

# Bayesian Factor Model Shrinkage for Linear IV Regression With Many Instruments

P. Richard Hahn, Jingyu He & Hedibert Lopes

To cite this article: P. Richard Hahn, Jingyu He & Hedibert Lopes (2018) Bayesian Factor Model Shrinkage for Linear IV Regression With Many Instruments, Journal of Business & Economic Statistics, 36:2, 278-287, DOI: [10.1080/07350015.2016.1172968](https://doi.org/10.1080/07350015.2016.1172968)

To link to this article: <https://doi.org/10.1080/07350015.2016.1172968>



Accepted author version posted online: 11 Apr 2016.  
Published online: 28 Apr 2017.



Submit your article to this journal [↗](#)



Article views: 171



View related articles [↗](#)



View Crossmark data [↗](#)

# Bayesian Factor Model Shrinkage for Linear IV Regression With Many Instruments

**P. Richard HAHN**

Booth School of Business, University of Chicago, Chicago, IL ([richard.hahn@chicagobooth.edu](mailto:richard.hahn@chicagobooth.edu))

**Jingyu HE**

Department of Statistics, University of Chicago, Chicago, IL ([jingyuhe@uchicago.edu](mailto:jingyuhe@uchicago.edu))

**Hedibert LOPES**

INSPER—Institute of Education and Research ([hedibertfl@insper.edu.br](mailto:hedibertfl@insper.edu.br))

A Bayesian approach for the many instruments problem in linear instrumental variable models is presented. The new approach has two components. First, a slice sampler is developed, which leverages a decomposition of the likelihood function that is a Bayesian analogue to two-stage least squares. The new sampler permits nonconjugate shrinkage priors to be implemented easily and efficiently. The new computational approach permits a Bayesian analysis of problems that were previously infeasible due to computational demands that scaled poorly in the number of regressors. Second, a new predictor-dependent shrinkage prior is developed specifically for the many instruments setting. The prior is constructed based on a factor model decomposition of the matrix of observed instruments, allowing many instruments to be incorporated into the analysis in a robust way. Features of the new method are illustrated via a simulation study and three empirical examples.

**KEY WORDS:** Bayesian econometrics; Horseshoe prior; Instrumental variables; Slice sampler.

## 1. INTRODUCTION

Linear instrumental variable (IV) regression is a common method for calculating treatment effects for endogenous regressors. While a single valid instrument is theoretically sufficient to identify a treatment effect in this setting, one might hope to increase the precision of IV estimates by including additional instruments (both new instruments as well as interactions between, and nonlinear transformations of, existing instruments). This strategy, in conjunction with the increasing availability of high-dimensional data, has spurred recent interest in treatment effect estimation procedures which use a large number of instrumental variables. The need for special methods in this context is because the usual two-stage least squares (2SLS) estimator is recognized to have nonnegligible bias when the sample size is inadequate relative to the number of instruments (Bekker 1994; Newey and Smith 2004).

This article proposes a Bayesian model that is tailored to the many-instruments setting. First a factor model governing the covariation structure among the instrumental variables is inferred. Based on this structure, a shrinkage prior for the first-stage regression coefficients (the treatment variable as a function of the instruments) is developed, which favors the assumption that this common factor structure also predicts the treatment variable. The proposed model is similar in spirit to non-Bayesian methods which regularize the first stage regression (Chamberlain and Imbens 2004; Okui 2011; Carrasco 2012). The new approach differs from these earlier approaches in two ways. First, a factor-motivated shrinkage prior is used to impose the regularization. Second, the approach is fully Bayesian, so the first and second stage estimations mutually influence one another during joint estimation. This shared influence can be observed concretely in the form of the proposed slice sampler.

The body of literature on Bayesian IV is extensive and long-established. Seminal references include Lindley and El-Sayed (1968) and Dreze (1976). Other notable papers include Geweke (1996), Chao and Phillips (1998), and Lopes and Polson (2014). An excellent textbook treatments is Rossi, Allenby, and McCulloch (2006, chap. 7). Recent work has looked at variations on the typical Gaussian IV model, such as nonparametric error terms (Conley et al. 2008) and violated exclusion restrictions (Conley, Hansen, and Rossi 2012; Chan and Tobias 2014).

Despite this abundance of literature, most Bayesian IV research has not focused on the many instruments setting. Three notable exceptions are Chamberlain and Imbens (2004), Hahn and Hansen (2011), and Koop, Leon-Gonzalez, and Strachan (2012). Chamberlain and Imbens (2004) proposed a hierarchical model which serves to regularize the first-stage regression, while Hahn and Hansen (2011) revisited the problem of prior specification in the many instruments setting and develop a reparameterization that relates the use of diffuse priors to limited information maximum likelihood (LIML) methods. This article differs from these contributions in focusing on a class of informative, instrument-dependent, priors. Koop, Leon-Gonzalez, and Strachan (2012) considered instrument selection using variable selection priors, whereas the present approach focuses on shrinkage rather than on selection. Conceptually, the new approach presumes (with probability one) that all of the available instruments contribute to the first stage regression, whereas a variable selection approach puts nonzero probability

on the possibility that some candidate instruments are spurious (with exactly zero first-stage coefficients).

The proposed approach also provides an a priori bias that directions of shared covariation among the instruments are more likely to explain the observed treatment. As such, this article complements recent non-Bayesian work considering the use of factor models in the many instruments context (Groen and Kapetanios 2009; Ng and Bai 2009; Kapetanios and Marcellino 2010). The new approach differs from these earlier uses of factor models in two important respects. First, the bias is provided via a shrinkage prior, rather than via a direct dimension reduction step, bypassing a separate factor selection step. Second, the factor modeling ideas utilized here are based on a factor model that permits additive idiosyncratic errors, as distinct from factor models which simply rotate the instrument matrix (e.g., singular value decompositions). See Section 3.2 for further details on this distinction.

The rest of the article is organized as follows. Section 2 reviews the Bayesian IV model and presents a slice sampler for use with general shrinkage priors. Section 3 introduces the new factor shrinkage prior. Section 4 reports on simulation studies and Section 5 demonstrates the new method on empirical data.

## 2. “TWO-STAGE” BAYESIAN IV

This section describes a reparametrization of the usual Gaussian instrumental variables (IV) model. Building on this representation, a slice sampler is developed, which facilitates the use of nonconjugate shrinkage priors for the instrument coefficients.

### 2.1 A Reparameterization of Bayesian Linear IV

The starting point of Bayesian approaches to endogenous regressors is the structural equation model

$$\begin{aligned} y_i &= \beta x_i + \epsilon_{y_i} \\ x_i &= z_i' \delta + \epsilon_{x_i}, \end{aligned} \quad (1)$$

where  $(\epsilon_x, \epsilon_y)$  are jointly Gaussian with mean zero and covariance

$$\text{cov} \begin{pmatrix} \epsilon_x \\ \epsilon_y \end{pmatrix} := \mathbf{S} = \begin{pmatrix} \sigma_x^2 & \sigma_{xy} \\ \sigma_{yx} & \sigma_y^2 \end{pmatrix}.$$

The variable  $x_i$  is referred to as the treatment variable,  $y_i$  is the response variable and  $z_i$  is a vector of *instruments*. The unknown parameters in this model are  $\beta$ ,  $\delta$ ,  $\sigma_x^2$ ,  $\sigma_y^2$ , and  $\sigma_{xy} = \sigma_{yx}$ ; the parameter of interest is  $\beta$ . Because of the implied covariance between  $x_i$  and  $\epsilon_{y_i}$ , valid estimates of  $\beta$  cannot be obtained from just a regression of  $y_i$  onto  $x_i$ .

The joint distribution of the observables can be found by substitution

$$\begin{aligned} x_i &= z_i' \delta + \epsilon_{x_i}, \\ y_i &= z_i' \delta \beta + \beta \epsilon_{x_i} + \epsilon_{y_i}. \end{aligned} \quad (2)$$

A further reparameterization yields

$$\begin{aligned} x_i &= z_i' \delta + \nu_{x_i}, \\ y_i &= z_i' \delta \beta + \nu_{y_i}, \end{aligned} \quad (3)$$

with

$$\text{cov} \begin{pmatrix} \nu_x \\ \nu_y \end{pmatrix} = \mathbf{\Omega} = \mathbf{TST}' ,$$

where  $\mathbf{T} = \begin{pmatrix} 1 & 0 \\ \beta & 1 \end{pmatrix}$ .

Equation (3) is referred to as the “reduced form” equations, in contrast to (1), the “structural” equations.

