

# 1 Introduction

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## 1.1 Motivation

When I wrote my first book, *Qualitative Choice Analysis*, in the mid-1980s, the field had reached a critical juncture. The breakthrough concepts that defined the field had been made. The basic models – mainly logit and nested logit – had been introduced, and the statistical and economic properties of these models had been derived. Applications had proven successful in many different areas, including transportation, energy, housing, and marketing – to name only a few.

The field is at a similar juncture today for a new generation of procedures. The first-generation models contained important limitations that inhibited their applicability and realism. These limitations were well recognized at the time, but ways to overcome them had not yet been discovered. Over the past twenty years, tremendous progress has been made, leading to what can only be called a sea change in the approach and methods of choice analysis. The early models have now been supplemented by a variety of more powerful and more flexible methods. The new concepts have arisen gradually, with researchers building on the work of others. However, in a sense, the change has been more like a quantum leap than a gradual progression. The way that researchers think about, specify, and estimate their models has changed. Importantly, a kind of consensus, or understanding, seems to have emerged about the new methodology. Among researchers working in the field, a definite sense of purpose and progress prevails.

My purpose in writing this new book is to bring these ideas together, in a form that exemplifies the unity of approach that I feel has emerged, and in a format that makes the methods accessible to a wide audience. The advances have mostly centered on simulation. Essentially, simulation is the researcher's response to the inability of computers to perform integration. Stated more precisely, simulation provides a numerical

approximation to integrals, with different methods offering different properties and being applicable to different kinds of integrands.

Simulation allows estimation of otherwise intractable models. Practically any model can be estimated by some form of simulation. The researcher is therefore freed from previous constraints on model specification – constraints that reflected mathematical convenience rather than the economic reality of the situation. This new flexibility is a tremendous boon to research. It allows more realistic representation of the hugely varied choice situations that arise in the world. It enables the researcher to obtain more information from any given dataset and, in many cases, allows previously unapproachable issues to be addressed.

This flexibility places a new burden on the researcher. First, the methods themselves are more complicated than earlier ones and utilize many concepts and procedures that are not covered in standard econometrics courses. Understanding the various techniques – their advantages and limitations, and the relations among them – is important when choosing the appropriate method in any particular application and for developing new methods when none of the existing models seems right. The purpose of this book is to assist readers along this path.

Second, to implement a new method or a variant on an old method, the researcher needs to be able to program the procedure into computer software. This means that the researcher will often need to know how maximum likelihood and other estimation methods work from a computational perspective, how to code specific models, and how to take existing code and change it to represent variations in behavior. Some models, such as mixed logit and pure probit (in addition, of course, to standard logit), are available in commercially available statistical packages. In fact, code for these and other models, as well as manuals and sample data, are available (free) at my website <http://elsa.berkeley.edu/~train>. Whenever appropriate, researchers should use available codes rather than writing their own. However, the true value of the new approach to choice modeling is the ability to create tailor-made models. The computational and programming steps that are needed to implement a new model are usually not difficult. An important goal of the book is to teach these skills as an integral part of the exposition of the models themselves. I personally find programming to be extremely valuable pedagogically. The process of coding a model helps me to understand how exactly the model operates, the reasons and implications of its structure, what features constitute the essential elements that cannot be changed while maintaining the basic approach, and what features are arbitrary and can easily be changed. I imagine other people learn this way too.

## 1.2 Choice Probabilities and Integration

To focus ideas, I will now establish the conceptual basis for discrete choice models and show where integration comes into play. An agent (i.e., person, firm, decision maker) faces a choice, or a series of choices over time, among a set of options. For example, a customer chooses which of several competing products to buy; a firm decides which technology to use in production; a student chooses which answer to give on a multiple-choice test; a survey respondent chooses an integer between 1 and 5 on a Likert-scale question; a worker chooses whether to continue working each year or retire. Denote the outcome of the decision(s) in any given situation as  $y$ , indicating the chosen option or sequence of options. We assume for the purposes of this book that the outcome variable is discrete in that it takes a countable number of values. Many of the concepts that we describe are easily transferable to situations where the outcome variable is continuous. However, notation and terminology are different with continuous outcome variables than with discrete ones. Also, discrete choices generally reveal less information about the choice process than continuous-outcome choices, so that the econometrics of discrete choice is usually more challenging.

Our goal is to understand the behavioral process that leads to the agent's choice. We take a causal perspective. There are factors that collectively determine, or cause, the agent's choice. Some of these factors are observed by the researcher and some are not. The observed factors are labeled  $x$ , and the unobserved factors  $\varepsilon$ . The factors relate to the agent's choice through a function  $y = h(x, \varepsilon)$ . This function is called the behavioral process. It is deterministic in the sense that given  $x$  and  $\varepsilon$ , the choice of the agent is fully determined.

