

## 1 Panel data models

### Problem 1

Suppose that the random effects model  $y_{it} = x'_{it}\beta + \eta_i + v_{it}$  is to be estimated with a panel in which the groups have different numbers of observations. Let  $T_i$  be the number of observations in group  $i$ . Show that the pooled least squares estimator is unbiased and consistent despite this complication.

### Solution 1

The model is equivalent to

$$y_i = X_i\beta + v_i + \eta_i\iota, \quad y_i \in \mathbb{R}^{T_i}, \quad X_i \in \mathbb{R}^{T_i \times K}, \quad v_i \in \mathbb{R}^{T_i}, \quad \iota := (1, \dots, 1)' \in \mathbb{R}^{T_i}, \quad i = 1, \dots, n,$$

and given the random effects model assumption,  $\mathbb{E}[\eta_i\iota] = 0$ . The pooled OLS estimator of  $\beta$  is

$$\hat{\beta} = \left( \sum_{i=1}^n X_i' X_i \right)^{-1} \sum_{i=1}^n X_i' y_i$$

given that  $\sum_{i=1}^n X_i' X_i$  is invertible. To show the bias, rewrite

$$\begin{aligned} \hat{\beta} &= \left( \sum_{i=1}^n X_i' X_i \right)^{-1} \sum_{i=1}^n X_i' (X_i\beta + v_i + \eta_i\iota) \\ &= \beta + \left( \sum_{i=1}^n X_i' X_i \right)^{-1} \sum_{i=1}^n X_i' (v_i + \eta_i\iota) \\ &= \beta + \left( \sum_{i=1}^n X_i' X_i \right)^{-1} \sum_{i=1}^n X_i' u_i \end{aligned}$$

with  $u_i := v_i + \eta_i\iota$ . Hence, the bias  $\mathbb{E}[\hat{\beta} - \beta | X_i]$  is zero if  $\mathbb{E}[X_i' u_i | X_i] = X_i' \mathbb{E}[u_i | X_i] = X_i' (\mathbb{E}[v_i | X_i] + \mathbb{E}[\eta_i | X_i]) = 0$ . It holds because the first expectation is zero by the i.i.d. independent mean zero errors  $v_{it}$ , and the second expectation is zero by the random effects assumption and the law of iterated expectations.

To show consistency, rewrite

$$\hat{\beta} - \beta = \left( \frac{1}{n} \sum_{i=1}^n X_i' X_i \right)^{-1} \left( \frac{1}{n} \sum_{i=1}^n X_i' u_i \right).$$

As  $n \rightarrow \infty$ , using the weak law of large numbers and Slutsky's theorem, we have that

$$\hat{\beta} - \beta \xrightarrow{p} Q^{-1} \mathbb{E}[X_i' u_i],$$

where  $\lim_{n \rightarrow \infty} n^{-1} \sum_{i=1}^n X_i' X_i = \mathbb{E}[X_i' X_i] := Q$  is a non-deficient matrix with full rank. Under the random effects assumption and arguments as above, we have that  $\mathbb{E}[X_i' u_i] = 0$ . Hence, the estimator is consistent.

## Problem 2

Consider  $y_{it} = x'_{it}\beta + \eta_i + v_{it}$ ,  $i = 1, \dots, N$ ,  $t = 1, \dots, T$ , where  $v_{it} \sim \mathcal{N}(0, \sigma^2)$  and  $\beta = 0$ . Write out the likelihood for estimating  $\eta_i$  and  $\sigma^2$ , and show that the MLE estimator  $\hat{\sigma}^2$  is biased when  $T < \infty$ .

## Solution 2

From the setup, it implies that  $y_{it} \sim \mathcal{N}(\eta_i, \sigma^2)$ . The individual log-likelihood for each  $i$  (across  $T$ ) is then

$$\log \mathcal{L}(y_{it}|\eta_i, \sigma^2) = C_0 - \frac{T}{2} \log \sigma^2 - \frac{1}{2\sigma^2} \sum_{t=1}^T (y_{it} - \eta_i)^2$$

where  $C_0$  is some constant independent of  $\eta_i$  and  $\sigma^2$ . The ML estimator of  $\eta_i$  is the solution to the equation

$$\frac{\partial \log \mathcal{L}(y_{it}|\eta_i, \sigma^2)}{\partial \eta_i} = \sum_{t=1}^T (y_{it} - \hat{\eta}_i) = 0,$$

which is  $\hat{\eta}_i = T^{-1} \sum_{t=1}^T y_{it} := \bar{y}_i$ .

To estimate  $\sigma^2$ , we use the joint log-likelihood (across  $i$  and  $T$ ),

$$\log \mathcal{L}(y_{it}|\eta_i, \sigma^2) = C_1 - \frac{NT}{2} \log \sigma^2 - \frac{1}{2\sigma^2} \sum_{i=1}^N \sum_{t=1}^T (y_{it} - \eta_i)^2$$

where  $C_1$  is some constant independent of  $\eta_i$  and  $\sigma^2$ . The ML estimator of  $\sigma^2$  is the solution to the equation

$$\frac{\partial \log \mathcal{L}(y_{it}|\eta_i, \sigma^2)}{\partial \sigma^2} = -\frac{NT}{2} \cdot \frac{1}{\sigma^2} + \frac{1}{2\sigma^4} \sum_{i=1}^N \sum_{t=1}^T (y_{it} - \hat{\eta}_i)^2 = 0.$$

Substituting for  $\hat{\eta}_i$  and rearranging, we have

$$\hat{\sigma}^2 = \frac{1}{NT} \sum_{i=1}^N \sum_{t=1}^T (y_{it} - \bar{y}_i)^2.$$

Expectation of the estimator is

$$\begin{aligned} \mathbb{E}[\hat{\sigma}^2] &= \mathbb{E} \left[ \frac{1}{T} \sum_{t=1}^T (y_{it} - \bar{y}_i)^2 \right] \\ &= \mathbb{E} \left[ \frac{1}{T} \sum_{t=1}^T y_{it}^2 - \frac{2}{T} \sum_{t=1}^T y_{it} \bar{y}_i + \frac{1}{T} \sum_{t=1}^T \bar{y}_i^2 \right] \\ &= \sigma^2 - \frac{2}{T} \sum_{t=1}^T \mathbb{E}[y_{it} \bar{y}_i] + \frac{1}{T} \sum_{t=1}^T \mathbb{E}[\bar{y}_i^2] \\ &= \sigma^2 - \frac{2}{T} \sigma^2 + \frac{1}{T} \sigma^2 = \sigma^2 - \frac{\sigma^2}{T}, \end{aligned}$$

which is not equal to  $\sigma^2$  unless  $T \rightarrow \infty$ .

