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Shapoor Vali

# Principles of Mathematical Economics



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# Editorial

Recent years have witnessed an extraordinarily rapid advance in the direction of information technology within the scientific, engineering, and other disciplines, in which mathematics play a crucial role. To meet such urgent demands, effective mathematical models as well as innovative mathematical theory, methods, and algorithms have to be developed for data information manipulation, understanding, visualization, communication, and other applications.

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This third volume, authored by Prof. Shapoor Vali, on the principles of mathematical economics, with emphasis on non-linear mathematical models, is a very valuable contribution to the MTSE series. Written for students in economics, business, management, and related fields, this textbook is self sufficient and self contained for the reader with only a basic knowledge of pre-college algebra as well as introductory micro- and macro-economics. A distinct and important feature of this nicely written textbook is the connection of the mathematical models, developed and formulated in each chapter, to specific real-world problems. We welcome this textbook to the MTSE book series.

Menlo Park, CA

Charles K. Chui

*To Firoozeh, Behrang, and Seena*

# Preface

This book has evolved from over many years of teaching Mathematical Economics (Math-Econ, for short) and other quantitative courses at Fordham University. In my Math-Econ classes, I have used different books as text or reference. However, I always felt compelled to complement the texts by a large volume of my own notes and handouts covering areas and topics that I considered important but either not covered or not fully developed in the existing text books. So in 2009, I decided to collect my notes and develop them into an organized text book. The result was a manuscript which I have used as a text in my Math-Econ courses for the last 4 years and annually revised it based on students' feedbacks.

This textbook is written for students in economics, business, management, and related fields, for both undergraduate and introductory level graduate courses. [Chaps. 1 through 7](#) and parts of [Chaps. 8 and 9](#) could be covered in a one-semester undergraduate course. The entire book can be covered in a one-semester graduate course, with emphasis on [Chaps. 6 through 13](#).

Mathematical Economics is generally a required course for students majoring in economics. It is also a widely recommended course for business schools students. This book is designed to be useful in both areas.

Economics is a quantitatively oriented discipline where mathematics plays a fundamental role in all of its related fields. Working with and manipulating numbers is an indispensable and inescapable part of economics and business studies, even in the field of economic history. A 1993 Nobel Prize in Economics was awarded to Robert Fogel of University of Chicago and Douglass North of Washington University, both economic historians, for their contribution to the application of quantitative methods to the field of economic history. Fogel and North advanced "Cliometrics",<sup>1</sup> a new quantitative technique for analyzing historical data and solving historical puzzles.

Lack of proficiency in mathematics is a great obstacle to learning economics. Lack of proficiency should not be interpreted only as lack of skill in manipulating algebraic or arithmetic expressions, but rather a lack of power of abstraction and

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<sup>1</sup> Combination of 'Clio', muse and daughter of Zeus in Greek mythology, and 'metrics'. There is a Cliometric society which publishes *Cliometrica—Journal of Historical Economics and Econometric History*.

generalization. In economics, and in many other fields for that matter, power of abstraction is much more important than mechanical skills.

Mathematical Economics is not a distinct area in economics, like *International Economics*, *Money and Banking*, or *Urban and Regional Economics*. It is simply an application of mathematical tools in economics, all areas of economics, in the process of formulation and test of theories (or their purely logical aspects called *models*), and stating and providing solutions to economic “problems.”

I consider Math-Econ as not simply a specific area of applied mathematics. I am sure many economists will agree with me that the main purpose of Math-Econ is not to learn more mathematics, but rather use mathematics as an aid for learning more economics. This principle has been the guiding star in writing this book. Naturally, the text contains a lot of *economics*.

A glance at various topics covered in different chapters shows that some of these topics are classic Math-Econ repertoire. But in addition to covering traditional topics, I used the same mathematical tools for formulating and solving some important Economics models that are either completely ignored or not fully explored by other textbooks, in some cases for the simple reason that they lead to nonlinearity. Almost all of mathematical text books published in the last 74 years, following R. G. D. Allen’s classic *Mathematical Analysis for Economists* published in 1938, have avoided nonlinearity by framing the models such that solutions do not go beyond solving quadratic equations.

A very simple example arises in the context of standard market equilibrium model. Here we have a supply function, a demand function, and an equilibrium condition. As long as the supply and demand functions are linear or quadratic, we have no problem determining the equilibrium price and quantity, but if the supply and demand functions are nonlinear we may run into computational problem. Consider the following simple model

$$Q_d = \frac{100P + 1500}{(P^2 + 10)}$$

$$Q_s = 10P^{0.7}$$

Here demand is a rational function and supply is a polynomial of degree 0.7.

