

Log-Log Regression

April 14, 2024

Overview

Log-log regression is a statistical technique used to model the relationship between a dependent variable and one or more independent variables, where both the dependent and the independent variables undergo logarithmic transformations. This method is particularly effective for examining multiplicative relationships and elasticities between variables that exhibit exponential growth or decline.

Purpose

- **Elasticity Analysis:** Log-log regression is commonly employed to analyze the elasticity of a variable, which is useful for understanding how percentage changes in one variable are associated with percentage changes in another.
- **Scale Invariance:** The logarithmic transformation of both dependent and independent variables helps in handling data across different scales and makes the model scale-invariant.

Business Applications of Log-Log Regression

Marketing

The following are some marketing applications of log-log regression:

Price Elasticity: Log-log regression can be used to estimate the price elasticity of a product's demand. A linear relationship can be depicted between the **log of the quantity demanded** and the **log of the price** by taking the natural logarithm of both the dependent and independent variables. The estimated **price elasticity of demand** can be used to inform pricing strategies and maximize revenue for businesses.

Advertising Effectiveness: The effect of advertising on sales can be estimated using log-log regression. A linear relationship can be modeled between the **log of sales** and the **log of advertising** expenditure by taking the natural logarithm of both the dependent and independent variables. The estimated coefficient can be used to guide advertising expenditure decisions and assist businesses in optimizing their marketing campaigns.

Brand Loyalty: Log-log regression can be utilized to estimate the impact of brand loyalty on sales. A linear relationship can be modeled between the **log of sales** and the **log of brand loyalty** by taking the natural logarithm of both the dependent and independent variables. The estimated coefficient can be used to **inform brand strategy decisions** and assist businesses in identifying market share expansion opportunities.

Market Segmentation Analysis: Log-log regression can be used to identify and analyze market segments based on product attributes. A linear relationship can be modeled between the log of the product attribute and the log of market share by taking the natural logarithm of both the dependent and independent variables. Estimates of the resulting coefficients can be used to determine which product attributes are most essential to each market segment and to inform decisions regarding product development. [2]

Finance

The following are some finance applications of log-log regression:

Asset Pricing Models: Log-log regression can be used to estimate asset pricing models, such as the capital asset pricing model (CAPM). By taking the natural logarithm of both the dependent and independent variables, a linear relationship can be modeled between the **log of the expected return** and the **log of the risk premium**. The resulting coefficient estimate can be used to inform investment decisions and help investors evaluate the risk and return of a portfolio.

Risk Management: Log-log regression can be used to estimate risk models, such as **value at risk (VaR)**. By taking the natural logarithm of both the dependent and independent variables, a linear relationship can be modeled between the **log of the portfolio value** and the **log of the portfolio risk**. The resulting coefficient estimate can be used to estimate the level of risk that the portfolio is exposed to and inform risk management decisions.

Option Pricing: Log-log regression can be used to estimate option pricing models, such as the Black-Scholes model. By taking the natural logarithm of both the dependent and independent variables, a linear relationship can be modeled between the **log of the stock price** and the **log of the option price**. The resulting coefficient estimate can be used to inform option pricing decisions and help investors **evaluate the fair value of an option**.

Credit Risk Analysis: Log-log regression can be used to estimate credit risk models, such as the **credit default swap (CDS) pricing** model. By taking the natural logarithm of both the dependent and independent variables, a linear relationship can be modeled between the

log of the CDS spread and the **log of the credit risk**. The resulting coefficient estimate can be used to inform credit risk analysis and help investors evaluate the **creditworthiness** of a company. [3]

Organizational Behavior

The following are some applications of log-log regression in Organizational Behavior:

Analysis of Employee attrition: Log-log regression can be used to predict employee attrition rates based on a variety of variables, including compensation, job satisfaction, and work environment. A linear relationship can be modeled between the log of the employee turnover rate and the log of the various factors by taking the natural logarithm of both the dependent and independent variables. Estimates of the resulting coefficients can be used to identify the most influential factors influencing employee attrition and inform strategies for employee retention.

Analysis of Employee Performance: Log-log regression can be used to predict employee performance based on a number of variables, including job training, work experience, and job satisfaction. A linear relationship can be modeled between the log of employee performance and the log of the various factors by taking the natural logarithm of both the dependent and independent variables. The estimated coefficients can be used to determine the most influential employee performance factors and to inform training and development strategies.

