

UNIT-6

- a. Circular flow of income and expenditure in two sector, three sector and four sector economy.

What is Economy?

- The economy is **the total of all activities related to the production, sale, distribution, exchange, and consumption** through limited resources by a group of living and operating within it.

- **How does Economy Work?**

We can simply understand economy how it work by the circular flow of income and expenditure, which are directly determined by the level of aggregate economic activity in the economy.

Circular flow of income and expenditure can be measure in different economic sectors: **2 sectors, 3 sectors and 4 sectors economy.**

Circular flow of income and expenditure in a closed and open economy

The circular flow of the income and expenditure is the continuous circular manner of an economy.

Consumption, Saving, investment, taxation, export import etc. are the major components of national income and expenditure which flows in circular manner.

The circular flow flows in such a manner that national income equals to national expenditure.

The circular flow of income and expenditure are directly determined by the level of aggregate economic activity in the economy. Circular flow of income and expenditure can be measure in different economic sectors:

a) Closed economy: The economy which has no international trade is called closed economy: no export and no import in an economy, which can be divided into two type

(i) Circular flow of income and expenditure in a *two-sector economy*

(ii) Circular flow of income and expenditure in a *three-sector economy*

(b) The economy which consists of household sector, Business sector, government sector and foreign sector is called open economy. In open economy 4 sector circular flow of income and expenditure can be found.

Circular flow of income and expenditure in a *four-sector economy*



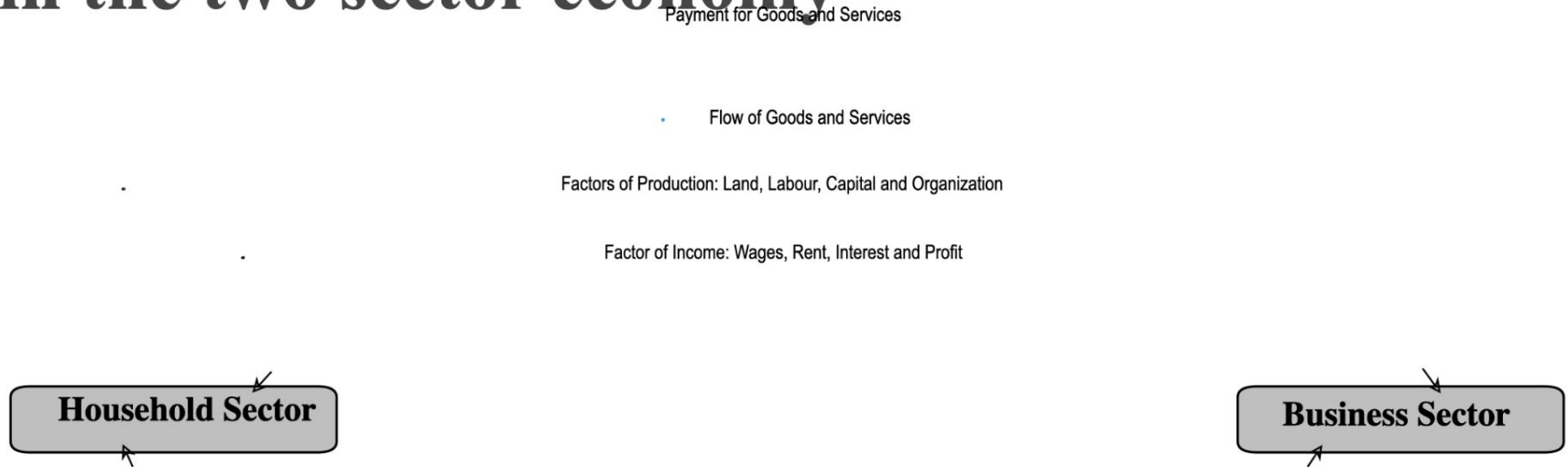
Closed Economy: Circular flow of income and expenditure in a Two-Sector Economy

A two-sector economy consists of only **household sector** and **business sector** in a close economy, where household sectors own all the factors of production in different forms, like land, labour, capital and organization.

Assumptions

- There are only **two sectors** in the economy i.e., the households and business.
- **Households** are the **owners of factors** of production and **business firms hire factors** from the households.
- **All income is spent** on consumption.
- There is **no government** intervention.
- Supply of capital and **technology** remain **constant**.
- All **prices** remain **constant**.
- It is two-sector **close economy** without export and imports.

Figure: Circular flow of Income and expenditure in the two sector economy



Closed Economy: Circular flow of income and expenditure in a Three-Sector Economy

If we add the government sectors' activities in two sectors economy then three sector economies become as closed economy model. Three sector economy consist of household sector, business sector and government sector. In this model, we have to add the taxes and government purchases. Taxation is a leakage from circular flow and government purchases are injections in to the circular flow.

