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ABSTRACT

In this paper we consider the risk (under quadratic loss) of an estimator of the error variance after a pre-test for homogeneity of the variances in the two-sample linear regression model. We investigate the effects on risk of assuming normal disturbances when in fact the error distribution is spherically symmetric. We also broaden the standard assumption that the never-pool variance estimators are based on the least squares principle. Using the special case of multivariate Student-t regression disturbances as an illustration, our results show that in some situations we should always pre-test, *even if the error variances are equal*, and we provide the optimal test critical value. The evaluations also show that using the least squares technique to form the never-pool estimators may not always be the preferred strategy.

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1. Introduction and estimator definitions

We consider a regression model which uses two samples, with T_1 and T_2 observations ($T_1+T_2=T$). There is a common location vector, β, but possibly different error variances:

$$\begin{bmatrix} y_1 \\ y_2 \end{bmatrix} = \begin{bmatrix} X_1 \\ X_2 \end{bmatrix}\beta + \begin{bmatrix} e_1 \\ e_2 \end{bmatrix} , \tag{1}$$

or more compactly, $y=X\beta+e$, where y_i is a $(T_i\times 1)$ vector of observations on the dependent variable, X_i is a non-stochastic $(T_i\times k)$ design matrix of rank k $(<T_i)$, and e_i is a $(T_i\times 1)$ vector of regression disturbances, i=1,2. We assume that $E(e_i)=0$, and that $E(e_ie_i')=\sigma^2_{e_i}I_{T_i}$. Let $\phi=\sigma^2_{e_1}/\sigma^2_{e_2}$, and

$$E(ee') = \begin{bmatrix} \sigma^2_{e_1}I_{T_1} & 0 \\ 0 & \sigma^2_{e_2}I_{T_2} \end{bmatrix} = \sigma^2_{e_2}\begin{bmatrix} \phi I_{T_1} & 0 \\ 0 & I_{T_2} \end{bmatrix} = \sigma^2_{e_2}\Sigma . \tag{2}$$

Suppose that e has a non-normal distribution of the form $f(e)={}_0\int^{\infty}f_N(e)f(\tau)d\tau$, where $f_N(e)$ is f(e) when $e\sim N(0,\tau^2\Sigma)$,and $f(\tau)$ is supported on $[0,\infty)$. Hence, $\sigma^2_{e_2}=E(\tau^2)$ and $\sigma^2_{e_1}=\phi E(\tau^2)$. So, (Muirhead (1982)) the joint distribution of the disturbances in each sample is spherically symmetric, while e has an elliptically symmetric distribution (ESD) when $\sigma^2_{e_1}\neq\sigma^2_{e_2}$, and a spherically symmetric distribution (SSD) when the variances are equal.[1,2] The normal and multivariate Student-t (Mt) distributions are well known members of this family. The latter distribution arises if $f(\tau)$ is an inverted gamma density with, say, scale parameter σ^2_2 and degrees of freedom parameter ν; we write $\tau\sim IG(\sigma^2_2,\nu)$ and $e\sim Mt\left(0,\nu\sigma^2_2/(\nu-2)\Sigma\right)$. The marginal distributions are univariate Student-t and for small values of ν they will have thicker tails than under normality. When $\nu=1$ the probability density function (pdf) is Cauchy while it is normal when $\nu=\infty$.[3]

We consider the estimation of $\sigma^2_{e_1}$ given uncertainty about whether the second sample comes from the same population as the first when the researcher wrongly assumes that $e \sim N\left(0, \sigma^2_{e_2} \Sigma\right)$. The pre-test under investigation is of

$$H_0 : \phi = 1 \quad \text{vs} \quad H_1 : \phi < 1 . \tag{3}$$

We assume for simplicity a one-sided alternative hypothesis, though the analysis can be extended to the two-sided case.[4]

The research on this particular pre-test problem has followed the literature associated with the pooling of two normal samples. If the variances are unequal then an unbiased (never-pool) estimator of $\sigma^2_{e_1}$ is $s^2_{NL} = s^2_1$ where $s^2_i = (y_i - X_i b_i)'(y_i - X_i b_i)/v_i = e_i' M_i e_i / v_i$, $v_i = T_i - k$, $M_i = I_{T_i} - X_i S_i^{-1} X_i'$, and $b_i = S_i^{-1} X_i' y_i$, $S_i = (X_i' X_i)$, $i=1,2$. s^2_i is the usual unbiased least squares (L) estimator of $\sigma^2_{e_i}$. Conversely, if the variances are equal then the two samples may be pooled and an unbiased (always-pool) estimator of $\sigma^2_{e_1}$ is $s^2_{AL} = \left(v_1 s^2_1 + v_2 s^2_2\right)/(v_1 + v_2)$. A test statistic for homoscedasticity is $J = \left(v_1 e_2' M_2 e_2\right) / \left(v_2 e_1' M_1 e_1\right)$, and $f(J) = \phi^{-1} f\left(F_{(v_2, v_1)}\right)$, where $F_{(v_2, v_1)}$ is a central F random variate with v_2 and v_1 degrees of freedom.

