

# Introductory Statistics for Economics

## ECON1013: LAB 3

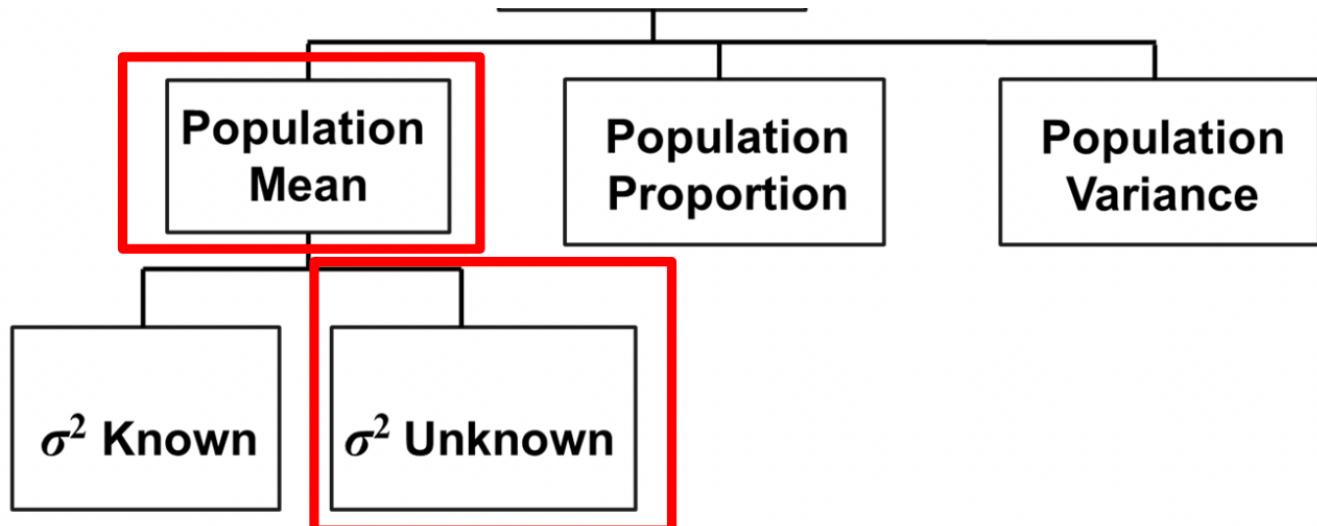
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March 2022

# PRELIMINARIES

# Estimation and Hypothesis Testing



(From normally distributed populations)

# Exercise 1

## Picture the Scenario

- ▶ **Objective:** The manager at a plant that bottles drinking water wants to be sure that the process to fill one-gallon bottles is operating properly (1 gallon  $\approx$  3.785 liters). Currently, the company is testing the volumes of one-gallon bottles. A random sample of 75 one-gallon bottles is tested.
- ▶ **Dataset:** Water.csv

## Questions

- (a) Find the 95% confidence interval estimate of the population mean volume.
- (b) Without doing calculations, state whether an 80% confidence interval for the population mean would be wider than, narrower than or the same as the answer to part (a).
- (c) Without doing calculations, test the null hypothesis  $H_0 : \mu = 3.785$  against the  $H_1 : \mu \neq 3.785$  at 1% significance level.

# Solution

```
# Load Dataset
Water <- read.csv('Water.csv')
str(Water)

## 'data.frame':    75 obs. of  1 variable:
## $ Weights: num  3.93 3.78 3.98 3.82 3.77 3.94 3.76 4.11 3.78

# Volumes of bottles in the sample
x <- Water$Weights
```

(a) Find the 95% confidence interval estimate of the population mean volume.

