POLS/CS&SS 503:

Advanced Quantitative Political Methodology

PANEL DATA

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Overview

Fixed and Random Effects

Dynamic Panel Models

Panel-Corrected Standard Errors

Advice

References

Panel Data

- · What is Panel Data?
- · Why use it?
- · What are the problems?
- · What methods address them?
- Causal inference interpretations?

Example: Garrett (1998) government composition and economic indicators in OECD countries

countryname	year	gdp	infl	unem	capmob	corp
US	1966	5.11	2.90	3.80	0	1.80
US	1967	2.28	2.80	3.80	0	1.81
US	1990	0.90	5.40	5.41	0	2.01
Canada	1966	6.80	3.70	3.60	0	2.27
Canada	1967	2.92	3.60	4.10	0	2.30
Canada	1990	0.40	4.80	8.06	0	1.71
UK	1966	1.88	3.90	1.50	1	2.14
UK	1967	2.26	2.50	2.30	1	2.13
UK	1990	0.80	9.50	5.47	0	2.89

N=14 OECD countries, T=25 years (1966–1990).

Data (and models) structured into units and periods units

$$y_{i,t} = x_{i,t}\beta + \epsilon_{i,t}$$

- units $i=1,\ldots,N$ each observed over $t=1,\ldots,T$, for a total of $N\times T$ observations.
- balanced data: all units i have same number of observations T
- unbalanced data: units have different values of ${\cal T}$ (missingness, sample selection)
- some methods may require adjustments if using unbalanced data

Many different names, sometimes different things

- Other names
 - · panel data
 - longitudinal
 - time-series cross-section (TSCS)
- But can mean different things with different appropriate methods depending on the size of ${\cal N}$ and ${\cal T}$.

Different N and T in different contexts

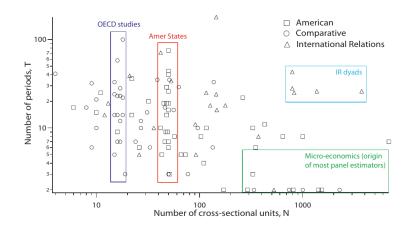


Image from Christopher Adolph

Different things

- Size of dimensions can influence which methods are appropriate:
 - Big N, small T (e.g. panel surveys)
 - Small(er) N, big T (e.g. country time series, financial)
- Some methods emphasize unit differences (fixed/random effects, PCSE)
- Others emphasize time (lagged dependent variables, serial correlation)

Why use Panel Data?

- More data, which might make inference more precise (at least if we believe β is the same or similar across units)
- Can help with omitted variables, especially if they are time invariant
- Some analysis only possible with panel data; e.g., if variables don't change much over time, like institutions
- Heterogeneity is interesting! As long as we can specify a general DGP for whole panel, can parameterize and estimate more substantively interesting relationships

Difficulties of Panel Data?

- More complex to conceptualize and model
- Need to worry about issues in time and space
- Needs more powerful or flexible estimation tools

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A Pooled Time Series Model

Example with GDP data

$$\texttt{gdp}_{i,t} = \alpha + \beta_1 \texttt{corp}_{i,t} + \beta_2 \texttt{leftlab}_{i,t} + \beta_3 \texttt{leftlab} \times \texttt{corp}_{i,t} + \beta_4 \texttt{demand}_{i,t}$$

- The model is **pooled** because it assumes β are the same between all countries
- · Ignores heterogeneity between units
- Almost always overestimates precision
- However, some amount of pooling is always necessary in a model, the question is how much.

Varying Intercepts Models

$$\begin{split} \mathsf{gdp}_{i,t} &= \frac{\alpha_i}{\alpha_i} + \beta_1 \mathsf{corp}_{i,t} + \beta_2 \mathsf{leftlab}_{i,t} + \beta_3 \mathsf{leftlab} \times \mathsf{corp}_{i,t} \\ &+ \beta_4 \mathsf{demand}_{i,t} + \epsilon_{i,t} \end{split}$$

Fixed Effects

No stochastic component of intercepts.

$$\alpha_i = \alpha_i^*$$

Random Effects

Intercepts are modeled as coming from a distribution; part of the error term.

$$\alpha_i \sim N(0, \sigma_\alpha^2)$$

Fixed effects

$$\begin{aligned} \mathsf{gdp}_{i,t} &= \frac{\alpha_i}{} + \beta_1 \mathsf{corp}_{i,t} + \beta_2 \mathsf{leftlab}_{i,t} + \beta_3 \mathsf{leftlab} \times \mathsf{corp}_{i,t} \\ &+ \beta_4 \mathsf{demand}_{i,t} + \epsilon_{i,t} \end{aligned}$$

- $\alpha_i = \alpha_i^*$ are individual for each country
- α_i can be correlated with $x_{i,t}$. Controls for *all* (known and unknown) time-invariant variables
- Cost: we're purging the cross-sectional variation from the analysis
- Assuming change in $x_{i,t}$ has same response in each series
- Uses over-time variation in covariates to estimate parameters

Estimating Fixed Effects

Dummy Variable Estimator (LSDV)

$$y_{i,t} = x_{i,t}\beta + \sum_{j=1}^{N} \alpha_j 1(j == i) + u_{i,t}$$

- Include a dummy (indicator) variable for each invidual
- Estimates α_i , which may be useful for understanding the model
- ullet For large T, it is similar to within estimator
- For small T, estimates of α_i will be poor.

