General considerations on finite-sample inference in econometrics and statistics *

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1. Valid tests

$$Y_n : \text{Vector of observations } (n \times 1)$$
$$Y_n \sim P_\theta$$

θ : Vector of unknown parameters
Finite (Parametric problems)
or
Infinite (Non parametric problem)

$$\theta \in \Omega \tag{1.1}$$

$$H_0 : \theta \in \Omega_0 \tag{1.2}$$

$$\phi \neq \Omega_0 \subset \Omega \tag{1.3}$$

Consider critical region of the form:

$$T_n \equiv T_n(Y_n) > c_n(\alpha) \tag{1.4}$$

We reject H_0 if

$$T_n \geq c_n(\alpha)\,,\ 0 \leq \alpha \leq 1\,. \tag{1.5}$$

The test is valid at **level** α if

$$P_\theta\left[T_n > c_n(\alpha)\right] \leq \alpha\ \ ,\ \forall\theta \in \Omega_0\,.$$

The test has **size** α if

$$\sup_{\theta \in \Omega_0} P_0 \left[T_n > c_n(\alpha) \right] = \alpha \, ; \tag{1.6}$$

see Lehmann (1986, Section 3.1).
In general,

$P_0 \left[T_n > c_n(\alpha) \right]$ depends on $\theta \in \Omega_0$,
if $P_\theta \left[T_n \geq c_n(\alpha) \right]$ = constant similar test.

If no data-dependent critical region which satisfies the level constraint can be found,

$\theta \in \Omega_0$ is not testable at level α.
We have a non-sensical problem.
We must restrict the hypothesis model up to the point where it becomes testable.

In many econometric and statistical problems appropriate $c_n(\alpha)$ difficult to determine. The usual strategy consists in finding $c_n'(\alpha)$ such that

$$\lim_{n \to \infty} P_0 \left[T_n > c_n'(\alpha) \right] = \alpha \; , \quad \forall \theta \in \Omega_0 \, . \tag{1.7}$$

But this does not entail that

$$\lim_{n \to \infty} \left\{ \sup_{\theta \in \Omega_0} P \left[T_n > c_n'(\alpha) \right] \right\} = \alpha \, . \tag{1.8}$$

Possible that (1.7) be satisfied, while

$$\sup_{\theta \in \Omega_0} P\left[T_n > c_n'(\alpha)\right] = 1 \ , \quad \forall n \geq 1 \, .$$

In such a case, the test is "asymptotically valid" in the usual sense but invalid for any finite sample size n.

1.1 Example Linear regression with AR(1) errors:

$$\begin{aligned} y_t &= x_t'\beta + u_t && (1.9) \\ u_t &= \rho u_{t-1} + \varepsilon_t \ , \quad |\rho| < 1, && (1.10) \\ & \varepsilon_t \overset{i.i.d}{\sim} N\left(0, \sigma^2\right) \end{aligned}$$

In such a case, the usual uncorrected F-test for linear restrictions on β is asymptotically valid but invalid for any finite sample [Kiviet (1980, JASA, 353-359)].

2. Approaches to deal with nuisance parameters

3 main approaches:

1. Bounding;
2. Conditioning;
3. Transforming.

2.1. Bounding

Bound the distribution of T_n over $\theta \in \Omega_0$

- Dufour (1989, Econometrica, 335-355)
- Dufour (1990, Econometrica, 475-494)
- Dufour (1991, Hackl and A. Westlund, eds, 49-57)
- Kiviet (1991, J. Gruber, ed., 464-518)

2.2. Conditioning

Consider the conditional distribution of T_n given some appropriate statistic, so that conditional distribution has no nuisance parameter, e.g.

- Regressors (linear regression)
- Sufficient statistic
- Order statistics / Absolute values } Nonparametric statistic

2.3. Transforming

1. Transform the observations so that the transformed observations have distributions with no nuisance parameter

- t-tests in multiple linear regression
- Ranks
- Signs

2. Choice of transformations based on invariance principles
3. Sign and signed rank tests based on techniques conditioning and transformations
4. Transforming in an appropriate way

$$\text{eliminates an infinity of nuisance parameters.} \tag{2.11}$$

References

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