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SUBJECT - ECONOMICS

TOPIC - CIRCULAR FLOW OF INCOME

COURSE - B.A. AND B.A. B.Ed

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PAGES - 13

NAME - POOJA GUPTA

Meaning by Circular Flow of Income

- The Circular Flow of Income is a simple model of economy showing flows of goods & services and factors of production between firms and households. In the absence of government and international trade, this simple model shows that households provide the factors of production for firms who produce goods and services, in return the factors of production receive factor payments i.e. Land receives rent, Labour receives wages, Capital receives interest and Organization earns profits (losses). These factor incomes - wages, rent, interest and profits are spent on the output of firms.
- In reality the households do not spend all their current income. The 'savings' by them represents a leakage from the circular flow. Firms also have, besides, consumer spending, investment spending. This is injected to the circular flow of income, as it does not originate from consumer's current income.

Importance of the Circular Flow

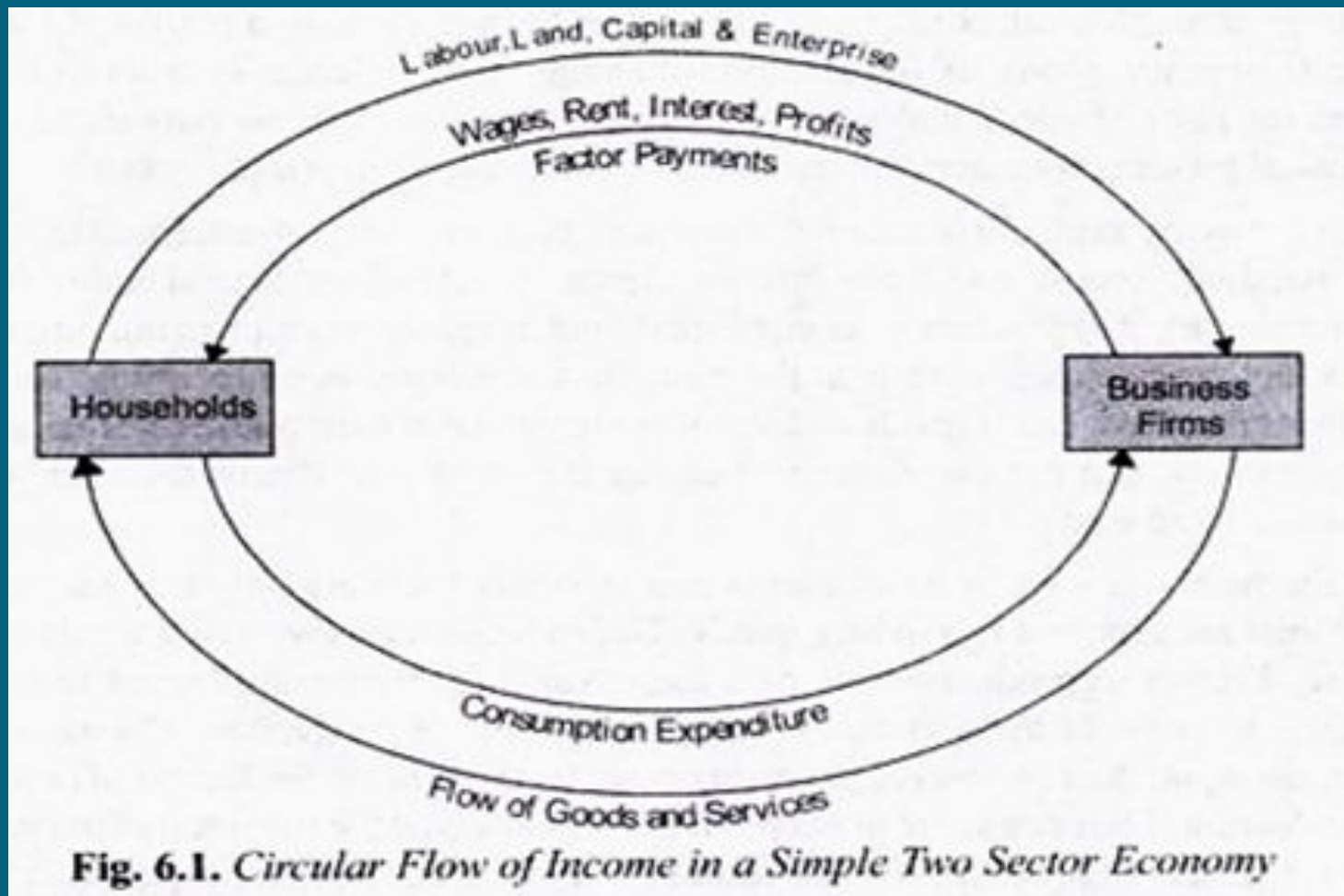
- Study of Problems
- Inflationary and Deflationary Tendencies
- Link between Producers and Consumers
- Creates a Network of Markets
- Effects of Leakages and Inflows
- Basis of the Multiplier
- Importance of Monetary Policy
- Basis of Flow of Funds Accounts
- Importance of Trade Policies
- Importance of Fiscal Policy

Circular Income Flow in a Two Sector Economy

Real flows of resources, goods and services have been shown in Figure below. In the upper loop of this figure, the resources such as land, capital and entrepreneurial ability flow from households to business firms as indicated by the arrow mark.

