

# ECON 815 - COMPUTATIONAL METHODS FOR ECONOMISTS

Fall 2019

Notes on Maximum Score Estimation

## Estimation of Two-sided matching problems

- What we want to do is to be able to estimate the structural parameters of this matching model
  - We observe the matches that happen
  - We observe characteristics of the agents who are matched
  - From this we can infer the payoffs to the match for the agents
- The structure of the data
  - The structure of the data affects the asymptotic of the estimator
  - e.g., do we observe all matches in a market - so that the asymptotics depend on observing more markets?
  - Or do we observe only some of the matches in a large market - so that the asymptotics depend on observing more matches in this market?

## Maximum Score Estimation

- The maximum score estimator (MSE) was introduced by Manski (*Journal of Econometrics*, 1975)
- The maximum score estimator is similar to the maximum likelihood estimator
  - The MLE maximizes the likelihood function
  - The MSE maximizes the “score function”
- The score function is the number of observations correctly predicted by the discrete choice model:

$$Q_n(\beta) = \sum \mathbb{1}[f(X; \beta)] \quad (1)$$

- Note: the argument inside the indicator function will vary depending upon the discrete choice model and the data
- The maximum score estimator is identified by the property that the outcomes for model agents can be rank-ordered by the deterministic part of their payoff function.
  - Unlike a maximum likelihood estimator, this stochastic structure does not need to be parameterized
  - This estimator uses the idea of revealed preference: if one option was chosen over another, then that one is revealed preferred to the others and must be ahead of those in rank order of the agent’s preferences
- Maximum score estimators can be used for any discrete choice model, but maybe most helpful for models with matching since they can help to capture the equilibrium effects.
- Pros of MSE relative to MLE:
  - Do not need strong assumptions on the distribution of the error term
  - Captures equilibrium effects in a matching model
  - Simple, intuitive statistical objective function that is easy to compute

- Cons of MSE relative to MLE:
  - Convergence is slower
  - Inference is more difficult

### The Estimator

- Notation for representing matches:
  - Let  $m$  refer to the market
  - Let  $i$  refer to the “upstream” agent in the match
  - Let  $j$  refer to the “downstream” agent in the match
  - Ordering is not important
  - A one-to-one match is then identified by the tuple  $\{m, i, j\}$
  - For many-to-many matches, use  $\{m, \{i_1, i_2, \dots\}, \{j_1, j_2, \dots\}\}$  to denote the match
- The payoff function:
  - Let  $f_\beta(m, i, j)$  represent the payoff for the match of  $i$  and  $j$  in market  $m$  given parameter vector  $\beta$
  - The represents the value of the match to for upstream agent  $i$  matching with downstream agent  $j$  in market  $m$
  - $f_\beta(m, j, i)$  is the value for the agent on the other side of the match, i.e., looking at this match from the perspective of  $j$  matching with  $i$
- The statistical objective function:
  - For one-to-one matches:
 
$$Q(\beta) = \sum_{m \in M} \sum_{i \in U_m} \sum_{j \in U_m \setminus i} \mathbb{1} [f_\beta(m, i, \mu_m(i)) + f_\beta(m, j, \mu_m(j)) > f_\beta(m, i, \mu_m(j)) + f_\beta(m, j, \mu_m(i))] \quad (2)$$
    - \*  $M$  is the set of markets
    - \*  $U_m$  is the set of upstream agents in market  $m$
    - \*  $\mu_m(i)$  is the function to reference the downstream partner of the upstream agent in market  $m$
  - For many-to-many matches (more general formulation that can also account for 1-to-1 matches):
 
$$Q(\beta) = \sum_{m \in M} \sum_{\{C^{LHS}, C^{RHS}\} \in I_m} \mathbb{1} \left[ \sum_{\vec{a} \in C^{LHS}} f_\beta(\vec{x}_a) > \sum_{\vec{a} \in C^{RHS}} f_\beta(\vec{x}_a) \right] \quad (3)$$
    - \*  $I_m$  are the sets of inequalities to be compared
    - \* Each element of  $I_m$  is a pair of sets of coalitions,  $\{C^{LHS}, C^{RHS}\}$ , one of which is observed and one of which is hypothetical
    - \*  $\vec{x}_a$  are the covariates of coalition  $a$
- Normalization
  - The objective function needs to be normalized for anything that requires it have an asymptotic limit
  - There are two ways to do this:

1. If complete markets are observed and new observations come from observing new markets: divide  $Q(\beta)$  by  $M$ , the number of markets
  2. If there is one big market and new observations come from observing more matches in this market: divide  $Q(\beta)$  by  $H(H-1)$ , where  $H$  is the number of matches observed
    - \* Note  $H(H-1)/2$  is the number of comparisons that will be performed in the nested sums
- The Smooth Maximum Score Estimator
    - The MSE estimator outlined above will have discrete jumps as the parameters are changed and the inequalities flip
    - This can pose problems for the numerical optimization routines used to maximize the score function and also for statistical inference
    - Thus, Horowitz (*Econometrica*, 1992) proposed a smoothed MSE
    - To do this, replace the indicator function in the score function with a kernel,  $K(\cdot)$
    - $K(\cdot)$  has the following properties
      - \*  $K(v)$  is finite valued for all  $v$
      - \*  $\lim_{v \rightarrow -\infty} K(v) = 0$
      - \*  $\lim_{v \rightarrow \infty} K(v) = 1$
    - With this, we have a CDF-like kernel
    - With the smooth MSE, then with pairwise matches, inequalities that are not satisfied receive little weight and those satisfied by a large margin receive the most weight
    - Another nice property of the smoothed estimator is that bootstrapped standard errors are consistent (Horowitz (*Journal of Econometrics*, 2002))

### Inference

- Constructing standard errors or confidence intervals for the MSE is not entirely straightforward.
- Bootstrapping is not consistent (in general) and one needs to account for the convergence properties of this estimator.
- But there are at least a couple methods:
  1. Subsampling confidence intervals
    - Pick  $S$  random sample of subsamples, each with size  $n_s <$  the number of observations in the full data set, where  $s$  denotes a particular subsample
    - Find the maximum score estimate for each  $s$ ,  $\hat{\beta}_s$
    - The approximate sampling distribution for the parameter vector can be computed as
 
$$\tilde{\beta}_s = (n_s/N)^{1/3}(\hat{\beta}_s - \hat{\beta}_{full}) + \hat{\beta}_{full} \quad (4)$$
      - \*  $\hat{\beta}_{full}$  is the MSE from the full sample
      - \* This procedure accounts for the  $\sqrt[3]{N}$  convergence property of the MSE
    - To compute the 95% confidence interval, take the 2.5th and 97.5th percentiles from this distribution
  2. Bootstrapping standard errors/confidence intervals
    - Is consistent with a smoothed MSE!

### An Example:

- “The Determinants of Bank Mergers: A Revealed Preference Analysis” by Akkus, Cookson, and Hortaçsu (*Management Science*, 2016)
- Authors seek to understand how value is created from bank mergers (e.g. from reducing regulatory compliance costs, network effects, etc.)
- Framework - The matching model
  - The authors propose a one-to-one matching model where buyer banks look for target banks to purchase
  - The authors assume one national market per year and that markets in different years are independent of one another
  - There are  $M^y$  matches in the market in year  $y$
  - The value of the merger is the joint value to the buyer and the target bank:

$$f(b, t) = V_b(b, t) + V_t(b, t) \quad (5)$$

- The payoff to the buyers is the post-merger valuation less the price paid to acquire the target,  $V_b(b, t) = f(b, t) - p_{bt}$
- The target’s payoff is equal to their purchase price,  $V_t(b, t) = p_{bt}$
- Each buyer maximizes  $V_b(b, t)$  across targets
- Each target maximizes  $V_t(b, t)$  across buyers
- In equilibrium, all observed matches yield higher value than the counterfactual matches
  - \* Else we would have observed the counterfactual matches
  - \* Note this use of revealed preference
- This means that if buyer  $b$  bought target  $t$  and not target  $t'$ , then:

$$\begin{aligned} V_b(b, t) &\geq V_b(b, t') \\ f_b(b, t) - p_{bt} &\geq f(b, t') - p_{bt'} \end{aligned} \quad (6)$$