To find the equilibrium price algebraically, we follow the familiar routine

$$Q_d = Q_s \rightarrow \frac{100P + 1500}{(P^2 + 10)} = 10P^{0.7}$$

leading to

$$P^{2.7} + 10P^{0.7} - 10P - 150 = 0$$

This equation is not a run of the mill familiar equation, like linear or quadratic, and does not yield an analytical solution.

Another typical problem arises in the context of a firm production decision. Given a firm’s total cost function (*TC*) and the demand function for its product, we



typically want to determine the firm's profit maximizing output/price combination, its break-even level(s) of output/price and the normal profit level of output and price. We can safely do all three if the total cost function is linear or quadratic and the demand function is linear. But as soon as we introduce a more realistic cubic total cost function, a function that produces all the nice average total, average variable, and marginal cost curves, which are used in all the existing economics textbooks, then the determination of break-even and normal profit output/price leads to solving cubic equations. If we assume

$$TC = aQ^3 + bQ^2 + cQ + d$$

$$P = e - fQ$$

then for break-even(s) we need to solve  $TC - TR = 0$  (where  $TR$  is the total revenue), that is the following cubic equation

$$aQ^3 + (b + f)Q^2 + (c - e)Q + d = 0$$

And for the long run normal profit scenario, not only we need  $TC - TR = 0$ , but we also need  $MC - MR = 0$  (where  $MC$  and  $MR$  are the marginal cost and marginal revenue). This leads to solving the following cubic equation

$$2aQ^3 + (b + f)Q^2 - d = 0$$

Determining a firm's normal profit output/price when the market is competitive leads to a similar situation. In this case, we must solve

$$\frac{dATC}{dQ} = 2aQ^3 + bQ^2 - d = 0$$

So far we simply assumed that a noncompetitive firm faces a linear demand function in the market. What if the demand function is not linear? What if it is a quadratic function? A semi-log function? Or a log-linear function (a model so widely used in practice for estimating demand functions due to its desirable property of having constant price and nonprice elasticity)? In the log-linear case,

$$\ln P = \ln d - \beta \ln Q$$

a simple profit optimization routine leads to solving an equation of the form

$$3aQ^{(2+\beta)} + 2bQ^{(1+\beta)} + cQ^\beta - (1 - \beta)d = 0$$

if the total cost function is cubic, or

$$2aQ^{(1+\beta)} + bQ^\beta - (1 - \beta)d = 0$$

if the cost function is quadratic.

Modeling and solving numerous real world problems invariably leads to a nonlinear scenario, both in economics and in business. I believe in the validity of the view expressed by Naseem Talib, which is quoted in the opening page of [Chap. 7](#) “Nonlinear Models.” The last sentence of the quote reads:

Yesterday afternoon I tried to take a fresh look around me to catalog what I could see during my day that was linear. I could not find anything.

The introduction of nonlinearity may also lead to interestingly unexpected results; an issue ignored in current textbooks and economics literature.

We have reached a level of computational sophistication that many of these nonlinear models can be handled fairly easily. The currently available tools, some like WolframAlpha, **R**, and SAGE freely available online, or Microsoft Mathematics that can be downloaded, remove the barrier to the introduction of this type of models in economics and Math-Econ textbooks and free us from exclusively graphic presentation of many important economic models. Even in the absence of access to Internet-based mathematical software, an inherently nonlinear system can be transformed into a linear or quadratic model and subsequently solved, in many cases with small or tolerable errors. In an appendix to [Chap. 6](#), some of these tools are introduced and in [Chap. 7](#), and the subsequent chapters, a large number of nonlinear models are presented and solved.

My own experience is that students prefer the use of computer-based learning to paper/pencil. They only use paper/pencil when we insist that they must show their work on their weekly homework assignments. They come to class with laptops, tablets, and smart phones which are all capable of accessing the Internet and thus the full scope power of the web.

Based on my observations, it takes students not more than 30 min to learn how WolframAlpha works, along with the basics of graphing and solving equations.<sup>2</sup> In my undergraduate Math-Econ classes, I cover [Chaps. 1](#) through [7](#) plus logarithms and exponential functions ([Chap. 9](#)) along with some sections from [Chap. 8](#) (Additional Topics in Perfect and Imperfect Competition). After a short review of optimization models in [Chap. 6](#), I cover the remaining chapters in a graduate Math-Econ course. I introduced both classes to WolframAlpha and Microsoft Mathematics, which both sets of students easily learn. In my graduate class, I introduced some of the tools of **R**, especially for matrix operations and applications of matrices covered in [Chap. 13](#), along with basics of Maple. Nowadays, almost all 4-year universities with a Mathematics department have license for some mathematical software including Maple. I share with some of my grad students, who are eager to learn Maple, a series of Maple snippets (a short collection of Maple commands for solving specific problems). I have included a sample of Maple snippets at the end of [Chap. 8](#).

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<sup>2</sup> Besides computational and graphic power, WolframAlpha provides students with up to date economics and business information and data.

