

Weak Instrumental Variables: Limitations of Traditional 2SLS and Exploring Alternative IV Estimators

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Abstract

This paper delves into theoretical aspects of weak instrumental variables. We present the problems the two-stage least squares instrumental variables estimator runs into in presence of weak instruments, rendering our estimates biased. We take a deeper look at defining and testing for weakness of instruments. We then present two alternative estimators which are partially robust with weak instruments.

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Contents

1	Introduction	1
2	Two-Stage Least Squares and its Limitations	2
2.1	Basic Model	2
2.2	Concentration Parameter	3
2.3	Two-Stage Least Squares Estimator	4
2.4	Limitations of 2SLS: Bias	4
2.4.1	Bias in Single Instrument case	5
2.4.2	Approximate Expression of Bias in Multiple-Instruments case	5
2.4.3	Inconsistency of the 2SLS estimator	7
3	Testing for Weak Instruments	7
3.1	Defining the ‘Weakness’ precisely	7
3.2	First Stage F-statistic	8
3.3	Anderson-Rubin Test	8
4	Alternative Estimators	9
4.1	Jackknife Instrumental Variables Estimator	9
4.2	Limited Information Maximum-Likelihood Estimator	11
A	Appendix	13
A.1	Deriving the approximate expression of 2SLS Bias	13

1 Introduction

Instrumental variables estimation has gained considerable traction in recent decades as a tool for causal inference, particularly amongst empirical researchers. However, this has also highlighted the importance of taking a deeper look at the theoretical properties underlying one’s estimator of choice, whether it is instrumental variable estimator or any other estimator. A case-in-point is the well-known 1991 quarter-of-birth study on returns to schooling estimates by Angrist and Krueger (1991) and the equally famous rebuttal of their results published by Bound et al. (1995).

The Bound et al. (1995) critique of the quarter-of-birth study in essence formed the starting point of the weak instruments literature. They provided simulation evidence that the instruments used by Angrist and Krueger (1991) were very weak and this in turn led to misleading results. Interestingly, their study was not the first time that the poor finite-sample behavior of the instrumental variables estimator (two-stage least squares estimator in particular) was discussed. Previously, numerous authors had presented results on the magnitude of the finite-sample bias of the 2SLS estimator towards OLS, such as Nagar (1959), Basmann (1960), Richardson (1968) and Sawa (1969). However, their critique was the first to suggest some practices for the detection of possible presence of weak instruments (reporting first-stage F-statistic and the R^2 of the first stage regression), which have since become standard practice for using instrumental variables in empirical studies.

The literature on weak instruments have since developed considerably and continues to do so. Staiger and Stock (1997) showed that conventional asymptotic approaches fail to provide good approximations for weak instruments, and formalized the problem of weak instruments by introducing ‘weak-instrument asymptotics’ which mimics the situation of weak instruments better. Stock et al. (2002) provide a comprehensive survey of the weak instruments literature, wherein they emphasize that the problem of bias of the two-stage least-squares estimator is not solely a small sample problem. It affects estimates carried out on large sample sizes as well, as is the case with the quarter-of-birth study which has a dataset of around 300,000 observations.

Further, given the poor finite-sample properties of the two-stage least squares estimator, numerous alternate estimators have also been proposed. These include the USSIV estimator suggested by Angrist and Krueger (1995), Fuller-k estimator by Fuller (1977), bias-adjusted 2SLS estimator by Donald and Newey (2001), JIVE estimators by Angrist et al. (1999) and Blomquist and Dahlberg (1999). Another estimator, the LIML was formalized by Anderson et al. (1949). In our paper, we

take a deeper look at two of these estimators - JIVE and LIML estimators.

We introduce the two conditions for instrumental variables estimation, the first of which will be a recurring theme in our paper, since it connects to the problem of weak instruments. Consider the standard population regression model:

$$Y_i = \beta_0 + \beta_1 X_i + \varepsilon_i, \quad i = 1, 2, \dots, n$$

where ε_i is the error term representing omitted factors that determine Y_i . Variables correlated with the error term are termed endogenous variables and those uncorrelated with the error term are exogenous. A valid instrument Z_i must satisfy two conditions:

- Instrument Relevance: $\text{corr}(Z_i, X_i) \neq 0$.

It is the implications of this condition, specifically the strength (or weakness) of this correlation between the instrument and the endogenous regressor, that we are interested in. Instruments that explain little of the variation in X are called weak instruments. A precise definition is introduced in section 3.1.

- Instrument Exogeneity: $\text{corr}(Z_i, \varepsilon_i) = 0$

Note that this condition cannot be statistically tested, since it involves the covariance between Z_i and the unobserved ε_i .

