12th ECONOMICS
National Income
Chapter – 1
File – 1
Content –

Meaning and concept of circular flow of income

Circular flow of income

Introduction

- The term circular flow of income or circular flow of economic activity refers to a simple economic model which describes the circulation/flow of income between producers and consumers.
- In the circular flow model, producer is referred to as firms and consumer are referred to as households.
- The major exchanges are represented as flows of money, goods and services, etc.

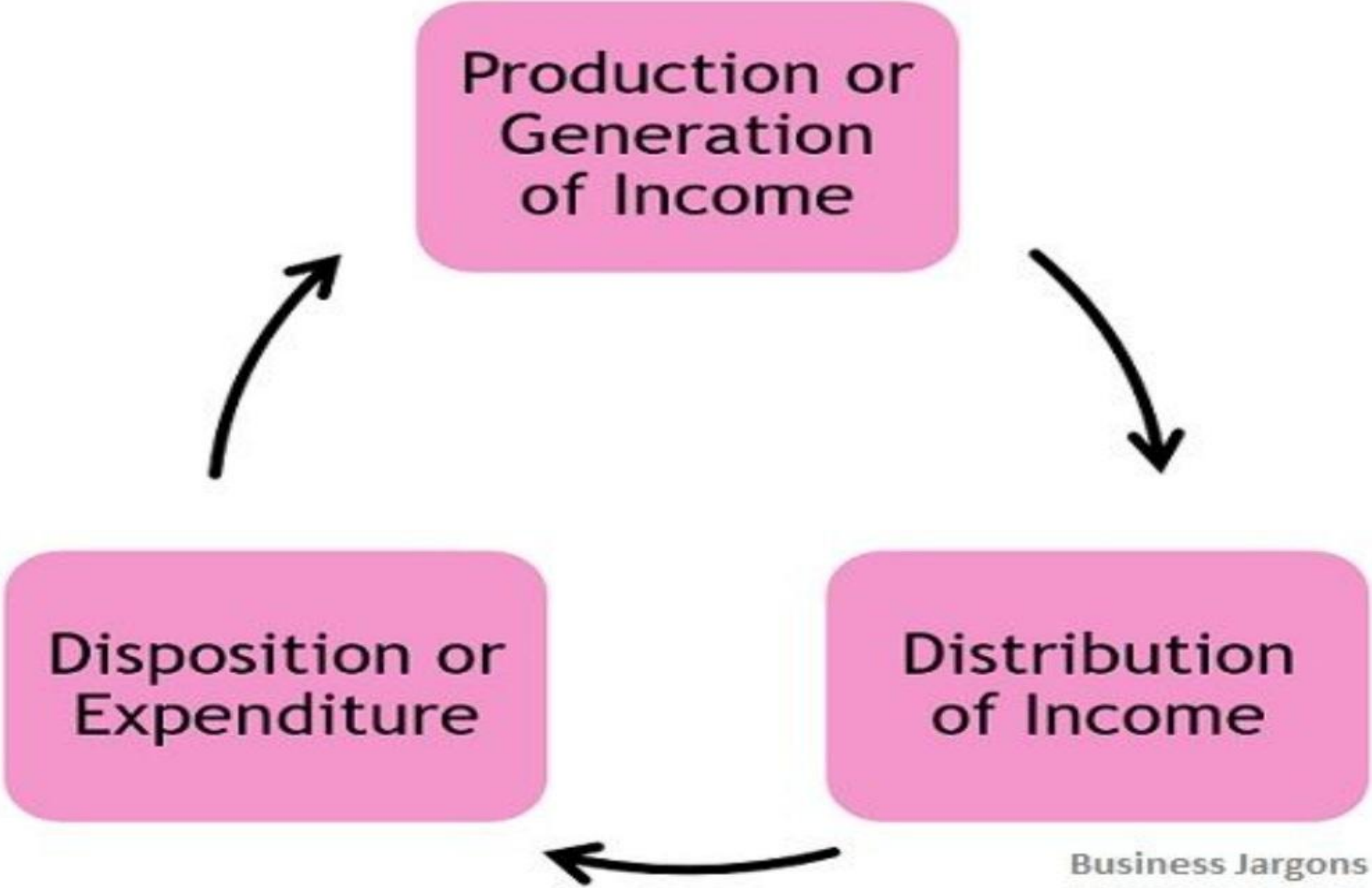
Economic Activities

- Consumption
  - Process of utilisation of goods and services to satisfy human wants



