

The Circular Flow of Resources, Goods, Services and Money Payments

One way of illustrating the overall operation of a market economy is through a *circular flow diagram* such as the one on this page. This diagram presents a highly simplified overview of how a market economy operates.

Owners of resources (families and individuals) supply the services of their land, labor and capital to business firms in exchange for money-income payments in the form of wages and salaries, rents, interest and profits. Owners of the resources in turn use these income payments to purchase the finished goods and services supplied by the business firms. Business firms then use the proceeds from these sales to pay the resource owners for the services the firms receive by employing the resources. This is how the circular flow of resources, goods and services, and money-income payments is established and maintained.

Payments in the lower part of the diagram, which is sometimes called the *factor market*, appear as income to the resource owners who sell productive services. But these same payments appear as costs to the business firms that buy productive services.

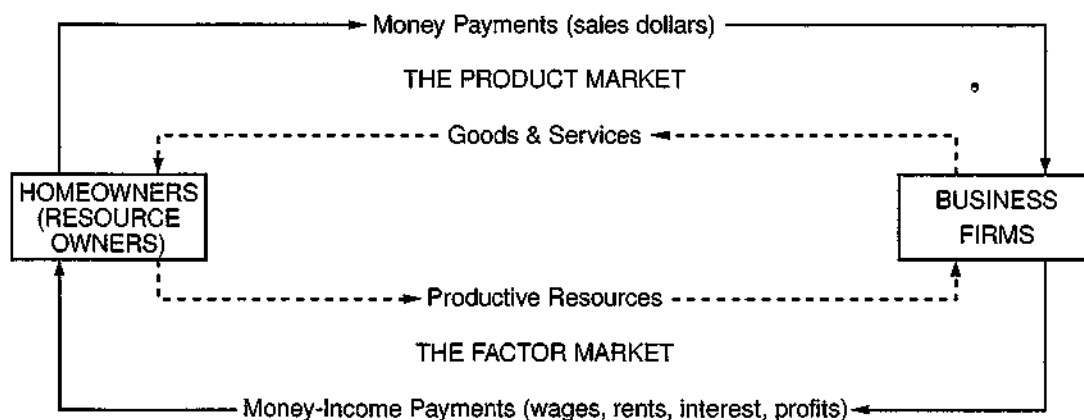
Likewise, payments in the upper part of the diagram, which represents the *product market*, appear as costs to the resource owners who buy goods and services, but these same payments appear as income to the business firms that sell goods and services.

An important point to emphasize is that all of the money payments shown in the diagram are determined by an interdependent set of markets. In a system of interdependent markets, every price depends to some extent on every other price. For example, the prices resource owners are willing to pay for finished goods and services depend on the prices (income) they receive for the use of their resources. The prices of resources, in turn, depend on how much business firms are willing to pay for the services the resources provide. The diagram shows that everyone's expenditure is someone else's income and that the interaction between the markets determines these flows.



Figure 5.1

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Adapted from National Council on Economic Education, *Master Curriculum Guide in Economics: A Framework for Teaching the Basic Concepts* (New York: National Council on Economic Education, 1993), p. 24.

Circular Flow Activity

1. Give three examples of resource owners.
2. Define a business firm.
3. What is the product market?
4. Give three examples of transactions you made this week in the product market.
5. What is a factor market?
6. Give an example of a transaction you or your family made this month in a factor market.
7. How are businesses connected to factor and product markets?

8. What determines the prices of land, labor, capital and entrepreneurship in a factor market?
9. Where do resource owners get the money to buy goods and services in the product market?
10. Where do business firms get the money to pay resource owners for their land, labor, capital and entrepreneurship in factor markets?
11. Why is it important to know that a market economy is characterized by interdependence?