The focus in this article will be on priors for  $\delta$  when the number of instruments  $p$  is large relative to the number of available observations  $n$ . Priors over the remaining parameters are determined by a factorization of the likelihood based on  $\epsilon_y | \epsilon_x \sim N(\alpha \epsilon_x, \xi^2)$ , where

$$\alpha = \frac{\sigma_y}{\sigma_x} \rho; \quad \xi^2 = (1 - \rho^2) \sigma_y^2, \quad (4)$$

with  $\rho \equiv \frac{\sigma_{xy}}{\sigma_x \sigma_y}$ . The matrix  $\mathbf{\Omega}$  can be written in terms of  $\beta$ ,  $\alpha$ ,  $\xi^2$ , and  $\sigma_x^2$ ,

$$\mathbf{\Omega} = \begin{pmatrix} \sigma_x^2 & (\beta + \alpha) \sigma_x^2 \\ (\beta + \alpha) \sigma_x^2 & (\beta + \alpha)^2 \sigma_x^2 + \xi^2 \end{pmatrix}, \quad (5)$$

which in turn corresponds to the following factorization of the joint likelihood over observables  $(x, y)$ :

$$\begin{aligned} f(x, y | z) &= f(y | x, z) f(x | z) \\ &= N_{y|x}(x\beta + \alpha(x - z'\delta), \xi^2) \\ &\quad \times N_x(z'\delta, \sigma_x^2). \end{aligned} \quad (6)$$

The appearance of  $\delta$  in both factors on the right-hand side means that observations of  $(y_i, z_i)$  allow one to disentangle  $\beta$  and  $\alpha$ . It is conceivable, of course, that in a given applied problem one instead has

$$\begin{aligned} f(x, y | z) &= f(y | x, z) f(x | z) \\ &= N_{y|x}(x\beta + \alpha(x - z'\delta), \xi^2) N_x(z'\delta^*, \sigma_x^2), \end{aligned} \quad (7)$$

with  $\delta^* \neq \delta$ . The assumption that  $\delta^* = \delta$  is referred to as the instrument exclusion restriction and in general is untestable. See Conley, Hansen, and Rossi (2012) and Chan and Tobias (2014) for approaches which weaken this assumption, yielding only partial identification of  $\beta$ . In this article, the exclusion restriction will be assumed.

### 2.2 A Slice Sampler for Bayesian IV With Arbitrary Shrinkage Priors

In this section, a computational strategy for sampling from Bayesian IV models is described. This strategy, which builds upon the elliptical slice sampler of Murray, Adams, and MacKay (2009), confers two advantages over standard approaches. First, the new strategy allows for jointly sampling the vector of coefficients in the IV model above, even when shrinkage priors are used for  $\delta$ . Common approaches for implementing shrinkage priors in Bayesian regression models employ a Gibbs sampling strategy that requires looping over each regression coefficient in turn (Carvalho, Polson, and Scott 2009). When the number of instruments is large, this Gibbs sampling approach is computationally demanding simply because every Monte Carlo iteration requires a length  $p$  loop over the variables. Second, the sampler

described here can be applied with arbitrary shrinkage priors, as long as the joint prior density over the coefficients can be evaluated. This property will allow us to incorporate factor structure into our prior relatively easily via a structured prior over  $\delta$  (see Section 3.1). By comparison, fitting a full Bayesian factor model typically requires drawing latent factor scores, an approach that scales poorly in the sample size,  $n$ . The slice sampler described below can be described in terms of sufficient statistics of the linear regression model, allowing large samples to be analyzed with no additional computational cost.

Murray, Adams, and MacKay (2009) developed an algorithm for sampling from posteriors proportional to  $f(\mathbf{y} | \delta)\pi(\delta)$  when  $\pi(\delta)$  is Gaussian; that is, they advertise their algorithm as applying to the case of arbitrary likelihood and Gaussian prior. In the present case, it is desired to sample from a posterior proportional to  $f(\mathbf{x} | \delta, \sigma_x^2)f(\mathbf{y} | \mathbf{x}, \delta, \alpha, \beta, \xi^2)\pi(\delta)$  where  $f(\mathbf{x} | \delta, \sigma_x^2)$  is a Gaussian *likelihood* (as described in the previous section). Letting  $\pi(\delta | \mathbf{x}, \mathbf{Z}, \sigma_x^2)$  denote the Gaussian posterior for  $\delta$  under a flat prior, and integrating  $\alpha, \beta$ , and  $\xi^2$  from the model a priori yields

$$\pi(\delta | \sigma_x^2, \mathbf{x}, \mathbf{y}, \mathbf{Z}) \propto \pi(\delta, \sigma_x^2 | \mathbf{x}, \mathbf{Z}) f(\mathbf{y} | \mathbf{x}, \mathbf{Z}, \delta)\pi(\delta), \quad (8)$$

for arbitrary  $\pi(\delta)$ . Therefore, one can directly apply the algorithm of Murray, Adams, and MacKay (2009), using  $\pi(\delta | \mathbf{x}, \mathbf{Z}, \sigma_x^2)$  in place of their Gaussian prior and using  $f(\mathbf{y} | \mathbf{x}, \mathbf{Z}, \delta)\pi(\delta)$  in place of their likelihood.

In this article, a normal-inverse-Gamma prior is used for  $(\alpha, \beta, \xi^2)$ , with prior mean  $E(\alpha) = E(\beta) = 0$ , covariance of  $\text{diag}((c_\beta^{-1}, c_\alpha^{-1})^t)$ , and Gamma shape parameter of  $s/2$  and scale parameter of  $\kappa/2$ . Define  $\tilde{x}_i := (x_i, x_i - z_i^t \delta)$ . Let  $\mathbf{M} = \text{diag}((c_\beta, c_\alpha)^t) + \tilde{\mathbf{x}}^t \tilde{\mathbf{x}}$ ,  $b = s + \mathbf{y}^t \mathbf{y} - \mathbf{y}^t \tilde{\mathbf{x}} \mathbf{M}^{-1} \tilde{\mathbf{x}}^t \mathbf{y}$ , and  $a = n + \kappa$ . Note that  $\tilde{\mathbf{x}}, \mathbf{M}, a$ , and  $b$  depend implicitly on  $\delta$ ; then  $f(\mathbf{y} | \mathbf{x}, \mathbf{Z}, \delta) \propto \det(\mathbf{M})^{-\frac{1}{2}} b^{-\frac{a}{2}}$ , which is the kernel of a multivariate  $t$ -distribution. For the time being, the algorithm is described in terms of a generic prior  $\pi(\delta)$ ; Section 3 describes the new factor shrinkage prior.

With these definitions, the slice sampler can be described as follows (for fixed  $\sigma_x^2$ ). Let  $\hat{\delta} = (\mathbf{Z}\mathbf{Z}^t)^{-1}\mathbf{Z}\mathbf{x}$  and for an initial value of  $\delta$ , define  $\Delta := \delta - \hat{\delta}$ .

#### *Elliptical slice sampler for Bayesian IV*

1. Draw  $\zeta \sim N(0, \sigma_x^2(\mathbf{Z}\mathbf{Z}^t)^{-1})$ .
2. For  $v \sim \text{Uniform}(0, 1)$  define  $\ell := \log(f(\mathbf{y} | \mathbf{x}, \mathbf{Z}, \delta)) + \log(\pi(\delta)) + \log(v)$ .
3. Draw angle  $\varphi \sim \text{Uniform}(0, 2\pi)$ ; set *lower*  $\leftarrow \varphi - 2\pi$  and *upper*  $\leftarrow \varphi$ .
4. Set  $\Delta' \leftarrow \Delta \cos \varphi + \zeta \sin \varphi$  and  $\delta' \leftarrow \hat{\delta} + \Delta'$ .
5. **while**  $\log(f(\mathbf{y} | \mathbf{x}, \mathbf{Z}, \delta')) + \log(\pi(\delta')) < \ell$ 
  - (a) **if**  $\varphi < 0$ , set *lower*  $\leftarrow \varphi$ , **else** set *upper*  $\leftarrow \varphi$ .
  - (b) Draw angle  $\varphi \sim \text{Uniform}(\text{lower}, \text{upper})$
  - (c) Update  $\Delta' \leftarrow \Delta \cos \varphi + \zeta \sin \varphi$  and  $\delta' \leftarrow \hat{\delta} + \Delta'$ .
6. Set  $\Delta \leftarrow \Delta'$  and  $\delta \leftarrow \hat{\delta} + \Delta'$ .

