10
INCOME FLOWS

10.1 INTRODUCTION

Most of you must have heard or read about national income. It is a very important economic concept. However, it has a specific meaning in Economics. It consists of two words 'national' and 'income'. Each of these words have specific meaning in Economics. In this lesson, you will learn about the meaning of 'income' and the process of income generation.

10.2 OBJECTIVES

After going through this lesson, you will be able to :

- distinguish between factor incomes and non-factor incomes;
- explain the meaning of the four factors of production and the type of factor income accruing to each one of them;
- explain the meaning of a production unit;
- explain the basic economic activities of production, consumption and investment;
- distinguish between money flows and real flows;
- distinguish between a closed economy and an open economy;
- explain the sectorization of an economy into production units, households, general government, capital and the rest of the world sectors;
- explain the various money and real flows among the sectors.

10.3 MEANING OF INCOME

One may receive income from many sources. Some receive wages from their employers. Some receive interest on lending money. Some receive gifts, donations etc from others. Some earn profit from doing business.

For receiving some of these incomes, one has to give some thing in return. For example, for receiving wages one has to work for the employers. However, there are some money incomes for which one has not to give anything in return. For example, when one receives a gift or a donation he or she has not to give anything in return. It means that all income receipts are not of the same type. For receiving some incomes, one has to make some sacrifice and for some others one has not to make any sacrifice.

Accordingly, in national income accounting we distinguish between two types of incomes: (a) factor incomes and (b) non-factor incomes. The meanings of these two types of incomes are explained below:

(a) Factor Incomes

The term 'factor' here means factor of production. There are four factors of production: land, labour, capital and entrepreneurship. The owners of these factors of production sell the services of their factors to the production units. The production units in turn pay the price for the factor services purchased by them from the factor owners. This price is the **factor cost** to the production unit and **factor income** to the owner of the factor of production.

So, a factor income is the income accruing to the owner of a factor of production in return for the services rendered to the production units. A worker earns income called **wages** in return for the labour services rendered. A land owner earns **rent** by allowing the use of his land to the production units. The owner of capital earns **interest** by lending his funds for investment to the production units. The entrepreneur, i.e. the owner of the production unit, earns **profit** in return for the risk he undertakes in organising the business There are thus four types of factor incomes in the form of wages, rent, interest and profits

(b) Non-factor Incomes

There are certain money receipts which do not involve any sacrifice on the part of their recipients. The main examples are the gifts, donations, charities, taxes, fines, etc. No sale or provision of any factor service is involved in getting these incomes. These incomes are also known as **transfer incomes** because such incomes merely represent transfer of money without any good or service being provided in return for the receipts. National income does not includes these incomes. National income includes only the factor incomes.

10.4 WHO GENERATES FACTOR INCOMES?

It is the production unit which generates factor income. Let us take the example of a factory which produces goods.

Who actually produces these goods? The workers or the landlord or the money lender or the owner? None of these individually can produce any good. The worker cannot produce the goods if there is no owner to start the factory; if there is no land to build the factory; if there is no money to invest. For producing a good we require workers, the land, the finance and the owner who brings together all these factors of production. It is the joint effort of the four factors of production i.e. the land, labour, capital and entrepreneur which is required to produce a good or a service.

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10.5 THE FOUR FACTORS OF PRODUCTION

The production of any good or service is the result of the joint efforts of the four factors of production. We explain below briefly the meaning of these four factors of production.

(a) Labour

Labour includes all physical and mental efforts of human beings used for producing goods and services. The physical and mental efforts are inseparable. A worker requires both. The difference is of only degree. Some of the jobs require more of physical than mental labour. For example, a worker who is operating a machine as a routine may be doing more of physical labour than mental labour. On the other hand, an engineer who is looking after the machine may be performing more of mental labour than physical labour. The remuneration paid to the workers is popularly termed as 'wages and salaries'. In national income accounting it is termed as **compensation of employees.**

(b) Land

The alternative term for land as used in economics is 'natural resources'. It includes all gifts of nature on, below or above the surface of the earth. On the surface there is land used for agricultural, industrial, residential and other purposes like rivers, dams, bridges etc. Below the surface are the mineral deposits, water streams, etc. Above the surface are the sun, the moon, the wind, the rain etc. Thus, the term land includes all that is given to us free by the nature. Historically, when land was abundant, there was no need to pay any price for owning land. But as land became scarce sale and purchase of land started. Those who owned land started charging payments for the use of the land owned by them. Such a remuneration accruing to the land owner is termed as **rent** in national income accounting.

(c) Capital

Capital includes all the man-made assets used for producing a good or a service like structures on land, machines, equipments, vehicles, stock of materials etc. The main difference between land and capital is that land is a free gift of nature while capital is produced by man. We cannot reproduce land but we can reproduce capital. The remuneration accruing to the capital is termed as **interest** in national income accounting.

