Circular Flow of National Income- Closed and Open economy

The value of goods and services produced by a country during a financial year contributes to its National Income. It is the net result of all economic activities of any country during a period of one year, calculated in terms of money.
Economic transactions generate two kinds of flows :

1. Real flow i.e. the flow of goods and services, and
2. Money flow.

Real and Money flows go in opposite directions in a circular fashion.

The goods flow consists of

(a) factor flow, i.e., flow of factor services, and

(b) product flow, i.e., flow of goods and services.

In a monetized economy, the flow of factor services generates money flows in the form of factor payments which take the form of income flows. The factor payments and expenditure on consumer goods and services take the form of expenditure flows.

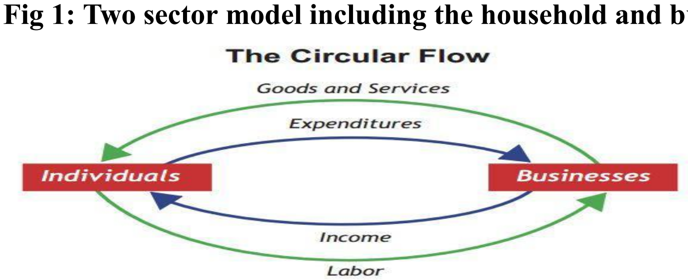
Economies are of closed/ partially open and/ or open economies.

A closed economy is one that has very less or no trading activity with rest of the world. We can define it as an entirely self-sufficient economy, which means very restricted or no imports come into the country and no exports leave the country. The goal of a closed economy is to provide domestic consumers with everything they need from within the country's borders.
A nation in which freedom to buy and sell goods and services is given with no or very few restrictions is termed as **open economy**. The GDP of such a nation is comprised of Net Export. In the present world almost all nations are open economies to certain extents.

To understand the flows of income and expenditure, the economy is divided into four sectors i.e. the household sector, business sector, the firms, government sector and foreign sector. These are combined to make the following three models for the purpose of showing the circular flows.

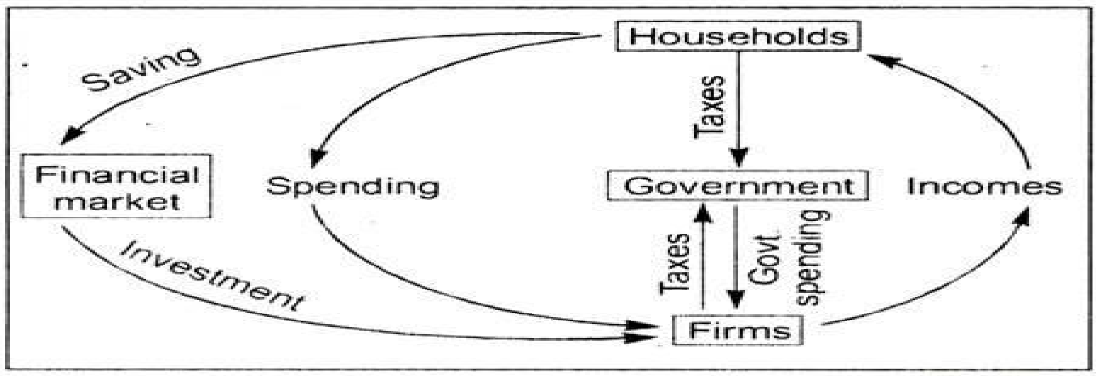
1. Two sector model including the household and business sectors
2. Three sector model including the household, business/ firms and government sectors
3. Four sector model including the household, business/ firms, government and the foreign sectors.

Fig 1: Two sector model including the household and business sectors



Source: Google Image

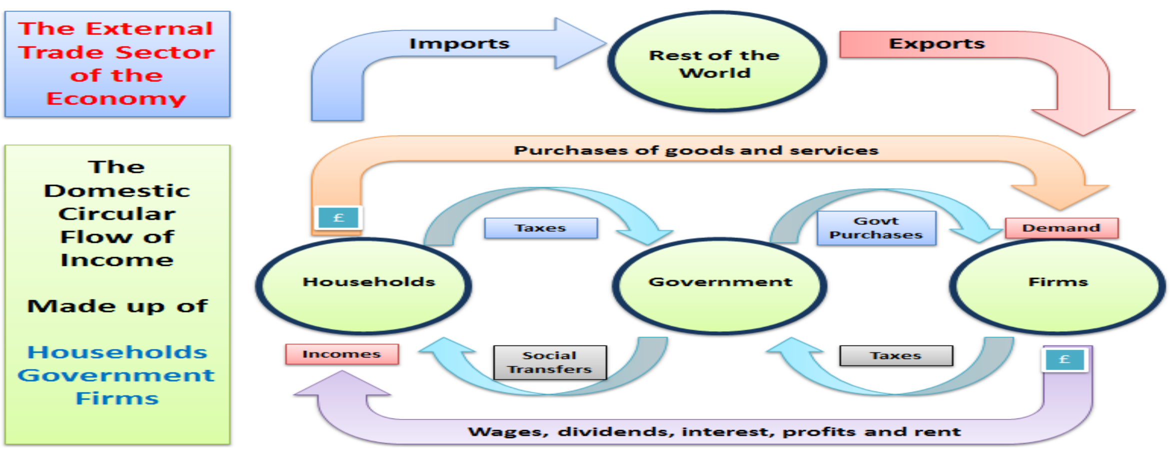
Fig 2: Three sector model including the household, business/ firms and government sectors



Source: Google Image

This Figure shows closed economy NI circular flows with Saving and Investment parameters.

Fig 3: Four sector model including the household, business/ firms, government and the foreign sectors.



Source: Google Image

Difficulties in measuring National Income in Developing Countries

National Income measurement problems are more profound in LDCs like India than advanced countries.

These problems can be grouped into two:

1. Conceptual or theoretical problem
2. Practical or statistical problem.

There is no escape to avoid all the conceptual problems such as services rendered by mother at home, goods that are to be sold but are used for self-consumption by the farmer etc. so, we set aside these problems and let's consider only practical problems.

Some of the difficulties in measuring national income are as follows:

1. Lack of Reliable Data:

The reliability of data relating to national income estimation is often questioned in India. National income estimates are made on the basis of primary data; this source is supposed to be obscure. The reasons behind this are many including illiteracy, reluctance of the people to cooperate with the data collectors, data collectors often 'fabricate' data even without approaching the door of producing sectors or economic units.

2. Existence of Non-Monetised Sector:

In many developing economies an unorganized barter economy where money is not used for transaction purposes exists. Hence, the problem of valuation of goods transacted crops up. Further, poor farmers of these countries retain large chunks of their output for self-consumption. Therefore, a large amount of output does not come to the market and is not subject to the valuation process.

3. Difficulties in the Classification of Working Population:

In India, the working population is not clearly defined. For instance, agriculturists in India are not engaged in agriculture round the year. Obviously, in the off-season they engage themselves in alternative occupations. In such a case, it is very difficult to identify their incomes to a particular occupation.

4. Illegal Income:

Illegal incomes which do not get reported in national income accounts but create the parallel activities in the economy are called underground or black economy. For instance, gambling and drug trade are illegal forms of economic activities while people in power receive bribes but these people either underreport or do not report the bribed incomes that are illegal.

5. Depreciation:

Insufficient calculating methods for depreciation of the assets also cost dearly to the national income measurement.

Student Homework

Make own Notes on:

GDP Deflator

Green GDP