

HETEROSCEDASTICITY

EE325(Ajarn Kaewkwan Tangtipongkul)

THE NATURE OF HETEROSCEDASTICITY

One of the important assumptions of CLRM is that the variance of each disturbance term u_i , conditional on the chosen values of the explanatory variables, is some constant number equal to σ^2 (Homoscedasticity)

$$E(u_i^2) = \sigma^2 \quad i = 1, \dots, n$$

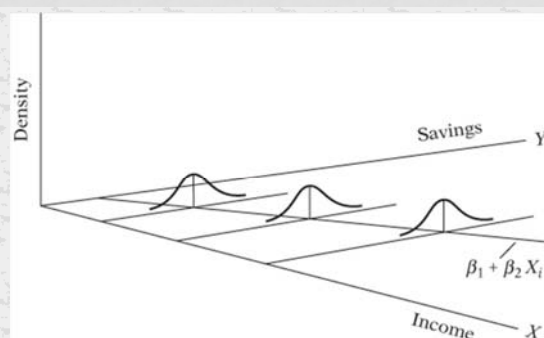
EE325(Ajarn Kaewkwan Tangtipongkul)

The conditional variance of Y_i increases as X increases. Here, the variances of Y_i are not the same. Here, there is heteroscedasticity.

$$E(u_i^2) = \sigma_i^2 \quad i = 1, \dots, n$$

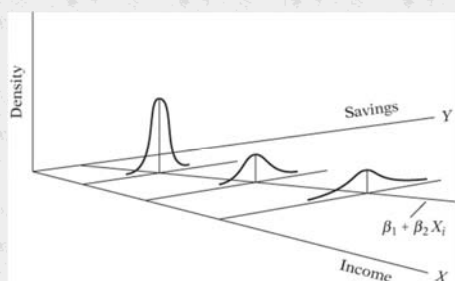
EE325(Ajarn Kaewkwan Tangtipongkul)

HOMOSCEDASTIC DISTURBANCES



EE325(Ajarn Kaewkwan Tangtipongkul)

HETEROSCEDASTIC DISTURBANCES



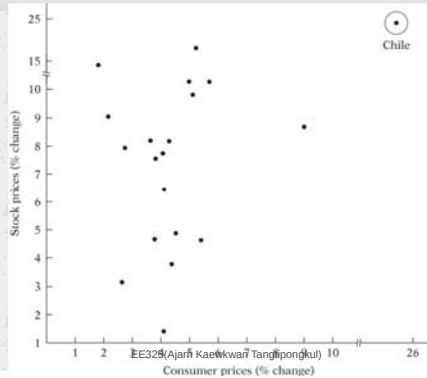
EE325(Ajarn Kaewkwan Tangtipongkul)

SEVERAL REASONS WHY THE VARIANCES OF u_i MAY BE VARIABLE

- As incomes grow, people have more discretionary income and hence more scope for choice about the disposition of their income. Hence σ_i^2 is likely to increase with income.
- As data collecting techniques improve, σ_i^2 is likely to decrease

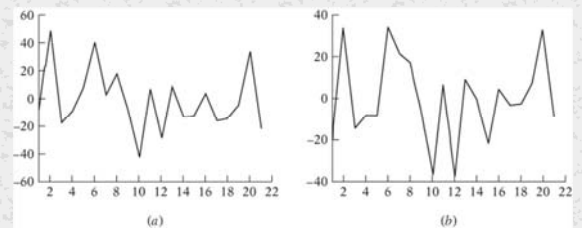
EE325(Ajarn Kaewkwan Tangtipongkul)

HETEROSCEDASTICITY CAN ALSO ARISE AS A RESULT OF THE PRESENCE OF **OUTLIERS**



SPECIFICATION ERROR

- Some important variables are omitted from the model



EE325(Ajarn Kaewkwan Tangtipongkul)

- Incorrect data transformation
- Incorrect functional form

EE325(Ajarn Kaewkwan Tangtipongkul)

- Heteroscedasticity is likely to be more common in cross-sectional than in time series data
- Example
 - Compensation per employee in 10 nondurable goods manufacturing industries, classified by the employment size of the firm or the establishment for the year 1958
 - Table shows that on the average large firms pay more than small firms
 - There is considerable variability in earnings among various employment classes as indicated by the estimated standard deviations of earnings
 - On average, the standard deviation of compensation increases with the average value of compensation

