

8.5 Two-stage estimation of Heckman's model

Heckman (1974) considered a model of labor supply in which wages and hours worked are the two endogenous variables. The model consists of the shadow-wage equation

$$S = \gamma_0 + \gamma_1 H + \gamma_2 Z + u_1 \quad (8.29)$$

and the market-wage equation

$$W = \beta_0 + \beta_1 X + u_2 \quad (8.30)$$

where X and Z are exogenous variables. Heckman assumed that hours worked H adjust, so that $S=W$. Hence, from equations (8.29) and (8.30), we get

$$H = \frac{\beta_0 + \beta_1 X - \gamma_0 - \gamma_2 Z}{\gamma_1} + \frac{u_2 - u_1}{\gamma_1} \quad (8.31)$$

If $H > 0$, the person is in the labor force, and we observe H and W . If $H \leq 0$, the person is not in the labor force. For the observations for which $H \leq 0$, we have

$$\frac{u_2 - u_1}{\gamma_1} < \frac{\gamma_0 - \beta_0 + \gamma_2 Z - \beta_1 X}{\gamma_1}$$

or

$$u_2 - u_1 < \gamma_0 - \beta_0 + \gamma_2 Z - \beta_1 X$$

because γ_1 is expected to be positive. If $\text{Var}(u_2 - u_1) = \sigma^2$, then

$$\text{Prob}(H \leq 0) = \Phi\left(\frac{\gamma_0 - \beta_0 + \gamma_2 Z - \beta_1 X}{\sigma}\right) \quad (8.32)$$

where $\Phi(\cdot)$ is the distribution function of the standard normal. Thus, the likelihood function for this model is

$$L = \prod_{H>0} F(W, H) \cdot \prod_{H \leq 0} \Phi(\Delta) \quad (8.33)$$

where

$$\Delta = \frac{\gamma_0 - \beta_0 + \gamma_2 Z - \beta_1 X}{\sigma} \quad (8.34)$$

Heckman (1974) estimated this model by ML methods. Later (Heckman, 1976b), he suggested a two-stage estimation method.⁴ For the two-stage method we need to evaluate $E(u_2 | H > 0)$ in equation (8.30). This is

⁴ The discussion of the two-stage method that follows is not exactly the same as that expounded by Heckman. We shall follow the line of reasoning in the preceding sections.

$$E\left(u_2 \mid \frac{u_2 - u_1}{\sigma} > \Delta\right)$$

Denoting $\text{Var}(u_2) = \sigma_2^2$ and $\text{Cov}(u_2, u_1) = \sigma_{12}$, we get this [see equation (8.10)] as

$$\frac{\sigma_2^2 - \sigma_{12}}{\sigma} \frac{\phi(\Delta)}{1 - \Phi(\Delta)}$$

Thus, the wage equation (8.30) can be written as

$$W = \beta_0 + \beta_1 X + \frac{\sigma_2^2 - \sigma_{12}}{\sigma} \frac{\phi(\Delta)}{1 - \Phi(\Delta)} + V_2 \quad (8.35)$$

where V_2 is the new residual with the property that $E(V_2) = 0$.

The two-stage procedure that Heckman suggested is to get estimates of the parameters in Δ from a probit ML estimation and then estimate equation (8.35) by OLS after substituting $\phi(\hat{\Delta})/[1 - \Phi(\hat{\Delta})]$ for $\phi(\Delta)/[1 - \Phi(\Delta)]$. This gives us consistent estimates of β_0 , β_1 , and $(\sigma_2^2 - \sigma_{12})/\sigma$. To see how we can get estimates of all the parameters, note that the probit ML gives estimates of $(\gamma_0 - \beta_0)/\sigma$:

$$\frac{\gamma_{2j} - \beta_{1j}}{\sigma} \quad \text{for the common variables in } X \text{ and } Z$$

$$\frac{\gamma_{2j}}{\sigma} \quad \text{for the variables in } Z \text{ not in } X$$

$$\frac{\beta_{1j}}{\sigma} \quad \text{for the variables in } X \text{ not in } Z$$

Now, examining equations (8.29) and (8.30), we note that (if we assume $\sigma_{12} \neq 0$) the condition for identification is that there be at least one variable in X not included in Z . For this excluded variable we get an estimate of β_{1j}/σ from the probit equation, and because we have an estimate of β_{1j} from the wage equation, we can get an estimate of σ . Once we have an estimate of σ and estimates of β_0 and β_1 , it is easy to see that all elements of γ_0 and γ_2 can now be estimated. Also, because $\sigma^2 = \sigma_1^2 + \sigma_2^2 - 2\sigma_{12}$, we have an estimate of $\sigma_1^2 - \sigma_{12}$ (from the estimates of σ^2 and $\sigma_2^2 - \sigma_{12}$). The problem now is to get separate estimates of σ_1^2 , σ_2^2 , and σ_{12} . For this purpose we have to use the estimated residuals in the wage equation, as we did in the preceding section for the switching regression model.

