay taxes to the government (orange arrow), and the government provides certain goods and services to businesses (brown arrow).

Now look at Exhibit 3-2 as a whole rather than focusing on any of its parts. Notice in particular the relationships between different economic individuals, businesses, and institutions.

- **Businesses and households.** Households sell resources to businesses, and businesses pay for those resources. It is also the case that businesses sell goods and services to households, and then households pay for those goods and services.
- **Government and households.** Households pay taxes to the government, and the government provides goods and services to households.
- **Government and businesses.** Businesses pay taxes to the government, and the government provides goods and services to businesses.

### Why Is the Circular Flow Diagram Useful?

Suppose you are watching the news one night on television. An economist who works for the president of the United States is stating that the president is seriously considering raising people's taxes. Look at Exhibit 3-2 and ask yourself which arrow will be affected by this action. It is the yellow arrow labeled “Households pay taxes,” which goes from households to the government. If all other things remain the same, this arrow grows larger, because more tax dollars will flow through it.

Next, ask yourself this question: If more tax dollars flow through the yellow arrow from households to government, will fewer dollars flow through some other arrow? The answer is yes—through the blue arrow that moves from households to businesses. In other words, because households pay more of their income in taxes, they have less of their income to buy things such as television sets, cars, and computers. The circular flow diagram helps us see how a change in one economic activity (such as paying taxes) will lead to a change somewhere else in the economy (such as the amount households spend on goods and services produced by businesses).

### Defining Terms

1. Define:
   a. private property
   b. public property
   c. households
   d. circular flow of economic activity
2. Use the word *incentive* correctly in a sentence.

### Reviewing Facts and Concepts

3. According to the circular flow of economic activity, in what economic activities is the government engaged? (Look at Exhibit 3-2 to help you answer the question.)

4. In a free enterprise economy, how would you answer this question: *For whom are goods produced?*

5. Under free enterprise, everyone has the right to own property. Does it follow that everyone will own property? Why or why not?

6. How does voluntary exchange benefit a person?

7. What advantages do consumers get from the competition between sellers?

### Critical Thinking

8. Would Adam Smith agree that the benefits of free enterprise are a consequence of the human desire to make life better for others? Explain.

### Applying Economic Concepts

9. Teachers want students to do their homework completely, carefully, and on time. Identify an incentive that you think would increase student efforts toward reaching these objectives.
Focus Questions
- What roles do profits and losses play in a free enterprise economy?
- What do profits, losses, and resources have to do with one another?
- How do profit and loss operate as signals to business firms?

Key Terms
profit
loss

Profits and Losses

In a free enterprise economy there are no guarantees. A business can either succeed or fail. Whether a business is successful or not depends on whether it generates profits or losses.

Profits

Suppose that a computer company spends $800 to produce a computer, and then sells the computer for $1,200. In this case the company earns $400 in profit. Profit is the amount of money left over after all the costs of production have been paid. Profit exists whenever total revenue is greater than total cost.

Total revenue = Price of a good × Number of units sold

For example, suppose you sell radios at a price of $30 apiece. On Monday you sell five radios, so the total revenue for Monday is $150.

Suppose the average cost of the five radios you sell is $30 per radio. The total cost is $150. For the five radios, the difference between total revenue ($150) and total cost ($150) is $100. This $100 is profit.

Losses

Notice that profit results any time total revenue is greater than total cost. When the opposite is true—when total cost is greater than total revenue—a loss occurs, stated in terms of the amount of money by which total cost exceeds total revenue. For example, suppose that in a given year, a clothing store has a total revenue of $150,000 and total costs of $200,000. If we subtract the store’s costs from its revenues, we get $-50,000, a loss for the year.

Profit = Total revenue > Total cost
Loss = Total cost > Total revenue

Total cost is the average cost of a good times the number of units of the good sold:

Total cost = Average cost of a good × Number of units sold
QUESTION: How many new businesses start up in the United States each year? How many business failures happen each year?

ANSWER: About 3.4 million new businesses start up each year (including businesses of all sizes, even one-person businesses) and about 3.2 million businesses fail each year. The source for these data is the Statistical Abstract of the United States which you can find online at www.census.gov/businesses.

Profit and Loss as “Signals”

At any time in a free enterprise economy, some business firms are earning profits, and some are taking losses. Profits and losses are (1) signals to the firms actually earning the profits or taking the losses and (2) signals to firms standing on the sidelines.

Suppose the NBC television network airs a comedy show on Thursday night that earns high ratings. Because companies will pay more to advertise on high-rated shows, the comedy show creates more profits for NBC. The CBS network airs a crime show on Thursday night that receives low ratings and losses. What are NBC and CBS likely to do now?

NBC will probably do nothing new; it will continue doing what it has been doing. The comedy show is earning high ratings, and the network is earning high profits. CBS, in contrast, will probably cancel its crime show, because the public does not like it. CBS might replace the crime show with a comedy, because NBC already showed that a comedy does better than a crime show.

So far the third major network, ABC, remained on the sidelines watching what was happening to NBC and CBS on Thursday night. ABC is thinking about developing a new program. Will what happened to NBC and CBS influence ABC’s decision as to what type of program it will

In a free enterprise economy there is no guarantee that a new business will succeed. Why do you think more than 3 million businesses fail each year?

