

ECONOMIC STATISTICS





NEW

SZÉCHENYI PLAN

ECONOMIC STATISTICS

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ECONOMIC STATISTICS

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ECONOMIC STATISTICS

Week 7

Omitted variables, multicollinearity,
binary regressors – introduction

Anikó Bíró

Simple vs. multivariate

Example: housing prices (CAD, source: hprice.xls)

- Multivariate:

$$\hat{P} = -4009.6 + 5.4\text{lot} + 2824.6\text{bedroom} + \\ + 17105.2\text{bathroom} + 7634.9\text{stories}$$

- Univariate:

$$\hat{P} = 32794.0 + 27477.0\text{bathroom}$$

- Larger estimated coefficient

Example, cont.

Explanation for different coefficients:

- Influence of several factors
- Correlation with the number of bathrooms
 - E.g. positive correlation between lot size – number of bathroom
- Univariate regression: cannot separate the effects

Omitted variables

- Bias due to omitted variables:
 - Estimation is not correct if we omit such a variable which is correlated with the included explanatory variables
- Include those variables which have explanatory power!
- But: redundant variables – estimation precision decreases
 - General practice: omit the insignificant ones

Wage tariff example

- Simple:

	<i>Coeff.</i>	<i>Standard dev.</i>	<i>t stat.</i>	<i>P-value</i>
Intercept	-161796,32	9514,04	-17,01	0,00
Education	24855,33	707,51	35,13	0,00

- Multiple, $\text{corr}(\text{educ.}, \text{age}) = -0.04$

	<i>Coeff.</i>	<i>Standard dev.</i>	<i>t stat.</i>	<i>P-value</i>
Intercept	-328321,34	8040,13	-40,84	0,00
Education	27250,22	452,97	60,16	0,00
Age	3171,29	109,05	29,08	0,00

Multicollinearity

- Some of the explanatory variables are strongly correlated
- The effects of the regressors are difficult to separate
- Solution: omit some of the regressors
– not always desirable!

Multicollinearity

- "Symptoms":
 - Low t-, high P-values
 - At the same time, R-squared is high
 - Coefficients are very sensitive to the inclusion of additional (collinear) variables
 - Estimated coefficients are very different from the expected values (clearly unreasonable coefficients)

Multicollinearity - example

Earnings regressions, $\text{corr}(\text{age}, \text{experience})=0,97$

r-squared 0,468

	<i>Coeff.</i>	<i>Standard dev.</i>	<i>t stat.</i>	<i>P-value</i>
Intercept	-1,7E+11	3,05E+10	-5,647	1,72E-08
Education	-2,9E+10	5,08E+09	-5,647	1,72E-08
Age	2,87E+10	5,08E+09	5,647	1,72E-08
Experience	-2,9E+10	5,08E+09	-5,647	1,72E-08

r-squared 0,465

	<i>Coeff.</i>	<i>Standard dev.</i>	<i>t stat.</i>	<i>P-value</i>
Intercept	-328321	8040,126	-40,835	0
Education	27250,22	452,9723	60,159	0
Age	3171,293	109,0451	29,082	6,3E-172

Binary explanatory variables

- Qualitative, coding: 0 – 1
- Binary = dummy = dichotomous variable
- Examples:
 - Housing prices: is there garage, air conditioning, ...
 - Wages: male – female
 - Medical expenditures: if insured or not
 - Etc.

Estimation, coefficients

- OLS method unchanged, different interpretation of coefficients
- Simple regression:

$$Y = \alpha + \beta D + e$$

$$\hat{Y} = \hat{\alpha} + \hat{\beta} D$$

$$\hat{Y} = \hat{\alpha}, \text{ if } D = 0$$

$$\hat{Y} = \hat{\alpha} + \hat{\beta}, \text{ if } D = 1$$

- Mean of two subgroups

Examples

1. Housing prices

$$\hat{P} = 59\,885 + 25\,996\textit{Cond}$$

- Mean price with air conditioning: 85 881 CAD

2. Earnings (Wage tariff 2003 subsample)

$$\hat{W} = 159\,289 + 66\,854\textit{male}$$

- Average earnings, males: 226 142 Ft
- Average earnings, females: 159 289 Ft

More binary variables

$$Y_i = \alpha + \beta_1 D_{i1} + \dots + \beta_k D_{ik} + e_i$$

- Number of groups: 2^k
- Group means: sum of respective coefficients
- Interpretation of coefficients: partial effect

