Edexcel Economics (A) A-level

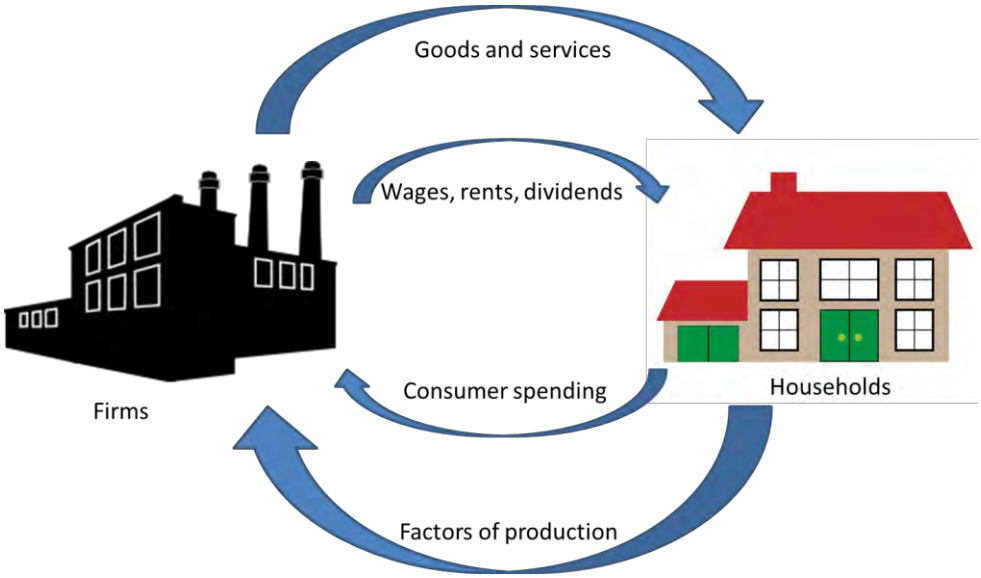
Theme 2: The UK Economy - Performance and Policies

2.4 National Income

Summary Notes

2.4.1 National income

The circular flow of income



- Firms and households interact and exchange resources in an economy. Households supply firms with the factors of production, such as labour, land, capital and enterprise, and in return, they receive wages, rent, dividends and profit.
- Firms supply goods and services to households. Consumers pay firms for these.
- This spending and income circulates around the economy in the circular flow of income, which is represented in the diagram above. Therefore, national income= national output=national expenditure.

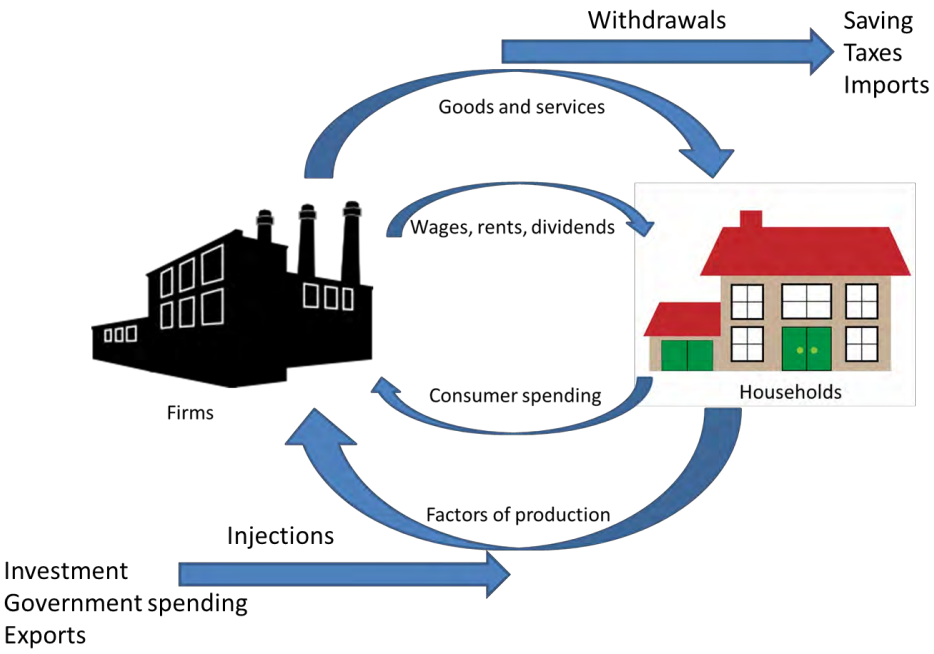
- Saving income removes it from the circular flow. This is a **withdrawal** of income. Investing money into the economy is an **injection**.

