

Assignment 1

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1 Cobb-Douglas production with CRS

In this assignment we want to test whether the Cobb-Douglas production function (CD) exhibits constant returns to scale (CRS) at a firm level using real data and panel data methods. The Cobb-Douglas production function is given by,

$$F(K, L) = AK^{\beta_K} L^{\beta_L}$$

where K is capital, L is labor, A is total factor productivity (TFP) and β_K, β_L are the output elasticities of capital and labor, respectively. It follows that for CD to have CRS, it must be homogeneous of degree one, i.e. $\beta_K + \beta_L = 1$, as seen from,

$$F(\lambda K, \lambda L) = A(\lambda K)^{\beta_K} (\lambda L)^{\beta_L} = A\lambda^{\beta_K + \beta_L} K^{\beta_K} L^{\beta_L} = \lambda F(K, L) \iff \beta_K + \beta_L = 1.$$

which forms the linear hypothesis we want to test i.e. $H_0 : \beta_K + \beta_L = 1$ vs. $H_A : \beta_K + \beta_L \neq 1$. While K and L are certainly important production inputs, we cannot hope to observe **all** input factors that make up production. To investigate the functional form of the production function, we estimate a simple (two-way) fixed effects (FE) model, to remove the time-invariant and time-varying unobserved heterogeneity. Note, that these factors with control for much more than just TFP, in fact all other unobserved factors that affect production.

We start by taking logs of the production function to linearize it,

$$\begin{aligned} \ln Y_{it} &= \ln A_{it} + \beta_K \ln K_{it} + \beta_L \ln L_{it} \\ y_{it} &= \beta_K k_{it} + \beta_L l_{it} + u_{it}, \quad u_{it} = \ln A_{it} \end{aligned}$$

Suppose that $\ln A_{it}$ can be decomposed into time-invariant firm-specific effects, α_i , a time-varying effects, γ_t , and add an idiosyncratic error, ε_{it} , i.e. $u_{it} = \alpha_i + \gamma_t + \varepsilon_{it}$. The FE model is then given by,

$$\begin{aligned} u_{it} &= \alpha_i + \gamma_t + \varepsilon_{it}, \\ y_{it} &= \alpha_i + \gamma_t + \beta_K k_{it} + \beta_L l_{it} + \varepsilon_{it}, \end{aligned}$$

where $y_{it} = \ln Y_{it}$, $k_{it} = \ln K_{it}$ and $l_{it} = \ln L_{it}$. Collect the RHS variables in the vector $\mathbf{x}_{it} = (k_{it}, l_{it})$ and the parameters in the vector $\boldsymbol{\beta} = (\beta_K, \beta_L)$. The FE model can then be written on compact form as,

$$y_{it} = \alpha_i + \gamma_t + \mathbf{x}_{it}\boldsymbol{\beta} + \varepsilon_{it}.$$

Due to α_i and γ_t being unobserved, we cannot estimate them directly, and if we suspect that they are correlated with \mathbf{x}_{it} , we need to control for them to obtain consistent estimates of the parameters. This can be done by transforming the data to remove these effects, and then estimate the parameters using OLS on the transformed data.

The transformation used to remove α_i is the within transformation, which subtracts the individual specific mean from each observation, i.e. $\tilde{y}_{it} = y_{it} - \bar{y}_i$, where $\bar{y}_i = \frac{1}{T} \sum_{t=1}^T y_{it}$ is the individual specific mean. Similarly to remove the time variant fixed effect, we can use the time within transformation, which subtracts the time specific mean from each observation, i.e. $\dot{y}_{it} = y_{it} - \bar{y}_t$, where $\bar{y}_t = \frac{1}{N} \sum_{i=1}^N y_{it}$ is the time specific mean. However, since we have both individual and time fixed effects, we need to use a two-way transformation to remove both effects. This can be done by applying the within transformation twice, first over the individual dimension and then over the time dimension (or vice versa).

Denote the transformation matrices,

$$Q_T = I_T - \frac{1}{T} \iota_T \iota_T', \quad Q_N = I_N - \frac{1}{N} \iota_N \iota_N',$$

The same transformation is applied to \mathbf{x}_{it} and ε_{it} , i.e. $\tilde{\mathbf{x}}_{it} = \mathbf{x}_{it} - \bar{\mathbf{x}}_i$ and $\tilde{\varepsilon}_{it} = \varepsilon_{it} - \bar{\varepsilon}_i$. The time fixed effects, γ_t , can be removed by including time dummies in the regression (or by a similar transformation over the cross-sectional dimension). The transformed model is then given by,

$$\tilde{y}_{it} = \tilde{\mathbf{x}}_{it}\boldsymbol{\beta} + \tilde{\varepsilon}_{it}.$$

Gameplan:

Write stuff about assumptions, and then transformations, prob go from inconsistent pooled OLS to consistent FE. Right the estimator, list assumptions for identification and consistency (strict/cont exog, non-generacy) - show consistency by LLN convergence in plim. Next, talk about asymptotic normality, CLT, variance estimation (efficiency - robust, cluster). Finally, hypothesis testing (Wald). Then proceed to empirical application (include wald-test code, since it is not given or done in any exercises).

