

FIXED-EFFECTS MODEL

*(Covariance Model, Within Estimator,
Individual Dummy Variable Model, Least
Squares Dummy Variable Model)*

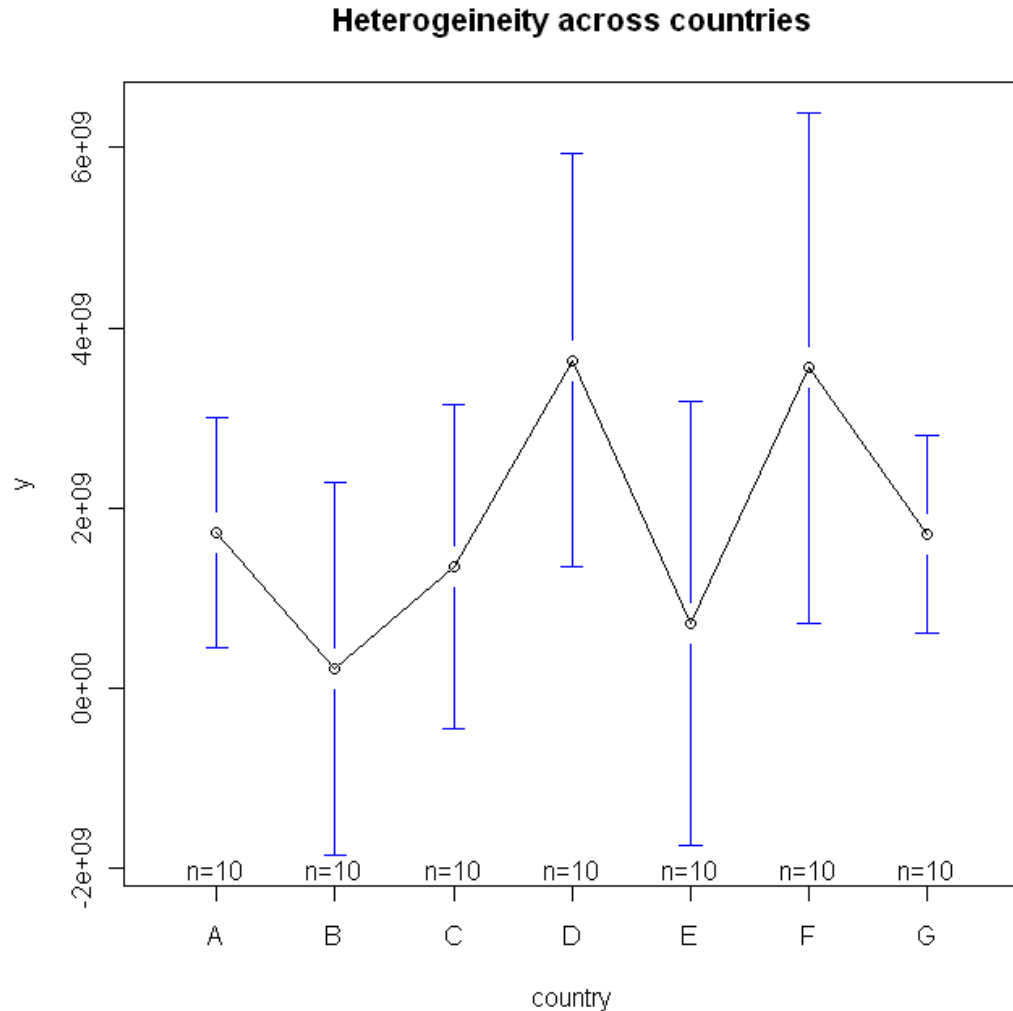
Fixed effects: Heterogeneity across countries (or entities)

```
library(foreign)
Panel <- read.dta("http://dss.princeton.edu/training/Panel101.dta")
library(gplots)
plotmeans(y ~ country, main="Heterogeineity across countries", data=Panel)

# plotmeans draw a 95%
confidence interval
around the means

detach("package:gplots")

# Remove package 'gplots'
from the workspace
```



