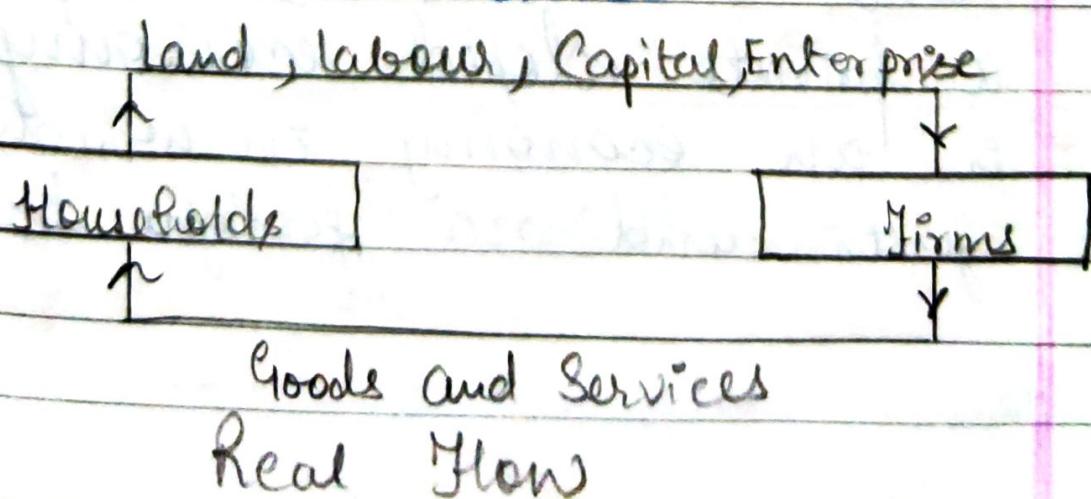


CIRCULAR FLOW OF INCOME

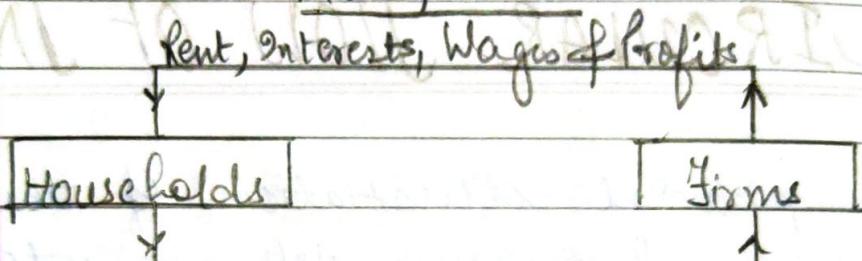
A pictorial illustration of the interrelationships between different sectors of economic activities is called circular flow of Income.

1. Real Flow - Real Flow implies the flow of factor services from household to firms and goods and services from firms to households. In short real flow consists of -
- Factor Flow , flow of factor services
 - Product Flow , i.e , flow of goods and services



2. Money Flow - The cycle of monetary payment from firms to the households for their factor services and in turn the monetary payment from households to the firms against their goods and services is known as Money Flow.

Money Flow



Monetary payment for goods & services

Forms / Models of Circular Flow of Income

1) Circular Flow of Income in a Two Sector Economy

The two sector model means only two sectors in the economy (Households and Firms sector). It represents a private closed economy. It is an economy in which no govt. and no foreign trade.

(i) Two Sector Economy Without Savings -

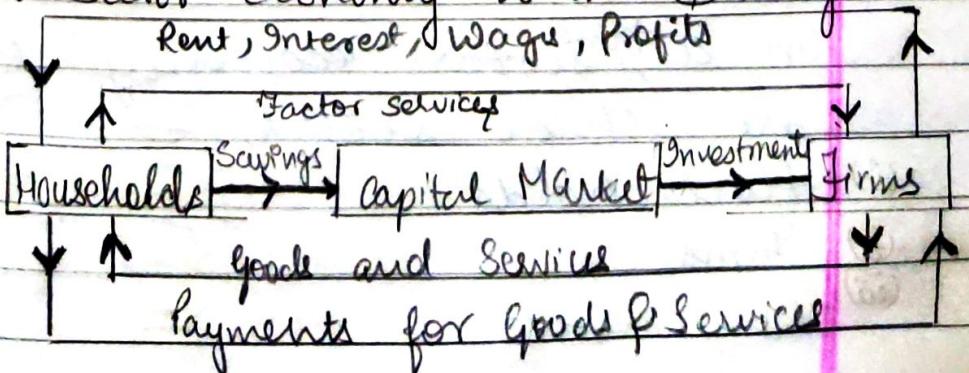
Households are the ~~own~~ owners of all factors of production and consumers of goods and services.

