Mostly Dangerous Econometrics: How to do Model Selection with Inference in Mind

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- Focus discussion on the linear endogenous model

$$\underbrace{y_i}_{\text{outcome}} = \underbrace{d_i}_{\text{treatment}} \overbrace{\alpha}^{\text{effect}} + \underbrace{\sum_{j=1}^{p} x_{ij}\beta_j}_{\text{controls}} + \underbrace{\epsilon_i}_{\text{noise}}, \tag{1}$$

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- Controls can be richer as more features become available (Census characteristics, housing characteristics, geography, text data)

  $\Leftarrow$ "big" data
- Controls can contain transformation of "raw" controls in an effort to make models more flexible

  $\Leftarrow$ nonparametric series modeling, "machine learning"

Introduction

- This **forces** us to explicitly consider **model selection** to select controls that are "most relevant".
- Model selection techniques:
  - CLASSICAL: **t and F tests**
  - MODERN: **Lasso**, Regression Trees, Random Forests, Boosting

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- Model selection techniques:
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If you are using *any* of these MS techniques directly in (1), you are doing it *wrong.*

Have to do *additional selection* to make it right.

An Example: Effect of Institutions on the Wealth of Nations

- Acemoglu, Johnson, Robinson (2001)
- Impact of institutions on wealth

$$\underbrace{y_i}_{\text{log gdp per capita today}} = \underbrace{d_i}_{\text{quality of institutions}} \overbrace{\alpha}^{\text{effect}} + \underbrace{\sum_{j=1}^{p} x_{ij}\beta_j}_{\text{geography controls}} + \epsilon_i, \qquad (2)$$

- Instrument z_i: the early settler mortality (200 years ago)
- Sample size $n = 67$
- Specification of controls:
  - Basic: constant, latitude (p=2)
  - Flexible: + cubic spline in latitude, continent dummies (p=16)

Example: The Effect of Institutions

	Institutions	
	Effect	Std. Err.
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Potentially Dangerous. Very.

Analysis: things can go wrong even with $p = 1$

- Consider a very simple exogenous model

$$y_i = d_i\alpha + x_i\beta + \epsilon_i, \quad \mathbb{E}[\epsilon_i \mid d_i, x_i] = 0.$$

- Common practice is to do the following.

- **Post-single selection** procedure:

Step 1. Include x_i only if it is a significant predictor of y_i as judged by a conservative test (t-test, Lasso, etc.). Drop it otherwise.

Step 2. Refit the model after selection, use standard confidence intervals.

- This can **fail miserably**, if $|\beta|$ is close to zero but not equal to zero, formally if

$$|\beta| \propto 1/\sqrt{n}$$

What can go wrong? Distribution of $\sqrt{n}(\hat{\alpha} - \alpha)$ is not what you think

$$y_i = d_i\alpha + x_i\beta + \epsilon_i, \quad d_i = x_i\gamma + v_i$$

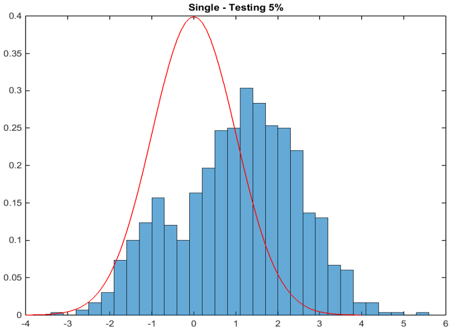
$$\alpha = \mathbf{0}, \quad \beta = \mathbf{.2}, \quad \gamma = .8,$$

$$n = 100$$

$$\epsilon_i \sim N(0,1)$$

$$(d_i, x_i) \sim N\left(0, \begin{bmatrix} 1 & .8 \\ .8 & 1 \end{bmatrix}\right)$$

- selection done by a **t-test**



Reject $H_0 : \alpha = 0$ (the truth) about 50% of the time (with nominal size of 5%)

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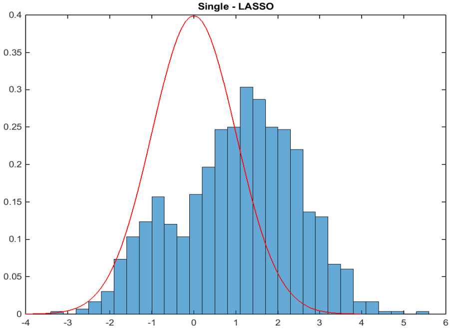
- selection done by **Lasso**



Reject $H_0 : \alpha = 0$ (the truth) of no effect about 50% of the time

Solutions?

