Data Processing
– Causal Inference using Instrument Variables

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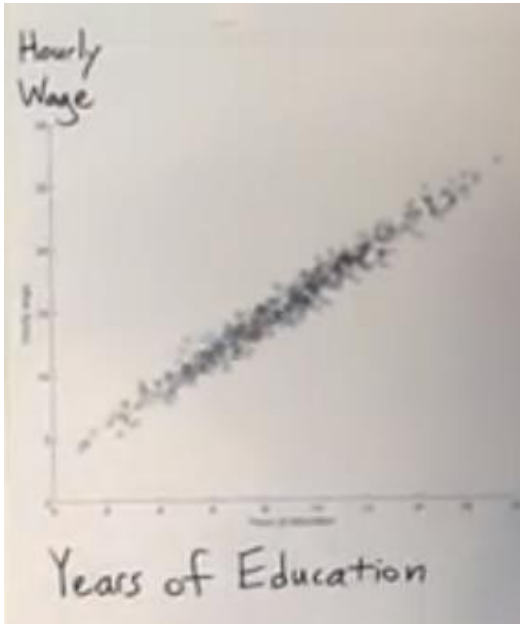
Table of contents
: Causal inference using instrument variables

- Correlation is not causality
- A method to separate a causal part from confounding – Instrument variable
- How to find a good instrument variable - three assumptions
- Another use of IV: handling noncompliers
- Actual calculation of causality using R
  - Indirect inference
  - Two Stage Least Square (2SLS) method
  - Local Average Treatment Effect (LATE)

Correlation is not causality

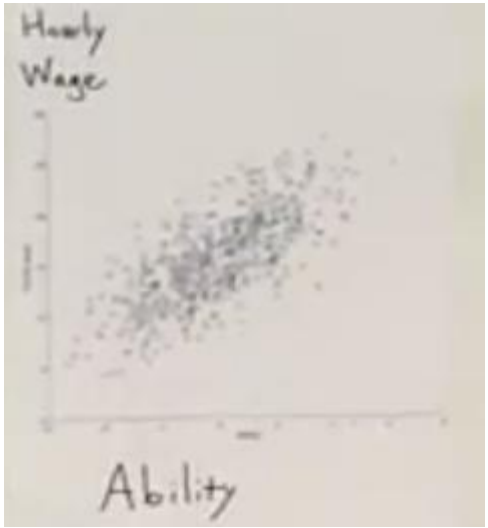
- One of the basics of scientific experiments is to change a parameter of our interest while keeping everything else the same.
- However, in social science, researchers often collect observation data instead of designing an experiment. The approach is equivalently valid only if the samples are randomly collected so that the values of everything else are equivalent.

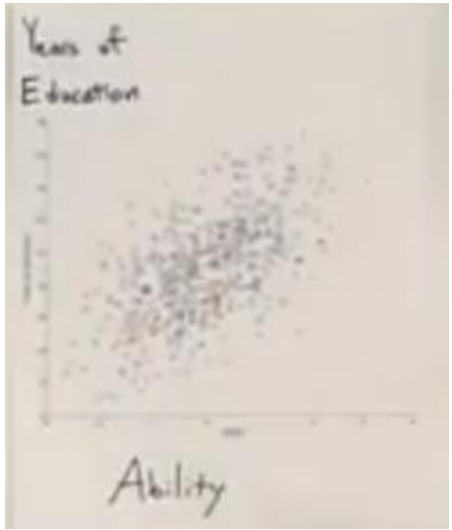
Correlation is not causality - example



- Let’s assume that we found a correlation between years of education and hourly wage in a dataset
- This doesn’t mean that if you have more education, you will get higher hourly wage

