What Are the Four Factors of Production?

Innovations in how the factors of production are used affects their yield through profits, labor productivity or income streams. (Getty Images)

The factors of production are the inputs used to produce a good or service in order to produce income.

Economists define four factors of production: land, labor, capital and entrepreneurship. These can be considered the building blocks of an economy. How these factors are combined determines the success or failure of the outcome.

"The four factors of production are needed in an efficient market to provide goods and services at an affordable price at the right time, place and mix," says Bob Castaneda, program director for Walden University's Master of Science in Finance. "Missing the calibration of these factors can be disastrous for the supplier and consumer." The supplier may face higher costs of production, forcing them to charge a higher price to the consumer or risk going out of business.

An example Castaneda uses to illustrate the importance of the four factors of production is when Ray Kroc bought McDonald's (ticker: MCD) and then found himself lacking capital, land and entrepreneurs to open new stores. To remedy this, Kroc created a franchise model that brought all three of these factors together.

A key element of the factors of production is their scarcity. "The availability, quality and costs of these factors affect costs of production, R&D spending and market potential," says Usha Haley, director of the Center of International Business Advancement at Wichita State University's Barton School of Business. "They contribute to rents, wages, interest rates, and capacities for innovation and in that fashion are important for investors to understand."

Investors can gauge investment opportunities by where factors of production are improving and where they are disadvantaged. "For example, looking at the factors of production in the U.S. versus globally in the developing world can offer perspective on where investors can put their money to work for the highest returns," says Jack McIntyre, a portfolio manager at Brandywine Global.

Here is a closer look at each of the four factors of production and how they come together to impact the financial markets:

- Land.
- Labor.
- Capital.
- Entrepreneurship.

Land

Land as a factor of production includes the natural resources used to create a good or service. These can be renewable resources like forests or nonrenewable resources like oil, gold or water, says Edward Petersmarck, executive director of practice development at M&O Marketing.

The U.S. is advantaged in terms of land as a factor of production. The third-largest nation by geography, America is home to an abundance of natural resources, including more than 750 million acres of forest, nearly 2.3 billion acres of agricultural land and the largest supply of coal, natural gas and petroleum. Other nations may have similar land mass but are unable to access these resources as readily due to harsher climates.

An interesting facet of land as a factor of production is how use is influenced by the capital markets. "Tax schemes can heavily influence the land component and where people do business," McIntyre says. "For example, Tesla moving out of California to Texas."

Similarly, many companies and people have been moving out of urban areas due to the pandemic. "One of the key advantages of urban areas was the centralized transportation system," McIntyre says. "If you're working from home, that advantage is diminished."

Labor

"When we think about the factors of production, the one we are most focused on is labor," says John Traynor, chief investment officer of People's United Advisors. Labor is the work done by the people in a workforce. Its value is dependent on the human capital, or the skills, knowledge, training and experience of these workers.

"So many of the topics being debated today in the political and economic spheres revolve around human capital and finding ways to increase productivity for all workers," Traynor says. Increasing the factors of production used in creating a good can increase production, but it is the more efficient use of those factors "that leads to greater productivity and rising living standards," he adds.

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Traynor gives the classic example of a team of men digging a trench with shovels. An entrepreneur can invest in a bulldozer to speed production, but if he doesn't teach the men how to use it, all he has is "men with shovels and a costly lawn ornament."

Thanks to inventions like bulldozers, labor has been disadvantaged by increasing productivity, as fewer workers are required to create the same amount of output. Similarly, globalization has placed increasing pressure on domestic labor forces to compete with outsourcing opportunities.

Labor is also a key consideration for many businesses as they need to operate sizable, and often educated or experienced, workforces, Castaneda says.

Capital

Capital as a factor of production refers to capital goods, or man-made resources, such as tools and infrastructure, used in the production of a good or service. Petersmarck gives examples such as a craftsman's hammer or a doctor's MRI machine. It is not to be confused with money, which he says "can buy capital but is not used to produce capital."

Capital goods can also be distinguished from consumer goods in that capital goods are used for production, while consumer goods are used for consumption. For example, a business complex is a capital good, while an apartment complex is a consumer good.

Capital naturally varies based on the industry and workforce. Capital for the construction industry may include a jackhammer and bulldozer, for instance.

Entrepreneurship

Entrepreneurs are the people who combine the other factors of production – land, labor and capital – to generate profit. You can think back to McDonald's franchiser Ray Kroc as an example of the entrepreneurial factor of production.

"Entrepreneurial activity is the engine of innovation that brings new ways of organizing land, capital and labor to produce new goods and services," says Luis Portes, professor of economics at Montclair State University.

Global events can also impact entrepreneurial success. For example, "post-9/11 there was a spike in companies focused on security," McIntyre says. "Now, with the pandemic, there's an uptick in medical-focused companies."

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The Factors of Production and the Financial Markets

"Improvements and revisions to the use of capital, labor and land all funnel to the functioning of financial markets, where capital is sourced and allocated, and of the labor market, thus affecting investors and consumers alike," Portes says. Innovations in how the factors of production are used affects their yield through profits, labor productivity or income streams.

These changes are reflected in the value of the linked financial instruments, such as bonds, stocks or special purpose vehicles either for funding or savings, Portes says.

"Financial markets continually move back and forth trying to calibrate with the slightest hint anticipating changes in factors of productions," Castaneda says. For example, lower interest rates impact rates of return, cost of capital and an investor's risk.

"The most recent examples of this are the current unemployment rate's impact on the cost of labor and corporate real estate downsizing due to work-from-home initiatives brought on by the pandemic, which can affect residential and corporate real estate prices," Castaneda says. These changes have had a direct impact on restaurants, retailers and the travel industry.

The factors of production should influence investing decisions, Castaneda says. If a company faces hardships in obtaining factors of production, it could threaten profits and thus investment returns. Contrarily, a company that has a sustainable market with willing consumers will be a more attractive investment opportunity.

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