

The Predictive Paradigm

Big Data y Machine Learning para Economía Aplicada

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¿Qué entendemos por Big Data y ML?

- ▶ ¿Que es Big Data?
 - ▶ Big n , es solo parte de la historia
 - ▶ Big también es big k , muchos covariates, a veces $n \ll k$
 - ▶ Vamos a entender Big también como datos que no surgen de fuentes tradicionales (cuentas nac., etc)
 - ▶ Datos de la Web, Geográficos, etc.
- ▶ Machine Learning
 - ▶ Cambio de paradigma de estimación a predicción

Agenda

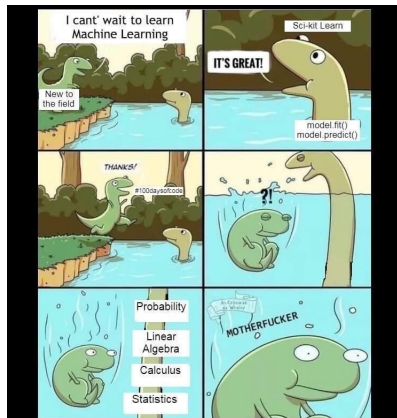
- 1 About the Course
- 2 Machine learning is all about prediction
- 3 Prediction vs Causality
- 4 ML Tasks
- 5 Regression, Prediction and loss functions
- 6 Bias/Variance Decomposition
- 7 Prediction and linear regression

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Lenguajes

- ▶ Estadística y Econometría
- ▶ Inglés
- ▶ Código
 - ▶ Elijan el que quieran:
 - ▶ R, Python, o cualquier otro
 - ▶ no hay restricción
 - ▶ yo me basare en R
 - ▶ Github
 - ▶ Slack
- ▶ Aprender haciendo y mucha prueba y error!



Material

1 Bloque Neón

2 Statistical Learning (FREE!!! (as beer, not speech)) <https://www.gnu.org/philosophy/free-sw.en.html>

- ▶ James, G., Witten, D., Hastie, T., & Tibshirani, R. (2013). An introduction to statistical learning (ISLR)
- ▶ Hastie, T., Tibshirani, R., & Friedman, J. (2009). The elements of statistical learning: data mining, inference, and prediction

3 Libros de econometría

- ▶ Davidson, R., & MacKinnon, J. G. (2004). Econometric theory and methods
- ▶ Wooldridge, J. M. (2010). Econometric analysis of cross section and panel data.
- ▶ Hayashi, F. (2000). Econometrics

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Machine learning is all about prediction

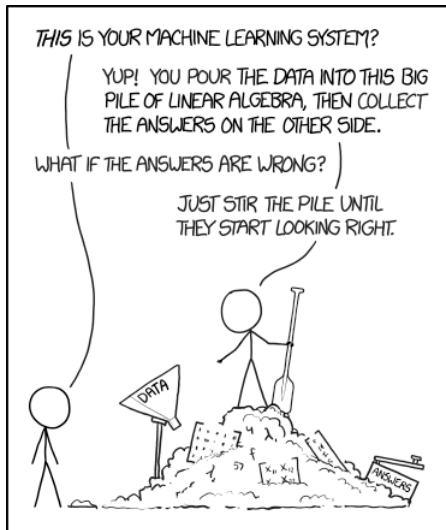
- ▶ Machine learning is a branch of computer science and statistics, tasked with developing algorithms to predict outcomes y from observable variables x .
- ▶ The learning part comes from the fact that we don't specify how exactly the computer should predict y from x .
- ▶ This is left as an empirical problem that the computer can “learn”.
- ▶ In general, this means that we abstract from the underlying model, the approach is pragmatic

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“Whatever works, works....”

“Whatever works, works....”



“Whatever works, works....”????

- ▶ In many applications, ML techniques can be successfully applied by data scientists with little knowledge of the problem domain.
- ▶ For example, the company Kaggle hosts prediction competitions (www.kaggle.com/competitions) in which a sponsor provides a data set, and contestants around the world can submit entries, often predicting successfully despite limited context about the problem.

“Whatever works, works....”????

- ▶ However, much less attention has been paid to the limitations of pure prediction methods.
- ▶ When ML applications are used “off the shelf” without understanding the underlying assumptions then the validity and usefulness of the conclusions can be compromised.
- ▶ A deeper question concerns whether a given problem can be solved using only techniques for prediction, or
- ▶ whether statistical approaches to estimating the causal effect of an intervention are required.