Note that we have, in a fashion analogous to equation (8.15),

$$E(u_{2i}^2 \mid H > 0) = E\left(u_{2i}^2 \mid \frac{u_{2i} - u_{1i}}{\sigma} > \Delta_i\right)$$

$$= \sigma_2^2 + \left(\frac{\sigma_2^2 - \sigma_{12}}{\sigma} \right)^2 \Delta_i \frac{\phi(\Delta_i)}{1 - \Phi(\Delta_i)} \quad (8.36)$$

Thus, after computing the residuals

$$\hat{u}_{2i} = W_i - \hat{\beta}_0 - \hat{\beta}_1 X_i \quad (8.37)$$

we estimate σ_2^2 by

$$\hat{\sigma}_2^2 = \frac{1}{N_1} \sum_{i=1}^{N_1} \left[\hat{u}_{2i}^2 - \left(\frac{\sigma_2^2 - \sigma_{12}}{\sigma} \right)^2 \hat{\Delta}_i \frac{\phi(\hat{\Delta}_i)}{1 - \Phi(\hat{\Delta}_i)} \right] \quad (8.38)$$

where N_1 is the number of observations for which $H > 0$. Once we obtain an estimate of σ_2^2 , we have estimates of σ_{12} and σ_1^2 , because we have earlier estimated $\sigma_2^2 - \sigma_{12}$ and $\sigma_1^2 - \sigma_{12}$. Finally, to obtain an estimate of γ_1 , we have to estimate equation (8.31) by the tobit method.

The essential features of the two-stage methods are clear. First we obtain the expected values of the residuals that are truncated. These expected values involve unknown parameters, but these usually can be estimated by the probit method. We then introduce the estimated values of these variables into the original equation and estimate it by ordinary least squares (or weighted least squares if we take account of the heteroscedasticity problems). Note that to obtain estimates of the residual variances we have to compute the estimated residuals and use formulas like (8.17) and (8.18).

In the foregoing discussion of Heckman's model, we assumed $\sigma_{12} \neq 0$. If $\sigma_{12} = 0$, then we do not need the condition (for identification) that there be at least one variable in X not included in Z . But now the procedure for getting consistent estimates of the parameters is different. From two-stage estimation of the wage equation (8.35) we get estimates of β_0 , β_1 , and σ_2^2/σ . We next estimate σ_2^2 from the computed residuals for the wage equation according to formula (8.38), using $\sigma_{12} = 0$. We can thus get an estimate of σ , and now the estimates from the probit ML lead us to estimates of γ_0 and γ_2 . Because $\sigma^2 = \sigma_1^2 + \sigma_2^2$, we also have an estimate of σ_1^2 . As before, γ_1 has to be estimated by using the tobit method for equation (8.31).

Note that the Heckman model can be written as

$$\left. \begin{aligned} y_1 &= \gamma_0 + \gamma_1 y_2 + \gamma_2 Z + u_1 \\ y_2 &= \beta_0 + \beta_1 X + u_2 \end{aligned} \right\} \text{if } y_2 > 0 \quad (8.39)$$

$$y_1 = y_2 = 0 \quad \text{otherwise}$$

The conditions for identification for the simultaneous-equations model (8.39) are well known; namely, $\text{Cov}(u_1, u_2) = 0$, or there is at least one

variable in X not included in Z . These are the conditions for identification in Heckman's model.

Finally, note that the two-stage estimation of the wage equation, as described in equation (8.35), uses only the working individuals. One can easily extend this to cover data on all individuals (working and non-working), along the lines described at the end of the preceding section.

