Essentials of Economics II

Chapter 3: the circular flow of income

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Ferdowsi University of Mashhad

Spring Term 2024

What is the circular flow of income?

- The circular flow model of economics illustrates how money continuously circulates within an economy. It moves from producers to households as wages and then returns from households to producers when they spend money on goods and services. Essentially, an economy operates as an **unending loop** of money flow.

- This model helps us understand the interplay between different economic players, such as households and corporations. It breaks down the economy into sectors, including markets for goods and services and markets for factors of production.

- By tracking cash flows, we can measure a nation's income or gross domestic product (GDP). The circular flow model highlights the interconnectedness of these sectors, impacting everything from government policies to business sales. Funds continuously move between sectors, ensuring a well-functioning economy.

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Types of Circular Flow of Income

- **Real Flow:** Otherwise called as Product Flow or Output Flow, it implies the movement of factor services and, goods and services among different sectors of the economy. Thus, it comprises of:

Factor Flow
Product Flow

- **Money Flow:** Money Flow or Nominal flow involves the exchange of goods and services for money. Households provide factor services to the firm, in the form of land labour, capital and entrepreneur and get factor payments for the same, in terms of money. Now the money received is spent on buying goods and services produced by the firm.

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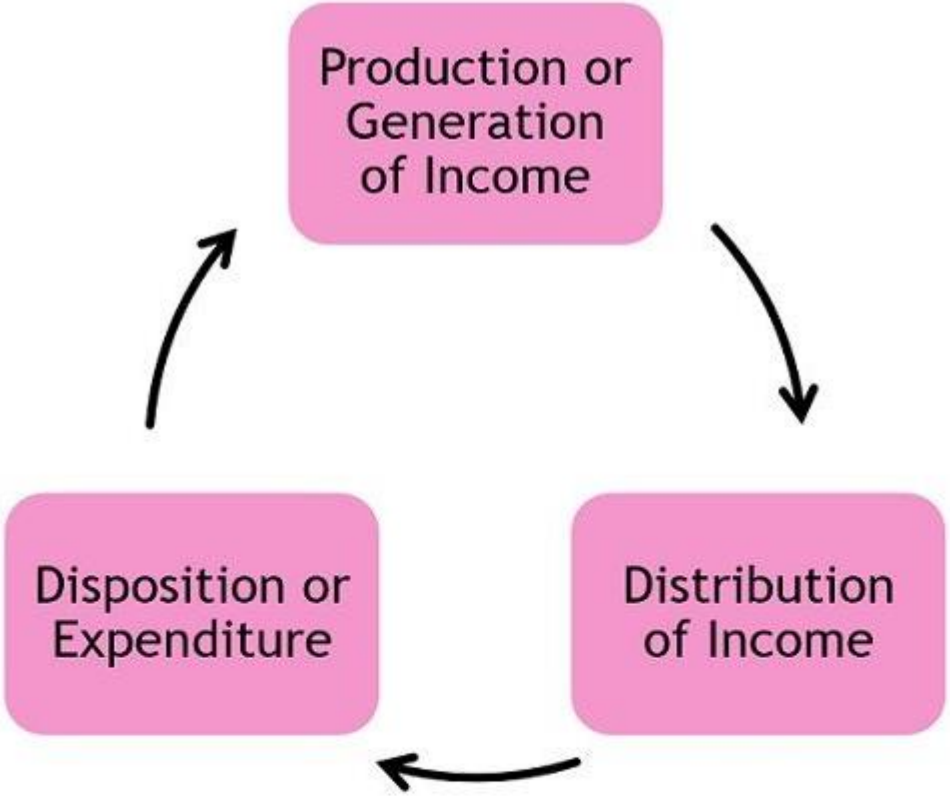
Phases of Circular Flow of Income



