

# The R-package **phtt**: Panel Data Analysis with Heterogeneous Time Trends

Oualid Bada  
University of Bonn

Dominik Liebl  
Universities of Cologne and Bonn

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## Abstract

A slightly modified version of this introduction to the **phtt** package is submitted to the Journal of Statistical Software.

The R-package **phtt** provides estimation procedures for panel data with large dimensions  $n$ ,  $T$ , and general forms of unobservable heterogeneous effects. Particularly, the estimation procedures are those of [Bai \(2009\)](#) and [Kneip, Sickles, and Song \(2012\)](#), which complement one another very well: both models assume the unobservable heterogeneous effects to have a factor structure. The method of [Bai \(2009\)](#) assumes that the factors are stationary, whereas the method of [Kneip \*et al.\* \(2012\)](#) allows the factors to be non-stationary. Additionally, the **phtt** package provides a wide range of dimensionality criteria in order to estimate the number of the unobserved factors simultaneously with the remaining model parameters.

*Keywords:* Panel data, unobserved heterogeneity, principal component analysis, factor dimension.

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## 1. Introduction

One of the main difficulties and at the same time appealing advantages of panel models is their need to deal with the problem of unobserved heterogeneity. Classical panel models, such as *fixed effects* or *random effects*, try to model unobserved heterogeneity using dummy variables or structural assumptions on the error term (see, e.g., [Baltagi \(2005\)](#)). In both cases the unobserved heterogeneity is assumed to remain constant over time within each cross-sectional unit—apart from an eventual common time trend. This assumption might be reasonable for approximating panel data with fairly small temporal dimensions  $T$ ; however, for panel data with large  $T$  this assumption becomes implausible.

Nowadays, the availability of panel data with large cross-sectional dimensions  $n$  and large time dimensions  $T$  has triggered the development of a new class of panel data models. Recent discussions by [Ahn, Lee, and Schmidt \(2006\)](#), [Pesaran \(2006\)](#), [Bai \(2009\)](#), [Bai, Kao, and Ng \(2009\)](#), and [Kneip \*et al.\* \(2012\)](#) have focused on advanced panel models for which the unobservable individual effects are allowed to have heterogeneous time trends that can be approximated by a factor structure. The basic form of this new class of panel models can be presented as follows:

$$y_{it} = \sum_{j=1}^P x_{itj} \beta_j + \nu_{it} + \epsilon_{it}, \quad \text{for } i \in \{1, \dots, n\}, \text{ and } t \in \{1, \dots, T\}, \quad (1)$$

where  $y_{it}$  is the dependent variable for each individual  $i$  at time  $t$ ,  $x_{itj}$  is the  $j$ th element of the vector of explanatory variables  $x_{it} \in \mathbb{R}^P$ , and  $\epsilon_{it}$  is the idiosyncratic error term. The time-varying individual effects  $\nu_{it} \in \mathbb{R}$  of individual  $i$  for the time points  $t \in \{1, \dots, T\}$  are assumed to have a  $d$ -dimensional factor structure. The following two specifications of the time-varying individual effects  $\nu_{it}$  are implemented in the R package **phtt**:

$$\nu_{it} = \begin{cases} v_{it} &= \sum_{l=1}^d \lambda_{il} f_{lt}, & \text{for the model of Bai (2009),} \\ v_i(t) &= \sum_{l=1}^d \lambda_{il} f_l(t), & \text{for the model of Kneip et al. (2012).} \end{cases} \quad (2)$$

Here,  $\lambda_{il}$  are unobserved individual loadings parameters,  $f_{lt}$  are unobserved common factors for the model of Bai (2009),  $f_l(t)$  are the unobserved common factors for the model of Kneip et al. (2012), and  $d$  is the unknown factor dimension. We consider the standard case of iid error terms  $\epsilon_{it}$  with  $E(\epsilon_{it}) = 0$  and  $V(\epsilon_{it}) = \sigma^2$ .

Note that the explicit consideration of an intercept in model (1) is not necessary but may facilitate interpretations. If  $x_{it}$  includes an intercept, the time-varying individual effects  $\nu_{it}$  are centered around zero. If  $x_{it}$  does not include an intercept, the time-varying individual effects  $\nu_{it}$  are centered around the overall mean.

Model (1) includes the classical panel data models with additive time-invariant individual effects and common time-specific effects. Consider the case in which  $d = 2$  with a first common factor  $f_{1t} = 1$  for all  $t \in \{1, \dots, T\}$  that has individual loadings parameters  $\lambda_{i1}$ , and a second common factor  $f_{2t}$  that has the same loadings parameter  $\lambda_{i2} = 1$  for all  $i \in \{1, \dots, n\}$ .

An intrinsic problem of factor models lies in the fact that the true factors are only identifiable up to rotation. In order to ensure the uniqueness of these parameters, a number of  $d^2$  restrictions are required. The usual normalization conditions are given by

- (a)  $\frac{1}{T} \sum_{t=1}^T f_{lt}^2 = 1$  for all  $l \in \{1, \dots, d\}$ ,
- (b)  $\sum_{t=1}^T f_{lt} f_{kt} = 0$  for all  $l, k \in \{1, \dots, d\}$  with  $k \neq l$ , and
- (c)  $\sum_{i=1}^N \lambda_{il} \lambda_{ik} = 0$  for all  $l, k \in \{1, \dots, d\}$  with  $k \neq l$ .

For the model of Kneip et al. (2012),  $f_{lt}$  in conditions (a) and (b) has to be replaced by  $f_l(t)$ . Kneip et al. (2012) consider the case in which the common factors  $f_l(t)$  show relatively smooth patterns over time. This includes strongly positive auto-correlated stationary as well as non-stationary factors. The authors propose to approximate the time-varying individual effects  $v_i(t)$  by smooth functions  $\vartheta_i(t)$ . In this way (1) becomes a semi-parametric model and its estimation is done using a two-step estimation procedure, explained in more detail in Section 2.

Alternatively, Bai (2009) proposes an iterated least squares approach to estimate (1) for stationary time-varying individual effects  $v_{it}$  such as ARMA or white noise processes. The estimators are the result of an iterative procedure solving a system of non-linear equations. However, Bai (2009) assumes the factor dimension  $d$  to be a known parameter, which is usually not the case. Therefore, the **phtt** package uses an algorithmic refinement of Bai's method proposed by Bada and Kneip (2010) in order to estimate the number of unobserved common factors  $d$  jointly with the remaining model parameters; see Section 4 for more details. Besides the implementations of the methods proposed by Kneip et al. (2012), Bai (2009), and Bada and Kneip (2010) the R package **phtt** comes with a wide range of criteria (13 in total)

for estimating the factor dimension  $d$ . The main functions of the **phtt** package are given in the following list:

- **KSS()** : Computes the estimators of the model parameters according to the method of Kneip *et al.* (2012); see Section 2
- **Eup()** : Computes the estimators of the model parameters according to the method of Bai (2009) and Bada and Kneip (2010); see Section 4
- **OptDim()** : Allows for a comparison of the optimal factor dimensions  $\hat{d}$  obtained from many different panel criteria; see Section 3
- **checkSpecif()** : Tests whether to use a classical fix effects panel model or a panel model with individual effects  $\nu_{it}$ ; see Section 5.1

The functions are provided with **print()**-, **summary()**-, **plot()**-, **coef()**- and **residuals()**-methods.

Standard methods for estimating models for panel and longitudinal data are also implemented in the R R Development Core Team (2012) packages **plm** (Croissant and Millo 2008), **nlme** (Pinheiro, Bates, DebRoy, Sarkar, and R Core team 2012), and **lme4** (Bates, Maechler, and Bolker 2012); see Croissant and Millo (2008) for an exhaustive comparison of these packages. Recently, Millo and Piras (2012) published the R package **splm** for spatial panel data models. The **phtt** package further extends the toolbox for statisticians and econometricians and provides the possibility of analyzing panel data in the case when the unobserved heterogeneity is time-varying.

To the best of our knowledge, the **phtt** package Bada and Liebl (2012) is the first software package that offers the estimation methods of Bai (2009) and Kneip *et al.* (2012). Regarding the different dimensionality criteria (in total 13) that can be accessed via the function **OptDim()** only those of Bai and Ng (2002) are publicly available as MATLAB codes (The MathWorks Inc. 2012) from the homepage of Serena Ng (<http://www.columbia.edu/~sn2294/>).

To demonstrate the use of our functions, we re-explore the well known **Cigar** dataset, which is frequently used in the literature of panel models. The panel contains the amounts of cigarette consumption of  $n = 46$  American states from 1963 to 1992 ( $T = 30$ ) as well as data about the income per capita and cigarette prices in the same states during the same period (see, e.g., Baltagi and Levin (1986) for more details on the dataset).

We follow Baltagi and Li (2004), who estimate the following panel model:

$$\ln(\text{Consumption}_{it}) = \mu + \beta_1 \ln(\text{Price}_{it}) + \beta_2 \ln(\text{Income}_{it}) + e_{it}. \quad (3)$$

Here,  $\text{Consumption}_{it}$  presents the sales of cigarettes (packs of cigarettes per capita),  $\text{Price}_{it}$  is the average real retail price of cigarettes, and  $\text{Income}_{it}$  is the real disposable income per capita. The index  $i \in \{1, \dots, 46\}$  denotes the single states and the index  $t \in \{1, \dots, 30\}$  denotes the year.

Baltagi and Li (2004) assume the error term  $e_{it}$  to be affected by time-varying spatial correlations between neighboring states. To estimate the model, the authors use a pre-defined  $n \times n$  spatial weights matrix  $W = \{\omega_{ij}\}_{i,j=1,\dots,n}$ , where  $\omega_{ij}$  is equal to one if state  $i$  and state  $j$  are neighboring states and zero else. If a state  $i$  has more than one neighboring state then the corresponding  $\omega_{ij}$ 's are normalized to sum up to one.

However, the model of Baltagi and Li (2004) is very restrictive, since the assumptions on the structure of the error term  $e_{it}$  are fixed a priori. Instead, we apply the panel methods introduced above and allow for the state-cross-correlations in the error term  $e_{it}$  to be approximated from the data by a multidimensional factor structure such that

$$e_{it} = \sum_{l=1}^d \lambda_{il} f_{lt} + \epsilon_{it}.$$

The **Cigar** dataset can be obtained from the **pht** package using the function `data("Cigar")`. The panels of the variables  $\ln(\text{Consumption}_{it})$ ,  $\ln(\text{Price}_{it})$ , and  $\ln(\text{Income}_{it})$  are shown in Figure 1.