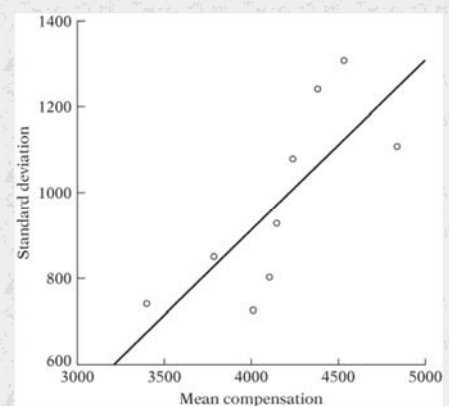
EE325(Ajarn Kaewkwan Tangtipongkul)

IND	A	B	C	D	E	F	G	H	I
1	2994	3295	3565	3907	4189	4486	4676	4968	5342
2	1721	2057	3336	3320	2980	2848	3072	2969	3822
3	3600	3657	3674	3437	3340	3334	3225	3163	3168
4	3494	3787	3533	3215	3030	2834	2750	2967	3453
5	3498	3847	3913	4135	4445	4885	5132	5342	5326
6	3611	4206	4695	5083	5301	5269	5182	5395	5552
7	3875	4660	4930	5005	5114	5248	5630	5870	5876
8	4616	5181	5317	5337	5421	5710	6316	6455	6347
9	3538	3984	4014	4287	4221	4539	4721	4905	5481
10	3016	3196	3149	3317	3414	3254	3177	3346	4067
11	3396	3787	4013	4014	4146	4241	4387	4538	4843
12	743.7	851.4	727.8	805.06	929.9	1080.6	1243.2	1307.7	1112.5
13	9355	8584	7962	8275	8389	9418	9795	10281.00	1750

IND = Industry
 where: 1=Food and Kindred Products
 2=Tobacco Products
 3=Textile Mill Products
 4=Apparel and Related Products
 5=Paper and Allied Products
 6=Printing and Publishing
 7=Chemicals and Allied Products
 8=Petroleum and Coal Products
 9=Rubber and Plastic Products
 10=Leather and Leather Products
 11=Average Compensation
 12=Standard Deviation
 13=Average Productivity

EMPLOYMENT SIZE = Average Number of Employees
 where: A=1 to 4
 B=5 to 9
 C=10 to 19
 D=20 to 49
 E=50 to 99
 F=100 to 249
 G=250 to 499
 H=500 to 999
 I=1000 to 2499

EE325(Ajarn Kaewkwan Tangtipongkul)



EE325(Ajarn Kaewkwan Tangtipongkul)

OLS ESTIMATION IN THE PRESENCE OF HETEROSCEDASTICITY

EE325(Ajarn Kaewkwan Tangtipongkul)

$\hat{\beta}_2$ is best linear unbiased estimator (BLUE)

$$Y_i = \beta_1 + \beta_2 X_i + u_i$$

$$\hat{\beta}_2 = \frac{\sum (X_i - \bar{X})(Y_i - \bar{Y})}{\sum (X_i - \bar{X})^2} = \frac{\sum x_i y_i}{\sum x_i^2}$$

$$\text{var}(\hat{\beta}_2) = \frac{\sum x_i^2 \sigma_i^2}{(\sum x_i^2)^2}$$

$$\text{var}(\hat{\beta}_2) = \frac{\sigma^2}{\sum x_i^2} \quad \text{Homoscedasticity}$$

EE325(Ajarn Kaewkwan Tangtipongkul)

IS $\hat{\beta}_2$ STILL BLUE WHEN WE DROP ONLY HOMOSCEDASTICITY ASSUMPTION AND REPLACE IT WITH THE ASSUMPTION OF HETEROSCEDASTICITY?

$\hat{\beta}_2$ is **no longer best and the minimum variance** given by

$$\text{var}(\hat{\beta}_2) = \frac{\sum x_i^2 \sigma_i^2}{(\sum x_i^2)^2}$$

EE325(Ajarn Kaewkwan Tangtipongkul)

THE METHOD OF GENERALIZED LEAST SQUARES (GLS)

EE325(Ajarn Kaewkwan Tangtipongkul)

$$Y_i = \beta_1 + \beta_2 X_i + u_i$$

$$Y_i = \beta_1 X_{0i} + \beta_2 X_i + u_i \quad \text{where } X_{0i} = 1 \text{ for each } i$$