Pseudo-solutions:

- **Practical:** bootstrap (does not work),
- **Classical:** assume the problem away by assuming that either $\beta = 0$ or $|\beta| \gg 0$,
- **Conservative:** don't do selection

Solution: Post-double selection

- **Post-double selection** procedure (BCH, 2010, ES World Congress, ReStud, 2013):

Step 1. Include x_j if it is a significant predictor of y_i as judged by a conservative test (t-test, Lasso etc).

Step 2. Include x_j if it is a significant predictor of d_i as judged by a conservative test (t-test, Lasso etc). [In the IV models must include x_j if it a significant predictor of z_i].

Step 3. Refit the model after selection, use standard confidence intervals.

Theorem (Belloni, Chernozhukov, Hansen: WC ES 2010, ReStud 2013)

DS works in low-dimensional setting and in high-dimensional approximately sparse settings.

Double Selection Works

$$y_i = d_i\alpha + x_i\beta + \epsilon_i, \quad d_i = x_i\gamma + v_i$$

$$\alpha = \mathbf{0}, \quad \beta = \mathbf{.2}, \quad \gamma = .8,$$

$$n = 100$$

$$\epsilon_i \sim N(0,1)$$

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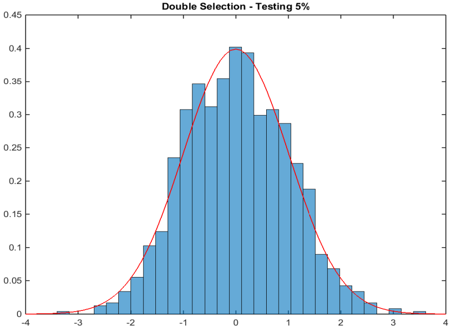
- **double selection** done by **t-tests**



Reject $H_0 : \alpha = 0$ (the truth) about 5% of the time (for nominal size = 5%)

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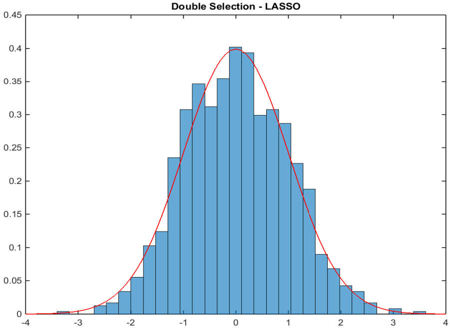
- **double selection** done by **Lasso**



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Intuition

- The **Double Selection** — the selection among the controls x_i that predict *either* d_i *or* y_i – creates this robustness. It finds controls whose omission would lead to a ”large” omitted variable bias, and includes them in the regression.
- In essence the procedure is a model selection version of Frisch-Waugh-Lovell partialling-put procedure for estimating linear regression.
- The double selection method is robust to moderate selection mistakes in the two selection steps.

More Intuition via OMVB Analysis

Think about omitted variables bias:

$$y_i = \alpha d_i + \beta x_i + \zeta_i \quad ; \quad d_i = \gamma x_i + v_i$$

If we drop x_i, the short regression of y_i on d_i gives

$$\sqrt{n}(\widehat{\alpha} - \alpha) = \text{good term} + \sqrt{n} \underbrace{(D'D/n)^{-1}(X'X/n)(\gamma\beta)}_{\text{OMVB}}.$$

- the good term is asymptotically normal, and we want
$$\sqrt{n}\gamma\beta \to 0.$$
- **single selection** can drop x_i only if $\beta = O(\sqrt{1/n})$, but
$$\sqrt{n}\gamma\sqrt{1/n} \not\to 0$$
- **double selection** can drop x_i only if *both* $\beta = O(\sqrt{1/n})$ and $\gamma = O(\sqrt{1/n})$, that is, if
$$\sqrt{n}\gamma\beta = O(1/\sqrt{n}) \to 0.$$

Example: The Effect of Institutions, Continued

Going back to Acemoglu, Johnson, Robinson (2001):

- **Double Selection:** include x_{ij}'s that are significant predictors of either y_i or d_i or z_i, as judged by Lasso. Drop otherwise.

	Intitutions	
	Effect	Std. Err.
Basic Controls	**.96****	0.21
Flexible Controls	**.98**	0.80
Double Selection	**.78****	0.19

Application: Effect of Abortion on Murder Rates in the U.S.