## Problem 3

Consider  $y_{it} = \mathbb{1}\{x_{it}\beta + \eta_i + v_{it} \geq 0\}$ , where the errors  $v_{it}$  have the logistic cdf. Consider  $T = 2$ ,  $x_{i1} = 0$  and  $x_{i2} = 1$ , and show that the sufficient statistic for  $\eta_i$  is  $y_{i1} + y_{i2} = 1$ , i.e. conditioning on  $y_{i1} + y_{i2} = 1$  implies that the MLE does not depend on  $\eta_i$ .

### Solution 3

The log-likelihood function for two periods is given by

$$\begin{aligned}\log \mathcal{L}(y_i|x_i, \beta, \eta_i) &= y_{i1} \log \Lambda(x_{i1}\beta + \eta_i) + (1 - y_{i1}) \log(1 - \Lambda(x_{i1}\beta + \eta_i)) \\ &\quad + y_{i2} \log \Lambda(x_{i2}\beta + \eta_i) + (1 - y_{i2}) \log(1 - \Lambda(x_{i2}\beta + \eta_i)),\end{aligned}$$

where  $\Lambda(z) = 1/(1 + e^{-z})$ , and given known values of the covariates,

$$\log \mathcal{L}(y_i|\beta, \eta_i) = y_{i1} \log \Lambda(\eta_i) + (1 - y_{i1}) \log(1 - \Lambda(\eta_i)) + y_{i2} \log \Lambda(\beta + \eta_i) + (1 - y_{i2}) \log(1 - \Lambda(\beta + \eta_i)).$$

Taking the first derivative w.r.t.  $\eta_i$ , and using  $\Lambda(z)' / \Lambda(z) = (1 - \Lambda(z))$ , we have

$$\frac{\partial \log \mathcal{L}(y_i|\beta, \eta_i)}{\partial \eta_i} = y_{i1}(1 - \Lambda(\hat{\eta}_i)) - (1 - y_{i1})\Lambda(\hat{\eta}_i) + y_{i2}(1 - \Lambda(\hat{\eta}_i + \beta)) - (1 - y_{i2})\Lambda(\hat{\eta}_i + \beta) = 0,$$

which implies

$$y_{i1} + y_{i2} = \Lambda(\hat{\eta}_i) + \Lambda(\hat{\eta}_i + \beta).$$

Now, we discuss three cases:

1. if  $y_{i1} + y_{i2} = 0$ ,  $\hat{\eta}_i = -\infty$ ,
2. if  $y_{i1} + y_{i2} = 2$ ,  $\hat{\eta}_i = \infty$ ,
3. if  $y_{i1} + y_{i2} = 1$ ,  $-2\hat{\eta}_i = \beta$ , and  $\hat{\eta}_i = -\beta/2$ .

Hence, in the case 3., it is possible to identify  $\eta_i$  from the estimate of  $\beta$  only. It implies that conditional on  $\zeta_i := y_{i1} + y_{i2} = 1$ , the log-likelihood is independent on  $\eta_i$  making  $\zeta_i$  a sufficient statistic.

### Problem 4

Derive the bias of the OLS estimator for  $\alpha$  in a dynamic panel of the form  $y_{it} = \alpha y_{it-1} + \eta_i + v_{it}$ . Are there any conditions on  $\alpha$  that should hold for the estimator to be well-defined?

### Solution 4

First, rewrite the model in recursive form,

$$\begin{aligned}y_{it} &= \alpha(y_{it-2} + \eta_i + v_{it-1}) + \eta_i + v_{it} \\ &= \alpha^2(y_{it-3} + \eta_i + v_{it-2}) + \alpha\eta_i + \alpha v_{it-1} + \eta_i + v_{it} \\ &= \dots \\ &= \alpha^t y_0 + \left( \sum_{s=0}^{t-1} \alpha^s \right) \eta_i + \sum_{s=0}^{t-1} \alpha^s v_{it-s}.\end{aligned}$$

The bias of the OLS estimator is driven by  $\mathbb{E}[y_{it-1}u_{it}]$ , where  $u_{it} := \eta_i + v_{it}$ . Using the property of the geometric series,  $\sum_{k=0}^{n-1} r^k = \frac{1-r^n}{1-r}$  for  $|r| < 1$ , we have

$$\begin{aligned}y_{it-1} &= \alpha^{t-1} y_0 + \left( \sum_{s=0}^{t-2} \alpha^s \right) \eta_i + \sum_{s=0}^{t-2} \alpha^s v_{it-s} \\ &= \alpha^{t-1} y_0 + \left( \frac{1 - \alpha^{t-1}}{1 - \alpha} \right) \eta_i + \sum_{s=0}^{t-2} \alpha^s v_{it-s}.\end{aligned}$$

Now taking expectations,

$$\begin{aligned}\mathbb{E}[y_{it-1}\eta_i] &= \mathbb{E} \left[ \alpha^{t-1} y_0 \eta_i + \left( \frac{1 - \alpha^{t-1}}{1 - \alpha} \right) \eta_i^2 + \sum_{s=0}^{t-2} \alpha^s v_{it-s} \eta_i \right] \\ &= \alpha^{t-1} \mathbb{E}[y_0 \eta_i] + \left( \frac{1 - \alpha^{t-1}}{1 - \alpha} \right) \sigma_\eta^2 \neq 0.\end{aligned}$$

Because we have that  $\mathbb{E}[y_{it-1}u_{it}] = \mathbb{E}[y_{it-1}\eta_i] + \mathbb{E}[y_{it-1}v_{it}]$ , the bias is nonzero even if  $\mathbb{E}[y_{it-1}v_{it}] = 0$ .

