

ECON 815 - COMPUTATIONAL METHODS FOR ECONOMISTS

Fall 2017

Notes on Maximum Score Estimation

Two-sided matching problems

- Matching models look at relationships between two different entities
- Matches may be one-to-one, one-to-many, or many-to-many
- Matches take place in market
- Some examples:
 - One-to-one: Men and women in a dating market
 - One-to-many: Venture capitalists and entrepreneurs
 - Many-to-many: Manufactures and suppliers
- What we want to do is to be able to estimate the structural parameters of this matching model
 - We observe the matches that happen
 - We observe characteristics of the agents who are matched
 - From this we can infer the payoffs to the match for the agents
- The structure of the data
 - The structure of the data affects the asymptotic of the estimator
 - e.g., do we observe all matches in a market - so that the asymptotics depend on observing more markets?
 - Or do we observe only some of the matches in a large market - so that the asymptotics depend on observing more matches in this market?

Maximum Score Estimation

- The maximum score estimator (MSE) was introduced by Manki (*Journal of Econometrics*, 1975)
- The maximum score estimator is similar to the maximum likelihood estimator
 - The MLE maximizes the likelihood function
 - The MSE maximizes the “score function”
- The score function is the number of observations correctly predicted by the discrete choice model:

$$Q_n(\beta) = \sum \mathbb{1}[\cdot] \tag{1}$$

- Note: the argument inside the indicator function will vary depending upon the discrete choice model and the data
- The maximum score estimator is identified by the property that the outcomes for model agents can be rank-ordered by the deterministic part of their payoff function.
 - Unlike a maximum likelihood estimator, this stochastic structure does not need to be parameterized

- This estimator uses the idea of revealed preference: if one option was chosen over another, then that one is revealed preferred to the others and must be ahead of those in rank order of the agent's preferences
- Maximum score estimators can be used for any discrete choice model, but maybe most helpful for models with matching since they can help to capture the equilibrium effects.
- Pros of MSE relative to MLE:
 - Do not need strong assumptions on the distribution of the error term
 - Captures equilibrium effects in a matching model
 - Simple, intuitive statistical objective function that is easy to compute
- Cons of MSE relative to MLE:
 - Convergence is slower
 - Inference is more difficult

The Estimator

- Notation for representing matches:
 - Let m refer to the market
 - Let i refer to the “upstream” agent in the match
 - Let j refer to the “downstream” agent in the match
 - Ordering is not important
 - A one-to-one match is then identified by the tuple $\{m, i, j\}$
 - For many-to-many matches, use $\{m, \{i_1, i_2, \dots\}, \{j_1, j_2, \dots\}\}$ to denote the match
- The payoff function:
 - Let $f_\beta(m, i, j)$ represent the payoff for the match of i and j in market m given parameter vector β
 - The represents the value of the match to for upstream agent i matching with downstream agent j in market m
 - $f_\beta(m, j, i)$ is the value for the agent on the other side of the match, i.e., looking at this match from the perspective of j matching with i
- The statistical objective function:
 - For one-to-one matches:
$$Q(\beta) = \sum_{m \in M} \sum_{i \in U_m} \sum_{j \in U_m \setminus i} \mathbb{1} [f_\beta(m, i, \mu_m(i)) + f_\beta(m, j, \mu_m(j)) > f_\beta(m, i, \mu_m(j)) + f_\beta(m, j, \mu_m(i))] \quad (2)$$
 - * M is the set of markets
 - * U_m is the set of upstream agents in market m
 - * $\mu_m(i)$ is the function to reference the downstream partner of the upstream agent in market m
 - For many-to-many matches (more general formulation that can also account for 1-to-1 matches):

$$Q(\beta) = \sum_{m \in M} \sum_{\{\vec{C}^{LHS}, \vec{C}^{RHS}\} \in I_m} \mathbb{1} \left[\sum_{\vec{a} \in \vec{C}^{LHS}} f_\beta(\vec{x}_a) > \sum_{\vec{a} \in \vec{C}^{RHS}} f_\beta(\vec{x}_a) \right] \quad (3)$$