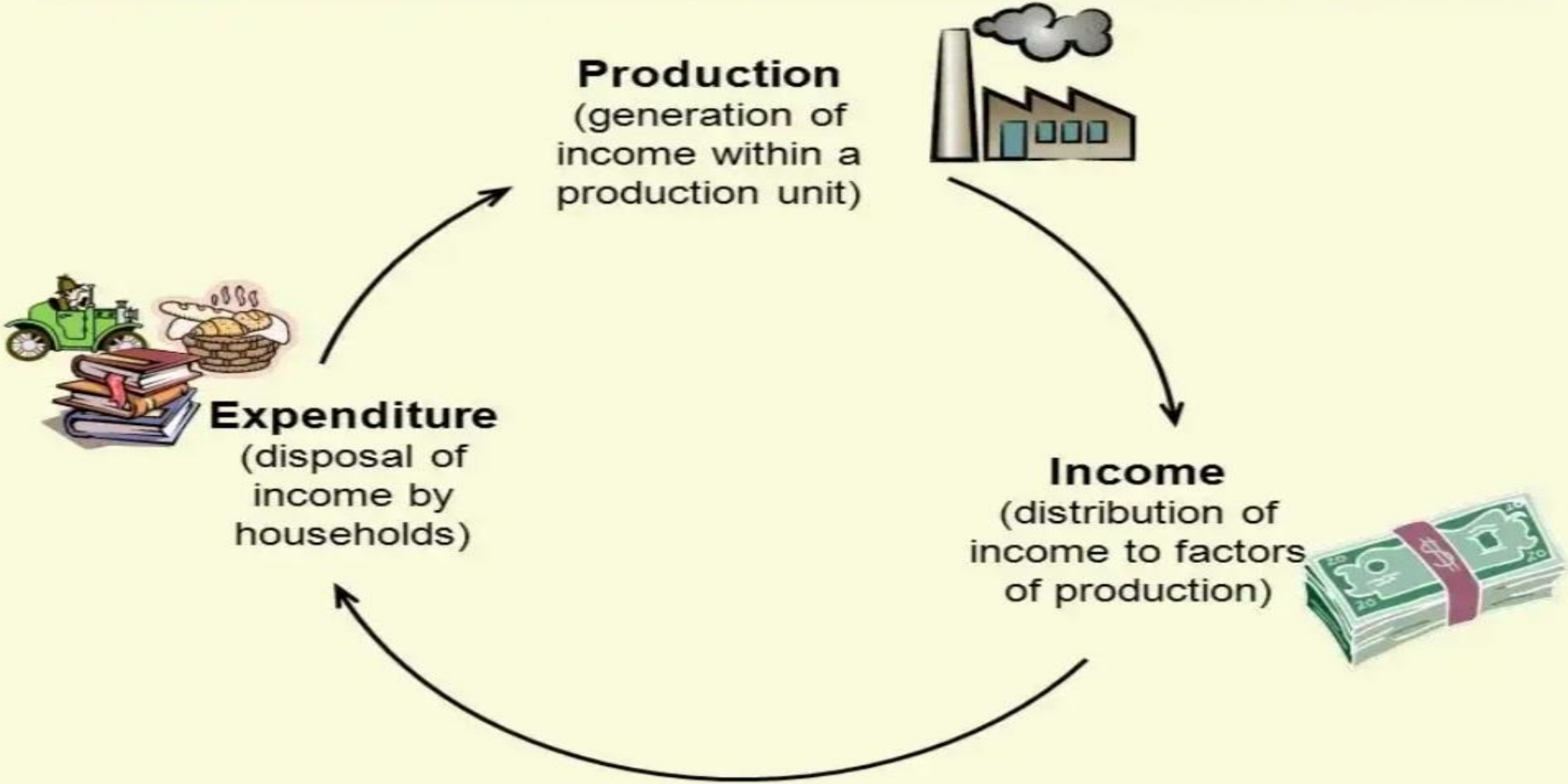

  - Accounted for at the time of purchase of product, even though service may be provided over a period of time

- Production
  - Process through which raw materials are converted into output using factors of production

