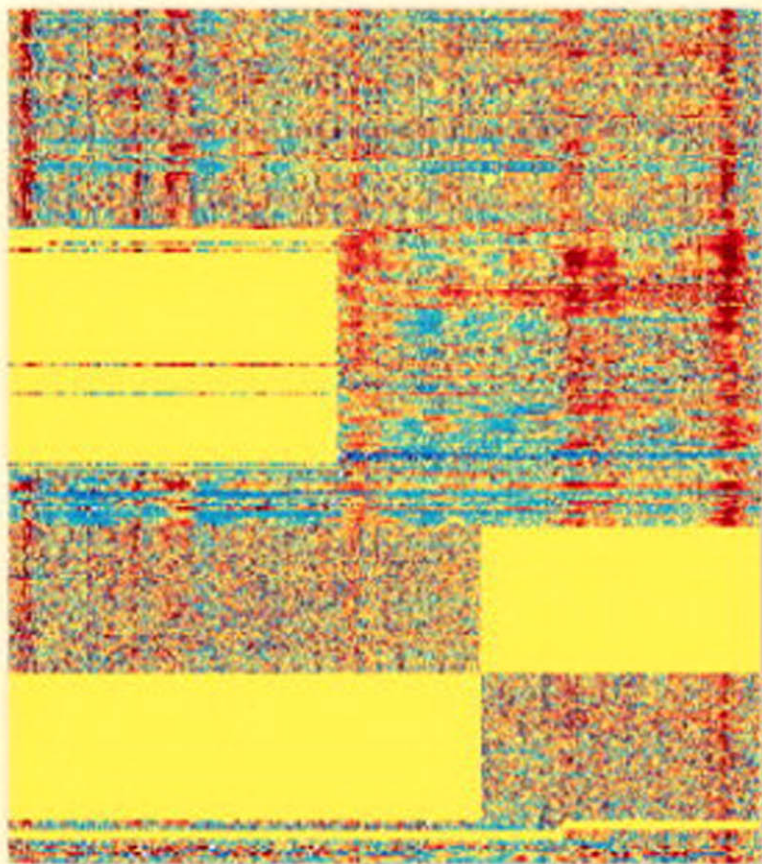


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INTRODUCTION TO ECONOMETRICS

THIRD EDITION



James H. Stock
Mark W. Watson

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THIRD EDITION UPDATE

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Brief Contents

PART ONE Introduction and Review

CHAPTER 1 Economic Questions and Data 1

CHAPTER 2 Review of Probability 14

CHAPTER 3 Review of Statistics 65

PART TWO Fundamentals of Regression Analysis

CHAPTER 4 Linear Regression with One Regressor 109

CHAPTER 5 Regression with a Single Regressor: Hypothesis Tests and Confidence Intervals 146

CHAPTER 6 Linear Regression with Multiple Regressors 182

CHAPTER 7 Hypothesis Tests and Confidence Intervals in Multiple Regression 217

CHAPTER 8 Nonlinear Regression Functions 256

CHAPTER 9 Assessing Studies Based on Multiple Regression 315

PART THREE Further Topics in Regression Analysis

CHAPTER 10 Regression with Panel Data 350

CHAPTER 11 Regression with a Binary Dependent Variable 385

CHAPTER 12 Instrumental Variables Regression 424

CHAPTER 13 Experiments and Quasi-Experiments 475

PART FOUR Regression Analysis of Economic Time Series Data

CHAPTER 14 Introduction to Time Series Regression and Forecasting 522

CHAPTER 15 Estimation of Dynamic Causal Effects 589

CHAPTER 16 Additional Topics in Time Series Regression 638

PART FIVE The Econometric Theory of Regression Analysis

CHAPTER 17 The Theory of Linear Regression with One Regressor 676

CHAPTER 18 The Theory of Multiple Regression 705

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Contents

Preface xxix

PART ONE Introduction and Review

CHAPTER 1 Economic Questions and Data 1

- 1.1 Economic Questions We Examine 1
 - Question #1: Does Reducing Class Size Improve Elementary School Education? 2
 - Question #2: Is There Racial Discrimination in the Market for Home Loans? 3
 - Question #3: How Much Do Cigarette Taxes Reduce Smoking? 3
 - Question #4: By How Much Will U.S. GDP Grow Next Year? 4
 - Quantitative Questions, Quantitative Answers 5
- 1.2 Causal Effects and Idealized Experiments 5
 - Estimation of Causal Effects 6
 - Forecasting and Causality 7
- 1.3 Data: Sources and Types 7
 - Experimental Versus Observational Data 7
 - Cross-Sectional Data 8
 - Time Series Data 9
 - Panel Data 11

CHAPTER 2 Review of Probability 14

- 2.1 Random Variables and Probability Distributions 15
 - Probabilities, the Sample Space, and Random Variables 15
 - Probability Distribution of a Discrete Random Variable 16
 - Probability Distribution of a Continuous Random Variable 19
- 2.2 Expected Values, Mean, and Variance 19
 - The Expected Value of a Random Variable 19
 - The Standard Deviation and Variance 21
 - Mean and Variance of a Linear Function of a Random Variable 22
 - Other Measures of the Shape of a Distribution 23
- 2.3 Two Random Variables 26
 - Joint and Marginal Distributions 26

	Conditional Distributions	27
	Independence	31
	Covariance and Correlation	31
	The Mean and Variance of Sums of Random Variables	32
2.4	The Normal, Chi-Squared, Student t , and F Distributions	36
	The Normal Distribution	36
	The Chi-Squared Distribution	41
	The Student t Distribution	41
	The F Distribution	42
2.5	Random Sampling and the Distribution of the Sample Average	43
	Random Sampling	43
	The Sampling Distribution of the Sample Average	44
2.6	Large-Sample Approximations to Sampling Distributions	47
	The Law of Large Numbers and Consistency	48
	The Central Limit Theorem	50
	APPENDIX 2.1 Derivation of Results in Key Concept 2.3	63

CHAPTER 3 Review of Statistics 65

3.1	Estimation of the Population Mean	66
	Estimators and Their Properties	66
	Properties of \bar{Y}	68
	The Importance of Random Sampling	70
3.2	Hypothesis Tests Concerning the Population Mean	71
	Null and Alternative Hypotheses	71
	The p -Value	72
	Calculating the p -Value When σ_Y Is Known	73
	The Sample Variance, Sample Standard Deviation, and Standard Error	74
	Calculating the p -Value When σ_Y Is Unknown	76
	The t -Statistic	76
	Hypothesis Testing with a Prespecified Significance Level	77
	One-Sided Alternatives	79
3.3	Confidence Intervals for the Population Mean	80
3.4	Comparing Means from Different Populations	82
	Hypothesis Tests for the Difference Between Two Means	82
	Confidence Intervals for the Difference Between Two Population Means	84

- 3.5 Differences-of-Means Estimation of Causal Effects Using Experimental Data 84
 - The Causal Effect as a Difference of Conditional Expectations 85
 - Estimation of the Causal Effect Using Differences of Means 85
- 3.6 Using the t -Statistic When the Sample Size Is Small 87
 - The t -Statistic and the Student t Distribution 87
 - Use of the Student t Distribution in Practice 89
- 3.7 Scatterplots, the Sample Covariance, and the Sample Correlation 91
 - Scatterplots 91
 - Sample Covariance and Correlation 92
 - [APPENDIX 3.1 The U.S. Current Population Survey](#) 106
 - [APPENDIX 3.2 Two Proofs That \$\bar{Y}\$ Is the Least Squares Estimator of \$\mu_Y\$](#) 107
 - [APPENDIX 3.3 A Proof That the Sample Variance Is Consistent](#) 108

PART TWO **Fundamentals of Regression Analysis**

CHAPTER 4 **Linear Regression with One Regressor** **109**

- 4.1 The Linear Regression Model 109
- 4.2 Estimating the Coefficients of the Linear Regression Model 114
 - The Ordinary Least Squares Estimator 116
 - OLS Estimates of the Relationship Between Test Scores and the Student–Teacher Ratio 118
 - Why Use the OLS Estimator? 119
- 4.3 Measures of Fit 121
 - The R^2 121
 - The Standard Error of the Regression 122
 - Application to the Test Score Data 123
- 4.4 The Least Squares Assumptions 124
 - Assumption #1: The Conditional Distribution of u_i Given X_i Has a Mean of Zero 124
 - Assumption #2: $(X_i, Y_i), i = 1, \dots, n$, Are Independently and Identically Distributed 126
 - Assumption #3: Large Outliers Are Unlikely 127
 - Use of the Least Squares Assumptions 128

4.5 Sampling Distribution of the OLS Estimators 129
The Sampling Distribution of the OLS Estimators 130

4.6 Conclusion 133

APPENDIX 4.1 The California Test Score Data Set 141

APPENDIX 4.2 Derivation of the OLS Estimators 141

APPENDIX 4.3 Sampling Distribution of the OLS Estimator 142

CHAPTER 5 Regression with a Single Regressor: Hypothesis Tests and Confidence Intervals 146