(d) Entrepreneurship

It refers to the initiative taken by a person or a group of persons in starting and organizing a business and take upon their shoulders all the good and bad consequences of doing so. The good consequence of a business is the profit it earns. The bad consequence is the losses it ma incur. Unless somebody takes this initiative no business can be started. The one who takes the initiative is termed as 'entrepreneur'. He brings together the owners of labour, land and capital and uses their factors of production in the production unit. The remuneration accruing to the entrepreneur is termed as **profit** in national income accounting.

10.6 PRODUCTION UNIT

A production unit is formed when the owners of the four factors of production join hands to produce a good or a service. The factories, shops, offices, schools, colleges, service centres, hospitals, railways, radio station. government offices, police departments etc. are all production units because each one of these produces either a good or a service. Each one requires the services of all the four factors of production, though not necessarily in equal proportion

The basic function of a production unit is to produce goods and services. To do so it incurs cost on (a) purchasing goods and services from other production units and (b) hiring the services of the four factors of production. The two types of costs are respectively called **(i) intermediate costs and (ii) factor costs.**

The goods and services so produced, in most cases, are sold in the market. The receipts from sales are used by the production unit for meeting the two types of costs i.e. intermediate cost and factor cost. For the factor owners these factor costs are factor incomes. As such factor cost is nothing but the factor incomes generated by the production unit. Since this income is generated by the four factors of production it is shared by them. The owner of labour gets wages, more appropriately termed as compensation of employees. The owner of land gets rent. The owner of capital gets interest The entrepreneur gets profit.

POINTS TO REMEMBER

- Factor income is the income accruing to the owner of the factor of production in return for the services rendered to the production units.
- There are four types of factor incomes in the form of wages, interest, rent and profits.
- A non-factor or a transfer income is the income without any good or service provided in return.
- National income includes only the factor incomes.
- The joint effort of the land, labour, capital, and entrepreneur generates income.
- Labour includes all physical and mental efforts of the human beings involved in production. Its remuneration is termed as compensation of employees.
- Land includes all free gifts of nature and its remuneration is termed as rent.
- Capital includes all man-made capital goods and its remuneration is termed as interest
- The entrepreneu. the owner of the business who earns profit.

INTEXT QUESTIONS 10.1

Fill in the blanks from among the given clues:
(compensation, non-factor, interest, transfer, factor, profit)

(i) The income received in return for the factor service rendered is termed as ____________ income.

(ii) The gift received is a ____________ income.

(iii) National income includes only the ____________ incomes.

(iv) The remuneration of the entrepreneur is termed as _________ .

(v) The remuneration to the labour is termed as ____________ of employees.

10.7 BASIC ECONOMIC ACTIVITIES

Production is not the only economic activity. There are other economic activities as well. Why do production units produce goods and services ? They produce them because people need them to satisfy their wants. The use of goods and services for satisfaction of wants is called **consumption.** It will include all goods and services purchased by households like food items, clothes, shoes, vehicles, TV sets, radios, furniture etc.

We also produce goods and services for using them to produce more goods and services. These include all such items as machines, equipments, materials etc. used by production units. Acquiring such goods and services for use in the production process is called **capital formation or investment**. So, there is not one but three economic activities i.e. production, consumption and investment.

The three economic activities are interrelated and interdependent. The interrelation is clear from the fact that goods and services produced are either used for consumption or for investment: Let us try to understand it more clearly. Firstly, unless there is need for consumption and investment no production activity will be undertaken. Secondly, it is true the other way round also. Unless there is production, no consumption or investment can take place. Thus besides production, consumption and investment are also the basic economic activities. These three economic activities are responsible for generating the income flows in the economy

10.8 FLOWS DURING ECONOMIC ACTIVITIES

The goods and services produced by the production units are generally sold for money. Any sale of a good or service involves two types of flows. One flow is from the buyer and the other is from the seller. These flows are called the real flows and the money flows. The flow of good or service from its seller is a **real flow** while the flow of money from the buyer is a **money flow.**

Let us explain it with the help of an example. Suppose, Ram buys goods worth Rs. 200/- from Rahim. In this transaction the parting of goods by Rahim is a real flow while the payment of money by Ram is a money flow. Similarly, the receipt of goods by Ram is a real flow while the receipt of money by Rahim is a money flow. Both the real and money flows take place continuously in every economy.

Let us try to understand how these flows take place among different sections of an economy namely, the producers, the consumers and the investors. But before it, it is necessary to know (a) the distinction between a closed economy and an open economy and (b) the division of an economy into different groups or sectors.