If number of instruments (K) equals the number of endogenous regressors (L) we have the just or exactly identified case. If the number of instruments exceeds the number of endogenous regressors, $K \geq L$, then we have the over-identified case.

The rest of the paper is sectioned as follows. Chapter 2 presents a derivation of the 2SLS estimator and its limitations in the weak instruments case. Chapter 3 discusses methods to test for weak instruments. Chapter 4 presents the alternative estimators (JIVE and LIML). Chapter 5 presents the simulation study. Chapter 6 presents the application to returns to schooling. Chapter 7 concludes.

2 Two-Stage Least Squares and its Limitations

2.1 Basic Model

Throughout the paper, unless stated otherwise, we consider the following basic model with two equations, following the notation of Angrist et al. (1999):

$$Y_i = X_i\beta + \varepsilon_i$$

$$X_i = Z_i\pi + \eta_i$$

Y_i is scalar. X_i is $1 \times L$ row vector of potentially endogenous regressors. Z_i is $1 \times K$ row vector, with $K \geq L$. $K - L$ is the number of over-identifying restrictions. In matrix notation:

$$\underset{(N \times 1)}{\mathbf{Y}} = \underset{(N \times L)}{\mathbf{X}} \underset{(N \times 1)}{\beta} + \underset{(N \times 1)}{\varepsilon} \quad (1)$$

$$\underset{(N \times L)}{\mathbf{X}} = \underset{(N \times K)}{\mathbf{Z}} \underset{(N \times L)}{\pi} + \underset{(N \times L)}{\eta} \quad (2)$$

where (2.1) denotes the structural equation, (2.2) is the first stage. \mathbf{Y} and ε are $N \times 1$ vectors. \mathbf{X} and η are $N \times L$ matrices, and \mathbf{Z} is $N \times K$ matrix. If the vectors of regressors and that of instruments have M common elements, then M columns of the $N \times L$ matrix η have their elements as zero.

The following assumptions hold for our model:

1. Conditional on instruments Z_i , the error term ε_i has expectation zero ($E[\varepsilon_i|Z_i] = 0$) and variance σ^2 .
2. $E[\eta|\mathbf{Z}] = 0$ and $E[\eta'_i\eta_i|\mathbf{Z}] = \Sigma_\eta$, with rank $L - M$.
3. $E[\varepsilon_i\eta'_i|\mathbf{Z}] = \sigma_{\varepsilon\eta}$, where $\sigma_{\varepsilon\eta}$ is an L -dimensional column vector.
4. All observations of (Y_i, X_i, Z_i) are independent and identically distributed.

2.2 Concentration Parameter

The Concentration Parameter μ^2 , given by:

$$\mu^2 = \frac{\pi' \mathbf{Z}' \mathbf{Z} \pi}{\sigma_\eta^2} \quad (3)$$

measures the strength of the instruments. It is unitless. An important question to be addressed at this point is that since π , and thus μ^2 , is unknown, how is the researcher supposed to know whether μ^2 value is low enough for the instrument under study to be weak? This is addressed by the fact that the concentration parameter can be interpreted in terms of the first stage F statistic, discussed in Section 3. If the sample size is large, $E(F) \cong \mu^2/K + 1$, and thus $F - 1$ can be treated as an estimator of μ^2/K , which gives us a convenient way to test for weak instruments.

The concept of μ^2 is essentially the starting point for understanding the weak instruments literature. Rothenberg (1984) showed that the concentration parameter plays the role we commonly associate with the sample size or number of observations:

as μ^2 becomes large, the normal distribution becomes a good approximation for the 2SLS distribution. Likewise a small concentration parameter leads to a non-normal distribution of 2SLS, and the estimator becomes biased. Thus μ^2 can be interpreted as the effective sample size.

2.3 Two-Stage Least Squares Estimator

It is helpful to characterize the 2SLS and (later on the jackknife estimator as well), as a feasible version of the ideal but infeasible instrumental variables estimator. Adhering to the notation defined in section 2.1, we derive the formula for the 2SLS estimator using this characterization. The derivation is adopted, with modifications to the notation, from Hansen (2019) and Angrist et al. (1999).

First, we estimate the ideal estimator $\hat{\beta}_{OPT}$ using the optimal instrument $Z\pi$, by ordinary least-squares:

$$\hat{\beta}_{OPT} = ((Z\pi)'X)^{-1}((Z\pi)'Y) \quad (4)$$

π is unknown however, and so the optimal estimator $\hat{\beta}_{OPT}$ is infeasible.