- Taxes are also a withdrawal of income, whilst government spending on public and merit goods, and welfare payments, are injections into the economy.

- International trade is also included in the circular flow of income. **Exports** are an injection into the economy, since goods and services are sold to foreign countries and revenue in earned from the sale. **Imports** are a withdrawal from the economy, since money leaves the country when goods and services are bought from abroad.

- The economy reaches a state of equilibrium when the rate of withdrawals = the rate of injections.

- The full circular flow of income can be derived from this:



The distinction between income and wealth:

- **Income is a flow of money** that goes to the factors of production. For example, wages, welfare payments, profits, dividends, rents and interest are forms of income.

- **Wealth is a stock of assets**, such as savings, shares, property, bonds and pension schemes.

2.4.2 Injections and withdrawals

The impact of injections and withdrawals from the circular flow of income

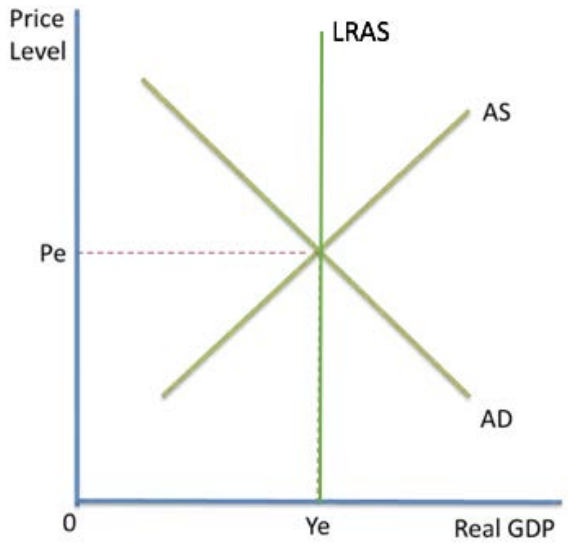
- An **injection** into the circular flow of income is money which enters the economy. This is in the form of government spending, investment and exports.
- A **withdrawal** from the circular flow of income is money which leaves the economy. This can be from taxes, saving and imports.
- The economy reaches a state of equilibrium when the rate of withdrawals = the rate of injections.
- If there are **net injections** into the economy, there will be an expansion of national output.
- If there are **net withdrawals** from the economy, there will be a contraction of production, so output decreases.

2.4.3 Equilibrium levels of real national output

Equilibrium real national output

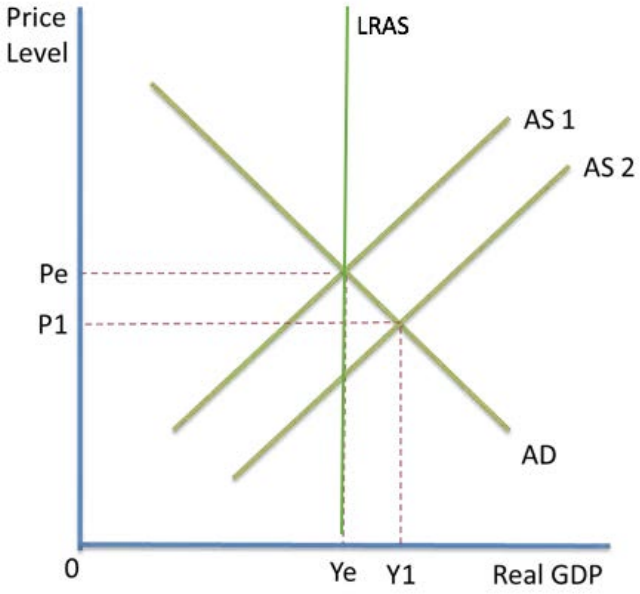
- The economy reaches a state of equilibrium when the rate of withdrawals = the rate of injections. This is equivalent to the point where AD = AS.

