

# ECON312 Problem Set 5

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05/07/2020

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```
library(dplyr)
library(knitr)
library(haven)
```

## 1. Describe the data

```
data <- read_dta("PS5.dta")
psych::describe(data) %>%
  select(n, mean, sd, median, min, max) %>%
  kable(digits = 2)
```

	n	mean	sd	median	min	max
sheet	816	245.72	148.08	236.50	1.0	522.00
post	816	0.50	0.50	0.50	0.0	1.00
chain	816	2.11	1.11	2.00	1.0	4.00
state	816	0.81	0.39	1.00	0.0	1.00
empft	798	8.26	8.31	6.00	0.0	60.00
hrsopen	805	14.47	2.77	15.00	7.0	24.00
nregs	788	3.61	1.25	3.00	2.0	8.00
minwage	816	4.49	0.49	4.25	3.8	5.05
temp	816	0.50	0.50	1.00	0.0	1.00
d1	816	0.42	0.49	0.00	0.0	1.00
d2	816	0.19	0.40	0.00	0.0	1.00
d3	816	0.24	0.43	0.00	0.0	1.00
d4	816	0.14	0.35	0.00	0.0	1.00

## 2. Estimate the following regression on the sample of fast food restaurants in Feb-Mar 1992:

$$empft_{ikt} = \alpha + \gamma minwage_{kt} + \beta_1 nregs_{ikt} + \beta_2 hrsopen_{ikt} + \sum_{j=2}^4 \eta_j d_j + \epsilon_{ikt}$$

$i$  denotes restaurant,  $k$  denotes state, and  $t = 0$  if the observation is from Feb-Mar and  $t = 1$  if the observation is from Nov-Dec.

```
# drop missing observations
for_regression <- data %>%
  select(state, post, empft, minwage, nregs, hrsopen, d2, d3, d4) %>%
  na.omit()

regress_formula <- formula(empft ~ minwage + nregs + hrsopen + d2 + d3 + d4)
linear_model <- lm(regress_formula, data = for_regression)
summary(linear_model)
```

```
##
## Call:
## lm(formula = regress_formula, data = for_regression)
##
## Residuals:
##      Min       1Q   Median       3Q      Max
## -18.302  -5.273  -1.413   3.442  40.265
##
## Coefficients:
##              Estimate Std. Error t value Pr(>|t|)
## (Intercept) -12.6563     3.6990  -3.422 0.000656 ***
```

```
## minwage      0.2278      0.5735      0.397 0.691387
## nregs        0.4038      0.3112      1.298 0.194756
## hrsopen      1.2508      0.1598      7.828 1.64e-14 ***
## d2           1.1744      1.1357      1.034 0.301432
## d3          -1.8273      0.8473     -2.157 0.031344 *
## d4           4.1736      1.1020      3.787 0.000164 ***
## ---
## Signif. codes:  0 '***' 0.001 '**' 0.01 '*' 0.05 '.' 0.1 ' ' 1
##
## Residual standard error: 7.79 on 768 degrees of freedom
## Multiple R-squared:  0.1262, Adjusted R-squared:  0.1194
## F-statistic: 18.49 on 6 and 768 DF,  p-value: < 2.2e-16
```

### 3. Interpret the coefficient $\gamma$ and calculate a 90% confidence interval.

$\gamma = 0.23$  is the average change in number of full time employees for a \$1 increase in the minimum wage, adjusted for the other variables in the regression. The 90% CI is

```
confint.lm(linear_model, level = 0.9)[2,]
```

```
##          5 %          95 %
## -0.7167418  1.1722597
```

### 4. Use the Sum of squares table from the regression output to calculate the $R^2$ and the standard error of the regression (Root MSE).

