

Essex Summer School in Social Science Data Analysis  
Panel Data Analysis for Comparative Research

Basic Concepts for Panel Data

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## Panel Data Structure

Suppose we observe our response over both time and place:

$$y_{it} = x_{it}\beta + \varepsilon_{it}$$

We have units  $i = 1, \dots, N$ , each observed over periods  $t = 1, \dots, T$ , for a total of  $N \times T$  observations

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Balanced data: all units  $i$  have the same number of observations  $T$ .

Unbalanced data: some units are shorter in  $T$ , perhaps due to missing data, perhaps due to sample selection

All of our discussion in class will assume balanced panels.

Small adjustments may be needed for unbalanced panels, unless the imbalance is due to sample selection, which could lead to significant bias.

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2. Data with any  $N, T$ , and repeated observations on units  $i = 1, \dots, N$  (esp. in opinion research)
3. Any data with both  $N > 1$  and  $T > 1$  (sometimes in political science)

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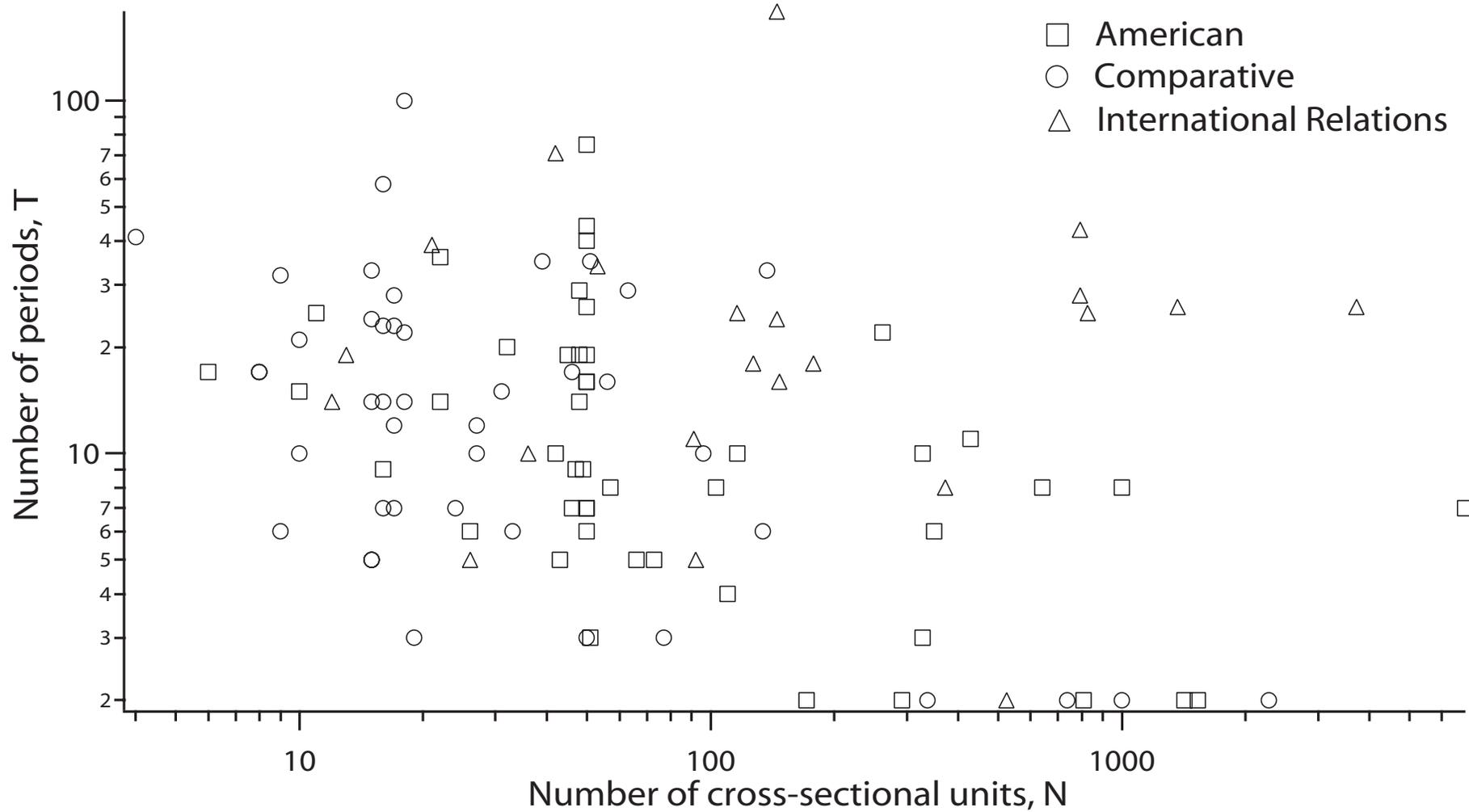
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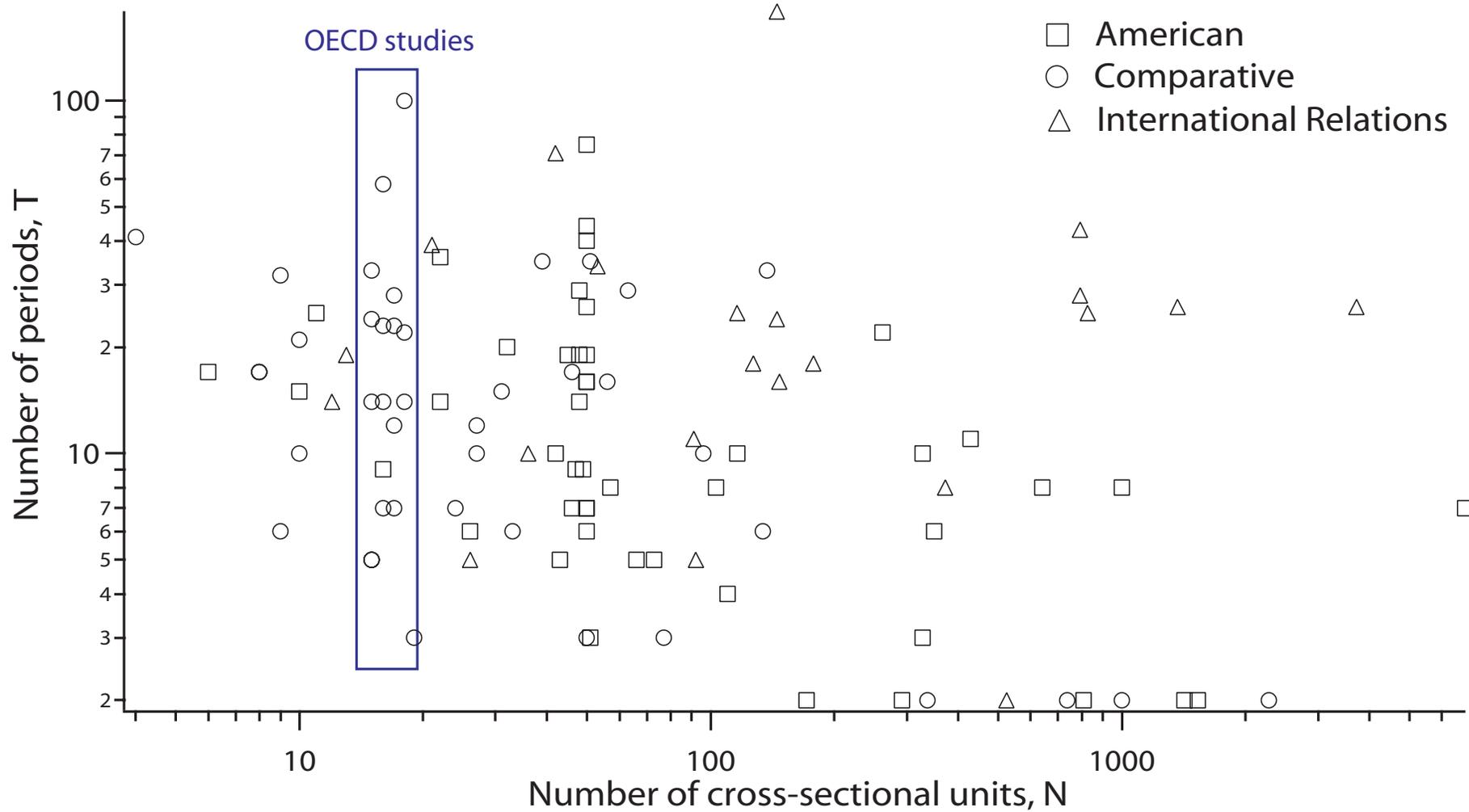
Data with large  $N$  and small  $T$  offer different problems and opportunities compared to data with small  $N$  and medium  $T$

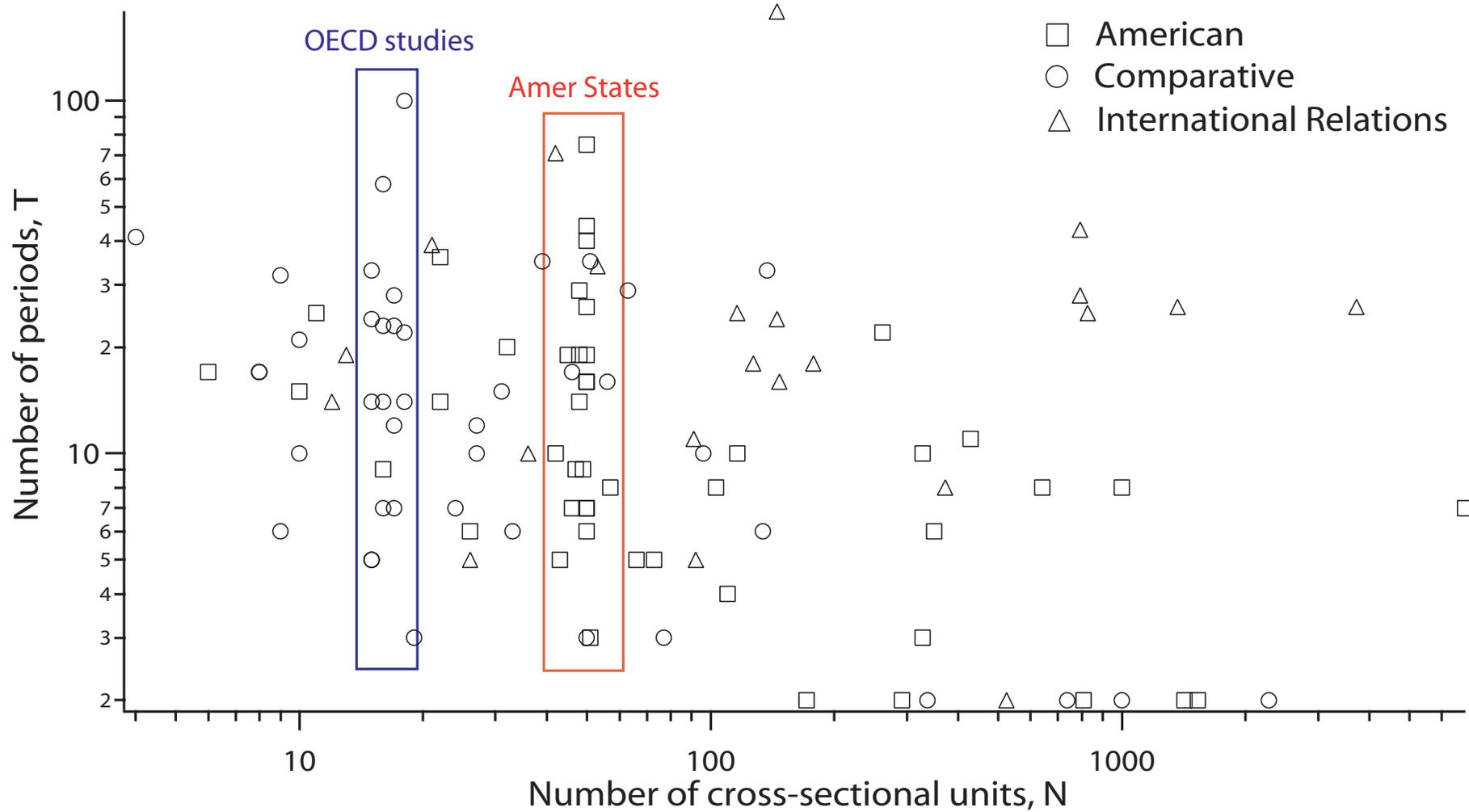
Beware blanket statements about *panel estimators* or *panel data*.

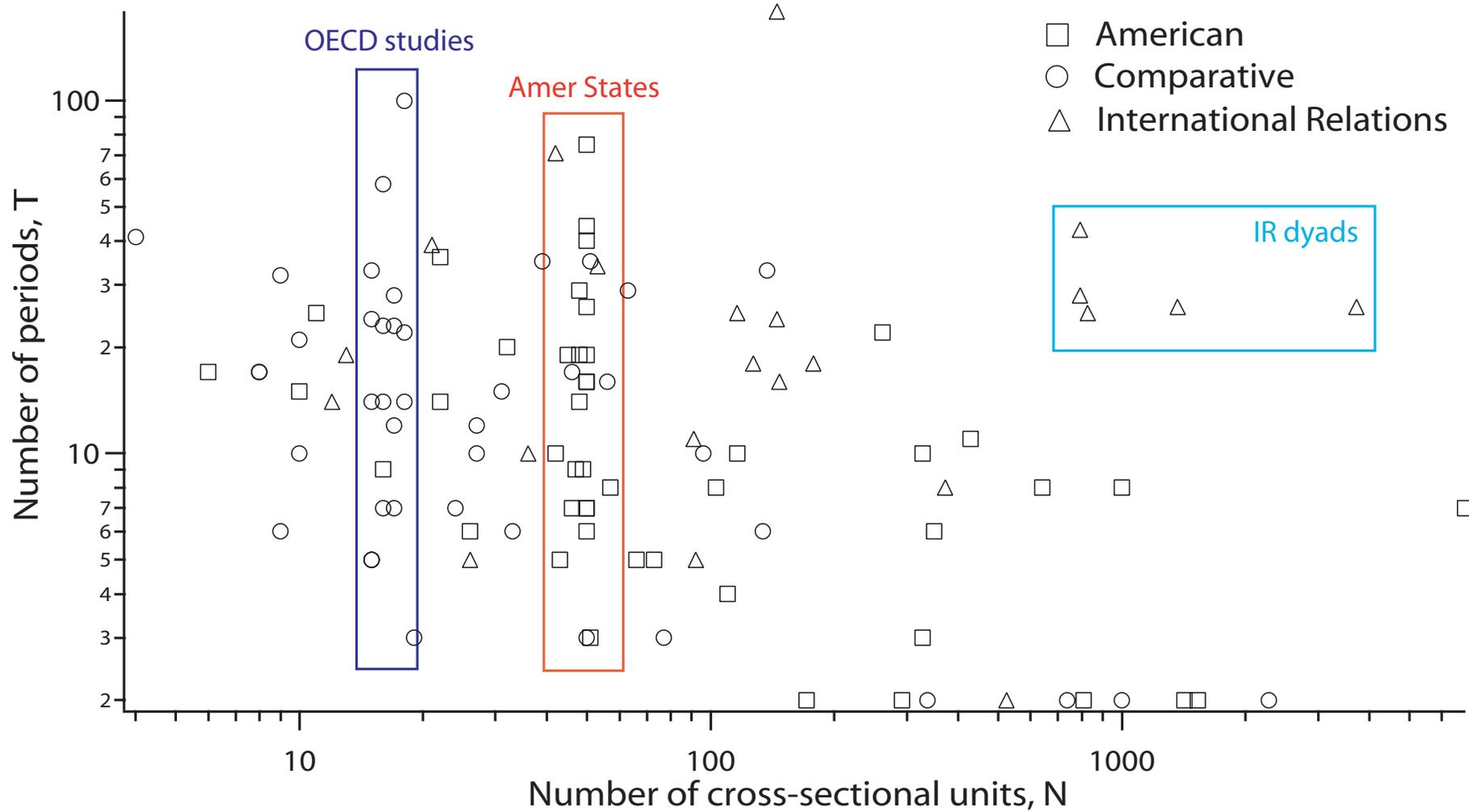
The author—even in a textbook—may be assuming an  $N$  and  $T$  ubiquitous in his field, but uncommon in yours!

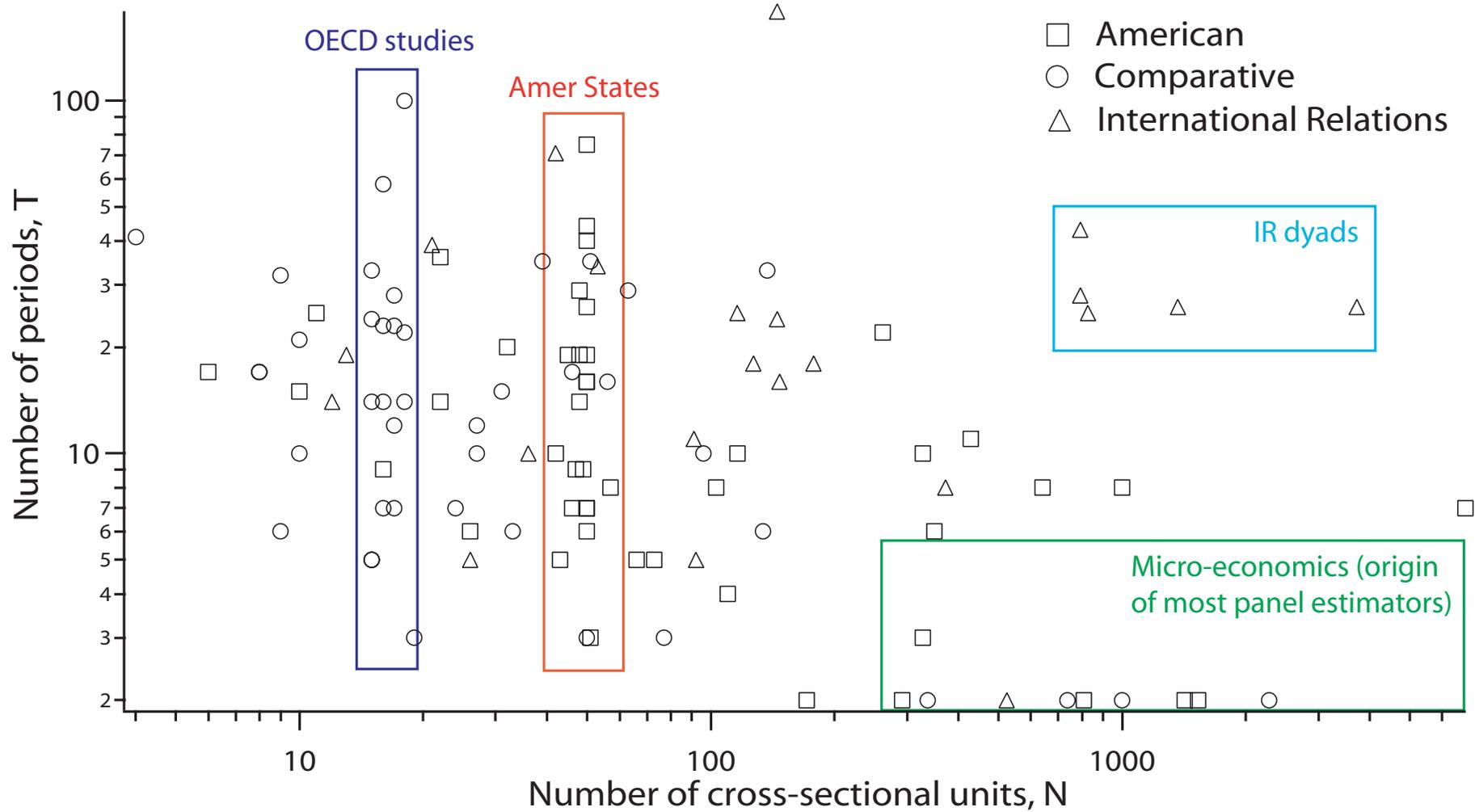
Especially a problem for comparativists learning from econometrics texts











## A pooled TSCS model

$$\text{GDP}_{it} = \phi_1 \text{GDP}_{i,t-1} + \beta_0 + \beta_1 \text{Democracy}_{it} + \varepsilon_{it}$$

This model assumes the same effect of Democracy on GDP for all countries  $i$  ( $\beta_1$ )

And influence of past GDP on current GDP is the same for all countries  $i$  ( $\phi_1$ )

The shared parameters make this a *Pooled* Time Series Cross Section model

## Data storage issues

To get panel data ready for analysis, we need it *stacked* by unit and time period, with a time variable and a grouping variable included:

Cty	Year	GDP	lagGDP	Democracy
1	1962	5012	NA	0
1	1963	6083	5012	0
1	1964	6502	6083	0
...				
1	1989	12530	12266	0
1	1990	12176	12530	0
2	1975	1613	NA	NA
2	1976	1438	1613	0
...				
135	1989	6575	6595	0
135	1990	6450	6575	0

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135	1990	6450	6575	0

Don't use `lag()` to create lags in panel data!  
(*Exception:* okay inside `plm()` formulas)

You need a panel lag command that accounts for the breaks where the unit changes, such as `lagpanel()` in the `simcf` package.