We use an estimate of π instead, and denote it by $\hat{\pi}$. $\hat{\pi}$ is estimated from the reduced form regression which yields $\hat{\pi} = (Z'Z)^{-1}(Z'X)$. Substituting $\hat{\pi}$ into (2.4),

$$\hat{\beta}_{2SLS} = ((Z\hat{\pi})'(Z\hat{\pi}))^{-1}((Z\hat{\pi})'Y) \quad (5)$$

$$\hat{\beta}_{2SLS} = ((Z(Z'Z)^{-1}(Z'X))'(Z(Z'Z)^{-1}(Z'X))^{-1}((Z(Z'Z)^{-1}(Z'X))'Y) \quad (6)$$

$$\hat{\beta}_{2SLS} = ((X'Z)(Z'Z)^{-1}Z'X)^{-1}X'Z(Z'Z)^{-1}Z'Y \quad (7)$$

This is the two-stage least squares estimator. $\hat{\beta}_{2SLS}$ can be thought of as an estimator with the constructed instrument $(Z\hat{\pi})$ where $\hat{\pi} = (Z'Z)^{-1}(Z'X)$.

Representing (2.7) in terms of the projection matrix $P_Z = Z(Z'Z)^{-1}Z'$:

$$\hat{\beta}_{2SLS} = ((X'P_ZX)^{-1}X'P_ZY) \quad (8)$$

The two-stage least squares is by far the most widely used estimator for instrumental variables estimation, however, as we briefly discussed in chapter 1, it has certain concerning limitations, which we expand upon in the next section.

2.4 Limitations of 2SLS: Bias

In the weak instruments case, the 2SLS estimator fails to provide unbiased, reliable estimates. As shown in Section 2.3, we arrived at the 2SLS estimator using an

estimate of π since the true value of the first-stage coefficients is unknown, which implies a certain amount of over-fitting of the first-stage equation, leading to bias in the direction of the expectation of the OLS estimator of β .

There is considerable theoretical research noting the poor finite-sample properties of instrumental variables estimator. Results on the magnitude of this bias have been provided by Nagar (1959), Richardson (1968), Sawa (1969) and Buse (1992). Further, as shown by noteworthy results of Bound et al. (1995), with weak instruments particularly, the finite sample behavior worsens and the estimator can become biased as well as inconsistent.

2.4.1 Bias in Single Instrument case

To visualize the problem intuitively, first let us consider the simple case of a single (weak) instrument and endogenous regressor:

$$Y_i = X_i\beta + \varepsilon_i$$

$$X_i = Z_i\pi_1 + \eta_i$$

In this case, the 2SLS estimator is simply given by the ratio of the two covariances:

$$\hat{\beta}_{2SLS} = \frac{\sigma_{Y_i Z_i}}{\sigma_{X_i Z_i}} \quad (9)$$

However, given the fact that our instrument is very weak, $\sigma_{X_i Z_i} = 0$. Hence, $\hat{\beta}_{2SLS}$ does not exist.

In the simplest case, the 2SLS estimator is just the ratio of two covariances, and with weak instruments, the 2SLS or general instrumental variables estimator does not exist.

2.4.2 Approximate Expression of Bias in Multiple-Instruments case

In this section we provide two different expressions approximating the bias of the two-stage least squares estimator in the general case and show how it centers around ordinary least squares.

Defining the ‘relative bias’ of 2SLS to be its bias relative to the inconsistency of OLS, Buse (1992) derived an expression for the approximate bias of $\hat{\beta}_{2SLS}$ using power series approximations. This result holds even when the errors are not normally distributed:

$$\frac{\sigma_{\varepsilon\eta}(K-2)}{\pi'Z'Z\pi} \quad (10)$$

where N is the sample size and K is the number of excluded instruments. This expression is approximately inversely proportional to $\mu^2/(K - 2)$, as shown:

$$\frac{\sigma_{\varepsilon\eta}\sigma_{\eta}^2(K - 2)}{\sigma_{\eta}^2\pi'\mathbf{Z}'\mathbf{Z}\pi} = \frac{\sigma_{\varepsilon\eta}(K - 2)}{\sigma_{\eta}^2\mu^2} \quad (11)$$

where μ^2 denotes the concentration parameter (measure of the strength of the instrument as discussed in Section 1.). Note that in the above equation, the term $\frac{\sigma_{\varepsilon\eta}}{\sigma_{\eta}^2}$ approximately equals the asymptotic bias of the OLS estimator when the instrument explains little of the variation of \mathbf{X} . Hence, from equation (2.10) it is clearly seen that for $K > 2$, the bias of the 2SLS estimator relative to OLS is inversely proportional to the concentration parameter, hence, weaker the instrument(s), lower is the concentration parameter, and higher is the bias of 2SLS towards the OLS estimate.