All of these tools will undoubtedly enhance the text. No other text currently available covers this important area and uses any technological tools to enhance learning. I am confident that the economics profession welcomes a new generation Math-Econ textbook with both theoretical and computational orientation, utilizing some of the readily available computer tools for formalizing and solving many economic models that currently limited to graphic presentation. We should also note that a text of this nature will be even more attractive to new generation of students who are computationally very savvy. Each instructor will, of course, emphasize different topics covered in the book. It has been my intention to put together a book with rich ingredients to allow Math-Econ teachers to select the menu that will be closest to their students level and need.

The book is self-sufficient and self-contained. [Chaps. 3 and 5](#) in the book cover all the mathematical tools that students need in order to understand topics covered in other chapters. It is only assumed that students have a good knowledge of algebra and have taken introductory micro- and macro-economics. Basic macro- and micro-economics are universally taken by students majoring in economics or business and in many cases by nonmajors as a part of social science core requirement.

I have attempted to connect mathematical models developed, formulated, and discussed in each chapter to real world problems by using, as much as possible, actual data in the process of operationalizing and solving the models. I consider this approach to be a distinct feature of this text.

In addition to a large number of economic examples specified and solved in each chapter, exercise sections of chapters contain a large number of problems covering application of chapter's material in various real world situations and fields of economics. As an example, exercise section of [Chap. 6](#) that deals with various optimization problems and short- or long-run equilibrium is nine pages long. This is another desirable feature of this book.

I owe thanks to many people, including some of my students and colleagues at Fordham University, who, in one form or another, have been helpful in the process of writing this book over several years. I would like to thank all of them, especially Keith Tipple, Shanu Bajaj, Mohammed Khalil, and Yuichi Yokoyama. I would like to thank Joseph Bertino and Michael Malenbaum for proofreading, editing, and offering many helpful comments and technical assistance. I also wish to express my gratitude to Dr. Gregory Bard of the Department of Applied Mathematics and Computer Science at the University of Wisconsin-Stout, for his encouragement and valuable suggestions.

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# Contents

<b>1</b>	<b>Household Expenditure</b> . . . . .	1
1.1	Consumer's Expenditure and Budget Constraint . . . . .	1
1.1.1	A Simple Two-Commodity Model . . . . .	5
1.2	Exercises . . . . .	9
	Appendix A: A Short Note on Sigma Notation . . . . .	10
<b>2</b>	<b>Variables, a Short Taxonomy</b> . . . . .	17
2.1	Exercises . . . . .	23
<b>3</b>	<b>Sets and Functions</b> . . . . .	25
3.1	Sets and Set Presentation . . . . .	25
3.2	Set Inclusion and Set Relationships . . . . .	27
3.3	Set Operations . . . . .	28
3.4	Cartesian Product . . . . .	31
3.5	Relation, Correspondence, and Function . . . . .	35
3.6	Forms of Univariate and Bivariate Functions . . . . .	38
3.7	Exercises . . . . .	44
<b>4</b>	<b>Market Equilibrium Model</b> . . . . .	47
4.1	Market Demand and Aggregation Problem . . . . .	47
4.1.1	Market Supply . . . . .	53
4.2	Market Equilibrium . . . . .	55
4.2.1	Another Look at Single Commodity Linear Demand and Supply Model . . . . .	58
4.2.2	Two-Commodity Market Model . . . . .	63
4.3	US Economic Crisis and Return of Keynesian Economics . . . . .	65
4.3.1	Macroeconomic Model and Equilibrium in National Income . . . . .	66
4.4	Exercises . . . . .	71
<b>5</b>	<b>Rates of Change and the Derivative</b> . . . . .	77
5.1	Linear Functions . . . . .	77
5.1.1	Rate of Change of Non-Linear Functions . . . . .	79
5.2	Limits, Continuity, and Differentiability . . . . .	83

