Circular Flow of Income

The circular flow of income and expenditure refers to the process whereby the national income and expenditure of an economy flow in a circular manner continuously through time.

From the point of view of an economy, income of one person is expenditure of another. In other words, national income and national expenditure are always equal.

The various components of national income and expenditure such as saving, investment, taxation, government expenditure, exports, imports, etc. An economy is divides into four sectors:

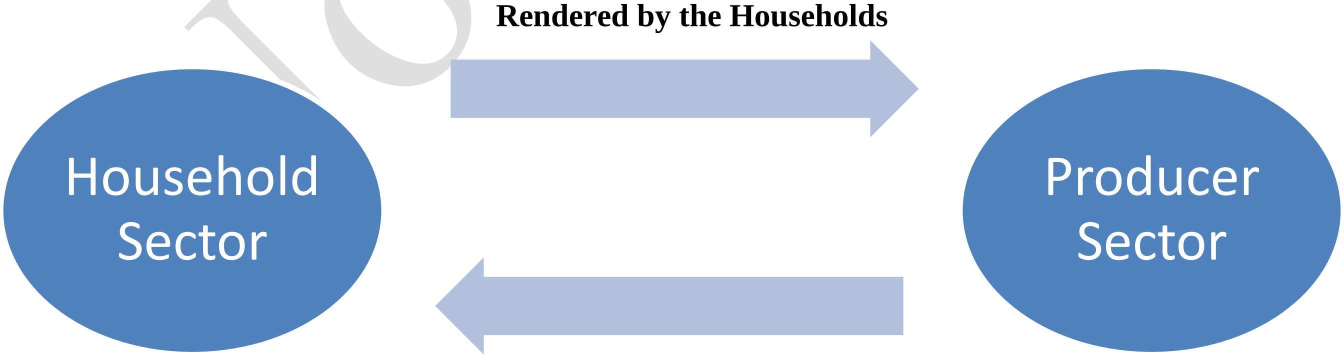
1) Household Sector
2) Producing Sector
3) Government Sector
4) Foreign Sector

Circular flow of income can be viewed from two different angles:

1) Real flow of income

These refer to the flows of goods and services. These are real because they consist of actual goods and services. When factor services (services of land, labor, capital, enterprise) flow from household to firms which require them for producing goods and services, these are called real flows. Similarly, when goods and services produced by firms flow from producing enterprises to households who buy them for satisfying their wants, these are also real flows. Such flows are continuous and there is no beginning point or ending point in these flows.

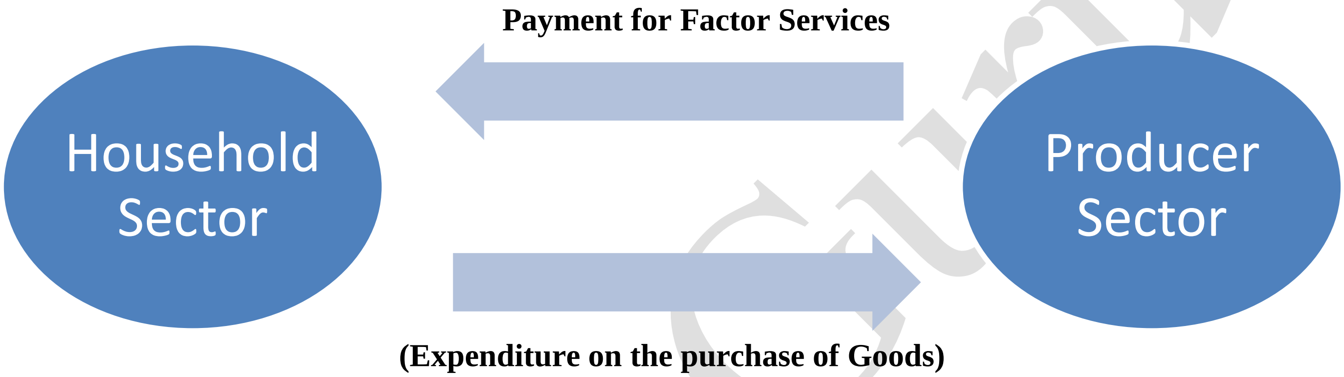
Factor Services (Land, labor, capital and entrepreneurship)
Rendered by the Households



Goods produced and sold by the firms

2) **Money flow of income:** These refer to the flows of money in the form of factor payments and consumption expenditure. The money flows occur since it is through money that various transactions are conducted. It is money that facilitates such transactions bringing flows of money from one sector to another.