See Murray, Adams, and MacKay (2009) for a proof that this algorithm has the desired stationary distribution. Note that this sampler requires the ability to evaluate the (possibly unnormalized) prior density  $\pi(\delta)$ . Sampling the univariate parameter  $\sigma_x^2$  can be done in between taking samples of  $\delta$ , using either a conditionally conjugate inverse-gamma prior (which includes a flat

prior as a limiting case) or an arbitrary prior in conjunction with a Metropolis-Hastings step.

Finally, given samples of  $\delta$ , draw samples  $(\alpha, \beta, \xi^2)$  from  $\pi(\alpha, \beta, \xi^2 | \mathbf{x}, \mathbf{Z}, \mathbf{y}, \delta)$ , which is a conjugate Gaussian regression with predictor vector  $\tilde{\mathbf{x}}$ . More specifically, draw  $\xi^2$  from an inverse-Gamma distribution with shape parameter  $b/2$  and scale parameter  $a/2$ , then draw  $(\alpha, \beta)$  as a vector with mean  $\mathbf{M}^{-1}\tilde{\mathbf{x}}^t \mathbf{y}$  and covariance  $\xi^2 \mathbf{M}^{-1}$ .

### 3. A FACTOR-BASED SHRINKAGE PRIOR

If it were possible to extract latent factors governing the correlation structure in a vector of instruments, one might suppose that these factors would make “strong” instruments. This is simply the usual factor regression rationale, applied to the treatment equation in an instrumental variable analysis.

It is worth distinguishing how this factor regression prior assumption differs from a variable selection prior. Instead of presuming one has only a few good instruments among a whole batch of candidate instruments and that one simply does not know which ones they are, it is instead supposed that each available instrument may itself be weak, but that there exists a linear combination of them that is, taken together, much stronger. In this section, it is described how this intuition can be incorporated into a prior distribution over  $\delta$ .

To begin, suppose the covariance of the instruments decomposes as

$$\text{cov}(z_i) = \mathbf{B}\mathbf{B}^t + \Psi^2, \quad (9)$$

where  $\mathbf{B}$  is a  $p$ -by- $k$  matrix with and  $\Psi^2$  is diagonal with non-negative elements. Any covariance matrix admits such a decomposition, but present interest is in the case where  $k \ll p$ ; see the following section for additional details.

Next, consider the factor regression model

$$x_i = \theta \hat{f}_i + \varepsilon_i, \quad (10)$$

where  $\hat{f}_i = E(f_i | z_i, \mathbf{B}) = \mathbf{B}^t(\mathbf{B}\mathbf{B}^t + \Psi^2)^{-1}z_i = \mathbf{A}z_i$ . This expression follows by positing a joint Gaussian distribution between  $k$ -by-1 latent factors  $\mathbf{f}$  and instrument vector  $\mathbf{z}$ , with cross covariance  $\mathbf{B}$  and marginal covariance  $\text{cov}(\mathbf{f}) = \mathbf{I}_k$ . This model encodes the assumption that the conditional mean of  $\mathbf{x}$  lies in the same subspace as the directions of common covariation in  $\mathbf{z}$ . By substitution, it is seen that  $\delta$  can be written as  $\delta^t = \theta \mathbf{A}$ .

If  $\delta$  does not actually lie in the row space of  $\mathbf{A}$ , the model has a misspecified support, which can dramatically degrade inference. To accommodate this possibility, consider instead the overparameterized factor model

$$x_i = \theta \hat{f}_i + \eta \hat{r}_i + \varepsilon_i, \quad (11)$$

where  $\hat{r}_i = z_i - \mathbf{A}^\dagger \mathbf{A}z_i$  and  $\dagger$  denotes the Moore-Penrose pseudo-inverse of a matrix. Such models, referred to as “partial factor models” (Hahn, Carvalho, and Mukherjee 2013), entail that

$$\delta^t = \theta \mathbf{A} + \eta(\mathbf{I} - \mathbf{A}^\dagger \mathbf{A}). \quad (12)$$

With this formulation, a prior over  $\delta$  can be induced by placing priors over  $\tilde{\delta}^t \equiv (\theta, \eta)$ . More specifically, a strong shrinkage prior over the  $p+k$  regression coefficients comprising  $\tilde{\delta}$  embeds the prior bias that the derived factors  $\hat{f}_i$  are likely to play

a strong role in determining the conditional mean of the treatment. Meanwhile, the prior still gives  $\delta$  full support in  $\mathbb{R}^p$ ;  $\theta$  constitutes the part of  $\delta$  that lies in the row space of  $\mathbf{A}$ , while  $\eta$  constitutes the part lying in the corresponding orthogonal complement. Observe also that sparsity in the overparameterized  $\tilde{\delta}$  basis (in the sense of a few very large coefficients and many more nearly zero ones) does not in general result in a sparse  $\delta$  vector.

### 3.1 A Latent Variable Specification

One obvious approach to incorporating a bias toward factor structure would be to sample  $\tilde{\delta}$  directly. However, this approach proves to be inefficient precisely because  $\tilde{\delta}$  is unidentified; exploring the corresponding multimodal posterior can require many Monte Carlo iterations. Instead, one can leverage results from the theory of pseudoinverses to specify a prior that permits drawing posterior samples of  $\delta$  directly, while still imposing the sparsity penalty in the  $\tilde{\delta}$  partial factor representation.

First, note that  $\delta = \mathbf{H}\tilde{\delta}$ , where

$$\mathbf{H}^t = \begin{pmatrix} \mathbf{A} \\ \mathbf{I} - \mathbf{A}^t\mathbf{A} \end{pmatrix}.$$

Therefore, by the theory of pseudoinverses,  $\tilde{\delta} = \mathbf{H}^\dagger\delta + (\mathbf{I} - \mathbf{H}^\dagger\mathbf{H})\omega$  for any  $(p + k)$ -dimensional real vector  $\omega$ . Using this identity, conditional on  $\omega$ , it is possible to evaluate the density

$$\pi(\delta | \omega) = \prod_{j=1}^{p+k} \left\{ (2\pi)^{-\frac{3}{2}} \log \left( 1 + 4/\tilde{\delta}_j^2 \right) \right\}.$$

This choice of prior density in  $\tilde{\delta}$  space is motivated by an analytic approximation of the so-called horseshoe prior; see Carvalho, Polson, and Scott (2010) for details and operating characteristics of this prior. Figure 1 depicts this prior for a single coefficient. The specification is completed with independent standard normal priors over the elements of  $\omega$ , which is convenient, maintains the full support, and is demonstrated to work well in simulation studies.

However, observing that  $(\mathbf{I} - \mathbf{H}^\dagger\mathbf{H})$  has rank  $k$  and is idempotent, it follows that for  $\mathbf{U}\mathbf{U}^t = (\mathbf{I} - \mathbf{H}^\dagger\mathbf{H})$  with  $\mathbf{U}$  a  $(p + k)$ -by- $k$

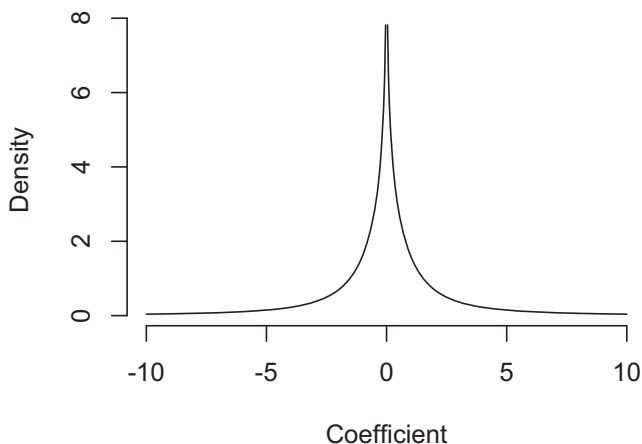


Figure 1. In the overparameterized space the individual coefficients have a prior with a pole at the origin and polynomial tails.

matrix, the prior may be specified via  $\tilde{\delta} = \mathbf{H}^\dagger\delta + \mathbf{U}w$ , where  $w$  is a  $k$  dimensional vector, also with a standard normal prior. Putting these pieces together, the factor shrinkage prior can be expressed as

$$\begin{aligned} \pi(\delta) &= \int \pi(\delta | w) \phi(w) dw, \\ &= h \int \prod_j \log \left( 1 + \frac{4}{\tilde{\delta}_j^2} \right) \phi(w) dw, \\ \tilde{\delta} &= \mathbf{H}^\dagger\delta + \mathbf{U}w, \end{aligned} \tag{13}$$

where  $h$  is a normalizing constant and  $\phi(\cdot)$  denotes the (multivariate, independent) standard normal density function. To implement this prior, one alternately samples from  $w$  and  $\delta$ , using the slice sampler previously described. Note that  $w$  appears in  $\pi(\delta | w)$  as a location parameter, and so does not appear in its normalizing constant (and vice-versa, interchanging the roles of  $\delta$  and  $w$ ), which allows the algorithm to proceed using only evaluations of  $\prod_j \log(1 + \frac{4}{\tilde{\delta}_j^2})$ . Finally, one may incorporate a global scale parameter  $v$ , with prior  $\pi(\delta | w, v) \propto v^{-p-k} \prod_j \log(1 + \frac{4}{(\tilde{\delta}_j/v)^2})$ , where  $v$  is sampled via a Metropolis-Hastings step.