- 5.2.1 Limits . . . . . 83
- 5.2.2 Continuity . . . . . 85
- 5.2.3 Differentiability . . . . . 86
- 5.3 Rules of Differentiation. . . . . 87
- 5.4 Exercises . . . . . 98
- 5.5 Optimization: Determining the Maximum and/or Minimum of a Function . . . . . 101
  - 5.5.1 Constraint Optimization. . . . . 111
- 5.6 Exercises . . . . . 112
- 5.7 Partial Derivatives and Extreme Values of Bivariate Functions . . . . . 113
  - 5.7.1 Higher Order Partial Derivatives . . . . . 115
  - 5.7.2 Maximum and Minimum of a Bivariate Function . . . . . 117
- 5.8 Exercises . . . . . 121
- 6 Optimal Level of Output and Long Run Price . . . . . 123**
  - 6.1 Golden Rule of Profit Maximization . . . . . 123
    - 6.1.1 Firms with Quadratic Cost Functions in a Competitive Market . . . . . 126
    - 6.1.2 Economically Legitimate Quadratic Cost Functions. . . . . 127
    - 6.1.3 Quadratic Cost Function and Firm’s Break-Even Point . . . . . 131
    - 6.1.4 Quadratic Cost Function and Long-Run Price and Output . . . . . 135
  - 6.2 Firms with Cubic Cost Functions in Competitive Industry. . . . . 140
    - 6.2.1 Restrictions on Coefficients of a Cubic Cost Function. . . . . 141
    - 6.2.2 Profit Maximization with Cubic Cost Functions: Additional Restrictions . . . . . 144
    - 6.2.3 Cubic Cost Function and Break-Even Points . . . . . 145
    - 6.2.4 Cubic Cost Functions and Market Equilibrium Price and Firm’s Output in the Long Run . . . . . 146
  - 6.3 Profit Maximization in a Non-Competitive Market . . . . . 148
  - 6.4 Long Run Price-Output Combination for a Monopolistically Competitive Firm . . . . . 152
  - 6.5 Short-Run Production Function and Profit Maximization for a Noncompetitive Firm . . . . . 155
  - 6.6 Constraint Optimization. . . . . 157
  - 6.7 Elasticity of Demand and Supply . . . . . 158
    - 6.7.1 Elasticity of a Function . . . . . 158
    - 6.7.2 Elasticity of Demand and Supply . . . . . 160

6.7.3	Price Elasticity of Demand and a Firm’s Total Revenue . . . . .	164
6.8	Exercises . . . . .	167
	Appendix A: Linear Demand Function and Marginal Revenue . . . . .	176
	Appendix B: Finding Roots of Third and Higher Degree Polynomials and Other Nonlinear Equations . . . . .	179
<b>7</b>	<b>Nonlinear Models</b> . . . . .	<b>193</b>
7.1	Nonlinear Supply and Demand Models . . . . .	194
7.2	Linear Approximation of the Model (Linearization) . . . . .	198
7.3	Linear and Quadratic Approximation Using Taylor Series . . . . .	199
7.3.1	Long Run Competitive Market Equilibrium Price . . . . .	202
7.3.2	Terms of Trade . . . . .	205
7.3.3	Joint Production . . . . .	206
7.3.4	Nonlinear Demand and Optimal Price and Output for a Noncompetitive Firm . . . . .	209
7.3.5	Optimal Price and Output for a Multi-Plant firm . . . . .	214
7.3.6	Nonlinear National Income Model . . . . .	216
7.4	Exercises . . . . .	219
<b>8</b>	<b>Additional Topics in Perfect and Imperfect Competition</b> . . . . .	<b>225</b>
8.1	Competitive Firms and Market Supply Functions . . . . .	225
8.2	From Firm to Industry: A Comprehensive Firm and Market Equilibrium Model for Competitive Market . . . . .	227
8.2.1	Aggregation and Related Problems . . . . .	231
8.3	Urge to Merge . . . . .	239
8.4	Deriving the Trace of Optimal Output for a Noncompetitive Firm . . . . .	244
8.5	Nonlinear Demand Function and the Shutdown Price . . . . .	251
8.6	Exercises . . . . .	256
<b>9</b>	<b>Logarithmic and Exponential Functions</b> . . . . .	<b>273</b>
9.1	Logarithm . . . . .	273
9.1.1	Change of Base Rule . . . . .	278
9.1.2	Characteristic and Mantissa . . . . .	278
9.2	Logarithmic Functions . . . . .	278
9.3	Exponential Functions . . . . .	279
9.4	Derivative of Logarithmic and Exponential functions . . . . .	290
9.5	Economic Application of Derivative of Logarithm . . . . .	293
9.5.1	Exponential Supply and Demand Functions and Market Equilibrium . . . . .	293