The researcher tests H_0 using J and so he employs the pre-test estimator

$$s^2_P = \begin{cases} s^2_{NL} & \text{if } J > c \\ s^2_{AL} & \text{if } J \le c \end{cases} = I_{[0,c]}(J) s^2_{AL} + I_{(c,\infty)}(J) s^2_{NL} , \tag{4}$$

where $I_{[.,.]}(J)$ takes the value unity if J lies within [.,.], zero otherwise, and c is the critical value of the test corresponding to a test size of α. Assuming normal errors and the least squares based estimators s^2_{NL} and s^2_{AL}, Bancroft (1944), Toyoda and Wallace (1975), Ohtani and Toyoda (1978), and Bancroft and Han (1983) have examined the sampling properties of s^2_P.[5] We generalise both of these assumptions in this paper.

There is substantial empirical evidence to support the possibility that

There is substantial empirical evidence to support the possibility that some economic series may be generated by processes whose distributions have more kurtosis than the normal distribution (e.g., Mandelbrot (1963, 1967), Fama (1963, 1965), Blattberg and Gonedes (1974), Praetz (1972), and Praetz and Wilson (1978)). The family of distributions that we investigate is motivated by some of these studies, and by those papers which have studied linear regression models with ESD (or SSD) disturbances, including Thomas (1970), King (1979), Chmielewski (1981), Judge, Miyazaki and Yancey (1985), Ullah and Zinde-Walsh (1985), Zinde-Walsh and Ullah (1987), and Giles (1990b). In particular, Chmielewski (1981) shows that f(J) holds for all members of the elliptically symmetric family[6], and Giles (1990b) derives the exact risk (under quadratic loss) of pre-test estimators of the prediction vector and of the error variance of a linear regression model with spherically symmetric disturbances when the pre-test is for the validity of a set of exact linear restrictions on the coefficient vector. She finds that when estimating the conditional forecast of y the widening of the error distribution assumption has little impact on the qualitative properties of the risk function of the predictor pre-test estimator, though there are quantitative effects. In contrast, there can be a substantial impact on the risk functions of the estimators of the error variance. Specifically, she shows that pre-testing, with a critical value of unity, is the preferable strategy when the disturbances are Mt with small ν.[7]

In this paper we extend the aforementioned pre-testing literature first by deriving the risk functions of a family of pre-test estimators of $\sigma^2_{e_1}$ after a pre-test for H_0, when the researcher wrongly assumes that the sub-sample spherically symmetric disturbances are normally distributed. Our second extension relates to the component estimators under investigation. To date the research in this area has only considered the pre-test estimator based on s^2_{NL} and s^2_{AL} while, within the linear regression model framework, two other never-pool estimators of $\sigma^2_{e_i}$ are commonly used (assuming normality): the maximum likelihood (ML) estimator and the minimum mean squared error (M) estimator. Let these estimators be denoted by s^2_{iML} and s^2_{iM} respectively. They differ from s^2_{iL} by the divisor used, this being T_i for the ML estimators and (v_i+2) for the M estimators. These estimators are members of the family

$$S^2_i = (e_i' M_i e_i)/(T_i+\mu). \tag{5}$$

We can generate s^2_{iL}, s^2_{iML}, and s^2_{iM} by setting μ to $-k$, 0, and $(-k+2)$, respectively. Let $S^2_N = S^2_1$ be the family of never-pool estimators of $\sigma^2_{e_1}$.

In the spirit of s^2_{AL} we can conceive of two alternative always-pool estimators s^2_{AML} and s^2_{AM}, which have as their components the sample ML and M estimators, s^2_{iML} and s^2_{iM}, respectively. That is, $s^2_{AML} = \left(T_1 s^2_{1ML} + T_2 s^2_{2ML}\right)/T$ and $s^2_{AM} = \left((v_1+2)s^2_{1M} + (v_2+2)s^2_{2M}\right)/(v_1+v_2+4)$. s^2_{AL}, s^2_{AML}, and s^2_{AM} are always-pool estimators of the form

$$S^2_A = \left[(T_1+\mu)\left(e_1' M_1 e_1/(T_1+\mu)\right) + (T_2+\mu)\left(e_2' M_2 e_2/(T_2+\mu)\right)\right]/(T+2\mu). \tag{6}$$