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- Some analysis only possible with panel data; e.g., if variables don't change much over time, like institutions
- Heterogeneity is interesting! As long as we can specify a general DGP for whole panel, can parameterize and estimate more substantively interesting relationships

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- Differences across the panel would appear the biggest problem, but we can relax any homogeneity assumption to get a more flexible panel model
- The price of panel data is a more complex structure to conceptualize and model
- Often need more powerful or flexible estimation tools

## Building Time Series into Panel

Consider the ARIMA(p,d,q) model:

$$\Delta^d y_t = \alpha + \mathbf{x}_t \boldsymbol{\beta} + \sum_{p=1}^P \Delta^d y_{t-p} \phi_p + \sum_{q=1}^Q \varepsilon_{t-q} \rho_q + \varepsilon_t$$

where  $\varepsilon \sim N(0, \sigma^2)$  is white noise

An encompassing specification for many time series processes

Includes as special cases:

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AR(p) models: Set  $d = Q = 0$

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An encompassing specification for many time series processes

Includes as special cases:

ARMA(p,q) models: Set  $d = 0$

AR(p) models: Set  $d = Q = 0$

MA(q) models: Set  $d = P = 0$

Linear regression: Set  $d = P = Q = 0$

Could even be re-written as an error correction model

## Multiple Time Series

Now notice that if we had several parallel time series  $y_{1t}, y_{2t}, \dots, y_{Nt}$ , as for  $N$  countries, we could estimate a series of regression models:

$$\Delta^{d_1} y_{1t} = \alpha_1 + \mathbf{x}_{1t} \boldsymbol{\beta}_1 + \sum_{p=1}^{P_1} \Delta^{d_1} y_{1,t-p} \phi_{1p} + \sum_{q=1}^{Q_1} \varepsilon_{1,t-q} \rho_{1q} + \varepsilon_{1t}$$

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...

$$\Delta^{d_N} y_{Nt} = \alpha_N + \mathbf{x}_{Nt} \boldsymbol{\beta}_N + \sum_{p=N}^{P_N} \Delta^{d_N} y_{N,t-p} \phi_{Np} + \sum_{q=N}^{Q_N} \varepsilon_{N,t-q} \rho_{Nq} + \varepsilon_{Nt}$$

Each of these models could be estimated separately

## Multiple Time Series

The results would be a panel analysis of a particular kind:

- one with maximum flexibility for heterogeneous data generating processes across units  $i$ ,
- and no borrowing of strength across units  $i$

Generally, we can write this series of regression models as:

$$\Delta^{d_i} y_{it} = \alpha_i + \mathbf{x}_{it} \boldsymbol{\beta}_i + \sum_{p=1}^{P_i} \Delta^{d_i} y_{i,t-p} \phi_{ip} + \sum_{q=1}^{Q_i} \varepsilon_{i,t-q} \rho_{iq} + \varepsilon_{it}$$

We've just written all our time series equations in a single matrix

But estimation is still *separate* for each equation

Be clear what the subscripts and variables are

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- $\phi_{ip}$  is the AR parameter applied to the  $p$ th lag,  $\Delta^{d_i} y_{i,t-p}$ , for unit  $i$ .

## Pooling and Partial Pooling

Alternative: we could “borrow strength” across units in estimating parameters

This involves imposing restrictions on (at least some of) the parameters to assume they are either related or identical across units

Trade-off between flexibility to measure heterogeneity, and pooling data to estimate shared parameters more precisely

Same kind of trade-off is at work in *all* modeling decisions, and all modeling involves weighing these trade-offs

## All models are oversimplifications

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For example, why can't we estimate, for a standard cross-sectional dataset with a Normally distributed  $y_i$ , this inarguably "correct" linear model:

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To do any inference,

to learn anything non-obvious from data,

to reduce any data to a simpler model,

we must impose restrictions on parameters which are arguably false

Panel data simply offers a wider range of choices on which parameters to "pool" and which to separate out

## The range of models available for panel data

Full flexibility:

$$\Delta^{d_i} y_{it} = \alpha_i + \mathbf{x}_{it} \beta_i + \sum_{p=1}^{P_i} \Delta^{d_i} y_{i,t-p} \phi_{ip} + \sum_{q=1}^{Q_i} \varepsilon_{i,t-q} \rho_{iq} + \varepsilon_{it}$$
$$\varepsilon_{it} \sim N(0, \sigma_i^2)$$

For each  $i$ , we need to choose  $p_i, d_i, q_i$  and estimate  $\alpha_i, \beta_i, \phi_i, \rho_i, \sigma_i^2$

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Full pooling:

$$\Delta^d y_{it} = \alpha + \mathbf{x}_{it} \boldsymbol{\beta} + \sum_{p=1}^P \Delta^d y_{i,t-p} \phi_p + \sum_{q=1}^Q \varepsilon_{i,t-q} \rho_q + \varepsilon_{it}$$
$$\varepsilon_{it} \sim N(0, \sigma^2)$$

We choose common  $p, d, q$  across all  $i$ , and estimate common  $\alpha, \boldsymbol{\beta}, \boldsymbol{\rho}, \phi, \sigma^2$

# Popular panel specifications

Variable intercepts

$$\Delta^d y_{it} = \alpha_i + \mathbf{x}_{it}\boldsymbol{\beta} + \sum_{p=1}^P \Delta^d y_{i,t-p} \phi_p + \sum_{q=1}^Q \varepsilon_{i,t-q} \rho_q + \varepsilon_{it}$$
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## Variable slopes and intercepts

$$\Delta^d y_{it} = \alpha_i + \mathbf{x}_{it}\boldsymbol{\beta}_i + \sum_{p=1}^P \Delta^d y_{i,t-p} \phi_p + \sum_{q=1}^Q \varepsilon_{i,t-q} \rho_q + \varepsilon_{it}$$
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Variable lag structures

$$\Delta^{d_i} y_{it} = \alpha + \mathbf{x}_{it} \boldsymbol{\beta} + \sum_{p=1}^{P_i} \Delta^{d_i} y_{i,t-p} \phi_{ip} + \sum_{q=1}^{Q_i} \varepsilon_{i,t-q} \rho_{iq} + \varepsilon_{it}$$

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Panel heteroskedasticity

$$\Delta^d y_{it} = \alpha + \mathbf{x}_{it} \boldsymbol{\beta} + \sum_{p=1}^P \Delta^d y_{i,t-p} \phi_p + \sum_{q=1}^Q \varepsilon_{i,t-q} \rho_q + \varepsilon_{it}$$
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## Still more time series options

Variable intercepts with a unit-specific trend

$$\Delta^d y_{it} = \alpha_i + t\theta_i + \mathbf{x}_{it}\boldsymbol{\beta} + \sum_{p=1}^P \Delta^d y_{i,t-p}\phi_p + \sum_{q=1}^Q \varepsilon_{i,t-q}\rho_q + \varepsilon_{it}$$

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Variable intercepts with unit-specific additive seasonality

$$\Delta^d y_{it} = \alpha_i + \kappa_{k,i} + \mathbf{x}_{it}\boldsymbol{\beta} + \sum_{p=1}^P \Delta^d y_{i,t-p}\phi_p + \sum_{q=1}^Q \varepsilon_{i,t-q}\rho_q + \varepsilon_{it}$$
$$\varepsilon_{it} \sim \text{N}(0, \sigma^2)$$

Note that you could also assume the same trend and/or seasonality applies to the whole panel by dropping the relevant  $i$  subscripts

## Models of variable intercepts

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How do we model  $\alpha_i$ ?

Let the mean of  $\alpha_i$  be  $\alpha_i^*$ .

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Then there are a range of possibilities:

Let  $\alpha_i$  be a random variable with no systemic component (this type of  $\alpha_i$  known as a *random effect*)

$$\alpha_i \sim N(0, \sigma_\alpha^2)$$

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Let  $\alpha_i$  be a systematic component with no stochastic component  
(this type of  $\alpha_i$  is known as a *fixed effect*)

$$\alpha_i = \alpha_i^*$$

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$$\alpha_i = \alpha_i^*$$

Let  $\alpha_i$  be a random variable with a unit-specific systematic component  
(this type of  $\alpha_i$  known as a *mixed effect*)

$$\alpha_i \sim N(\alpha_i^*, \sigma_\alpha^2)$$

## Random effects

$$\alpha_i \sim N(0, \sigma_\alpha^2)$$

Intuitive from a maximum likelihood modeling perspective

A unit specific error term

Assumes the units come from a common population,  
with an unknown (estimated) variance,  $\sigma_\alpha^2$

In likelihood inference, estimation focuses on this variance, not on particular  $\alpha_i$ 's

Uncorrelated with  $\mathbf{x}_{it}$  by design

Need MLE to estimate

## Random effects example

A (contrived) example may help clarify what random effects are.

Suppose that we have data following this true model:

$$y_{it} = \beta_0 + \beta_1 x_{it} + \alpha_i + \varepsilon_{it}$$

$$\alpha_i \sim \mathcal{N}(0, \sigma_\alpha^2)$$

$$\varepsilon_{it} \sim \mathcal{N}(0, \sigma^2)$$

with  $i \in \{1, \dots, N\}$  and  $t \in \{1, \dots, T\}$

Note that we are ignoring time series dynamics for now

It may help to pretend that these data have a real world meaning though remember throughout we have created them out of thin air and `rnorm()`

So let's pretend these data reflect undergraduate student assignment scores over a term for  $N = 100$  students and  $T = 5$  assignments

## Random effects example: Student aptitude & effort

Let's pretend these data reflect undergraduate student assignment scores over a term for  $N = 100$  students and  $T = 5$  assignments:

$$\text{score}_{it} = \beta_0 + \beta_1 \text{hours}_{it} + \alpha_i + \varepsilon_{it}$$

$$\alpha_i \sim \mathcal{N}(0, \sigma_\alpha^2)$$

$$\varepsilon_{it} \sim \mathcal{N}(0, \sigma^2)$$

with  $i \in \{1, \dots, N\}$  and  $t \in \{1, \dots, T\}$

The response is the assignment score,  $\text{score}_{it}$

and the covariate is the hours studied,  $\text{hours}_{it}$

and each student has an unobservable aptitude  $\alpha_i$  which is Normally distributed

Aptitude has the same (random) effect on each assignment by a given student

## Random effects example: Student aptitude & effort

Let's pretend these data reflect undergraduate student assignment scores over a term for  $N = 100$  students and  $T = 5$  assignments:

$$\text{score}_{it} = 0 + 0.75 \times \text{hours}_{it} + \alpha_i + \varepsilon_{it}$$

$$\alpha_i \sim \mathcal{N}(0, 0.7^2)$$

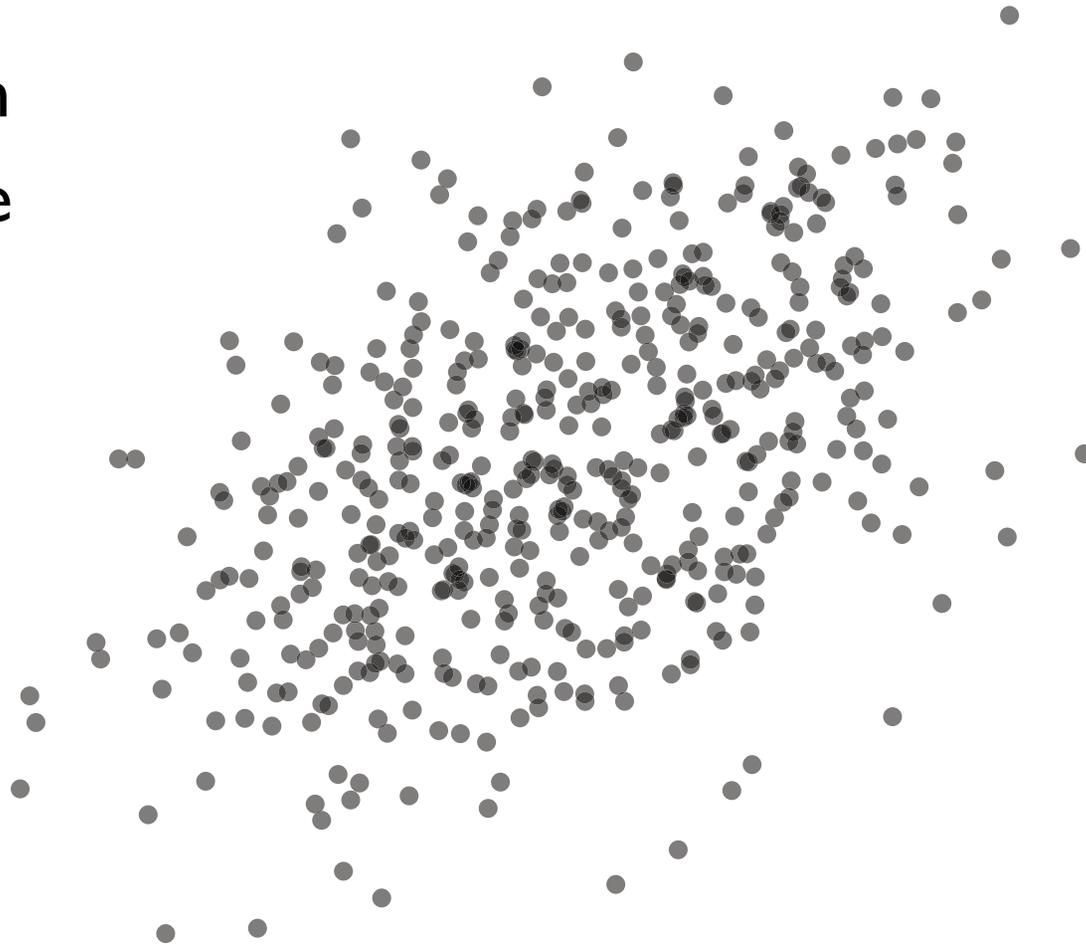
$$\varepsilon_{it} \sim \mathcal{N}(0, 0.2^2)$$

with  $i \in \{1, \dots, 100\}$  and  $t \in \{1, \dots, 5\}$

the above are the true values of the parameters I used to generate the data

let's see what role the random effect  $\alpha_i$  plays here

exam  
score

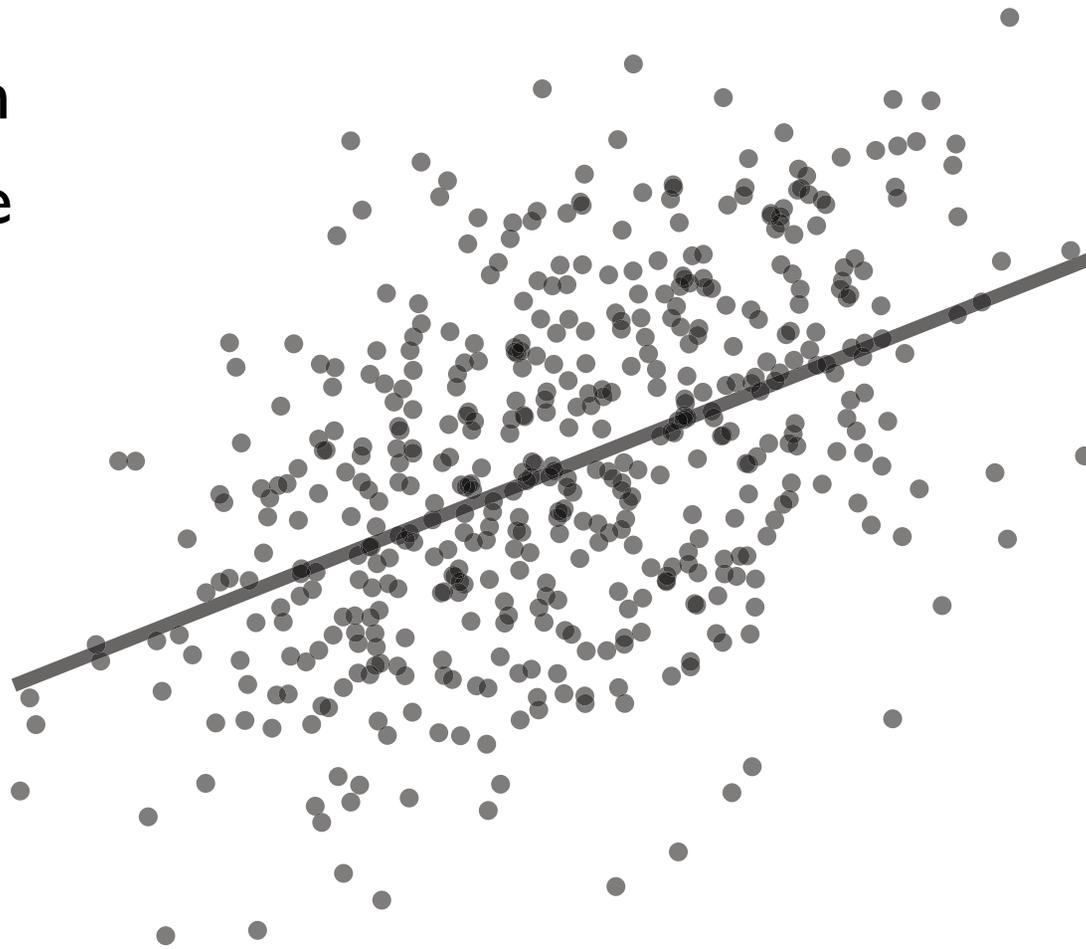


hours of study

The 500 observations

A relationship between  
effort & scores seems  
evident

exam  
score



hours of study

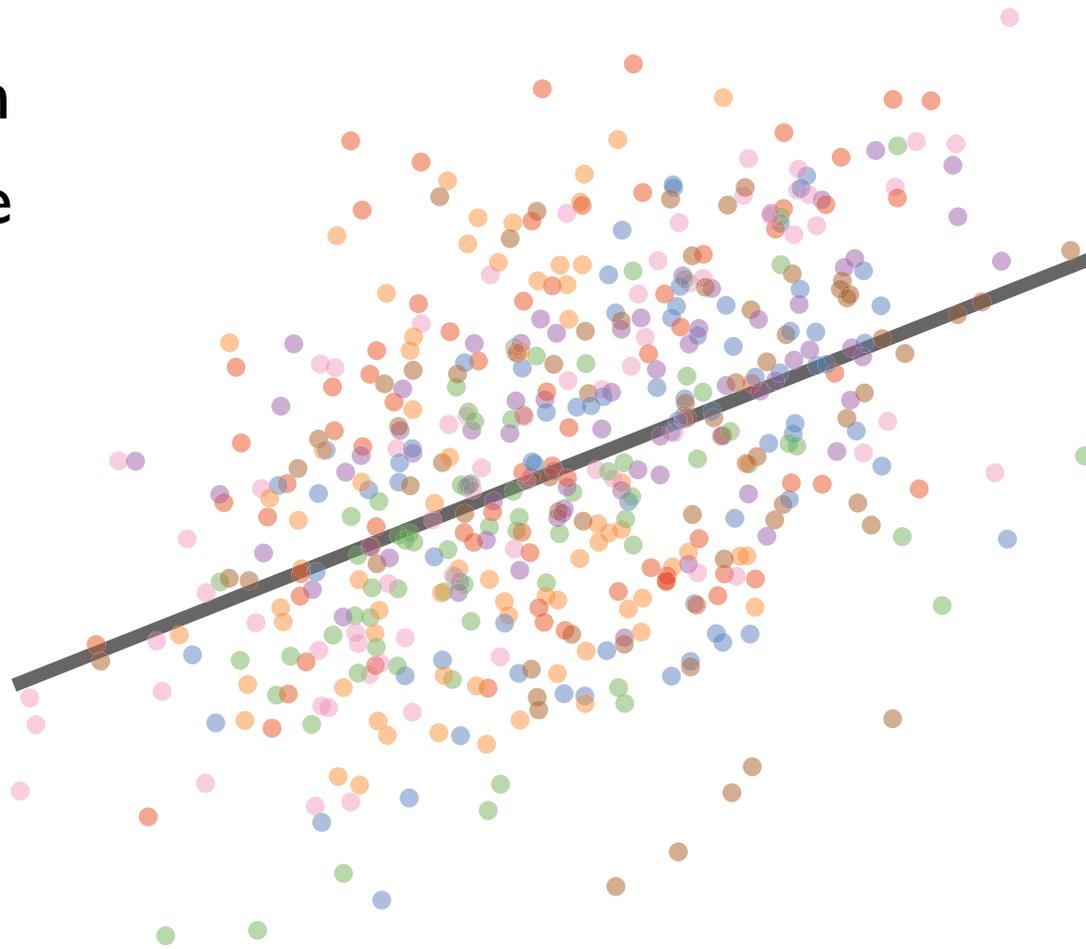
Let's summarize the relationship using the least squares  $\hat{\beta}_1$

Approximately equal to the true  $\beta_1 = 0.75$

Haven't discussed, used, or estimated the random effects yet

Do we need them?