### Problem 5

Consider the panel AR(1) model with individual effects,

$$y_{it} = \alpha y_{it-1} + \eta_i + v_{it}$$

where  $\eta_i \sim \text{i.i.d.}(0, \sigma_\eta^2)$  and  $v_{it} \sim \text{i.i.d.}(0, \sigma_v^2)$  are mutually independent, and for all  $i$  we have  $y_{i0} = 0$ . Derive  $\text{var}[y_{it}]$  for  $t = 1, \dots, T$ .

### Solution 5

In the previous exercise we have shown that

$$y_{it} = \alpha^t y_0 + \left( \sum_{s=0}^{t-1} \alpha^s \right) \eta_i + \sum_{s=0}^{t-1} \alpha^s v_{it-s},$$

and given that  $y_{i0} = 0$ , we have

$$y_{it} = \left( \sum_{s=0}^{t-1} \alpha^s \right) \eta_i + \sum_{s=0}^{t-1} \alpha^s v_{it-s}.$$

Now, the variance is

$$\text{var} \left[ \sum_{s=0}^{t-1} \alpha^s v_{it-s} \right] = \sigma_v^2 \sum_{s=0}^{t-1} \alpha^{2s} = \sigma_v^2 \frac{1 - \alpha^{2t}}{1 - \alpha^2},$$

so that

$$\text{var}[y_{it}] = \sigma_\eta^2 \left( \frac{1 - \alpha^t}{1 - \alpha} \right)^2 + \sigma_v^2 \frac{1 - \alpha^{2t}}{1 - \alpha^2}.$$

### Problem 6

Assume that we are in the AR(1) dynamic model setup such that

$$y_{it} = \alpha y_{it-1} + \eta_i + v_{it}$$

but now our  $v_{it}$  follows an MA(1) process such that

$$v_{it} = w_{it} + b w_{it-1},$$

where  $w_{it} \sim \text{i.i.d.}(0, \sigma_w^2)$  (i.e.  $v_{it}$  is serially correlated). Show that in this case the instrument  $y_{it-2}$  is not a valid instrument for estimating  $\alpha$  with GMM in first differences, while the instruments  $y_{it-j}$  for  $j \geq 3$  remain valid.

### Solution 6

Given that  $v_{it} \sim \text{MA}(1)$ , the autocovariance of order  $s = 0$  is

$$\begin{aligned} \mathbb{E}[v_{it} v_{it}] &= \mathbb{E}[(w_{it} + b w_{it-1})(w_{it} + b w_{it-1})] \\ &= \mathbb{E}[w_{it}^2] + 2b \mathbb{E}[w_{it} w_{it-1}] + b^2 \mathbb{E}[w_{it-1}^2] \\ &= \sigma_w^2 + b^2 \sigma_w^2 = \sigma_w^2 (1 + b^2), \end{aligned}$$

of order  $s = 1$  is

$$\begin{aligned} \mathbb{E}[v_{it} v_{it-1}] &= \mathbb{E}[(w_{it} + b w_{it-1})(w_{it-1} + b w_{it-2})] \\ &= \mathbb{E}[w_{it} w_{it-1}] + b \mathbb{E}[w_{it-1}^2] + b \mathbb{E}[w_{it} w_{it-2}] + b^2 \mathbb{E}[w_{it-1} w_{it-2}] = b \sigma_w^2, \end{aligned}$$

and of order  $s > 1$  is

$$\mathbb{E}[v_{it} v_{it-s}] = \mathbb{E}[(w_{it} + b w_{it-1})(w_{it-s} + b w_{it-s-1})] = \dots = 0,$$

where we use the fact that  $w_{it}$  and  $w_{it-s}$  for  $\forall s$  is independent by assumption of i.i.d. data. The first differences model is then

$$y_{it} - y_{it-1} = \alpha(y_{it-1} - y_{it-2}) + v_{it} - v_{it-1},$$

so to be valid, the instrument should not be correlated with the error  $u_{it} := v_{it} - v_{it-1}$ . In other words, for  $y_{it-2}$  to be valid, we require

$$\mathbb{E}[u_{it}y_{it-2}] = 0,$$

which holds if  $v_{it-2}$  (that is inside  $y_{it-2}$ ) is uncorrelated to  $v_{it}$  and  $v_{it-1}$ . However, we have shown that

$$\mathbb{E}[v_{it}v_{it-1}] = \mathbb{E}[v_{it-1}v_{it-2}] = b\sigma_w^2 \neq 0,$$

which in turns implies that  $y_{it-2}$  is not a valid instrument.

On the other hand, any instrument that is of the form  $y_{it-j}$  for  $j > 2$  is valid, because

$$\mathbb{E}[y_{it-j}u_{it}] = 0$$

due to  $\mathbb{E}[v_{it}v_{it-s}] = 0$  for  $s > 1$  with  $s = j - 1$ .

## Problem 7

We have data for a panel of companies on gross investment expenditures  $I_{it}$  and net capital stock  $K_{it}$ . We model the investment rate  $y_{it} = I_{it}/K_{it}$  as

$$\left(\frac{I_{it}}{K_{it}}\right) = \alpha \left(\frac{I_{it-1}}{K_{it-1}}\right) + \eta_i + v_{it},$$

and Table 2 shows the results of estimating the model in *levels* by OLS and WG, and the model in *first differences* with one instrument, two instruments, and all Arellano-Bond instruments. For the last two estimators, it also shows the Sargan test statistic and the  $m_2$  statistic for second-order serial correlation in the residuals from the estimated model.

