

# Error-correction–based cointegration tests for panel data

Damiaan Persyn  
LICOS  
Katholieke Universiteit Leuven  
Leuven, Belgium  
damiaan.persyn@econ.kuleuven.be

Joakim Westerlund  
Department of Economics  
Lund University  
Lund, Sweden

**Abstract.** This article describes a new Stata command called `xtwest`, which implements the four error-correction–based panel cointegration tests developed by [Westerlund \(2007\)](#). The tests are general enough to allow for a large degree of heterogeneity, both in the long-run cointegrating relationship and in the short-run dynamics, and dependence within as well as across the cross-sectional units.

**Keywords:** `st0146`, `xtwest`, panel cointegration test, common-factor restriction, cross-sectional dependence, health-care expenditures

## 1 Introduction

The use of panel cointegration techniques to test for the presence of long-run relationships among integrated variables with both a time-series dimension,  $T$ , and a cross-sectional dimension,  $N$ , has received much attention recently, especially in the empirical literature. One of the most important reasons for this attention is the increased power that may be gained by accounting not only for the time-series dimension but also for the cross-sectional dimension. In spite of this, many studies fail to reject the no-cointegration null, even in cases where cointegration is strongly suggested by theory.

One explanation for this failure to reject centers on the fact that most residual-based cointegration tests, both in pure time series and in panels, require that the long-run parameters for the variables in their levels are equal to the short-run parameters for the variables in their differences. [Banerjee, Dolado, and Mestre \(1998\)](#) and [Kremers, Ericsson, and Dolado \(1992\)](#) refer to this as a common-factor restriction and show that its failure can cause a significant loss of power for residual-based cointegration tests.

As a response to this, [Westerlund \(2007\)](#) developed four new panel cointegration tests that are based on structural rather than residual dynamics and, therefore, do not impose any common-factor restriction. The idea is to test the null hypothesis of no cointegration by inferring whether the error-correction term in a conditional panel error-correction model is equal to zero. The new tests are all normally distributed and are general enough to accommodate unit-specific short-run dynamics, unit-specific trend and slope parameters, and cross-sectional dependence. Two tests are designed to test

the alternative hypothesis that the panel is cointegrated as a whole, while the other two test the alternative that at least one unit is cointegrated.

In this paper, we develop a new Stata command, called `xtwest`, that implements these tests.

## 2 The error-correction tests

The error-correction tests assume the following data-generating process:

$$\Delta y_{it} = \delta'_i d_t + \alpha_i(y_{i,t-1} - \beta'_i x_{i,t-1}) + \sum_{j=1}^{p_i} \alpha_{ij} \Delta y_{i,t-j} + \sum_{j=-q_i}^{p_i} \gamma_{ij} \Delta x_{i,t-j} + e_{it} \quad (1)$$

where  $t = 1, \dots, T$  and  $i = 1, \dots, N$  index the time-series and cross-sectional units, respectively, while  $d_t$  contains the deterministic components, for which there are three cases. In the first case,  $d_t = 0$  so (1) has no deterministic terms; in the second case,  $d_t = 1$  so  $\Delta y_{it}$  is generated with a constant; and in the third case,  $d_t = (1, t)'$  so  $\Delta y_{it}$  is generated with both a constant and a trend. For simplicity, we model the  $K$ -dimensional vector  $x_{it}$  as a pure random walk such that  $\Delta x_{it}$  is independent of  $e_{it}$ , and we further assume that these errors are independent across both  $i$  and  $t$ .<sup>1</sup> We will handle any dependence across  $i$  by means of bootstrap methods.