We obtain s^2_{AL}, s^2_{AML}, and s^2_{AM} by setting μ to $-k$, 0, and $(-k+2)$. Clearly s^2_{AML} is not a ML estimator, nor does s^2_{AM} possess the M property, even if the errors are normal. Of course, when the errors are non-normal then even the sample estimators are not the ML or M estimators, though the researcher proceeds assuming that they possess these properties.[8]

So, given (5) and (6), the pre-test estimator we investigate is

$$S^2_P = \begin{cases} S^2_N & \text{if } J > c \\ S^2_A & \text{if } J \le c \end{cases} = I_{[0,c]}(J)S^2_A + I_{(c,\infty)}(J)S^2_N \ . \tag{7}$$

In the next section we derive and discuss the risk functions of S^2_N, S^2_A, and S^2_P. To illustrate our results we consider exact evaluations of the risks for the special case of Mt regression disturbances in Section 3. The final section is devoted to concluding remarks.

2. The risk functions

Theorem 1 gives the risk functions of the estimators, where we define the risk of an estimator $\bar{s}^2$ of $\sigma^2_{e_1}$ as $\rho(\sigma^2_{e_1},\bar{s}^2)=E(\bar{s}^2-\sigma^2_{e_1})^2=E\left(\bar{s}^2-\phi E(\tau^2)\right)^2$.

Theorem 1. If e~ESD with E(e)=0, $E(ee')=\sigma^2_{e_2}\Sigma$ and the pre-test is of H_0 in (3), then

$$\rho(\sigma^2_{e_1},S^2_N) = \phi^2\left(v_1(v_1+2)E(\tau^4)+\left(E(\tau^2)\right)^2(T_1+\mu)(T_1+\mu-2v_1)\right)/(T_1+\mu)^2, \tag{8}$$

$$\rho(\sigma^2_{e_1},S^2_A) = \Bigg(\phi^2\left[v_1(v_1+2)E(\tau^4)+\left(E(\tau^2)\right)^2(T+2\mu)(T+2\mu-2v_1)\right]$$
$$+ 2v_2\phi\left[v_1E(\tau^4)-(T+2\mu)\left(E(\tau^2)\right)^2\right]+v_2(v_2+2)E(\tau^4)\Bigg)/(T+2\mu)^2, \tag{9}$$

$$\rho(\sigma^2_{e_1},S^2_p) = \Bigg(\phi^2\Big[v_1(v_1+2)E(\tau^4)\left((T+2\mu)^2-(T_2+\mu)(2T_1+T_2+3\mu)Q_{04}\right)$$
$$+ (T+2\mu)(T_1+\mu)\left(E(\tau^2)\right)^2\left((T_1+\mu-2v_1)(T+2\mu)+2(T_2+\mu)v_1Q_{02}\right)\Big]$$
$$+ 2(T_1+\mu)^2\phi\left[v_1v_2E(\tau^4)Q_{22}-v_2(T+2\mu)\left(E(\tau^2)\right)^2Q_{20}\right]$$
$$+ v_2(v_2+2)(T_1+\mu)^2E(\tau^4)Q_{40}\Bigg)/\left((T_1+\mu)(T+2\mu)\right)^2 , \tag{10}$$

where $Q_{ij} = Pr.\left[F_{(v_2+i,v_1+j)}\le\left(v_2(v_1+j)c\phi\right)/\left(v_1(v_2+i)\right)\right]$, i,j = 0,1,... .

Note that Q_{ij} does not depend on τ.

Proof. See the appendix.

Corollary 1. If $e\sim Mt\left(0,\nu\sigma^2_2/(\nu-2)\Sigma\right)$ then, for $\nu>4$

$$\rho_{Mt}(\sigma^2_{e_1},S^2_N) = \phi^2\nu^2\sigma^4_2\left(2v_1(v_1+\nu-2)+(k+\mu)^2(\nu-4)\right)/$$
$$\left((T_1+\mu)^2(\nu-4)(\nu-2)^2\right) , \tag{11}$$

$$\rho_{Mt}(\sigma^2_{e_1},S^2_A) \doteq \nu^2\sigma^4_2\Bigg(\phi^2\left[(\nu-4)\left(v_2+2(k+\mu)\right)^2+2v_1(v_1+\nu-2)\right]$$
$$+ 2v_2\phi\left[2v_1-(\nu-4)\left(v_2+2(k+\mu)\right)\right]+v_2(v_2+2)(\nu-2)\Bigg)/$$

$$\left((T+2\mu)^2(\nu-2)^2(\nu-4)\right), \qquad (12)$$

$$\rho_{Mt}(\sigma^2_{e_1}, S^2_p) = \nu^2\sigma_2^4\Big(\phi^2\Big[(T+2\mu)^2\Big((\nu-4)(k+\mu)^2+2v_1(v_1+\nu-2)\Big)$$

$$- v_1(v_1+2)(\nu-2)(2T_1+T_2+3\mu)(T_2+\mu)Q_{04}+2v_1(T_1+\mu)(T+2\mu)$$

$$.(T_2+\mu)(\nu-4)Q_{02}\Big]+2(T_1+\mu)^2\phi v_2\Big[v_1(\nu-2)Q_{22}-(T+2\mu)(\nu-4)Q_{20}\Big]$$

$$+ v_2(v_2+2)(T_1+\mu)^2(\nu-2)Q_{40}\Big)\Big/\Big((T_1+\mu)^2(T+2\mu)^2(\nu-4)(\nu-2)^2\Big). \qquad (13)$$