exam  
score



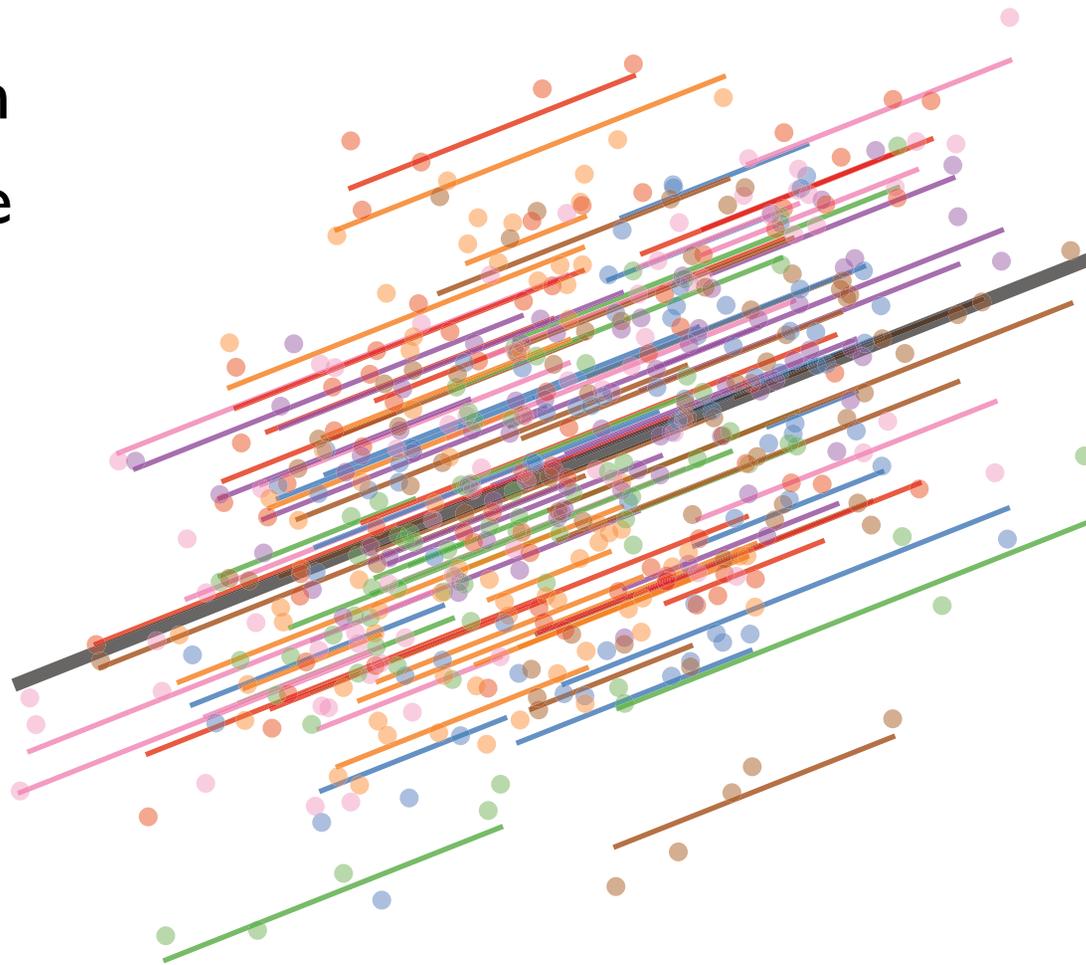
hours of study

Identify each of the 100 students using colored dots (we have 8 colors; they repeat)

Clear that each student's scores are tightly clustered

Note the student-level slopes

exam  
score



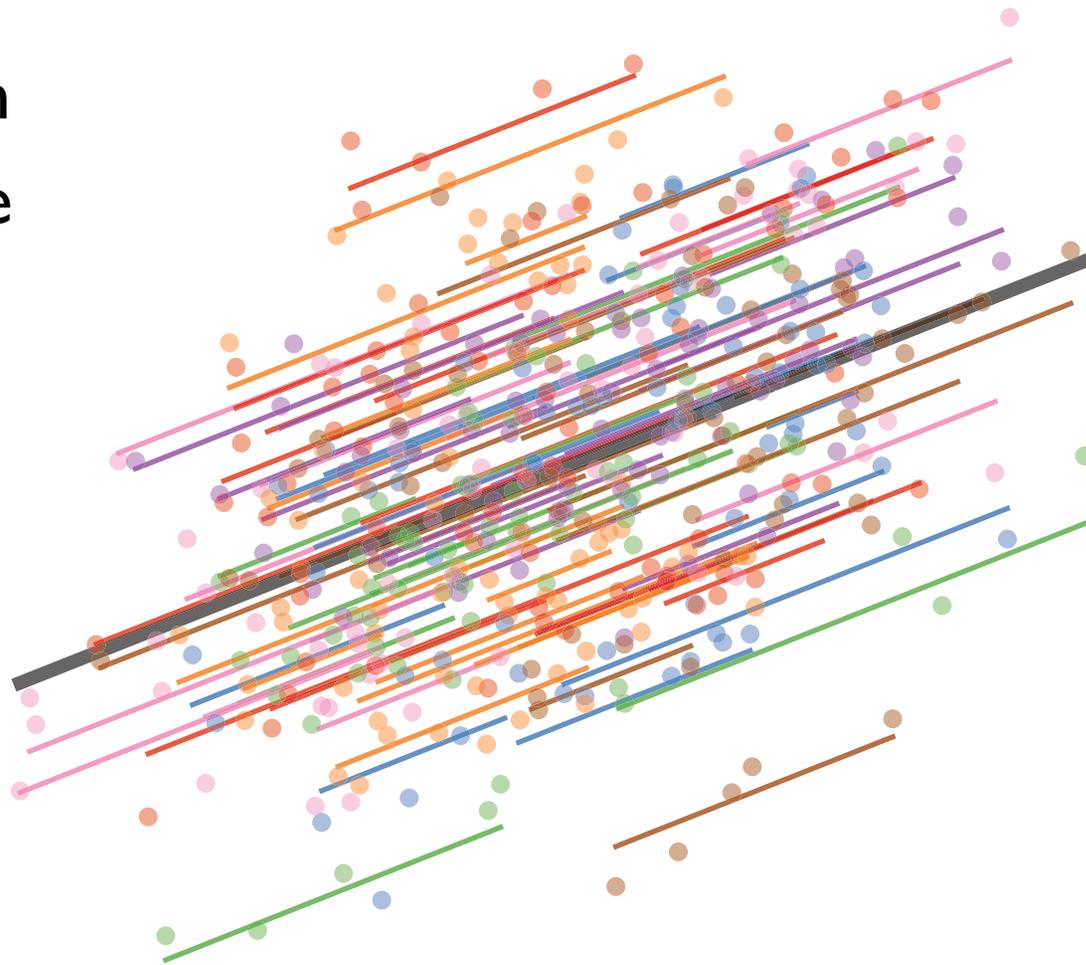
hours of study

Each student follows the same regression line as the whole class, but with a unique intercept

That intercept is the random effect  $\alpha_i$

It's also the average difference between student  $i$ 's scores and the class-level regression line

exam  
score

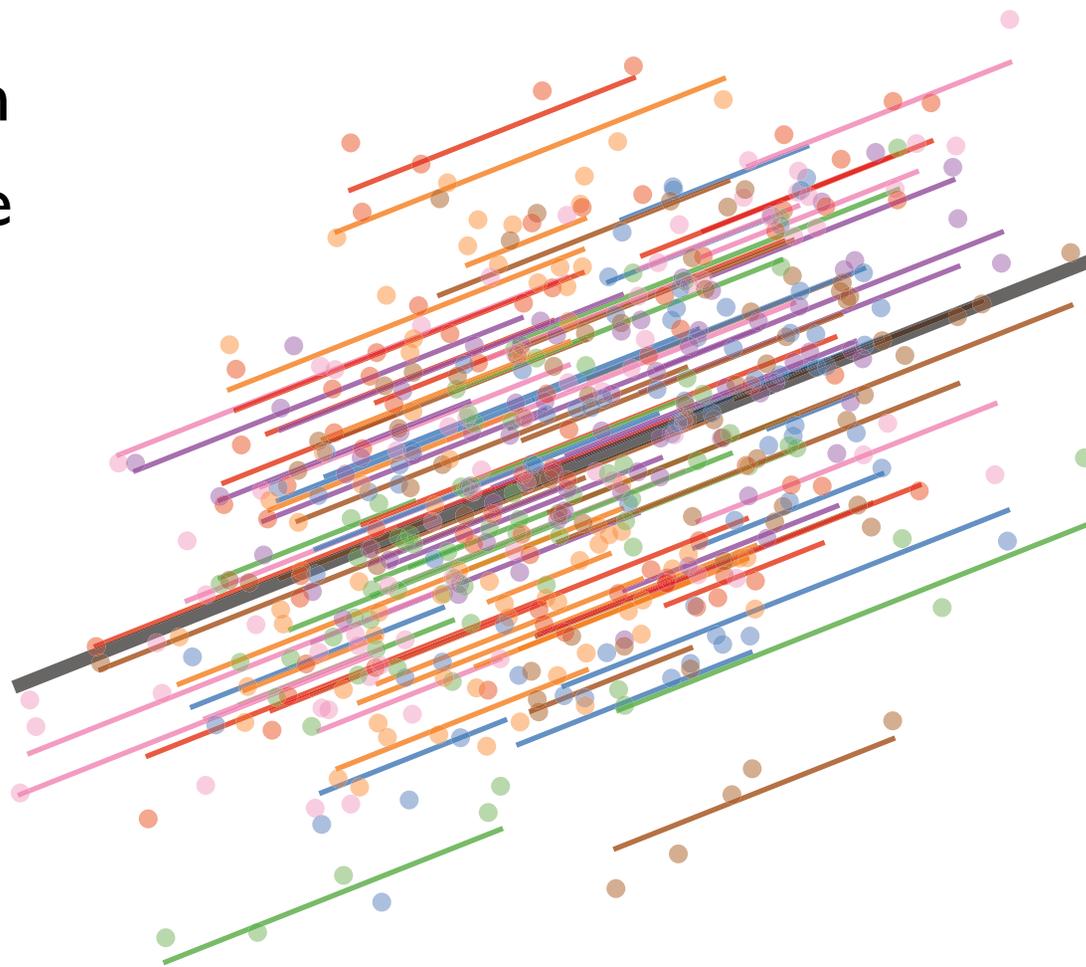


hours of study

The student random effect is the student-specific component of the error term

After we remove it, a student's scores across exams exhibit white noise variation around a student-specific version of the overall regression line

exam  
score



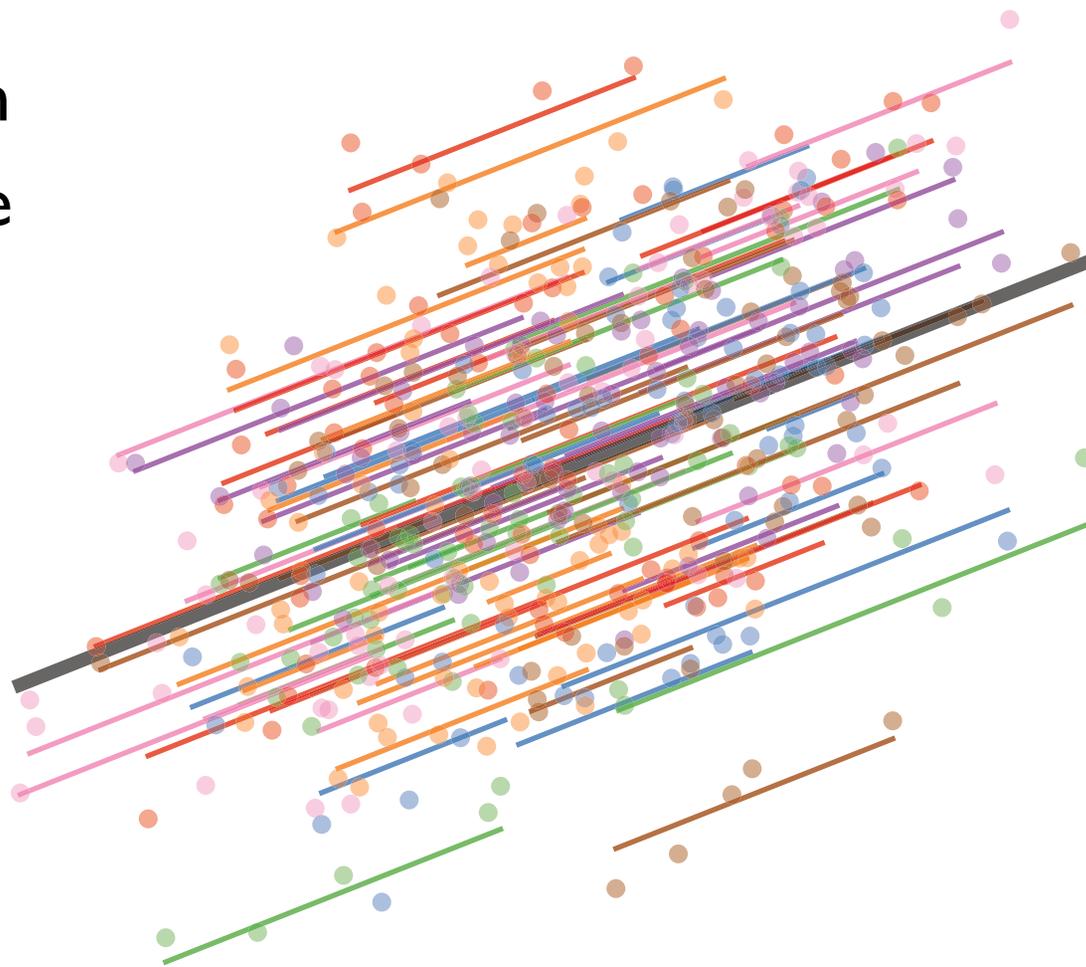
hours of study

These random effects  $\alpha_i$  reflect the portion of the error term that results from unmeasured student characteristics

I've labelled this random component "aptitude"

But that's just a word for everything related to a student's ability

exam  
score

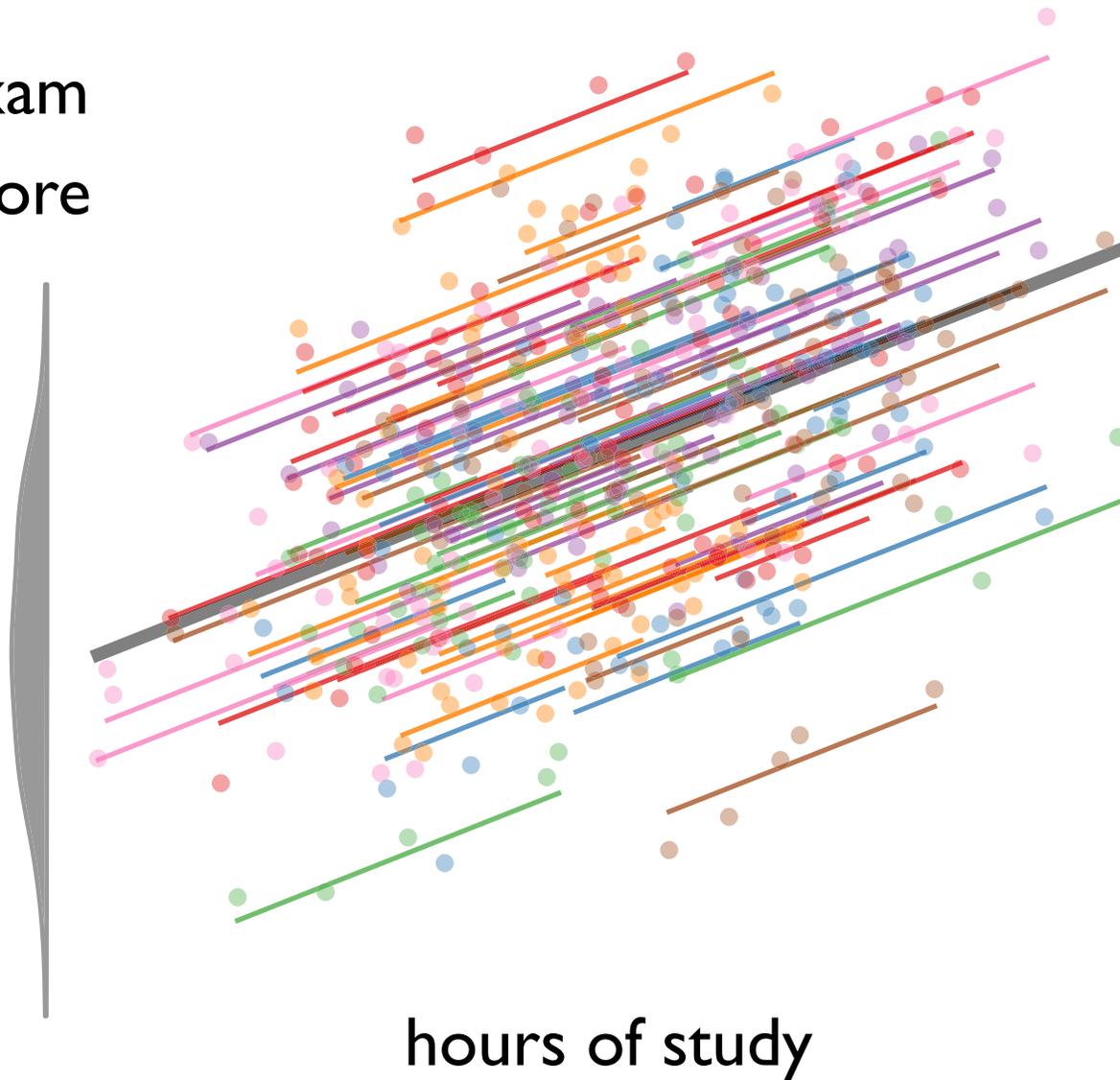


hours of study

The distribution of the random effects is shown at the left

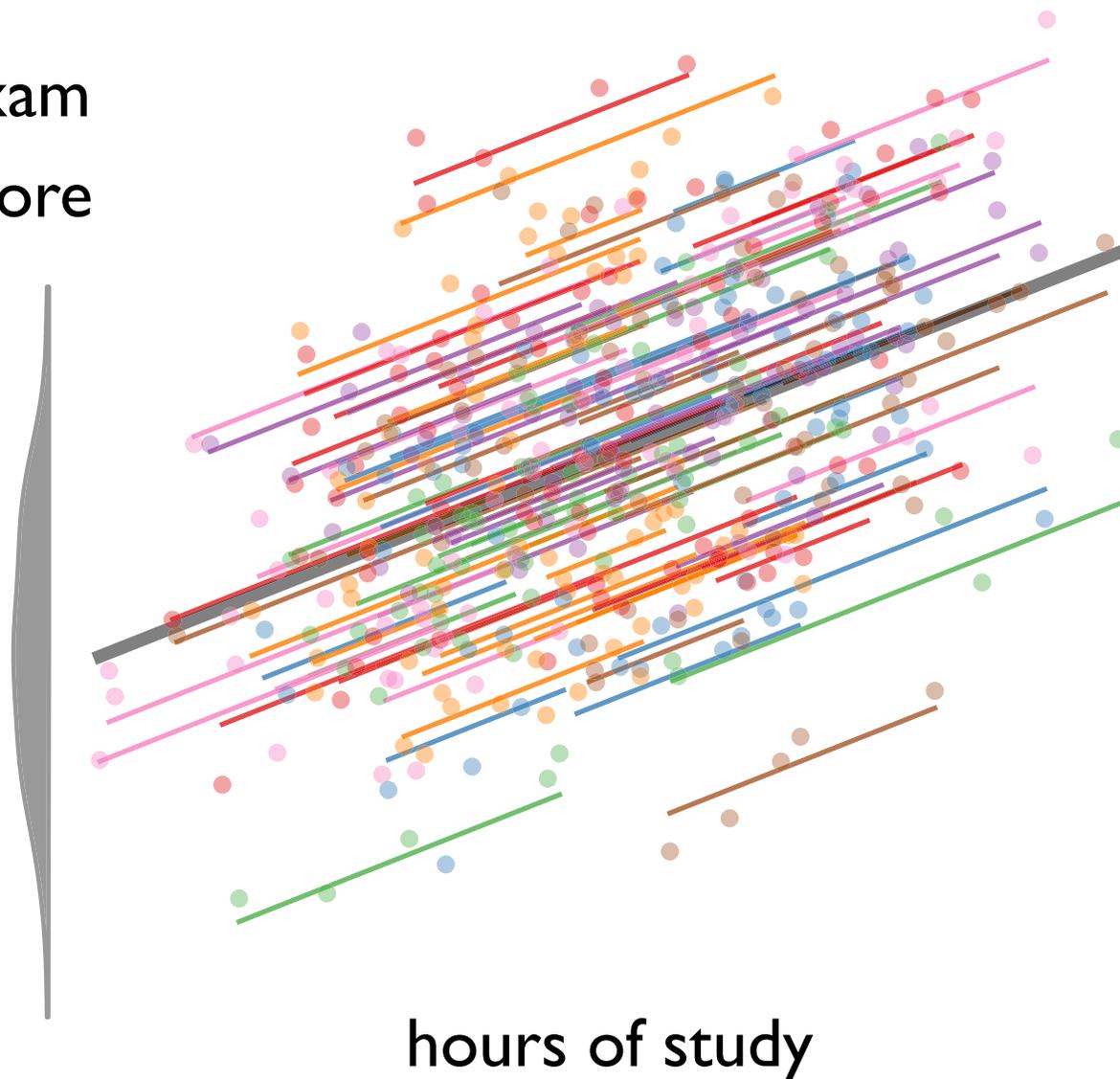
A plot of a marginal distribution on the side of a scatterplot is called a “rug”

exam  
score



A density plot of the distribution of random effects suggests they are approximately Normal