We can write (1) as

$$\Delta y_{it} = \delta'_i d_t + \alpha_i y_{i,t-1} + \lambda'_i x_{i,t-1} + \sum_{j=1}^{p_i} \alpha_{ij} \Delta y_{i,t-j} + \sum_{j=-q_i}^{p_i} \gamma_{ij} \Delta x_{i,t-j} + e_{it} \quad (2)$$

where  $\lambda'_i = -\alpha_i \beta'_i$ . The parameter  $\alpha_i$  determines the speed at which the system corrects back to the equilibrium relationship  $y_{i,t-1} - \beta'_i x_{i,t-1}$  after a sudden shock. If  $\alpha_i < 0$ , then there is error correction, which implies that  $y_{it}$  and  $x_{it}$  are cointegrated; if  $\alpha_i = 0$ , then there is no error correction and, thus, no cointegration. Thus we can state the null hypothesis of no cointegration as  $H_0: \alpha_i = 0$  for all  $i$ . The alternative hypothesis depends on what is being assumed about the homogeneity of  $\alpha_i$ . Two of the tests, called group-mean tests, do not require the  $\alpha_i$ s to be equal, which means that  $H_0$  is tested versus  $H_1^g: \alpha_i < 0$  for at least one  $i$ . The second pair of tests, called panel tests, assume that  $\alpha_i$  is equal for all  $i$  and are, therefore, designed to test  $H_0$  versus  $H_1^p: \alpha_i = \alpha < 0$  for all  $i$ .

### 2.1 Computing the group-mean tests

We can construct the group-mean tests in three steps. The first step is to estimate (2) by least squares for each unit  $i$ , which yields

$$\Delta y_{it} = \hat{\delta}'_i d_t + \hat{\alpha}_i y_{i,t-1} + \hat{\lambda}'_i x_{i,t-1} + \sum_{j=1}^{p_i} \hat{\alpha}_{ij} \Delta y_{i,t-j} + \sum_{j=-q_i}^{p_i} \hat{\gamma}_{ij} \Delta x_{i,t-j} + \hat{e}_{it} \quad (3)$$

1. As usual, we also require that  $x_{it}$  is not cointegrated, in case we have multiple regressors.

where the lag and lead orders,  $p_i$  and  $q_i$ , are permitted to vary across individuals and can be determined preferably by using a data-dependent rule.<sup>2</sup>

Having obtained  $\hat{e}_{it}$  and  $\hat{\gamma}_{ij}$ , the second step is to compute

$$\hat{u}_{it} = \sum_{j=-q_i}^{p_i} \hat{\gamma}_{ij} \Delta x_{i,t-j} + \hat{e}_{it}$$

which we then use to obtain  $\hat{\alpha}_i(1) = \hat{\omega}_{ui}/\hat{\omega}_{yi}$ , where  $\hat{\omega}_{ui}$  and  $\hat{\omega}_{yi}$  are the usual Newey and West (1994) long-run variance estimators based on  $\hat{u}_{it}$  and  $\Delta y_{it}$ , respectively.<sup>3</sup>

The third step is to compute the group-mean tests in the following way:

$$G_\tau = \frac{1}{N} \sum_{i=1}^N \frac{\hat{\alpha}_i}{\text{SE}(\hat{\alpha}_i)}, \quad G_\alpha = \frac{1}{N} \sum_{i=1}^N \frac{T \hat{\alpha}_i}{\hat{\alpha}_i(1)}$$

where  $\text{SE}(\hat{\alpha}_i)$  is the conventional standard error of  $\hat{\alpha}_i$ .

## 2.2 Computing the panel tests

We can also compute the panel tests in three steps. The first step is the same as for the group-mean tests and involves regressing  $\Delta y_{it}$  and  $y_{i,t-1}$  onto  $d_t$ , the lags of  $\Delta y_{it}$ , and the contemporaneous and lagged values of  $\Delta x_{it}$ . This yields the projection errors

$$\Delta \tilde{y}_{it} = \Delta y_{it} - \hat{\delta}'_i d_t - \hat{\lambda}'_i x_{i,t-1} - \sum_{j=1}^{p_i} \hat{\alpha}_{ij} \Delta y_{i,t-j} - \sum_{j=-q_i}^{p_i} \hat{\gamma}_{ij} \Delta x_{i,t-j}$$

and

$$\tilde{y}_{i,t-1} = y_{i,t-1} - \tilde{\delta}'_i d_t - \tilde{\lambda}'_i x_{i,t-1} - \sum_{j=1}^{p_i} \tilde{\alpha}_{ij} \Delta y_{i,t-j} - \sum_{j=-q_i}^{p_i} \tilde{\gamma}_{ij} \Delta x_{i,t-j}$$