10.9 CLOSED ECONOMY VS. OPEN ECONOMY

In the modern age nearly every country has some economic relations with other countries. Almost all the countries buy goods and services from each other. Borrowing and lending also takes place among different countries. The people of one country also visit other countries. If the two countries have economic relations with each other the real and money flows also take place between these two countries.

The **open economy** is the term used for a country which has economic relations with the rest of the world. Most countries of the world are open economies. The **closed economy** is the term used for a country which has no economic relations with the rest of the world. The example of a closed economy is difficult to find in the present day world

10.10 SECTORIZATION OF A ECONOMY

Production, consumption and investment are the three basic economic activities. Those who perform these activities are called producers (or production units), consumers and investors. This classification is. based on the activities performed by these persons. A person can perform all the three activities but each of his activity is accounted for in a separate sector.

Out of the three sectors, the consumer sector is further classified into households and government. **Households** comprise of all individuals and families who purchase or aquire goods and services for personal satisfaction of their wants. The government comprises of all government departments providing free services to the people. Such government departments are called **General Government**.

The reason behind classifying consumers into households and general government is that the motive behind the consumption expenditure of each is different. Households spend on consumption keeping in mind personal or family welfare. General government spends on consumption keeping in mind public or social welfare.

The borrowing and lending activities are grouped in a separate sector termed as the capital sector. The savings of all the groups in the society are pooled in this sector which in turn lends these savings to the production units for investment.

Thus an economy is classified into four basic sectors i.e. production units, households, general government and capital. Another sector, the **rest of the world**, is added to take care of the flows among different countries. In this way an economy can be divided into following five sectors:

(i) Production units
(ii) Households
(iii) General government
(iv) Capital
(v) Rest of the world.

10.11 INFLOWS AND OUTFLOWS AMONG DIFFERENT SECTORS

We now learn the nature of flows that take place between different sectors. The flows are also presented in the form of a following figure. 10.1

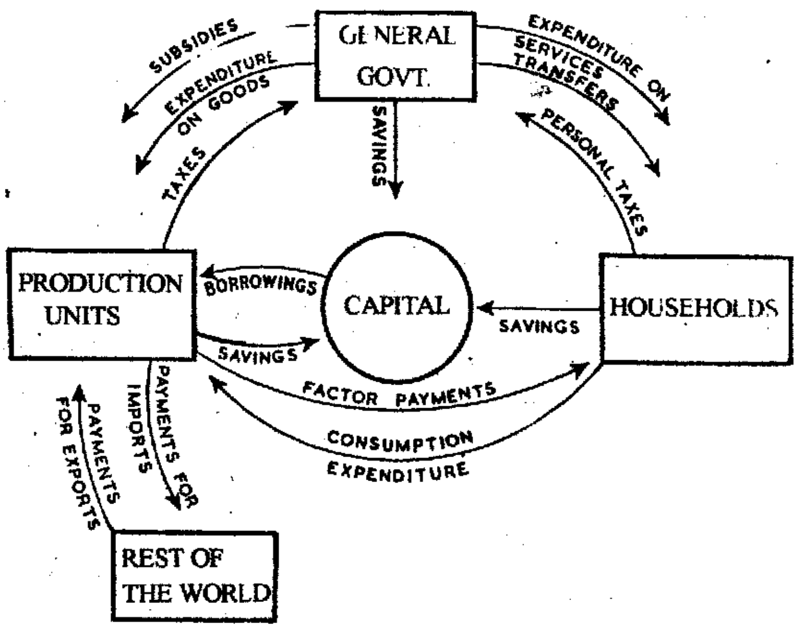

Fig.10.1: Inflows and outflows among different sectors

1. Flows from and to the Production Units

(a) They buy factor services from households (real inflow). In return they make factor payments in the form of wages, rent, interest and profits (money outflows).

(b) They deposit savings in the capital sector (money outflow).

(c) They import goods and services (real inflow) and in return make payments for imports (money outflow).

(d) They exports goods and services (real outflow) and in return they get payments for the exports (money inflow).

(e) They pay taxes to the general government (money outflow).

(f) They sell goods and services to the households and general government (real out flow). In return they get payments from households (private consumption expenditure) and general government (government consumption expenditure) (money inflows).

(g) They receive subsidies from government (money inflow).

(h) They borrow from the capital sector (money inflow).

2. Flows from and to the Households

(a) They buy goods and services from the production units (real inflow) and in return make payments (consumption expenditure) (a money outflow).

(b) They pay personal taxes to the general government (money outflow).

(c) They deposit savings in the capital sector (money outflow).

(d) They sell factor services to the enterprises (real outflow) and in return get factor incomes (money inflow).