- Mikkel: Requirements for FE and why pooled OLS is inconsistent (identification, assumptions, consistency, exogeneity).
- Mikkel: Show consistency (LLN \rightarrow plim convergence).
- Mikkel: Show Asymptotic normality.
- Mathias: Show Efficiency (Robust or not).
- Noah: Serial Corr, Rank test, Homoskedasticity (maybe).
- Noah: Wald-Test (one sided as well)? Check form of test when using robust std. err.
- Mathias: Potentially the above, for time variant fixed effects.
- Noah: Present empirical results.
- Noah: Estimation table.
- Noah: Misspecification test table.
- Noah: Test table for linear hypothesis (Wald).

Plan:

1. Alle prøver at nå at lave hver deres til/inden torsdag
2. Alle læser hinandens arbejde torsdag eftermiddag
3. Zoom møde fredag eftermiddag, hvor vi får den sendt afsted

2 Methodology

2.1 Efficiency

It follows, that for the FE estimator to be efficient - i.e. have the smallest possible (asymptotic) variance -, we need to make some assumptions regarding the variance of the idiosyncratic error term, ε_{it} . Specifically, we need that the variance is homoscedastic and not serially correlated, i.e. $\text{Var}(\varepsilon_{it}) = \sigma^2$ and $\text{Cov}(\varepsilon_{it}, \varepsilon_{is}) = 0$ for $t \neq s$, or in the stacked notation, that, $\Omega_\varepsilon = \sigma^2 I_T$. This results in the following (ref Mikkel's eq for asymptotic normality),

$$\begin{aligned}\mathbb{E} [\ddot{\mathbf{X}}_i' \mathbf{u}_i \mathbf{u}_i' \ddot{\mathbf{X}}_i] &= \mathbb{E} [\ddot{\mathbf{X}}_i' \mathbb{E}[\mathbf{u}_i \mathbf{u}_i' | \mathbf{x}_i \alpha_i] \ddot{\mathbf{X}}_i] \\ &= \mathbb{E}[\ddot{\mathbf{X}}_i' \sigma_u^2 \mathbf{I}_T \ddot{\mathbf{X}}_i]\end{aligned}$$

such that the asymptotic variance is,

$$\text{Avar}(\hat{\beta}_{FE}) = \sigma_u^2 \mathbb{E}[\ddot{\mathbf{X}}_i' \ddot{\mathbf{X}}_i]^{-1} / N$$

If these assumptions do not hold, we can still obtain consistent estimates of the standard errors using robust or clustered standard errors, though often at the cost of efficiency. In which case we estimate

the middle part of the sandwich from (Mikkel ref normality) using the analogy principle i.e. using the estimated residuals, such that,

$$\hat{\text{Avar}}(\hat{\beta}_{FE}) = \left(\sum_{i=1}^N \ddot{X}_i' \ddot{X}_i \right)^{-1} \left(\sum_{i=1}^N \ddot{X}_i' \hat{u}_i \hat{u}_i' \ddot{X}_i \right) \left(\sum_{i=1}^N \ddot{X}_i' \ddot{X}_i \right)^{-1}$$

Which is consistent under just the strict exogeneity assumption as well as the rank assumption - because consistent estimation of the error, as well as the outer matrices being invertible? (remove outer sums possibly and go full stacked like a maniac).

2.2 (Econometric theory and methodology)

Wald-test

(We could also test for joint significance for the year dummies)
We utilise the Wald-test to test for CRS, (and maybe

Serial correlation

Rank test

Homoskedasticity (maybe)

3 Empirical results

The data consists of $N = 441$ French manufacturing firms over 12 years ($T = 12$) from 1968 to 1979, and is thus a panel data set with $NT = 5292$ observations. The data is balanced.

Maybe variable def.

We perform the two-way or double-demean transformation of our data matrices as described in the methodology section (Ref). The estimates along with standard errors and p -values are reported in Table ??.

Next we proceed to test the null hypothesis of constant returns to scale. We reject the null at the 1 % significance level with a p -value of ≈ 0 . Thus, we conclude that the (Cobb-Douglas) production function does not exhibit constant returns to scale, for French manufacturing firms in the period 1968-1979.

In addition one might want to test whether the production function exhibits increasing or decreasing returns to scale. This can be done by testing the null hypothesis of $\beta_K + \beta_L \geq 1$ against the alternative of $\beta_K + \beta_L < 1$ (decreasing returns to scale) or vice versa for increasing returns to scale. One might suspect that this particular sector exhibits increasing returns to scale, as firms in manufacturing often benefit from economies of scale.

References

Wooldridge, Jeffrey M. (2010). *Econometric Analysis of Cross Section and Panel Data*. MIT press.