Since  $\varepsilon$  is not observed, the agent's choice is not deterministic and cannot be predicted exactly. Instead, the *probability* of any particular outcome is derived. The unobserved terms are considered random with density  $f(\varepsilon)$ . The probability that the agent chooses a particular outcome from the set of all possible outcomes is simply the probability that the unobserved factors are such that the behavioral process results in that outcome:  $P(y | x) = \text{Prob}(\varepsilon \text{ s.t. } h(x, \varepsilon) = y)$ .

We can express this probability in a more usable form. Define an indicator function  $I[h(x, \varepsilon) = y]$  that takes the value of 1 when the statement in brackets is true and 0 when the statement is false. That is,  $I[\cdot] = 1$  if the value of  $\varepsilon$ , combined with  $x$ , induces the agent to choose outcome  $y$ , and  $I[\cdot] = 0$  if the value of  $\varepsilon$ , combined with  $x$ , induces the agent to choose some other outcome. Then the probability that the agent chooses outcome  $y$  is simply the expected value of this

indicator function, where the expectation is over all possible values of the unobserved factors:

$$(1.1) \quad \begin{aligned} P(y | x) &= \text{Prob}(I[h(x, \varepsilon) = y] = 1) \\ &= \int I[h(x, \varepsilon) = y]f(\varepsilon) d\varepsilon. \end{aligned}$$

Stated in this form, the probability is an integral – specifically an integral of an indicator for the outcome of the behavioral process over all possible values of the unobserved factors.

To calculate this probability, the integral must be evaluated. There are three possibilities.

### 1.2.1. Complete Closed-Form Expression

For certain specifications of  $h$  and  $f$ , the integral can be expressed in closed form. In these cases, the choice probability can be calculated exactly from the closed-form formula. For example, consider a binary logit model of whether or not a person takes a given action, such as buying a new product. The behavioral model is specified as follows. The person would obtain some net benefit, or utility, from taking the action. This utility, which can be either positive or negative, consists of a part that is observed by the researcher,  $\beta'x$ , where  $x$  is a vector of variables and  $\beta$  is a vector of parameters, and a part that is not observed,  $\varepsilon$ :  $U = \beta'x + \varepsilon$ . The person takes the action only if the utility is positive, that is, only if doing so provides a net benefit. The probability that the person takes the action, given what the researcher can observe, is therefore  $P = \int I[\beta'x + \varepsilon > 0]f(\varepsilon) d\varepsilon$ , where  $f$  is the density of  $\varepsilon$ . Assume that  $\varepsilon$  is distributed logistically, such that its density is  $f(\varepsilon) = e^{-\varepsilon}/(1 + e^{-\varepsilon})^2$  with cumulative distribution  $F(\varepsilon) = 1/(1 + e^{-\varepsilon})$ . Then the probability of the person taking the action is

$$\begin{aligned} P &= \int I[\beta'x + \varepsilon > 0]f(\varepsilon) d\varepsilon \\ &= \int I[\varepsilon > -\beta'x]f(\varepsilon) d\varepsilon \\ &= \int_{\varepsilon=-\beta'x}^{\infty} f(\varepsilon) d\varepsilon \\ &= 1 - F(-\beta'x) = 1 - \frac{1}{1 + e^{\beta'x}} \\ &= \frac{e^{\beta'x}}{1 + e^{\beta'x}}. \end{aligned}$$

For any  $x$ , the probability can be calculated exactly as  $P = \exp(\beta'x)/(1 + \exp(\beta'x))$ .

Other models also have closed-form expressions for the probabilities. Multinomial logit (in Chapter 3), nested logit (Chapter 4), and ordered logit (Chapter 7) are prominent examples. The methods that I described in my first book and that served as the basis for the first wave of interest in discrete choice analysis relied almost exclusively on models with closed-form expressions for the choice probabilities. In general, however, the integral for probabilities cannot be expressed in closed form. More to the point, restrictions must be placed on the behavioral model  $h$  and the distribution of random terms  $f$  in order for the integral to take a closed form. These restrictions can make the models unrealistic for many situations.