```
SSE <- sum(linear_model$residuals^2)
SST <- var(for_regression$empft)*(for_regression %>% nrow() -1)
SSR <- SST - SSE
R2 <- SSR/SST
root_MSE <- sqrt(SSE/(for_regression %>% nrow()))
```

The  $R^2 = 0.13$  and the  $MSE = 7.8$

### 5. Give an economic interpretation of the coefficients $\eta_2, \eta_3, \eta_4$ . What might explain the relatively large coefficient on -d4-?

These are fixed effects for each restaurant, specifically the average difference in number of employees relative to burger king. d-1 The large coefficient  $\eta_4$  means that Wendy's employed 4.17 more people on average than Burger King, adjusted for the other variables in the regression. One possible explanation is that Wendy's has more customers and hence hires more employees.

### 6. Test $H_0 : \eta_2 = \eta_3 = 0$

```
car::linearHypothesis(linear_model, c("d2 = 0", "d3 = 0"))
```

```
## Linear hypothesis test
##
## Hypothesis:
## d2 = 0
## d3 = 0
##
## Model 1: restricted model
## Model 2: empft ~ minwage + nregs + hrsopen + d2 + d3 + d4
##
##   Res.Df    RSS Df Sum of Sq      F Pr(>F)
## 1      770 47093
## 2      768 46603   2    489.92 4.0369 0.01803 *
## ---
## Signif. codes:  0 '***' 0.001 '**' 0.01 '*' 0.05 '.' 0.1 ' ' 1
```

We can reject the hypothesis  $\eta_2 = \eta_3 = 0$  at a significance level of  $\alpha = 0.05$

**7. Test the hypothesis  $H_0 : \eta_2 = \eta_3$  using the estimated covariance matrix of the coefficients. Verify your answer by running the test in Stata using and/or by performing an F-test. We now want to control for potential selection issues by using the panel structure of our data.**

We performed a wald test, i.e.

$$T_n = n(R \hat{\beta}_n - c)' (R \hat{\Omega}_n R')^{-1} (R \hat{\beta}_n - c)$$

where  $R = (0, 0, 0, 0, 1, -1, 0)$ . We showed in empirical analysis I that this test statistic

$$T_n \sim \chi_1^2$$

Where  $df = 1$  here because there is one linear restriction.

```
cov_matrix <- vcov(linear_model)
beta <- linear_model$coefficients
R <- c(0,0,0, 0, 1, -1, 0)

T_n <- (R%*%beta)%*%solve(t(R)%*%cov_matrix%*%R)%*%t(R%*%beta)

T_n

##           [,1]
## [1,] 6.566318
1- pchisq(T_n, df = 1)

##           [,1]
## [1,] 0.01039268
```

The wald test statistic is  $T_n = 6.57$ , which means we can reject the null hypothesis  $\eta_2 = \eta_3$  at the  $\alpha = 0.05$  significance level

Comparing the result to an F-test:

```
car::linearHypothesis(linear_model, c("d2 = d3"))

