

# Circular flow of Income

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#### 4. Circular Flow of Income

In every economy, three activities never stop: (i) production of goods and services, (ii) generation of income (in terms of wages, interest, rent and profit), and (iii) expenditure (in terms of consumption expenditure and investment expenditure). In fact, these activities are the lifeline of an economy—the concept of an economy does not exist without these activities.

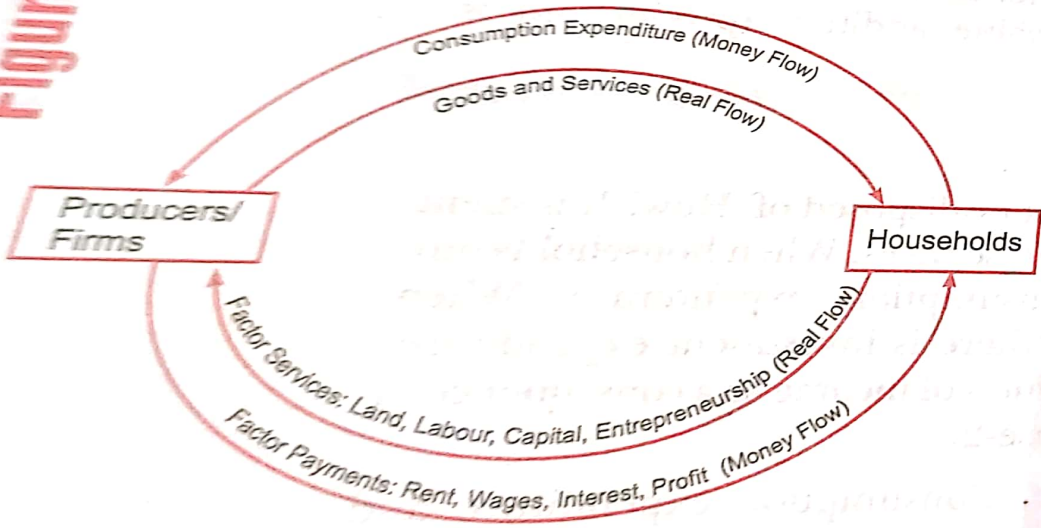
It is difficult to trace the beginning of these activities and it is impossible to predict their end. Production, income and expenditure are flow variables. These have been in existence like a circle without a beginning or an end. Circular flow of income means the circularity of the flows of production, income and expenditure in any economy. In fact, production, income and expenditure are the three phases of a circular flow in the economy.

*Circular flow of income refers to the unending flow of the activities of production, income generation and expenditure involving different sectors of the economy, the producers and the households in particular. Each activity is the cause as well as the consequence of the other activity. Production in the producing sector generates income for the households who are owners of the factors of production. Expenditure by the households generates demand for further production. Accordingly, production, income generation and expenditure keep chasing each other like three dots continuously moving in a circle.*

#### Three Phases of Circular Flow

**Figure 3**

### 2-Sector Circular Flow Model



**The assumptions:**

- (i) Domestic economy comprises only 2-sectors, the producers and the households.
- (ii) The households spend their entire income, so that there are no savings.
- (iii) The domestic economy is a closed economy, so that there are no exports and imports.
- (iv) There is no government in the domestic economy.

The model offers following observations:

- (i) Total production of goods and services by firms = Total consumption of goods and services by the household sector.
- (ii) Factor payments by firms = Factor incomes of the household sector.
- (iii) Consumption expenditure of household sector = Income of household sector ( $C + Saving = 0$ ).
- (iv) Money flows are opposite to real flows. Thus, while factor services flow from households to the producers, (which are real flows) factor payments flow from producers to the households (which are money flows).

**2-Sector Model with Savings/Financial System**

So far we assumed that households spend the entire income on the purchase of goods and services. As a matter of fact, households tend to save a part of their income.