It can be seen from the above formulation that increasing the number of instruments with the explanatory power remaining constant, causes the relative bias of the 2SLS to only increase.

Before moving on to the second expression, it is important to briefly introduce alternate asymptotic representations that are generally used for the weak instruments case. As discussed by Stock et al. (2002), for weak instruments, conventional asymptotic approximations to finite-sample distributions are quite poor. Two alternate asymptotic methods commonly employed are **weak-instrument asymptotics** (involving a sequence of models chosen to keep μ^2/K constant as sample size $N \rightarrow \infty$) pioneered by Staiger and Stock (1997) and **many-instrument or group asymptotics** (involving sequence of models with fixed instruments and normal errors, where K is proportional to N and μ^2/K converges to a constant finite limit), first proposed by Bekker (1994). In the 1995 working paper version of Angrist et al. (1999), it was referred to as group asymptotics.

We present an expression for the approximate bias of the 2SLS estimator using group asymptotics, wherein we let the number of instruments grow proportional to rate of the sample size. This keeps the instruments weak. The detailed derivation of this expression is provided in the appendix A.1.

$$E[\hat{\beta}_{2SLS} - \beta] \approx \frac{\sigma_{\varepsilon\eta}}{\sigma_{\eta}^2} \frac{1}{F + 1} \quad (12)$$

where F is the population analog of the F-statistic for the joint significance of the instruments in the first-stage regression. $\frac{\sigma_{\varepsilon\eta}}{\sigma_{\eta}^2}$ approximately equals the asymptotic bias of the OLS estimator. Given a weak first-stage (weak instruments case), $F \rightarrow 0$, and we can see that the bias approaches $\frac{\sigma_{\varepsilon\eta}}{\sigma_{\eta}^2}$. With a strong first-stage, $F \rightarrow \infty$ and then the 2SLS bias goes to 0.

2.4.3 Inconsistency of the 2SLS estimator

In this section we relate the two conditions for instrumental variables estimation to the consistency property of the 2SLS estimator. If the weak correlation (between the instrument(s) and the endogenous variable) is coupled together with even a small violation of the second condition of instrumental variables estimation (which is the instrument exogeneity condition) then we have an inconsistent estimator. This insight was first discussed by Bound et al. (1995).

To represent the problem discussed above, let us consider the probability limit of the 2SLS estimator:

$$plim \hat{\beta}_{2SLS} = \beta + \frac{\sigma_{\hat{\mathbf{X}},\varepsilon}}{\sigma_{\hat{\mathbf{X}}}^2} \quad (13)$$

where $\hat{\mathbf{X}}$ is the projection of \mathbf{X} onto \mathbf{Z} , and $\sigma_{\hat{\mathbf{X}},\varepsilon}$ is the covariance between $\hat{\mathbf{X}}$ and ε .

From equation (2.13) we can intuitively understand that if $\sigma_{\hat{\mathbf{X}}}^2$ is small, which implies that we have a weak instrument, then as long as $\sigma_{\hat{\mathbf{X}},\varepsilon}$ is zero the estimator will be consistent. However, suppose we have a weak instrument and also, $\sigma_{\hat{\mathbf{X}},\varepsilon}$ is small but non-zero, then even that small correlation between \mathbf{Z} (and thus, $\hat{\mathbf{X}}$) and the structural error term ε can lead to a large inconsistency.

Hence, with weak instruments, even moderate correlation between instrument and structural error term can magnify the inconsistency of IV estimator.

3 Testing for Weak Instruments

Testing for presence of weak instruments is, at the time of writing, an active field of research. For a detailed overview, see Stock et al. (2002). For the purpose of our study, we limit our attention to two tests - the widely-used first-stage F-statistic and the Anderson-Rubin Test, which has gained resurgence in recent years in light of new developments in instrumental variables research.

3.1 Defining the ‘Weakness’ precisely

Stock and Yogo (2002) posit that the definition of weak instruments depends on the inferential task to be carried out, and cannot be resolved in the abstract. One approach is to define a set of instruments to be weak if μ^2/K is small enough that inferences based on conventional normal approximating distributions are misleading. For instance, if a researcher wants their 2SLS estimate bias to be small, one measure

of whether an instrument(s) is strong is whether μ^2/K is large enough such that the 2SLS relative bias (relative to the bias of ordinary least squares) is below a certain threshold, for example the relative bias is below 10%. Hence, to be deemed a ‘weak’ instrument, the 2SLS estimate using that instrument should have relative bias above 10%. The definition we discussed (and use for our simulation) is based on relative bias, another definition (for instance on size of test) may result in a different cut-off value.

