CHAPTER

TWO

ECONOMIC MODELS

As mentioned before, any economic theory is necessarily an abstraction from the real world. For one thing, the immense complexity of the real economy makes it impossible for us to understand all the interrelationships at once; nor, for that matter, are all these interrelationships of equal importance for the understanding of the particular economic phenomenon under study. The sensible procedure is, therefore, to pick out what appeal to our reason to be the primary factors and relationships relevant to our problem and to focus our attention on these alone. Such a deliberately simplified analytical framework is called an *economic model*, since it is only a skeletal and rough representation of the actual economy.

2.1 INGREDIENTS OF A MATHEMATICAL MODEL

An economic model is merely a theoretical framework, and there is no inherent reason why it must be mathematical. If the model *is* mathematical, however, it will usually consist of a set of *equations* designed to describe the structure of the model. By relating a number of *variables* to one another in certain ways, these equations give mathematical form to the set of analytical assumptions adopted. Then, through application of the relevant mathematical operations to these equations, we may seek to derive a set of conclusions which logically follow from those assumptions.

Variables, Constants, and Parameters

A *variable* is something whose magnitude can change, i.e., something that can take on different values. Variables frequently used in economics include price, profit, revenue, cost, national income, consumption, investment, imports, exports, and so on. Since each variable can assume various values, it must be represented by a symbol instead of a specific number. For example, we may represent price by P, profit by π, revenue by R, cost by C, national income by Y, and so forth. When we write $P = 3$ or $C = 18$, however, we are "freezing" these variables at specific values (in appropriately chosen units).

Properly constructed, an economic model can be solved to give us the *solution values* of a certain set of variables, such as the market-clearing level of price, or the profit-maximizing level of output. Such variables, whose solution values we seek from the model, are known as *endogenous variables* (originating from within). However, the model may also contain variables which are assumed to be determined by forces external to the model, and whose magnitudes are accepted as given data only; such variables are called *exogenous variables* (originating from without). It should be noted that a variable that is endogenous to one model may very well be exogenous to another. In an analysis of the market determination of wheat price (P), for instance, the variable P should definitely be endogenous; but in the framework of a theory of consumer expenditure, P would become instead a datum to the individual consumer, and must therefore be considered exogenous.

Variables frequently appear in combination with fixed numbers or constants, such as in the expressions $7P$ or $0.5R$. A *constant* is a magnitude that does not change and is therefore the antithesis of a variable. When a constant is joined to a variable, it is often referred to as the *coefficient* of that variable. However, a coefficient may be symbolic rather than numerical. We can, for instance, let the symbol a stand for a given constant and use the expression aP in lieu of $7P$ in a model, in order to attain a higher level of generality (see Sec. 2.7). This symbol a is a rather peculiar case—it is supposed to represent a given constant, and yet, since we have not assigned to it a specific number, it can take virtually any value. In short, it is a *constant* that is *variable*! To identify its special status, we give it the distinctive name *parametric constant* (or simply *parameter*).

It must be duly emphasized that, although different values can be assigned to a parameter, it is nevertheless to be regarded as a datum in the model. It is for this reason that people sometimes simply say "constant" even when the constant is parametric. In this respect, parameters closely resemble exogenous variables, for both are to be treated as "givens" in a model. This explains why many writers, for simplicity, refer to both collectively with the single designation "parameters."

As a matter of convention, parametric constants are normally represented by the symbols a, b, c, or their counterparts in the Greek alphabet: α, β, and γ. But other symbols naturally are also permissible. As for exogenous variables, in order that they can be visually distinguished from their endogenous cousins, we shall follow the practice of attaching a subscript 0 to the chosen symbol. For example, if P symbolizes price, then P_0 signifies an exogenously determined price.

Equations and Identities

Variables may exist independently, but they do not really become interesting until they are related to one another by equations or by inequalities. At this juncture we shall discuss equations only.

In economic applications we may distinguish between three types of equation: definitional equations, behavioral equations, and equilibrium conditions.