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Policy Prediction Problems

- ▶ Empirical policy research often focuses on causal inference.
- ▶ Since policy choices seem to depend on understanding the counterfactual— what happens with and without a policy—this tight link of causality and policy seems natural.
- ▶ While this link holds in many cases, there are also many policy applications where causal inference is not central, or even necessary.

Prediction vs. Causality

Prepare

- ▶ A loan officer wants to know the likelihood of an individual repaying a loan based on income, employment, and other characteristics.

Influence

- ▶ A mortgage lender wants to know if direct debit will increase loan repayments.

Prediction vs. Causality

Prepare

- ▶ A home seller wants to know what price homes with the characteristics of his or her home typically sell for.

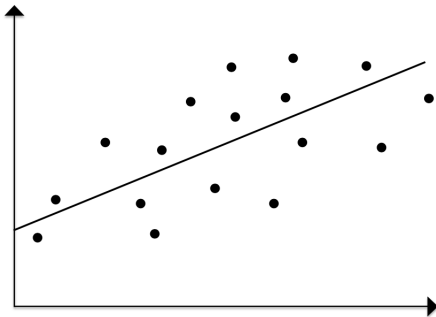
Influence

- ▶ A home seller wants to know by how much installing new windows will raise the value of his or her home.

Prediction vs. Causality: Target

$$y = f(x) + \epsilon \quad (1)$$

$$y = \alpha + \beta x + \epsilon \quad (2)$$



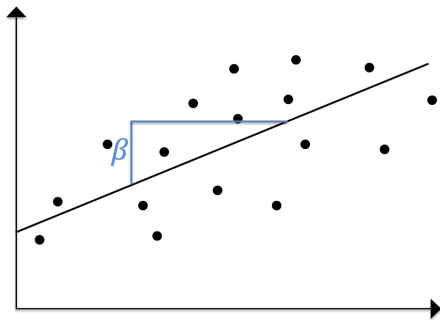
The Causal Paradigm

$$y = f(X) + u \quad (3)$$

- ▶ Interest lies on inference
- ▶ "Correct" $f()$ to understand how y is affected by X
- ▶ Model: Theory, experiment
- ▶ Hypothesis testing (std. err., tests)

Prediction vs. Causality: Target

$$y = \alpha + \beta x + \epsilon \quad (4)$$



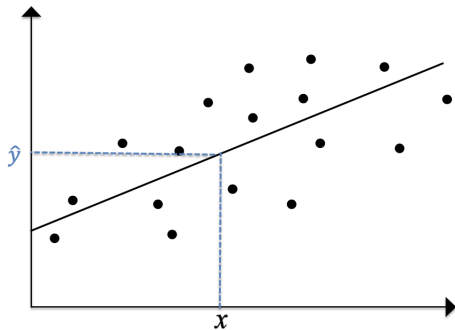
The Predictive Paradigm

$$y = f(X) + u \quad (5)$$

- ▶ Interest on predicting y
- ▶ "Correct" $f()$ to be able to predict (no inference!)
- ▶ Model? We treat $f()$ as a black box, and
- ▶ any approximation $\hat{f}()$ that yields a good prediction is good enough (*Whatever works, works.*).

Prediction vs. Causality: Target

$$y = \underbrace{\alpha + \beta x}_{\hat{y}} + \epsilon \quad (6)$$



Prediction vs. Causality: The garden of the parallel paths?

- ▶ We've seen that prediction and causality
 - ▶ Answer different questions
 - ▶ Serve different purposes
 - ▶ Seek different targets
- ▶ Different strokes for different folks, or complementary tools in an applied economist's toolkit?

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ML branches

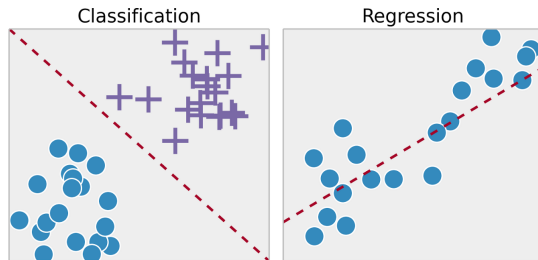
- ▶ ML tasks can (?) be divided into two main branches:

- 1 Supervised Learning

ML branches

► Supervised Learning

- for each predictor x_i a 'response' is observed y_i .
- everything we have done in econometrics is supervised