The effects of shifts in AD and AS on the price level and real national output



- At a price above equilibrium, there will be excess supply. At a price below equilibrium, there will be excess aggregate demand, in the short run.

- **Shift in AS:**



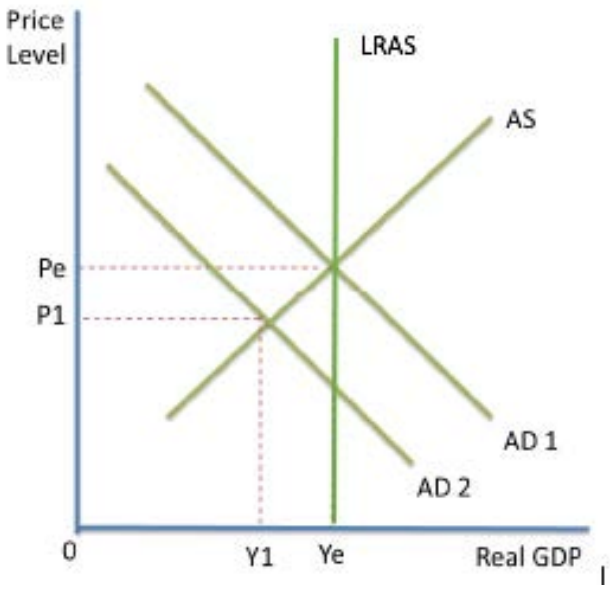
- If the economy becomes more productive, or if there is an increase in efficiency, supply will shift to the right. This lowers the average price level (Pe to P1) and increases national output (Ye to Y1). The economy is no longer producing at long run equilibrium, as they producing beyond the LRAS.

- If AS shifts inwards, price increases and national output decreases.

- **Shift in AD:**

- If firms have less confidence or there is a recession, AD might shift inwards. This causes the price level to fall from Pe to P1, and national output to fall from Ye to Y1.

- If AD increases, the price level and level of national output both increase.



2.4.4 The multiplier

The multiplier ratio

This is the ratio of the rise national income to the initial rise in AD. In other words, it is the number of times a rise in national income is larger than the rise in the initial injection of AD, which led to the rise in national income.

The multiplier process

The multiplier effect occurs when there is new demand in an economy. This leads to an injection of more income into the circular flow of income, which leads to economic growth. This leads to more jobs being created, higher average incomes, more spending, and eventually, more income is created.

The multiplier effect refers to how an initial increase in AD leads to an even bigger increase in national income.

It occurs since 'one person's spending is another person's income'.

Effects of marginal propensities on the multiplier

- **Marginal propensity to consume (MPC)**
  A consumer's **marginal propensity to consume** is the proportion of each additional pound of household income that is spent.
  The higher the MPC, the bigger the size of the multiplier.
  The government could influence the MPC by changing the rate of direct tax. If consumers have more disposable income due to lower income tax rates, their propensity to consume might increase.

- **Marginal propensity to save (MPS)**
  A consumer's marginal propensity to save plus the marginal propensity to consume is equal to 1.
  If consumers save more than they spend, the size of the multiplier will be small.

- **Marginal propensity to tax (MPT)**

This is defined as the proportion of each pound taxed by the government. The higher the rate of tax, the less disposable income each consumer has, and the smaller the size of the multiplier.

