

Instrumental Variables

1 Introduction

This handout extends the handout on "The Multiple Linear Regression Model" and refers to its definitions and assumptions in section 2. It discusses the violation of the exogeneity assumption (OLS3), its consequences and the potential solution through the use of instrumental variables.

In many applications of the linear model, we suspect that some regressors are endogenous, i.e. the regressors are correlated with the error term, $cov(x_i, u_i) \neq 0$. In this situation, OLS cannot consistently estimate the causal effect of the regressor on the dependent variable.

Sometimes, we are able to find exogenous variables z_i which are correlated with the regressors in x_i but not correlated with the error term, i.e. $cov(z_i, u_i) = 0$. Such variables z_i are called *instruments*. If there are enough good such instrumental variables, we are able to estimate the causal effect of the regressor on the dependent variable.

2 Canonical Examples

2.1 Measurement Errors (Errors in Variables)

Consider the true regression model i)

$$y_i = x_{i1}\beta_1 + x_{i2}^*\beta_2 + u_i^*$$

which conforms the standard OLS assumptions. Suppose that the variable x_2^* is only observed with an error

$$x_{i2} = x_{i2}^* + v_i$$

where the error v is uncorrelated with x^* . The estimated regression model uses x_2 as a proxy for x_2^*

$$y_i = x_{i1}\beta_1 + x_{i2}\beta_2 + u_i$$

where $u_i = u_i^* - v_i\beta_2$. The regressor x_2 is therefore correlated with the error term u as both depend on v . Assuming independence between v and u^* , the covariance in the above example is $cov(x_2, u) = -\beta_2\sigma_v^2$.

2.2 Simultaneity and Reversed Causality

Consider the following system of equations

$$y_{i1} = z_{i1}'\beta_1 + y_{i2}\gamma_1 + u_{i1}$$

$$y_{i2} = z_{i2}'\beta_2 + y_{i1}\gamma_2 + u_{i2}$$

where we assume that both z_1 and z_2 are uncorrelated with both u_1 and u_2 . This system is called a *structural simultaneous equation system* since y_1 and y_2 are simultaneously determined. The regressor y_2 depends on y_1 through the second equation. As y_1 is directly dependent on u_1 , the regressor y_2 is also correlated with u_1 and hence endogenous in the first equation. Assuming that u_1 and u_2 are uncorrelated, $cov(y_{i2}, u_{i1}) = \gamma_2/(1 - \gamma_1\gamma_2)\sigma_{u_1}^2$. The above equation system is also described as *reversed causality* because the dependent variable y_1 has a feedback effect on the regressor y_2 .

In the above example z_2 and z_1 are straightforward instruments for IV estimation of the first and second equation, respectively.¹

¹Instead of estimating the single structural equations directly by IV it is possible to formulate and estimate a so-called *reduced form* of the above equation system. The RHS of the reduced form equations consists of exogenous variables only. If the system is *identified*, the parameters in the structural form can be deduced from the estimated parameters in the reduced form.

2.3 Omitted Variables

Consider the following regression model

$$y_i = x'_{i1}\beta_1 + x_{i2}\beta_2 + v_i$$

which conforms with standard OLS assumptions. Suppose that the variable x_2 is not observed. The estimated regression model is therefore

$$y_i = x'_{i1}\beta_1 + u_i$$

where $u_i = x_{i2}\beta_2 + v_i$. Regressors x_k in x_1 are therefore correlated with the error term u if they are correlated with the omitted variable x_2 . In case x_{i1} and x_{i2} are scalars, $cov(x_{ik}, u_i) = \beta_2 cov(x_{ik}, x_{i2})$.

3 The Econometric Model

Consider the multiple linear regression model for observations $i = 1, \dots, N$

$$y_i = x'_i\beta + u_i$$

where y_i is the dependent variable, x'_i is a row vector of $K+1$ explanatory variables including a constant, β is a $(K+1)$ -dimensional column vector of parameters, and u_i is the error term. Each observation is also described by a row vector z'_i of $L+1$ exogenous variables including a constant.

The variables x_{ik} which appear in x_i but not in z_i are called *endogenous regressors*, the ones that are included in z_i are called *exogenous regressors*. Additional variables in z_i which are not included in x_i are called the *instruments*. It is often useful to explicitly partition $x'_i = [x'_{i1} \ x'_{i2}]$ and $z'_i = [x'_{i1} \ z'_{i2}]$ into $K_1 + 1$ exogenous regressors in x_{i1} , K_2 endogenous regressors in x_{i2} and L_2 instruments in z_{i2} with $K+1 = K_1 + K_2 + 1$ and $L+1 = K_1 + L_2 + 1$.

The data generation process (dgp) is fully described by the following set of assumptions:

IV1: Linearity

$$y_i = x'_i\beta + u_i \text{ and } E(u_i) = 0$$

IV2: Independence

$$\{x_i, z_i, y_i\}_{i=1}^N \text{ i.i.d. (independent and identically distributed)}$$

IV2 means that regressors, instruments and dependent variables are independent across observations. In practice guaranteed by random sampling.

