Demand Analysis as an Ill-Posed Inverse Problem with Semiparametric Specification

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Abstract

In this paper we are concerned with analyzing the behavior of a semiparametric estimator which corrects for endogeneity in a nonparametric regression by assuming mean independence of residuals from instruments only. Because it is common in many applications, we focus on the case where endogenous regressors and additional instruments are jointly normal, conditional on exogenous regressors. This leads to a severely ill-posed inverse problem. In this setup, we show first how to test for conditional normality. More importantly, we then establish how to exploit this knowledge when constructing an estimator, and we derive results characterizing the large sample behavior of such an estimator. In addition, in a Monte Carlo experiment we analyze the finite sample behavior of the proposed estimator.

Our application comes from consumer demand. We obtain new and interesting findings that highlight both the advantages, and the difficulties of an approach which leads to ill-posed inverse problems. Finally, we discuss the somewhat problematic relationship between endogenous nonparametric regression models, and the recently emphasized issue of unobserved heterogeneity in structural models.

Keywords: Instrumental variables; Inverse problem; Nonparametric regression, Consumer Demand, Convergence rates.

1   Introduction

1.1   General Motivation

Regression models with endogenous regressors are a commonplace throughout much of applied Economics, and perhaps the rule rather than the exception. To deal with this problem, most of the time applied researchers employ instrumental variables (in the following denoted W). While it is well established how they are to be used if the model is known to be linear, it is much less clear in more general settings. Indeed, in this paper we will be concerned with the most general, the nonparametric setting, where it is only known that the structural relationship between a variable Y and an endogenous regressor X is a smooth, but otherwise unrestricted function m. In this setting, we focus specifically on the case when the endogenous regressor X and the instrument W are jointly normally distributed.

This choice of focus is intentional: Indeed, the aim of the paper is to show the scope of the nonparametric IV approach in a typical economic application - and (approximate) normality is arguably the leading distribution of continuous variables we find in applications[1]. Consider for instance figure 2 which shows a kernel density estimate of the marginal distribution of log total expenditure against a maximum likelihood estimate of a normal distribution using the same data. Judging from the marginals, normality of the joint distribution of log income and total expenditure seems to provide an acceptable description of the data.

In consumer demand, a well developed area of application, log total expenditure is suggested by economic theory as one of the regressor. However, it is believed to be endogenous, and log disposable income is usually taken as instrument. As we will demonstrate below, both variables are well characterized by joint normality, conditional on household covariables. While normality is commonly associated with benign behavior, this is not at all the case in a nonparametric regression with endogenous regressors. Indeed, joint normality can lead to very slow rates of convergence by various authors (Blundell, Chen and Kristensen 2006, henceforth BCK, Darolles et al. 2004 and Severini and Tripathi 2006).

In this paper we examine what can be learned about the relationship of interest m in such a scenario, and by what means. Specifically, we consider the population model

$$Y = m(X, Z) + U, \qquad \mathbb{E}(U|W, Z) = 0, \tag{1.1}$$

where m is an unknown function, Y, X and W are as defined above, Z denotes additional exogenous regressors, and U is an (unobservable) random error. This model will be called a

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[1]Of course, joint (conditional) normality can be tested, and we will propose and implement a test below. A byproduct is that once conditional normality is accepted, it is actually possible to derive a test for identification, as demonstrated below.

nonparametric IV regression model.

We propose a series estimator in the Hermite polynomials where the coefficients are obtained by additional nonparametric regression of the relevant quantities on Z. In comparison with other estimators in related settings, our estimator has the main advantages that its construction is intuitive, that it is simple and transparent, that it is fairly easy to compute, and that it is designed for an economically particularly relevant situation (model (1.1) with continuously distributed Z and conditional normality of (X, W) given Z). Given the complexity of the other models in this area, for these reasons it should be rather attractive for applied researchers.

1.2 Relationship to the Literature

The approach put forward in this paper is nonparametric, but under a semiparametric specification. Moreover, it is motivated by an application and also provides, to the best of our knowledge, the first application of a kernel based nonparametric model to an economic application in an ill-posed scenario. Therefore, it is most closely related to the model of BCK, who successfully implement a generalized partially linear model using the method of sieves. We will compare our approach to theirs at various places throughout the paper. Specifically, we discuss specification issues arising from a heterogeneity of a population of rational individuals for both approaches in section 5. Here we just mention that BCK assume discrete exogenous covariates Z, and model their influence semiparametrically. For the nonparametric part, BCK use a sieve estimator. As candidate sieve spaces they consider the Hermite functions (not the polynomials), but in addition other bases like spline bases as well. Thus, their estimation strategy allows for quite some flexibility by allowing to choose the appropriate sieves. They introduce a sieve measure of ill-posedness, and obtain rates of convergence both for the mildly ill-posed (polynomial decay) as well as severely ill-posed (exponential decay) case.