Emergence of savings implies the emergence of a financial system. It refers to the existence of a money market (or capital market) in the economy including a variety of financial intermediaries such as commercial banks and insurance companies. These financial intermediaries serve as a link between savers and investors. Those who save, park their funds with the financial intermediaries and those who invest, borrow funds from the financial intermediaries. The activity of 'saving and borrowing for investment' is reflected in the circular flow model as under:

**2-Sector Circular Flow Model with Savings/Financial System**

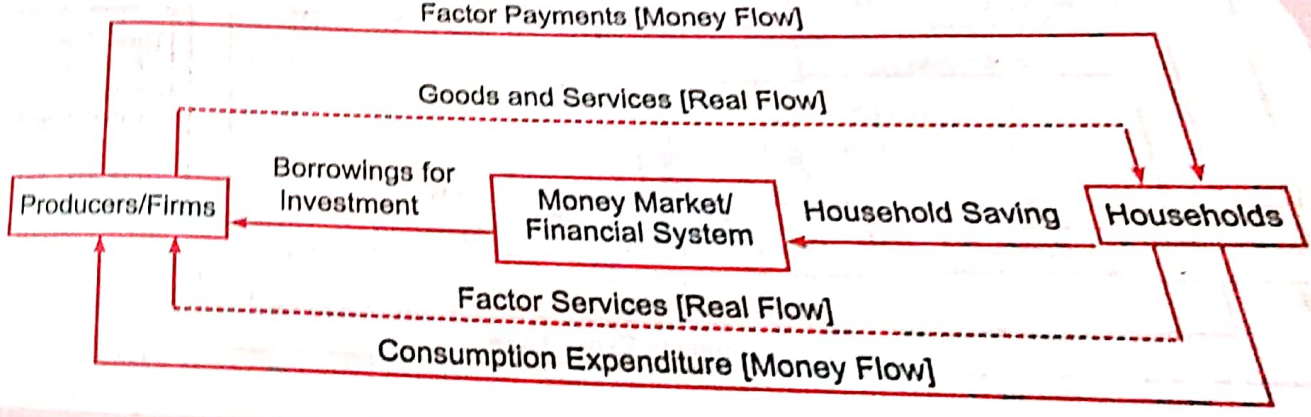


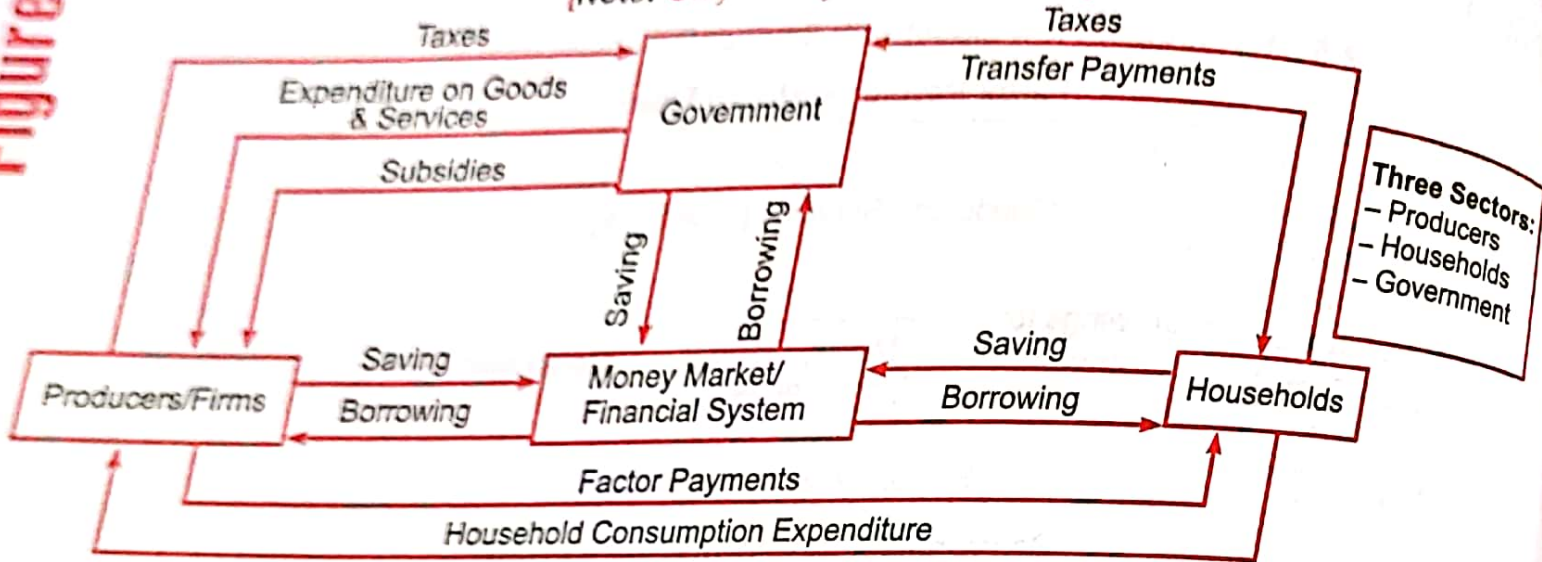
Figure 4

This is called triple identity. It corresponds to three phases of circular flow. We shall study more about 'triple identity' in the next chapters.

### The Circular Flow Model in a 3-Sector Economy

We now consider an economy that includes: (i) the producers, (ii) the households, and (iii) the government. In such an economy, the circular flow model will be as in Fig. 5.

**Figure 5**  
3-Sector Circular Flow Model reflecting activities of Government along with Producers and Households  
[Note: Only money flows are shown]



This model reflects activities of the government along with other sectors of the economy. Important activities of the government are: (i) the government taxes the households and offers them transfer payments (like scholarships and old-age pensions), (ii) the government taxes the producers, and offers them subsidies (compensation for selling goods at the lower price), (iii) the government buys goods and services from the producers and accordingly, makes payment to them, (iv) the government parks its funds in the money market, and also borrows money.

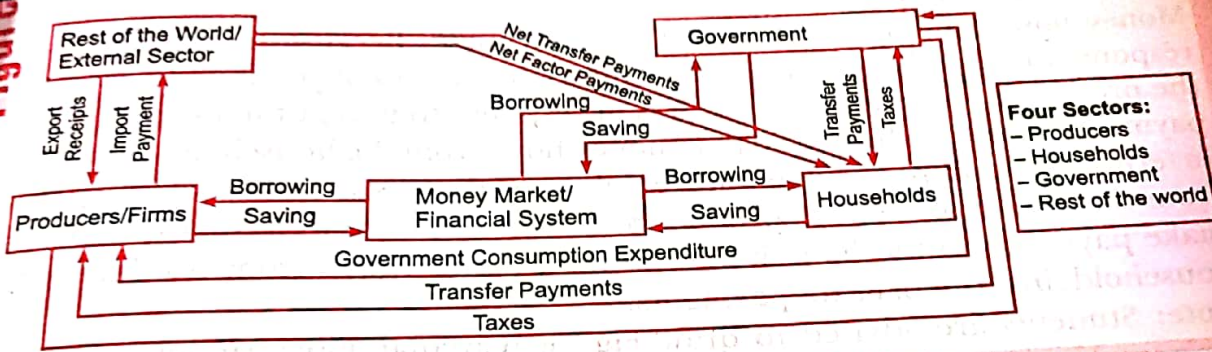