The  $100(1 - \alpha)\%$  confidence interval for the population mean (when population variance is unknown) is given by:

$$LB = \bar{x} - t_{n-1, \frac{\alpha}{2}} \times \frac{s}{\sqrt{n}} \quad \text{and} \quad UB = \bar{x} + t_{n-1, \frac{\alpha}{2}} \times \frac{s}{\sqrt{n}}$$

where  $t_{n-1, \frac{\alpha}{2}}$  is the critical value of the  $t$  distribution with  $n - 1$  degrees of freedom satisfying:

$$P \left( \frac{\bar{X} - \mu}{s/\sqrt{n}} > t_{n-1, \frac{\alpha}{2}} \right) = \frac{\alpha}{2}$$

(a) Find the 95% confidence interval estimate of the population mean volume.

```
# Compute the level of significance
alpha <- 1 - 0.95
# Compute the sample size
n <- length(x)
# Compute the critical value t_c from the t-distribution with n-
t_c <- qt(1-alpha/2, n-1)
# Compute the lower bound (lb) and the upper bound (ub)
lb <- mean(x) - t_c*sd(x)/sqrt(n)
ub <- mean(x) + t_c*sd(x)/sqrt(n)
# Compute the confidence interval manually
c(lb,ub)
```

```
## [1] 3.784305 3.831428
```

(a) Find the 95% confidence interval estimate of the population mean volume.

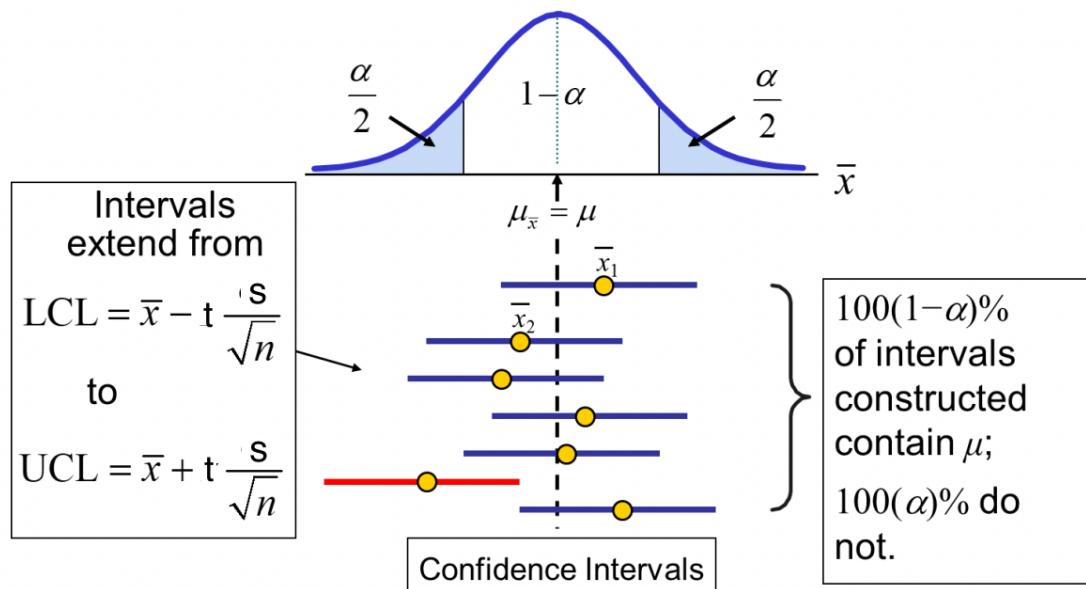
```
# Alternative: Use the command in R  
t.test(x)
```

```
##  
## One Sample t-test  
##  
## data: x  
## t = 322.02, df = 74, p-value < 2.2e-16  
## alternative hypothesis: true mean is not equal to 0  
## 95 percent confidence interval:  
## 3.784305 3.831428  
## sample estimates:  
## mean of x  
## 3.807867
```

# (a) Find the 95% confidence interval estimate of the population mean volume.

## (!) Interpretation

- We are 95% confident that the true mean volume is between 3.7843 and 3.8314 kg
- Although the true mean may or may not be in this interval, 95% of intervals formed in this manner will contain the true mean



(b) Whether an 80% confidence interval for the population mean would be wider than, narrower than or the same as the answer to part (1).

