Practitioner's Guide to Stochastic Frontier Analysis Using Stata

Stochastic frontier analysis (SFA) is a powerful technique for estimating the production or cost frontier of a firm or industry. The frontier represents the maximum possible output or minimum possible cost that a firm can achieve given its inputs. SFA allows us to identify firms that are operating inefficiently and to estimate the magnitude of their inefficiency.

SFA is a parametric technique that assumes that the error term in the production or cost function is composed of two components: a random error term and an inefficiency error term. The random error term is assumed to be normally distributed, while the inefficiency error term is assumed to be half-normally distributed.

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4.8 out of 5

Language	: English
File size	: 33418 KB
Text-to-Speech	: Enabled
Screen Reader	: Supported
Enhanced typesetting	: Enabled
Print length	: 702 pages

The inefficiency error term is a function of a set of firm-specific factors that affect the firm's ability to operate efficiently. These factors can include management practices, employee skills, and access to capital.

SFA can be used to estimate a variety of different frontiers, including production frontiers, cost frontiers, and profit frontiers. Production frontiers measure the maximum possible output that a firm can achieve given its inputs. Cost frontiers measure the minimum possible cost that a firm can achieve given its inputs. Profit frontiers measure the maximum possible profit that a firm can achieve given its inputs.

SFA is a valuable tool for practitioners in a variety of fields, including economics, finance, and accounting. It can be used to:

* Identify firms that are operating inefficiently * Estimate the magnitude of inefficiency * Evaluate the impact of firm-specific factors on efficiency * Make recommendations for improving efficiency

Data Requirements

The data requirements for SFA are relatively simple. The data must include information on the firm's inputs and outputs, as well as a set of firm-specific factors that affect the firm's ability to operate efficiently.

The inputs and outputs can be any variables that are relevant to the firm's production or cost function. For example, the inputs might include labor, capital, and materials. The outputs might include sales, revenue, or profit.

The firm-specific factors can be any variables that are thought to affect the firm's ability to operate efficiently. These factors might include management practices, employee skills, and access to capital.

Model Specification

The first step in conducting an SFA is to specify the production or cost function. The production function is a mathematical equation that describes the relationship between the firm's inputs and outputs. The cost function is a mathematical equation that describes the relationship between the firm's inputs and costs.

The most common functional forms for production functions and cost functions are the Cobb-Douglas function and the translog function. The Cobb-Douglas function is a simple and flexible functional form that is often used in SFA. The translog function is a more flexible functional form that can be used to capture more complex relationships between the inputs and outputs.

Once the production or cost function has been specified, the next step is to specify the inefficiency error term. The inefficiency error term is a function of the firm-specific factors that affect the firm's ability to operate efficiently.

The most common functional forms for inefficiency error terms are the half-normal distribution and the exponential distribution. The half-normal distribution is a simple and flexible distribution that is often used in SFA. The exponential distribution is a more flexible distribution that can be used to capture more complex relationships between the firm-specific factors and the inefficiency error term.

Estimation

The next step in conducting an SFA is to estimate the parameters of the production or cost function and the inefficiency error term. The parameters can be estimated using a variety of different methods, including maximum likelihood estimation and Bayesian estimation.

Maximum likelihood estimation is the most common method for estimating the parameters of an SFA model. Maximum likelihood estimation finds the values of the parameters that maximize the likelihood function. The likelihood function is a function of the data and the parameters of the model.

Bayesian estimation is a more flexible method for estimating the parameters of an SFA model. Bayesian estimation uses Bayes' theorem to update our beliefs about the parameters of the model as we learn more about the data. Bayes' theorem is a mathematical equation that describes the relationship between the prior distribution, the likelihood function, and the posterior distribution.

The prior distribution is our initial belief about the parameters of the model. The likelihood function is a function of the data and the parameters of the model. The posterior distribution is our updated belief about the parameters of the model after we have observed the data.

Interpretation

The final step in conducting an SFA is to interpret the results. The results of an SFA can be used to:

* Identify firms that are operating inefficiently * Estimate the magnitude of inefficiency * Evaluate the impact of firm-specific factors on efficiency * Make recommendations for improving efficiency

To identify firms that are operating inefficiently, we can compare the estimated inefficiency scores for the firms in the sample. The firms with the

highest inefficiency scores are the firms that are operating the most inefficiently.

To estimate the magnitude of inefficiency, we can calculate the average inefficiency score for the firms in the sample. The average inefficiency score is a measure of the overall level of inefficiency in the sample.

To evaluate the impact of firm-specific factors on efficiency, we can regress the inefficiency scores on the firm

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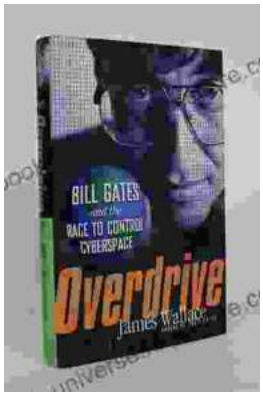

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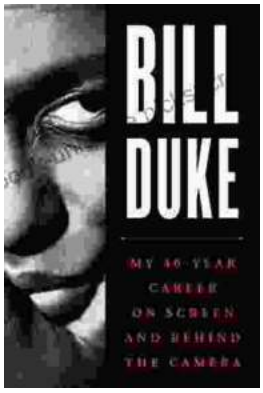

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