The second step is to make use of  $\Delta \tilde{y}_{it}$  and  $\tilde{y}_{i,t-1}$  in estimating the common error-correction parameter,  $\alpha$ , and its standard error. In particular, we compute

$$\hat{\alpha} = \left( \sum_{i=1}^N \sum_{t=2}^T \tilde{y}_{i,t-1}^2 \right)^{-1} \sum_{i=1}^N \sum_{t=2}^T \frac{1}{\hat{\alpha}_i(1)} \tilde{y}_{i,t-1} \Delta \tilde{y}_{it}$$

The standard error of  $\hat{\alpha}$  is

$$\text{SE}(\hat{\alpha}) = \left( (\hat{S}_N^2)^{-1} \sum_{i=1}^N \sum_{t=2}^T \tilde{y}_{i,t-1}^2 \right)^{-1/2}$$

- 
2. By adding leads and not just lags of  $\Delta x_{it}$ , we can allow for regressors that are weakly but not necessarily strictly exogenous.
  3. This estimation procedure does not account for any deterministic terms. To correct for this,  $\Delta y_{it}$  in  $\omega_{yi}^2$  has to be replaced by the fitted residuals from a first-stage regression of  $\Delta y_{it}$  onto  $d_t$ .

where  $\hat{S}_N^2 = 1/N \sum_{i=1}^N \hat{\sigma}_i / \hat{\alpha}_i(1)$ , with  $\hat{\sigma}_i$  being the estimated regression standard error in (3).

The third step is to compute the panel statistics as

$$P_\tau = \frac{\hat{\alpha}}{\text{SE}(\hat{\alpha})}, \quad P_\alpha = T\hat{\alpha}$$

### 2.3 Asymptotic test distribution

The asymptotic distribution of the error-correction tests is based on the sequential-limit theory, in which  $T$  is taken to infinity before  $N$  is. This implies that the tests may be justified in cases where  $T$  is substantially larger than  $N$ .

Let us define

$$C_i = \left( \int_0^1 U_i^2, \int_0^1 U_i dV_i \right)', \quad \tilde{C}_i = \left( \frac{\int_0^1 U_i dV_i}{\int_0^1 U_i^2}, \frac{\int_0^1 U_i dV_i}{(\int_0^1 U_i^2)^{1/2}} \right)'$$

where

$$U_i = V_i - \left( \int_0^1 V_i (W_i^d)' \right) \left( \int_0^1 W_i^d (W_i^d)' \right)^{-1} W_i^d$$

where  $W_i^d = (d', W_i')'$ ,  $d$  is the limiting trend function, and  $V_i$  and  $W_i$  are scalar and  $K$ -dimensional standard Brownian motions that are independent of each other.<sup>4</sup> Let  $\Theta$  and  $\tilde{\Theta}$  denote the mean values of  $C_i$  and  $\tilde{C}_i$ , respectively, and let  $\Sigma$  and  $\tilde{\Sigma}$  denote their respective variances. Under the assumptions laid out above and the null hypothesis  $H_0$ , as  $T \rightarrow \infty$  and then  $N \rightarrow \infty$ , sequentially,

$$H_j - \sqrt{N}(\Theta_j^H) \Rightarrow N(0, \Sigma_j^H) \quad (4)$$

where  $H = (\sqrt{N}G_\alpha, \sqrt{N}G_\tau, \sqrt{N}P_\alpha, P_\tau)$  is the vector of tests, while

$$\Theta^H = \left( \tilde{\Theta}_1, \tilde{\Theta}_2, \frac{\Theta_2}{\Theta_1}, \frac{\Theta_2}{\sqrt{\Theta_1}} \right), \quad \Sigma^H = \left( \tilde{\Sigma}_{11}, \tilde{\Sigma}_{22}, \phi' \Sigma \phi, \varphi' \Sigma \varphi \right)$$

with

$$\phi = \left( -\frac{\Theta_2}{\Theta_1^2}, \frac{1}{\Theta_1} \right)', \quad \varphi = \left( -\frac{\Theta_2}{2\Theta_1^{3/2}}, \frac{1}{\sqrt{\Theta_1}} \right)'$$

as the associated mean and variance vectors. In other words, to test the null hypothesis of no cointegration based on the moments in  $\Theta$ ,  $\tilde{\Theta}$ ,  $\Sigma$ , and  $\tilde{\Sigma}$ , we simply compute the value of the normalized test  $H_j$  with  $j = 1, \dots, 4$  so that it is in the form specified in (4). This value is then compared with the left tail of the normal distribution. Large negative values imply that the null hypothesis should be rejected.