### 1.2.2. Complete Simulation

Rather than solve the integral analytically, it can be approximated through simulation. Simulation is applicable in one form or another to practically any specification of  $h$  and  $f$ . Simulation relies on the fact that integration over a density is a form of averaging. Consider the integral  $\bar{t} = \int t(\varepsilon)f(\varepsilon)d\varepsilon$ , where  $t(\varepsilon)$  is a statistic based on  $\varepsilon$  which has density  $f(\varepsilon)$ . This integral is the expected value of  $t$  over all possible values of  $\varepsilon$ . This average can be approximated in an intuitively straightforward way. Take numerous draws of  $\varepsilon$  from its distribution  $f$ , calculate  $t(\varepsilon)$  for each draw, and average the results. This simulated average is an unbiased estimate of the true average. It approaches the true average as more and more draws are used in the simulation.

This concept of simulating an average is the basis for all simulation methods, at least all of those that we consider in this book. As given in equation (1.1), the probability of a particular outcome is an average of the indicator  $I(\cdot)$  over all possible values of  $\varepsilon$ . The probability, when expressed in this form, can be simulated directly as follows:

1. Take a draw of  $\varepsilon$  from  $f(\varepsilon)$ . Label this draw  $\varepsilon^1$ , where the superscript denotes that it is the first draw.
2. Determine whether  $h(x, \varepsilon^1) = y$  with this value of  $\varepsilon$ . If so, create  $I^1 = 1$ ; otherwise set  $I^1 = 0$ .
3. Repeat steps 1 and 2 many times, for a total of  $R$  draws. The indicator for each draw is labeled  $I^r$  for  $r = 1, \dots, R$ .
4. Calculate the average of the  $I^r$ 's. This average is the simulated probability:  $\hat{P}(y | x) = \frac{1}{R} \sum_{r=1}^R I^r$ . It is the proportion of times that the draws of the unobserved factors, when combined with the observed variables  $x$ , result in outcome  $y$ .

As we will see in the chapters to follow, this simulator, while easy to understand, has some unfortunate properties. Choice probabilities can often be expressed as averages of other statistics, rather than the average of an indicator function. The simulators based on these other statistics are calculated analogously, by taking draws from the density, calculating the statistic, and averaging the results. Probit (in Chapter 5) is the most prominent example of a model estimated by complete simulation. Various methods of simulating the probit probabilities have been developed based on averages of various statistics over various (related) densities.

### 1.2.3. Partial Simulation, Partial Closed Form

So far we have provided two polar extremes: either solve the integral analytically or simulate it. In many situations, it is possible to do some of both.

Suppose the random terms can be decomposed into two parts labeled  $\varepsilon_1$  and  $\varepsilon_2$ . Let the joint density of  $\varepsilon_1$  and  $\varepsilon_2$  be  $f(\varepsilon) = f(\varepsilon_1, \varepsilon_2)$ . The joint density can be expressed as the product of a marginal and a conditional density:  $f(\varepsilon_1, \varepsilon_2) = f(\varepsilon_2 | \varepsilon_1) \cdot f(\varepsilon_1)$ . With this decomposition, the probability in equation (1.1) can be expressed as

$$\begin{aligned} P(y | x) &= \int I[h(x, \varepsilon) = y] f(\varepsilon) d\varepsilon \\ &= \int_{\varepsilon_1} \left[ \int_{\varepsilon_2} I[h(x, \varepsilon_1, \varepsilon_2) = y] f(\varepsilon_2 | \varepsilon_1) d\varepsilon_2 \right] f(\varepsilon_1) d\varepsilon_1. \end{aligned}$$

Now suppose that a closed form exists for the integral in large brackets. Label this formula  $g(\varepsilon_1) \equiv \int_{\varepsilon_2} I[h(x, \varepsilon_1, \varepsilon_2) = y] f(\varepsilon_2 | \varepsilon_1) d\varepsilon_2$ , which is conditional on the value of  $\varepsilon_1$ . The probability then becomes  $P(y | x) = \int_{\varepsilon_1} g(\varepsilon_1) f(\varepsilon_1) d\varepsilon_1$ . If a closed-form solution does not exist for this integral, then it is approximated through simulation. Note that it is simply the average of  $g$  over the marginal density of  $\varepsilon_1$ . The probability is simulated by taking draws from  $f(\varepsilon_1)$ , calculating  $g(\varepsilon_1)$  for each draw, and averaging the results.

This procedure is called *convenient error partitioning* (Train, 1995). The integral over  $\varepsilon_2$  given  $\varepsilon_1$  is calculated exactly, while the integral over  $\varepsilon_1$  is simulated. There are clear advantages to this approach over complete simulation. Analytic integrals are both more accurate and easier to calculate than simulated integrals. It is useful, therefore, when possible, to decompose the random terms so that some of them can be integrated analytically, even if the rest must be simulated. Mixed logit (in Chapter 6) is a prominent example of a model that uses this decomposition

effectively. Other examples include Gouieroux and Monfort's (1993) binary probit model on panel data and Bhat's (1999) analysis of ordered responses.

