The circular flow of income and expenditure

Economics, Tax

The Circular Flow of Income and Expenditure 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. The various components of national income and expenditure such as saving, investment, taxation, government expenditure, exports, imports, etc are shown on diagrams in the form of currents and cross-currents in such a manner that national income equals national expenditure. We begin with a simple hypothetical economy where there are only two sectors, the household and business. The household sector owns all the factors of production, that is, land, labour and capital. This sector receives income by selling the services of these factors to the business sector. The business sector consists of producers who produce products and sell them to the household sector or consumers. Thus the household sector buys the output of products of the business sector. The circular flow of income and expenditure in such an economy is shown in Figure 5. 1 where the product market is shown in the upper portion and the factor market in the lower portion. [pic] In the product market, the household sector purchases goods and services from the business sector while in the factor market the household sector receives income from the former for providing services. Thus the household sector purchase all goods and services provided by the business sector and makes payments to the latter in lieu of these. The business sector, in turn, makes payments to the households for the services rendered by the latter to the business â†’ wage payments for labour services, â†’profit for capital supplied, etc Thus payments go around in a circular manner from the business sector to the household sector, and from the household sector to the business sector, as shown by arrows in the outer portion of the figure. There are also flows of goods and services in the opposite direction to the money payments flows. Goods flow from the business sector to the household sector in the product market, and services flow from the household sector to the business sector in the factor market, as shown in the inner portion of the figure. These two flows give GNP = GNI . The Circular Flow with Saving and Investment Added The actual economy is not as explained above. In an economy, “ inflows" and “ leakages" occur in the expenditure and income flows. Such leakages are saving, and inflows or injections are investment which equal each other. [pic] Figure 5. 2 shows how the circular flow of income and expenditure is altered by the inclusion of saving and investment. Expenditure has now two alternative paths from household and product markets: i) directly via consumption expenditure, and ii) indirectly via investment expenditure. In Figure 5. 2 there is a capital or credit market in between saving and investment-flows from households to business firms. The capital market refers to a number of financial institutions such as commercial banks savings banks, loan institutions, the stock and bond markets, etc. The capital market co-ordinates the saving and investment activities of the households and the business firms. The households supply saving to the capital market and the firms, in turn, obtain investment funds from the capital market. The Circular Flow in a Three-Sector Closed Economy So far we have been working on the circular flow of a two-sector model of an economy. To this we add the government sector so as to make it a three-sector closed model of circular flow of income and expenditure. For this, we add taxation and government purchases (or expenditure) in our presentation. Taxation is a leakage from the circular flow and government purchases are injections into the circular flow. First, take the circular flow between the household sector and the government sector. Taxes in the form of personal income tax and commodity taxes paid by the household sector are outflows or leakages from the circular flow. But the government purchases the services of the households, makes transfer payments in the form of old age pensions, unemployment relief, sickness benefit, etc. and also spends on them to provide certain social services like education, health. housing, water, parks and other facilities. All such expenditures by the government are injections into the circular flow. [pic] Next take the circular flew between the business sector and the government sector. All types of taxes paid by the business sector to the government are leakages from the circular flow. On the other hand, the government purchases all its requirements of goods of all types from the business sector, gives subsidies and makes transfer payments to firms in order to encourage their production. These government expenditures are injections into the circular flow. Now we take the household, business and government sectors together to show their inflows and outflows in the circular flow. As already noted, taxation is a leakage from the circular flow. It tends to reduce consumption and saving of the household sector. Reduced consumption, in turn, reduces the sales and incomes of the firms. On the other hand, taxes on business firms tend to reduce their investment and production. The government offsets these leakages by making purchases from the business sector and buying services of the household sector equal to the amount of taxes. Thus total sales again equal production of firms. In this way, the circular flows of income and expenditure remain in equilibrium. Figure 5. 3 shows that taxes flow out of the household and business sectors and go to the government. Now the government makes investment and for this purchases goods from firms and also factors of production from households. Thus government purchases of goods and services are an injection in the circular flow of income and taxes are leakages. If government purchases exceed net taxes then the government will incur a deficit equal to the difference between the two, i. e., government expenditure and taxes. The government finances its deficit by borrowing from the capital market which receives funds from households in the form of saving. On the other hand, if net taxes exceed government purchases the government will have a budget surplus. In this case, the government reduces the public debt and supplies funds to the capital market which are received by firms.