Firms produce and sells goods and services to the households.

Assumptions -

- There are only two sectors
- Household sector are the owners of FOP (Factor of Production) and supply goods factor services to the firms.
- Firms produce goods and services and sell their entire output to the household.
- Household receive income for their factor services and spent entire income on consumption.
- No savings in the economy.
- There is no government sector.
- There is a closed economy.

(ii) Two Sector Economy with Savings:



In the real world economy whole of the income is not spent on consumption rather a part of it is saved. All the savings made by the households are deposited in the capital market and from the capital market these savings return to the firms for investment.

Conditions for equilibrium

$$S = I \quad (C + S = C + I)$$

where,

S = Savings

I = Investments

C = Consumption

(iii) Three Sector Economy (Govt.)

Circular Flow of Income in a Three Sector Economy

In a three sector economy there are three sectors -

(i) Households

(ii) Firms

(iii) Government

In this model activities of the govt. also influence the flow of income. Government activities are classified into two categories -

- government revenue
- government expenditure.

a) Government Revenue (Govt. receive income from taxes of many types)

- Taxes on Household (T_1) for ex- Income tax, excise duty, Sales Tax
- Taxes on Companies or ~~Corporation~~ Tax (T_2)

Thus,

$$T = T_1 + T_2$$

b) Government Expenditure

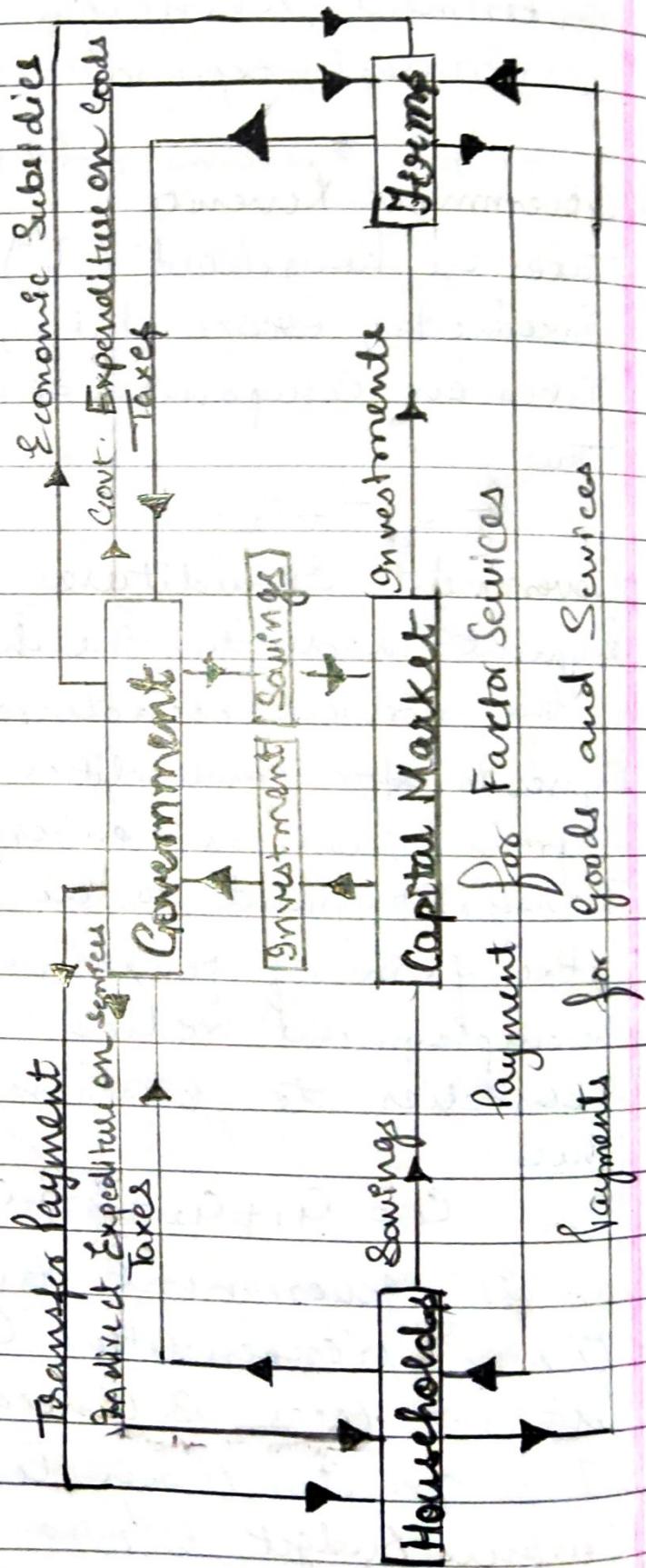
- Payment made to the households for the services rendered by them (G_1)
- Payments for commodities purchased from business enterprise (G_2)
- Transfer payment to the household in the form of pension, scholarship, unemployment relief (G_3)
- Subsidies to business firms (G_4)