exam  
score

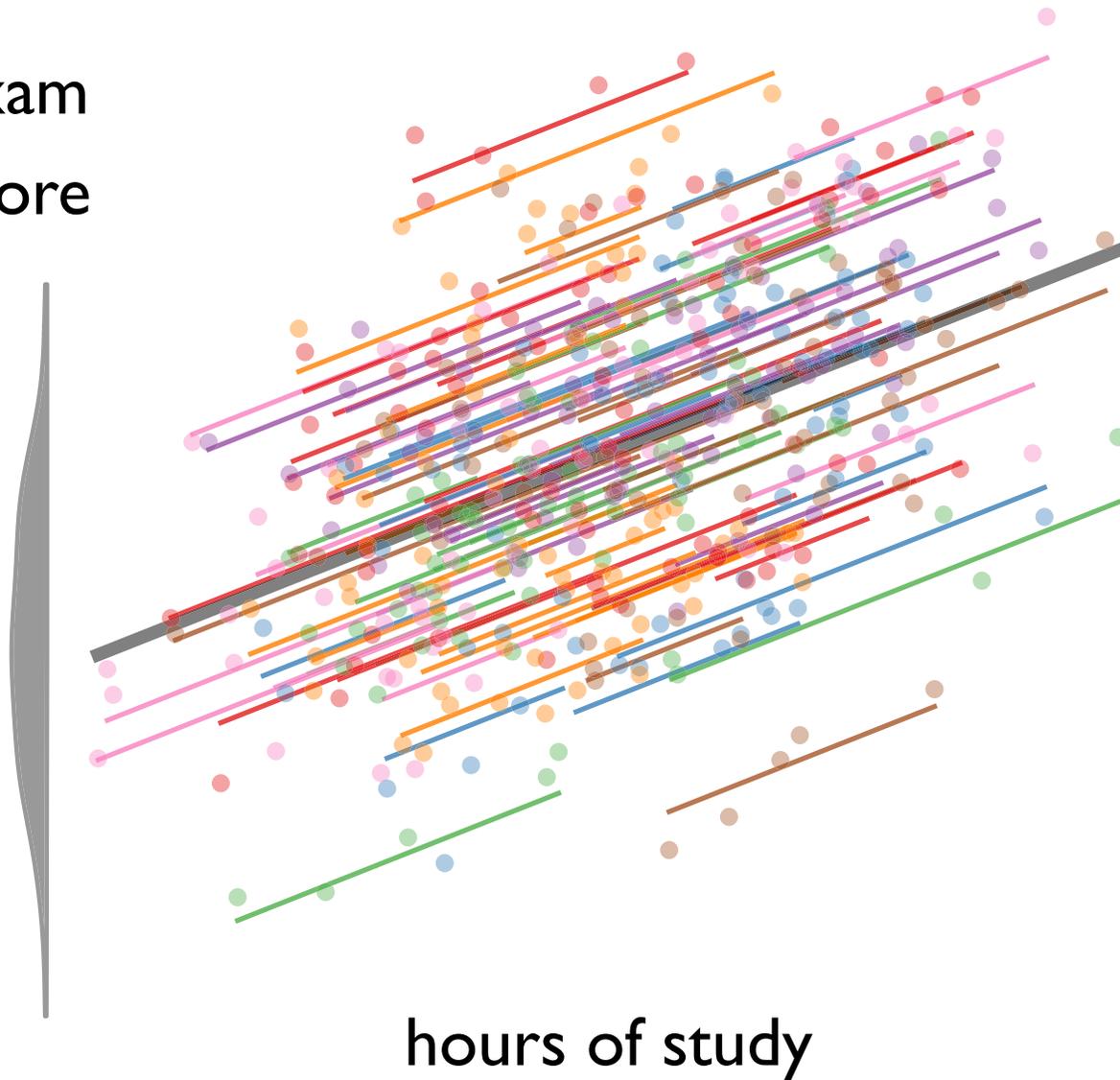


Random effects are a decomposition of the error term into

1. a unit-specific part
2. an idiosyncratic part

Random effects are determined after we have the overall regression slope and cannot change that slope

exam  
score



The model is now  
hierarchical or  
multilevel

Level 1: Student level

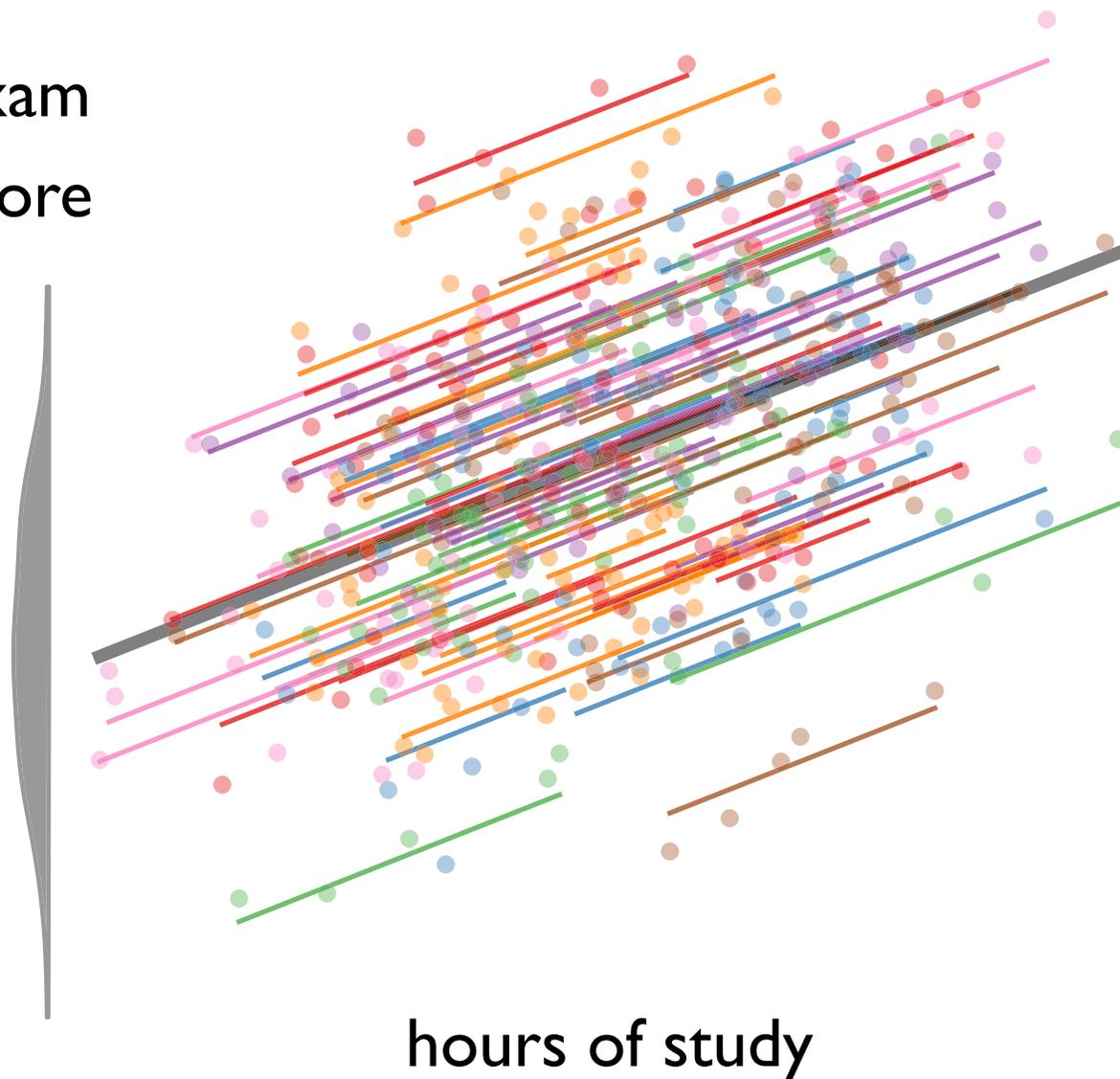
*sits above*

Level 2: Student  $\times$   
exam level

There's random  
variation at both levels

But mainly at the  
student level

exam  
score

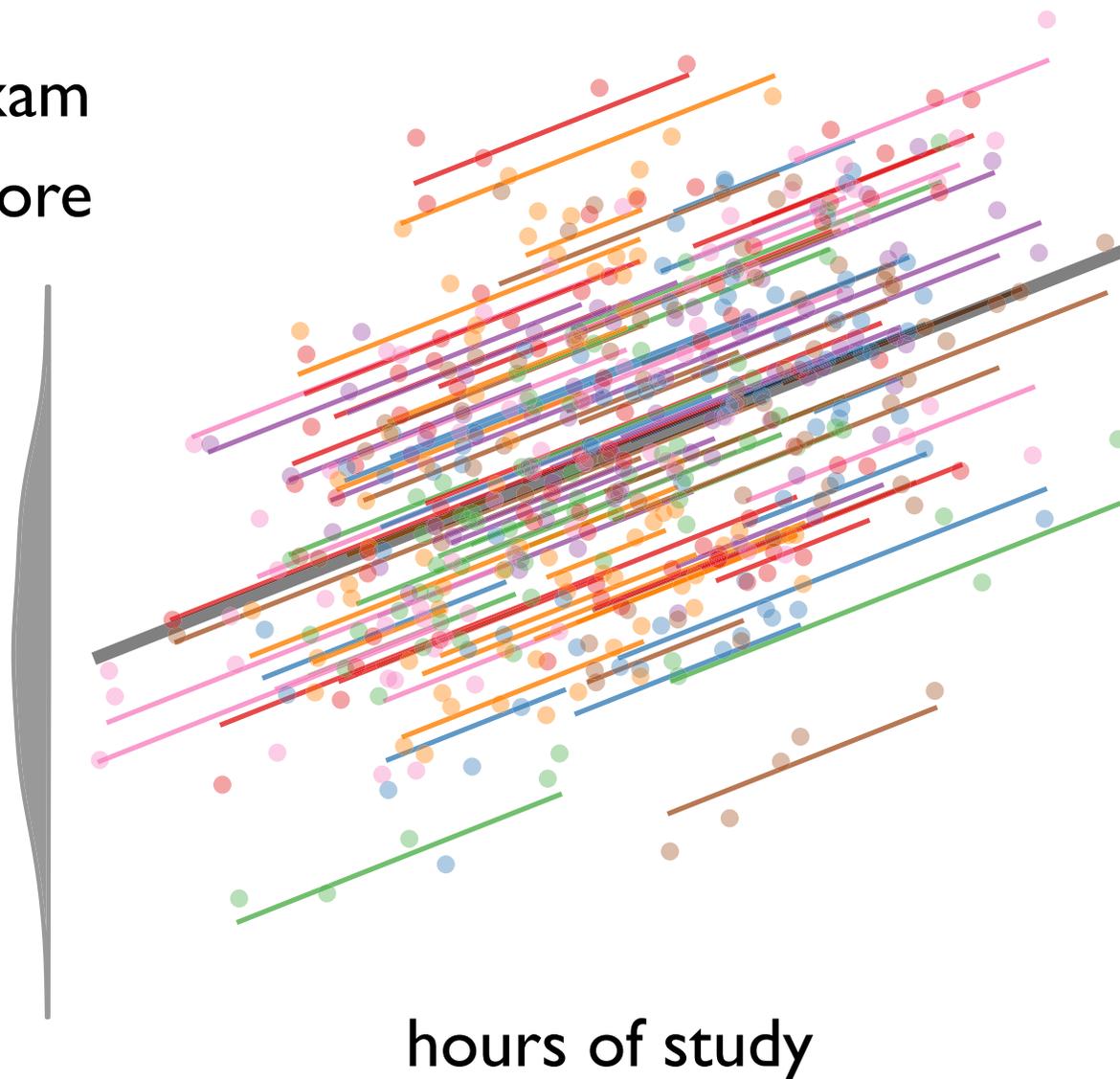


Students randomly  
vary a lot:  $\sigma_{\alpha} = 0.7$

Exams for a given  
student vary little:  
 $\sigma_{\varepsilon} = 0.2$

Student level random  
effects comprise  
 $100\% \times$   
 $\sqrt{0.7^2 / (0.7^2 + 0.2^2)} =$   
96% of the total error  
variance

exam  
score



We haven't controlled  
for any omitted  
confounders

What if unmeasured  
ability were correlated  
with study effort?

Our  $\hat{\beta}_1$  estimate would  
be biased

This bias persists even  
if we allow for random  
effects

## Random effects example: Student aptitude & effort

Suppose that ability *is* correlated with effort

For example, perhaps high ability students rationally choose to study harder as their best available human capital investment opportunity

We have the same model, but now  $\text{hours}_{it}$  is a function of  $\alpha_i$ :

$$\text{score}_{it} = 0 + 0.75 \times \text{hours}_{it} + \alpha_i + \varepsilon_{it}$$

$$\text{hours}_{it} = 0 + 0.5 \times \alpha_i + \text{uniform}(-0.7, 0.7)$$

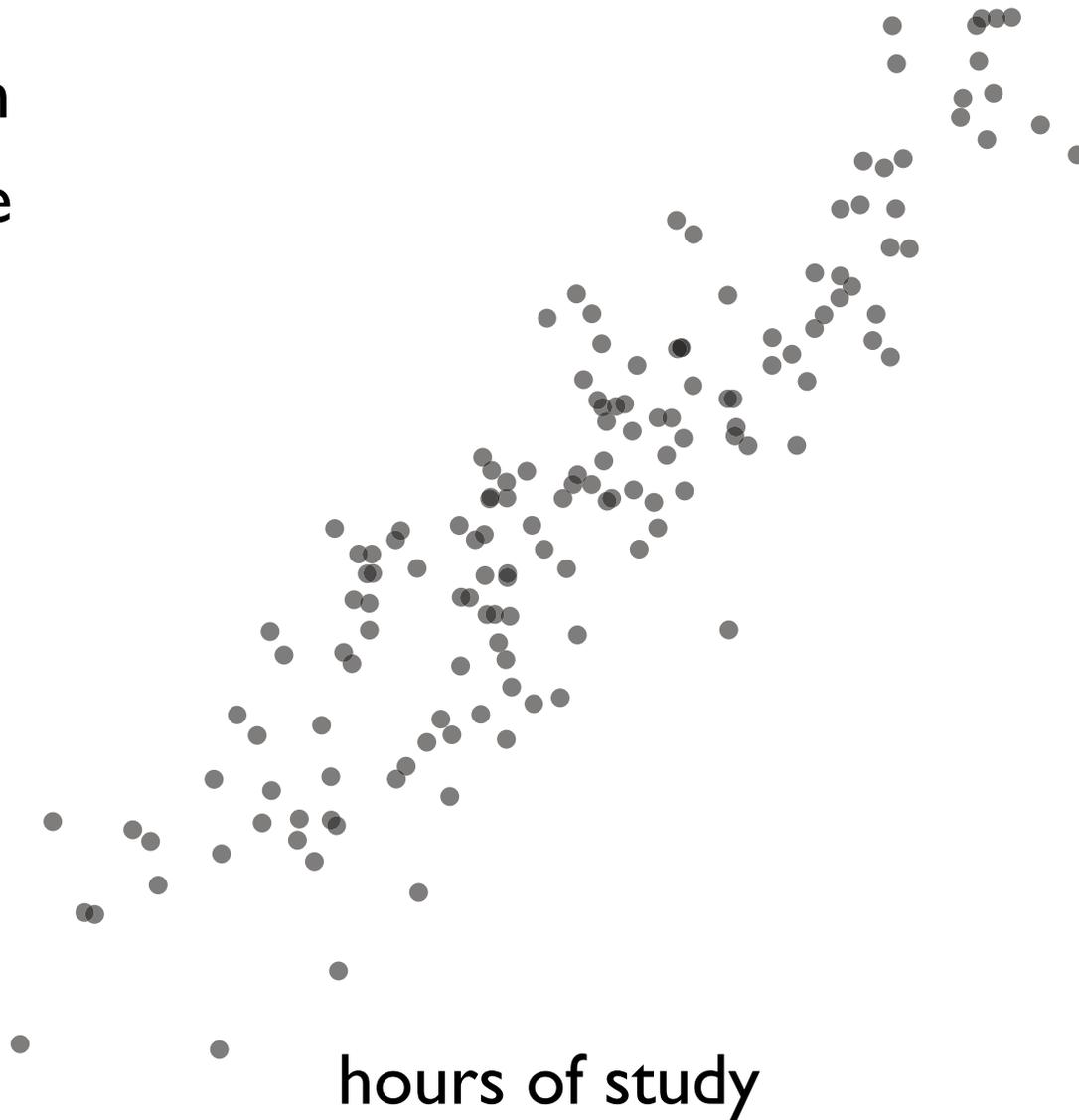
$$\alpha_i \sim \mathcal{N}(0, 0.7^2)$$

$$\varepsilon_{it} \sim \mathcal{N}(0, 0.2^2)$$

with  $i \in \{1, \dots, 100\}$  and  $t \in \{1, \dots, 5\}$

What happens when we estimate a treat  $\alpha_i$  as a random effect and estimate  $\hat{\beta}_1$ ?

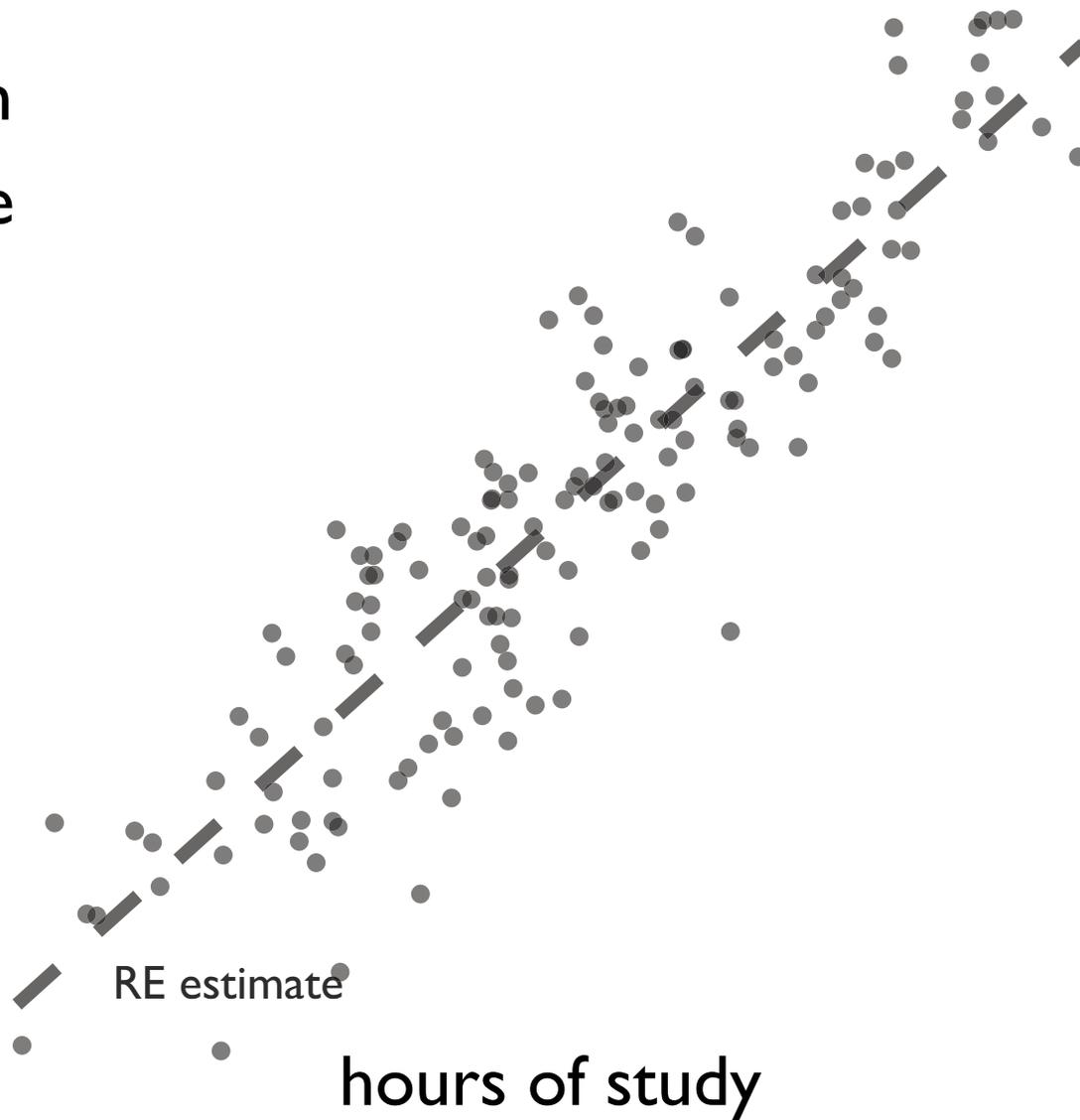
exam  
score



I've shown only the first 30 students to make the graph easier to read

*A stronger relationship between effort and grades seems evident*

exam  
score

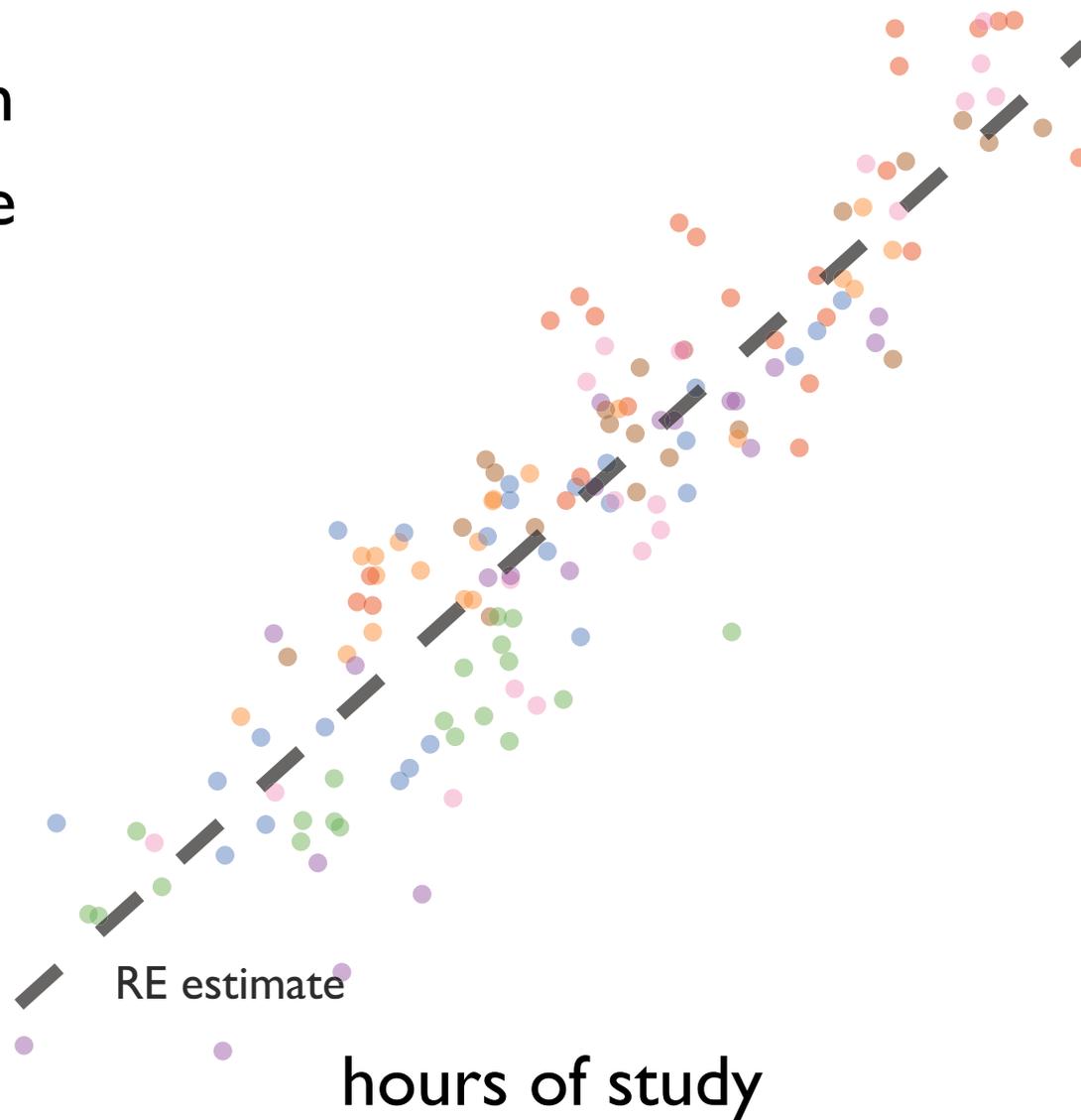


Least squares model  
finds  $\hat{\beta}_1 \approx 1.6$

More than double the  
true value of 0.75!