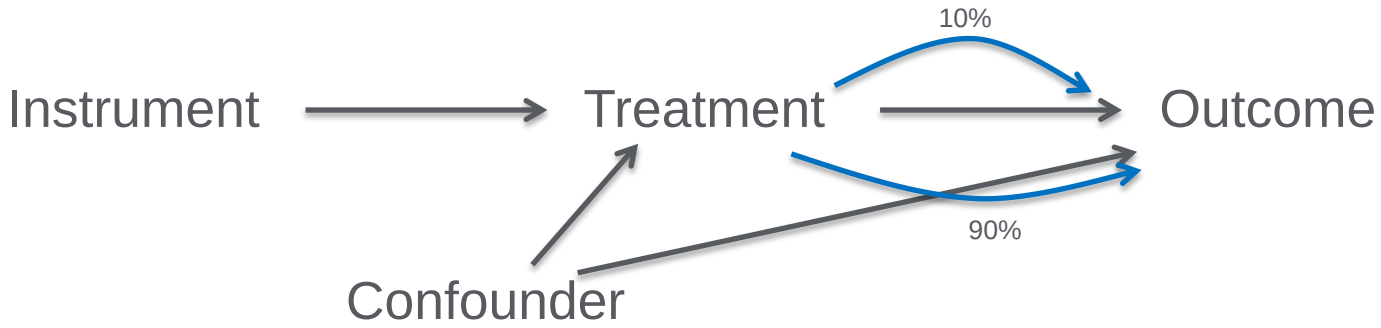
Correlation is not causality - example





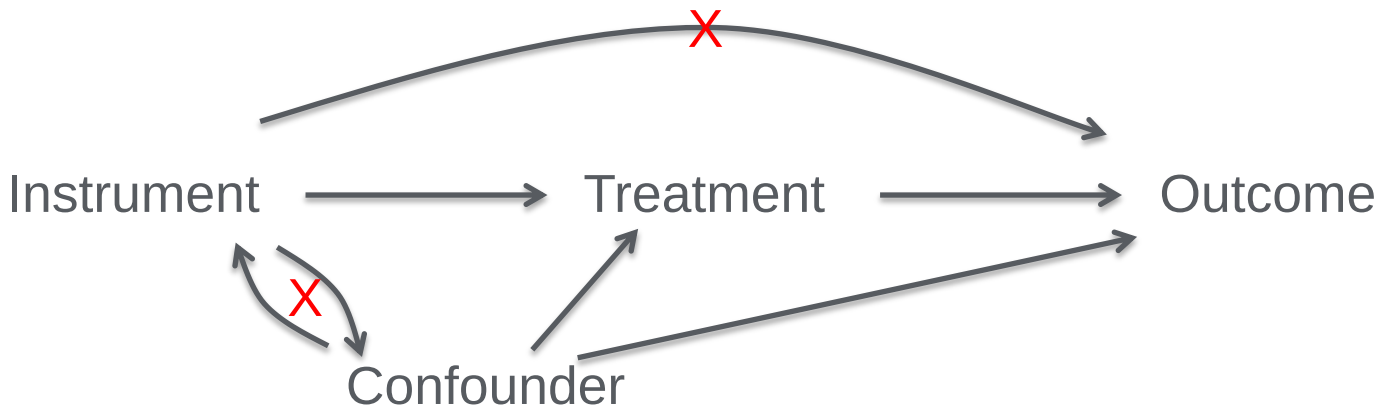
- The correlation may exists simply because the two variables are correlated by another variable, Ability
- Ability is conceptual and cannot measure. It can be instead considered as self-confidence, inherited intelligence, emotional intelligence, etc.
- Ability is called as a confounder
- The year of education is endogenous as it is related to hourly wage through ability

A method to separate a causal part from confounding – Instrument variable



- By using an instrument, we can separate the direct causal effect of treatment to outcome from the indirect correlation caused by confounders