A *definitional equation* sets up an identity between two alternate expressions that have exactly the same meaning. For such an equation, the identical-equality sign $\equiv$ (read: "is identically equal to") is often employed in place of the regular equals sign $=$, although the latter is also acceptable. As an example, total profit is defined as the excess of total revenue over total cost; we can therefore write

$$\pi \equiv R - C$$

A *behavioral equation*, on the other hand, specifies the manner in which a variable behaves in response to changes in other variables. This may involve either human behavior (such as the aggregate consumption pattern in relation to national income) or nonhuman behavior (such as how total cost of a firm reacts to output changes). Broadly defined, behavioral equations can be used to describe the general institutional setting of a model, including the technological (e.g., production function) and legal (e.g., tax structure) aspects. Before a behavioral equation can be written, however, it is always necessary to adopt definite assumptions regarding the behavior pattern of the variable in question. Consider the two cost functions

$$C = 75 + 10Q \tag{2.1}$$

$$C = 110 + Q^2 \tag{2.2}$$

where Q denotes the quantity of output. Since the two equations have different forms, the production condition assumed in each is obviously different from the other. In (2.1), the fixed cost (the value of C when $Q = 0$) is 75, whereas in (2.2) it is 110. The variation in cost is also different. In (2.1), for each unit increase in Q, there is a constant increase of 10 in C. But in (2.2), as Q increases unit after unit, C will increase by progressively larger amounts. Clearly, it is primarily through the specification of the form of the behavioral equations that we give mathematical expression to the assumptions adopted for a model.

The third type of equations, *equilibrium conditions*, have relevance only if our model involves the notion of equilibrium. If so, the equilibrium condition is an equation that describes the prerequisite for the attainment of equilibrium. Two of the most familiar equilibrium conditions in economics are

$$Q_d = Q_s \qquad \text{[quantity demanded = quantity supplied]}$$

and

$$S = I \qquad \text{[intended saving = intended investment]}$$

which pertain, respectively, to the equilibrium of a market model and the equilibrium of the national-income model in its simplest form. Because equations of this type are neither definitional nor behavioral, they constitute a class by themselves.

2.2 THE REAL-NUMBER SYSTEM

Equations and variables are the essential ingredients of a mathematical model. But since the values that an economic variable takes are usually numerical, a few words should be said about the number system. Here, we shall deal only with so-called "real numbers."

Whole numbers such as 1, 2, 3, ... are called *positive integers*; these are the numbers most frequently used in counting. Their negative counterparts $-1, -2, -3, \ldots$ are called *negative integers*; these can be employed, for example, to indicate subzero temperatures (in degrees). The number 0 (zero), on the other hand, is neither positive nor negative, and is in that sense unique. Let us lump all the positive and negative integers and the number zero into a single category, referring to them collectively as the *set of all integers*.

Integers, of course, do not exhaust all the possible numbers, for we have *fractions*, such as $\frac{2}{3}$, $\frac{5}{4}$, and $\frac{7}{3}$, which—if placed on a ruler—would fall between the integers. Also, we have negative fractions, such as $-\frac{1}{2}$ and $-\frac{2}{5}$. Together, these make up the *set of all fractions*.

The common property of all fractional numbers is that each is expressible as a ratio of two integers; thus fractions qualify for the designation *rational numbers* (in this usage, rational means *ratio*-nal). But integers are also rational, because any integer n can be considered as the ratio $n/1$. The set of all integers and the set of all fractions together form the *set of all rational numbers*.

Once the notion of rational numbers is used, however, there naturally arises the concept of *irrational numbers*—numbers that *cannot* be expressed as ratios of a pair of integers. One example is the number $\sqrt{2} = 1.4142\ldots$, which is a nonrepeating, nonterminating decimal. Another is the special constant $\pi = 3.1415\ldots$ (representing the ratio of the circumference of any circle to its diameter), which is again a nonrepeating, nonterminating decimal, as is characteristic of all irrational numbers.

Each irrational number, if placed on a ruler, would fall between two rational numbers, so that, just as the fractions fill in the gaps between the integers on a ruler, the irrational numbers fill in the gaps between rational numbers. The result of this filling-in process is a continuum of numbers, all of which are so-called "real numbers." This continuum constitutes the *set of all real numbers*, which is often denoted by the symbol R. When the set R is displayed on a straight line (an extended ruler), we refer to the line as the *real line*.

In Fig. 2.1 are listed (in the order discussed) all the number sets, arranged in relationship to one another. If we read from bottom to top, however, we find in effect a classificatory scheme in which the set of real numbers is broken down into its component and subcomponent number sets. This figure therefore is a summary of the structure of the real-number system.