The Tonight Show with Jay Leno is a profitable show for NBC. How do one company’s profits affect decisions made by its competitors?
Private property is one of the features of free enterprise. Many of the advocates of free enterprise argue that without private property, free enterprise could not produce as much wealth as it does.

Private property is not without its critics, though. Some people argue that private property breeds greed and selfishness. Common property—property held in common by the community—motivates people to be more civic minded, peaceful, and caring, they say. The advocates of private property retort that this notion of common property is idealistic and wrong. The truth is, they say, that common property often leads to poverty and unhappiness.

With this background, consider the Pilgrims in the early 1600s. When the Pilgrims left the Old World, they formed a partnership in a joint-stock company with some London merchants. When the Pilgrims landed off the coast of Massachusetts in 1620, they followed the advice of the company and declared that all pastures and produce would be common property. The result was chaos and starvation; after the first winter, half the colonists were dead.

Bad weather is often blamed for what happened to the Pilgrims, but the governor of the Plymouth colony, William Bradford, believed otherwise. He thought it had a lot to do with the fact that the Pilgrims held common property instead of private property. Bradford, therefore, assigned every family in the colony a private parcel of land, on which the family could produce food that it sold for profit. In his diary, Bradford wrote that privatizing the land “had very good success for it made all the hands very industrious, as much more corn was planted than otherwise would have been.” He also remarked on how unsuccessful the common property scheme had turned out to be when he said, somewhat philosophically, that it had proved the “vanity of that conceit of Plato’s . . . that the taking away of [private] property and bringing community into a commonwealth [of common property] would make them happy and flourishing.” It seemed that common property, far from making people happy and flourishing, had instead made them poor and hungry.

Some historians now say that it was probably Bradford’s decision to turn common property into private property, more than a change in the weather, that produced the first plentiful harvest in the Plymouth colony—a plentiful harvest that was subsequently celebrated as Thanksgiving.

To get an idea of how private property affects incentives, consider two settings. In the first setting, you and five of your friends share the ownership of a car. In the second setting, you are the only owner of the car. In which setting are you more likely to take care of the car (for example, to make sure it is clean and in good running order)? Explain your answer.
develop? Yes, ABC will be more likely to develop a comedy than a crime show.
Let’s summarize what happened:

- The people at home decide what they want to watch on television.
- Many more people watch the NBC comedy show (giving it high ratings) than the CBS crime show (which gets low ratings).
- Companies pay more to advertise on high-rated shows than low-rated shows, so NBC earns profits on its Thursday show and CBS takes losses.
- NBC realizes it has a winning show, so it keeps the comedy show on the air. CBS realizes it has a losing show, so it takes the crime show off the air.
- ABC, on the sidelines, decides to copy NBC instead of CBS.

You recall that resources consist of land, labor, capital, and entrepreneurship. When CBS decides to take its crime show off the air and replace it with a comedy show, what happens to the resources that were previously used to produce the crime show? An economist would say the resources are being reallocated—moved from one place to another, or used differently. Some of the resources used to produce the crime show—the people who worked on the show, the cameras used to film the show, the accountants who kept the books—will probably be used to work on a comedy show instead of a crime show. Simply put, resources flow toward profit; resources flow away from losses. Profit is like a big magnet: it pulls resources toward it. Loss is like a big wind: it pushes resources away.

**Example:** In the early days of the VCRs, DVD players, personal calculators, and personal computers, profits were relatively high for the relatively few companies that produced the new products. This “high profit” attracted competitors. It was as if the high profit were saying, “Look, I’m over here, come and get me.” Soon, numerous companies were producing VCRs, DVD players, calculators, and personal computers, instead of only few. As a result, the prices of these goods came down, and with it, profit too.

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**Defining Terms**

1. Define:
   a. profit
   b. loss

**Reviewing Facts and Concepts**

2. Explain how profits and losses affect where resources will be used.
3. If a business is currently earning high profits producing lamps, what are other firms that observe this fact likely to do? Explain your answer.
4. If price is $40, number of units sold is 450, and average cost is $33, what is the profit?
5. If average cost is $423, price is $399, and the number of units sold is 23, what is the loss?

**Critical Thinking**

6. Many people think that profit benefits only the person who earns it; in other words, profit provides no social function. Do you agree or disagree? Explain your answer.
Ethics and Free Enterprise

Ethics consists of the principles of conduct, such as right and wrong, morality and immorality, good and bad. We often evaluate a person as being ethical or not. Can we do the same thing for an economic system? For example, can we determine whether the free enterprise system is an ethical economic system? Another way of approaching this question is to ask what characteristics or qualities would the free enterprise system need to have to be an ethical system. What goals would it need to meet? (See Exhibit 3-3.)

People Can Choose

First, the supporters of free enterprise state that an ethical economic system allows individuals to choose their own occupations or professions. An ethical system, they say, does not force people to do jobs or tasks that they would rather not do. On this count, the supporters of free enterprise argue that it is an ethical system, because no one is forced to work at a job he or she does not want. People are free to choose the type of work they want to do.