Die heruntergeladenen Quellpakete sind in  
'/tmp/RtmpmFJYZs/downloaded\_packages'

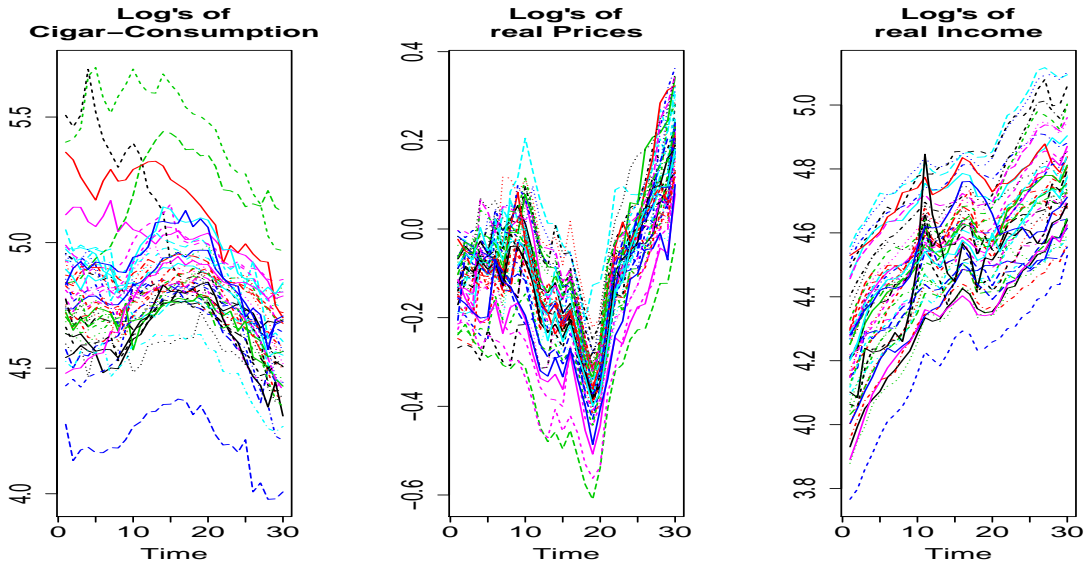


Figure 1: Plots of the dependent variable  $\ln(\text{Consumption}_{it})$  and regressor variables  $\ln(\text{Price}_{it})$  and  $\ln(\text{Income}_{it})$ .

Section 2 is devoted to a short introduction of the method of Kneip *et al.* (2012), which is appropriate for relatively smooth common factors  $f_l(t)$ . Section 3 presents the usage of the function `OptDim()`, which provides access to a wide range of panel dimensionality criteria recently discussed in the literature on factor models. Section 4 deals with the explanation as well as application of the panel method proposed by Bai (2009), which is appropriate for stationary and relatively unstructured common factors  $f_{lt}$ .

## 2. Panel models for heterogeneity in time trends

The panel model proposed by [Kneip et al. \(2012\)](#) can be presented as follows:

$$y_{it} = \sum_{j=1}^P x_{itj} \beta_j + v_i(t) + \epsilon_{it}, \quad (4)$$

where the time-varying individual effects  $v_i(t)$  are parametrized in terms of common non-parametric basis functions  $f_1(t), \dots, f_d(t)$  such that

$$v_i(t) = \sum_{l=1}^d \lambda_{il} f_l(t). \quad (5)$$

The asymptotic properties of this method rely on second order differences of  $v_i(t)$ , which apply for continuous functions as well as for classical discontinuous stochastic time series processes such as (S)AR(I)MA processes. Therefore, the functional notation of the time-varying individual effects  $v_i(t)$  and their underlying common factors  $f_1(t), \dots, f_d(t)$  does not restrict them to a purely functional interpretation. The main idea of this approach is to approximate the time series of the time-varying individual effects  $v_i(t)$  by smooth functions  $\vartheta_i(t)$ .

The estimation approach proposed by [Kneip et al. \(2012\)](#) relies on a two-step procedure: first, estimates of the common slope parameters  $\beta_j$  and the time-varying individual effects  $v_i(t)$  are obtained semi-parametrically. Second, functional principal component analysis is used to estimate the common factors  $f_1(t), \dots, f_d(t)$ , and to re-estimate the time-varying individual effects  $v_i(t)$  more efficiently. In the following we describe both steps in more detail.

**Step 1:** The unobserved parameters  $\beta_j$  and  $v_i(t)$  are estimated by the minimization of

$$\sum_{i=1}^n \frac{1}{T} \sum_{t=1}^T \left( y_{it} - \sum_{j=1}^P x_{itj} \beta_j - \vartheta_i(t) \right)^2 + \sum_{i=1}^n \kappa \int_1^T \frac{1}{T} \left( \vartheta_i^{(m)}(s) \right)^2 ds, \quad (6)$$

over all  $\beta_j \in \mathbb{R}$  and all  $m$ -times continuously differentiable functions  $\vartheta_i$ , where  $\vartheta_i^{(m)}$  denotes the  $m$ th derivative of the function  $\vartheta_i$ . A first approximation of  $v_i(t)$  is then given by  $\tilde{v}_i(t) := \hat{\vartheta}_i(t)$ . Spline theory implies that any solution  $\hat{\vartheta}_i(t)$  possesses an expansion in terms of a natural spline basis  $z_1(t), \dots, z_T(t)$  such that  $\hat{\vartheta}_i(t) = \sum_{s=1}^T \hat{\zeta}_{is} z_s(t)$ ; see, e.g., [De Boor \(2001\)](#). Using the latter expression, we can rewrite (6) to formalize the following objective function:

$$S(\beta, \zeta) = \sum_{i=1}^n \left( \|Y_i - X_i \beta - Z \zeta_i\|^2 + \kappa \zeta_i^\top A \zeta_i \right), \quad (7)$$

where  $Y_i = (y_{i1}, \dots, y_{iT})^\top$ ,  $X_i = (x_{i1}^\top, \dots, x_{iT}^\top)^\top$ ,  $\beta = (\beta_1, \dots, \beta_P)^\top$ ,  $\zeta_i = (\zeta_{i1}, \dots, \zeta_{iT})^\top$ ,  $Z$  and  $A$  are  $T \times T$  matrices with elements  $\{z_s(t)\}_{s,t=1,\dots,T}$  and  $\{\int z_s^{(m)}(t) z_k^{(m)}(t) dt\}_{s,k=1,\dots,T}$  respectively.  $\kappa$  is a preselected smoothing parameter to control the smoothness of  $\hat{\vartheta}_i(t)$ . We follow the usual choice of  $m = 2$ , which leads to cubic smoothing splines.

The semi-parametric estimators  $\hat{\beta}, \hat{\zeta}_i = (\hat{\zeta}_{i1}, \dots, \hat{\zeta}_{iT})^\top$ , and  $\tilde{v}_i = (\tilde{v}_{i1}, \dots, \tilde{v}_{iT})^\top$  can be obtained by minimizing  $S(\beta, \zeta)$  over all  $\beta \in \mathbb{R}^p$  and  $\zeta \in \mathbb{R}^{T \times n}$ .

The solutions are given by

$$\hat{\beta} = \left( \sum_{i=1}^N X_i^\top (I - \mathcal{Z}_\kappa) X_i \right)^{-1} \left( \sum_{i=1}^N X_i^\top (I - \mathcal{Z}_\kappa) Y_i \right), \quad (8)$$

$$\hat{\zeta}_i = (Z^\top Z + \kappa R)^{-1} Z^\top (Y_i - X_i \hat{\beta}), \text{ and} \quad (9)$$

$$\tilde{v}_i = \mathcal{Z}_\kappa (Y_i - X_i \hat{\beta}), \text{ where } \mathcal{Z}_\kappa = Z (Z^\top Z + \kappa R)^{-1} Z^\top. \quad (10)$$

**Step 2:** The common factors are obtained by the first  $d$  eigenvectors  $\hat{\gamma}_1, \dots, \hat{\gamma}_d$  that correspond to the largest eigenvalues  $\hat{\rho}_1, \dots, \hat{\rho}_d$  of the empirical covariance matrix

$$\hat{\Sigma} = \frac{1}{n} \tilde{v}_i \tilde{v}_i^\top. \quad (11)$$

The estimator of the common factor  $f_l(t)$  is then defined by the  $l$ th scaled eigenvector

$$\hat{f}_l(t) = \sqrt{T} \hat{\gamma}_{lt} \text{ for all } l \in \{1, \dots, d\}, \quad (12)$$

where  $\hat{\gamma}_{lt}$  is the  $t$ th element of the eigenvector  $\hat{\gamma}_l$ . The scaling factor  $\sqrt{T}$  yields that  $\hat{f}_l(t)$  satisfies the normalization condition  $\frac{1}{T} \sum_{t=1}^T \hat{f}_l(t)^2 = 1$  as listed above in Section 1. The estimates of the individual loadings parameters  $\lambda_{il}$  are obtained by ordinary least squares regressions of  $(Y_i - X_i \hat{\beta})$  on  $\hat{f}_l$ , where  $\hat{f}_l = (\hat{f}_l(1), \dots, \hat{f}_l(T))'$ . Recall from conditions (a) and (b) that  $\hat{\lambda}_{il}$  can be calculated as follows:

$$\hat{\lambda}_{il} = \frac{1}{T} \hat{f}_l^\top (Y_i - X_i \hat{\beta}). \quad (13)$$

The time-varying individual effects  $v_i(t)$  are re-estimated by  $\hat{v}_i(t) := \sum_{l=1}^d \hat{\lambda}_{il} \hat{f}_l(t)$ , where the factor dimension  $d$  can be determined, e.g., by the sequential testing procedure of [Kneip et al. \(2012\)](#) or by any other dimensionality criteria. In Section 3 we introduce several such criteria. To determine the optimal smoothing parameter  $\kappa_{opt}$ , the authors propose the following cross validation (CV) criterion:

$$CV(\kappa) = \sum_{i=1}^n \|Y_i - X_i \hat{\beta}_{-i} - \sum_{l=1}^d \hat{\lambda}_{-i,l} \hat{f}_{-i,l}\|^2. \quad (14)$$

Unfortunately, this criterion is computationally very costly and requires determining the factor dimension  $d$  in advance. To overcome this disadvantage, we propose a plug-in smoothing parameter that is discussed in more detail in Section 2.1.

[Kneip et al. \(2012\)](#) show the consistency of the estimators as  $n, T \rightarrow \infty$  and derive the asymptotic distribution of common slope estimators  $\hat{\beta}$  as  $(\hat{\beta} - E(\hat{\beta}|\epsilon)) = \mathbf{N}(0, \hat{\Sigma}_\beta)$ , where

$$\hat{\Sigma}_\beta = \sigma^2 \left( \sum_{i=1}^n X_i^\top (I - \mathcal{Z}_\kappa) X_i \right)^{-1} \left( \sum_{i=1}^n X_i^\top (I - \mathcal{Z}_\kappa)^2 X_i \right) \left( \sum_{i=1}^n X_i^\top (I - \mathcal{Z}_\kappa) X_i \right)^{-1}. \quad (15)$$

A consistent estimator of  $\sigma^2$  can be obtained by

$$\hat{\sigma}^2 = \frac{1}{(n-1)T} \sum_{i=1}^n \|Y_i - X_i \hat{\beta} - \sum_{l=1}^{\hat{d}} \hat{\lambda}_{i,l} \hat{f}_l(t)\|^2. \quad (16)$$

## 2.1. Computational details

A problem that remains to be discussed is the determination of the smoothing parameter  $\kappa$  in (8), (12), and (13). Generally, it is possible to determine  $\kappa$  by the CV criterion in (14); however, for relatively large dimensions  $T$  and  $n$  cross validation is computationally very costly. Moreover, Kneip *et al.* (2012) do not explain how the factor dimension  $d$  is to be specified during the optimization process, which is critical since  $\hat{d}$  itself depends on  $\kappa$ ; see (21) in Section 3.