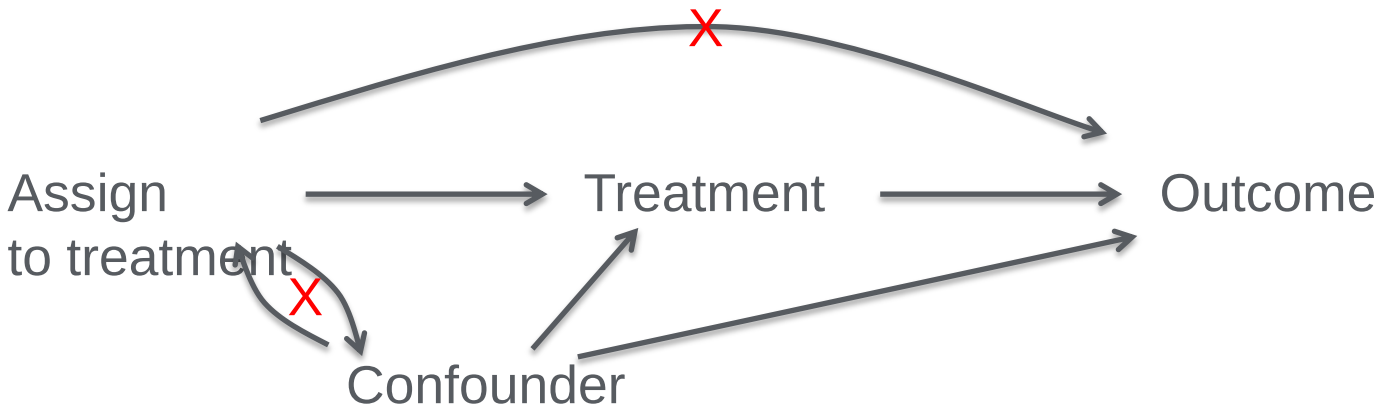
How to find a good instrument variable - three assumptions



1. Relevance: instrument is causing treatment
2. Exclusion restriction: instrument is related to outcome but without cauality
3. Exogenous assumption: instrument is randomly distributed regardless to confounders

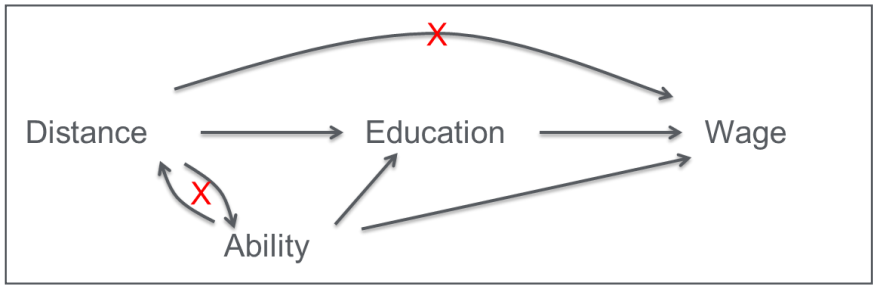
Another use of IV: handling noncompliers

- A human being doesn't always follow the intention of experiment
- "Assign to treatment" is an excellent example of instrument variable satisfying the three assumptions of relevance, exclusion and exogeneity
- Because of noncompliers, we need to use 2SLS method to segregate the actual effect of treatment to outcome



Actual calculation of causality using R
- Two Stage Least Square (2SLS) method

```
# attach the package Applied Econometrics with R (AER)
library(AER)

# load the `CollegeDistance` data set
data(CollegeDistance)

# first stage: regress education on distance
first <- lm(education ~ distance, data = CollegeDistance)

# generate predicted education
CollegeDistance$ed.pred<- predict(first)

# second stage: regress log(wage) on predicted education
second <- lm(log(wage) ~ ed.pred, data = CollegeDistance)

#  the same 2SLS using ivreg
TwoStage <- ivreg(log(wage) ~ education | distance, data = CollegeDistance)

# modified from https://www.econometrics-with-r.org/12-6-exercises-10.html
```



References

YOUR GUIDE TO INSTRUMENTAL VARIABLES MODULE by Matt Masten
https://modu.ssri.duke.edu/module/your-guide-instrumental-variables

Introduction to Econometrics with R, by Christoph Hanck, Martin Arnold, Alexander Gerber and Martin Schmelzer
https://www.econometrics-with-r.org/12-6-exercises-10.html