Thus

$$G = G_1 + G_2 + G_3 + G_4$$

If government tax revenue (T) and expenditure (G) are equal it is called Balanced Budget or if T is greater than G , it is called Surplus Budget whereas if $T < G$

Tax revenue is less than govt. expenditure then it is called deficit Budget.



Conditions for Equilibrium

$$C + S + T = C + I + G$$

where

C = Consumption

I = Investment

S = Savings

G = Expenditure

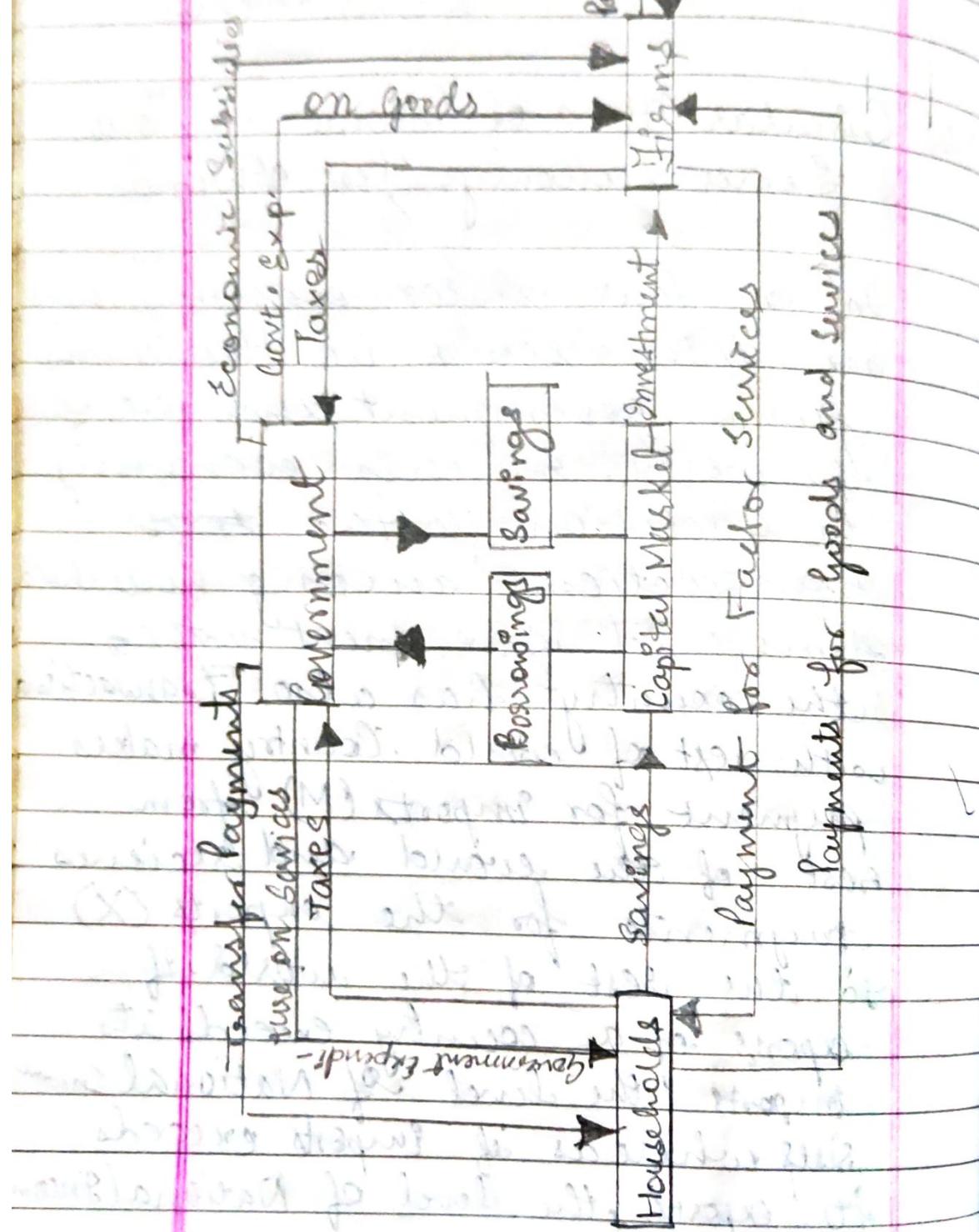
T = Tax Revenue

(iv) Circular Flow of Income in Four Sector Economy: (Rest of World)

In a four sector economy there are four sectors i.e Households, firms, government and rest of the world. In this economy in addition to the ~~tran~~ transactions among household, firms and government sectors, the country has also transactions with rest of world. Country makes payment for imports (M) from rest of the world and receives payments for the exports (X) to the rest of the world. If exports of a country exceeds its imports the level of National Income will whereas if imports exceeds its exports, the level of National Income

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goes down.



Condition for Equilibrium

$$C + S + T = C + I + G + (X - M)$$

where,

C = Consumption

G_{govt} = Government expenditure

S = Savings

X = Exports

T = Tax Revenue

M = Imports

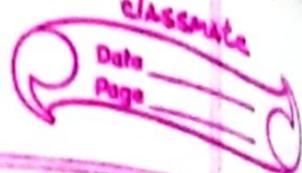
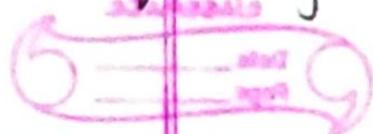
If $X - M$ is positive then there is inflow of money in the country whereas if it is negative there is outflow of money from the country.

Injections and Withdrawals