We propose to determine the smoothing parameter  $\kappa$  by generalized cross validation (GCV). However, we cannot apply the classical GCV formulas as proposed, e.g., in Craven and Wahba (1978) since we do not know the parameters  $\beta$  and  $v_i(t)$ . Our computational algorithm for determining the GCV smoothing parameter  $\kappa_{GCV}$  is based on the method of Cao and Ramsay (2010), who propose optimizing objective functions of the form (7) by updating the parameters iteratively in a functional hierarchy. Formally, the iteration algorithm can be described as follows:

1. For given  $\kappa$  and  $\beta$ , we optimize (7) with respect to  $\zeta_i$  to get

$$\hat{\zeta}_i = (Z'Z + \kappa R)^{-1} Z^\top (Y_i - X_i \beta). \quad (17)$$

2. By using (17), we minimize (7) with respect to  $\beta$  to get

$$\hat{\beta} = \left( \sum_{i=1}^N X_i^\top X_i \right)^{-1} \left( \sum_{i=1}^N X_i^\top (Y_i - Z \hat{\zeta}_i) \right) \quad (18)$$

3. Once (17) and (18) are obtained, we optimize the following GCV criterion to calculate  $\kappa_{GCV}$ :

$$\kappa_{GCV} = \arg \min_{\kappa} \frac{1}{\frac{n}{T} \text{tr}(I - \mathcal{Z}_\kappa)^2} \sum_{i=1}^n \|Y_i - X_i \hat{\beta} - \mathcal{Z}_\kappa(Y_i - X_i \hat{\beta})\|^2. \quad (19)$$

The program starts with initial estimates of  $\beta$  and  $\kappa$  and proceeds with steps 1, 2, and 3 in recurrence until convergence of all parameters, where the initial value  $\hat{\beta}_{start}$  is defined in (45) and the initial value  $\kappa_{start}$  is the GCV-smoothing parameter of the residuals  $Y_i - X_i \hat{\beta}_{start}$ .

The advantage of this approach is that the inversion of the  $P \times P$  matrix in (18) does not have to be updated during the iteration process. Moreover, the determination of the GCV-minimizer in (19) can be easily performed in R using the function `smooth.spline()`, which calls on a rapid C-routine.

The GCV smoothing parameter  $\kappa_{GCV}$  in (19) does not explicitly account for the factor structure of the time-varying individual effects  $v_i(t)$  as formalized in (2). However, given the assumption of a factor structure, the goal is not to obtain optimal estimates of  $v_i(t)$  but rather to obtain optimal estimates of the common factors  $f_l(t)$ , which implies that the optimal smoothing parameter  $\kappa_{opt}$  will be smaller than  $\kappa_{GCV}$ ; see Kneip *et al.* (2012).

We use the GCV smoothing parameter  $\kappa_{GCV}$  as an upper bound for  $\kappa_{opt}$  and approximate the optimal smoothing parameter by the following naive plug-in estimator:

$$\kappa_{plug-in} = 0.75 \cdot \kappa_{GCV}.$$



Alternatively, it is possible to optimize the CV criterion (14). In this case, the optimal smoothing parameter  $\kappa_{opt}$  is selected from the interval  $(0, \kappa_{GCV})$  and the factor dimension  $d$  in (14) is estimated by (21) using the plug-in estimator  $\kappa_{plug-in}$ .

## 2.2. Application

This section is devoted to the application of the method above discussed, which is accessible through the function `KSS()`. In total, the function `KSS()` has the following arguments:

```
R> args(KSS)

function (formula, additive.effects = c("none", "individual",
    "time", "twoways"), consult.dim.crit = FALSE, d.max = NULL,
    sig2.hat = NULL, factor.dim = NULL, level = 0.01, spar = NULL,
    CV = FALSE, convergence = 1e-06, restrict.mode = c("restrict.factors",
    "restrict.loadings"), ...)
NULL
```

The argument `additive.effects` makes it possible to extend the model (4) for additional additive `individual`, `time`, or `twoways` effects as discussed in Section 5. If the logical argument `consult.dim.crit` is set to `TRUE` all dimensionality criteria discussed in Section 3 are computed and the user is asked to choose one of their results.

The arguments `d.max` and `sig2.hat` are required for the computation of some dimensionality criteria discussed in Section 3. If their default values are maintained, the function internally computes `d.max` =  $\lfloor \min\{\sqrt{n}, \sqrt{T}\} \rfloor$  and `sig2.hat` as in (16), where  $\lfloor x \rfloor$  indicates the integer part of  $x$ . The argument `level` allows us to adjust the significance level for the dimensionality testing procedure (21) of Kneip *et al.* (2012); see Section 3.

The factor dimension  $d$  can also be pre-specified by the argument `factor.dim`. Recall from restriction (a) that  $\frac{1}{T} \sum_{t=1}^T \hat{f}_l(t)^2 = 1$ . Alternatively, it is possible to standardize the individual loadings parameters such that  $\frac{1}{n} \sum_{i=1}^n \hat{\lambda}_{il} = 1$ , which can be done by setting `restrict.mode` = `"restrict.loadings"`.

As an illustration we estimate the Cigarettes model (3) introduced in Section 1:

$$\begin{aligned} \ln(\text{Consumption}_{it}) &= \mu + \beta_1 \ln(\text{Price}_{it}) + \beta_2 \ln(\text{Income}_{it}) + e_{it} \\ \text{with } e_{it} &= \sum_{l=1}^d \lambda_{il} f_l(t) + \epsilon_{it}, \end{aligned} \quad (20)$$

where  $v_i(t) = \sum_{l=1}^d \lambda_{il} f_l(t)$ . In the following lines of code we load the `Cigar` dataset and take logarithms of the three variables, `Consumptionit`, `Priceit/cpit` and `Incomeit/cpit`, where `cpit` is the consumer price index. Please note that we store the variables as  $T \times n$ -matrices. This is necessary, because the `formula` argument of the `KSS()`-function takes the panel variables as matrices in which the number of rows has to be equal to the temporal dimension  $T$  and the number of columns has to be equal to the individual dimension  $n$ .

Note that the function `KSS()` is written for balanced panels, and eventually missing values have to be replaced in a pre-processing step by appropriate estimates.



```

R> library("phtt")
R> data("Cigar")
R> N <- 46
R> T <- 30
R> l.Consumption <- log(matrix(Cigar$sales, T, N))
R> cpi <- matrix(Cigar$cpi, T, N)
R> l.Price <- log(matrix(Cigar$price, T, N)/cpi)
R> l.Income <- log(matrix(Cigar$ndi, T, N)/cpi)

```

The model parameters  $\beta_1, \beta_2$ , the factors  $f_l(t)$ , the loadings parameters  $\lambda_{il}$ , and the factor dimension  $d$  can be estimated by the `KSS()`-function with its default arguments. Inferences about the slope parameters can be obtained by using the method `summary()`.

```

R> Cigar.KSS <- KSS(formula = l.Consumption ~ l.Price + l.Income)
R> (Cigar.KSS.summary <- summary(Cigar.KSS))

```

Call:

```
KSS.default(formula = l.Consumption ~ l.Price + l.Income)
```

Residuals:

Min	1Q	Median	3Q	Max
-0.11	-0.01	0.00	0.01	0.12

Slope-Coefficients:

	Estimate	StdErr	z.value	Pr(>z)
(Intercept)	4.0600	0.1770	23.00	< 2.2e-16 ***
l.Price	-0.2600	0.0223	-11.70	< 2.2e-16 ***
l.Income	0.1550	0.0382	4.05	5.17e-05 ***

---

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

Additive Effects Type: none

Used Dimension of the Unobserved Factors: 6

Residual standard error: 0.000725 on 921 degrees of freedom

R-squared: 0.99

The effects of the log-real prices for cigarettes  $\ln(\text{Price}_{it})$  and the log-real incomes  $\ln(\text{Income}_{it})$  on the log-sales of cigarettes  $\ln(\text{Consumption}_{it})$  are highly significant and in line with results in the literature. The summary output reports an estimated factor dimension of  $\hat{d} = 6$ . In order to get a visual impression of the six estimated common factors  $\hat{f}_1(t), \dots, \hat{f}_6(t)$  and the estimated time-varying individual effects  $\hat{v}_1(t), \dots, \hat{v}_n(t)$ , we provide a `plot()`-method for the `KSS-summary` object.

```
R> plot(Cigar.KSS.summary)
```

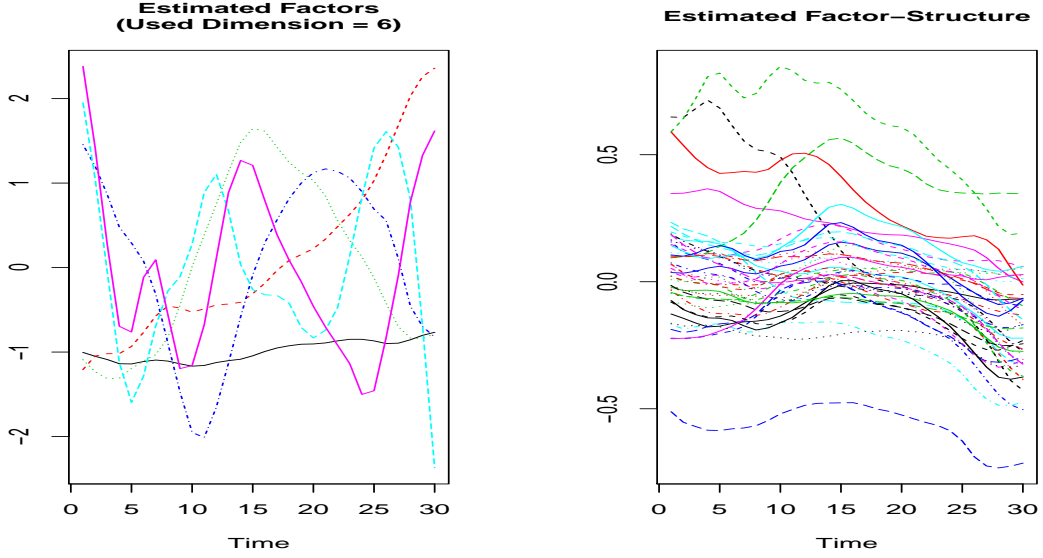


Figure 2: LEFT PANEL: Estimated factors  $\hat{f}_1(t), \dots, \hat{f}_6(t)$ . RIGHT PANEL: Estimated time-varying individual effects  $\hat{v}_1(t), \dots, \hat{v}_n(t)$ .

The left panel of Figure 2 shows the six estimated common factors  $\hat{f}_1(t), \dots, \hat{f}_6(t)$  and the right panel of Figure 2 shows the  $n = 46$  estimated time-varying individual effects  $\hat{v}_1(t), \dots, \hat{v}_n(t)$ . Obviously, there is one nearly time-invariant common factor; this suggests extending the model (20) by additive individual effects; see Section 5 for more details.