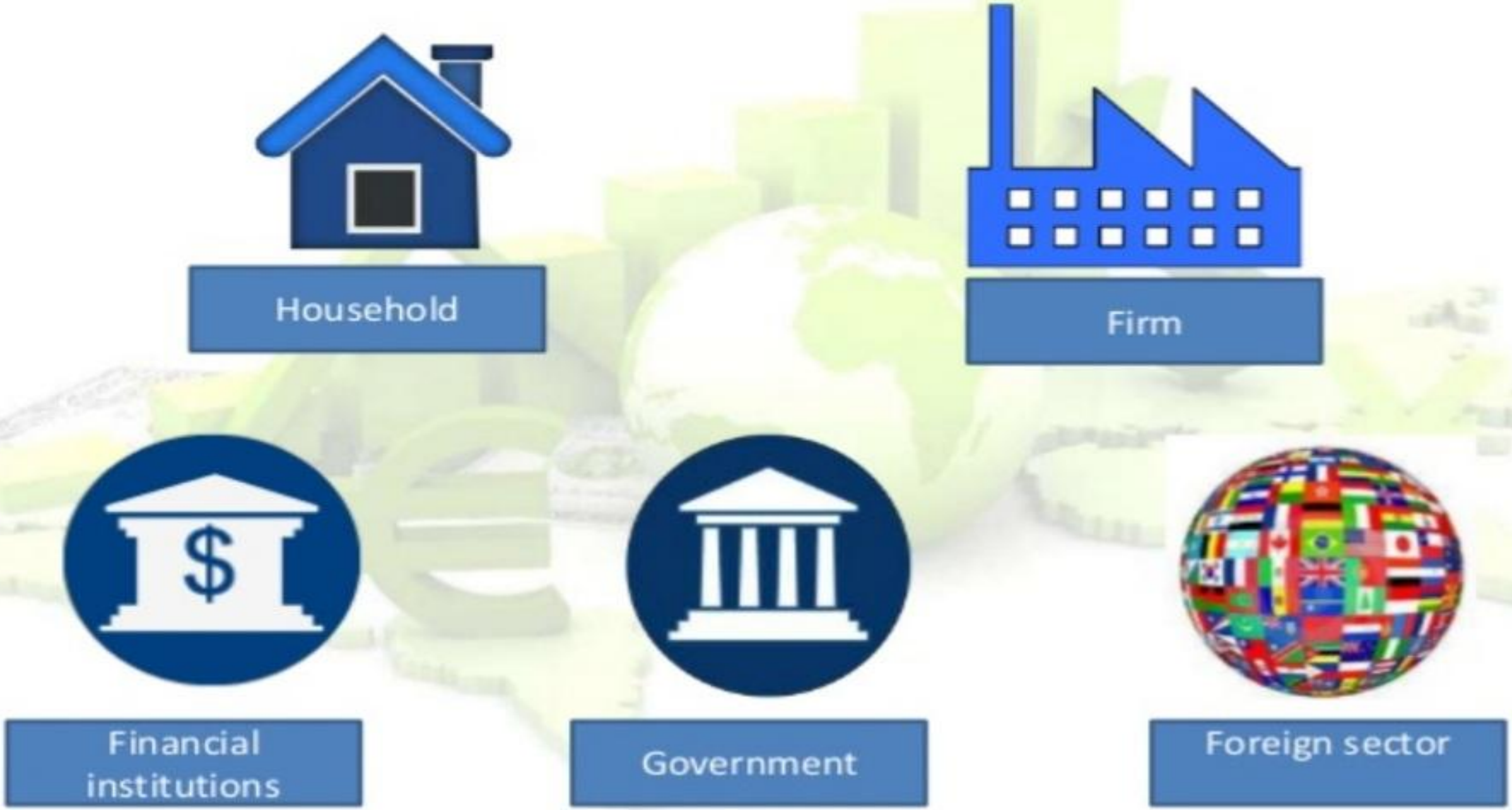

Production or Generation of Income
Distribution of Income
Disposition or Expenditure
Business Jargons

Circular flow of income refers to cycle of generation of income in the production process, its distribution among the factors of production and finally it's circulation from households to firms in the form of consumption expenditure on goods and services produced by them.