Now assume that the heteroscedastic variance σ_i^2 are known

$$\frac{Y_i}{\sigma_i} = \beta_1 \left(\frac{X_{0i}}{\sigma_i} \right) + \beta_2 \left(\frac{X_i}{\sigma_i} \right) + \left(\frac{u_i}{\sigma_i} \right)$$

$$Y_i^* = \beta_1^* X_{0i}^* + \beta_2^* X_i^* + u_i^*$$

EE325(Ajarn Kaewkwan Tangtipongkul)

$$\begin{aligned} \text{var}(u_i^*) &= E(u_i^*)^2 = E\left(\frac{u_i}{\sigma_i}\right)^2 \quad \text{Since } E(u_i) = 0 \\ &= \frac{1}{\sigma_i^2} E(u_i^2) \quad \text{Since } \sigma_i^2 \text{ is known} \\ &= \frac{1}{\sigma_i^2} (\sigma_i^2) \quad \text{Since } E(u_i^2) = \sigma_i^2 \\ &= 1 \end{aligned}$$

EE325(Ajarn Kaewkwan Tangtipongkul)

- Since we are still retaining the other assumptions of the classical model, the finding that it is u_i^* that is homoscedastic suggests that if we apply OLS to the transformed

$$\frac{Y_i}{\sigma_i} = \beta_1 \left(\frac{X_{0i}}{\sigma_i} \right) + \beta_2 \left(\frac{X_i}{\sigma_i} \right) + \left(\frac{u_i}{\sigma_i} \right)$$

it will produce estimators that are BLUE. In short, the estimated β_1^* and β_2^* are now BLUE and not the OLS estimators $\hat{\beta}_1$ and $\hat{\beta}_2$

EE325(Ajarn Kaewkwan Tangtipongkul)

GLS is OLS on the transformed variables that satisfy the standard least-squares assumptions

The estimators thus obtained are known as GLS estimators, and it is these estimators that are BLUE

EE325(Ajarn Kaewkwan Tangtipongkul)

$$\frac{Y_i}{\sigma_i} = \hat{\beta}_1^* \left(\frac{X_{0i}}{\sigma_i} \right) + \hat{\beta}_2^* \left(\frac{X_i}{\sigma_i} \right) + \left(\frac{\hat{u}_i}{\sigma_i} \right)$$

$$Y_i^* = \hat{\beta}_1^* X_{0i}^* + \hat{\beta}_2^* X_i^* + \hat{u}_i^*$$

$$\sum \hat{u}_i^{2*} = \sum (Y_i^* - \hat{\beta}_1^* X_{0i}^* - \hat{\beta}_2^* X_i^*)^2$$

$$\sum \left(\frac{\hat{u}_i}{\sigma_i} \right)^2 = \sum \left[\left(\frac{Y_i}{\sigma_i} \right) - \hat{\beta}_1^* \left(\frac{X_{0i}}{\sigma_i} \right) - \hat{\beta}_2^* \left(\frac{X_i}{\sigma_i} \right) \right]^2$$

EE325(Ajarn Kaewkwan Tangtipongkul)

*the GLS estimator of β_2^**

$$\hat{\beta}_2^* = \frac{(\sum w_i)(\sum w_i X_i Y_i) - (\sum w_i X_i)(\sum w_i Y_i)}{(\sum w_i)(\sum w_i X_i^2) - (\sum w_i X_i)^2}$$

$$\text{var}(\hat{\beta}_2^*) = \frac{\sum w_i}{(\sum w_i)(\sum w_i X_i^2) - (\sum w_i X_i)^2}$$

where $w_i = 1/\sigma_i^2$

EE325(Ajarn Kaewkwan Tangtipongkul)

DIFFERENCE BETWEEN OLS AND GLS

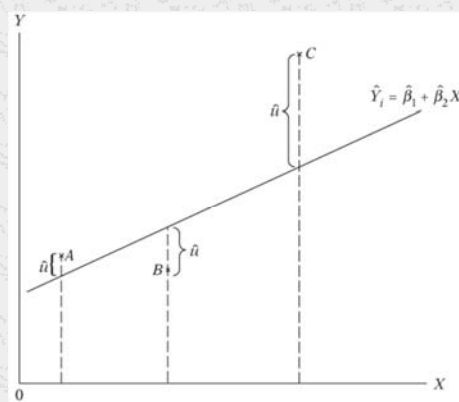
OLS we minimize

$$\sum \hat{u}_i^2 = \sum (Y_i - \hat{\beta}_1 - \hat{\beta}_2 X_i)^2$$

GLS we minimize

$$\sum w_i \hat{u}_i^2 = \sum w_i (Y_i - \hat{\beta}_1^* X_{0i} - \hat{\beta}_2^* X_i)^2, w_i = 1/\sigma_i^2$$