By setting the logical argument `consult.dim.crit=TRUE`, the user can choose from other dimensionality criteria, which are discussed in Section 3. Note that the consideration of different factor dimensions  $d$  would not alter the results for the slope parameters  $\beta$  since the estimation procedure of Kneip *et al.* (2012) for the slope parameters  $\beta$  does not depend on the dimensionality parameter  $d$ .

### 3. Panel criteria for selecting the number of factors

In order to estimate the factor dimension  $d$ , Kneip *et al.* (2012) propose a sequential testing procedure based on the following test statistic:

$$KSS(d) = \frac{n \sum_{r=d+1}^T \hat{\rho}_r - (n-1) \hat{\sigma}^2 \text{tr}(\mathcal{Z}_\kappa \hat{\mathcal{P}}_d \mathcal{Z}_\kappa)}{\hat{\sigma}^2 \sqrt{2N \cdot \text{tr}((\mathcal{Z}_\kappa \hat{\mathcal{P}}_d \mathcal{Z}_\kappa)^2)}} \stackrel{a}{\sim} N(0, 1), \quad (21)$$

where  $\hat{\mathcal{P}}_d = I - \frac{1}{T} \sum_{l=1}^d f_l f_l^\top$  with  $f_l = (f_l(1), \dots, f_l(T))^\top$ , and

$$\hat{\sigma}^2 = \frac{1}{(n-1) \text{tr}((I - \mathcal{Z}_\kappa)^2)} \sum_{i=1}^n \|(I - \mathcal{Z}_\kappa)(Y_i - X_i \hat{\beta})\|^2. \quad (22)$$

The selection method can be described as follows: choose a significance level  $\alpha$  (e.g.,  $\alpha = 1\%$ ) and begin with  $H_0 : d = 0$ . Test if  $KSS(0) \leq z_{1-\alpha}$ , where  $z_{1-\alpha}$  is the  $(1 - \alpha)$ -quantile of the

standard normal distribution. If the null hypothesis can be rejected, go on with  $d = 1, 2, 3, \dots$  until  $H_0$  cannot be rejected.

The dimensionality criterion of [Kneip et al. \(2012\)](#) can be used for stationary as well as non-stationary factors. However, this selection procedure has a tendency to ignore factors that are weakly auto-correlated. As a result, the number of factors can be underestimated.

More robust against this kind of underestimation are the criteria of [Bai and Ng \(2002\)](#). The basic idea of their approach consists simply of finding a suitable penalty term  $g_{nT}$ , which countersteers the undesired variance reduction caused by an increasing number of factors  $\hat{d}$ . Formally,  $\hat{d}$  can be obtained by minimizing the following criterion:

$$PC(l) = \frac{1}{nT} \sum_{i=1}^n \sum_{t=1}^T (y_{it} - \hat{y}_{it}(l))^2 + lg_{nT} \quad (23)$$

for all  $l \in \{1, 2, \dots\}$ , where  $\hat{y}_{it}(l)$  is the fitted variable for a given factor dimension  $l$ . To estimate consistently the dimension of stationary factors [Bai and Ng \(2002\)](#) propose specifying  $g_{nT}$  by one of the following penalty terms:

$$g_{nT}^{(PC1)} = \hat{\sigma}^2 \frac{(n+T)}{nT} \log\left(\frac{nT}{n+T}\right) \quad (24)$$

$$g_{nT}^{(PC2)} = \hat{\sigma}^2 \frac{(n+T)}{nT} \log(\min\{n, T\}) \quad (25)$$

$$g_{nT}^{(PC3)} = \hat{\sigma}^2 \frac{\log(\min\{n, T\})}{\min\{n, T\}}, \quad (26)$$

where  $\hat{\sigma}^2$  is a consistent estimator of  $\sigma^2$ , the variance of  $\epsilon_{it}$ . The proposed criteria are denoted by PC1, PC2, and PC3, respectively. In practice,  $\hat{\sigma}^2$  can be obtained by

$$\hat{\sigma}^2(d_{max}) = \frac{1}{nT} \sum_{i=1}^n \sum_{t=1}^T (y_{it} - \hat{y}_{it}(d_{max}))^2, \quad (27)$$

where  $d_{max}$  is an arbitrary maximal dimension that is larger than  $d$ . This kind of variance estimation can, however, be inappropriate in some cases, especially when (27) underestimates the true variance  $\sigma^2$ . The latter can be the case, if the error terms are auto-correlated. To overcome this problem, [Bai and Ng \(2002\)](#) propose three additional criteria (IC1, IC2, and IC3):

$$IC(l) = \log \left( \frac{1}{nT} \sum_{i=1}^n \sum_{t=1}^T (y_{it} - \hat{y}_{it}(l))^2 \right) + lg_{nT} \quad (28)$$

with

$$g_{nT}^{(IC1)} = \frac{(n+T)}{nT} \log\left(\frac{nT}{n+T}\right) \quad (29)$$

$$g_{nT}^{(IC2)} = \frac{(n+T)}{nT} \log(\min\{n, T\}) \quad (30)$$

$$g_{nT}^{(IC3)} = \frac{\log(\min\{n, T\})}{\min\{n, T\}}. \quad (31)$$

Under similar assumptions, [Ahn and Horenstein \(2009\)](#) propose selecting  $d$  by maximizing the ratio of adjacent eigenvalues (or the ratio of their growth rate). The criteria are referred to as *Eigenvalue Ratio* (ER) and *Growth Ratio* (GR) and defined as following:

$$ER = \frac{\hat{\rho}_l}{\hat{\rho}_{l+1}}$$

$$GR = \frac{\log(\sum_{r=l}^T \hat{\rho}_r / \sum_{r=l+1}^T \hat{\rho}_r)}{\log(\sum_{r=l+1}^T \hat{\rho}_r / \sum_{r=l+2}^T \hat{\rho}_r)}.$$

Note that the theory of the above dimensionality criteria PC1, PC2, PC3, IC1, IC2, IC3, ER, and GR is developed for stationary factors. In order to estimate the number of unit root factors, [Bai \(2004\)](#) proposes the following panel criteria:

$$IPC(l) = \frac{1}{nT} \sum_{i=1}^n \sum_{t=1}^T (y_{it} - \hat{y}_{it}(l))^2 + lg_{nT} \quad (32)$$

where

$$g_{nT}^{(IPC1)} = \hat{\sigma}^2 \frac{\log(\log(T))}{T} \frac{(n+T)}{nT} \log\left(\frac{nT}{n+T}\right) \quad (33)$$

$$g_{nT}^{(IPC2)} = \hat{\sigma}^2 \frac{\log(\log(T))}{T} \frac{(n+T)}{nT} \log(\min\{n, T\}) \quad (34)$$

$$g_{nT}^{(IPC3)} = \hat{\sigma}^2 \frac{\log(\log(T))}{T} \frac{\log(\min\{n, T\})}{\min\{n, T\}}. \quad (35)$$

Alternatively, [Onatski \(2010\)](#) has introduced a threshold approach based on the empirical distribution of the largest eigenvalue, which can be used for both stationary and non-stationary factors. The estimated dimension is obtained by

$$\hat{d} = \max\{l \leq d_{max} : \hat{\rho}_l - \hat{\rho}_{l-1} \geq \delta\},$$

where  $\delta$  is a positive threshold, estimated iteratively from the data.

### 3.1. Application

The dimensionality criteria introduced above are implemented in the function `OptDim()`, which has the following arguments:

```
R> args(OptDim)
```

```
function (Obj, criteria = c("PC1", "PC2", "PC3", "IC1", "IC2",
  "IC3", "IPC1", "IPC2", "IPC3", "KSS.C", "ED", "ER", "GR"),
  standardize = FALSE, d.max, sig2.hat, spar, level = 0.01)
NULL
```

The desired criteria can be selected by one or several of the following character variables: "KSS.C", "PC1", "PC2", "PC3", "IC1", "IC2", "IC3", "ER", "GR", "IPC1", "IPC2", "IPC3", and "ED". The default significance level used for the "KSS"-criterion is `level = 0.01`. The

values of  $d_{max}$  and  $\hat{\sigma}^2$  can be specified externally by the arguments `d.max` and `sig2.hat`. By default, `d.max` is computed internally as `d.max = floor(min{sqrt(n), sqrt(T)})` and `sig2.hat` as in (22) and (27). The input variable can be standardized by choosing `standardize = TRUE`. In this case, the calculation of the eigenvalues is based on the correlation matrix instead of the covariance matrix.

As an illustration, imagine that we are interested in the estimation of the factor dimension of the variable  $\ln(\text{Consumption}_{it})$  with the dimensionality criterion "PC1". The function `OptDim()` requires a  $T \times n$  matrix as input variable.

```
R> OptDim(Obj = l.Consumption, criteria = "PC1")
```

```
Call: OptDim.default(Obj = l.Consumption, criteria = "PC1")
```

```
-----
Criterion of Bai and Ng (2002):
```

```
PC1
  7
```

`OptDim()` offers the possibility of comparing the result of different selection procedures by giving the corresponding criteria to the argument `criteria`. If the argument `criteria` is left unspecified, `OptDim()` automatically compares all 13 dimensionality selection procedures.

```
R> (OptDim.obj <- OptDim(Obj = l.Consumption, criteria = c("PC3", "ER", "GR",
+                                                         "IPC1", "IPC2", "IPC3"), standardize = TRUE))
```

```
Call: OptDim.default(Obj = l.Consumption, criteria = c("PC3", "ER",
                                                         "GR", "IPC1", "IPC2", "IPC3"), standardize = TRUE)
```

```
-----
Criterion of Bai and Ng (2002):
```

```
PC3
  8
```

```
-----
Criteria of Ahn and Horenstein (2008):
```

```
ER GR
  3  3
```

```
-----
Criteria of Bai (2004):
```

```
IPC1 IPC2 IPC3
  3    3    2
```

In order help users to choose the most appropriate dimensionality criterion for the data, `OptDim`-objects are provided with a `plot()`-method. This method displays, in descending order, the magnitude of the eigenvalues in percentage of the total variance and indicates where the given criteria detect the optimal dimension: see Figure 3.

```
R> plot(OptDim.obj)
```

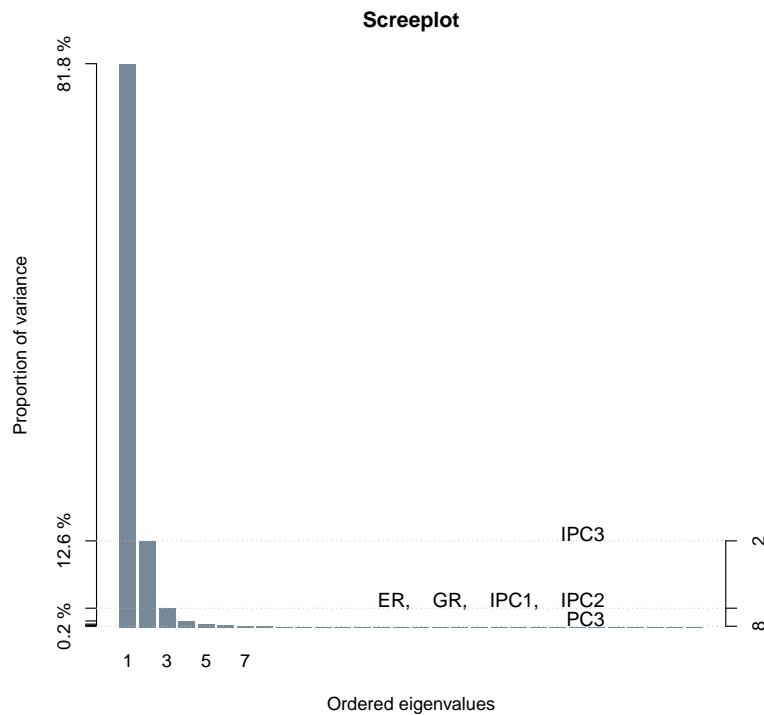


Figure 3: Scree plot produced by the `plot()`-method for `OptDim`-objects. Most of the dimensionality criteria (ER, GR, IPC1 and IPC2) suggest using the dimension  $\hat{d} = 3$ .

