private property. The Soviet Union was the most prominent planned economy of the twentieth century.

**Market Economic System:** A market (also called capitalist) economy is one in which answers to the three basic questions are the cumulative result of many individual decisions about what to buy and what to sell in the public marketplace. Buyers express their preference for certain goods and services, thereby influencing what is produced. The means of production are privately owned by sellers, who try to produce things as cheaply and efficiently as possible in order to make a profit (meaning that they sell an item for more than it cost to produce). In its purest form a market economy should function without any government intervention. Market economies are founded on the idea that the good of the whole society depends upon freedom of choice, competition, and the right of every individual to pursue private wealth. The United States is the largest market economy in the world.

In reality, most countries employ some mix of economic systems. For example, although the United States identifies itself as a market economy, the government controls public education, the postal service, and a number of other enterprises that are integral to the functioning of the economy. The U.S. government also imposes various business regulations that supersede market forces, such as a minimum wage that all businesses must pay their workers, emissions standards that limit pollution, and excise taxes designed to offset the negative social impact of certain goods, such as cigarettes. Implicit in such regulations is the idea that freedom to profit (in a pure, unregulated market) is not the only measure of public good. In the United States there is constant debate about how much or how little the government should intervene in the market.

**Recent Trends**

In the 1980s most of the world’s command economies began to embrace elements of the market system. In 1985, for example, President Mikhail Gorbachev (b. 1931) introduced in the Soviet Union an economic-reform program called perestroika (the Russian word for “restructuring”). The reforms led to economic upheaval, however, and the Soviet Union collapsed in 1991. Since then Russia and other former Soviet countries have continued to gravitate toward a market economic system, but the process has been fraught with difficulties.

In the late twentieth century the country that had transitioned most successfully from a command to a market economy was China. Beginning in the late 1970s, reforms in China were carried out as the government began to relinquish its control over the means of production and allow market forces to exert an increasing influence over the three basic economic questions: what gets produced, how it gets produced, and for whom it gets produced. Despite these changes, in the early years of the twenty-first century China still described itself as a “socialist market economy.”

**$ Factors of Production: Land, Labor, Capital**

**What It Means**

In economics the term *factors of production* refers to all the resources required to produce goods and services. A paper company might need, among many other things, trees, water, a large factory full of heavy machinery, a warehouse, an office building, and delivery trucks. It might require a thousand workers to run the factory, take orders, market (or sell) the paper, and deliver it to wholesalers or retail stores. It might need thousands more resources of varying size and cost. Some of these items, such as workers’ skills, might be intangible. Together, these resources constitute the factors of production necessary for the paper company to do business.

Though the number and variety of the different resources businesses require is limitless, economists divide the factors of production into three basic categories: land, labor, and capital. Land refers to all of the natural resources that businesses need to make and distribute goods and services. Among the resources that the paper company requires, the trees and water used to make paper would be classified as land, as would the ground on which the factory, warehouse, and office buildings are located. In economics, terms as various as gold, soil, forests, oil, coal, air, lakes, rivers, wildlife, fish, the sun, and even outer space fall under the heading of land. All of these
things are alike in that they are provided by nature rather than made by humans.

Labor refers to the workers needed to produce goods and services. The factory workers, office workers, marketing staff, and sales staff of the paper company would all be considered labor. Labor includes not just the number of employees but also the various abilities called for from workers. The labor needs of a paper company would probably differ substantially from the labor needs of a computer company, even if both needed the same number of employees.

Capital refers to the human-made equipment required to produce goods and services. The paper company’s factory, machinery, office building, and delivery trucks would be examples of capital. Sometimes capital is also defined to include the money used to buy such equipment and to start and maintain business operations.

Some economists include a fourth category among the factors of production: entrepreneurship. Others consider entrepreneurship a form of labor or capital. An entrepreneur is someone with the creative ability required to organize the other factors of production in ways that produce profits. The profitability of the paper company depends not simply on the presence and quality of its land, labor, and capital but also on the decisions made about how to employ these resources.

On a national scale the study of economics looks at problems related to the scarcity of resources, among other things. Since no economy has an unlimited supply of the factors of production, it is not possible to satisfy all of a population’s wants and needs. All societies must make choices about how to use resources. In a market economy these choices emerge from the interactions of countless individual buyers and sellers competing with one another for profit and economic well-being. Economists study how these choices are made and how they might be made differently.

When Did It Begin

Capitalism, the economic system in which individuals own property and can compete freely for profits, could not exist without the factors of production. In fact the factors of production probably did not exist in any arrangement that could sustain capitalism before the sixteenth century. Though the ancient and medieval worlds had land, workers, and tools for producing goods and services, these things were controlled by central authority figures, such as kings and the elite classes of society, so
that they could not be mobilized in the pursuit of wealth. Those who controlled the land controlled not just the natural resources but also the very people who lived on the land, and those in control had the authority to regulate the work these people did. Since workers were subject to the command of rulers, their tools did not function to create wealth in the same way that capital does.

A variety of historical and economic circumstances converged to bring the factors of production into being in Europe beginning in the sixteenth century. These changes took different forms in different countries, but they combined to pave the way for capitalism. In England peasants were evicted from rural areas so that nobles could use the land to pasture their sheep, whose wool had become a profitable commodity. This resulted in an influx of workers into cities, where they were able to (or were forced to) sell their labor to employers. Thus a market for labor developed. In France an influx of gold from the New World caused the prices of many goods and services to rise, and yet the landowning nobility had no way of increasing their wealth because it was based on collecting fixed amounts of money and farm produce from the tenants who farmed their land. These newly impoverished nobles thus began selling off their land to increasingly wealthy merchants. The result was the emergence of a market for land. In these and other ways land, labor, and capital were freed from their traditional restrictions and made available to anyone who could pay for them. Those who could buy the factors of production could combine them in the pursuit of profits.