3.2 First Stage F-statistic

The first-stage F-statistic is the F-statistic testing the hypothesis that the coefficients on the instruments equal zero ($\pi = 0$) in the first stage of two stage least squares. Stock and Yogo (2002) show that the definition of weak instruments discussed above implies a threshold value for μ^2/K , under weak asymptotics. A weak instrument will have a μ^2/K value (and hence, an F-statistic value, since $F-1$ can be treated as an estimator of μ^2/K as discussed in Section 2.2) lower than the threshold. For the case of a single endogenous regressor, Staiger and Stock (1997) provide a rule-of-thumb threshold of 10: a value less than 10 indicates that the instruments are weak, in which case the 2SLS estimator is biased and 2SLS t-statistics and confidence intervals are unreliable.

Stock et al. (2002) provide a table listing critical values of the first-stage F-statistic such that the relative bias of 2SLS estimates is greater than 10%, for different numbers of instruments. The authors arrived at those critical values based on weak-instrument asymptotic approximations. We include a subset of this table (which is relevant for our simulations) as Table B.1 in appendix B for reference.

3.3 Anderson-Rubin Test

The AR test is a hypothesis test that has the property of being valid whether instruments are strong, weak or even irrelevant ($\pi = 0$). It tests the null hypothesis $\beta = \beta_0$ using the statistic. It was proposed by Anderson et al. (1949).

$$AR(\beta) = \frac{(\mathbf{Y} - \mathbf{X}\beta)'P_z(\mathbf{Y} - \mathbf{X}\beta)/K}{(\mathbf{Y} - \mathbf{X}\beta)'M_Z(\mathbf{Y} - \mathbf{X}\beta)/(N - K)} \quad (14)$$

One definition of the LIML estimator is that it minimizes $AR(\beta)$. With fixed instruments and normal errors, the quadratic forms in the numerator and denominator of (3.1) are independent chi-squared random variables under the null hypothesis,

and $AR(\beta_0)$ has an exact $F_{K,T-K}$ null distribution. Under the more general conditions of weak-instrument asymptotics, $AR(\beta_0) \xrightarrow{d} \chi_k^2/K$ under the null hypothesis, regardless of the value of μ^2/K . Thus the AR statistic provides a fully robust test of the hypothesis $\beta = \beta_0$.

The set of values of β that are not rejected by a 5% Anderson–Rubin test will constitute a 95% confidence set for β . The logic behind the Anderson–Rubin statistic is that it never assumes instrument relevance, and the AR confidence set will have a coverage probability of 95% in large samples, regardless of the strength or weakness of instruments. In light of the importance given to the problem of weak instruments in recent years, this test has gained traction among econometricians, who increasingly advocate for its use for robust inference with weak instruments (See Staiger and Stock (1997)). Particularly, recent research has shown the AR confidence set to be optimal in the single-endogenous-regressor just-identified setting.

4 Alternative Estimators

In this section we present a detailed overview of two alternative estimators which in theory exhibit better finite sample properties.

Both of these estimators, the Jackknife IV estimator and the LIML estimator, fall under the broader class of k-class estimators. These estimators are partially robust ie less sensitive to weak instruments; with weak instruments, they are more reliable than 2SLS estimates. Conventional asymptotic approximations are used for their inference.

4.1 Jackknife Instrumental Variables Estimator

For an intuitive sense of the functioning of the jackknife instrumental variables estimator, consider the term ‘jackknife’ as presented in statistical literature. The jackknife estimator of a parameter is found by leaving out each observation from a dataset, calculating the estimate and computing the average of these calculations. Given a sample of size N , the jackknife estimate is found by aggregating the estimates of each sub-sample of size $(N - 1)$. In a similar vein, the estimator we describe in this section replaces the usual fitted values from the reduced form regression of the two-stage least squares by ‘omit-one’ fitted values.

The key feature of the JIVE estimator is that it eliminates the correlation between the fitted values and the structural equation errors, as explain in detail below. The fitted value of the standard 2SLS estimator is only asymptotically independent

of the structural error (ε_i), but the JIVE is independent even in finite samples.