Proof. $e \sim Mt\left(0, \nu\sigma_2^2/(\nu-2)\Sigma\right)$ when $\tau \sim IG(\sigma_2^2, \nu)$. Then, $f(\tau) = \left[2/\Gamma(\nu/2)\right]$ $.(\nu\sigma_2^2/2)^{\nu/2}\tau^{-(\nu+1)}e^{-\nu\sigma_2^2/2\tau^2}$, so, $E(\tau^2)=\nu\sigma_2^2/(\nu-2)$, $E(\tau^4)=\nu^2\sigma_2^4/\left((\nu-2)(\nu-4)\right)$. Using these expressions appropriately in Theorem 1 yields Corollary 1. #

Corollary 2. If $e \sim N(0,\sigma_2^2\Sigma)$ then $\sigma^2_{e_2}=\sigma_2^2$, $\sigma^2_{e_1}=\sigma_1^2$ (say), and

$$\rho_N(\sigma_1^2, S_N^2) = \phi^2\sigma_2^4\left(2v_1+(k+\mu)^2\right)/(T_1+\mu)^2, \qquad (14)$$

$$\rho_N(\sigma_1^2, S_A^2) = \sigma_2^4\Big(\phi^2\Big[\Big(v_2+2(k+\mu)\Big)^2+2v_1\Big]-2\phi v_2\Big(v_2+2(k+\mu)\Big)$$

$$+ v_2(v_2+2)\Big)/(T+2\mu)^2, \qquad (15)$$

$$\rho_N(\sigma_1^2, S_P^2) = \sigma_2^4\Big(\phi^2\Big[(T+2\mu)^2\Big((k+\mu)^2+2v_1\Big)-v_1(v_1+2)(T_2+\mu)(2T_1+T_2+3\mu)Q_{04}$$

$$+ 2v_1(T_1+\mu)(T_2+\mu)(T+2\mu)Q_{02}\Big]+2(T_1+\mu)^2\phi v_2\Big[v_1Q_{22}-(T+2\mu)Q_{20}\Big]$$

$$+ v_2(v_2+2)(T_1+\mu)^2Q_{40}\Big)\Big/\Big((T_1+\mu)^2(T+2\mu)^2\Big). \qquad (16)$$

Proof. This corollary follows from Corollary 1 as $e \sim N(0,\sigma_2^2\Sigma)$ when $\nu=\infty$. #

Remarks.

(i) The risk expressions of Bancroft (1944) (allowing for the change in H_1) and of Toyoda and Wallace (1975) follow from Corollary 2 by setting $\mu=-k$.

(ii) If $\alpha=0$, $c=\infty$, then $Q_{ij}=1$ so we never reject H_0. Then, $\rho(\sigma^2_{e_1},S^2_P)=\rho(\sigma^2_{e_1},S^2_A)$. Conversely, if $\alpha=1$, $c=0$, then $Q_{ij}=0$ so that we reject H_0. Then, $\rho(\sigma^2_{e_1},S^2_P)=\rho(\sigma^2_{e_1},S^2_N)$.

(iii) $\lim_{\phi\to 0}\left[\rho(\sigma^2_{e_1},S^2_P)\right]=\lim_{\phi\to 0}\left[\rho(\sigma^2_{e_1},S^2_N)\right]=0$ while $\lim_{\phi\to 0}\left[\rho(\sigma^2_{e_1},S^2_A)\right]=\left(v_2(v_2+2)E(\tau^4)\right)/(T+2\mu)^2>0$. Intuitively it is better to ignore the prior information when it is very false, and pre-testing leads us to follow the correct strategy of ignoring the second sample when estimating $\sigma^2_{e_1}$.