It is important to note that even when the government sector is introduced into the Circular Flow Model, the 'triple identity' (across production, income and expenditure) is not disturbed. It continues to be intact. We shall discuss more about it in the subsequent chapters.

### The Circular Flow Model in a 4-Sector Economy

We now consider an open economy. In an open economy, there are exports and imports with rest of the world. Accordingly, rest of the world sector is introduced into the circular flow model. The 4-sector circular flow model will be as in Fig. 6.

**Figure 6**

**4-Sector Circular Flow Model reflecting activities of Rest of the World along with Producers, Households and the Government**



The model reflects activities of 'rest of the world sector'. These activities include: (i) exports and imports with the producing sector. The producing sector receives payments for its exports to rest of the world; it makes payments for imports to rest of the world, (ii) factor payments to the households for their factor services (These payments are reflected as shown as 'net factor payments' in the model. This is the difference between factor payments received from rest of the world and factor payments made to rest of the world), (iii) transfer payments to the households (shown as net transfer payments). It may be noted that factor payments (rent, interest, profit and wages/salaries) are related to goods or services; transfer payments are not. Transfer payments are charity or grant from one sector to the other.

In the four sector model also, the 'triple identity' is not disturbed. The model only shows a comprehensive view of the circular flow. It shows how different sectors of an open economy are engaged in the process of production of goods and services, generation of income and its disposition (or expenditure) of income.