Other than through the (testable) semiparametric element of joint normality, our paper is entirely nonparametric. Fully nonparametric estimation of m in model (1.1) has been studied quite intensively in recent years. Here we briefly put are assumptions and results into perspective with the existing literature, specifically with Carrasco, Florens and Renault (2005) and Darolles, Florens and Renault (2004), Hall and Horowitz (2005), and Newey and Powell (2003).

Carrasco et al. (2005) and Darolles et al. (2004) consider primarily model (1.1) without an exogenous variable Z, i.e. $Y = m(X) + U$ where $\mathbb{E}(U|W) = 0$. Darolles et al. (2004) do not impose any distributional restrictions, but rather use a Tikhonov regularization of the inverse of the estimated operator $A : L_2(\mu_X) \to L_2(\mu_W)$, $(A\psi)(w) = \mathbb{E}(\psi(X)|W = w)$, where they plug in kernel estimates in the expression of A. Thus, in case that joint normality holds true, their estimator is similar to the series estimator with Tikhonov regularization scheme, except that

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they have an additional estimation error arising from nonparametric estimation of the operator A. Carrasco et al. (2005) also consider other regularization schemes like the Landweber-Friedmann regularization. Both Carrasco et al. (2005) and Darolles et al. (2004) restrict the class of functions for m more narrowly, and then obtain polynomial rates of convergence even in case when (X, W) are jointly normal.

Hall and Horowitz (2005) allow for a continuously distributed exogenous variable Z in model (1.1). They do not make any parametric distributional assumptions but rather assume that X, W and Z have compact support, and therefore exclude any normally distributed components. Further, they restrict attention to the case when the problem is mildly ill-posed, meaning that the eigenvalues of the operators A_z decay at a polynomial rate, and not, as in the case of joint normality considered here, exponentially fast. Moreover, they use a density weighting that leads them to consider (in the univariate endogenous case) rates of convergence in $L_2(I)$ (I is the compact interval under consideration) instead of $L_2(\mu_X)$ (as used in Carrasco et al 2005, Darolles et al. 2004 and BCK). Indeed, one could argue that it is more natural to use $L_2(\mu_X)$ since one should aim to estimate $m(x)$ more precisely where many observations X are available.

Newey and Powell (2003) also allow for continuously distributed Z without any additional parametric assumptions or assumptions on the support of the distribution of Z. Instead, they make stronger assumptions on the function m itself, namely that it belongs to a certain compact subset of L_2. Thus, they impose stronger (untestable) assumptions on the unknown regression function, where we prefer to restrict the distribution of (X, W, Z), which is justified in our application, and leave m as general as possible. Their estimator is a truncated series estimator in the Hermite functions (roughly the Hermite polynomials weighted by the standard normal density).

Finally, inverse problems in a statistical framework like noisy integral equations and density deconvolution problems were more generally studied within the last two decades (cf. e.g. O'Sullivan 1986, Nychka and Cox 1989, Donoho 1995, Johnstone and Silverman 1990, Mair and Ruymgaart 1996 and Cavalier and Tsybakov 2002).

1.3   Structure of the Paper

The paper proceeds as follows. In section 2, we introduce the exact assumptions for model (1.1), in particular conditional normality of (X, W) given Z. In order to check this assumption in applications, we propose a novel bootstrap test for conditional normality against nonparametric alternatives. Section 2.2 contains a result on identification of m under our semiparametric specification. In contrast to fully nonparametric specifications, identification in our semiparametric framework can be tested statistically. We suggest an estimator based on the principle of sample counterparts, and establish rates of convergence of this estimator, both in L_2 as well

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as uniformly. As an illustration, in Section 2.4 we briefly discuss the case where all variables (X, W, Z) are jointly normally distributed. In section 3 we investigate the finite sample behavior of our estimator in a Monte Carlo experiment, before we turn to an application in section 4. Specifically, we analyze the behavior of our estimator in a real world scenario, by using food expenditure from the British Family Expenditure Survey. The greater perspective of our application is discussed in section 5, where we argue that the conditions when a model with additive error arises are restrictive from an economic perspective. In particular, as an example we show that the the semiparametric specification of BCK is only compatible with a population with heterogeneous preferences if all individuals are identical (and the error is an orthogonal measurement error or the like), or a set of fairly implausible and untestable additional conditions hold. We conclude this paper with a summary.

2 Nonparametric IV Regression when Instruments and Regressors are Gaussian

We start with some basic assumptions and notations. Throughout we assume to have i.i.d. observations (X_i, Z_i, Y_i, W_i), $i = 1, \ldots, n$ from the population model (1.1), and focus on the case where $X_i \in \mathbb{R}$ and $W_i \in \mathbb{R}$ (i.e., the univariate case) to keep the exposition concise. In Remark 2.2 we briefly sketch how to extend our approach to the multivariate case.