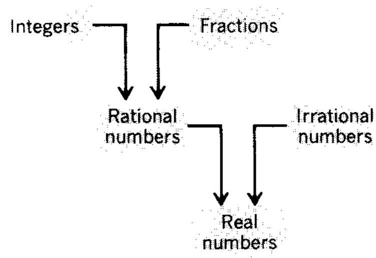

Figure 2.1

Real numbers are all we need for the first 14 chapters of this book, but they are not the only numbers used in mathematics. In fact, the reason for the term "real" is that there are also "imaginary" numbers, which have to do with the square roots of negative numbers. That concept will be discussed later, in Chap. 15.

2.3 THE CONCEPT OF SETS

We have already employed the word "set" several times. Inasmuch as the concept of sets underlies every branch of modern mathematics, it is desirable to familiarize ourselves at least with its more basic aspects.

Set Notation

A *set* is simply a collection of distinct objects. These objects may be a group of (distinct) numbers, or something else. Thus, all the students enrolled in a particular economics course can be considered a set, just as the three integers 2, 3, and 4 can form a set. The objects in a set are called the *elements* of the set.

There are two alternative ways of writing a set: by *enumeration* and by *description*. If we let S represent the set of three numbers 2, 3, and 4, we can write, by enumeration of the elements,

$$S = \{2, 3, 4\}$$

But if we let I denote the set of *all* positive integers, enumeration becomes difficult, and we may instead simply describe the elements and write

$$I = \{x \mid x \text{ a positive integer}\}$$

which is read as follows: "I is the set of all (numbers) x, such that x is a positive integer." Note that braces are used to enclose the set in both cases. In the descriptive approach, a vertical bar (or a colon) is always inserted to separate the general symbol for the elements from the description of the elements. As another example, the set of all real numbers greater than 2 but less than 5 (call it J) can be expressed symbolically as

$$J = \{x \mid 2 < x < 5\}$$

Here, even the descriptive statement is symbolically expressed.

A set with a finite number of elements, exemplified by set S above, is called a *finite set*. Set I and set J, each with an infinite number of elements, are, on the other hand, examples of an *infinite set*. Finite sets are always *denumerable* (or *countable*), i.e., their elements can be counted one by one in the sequence $1, 2, 3, \ldots$. Infinite sets may, however, be either denumerable (set I above), or *nondenumerable* (set J above). In the latter case, there is no way to associate the elements of the set with the natural counting numbers $1, 2, 3, \ldots$, and thus the set is not countable.

Membership in a set is indicated by the symbol $\in$ (a variant of the Greek letter epsilon ϵ for "element"), which is read: "is an element of." Thus, for the two sets S and I defined above, we may write

$$2 \in S \qquad 3 \in S \qquad 8 \in I \qquad 9 \in I \qquad \text{(etc.)}$$

but obviously $8 \notin S$ (read: "8 is not an element of set S"). If we use the symbol R to denote the set of all real numbers, then the statement "x is some real number" can be simply expressed by

$$x \in R$$

Relationships between Sets

When two sets are compared with each other, several possible kinds of relationship may be observed. If two sets S_1 and S_2 happen to contain identical elements,

$$S_1 = \{2, 7, a, f\} \qquad \text{and} \qquad S_2 = \{2, a, 7, f\}$$

then S_1 and S_2 are said to be *equal* ($S_1 = S_2$). Note that the order of appearance of the elements in a set is immaterial. Whenever even one element is different, however, two sets are not equal.

Another kind of relationship is that one set may be a *subset* of another set. If we have two sets

$$S = \{1, 3, 5, 7, 9\} \qquad \text{and} \qquad T = \{3, 7\}$$

then T is a subset of S, because every element of T is also an element of S. A more formal statement of this is: T is a subset of S if and only if "$x \in T$" implies "$x \in S$." Using the set inclusion symbols $\subset$ (is contained in) and $\supset$ (includes), we may then write

$$T \subset S \qquad \text{or} \qquad S \supset T$$

It is possible that two given sets happen to be subsets of each other. When this occurs, however, we can be sure that these two sets are equal. To state this formally: we can have $S_1 \subset S_2$ and $S_2 \subset S_1$ if and only if $S_1 = S_2$.

Note that, whereas the $\in$ symbol relates an individual *element* to a *set*, the $\subset$ symbol relates a *subset* to a *set*. As an application of this idea, we may state on the basis of Fig. 2.1 that the set of all integers is a subset of the set of all rational numbers. Similarly, the set of all rational numbers is a subset of the set of all real numbers.