   When factor incomes (rent, wages, interest and profit) flow from firms to households as rewards for their factor services, these are called money flows. Similarly, when households spend their incomes on purchase of goods and services and as result money flows back to firms, these also indicate money flows.



Circular Flow of Income in Different Sectors

Circular flow of income is analyzed under three different situation or three different sectors:

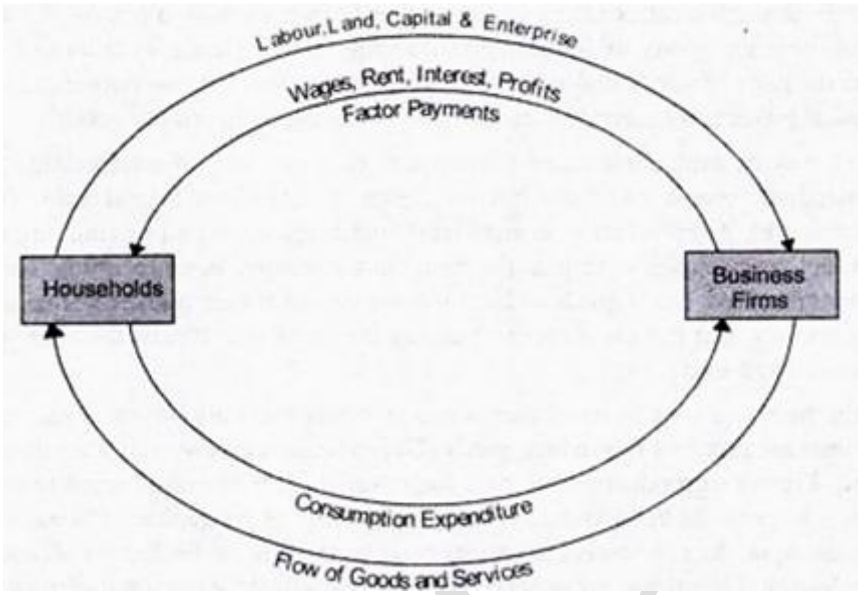
1) Two Sector Model:

Let us start with a simplified model involving two sectors, namely, household sector and firm sector, assuming that there is no government. We further assume that the economy is a closed one having no exports or Imports. Similarly, there is no saving by the households, who spend all what they earn; and no investment by the firms.

Such an economy has two types of markets—Product Market and Factor Market. Under these presumptions, the firm sector hires factor services from households who are owners of factors of production (land, labour, capital and enterprise) for producing goods and services and pays them remuneration (or compensation) in the form of money for rendering the productive services.

For the factors of production, these are factor incomes known as rent, wages, interest and profit which have been generated in the production process. Thus, money income flows from firm sector to the households. With this money, the households purchase from the firms, manufactured goods and services to satisfy their wants with the result that the same money flows back from households to the firm sector.

Thus, the entire income of the economy comes back to firms in the form of sale revenue. The counter flow of money from households to the firms leading to the circular flow of money between the two sectors is represented in the following diagram.



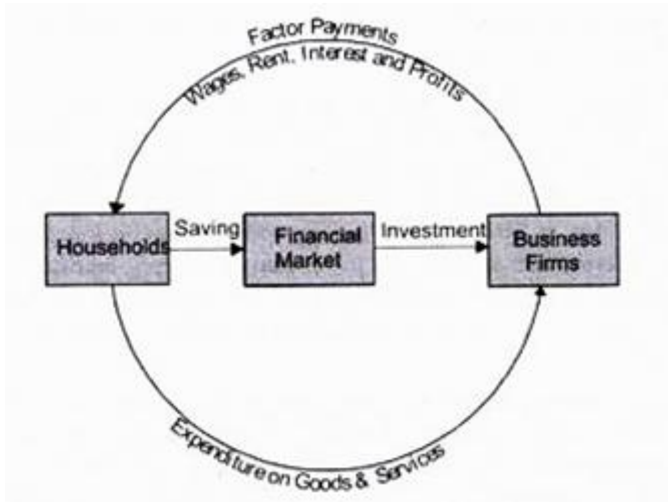
The outer circle represents real flow and the inner circle represents monetary flow. Real flow indicated that services of the factors flow from household sector to business firms and goods and services flow from business firms to household sector. Monetary flow expresses that rent, wages, interest and profit in terms of money flow from business firms to household sector. On the other hand, expenditure on consumption of goods and services in terms of money flow from household sector to business firms.

