Describing The Income Flows In A Simple Economic System

The economy consists of multiple income flows, namely through government activities, movement of goods and services, money circulation and cash flow through financial markets. In a basic model, we have two important components which are:

- Firms provide households with goods and services. Firms get factors of production from households.it can be labour, land, capital or entrepreneurship.
- Households, which receive the income from firms and consume goods.

Nothing between the two entities is provided for free. Households do not get free goods or services from firms and on the other hand, they do not provide free labour to firms. This means that there is money flowing in opposite directions. Households pay firms for the goods they get. Firms also pay households in the form of wages, rents, interests or profits.

Since households do not spend everything they earn in real life, savings are introduced. Savings is money not spent, so there is money flowing out. Savings are not money stored in banks. Banks invest in firms by lending them money as firms need money to buy capital, equipment or cover other costs of production. This means that there are investments flowing into the economy.

Government buys stuff as well, so there is money flowing in. Government in return gets money from taxes, so there is money flowing out. Money paid in taxes, is also money which households can’t spend.

Countries also interact with each other. Malta imports stuff. As an example, Malta can import shoes from China. Shoes flow from China into Malta and money spent on imports flows out of Malta into China. Malta exports too. Malta can produce beer and export it to foreigners. Money then flows from foreign countries into Malta. This is Malta’s export earnings.

Investments, Government spending and export earnings are called injections as money is flowing in. Savings, taxes and import spending are called leakages or withdrawals because money is leaking out of the system. Injections and leakages are related. Investments come from savings. Government spending comes from taxes. Malta makes money from foreigners by exporting, but foreigners also make money from Malta when Malta imports. The circular flow of income provides a high level understanding of how an economy functions.

Money paid by households to firms for provided good and services is referred to as the National Expenditure. Goods and services produced and sold to the households are referred to as National Output. These should be roughly equivalent because when firms sell goods to households, these are goods transformed into money. Money used for spending comes from income made by the households. This is called as the National Income and should be equal to the National Expenditure therefore:

National Income = National Expenditure = National Output

The size of such economy is determined by the measurement of the Gross Domestic Product (GDP). This is the measurement of the total value of all final goods and services produced within the borders of a country during a given period. GDP can be calculated using the output approach and the value-added approach.