More Detailed Information
The availability of the factors of production for use as economic resources was not an inherent feature of the world, then, but the result of specific historical changes. In particular, the freeing of land, labor, and capital from the control of rulers and other authority figures was necessary for these entities to function in a market economy. Released from traditional restrictions, the factors of production are now subject to the control of such market forces as supply and demand. Supply is the quantity of a good or service that sellers are willing to sell at a particular price, and demand is the quantity of a good or service that buyers are willing to buy at a particular price. Since both buyers and sellers want to maximize their economic well-being, sellers want to sell at the highest possible price, and buyers want to buy at the lowest possible price. The compromise between these opposing forces will set the terms for the production of any particular good or service.

While we may normally think of supply and demand as functioning in markets for consumer products, they are also components of markets for the factors of production (the factor, or resource, markets). The factor markets reverse the flow of the consumer markets: business owners are the buyers of land, labor, and capital, and individuals and households are the sellers. The owners of land receive payments (called rent) from businesses in return for the use of the land. In return for the use of their labor, workers receive payments (called wages) from businesses.

The payments that households receive in return for the third factor of production, capital, are called interest payments. Capital markets work according to slightly more complicated processes than do the land and labor markets. In general, businesses must borrow money to make the large investments in the equipment that they need to increase their profitability. Companies often borrow money from banks, but banks are really nothing more than intermediaries. Banks take in money from individuals and households in the form of deposits, then they lend it out to borrowers. The bank pays depositors interest (a fee for the use of their money), and borrowers pay the bank a higher rate of interest. The bank makes a profit on the difference between the two interest rates, but it is ultimately the savings of individuals and households, rather than the bank’s money, that businesses are using to purchase capital. The interest payments that those individuals and households receive are the payments for capital in the factor markets.

The resource or factor markets, together with the markets for products, have a profound effect on all production and distribution decisions. The paper company above, for example, might find that at a certain price, its paper products sell rapidly and ensure it a comfortable rate of profit. If, however, the price of wood (a natural resource it depends on) rises drastically as a result of government regulation of the logging industry or some other event, the company might have to choose to either cut costs (by modifying the way it uses the factors of production) or raise the prices it charges consumers.

One way the company might cut costs is by laying off workers and increasing the workload required of its remaining employees. But those employees might, in response, demand higher wages, which would again force the company to find new ways of balancing its production and pricing decisions. Yet another way in which the paper company might juggle the factors of production in order to maintain or increase profits is to upgrade some of its machinery. To do this, it might need to borrow money. Interest rates fluctuate, however, and if the rates happen to be high when the company is thinking about making this investment in capital, the company may decide against the investment. From the point of view of a single business, then, the factor markets and the factors themselves are of supreme importance. Accordingly, there is a large body of economic theory devoted to investigating the best ways of combining the factors of production.

From the point of view of a nation or of the world as a whole, too, the factors of production represent one of the most important variables in the overall economic
equation. If we think of a nation’s economic output as a river, the factors of production might be represented as the river’s headwaters. Changes in the cost of land (or natural resources; for example, rising oil prices), labor (rising wages), or capital (rising interest rates) can profoundly affect the economy as a whole. Similarly, manipulation of the factors of production (for example, by raising or lowering taxes on imports, changing minimum wage laws, or raising or lowering interest rates) is one of the most direct and comprehensive ways a government has of altering its economy’s shape. Any adjustments made at the headwaters of the economic river will affect nearly everything that happens downstream.

Recent Trends
Prior to the twentieth century economists often thought of a business owner primarily as an organizer of the existing factors of production. Increasingly, however, economists began to emphasize the role of the entrepreneur, who was not simply an organizing force but also an innovative, creative force capable of combining the other factors in visionary ways. Since these qualities seemed to distinguish entrepreneurship from other forms of labor or capital, many people have come to view entrepreneurship as a factor of production in its own right.

In the late twentieth century, moreover, agreement about the definition of the term capital began to dissolve. Capital had traditionally been defined as the investments in equipment that businesses make with a view toward future increases in profits, but the term increasingly came to include the financial resources a business has at its disposal.

Another form of capital has also taken on an increased prominence in economic thought: human capital. Human capital is the set of skills that any worker has as a result of his or her background, education, and experience. Some economists draw a distinction between human capital and traditional conceptions of labor, because investments in human capital yield future returns much in the same way that investments in physical capital (equipment) do. For example, a marketing manager at an insurance company might take time off of work and spend a great deal of money to pursue an M.B.A. degree. This investment would be likely to increase the manager’s future income dramatically, as well as the future profits of the company that hired him or her. Sometimes employers support their workers in such endeavors.

$\textbf{Circular Flow of Economic Activity}$

**What It Means**

All market economies are characterized by a circular flow of economic activity. This means that money and products (including the products businesses need to operate) move in a circular fashion between businesses and households. This situation is often illustrated using a diagram that allows us to visualize the basic workings of the overall economy.

A market is any place or system allowing buyers and sellers to come together. A market economy is one in which the free interaction of buyers and sellers determines most of the important features of economic life. Most economic decisions in a market economy are based on the forces of supply (the amount of any good or service that a seller is willing to sell at a given price), demand (the amount of any good or service that buyers are willing to buy at a given price), and prices. Sellers tend to supply more and more of their products as prices rise (because they want to maximize their profits), while buyers tend to buy less and less of a product as prices rise (because they want to maximize their own economic well-being). When buyers decide to purchase or not purchase certain goods...