In opposite direction to this, money flows from business firms to the households as factor payments such as wages, rent, interest and profits.

Circular Income Flow in a Two Sector Economy



Circular Income Flow in a Three Sector Economy with Government

- In our above analysis of money flow, we have ignored the existence of government for the sake of making our circular flow model simple. This is quite unrealistic because government absorbs a good part of the incomes earned by households. Government affects the economy in a number of ways.
- Here we will concentrate on its taxing, spending and borrowing roles. Government purchases goods and services just as households and firms do. Government expenditure takes many forms including spending on capital goods and infrastructure (highways, power, communication), on defence goods, and on education and public health and so on. It will be seen that government purchases of goods and services from firms and households are shown as flow of money spending on goods and services.

Circular Income Flow in a Three Sector Economy with Government

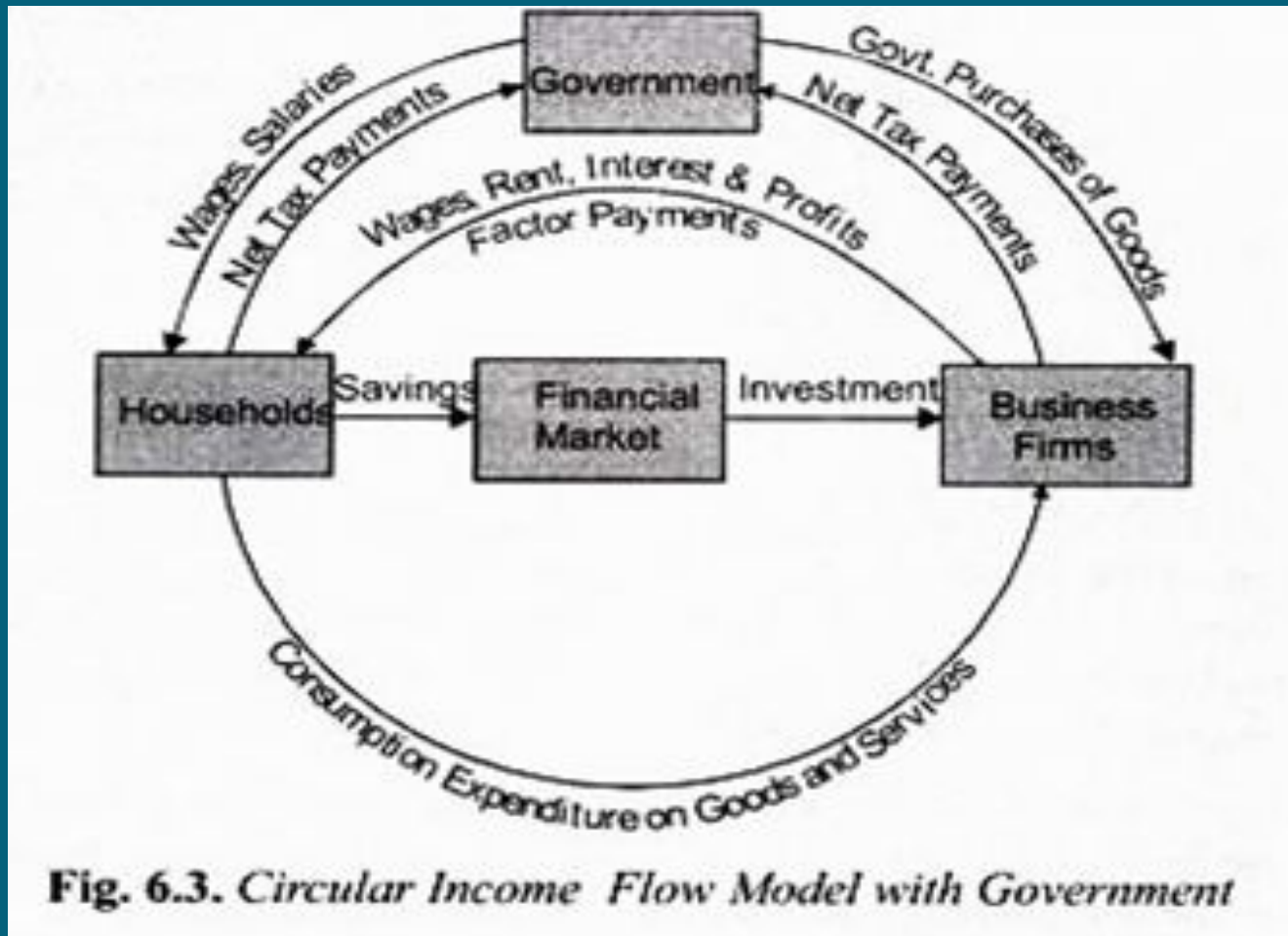


Fig. 6.3. *Circular Income Flow Model with Government*

Circular Flow of Income in four sector Economy

- A modern monetary economy comprises a network of four sector economy these are:
- Household sector
- Firms or Producing sector
- Government sector
- Rest of the world sector.