Estimate the consequences of abortion rates on crime in the U.S., Donohue and Levitt (2001)

$$y_{it} = \alpha d_{it} + x_{it}'\beta + \zeta_{it}$$

- $y_{it} =$ change in crime-rate in state i between t and $t-1$,
- $d_{it} =$ change in the (lagged) abortion rate,

1. $x_{it} =$ basic controls (time-varying confounding state-level factors, trends; p =20)
2. $x_{it} =$ flexible controls (basic $+$state initial conditions $+$ two-way interactions of all these variables)

- $p = 251$, $n = 576$

Effect of Abortion on Murder, continued

	Abortion on Murder	
Estimator	Effect	Std. Err.
Basic Controls	**-0.204****	0.068
Flexible Controls	-0.321	1.109
Single Selection	**- 0.202****	0.051
Double Selection	-0.166	0.216

- Double selection by Lasso: 8 controls selected, including state initial conditions and trends interacted with initial conditions

- This is sort of a negative result, unlike in AJR (2011)
- Double selection doest not always overturn results. Plenty of positive results confirming:
  - Barro and Lee's convergence results in cross-country growth rates;
  - Poterba et al results on positive impact of 401(k) on savings;
  - Acemoglu et al (2014) results on democracy causing growth;

High-Dimensional Prediction Problems

- Generic prediction problem

$$u_i = \sum_{j=1}^{p} x_{ij}\pi_j + \zeta_i, \quad \mathbb{E}[\zeta_i \mid x_i] = 0, \quad i = 1, \ldots, n,$$

  can have $p = p_n$ small, $p \propto n$, or even $p \gg n$.

- In the double selection procedure, u_i could be outcome y_i, treatment d_i, or instrument z_i. Need to find good predictors among x_{ij}'s.

- APPROXIMATE SPARSITY: after sorting, absolute values of coefficients decay fast enough:

$$|\pi|_{(j)} \leq Aj^{-a}, \quad a > 1, j = 1, ..., p = p_n, \forall n$$

- RESTRICTED ISOMETRY: small groups of $x_{ij}'s$ are not close to being collinear.

Selection of Predictors by Lasso

Assuming $x_{ij}'s$ normalized to have the second empirical moment to 1.

- Ideal (Akaike, Schwarz): minimize

$$\sum_{i=1}^{n}\left(u_i - \sum_{j=1}^{p} x_{ij} b_j\right)^2 + \lambda\left(\sum_{j=1}^{p} 1\{b_j \neq 0\}\right).$$

- Lasso (Bickel, Ritov, Tsybakov, Annals, 2009): minimize

$$\sum_{i=1}^{n}\left(u_i - \sum_{j=1}^{p} x_{ij} b_j\right)^2 + \lambda\left(\sum_{j=1}^{p} |b_j|\right), \quad \lambda = \sqrt{\mathbb{E}\zeta^2} 2\sqrt{2nlog(pn)}$$

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- Root Lasso (Belloni, Chernozhukov, Wang, Biometrika, 2011): minimize

$$\sqrt{\sum_{i=1}^{n}\left(u_i - \sum_{j=1}^{p} x_{ij} b_j\right)^2} + \lambda \left(\sum_{j=1}^{p} |b_j|\right), \quad \lambda = \sqrt{2n log(pn)}$$

Lasso provides high-quality model selection

Theorem (Belloni and Chernozhukov: Bernoulli, 2013, Annals, 2014)

Under approximate sparsity and restricted isometry conditions, Lasso and Root-Lasso find parsimonious models of approximately optimal size

$$s = n^{\frac{1}{2a}}.$$

Using these models, the OLS can approximate the regression functions at the nearly optimal rates in the root mean square error:

$$\sqrt{\frac{s}{n} log(pn)}$$

Double Selection in Approximately Sparse Regression

- Exogenous model

$$y_i = d_i\alpha + \sum_{j=1}^{p} x_{ij}\beta_j + \zeta_i, \quad \mathbb{E}[\zeta_i \mid d_i, x_i] = 0, \quad i = 1, \ldots, n,$$

$$d_i = \sum_{j=1}^{p} x_{ij}\gamma_j + \nu_i, \quad \mathbb{E}[\nu_i \mid x_i] = 0, \quad i = 1, \ldots, n,$$

can have p small, $p \propto n$, or even $p \gg n$.

- APPROXIMATE SPARSITY: after sorting absolute values of coefficients decay fast enough:

$$|\beta|_{(j)} \leq Aj^{-a}, \quad a > 1, \quad |\gamma|_{(j)} \leq Aj^{-a}, \quad a > 1.$$

- RESTRICTED ISOMETRY: small groups of $x_{ij}'s$ are not close to being collinear.

Double Selection Procedure

- **Post-double selection** procedure (BCH, 2010, ES World Congress, ReStud 2013):

Step 1. Include x_{ij}'s that are significant predictors of y_i as judged by LASSO or OTHER high-quality selection procedure.

