Heteroscedasticity Problem

1 Nature and Consequences of heteroscedasticity for OLS

- Heteroskedasticity (broadly) -

- Heteroskedasticity (in econometrics) -

1.1 Nature of Heteroskedasticity

1.2 Consequences of Heteroskedasticity

1. Does not affect the biasedness of the OLS estimators

2. Does not affect the value of R^2 and $adj.R^2$

3. Make the estimated value of $Var(\widehat{\beta}_{OLS})$ wrong

4. Affect the correctness of our inference

1.3 How can the estimated value of $Var(\widehat{\beta}_{OLS})$ be wrong?

Suppose

$$y_i = \beta_0 + \beta_1 x_i + u_i$$

Given that assumption 1 to 4 are true, but assumption 5 (homoskedasticity) is violated. Thus,

$$Var(u_i|x_i) =$$

And from the OLS estimation steps, we can write

$$\hat{\beta}_1 = \beta_1 +$$

1.4 Two types of remedies

1. Passive

2. Active

2 Testing for heteroskedasticity

- The main point -

Suppose

$$y = \beta_0 + \beta_1 x_1 + \beta_2 x_2 + ... + \beta_k x_k + u$$

Assume that assumption 1 to 4 are true. Our hypotheses to test for heteroskeroskedasticity would be

We know that $Var(u|\mathbf{x}) = E(u^2|\mathbf{x}) - [E(u|\mathbf{x})]^2$. But ______________________ according to assumption 4. Thus, H_0 and H_a can be written as

2.1 Breusch-Pagan test (BP test)

To perform the Breusch-Pagan Test in STATA

STATA commands (in case $k = 4$):

regress y x_1 x_2 x_3 x_4

predict u_hat, residual

generate u_hat_sq = u_hat^2

regress u_hat_sq x_1 x_2 x_3 x_4

** Then, check the F-statistic on the top right-hand corner of the result table.

Example: Finding the determinants of GPA.

```
. regress  termgpa attend priGPA final frosh soph
```

Source	SS	df	MS
Model	226.077541	5	45.2155081
Residual	142.319996	674	.211157264
Total	368.397537	679	.542558964

Number of obs	=	680
F(5, 674)	=	214.13
Prob > F	=	0.0000
R-squared	=	0.6137
Adj R-squared	=	0.6108
Root MSE	=	.45952

termgpa	Coef.	Std. Err.	t	P>|t|	[95% Conf.	Interval]
attend	.046594	.0036082	12.91	0.000	.0395093	.0536787
priGPA	.5329307	.0403281	13.21	0.000	.4537468	.6121146
final	.0503197	.0040339	12.47	0.000	.0423992	.0582403
frosh	.0974307	.0560211	1.74	0.082	-.0125662	.2074276
soph	.0689273	.0467006	1.48	0.140	-.0227689	.1606236
_cons	-1.361077	.1316861	-10.34	0.000	-1.619642	-1.102513

```
. predict u_hat, residual

. generate u_hat_sq = u_hat^2

. regress u_hat_sq  attend priGPA final frosh soph

 regress u_hat_sq attend priGPA final frosh soph

      Source |       SS       df       MS              Number of obs =     680
-------------+------------------------------           F(  5,   674) =   14.54
       Model |  8.22606613     5  1.64521323           Prob > F      =  0.0000
    Residual |  76.2624962   674  .113149104           R-squared     =  0.0974
-------------+------------------------------           Adj R-squared =  0.0907
       Total |  84.4885623   679  .124430872           Root MSE      =  .33638

------------------------------------------------------------------------------
    u_hat_sq |      Coef.   Std. Err.      t    P>|t|     [95% Conf. Interval]
-------------+----------------------------------------------------------------
      attend |  -.0088079   .0026413    -3.33   0.001    -.0139941   -.0036218
      priGPA |  -.1454432    .029521    -4.93   0.000    -.2034074   -.0874791
       final |   .0061879   .0029529     2.10   0.036     .0003899    .0119859
       frosh |  -.1077493   .0410085    -2.63   0.009    -.1882692   -.0272294
        soph |  -.0975658   .0341858    -2.85   0.004    -.1646892   -.0304423
       _cons |   .7368933   .0963968     7.64   0.000     .5476191    .9261674
------------------------------------------------------------------------------
```

Alternatively, you can use the following set of STATA commands:
regress y x_1 x_2 x_3 x_4
estat hettest x_1 x_2 x_3 x_4

```
. regress termgpa attend priGPA final frosh soph

      Source |       SS       df       MS              Number of obs =     680
-------------+------------------------------           F(  5,   674) =  214.13
       Model |  226.077541     5  45.2155081           Prob > F      =  0.0000
    Residual |  142.319996   674  .211157264           R-squared     =  0.6137
-------------+------------------------------           Adj R-squared =  0.6108
       Total |  368.397537   679  .542558964           Root MSE      =  .45952

------------------------------------------------------------------------------
     termgpa |      Coef.   Std. Err.      t    P>|t|     [95% Conf. Interval]
-------------+----------------------------------------------------------------
      attend |    .046594   .0036082    12.91   0.000     .0395093    .0536787
      priGPA |   .5329307   .0403281    13.21   0.000     .4537468    .6121146
       final |   .0503197   .0040339    12.47   0.000     .0423992    .0582403
       frosh |   .0974307   .0560211     1.74   0.082    -.0125662    .2074276
        soph |   .0689273   .0467006     1.48   0.140    -.0227689    .1606236
       _cons |  -1.361077   .1316861   -10.34   0.000    -1.619642   -1.102513
------------------------------------------------------------------------------

. estat hettest attend priGPA final frosh soph

Breusch-Pagan / Cook-Weisberg test for heteroskedasticity
         Ho: Constant variance
         Variables: attend priGPA final frosh soph

         chi2(5)      =    93.90
         Prob > chi2  =   0.0000
```