EE325(Ajarn Kaewkwan Tangtipongkul)



EE325(Ajarn Kaewkwan Tangtipongkul)

CONSEQUENCES OF USING OLS IN THE PRESENCE OF HETEROSCEDASTICITY

EE325(Ajarn Kaewkwan Tangtipongkul)

- OLS Estimation allowing for heteroscedasticity
- OLS Estimation disregarding heteroscedasticity

EE325(Ajarn Kaewkwan Tangtipongkul)

EXAMPLE P 374-375

Value of α	Standard error of $\hat{\beta}_1$			Standard error of $\hat{\beta}_2$		
	OLS	OLS_{het}	GLS	OLS	OLS_{het}	GLS
0.5	0.164	0.134	0.110	0.285	0.277	0.243
1.0	0.142	0.101	0.048	0.246	0.247	0.173
2.0	0.116	0.074	0.0073	0.200	0.220	0.109
3.0	0.100	0.064	0.0013	0.173	0.206	0.056
4.0	0.089	0.059	0.0003	0.154	0.195	0.017

EE325(Ajarn Kaewkwan Tangtipongkul)

The most striking feature of these results is that OLS, with or without correction for heteroscedasticity, consistently overestimates the true standard error obtained by the (correct) GLS procedure, especially for large values of α , thus establishing the superiority of GLS

EE325(Ajarn Kaewkwan Tangtipongkul)

DETECTION OF HETEROSCEDASTICITY

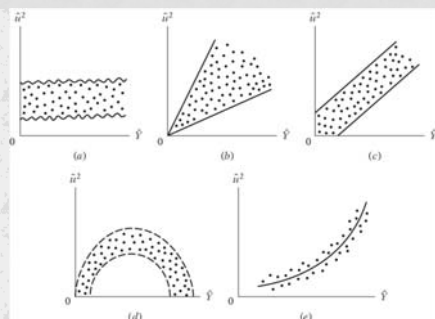
EE325(Ajarn Kaewkwan Tangtipongkul)

DETECTION OF HETEROSCEDASTICITY

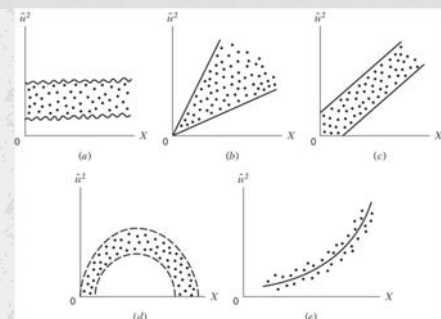
- Informal method
 - Graphical method
- Formal methods
 - Park Test
 - Breusch-Pagan Test
 - White's General Heteroscedasticity Test

EE325(Ajarn Kaewkwan Tangtipongkul)

GRAPHICAL METHOD



EE325(Ajarn Kaewkwan Tangtipongkul)



EE325(Ajarn Kaewkwan Tangtipongkul)

PARK TEST

Park formalizes the graphical method by suggesting that σ_i^2 is some function of the explanatory variable X_i . The functional form he suggests is

$$\sigma_i^2 = \sigma^2 X_i^\beta e^{v_i}$$

or

$$\ln \sigma_i^2 = \ln \sigma^2 + \beta \ln X_i + v_i$$

Where v_i is the stochastic disturbance term

EE325(Ajarn Kaewkwan Tangtipongkul)

Since σ_i^2 is generally not known, Park suggests using $\hat{u}_i^2$ as a proxy and running the following regression:

$$\begin{aligned} \ln \hat{u}_i^2 &= \ln \sigma^2 + \beta \ln X_i + v_i \\ &= \alpha + \beta \ln X_i + v_i \end{aligned}$$

If β turns out to be statistically significant, it would suggest that heteroscedasticity is present in the data

EE325(Ajarn Kaewkwan Tangtipongkul)

EXAMPLE

Table 11.1 Relationship between compensation and productivity

$$Y_i = \beta_1 + \beta_2 X_i + u_i$$

Y = average compensation in thousands of dollars

X = average productivity in thousands of dollars

i = ith employment size of the establishment

EE325(Ajarn Kaewkwan Tangtipongkul)