### 1.3 Outline of Book

Discrete choice analysis consists of two interrelated tasks: specification of the behavioral model and estimation of the parameters of that model. Simulation plays a part in both tasks. Simulation allows the researcher to approximate the choice probabilities that arise in the behavioral model. As we have stated, the ability to use simulation frees the researcher to specify models without the constraint that the resulting probabilities must have a closed form. Simulation also enters the estimation task. The properties of an estimator, such as maximum likelihood, can change when simulated probabilities are used instead of the actual probabilities. Understanding these changes, and mitigating any ill effects, is important for a researcher. In some cases, such as with Bayesian procedures, the estimator itself is an integral over a density (as opposed to the choice probability being an integral). Simulation allows these estimators to be implemented even when the integral that defines the estimator does not take a closed form.

The book is organized around these two tasks. Part I describes behavioral models that have been proposed to describe the choice process. The chapters in this section move from the simplest model, logit, to progressively more general and consequently more complex models. A chapter is devoted to each of the following: logit, the family of generalized extreme value models (whose most prominent member is nested logit), probit, and mixed logit. This part of the book ends with a chapter titled "Variations on a Theme," which covers a variety of models that build upon the concepts in the previous chapters. The point of this chapter is more than simply to introduce various new models. The chapter illustrates the underlying concept of the book, namely, that researchers need not rely on the few common specifications that have been programmed into software but can design models that reflect the unique setting, data, and goals of their project, writing their own software and using simulation as needed.

Part II describes estimation of the behavioral models. Numerical maximization is covered first, since most estimation procedures involve maximization of some function, such as the log-likelihood function. We then describe procedures for taking draws from various kinds of densities, which are the basis for simulation. This chapter also describes different kinds of draws, including antithetic variants and quasi-random

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sequences, that can provide greater simulation accuracy than independent random draws. We then turn to simulation-assisted estimation, looking first at classical procedures, including maximum simulated likelihood, method of simulated moments, and method of simulated scores, and then at Bayesian procedures, including Markov Chain Monte Carlo methods. Up to this point in the book, we assume that explanatory variables are exogenous, that is, independent of unobserved factors. Chapter 13, which is new in this second edition, examines endogeneity, identifying situations where unobserved factors are correlated with explanatory variables and describing estimation methods that are appropriate for these situations, including the BLP approach, control functions, and full information maximum likelihood. The final chapter, which is also new, shows how EM algorithms, which have been used extensively in other areas of statistics, can be helpful for complex choice models, including non-parameteric estimation of the distribution of preferences over agents. The simplicity and power of EM algorithms when applied to choice models makes this chapter a fitting finale for the book.

## 1.4 A Couple of Notes

Throughout the book, I refer to the researcher as “she” and the decision maker as “he.” This usage, as well as being comparatively gender-neutral (or at least symmetrically noninclusive), allows both people to be referred to in the same paragraph without confusion.

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## *Part I*

# Behavioral Models

## 2 Properties of Discrete Choice Models

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### 2.1 Overview

This chapter describes the features that are common to all discrete choice models. We start by discussing the choice set, which is the set of options that are available to the decision maker. We then define choice probabilities and derive them from utility-maximizing behavior. The most prominent types of discrete choice models, namely logit, generalized extreme value (GEV), probit, and mixed logit, are introduced and compared within the context of this general derivation. Utility, as a constructed measure of well-being, has no natural level or scale. This fact has important implications for the specification and normalization of discrete choice models, which we explore. We then show how individual-level models are aggregated to obtain market-level predictions, and how the models are used for forecasting over time.

### 2.2 The Choice Set

Discrete choice models describe decision makers' choices among alternatives. The decision makers can be people, households, firms, or any other decision-making unit, and the alternatives might represent competing products, courses of action, or any other options or items over which choices must be made. To fit within a discrete choice framework, the set of alternatives, called the *choice set*, needs to exhibit three characteristics. First, the alternatives must be *mutually exclusive* from the decision maker's perspective. Choosing one alternative necessarily implies not choosing any of the other alternatives. The decision maker chooses only one alternative from the choice set. Second, the choice set must be *exhaustive*, in that all possible alternatives are included. The decision maker necessarily chooses one of the alternatives. Third, the number of alternatives must be finite. The researcher can count the alternatives and eventually be finished counting.