- * I_m are the sets of inequalities to be compared
- * Each element of I_m is a pair of sets of coalitions, $\{C^{LHS}, C^{RHS}\}$, one of which is observed and one of which is hypothetical
- * \vec{x}_a are the covariates of coalition a
- Normalization
 - The objective function needs to be normalized for anything that requires it have an asymptotic limit
 - There are two ways to do this:
 1. If complete markets are observed and new observations come from observing new markets: divide $Q(\beta)$ by M , the number of markets
 2. If there is one big market and new observations come from observing more matches in this market: divide $Q(\beta)$ by $H(H-1)$, where H is the number of matches observed
 - * Note $H(H-1)/2$ is the number of comparisons that will be performed in the nested sums
- The Smooth Maximum Score Estimator
 - The MSE estimator outlined above will have discrete jumps as the parameters are changed and the inequalities flip
 - This can pose problems for the numerical optimization routines used to maximize the score function and also for statistical inference
 - Thus, Horowitz (*Econometrica*, 1992) proposed a smoothed MSE
 - To do this, replace the indicator function in the score function with a kernel, $K(\cdot)$
 - $K(\cdot)$ has the following properties
 - * $K(v)$ is finite valued for all v
 - * $\lim_{v \rightarrow -\infty} K(v) = 0$
 - * $\lim_{v \rightarrow \infty} K(v) = 1$
 - With this, we have a CDF-like kernel
 - With the smooth MSE, then with pairwise matches, inequalities that are not satisfied receive little weight and those satisfied by a large margin receive the most weight
 - Another nice property of the smoothed estimator is that bootstrapped standard errors are consistent (Horowitz (*Journal of Econometrics*, 2002))

Inference

- Constructing standard errors or confidence intervals for the MSE is not entirely straightforward.
- Boot-strapping is not consistent (in general) and one needs to account for the convergence properties of this estimator.
- But there are at least a couple methods:
 1. Subsampling confidence intervals
 - Pick S random sample of subsamples, each with size $n_s <$ the number of observations in the full data set, where s denotes a particular subsample
 - Find the maximum score estimate for each s , $\hat{\beta}_s$
 - The approximate sampling distribution for the parameter vector can be computed as

$$\tilde{\beta}_s = (n_s/N)^{1/3}(\hat{\beta}_s - \hat{\beta}_{full}) + \hat{\beta}_{full} \quad (4)$$

- * $\hat{\beta}_{full}$ is the MSE from the full sample
- * This procedure accounts for the $\sqrt[3]{N}$ property of the MSE
- To compute the 95% confidence interval, take the 2.5th and 97.5th percentiles from this distribution
- 2. Bootstrapping standard errors/confidence intervals
 - Is consistent with a smoothed MSE!

An Example:

- “The Determinants of Bank Mergers: A Revealed Preference Analysis” by Akkus, Cookson, and Hortaçsu (*Management Science*, 2016)
- Authors seek to understand how value is created from bank mergers (e.g. from reducing regulatory compliance costs, network effects, etc.)
- Framework - The matching model
 - The authors propose a one-to-one matching model where buyer banks look for target banks to purchase
 - The authors assume one national market per year and that markets in different years are independent of one another
 - There are M^y matches in the market in year y
 - The value of the merger is the joint value to the buyer and the target bank:

$$f(b, t) = V_b(b, t) + V_t(b, t) \quad (5)$$

- The payoff to the buyers is the post-merger valuation less the price paid to acquire the target, $V_b(b, t) = f(b, t) - p_{bt}$
- The target’s payoff is equal to their purchase price, $V_t(b, t) = p_{bt}$
- Each buyer maximizes $V_b(b, t)$ across targets
- Each target maximizes $V_t(b, t)$ across buyers
- In equilibrium, all observed matches yield higher value than the counterfactual matches
 - * Else we would have observed the counterfactual matches
 - * Note this use of revealed preference
- This means that if buyer b bought target t and not target t' , then:

$$\begin{aligned} V_b(b, t) &\geq V_b(b, t') \\ f_b(b, t) - p_{bt} &\geq f(b, t') - p_{bt'} \end{aligned} \quad (6)$$