Binary and continuous explanatory variables

- Only binary: different means
- Binary and not binary: different intercept
- Simplest model:

$$Y_i = \alpha + \beta_1 D_i + \beta_2 X_i + e_i$$

Intercept: α or $\alpha + \beta_1$

Binary regressors – example

Hprice.xls – housing price regression:

	<i>Coeff.</i>	<i>Standard dev.</i>	<i>t stat.</i>	<i>P-value</i>
Intercept	30555,75	2289,991	13,34317	2,59E-35
Air cond.	19268,8	1909,658	10,09018	4,72E-22
Recreation room	7395,032	2462,386	3,003198	0,002795
Basement	6187,162	1945,687	3,179937	0,001557
Lot size	5,433193	0,410367	13,23985	7,35E-35

Wage tariff (gross monthly earnings) example

	<i>Coeff.</i>	<i>Standard dev.</i>	<i>t stat.</i>	<i>P-value</i>
Intercept	159288,68	1823,60	87,35	0,00
Male	66853,52	3249,19	20,58	0,00

	<i>Coeff.</i>	<i>Standard dev.</i>	<i>t stat.</i>	<i>P-value</i>
Intercept	-296984,11	7674,03	-38,70	0,00
Male	24708,10	2547,18	9,70	0,00
Education	29187,63	482,57	60,48	0,00
Experience	3033,58	108,97	27,84	0,00

Summary

- Omitted variables
- Redundant variables
- Multicollinearity
- Binary regressors

Omitted variables, multicollinearity, binary regressors – introduction

Seminar 7

Omitted variables

- Bias due to omitted variables:
 - Estimation is not correct if we omit such a variable which is correlated with the included explanatory variables
- Include those variables which have explanatory power!
- But: redundant variables – estimation precision decreases
 - General practice: omit the insignificant ones

Omitted variables – example

Electricity firms (electric.xls), regression of total production cost, logarithmic form

- Coefficients of labor and capital unit cost are insignificant
 - Explanation? Small importance, small variance, ...
- How do the coefficients of output and fuel cost change if the other regressors are omitted?

Multicollinearity

- Some of the explanatory variables are strongly correlated
- The effects of the regressors are difficult to separate
- "Symptoms":
 - Low t-, high P-values
 - At the same time, R-squared is high
- Solution: omit some of the regressors – not always desirable!

Multicollinearity, example

Textbook example 6.3 (forest.xls)

Binary regressors

$$Y_i = \alpha + \beta_1 D_{i1} + \dots + \beta_k D_{ik} + e_i$$

- Number of groups: 2^k
- Group means: sum of respective coefficients
- Interpretation of coefficients: partial effect

Binary and continuous explanatory variables

- Only binary: different means
- Binary and not binary: different intercept
- Simplest model:

$$Y_i = \alpha + \beta_1 D_i + \beta_2 X_i + e_i$$

Intercept: α or $\alpha + \beta_1$

Example 1

Housing prices (hprice.xls)

- Explanatory variables: lot size, air conditioning, recreation room, basement
- Coefficient of lot size (sq. foot)? – Same for all subgroups!
- Coefficients of the binary variables?

Example 2

Earnings regression based on Wage tariff data

- Regressors: male, years of schooling (education), experience

$$\hat{W} = -296\,984 + 24\,708\text{male} + 29\,188\text{educ} + 3\,034\text{exp}$$

$$\hat{W} = 159\,289 + 66\,854\text{male}$$

- Explanation for different estimated coefficient?

Homework 4 (groups)

Estimation of a macroeconomic model (similar to the example in seminar 6) with current data.

Use a cross sectional sample of a group of countries. Analyze the GDP growth averaged over a selected period.

- Specify a multivariate regression model with brief reasoning.
- Estimate the model, interpret the coefficients, analyze their significance.
- Omit a significant variable. Analyze the effect of omission.