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## 1. Description

This repository contains the Matlab code for performing the cross-sectional error dependence tests in panel data models, including the Lagrange multiplier () test by Breusch and Pagan (1980), the cross-sectional dependence () and scaled LM () tests by Pesaran (2004, 2015), the bias‐adjusted LM () test by Pesaran, Ullah, and Yamagata (2008), and the bias-corrected scaled LM () test by Baltagi, Feng, and Kao (2012).

## 2. Citation

This code is provided as supplementary material for our paper:

Haghnejad, A., Samadi, S., Nasrollahi, K., Azarbayjani, K., & Kazemi, I. (2020). Market power and efficiency in the Iranian banking industry. *Emerging Markets Finance and Trade*, 56(13), 3217-3234.

Please cite this paper if you are using the code in your research.

## 3. Cross-sectional dependence tests

The procedure for testing the presence of cross equation error correlations in the panels is based on the following model:

where is the cross‐sectional dimension, is the time dimension, is the dependent variable, is a vector of regressors, and and are intercept and a vector of unknown slope coefficients, respectively, which are allowed to vary across individuals. The null hypothesis of no cross‐sectional dependence then becomes

against the alternative,

Breusch and Pagan (1980) have proposed a Lagrange Multiplier test for cross‐sectionaldependence based on the ordinary least squares (OLS) residuals. The test statistic is

where denote the pair‐wise correlations of the residuals derived from the OLS estimation of individual regressions in Equation (1). Under the null hypothesis, the statistic has a limiting distribution with degrees of freedom. However, it is well known that the Breusch and Pagan test is likely to exhibit considerable sizedistortions when . In this case, Pesaran (2004) proposes a scaled version ofthe statistic, defined as

Under the null hypothesis of cross‐sectional independence with first, and then , the statistic has a distribution, and can be used even in cases where both and are large. To address the large bias of the Breusch and Pagan test, Pesaran (2004) proposes another statistic with the reasonable finite sample properties as follows:

Under the null hypothesis of no cross-sectional dependence, the statistic is asymptotically distributed as , provided that and is sufficiently large. Pesaran (2015) establishes that the test is best viewed as a test of weak cross sectional dependence, namely the null of weak dependence is more appropriate than the null of independence in the case of large panel data models where only pervasive cross-dependence is of concern.

Pesaran, Ullah, and Yamagata (2008) propose an alternative bias‐adjusted version of the statistic to test the cross‐sectional dependence in the context of a heterogeneous panel data model. This bias-adjusted statistic is given by

where and denote the exact mean and standard deviation of respectively, which are provided by Pesaran, Ullah, and Yamagata (2008). Under the null hypothesis of cross-sectional independence, with first, and then the statistic is asymptotically distributed as .

Baltagi, Feng, and Kao (2012) correct the asymptotic bias of the statistic proposed by Pesaran (2004) but applied in the context of a homogeneous panel data model with fixed effects. The bias‐corrected test statistic is calculated as

Under the null hypothesis of cross‐sectional independence, .

**References**

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