Where did the bias  
come from?

exam  
score

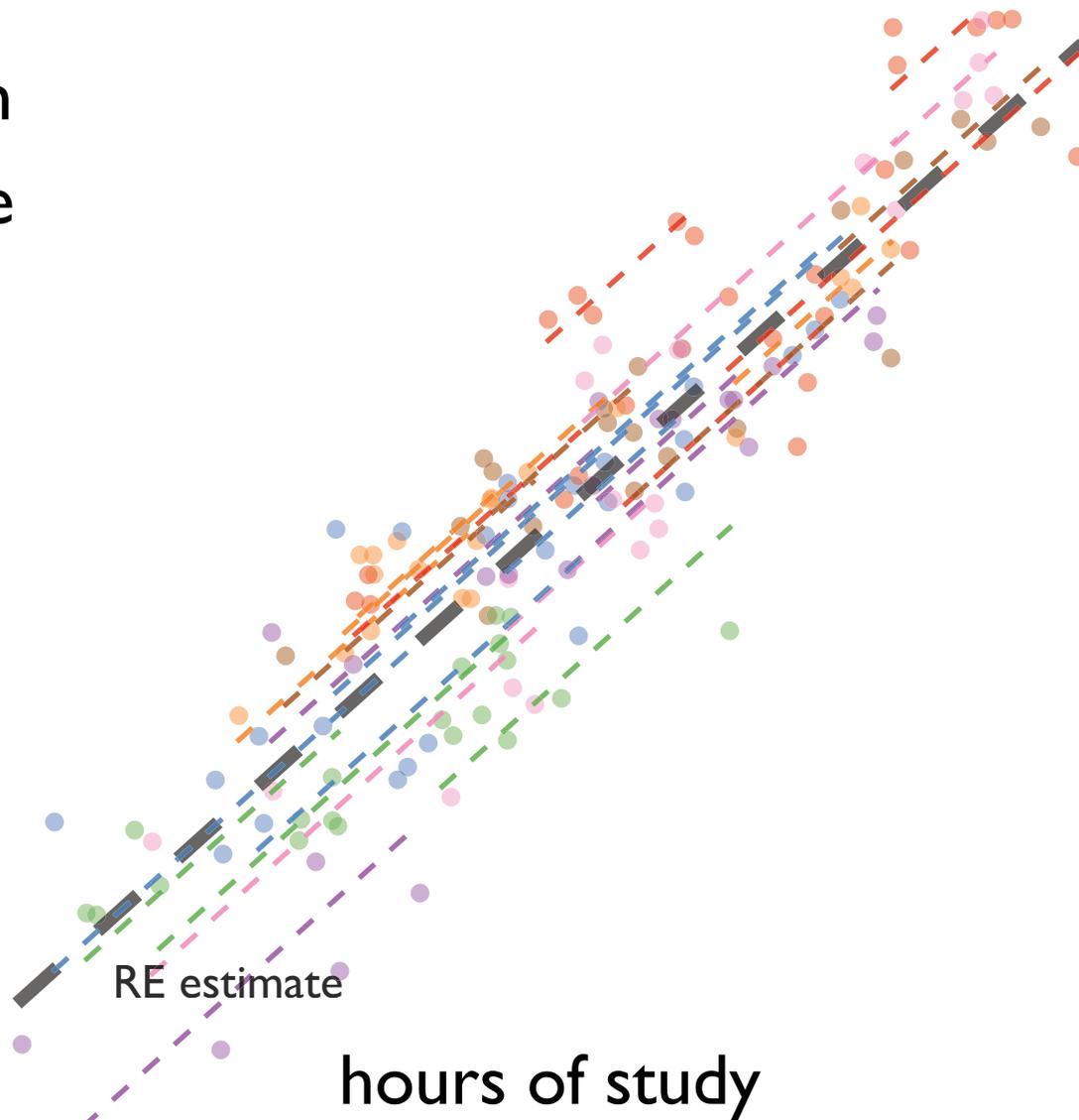


With multilevel data,  
it helps to start at the  
lowest level

I've colored the points  
by student

A random effects  
model finds the  
student specific  
intercept *after*  
estimating the slope of  
the main regression  
line

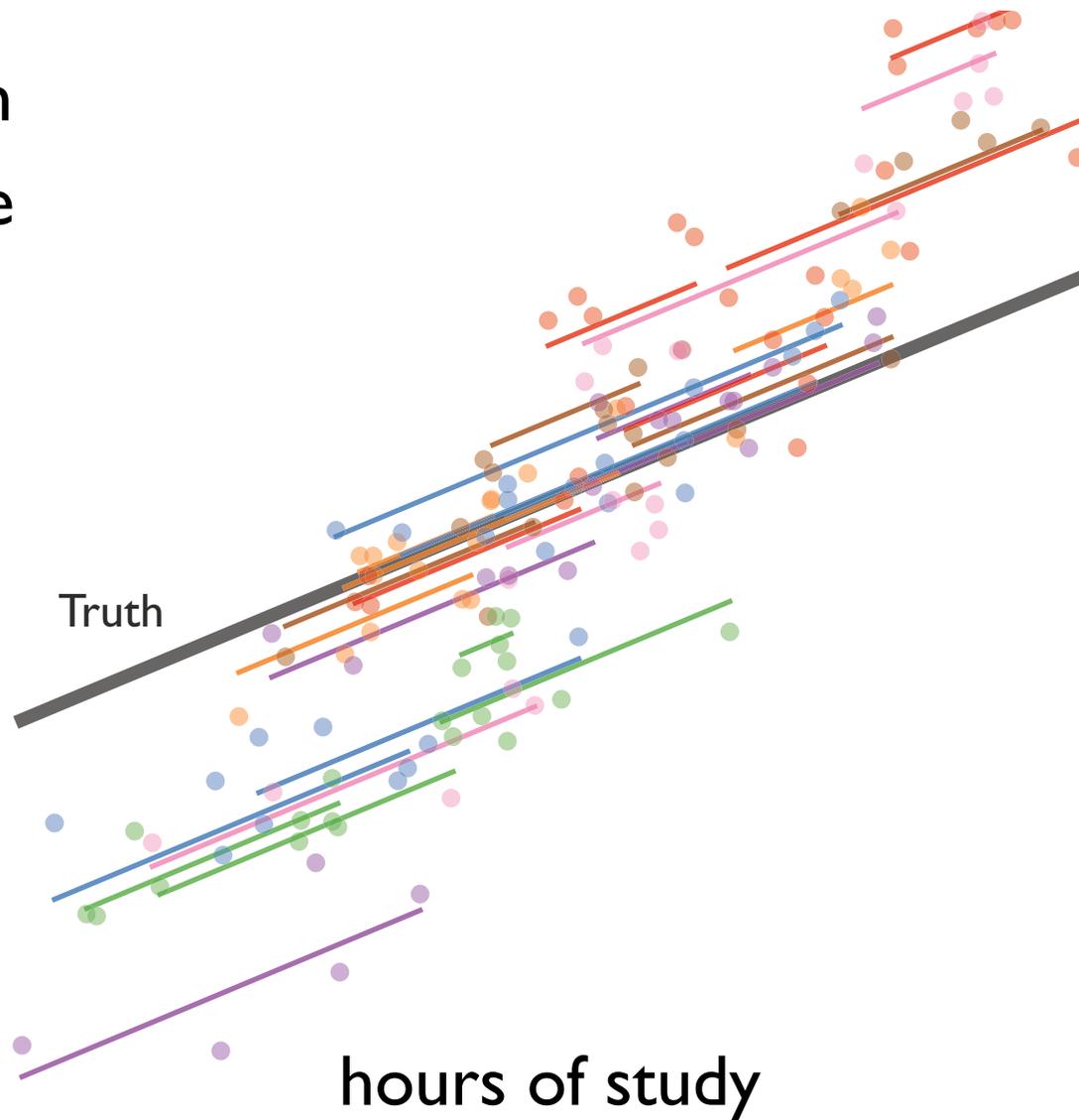
exam  
score



The student specific relationships between effort and scores as estimated by a random effects model

*Are these estimates right?*

exam  
score

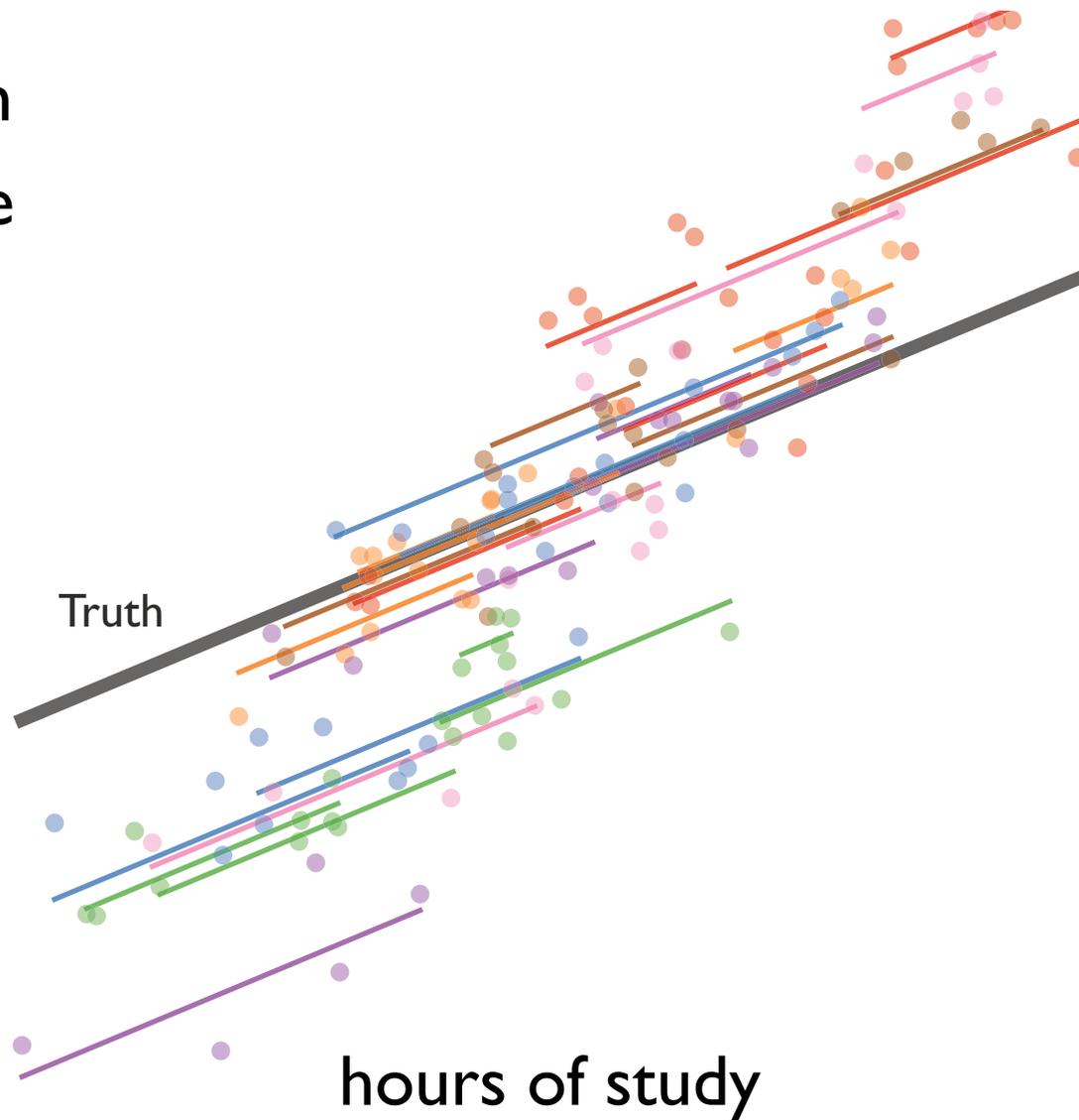


Not even close

The *true* regression  
lines by student and  
overall

Random effects  
estimates of effort is  
*biased* because the  
student-specific effect  
is correlated with effort

exam  
score



Random effects are an inadequate model when the grouping indicator is correlated with our covariates

In this case we have *omitted variable bias*

We need a different model of  $\alpha$ :  
fixed effects

# Fixed effects

$$\alpha_i = \alpha_i^*$$

Easiest to conceptualize in a linear regression framework

Easiest to estimate: just add dummies for each unit, and drop the intercept

Can be correlated with  $\mathbf{x}_{it}$ : FEs control for *all* omitted time-invariant variables

Indeed, that's usually the point.

FEs usually included to capture unobserved variance potentially correlated with  $\mathbf{x}_{it}$ .

Comes at a large cost:

we're actually purging the cross-sectional variation from the analysis

Then assuming a change in  $\mathbf{x}$  would yield the same response in each time series

Fixed effects models use over-time variation in covariates to estimate parameters;

Cannot be added to models with perfectly time invariant covariates

## More on fixed effects

$$\alpha_i = \alpha_i^*$$

Fixed effects specifications incur an incidental parameters problem:  
MLE is consistent as  $T \rightarrow \infty$ , but *not* as  $N \rightarrow \infty$ .

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Of concern in microeconomics, where panels are sampled on  $N$  with  $T$  fixed. Not of concern in CPE/IPE, where  $N$  is fixed, and  $T$  could expand

Monte Carlo experiments indicate small sample properties of fixed effects pretty good if  $t > 15$  or so; we'll see some of these results later

Fixed effects are common in studies where  $N$  is not a random sample, but a (small) universe (e.g., the industrialized countries).

## More on fixed effects

$$\alpha_i = \alpha_i^*$$

Fixed effects specifications incur an incidental parameters problem: MLE is consistent as  $T \rightarrow \infty$ , but *not* as  $N \rightarrow \infty$ .

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Fixed effects are common in studies where  $N$  is not a random sample, but a (small) universe (e.g., the industrialized countries).

*Sui generis*: Fixed effects basically say “France is different because it’s France,” “America is different because it’s America,” etc.

## Fixed effects example

Another example may help clarify what fixed effects are.

Suppose that we have data following this true model:

$$y_{ij} = \beta_0 + \beta_1 x_{ij} + \beta_2 z_i + \varepsilon_{ij}$$
$$\varepsilon_{ij} \sim \mathcal{N}(0, \sigma^2)$$

with  $i \in \{1, \dots, N\}$  and  $j \in \{1, \dots, M_i\}$

$j$  indexes a set of  $M_i$  counties drawn from state  $i$

There are  $N = 15$  states total, and we drew  $M_j = M = 15$  counties from each state

Note that we are ignoring time series dynamics completely now

(We could add them back in if  $j$  were ordered in time)

## Fixed effects example

Suppose the data represent county level voting patterns for the US

(I.e., let's illustrate Gelman *et al*, *Red State, Blue State, Rich State, Poor State* w/ contrived data)

$$\text{RVS}_{ij} = \beta_0 + \beta_1 \text{Income}_{ij} + \beta_2 \text{ConservativeCulture}_i + \varepsilon_{ij}$$
$$\varepsilon_{ij} \sim \mathcal{N}(0, \sigma^2)$$

with  $i \in \{1, \dots, N\}$  and  $j \in \{1, \dots, M_i\}$

$j$  indexes a set of  $M_i$  counties drawn from state  $i$

Remember: the data I'm using are fake, and contrived to illustrate a concept simply

Gelman *et al* investigate this in detail with real data and get similar but more nuanced findings

We will review the real data later in this lecture

## Fixed effects example: What's the matter with Kansas?

Suppose the data represent county level voting patterns for the US

(I.e., let's illustrate Gelman *et al*, *Red State, Blue State, Rich State, Poor State* using similar but contrived data)

$$\begin{aligned} \text{RVS}_{ij} &= \beta_0 + \beta_1 \text{Income}_{ij} + \beta_2 \text{Conservatism}_i + \varepsilon_{ij} \\ \varepsilon_{ij} &\sim \mathcal{N}(0, \sigma^2) \end{aligned}$$

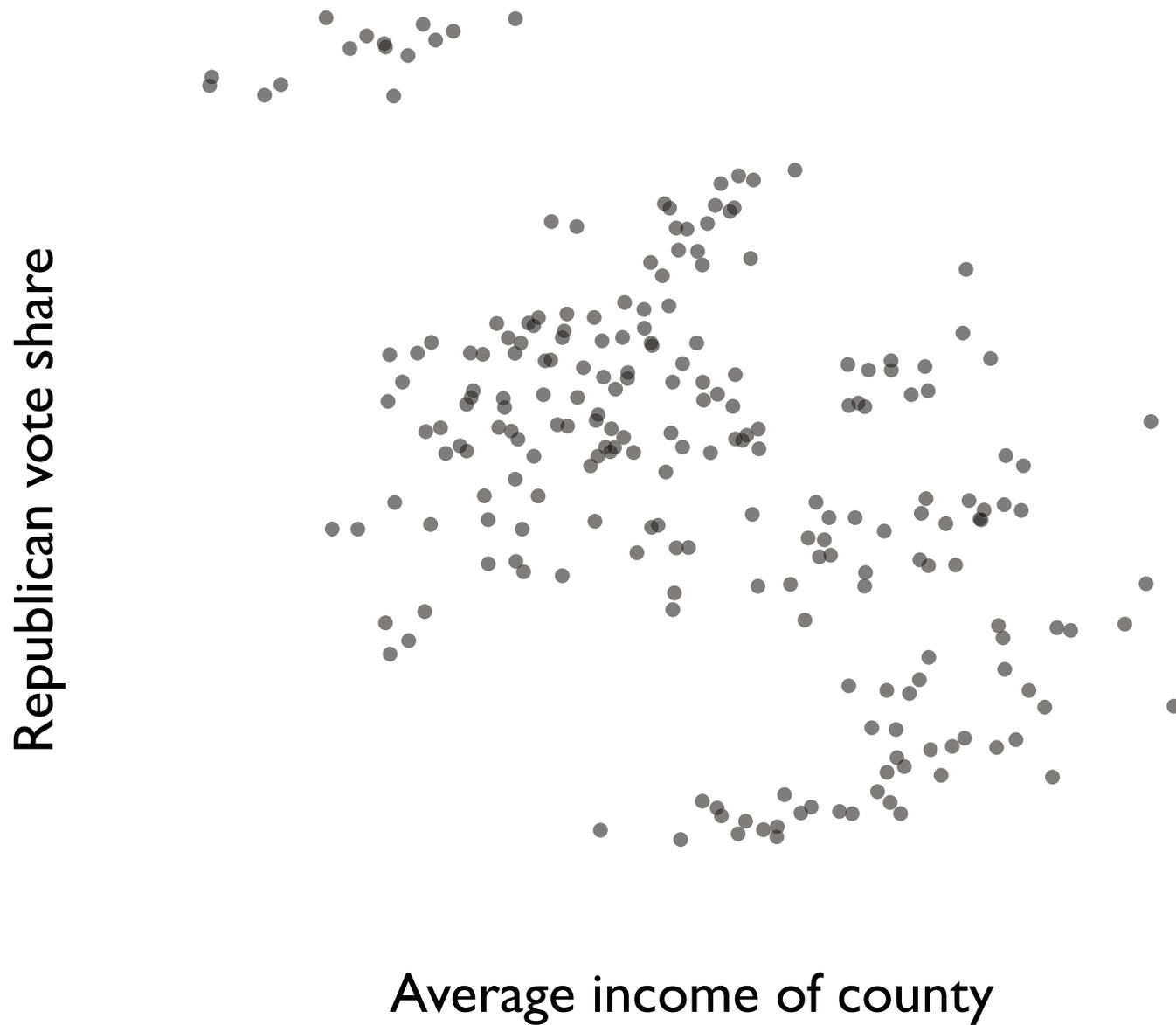
with  $i \in \{1, \dots, N\}$  and  $j \in \{1, \dots, M_i\}$