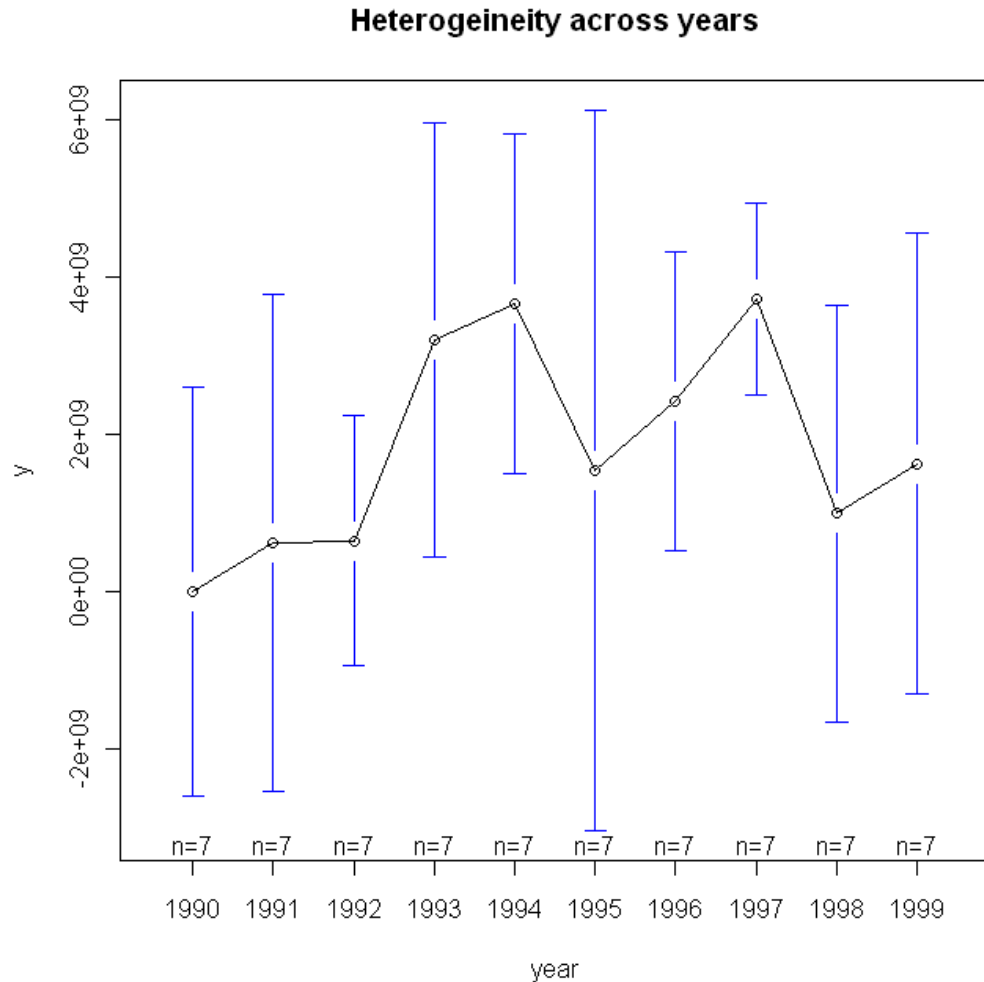
Fixed effects: Heterogeneity across years

```
library(foreign)
Panel <- read.dta("http://dss.princeton.edu/training/Panel101.dta")
library(gplots)
plotmeans(y ~ year, main="Heterogeineity across years", data=Panel)
```

```
# plotmeans draw a 95%
confidence interval
around the means
```

```
detach("package:gplots")
```

```
# Remove package 'gplots'
from the workspace
```



```
> library(foreign)
> Panel <- read.dta("http://dss.princeton.edu/training/Panel101.dta")
> ols <- lm(y ~ x1, data=Panel)
> summary(ols)
```

```
Call:
lm(formula = y ~ x1, data = Panel)
```

```
Residuals:
    Min       1Q   Median       3Q      Max
-9.546e+09 -1.578e+09  1.554e+08  1.422e+09  7.183e+09
```