In practice, of course,  $\mathbf{B}$  and  $\Psi^2$  are unknown and must be estimated in some fashion. Although a natural option would be to infer these parameters hierarchically, here plug-in point estimates are recommended. The reason to avoid a Bayesian model for the instrument vector is mainly computational; current factor model sampling algorithms scale poorly in  $n$ . Additionally, it is often the case that instruments are not continuous, which substantially complicates the factor modeling (Murray et al., 2013). The concrete form of the suggested empirical plug-in estimate of  $\mathbf{B}$  and  $\Psi$  is the topic of the next section.

### 3.2 The Frisch Decomposition

The notion of “shared factors” among vectors of measurements can be characterized in terms of an optimization problem motivated by the early work of Ragnar Frisch on “confluence analysis” (Frisch 1934). Specifically, given a covariance matrix  $\Sigma$ , consider the following rank minimization problem:

$$\begin{aligned} \min_{\mathbf{D}} \quad & \text{rank}(\Sigma - \mathbf{D}) \\ \text{s.t.} \quad & \mathbf{D} \text{ diagonal,} \\ & \Sigma - \mathbf{D} \geq 0. \end{aligned} \tag{14}$$

If  $\mathbf{D}^*$  is a solution to (14), denote a matrix pair  $(\Psi^2, \mathbf{B})$  a Frisch decomposition of  $\Sigma$ , if

$$\Psi^2 = \mathbf{D}^*; \quad \mathbf{B}\mathbf{B}^t = \Sigma - \mathbf{D}^*. \tag{15}$$

By assuming  $\Sigma$  known, this problem is nonstatistical in nature, yet it readily captures an intuition about what makes factor models appealing as descriptions of data. Factor models are popular not merely because they decompose covariance structure into a common component and an independent (diagonal) component, but because it is anticipated that this decomposition can be done parsimoniously. Indeed, any  $p$ -by- $p$  covariance matrix

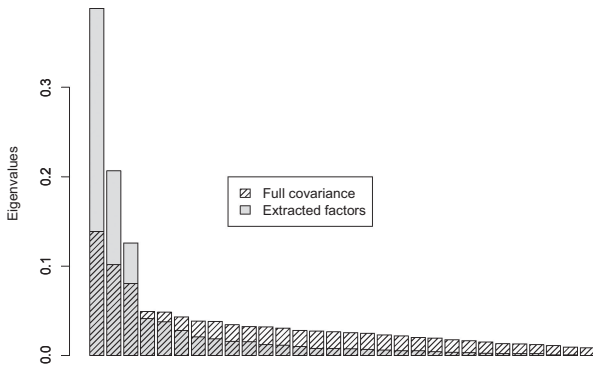


Figure 2. An illustration of how the eigenvalues of a full covariance matrix  $\Sigma$  can be flatter than the eigenvalues of the trace-heuristic derived loadings matrix  $\Sigma - \mathbf{D}^*$ . This occurs when  $\Sigma$  has an underlying factor structure with relatively large idiosyncratic variances.

has a  $p - 1$  dimensional factor representation (let  $\Psi^2 = \iota_p \mathbf{I}$  for  $\iota_p$  the smallest eigenvalue of the singular-value decomposition), whereas the Frisch decomposition demands that one find the most concise of all such descriptions.

Although solving (14) exactly is quite difficult, high quality approximations are available using a surrogate objective function based on the matrix trace (Fazel 2002):

$$\begin{aligned} \min_{\mathbf{D}} \quad & \text{trace}(\Sigma - \mathbf{D}) \\ \text{s.t.} \quad & \mathbf{D} \text{ diagonal,} \\ & \Sigma - \mathbf{D} \geq 0. \end{aligned} \quad (16)$$

The trace approximation is convex and can be routinely solved by readily available software (Grant and Boyd 2013, 2008). The specifics of this approximation are beyond the scope of this article; see Ning et al. (2015) for an excellent overview with many references. The trace approximation serves to extract a “sharper” set of eigenvectors, in the sense of having a more rapidly decaying set of eigenvalues, as seen in Figure 2, which overlays the eigenvalues of an example covariance matrix  $\Sigma$  and  $\Sigma - \mathbf{D}^*$ , where  $\mathbf{D}^*$  solves (16). In this sense, the trace heuristic still isolates “communalities.” Henceforth, whenever a Frisch decomposition is referred to, it is to be understood that it is computed approximately using the feasible trace formulation in (16).

With  $\mathbf{D}^*$  in hand, it remains to factor  $\Sigma - \mathbf{D}^* = \mathbf{B}\mathbf{B}'$ . Any factorization will do; here a routine singular value decomposition will be used. Note that many empirical factor models implicitly take  $\mathbf{D}$  to be the zero matrix.

Finally, note two additional details concerning the implemented Frisch decomposition. First, the solution to (14) is invariant to row and column scaling operations, while (16) is not. This observation has motivated weighted minimum trace approximations that attempt to define and compute an optimal weight matrix (Shapiro 1982; Ning et al. 2015). As a crude heuristic, the approach taken here is to solve (16) applied to the sample correlation matrix as opposed to the sample covariance matrix.

Similarly, because  $\Sigma$  is only known up to an empirical estimate, the actual rank of  $\mathbf{B}$  will tend not to be reduced, regardless

of whether there is true underlying factor structure or not. Accordingly,  $\mathbf{H}$  may be defined by approximating  $\mathbf{B}$  by its first few dominant eigenvectors. Various heuristics can be used based on inspection of the eigenvalues of  $\mathbf{B}$ . Our preferred heuristic, which is observed to work well empirically, is to truncate at the point of largest ratio between consecutive eigenvalues up to a prespecified maximum  $k_{\max} \ll p$ .

The choice of how to determine  $k$  can be thought of as a *definition* of the prior being used. The factor shrinkage prior is meant to encode the idea that directions of strong covariation among the instruments are likely to be good predictors of the treatment variable. Specifying a heuristic method for selecting  $k$  serves as a formalization of what it means to be a “strong direction of covariation.” At the same time, it is important to bear in mind that the implied prior for  $\delta$  still has full support, so “misspecification” of the prior in the sense of sub-optimally selecting  $k$  is not as damaging to posterior inferences as in the usual factor regression context.

#### 4. SIMULATION STUDY

Simulation studies reveal that, when exploitable factor structure is evident among the instruments, the factor shrinkage prior (FSP)—based on an approximate Frisch decomposition of an estimated covariance matrix—delivers more precise inferences than a model using a shrinkage prior on  $\delta$  that is not dependent on  $\mathbf{Z}$ . Despite using empirically estimated information about the factor structure, incorporating this information into the shrinkage prior yields better inferences concerning  $\delta$ , which translates to better inferences concerning the treatment effect coefficient,  $\beta$ —specifically, shorter posterior credible intervals (with comparable coverage rates) and smaller mean squared error.

Naturally, in any Bayesian simulation the performance is ultimately dictated by how closely the prior used to simulate the data matches the prior used in the model, which, at a high level, is an unilluminating finding. However, in the factor shrinkage model, the data-dependence adds an additional degree of freedom. The goal of the simulation study reported here is to describe the relationship between the instrument matrix and the underlying parameters and to understand in what situations the factor shrinkage model is anticipated to outperform a data-independent shrinkage prior.

First, in extensive simulation studies not reported here, it was determined that the qualitative behavior of the factor shrinkage prior mimics the behavior of the partial factor model described by Hahn, Carvalho, and Mukherjee (2013). That is, when there is strong factor structure, the factor shrinkage model performs on par with a factor model that explicitly models the instrument matrix (in terms of mean squared estimation error). When there is no strong factor structure, the factor shrinkage model performs on par with a direct shrinkage prior (canonically, the horseshoe prior of Carvalho, Polson, and Scott 2010). Modest deterioration is observed due to the empirical approximation, meaning that generally speaking the factor shrinkage prior performed somewhere in between the full factor model and the pure shrinkage prior in all regimes, usually closer to the better of the two. The purpose of the present investigation is to determine if this improved estimation translates to improved inferences regarding  $\beta$ .