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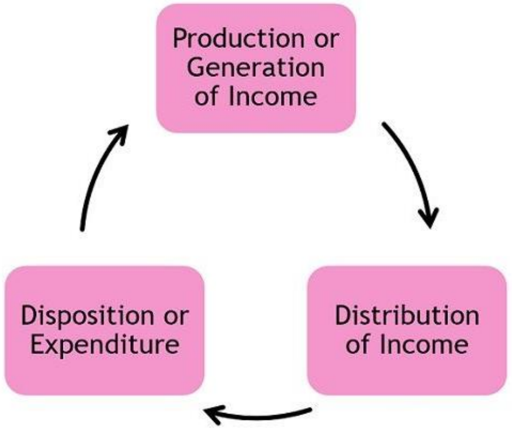

- **Production Phase:** In this phase, goods and services are manufactured by the firms, by making use of inputs, for the purpose of production of goods and services. As it leads to the generation of income, it is called a generation phase.
- **Distribution Phase:** In this part, the firm makes factor payments to the households, in the form of rent, wages, interest and profit, for the factor services provided by them. Hence, there is a distribution of income.
- **Disposition Phase:** Finally, the factor incomes received is invested in the purchase of goods and services for the purpose of consumption. Hence, there is the disposition of income in this phase.

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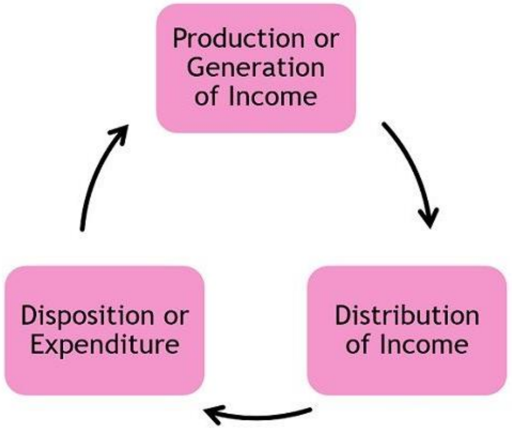

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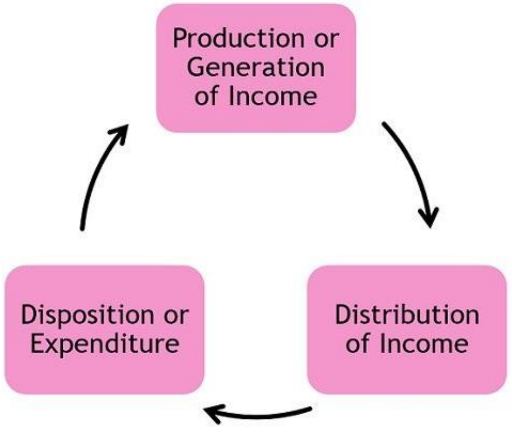

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Two-Sector Model

- The two-sector model: which is the most basic model containing only two sectors: individuals or households and businesses. In the two-sector model, it is assumed that households **spend all their incomes** as consumer expenditures and purchase the goods and services produced by businesses. Thus, there are **no** taxes, savings, or investments that are associated with other sectors.

Assumptions:

- The economy consists of two sectors: households and companies.
- Households spend all their income (Y) on goods and services or consumption (C). No save (S) is involved.
- All the output (O) produced by the firms is purchased by the household through their expenditure (E).
- There is no financial sector.
- There is no government sector.
- There is no external interfering part.