Focus Questions

- What are some of the qualities or characteristics of an ethical economic system?
- What are some of the freedoms in free enterprise?
- What economic principles are stated in the Bill of Rights, the Constitution, and the Declaration of Independence?
- What are some of the responsibilities people have in a free enterprise system?

Key Term
ethics

A Variety of Products

Second, an ethical economic system produces the goods and services preferred by both the majority and the minority. The supporters of free enterprise argue that under that economic system, if the majority of the people want to buy cars that are light colored and medium sized, with CD players, then manufacturers will produce that kind

EXHIBIT 3-3
An Ethical Economic System

1. Allows individuals to choose their own occupations or professions
2. Produces goods and services preferred by both the majority and the minority
3. Rewards or punishes producers based on how well or poorly they respond to the buying public
4. Supports the right of the individual to be free, including the freedom to acquire property, work where you choose, and start your own business
of car. (After all, they do not want to produce goods that consumers are not willing to buy.) If a few people want big cars instead of medium-sized cars, then it is likely that some big cars will be produced, too. If other people want small cars, some small cars will probably be produced.

Think of free enterprise at work in the restaurant business. In most U.S. cities of moderate size, many different types of restaurants serve a particular style of food: home cooking, fast food, and ethnic foods, for example. A wide variety of goods and services are available because free enterprise responds both to the majority and to minorities.

**Rewards Depend on Performance**

Third, an ethical economic system rewards (or punishes) producers according to how well (or poorly) they respond to the preferences of the buying public. Free enterprise fits this description. Sellers that continue to give consumers what they want to buy in terms of type of good, quality of good, and price of good will likely earn profits and stay in business. Those sellers that do not respond to public preferences end up taking losses and going out of business.

**Numerous Freedoms**

Fourth, the proponents of free enterprise argue that no economic system can be ethical if it limits people’s freedom. In free enterprise, they say, people have numerous freedoms: the freedom to work where they want to work, the freedom to start their own businesses if they want, the freedom to acquire property, the freedom to buy and sell the goods they want to buy and sell, and even the freedom to fail.

**Example:** Suppose Harris Jackson takes his entire savings and opens a shoe store. Six months later, Harris shuts down his business and declares bankruptcy. His problem was that few people wanted to buy shoes from him.

Businesses close in the U.S. free enterprise system every day. Free enterprise gives us the freedom to spend our money as we choose, and sometimes this freedom results in business failures for other people. Individuals must accept the consequences of their decisions. Free enterprise does not offer any guaranteed outcomes; rather, it offers freedom.

**A Student Asks**

**QUESTION:** Having the freedom to do something is different from having the ability to do it. What use is the freedom to start your own business if you do not have the money to start the business? Without the ability, the freedom seems useless.

**ANSWER:** No economic system can provide people with the ability to do anything, such as write a great novel, run the four-minute mile, or be a successful entrepreneur. However, economic systems may or may not give individuals the opportunity to realize their potential. The supporters of free enterprise argue that free enterprise does provide
people with the opportunity, or freedom, to start a business. They also argue that free enterprise gives individuals the opportunity to strengthen and develop their abilities. Suppose a person does not currently have the money or the knowledge to open up her own business, and she is currently working at a low-wage job. Is she destined never to start her own business? Not necessarily.

She can begin today doing those things that are necessary to start her own business in the future. These steps may include working hard in her current job, saving some money, attending school to learn about the business she wants to start, and obtaining a business loan. The economic history of the United States, under free enterprise, is full of stories of people who were poor and uneducated (and, in many cases, did not know the English language), yet went on to start their own businesses and become economically successful.

**Economic Principles in Key Documents**

The Constitution, the Bill of Rights, and the Declaration of Independence hold a special place in the hearts and minds of most Americans. It can also be argued that these three documents have a special significance to free enterprise: each document has free enterprise economic principles contained within it.

Remember that private property, choice, and competition are important features of free enterprise and that the essence of free enterprise is freedom. It is not difficult to find evidence that the Constitution, the Bill of Rights, and the Declaration of Independence are also about private property, choice, competition, and freedom, among other things.

**Bill of Rights**

The Bill of Rights, for example, notes that “private property [shall not] be taken for public use, without just compensation.” In other words, if the government wants some land you own in order to put in a road, it cannot simply take that land from you. It must justly compensate, or pay, you for that land. This fact shows the high regard for private property in the Bill of Rights.

**Declaration of Independence**

The signers of the Declaration of Independence listed many complaints against the king of Great Britain, George III. One complaint was that the king had prevented the 13 colonies from “trading with all parts of the world.” Surely the signers of the Declaration of Independence were angry at King George III for not allowing them to practice free trade—an essential ingredient of free enterprise—with the rest of the world.
Suppose the jet for the flight from Atlanta, Georgia, to Chicago, Illinois, can hold 150 passengers. How many tickets will an airline sell? The answer is “more than 150,” because the airlines know that some people will cancel their flight at the last moment or won’t turn up at the airport. In other words, the airlines “overbook” flights—they sell more tickets than seats available.

Because of overbooked flights, every now and then more people will turn up at the airport (to take a flight) than are seats available. For example, 155 people may turn up with reservations for 150 seats. In the past, airlines would often “bump” some passengers to the next flight. The bumped passengers were usually angry that they, and not someone else, had been bumped.