STEP 1

Run the OLS regression disregarding the heteroscedasticity question

$$\hat{Y}_i = 1992.3452 + 0.2329 X_i$$

$$se = (936.4791) \quad (0.0998)$$

$$t = (2.1275) \quad (2.333)$$

$$R^2 = 0.4375$$

EE325(Ajarn Kaewkwan Tangtipongkul)

STEP 2

We obtain $\hat{u}_i$ from this regression, and then in the second stage we run the regression

$$\ln \hat{u}_i^2 = \ln \sigma^2 + \beta \ln X_i + v_i \\ = \alpha + \beta \ln X_i + v_i$$

$$\ln \hat{u}_i^2 = 35.817 - 2.8099 \ln X_i$$

$$se = (38.319) \quad (4.216)$$

$$t = (0.934) \quad (-0.667)$$

$$R^2 = 0.0595$$

EE325(Ajarn Kaewkwan Tangtipongkul)

BREUSCH-PAGAN TEST (LM TEST)

Consider the k-variables linear regression model

$$Y_i = \beta_1 + \beta_2 X_{2i} + \dots + \beta_k X_{ki} + u_i$$

we assume that

$$E(u_i | x_1, x_2, \dots, x_k) = 0$$

, so that OLS is unbiased and consistent.

EE325(Ajarn Kaewkwan Tangtipongkul)

☺ TEST PROCEDURE ☺

Step 1 Estimate Equation

$$Y_i = \beta_1 + \beta_2 X_{2i} + \dots + \beta_k X_{ki} + u_i$$

by OLS and obtain the squared OLS residuals $\hat{u}^2$

Step 2 Run the regression

$$\hat{u}_i^2 = \alpha_1 + \alpha_2 X_{2i} + \alpha_3 X_{3i} + \alpha_4 X_{4i} + \dots + \alpha_k X_{ki} + v_i$$

Keep the R-Squared from this regression, $R_{\hat{u}^2}^2$

EE325(Ajarn Kaewkwan Tangtipongkul)

Step 3 Form either the F statistics or the LM statistic

$$F = \frac{R_{\hat{u}^2}^2 / k}{(1 - R_{\hat{u}^2}^2) / (n - k - 1)}$$

Where k is the number of regressors in step 2

The LM statistic for Heteroscedasticity is

$$LM = n \cdot R_{\hat{u}^2}^2$$

Under the null hypothesis, LM is distributed asymptotically as χ_k^2

EE325(Ajarn Kaewkwan Tangtipongkul)

The Breusch-Pagan test is **an asymptotic, or large sample, test** and in the present example 30 observations may not constitute a large sample. It should also be pointed out that in small samples the test is sensitive to the assumption that the disturbances u_i are normally distributed.

EE325(Ajarn Kaewkwan Tangtipongkul)

WHITE'S GENERAL HETEROSCEDASTICITY TEST

Consider the following three-variable regression model

$$Y_i = \beta_1 + \beta_2 X_{2i} + \beta_3 X_{3i} + u_i$$

The White test proceeds as follows:

Step 1 Given the data, we estimate

$$Y_i = \beta_1 + \beta_2 X_{2i} + \beta_3 X_{3i} + u_i$$

And obtain the residuals $\hat{u}_i$

EE325(Ajarn Kaewkwan Tangtipongkul)

Step 2 We then run the following (auxiliary) regression

$$\hat{u}_i^2 = \alpha_1 + \alpha_2 X_{2i} + \alpha_3 X_{3i} + \alpha_4 X_{2i}^2 + \alpha_5 X_{3i}^2 + \alpha_6 X_{2i} X_{3i} + \nu_i$$

Obtain the R-Squared from this (auxiliary) regression

EE325(Ajarn Kaewkwan Tangtipongkul)

Step 3 Under the null hypothesis that there is no heteroscedasticity, it can be shown that sample size (n) times the R-squared obtained from the auxiliary regression asymptotically follows the chi-square distribution with df equal to the number of regressors (excluding the constant term) in the auxiliary regression. That is,

$$n \cdot R^2 \xrightarrow{asy} \chi_{df}^2$$

EE325(Ajarn Kaewkwan Tangtipongkul)