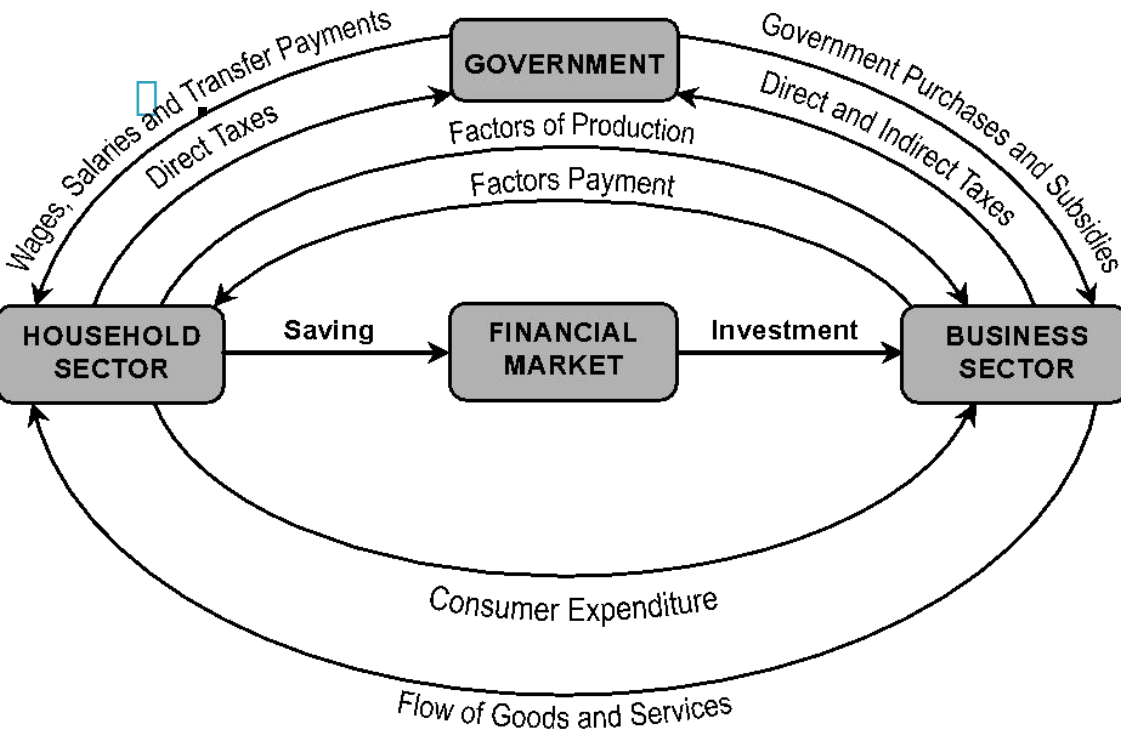
Assumptions

- There are only three sectors in the economy i.e., the households, business and government.
- Perfect competition in the market.
- There is government role.
- Government impose taxes and provides subsidies both household and business sector.
- Household sector pays only direct tax to the government but business sector pays both direct and indirect tax.
- It is three-sector closed economy without export and imports.

Contd.

On the basis, of above assumptions, we can illustrate circular flow of income and expenditure in closed economy in the following diagram:

Figure:



shows circular flow of income and expenditure in the three sector closed economy, where there are household, business and government sectors. In the half of the figure, households are paid for their factor services and government receives direct taxes from the households. Similarly, government imposes both direct and indirect taxes from the business firms.