Length of the  $100(1 - \alpha)\%$  confidence interval is:

$$UB - LB = 2 \times t_{n-1, \frac{\alpha}{2}} \times \frac{s}{\sqrt{n}}$$

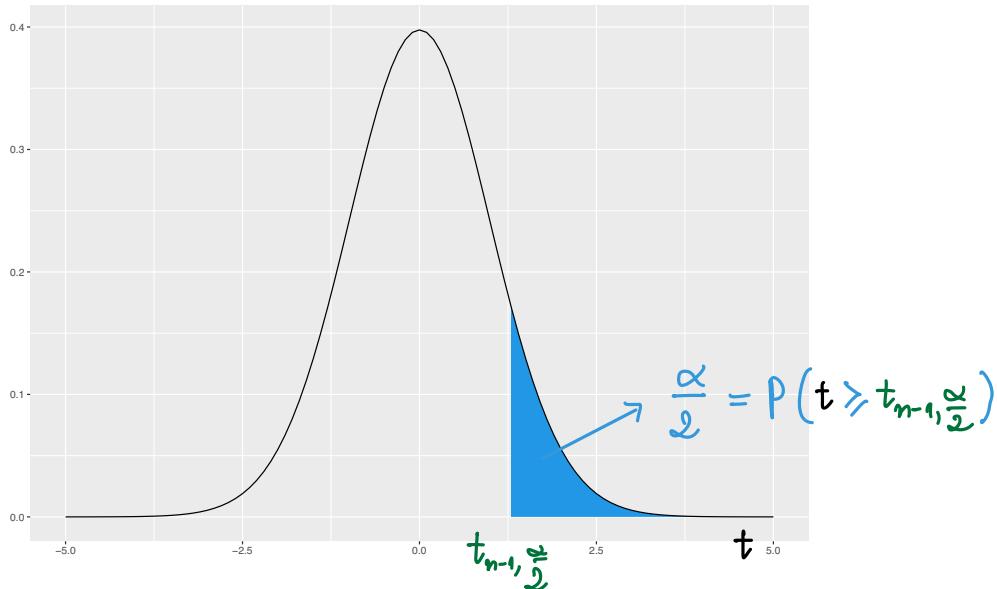


Figure 2: Student t distribution ( $df = n-1$ )

(b) Whether an 80% confidence interval for the population mean would be wider than, narrower than or the same as the answer to part (1).

Conclusion: The interval will be narrower, because the critical values will be smaller in absolute value.

(c) Test the null hypothesis  $H_0 : \mu = 3.785$  against the  $H_1 : \mu \neq 3.785$  at 1% significance level.

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In (a),  $\mu = 3.785$  lies inside the 95% confidence interval [3.7843, 3.8314], so the null hypothesis is already not rejected at 5%.

(c) Test the null hypothesis  $H_0 : \mu = 3.785$  against the  $H_1 : \mu \neq 3.785$  at 1% significance level.

In (1),  $\mu = 3.785$  lies inside the 95% confidence interval [3.7843, 3.8314], so the null hypothesis is already not rejected at 5%.

The 99% confidence interval contains the 95% confidence interval (when being constructed from the same sample), so  $\mu = 3.785$  also lies inside this interval. Hence, the null hypothesis is not rejected at 1%.

## Exercise 2

## Picture the Scenario

- ▶ **Objective:** You have accepted a job in Taiwan and want to optimize your commuting costs and rental costs. You are in the process of buying an apartment. You have been informed that a house in Taiwan is considered overpriced if it is sold at a price higher than 3,500 USD/ $m^2$ . You wonder if the population mean price of the houses sold in 2012-2013 was considered overpriced.
- ▶ **Dataset:** TaiwanRealEstate.csv

# Questions

- (a) Use a classical hypothesis test to determine if there is enough evidence to conclude that the population mean price of the houses sold in 2012-2013 was considered overpriced. Use a probability of Type I error equal to 0.05.
- (b) Prepare a power curve for the test (*Hint:* Find the population mean values for  $\beta = 0.50$ ,  $\beta = 0.25$ ,  $\beta = 0.10$  and  $\beta = 0.05$ , and plot those means versus the power of the test).