Organizational Culture Analysis: Analyzing the influence of organizational culture on employee behavior and attitudes can be accomplished through the use of log-log regression. By taking the natural logarithm of both the dependent and independent variables, it is possible to construct a linear relationship between the log of employee behavior and attitudes and the log of the different aspects of organizational culture. The estimated coefficients can be used to determine the most influential aspects of organizational culture on employee conduct and attitudes.

Leadership Effectiveness Analysis: Analyzing the influence of leadership on employee behavior and performance can be accomplished using log-log regression. A linear relationship can be modeled between the log of employee behavior and performance and the log of the various leadership factors by taking the natural logarithm of both the dependent and independent variables. The estimated coefficients can be used to identify the most influential leadership factors on employee behavior and performance, as well as to inform leadership development strategies. [4]

Model

Model Form

The general form of a log-log regression model is represented by the following equation:

$$\log(Y) = \beta_0 + \beta_1 \log(X_1) + \beta_2 \log(X_2) + \dots + \beta_n \log(X_n) + \epsilon \quad (0.1)$$

Where:

- Y is the dependent variable (after applying the logarithm).
- X_1, X_2, \dots, X_n are the independent variables (after applying logarithms to each).
- $\beta_0, \beta_1, \dots, \beta_n$ are the coefficients that the regression model aims to estimate.
- ϵ is the error term.

Assumptions

Similar to other regression analyses, log-log regression relies on several assumptions:

- **Linearity:** The relationship between the log-transformed dependent and independent variables is linear.
- **Independence:** Observations must be independent of each other.
- **Homoscedasticity:** The variance of error terms should be consistent across different values of independent variables.
- **Normal Distribution of Errors:** Errors should follow a normal distribution for valid hypothesis testing.

Advantages

- **Interpretability of Elasticities:** The coefficients in a log-log model represent the elasticity between variables, providing insights into how a percentage change in one variable affects another.
- **Handling Non-linear Patterns:** By transforming variables logarithmically, non-linear relationships can be modeled linearly, enhancing the analysis of complex patterns.

Disadvantages

- **Zero Values Problem:** Logarithmic transformation cannot be applied directly to zero or negative values, which might require additional data adjustments or transformations.
- **Interpretation Complexity:** Understanding and interpreting elasticities might be less straightforward compared to additive models, requiring a good grasp of logarithmic relationships. [1]

Estimation

1. The natural logarithm transformation of both variables can help to capture non-linear relationships, stabilize the data variance, and clarify the relationship between the variables. The coefficients β_0 and β_1 are elasticities that quantify the percentage change in the dependent variable for a one percent change in the independent variable.
2. The method of least squares is used to minimize the sum of squared residuals when estimating coefficients. This involves determining the values of β_0 and β_1 that minimize the difference between the observed and predicted values of the dependent variable. [5]

MODEL 1: Base Model

For reference and a point of comparison, we setup the same Base Model as the one used in the previous chapter on Log-Linear Regression.

```
data(mtcars)
attach(mtcars)
```

Simple Linear Regression

```
fit <- lm(mpg ~ wt, data = mtcars)
summary(fit)
```

Call:

```
lm(formula = mpg ~ wt, data = mtcars)
```

Residuals:

Min	1Q	Median	3Q	Max
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```
-4.5432 -2.3647 -0.1252 1.4096 6.8727
```

Coefficients:

```
              Estimate Std. Error t value Pr(>|t|)
(Intercept)  37.2851      1.8776   19.858 < 2e-16 ***
wt           -5.3445      0.5591   -9.559 1.29e-10 ***
```

Signif. codes: 0 '***' 0.001 '**' 0.01 '*' 0.05 '.' 0.1 ' ' 1

Residual standard error: 3.046 on 30 degrees of freedom

Multiple R-squared: 0.7528, Adjusted R-squared: 0.7446

F-statistic: 91.38 on 1 and 30 DF, p-value: 1.294e-10

MODEL 2: Log-Log Model

Model 2 adopts a log-log regression approach to explore the relationship between the weight (`wt`) of cars and their fuel efficiency (`mpg`) using the `mtcars` dataset. In contrast to a simple linear regression model that predicts `mpg` directly from `wt`, this model predicts the logarithm of `mpg` from the logarithm of `wt`. This double logarithmic transformation is particularly useful for examining how percentage changes in vehicle weight influence percentage changes in fuel efficiency, reflecting an elasticity-based relationship between these variables.