There are two aspects to consider when it comes simulating factor structure. The first aspect is whether or not the instrument matrix exhibits strong patterns of correlation and whether or not that pattern can be expressed in Frisch form with  $k \ll p$ . The second aspect is whether or not the treatment variable depends on these same patterns of dependence exhibited by the instrument matrix. Here only the second issue is considered. For this simulation study it will be assumed that the matrix of instruments possesses factor structure, and the simulation study reports how the factor shrinkage model performs as one varies the strength of dependence between these factors and the treatment variable. The basic data-generating process is as follows. For  $n = 200$ ,  $p = 20$ , and  $k = 3$ ,

$$\begin{aligned} z_i &\sim N(0, \mathbf{B}\mathbf{B}' + \Psi^2), \\ x_i &= z_i' \delta + \sigma_x \epsilon_{x|z;i}, \\ y_i &= \beta \mathbf{x}_i + \alpha (\mathbf{x}_i - z_i' \delta) + \xi \epsilon_{y|z,x;i}, \end{aligned} \tag{17}$$

where all error terms (the  $\epsilon$ 's) are independent standard normal. Parameters  $\beta$  and  $\alpha$  are drawn independently from normal inverse-gamma distributions with precision parameters 1 and 1/2, respectively, and common shape parameters  $\kappa/2 = 16$  and scale parameter  $s/2 = 4$ .

In preliminary simulations, two conditions that confer an advantage to the factor shrinkage model were determined. First, the factor shrinkage model will *not* outperform a straight shrinkage prior if there is ample data to estimate  $\delta$  without the prior having any noticeable influence. In terms of model parameters, this means that  $\sigma_x$  and  $\xi$  cannot be too small, otherwise the problem is “easy” and the two priors (indeed, any sensible prior) will perform comparably. Second, there must be a sufficient sample size to estimate  $\Sigma$ , and hence  $\mathbf{B}$ , reasonably well. Although  $\Sigma$  is a  $p$ -by- $p$  matrix, the assumption of factor structure suggests that estimation is possible with fewer observations than if there were no factor structure because the “intrinsic dimension” is smaller than  $p$ , although some amount of regularization may be beneficial (Aswani, Bickel, and Tomlin 2011). Intuitively, the factor shrinkage model is most useful when (1) the prior matters and (2) the prior information used is good. Practically, this means that one should trust that  $\Sigma$  has been estimated reasonably well before proceeding with this prior. One case where this is sensible is when there are observations of  $z$ , without the associated  $x$  and  $y$  observations, that can improve estimation of  $\Sigma$  for the purpose of prior specification (a setting sometimes referred to as semisupervised learning (Belkin, Niyogi, and Sindhvani 2006)). In this simulation study these conditions are assured by generating  $\mathbf{B}$ ,  $\Psi^2$ ,  $\delta$ ,  $\sigma_x$  and  $\xi$  as follows.

- Each of the  $k$  columns of  $\mathbf{B}$  is drawn uniformly on the unit hypersphere. The columns of  $\mathbf{B}$  are not forced to be orthogonal.
- Each  $\psi_j$ ,  $j = 1, \dots, p$ , is drawn uniformly on  $[2, 4]$ . In words, the standard deviation of the idiosyncratic errors in each dimension of  $z_i$  are between two and four times as big as the “signal” due to the factor loadings in the corresponding row. This is important because if the factors associate too strongly with any single instrument, then that instrument alone will be sufficient to accurately estimate

Table 1. Simulation results based on 500 simulated datasets

a	ARIL	HS	FSP
		(RMSE, coverage)	(RMSE, coverage)
100%	87.0%	0.37, 91.6%	0.32, 91.0%
90%	89.6%	0.38, 91.4%	0.36, 91.0%
80%	91.5%	0.38, 90.8%	0.38, 88.2%
70%	94.3%	0.34, 93.4%	0.32, 91.4%
60%	95.8%	0.40, 88.6%	0.39, 88.4%
50%	97.3%	0.37, 87.4%	0.35, 88.6%

NOTE: The parameter  $a$  denotes what proportion of  $\|\delta\|_2^2$  is due to the part of  $\delta$  that lies in the factor regression subspace of  $z$ . A factor shrinkage prior (FSP) is compared to a straight shrinkage (“horseshoe,” HS) prior in terms of the average ratio of interval lengths (ARIL) for a nominal 90% credible interval, the corresponding coverage, and the root mean squared estimation error (RMSE).

the conditional expectation of the treatment and no benefit is gained from the factor prior.

- Define  $\mathbf{A} := \mathbf{B}'(\mathbf{B}\mathbf{B}' + \Psi^2)^{-1}$ ,  $\delta_f := \theta' \mathbf{A}$ , and  $\delta_{\bar{f}} := \eta(\mathbf{I} - \mathbf{A}\mathbf{A}')$ . Draw  $\theta$  ( $k$ -by-1) and  $\eta$  ( $p$ -by-1) independently from unit hyperspheres. Then

$$\delta = \sqrt{a} \delta_f + \sqrt{1-a} \delta_{\bar{f}}.$$

This construction decomposes  $\delta$  into a part in the factor space and a part in the orthogonal complement, with  $a$  defining the proportion of the total variance attributable to the factor component.

- Finally, to determine sensible noise levels, define  $d^2 := \delta'(\mathbf{B}\mathbf{B}' + \Psi^2)\delta$  and  $q^2 = (\beta^2(1 + s_x^2) + s_x^2 \alpha^2)d^2$ . These terms represent the variation in  $x$  attributable to  $z$  and the variation in  $y$  attributable to  $x$  and  $z$ , respectively. Then, define  $\sigma_x = s_x d$  and  $\xi = s_y q$ , so that  $s_x$  and  $s_y$  control the signal-to-noise ratio in the two regression equations. Here,  $s_x = s_y = 2$ .

We compare the factor shrinkage prior to a straight horseshoe prior. Priors over  $(\beta, \alpha)$  are the same for both models and are set to the true normal-inverse-gamma data-generating prior mentioned above. The simulation results, based on 500 simulated datasets at each value of  $a$ , are reported in Table 1. As expected, the model performs best (in the sense of having the smallest interval length ratio) when the data-generating process is a pure factor regression model ( $a = 100\%$ ). However, the factor shrinkage prior performs well even when  $a = 50\%$ , indicating that a full half of the treatment regression “signal” comes from outside the factor regression model.

## 5. EMPIRICAL APPLICATIONS

This section demonstrates the factor shrinkage prior (FSP) method on three empirical applications, which have all been studied in the previous literature. The goal in these demonstrations is not a thorough stand-alone economic analysis, but rather a direct comparison with previously reported results on a variety of datasets. Special attention is paid to computational hurdles encountered with each dataset.

Each of the three datasets has features which illustrate different aspects of the many instruments problem as it manifests in applied work. The first example is a relatively tractable ap-

plication, with 23 exogenous controls, 48 instruments and 2217 observations. The elasticity of inter-temporal substitution example, from Yogo (2004), is rather more difficult, with 59 instruments for a mere 114 observations (and no additional controls). This example uses instruments that are numerical (as opposed to categorical or dummy instruments). Finally, the returns to schooling example has 180 instruments as well as many controls (509), and over 300,000 observations. This dataset has many dummy instruments, and it is observed that the factor shrinkage method works as expected despite the fact that fitting a factor model to the instruments themselves is infeasible with such a large sample size (using currently available factor model sampling algorithms).

To aid in direct comparison with the earlier analysis, exogenous covariates are incorporated by “partialing them out” via an initial application of ordinary least squares to both the treatment and response equations, with the Bayesian model then being applied to the resulting residuals. It is described in an appendix how one could instead include the variables directly into the model; arguably such an approach is sounder from a Bayesian perspective.

In all cases, priors are specified in terms of standardized response and treatment variables and then transformed to the original scale by post-processing posterior samples.

## 5.1 Automobile Data

Berry, Levinsohn, and Pakes (1995) performed a detailed regression analysis to infer the demand for automobiles. Here the same data is used, although the reanalysis of Chernozhukov, Hansen, and Spindler (2015) is followed for comparison.