Today the airlines don’t bump passengers. What they do is ask passengers if they would be willing to take an “upgrade” on a later flight (fly first class) or take a $200 voucher (or more) on any of their flights in exchange for taking a later flight. This new system of dealing with overbooked flights has resulted in much more satisfied flying customers.

Who came up with the system of offering overbooked passengers compensation (of one form or another) if they would take a later flight? Was it the president of an airline? Was it the airline ticket agents, the people who had to deal with the disgruntled bumped passengers? No, it was an economist, Julian Simon (1932–1998). In this regard, Simon behaved as an entrepreneur: he figured out a new and better way to do something.

Simon’s plan to deal with overbooked flights came to him as he was shaving one day. He wrote the presidents of several airlines, and each told him that his was a good idea, but that they weren’t going to implement it.

One day, Alfred Kahn, also an economist, was appointed chairman of the Civil Aeronautics Board. Simon wrote him about his plan for dealing with overbooked flights. Kahn liked the idea and strongly suggested that the airlines adopt it. They did. The rest, as they say, is history.

The Simon plan ended up being a plan that benefited the airlines and flying customers. Airline executives admitted that the Simon plan made it easier for them to overbook flights (and lower their costs because it is costly to fly an airplane half full) while at the same time maintaining a happy customer base. If the Simon plan was as good for the airlines as they now say, why didn’t an airline executive come up with the plan?

The Constitution

Article 1, Section 8, of the U.S. Constitution says that “no tax or duty shall be laid on articles exported from any State.” The Constitution favors preserving competition; if states had been allowed the right to impose a tax on each other’s goods, competition within each state would have been lessened. To preserve competition—an important feature of free enterprise—it was important to deny states the right to tax each other’s goods.


Economic Rights and Responsibilities in a Free Enterprise Economy

People have certain rights in a free enterprise economy, but rights rarely come without responsibilities. What are the responsibilities of persons in a free enterprise economy?

Open Disclosure

Many people argue that the right to voluntary exchange comes with the responsibility of giving the other person accurate information about what is being exchanged. Suppose Steve wants to exchange (sell) his 12-year-old house for the $270,000 that Roberto is willing and able to pay for it. In a free enterprise economic system, Steve and Roberto have the economic right to complete this exchange, but Steve also has the responsibility to tell Roberto the particulars about the house. For example, if the house has termites or faulty plumbing, Steve should tell Roberto this fact. In other words, Steve has the responsibility of truthfully relating to Roberto the facts about the product he is considering buying. This disclosure is a matter of simple fairness or justice.

Obeying the Law

Consider another economic right in a free enterprise economy: the right to private property. The responsibility associated with this right is the responsibility of using one's property only for legal purposes; it is a responsibility to respect and abide by the law. Suppose Isabella owns a car. She certainly has the right to use that car to drive to and from work, go on vacations, pick up friends at school, and so on. It is also the case, however, that Isabella has some responsibilities. For example, she has the responsibility of obeying the speed limit, knowing and following all other traffic laws, and driving carefully.

Being Truthful

Finally, consider the economic right to compete in a free enterprise system. The responsibility attached to this right is to compete in a truthful, legitimate manner. If both Tushar and Yolanda own pizzerias in town and are thus in competition with each other, both have the responsibility to be truthful about the other's business. Tushar should not lie to his customers that Yolanda's pizzeria was cited by the government health examiner for having insects in the kitchen. Yolanda must not lie and say that Tushar uses less cheese in his pizzas than he actually does.

Defining Terms

1. Define ethics.

Reviewing Facts and Concepts

2. “Under free enterprise, only the majority of people can buy the goods they prefer; the minority always end up buying those goods they would prefer not to buy.” Do you agree or disagree with this statement? Explain your answer.

3. “Free enterprise guarantees economic success.” Do you agree or disagree with this statement? Explain your answer.

4. Explain what responsibility goes with each of the following rights:
   a. the right to voluntary exchange
   b. the right to private property
   c. the right to compete

Critical Thinking

5. “In a free enterprise system, it is possible that more trashy novels will be published and sold than serious, soul-inspiring works of literature. Any system that produces this outcome can't be ethical.” Do you agree or disagree with this statement? Explain your answer.
Imagine Being an Entrepreneur

An entrepreneur is a person who has a special talent for searching out and taking advantage of new business opportunities, as well as developing new products and new ways of doing things. To get some idea of what being an entrepreneur is like, try to imagine you are one.

New Opportunities

How would you search out new business opportunities? No book in the library can give you a personalized answer. Even if such a book existed, by the time it was published and found its way into the library, the business opportunities listed in it would no longer be new. Most people, when confronted with the task of finding a new business opportunity, end up scratching their heads. Most people are not entrepreneurs; entrepreneurs are a tiny minority of the population.

Focus Questions

- What is an entrepreneur?
- How might the actions of an entrepreneur benefit you?
- What impact would a law that limited profits have on future entrepreneurs?
- Why are entrepreneurs willing to risk their time and money?

Key Term

entrepreneur

New Products

Think about the second task of an entrepreneur: developing new products. What new product can you think of developing? Most of us are accustomed to thinking in

entrepreneur

A person who has a special talent for searching out and taking advantage of new business opportunities.