The derivation we present in this section is adopted from Angrist et al. (1999). To derive the expression formally, consider again the expressions for $\hat{\beta}_{OPT}$ and $\hat{\beta}_{2SLS}$ from section 2.2, equations (2.4) and (2.5). $\hat{\beta}_{OPT}$ employed the optimal instrument $\mathbf{Z}\pi$ and $\hat{\beta}_{2SLS}$ used an estimate of $\mathbf{Z}\pi$, denoted by $\mathbf{Z}\hat{\pi}$. Now we introduce the new estimator for β by using a different estimate of the optimal instrument, $Z_i\tilde{\pi}$.

From the formulation of approximate bias of the 2SLS estimator we presented in section 2.4.2 (equation 2.11), it is clear that increasing the number of instruments while keeping the explanatory/predictive power of the instruments constant, leads to an increase in the bias of $\hat{\beta}_{2SLS}$. However, we can see that for the optimal estimator, increasing the number of instruments while keeping $Z_i\pi$ fixed will have no effect on the properties of $\hat{\beta}_{OPT}$. Thus, for finite samples in the presence of many instruments, $\hat{\beta}_{2SLS}$ fares much worse than $\hat{\beta}_{OPT}$.

Recall the representation of the 2SLS estimator using the projection matrix P_Z from Section 2 (equation 2.8). We can see that the first-stage fitted values $\mathbf{Z}\hat{\pi}$ can be written as:

$$\mathbf{Z}\hat{\pi} = P_Z\mathbf{X} = \mathbf{Z}\pi + P_Z\eta \quad (15)$$

The term $P_Z\eta$ in the above equation is correlated with the error term of the first-stage η (see equation 1.2) and hence with the structural error term ε . Put differently, since $\hat{\pi}$ is estimated on the full sample which includes the i th observation, it is correlated with η_i , which is correlated with ε_i . This correlation is given by:

$$E[\varepsilon_i Z_i \hat{\pi}] = E[E[\varepsilon_i Z_i \hat{\pi} | \mathbf{Z}]] = E[Z_i (\mathbf{Z}'\mathbf{Z})^{-1} \mathbf{Z}'_i \cdot E[\varepsilon_i \eta_i | \mathbf{Z}]] = E[Z_i (\mathbf{Z}'\mathbf{Z})^{-1} \mathbf{Z}'_i \cdot \sigma'_{\varepsilon\eta}] = (K/N) \cdot \sigma'_{\varepsilon\eta} \quad (16)$$

Due to this correlation between $\hat{\pi}$ and ε_i , $\hat{\beta}_{2SLS}$ is biased for β . While the correlation disappears asymptotically, it holds implications in finite samples.

In devising the new instrument, we attempt to keep the correlation in (4.2) equal to zero. The problem stems from $\hat{\pi}$ being estimated on the full sample which includes the i th observation. For the new estimator which has the constructed instrument $Z_i\tilde{\pi}$, $\tilde{\pi}$ is estimated not on the full sample but on the sample with the i th observation removed. Therefore, the new estimated instrument will be independent of ε_i even in finite samples.

The i th row of the estimated instrument for 2SLS, $\mathbf{Z}\hat{\pi}$, where $\hat{\pi} = (\mathbf{Z}'\mathbf{Z})^{-1}(\mathbf{Z}'\mathbf{X})$, is given by

$$Z_i\hat{\pi} = Z_i(\mathbf{Z}'\mathbf{Z})^{-1}(\mathbf{Z}'\mathbf{X}) \quad (17)$$

Remove the i th row from the matrices of regressors and instruments and denote them by $\mathbf{X}(i)$ and $\mathbf{Z}(i)$. Thus JIVE removes the dependence between $Z_i\hat{\pi}$ and the regressor X_i .

The corresponding estimate of π and the constructed instrument will be:

$$\tilde{\pi}(i) = (\mathbf{Z}(i)' \mathbf{Z}(i))^{-1} (\mathbf{Z}(i)' \mathbf{X}(i)) \quad (18)$$

$$Z_i \tilde{\pi}(i) = Z_i (\mathbf{Z}(i)' \mathbf{Z}(i))^{-1} (\mathbf{Z}(i)' \mathbf{X}(i) Y) \quad (19)$$

ε_i and X_j are independent when $i \neq j$, so it follows that

$$E[\varepsilon_i Z_i \tilde{\pi}(i)] = E[Z_i (\mathbf{Z}(i)' \mathbf{Z}(i))^{-1} (\mathbf{Z}(i)' E[\mathbf{X}(i) \varepsilon_i | \mathbf{Z}])] = 0 \quad (20)$$

Hence, now we have $E[\varepsilon_i Z_i \tilde{\pi}(i)] = 0$, so we have removed the correlation between the fitted values and the structural error presented in equation (4.2).