Table 1: Estimation results (703 firms, 4966 observations)

	OLS	WG	2SLS DIF	GMM DIF	GMM DIF
	(1)	(2)	(3)	(4)	(5)
$\hat{\alpha}$	0.2669 (.0185)	-0.0094 (.0181)	0.1626 (.0362)	0.1593 (.0327)	0.1560 (.0318)
$m_2$				0.52	0.46
Sargan test				0.36	0.43
Instruments			$(I/K)_{t-2}$	$(I/K)_{t-2}$ $(I/K)_{t-3}$	$(I/K)_{t-2}$ $(I/K)_{t-3}$ $\vdots$ $(I/K)_1$

- For each of the models in columns (2) and (3), write down the estimated equation(s).
- Comment on the estimates of  $\alpha$  in each of the columns. Are the results in line with theory (in terms of possible bias of the different estimators)? Why do we need to use instruments?
- Comment on the standard errors of the last three estimators. Are the results in line with theory?
- For the two GMM estimators (column (4) and (5)), what do you conclude from the two specification tests? What are these tests' null hypotheses and why are these useful to run?

## Solution 7

- a) In column (2), the WG model is estimated, which takes away individual averages over time. Thus, the estimated equation is

$$\left( \frac{I_{it}}{K_{it}} - \frac{\bar{I}_i}{\bar{K}_i} \right) = \alpha \left( \frac{I_{it-1}}{K_{it-1}} - \frac{\bar{I}_i}{\bar{K}_i} \right) + v_{it} - \bar{v}_i,$$

where  $\frac{\bar{I}_i}{\bar{K}_i} = T^{-1} \sum_{t=1}^T \frac{I_{it}}{K_{it}}$ .

In column (3), the model is estimated in first differences,

$$\left( \frac{I_{it}}{K_{it}} - \frac{I_{it-1}}{K_{it-1}} \right) = \alpha \left( \frac{I_{it-1}}{K_{it-1}} - \frac{I_{it-2}}{K_{it-2}} \right) + v_{it} - v_{it-1}.$$

The estimation is done using 2SLS with the instrument  $\frac{I_{it-2}}{K_{it-2}}$ , so that in the first stage we project the endogenous regressor on the instrument,

$$\left( \frac{I_{it-1}}{K_{it-1}} - \frac{I_{it-2}}{K_{it-2}} \right) = \gamma_0 + \gamma_1 \frac{I_{it-2}}{K_{it-2}} + \varepsilon_{it},$$

and in the second stage we project the outcome variable on fitted values from the first stage,

$$\left( \frac{I_{it}}{K_{it}} - \frac{I_{it-1}}{K_{it-1}} \right) = \alpha \left( \widehat{\frac{I_{it-1}}{K_{it-1}} - \frac{I_{it-2}}{K_{it-2}}} \right) + v_{it} - v_{it-1}$$

where  $\left( \widehat{\frac{I_{it-1}}{K_{it-1}} - \frac{I_{it-2}}{K_{it-2}}} \right)$  are fitted values,  $\hat{\gamma}_1 \left( \frac{I_{it-2}}{K_{it-2}} \right)$ .

- b) If the specified model is correct, and we have

$$\left( \frac{I_{it}}{K_{it}} \right) = \alpha \left( \frac{I_{it-1}}{K_{it-1}} \right) + \eta_i + v_{it},$$

we are in a dynamic panel setting and running OLS and WG will deliver biased estimates. Even if  $E[y_{it-1}v_{it}] = 0$ , we have

$$\text{plim}_{N \rightarrow \infty} \hat{\alpha}_{\text{OLS}} > \alpha, \quad \text{plim}_{N \rightarrow \infty} \hat{\alpha}_{\text{WG}} < \alpha,$$

because  $E[y_{it-1}\eta_i] > 0$ . Thus, OLS will overestimate  $\alpha$  whereas WG will underestimate  $\alpha$ . However, if we estimate the model in first differences and use instruments (as in columns (3), (4), and (5)) we will get consistent estimates of  $\alpha$  under the assumption that these are valid instruments. The instrument used in (3) implies the Anderson-Hsiao estimator for  $\alpha$ , column (4) expands the number of instruments, and column (5) uses all Arellano-Bond instruments. These rely on the moment conditions  $E[y_{t-j}\Delta v_{it}] = 0$  for  $j \geq 2$  which are satisfied as long as  $v_{it}$  are serially uncorrelated.

We need instruments in the first place, because the regressor  $\left( \frac{I_{it-1}}{K_{it-1}} - \frac{I_{it-2}}{K_{it-2}} \right)$  is by construction correlated with the error term  $v_{it} - v_{it-1}$ .

- c) The standard errors of the three last columns are decreasing which is what we expect from theory when adding valid instruments. The efficiency gains from the extra instruments are very small though.
- d) The two specification tests are the Sargan overidentification test and the test for second-order serial correlation in the residuals.

The Sargan overidentification test's null hypothesis is that the moment conditions are satisfied (the instruments are valid). The Sargan test statistic is distributed as a  $\chi^2$  with  $(L - K)$  degrees of freedom (which are 1 and  $T - 3$  in columns (4) and (5)) and in both models we obtain a low statistic of 0.36 and 0.43. Thus, we cannot reject the null hypothesis that the moment conditions are satisfied, and thus the instruments are valid. This test is crucial to determine whether we are using valid instruments and thus have a consistent estimate of  $\alpha$ .