A problem:

suppose we don't have (or don't trust) a measure of state-level Conservatism

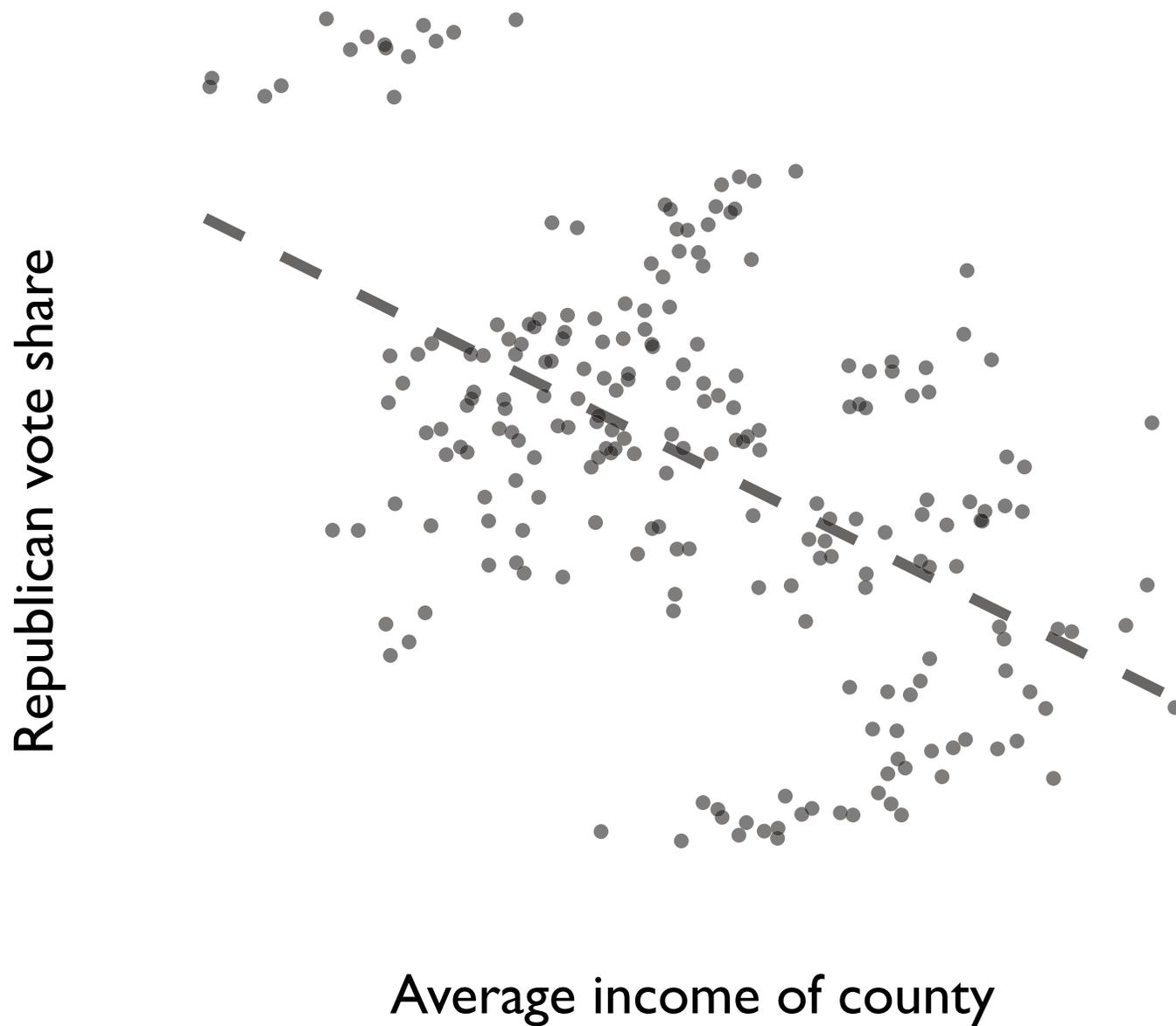
If we exclude it, or mismeasure it, we could get omitted variable bias in  $\hat{\beta}_1$

This leads to potentially large misconceptions. . .



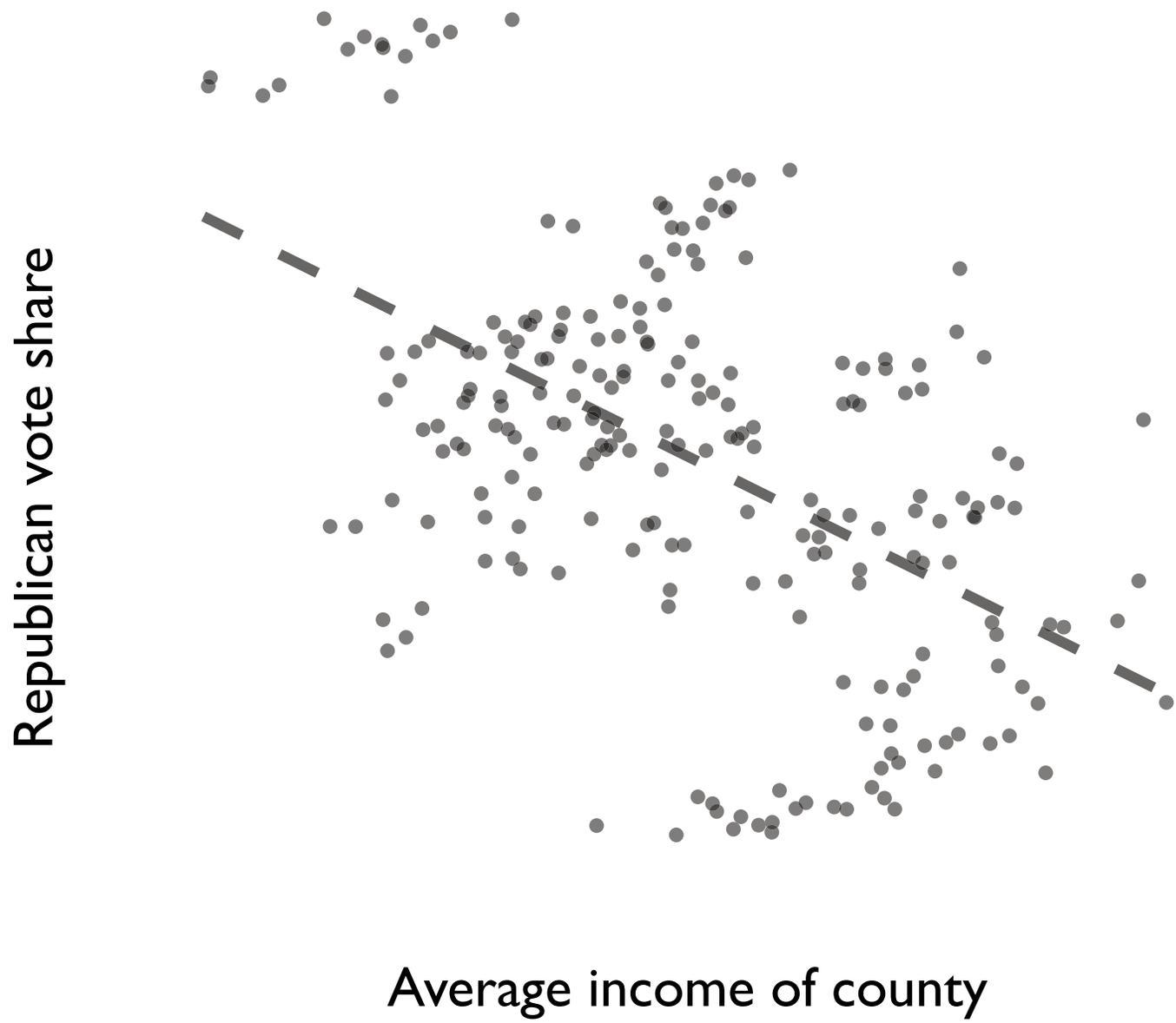
Suppose we observe 15 counties from each of 15 states (225 observations)

Our first cut is to estimate this simple linear regression:  $y_{ij} = \beta_0 + \beta_1 \text{Income}_{ij} + \varepsilon_{ij}$



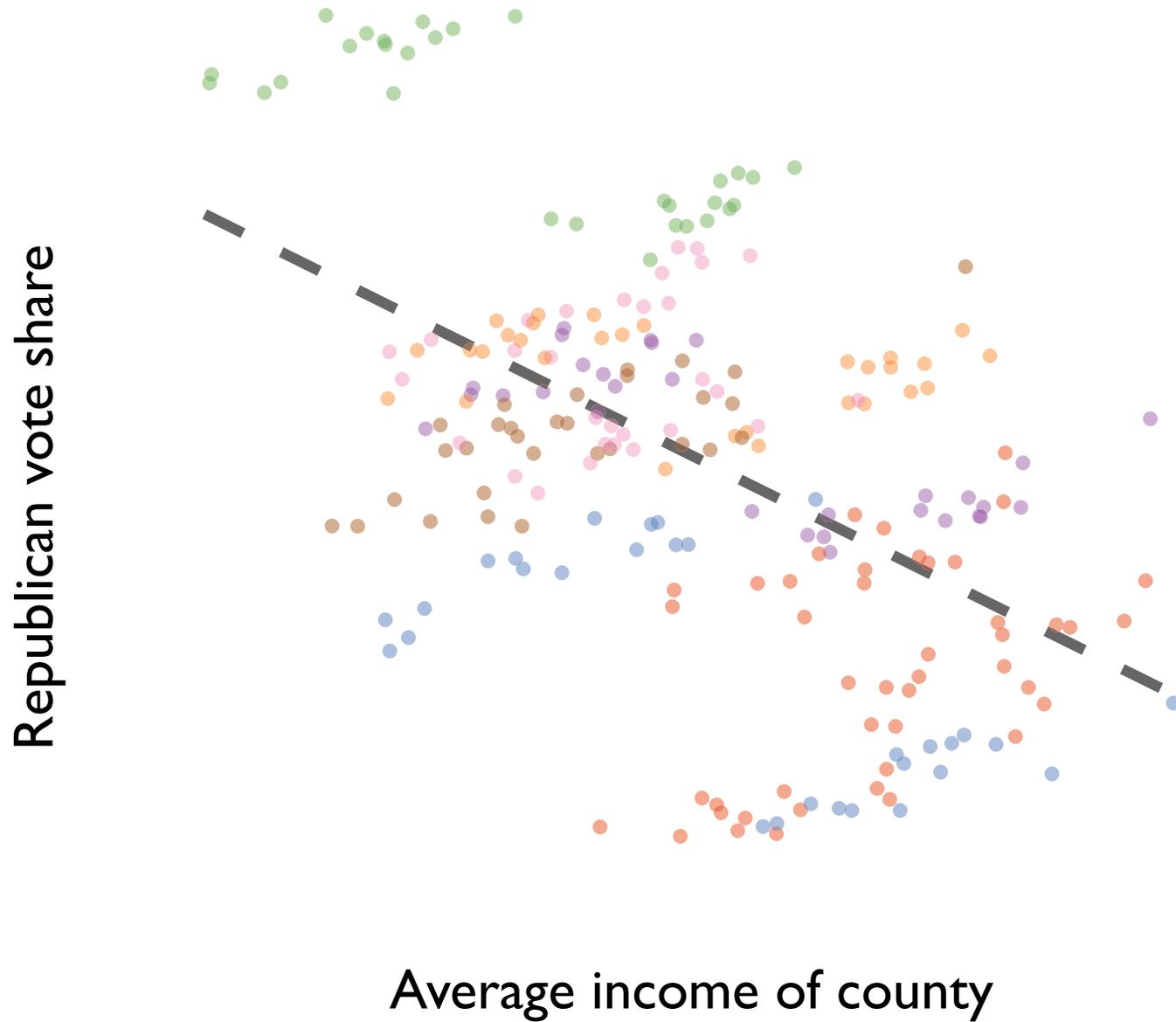
We find that  $\hat{\beta}_1$  is negative:

Poor counties seem to vote more Republican than rich counties!



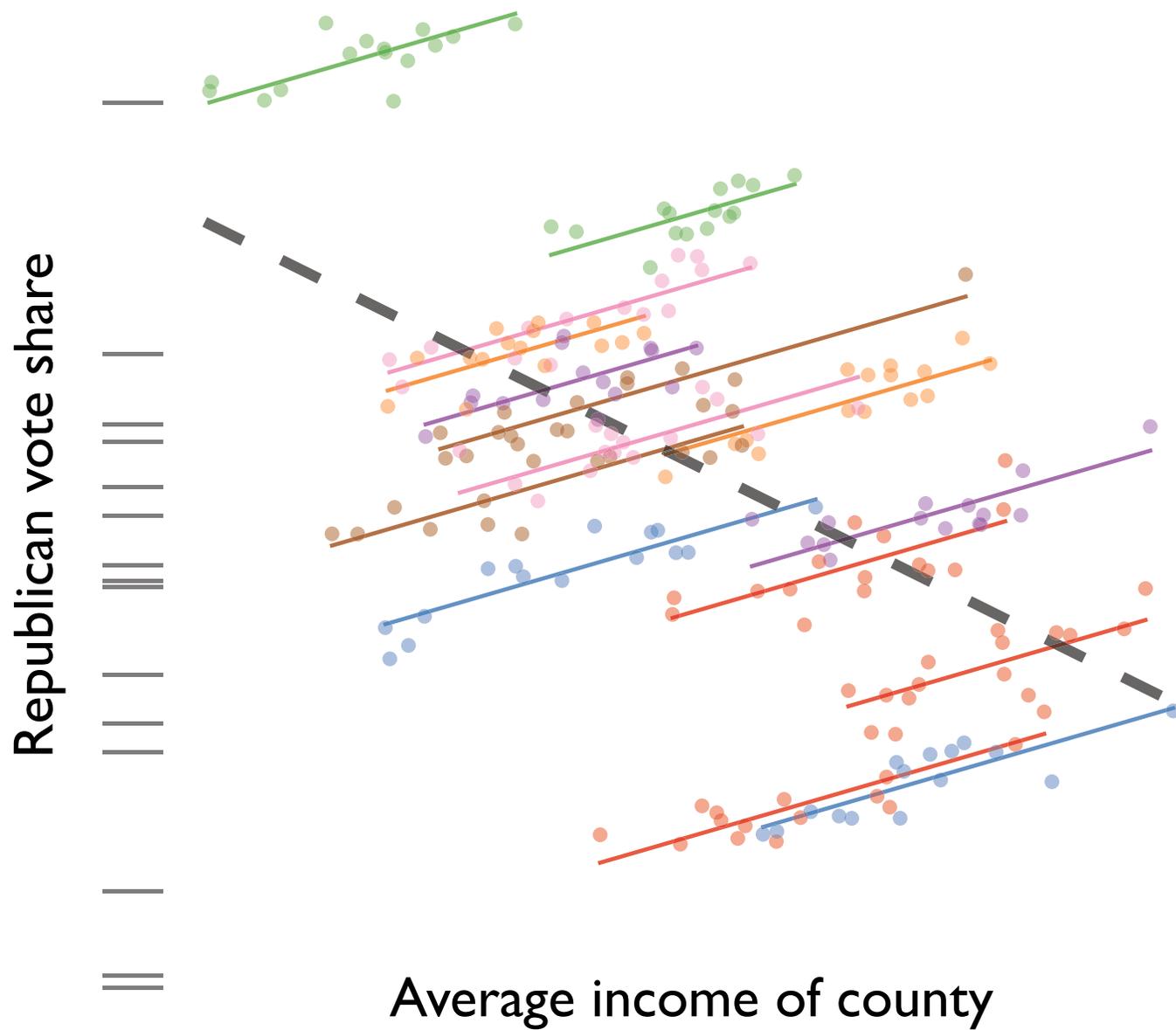
But Republican elected officials attempt to represent the affluent

What's the matter with (poor counties in) Kansas, as Thomas Frank asked?

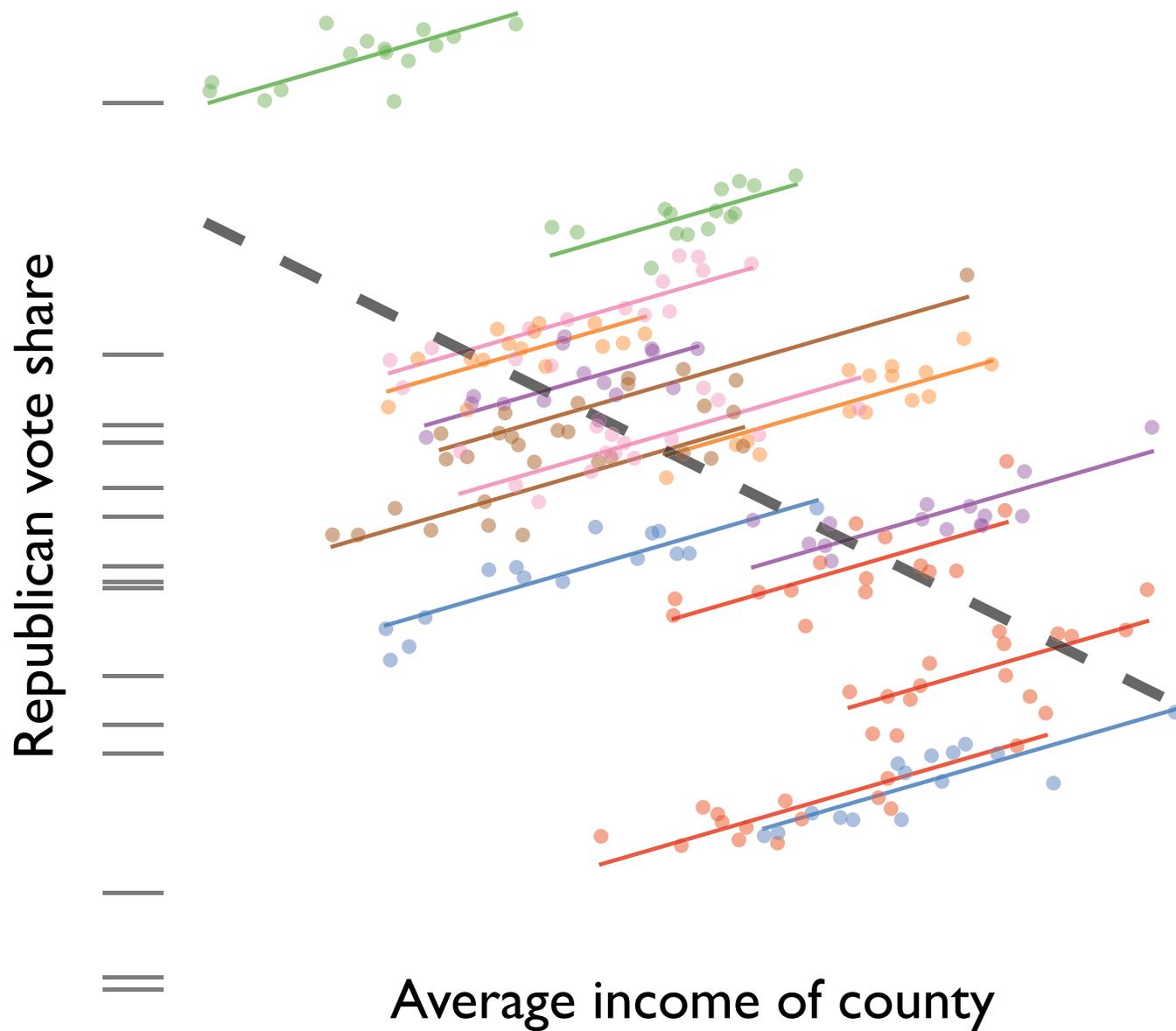


Let's look at which observations come from which states

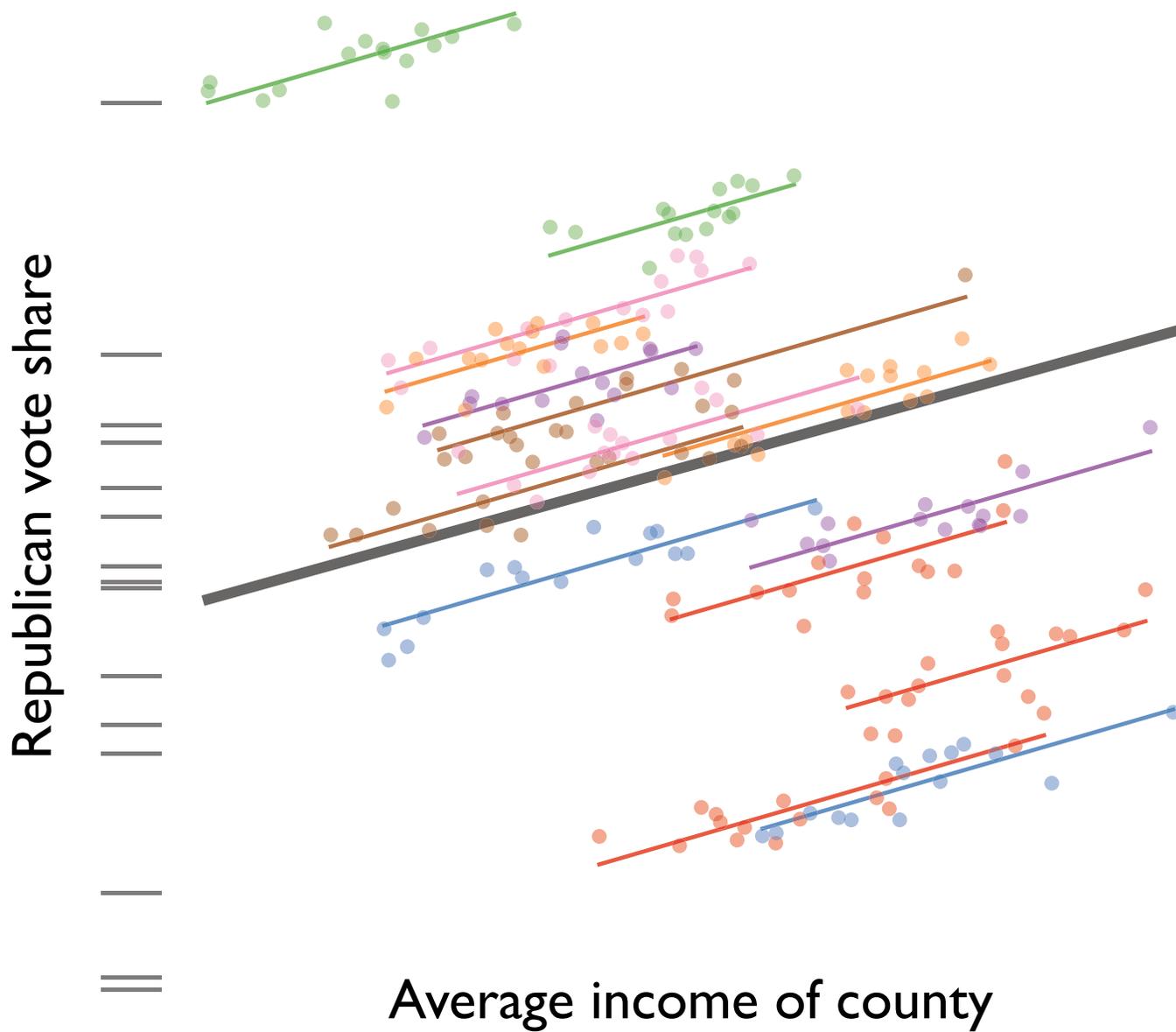
Clearly, counties from the same state are clustered