The JIVE estimator is equal to:

$$\hat{\beta}_{JIVE} = (\hat{\mathbf{X}}'_{JIVE} \mathbf{X})^{-1} (\hat{\mathbf{X}}'_{JIVE} \mathbf{Y}) \quad (21)$$

where $\hat{\mathbf{X}}_{JIVE}$ is $N \times L$ dimensional matrix with the i th row $Z_i \tilde{\pi}(i)$.

Blomquist and Dahlberg (1999) summarize the construction of the JIVE estimator by providing the following algorithm:

Algorithm 1 Jackknife Instrumental Variables Estimator

- 1: Use all observations but the i th to estimate parameters of the first-stage equation.
 - 2: Combine the estimated first stage parameters with the instruments for the i th observation, Z_i , to construct a fitted value for the i th observation X_i .
 - 3: Repeat steps 1 and 2 for all N observations.
 - 4: Regress Y on the fitted values and the exogenous regressors.
-

The estimator for $Z_i\pi$, $Z_i\tilde{\pi}(i)$ is consistent. $\hat{\beta}_{JIVE}$ has the same probability limit and first-order asymptotic distribution as $\hat{\beta}_{OPT}$ and $\hat{\beta}_{2SLS}$, under conventional fixed model asymptotics (Stock et al. (2002)).

4.2 Limited Information Maximum-Likelihood Estimator

Limited Information Maximum Likelihood (LIML) is an alternative method to estimate the parameters of the structural equation. It was formalized by Anderson

et al. (1949).

We follow the same model as described in Section 2, and extend it as shown below:

$$\mathbf{Y} = \mathbf{X}\beta + \varepsilon = \mathbf{X}_0\beta_0 + \mathbf{X}_1\beta_1 + \varepsilon \quad (22)$$

$$\mathbf{X}_1 = \mathbf{Z}\pi + \eta = \mathbf{Z}_0\pi_0 + \mathbf{Z}_1\pi_1 + \eta \quad (23)$$

where $\mathbf{Z}_0 = \mathbf{X}_0$.

Here, \mathbf{X}_0 is the matrix of exogenous variables and \mathbf{X}_1 of endogenous variables. $\mathbf{Z}_0 = \mathbf{X}_0$ is the matrix of included exogenous variables, \mathbf{Z}_1 is the matrix of excluded exogenous variables. Because the LIML estimator is based on the structural equation for \mathbf{Y} combined with the first-stage equation for \mathbf{X}_1 , it is called ‘limited information’. LIML estimator is given by:

$$\hat{\beta}_{LIML} = (\mathbf{X}'(\mathbf{I} - \hat{\kappa}\mathbf{M}_Z)\mathbf{X})^{-1}\mathbf{X}'(\mathbf{I} - \hat{\kappa}\mathbf{M}_Z)\mathbf{Y} \quad (24)$$

The LIML estimator has some excellent properties when the number of excluded instruments (number of columns in matrix \mathbf{X}_1) in the first-stage equation and the sample size are large. Although the LIML estimator and the 2SLS estimator are asymptotically equivalent in the standard large sample theory, they are quite different in case of many instruments or many weak instruments. It has no finite moments, which implies that its density tends to have very thick tails. Anderson et al. (2010) show that the LIML estimator shows asymptotic optimality with many weak instruments.

A Appendix

A.1 Deriving the approximate expression of 2SLS Bias

This derivation has been adopted from Pischke (2018). Start with the representation of the 2SLS estimator as shown in equation (2.8).

$$\hat{\beta}_{2SLS} = (\mathbf{X}'P_Z\mathbf{X})^{-1}\mathbf{X}'P_Z\mathbf{Y} = \beta + (\mathbf{X}'P_Z\mathbf{X})^{-1}\mathbf{X}'P_Z\varepsilon \quad (25)$$

where $P_Z = \mathbf{Z}(\mathbf{Z}'\mathbf{Z})^{-1}\mathbf{Z}'$ is the projection matrix. So the bias of $\hat{\beta}_{2SLS}$ will be

$$\hat{\beta}_{2SLS} - \beta = (\mathbf{X}'P_Z\mathbf{X})^{-1}(\pi'\mathbf{Z}' + \eta')P_Z\varepsilon = (\mathbf{X}'P_Z\mathbf{X})^{-1}\pi'\mathbf{Z}'\varepsilon + (\mathbf{X}'P_Z\mathbf{X})^{-1}\eta'P_Z\varepsilon \quad (26)$$