# Solution

```
# Load Dataset
Taiwan <- read.csv('TaiwanRealEstate.csv')
str(Taiwan)
# Price of houses in the sample
price <- Taiwan$House.price..usd.m.2.
# Check if there is any "Not Available" data point
anyNA(price)
# is.na(price)
# sum(is.na(price))
# Omit the "Not Available" elements
x <- na.omit(price)
```

## (a) Hypothesis test using $\alpha = 0.05$

Procedure includes 4 steps:

- ▶ Null hypothesis  $H_0$
- ▶ Alternative hypothesis  $H_1$
- ▶ Decision rule
- ▶ Conclusion

## (a) Hypothesis test using $\alpha = 0.05$

- ▶ Null hypothesis  $H_0$ 
  - $H_0$ : the population mean price of the houses sold in 2012-2013 was not considered overpriced  
 $H_0 : \mu \leq 3500$
- ▶ Alternative hypothesis  $H_1$ 
  - $H_1$ : the population mean price of the houses sold in 2012-2013 was considered overpriced  
 $H_1 : \mu > 3500$
- ▶ Decision rule
- ▶ Conclusion

## (a) Hypothesis test using $\alpha = 0.05$

- ▶ Null hypothesis  $H_0$ 
  - $H_0$ : the population mean price of the houses sold in 2012-2013 was not considered overpriced  
$$H_0 : \mu \leq 3500$$
- ▶ Alternative hypothesis  $H_1$ 
  - $H_1$ : the population mean price of the houses sold in 2012-2013 was considered overpriced  
$$H_1 : \mu > 3500$$

⇒ This is an *upper-tail test* since the alternative hypothesis is focused on the upper tail above the mean of 3500
- ▶ Decision rule
- ▶ Conclusion

# Decision Rule

Assume the population is normal, and the population variance is unknown:

$$\frac{\bar{X} - \mu_0}{s\sqrt{n}} \sim t_{n-1}$$

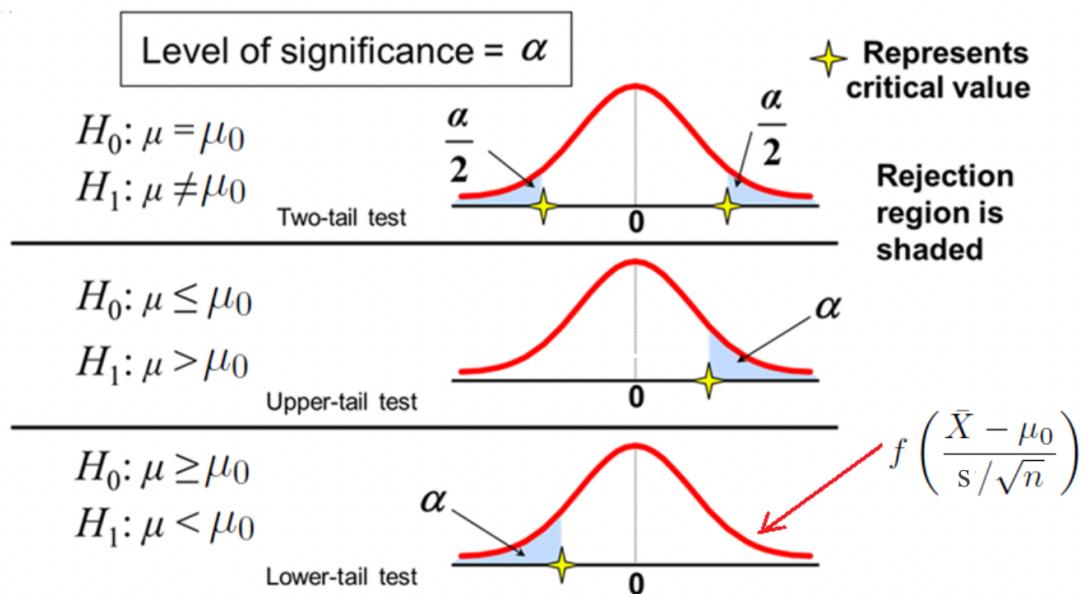


Figure 3: Level of Significance and the Rejection Region: one-sided vs two-sided alternatives