4. For notational simplicity, in this paper, the Brownian motions  $V_i(r)$  and  $W_i(r)$  defined on the interval  $r \in [0, 1]$  are written  $V_i$  and  $W_i$ , respectively, with the measure of integration omitted.

## 2.4 Cross-sectional dependence

We can generalize the results of the previous sections to account for cross-sectional dependence by using the bootstrap approach of [Westerlund \(2007\)](#). The method resembles that used by [Chang \(2004\)](#) and proceeds as follows.

The first step is to fit the least-squares regression,

$$\Delta y_{it} = \sum_{j=1}^{p_i} \hat{\alpha}_{ij} \Delta y_{i,t-j} + \sum_{j=-q_i}^{p_i} \hat{\gamma}_{ij} \Delta x_{i,t-j} + \hat{e}_{it} \quad (5)$$

and then to form the vector  $\hat{w}_t = (\hat{e}_t', \Delta x_t')'$ , where  $\hat{e}_t$  and  $\Delta x_t$  are vectors of stacked observations on  $\hat{e}_{it}$  and  $\Delta x_{it}$ , respectively. We then generate bootstrap samples  $w_t^* = (e_t^{*'}, \Delta x_t^{*'})'$  by sampling with replacement the centered residual vector,

$$\tilde{w}_t = \hat{w}_t - \frac{1}{T-1} \sum_{j=1}^T \hat{w}_j$$

The next step is to generate the bootstrap sample,  $\Delta y_{it}^*$ . We accomplish this by first constructing the bootstrap version of the composite error,  $u_{it}$ , as

$$u_{it}^* = \sum_{j=-q_i}^{p_i} \hat{\gamma}_{ij} \Delta x_{i,t-j}^* + e_{it}^*$$

where the least-squares estimate  $\hat{\gamma}_{ij}$  is obtained from (5). Given  $p_i$  initial values, we then generate  $\Delta y_{it}^*$  recursively from  $u_{it}^*$  as

$$\Delta y_{it}^* = \sum_{j=1}^{p_i} \hat{\alpha}_{ij} \Delta y_{i,t-j}^* + u_{it}^*$$

where we again obtain  $\hat{\alpha}_{ij}$  from (5). We initiate the recursion by generating excess values of  $\Delta y_{it}^*$ , which we then discard. Because this makes the initiation unimportant, we may simply use zeros.

Finally, we generate  $y_{it}^*$  and  $x_{it}^*$  with the null hypothesis imposed in the following way:

$$y_{it}^* = y_{i0}^* + \sum_{j=1}^t \Delta y_{ij}^*, \quad x_{it}^* = x_{i0}^* + \sum_{j=1}^t \Delta x_{ij}^*$$

which again requires initiation through  $x_{i0}^*$  and  $y_{i0}^*$ . The value zero will do.

Having obtained the bootstrap sample  $y_{it}^*$  and  $x_{it}^*$ , we then obtain the bootstrapped error-correction test of interest. We denote this initial bootstrap test by  $t_1^*$ . If we repeat this procedure, say,  $S$  times, we obtain  $t_1^*, \dots, t_S^*$ , the bootstrap distribution of the test. For a one-sided 5% nominal-level test, we then obtain the lower 5% quantile, say,  $t_C^*$ ,

of this distribution. We reject the null hypothesis if the calculated sample value of the statistic is smaller than  $t_C^*$ .

Simulation results for all tests, including the bootstrapped versions, can be found in [Westerlund \(2007\)](#).