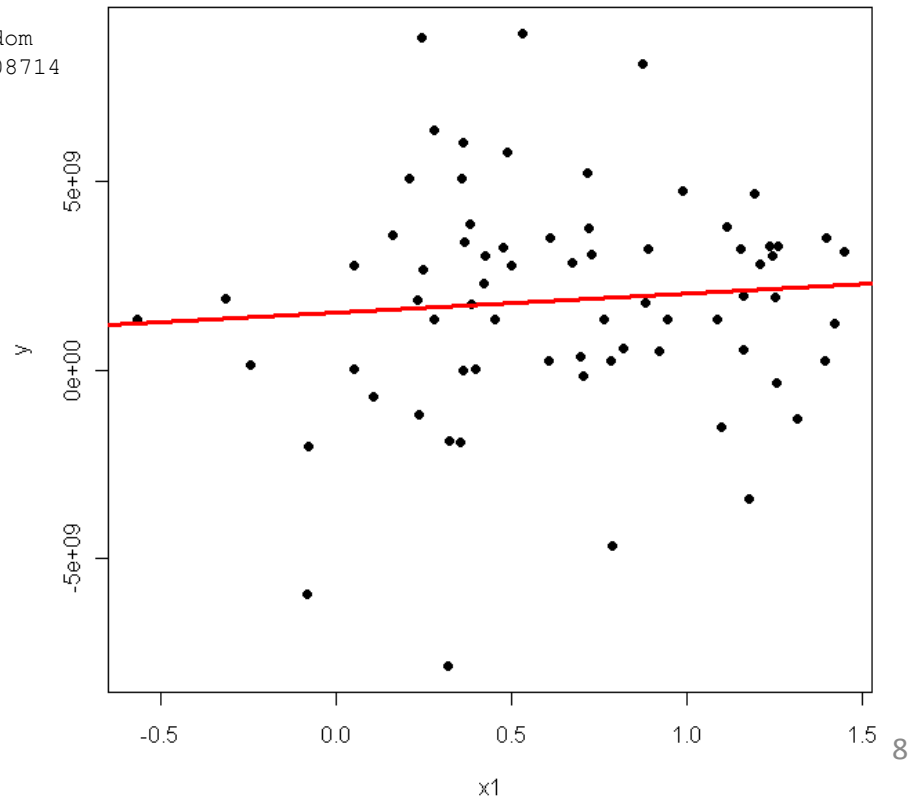
```
Coefficients:
            Estimate Std. Error t value Pr(>|t|)
(Intercept) 1.524e+09  6.211e+08  2.454  0.0167 *
x1          4.950e+08  7.789e+08  0.636  0.5272
---
Signif. codes:  0 '***' 0.001 '**' 0.01 '*' 0.05 '.' 0.1 ' ' 1
```

```
Residual standard error: 3.028e+09 on 68 degrees of freedom
Multiple R-squared:  0.005905,    Adjusted R-squared: -0.008714
F-statistic: 0.4039 on 1 and 68 DF,  p-value: 0.5272
```

```
> yhat <- ols$fitted
```

```
> plot(Panel$x1, Panel$y, pch=19, xlab="x1", ylab="y")
> abline(lm(Panel$y~Panel$x1),lwd=3, col="red")
```

Regular OLS regression does not consider heterogeneity across groups or time



Fixed effects using Least squares dummy variable model

```
> library(foreign)
> Panel <- read.dta("http://dss.princeton.edu/training/Panel101.dta")

> fixed.dum <- lm(y ~ x1 + factor(country) - 1, data=Panel)
> summary(fixed.dum)
```

Call:

```
lm(formula = y ~ x1 + factor(country) - 1, data = Panel)
```

Residuals:

```
      Min       1Q   Median       3Q      Max
-8.634e+09 -9.697e+08  5.405e+08  1.386e+09  5.612e+09
```

Coefficients:

	Estimate	Std. Error	t value	Pr(> t)
x1	2.476e+09	1.107e+09	2.237	0.02889 *
factor(country)A	8.805e+08	9.618e+08	0.916	0.36347
factor(country)B	-1.058e+09	1.051e+09	-1.006	0.31811
factor(country)C	-1.723e+09	1.632e+09	-1.056	0.29508
factor(country)D	3.163e+09	9.095e+08	3.478	0.00093 ***
factor(country)E	-6.026e+08	1.064e+09	-0.566	0.57329
factor(country)F	2.011e+09	1.123e+09	1.791	0.07821 .
factor(country)G	-9.847e+08	1.493e+09	-0.660	0.51190

