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THEORITICAL VIEW:“SIMPLE INCOME DETERMINATION MODEL”

Prof. Dr. D.G.Patil

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ABSTRACT

The Process of income determination in an economy involves many forces, sectors, variables and stages. We will attempt a simplistic analysis here for understanding the process of income generation we try to determine the equilibrium level of income in the following way.

KEYWORDS: income determination , economy involves , simplistic analysis, business sector.

INTRODUCTION

In a two sector model comprising households and business sector, aggregate demand or expenditure (E) is made up of consumption expenditure (C) and investment expenditure (I)

$$E=Y=C+I$$

While investment expenditure is assume to be autonomous and constant consumption is considered as $C=C_0+BY$ (C_0 =autonomous consumption) ---I

The following value are assumed to be given $C_0=150$ Rs, $b=0.5$, $I=100$ $Y=$ Means income thus $C=150+0.5Y$

$$Y=C+I$$

$$Y=C_0+by+I$$

$$Y=150+0.5Y+100$$

$$Y=0.5Y=250$$

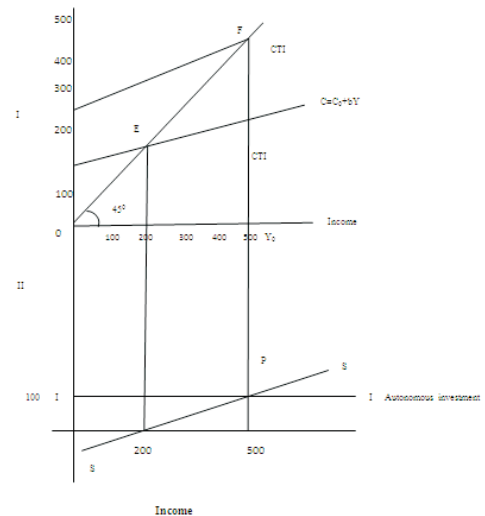
$$Y=500$$

$$\text{So } C=150+0.5 \times 500=400$$

$$S=(Y-C)=100$$

$$C+S=500=C+I$$

At this level aggregate demand and aggregate supply are balance the equilibrium level of income is shown in big.



In the above figure the equilibrium income is 500Rs. $S=100$ and $I=100$ the equilibrium income will be distribute under two situation (a) if $S \neq I$ (b) $AD \neq AS$

If the level of investment changes, Y will change this can be explained Keynesian investment multiplier:

$$K = \frac{\Delta Y}{\Delta I}$$

$$\Delta Y = K \cdot \Delta I$$

Let us derive it:

$$Y=C+I$$



$$\Delta Y = \Delta C + \Delta I$$

$$\frac{\Delta y}{\Delta Y} = \frac{\Delta C}{\Delta Y} + \frac{\Delta I}{\Delta Y} \text{-----dividing by } \Delta y$$

$$1 = \frac{\Delta c}{\Delta y} + \frac{\Delta i}{\Delta y}$$

$$\frac{\Delta i}{\Delta y} = 1 - \frac{\Delta c}{\Delta y}$$

$$\frac{\Delta y}{\Delta i} = \frac{1}{1 - \frac{\Delta c}{\Delta y}} \text{-----} \frac{\Delta c}{\Delta y} = \text{MPC}$$

There are various types of multiplier relevant for income generation e.g balance budget multiplier (BBM), Foreign trade multiplier (FTM), employment multiplier, consumption goods multiplier, policy multiplier, investment multiplier, and so on. How ever let us now introduced the government sector its effect on income generation.