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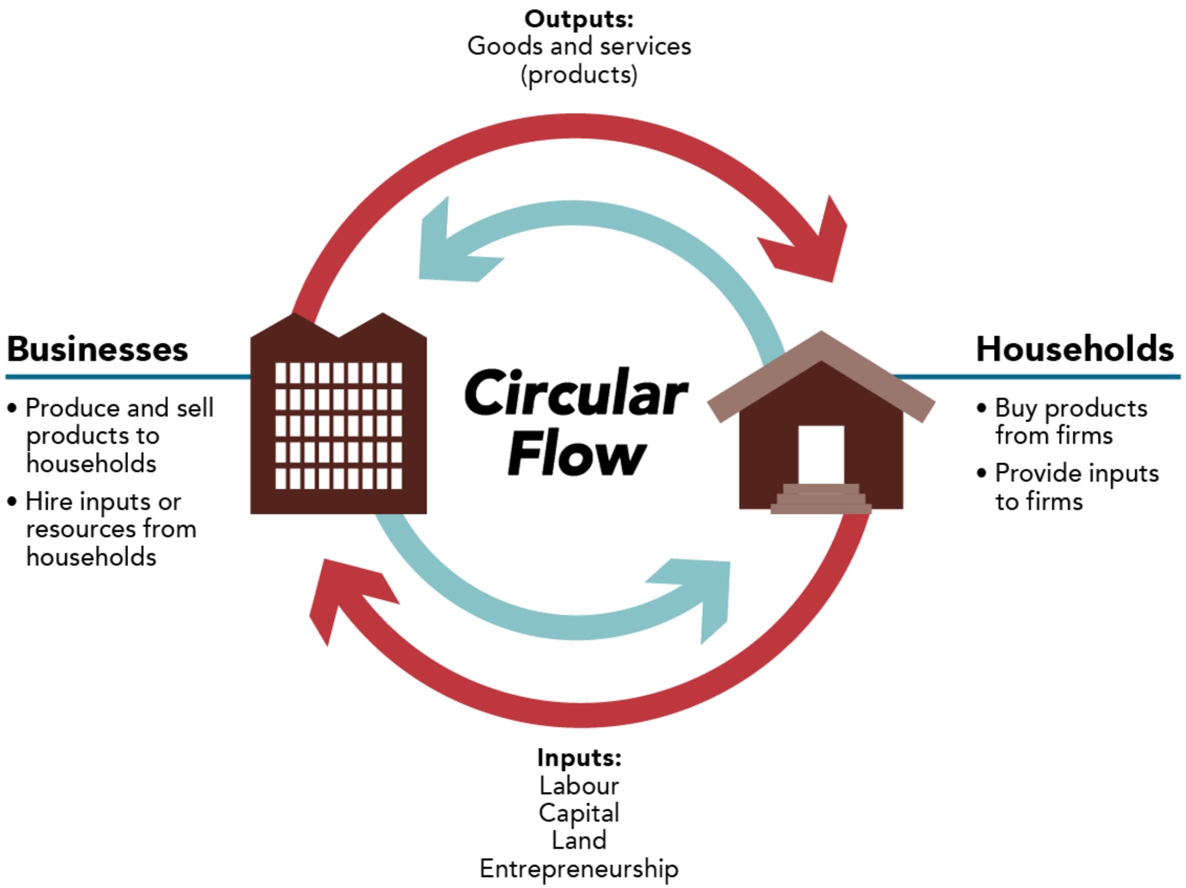
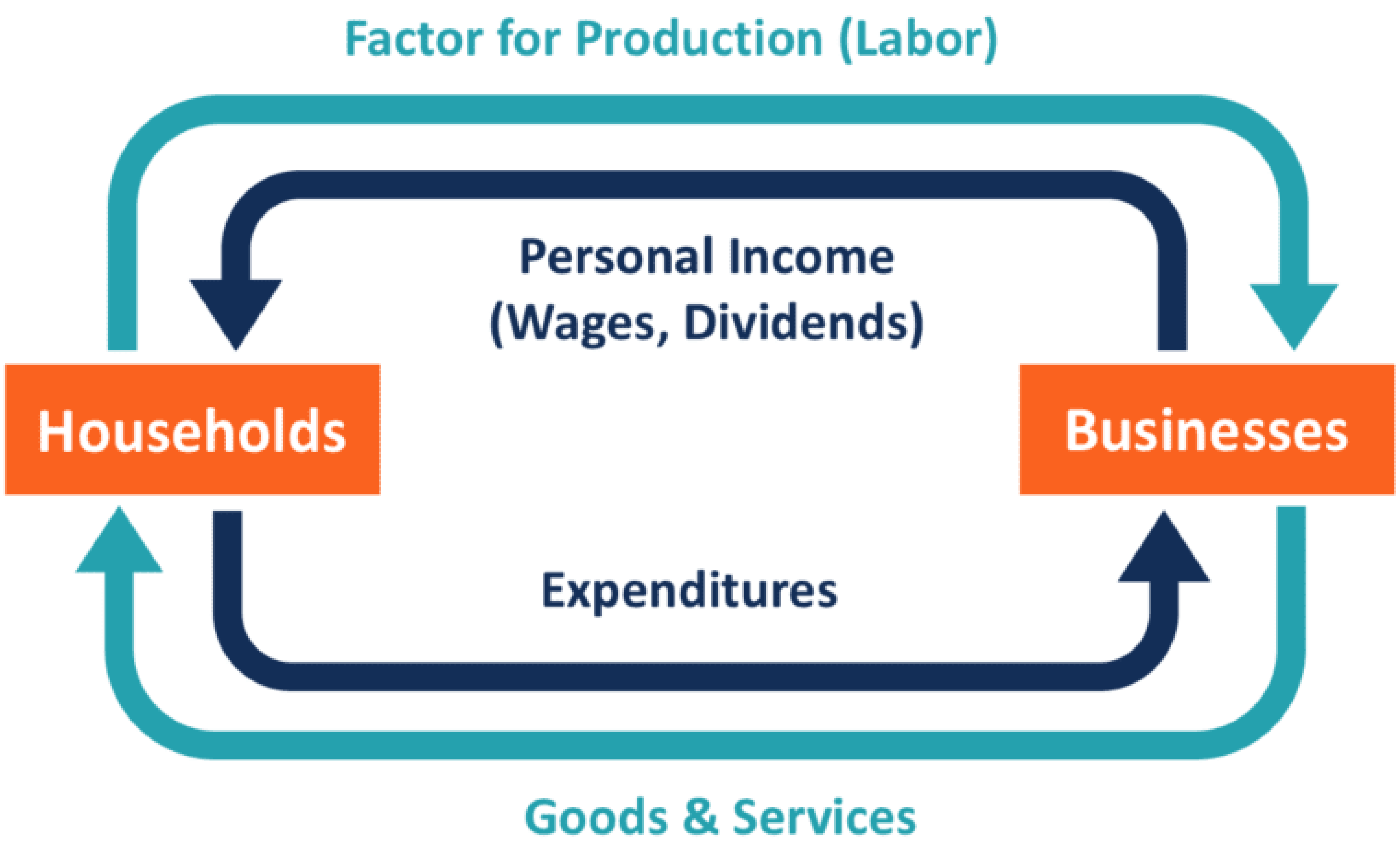


