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EE435 Assignment 4

1. Estimate model (1) using Panel Least Squares estimation method and PGLS assuming Heteroskedasticity, and test whether there exists Heteroskedasticity problem.

```
. xtgls y x1 x2 x3 x4 x5 x6 x7, igls panels(he
> teroskedastic) nolog


Cross-sectional time-series FGLS regression

Coefficients:  generalized least squares
Panels:        heteroskedastic
Correlation:   no autocorrelation

Estimated covariances      =       255          Number of obs     =      1,275
Estimated autocorrelations =         0          Number of groups  =        255
Estimated coefficients     =         8          Time periods      =          5
                                                Wald chi2(7)      =    3850.64
Log likelihood             =   519.361          Prob > chi2       =     0.0000
```

y	Coef.	Std. Err.	z	P>|z|	[95% Conf.	Interval]
x1	.0834067	.0045748	18.23	0.000	.0744403	.0923732
x2	.0163976	.0032919	4.98	0.000	.0099456	.0228497
x3	-.3631261	.0505673	-7.18	0.000	-.4622362	-.264016
x4	.3191455	.1093883	2.92	0.004	.1047484	.5335426
x5	-.1093301	.0043601	-25.07	0.000	-.1178758	-.1007844
x6	.1361732	.0275038	4.95	0.000	.0822667	.1900797
x7	-.2282655	.0063087	-36.18	0.000	-.2406303	-.2159007
_cons	-.037658	.0426502	-0.88	0.377	-.1212509	.0459349

```
. estimate store het
```

The above picture is the estimated result by using Panel Least Squares estimation method assuming the Heteroskedasticity.

```
. xtgls y x1 x2 x3 x4 x5 x6 x7

Cross-sectional time-series FGLS regression

Coefficients:  generalized least squares
Panels:        homoskedastic
Correlation:   no autocorrelation

Estimated covariances      =         1          Number of obs     =      1,275
Estimated autocorrelations =         0          Number of groups  =        255
Estimated coefficients     =         8          Time periods      =          5
                                                Wald chi2(7)      =     899.95
Log likelihood             =  209.4322          Prob > chi2       =     0.0000
```

y	Coef.	Std. Err.	z	P>|z|	[95% Conf.	Interval]
x1	.0794732	.0093881	8.47	0.000	.0610728	.0978735
x2	.0183375	.0051421	3.57	0.000	.0082592	.0284158
x3	.0977707	.0526329	1.86	0.063	-.0053879	.2009293
x4	.0873838	.2186064	0.40	0.689	-.3410767	.5158444
x5	-.1076457	.0069214	-15.55	0.000	-.1212114	-.0940801
x6	-.1432493	.0186811	-7.67	0.000	-.1798637	-.106635
x7	-.2712849	.011995	-22.62	0.000	-.2947946	-.2477753
_cons	-.0107965	.0860341	-0.13	0.900	-.1794201	.1578272

```
. estimate store pgls
```

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```
. local df=e(N_g)-1

. lrtest het pgls, df(`df')

Likelihood-ratio test                                 LR chi2(254)=    619.86
(Assumption: pgls nested in het)                      Prob > chi2 =    0.0000

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To test the heteroskedasticity problem, we use LR-test. From the above estimation, LR-chi^2 is statistically significant at 95% confidence level since its value is less than the critical point (0.00<0.05). Therefore, we refect the null hypothesis and there exists a heteroskedasticity problem.

2. Estimate the above three models including Panel Least Squares model, Fixed effects model, and Random-effects model. Perform fixed effects tests and random effects test, also state the null hypothesis of the tests. Then, determine the most appropriated model. Also, give an explanation of the choosing criterion (perform the tests), and make interpretation of the estimated models.

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```
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```

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The above picture presents the result of Panel Least Squares model.

```
. xtreg y x1 x2 x3 x4 x5 x6 x7, fe

Fixed-effects (within) regression               Number of obs     =      1,275
Group variable: crossid                         Number of groups  =        255

R-sq:                                           Obs per group:
     within  = 0.3772                                         min =          5
     between = 0.1103                                         avg =        5.0
     overall = 0.1644                                         max =          5

                                                F(7,1013)         =      87.64
corr(u_i, Xb)  = -0.2003                        Prob > F          =     0.0000
```

