Robust standard errors for panel regressions with cross-sectional dependence

Daniel Hoechle
Department of Finance
University of Basel
Basel, Switzerland
daniel.hoechle@unibas.ch

Abstract. I present a new Stata program, xtscc, that estimates pooled ordinary least-squares/weighted least-squares regression and fixed-effects (within) regression models with Driscoll and Kraay (Review of Economics and Statistics 80: 549–560) standard errors. By running Monte Carlo simulations, I compare the finite-sample properties of the cross-sectional dependence–consistent Driscoll–Kraay estimator with the properties of other, more commonly used covariance matrix estimators that do not account for cross-sectional dependence. The results indicate that Driscoll–Kraay standard errors are well calibrated when cross-sectional dependence is present. However, erroneously ignoring cross-sectional correlation in the estimation of panel models can lead to severely biased statistical results. I illustrate the xtscc program by considering an application from empirical finance. Thereby, I also propose a Hausman-type test for fixed effects that is robust to general forms of cross-sectional and temporal dependence.

Keywords: st0128, xtscc, robust standard errors, nonparametric covariance estimation