9.5.2	Profit Maximization for Noncompetitive Firms Facing Semi-Log or Log Linear Demand Functions . . . . .	301
9.5.3	Deriving the Trace Function of a Noncompetitive Firm Facing Semi-Log or Log Linear Demand Functions (Optional) . . . . .	304
9.6	Exercise . . . . .	309
<b>10</b>	<b>Production Function, Least-Cost Combination of Resources, and Profit Maximizing Level of Output . . . . .</b>	<b>311</b>
10.1	Production Function . . . . .	311
10.1.1	Isoquants, MRTS, and the Least-Cost Combination of Resources (Type I Optimization) . . . . .	314
10.1.2	The Cobb–Douglas Production Function . . . . .	318
10.2	The Cobb–Douglas Production Function and Cost Minimization (Type I Optimization) . . . . .	322
10.3	The Production Function, Isocosts and Cost Minimization (Type I Optimization) . . . . .	328
10.4	Type II Optimization Models . . . . .	332
10.4.1	Substitution Method . . . . .	332
10.4.2	The Method of the Lagrange Multiplier . . . . .	333
10.5	Production Function, Cost Function, and Profit Maximization . . . . .	336
10.5.1	Isoquant Meets Isocost, Again . . . . .	336
10.6	The Cobb–Douglas Production Function and Profit Maximization . . . . .	338
10.6.1	Type III Optimization and Restrictions on $\alpha$ and $\beta$ . . . . .	338
10.6.2	An Example of Type III Unconstrained Maximization . . . . .	340
10.7	Exercises . . . . .	342
<b>11</b>	<b>Economic Dynamics . . . . .</b>	<b>347</b>
11.1	Economic Dynamics and Difference Equations . . . . .	347
11.1.1	Basic Definitions . . . . .	348
11.2	Solution of a Difference Equation . . . . .	350
11.2.1	Solution to First Order Homogeneous Difference Equation . . . . .	351
11.2.2	Behavior of Solution of First Order Homogeneous Difference Equation . . . . .	351
11.2.3	First Order Non-Homogeneous Difference Equation . . . . .	358
11.3	Second and Higher Order Difference Equation . . . . .	370
11.4	Exercises . . . . .	371
	Appendix A: Measures of Estimation Accuracy . . . . .	374
	References . . . . .	377

<b>12</b>	<b>Mathematics of Interest Rates and Finance</b> . . . . .	379
12.1	Sequences and Series . . . . .	379
12.1.1	Arithmetic Sequences . . . . .	379
12.1.2	Geometric Sequences . . . . .	382
12.2	Simple and Compound Interest. . . . .	385
12.2.1	Simple Interest. . . . .	385
12.2.2	Compound Interest . . . . .	386
12.3	Present Value. . . . .	393
12.3.1	Financial Debt Instruments and Their Yields . . . . .	395
12.3.2	Yield to Maturity and Current Yield. . . . .	398
12.3.3	Money Market Instruments . . . . .	401
12.3.4	Present Value and Project Selection . . . . .	405
12.4	Fixed Payment Loans . . . . .	407
12.4.1	Fixed Mortgage Loan . . . . .	408
12.5	Refinancing . . . . .	411
12.5.1	Bound of Rates for Advantageous Refinancing . . . . .	414
12.5.2	Optimal Time Horizon for Refinancing. . . . .	415
12.5.3	Closing Costs and APR. . . . .	417
12.6	Savings Plan, Annuity. . . . .	419
12.7	College Fund . . . . .	421
12.8	Exercises . . . . .	422
	Appendix A: Estimating Time $t$ and New Interest Rate $i'$ . . . . .	425
<b>13</b>	<b>Matrices and Their Applications</b> . . . . .	429
13.1	Matrix. . . . .	429
13.2	Matrix Operation . . . . .	432
13.2.1	Matrix Addition, Scalar Multiplication and Subtraction . . . . .	432
13.2.2	Matrix Multiplication . . . . .	433
13.2.3	Transpose of a Matrix. . . . .	438
13.2.4	Some Special Vectors and Matrices . . . . .	439
13.3	Matrix Representation of a Linear System. . . . .	442
13.4	Matrix Inversion and Solution to a Linear System . . . . .	443
13.4.1	Determinants . . . . .	445
13.4.2	Matrix Inversion, Method of Adjoint . . . . .	448
13.4.3	Properties of Determinants. . . . .	450
13.4.4	Matrix Inversion, the Gauss-Jordan Elimination Method . . . . .	453
13.5	Matrix Operations Using EXCEL, R, WolframAlpha, and Microsoft Mathematics . . . . .	457
13.5.1	Matrix Operations in EXCEL <sup>®</sup> , Microsoft Mathematics, and WolframAlpha . . . . .	457
13.5.2	Matrix Operations and Solutions to Linear Systems in <b>R</b> . . . . .	459



13.6	Application of Matrices in Economics. . . . .	465
13.6.1	Matrix Representation of a 3-Commodity Market Model . . . . .	468
13.6.2	Matrix Representation of National Income Models. . .	470
13.7	The National Input–Output Model . . . . .	475
13.8	Exercises . . . . .	482
<b>Index</b>	. . . . .	<b>487</b>