In this regard, the function `KSS()` offers us the ability to compare the results of all dimensionality criteria and to select one of them. If the `KSS()`-argument `consult.dim = TRUE` the results of the dimensionality criteria are printed on the console of R and the user is asked to choose one of the results.

```
R> KSS(formula = l.Consumption ~ -1 + l.Price + l.Income, consult.dim = TRUE)
```

```
-----  
Results of Dimension-Estimations
```

```
-Bai:
```

PC1	PC2	PC3	IC1	IC2	IC3	IPC3	IPC2	IPC3
7	6	7	5	5	5	3	3	3

```

-KSS:
  KSS.C
    6

-Onatski:
  ED
    3

-RH:
  ER  GR
    3  4

```

-----

Please, choose one of the proposed integers:

After entering a number of factors, e.g., 6 we get the following feedback:

Used dimension of unobs. factor structure is: 6

-----

Note that the maximum number of factors that can be given, cannot exceed the maximal number of all proposed factor dimensions (here maximal dimension would be 7). A higher dimension can be chosen using the argument `factor.dim`.

#### 4. Panel models with stationary common factors

The panel model proposed by Bai (2009) can be presented as follows:

$$y_{it} = \sum_{j=1}^P x_{itj} \beta_j + v_{it} + \epsilon_{it}, \quad (36)$$

where

$$v_{it} = \sum_{l=1}^d \lambda_{il} f_{lt}. \quad (37)$$

Combining (36) with (37) and writing the model in matrix notation, we get

$$Y_i = X_i \beta + F \Lambda_i^\top + \epsilon_i \quad (38)$$

where  $Y_i = (y_{i1}, \dots, y_{iT})^\top$ ,  $X_i = (x_{i1}^\top, \dots, x_{iT}^\top)^\top$ ,  $\epsilon_i = (\epsilon_{i1}, \dots, \epsilon_{iT})^\top$ ,  $\Lambda_i = (\lambda_1, \dots, \lambda_n)^\top$  and  $F = (f_1, \dots, f_T)^\top$  with  $\lambda_i = (\lambda_{i1}, \dots, \lambda_{id})$ ,  $f_t = (f_{1t}, \dots, f_{dt})$ , and  $\epsilon_i = (\epsilon_{i1}, \dots, \epsilon_{iT})^\top$ .

The asymptotic properties of Bai's method rely, among others, on the following assumption:

$$\frac{1}{T} F^\top F \xrightarrow{p} \Sigma_F \text{ as } T \rightarrow \infty, \quad (39)$$

where  $\Sigma_F$  is a fixed positive definite  $d \times d$  matrix. This rules out the large class of non-stationary stochastic processes such as unit root processes.



#### 4.1. Model with known number of factors $d$

Bai (2009) proposes to estimate the model parameters  $\beta$ ,  $F$  and  $\Lambda_i$  by minimizing the following least squares objective function:

$$S(\beta, F, \Lambda_i) = \sum_i^n \|Y_i - X_i\beta - F\Lambda_i^\top\|^2 \quad (40)$$

For each given  $F$ , the OLS estimator of  $\beta$  can be obtained by

$$\hat{\beta}(F) = \left( \sum_{i=1}^n X_i^\top \mathcal{P}_d X_i \right)^{-1} \left( \sum_{i=1}^n X_i^\top \mathcal{P}_d Y_i \right)$$

where  $\mathcal{P}_d = I - F(F^\top F)^{-1}F^\top = I - FF^\top/T$ . If  $\beta$  is known,  $F$  can be estimated by using the first  $d$  eigenvectors  $\hat{\gamma} = (\hat{\gamma}_1, \dots, \hat{\gamma}_d)$  corresponding to the first  $d$  eigenvalues of the empirical covariance matrix  $\hat{\Sigma} = (nT)^{-1} \sum_{i=1}^n w_i w_i^\top$ , where  $w_i = Y_i - X_i\beta$ . That is,

$$\hat{F}(\beta) = \sqrt{T}\hat{\gamma}.$$

The idea of Bai (2009) is to start with initial values for  $\beta$  or  $F$  and calculate the estimators iteratively. The method requires, however, the factor dimension  $d$  to be known, which is usually not the case in empirical applications.

#### 4.2. Model with unknown number of factors $d$

Bada and Kneip (2010) propose an algorithmic refinement of the method of Bai (2009) in order to provide a joint estimation of the factor dimension  $d$  together with the other parameters  $\beta$ ,  $F$ , and  $\Lambda_i$ . In this case, the optimization criterion can be defined as a penalized least squares objective function:

$$S(\beta, F, \Lambda_i, l) = \sum_i^N \|Y_i - X_i\beta - F\Lambda_i^\top\|^2 + lg_{nT} \quad (41)$$

The role of the additional term  $lg_{nT}$  is to pick up the optimal dimension  $\hat{d}$ , of the unobserved factor structure. The penalty factor  $g_{nT}$  can be chosen according to Bai and Ng (2002). Alternatively,  $g_{nT}$  can be replaced by the threshold  $\delta$  proposed by Onatski (2010). The estimation algorithm is based on the parameter cascading method of Cao and Ramsay (2010) that can be described as follows:

1. Minimizing (41) with respect to  $\Lambda_i$  for each given  $\beta$ ,  $F$  and  $d$ , we get

$$\hat{\Lambda}_i^\top(\beta, F, d) = F^\top (Y_i - X_i\beta) / T. \quad (42)$$

2. Introducing (42) in (41) and minimizing with respect to  $F$  for each given  $\beta$  and  $d$ , we get

$$\hat{F}(\beta, d) = \sqrt{T}\hat{\gamma}(\beta, d), \quad (43)$$

where  $\hat{\gamma}(\beta, d)$  is a  $T \times d$  matrix that contains the first  $d$  eigenvectors corresponding to the first  $d$  eigenvalues  $\rho_1, \dots, \rho_d$  of the covariance matrix  $\hat{\Sigma} = (nT)^{-1} \sum_{i=1}^n w_i w_i^\top$  with  $w_i = Y_i - X_i\beta$ .

3. Reintegrating (43) and (42) in (41) and minimizing with respect to  $\beta$  for each given  $d$ , we get

$$\hat{\beta}(d) = \left( \sum_{i=1}^N X_i^\top X_i \right)^{-1} \left( \sum_{i=1}^N X_i^\top \left( Y_i - \hat{F} \hat{\Lambda}_i^\top(\hat{\beta}, d) \right) \right). \quad (44)$$

4. Optimizing (41) with respect to  $l$  given the results in (42), (43), and (44) allows us to select  $\hat{d}$  as

$$\hat{d} = \min_l \sum_i^N \|Y_i - X_i \hat{\beta} - \hat{F} \hat{\Lambda}_i^\top\|^2 + l g_{nT}, \quad \text{for all } l \in \{0, 1, \dots, d_{max}\}.$$

The final estimators are obtained by alternating between an inner iteration to optimize  $\hat{\beta}(d)$ ,  $\hat{F}(d)$ , and  $\hat{\Lambda}_i(d)$  for each given  $d$  and an outer iteration to select the optimal dimension  $\hat{d}$ . The updating process is repeated in its entirety till the convergence of all the parameters. This is why the estimators are called *entirely updated estimators* (Eup).

It is notable that the objective functions (41) and (40) are not globally convex. There is no guarantee that the iteration algorithm converges to the global optimum. Therefore, it is important to choose reasonable starting values  $\hat{d}_{start}$  and  $\hat{\beta}_{start}$ . We propose to select a large dimension  $d_{max}$  and to start the iteration with the following estimate of  $\beta$ :

$$\hat{\beta}_{start} = \left( \sum_{i=1}^N X_i^\top (I - GG^\top) X_i \right)^{-1} \left( \sum_{i=1}^N X_i^\top (I - GG^\top) Y_i \right), \quad (45)$$

where  $G$  is the  $T \times d_{max}$  matrix of the eigenvectors corresponding to the first  $d_{max}$  eigenvalues of the augmented covariance matrix

$$\Gamma^{Aug} = \frac{1}{nT} \sum_{i=1}^n (Y_i, X_i)(Y_i^\top, X_i^\top)^\top.$$

The intuition behind these starting estimates relies on the fact that the unobserved factors cannot escape from the space spanned by the eigenvectors  $G$ . The orthogonal projection of  $X_i$  on  $G$  in (45) eliminates the effect of a possible correlation between the observed regressors and unobserved factors, which can heavily distort the value of  $\beta^0$  if it is neglected. [Greenaway-McGrevy, Han, and Sul \(2012\)](#) give conditions under which (45) is a consistent estimator of  $\beta$ .

According to [Bai \(2009\)](#), the asymptotic distribution of the slope estimator  $\hat{\beta}$  for known  $d$  and i.i.d.  $\epsilon_{it}$  is:

$$\sqrt{nT}(\hat{\beta}(d) - \beta) \overset{a}{\sim} N(0, \Sigma_\beta),$$

where  $\Sigma_\beta = D_0^{-1} \sigma^2$ . Here,  $\sigma^2 = \text{Var}(\epsilon_{it})$  and  $D_0 = \text{plim}_{n,T} \frac{1}{nT} \sum_{i=1}^n Z_i^\top Z_i$  with  $Z_i = \mathcal{P}_d X_i - \frac{1}{n} \sum_{k=1}^n \mathcal{P}_d X_i a_{ik}$  and  $a_{ik} = \Lambda_i (\frac{1}{n} \sum_{i=1}^n \Lambda_i^\top \Lambda_i)^{-1} \Lambda_k^\top$ . [Bada and Kneip \(2010\)](#) show that if  $\lim_{n,T \rightarrow \infty} P(\hat{d} = d) = 1$ , the entirely updated estimator  $\hat{\beta} = \hat{\beta}(\hat{d})$  will have the same asymptotic distribution as  $\hat{\beta}(d)$ . The asymptotic variance of the estimator  $\hat{\beta}$  can be estimated as follows:

$$\hat{\Sigma}_\beta = \left( \frac{1}{nT} \sum_{i=1}^n Z_i^\top Z_i \right)^{-1} \frac{1}{nT} \sum_{i=1}^n \hat{\epsilon}_i^\top \hat{\epsilon}_i,$$

where  $\hat{\epsilon}_i = Y_i - X_i\hat{\beta} - \hat{F}\hat{\Lambda}_i^\top$ .

