

CIRCULAR FLOW OF INCOME AND EXPENDITURE:

Two Sector and Multi Sector Models

Circular flow of Income and Expenditure refers to the pictorial illustration of the inter-relationship and interdependence between different sectors of the economy

The economy is a complex system consisting of millions of Producers and Households. There is a continuous flow of economic activities like Production, Consumption, Exchange and Distribution . Through these activities, income and expenditure are generated. Then income and expenditure flow continuously through different sectors of the economy.

To illustrate the flows of income and expenditure, an economy is divided into four sectors

- 1) Household Sector
- 2) Firms(Business sector)
- 3)Government sector
- 4)Foreign Sector

1.CIRCULAR FLOW in a Two Sector Model:-

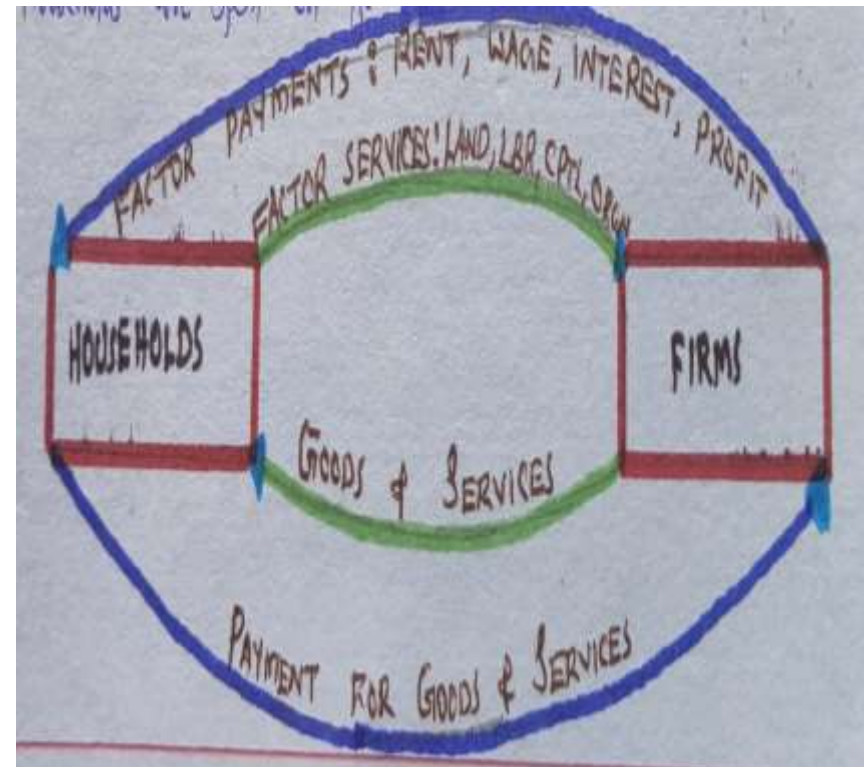
In a simple Two sector model, the two sectors are Households and Firms. Households own factors of production. They supply these factor services to firms and get factor payments in the form of rent, interest, wages and profit. This income is spent for buying goods and services produced by firms.

Simple Two sector circular flow model :

Assumptions

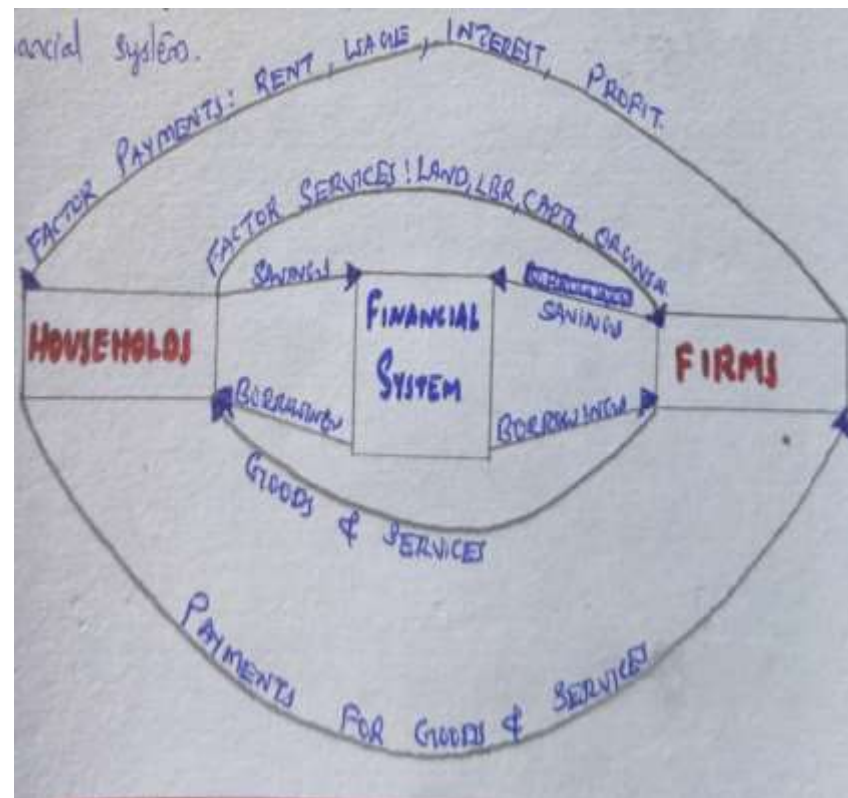
- 1) There are only two sectors in the economy- Households and Firms.
- 2) Households supply factor services and the firms buy factors of production from the Households.
- 3) Households spend their entire income on Consumption. I.e, no saving and no leakage from the income stream.
- 4) Firms sell their entire produce to the Households.
- 5) No Government.(Laissez-faire economy).
- 6) No foreign trade- Closed economy.