# Figures

Fig. 1.1	Budget line . . . . .	5
Fig. 1.2	Change in budget line due to increase in price of $X$ . . . . .	6
Fig. 1.3	Shift in budget line due to loss of income . . . . .	7
Fig. 1.4	Linear income-consumption path . . . . .	8
Fig. 2.1	Variable chart. . . . .	22
Fig. 3.1	A sample of Venn diagrams. . . . .	30
Fig. 3.2	The real number line. . . . .	33
Fig. 3.3	A sample of ordered pairs in $R^2$ . . . . .	34
Fig. 3.4	Plot of the function $y = f(x)$ . . . . .	37
Fig. 3.5	Plot of a correspondence between $x$ and $y$ . . . . .	37
Fig. 3.6	Graph of $y = x^2 - 5x + 6$ . . . . .	41
Fig. 3.7	The graph of function $A = s^2$ . . . . .	43
Fig. 4.1	Shift of demand curve due to rise in income . . . . .	49
Fig. 4.2	Shift of supply curve due to increase in input price. . . . .	54
Fig. 4.3	Supply and demand curves. . . . .	60
Fig. 4.4	Inconsistent market model . . . . .	61
Fig. 5.1	Graph of $y = 3 + 0.5x$ . . . . .	78
Fig. 5.2	Deriving the equation of a line from the coordinates of two points on the line . . . . .	78
Fig. 5.3	Rate of change of a non-linear function. . . . .	79
Fig. 5.4	Slope of the tangent as rate of change. . . . .	82
Fig. 5.5	This function has a limit at 5 . . . . .	84
Fig. 5.6	This function limit's at 3 is not defined. . . . .	84
Fig. 5.7	Non differentiable functions . . . . .	87
Fig. 5.8	Linear demand and marginal revenue curves . . . . .	96
Fig. 5.9	Non-linear demand and marginal revenue curves . . . . .	97
Fig. 5.10	Graphs of $y = (1/3)x^3 - 9x$ ( <i>top</i> ) and $y' = x^2 - 9$ ( <i>bottom</i> ) . .	101
Fig. 5.11	Local and global extreme points . . . . .	102
Fig. 5.12	Graph of $y = f(x) = 5x^2 - 40x + 10$ . . . . .	105
Fig. 5.13	Graph of $y = f(x) = -5x^2 + 40x + 10$ . . . . .	106
Fig. 5.14	Graph of $y = f(x) = x^3 - 6x^2 + 9x$ . . . . .	107

Fig. 5.15 Graph of  $y = 3x^4 - 10x^3 + 6x^2 + 1$  . . . . . 108

Fig. 5.16 Graph of fuel consumption and speed . . . . . 109

Fig. 5.17 Graphs of convex and concave functions . . . . . 110

Fig. 5.18 Graph of  $TC(Q) = Q^3 - 24Q^2 + 200Q + 500$ . . . . . 111

Fig. 5.19 The partial derivatives of  $f$  evaluated at  $(3, 2)$  are the slopes of the tangents to the surface of  $f$  at point  $(3, 2, f(3, 2) = 4)$ . . . . . 116

Fig. 5.20 A saddle point . . . . . 118

Fig. 5.21 Graph of  $f(x, y) = 2x^3 + 3y^2 - 6x - 6y + 24$  . . . . . 119

Fig. 5.22 Graph of  $f(x, y) = 2x^2y + 2y^2 - 2x^2 - 8y$ . . . . . 120

Fig. 6.1 A Competitive firm's marginal revenue and marginal cost curves . . . . . 125

Fig. 6.2 A noncompetitive firm's marginal revenue and marginal cost curves . . . . . 125

Fig. 6.3 Profit maximizing output and maximum profit . . . . . 128

Fig. 6.4 Graph of  $y = 3x^2 + 10x + 65$  . . . . . 129

Fig. 6.5 Graph of  $y = -3x^2 + 10x + 65$ . . . . . 129

Fig. 6.6 Firm's break-even points . . . . . 133

Fig. 6.7 Graph of linear marginal cost  $MC = 6Q$  and  $P = 30$ . . . . . 134

Fig. 6.8 Log-run Situation;  $TR$  tangent to  $TC$ . . . . . 138

Fig. 6.9 Log-run situation; minimum of  $ATC$  curve. . . . . 139

Fig. 6.10 Optimal level of output and profit for a firm with cubic cost function. . . . . 142

Fig. 6.11 Long-run normal profit and shutdown situation . . . . . 147

Fig. 6.12 A noncompetitive firm maximizes profit at the level of output where  $MC = MR$ . . . . . 149

Fig. 6.13 Optimal combination  $(Q^*, P^*) = (11, \$89)$  maximizes profit for the monopolistically competitive firm . . . . . 151

Fig. 6.14 Long run equilibrium of a monopolistically competitive firm. . . . . 152

Fig. 6.15 Graph of elasticity function  $\epsilon(x) = \frac{6x^2}{3x^2-2}$  . . . . . 159

Fig. 6.16 Graph of the elasticity function  $\epsilon(P) = \frac{-400P}{20000-400P}$ . . . . . 162

Fig. 6.17 Graph of supply elasticity function  $\eta(P) = \frac{5P}{-50+5P}$ . . . . . 165