Signif. codes: 0 '***' 0.001 '**' 0.01 '*' 0.05 '.' 0.1 ' ' 1

Residual standard error: 2.796e+09 on 62 degrees of freedom

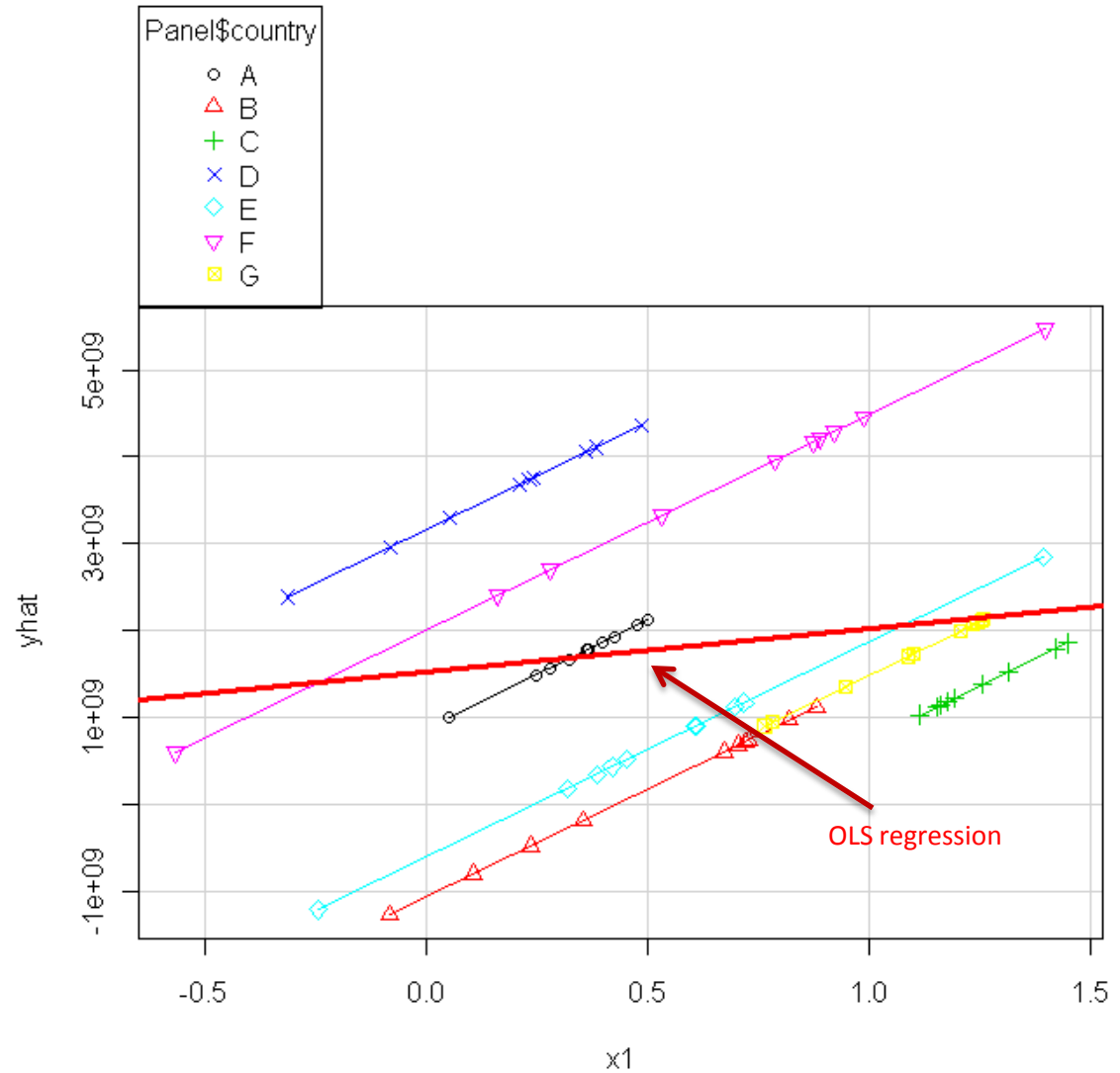
Multiple R-squared: 0.4402, Adjusted R-squared: 0.368

F-statistic: 6.095 on 8 and 62 DF, p-value: 8.892e-06



Least squares dummy variable model

```
> yhat <- fixed.dum$fitted
> library(car)
> scatterplot(yhat~Panel$x1|Panel$country, boxplots=FALSE, xlab="x1", ylab="yhat",smooth=FALSE)
> abline(lm(Panel$y~Panel$x1),lwd=3, col="red")
```



Each component of the factor variable (country) is absorbing the effects particular to each country. Predictor x_1 was not significant in the OLS model, once controlling for differences across countries, x_1 became significant in the OLS_DUM (i.e. LSDV model).

```
> library(apsrtable)
> apsrtable(ols, fixed.dum, model.names = c("OLS", "OLS_DUM")) # Displays a table in Latex form
```

```
\begin{table}[!ht]
\caption{}
\label{}
\begin{tabular}{l D{.}{.}{2}D{.}{.}{2} }
\hline
& \multicolumn{1}{c}{ OLS } & \multicolumn{1}{c}{ OLS_DUM } \\
\hline
% & OLS & OLS_DUM & \\
(Intercept) & 1524319070.05 ^* & & \\
& (621072623.86) & & \\
x1 & 494988913.90 & 2475617827.10 ^* \\
& (778861260.95) & (1106675593.60) \\
factor(country)A & & 880542403.99 \\
& & (961807052.24) \\
factor(country)B & & -1057858363.16 \\
& & (1051067684.19) \\
factor(country)C & & -1722810754.55 \\
& & (1631513751.40) \\
factor(country)D & & 3162826897.32 ^* \\
& & (909459149.66) \\
factor(country)E & & -602622000.33 \\
& & (1064291684.41) \\
factor(country)F & & 2010731793.24 \\
& & (1122809097.35) \\
factor(country)G & & -984717493.45 \\
& & (1492723118.24) \\
$N$ & & 70 & \\
$R^2$ & & 0.01 & 0.44 \\
adj. $R^2$ & & -0.01 & 0.37 \\
Resid. sd & & 3028276248.26 & 2795552570.60 \\
\multicolumn{3}{l}{\footnotesize{Standard errors in parentheses}} \\
\multicolumn{3}{l}{\footnotesize{^* indicates significance at $p < 0.05$}} \\
\end{tabular}
\end{table}
```