Estimating Fixed Effects

Within Estimator

$$y_{i,t} - \bar{y}_i = (\alpha_i - \bar{\alpha}_i)(x_{i,t} - \bar{x}_i)\beta + (\epsilon_{i,t} - \bar{\epsilon}_i)$$
$$= (x_{i,t} - \bar{x}_i)\beta + (\epsilon_{i,t} - \bar{\epsilon}_i)$$

- Differencing absorbs (removes) fixed effects
- · Cannot include time-varying variables
- Suggests complementary "between" estimator

$$\bar{y}_i = \bar{x}_i \beta + \epsilon_i \tag{1}$$

 Does not estimate the fixed effects; only removes them; but can recover them after the fact.

Time Varying Covariates and Fixed Effects

- The fixed effects absorb all time-varying covariates so you cannot get separate estimates of them (perfect collinearity).
- Can include interactions of time-invariate variables? Estimate
 how these time-invariate variables mediate the effects of other
 variables.
- Use random effects instead of fixed effects.
- Alternative methods that decompose fixed effects in to known and unknown covariates (Plumper and Troeger 2007)

Random Effects

$$\begin{split} \mathsf{gdp}_{i,t} &= \beta_1 \mathsf{corp}_{i,t} + \beta_2 \mathsf{leftlab}_{i,t} + \beta_3 \mathsf{leftlab} \times \mathsf{corp}_{i,t} \\ &+ \beta_4 \mathsf{demand}_{i,t} + \nu_{i,t} \\ \nu_{i,t} &= \frac{\alpha_i}{\alpha_i} + \epsilon_{i,t} \\ \alpha_i &\sim N(0,\sigma_\alpha^2) \\ \epsilon_{i,t} &\sim N(0,\sigma_\epsilon^2) \end{split}$$

- Error variance is $\sigma_{\alpha}^2 + \sigma_{\epsilon}^2$
- Random effects (α_i) treated as part of the error

Fixed Effects or Random Effects?

- Random effects are more efficient if ${\rm Cor}(\alpha_i,x)=0$, but inconsistent if ${\rm Cor}(\alpha_i,x)\neq 0$
- Fixed effects are consistent, but less efficient if random effects model is efficient.
- Run Hausmann test on random effects and f (R function phtest). H_a is one test is inconsistent (random effects) and means to use fixed effects.
- Use random effects if you want to estimate effects of time-invariant variables.
- Can include group level averages or time-invariant variables in random effects model to approx the fixed effects part.

Implementations

- plm R package for panel estimation. Includes random effects, fixed effects.
- **Ime4** R package for fixed and random effects. From a statistics background, not specific to panel data.

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What makes a panel dynamic?

Static panel model:

$$y_{i,t} = X_{i,t}\beta + \epsilon_{i,t}$$

Dynamic panel model (Lagged dependent variable):

$$y_{i,t} = \phi y_{i,t-1} + X_{i,t}\beta + \epsilon_{i,t}$$

Lagged Dependent Variable

Is equivalent to geometrically decaying independent variable

$$y_{i,t} = X_{i,t}\beta + \epsilon_{i,t} + \phi y_{i,t-1}$$

$$= X_{i,t}\beta + \epsilon_{i,t} + \phi (X_{i,t-1}\beta + \epsilon_{i,t-1} + y_{i,t-1})$$

$$= \sum_{k=0}^{1} \phi^k X_{i,t-k}\beta + \sum_{k=0}^{1} \phi^k \epsilon_{i,t-k} + \phi (X_{i,t-2}\beta + \epsilon_{i,t-2} + y_{i,t-2})$$

$$= \sum_{k=0}^{2} \phi^k X_{i,t-k}\beta + \sum_{k=0}^{2} \phi^k \epsilon_{i,t-k} + \phi (X_{i,t-3}\beta + \epsilon_{i,t-3} + y_{i,t-3})$$

$$\vdots$$

$$= \sum_{k=0}^{\infty} \phi^k X_{i,t-k}\beta + \sum_{k=0}^{\infty} \phi^k \epsilon_{i,t-k}$$

Lagged Dependent Variable

Estimation

- Important that $|\phi| < 1$ (stationarity). What would happen if $|\phi_i| > 1$?
- OLS is optimal if $\epsilon_{i,t}$ are IID.
- OLS inconsistent if $\epsilon_{i,t}$ are serially correlated.
- If $\epsilon_{i,t}$ are serially correlated, can estimate with appropriate method (Cochrane-Orcutt, Prais-Winsten).