Meaning of Circular Flow of Income

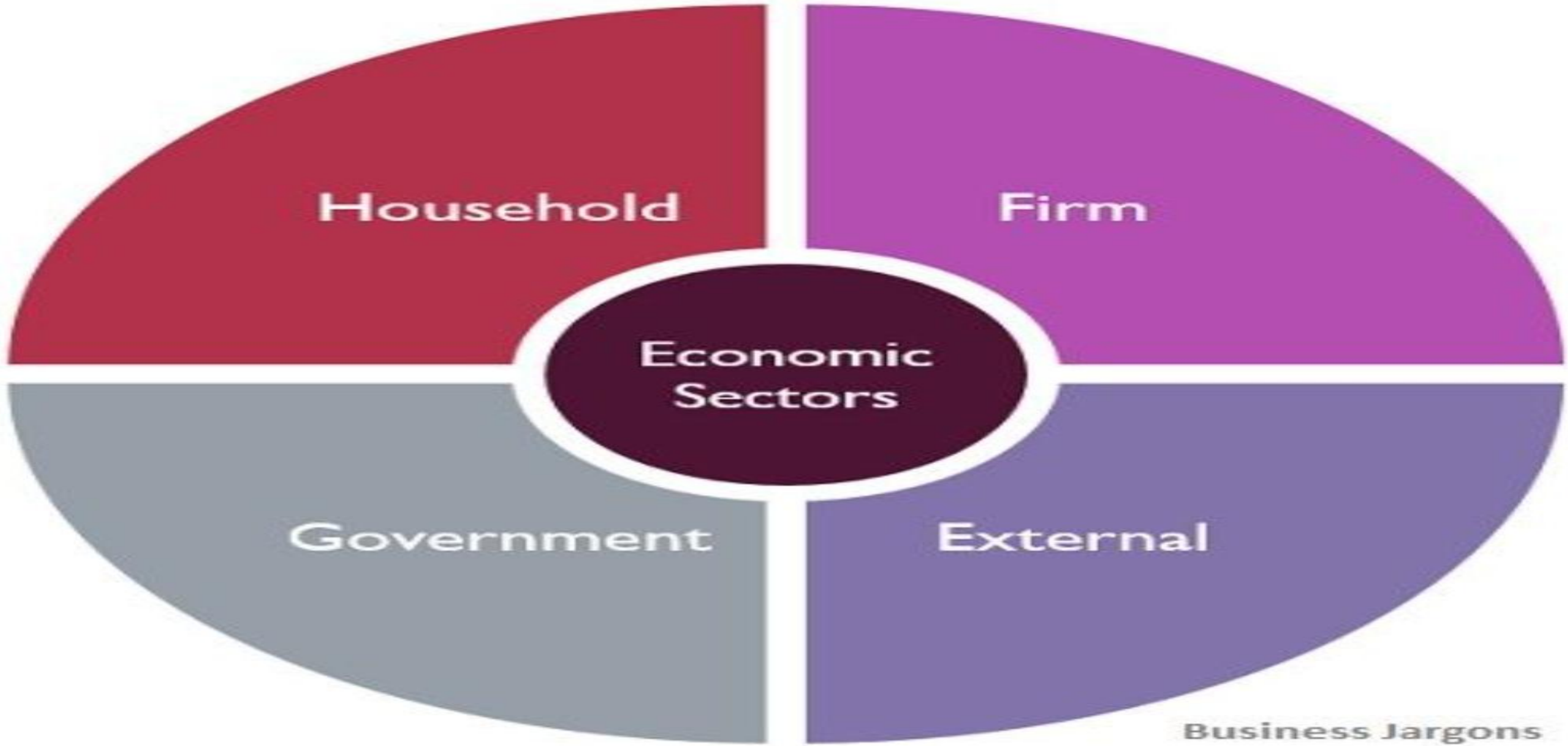


Determinants



Economic Sectors

An economy is classified into four broad sectors, these are:



Sectors in an Economy

- Households
  - Owners of factors of production
  - Provide factor services to firms
  - Receive factor income in return
  - Spend income on goods and services (consumption)

- Firms
  - Include both private and government owned
  - Hire factors of production to undertake production of goods and services
  - Sell output and generate income