The main additional assumption that we add to the specification of model (1.1) is the following: The conditional distribution of (X, W) given $Z = z$ is normal:

$$(X, W)|Z = z \sim \mathcal{N} \left(\left(\begin{array}{c} \mu_1(z) \\ \mu_2(z) \end{array} \right), \left(\begin{array}{cc} \sigma_1^2(z) & \rho(z)\sigma_1(z)\sigma_2(z) \\ \rho(z)\sigma_1(z)\sigma_2(z) & \sigma_2^2(z) \end{array} \right) \right). \qquad (2.1)$$

This assumption does not imply that the regression function $m(x, z)$ itself in (1.1) is parametrically specified, only that there are certain restrictions on the joint distribution of (X, W, Z). Moreover, we assume that $Z_i \in \mathbb{R}^d$ is continuously distributed, but this assumption can be relaxed, see the discussion after theorem 2. This set of assumptions will be invoked without further mentioning.

Further, let us introduce the following notation: Let μ_{XZW} denote the joint distribution of (X, Z, W), and let the marginal distributions be denoted in a similar fashion (e.g. μ_{XW} is the distribution of (X_i, W_i)). Let f_{XZW} denote the Radon-Nikodym derivative of μ_{XZW} with respect to Lebesgue measure (i.e., a density under our assumptions, and set $\mu_{XZ}(dx\,dz) = f_{XZ}(x, z)\,dx\,dz$, $\mu_{ZW}(dz\,dw) = f_{ZW}(z, w)\,dz\,dw$, where the marginal densities are again denoted in an obvious fashion. The conditional distribution of X given $Z = z$ is denoted by $\mu_{X|Z=z}$, it has density $f_{XZ}(x, z)/f_Z(z)$, and similarly for the conditional distribution of W given $Z = z$.

We denote the L_2 norm w.r.t. the probability measure $\mu_{X|Z=z}$ by $\|\cdot\|_{\mu_{X|Z=z}}$, and similarly for $\mu_{W|Z=z}$.

2.1   Testing Conditional Normality

Although there is an abundance of methods to test the goodness of fit of a parametric family of distributions, tests for a parametric form of a conditional distribution are surprisingly rare. In a recent contribution, Delgado and Stute (2008) suggest tests for parametric families of conditional distributions based on the martingale transform method. Here we propose a simple test based on comparing the L_2 distance of densities, using the bootstrap. We want to test whether

$$H_0: \quad \mathbb{P}(f(X,W|Z) = f(X,W|Z;\theta)) = 1,$$

is true. Here, $f(x,w|z)$ denotes the joint (nonparametric) density of X, W conditional on $Z = z$, and $f(X,W|Z;\theta))$ denotes the joint density of X, W conditional on $Z = z$ under the assumption that they are normally distributed with parameter θ, depending on Z, i.e. $\theta = \theta(Z)$. The alternative is that these functions differ on a subset of the support of (X, W, Z) of positive measure. The null is equivalent to the condition that the L_2 distance of the two functions is zero. Using a nonzero and bounded weighting function a, this condition can be written as

$$\Gamma_1 = \mathbb{E}\Big(\big(f(X,W|Z) - f(X,W|Z;\theta) \big)^2 a(X,W,Z) \Big) = 0. \tag{2.2}$$

The natural sample counterpart to Γ_1 is given by

$$\widehat{\Gamma}_1 = n^{-1} \sum_i \big(\hat{f}(X_i,W_i|Z_i) - f(X_i,W_i|Z_i;\hat{\theta}) \big)^2 a(X_i,W_i,Z_i), \tag{2.3}$$

where $\hat{f}(X_i,W_i|Z_i) = \hat{f}(X_i,W_i,Z_i)/\hat{f}(Z_i)$ is the ratio of two standard leave–one-out nonparametric kernel density estimators (e.g., $\hat{f}(Z_i) = \sum_{j\neq i} \big(nh^d\big)^{-1} K((Z_j - Z_i)/h)$, and K is a standard kernel. Moreover, $f(X_i,W_i|Z_i;\hat{\theta})$ is a semiparametric ML estimator defined as the minimizer of a local ML problem, i.e.

$$\mathcal{L}\left(\theta(Z_i)\right) = \big(nh^d\big)^{-1} \sum_{j\neq i} \log\left[\phi\left(X_j,W_j;\theta(Z_i)\right)\right] K((Z_j - Z_i)/h),$$

where ϕ is the density of the standard normal distribution. The asymptotic distribution of the test statistic (2.3) can be obtained using arguments as in Ait-Sahalia, Bickel and Stoker (2002), and because the large sample behavior of this test is not in the center of the paper we desist from presenting it here. Arguments for the consistency of bootstrap based procedures for the asymptotic distribution may be found there, as well as in Härdle and Mammen (1993). The following bootstrap procedure seems natural:

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1. For each $Z_i = z_i$, $i = 1, ..., n$, estimate $\theta(z_i)$ in $f(X_i, W_i | Z_i = z_i; \theta(z_i))$ through semiparametric ML.