Source: shorturl.at/opqKT

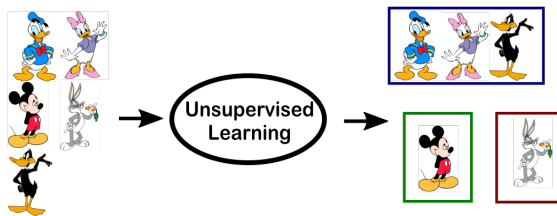
ML branches

► ML tasks can (?) be divided into two main branches:

- 1 Supervised Learning
- 2 Unsupervised Learning

ML branches

- ▶ Unsupervised Learning
 - ▶ observed x_i but no response.
 - ▶ example: cluster analysis



Source: shorturl.at/opqKT

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Getting serious about prediction: Regression

$$y = f(X) + u \quad (7)$$

- ▶ Interest on predicting y
- ▶ Model? We treat $f()$ as a black box, and any approximation $\hat{f}()$ that yields a good prediction is good enough (*“Whatever works, works...”*).
- ▶ How do we measure “what works”?

Getting serious about prediction: Regression

$$y = f(X) + u \quad (7)$$

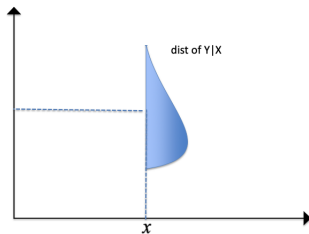
- ▶ Interest on predicting y
- ▶ Model? We treat $f()$ as a black box, and any approximation $\hat{f}()$ that yields a good prediction is good enough (*“Whatever works, works...”*).
- ▶ How do we measure “what works”?
- ▶ Formal statistics can help figure out this: what is a good prediction.

Minimizing our losses

- ▶ Want our prediction to be “close” i.e. minimize the expected loss function
- ▶ Formally, a supervised learning algorithm takes as an input a loss function $L(\hat{y}, y)$ and searches for a function \hat{f} within a function class \mathcal{F} that has a low expected prediction loss

$$E_{(y,X)}[L(\hat{f}(X), y)] \quad (8)$$

on a new data point from the same distribution.



Minimizing our losses

- ▶ A very common loss function in a regression setting is the squared loss $L(d) = d^2$
- ▶ Under this loss function the expected prediction loss is the mean squared error (MSE)
- ▶ Can we find the function f^* within a function class \mathcal{F} that has a low expected prediction loss?

Minimizing our losses

- By conditioning on X , it suffices to minimize the $MSE(f)$ point wise so

$$f(x) = \operatorname{argmin}_{f^*} E_{y|X}[(y - f^*)^2 | X = x] \quad (9)$$

- f^* a random variable and we can treat f^* as a constant (predictor)

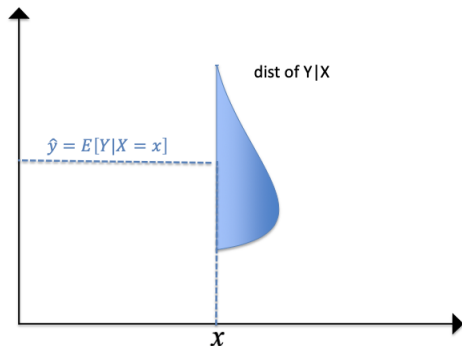
$$\min_{f^*} E(y - f^*)^2 = \int (y - f^*)^2 f(y) dy \quad (10)$$

- **Result:** The best prediction of y at any point $X = x$ is the conditional mean, when best is measured using a square error loss

Minimizing our losses

- **Result:** The best prediction of y at any point $X = x$ is the conditional mean, when best is measured using a square error loss

$$f^* = E[y|X = x] \quad (11)$$



Minimizing our losses

- Prediction problem solved if we knew $f^* = E[y|X = x]$

Minimizing our losses

- ▶ Prediction problem solved if we knew $f^* = E[y|X = x]$
- ▶ But we have to settle for an estimate: $\hat{f}(x)$
- ▶ The MSE of this

$$E(y - \hat{y})^2 = E(f(X) + u - \hat{f}(X))^2 \quad (12)$$

Reducible and irreducible error

$$E(y - \hat{y})^2 = \underbrace{E[f(X) - \hat{f}(X)]^2}_{\text{Reducible}} + \underbrace{\text{Var}(u)}_{\text{Irreducible}} \quad (13)$$

- ▶ The focus is on techniques for estimating f with the aim of minimizing the reducible error
- ▶ It is important to keep in mind that the irreducible error will always provide an upper bound on the accuracy of our prediction for y
- ▶ This bound is almost always unknown in practice