- **Marginal propensity to import (MPM)**
  If consumers spend income on imports rather than domestic goods and services, income is withdrawn from the circular flow of income. This reduces the size of the multiplier.

Calculating the multiplier

- One formula that can be used to calculate the multiplier is **1/(1-MPC).**

- **Example:**
  If consumers spend 0.6 of every £1 they earn, they save 0/4. Therefore, the multiplier will be:
  1/(1-0.6) = 1/0.4 = 2.5.

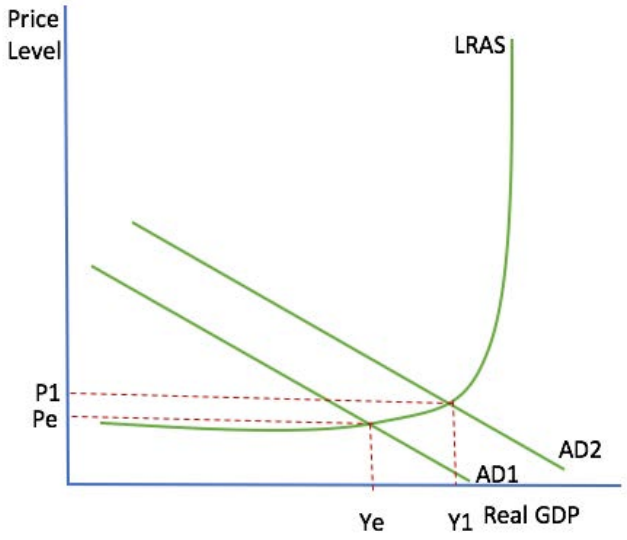
  This means that every £1 of income generates £2.50 of new income.

- An open economy has three areas of withdrawals: taxes, imports and savings.
- The marginal propensity to withdraw is calculated by MPW = MPS + MPT + MPM
- This gives another formula for calculating the multiplier:

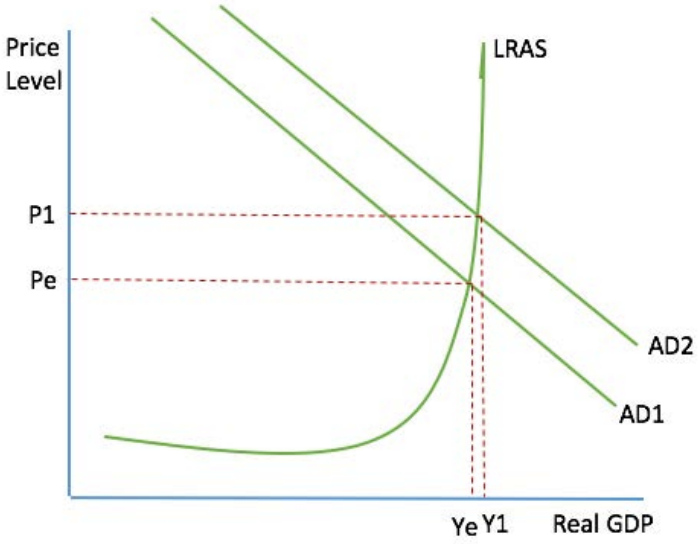
- **1/MPW**

The significance of the multiplier to shifts in AD

If an economy has a lot of spare capacity, extra output can be produced quickly and at little extra cost. This makes AS elastic and it means the size of the multiplier will be larger. A small increase in AD will lead to a large increase in national income. This is perhaps best shown on the Keynesian curve. The vertical section is perfectly inelastic, with no spare capacity, whilst the horizontal section is perfectly elastic, with lots of spare capacity.



If AS is inelastic, the multiplier effect is likely to be smaller than its potential. This is because if AD increases, prices will increase. The increase in output will not be as significant.



- It is also possible to have a ‘reverse’ multiplier. This means that a withdrawal of income form the circular flow of income could lead to an even larger decrease in income for the economy. This could decrease economic growth and potentially lead to a decline in the economy.