(iv) If $\phi=1$, that is, the error variances are equal, then the sign of

$$\rho(\sigma^2_{e_1},S^2_A|\phi=1)-\rho(\sigma^2_{e_1},S^2_N|\phi=1)=\Big\{E(\tau^4)\Big[(T_1+\mu)^2(v_1+v_2)(v_1+v_2+2)$$
$$-v_1(v_1+2)(T+2\mu)^2+\left(E(\tau^2)\right)^2(T+2\mu)(T_1+\mu)\Big[(T_2+\mu)\left(v_1-(k+\mu)\right)$$
$$-(T_1+\mu)\left(v_2-(k+\mu)\right)\Big]\Big]\Big\}/\left((T+2\mu)(T_1+\mu)\right)^2 \qquad (17)$$

is negative if $\{.\}<0$, so that imposing valid prior information produces a risk gain. The sign of (17) is not obvious. If we are employing the L components then (17) is equal to $\left[-2E(\tau^4)v_2/\left(v_1(v_1+v_2)\right)\right]$ which is negative for all v_1, v_2, $f(\tau)$. However, the sign is still ambiguous if we are using the ML or the M components. We will return to this feature in Section 3.

(v) The risk functions of S^2_N and S^2_A have two intersections with respect to ϕ. Let these be ϕ_1 and ϕ_2. Their values are

$$\phi_i = \Bigg[v_2(T_1+\mu)^2\left[v_1E(\tau^4)-(T+2\mu)\left(E(\tau^2)\right)^2\right]\pm(T_1+\mu)\Big\{v_1v_2\left(E(\tau^4)^2\right.$$
$$\left.\cdot\left[v_1v_2(T_1+\mu)^2+(v_1+2)(v_2+2)(T_2+\mu)(2T_1+T_2+3\mu)\right]+v_2^2(T_1+\mu)^2(T+2\mu)^2\left(E(\tau^2)\right)^4\right.$$
$$\left.-2v_1v_2(T_1+\mu)(T+2\mu)E(\tau^4)\left(E(\tau^2)\right)^2\left[v_2(T+2\mu)+2(T_2+\mu)\right]\right\}^{\frac{1}{2}}\Bigg]/\Big[v_1(v_1+2)E(\tau^4)$$
$$\cdot(T_2+\mu)(2T_1+T_2+3\mu)-2v_1(T_1+\mu)(T+2\mu)(T_2+\mu)\left(E(\tau^2)\right)^2\Big], \qquad (18)$$

$$= \omega\pm\kappa \quad , \quad i = 1,2.$$

to discern the signs of ϕ_1 and ϕ_2 from (18), though our numerical evaluations with Mt regression disturbances suggest that there are two possibilities. We comment on this in the next section.

(vi) Bancroft (1944) and Toyoda and Wallace (1975) show that there is a ϕ-range over which it is preferable to pre-test rather than to always-pool or to never-pool the two samples when $e \sim N(0, \sigma_2^2 \Sigma)$, using the usual L components. They find that there is a family of pre-test estimators, with $c \in (0,2)$, which strictly dominate first, the never-pool estimator for all ϕ and secondly, the always-pool estimator for a wide range of ϕ. It is only in the neighbourhood of $\phi=1$ that the risk of s_{AL}^2 is smaller than that of s_{PL}^2. Ohtani and Toyoda (1978) prove that of this family of dominating estimators the pre-test estimator with c=1 has the smallest risk. The following theorem extends this result to the case that we are investigating.

Theorem 2. The pre-test risk function has a minimum when $c^* = \left(v_1(T_2+\mu)\right) / \left(v_2(T_1+\mu)\right)$.

Proof. See the appendix.[9]

So, in particular, $c_L^*=1$, $c_{ML}^*=(v_1T_2)/(v_2T_1)$, and $c_M^* = \left(v_1(v_2+2)\right) / \left(v_2(v_1+2)\right)$.

3. Numerical evaluations of the risk functions

Given the complexities of the risk expressions, it is useful to evaluate them numerically, which we have done, assuming Mt errors, for the L, the ML and the M component estimators for various values of ν, α, v_1, v_2, and k, as functions of ϕ. We evaluate the risks relative to σ_2^2 and so, define the relative risk of an estimator $\bar{s}^2$ of $\sigma_{e_1}^2$ as $R_{\bar{s}^2} = \rho(\sigma_{e_1}^2, \bar{s}^2)/\sigma_2^4$.[10] Giles (1990a) details the range of the values of the arguments considered and the computer programs employed. Figures 1 and 2 depict typical results for the L components when $v_1=16$, $v_2=8$, k=3, $\nu=5$ and $\nu=\infty$. For this example c*=1 details the range of the values of the arguments considered and the computer programs employed. Figures 1 and 2 depict typical results for the L components when $v_1=16$, $v_2=8$, $k=3$, $\nu=5$ and $\nu=\infty$. For this example $c^*=1$ corresponds to $\alpha=47.3\%$. The risk functions for the ML and the M components are qualitative similar, though there are quantitative differences which we mention below.

Remarks.