The test for second-order serial correlation in the residuals has as the null hypothesis that the residuals from the first-difference model are *not* second-order serially correlated. If this is the case then it implies

that there is no correlation between  $v_{it} - v_{it-1}$  and  $v_{it-2} - v_{it-3}$  which would indicate that  $v_{it}$  are serially uncorrelated. This is a crucial assumption on which the validity of the instruments rests. The test statistic  $m_2$  is normally distributed and with the reported  $m_2$  of 0.52 and 0.46 we cannot reject the null hypothesis that the residuals from the first-difference model are *not* second-order serially correlated. Both specification tests go in the same direction and both imply that the instruments used are valid.

## Problem 8

Formulate a linear dynamic panel regression with a single weakly exogenous regressor, and AR(2) feedback in place of AR(1) feedback (i.e. when two most recent lags of the left side variable are present at the right side). Describe the algorithm of estimation of this model.

## Solution 8

Please, see *Problemnik 13.8*.

## 2 Causal inference

### Problem 1

In Table below, you have the potential outcomes of 4 cancer patients (as in the example in class) with their potential outcomes and treatment assignment for  $D_i = 0$  corresponding to undergoing chemotherapy and  $D_i = 1$  corresponding to surgery.

Table 2: Surgery vs therapy

patient	$Y_i^1$	$Y_i^0$	$\delta_i$	$Y_i$	$D_i$
<i>case 1</i>					
1	4	3	1	4	1
1	6	5	1	6	1
3	1	2	-1	2	0
4	3	6	-3	6	0
<i>case 2</i>					
1	5	3	2	5	1
1	6	5	1	6	1
3	7	6	1	6	0
4	10	8	2	8	0

Show that in one case there is no selection bias, whereas in the other there is no heterogeneous treatment effects bias.

### Solution 1

*Case 1.* Given that individual treatment effects are available, we can compute the average treatment effect (ATE) directly as

$$\text{ATE} = \frac{1 + 1 - 1 - 3}{4} = -0.5.$$

The naive approach of estimating it using the simple difference in outcomes (SDO) would yield

$$\text{SDO} = \frac{4 + 6}{2} - \frac{2 + 6}{2} = 1.$$

In general, it holds that  $\text{SDO} = \text{ATE} + \text{SB} + \text{HTB}$ , where SB is the selection bias and HTB is the heterogeneous treatment effect bias. Because we have that  $\text{ATE} \neq \text{SDO}$ , we conclude that one (or both) of the biases is nonzero.

The selection bias is given by

$$SB = \mathbb{E}[Y_i^0 | D_i = 1] - \mathbb{E}[Y_i^0 | D_i = 0] = \frac{3+5}{2} - \frac{2+6}{2} = 0.$$

For the heterogeneous treatment effect bias, we need to compute the average treatment effect on treated and untreated (ATT and ATU) respectively,

$$ATT = \mathbb{E}[\delta_i | D_i = 1] = \frac{1+1}{2} = 1, \quad ATU = \mathbb{E}[\delta_i | D_i = 0] = \frac{-1-3}{2} = -2.$$

The HTB is then

$$HTB = (1 - \pi)(ATT - ATU) = 0.5(1 + 2) = 1.5$$

with  $\pi$  denoting the proportion of the treated observations.

*Case 2.* For the second case, we briefly state the results:

$$\begin{aligned} ATE &= \frac{2+1+1+2}{4} = 1.5, \\ SDO &= \frac{5+6}{2} - \frac{6+8}{2} = -1.5, \\ ATT &= \frac{2+1}{2} = 1.5, \\ ATU &= \frac{1+2}{2} = 1.5, \\ SB &= \frac{3+5}{2} - \frac{6+8}{2} = -3, \\ HTB &= 0. \end{aligned}$$

## Problem 2

Show that running a regression

$$y_i = \beta_0 + \beta_1 D_i + \varepsilon_i, \quad i = 1, \dots, N, \quad \mathbb{E}[\varepsilon_i | D_i] = 0,$$

leads to the OLS estimate of  $\beta_1$  given by

$$\hat{\beta}_1 = \frac{1}{N_1} \sum_{i=1}^{N_1} (y_i | D_i = 1) - \frac{1}{N_0} \sum_{i=1}^{N_0} (y_i | D_i = 0),$$

which is a simple difference in means.

## Solution 2

For subsequent derivations, we define  $\bar{y}_1 := \frac{1}{N_1} \sum_{i=1}^{N_1} (y_i | D_i = 1)$  and  $\bar{y}_0 := \frac{1}{N_0} \sum_{i=1}^{N_0} (y_i | D_i = 0)$  so that we have to show  $\hat{\beta}_1 = \bar{y}_1 - \bar{y}_0$ . The OLS estimator is given by

$$\hat{\beta}_1 = \frac{\sum_{i=1}^N (D_i - \bar{D})(y_i - \bar{y})}{(D_i - \bar{D})^2},$$

where  $\bar{D} = N^{-1} \sum_{i=1}^N D_i = N_1/N$ , and  $\bar{y} = N^{-1} \sum_{i=1}^N y_i$ . Expanding the numerator, we have

$$\sum_{i=1}^N (D_i - \bar{D})(y_i - \bar{y}) = \sum_{i=1}^N D_i y_i - D_i \bar{y} - \bar{D} y_i + \bar{D} \bar{y}.$$

Working with each term separately,

- $\sum_{i=1}^N D_i y_i = \frac{N_1}{N_1} \sum_{i=1}^{N_1} D_i y_i = N_1 \cdot \frac{1}{N_1} \sum_{i=1, D_i=1}^{N_1} y_i = N_1 \cdot \bar{y}_1,$
- $-\sum_{i=1}^N \bar{D} y_i = -\sum_{i=1}^N \frac{N_1}{N} y_i = -N_1 \cdot \bar{y},$



- $-\sum_{i=1}^N D_i \bar{y} = -\sum_{i=1, D_i=1} \bar{y} = -N_1 \cdot \bar{y},$
- $\sum_{i=1}^N \bar{D} \bar{y} = \sum_{i=1}^N \frac{N_1}{N} \bar{y} = N_1 \cdot \bar{y},$

we have that

$$\sum_{i=1}^N (D_i - \bar{D})(y_i - \bar{y}) = N_1(\bar{y}_1 - \bar{y}) = \left(N_1 - \frac{N_1^2}{N}\right)(\bar{y}_1 - \bar{y}_0)$$

where we substitute for  $\bar{y}$  using the fact that  $N = N_0 + N_1$ , and  $\bar{y} = N^{-1}(N_1 \bar{y}_1 + N_0 \bar{y}_0)$ .