▲ Entrepreneurs feel that they have new and better ways of satisfying customers. What sort of business might you want to start someday?
Pod users will tell you that they like their iPods for many reasons. It's sleek looking, it holds thousands of songs, it's lightweight, and you can take it anywhere. For many iPod users, one of the features they like best is the scrollwheel. It's touch sensitive and has a rather slick, lightning fast feel about it.

"Buy it, use it, break it, fix it, trash it, change it, meet—upgrade it."

—from an iPod commercial (“Technologic” by Daft Punk)

Interestingly enough, the first generation of iPods didn't come with the current touch-sensitive scrollwheel. The first scrollwheel on the iPod was developed by Apple. It physically rotated and was not touch sensitive.

Apple wanted a better scrollwheel, so it turned to a company called Synaptics. Synaptics makes touchpads for laptop computers. Synaptics came up with the touch-sensitive, slick, lightning fast scrollwheel that iPods use today. In this regard, Synaptics was acting as an entrepreneur: it was developing new ways of doing things.

The new scrollwheel came with four touch-sensitive buttons above it. These buttons were used for various playback functions. When Apple was in the process of designing the iPod Mini, it decided that those buttons had to go because there just wasn't enough room for them.

Synaptic then came up with new scrollwheel with the former four buttons placed around the periphery of the scrollwheel. Now the scrollwheel could perform two functions: it could be used to scroll for songs and for playback control too.

We tend to think of an entrepreneur as a person; however, business firms can behave “entrepreneurially” as well. What business firms can you point to that act entrepreneurially?

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New Processes

As for the third task of an entrepreneur—developing new ways of doing things—ask yourself what things people would want to do differently. Then ask how people could do these things differently. You'll probably find that these questions are difficult to answer. Indeed, entrepreneurs must overcome obstacles, solve problems, and answer challenging questions.

Who Benefits?

If an entrepreneur succeeds in coming up with an idea for a new product, develops and produces it, and then offers it for sale, how are we made better off? Think of entrepreneurs whose new products have helped you. For example, think about Steve Jobs, one of the developers of the personal computer and the iPod. Was your life affected positively or negatively as a result of his entrepreneurship? Most would say we benefited from the introduction of, say, the personal computer. Entrepreneurs, it would seem, play an important role in society by taking risks to develop new products or new
ways of doing things that benefit the public. From a consumer's point of view, having more risk-taking entrepreneurs in a society likely means having more choices of goods and services in that society.

**Example:** On August 1, 1981, MTV was launched. The originators of MTV were entrepreneurs: They were one of the first to see that a market existed for combining one product (music) with another product (television). The first music video shown on MTV was “Video Killed the Radio Star” by the Buggles. The first music video shown on MTV Europe was “Money for Nothing” by Dire Straits. Choosing “Money for Nothing” was done tongue-in-cheek by MTV executives because the song mentions MTV—“Now look at them yo-yos, that’s the way you do it, you play the guitar on the MTV.”

**Entrepreneurs, Profit, and Risk**

“You can’t get something for nothing.” This saying is certainly true for entrepreneurship. We can’t get people to risk their own time and money, to try to develop new products, and to innovate unless they can potentially earn a profit. With this in mind, how would you respond to someone who says, “Look at that entrepreneur. He’s a billionaire; he’s earned high profits for years. We ought to pass a law that people can earn no more than 5 percent profit on anything they produce and sell”?

You may be inclined to agree, thinking that with a law that limited profits, you would be able to buy goods and services at lower prices. Less profit for the billionaire entrepreneur, in other words, would simply mean more money in your own pocket.

Things don’t always work this way, however. If potential entrepreneurs knew that they could earn only a 5 percent profit at best, they might not be willing to take the risks necessary to become actual entrepreneurs. With fewer entrepreneurs, fewer new goods and services and fewer innovations would be available for your benefit. Not all entrepreneurs are successful, of course. In fact, many entrepreneurs risk their time and money and end up with nothing. A few do end up with millions or even billions of dollars. It is the prospect of millions or billions of dollars that motivates entrepreneurs to assume the risks inherent in entrepreneurship.

**American prosperity and American free enterprise are both highly unusual in the world, and we should not overlook the possibility that the two are connected.”**

--- THOMAS SOWELL, ECONOMIST

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**Reviewing Facts and Concepts**

1. What does an entrepreneur do?
2. How might an entrepreneur’s risk-taking activities benefit society?

**Critical Thinking**

3. Economists speak of four categories of resources: land, labor, capital, and entrepreneurship. Suppose that country A has much more land, labor, and capital than country B, but it has no entrepreneurs. Country B, however, has many entrepreneurs. In which country would you prefer to live, and why?
Focus Questions

- What would happen if government did not enforce contracts?
- What is a public good?
- In a free enterprise economy, why won’t individuals produce nonexcludable public goods for sale?
- What is a negative externality? A positive externality?