2. Next, draw $Z_i^* = Z_i$, from the data.

3. For each $i = 1, ..., n$, draw one observation (X_i^*, W_i^*) from $f(X_i, W_i | Z_i = z_i^*; \hat{\theta}(z_i^*))$. This gives the bootstrap tuple (X_i^*, W_i^*, Z_i^*).

4. From (X_i^*, W_i^*, Z^*), $i = 1, ..., n$, compute $\widehat{\Gamma}_1^*$.

5. Repeat steps 2 to 4 often enough to obtain critical values for $\widehat{\Gamma}_1$.

2.2   Identification under Conditional Normality

First, to see how an integral equation arises in model (1.1), consider the conditional expectation operator

$$A : L_2(\mu_{XZ}) \to L_2(\mu_{ZW}), \qquad A\psi(z, w) \; = \; \mathbb{E}(\psi(X, Z) | Z = z, W = w) \qquad (2.4)$$
$$= \; \int \psi(x, z) \frac{f_{XZW}(x, z, w)}{f_{ZW}(z, w)} \, dx.$$

The regression function m is determined as the solution of the integral equation

$$\mathbb{E}(Y | Z = z, W = w) = (Am)(z, w). \qquad (2.5)$$

Thus, both the left hand side of (2.5) as well as the operator A are unknown in general and have to be estimated from the data.

Assume for the moment that

$$(X, W) | Z = z \sim \mathcal{N}\left(\begin{pmatrix} 0 \\ 0 \end{pmatrix}, \begin{pmatrix} 1 & \rho(z) \\ \rho(z) & 1 \end{pmatrix} \right), \qquad (2.6)$$

and consider the conditional expectation operator given $Z = z$,

$$A_z : L_2(\mu_{X|Z=z}) \to L_2(\mu_{W|Z=z}), \quad (A_z\phi)(w) = \int \phi(x) \frac{f_{XW|Z=z}(x, z, w)}{f_{W|Z=z}(z, w)} \, dx,$$

where obviously both $\mu_{X|Z=z}$ and $\mu_{W|Z=z}$ are the standard normal distribution for any z.

To present the spectral decomposition of A_z under assumption (2.6), consider the normalized Hermite polynomials $H_j(x)$ defined by

$$H_j(x) = (-1)^j \frac{\varphi^{(j)}(x)}{(j!)^{1/2}\varphi(x)},$$

where $\varphi(x)$ is the density of the standard normal distribution. The $(H_j)_{j\geq 0}$ form an orthonomal basis of $L_2(\mu_X)$, and

$$\big(A_z(H_k)\big)(w) = \rho^k(z) \, H_k(w), \qquad (2.7)$$

i.e. they form the orthonormal bases in the singular value decomposition of A_z, where the singular values are given by $\rho^k(z)$. Now expand

$$m(x, z) = \sum_{k \geq 0} \alpha_k(z) H_k(x), \quad \text{where} \quad \alpha_k(z) = \int m(x, z) H_k(x) \, d\mu_X(x) \qquad (2.8)$$

is the Fourier coefficient (w.r.t. the Hermite basis), conditional on z. Then in view of (2.7),

$$\big(A_z \, m(\cdot, z)\big)(w) = \sum_{k \geq 0} \beta_k(z) H_k(w) = \sum_{k \geq 0} \rho^k(z) \, \alpha_k(z) \, H_k(w),$$

where $\beta_k(z) = \mathbb{E}\big(Y H_k(W) | Z = z\big)$. Hence $\mathbb{E}\big(Y H_k(W) | Z = z\big) = \rho^k(z) \, \alpha_k(z)$, and the coefficients $\alpha_k(z)$ and hence the function m is identified on $\mathbb{R} \times I$ with $I \subset \mathbb{R}^d$ if and only if $\rho(z) \neq 0$ for all $z \in I$ (or at least μ_Z-almost all $z \in I$). In the general case (2.1), since all the objects μ_i and σ_i^2, $i = 1, 2$, are identified, we can simply assume that $(X, W) | Z$ is standardized. Thus, we obtain the following theorem giving sufficient and necessary conditions for identification under conditional normality:

Theorem 1. *Under assumption (2.1), the function $m(x, z)$ in model (1.1) is identified on $\mathbb{R} \times I$ with $I \subset \mathbb{R}^d$ if and only if $\rho(z) \neq 0$ for μ_Z-almost all $z \in I$.*

Remark 2.1 In the absence of restrictions on the joint distribution of (X, W, Z), in order to achieve identification one has to require that the conditional operators A_z are one-to-one for (a.e.) z or equivalently, that the singular values $\lambda_{k,z}$, $k \geq 1$, are non-zero for each z. This is clearly not a testable assumption, since it involves all the $\lambda_{k,z}$ simultaneously. In contrast, under the (testable) assumption (2.1), one can establish identification. Suppose that $\hat{\rho}(z)$ is a nonparametric estimate of $\rho(z)$ which does not change sign (otherwise identifiability is questionable), w.l.o.g. assume that $\hat{\rho}(z) > 0$. For a compact interval I with high concentration of observations Z_i, one can now bootstrap the distribution of $\inf_{z \in I} \hat{\rho}(z)$. If the 5% quantile of this distribution is larger than zero, the hypothesis of identification is not rejected.

Remark 2.2 The diagonalization of the conditional expectation operators A_z in terms of the Hermite polynomials is based on the so-called Mehler's formula, for which also multivariate and in particular bivariate extensions exist (cf. Erdelyi 1939).

Further, the theory can be extended to (conditional) distributions for which the conditional expectation operators A_z allow an explicit form for the diagonalization, i.e. distributions with densities which allow so-called diagonal expansions (cf. Barrett and Lampard 1955).

2.3   Estimation under Conditional Normality

Now let us turn to estimation under Assumption 2.5. Let $\hat{\mu}_i$, $\hat{\sigma}_i$, $i = 1, 2$, and $\hat{\rho}(z)$ be nonparametric estimates of μ_i, σ_i and $\rho(z)$. Generally, we have $\mathbb{E}\big(Y H_k(W^*) | Z = z\big) = \beta_k(z)$, where

$W^* = (W - \mu_2(Z))/\sigma_2(Z)$. Therefore, using the estimated normalized variables

$$\hat{W}_i^* = \frac{W_i - \hat{\mu}_2(Z_i)}{\hat{\sigma}_2(Z_i)}.$$

$\beta_k(z)$ can be estimated by nonparametric regression. We shall use a local linear estimator and for simplicity, restrict the following discussion to the case $d = 1$. Then the estimator for $\beta_k(z)$ is given by

$$\hat{\beta}_k(z) = \frac{\sum_{j=1}^n l_j(z) Y_j H_k(\hat{W}_j^*)}{\sum_{j=1}^n l_j(z)}, \tag{2.9}$$

where

$$l_j(z) = K\left(\frac{z - Z_j}{h}\right)\left(s_{n,2}(z) - (z - Z_j)s_{n,1}(z)\right),$$

$$s_{n,i}(z) = \sum_{j=1}^n K\left(\frac{z - Z_j}{h}\right)(z - Z_j)^i, \quad i = 1, 2,$$

and K is a kernel function and $h > 0$ the bandwidth.

The final estimator of $m(x, z)$ is hence given by

$$\hat{m}(x, z) = \sum_{k \geq 0} \hat{\beta}_k(z) \, w\left(\hat{\rho}(z), k; M\right) H_k\left(\frac{x - \hat{\mu}_1(z)}{\hat{\sigma}_1(z)}\right). \tag{2.10}$$

Here, $w(\cdot, \cdot)$ is a regularisation scheme, and M its regularisation parameter. For example, if $\hat{\rho}(z) \neq 0$ for all z, one can use a simple truncation scheme (spectral cut-off)

$$w_{sco}\left(\hat{\rho}(z), k; M\right) = \begin{cases} \hat{\rho}(z)^{-k}, & k \leq M, \\ 0 & k > M. \end{cases}$$

Alternatively, the Tikhonov regularization scheme with regularization parameter $\alpha > 0$ ($\alpha \to 0$ as $n \to \infty$) is given by

$$w_{Tyk}\left(\hat{\rho}(z), k; \alpha\right) = \frac{\hat{\rho}(z)^k}{\alpha + \hat{\rho}(z)^{2k}}.$$

We analyze the asymptotic behavior of this estimator under the following set of Assumptions. Here, $C > 0$ is an arbitrarily large but fixed constant.