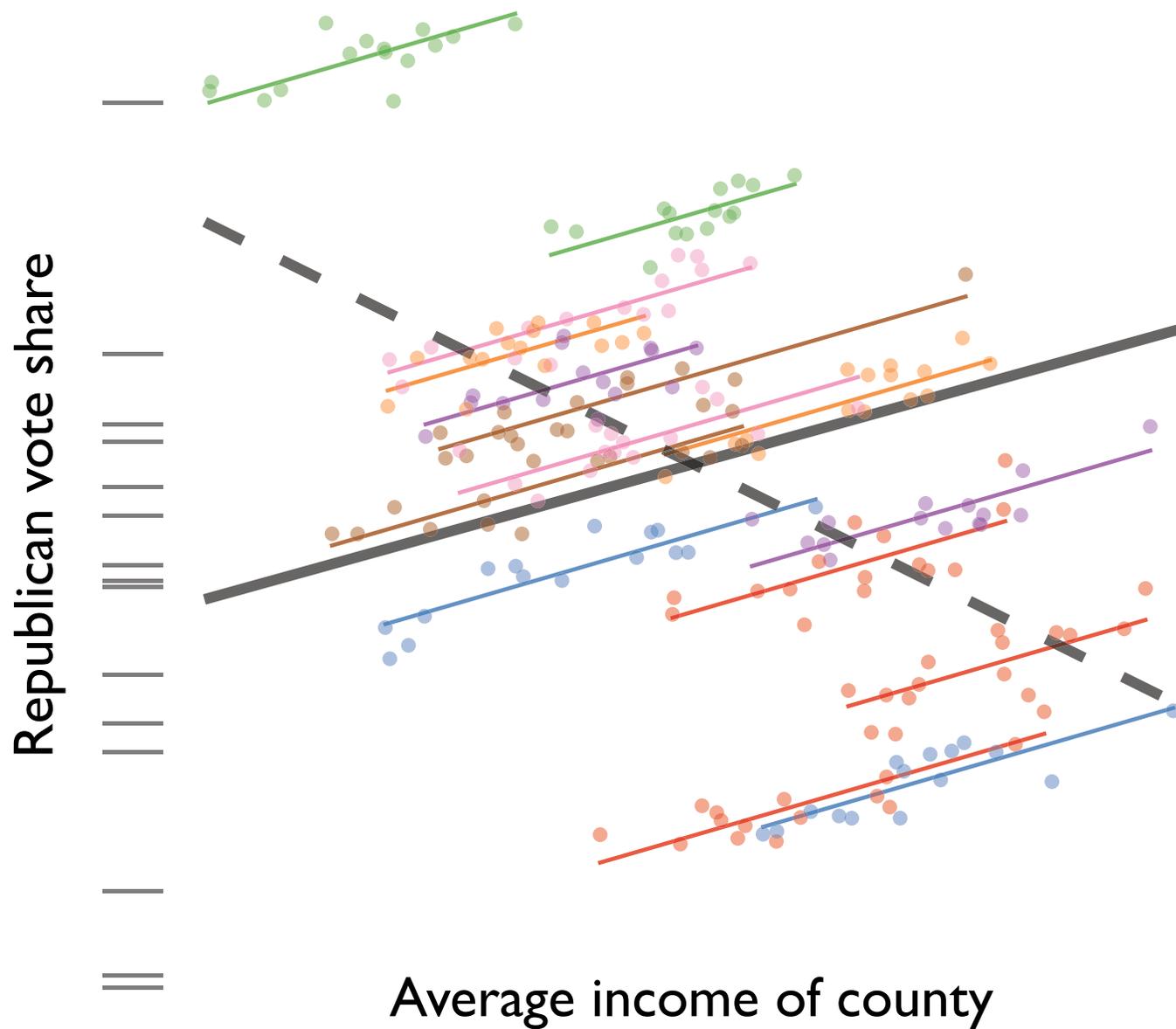
Within each state, there's a *positive* relationship between income & voting Republican



Suggests we need to control for variation at the state level, either by collecting the state level variables causing the variation, or . . .

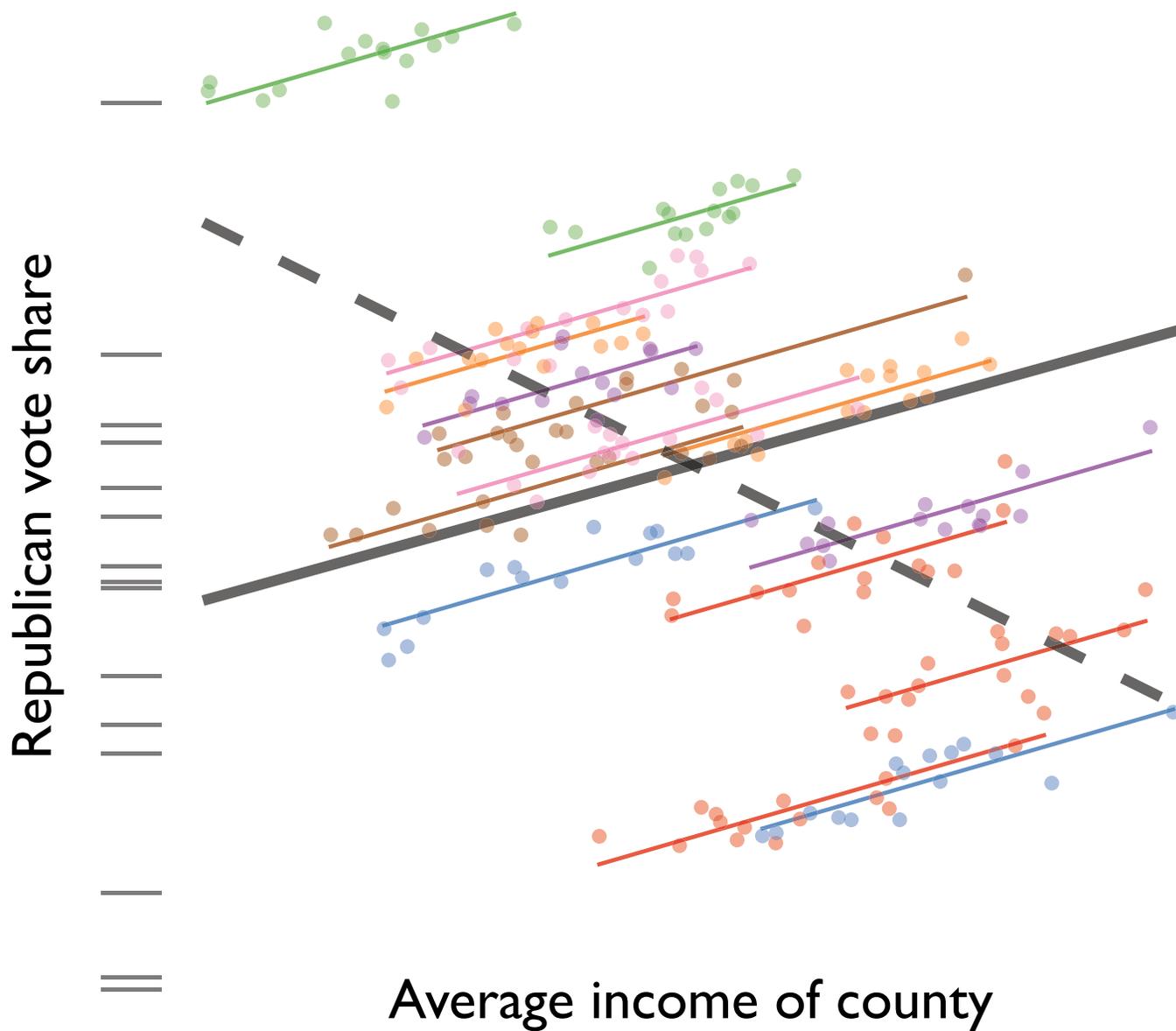


use brute force: add a dummy for each state to the matrix of covariates  
to purge the omitted variable bias

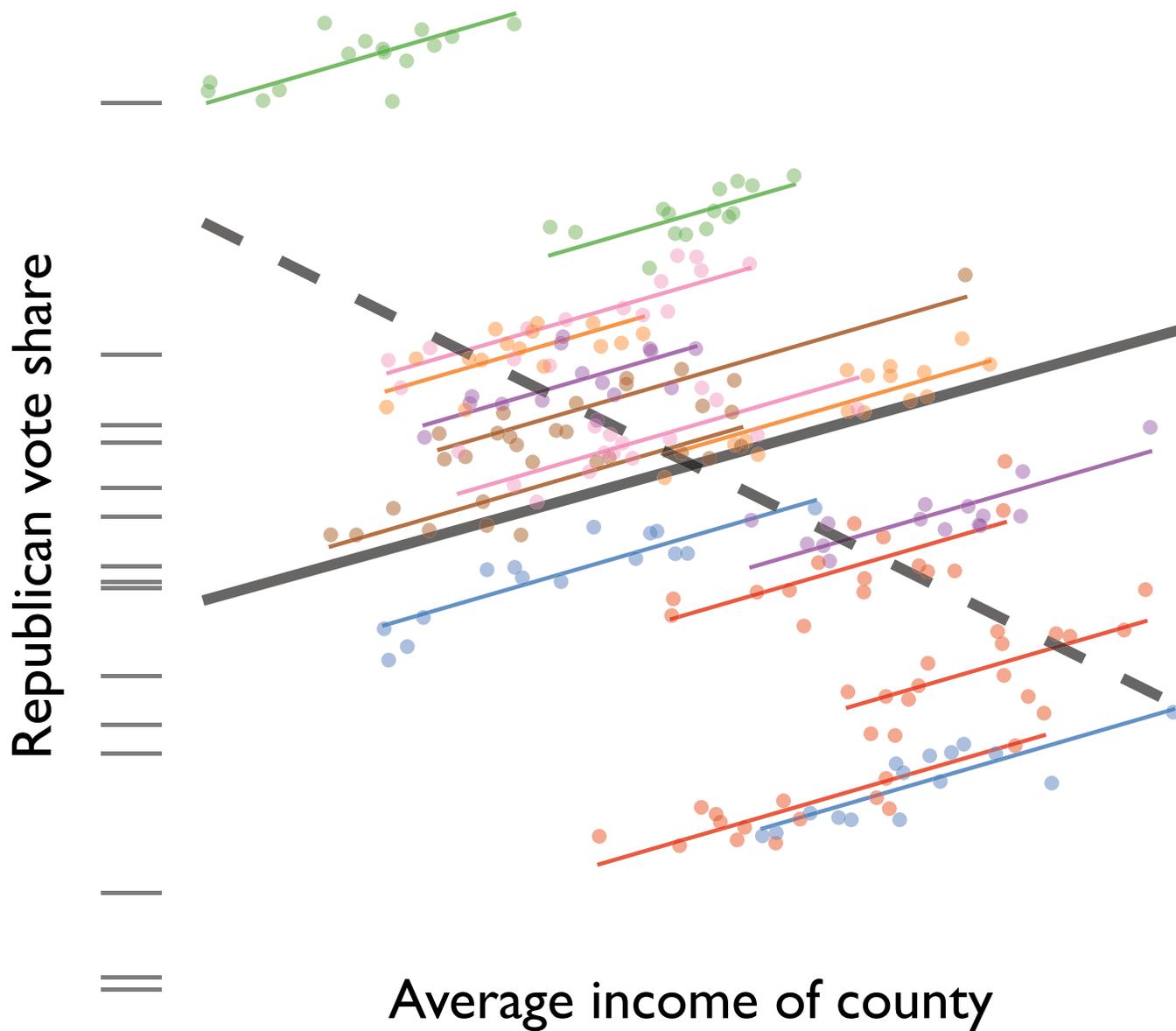


Controlling for state fixed effects,  $\hat{\beta}_1$  flips signs!

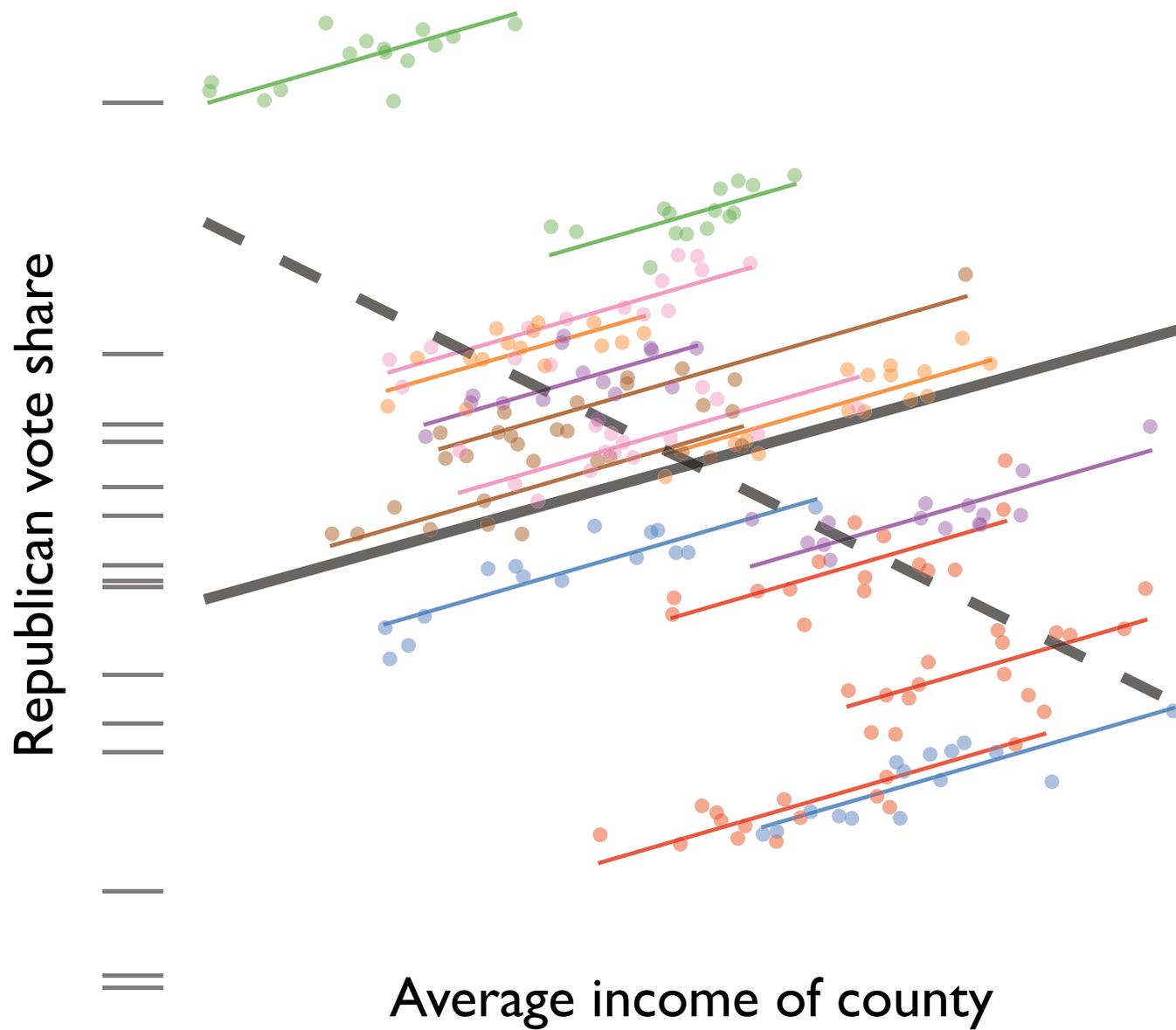
Including fixed effects for each state removes state-level omitted variable bias



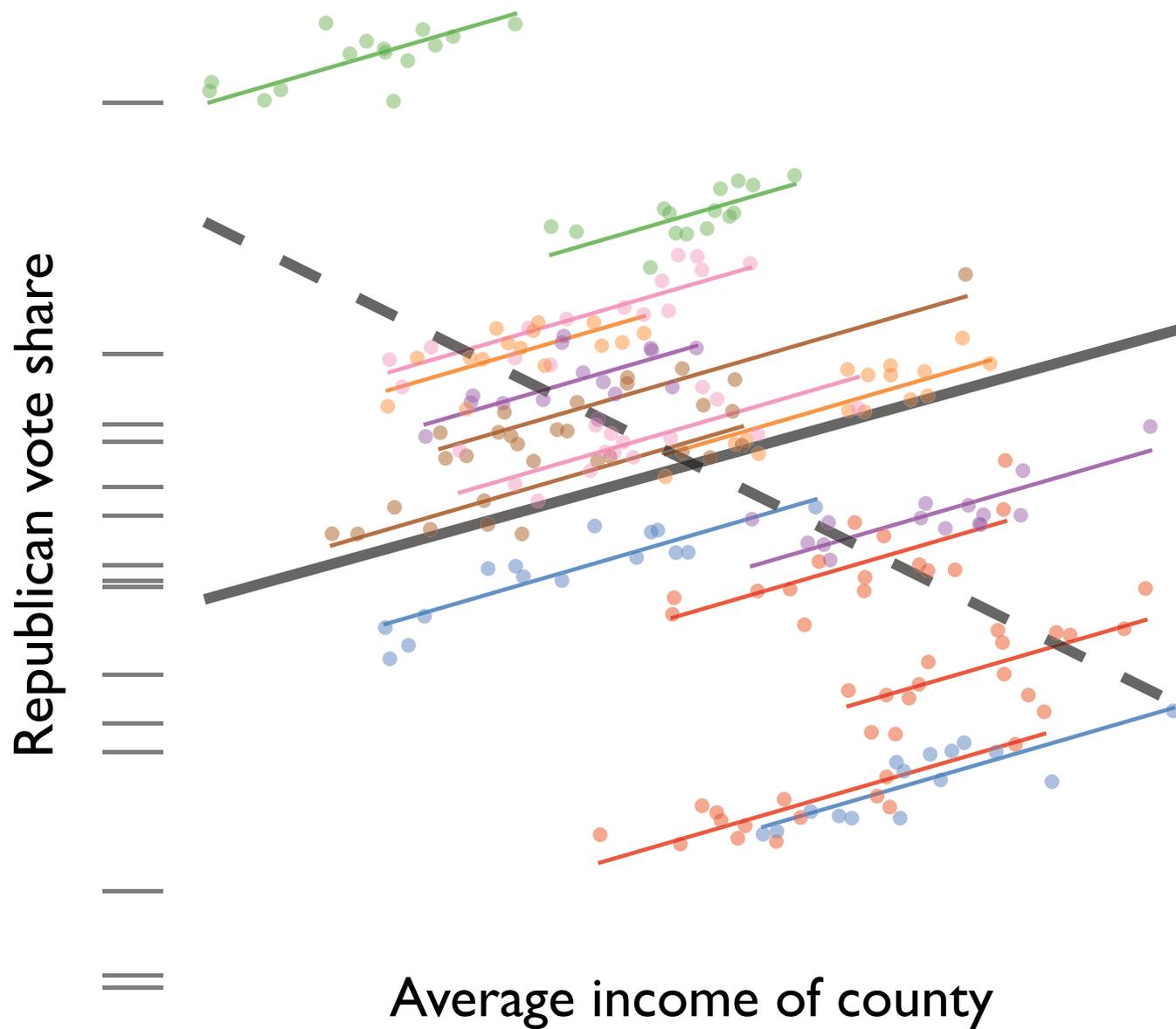
What's the matter with Kansas? On average, Kansans are more conservative than other Americans, but within Kansas, the same divide between rich and poor holds