### 3 The xtwest command

#### 3.1 Syntax

```
xtwest depvar indepvars [if] [in], lags(# [ #]) leads(# [ #])
      lrwindow(#) [constant trend bootstrap(#) westerlund noisily]
```

#### 3.2 Options

`lags(# [ #])` specifies the number of lags to be included in the error-correction equations. If one number is specified, it determines a fixed number of lags,  $p$ . If two numbers are specified, the Akaike information criterion (AIC) is used to determine an optimal lag length,  $p_i$ , for each separate time series, within the given limits.

`leads(# [ #])` specifies the number of leads to be included in the error-correction equations; this is similar to the `lags()` option.

`lrwindow(#)` sets the width of the Bartlett kernel window used in the semiparametric estimation of long-run variances.

`constant` adds a constant to the cointegration relationship.

`trend` allows for a deterministic trend in the cointegration relationship.

`bootstrap(#)` shows bootstrapped  $p$ -values for all four test statistics. These are robust in the presence of common factors in the time series. The argument determines the number of bootstrap replications. On Stata/IC, the number of replications must be smaller than 800.

`westerlund` replicates the tables in [Westerlund \(2007\)](#).

`noisily` shows the regressions for the separate series. If a range of lags or leads is given, only the regression chosen by the AIC is shown.

#### 3.3 Empirical application

In this section, we illustrate `xtwest` by analyzing the influence of per capita GDP ( $Y_{it}$ ) on per capita health-care expenditures ( $H_{it}$ ). The data consist of a panel of 20 countries covering the period 1970 to 2001; we obtained the data from the Organisation for Economic Co-operation and Development (OECD) Health Data 2003 database. The dataset must be `tsset` before using it.

```
. use xtwestdata
. tsset ctr year
    panel variable:  ctr (strongly balanced)
    time variable:  year, 1 to 32
                delta:  1 unit
```

The series are in constant 1995 prices and were transformed in logarithms. Before testing for cointegration, we need to make sure all series are integrated of order one. [Westerlund \(2007\)](#) used a series of unit-root tests and found strong evidence that both series are nonstationary. The postulated relationship between both variables allows for a linear time trend:

$$\ln(H_{it}) = \mu_i + \tau_i t + \beta_i \ln(Y_{it}) + e_{it} \quad (6)$$

We then used `xtwest` to test for cointegration, using the AIC to choose optimal lag and lead lengths for each series and with the Bartlett kernel window width set according to  $4(T/100)^{2/9} \approx 3$ . We used the `westerlund` option to replicate table 7 in [Westerlund \(2007\)](#).

```
. xtwest loghex loggdp, lags(1 3) leads(0 3) lrwindow(3) constant trend
> westerlund
Calculating Westerlund ECM panel cointegration tests.....
Results for H0: no cointegration
With 20 series and 1 covariate
Average AIC selected lag length: 2.8
Average AIC selected lead length: 1.65
```

Statistic	Value	Z-value	P-value
Gt	-4.082	-9.613	0.000
Ga	-27.702	-10.625	0.000
Pt	-12.969	-4.100	0.000
Pa	-22.470	-10.119	0.000

These results strongly reject the hypothesis that the series are not cointegrated.

We can use `xttest2` to test for cross-sectional independence in the residuals of (2). This test requires  $T > N$ . As our time series are rather short and some periods are lost in the calculation of differenced variables and lags, we tested only for independence of the first five cross-sectional units. Assuming the same short-run dynamics for all series (with a single lag and lead,  $p_i = q_i = 1$ ), we obtain the test for cross-sectional independence from

```
. xtreg d.loghex l.loghex l.loggdp ld.loghex l(-1/1).d.loggdp year if ctr < 6,
> fe
Fixed-effects (within) regression           Number of obs   =       145
Group variable: ctr                        Number of groups  =        5
R-sq:  within = 0.2794                     Obs per group: min =       29
        between = 0.5713                   avg             =      29.0
        overall = 0.0001                   max             =       29
                                           F(7,133)        =       7.37
corr(u_i, Xb) = -0.9338                   Prob > F         =      0.0000
```