If the null hypothesis is rejected (we have the heteroskedasticity problem), we can use the ", robust" option in STATA. This option gives us the correct standard error, or "heteroskedasticity-robust standard error". We can now use the t-statistics in this case.

```
. regress termgpa attend priGPA final frosh soph, robust

Linear regression                                      Number of obs =     680
                                                       F(  5,   674) =  234.28
                                                       Prob > F      =  0.0000
                                                       R-squared     =  0.6137
                                                       Root MSE      =  .45952

------------------------------------------------------------------------------
             |               Robust
     termgpa |      Coef.   Std. Err.      t    P>|t|     [95% Conf. Interval]
-------------+----------------------------------------------------------------
      attend |    .046594   .0044101    10.57   0.000     .0379348    .0552532
      priGPA |   .5329307   .0426426    12.50   0.000     .4492023     .616659
       final |   .0503197   .0041066    12.25   0.000     .0422564     .058383
       frosh |   .0974307   .0633543     1.54   0.125    -.0269648    .2218262
        soph |   .0689273   .0520495     1.32   0.186    -.0332713    .1711259
       _cons |  -1.361077   .1448208    -9.40   0.000    -1.645431   -1.076723
------------------------------------------------------------------------------
```

2.2 The White Test

Similar to the Breush-Pagan test, but is stricter because it does not allow $\widehat{u}^2$ to be correlated with x^2 or interactions among different x_s.

Suppose

$$y = \beta_0 + \beta_1 x_1 + \beta_2 x_2 + ... + \beta_k x_k + u$$

The White Test (special case) (save degree of freedom)

1. Get $\hat{\beta}_1, \hat{\beta}_2, ..., \hat{\beta}_k$ by OLS.
2. Calculate $\hat{u}_i^2 = [y_i - (\hat{\beta}_0 + \hat{\beta}_1 x_1 + \hat{\beta}_2 x_2 + ... + \hat{\beta}_k x_k)]^2$
3. Calculate $\hat{y}_i = (\hat{\beta}_0 + \hat{\beta}_1 x_1 + \hat{\beta}_2 x_2 + ... + \hat{\beta}_k x_k)$
4. Calculate $\hat{y}_i^2$
5. Estimate $\hat{u}_i^2 = \gamma_0 + \gamma_1 \hat{y}_i + \gamma_2 \hat{y}^2 + error$ (keep R^2 of this regression)
6. $LM = nR^2$
7. If $p - value > significance\ \ level$, cannot reject H_o.

3 Remedial measures

As mentioned before, there are 2 types of remedies – passive and active.

- The passive remedies just re-calculate the *std.err.* or $\hat{\beta}$ using the heteroskedasticity-robust standard error formula(s).
- The active remedies include the "weighted least squares (WLS) estimators", "generalized least squares (GLS) estimators", or "feasible GLS estimator".

3.1 Weighted Least Squares (WLS)

We assume that the heteroskedasticity may take the pattern

From

$$
\begin{aligned}
Var(u_i|\mathbf{x}) &= E(u_i^2|\mathbf{x}) - [E(u_i|\mathbf{x})]^2 \\
&=
\end{aligned}
$$

We get

To make the error term become homoskedastic, we weight every term by $\sqrt{h_i}$.

How do we find h_i *or* $\sqrt{h_i}$, the heteroskedasticity function?

1. If the heteroskedasticity is "known" to be caused by a multiplicative constant, we can adjust using that constant.

2. If the heteroskedasticity pattern is not known, we can estimate it. This procedure is called "Feasible Generalized Least Squares" (also called Feasible GLS or FGLS)

3.2 Feasible GLS

Since $Var(\hat{\beta}_j)$ would not be unbiased, we can make valid inferences about β_j, e.g. can use t-test, F-test, etc.

Feasible GLS in practice

1. Get $\hat{\beta}_1, \hat{\beta}_2, ..., \hat{\beta}_k$ by OLS. (regress y x_1 x_2 .... x_k)
2. Calculate $\hat{u}_i = [y_i - (\hat{\beta}_0 + \hat{\beta}_1 x_1 + \hat{\beta}_2 x_2 + \hat{\beta}_k x_k)]$ (predict u_hat, residual)
3. Create $\log(\hat{u}_i^2)$ (generate log_u_sq = log(u_hat^2))
4. Estimate $\log(\hat{u}_i^2) = \theta_0 + \theta_1 x_1 + \theta_2 x_2 + ... + \theta_k x_k + error$ (regress log_u_sq x_1 x_2 ... x_k)
5. Obtain the fitted value of $\widehat{\log(\hat{u}_i^2)}$, called $\hat{g}$.(predict g_hat, xb)
6. Create $\hat{h} = \exp(\hat{g})$ (generate h_hat = exp(g_hat))
7. Divide y and each x_{ij} by $\sqrt{\hat{h}}$
8. Estimate $\frac{y}{\sqrt{\hat{h}}} = \frac{\lambda_0}{\sqrt{\hat{h}}} + \lambda_1 \frac{x_1}{\sqrt{\hat{h}}} + \lambda_2 \frac{x_2}{\sqrt{\hat{h}}} + ... + \lambda_k \frac{x_k}{\sqrt{\hat{h}}} + \frac{error}{\sqrt{\hat{h}}}$

Steps 7 & 8 on STATA would be: regress y x_1 x_2 ... x_k [aweight = $\frac{1}{\sqrt{\hat{h}}}$]

3.3 What if the assumed h_i function is wrong?