Assumption 1. *The coefficients $\alpha_k(z)$ in the expansion (2.8) satisfy $|\alpha_k(z)| \leq Ck^{-\gamma}$, $\gamma > 3/4$, uniformly in z, are two-times continuously partially differentiable with uniformly bounded (in z and k) first and second derivatives.*

Assumption 2. *The functions $\mu_i(z)$ and $\sigma_i(z)$, $i = 1, 2$, and $\hat{\rho}(z)$ are two-times continuously partially differentiable and uniformly bounded up to the second derivative by $C > 0$. Further, $1 > \rho_{max} \geq |\rho(z)| \geq \rho_{min} > 0$ for $z \in I \subset \mathbb{R}$, and m is uniformly bounded by $C > 0$.*

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Assumption 3. *The estimators $\hat{\mu}_i(z)$, $\hat{\sigma}_i(z)$ and $\hat{\rho}(z)$ for $\rho(z)$ converge uniformly on compact intervals $I \subset \mathbb{R}$ with polynomial rate, e.g. there is a $\epsilon_0 > 0$ such that $\sup_{z \in I} |\hat{\rho}(z) - \rho(z)| = O(n^{-\epsilon_0})$.*

Assumption 4. *The density f_Z of the Z_j is bounded away from 0 by $1/C$ on compact intervals $I \subset \mathbb{R}$.*

Assumption 5. *The kernel function K in the local linear estimators (2.9) is a bounded, symmetric probability density function, $\int zK(z)dz = 0$, $\int z^2 K(z)dz < \infty$ and $\int K^2(x)dx < \infty$. The bandwidth is chosen as $h \sim n^{-1/5}$.*

Assumptions 1 and 2 are similar to assumption MV.3 in Hall and Horowitz (2005). Assumptions 4 and 5 are standard in nonparametric regression and are taken from Fan (1992). Finally, note that in Assumption 3 we do not further specify the nonparametric estimators of the functions $\mu_i(z)$, $\sigma_i(z)$ and $\rho(z)$. Uniform convergence is proved for $\mu_i(z)$ in Blondin (2007) for the local linear estimator, and for $\sigma_i(z)$ and $\rho(z)$ in Neumann (1994) for kernel estimators.

The following result, whose proof can be found in the appendix, summarizes the asymptotic behavior:

Theorem 2. *Suppose that $I \subset \mathbb{R}$ is compact. Let assumptions $1 - 5$ be true. For the estimator (2.10) based on the spectral cut-off regularization scheme, for $M = c \log n$ with sufficiently small c we have that for every $\delta > 0$ there is C_δ and n_0 such that for all $n \geq n_0$, and for all $z \in I$,*

$$\mathbb{P}\left(\|\hat{m}_{sco}(\cdot, z) - m(\cdot, z)\|^2_{L_2(\mu_{X|Z=z})} > C_\delta \left(\log n \right)^{-2\gamma+1} \right) < \delta. \tag{2.11}$$

Further, for compact $J \subset \mathbb{R}$ we have that for all $z \in I$,

$$\mathbb{P}\left(\sup_{x \in J} |\hat{m}_{sco}(x, z) - m(x, z)| > C_\delta \left(\log n \right)^{-\gamma+3/4} \right) < \delta. \tag{2.12}$$

Remark 2.4 The first part of the theorem, eq. (2.11), is similar to Theorem 4.3 in Hall and Horowitz (2005), though they consider operators A_z which are mildly ill-posed. The rate of convergence obtained in their setting also depends on the additional exogenous regressors Z, which is surprisingly not the case for the severely ill-posed problem with conditional normal endogenous regressors and instruments as considered in Theorem 2 (cf. the proof of Theorem 2 in the appendix for the mathematical reason).

2.4 Identification and Estimation under Full Joint Normality

In general the eigenvalues $\rho^k(z)$ of the operator A_z in section 2.2 will depend on z, and although the rate is independent of the magnitude of $\rho(z)$, the relevant constants will strongly depend

on it. Therefore, we investigate the dependence of $\rho(z)$ on z in a particular case, namely when we have joint normality of the vector (X, W, Z). It turns out that in this important special case, $\rho(z)$ will be constant. We shall suggest an alternative estimator under full joint normality and study its large sample behaviour.

Assume for simplicity that the (X, Z, W) have been standardized, so that they are jointly normally distributed with mean-vector zero and covariance matrix

$$\Sigma = \begin{pmatrix} 1 & \rho_{XZ} & \rho_{XW} \\ \rho_{XZ} & 1 & \rho_{ZW} \\ \rho_{XW} & \rho_{ZW} & 1 \end{pmatrix}. \tag{2.13}$$