Injections - Injections are the amount of money that is added to the flow of income in the economy. Injections increase the size of income flows. It consists of following items-

1. Investments (I) -
2. Government spending (G) It includes govt. expenditure on services, on the purchase of goods, transfer payment and economic subsidies to business enterprises.
3. Exports (X)

Transfer Payments — no service is rendered



$$\text{Injections} = I + G + X$$

Withdrawals are the amount of money which are withdrawn from the flow of income. They are also termed as leakages. It reduce the flow of income in the economy. It consists of following items -

1. Savings (S)

(i) House hold's Savings

(ii) Firm's Savings

(iii) Government Savings

$$[S = i + ii + iii]$$

2. Imports (M)

3. Taxes (T) ^{on households} paid by ^{to} and on companies.

Thus,

$$\text{Withdrawals} = S + M + T$$

Condition for Equilibrium

Withdrawals = Injections

$$S + M + T = I + G + X$$

Significance

- Measurement of national income - National income is an estimation of aggregation of any of economic activity of the circular flow. It is either the income of all the factors of production or the expenditure of various sectors of economy.
- Knowledge of interdependence - Circular flow of income signifies the interdependence of each of activity upon one another. If there is no consumption, there will be no demand and expenditure which in fact restricts the amount of production and income.
- Unending nature of economic activities - It signifies that production, income and expenditure are of unending nature, therefore, economic activities in an economy can never come to a halt. National income is also bound to rise in future.
- Injections and Leakages