8.6 Two-stage estimation of structural equations

What we discussed in the preceding section was probit and tobit estimation of the hours-worked equation and two-stage estimation of the wage equation (which is anyhow in its reduced form). Thus, both the equations being estimated are reduced-form equations, and we discussed how to recover the structural parameters from the estimates of these reduced-form parameters. One can, however, think of estimating the structural equation (8.29) directly by two-stage methods to obtain estimates of γ_0 , γ_1 , and γ_2 . To do this, note that $S=W$ and

$$E(u_1 | H > 0) = E\left(u_1 \mid \frac{u_2 - u_1}{\sigma} > \Delta\right) = \frac{\sigma_{12} - \sigma_1^2}{\sigma} \frac{\phi(\Delta)}{1 - \Phi(\Delta)}$$

where Δ is defined in (8.34). We can now write equation (8.29) as

$$W = \gamma_0 + \gamma_1 H + \gamma_2 Z + \frac{\sigma_{12} - \sigma_1^2}{\sigma} \frac{\phi(\Delta)}{1 - \Phi(\Delta)} + v_1 \quad (8.40)$$

where v_1 is the residual u_1 corrected for its mean, and hence $E(v_1) = 0$. However, we cannot estimate equation (8.40) by OLS, because H is an endogenous variable. What we have to do is get an estimate of H for the subsample $H > 0$. Note that

$$E\left(\frac{u_2 - u_1}{\gamma_1} \mid H > 0\right) = \frac{\sigma}{\gamma_1} E\left(\frac{u_2 - u_1}{\sigma} > \Delta\right) = \frac{\sigma}{\gamma_1} \frac{\phi(\Delta)}{1 - \Phi(\Delta)}$$

Hence, equation (8.31) for $H > 0$ can be written as

$$H = \frac{\beta_0 - \gamma_0}{\gamma_1} + \frac{\beta_1 X - \gamma_2 Z}{\gamma_1} + \frac{\sigma}{\gamma_1} \frac{\phi(\Delta)}{1 - \Phi(\Delta)} + v \quad (8.41)$$

where $E(v) = 0$. We estimate this equation by OLS after substituting $\hat{\Delta}$ for Δ . After estimating the parameters in (8.41) by this two-stage method, we get the estimated values \hat{H} . Note that these are obtained from (8.41), not (8.31). We substitute these values of \hat{H} in place of H in equation (8.40) and estimate that equation by OLS. Alternatively, we can use \hat{H} as an instrumental variable in estimating (8.40). This will also produce consistent estimates.

It can be easily shown that the resulting two-stage estimates of the structural parameters are consistent. Their asymptotic covariance matrix can be derived by the methods in the Appendix at the end of this chapter. The method suggested here is the appropriate analogue of the usual two-stage least-squares method for the case of truncated variables. Briefly, what we do is (a) evaluate the expected values of the residuals in both the structural and reduced-form equations, (b) estimate the reduced-form equations by the two-stage estimation method, and (c) substitute the estimated values of the endogenous variables on the right-hand side of each structural equation, as obtained from step (b), and use OLS to estimate the parameters of the structural equations.

The main difference between the ordinary two-stage least-squares (2SLS) procedure and the one suggested here lies in noting the fact that the residuals in the structural equations and the reduced-form equations do not have zero means and that the estimates from the reduced forms (to be substituted in the structural equations) should take this into account.

The advantage of the procedure described here, which was suggested by Lee et al. (1980), is that it can be used in any simultaneous-equations model with truncation. For instance, suppose that hours worked also occurs as an explanatory variable in the market-wage equation (8.20); then this equation also is in a structural form (not a reduced form as in Heckman's model). Again, one can proceed via the reduced-form estimation, as outlined in the preceding section. But this creates problems of multiple solutions for the structural parameters if the equations are overidentified. Hence, it will be desirable to estimate the structural equations by the two-stage methods. Equation (8.35) will now be changed to

$$W = \beta_0 + \beta_1 H + \beta_2 X + \frac{\sigma_2 - \sigma_{12}}{\sigma} \frac{\phi(\Delta)}{1 - \Phi(\Delta)} + v_2 \quad (8.42)$$

and we estimate this equation by OLS after substituting \hat{H} for H , as obtained from a two-stage estimation of (8.41), and $\hat{\Delta}$ for Δ , as obtained from the probit ML method.

The procedure described is very general and can be used in the estimation of all simultaneous-equations systems with censored dependent variables. The procedure gets complicated, however, if there is more than one condition to determine the censoring. In the Heckman model, for instance, there is only one condition: $H > 0$. Amemiya (1974b) considered a model in which there are two censoring conditions involved:

$$\begin{aligned} y_1 &= \gamma_1 y_2 + \beta_1' X_1 + u_1 & \text{if } y_1 > 0 \\ y_1 &= 0 & \text{otherwise} \end{aligned}$$