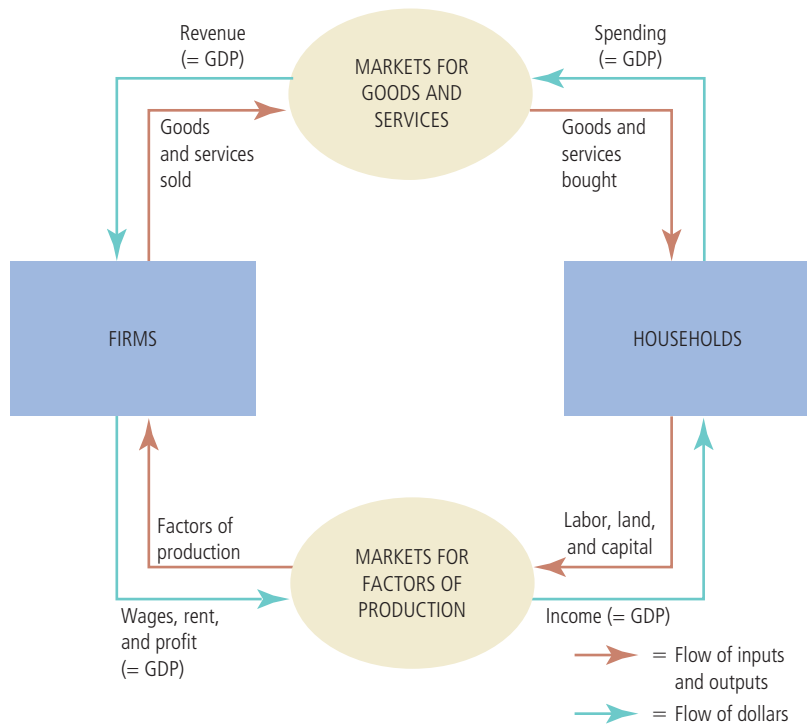


Figure 1

The Circular-Flow Diagram

Households buy goods and services from firms, and firms use their revenue from sales to pay wages to workers, rent to landowners, and profit to firm owners. GDP equals the total amount spent by households in the market for goods and services. It also equals the total wages, rent, and profit paid by firms in the markets for the factors of production.



contributes equally to the economy's income and to its expenditure. GDP, whether measured as total income or total expenditure, rises by \$100.

Another way to see the equality of income and expenditure is with the circular-flow diagram in Figure 1. As you may recall from Chapter 2, this diagram describes all the transactions between households and firms in a simple economy. It simplifies matters by assuming that all goods and services are bought by households and that households spend all of their income. In this economy, when households buy goods and services from firms, these expenditures flow through the markets for goods and services. When the firms in turn use the money they receive from sales to pay workers' wages, landowners' rent, and firm owners' profit, this income flows through the markets for the factors of production. Money continuously flows from households to firms and then back to households.

GDP measures this flow of money. We can compute it for this economy in one of two ways: by adding up the total expenditure by households or by adding up the total income (wages, rent, and profit) paid by firms. Because all expenditure in the economy ends up as someone's income, GDP is the same regardless of how we compute it.

The actual economy is, of course, more complicated than the one illustrated in Figure 1. Households do not spend all of their income; they pay some of it to the government in taxes, and they save some for use in the future. In addition, households do not buy all goods and services produced in the economy; some goods and services are bought by governments, and some are bought by firms that