Then the entries in the conditional distribution (2.1) are given by $\mu_1(z) = \rho_{XZ}z$, $\mu_2(z) = \rho_{WZ}z$, and $\sigma_1^2 = 1 - \rho_{XZ}^2$, $\sigma_2^2 = 1 - \rho_{WZ}^2$ and

$$\rho = \left(\rho_{XW} - \rho_{XZ}\rho_{ZW}\right)\left((1 - \rho_{XZ}^2)(1 - \rho_{WZ}^2)\right)^{-1/2}, \tag{2.14}$$

so that σ_1, σ_2 and ρ are in this case independent of z. Thus, global regularization in z is reasonable in this case. Also note that identification of m is now equivalent to $\rho \neq 0$, which can easily be tested parametrically. Under joint normality, one can also give the spectral decomposition of the unconditional operator A. It is in fact easy to show that the functions

$$\psi_{j,k}(x, z) = H_j\left(\frac{x - \rho_{XZ}z}{\sigma_1}\right)H_k(z), \quad \chi_{j,k}(z, w) = H_j\left(\frac{w - \rho_{ZW}z}{\sigma_2}\right)H_k(z),$$

form orthonormal bases of the spaces $L_2(\mu_{XZ})$ and $L_2(\mu_{ZW})$, respectively, and

$$(A\psi_{j,k})(z, w) = \rho^j \chi_{j,k}(z, w),$$

where ρ is given in (2.14). Therefore, under joint normality one can also use a double series estimator. Let

$$\beta_{j,k} = \int (Am)(z, w)\,\chi_{j,k}(z, w)\,\mu_{ZW}(dz\ dw), \qquad \alpha_{j,k} = \int m(x, w)\,\psi_{j,k}(x, w)\,\mu_{XW}(dx\ dw).$$

An estimator with a truncation regularisation scheme is given as follows.

$$\hat{m}_{JN}(x, z) = \sum_{j=0}^{M_1}\sum_{k=0}^{M_2} \frac{\hat{\beta}_{j,k}}{\hat{\rho}^j}\,\hat{\psi}_{j,k}(x, z), \tag{2.15}$$

where M_1 and M_2 are truncation parameters, and

$$\hat{\beta}_{j,k} = \frac{1}{n}\sum_{i=1}^{n} Y_i H_j\left(\frac{W_i - \hat{\rho}_{WZ}Z_i}{\hat{\sigma}_2}\right)H_k(Z_i), \qquad \psi_{j,k}(x, z) = H_j\left(\frac{x - \hat{\rho}_{XZ}z}{\hat{\sigma}_1}\right)H_k(z).$$

Further, one can e.g. choose $\hat{\rho}_{XZ} = \frac{1}{n} \sum_{k=1}^{n} X_k Z_k$, and $\hat{\rho}_{ZW}$ and $\hat{\rho}_{XW}$ are similar parametric estimators. Further, $\hat{\rho}$, $\hat{\sigma}_1$ and $\hat{\sigma}_2$ are obtained by plugging these into the corresponding expressions for ρ, σ_1 and σ_2, respectively. The convergence rates (2.11) and (2.12) also hold for this estimator. Moreover, one can give an even more global convergence result (w.r.t. the joint distribution μ_{XW}) under the following assumptions.

Assumption 6. *The coefficients $\alpha_{j,k}$ of m satisfy $|\alpha_{j,k}| \leq C j^{-\gamma} k^{-\delta}$ for some $\gamma, \delta > 1/2$.*

Assumption 7. *The conditional variance function $\sigma^2(w, z) = \mathbb{E}(U^2 | Z = z, W = w)$ and m are uniformly bounded (bounded in $\| \cdot \|_{\infty}$).*

Assumption 8. *The parameter estimates $\hat{\rho}_{XZ}$, $\hat{\rho}_{ZW}$, $\hat{\rho}_{XW}$, $\hat{\rho}$, $\hat{\sigma}_1$ and $\hat{\sigma}_2$ converge in probability with parametric rate $n^{-1/2}$.*

Assumption 6 is a standard smoothness assumption for the function m, Assumption 7 is also rather common in nonparametric regression. Assumption 8 is satisfied e.g. by as maximum likelihood estimators.

Theorem 3. *Suppose that (X, W, Z) are jointly normal and standardized with covariance structure given in (2.13), and that Assumptions 6, 7 and 8 are satisfied. Then for $M_1 = c \log n$ with $c > 0$ small enough and $M_2 = n^{-\epsilon}$ for $\epsilon > 0$ small we have for the estimator $\hat{m}_{JN}$ in (2.15) that*

$$\| \hat{m}_{JN} - m \|_{L_2(\mu_{XZ})}^2 = O_P\big((\log n)^{-2\gamma + 1} \big) \tag{2.16}$$

This appears to be the first result in which a rate of convergence is derived for an non-parametric IV estimator with additional continuous exogenous variables in $L_2(\mu_{XZ})$, i.e. w.r.t. the joint distribution of (X, Z). Again, the rate in (2.16) does not depend on the additional regression on Z.

