Economic myths: Diminishing Returns and Marginalism

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I have added this entry to this blog's glossary, it being a myth within neoclassical economics.

Diminishing Returns and Marginalism

Few ideas have done more damage to the teaching of economics than “marginalism”, which is the belief that firms and individuals make decisions by balancing costs and benefits “at the margin”. It sounds technical, precise and scientific. In reality, it is little more than an elegant simplification that obscures how modern economies actually work.

Assumption

According to the textbooks, each firm expands output until the additional (or ***marginal***) cost of producing one more unit equals the additional (or marginal) revenue earned from selling it. Beyond that point, costs supposedly rise faster than revenue because of “diminishing returns”. As more resources are used, productivity falls. The same logic is applied to individuals. We supposedly consume or work until the marginal benefit equals the marginal cost of effort. This “equilibrium on the margin” supposedly guarantees efficiency.

Reality

Real businesses rarely behave this way. In most modern industries, fixed costs, such as those of buildings, software, machinery, and intellectual property, dominate their cost structures, and once those costs are covered, the extra cost of each unit often falls rather than rises. For a tech company selling software downloads, the marginal cost of any sale is, in fact, as close to zero as makes no difference, but none is willing to sell at that price. Economies of scale, network effects, and increasing returns are the real forces shaping industrial structure. Moreover, firms make decisions under uncertainty:

they plan, invest, and compete strategically over years, and do not and cannot make instant marginal adjustments, not least because they will not have the data to do so in a great many cases. The neat mathematical curves of marginalism bear no resemblance to boardroom reality.

Marginalism also struggles to describe sectors such as public services, where output cannot easily be measured and where efficiency is not the goal. Teachers, nurses and carers cannot “optimise” marginal productivity because their value lies in relationships, not outputs. Yet marginalist logic has been used to impose spurious efficiency targets across the public realm.

And as for real people, no one thinks in the way that neoclassical economics teaches. The idea it presents is alien to human experience.

Why It Matters

Marginalism creates the illusion that markets naturally find optimal outcomes, while masking the structural realities of scale, power and uncertainty. It treats investment and innovation, which depend on bold leaps and not incremental adjustments, as aberrations.

It has also legitimised austerity: if every activity must yield marginal returns, public spending appears wasteful whenever its benefits are not easily priced. Economics must abandon its obsession with the margin and return to thinking about systems, not points on curves.

Summary

Modern economies thrive on increasing returns and interdependence, not marginal perfection, and policy must reflect that.