Agenda

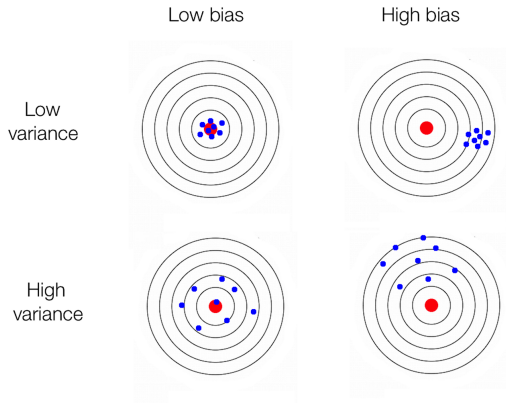
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Bias/Variance Decomposition

Recall that

- ▶ $Bias(\hat{f}(X)) = E(\hat{f}(X)) - f(X) = E(\hat{f}(X) - f(X))$
- ▶ $Var(\hat{f}(X)) = E(\hat{f}(X) - E(\hat{f}(X)))^2$

Bias/Variance Decomposition



Source: <https://tinyurl.com/y4lvjxpc>

Bias/Variance Decomposition

Recall that

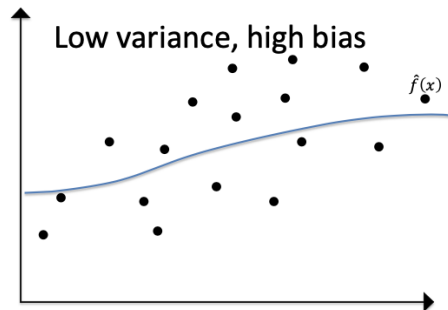
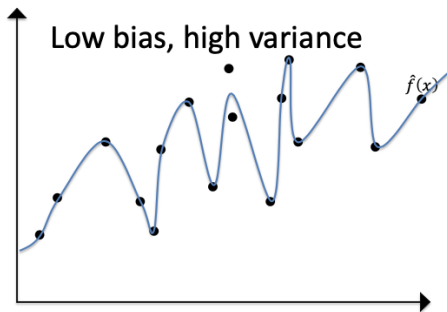
- ▶ $Bias(\hat{f}(X)) = E(\hat{f}(X)) - f(X) = E(\hat{f}(X) - f(X))$
- ▶ $Var(\hat{f}(X)) = E(\hat{f}(X) - E(\hat{f}(X)))^2$

Result (very important!)

$$MSE = Bias^2(\hat{f}(X)) + V(\hat{f}(X)) + \underbrace{Var(u)}_{Irreducible} \quad (14)$$

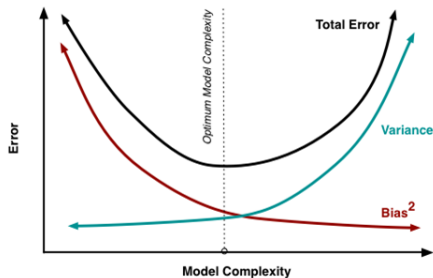
HW: Proof

Bias/Variance Decomposition



The Bias-Variance Trade-Off

$$MSE = Bias^2(\hat{f}(X)) + V(\hat{f}(X)) + \underbrace{Var(u)}_{Irreducible} \quad (15)$$



Source: <https://tinyurl.com/y4lvxpc>

- The best kept secret: tolerating some bias is possible to reduce $V(\hat{f}(X))$ and lower MSE

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Prediction and linear regression

- ▶ The goal is to predict y given another variables X .
- ▶ We assume that the link between y and X is given by the simple model:

$$y = f(X) + u \quad (16)$$

- ▶ we just learned that under a squared loss we need to approximate $E[y|X = x]$

Prediction and linear regression

- ▶ As economists we know that we can approximate $E[y|X = x]$ with a linear regression

$$f(X) = \beta_0 + \beta_1 X_1 + \cdots + \beta_p X_p \quad (17)$$

- ▶ The problem boils down to estimating β s
- ▶ We can estimate these using
 - ▶ OLS
 - ▶ MLE
 - ▶ MM



photo from <https://www.dailydot.com/parsec/batman-1966-labels-tumblr-twitter-vine/>

Review

- ▶ This Week:
 - ▶ Machine Learning is all about prediction
 - ▶ ML targets something different than causal inference, they can complement each other
 - ▶ ML best kept secret: tolerating some bias is possible to reduce $V(\hat{f}(X))$ and lower MSE
- ▶ Next Week:
 - ▶ Linear Regression details