Lagged Dependent Variables with Fixed Effects

- Lagged DV + fixed effects: estimates are biased
- Methods exist to correct for that bias. IV methods of Anderson and Hsiao, Arellano and Bond. Rely on asymptotics. Variance of those estimators much higher.
- However, in most TSCS research, the bias of the RMSE of OLS is better than or not much worse than the IV estimators. (Beck and Katz, 2011)

Autoregressive Distributed Lag

$$y_{i,t} = \beta x_{i,t} + \phi y_{i,t-1} + \gamma x_{i,t-1} + \epsilon_{i,t}$$

- Beck and Katz (2011), De Boef and Keele (2008) suggest it a "default" model for TSCS.
- Can usually estimate with OLS
- Extremely flexible: nests many different time-series specifications
- Works with stationary and non-stationary data.
- Equivalent to another model: error correction model
- Does not account for fixed effects; these could be added with previous caveats

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Panel-corrected standard errors

- What PCSE account for:
 - Heteroskedasticity between units,

$$V(\epsilon_{USA}) \neq V(\epsilon_{CAN})$$
 (2)

Contemporaneous correlation between units,

$$Cor(\epsilon_{USA,1990}, \epsilon_{CAN,1990}) \neq 0 \tag{3}$$

 They do not account for serial correlation or non-contemporaneous correlations.

$$Cor(\epsilon_{USA,1990}, \epsilon_{USA,1991}) = 0$$

 $Cor(\epsilon_{USA,1990}, \epsilon_{CAN,1991}) = 0$

Panel-corrected Standard Errors

How to adjust the standard errors?

 Replace variance-covariance matrix used in calculating standard errors

$$C(\beta) = (X'X)^{-1}(X'\Omega)(X'X)^{-1}$$

• Linear regression with classical SE, $\Omega=\sigma^2I_N$, so

$$\mathsf{C}(\beta) = \sigma^2 (X'X)^{-1}$$

• In PCSE, Ω is $NT\times NT$ block-diagonal matrix with $N\times N$ matrix Σ of contemporaneous covariances on the diagonal.

PCSE

What is the variance-covariance matrix?

$$\Sigma_{N} = \begin{bmatrix} \sigma_{\epsilon_{1}}^{2} & \sigma_{\epsilon_{1},\epsilon_{2}} & \dots & \sigma_{\epsilon_{1},\epsilon_{N}} \\ \sigma_{\epsilon_{1},\epsilon_{2}} & \sigma_{\epsilon_{2}}^{2} & \dots & \sigma_{\epsilon_{1},\epsilon_{N}} \\ \vdots & \vdots & \ddots & \vdots \\ \sigma_{\epsilon_{1},\epsilon_{N}} & \sigma_{\epsilon_{2},\epsilon_{N}} & \dots & \sigma_{\epsilon_{N}}^{2} \end{bmatrix}$$

$$\Omega_{NT\times NT} = \begin{bmatrix} \Sigma_{N} & 0_{N} & \dots & 0_{N} \\ 0_{N} & \Sigma_{N} & \dots & 0_{N} \\ \vdots & \vdots & \ddots & \vdots \\ 0_{N} & 0_{N} & \dots & \Sigma_{N} \end{bmatrix} = \Sigma_{N} \otimes I_{T}$$

Panel-corrected standard errors

- Suggest using OLS with PCSE and lagged DV as a baseline model
- Many think that fixed effects should also be used.
- PCSE (and other error corrections) are 2nd order to getting lag structure and including fixed effects where appropriate.
- Implementations: R packages pcse, plm (vcovBK)

How to estimate the matrix Σ ?

- · Suppose that the panel is balanced,
- Estimate OLS, and then use residuals to estimate Σ ,

$$\hat{\Sigma}_{i,j} = \sum_{t=1}^{T} \frac{E_{i,t} E_{j,t}}{T}$$

- Plug in $\hat{\Sigma}$ to calculate the covariance matrix
- This is possible, but notation more tedious in unbalanced panels.

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- Old-school Beck and Katz (1995): lagged dependent variable + PCSE
- New-school Beck and Katz (2011), De Boef and Keele (2008)
 - · ADL or ECM model
 - Try fixed effects (OLS will probably be fine as long as ${\cal T}$ not too small)
 - Try not to use error corrections to avoid thinking about dynamics
- Angrist and Pischke:
 - lagged dependent variable and fixed effects bound the effect of X: try both

There is no advice

- · Know your data
- Know your model
- Ensure your results are robust
- · Think!

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