## Decision Rule

For upper-tail test, reject  $H_0$  if:

$$t = \frac{\bar{x} - \mu_0}{s\sqrt{n}} > t_{n-1,\alpha}$$

$$\Leftrightarrow \bar{x} > \bar{x}_c = \mu_0 + t_{n-1,\alpha} \times \frac{s}{\sqrt{n}}$$

## Decision Rule

```
# Compute the level of significance
alpha <- 0.05
# Compute the sample size
n <- length(x)
# Compute the critical value t_c
t_c <- qt(1-alpha, n-1)
# Compute the critical value \bar{x}_c
x_c <- 3500 + t_c*sd(x)/sqrt(n)
x_c
```

```
## [1] 3608.572
```

```
# Compute the sample mean \bar{x}
mean(x)
```

```
## [1] 3740.474
```

```
# Test manually
mean(x) > x_c
```

```
## [1] TRUE
```

# Decision Rule

```
# Alternative: Use the command in R
t.test(x, mu = 3500, conf.level = 0.95, alternative = "greater")
```

```
##  
##  One Sample t-test  
##  
## data: x  
## t = 3.6513, df = 413, p-value = 0.0001472  
## alternative hypothesis: true mean is greater than 3500  
## 95 percent confidence interval:  
##  3631.902      Inf  
## sample estimates:  
## mean of x  
## 3740.474
```

## (a) Hypothesis test using $\alpha = 0.05$

- ▶ Null hypothesis:
  - $H_0: \mu \leq 3500$
- ▶ Alternative hypothesis:
  - $H_1: \mu > 3500$
- ▶ Decision rule:
  - Since  $\bar{x} = 3740.474 > 3608.572 = \bar{x}_c$ , we reject  $H_0$  at  $\alpha = 0.05$ .
- ▶ Conclusion:
  - There is sufficient evidence to conclude that the population mean price of the houses sold in 2012-2013 was considered overpriced.

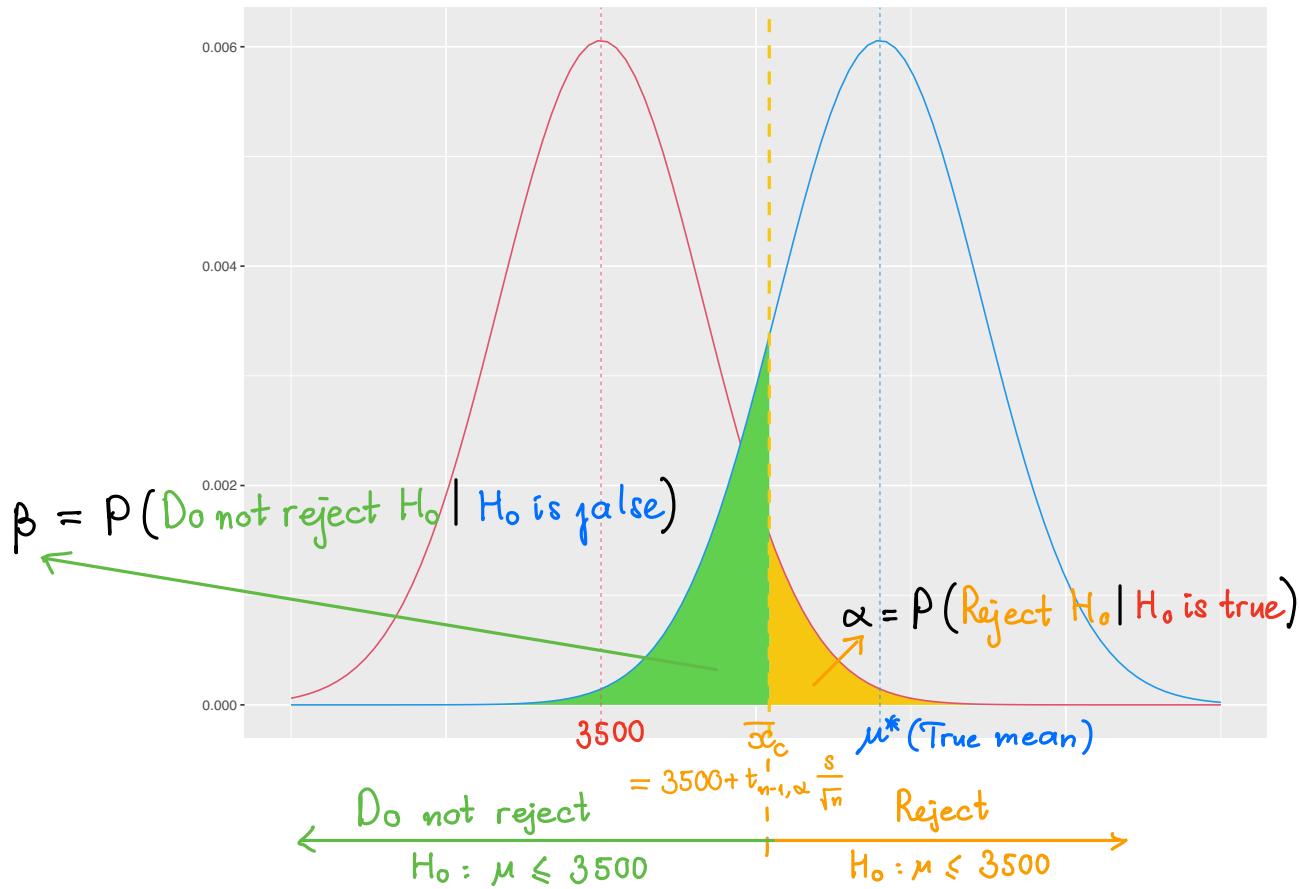
## (b) Prepare a power curve for the test