Now, for the denominator, we have

$$\begin{aligned} \sum_{i=1}^N (D_i - \bar{D})^2 &= \sum_{i=1}^N D_i^2 - 2D_i \bar{D} + \bar{D}^2 \\ &= \sum_{i=1}^N D_i^2 - 2 \sum_{i=1}^N D_i \bar{D} + \sum_{i=1}^N \bar{D}^2 \\ &= N_1 - 2 \sum_{i=1}^N D_i \frac{N_1}{N} + \sum_{i=1}^N \frac{N_1^2}{N^2} \\ &= N_1 - \frac{N_1^2}{N}. \end{aligned}$$

Putting everything together, we have

$$\hat{\beta}_1 = \frac{\left(N_1 - \frac{N_1^2}{N}\right)(\bar{y}_1 - \bar{y}_0)}{N_1 - \frac{N_1^2}{N}} = \bar{y}_1 - \bar{y}_0.$$

### Problem 3

Show that running a regression

$$y_i = \beta_0 + \beta_1 D_i + \varepsilon_i, \quad i = 1, \dots, N, \quad \mathbb{E}[\varepsilon_i | D_i] = 0,$$

with heteroskedasticity-robust standard errors provides an estimate that is numerically equivalent to the variance of the average treatment effect computed directly.

### Solution 3

In the previous exercise we showed that  $\hat{\beta}_1 = \bar{y}_1 - \bar{y}_0$ . Answering the question in the setup is equivalent to showing that

$$\widehat{\text{var}}[\hat{\beta}_1] = \widehat{\text{var}}[\bar{y}_1] - \widehat{\text{var}}[\bar{y}_0] = \hat{\sigma}_1^2/N_1 + \hat{\sigma}_0^2/N_0 \equiv \widehat{\text{var}}_{\text{EHW}}[\hat{\beta}_1]$$

where  $\hat{\sigma}_k^2, k \in \{0, 1\}$  are estimated variances of the outcome computed on treated and untreated respectively, and  $\widehat{\text{var}}_{\text{EHW}}[\hat{\beta}_1]$  are standard Eicker-Huber-White (EHW) standard errors.

Denote  $x_i := (1 \quad D_i)'$ . Then the asymptotic heteroskedasticity-robust variance of the OLS estimator is

$$\text{var} \left[ \begin{pmatrix} \hat{\beta}_0 \\ \hat{\beta}_1 \end{pmatrix} \right] = \frac{1}{N} \mathbb{E}[x_i x_i']^{-1} \mathbb{E}[x_i x_i' \varepsilon_i^2] \mathbb{E}[x_i x_i']^{-1}.$$

Denoting residuals as  $\hat{\varepsilon}_i := y_i - x_i' \hat{\beta}$ , the estimator is then the usual EHW estimator,

$$\begin{aligned} \widehat{\text{var}} \left[ \begin{pmatrix} \hat{\beta}_0 \\ \hat{\beta}_1 \end{pmatrix} \right] &= \frac{1}{N} \left( \frac{1}{N} \sum_{i=1}^N x_i x_i' \right)^{-1} \left( \frac{1}{N} \sum_{i=1}^N x_i x_i' \hat{\varepsilon}_i^2 \right) \left( \frac{1}{N} \sum_{i=1}^N x_i x_i' \right)^{-1} \\ &= \frac{1}{N} \left( \frac{1}{N} \sum_{i=1}^N \begin{pmatrix} 1 & D_i \\ D_i & D_i \end{pmatrix} \right)^{-1} \left( \frac{1}{N} \sum_{i=1}^N \begin{pmatrix} 1 & D_i \\ D_i & D_i \end{pmatrix} \hat{\varepsilon}_i^2 \right) \left( \frac{1}{N} \sum_{i=1}^N \begin{pmatrix} 1 & D_i \\ D_i & D_i \end{pmatrix} \right)^{-1} \\ &= \frac{1}{N} \begin{pmatrix} 1 & N_1/N \\ N_1/N & N_1/N \end{pmatrix}^{-1} \begin{pmatrix} N^{-1} \sum_{i=1}^N \hat{\varepsilon}_i^2 & N^{-1} \sum_{i=1, D_i=1} \hat{\varepsilon}_i^2 \\ N^{-1} \sum_{i=1, D_i=1} \hat{\varepsilon}_i^2 & N^{-1} \sum_{i=1, D_i=1} \hat{\varepsilon}_i^2 \end{pmatrix} \begin{pmatrix} 1 & N_1/N \\ N_1/N & N_1/N \end{pmatrix}^{-1} \\ &= \begin{pmatrix} N & N_1 \\ N_1 & N_1 \end{pmatrix}^{-1} \begin{pmatrix} \sum_{i=1}^N \hat{\varepsilon}_i^2 & \sum_{i=1, D_i=1} \hat{\varepsilon}_i^2 \\ \sum_{i=1, D_i=1} \hat{\varepsilon}_i^2 & \sum_{i=1, D_i=1} \hat{\varepsilon}_i^2 \end{pmatrix} \begin{pmatrix} N & N_1 \\ N_1 & N_1 \end{pmatrix}^{-1}. \end{aligned}$$

