

# Circular Flow of Income and National Income Accounting

Matthew Williams • Economics • May 17, 2026

## Circular Flow of Income and National Income Accounting

The circular flow model shows how money moves around an economy through spending, income, and production. National income accounting puts numbers on that flow. Together, they form the foundation for understanding how economists measure the size and health of an economy.

### The Circular Flow of Income

#### Two-Sector Model

In the simplest model, the economy has only two groups: **households** and **firms**.

- Households own the factors of production (land, labour, capital, enterprise) and supply them to firms.
- Firms use those factors to produce goods and services, paying households **rent, wages, interest, and profit** in return.
- Households spend their income on the goods and services firms produce.

This creates a continuous loop. Money flows from firms to households as factor payments, and from households back to firms as expenditure on goods and services.

In this two-sector model, with no saving and no spending outside the loop:

$$\text{Income (Y)} = \text{Output (Q)} = \text{Expenditure (AE)}$$

This is why there are three ways to measure national income — they all measure the same circular flow from different angles.