Step 4 If the chi-square value obtained in

$$n \cdot R^2 \xrightarrow{asy} \chi_{df}^2$$

Exceeds the critical chi-square value at the chosen level of significance, the conclusion is that there is heteroscedasticity. If it does not exceed the critical chi-square value, there is no heteroscedasticity, which is to say that in the auxiliary regression

$$\hat{u}_i^2 = \alpha_1 + \alpha_2 X_{2i} + \alpha_3 X_{3i} + \alpha_4 X_{2i}^2 + \alpha_5 X_{3i}^2 + \alpha_6 X_{2i} X_{3i} + \nu_i$$

$$\alpha_2 = \alpha_3 = \alpha_4 = \alpha_5 = \alpha_6 = 0$$

EE325(Ajarn Kaewkwan Tangtipongkul)

EXAMPLE P.387-388

From Cross-sectional data on 41 countries

$$\ln Y_i = \beta_1 + \beta_2 \ln X_{2i} + \beta_3 \ln X_{3i} + u_i$$

Y = ratio of Trade taxes to total Government revenue
 X_2 = ratio of the sum of Exports plus imports to GNP
 X_3 = GNP per capita

EE325(Ajarn Kaewkwan Tangtipongkul)

- By applying White's heteroscedasticity test to the residuals obtained from regression, the following results were obtained.

$$\begin{aligned} \hat{u}_i^2 = & -5.8417 + 2.5629 \ln Trade_i + 0.6918 \ln GNP_i \\ & -0.4081(\ln Trade_i)^2 - 0.0491(\ln GNP_i)^2 \\ & + 0.0015(\ln Trade_i)(\ln GNP_i) \\ R^2 = & 0.1148 \end{aligned}$$

EE325(Ajarn Kaewkwan Tangtipongkul)

$$n \cdot R^2 = 41(0.1148) = 4.7068$$

The 5 percent critical chi-square value for 5 df is 11.0705.
 $4.7068 < 11.0705$ On the basis of the White test, that there is no heteroscedasticity

EE325(Ajarn Kaewkwan Tangtipongkul)

REMEDIAL MEASURES

EE325(Ajarn Kaewkwan Tangtipongkul)

REMEDIAL MEASURES

- When σ_i^2 is known: The Method of Weighted Least Squares
- When σ_i^2 is not known

EE325(Ajarn Kaewkwan Tangtipongkul)

WHEN σ_i^2 IS KNOWN

If σ_i^2 is known, the most straightforward method of correcting heteroscedasticity is by means of weighted least squares, for the estimators thus obtained are BLUE.

EE325(Ajarn Kaewkwan Tangtipongkul)

EXAMPLE

TABLE 11.4
Illustration
of Weighted Least-
Squares Regression

Source: Data on Y and σ_i (standard deviation of compensation) are from Table 11.1. Employment size: 1 = 1-4 employees, 2 = 5-9 employees, etc. The latter data are also from Table 11.1.

Compensation, Y	Employment Size, X	σ_i	Y_i/σ_i	X_i/σ_i
3,396	1	742.2	4.5664	0.0013
3,787	2	851.4	4.4480	0.0023
4,013	3	727.8	5.5139	0.0041
4,104	4	805.06	5.0978	0.0050
4,146	5	929.9	4.4585	0.0054
4,241	6	1,080.6	3.9247	0.0055
4,387	7	1,241.2	3.5288	0.0056
4,538	8	1,307.7	3.4702	0.0061
4,843	9	1,110.7	4.3532	0.0081

Note: In regression (11.6.2), the dependent variable is (Y_i/σ_i) and the independent variables are $(1/\sigma_i)$ and (X_i/σ_i) .

EE325(Ajarn Kaewkwan Tangtipongkul)

$$\hat{Y}_i = 3417.833 + 148.767 X_i$$

Source	SS	df	MS	Number of obs =	9
Model	1327891.27	1	1327891.27	F(1, 7) =	196.46
Residual	87312.7333	7	12473.2476	Prob > F =	0.0000
Total	1415204	8	176900.5	R-squared =	0.9383
				Adj R-squared =	0.9295
				Root MSE =	111.68

	Y	Coef.	Std. Err.	t	P> t	[95% Conf. Interval]
X		148.7667	14.4183	10.32	0.000	114.6728 182.8665
_cons		3417.833	81.13632	42.12	0.000	3225.976 3609.69

EE325(Ajarn Kaewkwan Tangtipongkul)

$$\left(\frac{\hat{Y}_i}{\sigma_i}\right) = 3406.639 \left(\frac{1}{\sigma_i}\right) + 154.153 \left(\frac{X_i}{\sigma_i}\right)$$