Computing the inverses, and using the fact that  $N = N_0 + N_1$ , and  $\sum_{i=1}^N \hat{\varepsilon}_i^2 = \sum_{i=1, D_i=0} \hat{\varepsilon}_i^2 + \sum_{i=1, D_i=1} \hat{\varepsilon}_i^2$  we have

$$\begin{aligned} \widehat{\text{var}} \begin{bmatrix} \hat{\beta}_0 \\ \hat{\beta}_1 \end{bmatrix} &= \begin{pmatrix} 1/N_0 & -1/N_0 \\ -N_0 & 1/N_0 + 1/N_1 \end{pmatrix}^{-1} \begin{pmatrix} \sum_{i=1}^N \hat{\varepsilon}_i^2 & \sum_{i=1, D_i=1} \hat{\varepsilon}_i^2 \\ \sum_{i=1, D_i=1} \hat{\varepsilon}_i^2 & \sum_{i=1, D_i=1} \hat{\varepsilon}_i^2 \end{pmatrix} \begin{pmatrix} 1/N_0 & -1/N_0 \\ -N_0 & 1/N_0 + 1/N_1 \end{pmatrix}^{-1} \\ &= \begin{pmatrix} N_0^{-1} \sum_{i=1, D_i=0} \hat{\varepsilon}_i^2 & 0 \\ N_1^{-1} \sum_{i=1, D_i=1} \hat{\varepsilon}_i^2 - N_0^{-1} \sum_{i=1, D_i=0} \hat{\varepsilon}_i^2 & N_1^{-1} \sum_{i=1, D_i=1} \hat{\varepsilon}_i^2 \end{pmatrix} \begin{pmatrix} 1/N_0 & -1/N_0 \\ -N_0 & 1/N_0 + 1/N_1 \end{pmatrix}^{-1} \\ &= \begin{pmatrix} N_0^{-2} \sum_{i=1, D_i=0} \hat{\varepsilon}_i^2 & -N_0^{-2} \sum_{i=1, D_i=0} \hat{\varepsilon}_i^2 \\ -N_0^{-2} \sum_{i=1, D_i=0} \hat{\varepsilon}_i^2 & N_0^{-2} \sum_{i=1, D_i=0} \hat{\varepsilon}_i^2 + N_1^{-2} \sum_{i=1, D_i=1} \hat{\varepsilon}_i^2 \end{pmatrix}. \end{aligned}$$

We note that the low-right element is exactly the estimated variance of  $\hat{\beta}_1$ ,

$$\begin{aligned} \widehat{\text{var}} [\hat{\beta}_1] &= N_0^{-2} \sum_{i=1, D_i=0} \hat{\varepsilon}_i^2 + N_1^{-2} \sum_{i=1, D_i=1} \hat{\varepsilon}_i^2 \\ &:= \hat{\sigma}_0^2 / N_0 + \hat{\sigma}_1^2 / N_1. \end{aligned}$$

#### Problem 4

Show that *i)* if  $p(X)$  is the propensity score, then  $X \perp D \mid p(X)$ ; *ii)* if  $Y^1, Y^0 \perp D \mid X$ , then assignment to treatment is unconfounded given the propensity score, i.e.  $Y^1, Y^0 \perp D \mid p(X)$ .

#### Solution 4

For *i)*, first, note that

$$\mathbb{P}\{D = 1 \mid X, p(X)\} = \mathbb{E}[D \mid X, p(X)] = \mathbb{E}[D \mid X] = \mathbb{P}\{D = 1 \mid X\} := p(X),$$

and

$$\mathbb{P}\{D = 1 \mid p(X)\} = \mathbb{E}[D \mid p(X)] = \mathbb{E}[D \mid p(X), X] = \mathbb{E}[\mathbb{E}[D \mid p(X), X] \mid p(X)] = \mathbb{E}[p(X) \mid p(X)] = p(X).$$

So in total we have that

$$\mathbb{P}\{D = 1 \mid X, p(X)\} = \mathbb{P}\{D = 1 \mid p(X)\},$$

that is, conditional on  $p(X)$ , probability of receiving a treatment is the same with or without conditioning on the observed covariates  $X$ . In other words, conditional on  $p(X)$ , the treatment is independent of covariates.

For *ii)*, we have that

$$\begin{aligned} \mathbb{P}\{D = 1 \mid Y^1, Y^0, p(X)\} &= \mathbb{E}[D \mid Y^1, Y^0, p(X)] \\ &= \mathbb{E}_X \left[ \mathbb{E}[D \mid X, Y^1, Y^0] \mid Y^1, Y^0, p(X) \right] \\ &= \mathbb{E}_X \left[ \mathbb{E}[D \mid X] \mid Y^1, Y^0, p(X) \right] \\ &= \mathbb{E}_X \left[ p(X) \mid Y^1, Y^0, p(X) \right] = p(X), \end{aligned}$$

where the third equality follows from the “if” assumption in the setup. From *i)*, we have that

$$\mathbb{P}\{D = 1 \mid p(X)\} = \mathbb{P}\{D = 1 \mid Y^1, Y^0, p(X)\} = p(X),$$

that is, conditional on  $p(X)$ , the treatment and the potential outcomes are independent.