- ISSUE: counterfactual transactions don’t happen, so never observe  $p_{bt'}$
- Solution: In equilibrium  $p_{b't'} = p_{bt'}$ 
  - \* i.e., the counterfactual price is the price the bank who did buy that target pays for the target
- The same inequalities apply to buyer  $b'$  and we thus get the following set of inequalities:

$$\begin{aligned} f(b, t) - f(b, t') &\geq p_{bt} - p_{b't'} \\ f(b', t') - f(b', t) &\geq p_{b't'} - p_{bt} \end{aligned} \quad (7)$$

- We can use the above inequalities to construct a score function, but this is problematic if we don’t observe the purchase prices
- In this case, add the two inequalities in Equation 7 together to obtain:

$$f(b, t) + f(b', t') \geq f(b', t) + f(b, t') \quad (8)$$

- In words, this inequality says that the total value from any observed matches is at least as great as the value from any counterfactual matches.

- Parameterization of the payoff function:

- The value of buyer bank  $b$  purchasing target  $t$  is given by:

$$f(b, t) = \beta_1 W_b W_t + \gamma_1' X_t + \gamma_2' X_{bt} + \varepsilon_{bt} \quad (9)$$

- \*  $W_b$  are buyer characteristics and  $W_t$  are these same characteristics for the target
  - e.g., measures of bank size such as assets or number of branches
- \*  $X_t$  are target specific covariates
  - e.g., market concentration in target market
- \*  $X_{bt}$  are buyer-target specific characteristics (i.e., characteristics specific to the match)
  - e.g., market overlap
- \*  $\varepsilon_{bt}$  is a match-specific error term that is independent across matches

- The max score estimator

- With this, we can write the maximum score estimator as:

$$\hat{\beta} = \arg \max Q(\beta) = \sum_{y=1}^Y \sum_{b=1}^{M_y-1} \sum_{b'=b+1}^{M_y} \mathbb{1} \left[ f(b, t | \beta) + f(b', t' | \beta) \geq f(b', t | \beta) + f(b, t' | \beta) \right] \quad (10)$$

- A few notes about this:

- \* Perfectly fine estimator to use in general
- \* But:
  1. Leaving information on the table (if have pricing data)
  2. One of coefficients have to be normalize to one - all other coeffs interpreted relative that that effect
    - This is because the model is only identified up to a scale parameter.
    - When use prices, normalize the “coefficient” on price to one - so other coefficients interpreted as effect in dollars of the merger value
  3. If use data without prices *can't include buyer or target specific factors* – they cancel out as they are on both side of the inequality (see specifications above)
    - Note that acquirer specific information is differenced out whether or not price is used (see Equation 6).
- The authors thus propose another max score estimator that does use the merger price information to overcome this.
- The score function for this estimator is:

$$Q(\beta) = \sum_{y=1}^Y \sum_{b=1}^{M_y-1} \sum_{b'=b+1}^{M_y} \mathbb{1} \left[ f(b, t | \beta) - f(b, t' | \beta) \geq p_{bt} - p_{b't'} \wedge f(b', t' | \beta) - f(b', t | \beta) \geq p_{b't'} - p_{bt} \right] \quad (11)$$

- Findings:

- Bank mergers appear to be motivated by branching efficiency and competitive concerns
- Not so much driven by pre-merger performance of the target or the threat of antitrust regulation
- Through some counterfactual simulations, they look at the effects of dual charters on efficiency in the banking industry
  - \* The MSE suggests that banks are more likely to merge if they have the same charter
    - Two types of charters - national or state
    - National → federal regulator is the Federal Reserve
    - State → federal regulator is the FDIC
  - \* So some mergers don't happen because buyer doesn't want target with different charter
  - \* They use their estimated coefficients and the payoff functions to look at how merger value would change if all had same charter
  - \* Find that average merger value (i.e., welfare) increases in this case. Suggesting gains to deregulating (i.e., doing away with dual charters)