The coefficient of x_1 indicates how much Y changes when X increases by one unit. Notice x_1 is not significant in the OLS model

The coefficient of x_1 indicates how much Y changes overtime, controlling by differences in countries, when X increases by one unit. Notice x_1 is significant in the LSDV model

```
> apsrtable(ols, fixed.dum, model.names = c("OLS", "OLS_DUM"), Sweave=F), file="ols_fixed1.txt")
```

to a text file (in Latex code).



Fixed effects: n entity-specific intercepts (using plm)

```
> library(plm)
> fixed <- plm(y ~ x1, data=Panel, index=c("country", "year"), model="within")
> summary(fixed)
```

Oneway (individual) effect Within Model

Call:

```
plm(formula = y ~ x1, data = Panel, model = "within", index = c("country",
"year"))
```

Balanced Panel: n=7, T=10, N=70

Residuals :

Min.	1st Qu.	Median	Mean	3rd Qu.	Max.
-8.63e+09	-9.70e+08	5.40e+08	1.81e-10	1.39e+09	5.61e+09

Coefficients :

	Estimate	Std. Error	t-value	Pr(> t)							
x1	2475617827	1106675594	2.237	0.02889 *							

Signif. codes:	0	'***'	0.001	'**'	0.01	'*'	0.05	'.'	0.1	' '	1

Total Sum of Squares: 5.2364e+20
 Residual Sum of Squares: 4.8454e+20
 R-Squared : 0.074684
 Adj. R-Squared : 0.066148
 F-statistic: 5.00411 on 1 and 62 DF, p-value: 0.028892

```
> fixef(fixed) # Display the fixed effects (constants for each country)
      A          B          C          D          E          F
880542404 -1057858363 -1722810755 3162826897 -602622000 2010731793
      G
-984717493
```

```
> pFtest(fixed, ols) # Testing for fixed effects, null: OLS better than fixed
```

```
est for individual effects
```

```
l
Fall 2010 if1 = 6, df2 = 62, p-value = 0.01307
ypohthesis: significant effects
```

Outcome variable

Predictor variable(s)

Panel setting

Fixed effects option

n = # of groups/panels, T = # years, N = total # of observations

The coeff of x1 indicates how much Y changes overtime, on average per country, when X increases by one unit.

Pr(>|t|)= Two-tail p-values test the hypothesis that each coefficient is different from 0. To reject this, the p-value has to be lower than 0.05 (95%, you could choose also an alpha of 0.10), if this is the case then you can say that the variable has a significant influence on your dependent variable (y)

If this number is < 0.05 then your model is ok. This is a test (F) to see whether all the coefficients in the model are different than zero.

If the p-value is < 0.05 then the fixed effects model is a better choice



RANDOM-EFFECTS MODEL

(Random Intercept, Partial Pooling Model)



```
> random <- plm(y ~ x1, data=Panel, index=c("country", "year"), model="random")
> summary(random)
```

```
Oneway (individual) effect Random Effect Model
(Swamy-Arora's transformation)
```

Call:

```
plm(formula = y ~ x1, data = Panel, model = "random", index = c("country",
"year"))
```

Balanced Panel: n=7, T=10, N=70

Effects:

	var	std.dev	share
idiosyncratic	7.815e+18	2.796e+09	0.873
individual	1.133e+18	1.065e+09	0.127
theta:	0.3611		

Residuals :

	Min.	1st Qu.	Median	Mean	3rd Qu.	Max.
	-8.94e+09	-1.51e+09	2.82e+08	5.29e-08	1.56e+09	6.63e+09

Coefficients :

	Estimate	Std. Error	t-value	Pr(> t)
(Intercept)	1037014284	790626206	1.3116	0.1941
x1	1247001782	902145601	1.3823	0.1714

Total Sum of Squares: 5.6595e+20

Residual Sum of Squares: 5.5048e+20

R-Squared : 0.02733

Adj. R-Squared : 0.026549

F-statistic: 1.91065 on 1 and 68 DF, p-value: 0.17141

Interpretation of the coefficients is tricky since they include both the within-entity and between-entity effects. In the case of TSCS data represents the average effect of X over Y when X changes across time and between countries by one unit.

Pr(>|t|)= Two-tail p-values test the hypothesis that each coefficient is different from 0. To reject this, the p-value has to be lower than 0.05 (95%, you could choose also an alpha of 0.10), if this is the case then you can say that the variable has a significant influence on your dependent variable (y)

If this number is < 0.05 then your model is ok. This is a test (F) to see whether all the coefficients in the model are different than zero.