How many subsets can be formed from the five elements in the set $S = \{1, 3, 5, 7, 9\}$? First of all, each individual element of S can count as a distinct subset of S, such as $\{1\}$, $\{3\}$, etc. But so can any pair, triple, or quadruple of these elements, such as $\{1, 3\}$, $\{1, 5\}, \ldots, \{3, 7, 9\}$, etc. For that matter, the set S itself (with all its five elements) can be considered as one of its own subsets—every element of S is an element of S, and thus the set S itself fulfills the definition of a subset. This is, of course, a limiting case, that from which we get the "largest" possible subset of S, namely, S itself.

At the other extreme, the "smallest" possible subset of S is a set that contains no element at all. Such a set is called the *null set*, or *empty set*, denoted by the symbol $\varnothing$ or $\{\ \}$. The reason for considering the null set as a subset of S is quite interesting: If the null set is not a subset of S ($\varnothing \not\subset S$), then $\varnothing$ must contain at least one element x such that $x \notin S$. But since by definition the null set has no element whatsoever, we cannot say that $\varnothing \not\subset S$; hence the null set is a subset of S.

Counting all the subsets of S, including the two limiting cases S and $\varnothing$, we find a total of $2^5 = 32$ subsets. In general, if a set has n elements, a total of 2^n subsets can be formed from those elements.*

It is extremely important to distinguish the symbol $\varnothing$ or $\{\ \}$ clearly from the notation $\{0\}$; the former is devoid of elements, but the latter does contain an element, zero. The null set is unique; there is only one such set in the whole world, and it is considered a subset of *any* set that can be conceived.

As a third possible type of relationship, two sets may have no elements in common at all. In that case, the two sets are said to be *disjoint*. For example, the set of all positive integers and the set of all negative integers are disjoint sets. A fourth type of relationship occurs when two sets have some elements in common but some elements peculiar to each. In that event, the two sets are neither equal nor disjoint; also, neither set is a subset of the other.

Operations on Sets

When we add, subtract, multiply, divide, or take the square root of some numbers, we are performing mathematical operations. Sets are different from

* Given a set with n elements $\{a, b, c, \ldots, n\}$ we may first classify its subsets into two categories: one with the element a in it, and one without. Each of these two can be further classified into two subcategories: one with the element b in it, and one without. Note that by considering the second element b, we double the number of categories in the classification from 2 to 4 ($= 2^2$). By the same token, the consideration of the element c will increase the total number of categories to 8 ($= 2^3$). When all n elements are considered, the total number of categories will become the total number of subsets, and that number is 2^n.

numbers, but one can similarly perform certain mathematical operations on them. Three principal operations to be discussed here involve the union, intersection, and complement of sets.

To take the *union* of two sets A and B means to form a new set containing those elements (and only those elements) belonging to A, or to B, or to both A and B. The union set is symbolized by $A \cup B$ (read: "A union B").

Example 1 If $A = \{3, 5, 7\}$ and $B = \{2, 3, 4, 8\}$, then

$$A \cup B = \{2, 3, 4, 5, 7, 8\}$$

This example illustrates the case in which two sets A and B are neither equal nor disjoint and in which neither is a subset of the other.

Example 2 Again referring to Fig. 2.1, we see that the union of the set of all integers and the set of all fractions is the set of all rational numbers. Similarly, the union of the rational-number set and the irrational-number set yields the set of all real numbers.

The *intersection* of two sets A and B, on the other hand, is a new set which contains those elements (and only those elements) belonging to *both A and B*. The intersection set is symbolized by $A \cap B$ (read: "A intersection B").

Example 3 From the sets A and B in Example 1, we can write

$$A \cap B = \{3\}$$

Example 4 If $A = \{-3, 6, 10\}$ and $B = \{9, 2, 7, 4\}$, then $A \cap B = \varnothing$. Set A and set B are disjoint; therefore their intersection is the empty set—no element is common to A and B.

It is obvious that intersection is a more restrictive concept than union. In the former, only the elements *common to A and B* are acceptable, whereas in the latter, membership in *either A or B* is sufficient to establish membership in the union set. The operator symbols $\cap$ and $\cup$—which, incidentally, have the same kind of general status as the symbols $\sqrt{\ }$, $+$, $\div$, etc.—therefore have the connotations "and" and "or," respectively. This point can be better appreciated by comparing the following formal definitions of intersection and union:

Intersection: $\quad A \cap B = \{x \mid x \in A \text{ and } x \in B\}$

Union: $\quad A \cup B = \{x \mid x \in A \text{ or } x \in B\}$

Before explaining the *complement* of a set, let us first introduce the concept of *universal set*. In a particular context of discussion, if the only numbers used are the set of the first seven positive integers, we may refer to it as the universal set, U. Then, with a given set, say, $A = \{3, 6, 7\}$, we can define another set $\tilde{A}$ (read: "the complement of A") as the set that contains all the numbers in the universal set U which are not in the set A. That is,

$$\tilde{A} = \{x \mid x \in U \text{ and } x \notin A\} = \{1, 2, 4, 5\}$$

Note that, whereas the symbol $\cup$ has the connotation "or" and the symbol $\cap$ means "and," the complement symbol ~ carries the implication of "not."