## Linear hypothesis test
##
## Hypothesis:
## d2 - d3 = 0
##
## Model 1: restricted model
## Model 2: empft ~ minwage + nregs + hrsopen + d2 + d3 + d4
##
##   Res.Df    RSS Df Sum of Sq      F Pr(>F)
## 1      769 47001
## 2      768 46603   1    398.45 6.5663 0.01058 *
## ---
## Signif. codes:  0 '***' 0.001 '**' 0.01 '*' 0.05 '.' 0.1 ' ' 1
```

## 8. Explain why the previous estimate of $\lambda$ is likely to suffer from omitted variable bias.

$\lambda$  suffer from omitted variable bias if some of the unobservables that affect the number of employees are correlated with minimum wage. The omitted variable bias is likely because one can imagine many such unobservables such as unmeasured conditions of state economies or demographics. For example, some states have higher per capita income or the age structure is younger. These characteristics are potentially positively correlated with *minwage* and *empft*; then  $\gamma$  is upwardly biased.

## 9. Assume that $\epsilon_{ikt} = \mu_k + \zeta_t + u_{ikt}$ and that $E[u_{ikt}|X_{ikt}] = 0$ (where $X_{\{ikt\}}$ is the vector of RHS-variables in (2) except -minwage-). Explain how you can then use the increase in the minimum wage in New Jersey and a difference-in-differences (DD) model to identify the effect of the minimum wage on employment. Give an example where the necessary assumption(s) are violated.

Since  $\epsilon_{ikt} = \mu_k + \zeta_t + u_{ikt}$ , we know

$$Y = \alpha + \gamma \text{minwage}_{kt} + X'_{ikt}\beta + \mu_k + \zeta_t + u_{ikt}$$

Then  $E[u_{ikt}|X_{ikt}] = 0$  implies

$$\begin{aligned} E[Y|post = 1, state = 1, X_{ikt}] - E[Y|post = 0, state = 1, X_{ikt}] &= \gamma \Delta \text{minwage} + (\zeta_1 - \zeta_0) \\ E[Y|post = 1, state = 0, X_{ikt}] - E[Y|post = 0, state = 0, X_{ikt}] &= (\zeta_1 - \zeta_0) \end{aligned}$$

Thus,

$$\begin{aligned} &\{E[Y|post = 1, state = 1, X_{ikt}] - E[Y|post = 0, state = 1, X_{ikt}]\} \\ &- \{E[Y|post = 1, state = 0, X_{ikt}] - E[Y|post = 0, state = 0, X_{ikt}]\} = \gamma \Delta \text{minwage} \end{aligned}$$

Hence, we can use the following DD model:

$$\text{empft}_{ikt} = \pi_0 + \delta_{kt} \text{state}_k * \text{post}_t + \pi_1 \text{state}_k + \pi_2 \text{post}_t + X'_{ikt}\beta + u_{ikt}$$

and the DD estimator  $\delta_{kt}$  will identify the effect of the minimum wage on employment.

The necessary assumption is common trend in the absence of intervention:

$$E[Y_1^0 - Y_0^0 | D_1 = 1] = E[Y_1^0 - Y_0^0 | D_1 = 0]$$

This would be violated if, for example, the employment of one state (say, New Jersey) benefited more from progressive federal policies than Pennsylvania.

**10. Generate a table of means, a table of standard errors and a table of frequencies for -empft- in each state and each time period (post = 1 and post = 0).**

```
table <- for_regression %>%
  group_by(state, post) %>%
  summarise(mean_empft = mean(empft),
            sd_empft = sd(empft),
            n = n()) %>%
  mutate(stand_error = sd_empft/sqrt(n)) %>%
  select(state, post, mean_empft, stand_error, n)

table %>%
  kable(digits = 2)
```

state	post	mean_empft	stand_error	n
0	0	10.31	1.23	77
0	1	7.72	1.00	74
1	0	7.75	0.44	320
1	1	8.53	0.45	304

So average employment in fast-food dropped in Pennsylvania while it increased in New Jersey. There are also more restaurants in the New Jersey sample.

**11. Using these statistics, calculate a DID estimate of the impact of the minimum wage law on employment.**

```
diff_new_jersey <- filter(table, post == 1 & state == 1)$mean_empft - filter(table, post == 0 & state == 1)$mean_empft
diff_penn <- filter(table, post == 1 & state == 0)$mean_empft - filter(table, post == 0 & state == 0)$mean_empft
diff_new_jersey - diff_penn

## [1] 3.365113
```

## 12. Specify and estimate the corresponding regression.

The regression corresponding to (11) is

$$empft_{ikt} = \pi_0 + \delta state_k * post_t + \pi_1 state_k + \pi_2 post_t + v_{ikt}$$

```
DID1<-lm(empft~state*post,data=for_regression); summary(DID1)

