# Circular flow model

Economics

The circular flow model reflects the flow ofmoney, goods and services throughout the economy. This model is composed of households and business firms and it divides the markets into two categories, Product Market and Factor Market. In the Product Market, the households consume and purchase the goods and services that are sold by the business firms, creating exchange of currency (dollars) between the households who are receiving a finished product and the business firms who are making a profit.

If the circular flow model did not have the Factor Market to complete the circular cycle, all the money in the economy would be kept by businesses and all the finished products would be kept by households. This would put a stop to the economy. The Factor Market completes the flow of money in which the role of households and firms is switched compared to the Product Market. In order to have a finished product, firms require labor, capital, real estate and more. Households can be thought of as sellers in this case as they provide the labor, capital and other factors of production to firms.

In exchange for the use of factors of production, firms compensate households with salaries and wages. As the Product Market and Factor Market combines, a closed loop of the flow of money becomes evident. The loop allows the flow of income, preventing the households or business firms to keep all of the money which results in continued economic activity that is sustainable in the long run. It is important to note that firms use factors of production to produce finished products which households consume in order to provide factors of production.

The government also plays a key role in the circular flow model by intervening between firms, households and the markets. The government collects taxes from households which reduces the expenditures on goods and services. The government also regulates and collects taxes from firms. The collection of taxes funds government spending which can be in the form of infrastructure, welfare payments, and collective services, all of which contribute to GDP growth.

The detailed model of incomes and expenditures looks at GDP in a different way by dividing it into two sides: demand (expenditures) and supply (income). With limited exceptions, the total value of market incomes must equal the total value of expenditures because every dollar spent on output becomes a dollar of income for someone else. This is a simplified version of the circular flow model where the spending that flows into the Product Market gets funneled into the Factor Market. In other ords, resources are used to produce the goods that people consume. Also read about Open-access Goods

Consequently, the expenditure gets transferred to business owners, landlords, and other resource owners. Excluding taxes and depreciation, the spending on outputs becomes income to factors of production. Outputs are comprised of familiar components of the GDP such as consumption, investment, government spending and net exports (exports less imports). Income can be in the form of wages to workers, profits to corporations, interest to a lender or rent to a landlord.

None of funds used in the production of products are misplaced. Furthermore, it is important to note that the amount of income generated depends on the production and expenditures of firms, consumers and the government. Both the circular flow model and the income and expenditure model describe economic activity in a different way. However, each of these models gives equal importance to the role of consumers, firms and government and the interaction between them in overall economy.