(i) If $e \sim Mt\left(0,\nu\sigma_2^2/(\nu-2)\Sigma\right)$ and we are using the ML or the M components then the risk difference (17) is negative for all possible values of ν.[11] So, when the error variances are equal it is always preferable to pool the samples, rather than to ignore the prior information.

(ii) The numerical evaluations suggest that there are two possible values of ϕ_{1j} and ϕ_{2j}, j=L,ML,M. First, $0<\phi_{1j}<1$, $\phi_{2j}<0$ and secondly, $0<\phi_{1j}<1$, $\phi_{2j}>1$. Thus, there exists one feasible intersection, $\phi_{1j}\in(0,1)$. So, the never-pool estimator dominates the always-pool estimator when $0<\phi<\phi_{1j}$. Alternatively, the always-pool estimator has smaller risk than the never-pool estimator when $\phi_{1j}<\phi\leq 1$. For this ϕ-range the gain in sampling variance from the extra degrees of freedom when pooling the samples outweighs the bias from pooling the (unequal) variances. These conclusions accord with those found by Toyoda and Wallace (1975).

Our numerical evaluations also suggest that $\phi_{1ML}<\phi_{1M}<\phi_{1L}$ if $v_2\leq v_1$, while the inequalities are reversed if $v_1<v_2$. Further, ϕ_{1j} decreases as ν increases, j=L,ML,M. This implies if we assume normality when in fact $e \sim Mt\left(0,\nu\sigma_2^2/(\nu-2)\Sigma\right)$, $\nu<\infty$, that there is then a ϕ-range over which we would incorrectly choose to pool the samples.

(iii) For relatively small ν the pre-test estimator can strictly dominate *both* of its component estimators. In such cases, it is always preferable to pre-test, and given Theorem 2, to use $c=c^*$. For these values of ν the pre-test estimator has smaller variability than either of its component estimators.[12]

(iv) Of the L, ML, and the M estimators, the numerical results suggest, if one adopted a pre-test strategy and a crude minimax risk criterion, that for normal disturbance terms the preferred estimator is s^2_{PM} for α=0.01 and s^2_{PL} for $\alpha \geq 0.05$. However, if ν is relatively small then it is preferable to use the ML component estimators. So, given our previous discussion, for small ν we should pre-test using the ML components and a critical value of $(v_1T_2)/(v_2T_1)$.

4. Concluding remarks

In this paper we have examined the risk properties of estimators of the disturbance variance, after a preliminary test of homogeneity, when the joint distribution of the unobservable errors in each sample is SSD but it is assumed to be normal. We have considered the usual least squares estimators of the error variance and we have also investigated the risks of the never-pool, the always-pool and the pre-test estimators whose components are the usual never-pool maximum likelihood and the minimum mean squared error estimators assuming a correctly specified error distribution. Of course, under the investigated specification error these estimators do not possess their desired properties.

Nevertheless, our results suggest that these estimators are preferred to the usual least squares estimator when ν is small. Then the ML pretest estimator which uses $c=c^*$ strictly dominates: it is never preferable to always-pool the samples without testing the validity of the null hypothesis, nor is it optimal to ignore the prior information.

We should recall that the results discussed here apply to a one-sided alternative hypothesis. It remains for future research to consider the two-sided case. We also need to investigate the sensitivity of the results to the particular form of non-normality considered. Whether they will extend to the situation of non-normal but identically, independently distributed disturbances is not clear.

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Appendix

Proof of Theorem 1

$S_N^2=\phi e^{*\prime}M_1^*e^*/(T_1+\mu)$ where M_1^* is a (T×T) idempotent matrix partitioned as $M_1^*=\begin{bmatrix}M_1 & 0\\ 0 & 0\end{bmatrix}$, $M_1=X_1(X_1'X_1)^{-1}X_1'$, $r(M_1)=v_1$, and $e^{*\prime}=[e_1'/\sqrt{\phi} \quad e_2']$. Now, $\rho(\sigma_{e_1}^2,S_N^2)$ = $E(S_N^4)-2\phi E(\tau^2)E(S_N^2)+\phi^2\left(E(\tau^2)\right)^2$ and $E(S_N^2)=\int_0^\infty E_N(S_N^2)f(\tau)d\tau$ where $E_N(.)=E(.)$ when $e\sim N(0,\tau^2\Sigma)$. So, then $e^*\sim N(0,\tau^2 I_T)$ and $e^{*\prime}M_1^*e^*/\tau^2\sim\chi^2_{v_1}$, which gives $E_N(e^{*\prime}M_1^*e^*/\tau^2)=v_1$, $E_N(e^{*\prime}M_1^*e^*/\tau^2)^2=v_1(v_1+2)$. Using these results $\rho(\sigma_{e_1}^2,S_N^2)$ follows directly.

