**SSEMI1:** The student will describe how households, businesses, and governments are interdependent and interact through flows of goods, services, and money.

a. Illustrate by means of a circular flow diagram, the Product market; the Resource (factor) market; the real flow of goods and services between and among businesses, households, and government; and the flow of money.

**Overview:** Students will describe how each sector of the economy (households, businesses, and government) interacts with one another in markets. They will explain how each sector is both consumer and producer in order to create a circular flow of goods and services.

- Students will be able to read and interpret circular flow charts that show the characteristics of and relationships that exist among households, businesses, and governments. They will examine the product market and the resource market and explain how money acts as a medium of exchange within markets.

- The circular flow diagram illustrates the interactions between buyers and sellers in different markets. There are many versions of the circular flow diagram. The most basic circular flow diagram is the “two-sector” circular flow diagram. An example taken from the Economics EOCT Study Guide is shown below.
Households, in the Factor Market, are the owners of the productive resources (factors of production) in the circular flow model. They sell their land, labor, capital, and entrepreneurship to businesses (firms) in the Factor Market (Resources Market) in exchange for income payments. Households are represented by the supply curve in a Factor Market.

Households, in the Product Market, are consumers of goods and services in the circular flow model. They buy goods and services from businesses. They spend the income they earned in the Factor Market to buy these goods and services. Their spending is called “expenditures” which is just a fancy word for spending. Households are represented by the demand curve in the Product Market.

Income payments are money payments earned by households in exchange for their productive resources. Rent is the income payment earned by providing land to businesses. Interest is the income payment earned by loaning money for capital purchases by businesses. Wages and salaries are the income payments earned by selling labor and human capital to businesses. Profits are earned by households that act as Entrepreneurs in the economy.
- **Businesses (firms) in the Factor Market** are the consumers of the productive resources (factors of production) in the circular flow model. They purchase the use of land, labor, capital, and entrepreneurship from households in the Factor Market (Resources Market) using the revenue they earned in the product market. Businesses are represented by the demand curve in a Factor Market.

- **Businesses (firms) in the Product Market** are producers of goods and services in the circular flow model. They sell goods and services to households. They earn revenue in exchange for their goods and services. Businesses are represented by the supply curve in the Product Market.

- **Revenue** is a money payment to businesses by households in exchange for the goods and services households purchase. Revenue is equal to the price of the product times the quantity of goods and services sold at that price. All businesses that sell goods and services earn revenue. Revenue is not the same as profit.

- **Profit** is a payment to entrepreneurs if there is any revenue remaining after all costs of production/operation have been paid. Profit is equal to Total Revenue minus Total Costs. There are two types of profit discussed in microeconomics: Accounting (Normal) Profits and Economic Profits. Accounting profit is equal to Total Revenue minus “out of pocket” (or Explicit) costs for the business. Economic profit is equal to Total Revenue minus explicit costs plus opportunity costs. For example, if James left his job as a chef in a restaurant to open his own restaurant, an economic profit would not exist until he had covered his new restaurants expenses plus his old salary as a chef in someone else’s restaurant.

- **Government** is the third sector mentioned in this element of Standard One. Although the EOCT resources do not show a circular flow model with government included, the element suggests that students will need to know the government’s role in the model.

- **Government** is a consumer in both the factor and product markets and is represented by the demand curve in both markets. It makes income payments to household in exchange for productive resources and it pays businesses revenue in exchange for their goods and services. The government makes these money payments using tax dollars collected from both household and
businesses. The government may sometimes borrow funds to make purchases. In addition to purchases of resources and products, the government uses tax dollars to provide **Public Goods and Services** to households and firms as well as **Transfer Payments**.

- **Public Goods and Services** are provided by the government at little or no direct charge to households and businesses. They are usually provided by government because there is little or no profit incentive for businesses to produce them in the free market. Examples of public goods would be roads and national defense. Review fundamentals standard five element (a) for more on public goods.

- **Transfer Payments** are money payments made by governments to households and/or businesses without receiving any goods, services, or factors of production in exchange. For households, transfer payments may include social security payments, unemployment compensation, welfare payments, etc. For businesses, they may take the form of subsidies to farmers so they can compete in world markets at a lower price or as an incentive to become more energy efficient.

- Why is the **Circular Flow Model** a circle? The model is a circle because households must earn income before they can purchase goods and services. Businesses rely on households to make purchases of goods and services to receive revenue. Income earned by households in the factor market becomes revenue for firms in the product market.

**Important Note about Circular Flow Diagrams:** There are many different versions of the circular flow diagram. The markets and the sectors can be in different places on different versions. The key issue is the arrow labels. They must place the correct labels on the arrows no matter where they are located.