- Each of the above sectors receives some payments from the other in lieu of goods and services which makes a regular flow of goods and physical services. Money facilitates such an exchange smoothly. A residual of each market comes in capital market as saving which in turn is invested in firms and government sector. Technically speaking, so long as lending is equal to the borrowing i.e. leakage is equal to injections, the circular flow will continue indefinitely. However this job is done by financial institutions in the economy.

Take the inflows and outflows of the household, business and government sectors in relation to the foreign sector. The household sector buys goods imported from overseas and makes payment for them which is leakage from the circular flow. The households may receive transfer payments from the foreign sector for the services rendered by them in foreign countries.

Circular Flow of Income in four sector Economy

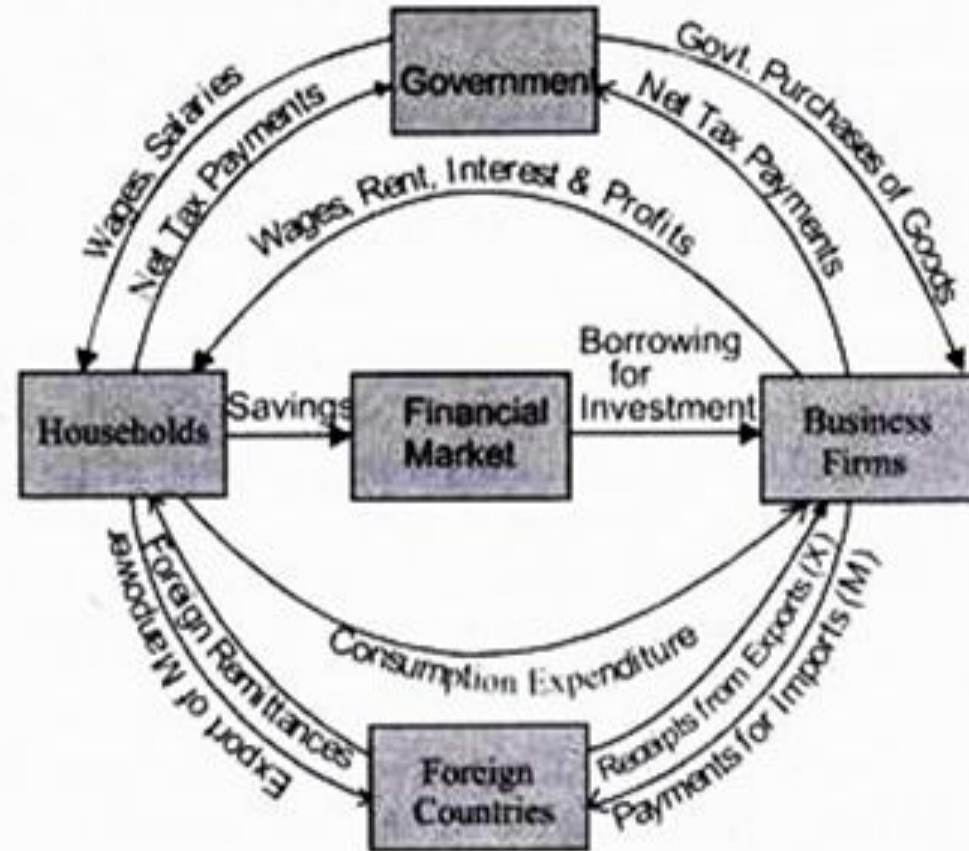


Fig. 6.4. Circular Flow of Income in an Open Economy with Government and Foreign Sector

References

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QUESTIONS

- Q. What do you mean by the meaning of circular flow of income? Explain in detail.
- Q. Explain the concept of circular of income in a two sector economy.
- Q. Explain the concept of circular flow of income in a three and four sector economy

THANK YOU