(e) They get free services (real inflow) and transfer payments (money inflow) from general government.

3. Flows from and to the General Government

(a) It purchases goods and services from production units (real inflow) and in return makes payments i.e. government consumption expenditure (a money outflow).

(b) It pays subsidies to the production units (money outflow).

(c) It provides free services to the households (real outflow) and makes transfer payments (money outflow).

(d) It deposits savings in the capital sector (money flow).

(e) It receives taxes from production units (money inflow).

(f) It receives personal taxes from households (money inflow).

4. Flows from and to the Capital Sector

(a) It lends capital to the production units (money outflow).

(b) It receives savings from production units, households and general government (money inflows).

5. Flows from and to the Rest of the World

(a) Goods and services are exported to the rest of the world (real inflow) and in return payments are received (money outflow).

(b) Goods and services are imported from rest of the world (a real outflow) and in return payments are made (money inflow).

Not all the above money flows influence the generation of national income. Some of these are the non-factor or transfer income flows and have no effect on national income. The significance of the distinction between the two types of flows will become more clear when you will study the lesson No. 12.

POINTS TO REMEMBER

- Production, consumption and investment are the three basic economic activities in an economy. These are interrelated and interdependent.
- Flows of goods and services are real flows and flows of money are money flows.
- An economy which has economic relations with the rest of the world is an open economy. The economy which does not have economic relations with the rest of the world is a closed economy.
- The economy is broadly divided into five sectors : Production Units, Households, General Government, Capital and the Rest of the World. The real and money flows take place among these sectors.
- Not all money flows are part of national income.

INTEXT QUESTIONS 10.2

Fill in the blanks from among the given clues :

(factor, general, real, closed, non-factor, open, money)

(i) The flow of a good or a service is a .... flow.

(ii) All government departments suppling free services to the people are termed as .... v nment.

(iii) The economy having no economic relations with the rest of the world is a .... economy.

(iv) The production units buy factor services from the households and in return make...... .... payments.

WHAT YOU HAVE LEARNT

- The payments in return for the factor services rendered are called factor payments. The payments against which no good or service is provided in return are non-factor or transfer payments.
- National income includes only the factor incomes in the form of compensation of employees, rent, interest and profits.
- The income is generated through the joint effort of the four factors of production.
- Production, consumption and investment are the three basic economic activities which are interrelated and interdependent.
- Flows of goods and services are the real flows while the payments in terms of money are the money flows.
- Not all money flows among the different sectors of an economy are necessarily the national income flows.

TERMINAL EXERCISE

1. Explain the meaning of the term 'factor income'. Give examples.
2. Explain the meaning of the term 'non-factor income'. Give examples.
3. Distinguish between factor incomes and non-factor incomes.
4. Explain briefly the meanings of the four factors of production and the remuneration accruing to them.
5. Explain the basic economic activities of an economy.
6. Distinguish between real flows and money flows. Give examples.
7. Distinguish between a closed economy and an open economy.
8. Explain the sectorization of an economy on the basis of the three basic economic activities.
9. Explain briefly the real and money flows between the sectors of an economy with the help of a diagram.

ANSWERS

Intext Questions 10.1

(i) factor (ii) transfer (iii) factor (iv) profit (v) compensation

Intext Questions 10.2

(i) real (ii) general (iii) closed (iv) factor

Terminal Exercise : Hints

1. The income received by the owners of factors of production from selling their factor services to production units is called factor income, e.g. wages paid to workers, profits paid to the entrepreneurs. [Read section 10.3(a)]
2. Non-factor incomes are those against which nothing is provided in return, e.g. gifts, donation, tax, fines etc. [Read section 10.3(b)]
3. Factor income is in return for a service. In non-factor income, nothing is sacrificed. [Read section 10.3]
4. Labour refers to the physical and mental efforts engaged in production. By land we mean natural resources. By capital we mean man – made capital goods. The entrepreneur is one who takes initiative in production. Their respective incomes are wages, rent, interest and profits. [Read section 10.5]
5. Production, consumption and investment are the three basic economic activities. Production refers to the creation of goods and services. Consumption refers to the using up of goods and services for satisfaction of wants. Investment refers to acquiring goods for use in production. [Read section 10.7]
6. Real flow is flow of a good or a service. Money flow is flow of money. For example, goods given by a seller is a real flow, while money paid by a buyer is a money flow. [Read section 10.8]
7. A closed economy is one which has no economic relation with the rest of the world. An open economy is one which has economic relation with the rest of the world. [Read section 10.9]
8. The economy is classified into production units, consumers and investors and the rest of the world. Consumers are further classified into household and general government. [Read section 10.10]
9. The flows take place between production units, households, general government, capital and the rest of the world. [Read section 10.11]