Fig. 6.18 Demand elasticity at various segments of demand curve . . . . . 166

Fig. 6.19 Average and marginal curves . . . . . 177

Fig. 6.20 ATC and MC Curves . . . . . 178

Fig. 6.21 Graph of  $f(Q) = \frac{1}{3}Q^3 - 7Q^2 + 111Q - 2500$  . . . . . 182

Fig. 6.22 Graph of  $f(Q) = 1/3Q^3 - 7Q^2 + 111Q - 2500$  over the interval  $21.631 < Q < 21.64$ . . . . . 183

Fig. 6.23 Graph of  $f(Q) = 0.0006Q^3 - 0.04Q^2 - 3700$ . . . . . 185

Fig. 6.24 Graph of  $f(x) = x^4 - 3x^2 + 10x - 20$  . . . . . 185

Fig. 6.25 Graph of  $f(x) = \sin(x^2) + 3\cos(x) - 2x$ . . . . . 185

Fig. 6.26	Graph of $f(x) = \sin x^2 + 3\cos x - 2x$ over the interval $1 < x < 1.2$ . . . . .	186
Fig. 6.27	Graph of $f(P) = P^2(3)^{0.02P} - 57$ . . . . .	186
Fig. 6.28	Graph of nonlinear supply and demand . . . . .	190
Fig. 7.1	Graph of excess demand function $\sqrt{520 - 8P} - 4\sqrt{3P - 4}$ . . . . .	195
Fig. 7.2	Graph of $f(P) = P^{2.7} + 10P^{0.7} - 10P - 150$ . . . . .	197
Fig. 7.3	Graph of $f(Q) = 2Q^3 - 24Q^2 - 500$ . . . . .	204
Fig. 7.4	Graph of $f(y) = (25y - y^2)(550 - 50y + 2y^2)^2 - 2400000y$ . . . . .	206
Fig. 7.5	Graph of $f(Q_1) = Q_1^4 - 1682Q_1^2 - 2240Q_1 + 707281$ . . . . .	208
Fig. 7.6	Graph of $\varphi(Q) = -0.25Q(100 - 0.1Q)^{1.5} + (100 - 0.1Q)^{2.5} - 3Q^2 + 40Q - 950$ . . . . .	211
Fig. 7.7	Graph of $\psi(Q) = 2Q^3 + 0.25Q^2(100 - 0.1Q)^{1.5} - 20Q^2 - 650000$ . . . . .	213
Fig. 7.8	Graph of $f(Q_2) = 6Q_2^2 - 114Q_2 + 6\sqrt{859 - 6Q_2} + 68$ . . . . .	215
Fig. 8.1	Monopolizing a competitive market . . . . .	243
Fig. 8.2	Tangency of demand and ATC curves and shutdown price $\tilde{P}$ . . . . .	246
Fig. 8.3	Graph of trace function . . . . .	254
Fig. 9.1	Graph of $\log(x)$ . . . . .	279
Fig. 9.2	Graph of $\log(x^2) - 1$ . . . . .	279
Fig. 9.3	Graph of $y = 2^x$ . . . . .	280
Fig. 9.4	Graph of $y = 2^x$ for $x \geq 0$ . . . . .	281
Fig. 9.5	Graph of $y = 0.5^x$ . . . . .	281
Fig. 9.6	Graph of $y = 0.5^x$ for $x \geq 0$ . . . . .	282
Fig. 9.7	Time plot of GDP . . . . .	284
Fig. 9.8	Sales of LP records (\$million) . . . . .	287
Fig. 9.9	Scatter plot of LP and CD sales . . . . .	287
Fig. 9.10	Graph of excess demand function . . . . .	295
Fig. 9.11	Graph of excess supply function . . . . .	297
Fig. 10.1	Graph of isoquant for $Q = 124$ . . . . .	315
Fig. 10.2	Isoquant map graph of isoquant for $Q = 100, 124,$ and $150$ units . . . . .	315
Fig. 10.3	Graph of CD production function $Q = 1.2K^{0.5}L^{0.5}$ and its isoquants . . . . .	322
Fig. 10.4	Graph of Isocosts . . . . .	330
Fig. 10.5	Isocost meets isoquant . . . . .	331
Fig. 10.6	Unit profit: increasing returns to scale . . . . .	340
Fig. 10.7	Unit profit: constant returns to scale . . . . .	340
Fig. 10.8	Unit profit: decreasing returns to scale . . . . .	340
Fig. 11.1	Graph of $y_t = 10(2)^t$ . . . . .	352
Fig. 11.2	Graph of $y_t = 10(-2)^t$ . . . . .	352
Fig. 11.3	Graph of $y_t = 10(\frac{1}{2})^t$ . . . . .	353
Fig. 11.4	Graph of $y_t = 10(-\frac{1}{2})^t$ . . . . .	353

