

Advice on using heteroscedasticity based identification

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February 12, 2019

Abstract

Lewbel (2012) provides a heteroscedasticity based estimator for linear regression models containing an endogenous regressor when no external instruments or other such information is available. The estimator is implemented in the Stata module `ivreg2h` by Baum and Schaer (2012). This note gives some advice and instructions to researchers who want to use this estimator.

1 Introduction

Linear regression models containing endogenous regressors are generally identified using outside information such as exogenous instruments, or by parametric distribution assumptions. Some papers obtain identification without external instruments by exploiting heteroscedasticity, including Rigobon (2003), Klein and Vella (2010), Lewbel (1997, 2018) and Prono (2014). In particular, Lewbel (2012) shows how one can use heteroskedasticity to construct instruments when no external instruments are available. Other papers that obtain identification using constructed instruments include Lewbel (1997) and Erickson and Whited (2002). See Lewbel (in press) for a general discussion of identification methods like these.

In this note, we provide advice and instructions for researchers who wish to apply the Lewbel (2012) estimator. That article includes estimators for fully simultaneous systems, semiparametric systems, and bounds for when

key identifying assumptions are violated. However, most empirical applications use the estimator for a single-equation linear regression model with a single endogenous regressor, which is the focus here. This linear single equation estimator has been implemented by Baum and Schaer (2012) as the Stata module `ivreg2h`, which is available from the SSC Archive.

2 The model and estimator

Assume a sample of observations of endogenous variables Y_1 and Y_2 and a vector of exogenous covariates X . We wish to estimate β_1 and the vector β_2 in the model

$$\begin{aligned} Y_1 &= X\beta_1 + Y_2 + \epsilon_1 \\ Y_2 &= X\beta_2 + \epsilon_2 \end{aligned}$$

where the errors ϵ_1 and ϵ_2 may be correlated.

Standard instrumental variables estimation depends on having an element of X that appears in the Y_2 equation but not in the Y_1 equation, and uses that excluded regressor as an instrument for Y_2 . The problem considered here is that perhaps no element of X is excluded from the Y_1 equation, or equivalently, we're not sure that any element of β_2 is zero. Lewbel (2012) provides identification and a corresponding very simple linear two stage least squares estimator for β_1 and β_2 in this case where no element of X can be used as an excluded instrument for Y_2 . The method consists of constructing valid instruments for Y_2 by exploiting information contained in heteroscedasticity of ϵ_2 .

In addition to the standard exogenous X assumptions that $E(X\epsilon_1) = 0$, $E(X\epsilon_2) = 0$, and $E(XX')$ is nonsingular, the key additional assumptions required for applying the Lewbel (2012) estimator are that $Cov(Z; \epsilon_1\epsilon_2) = 0$ and $Cov(Z; \epsilon_2^2) \neq 0$, where either $Z = X$ or Z is a subset of the elements of X .

The Lewbel (2012) estimator can be summarized as the following two steps.

1. Estimate β_2 by an ordinary least squares regression of Y_2 on X , and obtain estimated residuals $\hat{\epsilon}_2 = Y_2 - X\hat{\beta}_2$.
2. Let Z be some or all of the elements of X (not including the constant term). Estimate β_1 and β_2 by an ordinary linear two stage least squares

regression of Y_1 on X and Y_2 , using X and Z

Example: Suppose Y_2 is endogenous because it is mismeasured. Then U is the true outcome model error, and V is the measurement error. Classical measurement error in linear regression models satisfies Assumption A1.

Example: Suppose Y_1 is a wage, and Y_2 is education level. Here V could be unobserved ability, which affects both educational attainment Y_2

1. Use economic theory and/or data to justify linearity of the model $Y_1 = X^0 + Y_2 + \epsilon_1$ and the assumption that X is exogenous.
2. Use economic theory and/or data to justify the factor structure of the errors given by Assumption A1.
3. Choose a set of covariates Z (either all the elements of X except the constant, or some subset of those elements) to use for constructing the instruments $(Z - \bar{Z})^2$. For the chosen Z , apply theory and the above described tests to justify the remaining identifying assumptions.