Open Economy: Circular flow of income and expenditure in a Four-Sector Economy

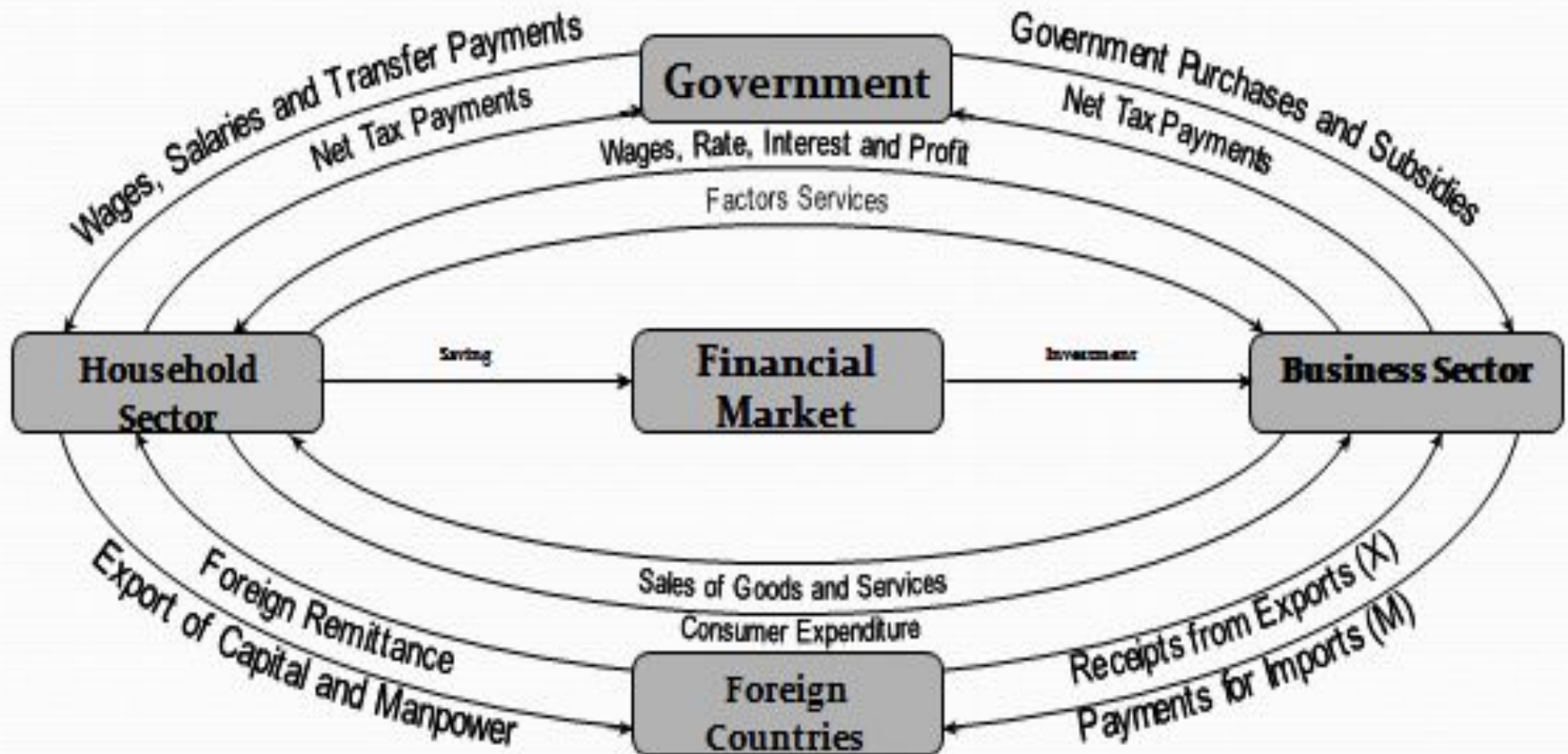
The four-sector economy, which is also called open economy, is formed by adding foreign sector to the three-sector economy. Four-sector economy consists of household sector, business sector, government sector and rest of the world sector. It is called an open economy, because it has trade relations with foreign countries and attached economy with world through trade openness. In this economy, foreigners interact with the domestic households and firms through exports and imports of goods and services.

Assumptions

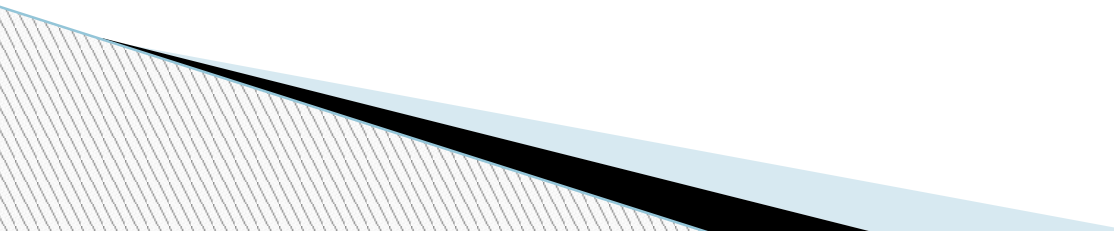
- There are four sectors in the economy i.e., the households, business, government and foreign.
- Perfect competition in internal and foreign market.
- There is minimum government role.
- There is well managed financial market.
- Household sector export only labour and capital.
- It is open economy with export and imports.

Open Economy: Circular flow of income and expenditure in a Four-Sector Economy

On the basis of these assumptions, we can illustrate circular flow of income and expenditure in the following diagram.



Explanation of figure:

- This figure shows the lower half of the circular flow shows circular flows of money in respect of foreign trade. Exports, as an injection to the economy, make goods and services flow out of the country and make money flow into the country in the form of export earnings. Similarly, imports as the withdrawals from the circular flows, make flow of goods and services in and flow of foreign exchange out of the country. Another flow is generated by the export of factor services, (especially, labor and capital) by the households.
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If you have any Queries,

Ask me.....

Thank you

