

# National Income Accounting

## Circular flow of Income

### Sectors of an Economy

- a) Household Sector - Cons.
- b) Firm (Producing Sector)
- c) Government Sector
- d) Rest of the World (Foreign Sector) R.O.W





The circular flow of income and product is the flow of goods and services among different sectors of the economy. (Household sector, Producing sector, Government Sector & Foreign Sector).

When we talk about only Household and producing sector, it is called TWO SECTOR economy Model. Also called Private closed economy model.

(Household Sector + Producing Sector = Two Sector economy )

Similarly,

Household Sector + Producing Sector + Govt. Sector = Three Sector economy Or closed Economy

Household Sector + Producing Sector + Govt. Sector + Rest of the World  
= Three Sector economy  
Or Open Economy

There is a flow of Income & Expenditure among these, Which is called 'Circular Flow of Income'.



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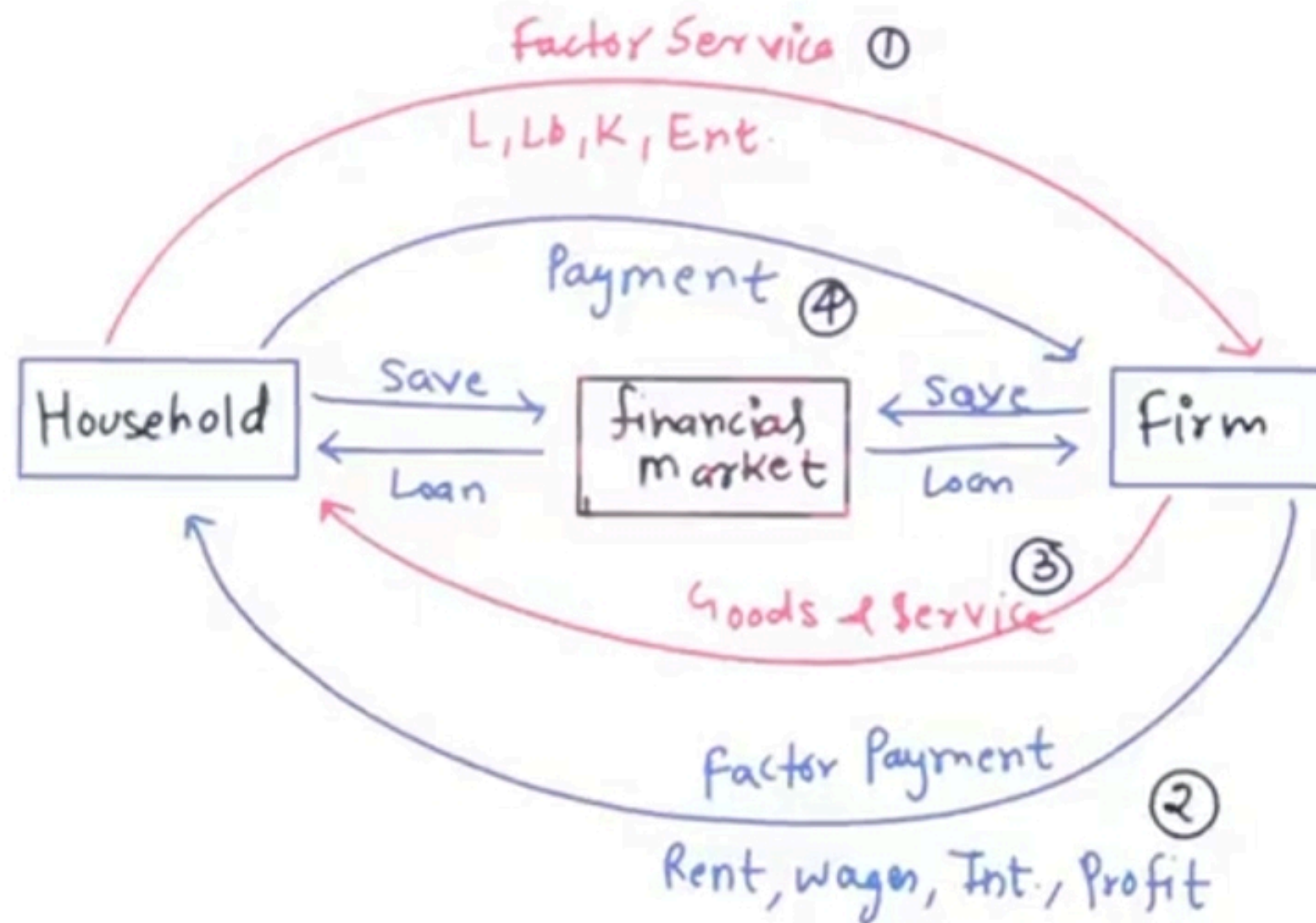
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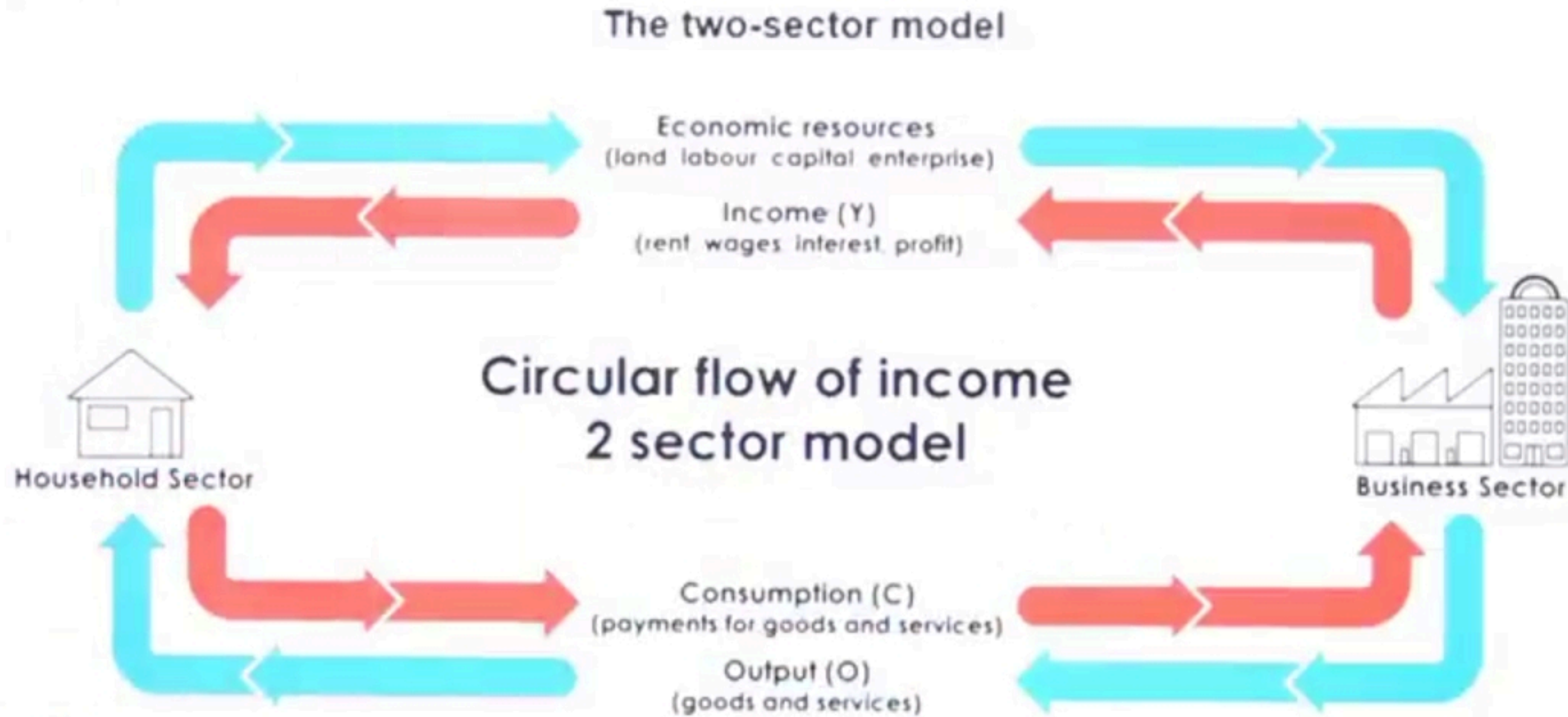
Household Sector + Producing Sector + Govt. Sector + Rest of the World  
= ~~Three~~ <sup>four</sup> Sector economy  
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# Circular flow of Income in Two Sector Economy





It is a model of private closed economy.

Circular flow of income in a two sector economy consists following assumption :-

1. There are only two sectors, i.e., household sector and firm sector in the economy.
2. Household sector is the owner of all the factors of production (Land, Labour, Capital & Entrepreneur).
3. Firm sector hire factor services from household for the production of goods and services.
4. Households sector spends entire income on consumption.
5. Firm sector sell all the products to household sectors.
6. There is no interference of government sector and external sector.



### Working of this model

All factors of production are owned by household sector. Therefore, firm sector hire factor services from households for the production of goods and services. As a reward of factor services from household, firm sector makes payment in the form of rent, wages, interest and profit to household which is called their factor income. This income is used by household on the purchase of goods and services. In exchange, firm sector sells whatever it produces to household sector for their consumption.

Households and firms interact in two types of markets.

In the markets for goods and services, households are buyers, and firms are sellers. In particular, households buy the output of goods and services that firms produce.

In the markets for the factors of production, households are sellers, and firms are buyers. In these markets, households provide the inputs that firms use to produce goods and services.