y	Coef.	Std. Err.	t	P>|t|	[95% Conf.	Interval]
x1	-.1256447	.0180942	-6.94	0.000	-.161151	-.0901384
x2	.0123739	.008023	1.54	0.123	-.0033697	.0281176
x3	.0747825	.039773	1.88	0.060	-.0032643	.1528293
x4	.6493144	.2855092	2.27	0.023	.0890573	1.209572
x5	-.1104883	.0061097	-18.08	0.000	-.1224773	-.0984992
x6	-.1461423	.0141035	-10.36	0.000	-.1738178	-.1184669
x7	-.0951497	.0121853	-7.81	0.000	-.1190611	-.0712383
_cons	1.756067	.1658407	10.59	0.000	1.430636	2.081497
sigma_u	.22676694					
sigma_e	.11725953					
rho	.78902632	(fraction of variance due to u_i)				

```
F test that all u_i=0: F(254, 1013) = 11.40                     Prob > F = 0.0000

. estimate store fixed
```

The above picture presents the result using of Fixed effects model. To test the Fixed effects, we set the null hypothesis of H_0: $\alpha_1 = \alpha_2 = \ldots = \alpha_n = \alpha$. The result is statistically significant at 95% confidence level since the probability of F-test of 0.00 is less than 0.05. Therefore, we reject the null hypothesis and there exists Fixed effects.

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```
. xtreg y x1 x2 x3 x4 x5 x6 x7, re

Random-effects GLS regression                   Number of obs     =      1,275
Group variable: crossid                         Number of groups  =        255

R-sq:                                           Obs per group:
     within  = 0.3492                                         min =          5
     between = 0.3404                                         avg =        5.0
     overall = 0.3377                                         max =          5

                                                Wald chi2(7)      =     663.43
corr(u_i, X)   = 0 (assumed)                    Prob > chi2       =     0.0000
```

y	Coef.	Std. Err.	z	P>|z|	[95% Conf.	Interval]
x1	-.0145018	.0133366	-1.09	0.277	-.040641	.0116375
x2	.0146948	.0064463	2.28	0.023	.0020604	.0273292
x3	.0985565	.0399464	2.47	0.014	.020263	.1768501
x4	.4693539	.2493856	1.88	0.060	-.0194329	.9581407
x5	-.1117985	.005959	-18.76	0.000	-.1234779	-.100119
x6	-.1541318	.014125	-10.91	0.000	-.1818163	-.1264472
x7	-.1494529	.0115006	-13.00	0.000	-.1719937	-.1269122
_cons	.7714573	.1226841	6.29	0.000	.5310009	1.011914
sigma_u	.15944933					
sigma_e	.11725953					
rho	.64900604	(fraction of variance due to u_i)				

```
.  estimate store random
```

The above picture represents the result of Random-effects model.

```
. hausman fixed random
```

	(b) fixed	(B) random	(b-B) Difference	sqrt(diag(V_b-V_B)) S.E.
x1	-.1256447	-.0145018	-.1111429	.0122284
x2	.0123739	.0146948	-.0023208	.0047765
x3	.0747825	.0985565	-.0237741	.
x4	.6493144	.4693539	.1799605	.1390048
x5	-.1104883	-.1117985	.0013102	.0013484
x6	-.1461423	-.1541318	.0079894	.
x7	-.0951497	-.1494529	.0543033	.0040273

```
                b = consistent under Ho and Ha; obtained from xtreg
     B = inconsistent under Ha, efficient under Ho; obtained from xtreg

  Test:  Ho:  difference in coefficients not systematic

              chi2(7) = (b-B)'[(V_b-V_B)^(-1)](b-B)
                      =      190.39
            Prob>chi2 =      0.0000
            (V_b-V_B is not positive definite)
```

From the previous estimated result, there is significant fixed effects. However, to determine whether the fixed-effects model or random-effects model is more appropriated, we perform the Hausman test. The null hypothesis is H_0: $\beta_{FE} = \beta_{RE}$. The p-value of Chi^2 is statistically significant at 95% confidence level since the value is less than the critical point (0.00<0.05). This implies that we can reject the null hypothesis and the fixed effects model is more appropriate.

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As we choose the Fixed effects model as a more appropriate model, this implies that each α_i represents the specific characteristics of the firm and not equal to others. Also, these specific behavious correlates with independent variables. The coefficients in the table refers to the impact on leverage of the firm by changing each x variables by 1 unit. For example, an increase in profitability index by 1 unit will increase the leverage of firm by 0.0748 unit. The overall F-test is statistically significant at 95% confidence level since the probability of F-test is 0.00 which is smaller than 0.05. The overall R^2 is 0.1644 meaning that the explanatory variables can help to explain the dependent variable by 16.44%. Besides, each independent variables is statistically significant at the 95% confidence level since p-value is smaller than critical point (0.00<0.05).