second term looks like the loglikelihood function for a linear regression model with normal errors. The third term is one that we have not seen before.

Maximum likelihood estimates can be obtained in the usual way by maximizing (15.55). However, this maximization is relatively burdensome, and so instead of ML estimation a computationally simpler technique proposed by Heckman (1976) is often used. **Heckman's two-step method** is based on the fact that the first equation of (15.53) can be rewritten as

$$y_t^* = \boldsymbol{X}_t\boldsymbol{\beta} + \rho\sigma v_t + e_t. \tag{15.56}$$

The idea is to replace y_t^* by y_t and v_t by its mean conditional on $z_t = 1$ and on the realized value of $\boldsymbol{W}_t\boldsymbol{\gamma}$. As can be seen from (15.42), this conditional mean is $\phi(\boldsymbol{W}_t\boldsymbol{\gamma})/\Phi(\boldsymbol{W}_t\boldsymbol{\gamma})$, a quantity that is sometimes referred to as the **inverse Mills ratio**. Hence regression (15.56) becomes

$$y_t = \boldsymbol{X}_t\boldsymbol{\beta} + \rho\sigma\frac{\phi(\boldsymbol{W}_t\boldsymbol{\gamma})}{\Phi(\boldsymbol{W}_t\boldsymbol{\gamma})} + \text{residual}. \tag{15.57}$$

It is now easy to see how Heckman's two-step method works. In the first step, an ordinary probit model is used to obtain consistent estimates $\hat{\boldsymbol{\gamma}}$ of the parameters of the selection equation. In the second step, the **selectivity regressor** $\phi(\boldsymbol{W}_t\boldsymbol{\gamma})/\Phi(\boldsymbol{W}_t\boldsymbol{\gamma})$ is evaluated at $\hat{\boldsymbol{\gamma}}$, and regression (15.57) is estimated by OLS for the observations with $z_t = 1$ only. This regression provides a test for sample selectivity as well as an estimation technique. The coefficient on the selectivity regressor is $\rho\sigma$. Since $\sigma \neq 0$, the ordinary t statistic for this coefficient to be zero can be used to test the hypothesis that $\rho = 0$; it will be asymptotically distributed as $N(0,1)$ under the null hypothesis. Thus, if this coefficient is not significantly different from zero, the investigator may reasonably decide that selectivity is not a problem for this data set and proceed to use least squares as usual.

Even when the hypothesis that $\rho = 0$ cannot be accepted, OLS estimation of regression (15.57) yields consistent estimates of $\boldsymbol{\beta}$. However, the OLS covariance matrix is valid only when $\rho = 0$. In this respect, the situation is very similar to the one encountered at the end of the previous section, when we were testing for possible simultaneity bias in models with truncated or censored dependent variables. There are actually two problems. First of all, the residuals in (15.57) will be heteroskedastic, since a typical residual is equal to

$$u_t - \rho\sigma\frac{\phi(\boldsymbol{W}_t\boldsymbol{\gamma})}{\Phi(\boldsymbol{W}_t\boldsymbol{\gamma})}.$$

Secondly, the selectivity regressor is being treated like any other regressor, when it is in fact part of the error term. One could solve the first problem by using a heteroskedasticity-consistent covariance matrix estimator (see Chapter 16), but that would not solve the second one. It is possible to obtain a valid covariance matrix estimate to go along with the two-step estimates of $\boldsymbol{\beta}$ from (15.57). However, the calculation is cumbersome, and the estimated covariance matrix is not always positive definite. See Greene (1981b) and Lee (1982) for more details.

It should be stressed that the consistency of this two-step estimator, like that of the ML estimator, depends critically on the assumption of normality. This can be seen from the specification of the selectivity regressor as the inverse Mills ratio $\phi(\boldsymbol{W}_t\boldsymbol{\gamma})/\Phi(\boldsymbol{W}_t\boldsymbol{\gamma})$. When the elements of $\boldsymbol{W}_t$ are the same as, or a subset of, the elements of $\boldsymbol{X}_t$, as is often the case in practice, it is only the nonlinearity of $\phi(\boldsymbol{W}_t\boldsymbol{\gamma})/\Phi(\boldsymbol{W}_t\boldsymbol{\gamma})$ as a function of $\boldsymbol{W}_t\boldsymbol{\gamma}$ that makes the parameters of the second-step regression identifiable. The exact form of the nonlinear relationship depends critically on the normality assumption. Pagan and Vella (1989), Smith (1989), and Peters and Smith (1991) discuss various ways to test this crucial assumption. Many of the tests suggested by these authors are applications of the OPG regression.

Although the two-step method for dealing with sample selectivity is widely used, our recommendation would be to use regression (15.57) only as a procedure for testing the null hypothesis that selectivity bias is not present. When that hypothesis is rejected, ML estimation based on (15.55) should probably be used in preference to the two-step method, unless it is computationally prohibitive.

15.9 Conclusion

Our treatment of binary response models in Sections 15.2 to 15.4 was reasonably detailed, but the discussions of more general qualitative response models and limited dependent variable models were necessarily quite superficial. Anyone who intends to do empirical work that employs this type of model will wish to consult some of the more detailed surveys referred to above. All of the methods that we have discussed for handling limited dependent variables rely heavily on the assumptions of normality and homoskedasticity. These assumptions should always be tested. A number of methods for doing so have been proposed; see, among others, Bera, Jarque, and Lee (1984), Lee and Maddala (1985), Blundell (1987), Chesher and Irish (1987), Pagan and Vella (1989), Smith (1989), and Peters and Smith (1991).