Example 5 If $U = \{5, 6, 7, 8, 9\}$ and $A = \{5, 6\}$, then $\tilde{A} = \{7, 8, 9\}$.

Example 6 What is the complement of U? Since every object (number) under consideration is included in the universal set, the complement of U must be empty. Thus $\tilde{U} = \varnothing$.

The three types of set operation can be visualized in the three diagrams of Fig. 2.2, known as *Venn diagrams*. In diagram *a*, the points in the upper circle form a set A, and the points in the lower circle form a set B. The union of A and B then consists of the shaded area covering both circles. In diagram *b* are shown the same two sets (circles). Since their intersection should comprise only the points common to both sets, only the (shaded) overlapping portion of the two circles satisfies the definition. In diagram *c*, let the points in the rectangle be the universal set and let A be the set of points in the circle; then the complement set $\tilde{A}$ will be the (shaded) area outside the circle.

Laws of Set Operations

From Fig. 2.2, it may be noted that the shaded area in diagram *a* represents not only $A \cup B$ but also $B \cup A$. Analogously, in diagram *b* the small shaded area is the visual representation not only of $A \cap B$ but also of $B \cap A$. When formalized,

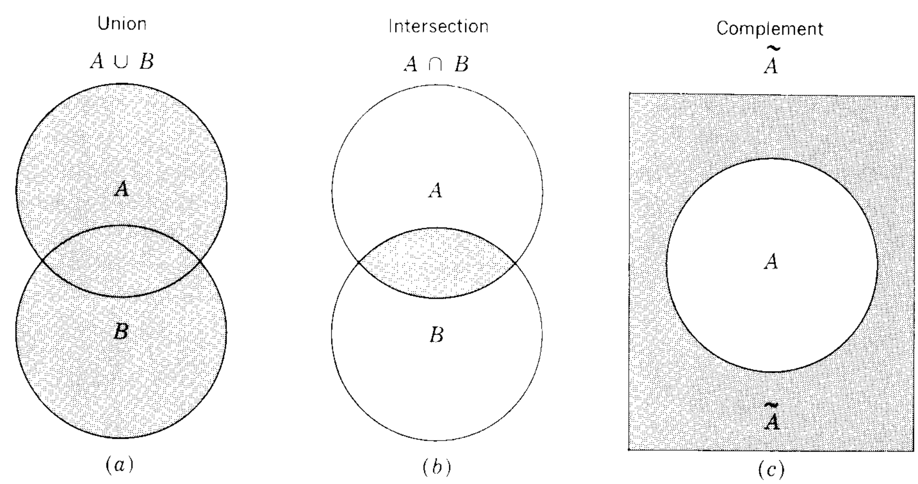

Figure 2.2

this result is known as the *commutative law* (of unions and intersections):

$$A \cup B = B \cup A \qquad A \cap B = B \cap A$$

These relations are very similar to the algebraic laws $a + b = b + a$ and $a \times b = b \times a$.

To take the union of three sets A, B, and C, we first take the union of any two sets and then "union" the resulting set with the third; a similar procedure is applicable to the intersection operation. The results of such operations are illustrated in Fig. 2.3. It is interesting that the order in which the sets are selected for the operation is immaterial. This fact gives rise to the *associative law* (of unions and intersections):

$$A \cup (B \cup C) = (A \cup B) \cup C$$

$$A \cap (B \cap C) = (A \cap B) \cap C$$

These equations are strongly reminiscent of the algebraic laws $a + (b + c) = (a + b) + c$ and $a \times (b \times c) = (a \times b) \times c$.

There is also a law of operation that applies when unions and intersections are used in combination. This is the *distributive law* (of unions and intersections):

$$A \cup (B \cap C) = (A \cup B) \cap (A \cup C)$$

$$A \cap (B \cup C) = (A \cap B) \cup (A \cap C)$$

These resemble the algebraic law $a \times (b + c) = (a \times b) + (a \times c)$.