IV3: Exogeneity of Instruments

$$cov(z_i, u_i) = 0 \text{ (uncorrelated)}$$

IV3 means that the exogenous variables (exogenous regressors and instruments) are uncorrelated with the error term.

IV4: Instrument Relevance

$$Z'X \text{ and } E(z_i x'_i) = Q_{ZX} \text{ both have rank } K+1 \leq L+1 < N$$

IV4 requires that there at least as many instruments as endogenous regressors, $L_2 \geq K_2$, and that the correlation between Instruments and endogenous regressors is not zero.

IV5: Error Variance

- a) $V(u_i|z_i) = \sigma^2 < \infty$ (homoscedasticity)
- b) $V(u_i|z_i) = \sigma_i^2 = g(z_i) < \infty$ (conditional heteroscedasticity)

IV6: Instrument Variance

$$Z \text{ is full rank and } E(z_i z'_i) = Q_{ZZ} \text{ is positive definite and finite}$$

IV6 assumes that the instruments are not perfectly collinear, that all instruments (but the constant) have non-zero variance and not too many extreme values.

4 Estimation with OLS

The OLS estimator of β is biased since $E(u|X) \neq 0$ and inconsistent since $\text{plim} \frac{1}{N} X'u \neq 0$.

5 Estimation with IV (2SLS)

The instrumental variables estimator for β is

$$\begin{aligned}\hat{\beta}_{IV} &= (X'P_Z X)^{-1} X'P_Z y \\ &= (\hat{X}'X)^{-1} \hat{X}'y\end{aligned}$$

where $P_Z = Z(Z'Z)^{-1}Z'$ and $\hat{X} = P_Z X = Z(Z'Z)^{-1}Z'X$.

If the number of instruments is larger than the number of endogenous regressors, $L_2 > K_2$, the IV estimator is called *over-identified*. If the number of instruments equals the number of endogenous regressors, $L_2 = K_2$, the IV estimator is called *just-identified* and reduces to

$$\hat{\beta}_{IV} = (Z'X)^{-1} Z'y.$$

The IV estimator can always be reformulated as

$$\hat{\beta}_{IV} = (\hat{X}'\hat{X})^{-1} \hat{X}'y$$

since the matrix $P_Z = P_Z'P_Z$ is symmetric and idempotent. The $(k+1)$ -th column in \hat{X} are the predicted values \hat{x}_k from a regression of x_k on Z . The IV estimator can in principal be calculated by regressing each x_k on Z , calculating the predictions $\hat{x}_k = Z'(Z'Z)^{-1}Z'x_k$ for all k and then regressing y on $\hat{X} = [\hat{x}_1 \dots \hat{x}_K]$. The IV estimator is therefore also called *two-stage least squares* (2SLS).

6 Small Sample Properties of the IV Estimator

No small sample properties can be analytically established. The IV estimator is in general biased.

7 Asymptotic Properties of the IV Estimator

The following large sample properties can be established under assumptions *IV1* through *IV6*:

- The IV estimator is consistent:

$$\text{plim} \hat{\beta}_{IV} = \beta$$

- The IV estimator is asymptotically normally distributed:

$$\sqrt{N}(\hat{\beta}_{IV} - \beta) \xrightarrow{d} N(0, \Sigma)$$

where $\Sigma = [Q_{XZ}Q_{ZZ}^{-1}Q_{ZX}]^{-1}$ under *OLS5a* and $\Sigma = \dots$ under *OLS5b*.

- The IV estimator is therefore approximately normally distributed in large, but finite samples:

$$\hat{\beta}_{IV} \overset{A}{\sim} N(\beta, \text{Avar}(\hat{\beta}_{IV}))$$

where the asymptotic variance $\text{Avar}(\hat{\beta}) = N^{-1}\Sigma$ can be consistently estimated under *OLS5a* (homoscedasticity) as

$$\widehat{\text{Avar}}(\hat{\beta}_{IV}) = \hat{\sigma}^2 [X'Z(Z'Z)^{-1}Z'X]^{-1} = \hat{\sigma}^2 [\hat{X}'\hat{X}]^{-1}$$

with $\hat{\sigma}^2 = \hat{u}'\hat{u}/N$ and under *OLS5b* (heteroscedasticity) as the *robust* or *Eicker-White* estimator (see handout on “Heteroscedasticity in the linear Model”)

$$\widehat{\text{Avar}}(\hat{\beta}_{IV}) = [\hat{X}'\hat{X}]^{-1} \left[\sum_{i=1}^N \hat{u}_i^2 \hat{x}_i \hat{x}_i' \right] [\hat{X}'\hat{X}]^{-1}$$

with $\hat{u}_i = y_i - x_i'\hat{\beta}_{IV}$.

Note: The estimated asymptotic variance given in the usual output of the 2nd stage OLS regression is incorrect since $\hat{\sigma}^2$ will be based on $\hat{u} = y - \hat{X}\hat{\beta}_{IV}$ rather than $\hat{u} = y - X\hat{\beta}_{IV}$.