For reference, the model being fit is as in (A.1):  $f(x, y | z) = N_{y|x}(x\beta + \alpha(x - z'\delta_z - v'\delta_v), \xi^2)N_x(z'\delta + v'\gamma, \sigma_x^2)$ , for  $y_{ht} = \log(s_{ht}) - \log(s_{0t})$ , with  $s_{it}$  denoting the market share of product  $h$  in market  $t$  and product 0 denoting the “outside option.” (Note that the double subscripts, product  $h$  and market  $t$ , are immaterial once the response variable and instruments have been formed; the usual panel regression model is obtained by reindexing with single subscript  $i$ .)

The treatment variable  $x_{ht}$  is the corresponding product price and  $v_{ht}$  are additional product characteristics: air conditioning (AC), horsepower to weight ratio (HWR), miles per dollar (MPD), and vehicle size (VS). Following Berry, Levinsohn, and Pakes (1995), the instrument vector,  $z_{ht}$ , is constructed by calculating the following:

- the sum of each characteristic in  $v$ , taken across models made by product  $h$ 's firm,
- the sum of each characteristic in  $v$ , taken across competitor firms' products,
- the total number of models produced by product  $h$ 's firm, and
- the total number of models produced by the firm's competitors.

Thus, with four attributes included in  $v$ , there are a total of 10 basic instruments. Following Chernozhukov, Hansen, and Spindler (2015), the model is augmented with the covariate vector  $v$  to include a time trend and quadratic and cubic terms in

Table 2. Estimates of the elasticity of inter-temporal substitution using the direct regression ( $\psi := \beta$ ), by various methods: ordinary least squares (OLS), two-stage least squares (2SLS), Bayesian IV with factor shrinkage prior (FSP) or unmodified horseshoe prior (HS IV), and the boosted factor IV of Ng and Bai (2009), Table 7b (FIV<sub>b</sub>)

Method	$\hat{\beta}$	s.d.
OLS	0.12	0.05
2SLS (all)	0.12	0.07
HS IV (all)	0.10	0.07
2SLS (Yogo)	0.06	0.09
HS IV (Yogo)	0.05	0.09
FSP (2 factors)	0.08	0.07
FIV <sub>b</sub> (Ng and Bai)	0.09	0.06

NOTE: Yogo's original four instruments appear in all models. For all FSP and HS models, the hyper-parameters for  $(\beta, \alpha)$  are  $\kappa = 8$ ,  $s = 2$ ,  $c_\beta = 4$ , and  $c_\alpha = 1$ . All figures have been rounded to two decimal places for comparison.

all continuous characteristics (everything except AC, including the time trend), as well as all first-order interaction terms. This yields a total of 23 additional covariates. Using this expanded covariate vector, the instrument vector  $z$  is constructed according to the procedure described above, yielding 48 total instruments.

The most notable challenge of the automobile data is that the covariance matrix is nearly singular, so the inversion needed by the factor shrinkage prior is ill-defined. Accordingly, a preregularized covariance estimate is used, obtained using the `CondReg` package in R (Oh, Rajaratnam, and Won 2015) and determining the amount of regularization by cross-validation.

Using the largest ratio between consecutive eigenvalues less than  $k_{\max} = 10$  chooses 2 factors. With moderately informative values ( $\kappa = 8$ ,  $s = 2$ ,  $c_\beta = 4$ ,  $c_\alpha = 1$ ) one obtains a point estimate of  $\hat{\beta} = -0.275$  (with standard deviation of 0.018), which is somewhat larger in magnitude than the estimate of  $-0.22$  reported by Chernozhukov, Hansen, and Spindler (2015). Results are not sensitive to moderate variation in prior parameters.

## 5.2 The Elasticity of Intertemporal Substitution

Yogo (2004) considered estimating the elasticity of inter-temporal substitution (EIS) via a linearization of the Euler equation, using macroeconomic data and an instrumental variable analysis. Ng and Bai (2009) extended this analysis by incorporating many additional macro variables (detailed by Ludvigson and Ng (2007)) as instruments and consolidating them into factors using a boosting approach. This section mimics that analysis for comparative purposes, focusing on the 1970:3 to 1998:4 quarterly data for the United States ( $n = 114$ ). Of the 209 macrovariables used as instruments in Ng and Bai (2009), a subset of 78 are used here<sup>1</sup>. This number of instruments is then further reduced to 55 by dropping one of each pair of variables with correlation greater than 0.9, to lessen numerical instability due to extreme multicollinearity (many of these series are essen-

<sup>1</sup>A complete dataset was not readily available. For the purposes of illustration, the distinction between 78 instruments and 209 instruments is minor; having strictly fewer instruments than earlier analyses is not essential to the model interpretation and comparison in the way that having the same control variables is.



Table 3. Posterior mean estimates of  $\beta$  across a range of hyperparameter values

$c_\beta$	$c_\alpha$				
	0.1	1	2	5	10
0.1	0.073 (0.075)	0.082 (0.072)	0.074 (0.077)	0.074 (0.074)	0.087 (0.078)
1	0.070 (0.076)	0.075 (0.072)	0.073 (0.073)	0.073 (0.070)	0.086 (0.066)
2	0.059 (0.075)	0.079 (0.074)	0.066 (0.071)	0.073 (0.071)	0.086 (0.066)
5	0.062 (0.073)	0.062 (0.070)	0.065 (0.075)	0.074 (0.065)	0.076 (0.065)
10	0.061 (0.069)	0.074 (0.064)	0.058 (0.070)	0.066 (0.064)	0.075 (0.059)

Table 4. Posterior mean estimates of  $\alpha$  across a range of hyperparameter values

$c_\beta$	$c_\alpha$				
	0.1	1	2	5	10
0.1	0.101 (0.125)	0.093 (0.124)	0.105 (0.135)	0.098 (0.120)	0.065 (0.125)
1	0.106 (0.128)	0.100 (0.122)	0.104 (0.124)	0.101 (0.109)	0.075 (0.102)
2	0.131 (0.125)	0.087 (0.133)	0.117 (0.119)	0.096 (0.113)	0.069 (0.102)
5	0.121 (0.127)	0.125 (0.120)	0.111 (0.126)	0.091 (0.100)	0.088 (0.099)
10	0.122 (0.126)	0.097 (0.117)	0.122 (0.118)	0.102 (0.105)	0.086 (0.091)

tially identical). A representative subset of these macrovariables includes, for example, gross domestic purchases, fixed investment in durable equipment, assets abroad, and net exports<sup>2</sup>. Including Yogo’s original four instruments (twice lagged nominal interest rate, inflation, consumption growth, and log dividend-price ratio), the model uses 59 total instruments. Unlike the automobile data or the returns to schooling data in the next example, the analyses of Yogo (2004) and Ng and Bai (2009) do not include exogenous controls.

For reference, the model being fit is as in (6):  $f(x, y | z) = N_{y|x}(x\beta + \alpha(x - z'\delta), \xi^2)N_x(z'\delta, \sigma_x^2)$ , where  $y_i$  is the quarterly consumption growth (i.e., the change in consumption) in the United States,  $x_i$  is the real interest rate and  $\beta$  denotes the elasticity of intertemporal substitution (EIS). The instrument vector  $z_i$  consists of aforementioned macroeconomic indicators (twice lagged), in addition to the original instruments used by Yogo (2004): twice lagged nominal interest rate, inflation, consumption growth, and log dividend-price ratio. See Yogo (2004) section II for a theoretical justification of this model.

Table 2 compares the estimates and standard errors/posterior uncertainty for various estimation methods. Straight shrinkage regularization with the larger set of instruments gives an answer somewhat smaller (0.10) than the corresponding OLS estimate (0.12) with similar standard deviation (0.07). The factor shrinkage prior with prior  $\kappa = 8$ ,  $s = 2$ ,  $c_\beta = 4$ , and  $c_\alpha = 1$  gives a posterior mean that is smaller yet (0.08) with similar posterior

standard deviation (0.07). Note that the factor shrinkage result is only slightly smaller than the estimate of Ng and Bai (2009) (0.09), with a somewhat higher standard deviation (0.07 versus 0.06).

For these data, least squares regression gives an  $R^2$  of only about 0.05 (with  $p = 59$  and  $n = 114$ ) and a corresponding sensitivity to choice of prior is observed. Through extensive investigation it was ascertained that the dominant prior impact is determined by the relative size of  $c_\beta$  and  $c_\alpha$ ; these parameters govern the a priori decomposition of the reduced form coefficient ( $\alpha + \beta$ ) into its constituent (economically interpretable) pieces. Table 3 records how the posterior mean estimate changes as a function of  $c_\beta$  and  $c_\alpha$  (the prior precision parameters). Notice that across this wide range of prior parameter values, the posterior estimate of  $\beta$  varies between the original estimate of Yogo (2004) (0.06) and the factor selected estimate of Ng and Bai (2009) (0.09). For no prior values does the estimate get any closer to the 2SLS (and OLS) estimate of 0.12.