GOVERNMENT SECTOR:-

We can now take the case of a closed economy with the government sector we them have;
 (Money put back) I+G=S+T (money taken out)

$$S = - a + s, y_d$$

$$Y_d = y - t_y$$

$$T = Y_t$$

{When s= saving, T =Tax, I= Investment, G= Govt expenditure, Y_d= disposable income, t=tax proportion, a=constant, s= MPS}

BALANCE BUDGET MULTIPLIER:-

It says that an increase in govt expenditure matched by an equal amount of taxation will lead to an increase in income this is called haavelma effect

$$\text{BBM} = \frac{\text{Net increase in income}}{\text{Initial increase in govt expenditure}}$$

$$\frac{\Delta y}{\Delta G}$$

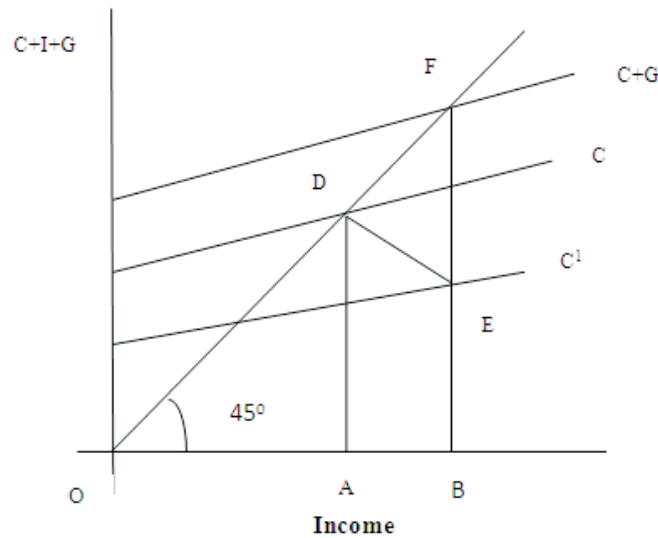
$$\text{BBM} \geq < 1$$

Now suppose $\Delta G = 100, \text{MPS} = \frac{4}{5}, S = 20$

If $\text{MPC} = \frac{4}{5}$ then $K=S$, if $S=I$ then $I=20$

$$\Delta Y = I \times K \quad 100 = S \times 20$$

$$\text{BBM} = \frac{100}{100} = 1$$



In the above diagram C is consumption function before tax and C' is the same after tax, DE (Tax) = EF (govt. expenditure)

Now $AB (\Delta Y) = DE (\Delta T) = EF (\Delta G)$

$$BBM = \frac{\Delta Y}{\Delta G} = \frac{\Delta Y}{\Delta T} = 1$$

Open Economy:-

In the open economy the level of income is given by the following equation

$$Y = C + I + G + (X - M)$$

X = export M = import

If x generate than m, y will increase and it will have same multiplier effect which can be described with the help of foreign trade multiplier (FTM)

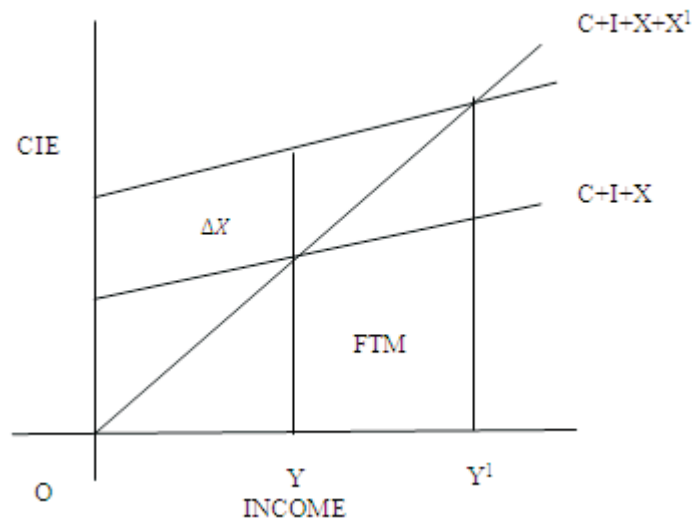
$$FTM = \frac{\text{final increase in income (y)}}{\text{intial increase in export}}$$

$$= \frac{\Delta y}{\Delta x}$$

FTM depend upon marginal propensity to import (M) and to save (S)

$$F_K = \frac{1}{M+S} = \frac{1}{0.1+0.3} = 2.5$$

This means that if x increases by 20 cr. Then the final increase in income would be Rs. 20 cr x 2.5 = 50cr. FTM can be represented in the following diagram



There are of course many leakages in the multiplier propagation of income; we have thus shown a short-term model of income determination.

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