5.1 Testing Hypotheses About One of the Regression Coefficients 146

Two-Sided Hypotheses Concerning β_1 147

One-Sided Hypotheses Concerning β_1 150

Testing Hypotheses About the Intercept β_0 152

5.2 Confidence Intervals for a Regression Coefficient 153

5.3 Regression When X Is a Binary Variable 155

Interpretation of the Regression Coefficients 155

5.4 Heteroskedasticity and Homoskedasticity 157

What Are Heteroskedasticity and Homoskedasticity? 158

Mathematical Implications of Homoskedasticity 160

What Does This Mean in Practice? 161

5.5 The Theoretical Foundations of Ordinary Least Squares 163

Linear Conditionally Unbiased Estimators and the Gauss–Markov Theorem 164

Regression Estimators Other Than OLS 165

5.6 Using the t -Statistic in Regression When the Sample Size Is Small 166

The t -Statistic and the Student t Distribution 166

Use of the Student t Distribution in Practice 167

5.7 Conclusion 168

APPENDIX 5.1 Formulas for OLS Standard Errors 177

APPENDIX 5.2 The Gauss–Markov Conditions and a Proof of the Gauss–Markov Theorem 178

CHAPTER 6 Linear Regression with Multiple Regressors 182

- 6.1 Omitted Variable Bias 182
 - Definition of Omitted Variable Bias 183
 - A Formula for Omitted Variable Bias 185
 - Addressing Omitted Variable Bias by Dividing the Data into Groups 187
- 6.2 The Multiple Regression Model 189
 - The Population Regression Line 189
 - The Population Multiple Regression Model 190
- 6.3 The OLS Estimator in Multiple Regression 192
 - The OLS Estimator 193
 - Application to Test Scores and the Student–Teacher Ratio 194
- 6.4 Measures of Fit in Multiple Regression 196
 - The Standard Error of the Regression (*SER*) 196
 - The R^2 196
 - The “Adjusted R^2 ” 197
 - Application to Test Scores 198
- 6.5 The Least Squares Assumptions in Multiple Regression 199
 - Assumption #1: The Conditional Distribution of u_i Given $X_{1i}, X_{2i}, \dots, X_{ki}$ Has a Mean of Zero 199
 - Assumption #2: $(X_{1i}, X_{2i}, \dots, X_{ki}, Y_i), i = 1, \dots, n$, Are i.i.d. 199
 - Assumption #3: Large Outliers Are Unlikely 199
 - Assumption #4: No Perfect Multicollinearity 200
- 6.6 The Distribution of the OLS Estimators in Multiple Regression 201
- 6.7 Multicollinearity 202
 - Examples of Perfect Multicollinearity 203
 - Imperfect Multicollinearity 205
- 6.8 Conclusion 206
 - [APPENDIX 6.1 Derivation of Equation \(6.1\)](#) 214
 - [APPENDIX 6.2 Distribution of the OLS Estimators When There Are Two Regressors and Homoskedastic Errors](#) 214
 - [APPENDIX 6.3 The Frisch–Waugh Theorem](#) 215

CHAPTER 7 Hypothesis Tests and Confidence Intervals in Multiple Regression 217

- 7.1 Hypothesis Tests and Confidence Intervals for a Single Coefficient 217
 - Standard Errors for the OLS Estimators 217
 - Hypothesis Tests for a Single Coefficient 218
 - Confidence Intervals for a Single Coefficient 219
 - Application to Test Scores and the Student–Teacher Ratio 220
- 7.2 Tests of Joint Hypotheses 222
 - Testing Hypotheses on Two or More Coefficients 222
 - The F -Statistic 224
 - Application to Test Scores and the Student–Teacher Ratio 226
 - The Homoskedasticity-Only F -Statistic 227
- 7.3 Testing Single Restrictions Involving Multiple Coefficients 229
- 7.4 Confidence Sets for Multiple Coefficients 231
- 7.5 Model Specification for Multiple Regression 232
 - Omitted Variable Bias in Multiple Regression 233
 - The Role of Control Variables in Multiple Regression 234
 - Model Specification in Theory and in Practice 236
 - Interpreting the R^2 and the Adjusted R^2 in Practice 237
- 7.6 Analysis of the Test Score Data Set 238
- 7.7 Conclusion 243
 - APPENDIX 7.1 The Bonferroni Test of a Joint Hypothesis 251
 - APPENDIX 7.2 Conditional Mean Independence 253

CHAPTER 8 Nonlinear Regression Functions 256

- 8.1 A General Strategy for Modeling Nonlinear Regression Functions 258
 - Test Scores and District Income 258
 - The Effect on Y of a Change in X in Nonlinear Specifications 261
 - A General Approach to Modeling Nonlinearities Using Multiple Regression 266
- 8.2 Nonlinear Functions of a Single Independent Variable 266
 - Polynomials 267
 - Logarithms 269
 - Polynomial and Logarithmic Models of Test Scores and District Income 277

- 8.3 Interactions Between Independent Variables 278
 - Interactions Between Two Binary Variables 279
 - Interactions Between a Continuous and a Binary Variable 282
 - Interactions Between Two Continuous Variables 286
- 8.4 Nonlinear Effects on Test Scores of the Student–Teacher Ratio 293
 - Discussion of Regression Results 293
 - Summary of Findings 297
- 8.5 Conclusion 298
 - [APPENDIX 8.1](#) Regression Functions That Are Nonlinear in the Parameters 309
 - [APPENDIX 8.2](#) Slopes and Elasticities for Nonlinear Regression Functions 313

CHAPTER 9 Assessing Studies Based on Multiple Regression 315

- 9.1 Internal and External Validity 315
 - Threats to Internal Validity 316
 - Threats to External Validity 317
- 9.2 Threats to Internal Validity of Multiple Regression Analysis 319
 - Omitted Variable Bias 319
 - Misspecification of the Functional Form of the Regression Function 321
 - Measurement Error and Errors-in-Variables Bias 322
 - Missing Data and Sample Selection 325
 - Simultaneous Causality 326
 - Sources of Inconsistency of OLS Standard Errors 329
- 9.3 Internal and External Validity When the Regression Is Used for Forecasting 331
 - Using Regression Models for Forecasting 331
 - Assessing the Validity of Regression Models for Forecasting 332
- 9.4 Example: Test Scores and Class Size 332
 - External Validity 332
 - Internal Validity 339
 - Discussion and Implications 341
- 9.5 Conclusion 342
 - [APPENDIX 9.1](#) The Massachusetts Elementary School Testing Data 349

PART THREE Further Topics in Regression Analysis

CHAPTER 10 Regression with Panel Data 350

- 10.1 Panel Data 351
 - Example: Traffic Deaths and Alcohol Taxes 352
- 10.2 Panel Data with Two Time Periods: “Before and After” Comparisons 354
- 10.3 Fixed Effects Regression 357
 - The Fixed Effects Regression Model 357
 - Estimation and Inference 359
 - Application to Traffic Deaths 361
- 10.4 Regression with Time Fixed Effects 361
 - Time Effects Only 362
 - Both Entity and Time Fixed Effects 363
- 10.5 The Fixed Effects Regression Assumptions and Standard Errors for Fixed Effects Regression 365
 - The Fixed Effects Regression Assumptions 365
 - Standard Errors for Fixed Effects Regression 367
- 10.6 Drunk Driving Laws and Traffic Deaths 368
- 10.7 Conclusion 372
 - [APPENDIX 10.1](#) The State Traffic Fatality Data Set 380
 - [APPENDIX 10.2](#) Standard Errors for Fixed Effects Regression 380

CHAPTER 11 Regression with a Binary Dependent Variable 385

- 11.1 Binary Dependent Variables and the Linear Probability Model 386
 - Binary Dependent Variables 386
 - The Linear Probability Model 388
- 11.2 Probit and Logit Regression 391
 - Probit Regression 391
 - Logit Regression 396
 - Comparing the Linear Probability, Probit, and Logit Models 398
- 11.3 Estimation and Inference in the Logit and Probit Models 398
 - Nonlinear Least Squares Estimation 399

	Maximum Likelihood Estimation	400
	Measures of Fit	401
11.4	Application to the Boston HMDA Data	402
11.5	Conclusion	409
	APPENDIX 11.1 The Boston HMDA Data Set	418
	APPENDIX 11.2 Maximum Likelihood Estimation	418
	APPENDIX 11.3 Other Limited Dependent Variable Models	421
CHAPTER 12	Instrumental Variables Regression	424
12.1	The IV Estimator with a Single Regressor and a Single Instrument	425
	The IV Model and Assumptions	425
	The Two Stage Least Squares Estimator	426
	Why Does IV Regression Work?	427
	The Sampling Distribution of the TSLS Estimator	431
	Application to the Demand for Cigarettes	433
12.2	The General IV Regression Model	435
	TSLS in the General IV Model	437
	Instrument Relevance and Exogeneity in the General IV Model	438
	The IV Regression Assumptions and Sampling Distribution of the TSLS Estimator	439
	Inference Using the TSLS Estimator	440
	Application to the Demand for Cigarettes	441
12.3	Checking Instrument Validity	442
	Assumption #1: Instrument Relevance	443
	Assumption #2: Instrument Exogeneity	445
12.4	Application to the Demand for Cigarettes	448
12.5	Where Do Valid Instruments Come From?	453
	Three Examples	454
12.6	Conclusion	458
	APPENDIX 12.1 The Cigarette Consumption Panel Data Set	467
	APPENDIX 12.2 Derivation of the Formula for the TSLS Estimator in Equation (12.4)	467