Here, **monetary receipts of the business firms = income of the households = consumption expenditure of the households**. In this way, the total demand of the economy will be equal to total supply. This position is called position of **Equilibrium**.

- **Saving and Investment in the Economy**

Financial institutions are primary intermediaries between savers and investors (or lenders and borrowers). All lendings and borrowings are channeled through capital market. In practical life, whatever is earned by the households is not spent on consumption goods.

A part of earning is saved and deposited in the capital market leading to money flow from households to the capital market. Similarly, firm also saves with the aim of meeting cost of depreciation and expanding its production capacity. Firms also borrow to finance their investment in plant and equipment. Thus, savings of the firms going to the capital market and borrowing by the former from the latter also create money flows as shown in the following diagram.

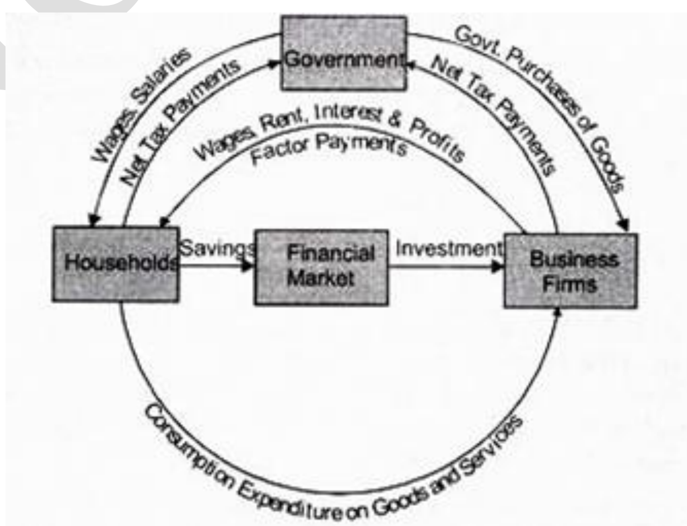


2) Three Sector Model:

We move further by introducing Government Sector which purchases goods from firms and labour services from households. Between households and the government, money flows from government to the households when the government makes transfer payments (like old-age pension, scholarships, etc.) and factor payments (for hiring services of factors of production) to the households. Money flows back to the government when it collects direct taxes (income tax, wealth tax) from the households.