Source	SS	df	MS	Number of obs =	9
Model	175.811214	2	87.905607	F(2, 7) =	4883.82
Residual	.128115078	7	.018302154	Prob > F =	0.0000
Total	175.939329	9	19.5488143	R-squared =	0.9993
				Adj R-squared =	0.9991
				Root MSE =	.13529

	Ysigma	Coef.	Std. Err.	t	P> t	[95% Conf. Interval]
Xsigma		154.2118	16.95407	9.10	0.000	114.1218 194.3018
consigma		3406.277	88.96623	42.67	0.000	3214.822 3597.731

EE325(Ajarn Kaewkwan Tangtipongkul)

EXAMPLE HETEROSCEDASTICITY

EE325(Ajarn Kaewkwan Tangtipongkul)

R&D Expenditure, Sales, and Profits in 14 Industry Groupings in the United States, 2005 (all figures in millions of dollars)

Since the cross-sectional data presented in this table are quite heterogeneous, in a regression of R&D on sales, heteroscedasticity is likely

EE325(Ajarn Kaewkwan Tangtipongkul)

TABLE 11.5
Sales and
Employment
for Companies
Performing
Industrial R&D
in the United States,
by Industry, 2005
(values are in
millions of dollars)

Industry	Sales	R&D	Profits
1 Food	374,342	2,716	234,662
2 Textiles, apparel, and leather	51,639	816	53,510
3 Basic chemicals	109,899	2,277	75,168
4 Resin, synthetic rubber, fibers, and filament	132,934	2,294	34,645
5 Pharmaceuticals and medicines	273,377	34,839	127,639
6 Plastics and rubber products	90,176	1,760	96,162
7 Fabricated metal products	174,165	1,375	155,801
8 Machinery	230,941	8,531	143,472
9 Computers and peripheral equipment	91,010	4,955	34,004
10 Semiconductor and other electronic components	176,054	18,724	81,317
11 Navigational, measuring, electromedical, and control instruments	118,648	15,204	73,258
12 Electrical equipment, appliances, and components	101,398	2,424	54,742
13 Aerospace products and parts	227,271	15,005	72,090
14 Medical equipment and supplies	56,661	4,374	52,443

Source: National Science Foundation, Division of Science Resources Statistics, Survey of Industrial Research and Development: 2005 and the U.S. Census Bureau Annual Survey of Manufacturers, 2005.

EE325(Ajarn Kaewkwan Tangtipongkul)

Source	SS	df	MS	Number of obs =
Model	298733442	1	298733442	14
Residual	1.0083e+09	12	84021567.1	F(1, 12) = 2.48
Total	1.2170e+09	13	93614788.2	Prob > F = 0.1419
				R-squared = 0.1715
				Adj R-squared = 0.1025
				Root MSE = 9186.3

	rd	Coef.	Std. Err.	t	P> t	[95% Conf. Interval]
	sales	.0437234	.0277484	1.58	0.141	-.0167178 .1041646
	_cons	1337.874	5815.141	0.27	0.794	-9589.18 12264.93

EE325(Ajarn Kaewkwan Tangtipongkul)

$$\widehat{R\&D}_i = 1338 + 0.0437Sale_i$$

$$se = (5015)(0.0277)$$

$$t = (0.27) \quad (1.58)$$

$$r^2 = 0.172$$

There is a positive relationship between R&D and sales, although it is not statistically significant at the traditional levels

EE325(Ajarn Kaewkwan Tangtipongkul)

WHITE TEST

EE325(Ajarn Kaewkwan Tangtipongkul)

Source	SS	df	MS	Number of obs =	14
Model	9.2405e+16	2	4.6203e+16	F(2, 11) =	4.23
Residual	1.2022e+17	11	1.0929e+16	Prob > F =	0.0435
				R-squared =	0.4346
				Adj R-squared =	0.3318
Total	2.1263e+17	13	1.6356e+16	Root MSE =	1.0e+08

	Coef.	Std. Err.	t	P> t	[95% Conf. Interval]
muhat2					
sales	577.6563	1307.034	0.44	0.667	-2301.007 3456.4
sales2	.0008456	.0031711	0.27	0.795	-.006134 .0078253
_cons	-4.67e+07	1.12e+08	-0.42	0.685	-2.94e+08 2.09e+08