  - Income paid to factors of production

Sectors in an Economy

- Government
  - Refers to the ‘general government’
  - Receives taxes from households and firms
  - Spends money on provision of services that improve welfare
  - Profit is not an objective

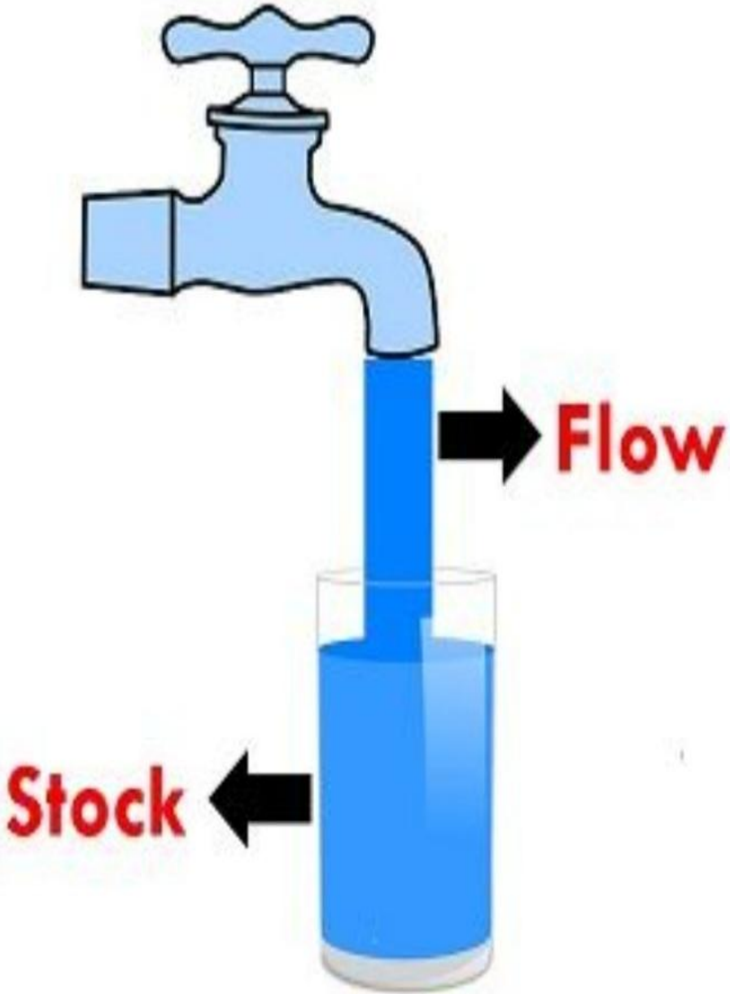
- Rest of the World
  - External economy
  - Domestic economy undertakes transactions with the external economy
    - Imports – purchase of foreign products by domestic economy
    - Exports – sale of domestic products to external economy