Key Terms

<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
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<tbody>
<tr>
<td>contract</td>
<td>An agreement between two or more people to do something.</td>
</tr>
<tr>
<td>private good</td>
<td>A good of which one person’s consumption takes away from another person’s consumption.</td>
</tr>
<tr>
<td>public good</td>
<td>A good of which one person’s consumption does not take away from another person’s consumption.</td>
</tr>
<tr>
<td>excludable public good</td>
<td>A public good that individuals can be excluded (physically prohibited) from consuming.</td>
</tr>
<tr>
<td>nonexcludable public good</td>
<td>A public good that individuals cannot be excluded (physically prohibited) from consuming.</td>
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Government as Enforcer of Contracts

Think of what life would be like in a nation without government—no city government, no state government, no federal government. Suppose you own a construction company and regularly purchase supplies from people. On Tuesday, you enter into a contract with a person (an agreement between the two of you to do something). You agree to pay her $1,000 today if she delivers a shipment of wood to you on Friday. Friday comes, and no wood is delivered. Saturday, no wood. Sunday, no wood. On Monday you call the person to ask what happened. She says that she has no intention of delivering the wood to you. “But you took my $1,000. That is theft!” you say. She just laughs at you and hangs up the telephone.

What do you do now? You can’t turn to the police, because police services are part of government, which doesn’t exist. You can’t take the person to court, because the court system also is a part of government.

You can see the need for some institution to enforce contracts. In our society today, government stands ready to punish persons who break their contracts.

Who is better off and who is worse off with government standing ready to enforce contracts? Just about everybody is better off. Only the contract breakers are worse off, because they can no longer break their contracts without at least the threat of punishment.

Could the free enterprise system function without a government to enforce contracts? Most economists believe that it could function, but not nearly as well as it does now. Instead, it would be severely crippled. Without government to enforce contracts, economists argue, the risk of going into business would be too great for many people. (Would you go into business if you knew people could break their contracts with you and not be punished?) Only a few people would assume the high risks of producing such items as television sets, houses, cars, and computers. The economy would be much smaller. Some economists believe that
A free enterprise system will be a large, thriving economy when government acts to enforce contracts and a small, sluggish economy when it does not.

**Government as Provider of Nonexcludable Public Goods**

Goods are categorized as two major types: private goods and public goods. A **private good** is a good in which one person’s consumption takes away from another person's consumption. For example, an apple and a computer are both private goods. If Micala takes a bite of an apple, then much less of the apple is available for someone else to consume. If Bill is working on the computer, then Janey cannot also be on the computer; in other words, Bill’s use of the computer takes away from Janey’s use of the computer.

In contrast, a **public good** is a good in which one person’s consumption does not take away from another person’s consumption. A movie in a movie theater and a lecture in college are public goods. If the movie is showing in a theater, then the fact that Vernon is watching the movie does not detract from Xavier’s watching the movie. Both men can view the same movie to the same degree. If a teacher in college is lecturing on biology to 30 students, one student’s consumption of the lecture does not take away anything from any other student’s consumption.

Not all public goods are alike, however. They might be **excludable public goods** or **nonexcludable public goods**. A public good is **excludable** if individuals can be excluded (physically prohibited) from consuming it. A public good is **nonexcludable** if individuals cannot be excluded from consuming it.

**Excludable Public Goods**

Again, consider the movie in the theater. It is an excludable public good, because movie theater owners can (and do) prevent people from watching the movie. If you go to the movie theater and choose not to pay the ticket price, then the theater owner will not
In another way, however, national defense is not like a movie or a lecture. The seller of a movie and the seller of a lecture can each exclude people from consuming what they have to sell, but the producer of national defense cannot exclude people from consuming the good it produces. The U.S. government cannot exclude anyone in the United States from consuming its national defense because it is physically impossible, or prohibitively costly, to do so.

For example, suppose an enemy's missiles are headed for the United States. The U.S. government decides to take action and fire on the incoming missiles. When it fires and destroys the incoming missiles, it protects Yang, who lives in a rather large city, and it is also (automatically) protects many other people. It cannot be any other way.

To make the matter even more stark, suppose that one of the spies of the country that launched the attack against the United States lives in the same city as Yang. The U.S. government may not want to protect this spy from the incoming missile attack, but it is physically impossible to protect some people and not others.

**Who Will Produce Nonexcludable Public Goods?**

Economists contend that in a free enterprise economy, people will be willing to produce private goods and excludable public goods, but no one will want to produce nonexcludable public goods. Why not? Because once a nonexcludable public good is produced, no one will pay for it. People will not pay for something they cannot be excluded from consuming.

Suppose a company builds a dam to stop the flooding on people's lands. After the dam is built, representatives of the company ask the people if they want to buy the dam's services (flood prevention). Each person says, "The dam is already in place. I am benefiting from it, and there is no physical way you can exclude me from benefiting from it. So why should I pay?" Economists call persons who receive the benefits of a good without paying for it free riders.
People know that they usually cannot get others to voluntarily pay for a nonexcludable public good, so they decide not to produce it. (Looking back, we can now see that the company that produced the dam in our example would probably never produce the dam in real life.) In contrast, though, people in a free enterprise economy will be quite willing to produce and offer to sell private goods and excludable public goods. First, all private goods are excludable. If you do not pay for an apple, computer, car, or book, then you do not get the good; you are excluded from it. If you do not pay for a movie or lecture, you do not get to consume these excludable public goods. In short, people in a free enterprise economy will produce those things that they can withhold from buyers if they do not get paid for producing them.