4 Implementing the estimator and tests

Using the Lewbel (2012) method, instruments are constructed as simple functions of the model's data. This approach may be (a) applied when no or-

allows the syntax

```
ivreg2h depvar exogvar (endogvar=) [ if exp] [ in range], options
```

as after augmentation with the generated regressors, the order condition for identification will be satisfied. The resulting estimates are saved in the `ereturn` list and as a set of estimates named `GenInst` and, optionally, `GenExtInst`.

The Pagan and Hall (1983) tests referenced above are available from the `ivreg2` package of Baum, Schafer, and Stillman (2003) using the `hettest` command. The default test does not assume normality of the errors.

4.1 Saved results

In the `estimates` table output, the displayed results `sj`, `jdf` and `jp` refer to the Hansen J statistic, its degrees of freedom, and its p-value. If i.i.d. errors are assumed and a Sargan test is displayed in the standard output, the Sargan statistic, its degrees of freedom and p-value are displayed in `jdf` and `jpval`, as the Hansen and Sargan statistics coincide in that case. The results of the most recent estimation are saved in the `ereturn` list.

5 Examples of usage

In this example from Lewbel (2012), centering of regressors is only used to match the published results.

```
ssc install center // (if needed)
ssc install bcuse // (if needed)
bcuse engeldat
center age-twocars, prefix(z_)
ivreg2h foodshare z_* (lrtotexp=), small robust
ivreg2h foodshare z_* (lrtotexp = lrinc), small robust
ivreg2h foodshare z_* (lrtotexp = lrinc), small robust gmm2s z(z_age-z_age2sp)
```

Example of use with panel data and HAC standard errors:

```
webuse grunfeld, clear
ivreg2h invest L(1/2).kstock (mvalue=), fe
ivreg2h invest L(1/2).kstock (mvalue=L(1/4).mvalue), fe robust bw(2)
```


6 Additional comments

Here we provide answers to additional questions that have been asked about the estimator.

1. Can validity of the estimator be tested?

Partially. The tests discussed in the previous sections are examples.

2. What if Y_1 or Y_2 is discrete?

It is possible that the estimator will still be valid in this case. Lewbel (2018) gives one set of conditions that suffice for validity of the estimator. However, the factor structure given by Assumption A1 will generally not hold if Y_1 or Y_2 is discrete, so it is much harder to justify application of the estimator. One might still apply the tests discussed in the previous section to provide some evidence to rationalize the estimator in this case.

3. What does it mean if coefficient estimates are close to those from ordinary least squares?

In any application of instrumental variables estimators, coefficient estimates can be close to ordinary least squares either by chance, or if the instruments are highly correlated with the endogenous regressors. The same is true of constructed instruments.

4. Can the estimator be used with more than one endogenous regressor?

Conditions for validity of the estimator have been proven for one endogenous regressor. The estimator may be valid with multiple endogenous regressors, but the exact conditions required for validity in that case have not been shown.

5. What if I have additional instruments?

This is the best case scenario, as those external instruments can be used along with the constructed instruments in the second step of the estimator (as discussed earlier). In particular, one of the best uses of the constructed instruments is to provide overidentifying information for model tests and for robustness checks. For example, one could apply the overidentification tests discussed in the previous sections to estimates based on both constructed and external instruments. If validity is rejected, then either the model is misspecified or at least one of these instruments is invalid. If validity is not rejected, it's still possible that the model is wrong or the instruments are invalid, but one would at least have increased confidence that both the external instruments and the constructed instruments are valid. More informally, one

might simply compare the estimated coefficients based on constructed instruments versus those based on external instruments. If they are numerically similar, that increases confidence in the robustness of the model, as the two estimators based on very different identifying assumptions are yielding similar results. More generally, identification based on constructed instruments is preferably not used in isolation, but rather is ideally employed in conjunction with other means of obtaining identification, both as a way to check robustness of results to alternative identifying assumptions and to increase the efficiency of estimation.

7 Conclusions

In the few years since the heteroskedasticity-based estimator was proposed, it has been cited more than five hundred times according to Google Scholar. But like any identification method that is based largely on structure and functional form, one must be very cautious about interpreting the results. This note should help ensure that the estimator is applied appropriately.

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⁴As discussed earlier, these alternative estimates are automatically provided by `ivreg2h`.

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