```
fit2 <- lm(log(mpg) ~ log(wt), data = mtcars)
summary(fit2)
```

Call:

```
lm(formula = log(mpg) ~ log(wt), data = mtcars)
```

Residuals:

```
      Min       1Q   Median       3Q      Max
-0.18141 -0.10681 -0.02125  0.08109  0.26930
```

Coefficients:

```
              Estimate Std. Error t value Pr(>|t|)
(Intercept)   3.90181    0.08790   44.39 < 2e-16 ***
log(wt)        -0.84182    0.07549  -11.15 3.41e-12 ***
```

Signif. codes: 0 '***' 0.001 '**' 0.01 '*' 0.05 '.' 0.1 ' ' 1

Residual standard error: 0.1334 on 30 degrees of freedom

Multiple R-squared: 0.8056, Adjusted R-squared: 0.7992
F-statistic: 124.4 on 1 and 30 DF, p-value: 3.406e-12

Model Output and Interpretation

The results from our log-log regression model are elucidated below:

Residuals

The residuals, or the differences between observed and predicted values of $\log(\text{mpg})$, show a median close to zero (-0.02125), indicating that, on average, the model's predictions closely match the actual log values. The spread of residuals from the minimum (-0.18141) to the maximum (0.26930) shows that most predictions fall within this range, suggesting a reasonable model fit.

Coefficients

- **Intercept (3.90181):** This value represents the expected value of $\log(\text{mpg})$ when $\log(\text{wt})$ equals zero. Since $\log(\text{wt})$ equals zero when wt is 1 (not zero due to the nature of logarithmic transformation), this intercept can be interpreted as the expected log of mpg for a car with a weight of 1 unit.
- **$\log(\text{wt})$ Coefficient (-0.84182):** This coefficient indicates the expected change in $\log(\text{mpg})$ for each one-unit increase in $\log(\text{wt})$. Specifically, a one-unit increase in $\log(\text{wt})$ is associated with a decrease of 0.84182 in $\log(\text{mpg})$. This negative coefficient reflects a strong inverse relationship, suggesting that as car weight increases on a logarithmic scale, fuel efficiency decreases.

Significance

Both coefficients (intercept and $\log(\text{wt})$) exhibit p-values significantly below conventional significance levels (e.g., 0.05), confirming their statistical significance and affirming that the logarithm of weight is a meaningful predictor of the logarithm of mpg.

Model Fit

- **Residual Standard Error (RSE): 0.1334** on 30 degrees of freedom indicates the typical deviation of the predicted values from the actual values.
- **Multiple R-squared (0.8056):** About 80.56% of the variability in $\log(\text{mpg})$ is explained by the model, indicating a strong fit.
- **Adjusted R-squared (0.7992):** This adjusted statistic accounts for the number of predictors and still explains about 79.92% of the variability in $\log(\text{mpg})$, supporting a robust model.
- **F-statistic (124.4):** This high value and the corresponding very low p-value ($3.406\text{e-}12$) affirm the overall significance of the model, demonstrating that the model fits the data well and the variables are appropriate.

Interpretation of the Beta Coefficient

The beta coefficient for $\log(\text{wt})$ in our log-log regression model is -0.84182. This coefficient is critical in understanding the elasticity of fuel efficiency to car weight.

In practical terms, a 1% increase in a car's weight leads to an approximate 0.84182% decrease in its fuel efficiency. This is interpreted as the elasticity of mpg to weight, indicating a highly elastic relationship where small percentage changes in weight lead to substantial percentage changes in mpg.

To visualize this relationship:

```
exp(-0.84182)
```

```
[1] 0.4309255
```

This calculation results in approximately 0.431, or 43.1%. Thus, for every 1% increase in weight, the fuel efficiency decreases by 56.9% ($100\% - 43.1\%$), reflecting a significant decline in efficiency due to an increase in weight.

Therefore, the beta coefficient of -0.84182 indicates a strong negative elasticity, signifying that increases in car weight have a substantial negative impact on fuel efficiency, all else being constant.

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