APPENDIX 12.3 Large-Sample Distribution of the TSLS Estimator 468

APPENDIX 12.4 Large-Sample Distribution of the TSLS Estimator When
the Instrument Is Not Valid 469

APPENDIX 12.5 Instrumental Variables Analysis with Weak
Instruments 471

APPENDIX 12.6 TSLS with Control Variables 473

CHAPTER 13 Experiments and Quasi-Experiments 475

13.1 Potential Outcomes, Causal Effects, and Idealized Experiments 476

Potential Outcomes and the Average Causal Effect 476

Econometric Methods for Analyzing Experimental Data 478

13.2 Threats to Validity of Experiments 479

Threats to Internal Validity 479

Threats to External Validity 483

13.3 Experimental Estimates of the Effect of Class Size Reductions 484

Experimental Design 485

Analysis of the STAR Data 486

Comparison of the Observational and Experimental Estimates of Class Size
Effects 491

13.4 Quasi-Experiments 493

Examples 494

The Differences-in-Differences Estimator 496

Instrumental Variables Estimators 499

Regression Discontinuity Estimators 500

13.5 Potential Problems with Quasi-Experiments 502

Threats to Internal Validity 502

Threats to External Validity 504

13.6 Experimental and Quasi-Experimental Estimates in Heterogeneous Populations 504

OLS with Heterogeneous Causal Effects 505

IV Regression with Heterogeneous Causal Effects 506

- 13.7 Conclusion 509
 - APPENDIX 13.1 The Project STAR Data Set 518
 - APPENDIX 13.2 IV Estimation When the Causal Effect Varies Across Individuals 518
 - APPENDIX 13.3 The Potential Outcomes Framework for Analyzing Data from Experiments 520

PART FOUR Regression Analysis of Economic Time Series Data

CHAPTER 14 Introduction to Time Series Regression and Forecasting 522

- 14.1 Using Regression Models for Forecasting 523
- 14.2 Introduction to Time Series Data and Serial Correlation 524
 - Real GDP in the United States 524
 - Lags, First Differences, Logarithms, and Growth Rates 525
 - Autocorrelation 528
 - Other Examples of Economic Time Series 529
- 14.3 Autoregressions 531
 - The First-Order Autoregressive Model 531
 - The p^{th} -Order Autoregressive Model 534
- 14.4 Time Series Regression with Additional Predictors and the Autoregressive Distributed Lag Model 537
 - Forecasting GDP Growth Using the Term Spread 537
 - Stationarity 540
 - Time Series Regression with Multiple Predictors 541
 - Forecast Uncertainty and Forecast Intervals 544
- 14.5 Lag Length Selection Using Information Criteria 547
 - Determining the Order of an Autoregression 547
 - Lag Length Selection in Time Series Regression with Multiple Predictors 550
- 14.6 Nonstationarity I: Trends 551
 - What Is a Trend? 551
 - Problems Caused by Stochastic Trends 554
 - Detecting Stochastic Trends: Testing for a Unit AR Root 556
 - Avoiding the Problems Caused by Stochastic Trends 561

- 14.7 Nonstationarity II: Breaks 561
 - What Is a Break? 562
 - Testing for Breaks 562
 - Pseudo Out-of-Sample Forecasting 567
 - Avoiding the Problems Caused by Breaks 573
- 14.8 Conclusion 573
 - APPENDIX 14.1 Time Series Data Used in Chapter 14 583
 - APPENDIX 14.2 Stationarity in the AR(1) Model 584
 - APPENDIX 14.3 Lag Operator Notation 585
 - APPENDIX 14.4 ARMA Models 586
 - APPENDIX 14.5 Consistency of the BIC Lag Length Estimator 587

CHAPTER 15 Estimation of Dynamic Causal Effects 589

- 15.1 An Initial Taste of the Orange Juice Data 590
- 15.2 Dynamic Causal Effects 593
 - Causal Effects and Time Series Data 593
 - Two Types of Exogeneity 596
- 15.3 Estimation of Dynamic Causal Effects with Exogenous Regressors 597
 - The Distributed Lag Model Assumptions 598
 - Autocorrelated u_t , Standard Errors, and Inference 599
 - Dynamic Multipliers and Cumulative Dynamic Multipliers 600
- 15.4 Heteroskedasticity- and Autocorrelation-Consistent Standard Errors 601
 - Distribution of the OLS Estimator with Autocorrelated Errors 602
 - HAC Standard Errors 604
- 15.5 Estimation of Dynamic Causal Effects with Strictly Exogenous Regressors 606
 - The Distributed Lag Model with AR(1) Errors 607
 - OLS Estimation of the ADL Model 610
 - GLS Estimation 611
 - The Distributed Lag Model with Additional Lags and AR(p) Errors 613
- 15.6 Orange Juice Prices and Cold Weather 616

- 15.7 Is Exogeneity Plausible? Some Examples 624
 - U.S. Income and Australian Exports 624
 - Oil Prices and Inflation 625
 - Monetary Policy and Inflation 626
 - The Growth Rate of GDP and the Term Spread 626
- 15.8 Conclusion 627
 - [APPENDIX 15.1](#) The Orange Juice Data Set 634
 - [APPENDIX 15.2](#) The ADL Model and Generalized Least Squares in Lag Operator Notation 634

CHAPTER 16 Additional Topics in Time Series Regression 638

- 16.1 Vector Autoregressions 638
 - The VAR Model 639
 - A VAR Model of the Growth Rate of GDP and the Term Spread 642
- 16.2 Multiperiod Forecasts 643
 - Iterated Multiperiod Forecasts 643
 - Direct Multiperiod Forecasts 645
 - Which Method Should You Use? 648
- 16.3 Orders of Integration and the DF-GLS Unit Root Test 649
 - Other Models of Trends and Orders of Integration 649
 - The DF-GLS Test for a Unit Root 651
 - Why Do Unit Root Tests Have Nonnormal Distributions? 654
- 16.4 Cointegration 656
 - Cointegration and Error Correction 656
 - How Can You Tell Whether Two Variables Are Cointegrated? 658
 - Estimation of Cointegrating Coefficients 659
 - Extension to Multiple Cointegrated Variables 661
 - Application to Interest Rates 662
- 16.5 Volatility Clustering and Autoregressive Conditional Heteroskedasticity 664
 - Volatility Clustering 664
 - Autoregressive Conditional Heteroskedasticity 666
 - Application to Stock Price Volatility 667
- 16.6 Conclusion 670

PART FIVE The Econometric Theory of Regression Analysis

CHAPTER 17 The Theory of Linear Regression with One Regressor 676

- 17.1 The Extended Least Squares Assumptions and the OLS Estimator 677
 The Extended Least Squares Assumptions 677
 The OLS Estimator 679
- 17.2 Fundamentals of Asymptotic Distribution Theory 679
 Convergence in Probability and the Law of Large Numbers 680
 The Central Limit Theorem and Convergence in Distribution 682
 Slutsky's Theorem and the Continuous Mapping Theorem 683
 Application to the t -Statistic Based on the Sample Mean 684
- 17.3 Asymptotic Distribution of the OLS Estimator and t -Statistic 685
 Consistency and Asymptotic Normality of the OLS Estimators 685
 Consistency of Heteroskedasticity-Robust Standard Errors 685
 Asymptotic Normality of the Heteroskedasticity-Robust t -Statistic 687
- 17.4 Exact Sampling Distributions When the Errors Are Normally Distributed 687
 Distribution of $\hat{\beta}_1$ with Normal Errors 687
 Distribution of the Homoskedasticity-Only t -Statistic 689
- 17.5 Weighted Least Squares 690
 WLS with Known Heteroskedasticity 690
 WLS with Heteroskedasticity of Known Functional Form 691
 Heteroskedasticity-Robust Standard Errors or WLS? 694
 APPENDIX 17.1 The Normal and Related Distributions and Moments of Continuous Random Variables 700
 APPENDIX 17.2 Two Inequalities 703

CHAPTER 18 The Theory of Multiple Regression 705

- 18.1 The Linear Multiple Regression Model and OLS Estimator in Matrix Form 706
 The Multiple Regression Model in Matrix Notation 706
 The Extended Least Squares Assumptions 708
 The OLS Estimator 709