What's the matter with Kansas? On average, Kansans are more conservative than other Americans, but within Kansas, the same divide between rich and poor holds . . . or at least it did until 2016



*How are fixed effects different from random effects?*

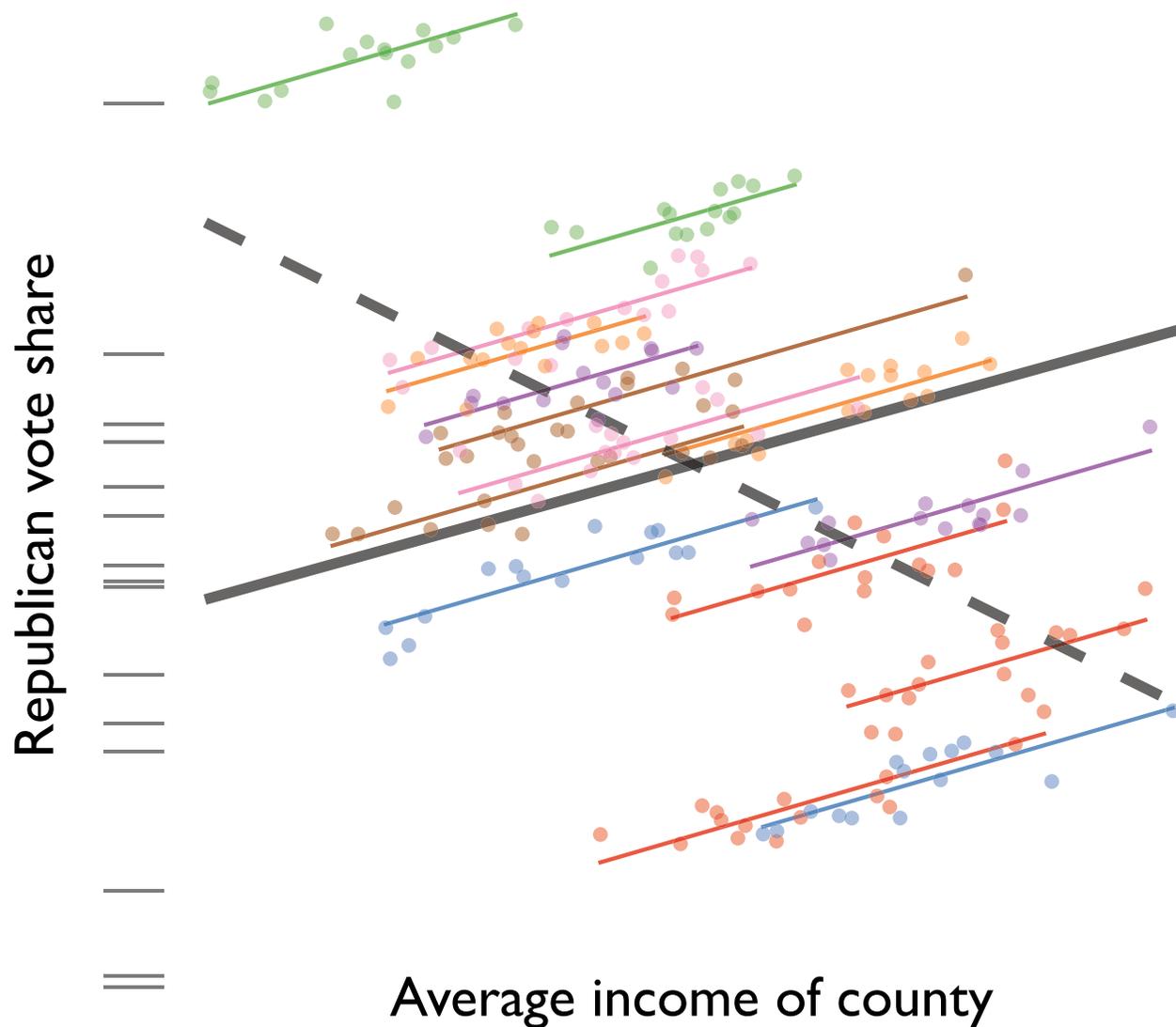


Fixed effects control for omitted variables

*random effects don't*

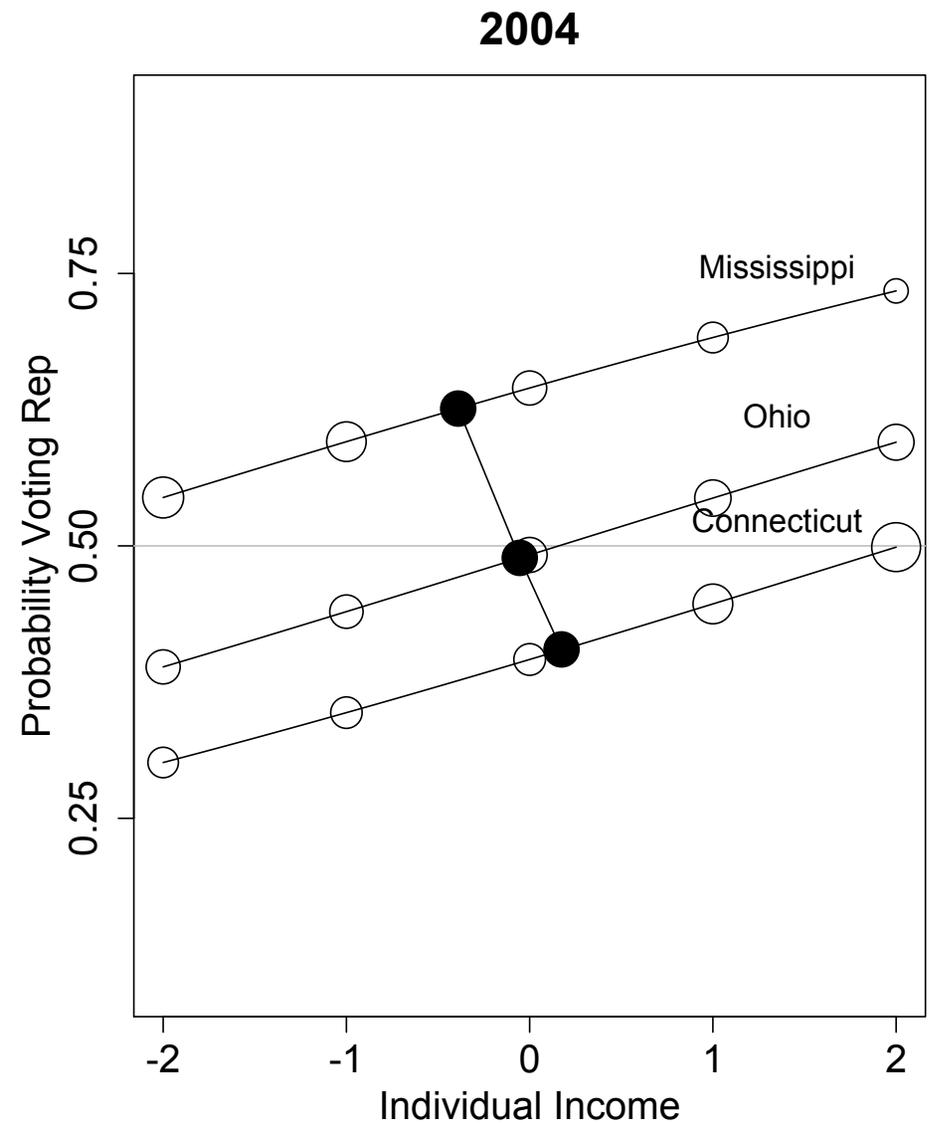
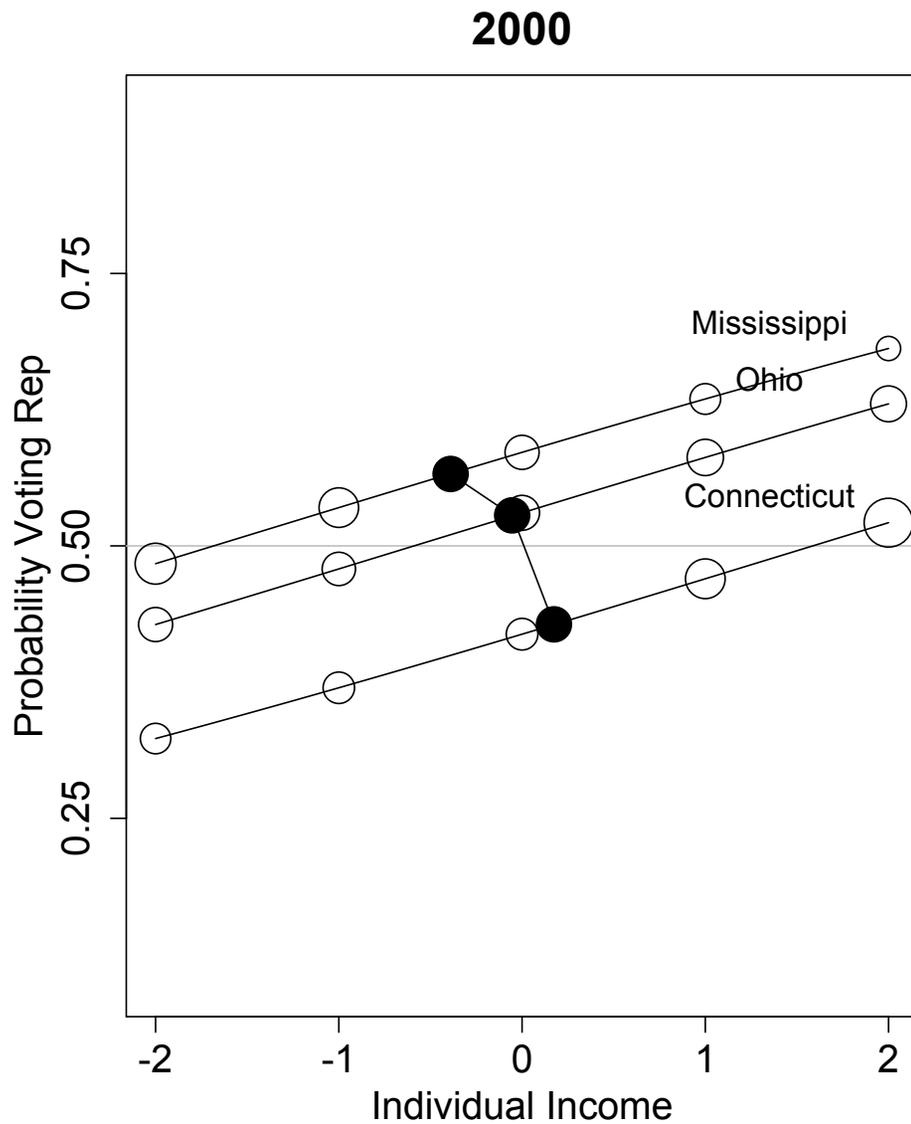
Fixed effects don't follow any particular distribution

*random effects do*



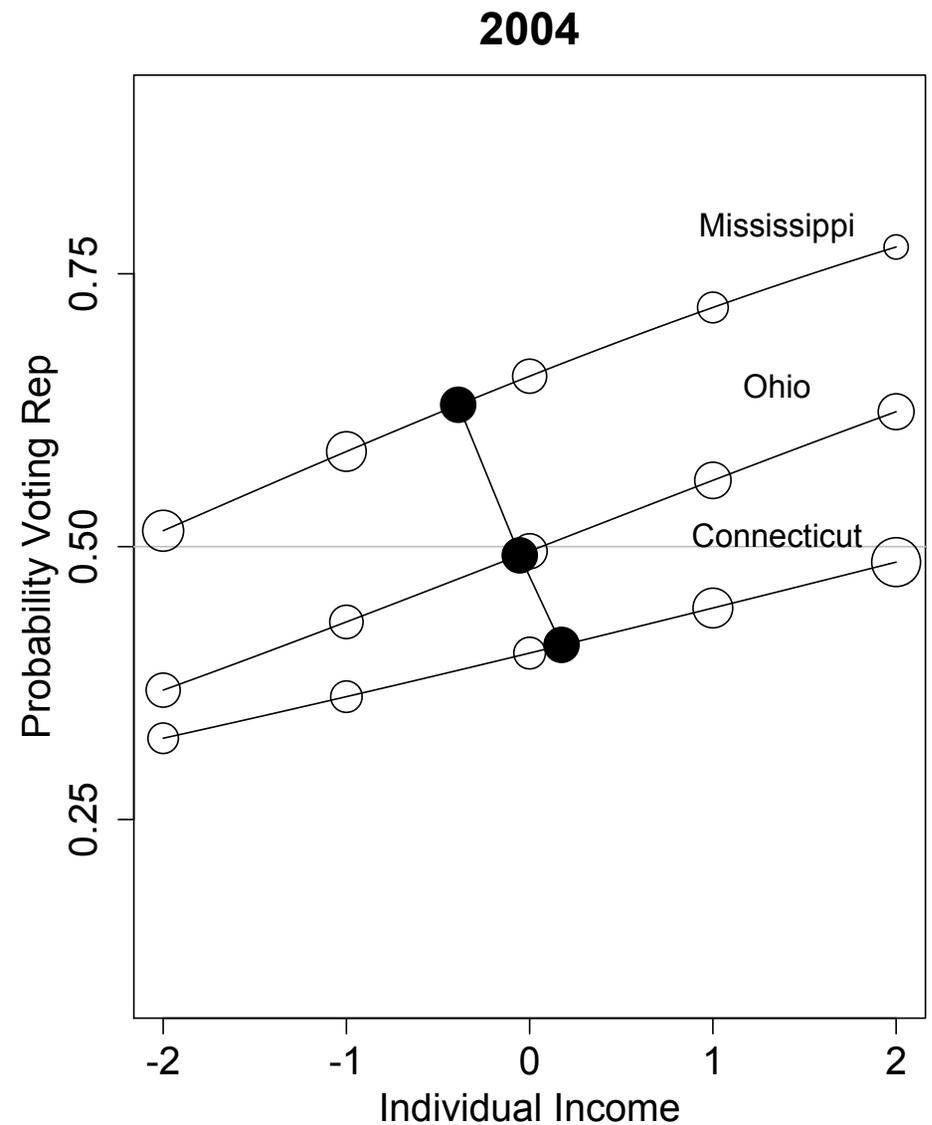
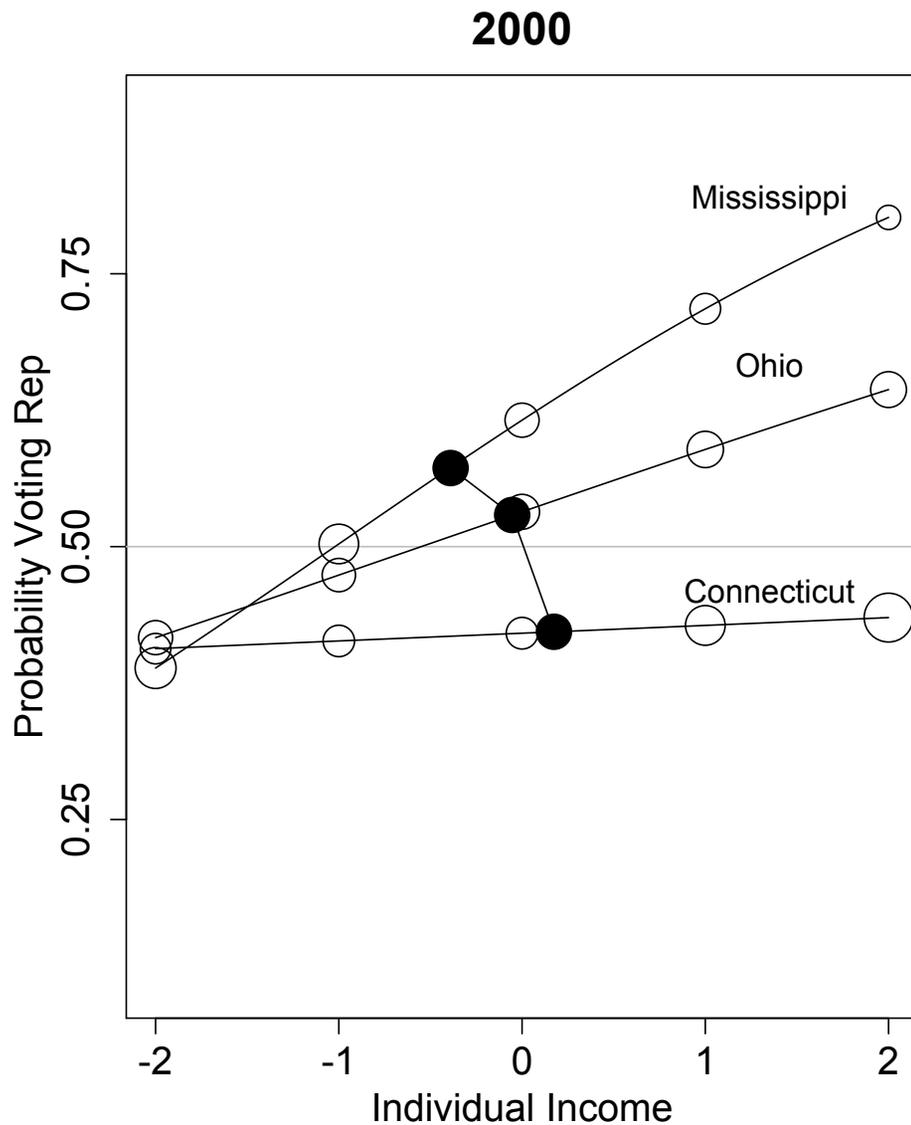
**Aside 1** the above reversal is an example of the *ecological fallacy*, which says that aggregate data can mislead us about individual level relationships

Here, the pattern across states mislead us as to the pattern within states



**Aside 2** Above are results on actual data from Gelman *et al*

This version of their model assume intercepts (but not slopes) vary by state



**Aside 2** When Gelman *et al* allow slopes  $\hat{\beta}_{1i}$  to vary across states, they find the rich-poor divide is actually *steeper* in poor states!

## Variable slopes and intercepts

$$\Delta^d y_{it} = \alpha_i + x_{it}\beta_i + \sum_{p=1}^P \Delta^d y_{i,t-p} \phi_p + \sum_{q=1}^Q \varepsilon_{i,t-q} \rho_q + \varepsilon_{it}$$

How do we let  $\beta_i$  vary over the units?

For the  $k$ th covariate  $x_{kit}$ , let  $\beta_{ki}$  be random, with a multivariate Normal distribution

$$\beta_{ki} \sim \text{MVN}(\beta_{ki}^*, \Sigma_{\beta_{ki}})$$

$$\beta_{ki}^* = \mathbf{w}_i \zeta$$

That is, the  $\beta_{ki}$ 's are now a function of *unit-level covariates*  $\mathbf{w}_i$  and their associated *hyperparameters*  $\zeta$

## Variable slopes and intercepts

$$\text{GDP}_{it} = \phi_1 \text{GDP}_{i,t-1} + \alpha_i + \beta_1 \text{Democracy}_{it} + \varepsilon_{it}$$

## Variable slopes and intercepts

$$\text{GDP}_{it} = \phi_1 \text{GDP}_{i,t-1} + \alpha_i + \beta_1 \text{Democracy}_{it} + \varepsilon_{it}$$

$$\alpha_i \sim \text{N}(0, \sigma_\alpha^2)$$

## Variable slopes and intercepts

$$\text{GDP}_{it} = \phi_1 \text{GDP}_{i,t-1} + \alpha_i + \beta_1 \text{Democracy}_{it} + \varepsilon_{it}$$

$$\alpha_i \sim \text{N}(0, \sigma_\alpha^2)$$

$$\beta_1 \sim \text{N}(\beta_{1i}^*, \sigma_{\beta_{1i}}^2)$$

## Variable slopes and intercepts

$$\text{GDP}_{it} = \phi_1 \text{GDP}_{i,t-1} + \alpha_i + \beta_1 \text{Democracy}_{it} + \varepsilon_{it}$$

$$\alpha_i \sim \text{N}(0, \sigma_\alpha^2)$$

$$\beta_1 \sim \text{N}(\beta_{1i}^*, \sigma_{\beta_{1i}}^2)$$

$$\beta_{1i}^* = \zeta_0 + \zeta_1 \text{Education}_i$$

Now the effect of Democracy on GDP varies across countries, as a function of their level of Education *and* a country random effect with variance  $\sigma_{\beta_{1i}}^2$

This is now a *multilevel* or *hierarchical* model

See Gelman & Hill for a nice textbook on these models

Easiest to accomplish using Bayesian inference  
(place priors on each parameter and estimate by MCMC)

## Variable slopes and intercepts: Poor man's version

$$\text{GDP}_{it} = \phi_1 \text{GDP}_{i,t-1} + \alpha_i + \beta_1 \text{Democracy}_{it} \\ + \beta_2 \text{Democracy} \times \text{Education} + \varepsilon_{it}$$

$\alpha_i$  is a matrix of country dummies

This version omits the random effects for  $\alpha_i$  and  $\beta_i$ ; instead, we have fixed country effects

and a fixed, interactive effect that makes the relation between Democracy and GDP conditional on Education

Note that we can't include an Education base term—it's part of the fixed effects already

But we can include the time invariant Education variable *within* a time-varying interaction

Should have approximately similar results to hierarchical