The Political Process

A free enterprise economy will produce private goods and excludable public goods, but it will not produce nonexcludable public goods. Suppose, though, that people still want nonexcludable public goods, such as national defense or flood protection. If the free enterprise economy will not produce these goods, who will?

The government will provide nonexcludable public goods and pay for them with taxes. Many economists argue that the government should provide nonexcludable public goods because no one else will. The framers of the Constitution recognized the legitimate role of government in providing nonexcludable public goods, such as national defense, in the Preamble:

We, the People of the United States, in Order to form a more perfect Union, establish Justice, insure domestic Tranquility, provide for the common defence, promote the general Welfare, and secure the Blessings of Liberty to ourselves and our Posterity, do establish this Constitution for the United States of America. (Emphasis added.)

You might wonder how people communicate to their government what nonexcludable public goods, and how much of these goods, it should provide. In the U.S. system of government, one way people communicate what nonexcludable public goods, and how much of these goods, they want is through the political process.

U.S. citizens have the right to vote, and they can influence what government does through the ballot box. For example, suppose the majority of the people want the U.S. government to provide less instead of more national defense. They will likely vote for politicians who voice this same preference and vote against politicians who do not share their preference. U.S. citizens also have the right to lobby their elected representatives directly, by writing letters or talking to the representatives in person.

As you know, scarcity prevents us from producing all the goods we want. How can you voice your opinion as to which nonexcludable public goods the government should produce?
Externalities

Suppose it is 3 a.m., and you are fast asleep. Suddenly, you awaken to the sounds of a radio blasting away. You get up, open the window of your bedroom, and realize that the loud music is coming from your neighbor’s house. Your neighbor is taking an action—playing the radio loudly—that has an adverse side effect on you. Economists call this adverse side effect a negative externality, or a negative third-party effect.

**Example:** The owners of a house rarely mow their lawn or cut their shrubbery. The people who live in the houses nearby complain that not only is this property not kept up and therefore unpleasant to look at, but the property also lowers the value of their own houses. One neighbor, who lives across the street, says, “I need to sell my house, but I’m going to have a hard time doing it because the people across the street don’t keep up their property. No one wants to live across from an eyesore. I will probably have to lower the price of my house before anyone will start to think about buying it.” Undoubtedly, the owners of the property that is not kept up are acting in a way that adversely affects their neighbors. The adverse side effect is a negative externality.

Externalities are not always negative. For example, Erica Richards is a beekeeper, who lives near an apple orchard. Erica’s bees occasionally fly over to the orchard and pollinate the blossoms of the apple trees, in the process making the orchard more productive. In this situation Erica takes an action—keeping bees—that benefits another person, the orchard owner. Because Erica’s beekeeping activity results in an externality that benefits someone else, it is referred to as a positive externality, or a positive third-party effect.

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**BY THE NUMBERS**

In the last chapter, we mentioned that the Wall Street Journal and the Heritage Foundation annually rank countries according to how much or how little economic freedom and free enterprise exists in a country. The rankings are on a scale of 1 to 5; the closer a country’s score is to 1, the more free enterprise it has. Here are the scores for the United States in the years 1995–2005. As you can see, the degree of free enterprise in the United States has not changed much during this period.

<table>
<thead>
<tr>
<th>Year</th>
<th>Score</th>
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<tbody>
<tr>
<td>1995</td>
<td>1.99</td>
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<tr>
<td>1996</td>
<td>1.94</td>
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<tr>
<td>1997</td>
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<td>2003</td>
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<td>2004</td>
<td>1.85</td>
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<tr>
<td>2005</td>
<td>1.85</td>
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</table>
Yolanda visits a physician and is inoculated against polio. Now she can be sure that she will not become sick with polio. Yolanda’s actions also benefit other people: People who come into contact with Yolanda are protected from getting polio from her. As far as the community as a whole is concerned, Yolanda’s inoculation against polio is a positive externality.

**Government and Positive Externalities**

Some people argue that education generates positive externalities. They say that when you attend school, you not only learn things that will directly help you in life and in the workplace, but you also become a better citizen and a more informed voter. Becoming a better citizen and a more informed voter ends up benefiting more people than just yourself.

Let’s analyze your own case. You are in high school taking this economics course. Because of the course, it is hoped, you will become more knowledgeable about economics issues than you would have been otherwise. One day, you are listening to two politicians running for the U.S. Senate from your state; they are debating some economics issues on television. One politician makes inaccurate statements on almost all the issues, while the other accurately portrays the economics issues. You decide to vote for the politician who is accurate on the issues, because you feel she will more likely end up promoting economic policies that are good for the United States.

Your informed vote increases (by a tiny percentage) the probability that the politician who understands economics will get elected. If she is elected, whom did you help? You helped yourself, no doubt, but you also helped all the other people who will now benefit by having a person knowledgeable about economics, instead of an uninformed person, shape government policy. In this case, your education produced a positive externality.

Some people argue that because your education can help other people, these other people ought to pay something for the benefits they derive from your education. One solution might be to have the members of society pay taxes to support the schools you attend. In other words, because the public benefits from your education and the education of other persons like you, it should pay toward that education. The public school system is a result of this thinking.