Similarly, $S_A^2=(\phi e^{*\prime}M_1^*e^*+e^{*\prime}M_2^*e^*)/(T+2\mu)$, where M_2^* is a (T×T) idempotent matrix partitioned as $M_2^*=\begin{bmatrix}0 & 0\\ 0 & M_2\end{bmatrix}$, $M_2=X_2(X_2'X_2)^{-1}X_2'$, $r(M_2)=v_2$. Now, when $e\sim N(0,\tau^2\Sigma)$ so that $e^*\sim N(0,\tau^2 I_T)$ it is straightforward to show that the quadratic forms $(e^{*\prime}M_2^*e^*/\tau^2)$ and $(e^{*\prime}M_1^*e^*/\tau^2)$ are independent. Further, $(e^{*\prime}M_2^*e^*/\tau^2)\sim\chi^2_{v_2}$. So, using the moments of a χ^2 random variate and the fact that we can write $E(.)=\int_0^\infty E_N(.)f(\tau)d\tau$ the $\rho(\sigma_{e_1}^2,S_A^2)$ follows in the same manner as it did for S_N^2.

Finally, to establish $\rho(\sigma_{e_1}^2,S_P^2)$ we write

$$S_P^2 = \Big(\phi(T+2\mu)(e^{*\prime}M_1^*e^*)+\Big[(T_1+\mu)(e^{*\prime}M_2^*e^*)-\phi(T_2+\mu)(e^{*\prime}M_1^*e^*)\Big] \cdot I_{[0,c\phi]}\Big((v_1e^{*\prime}M_2^*e^*)/(v_2e^{*\prime}M_1^*e^*)\Big)\Big)\Big/\Big((T_1+\mu)(T+2\mu)\Big) ,$$

and note that

$$\rho(\sigma_{e_1}^2,S_P^2) = E(S_p^4)-2\phi E(\tau^2)E(S_P^2)+\phi^2\left(E(\tau^2)\right)^2. \qquad \text{(A.1)}$$

Now, $E(.)=\int_0^\infty E_N(.)f(\tau)d\tau$ and so we require $E_N(S_P^2)$ and $E_N(S_P^4)$. Using Lemma 1 of Clarke *et al.* (1987) we have

$$E_N(S_P^2) = \left(\phi v_1\tau^2(T+2\mu)+v_2\tau^2(T_1+\mu)Q_{20}-v_1\phi(T_2+\mu)\tau^2Q_{02}\right)/\left((T_1+\mu)(T+2\mu)\right),$$

and

$$E_N(S_P^4) = \tau^4\Big(\phi^2v_1(v_1+2)(T+2\mu)^2-\phi^2v_1(v_1+2)(T_2+\mu)(2T_1+T_2+3\mu)Q_{04}$$
$$+ 2\phi v_1v_2(T_1+\mu)^2Q_{22}+v_2(v_2+2)(T_1+\mu)^2Q_{40}\Big)/\left((T_1+\mu)(T+2\mu)\right)^2.$$

To complete the proof we integrate these expressions with respect to τ to give $E(S_P^2)$ and $E(S_P^4)$, then substitute these into (A.1). #

Proof of Theorem 2

$$\rho(\sigma_{e_1}^2,S_P^2) = E\left[\left(S_A^2-\phi E(\tau^2)\right)^2I_{[0,c]}(J)+\left(S_N^2-\phi E(\tau^2)\right)^2I_{(c,\infty)}(J)\right]$$

$$= \int_0^\infty \tau^4E_N\Big\{\Big[\Big((\phi e^{*\prime}M_1^*e^*/\tau^2)+(e^{*\prime}M_2^*e^*/\tau^2)\Big)/(T+2\mu)$$
$$- \phi E(\tau^2)/\tau^2\Big]^2I\left((e^{*\prime}M_2^*e^*/\tau^2)\le g\right)+\Big[(\phi e^{*\prime}M_1^*e^*/\tau^2)/(T_1+\mu)$$
$$- \phi E(\tau^2)/\tau^2\Big]^2\Big[1-I\Big((e^{*\prime}M_2^*e^*/\tau^2)\le g\Big)\Big]\Big\}f(\tau)d\tau\ , \tag{A.2}$$

where $g=c\phi v_2(e^{*\prime}M_1^*e^*/\tau^2)/v_1$. Given (A.2) the remainder of this proof follows the approach outlined in Giles (1990b) for a similar theorem. #

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Footnotes

[1]A discussion of this family of distributions is beyond our scope. See, for example, Kelker (1970) and Muirhead (1982).

[2]We could assume that each sample is generated by a different variance mixing distribution. If the mixing distributions are independent then we can easily extend our analysis. However, it is unclear how we would proceed if they are dependent.

[3]In this paper we require $\nu>4$ and so, in particular, our results exclude the Cauchy case.

[4]Our alternative hypothesis is consistent with the majority of the existing literature.