D.loghex	Coef.	Std. Err.	t	P> t	[95% Conf. Interval]	
loghex						
L1.	-.1795043	.0328601	-5.46	0.000	-.2445004	-.1145083
loggdp						
L1.	.259809	.1191883	2.18	0.031	.0240592	.4955589
loghex						
LD.	.2265748	.0754693	3.00	0.003	.0772995	.3758501
loggdp						
FD.	.212405	.1632479	1.30	0.195	-.110493	.535303
D1.	-.1040444	.1645104	-0.63	0.528	-.4294396	.2213508
LD.	-.0926609	.1559727	-0.59	0.553	-.4011689	.2158471
year	-.0001086	.0018836	-0.06	0.954	-.0038344	.0036171
_cons	-1.265542	1.097529	-1.15	0.251	-3.436412	.9053288
sigma_u	.0705568					
sigma_e	.03372511					
rho	.81402076	(fraction of variance due to u_i)				

F test that all u\_i=0:      F(4, 133) =      0.78      Prob > F = 0.5404

```
. xttest2
```

Correlation matrix of residuals:

	__e1	__e2	__e3	__e4	__e5
__e1	1.0000				
__e2	0.3375	1.0000			
__e3	0.2746	0.4876	1.0000		
__e4	0.2152	-0.1169	0.1840	1.0000	
__e5	-0.2982	-0.0639	-0.5378	-0.3252	1.0000

Breusch-Pagan LM test of independence: chi2(10) =      29.259, Pr = 0.0011

Based on 26 complete observations over panel units

As these results strongly indicate the presence of common factors affecting the cross-sectional units, we bootstrapped robust critical values for the test statistics. Because the Akaike optimal lag and lead search is time-consuming when combined with bootstrapping, we held the short-term dynamics fixed.

(Continued on next page)



```
. xtwest loghex loggdp, constant trend lags(1) leads(1) lrwindow(3)
> bootstrap(800)

Bootstrapping critical values under H0.....
Calculating Westerlund ECM panel cointegration tests.....
Results for H0: no cointegration
With 20 series and 1 covariate
```

Statistic	Value	Z-value	P-value	Robust P-value
Gt	-2.681	-1.731	0.042	0.046
Ga	-10.927	0.713	0.762	0.113
Pt	-12.035	-2.959	0.002	0.041
Pa	-10.524	-1.160	0.123	0.060

When we take into account cross-sectional dependencies, the tests still reject the  $H_0$  of no cointegration.

In small datasets (such as in this application with  $T = 32$ ), the results may be sensitive to the specific choice of parameters such as lag and lead lengths and the kernel width. When we restrict the short-run dynamics and use a shorter kernel window, the  $G_\alpha$  statistic no longer rejects the  $H_0$  of no cointegration.

```
. xtwest loghex loggdp, constant trend lags(1 2) leads(0 1) lrwindow(2)
Calculating Westerlund ECM panel cointegration tests.....
Results for H0: no cointegration
With 20 series and 1 covariate
Average AIC selected lag length: 1.15
Average AIC selected lead length: .05
```

Statistic	Value	Z-value	P-value
Gt	-2.736	-2.033	0.021
Ga	-11.254	0.499	0.691
Pt	-12.859	-3.902	0.000
Pa	-11.773	-2.072	0.019

## 4 Summary

This paper proposes a new Stata command for implementing the four panel cointegration tests developed by [Westerlund \(2007\)](#). The underlying idea is to test for the absence of cointegration by determining whether the individual panel members are error-correcting or not. The command, called **xtwest**, is very flexible and allows for an almost completely heterogeneous specification of both the long- and short-run parts of the error-correction model, where the latter can be determined from the data and hence does not require the researcher to make any difficult choices. In order to avoid misleading inference in case of cross-member correlation, **xtwest** also comes with a **bootstrap()** option.

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### About the authors

Damiaan Persyn is a PhD candidate in economics at LICOS, Centre for Institutions and Economic Performance, Katholieke Universiteit Leuven, Belgium.

Joakim Westerlund is an associate professor in the Department of Economics at Lund University, Sweden.