18.2	Asymptotic Distribution of the OLS Estimator and t -Statistic	710
	The Multivariate Central Limit Theorem	710
	Asymptotic Normality of $\hat{\beta}$	711
	Heteroskedasticity-Robust Standard Errors	712
	Confidence Intervals for Predicted Effects	713
	Asymptotic Distribution of the t -Statistic	713
18.3	Tests of Joint Hypotheses	713
	Joint Hypotheses in Matrix Notation	714
	Asymptotic Distribution of the F -Statistic	714
	Confidence Sets for Multiple Coefficients	715
18.4	Distribution of Regression Statistics with Normal Errors	716
	Matrix Representations of OLS Regression Statistics	716
	Distribution of $\hat{\beta}$ with Normal Errors	717
	Distribution of s_e^2	718
	Homoskedasticity-Only Standard Errors	718
	Distribution of the t -Statistic	719
	Distribution of the F -Statistic	719
18.5	Efficiency of the OLS Estimator with Homoskedastic Errors	720
	The Gauss–Markov Conditions for Multiple Regression	720
	Linear Conditionally Unbiased Estimators	720
	The Gauss–Markov Theorem for Multiple Regression	721
18.6	Generalized Least Squares	722
	The GLS Assumptions	723
	GLS When Ω Is Known	725
	GLS When Ω Contains Unknown Parameters	726
	The Zero Conditional Mean Assumption and GLS	726
18.7	Instrumental Variables and Generalized Method of Moments Estimation	728
	The IV Estimator in Matrix Form	729
	Asymptotic Distribution of the TSLS Estimator	730
	Properties of TSLS When the Errors Are Homoskedastic	731
	Generalized Method of Moments Estimation in Linear Models	734
	APPENDIX 18.1 Summary of Matrix Algebra	746
	APPENDIX 18.2 Multivariate Distributions	749
	APPENDIX 18.3 Derivation of the Asymptotic Distribution of $\hat{\beta}$	751

APPENDIX 18.4 Derivations of Exact Distributions of OLS Test Statistics
with Normal Errors 752

APPENDIX 18.5 Proof of the Gauss–Markov Theorem for Multiple
Regression 753

APPENDIX 18.6 Proof of Selected Results for IV and GMM Estimation 754

Appendix 757

References 765

Glossary 771

Index 779

Key Concepts

PART ONE Introduction and Review

- 1.1 Cross-Sectional, Time Series, and Panel Data 12
- 2.1 Expected Value and the Mean 20
- 2.2 Variance and Standard Deviation 21
- 2.3 Means, Variances, and Covariances of Sums of Random Variables 35
- 2.4 Computing Probabilities Involving Normal Random Variables 37
- 2.5 Simple Random Sampling and i.i.d. Random Variables 44
- 2.6 Convergence in Probability, Consistency, and the Law of Large Numbers 48
- 2.7 The Central Limit Theorem 52
- 3.1 Estimators and Estimates 67
- 3.2 Bias, Consistency, and Efficiency 68
- 3.3 Efficiency of \bar{Y} : \bar{Y} Is BLUE 69
- 3.4 The Standard Error of \bar{Y} 75
- 3.5 The Terminology of Hypothesis Testing 78
- 3.6 Testing the Hypothesis $E(Y) = \mu_{Y,0}$ Against the Alternative $E(Y) \neq \mu_{Y,0}$ 79
- 3.7 Confidence Intervals for the Population Mean 81

PART TWO Fundamentals of Regression Analysis

- 4.1 Terminology for the Linear Regression Model with a Single Regressor 113
- 4.2 The OLS Estimator, Predicted Values, and Residuals 117
- 4.3 The Least Squares Assumptions 129
- 4.4 Large-Sample Distributions of $\hat{\beta}_0$ and $\hat{\beta}_1$ 131
- 5.1 General Form of the t -Statistic 147
- 5.2 Testing the Hypothesis $\beta_1 = \beta_{1,0}$ Against the Alternative $\beta_1 \neq \beta_{1,0}$ 149
- 5.3 Confidence Interval for β_1 154
- 5.4 Heteroskedasticity and Homoskedasticity 159
- 5.5 The Gauss–Markov Theorem for $\hat{\beta}_1$ 165
- 6.1 Omitted Variable Bias in Regression with a Single Regressor 185
- 6.2 The Multiple Regression Model 192
- 6.3 The OLS Estimators, Predicted Values, and Residuals in the Multiple Regression Model 194
- 6.4 The Least Squares Assumptions in the Multiple Regression Model 201
- 6.5 Large-Sample Distribution of $\hat{\beta}_0, \hat{\beta}_1, \dots, \hat{\beta}_k$ 202
- 7.1 Testing the Hypothesis $\beta_j = \beta_{j,0}$ Against the Alternative $\beta_j \neq \beta_{j,0}$ 219
- 7.2 Confidence Intervals for a Single Coefficient in Multiple Regression 220

- 7.3 Omitted Variable Bias in Multiple Regression 233
- 7.4 R^2 and \bar{R}^2 : What They Tell You—and What They Don't 238
- 8.1 The Expected Change on Y of a Change in X_1 in the Nonlinear Regression Model (8.3) 263
- 8.2 Logarithms in Regression: Three Cases 276
- 8.3 A Method for Interpreting Coefficients in Regressions with Binary Variables 281
- 8.4 Interactions Between Binary and Continuous Variables 284
- 8.5 Interactions in Multiple Regression 289
- 9.1 Internal and External Validity 316
- 9.2 Omitted Variable Bias: Should I Include More Variables in My Regression? 321
- 9.3 Functional Form Misspecification 322
- 9.4 Errors-in-Variables Bias 324
- 9.5 Sample Selection Bias 326
- 9.6 Simultaneous Causality Bias 329
- 9.7 Threats to the Internal Validity of a Multiple Regression Study 330

PART THREE Further Topics in Regression Analysis

- 10.1 Notation for Panel Data 351
- 10.2 The Fixed Effects Regression Model 359
- 10.3 The Fixed Effects Regression Assumptions 366
- 11.1 The Linear Probability Model 389
- 11.2 The Probit Model, Predicted Probabilities, and Estimated Effects 394
- 11.3 Logit Regression 396
- 12.1 The General Instrumental Variables Regression Model and Terminology 436
- 12.2 Two Stage Least Squares 438
- 12.3 The Two Conditions for Valid Instruments 439
- 12.4 The IV Regression Assumptions 440
- 12.5 A Rule of Thumb for Checking for Weak Instruments 444
- 12.6 The Overidentifying Restrictions Test (The J -Statistic) 448

PART FOUR Regression Analysis of Economic Time Series Data

- 14.1 Lags, First Differences, Logarithms, and Growth Rates 527
- 14.2 Autocorrelation (Serial Correlation) and Autocovariance 528
- 14.3 Autoregressions 535
- 14.4 The Autoregressive Distributed Lag Model 540

- 14.5 Stationarity 541
- 14.6 Time Series Regression with Multiple Predictors 542
- 14.7 Granger Causality Tests (Tests of Predictive Content) 543
- 14.8 The Augmented Dickey–Fuller Test for a Unit Autoregressive Root 559
- 14.9 The QLR Test for Coefficient Stability 566
- 14.10 Pseudo Out-of-Sample Forecasts 568
- 15.1 The Distributed Lag Model and Exogeneity 598
- 15.2 The Distributed Lag Model Assumptions 599
- 15.3 HAC Standard Errors 607
- 15.4 Estimation of Dynamic Multipliers Under Strict Exogeneity 616
- 16.1 Vector Autoregressions 639
- 16.2 Iterated Multiperiod Forecasts 646
- 16.3 Direct Multiperiod Forecasts 648
- 16.4 Orders of Integration, Differencing, and Stationarity 650
- 16.5 Cointegration 657

PART FIVE **Regression Analysis of Economic Time Series Data**

- 17.1 The Extended Least Squares Assumptions for Regression with a Single Regressor 678
- 18.1 The Extended Least Squares Assumptions in the Multiple Regression Model 707
- 18.2 The Multivariate Central Limit Theorem 711
- 18.3 Gauss–Markov Theorem for Multiple Regression 722
- 18.4 The GLS Assumptions 724

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General Interest Boxes

The Distribution of Earnings in the United States in 2012	33
A Bad Day on Wall Street	39
Financial Diversification and Portfolios	46
Landon Wins!	70
The Gender Gap of Earnings of College Graduates in the United States	86
A Novel Way to Boost Retirement Savings	90
The “Beta” of a Stock	120
The Economic Value of a Year of Education: Homoskedasticity or Heteroskedasticity?	162
The Mozart Effect: Omitted Variable Bias?	186
The Return to Education and the Gender Gap	287
The Demand for Economics Journals	290
Do Stock Mutual Funds Outperform the Market?	327
James Heckman and Daniel McFadden, Nobel Laureates	410
Who Invented Instrumental Variables Regression?	428
A Scary Regression	446
The Externalities of Smoking	450
The Hawthorne Effect	482
What Is the Effect on Employment of the Minimum Wage?	497
Can You Beat the Market? Part I	536
The River of Blood	546
Can You Beat the Market? Part II	570
Orange Trees on the March	623
NEWS FLASH: Commodity Traders Send Shivers Through Disney World	625
Nobel Laureates in Time Series Econometrics	669

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Preface

Econometrics can be a fun course for both teacher and student. The real world of economics, business, and government is a complicated and messy place, full of competing ideas and questions that demand answers. Is it more effective to tackle drunk driving by passing tough laws or by increasing the tax on alcohol? Can you make money in the stock market by buying when prices are historically low, relative to earnings, or should you just sit tight, as the random walk theory of stock prices suggests? Can we improve elementary education by reducing class sizes, or should we simply have our children listen to Mozart for 10 minutes a day? Econometrics helps us sort out sound ideas from crazy ones and find quantitative answers to important quantitative questions. Econometrics opens a window on our complicated world that lets us see the relationships on which people, businesses, and governments base their decisions.