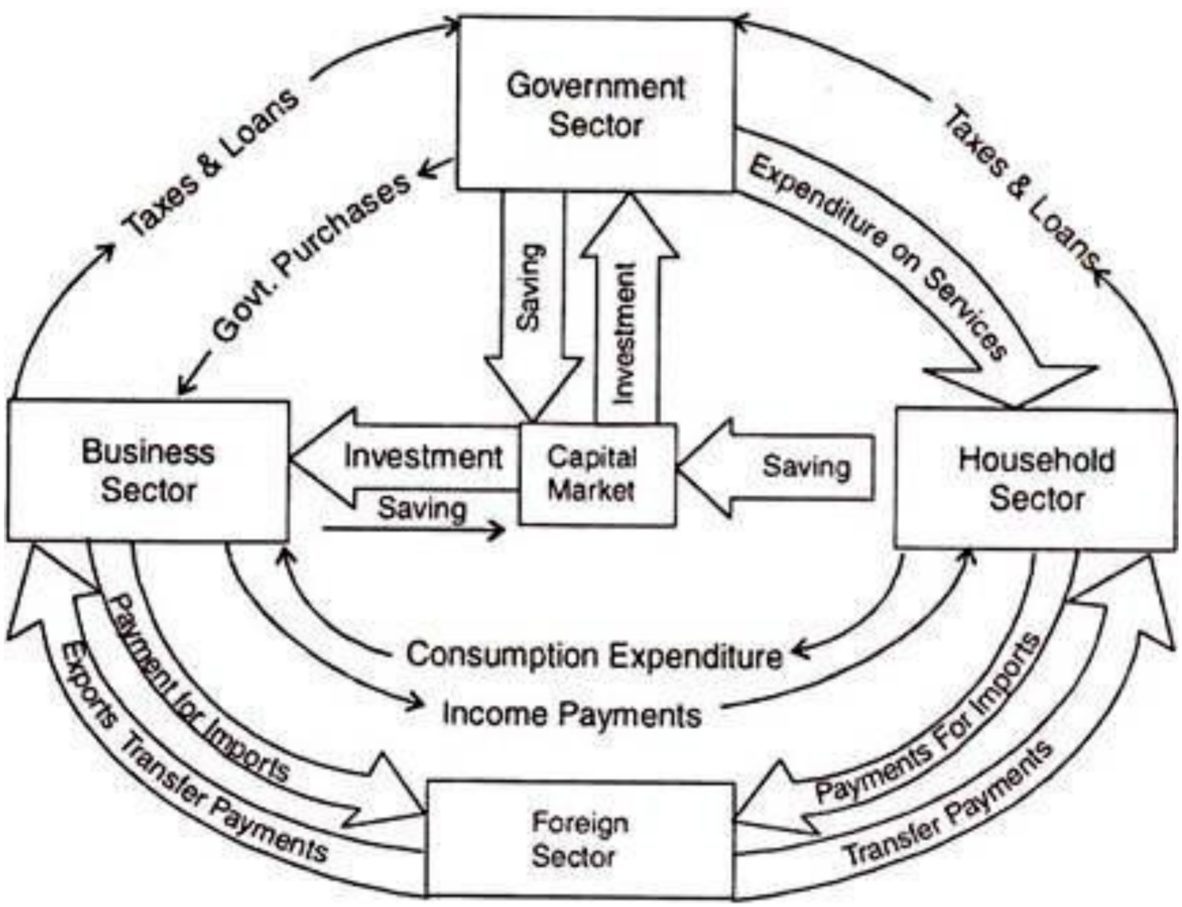
Similarly, there are flows of money between the government sector and the firm sector when government realizes corporate taxes from the firms, grants them subsidies (like land and electricity at cheap rates) and makes payment for the goods purchased by it.

A part of the government income is saved and deposited in the financial market. Government also takes loans from the financial market either to meet current expenditure or to invest the same in development projects.



3) Four Sector Model:

It is a complete model of circular flow of income. It studies the circular flow in an open economy. An open economy comprises of four sectors i.e. household sector, producing sector, government sector and rest of the world sector or foreign sector. There are no exports and imports in a closed economy. But it is an unreal situation. In reality every economy has four sectors. Circular flow of income in four sectors is explained below:



Circular flow of income in different sectors can be expressed in the following manner:

SECTORS	RECEIPTS	PAYMENTS
Household Sector	• Factor incomes from the producing sector like wages, rent, interest and profit. • Transfer payments from the government sector like old-age pensions, scholarships, etc.	• To producing sector for goods and services or consumption expenditure • Direct Taxes to the government sector • Savings into financial market

Producing Sector	• Income from household and government sector for goods and services • From rest of the world sector for exports • Borrowings from financial market • Subsidies from the government sector	• Factor payment to household sector for factor services • Taxes to the government sector • To rest of the world sector for imports • Savings to financial market
Government Sector	• Direct taxes from the household sector • Indirect taxes from the producing sector • Borrowings from financial market	• To producing sector for goods and services • Subsidies to producing sector • Transfer payments to the household sector • Surplus to financial market
Rest of the world sector	• From producing sector for imports by them	• To producing sector for exports by them
Financial Market	• Savings from household, producing and government sector	• Borrowings by producing or government sector

Leakage and Injections:

A leakage is the amount of money which is withdrawn from the now of income whereas injections are the amount of money that is added to the flow of income in the economy Thus, (i) savings, (ii) taxes by households and firms and (iii) import spending constitute a leakage from the circular flow of income (money).

On the other hand, (i) investment spending, (ii) government spending and (iii) export earnings become injection into the circular flow of income (money). For equilibrium at macro level leakage must be equal to Injections as equilibrium condition C + S = C + I Indicates S = I or Leakage = Injections.

Importance of Circular flow of income

- Study of Problems of Disequilibrium
- Effects of Leakages and Inflows
- Link between Producers and Consumers
- Creates a Network of Markets
- Inflationary and Deflationary Tendencies
- Basis of the Multiplier
- Estimate of National Income