Setting as panel data (an alternative way to run the above model

```
data(Panel, index = c("country", "year"))
```

```
using panel setting (same output as above)
```

```
y ~ x1, data = Panel.set, model="random")
```



FIXED OR RANDOM?



To decide between fixed or random effects you can run a Hausman test where the null hypothesis is that the preferred model is random effects vs. the alternative the fixed effects (see Green, 2008, chapter 9). It basically tests whether the unique errors (u_i) are correlated with the regressors, the null hypothesis is they are not.

Run a fixed effects model and save the estimates, then run a random model and save the estimates, then perform the test. If the p-value is significant (for example <0.05) then use fixed effects, if not use random effects.

```
> phtest(fixed, random)
```

```
Hausman Test
```

```
data: y ~ x1  
chisq = 3.674, df = 1, p-value = 0.05527  
alternative hypothesis: one model is inconsistent
```

If this number is < 0.05 then use fixed effects



OTHER TESTS/ DIAGNOSTICS



Testing for time-fixed effects

```
> library(plm)
> fixed <- plm(y ~ x1, data=Panel, index=c("country", "year"),
model="within")
> fixed.time <- plm(y ~ x1 + factor(year), data=Panel, index=c("country",
"year"), model="within")
> summary(fixed.time)
Oneway (individual) effect Within Model

Call:
plm(formula = y ~ x1 + factor(year), data = Panel, model = "within",
index = c("country", "year"))

Balanced Panel: n=7, T=10, N=70

Residuals :
      Min.   1st Qu.   Median     Mean   3rd Qu.    Max.
-7.92e+09 -1.05e+09 -1.40e+08  1.48e-07  1.63e+09  5.49e+09

Coefficients :
              Estimate Std. Error t-value Pr(>|t|)
x1             1389050354 1319849567  1.0524  0.29738
factor(year)1991  296381559 1503368528  0.1971  0.84447
factor(year)1992  145369666 1547226548  0.0940  0.92550
factor(year)1993  2874386795 1503862554  1.9113  0.06138 .
factor(year)1994  2848156288 1661498927  1.7142  0.09233 .
factor(year)1995  973941306 1567245748  0.6214  0.53698
factor(year)1996  1672812557 1631539254  1.0253  0.30988
factor(year)1997  2991770063 1627062032  1.8388  0.07156 .
factor(year)1998  367463593 1587924445  0.2314  0.81789
factor(year)1999 1258751933 1512397632  0.8323  0.40898
---
Signif. codes:  0 '***' 0.001 '**' 0.01 '*' 0.05 '.' 0.1 ' ' 1

Total Sum of Squares:    5.2364e+20
Residual Sum of Squares: 4.0201e+20
R-Squared      : 0.23229
  Adj. R-Squared : 0.17588
F-statistic: 1.60365 on 10 and 53 DF, p-value: 0.13113
```

```
> # Testing time-fixed effects. The null is that no time-fixed
effects needed
```

```
> pFtest(fixed.time, fixed)
```

```
F test for individual effects
```

```
data: y ~ x1 + factor(year)
F = 1.209, df1 = 9, df2 = 53, p-value = 0.3094
alternative hypothesis: significant effects
```

```
> plmtest(fixed, c("time"), type="bp")
```

```
Lagrange Multiplier Test - time effects (Breusch-Pagan)
```

```
data: y ~ x1
chisq = 0.1653, df = 1, p-value = 0.6843
alternative hypothesis: significant effects
```

If this number is < 0.05 then use time-fixed effects. In this example, no need to use time-fixed effects.



Testing for random effects: Breusch-Pagan Lagrange multiplier (LM)

```
> # Regular OLS (pooling model) using plm
>
> pool <- plm(y ~ x1, data=Panel, index=c("country", "year"), model="pooling")
> summary(pool)
Oneway (individual) effect Pooling Model

Call:
plm(formula = y ~ x1, data = Panel, model = "pooling", index = c("country",
"year"))

Balanced Panel: n=7, T=10, N=70

Residuals :
      Min.   1st Qu.   Median     Mean   3rd Qu.   Max.
-9.55e+09 -1.58e+09  1.55e+08  1.77e-08  1.42e+09  7.18e+09

Coefficients :
              Estimate Std. Error t-value Pr(>|t|)
(Intercept) 1524319070  621072624  2.4543  0.01668 *
x1           494988914  778861261  0.6355  0.52722
---
Signif. codes:  0 '***' 0.001 '**' 0.01 '*' 0.05 '.' 0.1 ' ' 1

Total Sum of Squares:    6.2729e+20
Residual Sum of Squares: 6.2359e+20
R-Squared      : 0.0059046
Adj. R-Squared : 0.0057359
F-statistic: 0.403897 on 1 and 68 DF, p-value: 0.52722
```

The LM test helps you decide between a random effects regression and a simple OLS regression.