Step 2. Include x_{ij}'s that are significant predictors of d_i as judged by LASSO or OTHER high-quality selection procedures.

Step 3. Refit the model by least squares after selection, use standard confidence intervals.

Uniform Validity of the Double Selection

Theorem (Belloni, Chernozhukov, Hansen: WC 2010, ReStud 2013)

Uniformly within a class of approximately sparse models with restricted isometry conditions

$$\sigma_n^{-1}\sqrt{n}(\check{\alpha} - \alpha_0) \to_d N(0, 1),$$

where σ_n^2 is conventional variance formula for least squares. Under homoscedasticity, semi-parametrically efficient.

- Model selection mistakes are asymptotically negligible due to double selection.
- Analogous result also holds for *endogenous* models, see Chernozhukov, Hansen, Spindler, *Annual Review of Economics*, 2015.

Monte Carlo Confirmation

- In this simulation we used: $p = 200, \ \ n = 100, \ \ \alpha_0 = .5$

$$y_i = d_i\alpha + x_i'\beta + \zeta_i, \ \ \zeta_i \sim N(0,1)$$

$$d_i = x_i'\gamma + v_i, \ \ v_i \sim N(0,1)$$

- **approximately sparse model:**

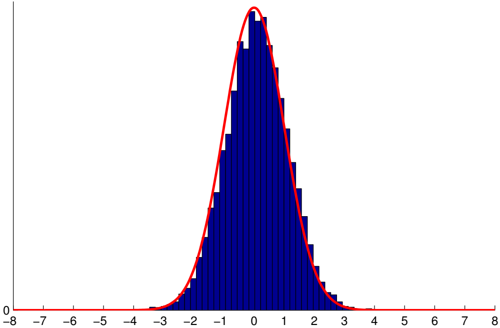
$$|\beta_j| \propto 1/j^2, |\gamma_j| \propto 1/j^2$$

- $R^2 = .5$ **in each equation**
- regressors are correlated Gaussians:

$$x \sim N(0,\Sigma), \ \ \Sigma_{kj} = (0.5)^{|j-k|}.$$

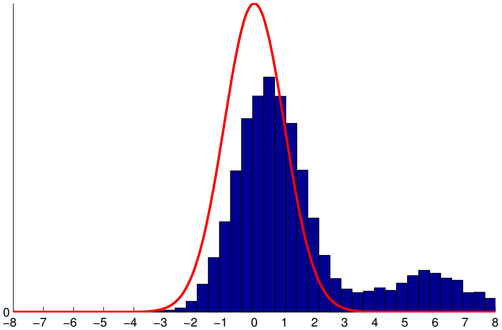
Distribution of Post Double Selection Estimator

$$p = 200, n = 100$$



Distribution of Post-Single Selection Estimator

$p = 200$ and $n = 100$



Generalization: Orthogonalized or "Doubly Robust" Moment Equations

- Goal:
  — inference on structural parameter α (e.g., elasticity)
  — having done Lasso & friends fitting of reduced forms $\eta(\cdot)$
- Use orthogonalization methods to remove biases. This often amounts to solving auxiliary prediction problems.
- In a nutshell, we want to set up moment conditions

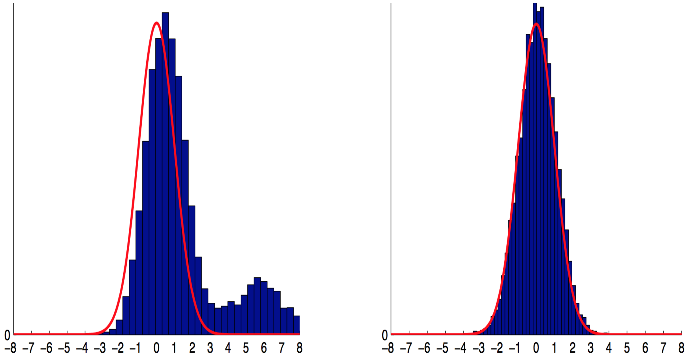
$$\mathbb{E}[g(\underbrace{W}_{\text{data}}, \underbrace{\alpha_0}_{\text{structural parameter}}, \underbrace{\eta_0}_{\text{reduced form}})] = 0$$

  such that the orthogonality conditions hold:

$$\partial_\eta \mathbb{E}[g(W, \alpha_0, \eta)]\Big|_{\eta=\eta_0} = 0$$

- See my website for papers on this.

Inference on Structural/Treatment Parameters



Without Orthogonalization

With Orhogonalization

Conclusion

- It is time to address model selection
- Mostly dangerous: naive (post-single) selection does not work
- Double selection works
- More generally, the key is to use orthogonolized moment conditions for inference