Tables 4 shows the corresponding table for  $\alpha$ . Table 5 shows the corresponding posterior mean of  $\alpha + \beta$ .

Notably, the Yogo data prove to be extremely computationally demanding, probably owing to multimodality in the posterior for  $\delta$ , which is a well-known result of fat-tailed priors used in conjunction with information-poor data. It took a staggering 50 million iterations before posterior mean estimates stabilized. The other two datasets did not require such heroic efforts, prob-

<sup>2</sup>It is a practically relevant question as to whether or not (lagged) macroeconomic indicators serve as valid instruments in the sense of satisfying the exclusion restriction. On the one hand, under a causal interpretation it seems reasonable to assert that past indicators should only relate to the present economy via the more recent indicators—a sort of Markov property. On the other hand, this narrative falls apart when one considers latent common causes that serve to induce dependence between today’s indicators, yesterday’s indicators, and today’s response variable. Such shared common causes clearly violate the desired exclusion restriction. That said, this possibility will not be discussed further here; rather, a narrow comparison is drawn with the results of Ng and Bai (2009), who assumed the validity of the macro indicators as instruments. As such, a detailed justification of these instruments is beyond the scope of the present illustration.

Table 5. Posterior mean estimates of  $\alpha + \beta$  across a range of hyperparameter values

$c_\beta$	$c_\alpha$				
	0.1	1	2	5	10
0.1	0.174	0.175	0.179	0.172	0.152
1	0.176	0.175	0.177	0.174	0.161
2	0.190	0.166	0.183	0.169	0.155
5	0.183	0.189	0.176	0.165	0.164
10	0.183	0.171	0.180	0.168	0.161

Table 6. A factor shrinkage analysis ( $k = 2$  factors) of the returns to schooling data produce estimates similar to those from other regularization methods for treatment effects. Table reproduced from Hansen and Kozbur (2014)

	2SLS	Post-LASSO	JIVE	RJIVE	FSP
	A. 3 instruments				
Schooling coefficient	0.1079	0.115	0.1091	0.1091	0.1098
Estimated standard error	0.0196	0.0205	0.0202	0.0202	0.0207
	B. 180 instruments				
Schooling coefficient	0.0928	0.1125	0.1096	0.1062	0.1107
Estimated standard error	0.0097	0.0173	0.0161	0.0157	0.0183
	C. 1527 instruments				
Schooling coefficient	0.0712	0.0862	0.0816	0.1067	0.0862
Estimated standard error	0.0049	0.0254	0.5168	0.0171	0.0066

ably due to larger sample sizes. So, while the slice sampler was fast enough to permit this amount of computation (about three hours), additional innovations in sampling such models is an open area of research.

### 5.3 Returns to Schooling Data

In this section, the well-known analysis of Angrist and Krueger (1991) is revisited, where the causal impact of schooling on wages was studied using data from the 1980 U.S. Census on 329,509 men born between 1930 and 1939. The analysis here closely follows that of Hansen and Kozbur (2014), who control for 509 variables, consisting of 9 year-of-birth indicators, 50 state-of-birth indicators, as well as the 450 interactions between them. For instruments, three quarter-of-birth indicators are used, as well as interactions with the 9 main effects for year-of-birth and 50 main effects for state-of-birth, for a total of 180 instruments. Further, one can use three quarter-of-birth dummies and their interactions with the full set of state-of-birth and year-of-birth controls to obtain a total of 1527 candidate instruments. For a detailed argument (based on compulsory schooling laws) regarding why quarter of birth serves as a valid instrument in this setting, please see the original thorough analysis of Angrist and Krueger (1991). Our response variable  $y_i = \log(\text{wage}_i)$  is the reported log wage of individual  $i$  and the treatment variable  $x_i$  is reported years of completed schooling for individual  $i$ .

In the 1527 instrument case, regularization was required to obtain a stable covariance estimate. Due to memory considerations the `glasso` package in R (Friedman, Hastie, and Tibshirani 2008) was used. The same maximum ratio-of-eigenvalues strategy as before was used to select the number of factors, which chooses  $k = 2$  (with  $k_{\max} = 100$ ).

Table 6 compares estimates for a range of different methods, reproducing a table from Hansen and Kozbur (2014) with a column added for the results of the factor shrinkage approach. Observe that the standard error reduction, relative to the basic three-instrument case, is modest to the point of being immaterial for every method except the factor shrinkage prior in the 1527 instrument analysis. However, this distinction is difficult to interpret given the conceptual differences between frequentist standard errors and Bayesian posterior credible intervals. Nonetheless, it means that a Bayesian would report with higher subjective precision by including the extra instruments, with a posterior standard deviation on the same order of magnitude as 2SLS (but a substantially higher posterior mean).

An interesting methodological question is how estimates from regularized methods behave as the number of instruments is increased. Specifically, it is observed that as more instruments are added, estimates from many estimators (including 2SLS) tend toward the OLS estimate. Therefore, it is interesting to see how regularization methods mitigate this recognized bias. Again, the results are equivocal in the sense that estimates lying between the three-instrument 2SLS estimate (0.1079) and the OLS estimate (0.0673) need not be incorrect. Hansen and Kozbur (2014) suggested informally that the stability of their RJIVE estimate as the number of instruments increases (at the three-instrument 2SLS estimate) is reassuring behavior, although this does not follow logically<sup>3</sup>. For example, there is not necessarily any reason to trust the RJIVE estimate (0.1067) more than the Post-LASSO estimate (0.0862). This comparison is relevant because the Bayesian estimate happens to line up with the Post-LASSO estimate in this instance and, from a Bayesian perspective, there is no special reason to find it suspect. Furthermore, if the three-instrument 2SLS is going to serve as a gold-standard, one might as well simply use that method exclusively, especially given that more elaborate methods do not appear to yield much increase in precision.

## 6. CONCLUSION

When many candidate instruments are available—including polynomial expansions and interactions of existing instruments—judicious regularization of the first-stage regression is a crucial component of a well-behaved IV estimator. This article proposes a Bayesian model built on the assumption that the treatment variable is more likely to depend on the commonalities of the instrument matrix than on the idiosyncrasies. Analysis on synthetic data reveals that the new prior performs according to intuition: when factor structure predictive of the treatment is apparent in the matrix of instruments, this concordance with the prior yields tighter inference concerning the treatment effect of

<sup>3</sup>To quote Hansen and Kozbur (2014): “The results reported in Panel C of Table 3 are based on using the full set of 1527 instruments and are the most interesting from the standpoint of the present article. In this case, both the Post-LASSO and JIVE point estimates have shifted substantively toward the OLS estimate. In contrast, the RJIVE is very stable, remaining around the value estimated by all of the procedures using only three instruments. More interesting is the fact that standard errors from both JIVE and Post-LASSO are now pronouncedly larger than the standard error from the RJIVE.”

interest. The new prior can be used even when the instruments are not jointly Gaussian, such as many binary instruments. Finally, the slice sampling approach described here allows us to try various shrinkage priors easily and allows fitting large datasets, both in terms of the sample size  $n$  and the number of instruments  $p$ .

## APPENDIX A: INCORPORATING EXOGENOUS COVARIATES

In many applied problems, in addition to the instrumental variables, one has available exogenous control covariates. In fact, the validity of the instruments often depends on incorporating a sufficiently rich set of control variables. Fortunately, the described slice sampling approach is easily modified to accommodate this possibility. Letting  $\mathbf{v}_i$  denote the vector of control variables

$$\begin{aligned} f(x, y | z) &= f(y | x, z) f(x | z) \\ &= N_{y|x} (x\beta + \alpha (x - z'\delta_z - \mathbf{v}'\delta_v) + \boldsymbol{\gamma}\mathbf{v}_i, \xi^2) \\ &\quad \times N_x (z'\delta_z + \mathbf{v}'\delta_v, \sigma_x^2). \end{aligned} \quad (\text{A.1})$$

Using this model, our sampler works as before, by drawing samples of  $\delta' = (\delta_z', \delta_v')$  based on  $\pi(\delta, \sigma_x^2 | \mathbf{x}, \mathbf{Z}, \mathbf{V})$  with  $\tilde{\mathbf{x}}_i := (x_i, x_i - z_i'\delta_z - \mathbf{v}_i'\delta_v, \mathbf{v}_i)$ .