The null hypothesis in the LM test is that variances across entities is zero. This is, no significant difference across units (i.e. no panel effect). (<http://dss.princeton.edu/training/Panel101.pdf>)

```
> # Breusch-Pagan Lagrange Multiplier for random effects. Null is no panel effect (i.e. OLS better).
```

```
> plmtest(pool, type=c("bp"))
```

Lagrange Multiplier Test - (Breusch-Pagan)

```
data: v ~ x1
```

```
. df = 1, p-value = 0.1023
H0: no significant effects
```

led to reject the null and conclude that random effects is not appropriate. This is, no significant differences across countries, therefore you can run a simple OLS regression.



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Testing for cross-sectional dependence/contemporaneous correlation: using Breusch-Pagan LM test of independence and Pasaran CD test

According to Baltagi, cross-sectional dependence is a problem in macro panels with long time series. This is not much of a problem in micro panels (few years and large number of cases).

The null hypothesis in the B-P/LM and Pasaran CD tests of independence is that residuals across entities are not correlated. B-P/LM and Pasaran CD (cross-sectional dependence) tests are used to test whether the residuals are correlated across entities*. Cross-sectional dependence can lead to bias in tests results (also called contemporaneous correlation).

```
> fixed <- plm(y ~ x1, data=Panel, index=c("country", "year"), model="within")
```

```
> pcdtest(fixed, test = c("lm"))
```

```
Breusch-Pagan LM test for cross-sectional dependence in panels
```

```
data: formula  
chisq = 28.9143, df = 21, p-value = 0.1161  
alternative hypothesis: cross-sectional dependence
```

```
> pcdtest(fixed, test = c("cd"))
```

```
Pesaran CD test for cross-sectional dependence in panels
```

```
data: formula  
z = 1.1554, p-value = 0.2479  
alternative hypothesis: cross-sectional dependence
```

No cross-sectional dependence



Testing for serial correlation

Serial correlation tests apply to macro panels with long time series. Not a problem in micro panels (with very few years). The null is that there is not serial correlation.

```
> pbgtest(fixed)
Loading required package: lmtest
```

```
Breusch-Godfrey/Wooldridge test for serial correlation in panel models
```

```
data: y ~ x1
chisq = 14.1367, df = 10, p-value = 0.1668
alternative hypothesis: serial correlation in idiosyncratic errors
```

No serial correlation



Testing for unit roots/stationarity

The Dickey-Fuller test to check for stochastic trends. The null hypothesis is that the series has a unit root (i.e. non-stationary). If unit root is present you can take the first difference of the variable.

```
> Panel.set <- plm.data(Panel, index = c("country", "year"))  
  
> library(tseries)  
  
> adf.test(Panel.set$y, k=2)
```

Augmented Dickey-Fuller Test

```
data: Panel.set$y  
Dickey-Fuller = -3.9051, Lag order = 2, p-value = 0.01910  
alternative hypothesis: stationary
```

If p-value < 0.05 then no unit roots present.



Testing for heteroskedasticity

The null hypothesis for the Breusch-Pagan test is homoskedasticity.

```
> library(lmtest)
> bptest(y ~ x1 + factor(country), data = Panel, studentize=F)
```

```
Breusch-Pagan test
```

```
data: y ~ x1 + factor(country)
BP = 14.6064, df = 7, p-value = 0.04139
```

Presence of heteroskedasticity

If heteroskedasticity is detected you can use robust covariance matrix to account for it. See the following pages.



Controlling for heteroskedasticity: Robust covariance matrix estimation (Sandwich estimator)

The `--vcovHC-` function estimates three heteroskedasticity-consistent covariance estimators:

- "white1" - for general heteroskedasticity but no serial correlation. Recommended for random effects.
- "white2" - is "white1" restricted to a common variance within groups. Recommended for random effects.
- "arellano" - both heteroskedasticity and serial correlation. Recommended for fixed effects.

The following options apply*:

- HC0 - heteroskedasticity consistent. The default.
- HC1, HC2, HC3 - Recommended for small samples. HC3 gives less weight to influential observations.
- HC4 - small samples with influential observations
- HAC - heteroskedasticity and autocorrelation consistent (type `?vcovHAC` for more details)

See the following pages for examples

For more details see:



project.org/web/packages/plm/vignettes/plm.pdf

project.org/web/packages/sandwich/vignettes/sandwich.pdf (see page 4)

2006.

Fall 2010 ^{leis}, 2008.

