Circular Flow Of Income

Idea In Short

Circular Flow of Income model is a macro-economic model that explains how money is distributed within an economy. The model takes into account six factors that influence cash flows within an economy.

In its simplest form, the circular flow of income economic model takes into account only two factors:

1. Households [consumers], and
2. Businesses

This is the model for a closed economy. Households have the means of production. Means of production (or production factors) are:

- Land (also referred to as nature),
- Labor, and
- Capital

On the one hand, money flows around. On the other hand, there is a flow of goods and services. Hence, the circle is round.Companies use the means of production to produce goods and services. The households receive money in exchange for the means of production. Rent for land, wages for labor and interest or dividend for money. Households purchase the goods and services from the companies, for which they pay the companies.

Circular Flows

The circular flow of income in an economy is, in practice, not that simple. There are several factors that cause money to flow [leaks] out of the closed economy. In addition, there are factors that cause money to flow into the economy [injections].

Injections

This represents money flows into the economy i.e. money leaks into the economy. These are such dynamics as:

- Government spending
- Taxes
- Export - Import
- Investments
- Savings

Public spending, export, and investments are the three factors that drive more money into an economy.

Withdrawal

Just as money is injected into the economy, money is withdrawn or leaked through various means as well. Withdrawals represent money flows out of the economy i.e. money leaks out the economy. These occur because money is spent to:

- Import goods or services from abroad
- Pay taxes, and
- Undertake savings

Factors

All factors from the Circular Flow of Income - including example:

- Income [Y] - Wages, dividends & interest that go from businesses and financial institutions to households
- Savings [S] - Savings from consumers, companies or the government that flows to financial institutions
- Expenditure [E] - Consumer spending, money that flows from households to businesses
- Taxation [T] - Taxes that go to the government from households and businesses
- Investments [I] - Investments [loans] from financial institutions in business, to consumers or the government

- Government spending [G] - Government spending on businesses in the form of contracts or towards households in the form of wages for civil servants or, for example, benefits
- Import [M] - Expenditure of companies, government and consumers abroad (money flows from the economy)
- Export [X] - Income from the sale of goods and services abroad (money flows into the economy).

Usage

There are different ways to attract money. Financial institutions can raise their interest rates. Government can implement tax measures i.e. raise or lower tax rates. Banks and businesses can raise the interest on bonds. You can borrow money from financial institutions etc. Another possibility is to limit your expenses. So, the government can reduce its spending. Likewise, households can keep their expenses low. Companies can lay off staff, which means they have fewer costs at the expense of government spending. All these measures affect on the circular flow of income. Via this flow, you can determine what effect certain trends can have on an economy. For example, if exports [X] drop, businesses earn less money. They can try to withdraw this money from the bank by requesting [borrowing] an investment [I]. The bank will have to top up its assets, for example with savings. You raise savings by increasing the interest. Because the companies have less income, the government has less income from taxes. The government can choose to raise taxes or limit government spending.

Calculations

The circular flow of income model is based on the comparison:

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S + T + M = I + G + X
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The total savings of households + the total tax revenue of the government + the total income from exports = always equal to the total expenditure of the financial sector [loans] + Total government spending + spending on imports. All goods and services produced by companies is the gross national product [GNP] of an economy. All the money that enters the households from the production factors that they own is called the gross national income

[GNI].

Summary

Keynesian economics, for example, believes that spending leads to economic growth, so a central bank might cut interest rates, making money cheaper, so that individuals will buy more goods, such as houses and cars, increasing overall spending. As consumer spending increases, companies increase output and hire more workers to meet the increase in demand. The increase in employed people means more wages and, therefore, more people spending in the economy, leading producers to increase output again, continuing the cycle.