EE325(Ajarn Kaewkwan Tangtipongkul)

$$\hat{u}_i^b = -46,746,325 + 578Sales_i + 0.000846Sales_i^2$$

$$se = (112,224,348) \quad (1308) \quad (0.003171)$$

$$t = (-0.42) \quad (0.44) \quad (0.27)$$

$$R^2 = 0.435$$

Using the R^2 value and n=14, we obtain $nR^2 = 6.090$

Under the null hypothesis of no heteroscedasticity, this should follow a chi-square distribution with 2 df (because there are two regressors). The p-value of obtaining a chi-square value of as much as 6.090 or greater is about 0.0476. Since this is a low value, the White test also suggests that there is heteroscedsticity.

EE325(Ajarn Kaewkwan Tangtipongkul)

The true error variance is unknown, we cannot use the method of weighted least squares to obtain heteroscedasticity-corrected standard errors and t-values.

Therefore, we would have to make some educated guesses about the nature of the error variance.

EE325(Ajarn Kaewkwan Tangtipongkul)

WHITE'S HETEROSCEDASTICITY-CONSISTENT STANDARD ERRORS

$$\widehat{R\&D}_i = 1337.87 + 0.0437Sale_i$$

$$se = (4892.447)(0.0411)$$

$$t = (0.27) \quad (1.06)$$

$$r^2 = 0.172$$

We see that the parameter estimates have not changed, the standard error of the intercept coefficient has decreased slightly, and the standard error of the slope coefficient has increased slightly. But remember that the White procedure is strictly a large-sample procedure, where as we have only 14 observations

EE325(Ajarn Kaewkwan Tangtipongkul)

STATA

Source	SS	df	MS	Number of obs =	14
Model	208733442	1	208733442	F(1, 12) =	2.48
Residual	1.0083e+09	12	84021567.1	Prob > F =	0.1410
				R-squared =	0.1715
				Adj R-squared =	0.1025
Total	1.2170e+09	13	93614788.2	Root MSE =	9166.3

RD	Coef.	Std. Err.	t	P> t	[95% Conf. Interval]
Sales	.0437234	.0277404	1.58	0.141	-.0167178 .1041646
_cons	1337.874	5015.141	0.27	0.794	-9589.18 12264.93

. whitetst

White's general test statistic : **6.0842** Chi-sq(2) P-value = **.0477**

EE325(Ajarn Kaewkwan Tangtipongkul)

H_0 : Homoscedasticity

H_1 : Otherwise

White's general test statistic is 6.0842.

Degree of freedom =2

Critical value of Chi-square at 5 percent significance level is 5.99147

6.0842 > 5.99147 Reject the null hypothesis

The White test also suggests that there is heteroscedsticity.

EE325(Ajarn Kaewkwan Tangtipongkul)

BREUSCH-PAGAN TEST

EE325(Ajarn Kaewkwan Tangtipongkul)

Source	SS	df	MS	Number of obs =	14
Model	288733442	1	288733442	F(1, 12) =	2.48
Residual	1.0883e+09	12	84821567.1	Prob > F =	0.1418
				R-squared =	0.1715
Total	1.2170e+09	13	93614788.2	Adj R-squared =	0.1025
				Root MSE =	9166.3

RD	Coef.	Std. Err.	t	P> t	[95% Conf. Interval]
Sales	.0437234	.0277464	1.58	0.141	-.0167178 .1041646
_cons	1337.874	5615.141	0.27	0.794	-9589.18 12264.83

EE325(Ajarn Kaewkwan Tangtipongkul)

```
. estat hettest
```

Breusch-Pagan / Cook-Weisberg test for heteroskedasticity
Ho: Constant variance
Variables: fitted values of RD

chi2(1) = 8.83
Prob > chi2 = 0.0030

EE325(Ajarn Kaewkwan Tangtipongkul)

H_0 : Homoscedasticity

H_1 : Otherwise

Breusch-Pagan test's general test statistic is 8.83.

Degree of freedom =1

Critical value of Chi-square at 5 percent significance level is
8.83 > 3.84146

Reject the null hypothesis

The Breusch-Pagan test also suggests that there is
heteroscedsticity.

EE325(Ajarn Kaewkwan Tangtipongkul)

SOURCE

Gujarati, D.N. (2009) Basic Econometrics. 5th ed. Singapore, McGraw-Hill.

EE325(Ajarn Kaewkwan Tangtipongkul)