Macro Story, the circular flow of income, two-Sector Model

Two-Sector Model



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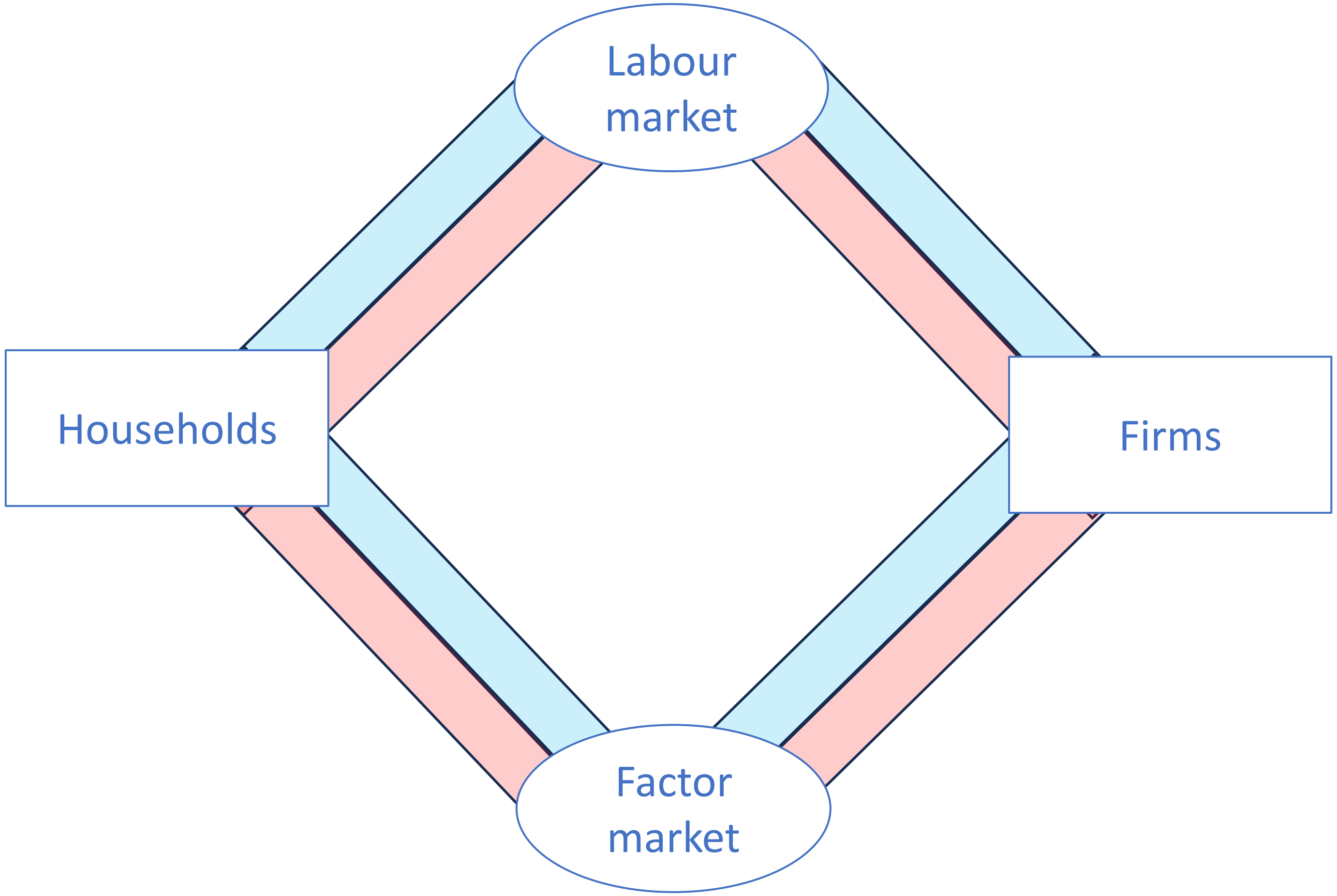

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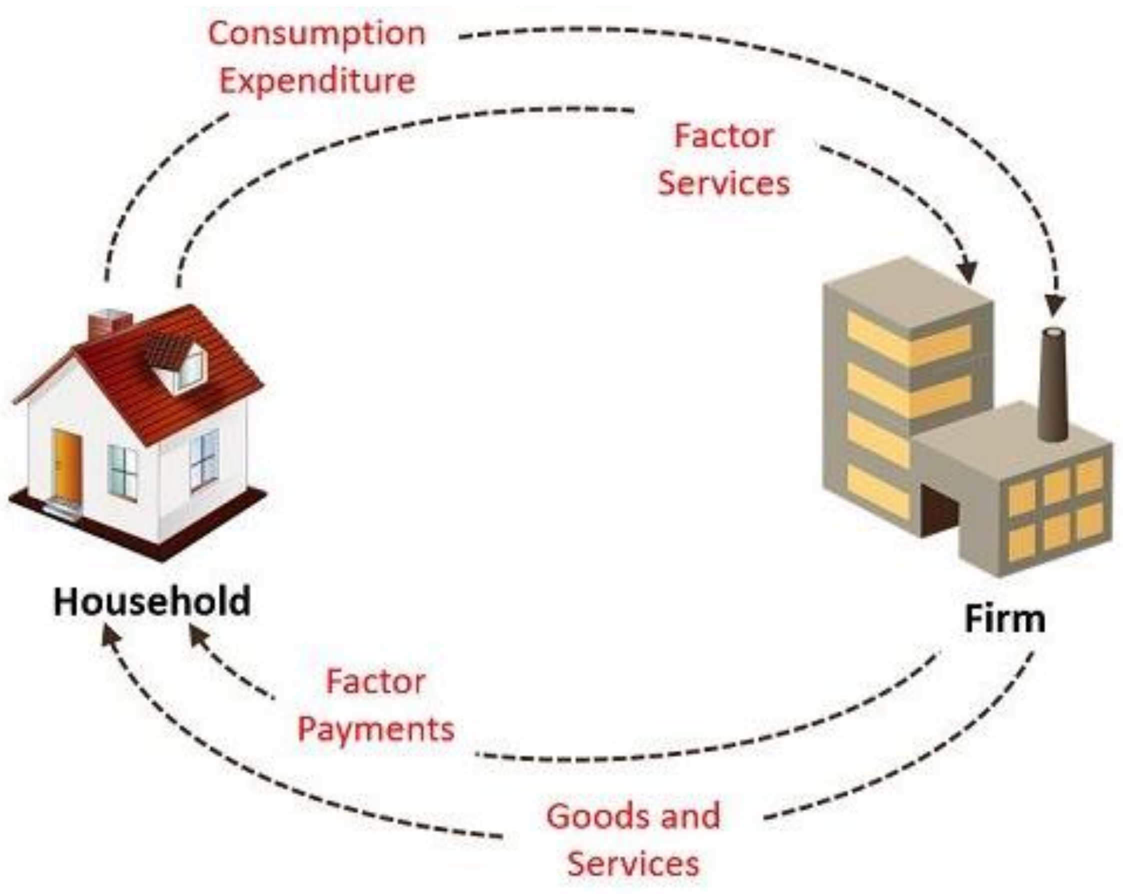