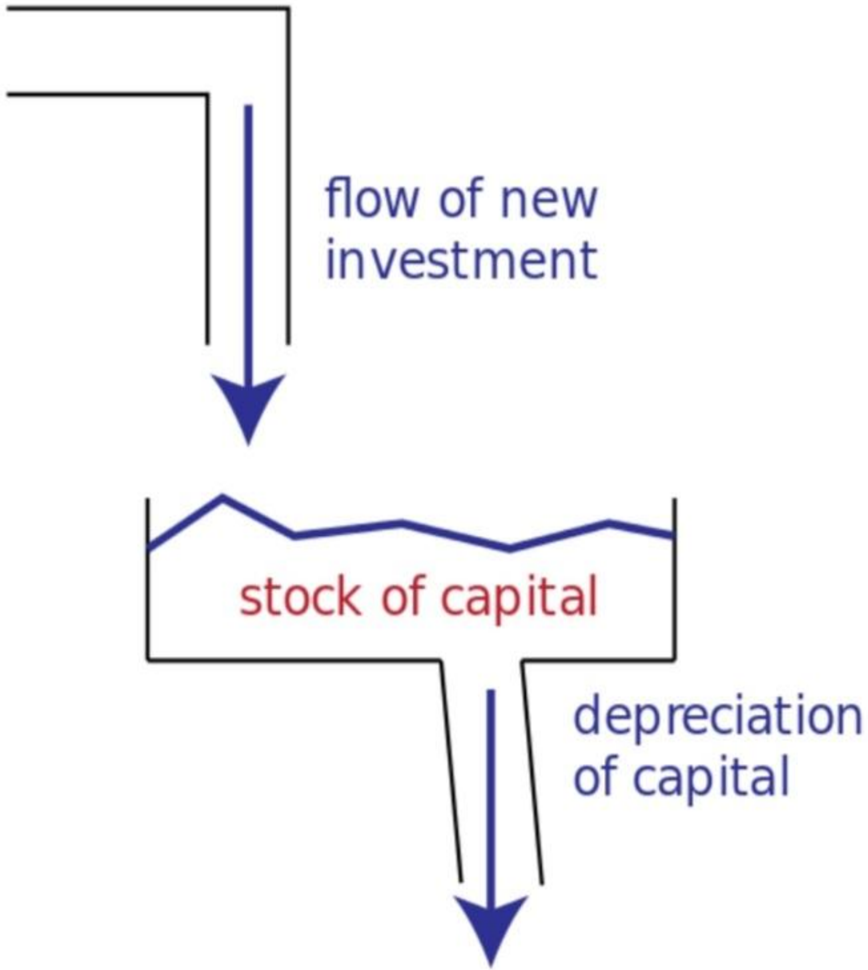
Stock

- Quantity of an economic variable measured at a particular point of time
- Has no time dimension
- Is a static concept
- **Eg: wealth, water in a tank, inventories, capital**

Flow

- Quantity of an economic variable measured during a period of time
- Has time dimension – like per hour, per month etc.,
- Is a dynamic concept
- **Eg: income,water in a stream, change in inventory, change in capital**


Flow
Stock


flow of new investment
stock of capital
depreciation of capital

Stock vs Flow Variables

Flow Variables

- Measured over a period of time
- Eg:
  - Profit & loss of a company
  - Birth rates & death rates
  - Income of an individual

Stock Variables

- Measured at a point in time
- Eg:
  - Balance Sheet of a company
  - Population
  - Wealth of an individual

Changes in stock variables occur

due to

changes in flow variables

Stock	Flow
Capital	Investment
Wealth	Income
Price Index	Inflation
Balance Sheet	Profit/Loss account
Forex Reserves	Exports/wages/taxes
Unemployment level	GDP

THANK YOU