- ISSUE: counterfactual transactions don’t happen, so never observe $p_{bt'}$
- Solution: In equilibrium $p_{b't'} = p_{bt'}$
 - * i.e., the counterfactual price is the price the bank who did buy that target pays for the target
- The same inequalities apply to buyer b' and we thus get the following set of inequalities:

$$\begin{aligned} f(b, t) - f(b, t') &\geq p_{bt} - p_{b't'} \\ f(b', t') - f(b', t) &\geq p_{b't'} - p_{bt} \end{aligned} \quad (7)$$

- We can use the above inequalities to construct a score function, but this is problematic if we don’t observe the purchase prices

- In this case, add the two inequalities in Equation 7 together to obtain:

$$f(b, t) + f(b', t') \geq f(b', t) + f(b, t') \quad (8)$$

- In words, this inequality says that the total value from any observed matches is at least as great as the value from any counterfactual matches.

- Parameterization of the payoff function:

- The value of buyer bank b purchasing target t is given by:

$$f(b, t) = \beta_1 W_b W_t + \gamma_1' X_t + \gamma_2' X_{bt} + \varepsilon_{bt} \quad (9)$$

- * W_b are buyer characteristics and W_t are these same characteristics for the target
 - e.g., measures of bank size such as assets or number of branches
- * X_t are target specific covariates
 - e.g., market concentration in target market
- * X_{bt} are buyer-target specific characteristics (i.e., characteristics specific to the match)
 - e.g., market overlap
- * ε_{bt} is a match-specific error term that is independent across matches

- The max score estimator

- With this, we can write the maximum score estimator as:

$$\hat{\beta} = \arg \max Q(\beta) = \sum_{y=1}^Y \sum_{b=1}^{M_y-1} \sum_{b'=b+1}^{M_y} \mathbb{1} \left[f(b, t|\beta) + f(b', t'|\beta) \geq f(b', t|\beta) + f(b, t'|\beta) \right] \quad (10)$$

- A few notes about this:

- * Perfectly fine estimator to use in general
- * But:
 1. Leaving information on the table (if have pricing data)
 2. One of coefficients have to be normalize to one - all other coeffs interpreted relative that that effect
 - This is because the model is only identified up to a scale parameter.
 - When use prices, normalize the “coefficient” on price to one - so other coefficients interpreted as effect in dollars on the merger value
 3. If use data without prices *can't include buyer or target specific factors* – they cancel out as they are on both side of the inequality (see specifications above)
 - Note that acquirer specific information is differenced out whether or not price is used (see Equation 6).

- The authors thus propose another max score estimator that does use the merger price information to overcome this.

- The score function for this estimator is:

$$Q(\beta) = \sum_{y=1}^Y \sum_{b=1}^{M_y-1} \sum_{b'=b+1}^{M_y} \mathbb{1} \left[f(b, t|\beta) - f(b, t'|\beta) \geq p_{bt} - p_{b't'} \wedge f(b', t'|\beta) - f(b', t|\beta) \geq p_{b't'} - p_{bt} \right] \quad (11)$$

- Findings:

- Bank mergers appear to be motivated by branching efficiency and competitive concerns
- Not so much driven by pre-merger performance of the target or the threat of antitrust regulation

- Through some counterfactual simulations, they look at the effects of dual charters on efficiency in the banking industry
 - * The MSE suggests that banks are more likely to merge if they have the same charter
 - Two types of charters - national or state
 - National → federal regulator is the Federal Reserve
 - State → federal regulator is the FDIC
 - * So some mergers don't happen because buyer doesn't want target with different charter
 - * They use their estimated coefficients and the payoff functions to look at how merger value would change if all had same charter
 - * Find that average merger value (i.e., welfare) increases in this case. Suggesting gains to deregulating (i.e., doing away with dual charters)