Introduction to Econometrics is designed for a first course in undergraduate econometrics. It is our experience that to make econometrics relevant in an introductory course, interesting applications must motivate the theory and the theory must match the applications. This simple principle represents a significant departure from the older generation of econometrics books, in which theoretical models and assumptions do not match the applications. It is no wonder that some students question the relevance of econometrics after they spend much of their time learning assumptions that they subsequently realize are unrealistic so that they must then learn “solutions” to “problems” that arise when the applications do not match the assumptions. We believe that it is far better to motivate the need for tools with a concrete application and then to provide a few simple assumptions that match the application. Because the theory is immediately relevant to the applications, this approach can make econometrics come alive.

New to the Third Edition

- Updated treatment of standard errors for panel data regression
- Discussion of when and why missing data can present a problem for regression analysis
- The use of regression discontinuity design as a method for analyzing quasi-experiments

- Updated discussion of weak instruments
- Discussion of the use and interpretation of control variables integrated into the core development of regression analysis
- Introduction of the “potential outcomes” framework for experimental data
- Additional general interest boxes
- Additional exercises, both pencil-and-paper and empirical

This third edition builds on the philosophy of the first and second editions that applications should drive the theory, not the other way around.

One substantial change in this edition concerns inference in regression with panel data (Chapter 10). In panel data, the data within an entity typically are correlated over time. For inference to be valid, standard errors must be computed using a method that is robust to this correlation. The chapter on panel data now uses one such method, clustered standard errors, from the outset. Clustered standard errors are the natural extension to panel data of the heteroskedasticity-robust standard errors introduced in the initial treatment of regression analysis in Part II. Recent research has shown that clustered standard errors have a number of desirable properties, which are now discussed in Chapter 10 and in a revised appendix to Chapter 10.

Another substantial set of changes concerns the treatment of experiments and quasi-experiments in Chapter 13. The discussion of differences-in-differences regression has been streamlined and draws directly on the multiple regression principles introduced in Part II. Chapter 13 now discusses regression discontinuity design, which is an intuitive and important framework for the analysis of quasi-experimental data. In addition, Chapter 13 now introduces the potential outcomes framework and relates this increasingly commonplace terminology to concepts that were introduced in Parts I and II.

This edition has a number of other significant changes. One is that it incorporates a precise but accessible treatment of control variables into the initial discussion of multiple regression. Chapter 7 now discusses conditions for control variables being successful in the sense that the coefficient on the variable of interest is unbiased even though the coefficients on the control variables generally are not. Other changes include a new discussion of missing data in Chapter 9, a new optional calculus-based appendix to Chapter 8 on slopes and elasticities of nonlinear regression functions, and an updated discussion in Chapter 12 of what to do if you have weak instruments. This edition also includes new general interest boxes, updated empirical examples, and additional exercises.

The Updated Third Edition

- The time series data used in Chapters 14–16 have been extended through the beginning of 2013 and now include the Great Recession.
- The empirical analysis in Chapter 14 now focuses on forecasting the growth rate of real GDP using the term spread, replacing the Phillips curve forecasts from earlier editions.
- Several new empirical exercises have been added to each chapter. Rather than include all of the empirical exercises in the text, we have moved many of them to the Companion Website, www.pearsonhighered.com/stock_watson. This has two main advantages: first, we can offer more and more in-depth exercises, and second, we can add and update exercises between editions. We encourage you to browse the empirical exercises available on the Companion Website.

Features of This Book

Introduction to Econometrics differs from other textbooks in three main ways. First, we integrate real-world questions and data into the development of the theory, and we take seriously the substantive findings of the resulting empirical analysis. Second, our choice of topics reflects modern theory and practice. Third, we provide theory and assumptions that match the applications. Our aim is to teach students to become sophisticated consumers of econometrics and to do so at a level of mathematics appropriate for an introductory course.

Real-World Questions and Data

We organize each methodological topic around an important real-world question that demands a specific numerical answer. For example, we teach single-variable regression, multiple regression, and functional form analysis in the context of estimating the effect of school inputs on school outputs. (Do smaller elementary school class sizes produce higher test scores?) We teach panel data methods in the context of analyzing the effect of drunk driving laws on traffic fatalities. We use possible racial discrimination in the market for home loans as the empirical application for teaching regression with a binary dependent variable (logit and probit). We teach instrumental variable estimation in the context of estimating the demand elasticity for cigarettes. Although these examples involve economic reasoning, all

can be understood with only a single introductory course in economics, and many can be understood without any previous economics coursework. Thus the instructor can focus on teaching econometrics, not microeconomics or macroeconomics.

We treat all our empirical applications seriously and in a way that shows students how they can learn from data but at the same time be self-critical and aware of the limitations of empirical analyses. Through each application, we teach students to explore alternative specifications and thereby to assess whether their substantive findings are robust. The questions asked in the empirical applications are important, and we provide serious and, we think, credible answers. We encourage students and instructors to disagree, however, and invite them to reanalyze the data, which are provided on the textbook's Companion Website (www.pearsonhighered.com/stock_watson).

Contemporary Choice of Topics

Econometrics has come a long way since the 1980s. The topics we cover reflect the best of contemporary applied econometrics. One can only do so much in an introductory course, so we focus on procedures and tests that are commonly used in practice. For example:

- ***Instrumental variables regression.*** We present instrumental variables regression as a general method for handling correlation between the error term and a regressor, which can arise for many reasons, including omitted variables and simultaneous causality. The two assumptions for a valid instrument—exogeneity and relevance—are given equal billing. We follow that presentation with an extended discussion of where instruments come from and with tests of overidentifying restrictions and diagnostics for weak instruments, and we explain what to do if these diagnostics suggest problems.
- ***Program evaluation.*** An increasing number of econometric studies analyze either randomized controlled experiments or quasi-experiments, also known as natural experiments. We address these topics, often collectively referred to as program evaluation, in Chapter 13. We present this research strategy as an alternative approach to the problems of omitted variables, simultaneous causality, and selection, and we assess both the strengths and the weaknesses of studies using experimental or quasi-experimental data.
- ***Forecasting.*** The chapter on forecasting (Chapter 14) considers univariate (autoregressive) and multivariate forecasts using time series regression, not large simultaneous equation structural models. We focus on simple and reliable tools, such as autoregressions and model selection via an information

criterion, that work well in practice. This chapter also features a practically oriented treatment of stochastic trends (unit roots), unit root tests, tests for structural breaks (at known and unknown dates), and pseudo out-of-sample forecasting, all in the context of developing stable and reliable time series forecasting models.

- **Time series regression.** We make a clear distinction between two very different applications of time series regression: forecasting and estimation of dynamic causal effects. The chapter on causal inference using time series data (Chapter 15) pays careful attention to when different estimation methods, including generalized least squares, will or will not lead to valid causal inferences and when it is advisable to estimate dynamic regressions using OLS with heteroskedasticity- and autocorrelation-consistent standard errors.

Theory That Matches Applications

Although econometric tools are best motivated by empirical applications, students need to learn enough econometric theory to understand the strengths and limitations of those tools. We provide a modern treatment in which the fit between theory and applications is as tight as possible, while keeping the mathematics at a level that requires only algebra.

Modern empirical applications share some common characteristics: The data sets typically are large (hundreds of observations, often more); regressors are not fixed over repeated samples but rather are collected by random sampling (or some other mechanism that makes them random); the data are not normally distributed; and there is no *a priori* reason to think that the errors are homoskedastic (although often there are reasons to think that they are heteroskedastic).

These observations lead to important differences between the theoretical development in this textbook and other textbooks:

- **Large-sample approach.** Because data sets are large, from the outset we use large-sample normal approximations to sampling distributions for hypothesis testing and confidence intervals. In our experience, it takes less time to teach the rudiments of large-sample approximations than to teach the Student t and exact F distributions, degrees-of-freedom corrections, and so forth. This large-sample approach also saves students the frustration of discovering that, because of nonnormal errors, the exact distribution theory they just mastered is irrelevant. Once taught in the context of the sample mean, the large-sample approach to hypothesis testing and confidence intervals carries directly through multiple regression analysis, logit and probit, instrumental variables estimation, and time series methods.

- **Random sampling.** Because regressors are rarely fixed in econometric applications, from the outset we treat data on all variables (dependent and independent) as the result of random sampling. This assumption matches our initial applications to cross-sectional data, it extends readily to panel and time series data, and because of our large-sample approach, it poses no additional conceptual or mathematical difficulties.
- **Heteroskedasticity.** Applied econometricians routinely use heteroskedasticity-robust standard errors to eliminate worries about whether heteroskedasticity is present or not. In this book, we move beyond treating heteroskedasticity as an exception or a “problem” to be “solved”; instead, we allow for heteroskedasticity from the outset and simply use heteroskedasticity-robust standard errors. We present homoskedasticity as a special case that provides a theoretical motivation for OLS.

Skilled Producers, Sophisticated Consumers

We hope that students using this book will become sophisticated consumers of empirical analysis. To do so, they must learn not only how to use the tools of regression analysis but also how to assess the validity of empirical analyses presented to them.