Two-Sector Model

- In the two-part circular flow of income model, the equilibrium state is a state in which there is no desire to change the levels of income (Y) and expenditure (E) and production or output (O), which is as follows:

$$Y = E = O$$

- This means that the expenses made by the buyer (household) become the income of the sellers (companies). After allocating a part of this income between production factors such as labor, capital and raw materials, companies transfer it to the owners of industries. Industry owners also use it to produce goods, which leads to a circular flow of income.

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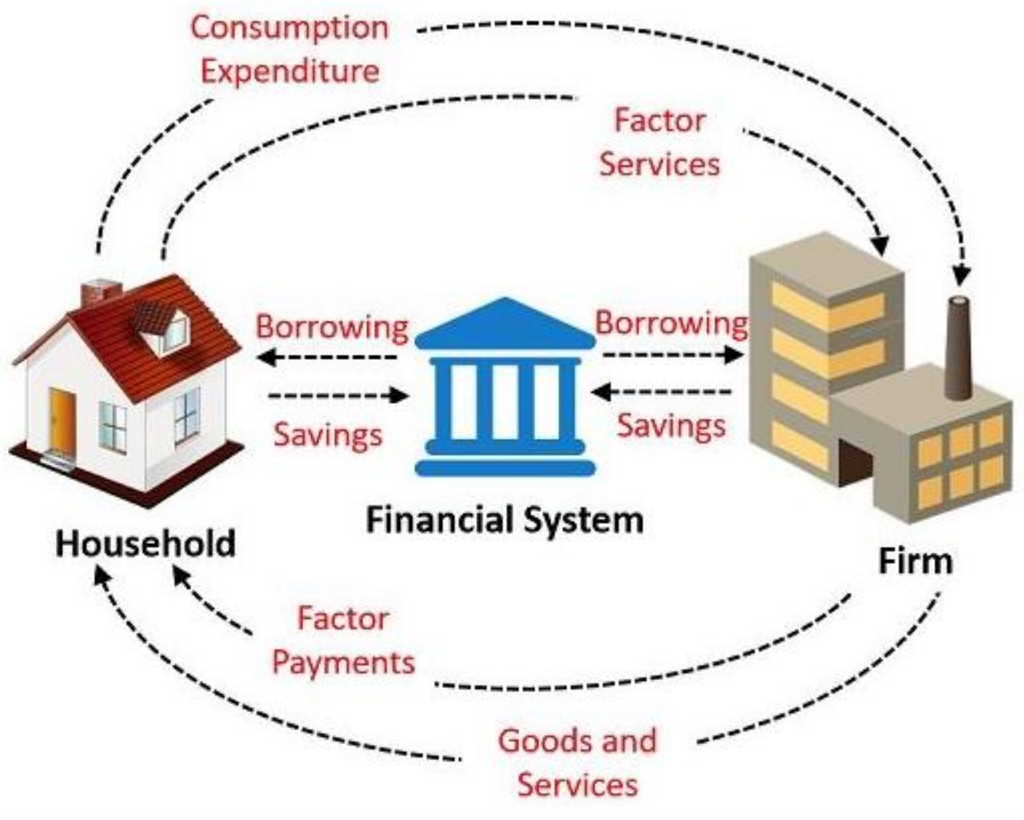
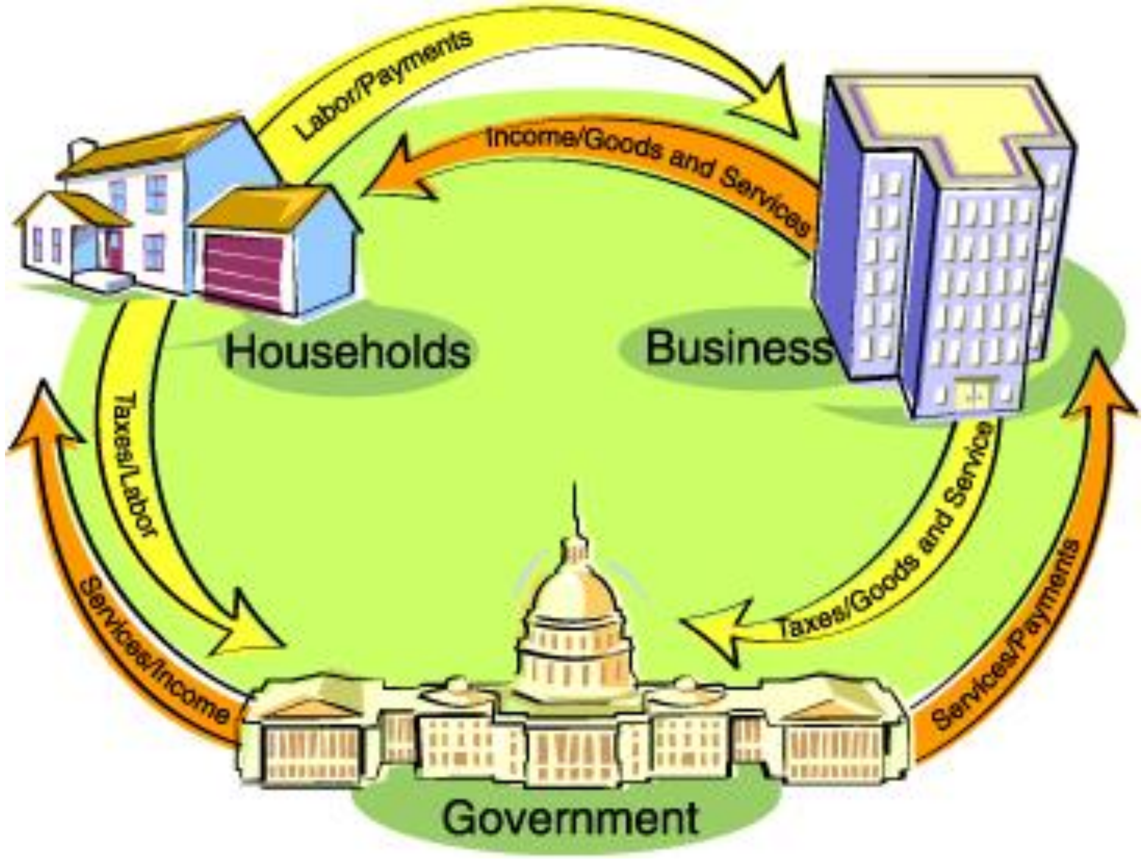
Two-Sector Economy with the Financial System



Three-Sector Model



Three-Sector Model

- The government also plays a crucial role in the economic development of a country. Therefore, the three-sector model includes: (1) **households**, (2) **firms**, and (3) **government**.