[5]Yancey *et al.* (1983) and Ohtani (1987) consider a related, though not identical, pre-test problem to that investigated here. They also assume normality.

[6]This result is also implied by King (1979).

[7]Giles (1990b) uses the least squares unrestricted and restricted estimators of the error variance. Giles (1990a) derives the critical values which minimise the pre-test risk function when one uses the usual maximum likelihood or the minimum mean squared error (assuming normality) component estimators. Then, the optimal critical values are zero and $v/(v+2)$ respectively, where $v=T-k$.

[8]One may then reasonably ask why we do not consider the L, ML, and M pooled estimators assuming that the error variances are equal and that the disturbances are normally distributed. These estimators should be more efficient than the pooled estimators that we consider as they incorporate the information that β is common to both samples. However, even under a normality assumption , the non-null distribution of $e'Me$ is not clear, so we do not proceed along this path. One could presumably conceive of many other always-pool estimators to that which we investigate.

[9]The form of this proof is not the same as that used by Ohtani and Toyoda (1978). Further, this proof can be easily extended to allow for omitted regressors. c^* remains unchanged. See Giles (1990a).

[10]We lose no generality in considering relative risk, and the results could equally be interpreted as the risk functions when $\sigma_2^2=1$.

[11]We noted in point (iv) of Section 2 that (17) is always negative for the L components but we could not algebraically sign (17) for the ML or the M components.

[12]This result is also found by Giles (1990b) when estimating the error variance after a pre-test for exact linear restrictions.

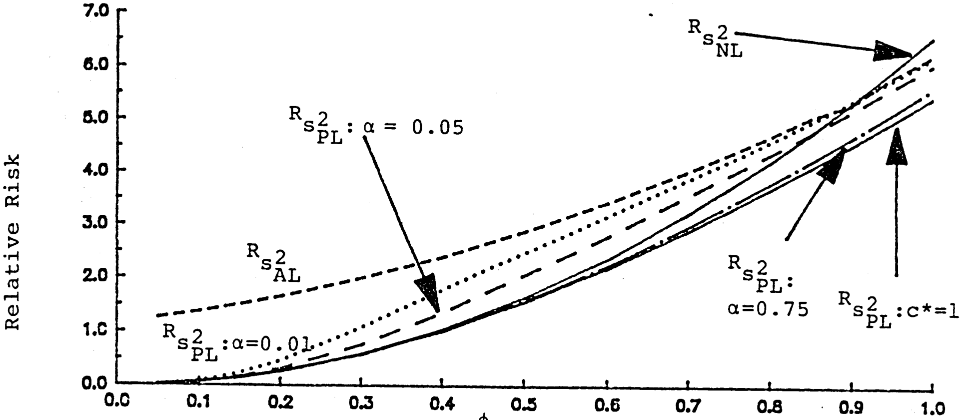

FIGURE 1. Relative risk functions for s^2_{NL}, s^2_{AL}, and s^2_{PL} when $e \sim Mt(0, \nu\sigma^2_2/(\nu-2)\Sigma)$, $v_1 = 16$, $v_2 = 8$, $k = 3$, $\nu = 5$.

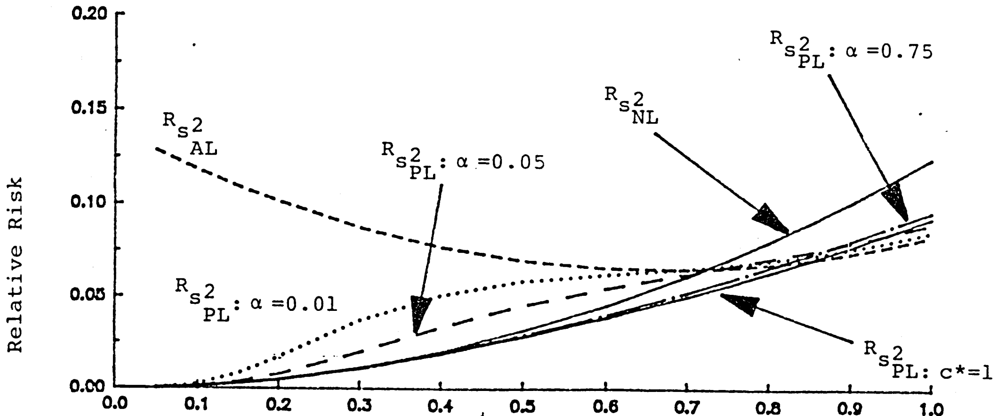

FIGURE 2. Relative risk functions for s^2_{NL}, s^2_{AL}, and s^2_{PL} when $e \sim N(0, \sigma^2_2\Sigma)$, $v_1 = 16$, $v_2 = 8$, $k = 3$.

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