Persons who attend public schools do not directly pay for the education they receive (although they indirectly pay if their parents pay property taxes). Instead, their education is paid for with taxpayer money. That is, the education of public school students is subsidized. Some people argue that government should subsidize all of the activities that generate positive externalities for society at large.

**Government and Negative Externalities**

If you are on the receiving end of a negative externality—if you are awakened at 3 a.m. by loud music, or the smoke a factory is emitting is getting into your lungs—you will probably feel that negative externalities are bad. But what can be done? Some people argue that it is government’s duty to minimize the “bad” in society—in other words, to reduce the negative externalities.
Almost half the population of the United States lives in 39 metropolitan areas. Most of the people who live in those metropolitan areas have fairly long commutes to work. Although 13 percent of all commuters spend 45 minutes or more in their cars each day, it is not uncommon for many commuters in major metropolitan areas to spend 1 1/2 to 3 hours in their cars each day commuting to and from work.

Try to think of people spending 45 minutes or more each day driving to work as a business opportunity. How could an entrepreneur—a person who has that special talent for searching out and taking advantage of new business opportunities—respond to these commuters?

Some entrepreneurs realized that people who spend at least 45 minutes each day in a car have plenty of time to listen to a book being read to them, so they started producing books on tape. Listening to a book on tape has become an important part of the way many commuters pass their time. Also, a satellite radio in the car gives drivers much of what they want on a long drive—music without the interruption of commercials.

McDonald's, the fast-food franchise, responded to long commutes by making sure that its food can be eaten in a car. For example, McDonald's places its hash browns in a half-sized paper bag with the top sticking out so that drivers can eat with one hand and drive with the other. McDonald's also offers super-sized sodas with containers that fit easily into traditional car cup holders. Other fast-food franchises have started offering sandwiches in bread pockets or tightly wrapped paper so that drivers can easily and comfortably eat and drive without any mess.

The rush to produce a cell phone may have been motivated partly by the desire of entrepreneurs to come up with a product that people with long commutes were likely to buy. Other entrepreneurs have been coming up with new uses for the cell phone. For example, you can now take photos with a cell phone, as well as play music, watch a music video, play a video game, and check your e-mail.

As wages and salaries rise in real terms, the value of time rises, too. A person who earns $100 an hour finds that his or her time is more valuable than a person who earns $30 an hour. Entrepreneurs realize that when the value of time rises people want to economize on time. Microwave ovens, computers, and cell telephones are all products that help people reduce the time it takes to complete a given task. Can you think of other relatively new products that help people economize on time?

Government can do so in three principal ways: through the court system, regulation, and taxation.

The Court System Suppose a firm near where you live is emitting smoke and pollutants into the air. As far as you are concerned, the polluted environment is a negative externality. You think you should be able to breathe unpolluted air, so you sue the firm. Obviously, the firm will hire a lawyer to counter your suit. In the end, a court will decide who has the right to do what. In other words, does the firm have the right to emit smoke and pollutants into the air, or do you have the right to breathe unpolluted air?
Regulation Sometimes government creates regulations to deal with negative externalities. For example, most states require car owners to meet pollution standards, and government often limits the amount of pollution that factories can emit into the air. Government may also deem it illegal to dump chemicals into rivers and lakes.

Taxation Suppose a business firm is producing steel. As a by-product, pollutants are discharged into the air through a smokestack. Instead of imposing an environmental regulation on the steel-producing firm to clean up the air, government decides to impose a tax. For every ton of steel produced, the firm has to pay $100 in taxes.

As a result of the tax, the business firm will find it costlier to produce steel. The firm is likely to produce less steel, which means fewer pollutants discharged into the air. In other words, the tax on steel indirectly reduced the amount of negative externality (pollutants in the air) by making the production of steel more costly.

We have to be careful in our analysis, though. Taxation, like regulation, sometimes comes with unintended consequences. For example, let’s say that in year 1, the automobile industry pays no taxes. In year 2, government places a tax of $500 per car on the auto industry. In other words, for every new car a firm produces, it must pay the government $500 in taxes. Do you think the auto industry will produce more cars in year 1 or year 2? The correct answer is year 1, all other things remaining the same. Taxes of the sort described here raise the cost of producing and selling cars, and car firms react by producing fewer cars.

At this point, you might point out that fewer cars mean less pollution. This statement overlooks something important, though. Although fewer new cars are produced and purchased, people may simply drive their old cars longer, and old cars emit more pollution than new cars. Thus, the tax on the production of new cars reduces the number of new cars on the road compared to the number of old cars. In this case, if miles driven do not change, we can expect more, not less, pollution from cars. Taxation, like regulation, does not always have its intended effect.

Defining Terms
1. Define:
   a. free rider
   b. contract
   c. private good
   d. public good
   e. excludable public good
   f. nonexcludable public good
   g. negative externality
   h. positive externality

Reviewing Facts and Concepts
2. Identify each of the following as a public or a private good: (a) a pair of shoes, (b) sunshine, (c) a pen, (d) a pizza, and (e) national defense.
3. Why won’t a private business firm produce a nonexcludable public good?

Applying Economic Concepts
4. How are nonexcludable public goods paid for?
5. Explain how taxes can be used to deal with negative externalities.
6. Give an example of a setting in which a free rider is present.