Our approach to teaching how to assess an empirical study is threefold. First, immediately after introducing the main tools of regression analysis, we devote Chapter 9 to the threats to internal and external validity of an empirical study. This chapter discusses data problems and issues of generalizing findings to other settings. It also examines the main threats to regression analysis, including omitted variables, functional form misspecification, errors-in-variables, selection, and simultaneity—and ways to recognize these threats in practice.

Second, we apply these methods for assessing empirical studies to the empirical analysis of the ongoing examples in the book. We do so by considering alternative specifications and by systematically addressing the various threats to validity of the analyses presented in the book.

Third, to become sophisticated consumers, students need firsthand experience as producers. Active learning beats passive learning, and econometrics is an ideal course for active learning. For this reason, the textbook website features data sets, software, and suggestions for empirical exercises of different scopes.

Approach to Mathematics and Level of Rigor

Our aim is for students to develop a sophisticated understanding of the tools of modern regression analysis, whether the course is taught at a “high” or a “low” level of mathematics. Parts I through IV of the text (which cover the substantive

material) are accessible to students with only precalculus mathematics. Parts I through IV have fewer equations and more applications than many introductory econometrics books and far fewer equations than books aimed at mathematical sections of undergraduate courses. But more equations do not imply a more sophisticated treatment. In our experience, a more mathematical treatment does not lead to a deeper understanding for most students.

That said, different students learn differently, and for mathematically well-prepared students, learning can be enhanced by a more explicitly mathematical treatment. Part V therefore contains an introduction to econometric theory that is appropriate for students with a stronger mathematical background. When the mathematical chapters in Part V are used in conjunction with the material in Parts I through IV, this book is suitable for advanced undergraduate or master's level econometrics courses.

Contents and Organization

There are five parts to *Introduction to Econometrics*. This textbook assumes that the student has had a course in probability and statistics, although we review that material in Part I. We cover the core material of regression analysis in Part II. Parts III, IV, and V present additional topics that build on the core treatment in Part II.

Part I

Chapter 1 introduces econometrics and stresses the importance of providing quantitative answers to quantitative questions. It discusses the concept of causality in statistical studies and surveys the different types of data encountered in econometrics. Material from probability and statistics is reviewed in Chapters 2 and 3, respectively; whether these chapters are taught in a given course or are simply provided as a reference depends on the background of the students.

Part II

Chapter 4 introduces regression with a single regressor and ordinary least squares (OLS) estimation, and Chapter 5 discusses hypothesis tests and confidence intervals in the regression model with a single regressor. In Chapter 6, students learn how they can address omitted variable bias using multiple regression, thereby estimating the effect of one independent variable while holding other independent variables constant. Chapter 7 covers hypothesis tests, including F -tests, and confidence intervals in multiple regression. In Chapter 8, the linear regression model is

extended to models with nonlinear population regression functions, with a focus on regression functions that are linear in the parameters (so that the parameters can be estimated by OLS). In Chapter 9, students step back and learn how to identify the strengths and limitations of regression studies, seeing in the process how to apply the concepts of internal and external validity.

Part III

Part III presents extensions of regression methods. In Chapter 10, students learn how to use panel data to control for unobserved variables that are constant over time. Chapter 11 covers regression with a binary dependent variable. Chapter 12 shows how instrumental variables regression can be used to address a variety of problems that produce correlation between the error term and the regressor, and examines how one might find and evaluate valid instruments. Chapter 13 introduces students to the analysis of data from experiments and quasi-, or natural, experiments, topics often referred to as “program evaluation.”

Part IV

Part IV takes up regression with time series data. Chapter 14 focuses on forecasting and introduces various modern tools for analyzing time series regressions, such as unit root tests and tests for stability. Chapter 15 discusses the use of time series data to estimate causal relations. Chapter 16 presents some more advanced tools for time series analysis, including models of conditional heteroskedasticity.

Part V

Part V is an introduction to econometric theory. This part is more than an appendix that fills in mathematical details omitted from the text. Rather, it is a self-contained treatment of the econometric theory of estimation and inference in the linear regression model. Chapter 17 develops the theory of regression analysis for a single regressor; the exposition does not use matrix algebra, although it does demand a higher level of mathematical sophistication than the rest of the text. Chapter 18 presents and studies the multiple regression model, instrumental variables regression, and generalized method of moments estimation of the linear model, all in matrix form.

Prerequisites Within the Book

Because different instructors like to emphasize different material, we wrote this book with diverse teaching preferences in mind. To the maximum extent possible,

the chapters in Parts III, IV, and V are “stand-alone” in the sense that they do not require first teaching all the preceding chapters. The specific prerequisites for each chapter are described in Table I. Although we have found that the sequence of topics adopted in the textbook works well in our own courses, the chapters are written in a way that allows instructors to present topics in a different order if they so desire.

Sample Courses

This book accommodates several different course structures.

TABLE I Guide to Prerequisites for Special-Topic Chapters in Parts III, IV, and V

Chapter	Prerequisite parts or chapters								
	Part I 1–3	Part II 4–7, 9 8		Part III 10.1, 10.2 12.1, 12.2		Part IV 14.1–14.4 14.5–14.8 15			Part V 17
10	X ^a	X ^a	X						
11	X ^a	X ^a	X						
12.1, 12.2	X ^a	X ^a	X						
12.3–12.6	X ^a	X ^a	X	X	X				
13	X ^a	X ^a	X	X	X				
14	X ^a	X ^a	b						
15	X ^a	X ^a	b			X			
16	X ^a	X ^a	b			X	X	X	
17	X	X	X						
18	X	X	X		X				X

This table shows the minimum prerequisites needed to cover the material in a given chapter. For example, estimation of dynamic causal effects with time series data (Chapter 15) first requires Part I (as needed, depending on student preparation, and except as noted in footnote a), Part II (except for Chapter 8; see footnote b), and Sections 14.1 through 14.4.

^aChapters 10 through 16 use exclusively large-sample approximations to sampling distributions, so the optional Sections 3.6 (the Student t distribution for testing means) and 5.6 (the Student t distribution for testing regression coefficients) can be skipped.

^bChapters 14 through 16 (the time series chapters) can be taught without first teaching Chapter 8 (nonlinear regression functions) if the instructor pauses to explain the use of logarithmic transformations to approximate percentage changes.

Standard Introductory Econometrics

This course introduces econometrics (Chapter 1) and reviews probability and statistics as needed (Chapters 2 and 3). It then moves on to regression with a single regressor, multiple regression, the basics of functional form analysis, and the evaluation of regression studies (all Part II). The course proceeds to cover regression with panel data (Chapter 10), regression with a limited dependent variable (Chapter 11), and instrumental variables regression (Chapter 12), as time permits. The course concludes with experiments and quasi-experiments in Chapter 13, topics that provide an opportunity to return to the questions of estimating causal effects raised at the beginning of the semester and to recapitulate core regression methods. *Prerequisites: Algebra II and introductory statistics.*

Introductory Econometrics with Time Series and Forecasting Applications

Like a standard introductory course, this course covers all of Part I (as needed) and Part II. Optionally, the course next provides a brief introduction to panel data (Sections 10.1 and 10.2) and takes up instrumental variables regression (Chapter 12, or just Sections 12.1 and 12.2). The course then proceeds to Part IV, covering forecasting (Chapter 14) and estimation of dynamic causal effects (Chapter 15). If time permits, the course can include some advanced topics in time series analysis such as volatility clustering and conditional heteroskedasticity (Section 16.5). *Prerequisites: Algebra II and introductory statistics.*

Applied Time Series Analysis and Forecasting

This book also can be used for a short course on applied time series and forecasting, for which a course on regression analysis is a prerequisite. Some time is spent reviewing the tools of basic regression analysis in Part II, depending on student preparation. The course then moves directly to Part IV and works through forecasting (Chapter 14), estimation of dynamic causal effects (Chapter 15), and advanced topics in time series analysis (Chapter 16), including vector autoregressions and conditional heteroskedasticity. An important component of this course is hands-on forecasting exercises, available to instructors on the book's accompanying website. *Prerequisites: Algebra II and basic introductory econometrics or the equivalent.*

Introduction to Econometric Theory

This book is also suitable for an advanced undergraduate course in which the students have a strong mathematical preparation or for a master's level course in

econometrics. The course briefly reviews the theory of statistics and probability as necessary (Part I). The course introduces regression analysis using the nonmathematical, applications-based treatment of Part II. This introduction is followed by the theoretical development in Chapters 17 and 18 (through Section 18.5). The course then takes up regression with a limited dependent variable (Chapter 11) and maximum likelihood estimation (Appendix 11.2). Next, the course optionally turns to instrumental variables regression and generalized method of moments (Chapter 12 and Section 18.7), time series methods (Chapter 14), and the estimation of causal effects using time series data and generalized least squares (Chapter 15 and Section 18.6). *Prerequisites: Calculus and introductory statistics. Chapter 18 assumes previous exposure to matrix algebra.*

Pedagogical Features

This textbook has a variety of pedagogical features aimed at helping students understand, retain, and apply the essential ideas. *Chapter introductions* provide real-world grounding and motivation, as well as brief road maps highlighting the sequence of the discussion. *Key terms* are boldfaced and defined in context throughout each chapter, and *Key Concept boxes* at regular intervals recap the central ideas. *General interest boxes* provide interesting excursions into related topics and highlight real-world studies that use the methods or concepts being discussed in the text. A *Summary* concluding each chapter serves as a helpful framework for reviewing the main points of coverage. The questions in the *Review the Concepts* section check students' understanding of the core content, *Exercises* give more intensive practice working with the concepts and techniques introduced in the chapter, and *Empirical Exercises* allow students to apply what they have learned to answer real-world empirical questions. At the end of the textbook, the *Appendix* provides statistical tables, the *References* section lists sources for further reading, and a *Glossary* conveniently defines many key terms in the book.