8 What are valid instruments

Valid instruments are uncorrelated with the error term (IV_3) but highly correlated with the endogenous regressors (IV_4). Such instruments may be derived from natural or random experiments (Angrist and Krueger 2001). In practice the two requirements are often conflicting as highly correlated instruments are usually difficult to defend as uncorrelated with the error term. The second requirement, instrument relevance, can be empirically tested in the first stage regression (see section 10) while the first requirement, instrument exogeneity, needs a strong theoretical argument and can in general not be tested (see section 9). This theoretical argument has to convincingly rule out any reverse effect of the dependent variable on the instrument as well as any direct effect of the instrument on the dependent variable. The latter is often called the *exclusion restriction*.

9 Testing for Exogeneity of the instruments

The exogeneity of the instruments (IV_3) can in general not be tested.

In case we have more instruments than necessary, $L > K$, we can perform a so-called J -test for *overidentifying restrictions*. This tests whether all instruments are exogenous *assuming* that a least one of the instruments is exogenous. The J -Test will therefore not necessarily detect a situation in which all instruments are endogenous.

10 Testing for Relevance of the instruments

Instruments with low correlation between the endogenous regressors are called *weak instruments*. There is empirical and theoretical evidence that IV estimation with weak instruments may perform bad and even poorer than OLS (surveyed in Stock, Wright and Yogo 2002).

The relevance of the instruments is tested in the first-stage regression.

As a rule of thumb, the F -statistic of a joint test whether all additional instruments (the variables in z_i which are not in x_i) are significant should be bigger than 10 in case of a one endogenous regressor. In case of a single instrument and a single endogenous regressor, this implies that the t -value for the instrument should be bigger than 3.2 or the corresponding p -value below 0.0016. This F -Test should always be reported when reporting IV estimates.

11 Testing for Exogeneity of the regressors

We may also want to know if there is an endogeneity problem in an application. This can be tested by a (Durbin-Wu-)Hausmann test if we have a set of valid instruments at hand. The test is performed by comparing $\hat{\beta}_{OLS}$ and $\hat{\beta}_{IV}$:

$$H = (\hat{\beta}_{IV} - \hat{\beta}_{OLS})' [\widehat{Avar}(\hat{\beta}_{IV}) - \widehat{Avar}(\hat{\beta}_{OLS})]^{-1} (\hat{\beta}_{IV} - \hat{\beta}_{OLS}) \stackrel{A}{\sim} \chi_J^2$$

where $J = K_2$ is the number of endogenous regressors (the variables which are part of X but not Z). The null hypothesis is that there are no endogeneous variables or that endogeneity does not affect the OLS estimator. Under H_0 , $\hat{\beta}_{OLS}$ is consistent and efficient and $\hat{\beta}_{IV}$ is consistent but inefficient; under H_A , $\hat{\beta}_{OLS}$ is inconsistent but $\hat{\beta}_{IV}$ remains consistent.

Note: This is a test for the exogeneity of the regressors x_i and not for the exogeneity of the instruments z_i . If the instruments are not valid, the Hausman test is not valid either. We can only perform this test if we already have the means to solve a potential endogeneity problem by instrumental variables.

12 Implementation in Stata 10.0

Stata calculates the IV (2SLS) estimator by the command

```
ivregress 2sls depvar [varlist1] (varlist2=varlist3)
```

where *varlist1* are exogeneous regressors (hence included in X and Z), *varlist2* are endogenous regressors (only included in X) and *varlist3* are additional exogenous variables (only included in Z). For example,

```
webuse hsng2
ivregress 2sls rent pcturban (hsngval = faminc reg2-reg4)
```

regresses median monthly rents (*rent*) of census divisions on the share of urban population (*pcturban*) and the median housing value (*hsngval*). Housing values are likely endogeneous and therefore instrumented by median family income (*faminc*) and 3 regional dummies.

The option `vce(robust)` reports the Eicker-Huber-White covariance estimator which is robust to heteroscedastic error terms. The option `first` requests that the first-stage regression results be displayed. First stage results are also provided by the postestimation command

```
estat firststage
```

which includes the F -statistic to assess weak instruments.

The Hausman test for exogeneity can be calculated by estimating OLS and IV and then comparing the estimates. For example,

```
regress rent pcturban hsngval
estimates store b_ols
ivregress 2sls rent pcturban (hsngval = faminc reg2-reg4), first
estimates store b_iv
hausman b_iv b_ols, constant sigmamore
```

Tests for overidentifying restrictions are reported with the postestimation command

```
estat overid
```

References

Introductory textbooks

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On IV and Measurement Errors

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On weak instruments

- Stock, J. H., J. H. Wright and M. Yogo (2002) A Survey of Weak Instruments and Weak Identification in Generalized Method of Moments, *Journal of Business and Economic Statistics*, 20(4), 518-29.