Controlling for heteroskedasticity: Random effects

```
> random <- plm(y ~ x1, data=Panel, index=c("country", "year"), model="random")
```

```
> coeftest(random)          # Original coefficients
```

```
t test of coefficients:
```

	Estimate	Std. Error	t value	Pr(> t)
(Intercept)	1037014284	790626206	1.3116	0.1941
x1	1247001782	902145601	1.3823	0.1714

```
> coeftest(random, vcovHC)      # Heteroskedasticity consistent coefficients
```

```
t test of coefficients:
```

	Estimate	Std. Error	t value	Pr(> t)
(Intercept)	1037014284	907983029	1.1421	0.2574
x1	1247001782	828970247	1.5043	0.1371

```
> coeftest(random, vcovHC(random, type = "HC3")) # Heteroskedasticity consistent coefficients, type 3
```

```
t test of coefficients:
```

	Estimate	Std. Error	t value	Pr(> t)
(Intercept)	1037014284	943438284	1.0992	0.2756
x1	1247001782	867137585	1.4381	0.1550

```
> # The following shows the HC standard errors of the coefficients
```

```
> t(sapply(c("HC0", "HC1", "HC2", "HC3", "HC4"), function(x) sqrt(diag(vcovHC(random, type = x)))))
```

(Intercept)	x1
907983029	828970247
921238957	841072643
925403820	847733474
943438284	867137584
941376033	866024033



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Standard errors given different types of HC.

```
> fixed <- plm(y ~ x1, data=Panel, index=c("country", "year"), model="within")
```

```
> coeftest(fixed) # Original coefficients
```

```
t test of coefficients:
```

```
Estimate Std. Error t value Pr(>|t|)
x1 2475617827 1106675594 2.237 0.02889 *
```

```
---
Signif. codes: 0 '***' 0.001 '**' 0.01 '*' 0.05 '.' 0.1 ' ' 1
```

```
> coeftest(fixed, vcovHC) # Heteroskedasticity consistent coefficients
```

```
t test of coefficients:
```

```
Estimate Std. Error t value Pr(>|t|)
x1 2475617827 1358388942 1.8225 0.07321 .
```

```
---
Signif. codes: 0 '***' 0.001 '**' 0.01 '*' 0.05 '.' 0.1 ' ' 1
```

```
> coeftest(fixed, vcovHC(fixed, method = "arellano")) # Heteroskedasticity consistent coefficients (Arellano)
```

```
t test of coefficients:
```

```
Estimate Std. Error t value Pr(>|t|)
x1 2475617827 1358388942 1.8225 0.07321 .
```

```
---
Signif. codes: 0 '***' 0.001 '**' 0.01 '*' 0.05 '.' 0.1 ' ' 1
```

```
> coeftest(fixed, vcovHC(fixed, type = "HC3")) # Heteroskedasticity consistent coefficients, type 3
```

```
t test of coefficients:
```

```
Estimate Std. Error t value Pr(>|t|)
x1 2475617827 1439083523 1.7203 0.09037 .
```

```
---
Signif. codes: 0 '***' 0.001 '**' 0.01 '*' 0.05 '.' 0.1 ' ' 1
```

```
> vs the HC standard errors of the coefficients
> HC1", "HC2", "HC3", "HC4"), function(x) sqrt(diag(vcovHC(fixed, type = x))))
```

```
1.x1 HC2.x1 HC3.x1 HC4.x1
[ 16931 1397037369 1439083523 1522166034
```

Controlling for heteroskedasticity: Fixed effects

Standard errors given different types of HC.



References/Useful links

- DSS Online Training Section <http://dss.princeton.edu/training/>
- Princeton DSS Libguides <http://libguides.princeton.edu/dss>
- John Fox's site <http://socserv.mcmaster.ca/jfox/>
- Quick-R <http://www.statmethods.net/>
- UCLA Resources to learn and use R <http://www.ats.ucla.edu/stat/R/>
- UCLA Resources to learn and use Stata <http://www.ats.ucla.edu/stat/stata/>
- DSS - Stata http://dss/online_help/stats_packages/stata/
- DSS - R http://dss.princeton.edu/online_help/stats_packages/r
- Panel Data Econometrics in R: the plm package <http://cran.r-project.org/web/packages/plm/vignettes/plm.pdf>
- Econometric Computing with HC and HAC Covariance Matrix Estimators <http://cran.r-project.org/web/packages/sandwich/vignettes/sandwich.pdf>



References/Recommended books

- *An R Companion to Applied Regression*, Second Edition / John Fox , Sanford Weisberg, Sage Publications, 2011
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- *R for Stata Users* / Robert A. Muenchen, Joseph Hilbe, Springer, 2010
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