Example 7 Verify the distributive law, given $A = \{4, 5\}$, $B = \{3, 6, 7\}$, and $C = \{2, 3\}$. To verify the first part of the law, we find the left- and right-hand expressions separately:

Left: $A \cup (B \cap C) = \{4, 5\} \cup \{3\} = \{3, 4, 5\}$

Right: $(A \cup B) \cap (A \cup C) = \{3, 4, 5, 6, 7\} \cap \{2, 3, 4, 5\} = \{3, 4, 5\}$

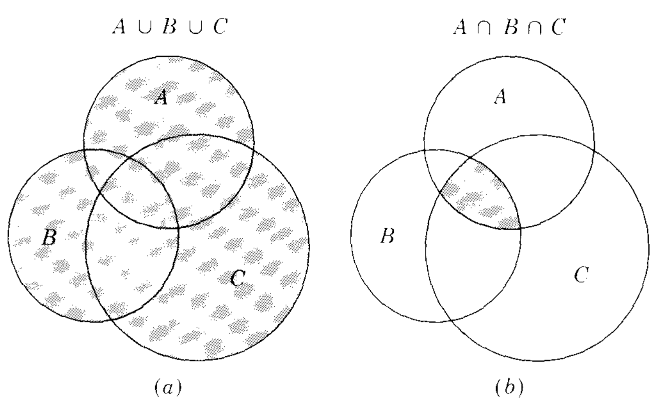

Figure 2.3

Since the two sides yield the same result, the law is verified. Repeating the procedure for the second part of the law, we have

Left: $A \cap (B \cup C) = \{4, 5\} \cap \{2, 3, 6, 7\} = \varnothing$

Right: $(A \cap B) \cup (A \cap C) = \varnothing \cup \varnothing = \varnothing$

Thus the law is again verified.

EXERCISE 2.3

1 Write the following in set notation:
(*a*) The set of all real numbers greater than 27.
(*b*) The set of all real numbers greater than 8 but less than 73.

2 Given the sets $S_1 = \{2, 4, 6\}$, $S_2 = \{7, 2, 6\}$, $S_3 = \{4, 2, 6\}$, and $S_4 = \{2, 4\}$, which of the following statements are true?
(*a*) $S_1 = S_2$ (*d*) $3 \notin S_2$ (*g*) $S_1 \supset S_4$
(*b*) $S_1 = R$ (*e*) $4 \notin S_4$ (*h*) $\varnothing \subset S_2$
(*c*) $5 \in S_2$ (*f*) $S_4 \subset R$ (*i*) $S_3 \supset \{1, 2\}$

3 Referring to the four sets given in the preceding problem, find:
(*a*) $S_1 \cup S_2$ (*c*) $S_2 \cap S_3$ (*e*) $S_4 \cap S_2 \cap S_1$
(*b*) $S_1 \cup S_3$ (*d*) $S_2 \cap S_4$ (*f*) $S_3 \cup S_1 \cup S_4$

4 Which of the following statements are valid?
(*a*) $A \cup A = A$ (*e*) $A \cap \varnothing = \varnothing$
(*b*) $A \cap A = A$ (*f*) $A \cap U = A$
(*c*) $A \cup \varnothing = A$ (*g*) The complement of $\tilde{A}$ is A.
(*d*) $A \cup U = U$

5 Given $A = \{4, 5, 6\}$, $B = \{3, 4, 6, 7\}$, and $C = \{2, 3, 6\}$, verify the distributive law.

6 Verify the distributive law by means of Venn diagrams, with different orders of successive shading.

7 Enumerate all the subsets of the set $\{a, b, c\}$.

8 Enumerate all the subsets of the set $S = \{1, 3, 5, 7\}$. How many subsets are there altogether?

9 Example 6 shows that $\varnothing$ is the complement of U. But since the null set is a subset of *any* set, $\varnothing$ must be a subset of U. Inasmuch as the term "complement of U" implies the notion of being *not in* U, whereas the term "subset of U" implies the notion of being *in* U, it seems paradoxical for $\varnothing$ to be both of these. How do you resolve this paradox?

2.4 RELATIONS AND FUNCTIONS

Our discussion of sets was prompted by the usage of that term in connection with the various kinds of numbers in our number system. However, sets can refer as well to objects other than numbers. In particular, we can speak of sets of