### 4.3. Application

The above described methods are implemented in the function `Eup()`, which takes the following arguments:

```
R> args(Eup)
```

```
function (formula, additive.effects = c("none", "individual",
    "time", "twoways"), dim.criterion = c("PC1", "PC2", "PC3",
    "IC1", "IC2", "IC3", "IPC1", "IPC2", "IPC3", "ED"), d.max = NULL,
    sig2.hat = NULL, factor.dim = NULL, double.iteration = TRUE,
    start.beta = NULL, max.iteration = 500, convergence = 1e-06,
    restrict.mode = c("restrict.factors", "restrict.loadings"),
    ...)
```

```
NULL
```

The argument `additive.effects` gives the possibility of extending the model (38) for additional additive effects as discussed in more detail in Section 5. The argument `dim.criterion` specifies the dimensionality criterion to be used if `factor.dim` is left unspecified and defaults to `dim.criterion = "PC1"`. The arguments `d.max` and `sig2.hat` are required for the computation of some dimensionality criteria discussed in Section 3. If their default values are maintained, the function internally computes `d.max` as  $\min\{\sqrt{n}, \sqrt{T}\}$  and `sig2.hat` according to (27).

Setting the argument `double.iteration=FALSE` may speed up computations, because the updates of  $\hat{d}$  will be done simultaneously with  $\hat{F}$  without waiting for their inner convergences. However, in this case, the convergence of the parameters is less stable than in the default setting.

The argument `start.beta` allows us to give a vector of starting values for the slope parameters  $\beta_{start}$ . The maximal number of iteration and the convergence condition can be controlled by `max.iteration` and `convergence`. Finally, by choosing `restrict.mode = c("restrict.loadings")`, the restriction  $\frac{1}{T} \sum_t f_{lt}^2 = 1$  will be replaced by the restriction  $\frac{1}{n} \sum_i \lambda_{il}^2 = 1$  for all  $l \in \{1, \dots, d\}$ .

In our application, we take first-order differences of the observed time series. This is because some factors show temporal trends, which can violate the stationarity condition (39); see Figure 2. We consider the following modified Cigarettes model:

$$\begin{aligned} \nabla \ln(\text{Consumption}_{it}) &= \beta_1 \nabla \ln(\text{Price}_{it}) + \beta_2 \nabla \ln(\text{Income}_{it}) + e_{it}, \\ \text{with } e_{it} &= \sum_{l=1}^d \lambda_{il} f_{lt} + \epsilon_{it}, \end{aligned}$$

where  $\nabla x_t = x_t - x_{t-1}$ . In order to avoid notational mess, we use the same notation for the unobserved time-varying individual effects  $v_{it} = \sum_{l=1}^d \lambda_{il} f_{lt}$  as above in (20). The  $\nabla$ -transformation can be easily performed in R using the standard `diff()`-function as follows:

```
R> d.l.Consumption <- diff(l.Consumption)
R> d.l.Price <- diff(l.Price)
R> d.l.Income <- diff(l.Income)
```

As previously mentioned for the `KSS()`-function, the `formula` argument of the `Eup()`-function takes balanced panel variables as  $T \times n$  dimensional matrices, where the number of rows has to be equal to the temporal dimension  $T$  and the number of columns has to be equal to the individual dimension  $n$ .

```
R> (Cigar.Eup <- Eup(d.l.Consumption ~ -1 + d.l.Price + d.l.Income,
+                   dim.criterion = "PC3"))
```

Call:

```
Eup.default(formula = d.l.Consumption ~ -1 + d.l.Price + d.l.Income,
             dim.criterion = "PC3")
```

Coeff(s) of the Observed Regressor(s) :

```
      d.l.Price d.l.Income
-0.3171044  0.1838808
```

Additive Effects Type: none

Dimension of the Unobserved Factors: 7

Number of iterations: 115

Inferences about the slope parameters can be obtained by using the method `summary()`.

```
R> summary(Cigar.Eup)
```

Call:

```
Eup.default(formula = d.l.Consumption ~ -1 + d.l.Price + d.l.Income,
             dim.criterion = "PC3")
```

Residuals:

	Min	1Q	Median	3Q	Max
	-0.09340	-0.01170	0.00063	0.01260	0.07690

Slope-Coefficients:

	Estimate	Std.Err	Z value	Pr(>z)
d.l.Price	-0.3170	0.0237	-13.40	< 2.2e-16 ***
d.l.Income	0.1840	0.0372	4.95	7.48e-07 ***

---

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

Additive Effects Type: none

Dimension of the Unobserved Factors: 7

Residual standard error: 0.0006995 on 807 degrees of freedom,  
R-squared: 0.78

The summary output reports that "PC3" detects 7 common factors. The effect of the log-real prices for cigarettes on the log-sales is negative and amounts to  $-0.317104$ . The estimated effect of the real disposable log-income per capita is  $0.183882$ , which is smaller than the effect estimated by the method of [Kneip et al. \(2012\)](#).

The estimated factors  $\hat{f}_{tl}$  as well as the individual effects  $\hat{v}_{it}$  can be plotted using the `plot()`-method for `summary.Eup`-objects. The corresponding graphics are shown in Figure 4.

```
R> plot(summary(Cigar.Eup))
```

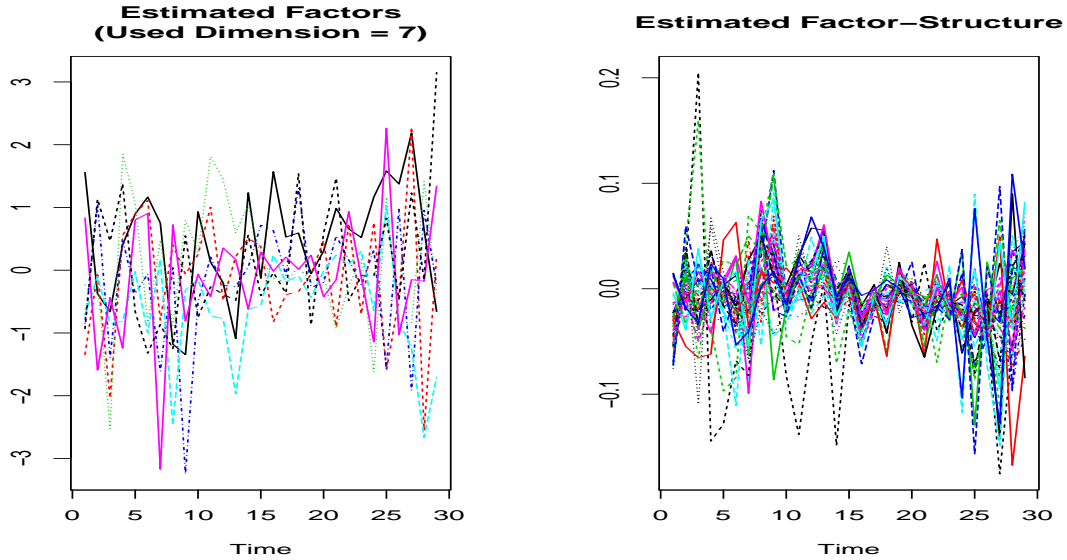


Figure 4: LEFT PANEL: Estimated factors  $\hat{f}_{1t}, \dots, \hat{f}_{7t}$ . RIGHT PANEL: Estimated time-varying individual effects  $\hat{v}_{1t}, \dots, \hat{v}_{nt}$ .

## 5. Models with additive and interactive unobserved effects

Even though the classical additive "individual", "time", and "twoways" effects can be absorbed by the factor structure, there are good reasons to model them explicitly. On the one hand, if there are such effects in the true model, then neglecting them will result in non-efficient estimators; see [Bai et al. \(2009\)](#). On the other hand, additive effects can be very useful for interpretation purposes.

Consider now the following model:

$$y_{it} = \mu + \alpha_i + \theta_t + x_{it}^\top \beta + \nu_{it} + \epsilon_{it} \quad (46)$$

with

$$\nu_{it} = \begin{cases} v_{it} &= \sum_{l=1}^d \lambda_{il} f_{lt}, & \text{for the model of Bai (2009),} \\ v_i(t) &= \sum_{l=1}^d \lambda_{il} f_l(t), & \text{for the model of Kneip et al. (2012),} \end{cases}$$

where  $\alpha_i$  are time-constant individual effects and  $\theta_t$  is a common time-varying effect.

In order to ensure identification of the additional additive effects  $\alpha_i$  and  $\theta_t$ , we need the following further restrictions:

$$(d) \sum_{i=1}^n \lambda_{il} = 0 \quad \text{for all } l \in \{1, \dots, d\}$$

$$(e) \sum_{t=1}^T f_{lt} = 0 \quad \text{for all } l \in \{1, \dots, d\}$$

$$(f) \sum_{i=1}^n \alpha_i = 0$$

$$(g) \sum_{t=1}^T \theta_t = 0$$

By using the classical within-transformations on the observed variables, we can eliminate the additive effects  $\alpha_i$  and  $\theta_t$ , such that

$$\dot{y}_{it} = \dot{x}_{it}^\top \beta + \nu_{it} + \dot{\epsilon}_{it},$$

where  $\dot{y}_{it} = y_{it} - \frac{1}{T} \sum_{t=1}^T y_{it} - \frac{1}{n} \sum_{i=1}^n y_{it} + \frac{1}{nT} \sum_{t=1}^T \sum_{i=1}^n y_{it}$ ,  $\dot{x}_{it} = x_{it} - \frac{1}{T} \sum_{t=1}^T x_{it} - \frac{1}{n} \sum_{i=1}^n x_{it} + \frac{1}{nT} \sum_{t=1}^T \sum_{i=1}^n x_{it}$ , and  $\dot{\epsilon}_{it} = \epsilon_{it} - \frac{1}{T} \sum_{t=1}^T \epsilon_{it} - \frac{1}{n} \sum_{i=1}^n \epsilon_{it} + \frac{1}{nT} \sum_{t=1}^T \sum_{i=1}^n \epsilon_{it}$ . Note that restrictions (d) and (e) insure that the transformation does not affect the time-varying individual effects  $\nu_{it}$ .

The parameters  $\beta$  and  $\nu_{it}$  can be estimated by the above introduced estimation procedures. All possible variants of (46) are implemented in the functions `KSS()` and `Eup()`. The appropriate model can be specified by the argument `additive.effects = c("none", "individual", "time", "twoways")`:

<b>"none"</b>	$y_{it} = \mu + x_{it}^\top \beta + \nu_{it} + \epsilon_{it}$
<b>"individual"</b>	$y_{it} = \mu + \alpha_i + x_{it}^\top \beta + \nu_{it} + \epsilon_{it}$
<b>"time"</b>	$y_{it} = \mu + \theta_t + x_{it}^\top \beta + \nu_{it} + \epsilon_{it}$
<b>"twoways"</b>	$y_{it} = \mu + \alpha_i + \theta_t + x_{it}^\top \beta + \nu_{it} + \epsilon_{it}$

The presence of  $\mu$  can be controlled by `-1` in the `formula`-object: a formula with `-1` refers to a model without intercept. However, for identification purposes, if a `twoways` model is specified, the presence `-1` in the `formula` will be ignored.