		Actual Situation	
Decision	$H_0$ True		$H_0$ False
Do Not Reject $H_0$	<b>Correct Decision</b> $(1 - \alpha)$		<b>Type II Error</b> $(\beta)$
Reject $H_0$	<b>Type I Error</b> $(\alpha)$		<b>Correct Decision</b> $(1 - \beta)$

- ▶  $1 - \beta$  is defined as **the power of the test**, the probability that a false null hypothesis is rejected.
- ▶ The value of  $\beta$  and the power will be different for each value of true mean  $\mu^*$ .

## (b) Prepare a power curve for the test

Suppose we do not reject  $H_0 : \mu \leq 3500$  when in fact, the true mean  $\mu = \mu^* > 3500$ :



## (b) Prepare a power curve for the test

$$\beta = P(\text{Do not reject } H_0 | H_0 \text{ is false})$$

$$\Leftrightarrow \beta = P(\bar{X} \leq \bar{x}_c | \mu = \mu^*)$$

$$\Leftrightarrow \beta = P\left(\frac{\bar{X} - \mu^*}{s/\sqrt{n}} \leq \frac{\bar{x}_c - \mu^*}{s/\sqrt{n}} \mid \mu = \mu^*\right)$$

$$\Leftrightarrow \beta = P\left(t \leq \frac{\bar{x}_c - \mu^*}{s/\sqrt{n}}\right) \text{ where } t = \frac{\bar{X} - \mu^*}{s/\sqrt{n}} \sim t_{n-1}$$

$$\Leftrightarrow 1 - \beta = P\left(t > \frac{\bar{x}_c - \mu^*}{s/\sqrt{n}}\right)$$

$$\Leftrightarrow \frac{\bar{x}_c - \mu^*}{s/\sqrt{n}} = t_{n-1, 1-\beta}$$

$$\Leftrightarrow \mu^* = \bar{x}_c - t_{n-1, 1-\beta} \times \frac{s}{\sqrt{n}}$$

## (b) Prepare a power curve for the test

```
# Assign values for probability of Type II error  
beta = c(.5,.25,.1,.05)  
# Compute corresponding power of the test  
power = 1 - beta  
# Compute true value of population mean  
mu_star = x_c - qt(1-power, df = n-1)*sd(x)/sqrt(n)  
# Power curve  
plot(mu_star, power, col = 'red')
```