Fig. 11.5 Time plot of GDP from 1990 to 2005 . . . . . 360

Fig. 11.6 Graph of GDP linear trend equation . . . . . 360

Fig. 11.7 Share of manufacturing form the US GDP . . . . . 361

Fig. 11.8 Graph of  $y_t = -5(10)^t + 10$  . . . . . 362

Fig. 11.9 Graph of  $y_t = 25(0.7)^t - 20$  . . . . . 364

Fig. 11.10 Path of price to equilibrium . . . . . 367

Fig. 11.11 US oil well productivity from 1972 to 2006 . . . . . 369

Fig. 12.1 Graph of  $120 \ln(i' + 12) + \ln(0.11991 - i') - 296.0678$  . . . . 417

Fig. 12.2 Graph of  $118737.81(1.00417)^t - 90116.22$   
 $(1.00333)^t - 371.21t - 28620.96$  . . . . . 425

Fig. 12.3 Graph of  $360 \ln(12 + i') + \ln(0.058475 - i') - 891.7272$  . . . 427

Fig. 13.1 Partial screen shot of MS mathematics “Insert Matrix”  
window . . . . . 459

Fig. 13.2 Partial screen shot of WolframAlpha page . . . . . 460

Fig. 13.3 Partial screen shot of WolframAlpha page . . . . . 471

# Tables

Table 1.1	Consumer expenditure survey 2008–2010 . . . . .	3
Table 1.2	Consumer expenditure survey 2010 . . . . .	4
Table 4.1	Aggregation problem . . . . .	50
Table 5.1	Limit of $f(x) = \frac{x-5}{x^2-25}$ as $x$ approaches 5. . . . .	83
Table 5.2	$f(x)$ , $f'(x)$ and $f''(x)$ for selected values of $x$ . . . . .	103
Table 5.3	$f(x)$ , $f'(x)$ and $f''(x)$ for selected values of $x$ . . . . .	105
Table 5.4	$f(x)$ , $f'(x)$ and $f''(x)$ for selected values of $x$ . . . . .	108
Table 5.5	$f(x)$ , $f'(x)$ and $f''(x)$ for selected values of $x$ . . . . .	109
Table 5.6	Change of sign of second derivative . . . . .	111
Table 6.1	Function $f(Q) = \frac{1}{3}Q^3 - 7Q^2 + 111Q - 2500$ . . . . .	181
Table 6.2	Function $f(Q) = 0.0006Q^3 - 0.04Q^2 - 3700$ . . . . .	184
Table 7.1	Demand, supply and excess demand . . . . .	195
Table 7.2	Values of $Q_d$ , $Q_s$ and $f(P)$ for different values of $P$ . . . . .	197
Table 7.3	Values of $f(Q)$ , $f'(Q)$ , $f''(Q)$ for selected values of $P$ . . . . .	204
Table 7.4	Values of $f(y)$ for selected values of $y$ . . . . .	206
Table 7.5	Values of $f(Q_1)$ for certain values of $Q_1$ . . . . .	207
Table 7.6	Values of $\varphi(Q)$ for selected values of $Q$ . . . . .	210
Table 7.7	Values of $\psi(Q)$ for certain values of $Q$ . . . . .	213
Table 7.8	Values of $f(Q_2)$ for certain values of $Q_2$ . . . . .	215
Table 9.1	US GDP from 1978 to 2007 . . . . .	283
Table 9.2	Sales of LP records and CD (in \$millions) . . . . .	286
Table 9.3	$P$ and $ED(P)$ . . . . .	294
Table 9.4	Values of $Q_s$ , $Q_d$ , and $ES(P)$ for selected values of $P$ . . . . .	296
Table 9.5	Values of $Q_s$ , $Q_d$ , and $ED(P)$ for selected values of $P$ . . . . .	298
Table 9.6	Values of $f(P) = 0.009542P + \log P - 1$ for selected values of $P$ . . . . .	300
Table 10.1	$MRTS$ and Saving from Substitution . . . . .	317
Table 10.2	Values of $f(L)$ for selected values of $L$ . . . . .	337
Table 11.1	Actual and estimated GDP based on model 1 . . . . .	355
Table 11.2	Actual and estimated GDP based on model 2 . . . . .	356
Table 11.3	U.S. real GDP from 1990 to 2005 . . . . .	359
Table 12.1	Comparing simple and compound interest . . . . .	391
Table 12.2	Calculating effective interest . . . . .	392

Table 12.3	Net present values of 3 projects . . . . .	406
Table 12.4	Amortization schedule of a 30-year fixed mortgage loan. . . . .	409
Table 12.5	Values of $f(t)$ for selected values of $t$ . . . . .	426
Table 12.6	Values of $f(i')$ and $f'(i')$ for selected values of $i'$ . . . . .	427
Table 13.1	Input of materials and labor. . . . .	465
Table 13.2	Hypothetical input-output table (Millions of Dollars) intermediate use (output). . . . .	476
Table 13.3	Input–output coefficients . . . . .	478
Table 13.4	NAISC 20-sector classification. . . . .	481