#### Problem 5

Show that the IV coefficient given by

$$\delta_{\text{IV}} = \frac{\text{cov}[Z_i, Y_i]}{\text{cov}[Z_i, D_i]}$$

results in

$$\delta_{\text{W}} = \frac{\mathbb{E}[Y_i \mid Z_i = 1] - \mathbb{E}[Y_i \mid Z_i = 0]}{\mathbb{E}[D_i \mid Z_i = 1] - \mathbb{E}[D_i \mid Z_i = 0]}.$$

## Solution 5

First, the numerator of  $\delta_{IV}$  is

$$\begin{aligned}\text{cov}[Z_i, Y_i] &= \mathbb{E}[Z_i Y_i] - \mathbb{E}[Z_i] \mathbb{E}[Y_i] \\ &= \mathbb{E}[Y_i | Z_i = 1] \cdot \mathbb{P}\{Z_i = 1\} - \mathbb{P}\{Z_i = 1\} \cdot (\mathbb{E}[Y_i | Z_i = 1] \cdot \mathbb{P}\{Z_i = 1\} + \mathbb{E}[Y_i | Z_i = 0] \cdot \mathbb{P}\{Z_i = 0\}) \\ &= \mathbb{E}[Y_i | Z_i = 1] \cdot \mathbb{P}\{Z_i = 1\} - \mathbb{P}\{Z_i = 1\}^2 \mathbb{E}[Y_i | Z_i = 1] - \mathbb{P}\{Z_i = 1\} (1 - \mathbb{P}\{Z_i = 1\}) \mathbb{E}[Y_i | Z_i = 0] \\ &= (\mathbb{E}[Y_i | Z_i = 1] - \mathbb{E}[Y_i | Z_i = 0]) \mathbb{P}\{Z_i = 1\} (1 - \mathbb{P}\{Z_i = 1\}).\end{aligned}$$

Next, the denominator is by analogy is

$$\text{cov}[Z_i, D_i] = (\mathbb{E}[D_i | Z_i = 1] - \mathbb{E}[D_i | Z_i = 0]) \mathbb{P}\{Z_i = 1\} (1 - \mathbb{P}\{Z_i = 1\}),$$

so that division  $\text{cov}[Z_i, Y_i] / \text{cov}[Z_i, D_i]$  yields  $\delta_W$ .

## Problem 6

Suppose that with heterogeneous treatment effects instead of monotonicity, we assume an eligibility rule of the form

$$\mathbb{P}(D_i = 1 | Z_i = 0) = 0.$$

Show that in this case, we can identify the average treatment effect on the treated.

## Solution 6

First, compute

$$\begin{aligned}\mathbb{E}[Y_i | Z_i = 1] &= \mathbb{E}[Y_i^0] + \mathbb{E}[(Y_i^1 - Y_i^0) D_i | Z_i = 1] \\ &= \mathbb{E}[Y_i^0] + \mathbb{E}[\mathbb{E}[(Y_i^1 - Y_i^0) D_i | D_i = 1, Z_i = 1] | Z_i = 1] \\ &= \mathbb{E}[Y_i^0] + \mathbb{E}[Y_i^1 - Y_i^0 | D_i = 1, Z_i = 1] \cdot \mathbb{P}\{D_i = 1 | Z_i = 1\} \\ &= \mathbb{E}[Y_i^0] + \mathbb{E}[Y_i^1 - Y_i^0 | D_i = 1] \cdot \mathbb{P}\{D_i = 1 | Z_i = 1\},\end{aligned}$$

where the last line follows from the eligibility rule assumption, because the event  $D_i = 1$  is sufficient for the event  $Z_i = 1$ .

Similarly,

$$\begin{aligned}\mathbb{E}[Y_i | Z_i = 0] &= \mathbb{E}[Y_i^0] + \mathbb{E}[(Y_i^1 - Y_i^0) D_i | Z_i = 0] \\ &= \mathbb{E}[Y_i^0] + \mathbb{E}[(Y_i^1 - Y_i^0) | D_i = 1, Z_i = 0] \cdot \mathbb{P}(D_i = 1 | Z_i = 1) \\ &= \mathbb{E}[Y_i^0]\end{aligned}$$

due to the eligibility rule assumption. It follows that

$$\frac{\mathbb{E}[Y_i | Z_i = 1] - \mathbb{E}[Y_i | Z_i = 0]}{\mathbb{P}(D_i = 1 | Z_i = 1)} = \mathbb{E}[Y_i^1 - Y_i^0 | D_i = 1].$$

By definition,  $\text{ATT} := \mathbb{E}[Y_i^1 - Y_i^0 | D_i = 1]$  so we have that

$$\text{ATT} = \frac{\mathbb{E}[Y_i | Z_i = 1] - \mathbb{E}[Y_i | Z_i = 0]}{\mathbb{P}(D_i = 1 | Z_i = 1)} = \frac{\mathbb{E}[Y_i | Z_i = 1] - \mathbb{E}[Y_i | Z_i = 0]}{\mathbb{E}[D_i | Z_i = 1]},$$

which is the Wald estimand having  $\mathbb{E}[D_i | Z_i = 0] = 0$  by the eligibility rule assumption.

## Problem 7

The following table contains data on civilian mortality for white men born in 1950 and 1951. For the men born in 1951, interpret the reduced form (intention-to-treat) and the IV estimates.

<i>Year</i>	<i>Draft eligibility<sup>a</sup></i>	<i>Number of deaths<sup>b</sup></i>	<i>Number of suicides<sup>c</sup></i>	<i>Probability of death<sup>d</sup></i>	<i>Probability of suicide</i>	<i>Probability of military service<sup>e</sup></i>
1950	Yes	2,601	436	.0204 (.0004)	.0034 (.0002)	.3527 (.0325)
	No	2,169	352	.0195 (.0004)	.0032 (.0002)	.1934 (.0233)
	<i>Difference (Yes minus No)</i>			.0009 (.0006)	.0002 (.0002)	.1593 (.0401)
	<i>IV estimates<sup>f</sup></i>			.0056 (.0040)	.0013 (.0013)	
1951	Yes	1,494	279	.0170 (.0004)	.0032 (.0002)	.2831 (.0390)
	No	2,823	480	.0168 (.0003)	.0029 (.0001)	.1468 (.0180)
	<i>Difference (Yes minus No)</i>			.0002 (.0005)	.0003 (.0002)	.1362 (.0429)
	<i>IV estimates</i>			.0015 (.0037)	.0022 (.0016)	

Figure 1: Data on civilian mortality (Angrist, Imbens, and Rubin, 1996)