##
## Call:
## lm(formula = empft ~ state * post, data = for_regression)
##
## Residuals:
##      Min       1Q   Median       3Q      Max
## -10.312  -6.170  -2.528   3.718  52.248
##
## Coefficients:
##              Estimate Std. Error t value Pr(>|t|)
## (Intercept)  10.3117     0.9439  10.925  <2e-16 ***
## state        -2.5601     1.0513  -2.435  0.0151 *
## post         -2.5887     1.3483  -1.920  0.0552 .
## state:post     3.3651     1.5026   2.240  0.0254 *
## ---
## Signif. codes:  0 '***' 0.001 '**' 0.01 '*' 0.05 '.' 0.1 ' ' 1
##
## Residual standard error: 8.282 on 771 degrees of freedom
## Multiple R-squared:  0.008404,    Adjusted R-squared:  0.004546
## F-statistic: 2.178 on 3 and 771 DF,  p-value: 0.08922
```

We can also add covariates and estimate

```
DID2<-lm(empft~state*post+nregs+hrosopen+d2+d3+d4,data=for_regression); summary(DID2)

##
## Call:
## lm(formula = empft ~ state * post + nregs + hrosopen + d2 + d3 +
##      d4, data = for_regression)
##
## Residuals:
##      Min       1Q   Median       3Q      Max
## -18.442  -5.130  -1.422   3.519  40.545
##
## Coefficients:
##              Estimate Std. Error t value Pr(>|t|)
## (Intercept)  -9.9380     2.7793  -3.576 0.000371 ***
## state        -2.3412     0.9898  -2.365 0.018258 *
## post         -2.8888     1.2650  -2.284 0.022668 *
## nregs         0.4474     0.3106   1.440 0.150216
## hrosopen      1.2514     0.1593   7.854 1.36e-14 ***
## d2           1.1988     1.1319   1.059 0.289909
## d3          -1.8780     0.8448  -2.223 0.026499 *
## d4           4.1681     1.0986   3.794 0.000160 ***
## state:post     3.6657     1.4096   2.601 0.009486 **
## ---
## Signif. codes:  0 '***' 0.001 '**' 0.01 '*' 0.05 '.' 0.1 ' ' 1
```

```
##
## Residual standard error: 7.763 on 766 degrees of freedom
## Multiple R-squared:  0.1344, Adjusted R-squared:  0.1253
## F-statistic: 14.87 on 8 and 766 DF,  p-value: < 2.2e-16
```

### 13. How much does this suggest that the minimum wage affects full time employment in fast food restaurants?

```
DID_est<-coef(DID1)[4]
names(DID_est)<-NULL

employment_effect <- DID_est/(5.05-4.25)
```

The DID estimate is 3.37. Dividing this by  $\Delta_{minwage}$ , we obtain 4.2, meaning that increasing minimum wage by 1 dollar will increase the number of employees in fast food restaurants more than 4.

Alternatively, we could include the minimum wage variable directly in the regression

```
did_alt <- formula(empft ~ minwage + post + post*minwage + nregs + hrsopen + d2 + d3 + d4)

DID_alt_model <- lm(did_alt, for_regression); summary(DID_alt_model)
```

```
##
## Call:
## lm(formula = did_alt, data = for_regression)
##
## Residuals:
##      Min       1Q   Median       3Q      Max
## -18.442  -5.130  -1.422   3.519  40.545
##
## Coefficients:
##              Estimate Std. Error t value Pr(>|t|)
## (Intercept)    9.8320     9.4967   1.035  0.30085
## minwage        -5.2026     2.1994  -2.365  0.01826 *
## post         -26.6853     9.9404  -2.685  0.00742 **
## nregs           0.4474     0.3106   1.440  0.15022
## hrsopen         1.2514     0.1593   7.854 1.36e-14 ***
## d2              1.1988     1.1319   1.059  0.28991
## d3             -1.8780     0.8448  -2.223  0.02650 *
## d4              4.1681     1.0986   3.794  0.00016 ***
## minwage:post    6.2622     2.3388   2.678  0.00758 **
## ---
## Signif. codes:  0 '***' 0.001 '**' 0.01 '*' 0.05 '.' 0.1 ' ' 1
##
## Residual standard error: 7.763 on 766 degrees of freedom
## Multiple R-squared:  0.1344, Adjusted R-squared:  0.1253
## F-statistic: 14.87 on 8 and 766 DF,  p-value: < 2.2e-16
```