Note that by incorporating  $\mathbf{v}_i$ ,  $\mathbf{M}$  is enlarged to be  $p_v + 2$  square, where  $p_v$  is the number of exogenous covariates. While this requires additional computation, evaluating  $\mathbf{M}$ ,  $\mathbf{M}^{-1}$ , and  $\det(\mathbf{M})$  can be done relatively efficiently using block matrix algebra, taking advantage of the fact that for each first-stage sample  $\delta$ ,  $\tilde{\mathbf{x}}_i$  only differs in a single entry.

## ACKNOWLEDGMENTS

The first author thanks the Booth School of Business for supporting this research.

[Received August 2014. Revised March 2016.]

## REFERENCES

- Angrist, J. D., and Krueger, A. B. (1991), "Does Compulsory School Attendance Affect Schooling and Earnings?" *Quarterly Journal of Economics*, 106, 979–1014. [286]
- Aswani, A., Bickel, P., and Tomlin, C. (2011), "Regression on Manifolds: Estimation of the Exterior Derivative," *The Annals of Statistics*, 39, 48–81. [283]
- Bekker, P. A. (1994), "Alternative Approximations to the Distributions of Instrumental Variable Estimators," *Econometrica: Journal of the Econometric Society*, 62, 657–681. [278]
- Belkin, M., Niyogi, P., and Sindhwani, V. (2006), "Manifold Regularization: A Geometric Framework for Learning From Labeled and Unlabeled Examples," *The Journal of Machine Learning Research*, 7, 2399–2434. [283]
- Berry, S., Levinsohn, J., and Pakes, A. (1995), "Automobile Prices in Market Equilibrium," *Econometrica: Journal of the Econometric Society*, 63, 841–890. [284]
- Carrasco, M. (2012), "A Regularization Approach to the Many Instruments Problem," *Journal of Econometrics*, 170, 383–398. [278]
- Carvalho, C. M., Polson, N. G., and Scott, J. G. (2009), "Handling Sparsity via the Horseshoe," in *International Conference on Artificial Intelligence and Statistics*, pp. 73–80. [279]
- Carvalho, C., Polson, N., and Scott, J. (2010), "The Horseshoe Estimator for Sparse Signals," *Biometrika*, 97, 465–480. [281,282]
- Chamberlain, G., and Imbens, G. (2004), "Random Effects Estimators With Many Instrumental Variables," *Econometrica*, 72, 295–306. [278]
- Chan, J., and Tobias, J. (2014), "Priors and Posterior Computation in Linear Endogenous Variable Models With Imperfect Instruments," *Journal of Applied Econometrics*, 30, 650–674. [278,279]
- Chao, J. C., and Phillips, P. C. (1998), "Posterior Distributions in Limited Information Analysis of the Simultaneous Equations Model Using the Jeffreys Prior," *Journal of Econometrics*, 87, 49–86. [278]
- Chernozhukov, V., Hansen, C., and Spindler, M. (2015), "Post-Selection and Post-Regularization Inference in Linear Models With Many Controls and Instruments," *American Economic Review*, 105, 486–90. [284]
- Conley, T. G., Hansen, C. B., McCulloch, R. E., and Rossi, P. E. (2008), "A Semi-Parametric Bayesian Approach to the Instrumental Variable Problem," *Journal of Econometrics*, 144, 276–305. [278]
- Conley, T. G., Hansen, C. B., and Rossi, P. E. (2012), "Plausibly Exogenous," *Review of Economics and Statistics*, 94, 260–272. [278,279]
- Dreze, J. H. (1976), "Bayesian Limited Information Analysis of the Simultaneous Equations Model," *Econometrica: Journal of the Econometric Society*, 1045–1075. [278]
- Fazel, M. (2002), *Matrix Rank Minimization With Applications*, PhD dissertation, Stanford University, Department of Electric Engineering. [282]
- Friedman, J., Hastie, T., and Tibshirani, R. (2008), "Sparse Inverse Covariance Estimation With the Graphical Lasso," *Biostatistics*, 9, 432–441. [286]
- Frisch, R. (1934), "Statistical Confluence Analysis by Means of Complete Regression Systems," Technical Report 5, University of Oslo, Economic Institute. [281]
- Geweke, J. (1996), "Bayesian Reduced Rank Regression in Econometrics," *Journal of Econometrics*, 75, 121–146. [278]
- Grant, M., and Boyd, S. (2008), "Graph Implementations for Nonsmooth Convex Programs," in *Recent Advances in Learning and Control*, eds. V. Blondel, S. Boyd, and H. Kimura, Lecture Notes in Control and Information Sciences, Springer-Verlag Limited, pp. 95–110. [282]
- Grant, M., and Boyd, S. (2013), "CVX: Matlab Software for Disciplined Convex Programming, version 2.0 Beta," available at <http://cvxr.com/cvx>. [282]
- Groen, J. J., and Kapetanios, G. (2009), "Parsimonious Estimation With Many Instruments," *Federal Reserve Bank of New York, Staff Report*, (386). [279]
- Hahn, P., Carvalho, C. M., and Mukherjee, S. (2013), "Partial Factor Modeling: Predictor-dependent Shrinkage for Linear Regression," *Journal of the American Statistical Association*, 108, 999–1008. [280,282]
- Hahn, J., and Hansen, K. (2011), "Parameter Orthogonalization and Bayesian Inference With Many Instruments," *Economics Letters*, 112, 207–209. [278]
- Hansen, C., and Kozbur, D. (2014), "Instrumental Variables Estimation With Many Weak Instruments Using Regularized JIVE," *Journal of Econometrics*, 182, 290–308. [286]
- Kapetanios, G., and Marcellino, M. (2010), "Factor-GMM Estimation With Large Sets of Possibly Weak Instruments," *Computational Statistics & Data Analysis*, 54, 2655–2675. [279]
- Koop, G., Leon-Gonzalez, R., and Strachan, R. (2012), "Bayesian Model Averaging in the Instrumental Variable Regression Model," *Journal of Econometrics*, 171, 237–250. [278]
- Lindley, D., and El-Sayed, G. (1968), "The Bayesian Estimation of a Linear Functional Relationship," *Journal of the Royal Statistical Society, Series B*, 30, 190–202. [278]
- Lopes, H. F., and Polson, N. G. (2014), "Bayesian Instrumental Variables: Priors and Likelihoods," *Econometric Reviews*, 33, 100–121. [278]
- Ludvigson, S. C., and Ng, S. (2007), "The Empirical Risk–Return Relation: A Factor Analysis Approach," *Journal of Financial Economics*, 83, 171–222. [284]
- Murray, I., Adams, R. P., and MacKay, D. J. (2009), "Elliptical Slice Sampling," *arXiv preprint arXiv:1001.0175*. [279,280]
- Murray, J. S., Dunson, D. B., Carin, L., and Lucas, J. E. (2013), "Bayesian Gaussian Copula Factor Models for Mixed Data," *Journal of the American Statistical Association*, 108, 656–665. [281]
- Newey, W. K., and Smith, R. J. (2004), "Higher Order Properties of GMM and Generalized Empirical Likelihood Estimators," *Econometrica*, 72, 219–255. [278]
- Ng, S., and Bai, J. (2009), "Selecting Instrumental Variables in a Data Rich Environment," *Journal of Time Series Econometrics*, 1. Available at <http://www.columbia.edu/~sn2294/pub/jtse-08.pdf> [279,285]
- Ning, L., Georgiou, T. T., Tannenbaum, A., and Boyd, S. P. (2015), "Linear Models Based on Noisy Data and the Frisch Scheme," *SIAM Review*, 57, 167–197. [282]
- Oh, S.-Y., Rajaratnam, B., and Won, J.-H. (2015), "On the Solution Path of Regularized Covariance Estimators," *arXiv preprint arXiv:1502.00471*. [284]
- Okui, R. (2011), "Instrumental Variable Estimation in the Presence of Many Moment Conditions," *Journal of Econometrics*, 165, 70–86. [278]
- Rossi, P. E., Allenby, G. M., and McCulloch, R. (2006), *Bayesian Statistics and Marketing*, Series in Probability and Statistics, New York: Wiley. [278]
- Shapiro, A. (1982), "Weighted Minimum Trace Factor Analysis," *Psychometrika*, 47, 243–264. [282]
- Yogo, M. (2004), "Estimating the Elasticity of Intertemporal Substitution When Instruments are Weak," *Review of Economics and Statistics*, 86, 797–810. [284,285]