Firms hire the factor services of Households and produce various goods and services. They sell these goods and services to the Households.



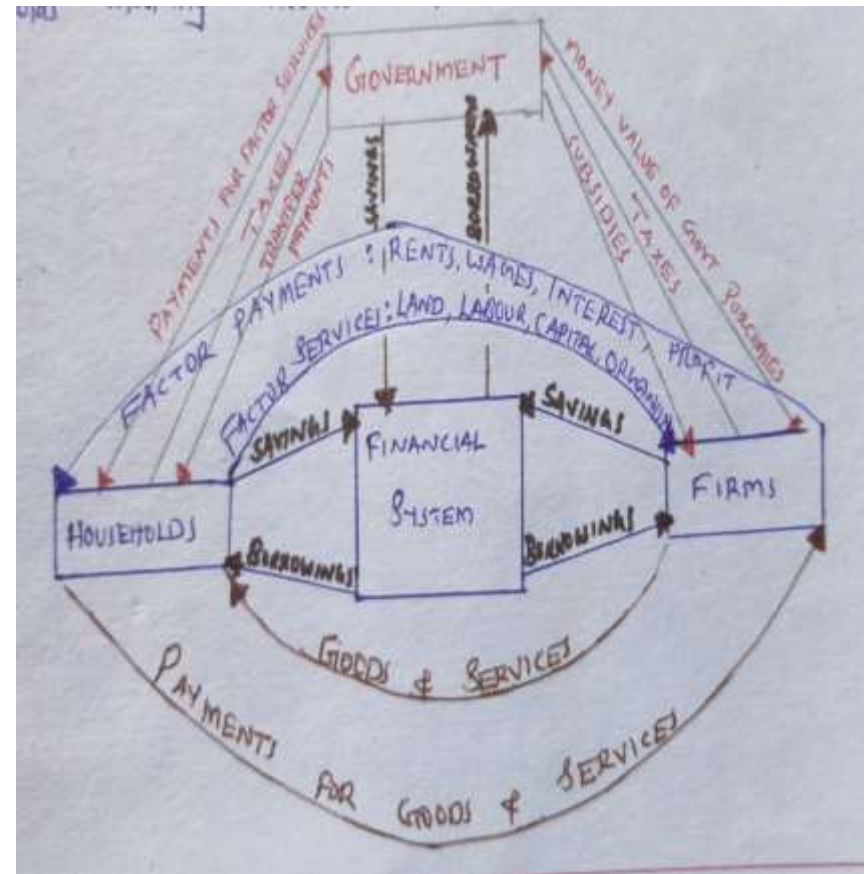
Two Sector Model with Financial system

Households may not spend their entire income on Goods & Services. They may save a part of their income. Unspent income is a Leakage from the economy. This saving is coming to the financial system or the capital market. Firms save to and borrow from the financial system. Like wise, Households also save and borrow from the financial system.



Circular Flow in a Three Sector Model (with Government)

The Government regulates economic activities and implements public welfare programmes. Thus, the Govt. interacts with firms and Households making Income- Expenditure flows more complex.



Circular Flow in a Four sector Model (with External Sector)

Modern economics are open economies. This brings in the external sector, also called the rest of the World sector. Now we have a four sector economy, consisting of Households, Firms, Govt. and external sector.