As an illustration we continue with the application of the `KSS()`-function in Section 2. The left panel of Figure 2 shows that one of the six estimated factors is nearly time-invariant. This motivates us to augment the model (20) for a time-constant additive effects  $\alpha_i$ . In this case it is convenient to use an intercept  $\mu$ , which yields the following model:

$$\ln(\text{Consumption}_{it}) = \mu + \beta_1 \ln(\text{Price}_{it}) + \beta_2 \ln(\text{Income}_{it}) + \alpha_i + v_i(t) + \varepsilon_{it}, \quad (47)$$

$$\text{where } v_i(t) = \sum_{l=1}^d \lambda_{il} f_l(t).$$

The estimation of the augmented model (47) can be done using the following lines of code.

```
R> Cigar2.KSS <- KSS(formula = l.Consumption ~ l.Price + l.Income,
+                   additive.effects = "individual")
R> (Cigar2.KSS.summary <- summary(Cigar2.KSS))
```

Call:

```
KSS.default(formula = l.Consumption ~ l.Price + l.Income, additive.effects = "individual")
```

Residuals:

Min	1Q	Median	3Q	Max
-0.11	-0.01	0.00	0.01	0.12

Slope-Coefficients:

	Estimate	StdErr	z.value	Pr(>z)
(Intercept)	4.0500	0.1760	23.10	< 2.2e-16 ***
l.Price	-0.2600	0.0222	-11.70	< 2.2e-16 ***
l.Income	0.1570	0.0381	4.11	3.88e-05 ***

---

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

Additive Effects Type: individual

Used Dimension of the Unobserved Factors: 5

Residual standard error: 0.000734 on 951 degrees of freedom

R-squared: 0.99

Again, the `plot()` method provides an useful visualization of the results.

```
R> plot(Cigar2.KSS.summary)
```

The "individual"-transformation of the data does not affect the estimation of the slope parameters but reduces the estimated dimension from  $\hat{d} = 6$  to  $\hat{d} = 5$ . The remaining five common factors  $\hat{f}_1, \dots, \hat{f}_5$  correspond to those of model (20); see the middle panel of Figure 5. The estimated time-constant state-specific effects  $\alpha_i$  are shown in the left plot of Figure 5. The extraction of the  $\alpha_i$ 's from the factor structure yields a denser set of time-varying individual effects  $\hat{v}_i$  shown in the right panel of Figure 5.

### 5.1. Specification tests

Model specification is an important step for any empirical analysis. The **phtt** package is equipped with two types of specification tests: the first is a Hausman-type test appropriate for the model of Bai *et al.* (2009); see Section 5.1.1. The second one examines the existence of a factor structure in Bai's model as well as in the model of Kneip *et al.* (2012); see Section 5.1.2.

*Testing the sufficiency of classical additive effects*



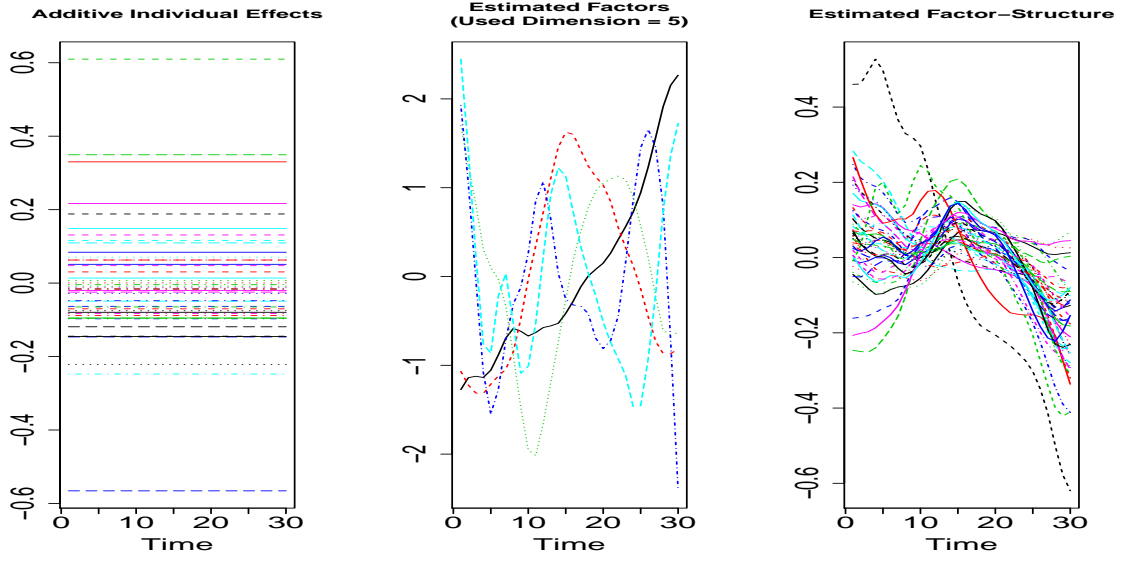


Figure 5: LEFT PANEL: Estimated time-constant state-specific effects  $\hat{\alpha}_1, \dots, \hat{\alpha}_n$ . MIDDLE PANEL: Estimated common factors  $\hat{f}_1(t), \dots, \hat{f}_5(t)$ . RIGHT PANEL: Estimated time-varying individual effects  $\hat{v}_1(t), \dots, \hat{v}_n(t)$ .

For the case in which there are only one or two factors ( $1 \leq d \leq 2$ ), it is interesting to check whether or not these factors can be interpreted as classical "individual", "time", or "twoways" effects. Bai *et al.* (2009) considers the following testing problem:

$$\begin{aligned} H_0: & \quad v_{it} = \alpha_i + \theta_t \\ H_1: & \quad v_{it} = \sum_{l=1}^2 \lambda_{il} f_{lt} \end{aligned}$$

The model with factor structure, as described in Section 4, is consistent under both hypotheses. However, it is less efficient under  $H_0$  than the classical within estimator, while the latter is inconsistent under  $H_1$  if  $x_{it}$  and  $v_{it}$  are correlated. These conditions are favorable for applying the Hausman test:

$$J_{Bai} = nT \left( \hat{\beta} - \hat{\beta}_{within} \right) \Delta^{-1} \left( \hat{\beta} - \hat{\beta}_{within} \right)^a \approx \chi_P^2, \quad (48)$$

where  $\hat{\beta}_{within}$  is the classical within least squares estimator,  $\Delta = Var \left( \hat{\beta} - \hat{\beta}_{within} \right)$ ,  $P$  is the vector-dimension of  $\beta$ , and  $\chi_P^2$  is the  $\chi^2$ -distribution with  $P$  degree of freedom.

The null hypothesis  $H_0$  can be rejected, if  $J_{Bai} > \chi_{P,1-\alpha}^2$ , where  $\chi_{P,1-\alpha}^2$  is the  $(1-\alpha)$ -quantile of the  $\chi^2$  distribution with  $P$  degrees of freedom.

To calculate  $J_{Bai}$  we can replace  $\Delta$  by its consistent estimator

$$\hat{\Delta} = \left( \left( \frac{1}{nT} \sum_{i=1}^n Z_i^\top Z_i \right)^{-1} - \left( \frac{1}{nT} \sum_{i=1}^n \sum_{t=1}^T \dot{x}_i^\top \dot{x}_i \right)^{-1} \right) \hat{\sigma}^2, \quad (49)$$

where

$$\hat{\sigma}^2 = \frac{1}{nT - (n+T)\hat{d} - P + 1} \sum_{i=1}^n \sum_{t=1}^T (y_{it} - x_{it}^\top \hat{\beta} - \sum_{l=1}^{\hat{d}} \hat{\lambda}_{il} \hat{f}_{lt})^2. \quad (50)$$

The test is implemented in the function `checkSpecif()`, which takes the following arguments:

```
R> checkSpecif(obj1, obj2, level = 0.05)
```

The arguments `obj1` and `obj2` take both objects of class `Eup` produced by the function `Eup()`:

`obj1` Takes an `Eup`-object from an estimation with "individual", "time", or "twoways" effects and a factor dimension equal to  $d = 0$ ; specified as `factor.dim = 0`.

`obj2` Takes an `Eup`-object from an estimation with "none"-effects and a positive factor dimension  $1 \leq d \leq 2$ :

`factor.dim=1` for testing "individual" or "time" effects.

`factor.dim=2` for testing "twoways" effects.

The argument `level` is used to specify the significance level.

However, the Hausman test of [Bai et al. \(2009\)](#) has a clear disadvantage. It is applicable only in situations of one or two factors ( $1 \leq d \leq 2$ ). This is, e.g., not fulfilled in our demonstrations using the `Cigar` dataset, where the estimated factor dimension  $\hat{d}$  lies between six and seven; see Figures 2 and 4. The problem is that in such cases the matrix  $\hat{\Delta}$  in (49) can become negative definite, which would yield a negative test statistic  $J_{Bai}$  in (48). If the test is applied in such situations, an error message is printed:

```
R> twoways.obj      <- Eup(d.l.Consumption ~ -1 + d.l.Price + d.l.Income,
+                          factor.dim = 0, additive.effects = "twoways")
R> not.twoways.obj <- Eup(d.l.Consumption ~ -1 + d.l.Price + d.l.Income,
+                          factor.dim = 2, additive.effects = "none")
R> checkSpecif(obj1 = twoways.obj, obj2 = not.twoways.obj, level = 0.01)
```

```
Error in checkSpecif(obj1 = twoways.obj, obj2 = not.twoways.obj, level = 0.01) :
```

```
The assumptions of the test are not fulfilled.
```

```
The (unobserved) true number of factors is probably greater than 2.
```

An alternative test for the sufficiency of a classical additive effects model is given by the following test proposed by [Kneip et al. \(2012\)](#). This test can be applied for arbitrary factor dimensions  $d$ .

### *Testing the existence of common factors*

This section is concerned with testing the existence of common factors. In contrast to the Hausman type statistic discussed above, the goal of this test is not merely to decide which model specification is more appropriate for the data, but rather to test in general the existence of common factors beyond the eventual presence of additional classical "individual", "time", or "twoways" effects in the model.

This test relies on using the dimensionality criterion proposed by [Kneip et al. \(2012\)](#) to test the following hypothesis after eliminating eventual additive "individual", "time", or "twoways" effects:

$$H_0: d = 0$$

$$H_1: d > 0$$

Under  $H_0$  the slope parameters  $\beta$  can be estimated by the classical within estimation method. In this simple case, the dimensionality test of Kneip *et al.* (2012) can be reduced to the following test statistic:

$$J_{KSS} = \frac{n \operatorname{tr}(\hat{\Sigma}_w) - (n-1)(T-1)\hat{\sigma}^2}{\sqrt{2n(T-1)\hat{\sigma}^2}} \stackrel{a}{\sim} N(0,1),$$

where  $\hat{\Sigma}_w$  is the covariance matrix of the within residuals. The reason for this simplification is that under  $H_0$  there is no need for smoothing, which allows us to set  $\kappa = 0$ .