- The government of a country acts as both a firm and a consumer. As a firm or producer, the government produces goods and services for the economy. However, as a consumer, it spends money on the consumption of goods and services produced by the firms.

- The money from the government to households flows in an economy in two forms. First, in the form of transfer payments, such as old age pensions, scholarships, etc. Second, in the form of factor payments for hiring factor services of the households. This money flows back from households to the government in the form of direct taxes, such as interest tax, income tax, etc.

- The money from firms to the government flows in an economy in the form of direct and indirect taxes. However, the money from the government to the firms flows into an economy in the form of subsidies. In this case, the government grants subsidies to the firms and makes payments to the firms for the purchase of goods and services produced by them.

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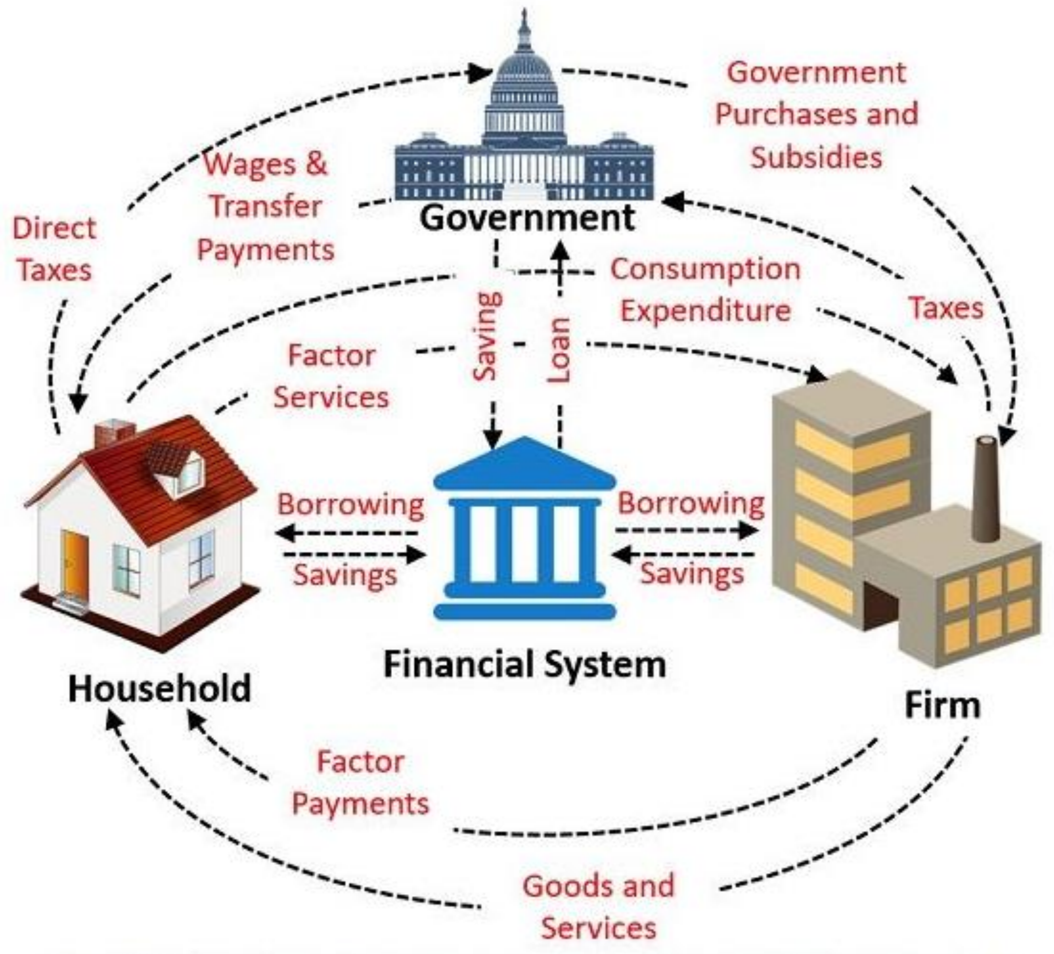

Four -Sector Model

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Macro Story, the circular flow of income, three-Sector Model

Four -Sector Model