Using group asymptotics the expectation of this expression can be presented as:

$$E[\hat{\beta}_{2SLS} - \beta] \approx (E[\mathbf{X}'P_Z\mathbf{X}])^{-1}E[\pi'\mathbf{Z}'\varepsilon] + (E[\mathbf{X}'P_Z\mathbf{X}])^{-1}E[\eta'P_Z\varepsilon] \quad (27)$$

Z_i instruments are uncorrelated with ε_i and η_i , so $E[\pi'\mathbf{Z}'\varepsilon] = 0$ and we will have

$$E[\hat{\beta}_{2SLS} - \beta] \approx (E[\mathbf{X}'P_Z\mathbf{X}])^{-1}E[\pi'\mathbf{Z}'\varepsilon] + (E[\mathbf{X}'P_Z\mathbf{X}])^{-1}E[\eta'P_Z\varepsilon] = (E[\mathbf{X}'P_Z\mathbf{X}])^{-1}E[\eta'P_Z\varepsilon] \quad (28)$$

Substituting the first stage equation $\mathbf{X} = \mathbf{Z}\pi + \eta$ we have

$$E[\hat{\beta}_{2SLS} - \beta] \approx (E[(\pi'\mathbf{Z}' + \eta')P_Z(\mathbf{Z}\pi + \eta)])^{-1}E[\eta'P_Z\varepsilon] \quad (29)$$

We have that $E[\pi'\mathbf{Z}'\eta] = 0$, so

$$E[\hat{\beta}_{2SLS} - \beta] \approx [E(\pi'\mathbf{Z}'\mathbf{Z}\pi) + E(\eta'P_Z\eta)]^{-1}E(\eta'P_Z\varepsilon) \quad (30)$$

Notice that $\eta'P_Z\eta$ is a scalar and is equal to its trace. P_Z is an idempotent matrix, so its trace is equal to its rank, Q . So

$$E(\eta'P_Z\eta) = E[\text{tr}(\eta'P_Z\eta)] = E[\text{tr}(P_Z\eta\eta')] = \text{tr}(P_ZE[\eta\eta']) = \text{tr}(P_Z\sigma_\eta^2 I) = \sigma_\eta^2 \text{tr}(P_Z) = \sigma_\eta^2 Q \quad (31)$$

With a similar technique we can show that $E(\eta'P_Z\varepsilon)$ is equal to $\sigma_{\varepsilon\eta}Q$. Substituting these results in equation (A.6) we have

$$E[\hat{\beta}_{2SLS} - \beta] \approx \sigma_{\varepsilon\eta}Q[E(\pi'\mathbf{Z}'\mathbf{Z}\pi) + \sigma_\eta^2 Q]^{-1} = \frac{\sigma_{\varepsilon\eta}}{\sigma_\eta^2} \left[\frac{E(\pi'\mathbf{Z}'\mathbf{Z}\pi)/Q}{\sigma_\eta^2} + 1 \right]^{-1} \quad (32)$$

The population F-statistic for the first stage regression is the following

$$F = \frac{E(\pi'\mathbf{Z}'\mathbf{Z}\pi)/Q}{\sigma_\eta^2} \quad (33)$$

So (A.8) can be expressed as

$$E[\hat{\beta}_{2SLS} - \beta] \approx \frac{\sigma_{\varepsilon\eta}}{\sigma_\eta^2} \frac{1}{F + 1} \quad (34)$$

Assume that the π coefficients are zero and $F = 0$. In this case $\sigma_X^2 = \sigma_\eta^2$ and

$$E[\hat{\beta}_{2SLS} - \beta] \approx \frac{\sigma_{\varepsilon\eta}}{\sigma_X^2} \quad (35)$$

Thus, when $\pi \neq 0$ and F is small, then 2SLS will be biased towards OLS.

Note that $\frac{\sigma_{\varepsilon\eta}}{\sigma_X^2}$ is also the bias of OLS estimator, because when $\pi = 0$, $cov(\varepsilon_i, X_i) = \sigma_{\eta\varepsilon}$ and

$$\beta_{OLS} = \frac{cov(Y_i, X_i)}{var(X_i)} = \frac{cov(\beta X_i + \varepsilon_i, X_i)}{var(X_i)} = \beta + \frac{cov(\varepsilon_i, X_i)}{var(X_i)} = \frac{\sigma_{\varepsilon\eta}}{\sigma_X^2} \quad (36)$$

Hence in this case OLS and 2SLS estimators on average are the same. And if π is different from zero, $\hat{\beta}_{2SLS}$ will be biased in the direction of OLS estimator. If we add weak instruments to the regression bias of 2SLS will only increase.

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