We reject  $H_0: d = 0$  at a significance level  $\alpha$  if  $J_{KSS} > z_{1-\alpha}$ , where  $z_{1-\alpha}$  is the  $(1-\alpha)$ -quantile of the standard normal distribution. It is important to note that the performance of the test depends heavily on the accuracy of the variance estimator  $\hat{\sigma}^2$ . We propose to use the variance estimators (16) or (50), which are consistent under both hypotheses as long as  $\hat{d}$  is greater than the unknown dimension  $d$ . Internally, the test procedure sets  $\hat{d} = \mathbf{d.max}$ .

This test can be performed for Eup- as well as for KSS-objects by using the function `checkSpecif()` leaving the second argument `obj2` unspecified. In the following we apply the test for both models:

```
R> Eup.obj <- Eup(d.l.Consumption ~ -1 + d.l.Price + d.l.Income,
+               additive.effects = "twoways")
R> checkSpecif(Eup.obj, level = 0.01)
```

```
-----
Testing the Presence of Interactive Effects
Test of Kneip, Sickles, and Song (2012)
-----
```

H0: The factor dimension is equal to 0.

Test-Statistic	p-value	crit.-value	sig.-level
13.29	0.00	2.33	0.01

```
R> KSS.obj <- KSS(l.Consumption ~ -1 + l.Price + l.Income,
+               additive.effects = "twoways")
R> checkSpecif(KSS.obj, level = 0.01)
```

```
-----
Testing the Presence of Interactive Effects
Test of Kneip, Sickles, and Song (2012)
-----
```

H0: The factor dimension is equal to 0.

Test-Statistic	p-value	crit.-value	sig.-level
104229.55	0.00	2.33	0.01

The null hypothesis  $H_0: d = 0$  can be rejected for both models at a significance level  $\alpha = 0.01$ .

## 6. Interpretation

This section is intended to outline an exemplary interpretation of the panel model (47), which is estimated by the function `KSS()` in Section 5. The interpretation of models estimated by the function `Eup()` can be done accordingly. For convenience sake we re-write the model (47) in the following:

$$\begin{aligned} \ln(\text{Consumption}_{it}) &= \mu + \beta_1 \ln(\text{Price}_{it}) + \beta_2 \ln(\text{Income}_{it}) + \alpha_i + v_i(t) + \varepsilon_{it}, \\ \text{where } v_i(t) &= \sum_{l=1}^d \lambda_{il} f_l(t). \end{aligned}$$

A researcher, who chooses the panel models proposed by Kneip *et al.* (2012) or Bai (2009) will probably find them attractive due to their ability to control for very general forms of unobserved heterogeneity. Beyond this a further great advantage of these models is that the time-varying individual effects  $v_i(t)$  provide a valuable source of information about the *differences* between the individuals  $i$ . These differences are often of particular interest as, e.g., in the literature on stochastic frontier analysis.

The left panel of Figure 5 shows that the different states  $i$  have considerable different time-constant levels  $\hat{\alpha}_i$  of cigarette consumption. A classical further econometric analysis could be to regress the additive individual effects  $\hat{\alpha}_i$  on other time-constant variables, such as the general populations compositions, the cigarette taxes, etc.

The right panel of Figure 5 shows the five estimated common factors  $\hat{f}_1(t), \dots, \hat{f}_5(t)$ . It is a good practice to start the interpretation of the single common factors with an overview about their importance in describing the differences between the  $v_i(t)$ 's, which is reflected in the variances of the individual loadings parameters  $\hat{\lambda}_{il}$ . A convenient depiction is the quantity of variance-shares of the individual loadings parameters on the total variance of the loadings parameters

$$\text{coef}(\text{Cigar2.KSS})\$Var.\text{shares.of.loadings.param}[l] = V(\hat{\lambda}_{il}) / \sum_{k=1}^d V(\lambda_{ik}),$$

which is shown for all common functions  $\hat{f}_1(t), \dots, \hat{f}_5(t)$  in the following table:

Common Factor	Share of total variance of $v_i(t)$
$\hat{f}_1(t)$	<code>coef(Cigar2.KSS)\$Var.shares.of.loadings.param[1]</code> = 66.32%
$\hat{f}_2(t)$	<code>coef(Cigar2.KSS)\$Var.shares.of.loadings.param[2]</code> = 24.28%
$\hat{f}_3(t)$	<code>coef(Cigar2.KSS)\$Var.shares.of.loadings.param[3]</code> = 5.98%
$\hat{f}_4(t)$	<code>coef(Cigar2.KSS)\$Var.shares.of.loadings.param[4]</code> = 1.92%
$\hat{f}_5(t)$	<code>coef(Cigar2.KSS)\$Var.shares.of.loadings.param[5]</code> = 1.50%

Table 1: List of the variance shares of the common factors  $\hat{f}_1(t), \dots, \hat{f}_5(t)$ .

The values in Table 1 suggest to focus on the first two common factors, which explain together about 90% of the total variance of the time-varying individual effects  $\hat{v}_i(t)$ .

The first two common factors

$$\begin{aligned} \text{coef}(\text{Cigar2.KSS})\$Common.factors[,1] &= \hat{f}_1(t) \quad \text{and} \\ \text{coef}(\text{Cigar2.KSS})\$Common.factors[,2] &= \hat{f}_2(t) \end{aligned}$$

are plotted as black solid and red dashed lines in the middle panel of Figure 5. Figure 6 visualizes the differences of the time-varying individual effects  $v_i(t)$  in the direction of the first common factor (i.e:  $\hat{\lambda}_{i1}\hat{f}_1(t)$ ) and in the direction of the second common factor (i.e:  $\hat{\lambda}_{i2}\hat{f}_2(t)$ ). As for the time-constant individual effects  $\hat{\alpha}_i$  a further econometric analysis could be to regress the individual loadings parameters  $\hat{\lambda}_{i1}$  and  $\hat{\lambda}_{i2}$  on other explanatory time-constant variables.

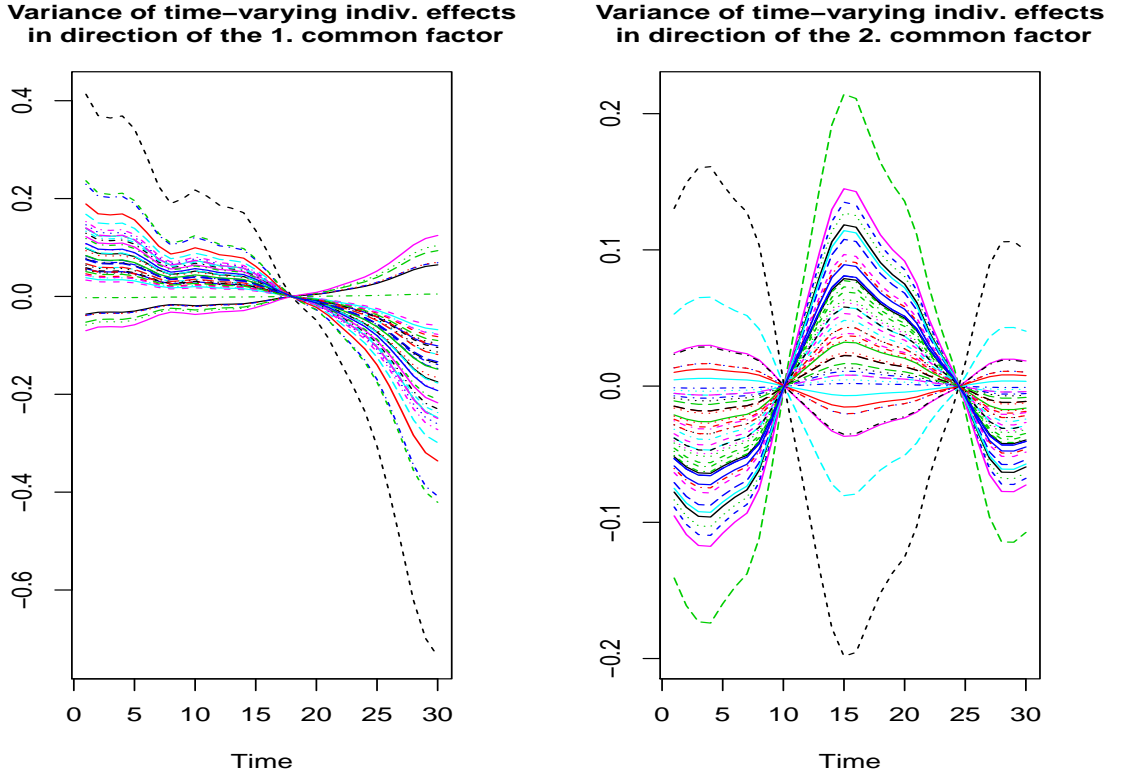


Figure 6: LEFT PANEL: Visualization of the differences of the time-varying individual effects  $v_i(t)$  in the direction of the first factor  $\hat{f}_1(t)$  (i.e:  $\hat{\lambda}_{i1}\hat{f}_1(t)$ ). RIGHT PANEL: Visualization of the differences of the time-varying individual effects  $v_i(t)$  in the direction of the second factor  $\hat{f}_2(t)$  (i.e:  $\hat{\lambda}_{i2}\hat{f}_2(t)$ ).

Generally, for both models proposed by Kneip *et al.* (2012) and Bai (2009) the time-varying individual effects

$$\nu_{it} = \sum_{l=1}^d \lambda_{il} f_{lt}$$

can be interpreted as it is usually done in the literature on factor models. An important topic that is not covered in this section is the rotation of the common factors. Often, the common factors  $f_l$  can be interpreted economically only after the application of an appropriate rotation scheme for the set of factors  $\hat{f}_1, \dots, \hat{f}_{\hat{d}}$ . The latter can be done, e.g., using

the function `varimax()` from the **stats** package. Sometimes it is also preferable to standardize the individual loadings parameters instead of the common factors as it is done, e.g., in [Ahn, Hoon Lee, and Schmidt \(2001\)](#). This can be done by choosing `restrict.mode = c("restrict.loadings")` in the functions `KSS()` and `Eup()` respectively.

## 7. Summary

This paper introduces the R package **phtt** for the new class of panel models proposed by [Bai \(2009\)](#) and [Kneip \*et al.\* \(2012\)](#). The two main functions of the package are the `Eup()`-function for the estimation procedure proposed in [Bai \(2009\)](#) and the `KSS()`-function for the estimation procedure proposed in [Kneip \*et al.\* \(2012\)](#). Both of the main functions are supported by several print, summary, and plot methods. While parts of the method of [Bai \(2009\)](#) are available for commercially available software packages, the estimation procedure proposed by [Kneip \*et al.\* \(2012\)](#) is not available elsewhere. A further remarkable feature of our **phtt** package is the `OptDim()`-function, which provides an ease access to many different dimensionality criteria proposed in the literature on factor models. The usage of the functions is demonstrated in several real data applications.

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### Affiliation:

Oualid Bada and Dominik Liebl  
 Statistische Abteilung  
 University of Bonn  
 Adenauerallee 24-26  
 53113 Bonn, Germany  
 E-mail: [bada@uni-bonn.de](mailto:bada@uni-bonn.de)  
 E-mail: [dliebl@uni-bonn.de](mailto:dliebl@uni-bonn.de)