Supplements to Accompany the Textbook

The online supplements accompanying the third edition update of *Introduction to Econometrics* include the Instructor's Resource Manual, Test Bank, and PowerPoint® slides with text figures, tables, and Key Concepts. The Instructor's Resource Manual includes solutions to all the end-of-chapter exercises, while the Test Bank, offered in Testgen, provides a rich supply of easily edited test problems and

questions of various types to meet specific course needs. These resources are available for download from the Instructor's Resource Center at www.pearsonhighered.com/stock_watson.

Companion Website

The Companion Website, found at www.pearsonhighered.com/stock_watson, provides a wide range of additional resources for students and faculty. These resources include more and more in depth empirical exercises, data sets for the empirical exercises, replication files for empirical results reported in the text, practice quizzes, answers to end-of-chapter Review the Concepts questions and Exercises, and EViews tutorials.

MyEconLab

The third edition update is accompanied by a robust MyEconLab course. The MyEconLab course includes all the Review the Concepts questions as well as some Exercises and Empirical Exercises. In addition, the enhanced eText available in MyEconLab for the third edition update includes URL links from the Exercises and Empirical Exercises to questions in the MyEconLab course and to the data that accompanies them. To register for MyEconLab and to learn more, log on to www.myeconlab.com.

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Introduction to Econometrics

Economic Questions and Data

Ask a half dozen econometricians what econometrics is, and you could get a half dozen different answers. One might tell you that econometrics is the science of testing economic theories. A second might tell you that econometrics is the set of tools used for forecasting future values of economic variables, such as a firm's sales, the overall growth of the economy, or stock prices. Another might say that econometrics is the process of fitting mathematical economic models to real-world data. A fourth might tell you that it is the science and art of using historical data to make numerical, or quantitative, policy recommendations in government and business.

In fact, all these answers are right. At a broad level, econometrics is the science and art of using economic theory and statistical techniques to analyze economic data. Econometric methods are used in many branches of economics, including finance, labor economics, macroeconomics, microeconomics, marketing, and economic policy. Econometric methods are also commonly used in other social sciences, including political science and sociology.

This book introduces you to the core set of methods used by econometricians. We will use these methods to answer a variety of specific, quantitative questions from the worlds of business and government policy. This chapter poses four of those questions and discusses, in general terms, the econometric approach to answering them. The chapter concludes with a survey of the main types of data available to econometricians for answering these and other quantitative economic questions.

1.1 Economic Questions We Examine

Many decisions in economics, business, and government hinge on understanding relationships among variables in the world around us. These decisions require quantitative answers to quantitative questions.

This book examines several quantitative questions taken from current issues in economics. Four of these questions concern education policy, racial bias in mortgage lending, cigarette consumption, and macroeconomic forecasting.

Question #1: Does Reducing Class Size Improve Elementary School Education?

Proposals for reform of the U.S. public education system generate heated debate. Many of the proposals concern the youngest students, those in elementary schools. Elementary school education has various objectives, such as developing social skills, but for many parents and educators, the most important objective is basic academic learning: reading, writing, and basic mathematics. One prominent proposal for improving basic learning is to reduce class sizes at elementary schools. With fewer students in the classroom, the argument goes, each student gets more of the teacher's attention, there are fewer class disruptions, learning is enhanced, and grades improve.

But what, precisely, is the effect on elementary school education of reducing class size? Reducing class size costs money: It requires hiring more teachers and, if the school is already at capacity, building more classrooms. A decision maker contemplating hiring more teachers must weigh these costs against the benefits. To weigh costs and benefits, however, the decision maker must have a precise quantitative understanding of the likely benefits. Is the beneficial effect on basic learning of smaller classes large or small? Is it possible that smaller class size actually has no effect on basic learning?

Although common sense and everyday experience may suggest that more learning occurs when there are fewer students, common sense cannot provide a quantitative answer to the question of what exactly is the effect on basic learning of reducing class size. To provide such an answer, we must examine empirical evidence—that is, evidence based on data—relating class size to basic learning in elementary schools.

In this book, we examine the relationship between class size and basic learning, using data gathered from 420 California school districts in 1999. In the California data, students in districts with small class sizes tend to perform better on standardized tests than students in districts with larger classes. While this fact is consistent with the idea that smaller classes produce better test scores, it might simply reflect many other advantages that students in districts with small classes have over their counterparts in districts with large classes. For example, districts with small class sizes tend to have wealthier residents than districts with large classes, so students in small-class districts could have more opportunities for learning outside the classroom. It could be these extra learning opportunities that lead to higher test scores, not smaller class sizes. In Part II, we use multiple regression analysis to isolate the effect of changes in class size from changes in other factors, such as the economic background of the students.

Question #2: Is There Racial Discrimination in the Market for Home Loans?

Most people buy their homes with the help of a mortgage, a large loan secured by the value of the home. By law, U.S. lending institutions cannot take race into account when deciding to grant or deny a request for a mortgage: Applicants who are identical in all ways except their race should be equally likely to have their mortgage applications approved. In theory, then, there should be no racial bias in mortgage lending.

In contrast to this theoretical conclusion, researchers at the Federal Reserve Bank of Boston found (using data from the early 1990s) that 28% of black applicants are denied mortgages, while only 9% of white applicants are denied. Do these data indicate that, in practice, there is racial bias in mortgage lending? If so, how large is it?

The fact that more black than white applicants are denied in the Boston Fed data does not by itself provide evidence of discrimination by mortgage lenders because the black and white applicants differ in many ways other than their race. Before concluding that there is bias in the mortgage market, these data must be examined more closely to see if there is a difference in the probability of being denied for *otherwise identical* applicants and, if so, whether this difference is large or small. To do so, in Chapter 11 we introduce econometric methods that make it possible to quantify the effect of race on the chance of obtaining a mortgage, *holding constant* other applicant characteristics, notably their ability to repay the loan.

Question #3: How Much Do Cigarette Taxes Reduce Smoking?

Cigarette smoking is a major public health concern worldwide. Many of the costs of smoking, such as the medical expenses of caring for those made sick by smoking and the less quantifiable costs to nonsmokers who prefer not to breathe secondhand cigarette smoke, are borne by other members of society. Because these costs are borne by people other than the smoker, there is a role for government intervention in reducing cigarette consumption. One of the most flexible tools for cutting consumption is to increase taxes on cigarettes.

Basic economics says that if cigarette prices go up, consumption will go down. But by how much? If the sales price goes up by 1%, by what percentage will the quantity of cigarettes sold decrease? The percentage change in the quantity demanded resulting from a 1% increase in price is the *price elasticity of demand*.

If we want to reduce smoking by a certain amount, say 20%, by raising taxes, then we need to know the price elasticity of demand to calculate the price increase necessary to achieve this reduction in consumption. But what is the price elasticity of demand for cigarettes?

Although economic theory provides us with the concepts that help us answer this question, it does not tell us the numerical value of the price elasticity of demand. To learn the elasticity, we must examine empirical evidence about the behavior of smokers and potential smokers; in other words, we need to analyze data on cigarette consumption and prices.

The data we examine are cigarette sales, prices, taxes, and personal income for U.S. states in the 1980s and 1990s. In these data, states with low taxes, and thus low cigarette prices, have high smoking rates, and states with high prices have low smoking rates. However, the analysis of these data is complicated because causality runs both ways: Low taxes lead to high demand, but if there are many smokers in the state, then local politicians might try to keep cigarette taxes low to satisfy their smoking constituents. In Chapter 12, we study methods for handling this “simultaneous causality” and use those methods to estimate the price elasticity of cigarette demand.

Question #4: By How Much Will U.S. GDP Grow Next Year?

It seems that people always want a sneak preview of the future. What will sales be next year at a firm that is considering investing in new equipment? Will the stock market go up next month, and, if it does, by how much? Will city tax receipts next year cover planned expenditures on city services? Will your microeconomics exam next week focus on externalities or monopolies? Will Saturday be a nice day to go to the beach?

One aspect of the future in which macroeconomists are particularly interested is the growth of real economic activity, as measured by real gross domestic product (GDP), during the next year. A management consulting firm might advise a manufacturing client to expand its capacity based on an upbeat forecast of economic growth. Economists at the Federal Reserve Board in Washington, D.C., are mandated to set policy to keep real GDP near its potential in order to maximize employment. If they forecast anemic GDP growth over the next year, they might expand liquidity in the economy by reducing interest rates or other measures, in an attempt to boost economic activity.

Professional economists who rely on precise numerical forecasts use econometric models to make those forecasts. A forecaster’s job is to predict the future

by using the past, and econometricians do this by using economic theory and statistical techniques to quantify relationships in historical data.

The data we use to forecast the growth rate of GDP are past values of GDP and the “term spread” in the United States. The *term spread* is the difference between long-term and short-term interest rates. It measures, among other things, whether investors expect short-term interest rates to rise or fall in the future. The term spread is usually positive, but it tends to fall sharply before the onset of a recession. One of the GDP growth rate forecasts we develop and evaluate in Chapter 14 is based on the term spread.

Quantitative Questions, Quantitative Answers

Each of these four questions requires a numerical answer. Economic theory provides clues about that answer—for example, cigarette consumption ought to go down when the price goes up—but the actual value of the number must be learned empirically, that is, by analyzing data. Because we use data to answer quantitative questions, our answers always have some uncertainty: A different set of data would produce a different numerical answer. Therefore, the conceptual framework for the analysis needs to provide both a numerical answer to the question and a measure of how precise the answer is.

The conceptual framework used in this book is the multiple regression model, the mainstay of econometrics. This model, introduced in Part II, provides a mathematical way to quantify how a change in one variable affects another variable, holding other things constant. For example, what effect does a change in class size have on test scores, *holding constant* or *controlling for* student characteristics (such as family income) that a school district administrator cannot control? What effect does your race have on your chances of having a mortgage application granted, *holding constant* other factors such as your ability to repay the loan? What effect does a 1% increase in the price of cigarettes have on cigarette consumption, *holding constant* the income of smokers and potential smokers? The multiple regression model and its extensions provide a framework for answering these questions using data and for quantifying the uncertainty associated with those answers.

1.2 Causal Effects and Idealized Experiments

Like many other questions encountered in econometrics, the first three questions in Section 1.1 concern causal relationships among variables. In common usage, an action is said to cause an outcome if the outcome is the direct result, or consequence,

of that action. Touching a hot stove causes you to get burned; drinking water causes you to be less thirsty; putting air in your tires causes them to inflate; putting fertilizer on your tomato plants causes them to produce more tomatoes. Causality means that a specific action (applying fertilizer) leads to a specific, measurable consequence (more tomatoes).

Estimation of Causal Effects

How best might we measure the causal effect on tomato yield (measured in kilograms) of applying a certain amount of fertilizer, say 100 grams of fertilizer per square meter?

One way to measure this causal effect is to conduct an experiment. In that experiment, a horticultural researcher plants many plots of tomatoes. Each plot is tended identically, with one exception: Some plots get 100 grams of fertilizer per square meter, while the rest get none. Moreover, whether a plot is fertilized or not is determined randomly by a computer, ensuring that any other differences between the plots are unrelated to whether they receive fertilizer. At the end of the growing season, the horticulturalist weighs the harvest from each plot. The difference between the average yield per square meter of the treated and untreated plots is the effect on tomato production of the fertilizer treatment.

This is an example of a **randomized controlled experiment**. It is controlled in the sense that there are both a **control group** that receives no treatment (no fertilizer) and a **treatment group** that receives the treatment (100 g/m² of fertilizer). It is randomized in the sense that the treatment is assigned randomly. This random assignment eliminates the possibility of a systematic relationship between, for example, how sunny the plot is and whether it receives fertilizer so that the only systematic difference between the treatment and control groups is the treatment. If this experiment is properly implemented on a large enough scale, then it will yield an estimate of the causal effect on the outcome of interest (tomato production) of the treatment (applying 100 g/m² of fertilizer).

In this book, the **causal effect** is defined to be the effect on an outcome of a given action or treatment, as measured in an ideal randomized controlled experiment. In such an experiment, the only systematic reason for differences in outcomes between the treatment and control groups is the treatment itself.

It is possible to imagine an ideal randomized controlled experiment to answer each of the first three questions in Section 1.1. For example, to study class size, one can imagine randomly assigning “treatments” of different class sizes to different groups of students. If the experiment is designed and executed so that the only systematic difference between the groups of students is their class size, then in

theory this experiment would estimate the effect on test scores of reducing class size, holding all else constant.

The concept of an ideal randomized controlled experiment is useful because it gives a definition of a causal effect. In practice, however, it is not possible to perform ideal experiments. In fact, experiments are relatively rare in econometrics because often they are unethical, impossible to execute satisfactorily, or prohibitively expensive. The concept of the ideal randomized controlled experiment does, however, provide a theoretical benchmark for an econometric analysis of causal effects using actual data.

Forecasting and Causality

Although the first three questions in Section 1.1 concern causal effects, the fourth—forecasting the growth rate of GDP—does not. You do not need to know a causal relationship to make a good forecast. A good way to “forecast” whether it is raining is to observe whether pedestrians are using umbrellas, but the act of using an umbrella does not cause it to rain.

Even though forecasting need not involve causal relationships, economic theory suggests patterns and relationships that might be useful for forecasting. As we see in Chapter 14, multiple regression analysis allows us to quantify historical relationships suggested by economic theory, to check whether those relationships have been stable over time, to make quantitative forecasts about the future, and to assess the accuracy of those forecasts.

1.3 Data: Sources and Types

In econometrics, data come from one of two sources: experiments or nonexperimental observations of the world. This book examines both experimental and nonexperimental data sets.

Experimental Versus Observational Data

Experimental data come from experiments designed to evaluate a treatment or policy or to investigate a causal effect. For example, the state of Tennessee financed a large randomized controlled experiment examining class size in the 1980s. In that experiment, which we examine in Chapter 13, thousands of students were randomly assigned to classes of different sizes for several years and were given standardized tests annually.

The Tennessee class size experiment cost millions of dollars and required the ongoing cooperation of many administrators, parents, and teachers over several years. Because real-world experiments with human subjects are difficult to administer and to control, they have flaws relative to ideal randomized controlled experiments. Moreover, in some circumstances, experiments are not only expensive and difficult to administer but also unethical. (Would it be ethical to offer randomly selected teenagers inexpensive cigarettes to see how many they buy?) Because of these financial, practical, and ethical problems, experiments in economics are relatively rare. Instead, most economic data are obtained by observing real-world behavior.

Data obtained by observing actual behavior outside an experimental setting are called **observational data**. Observational data are collected using surveys, such as telephone surveys of consumers, and administrative records, such as historical records on mortgage applications maintained by lending institutions.

Observational data pose major challenges to econometric attempts to estimate causal effects, and the tools of econometrics are designed to tackle these challenges. In the real world, levels of “treatment” (the amount of fertilizer in the tomato example, the student–teacher ratio in the class size example) are not assigned at random, so it is difficult to sort out the effect of the “treatment” from other relevant factors. Much of econometrics, and much of this book, is devoted to methods for meeting the challenges encountered when real-world data are used to estimate causal effects.

Whether the data are experimental or observational, data sets come in three main types: cross-sectional data, time series data, and panel data. In this book, you will encounter all three types.

Cross-Sectional Data

Data on different entities—workers, consumers, firms, governmental units, and so forth—for a single time period are called **cross-sectional data**. For example, the data on test scores in California school districts are cross sectional. Those data are for 420 entities (school districts) for a single time period (1999). In general, the number of entities on which we have observations is denoted n ; so, for example, in the California data set, $n = 420$.

The California test score data set contains measurements of several different variables for each district. Some of these data are tabulated in Table 1.1. Each row lists data for a different district. For example, the average test score for the first district (“district #1”) is 690.8; this is the average of the math and science test scores for all fifth graders in that district in 1999 on a standardized test (the Stanford

TABLE 1.1 Selected Observations on Test Scores and Other Variables for California School Districts in 1999

Observation (District) Number	District Average Test Score (fifth grade)	Student–Teacher Ratio	Expenditure per Pupil (\$)	Percentage of Students Learning English
1	690.8	17.89	\$6385	0.0%
2	661.2	21.52	5099	4.6
3	643.6	18.70	5502	30.0
4	647.7	17.36	7102	0.0
5	640.8	18.67	5236	13.9
⋮	⋮	⋮	⋮	⋮
⋮	⋮	⋮	⋮	⋮
418	645.0	21.89	4403	24.3
419	672.2	20.20	4776	3.0
420	655.8	19.04	5993	5.0

Note: The California test score data set is described in Appendix 4.1.

Achievement Test). The average student–teacher ratio in that district is 17.89; that is, the number of students in district #1 divided by the number of classroom teachers in district #1 is 17.89. Average expenditure per pupil in district #1 is \$6385. The percentage of students in that district still learning English—that is, the percentage of students for whom English is a second language and who are not yet proficient in English—is 0%.

The remaining rows present data for other districts. The order of the rows is arbitrary, and the number of the district, which is called the **observation number**, is an arbitrarily assigned number that organizes the data. As you can see in the table, all the variables listed vary considerably.

With cross-sectional data, we can learn about relationships among variables by studying differences across people, firms, or other economic entities during a single time period.

Time Series Data

Time series data are data for a single entity (person, firm, country) collected at multiple time periods. Our data set on the growth rate of GDP and the term spread in the United States is an example of a time series data set. The data set