Remark 2.7: If exogenous regressors Z_i are present in the regression problem (1.1), then the unconditional operator A in (2.4) is no longer a Hilbert Schmidt operator, since it acts as the identity on functions $g(z) \in L_2(\mu_Z) \subset L_2(\mu_{XZ})$. Therefore, the image A^*Am can no longer be estimated at a fast rate (in case of known A which is Hilbert-Schmidt, this rate is $n^{-1/2}$), and the strategy in Darolles, Florens and Renault (2006) to first estimate A^*Am and then to apply a regularized version of the inverse of A^*A (or its estimated version) can no longer be pursued. In Section 2.3 (and similarly in Hall and Horowitz 2005), this is overcome by assuming that the conditional operators A_z are Hilbert Schmidt and moreover satisfy a uniformity condition (expressed in the assumption that $\rho(z)$ is bounded away from 0). In this section under joint normality, we show that one can simply construct a bivariate series estimator which covers both the identity component of A as well as the Hilbert Schmidt component, and for which two distinct truncation parameters are required which grow at different rates.

3 Simulation

In this section we report the results of an extensive simulation study. We start with a scenario with conditional normality, and generate data (Y_i, X_i, Z_i, W_i) from model (1.1) for distinct functions m_j, where

$$m_1(x, z) = (-1.5x)(z + 2), \quad m_2(x, z) = (x^2 + 2)(z^2 x + 0.5) \quad m_3(x, z) = \exp(-0.2(z + 2)x).$$

For the (X, Z, W, U), generate a three-dimensional normal random vector (U, X^*, W^*) with mean vector zero and covariance matrix

$$\Sigma = \begin{pmatrix} 1 & 0.5 & 0 \\ 0.5 & 1 & 0.7 \\ 0 & 0.7 & 1 \end{pmatrix}.$$

Further, draw Z independent of (U, X^*, W^*) from a Beta distribution $B(1/2, 1/3)$, and standardize it. Then set $X = X^* + Z^2$ and $W = W^* - (Z^3 - Z)/2$. Thus, we have $\mu_1(z) = z^2$, $\mu_2(z) = -(z^3 - z)$, $\sigma_1^2(z) = \sigma_2^2(z) = 1$ and $\rho(z) = 0.7$ are constant. We estimate these functions nonparametrically by a local polynomial estimator of order one with a data-driven plug-in bandwidth choice. Then, we simulate 10000 times samples of size $N = 5000$ for each m_j, and use the estimator (2.10) with the simple truncation scheme and different truncation parameters. As in (2.11), we are mainly interested in the behavior of the m_j as a function of x for fixed z. Therefore, for two distinct values of z ($z_1 = 0.1$, $z_2 = 1$) we record the values of the coefficient $\hat{\beta}_k(z_i)$, $k = 0, \ldots, 4$ and $i = 1, 2$. Further, for each of these truncation parameters we compute $\|\hat{m}(x, z_i) - m_j(x, z_i)\|_{L_2(X|Z=z_i)}^2$ (the weighted error) and $\|\hat{m}(x, z_i) - m_j(x, z_i)\|^2$ (the unweighted error over the interval $[-2.5, 2.5]$).

The results for estimation at z_1 are presented in Tables 1 - 3, for z_2, the results were similar though a little less good. We see that for suitably chosen truncation parameter M, the estimator performs well for all target functions m_j, $j = 1, 2, 3$. However, if M is chosen too high, then the estimation precision decreases significantly, in particular the 0.75 and 0.95 quantiles of the distribution of the (weighted or unweighted) MISE increase. This effect is stronger for the unweighted case then for the weighted case. A similar effect can be observed for the coefficients $\beta_j(z_i)$. The estimates of higher order coefficients have high variance. Thus, even though the median of these estimates is reasonable, the variability becomes large, which can lead to very bad estimators in some cases if these coefficients are included. Nevertheless, since only a few (small and discrete) values of M have to be tested, a proper choice of the smoothing parameter is no problem in practice. See also Figure 1 for plots of the true functions and typical estimates. As a benchmark, we also performed simulations for estimating m_2 at z_1, but where the exogenous covariate is fixed at z_1. Although there is no asymptotic effect when regressing on Z,

there is quite a finite sample effect, compare Tables 4 and 2. One reason is the automatic bandwidth choice in the nonparametric estimation of the various quantities by a local linear estimator in the setting with exogenous covariate. We use a direct plug-in rule for estimating the bandwidth, which performs reasonably well in the majority of cases, but sometimes is also much too small, so that the estimator behaves rather poorly.

We furthermore conducted simulations with a nonconstant correlation function, in order to investigate its effect, in particular concerning the uniform choice of the truncation parameter M. We chose $\rho(z) = 0.6 + z\,0.3$, where $Z \sim B(1.5, 1.5)$, and considered the regression function $m(x, z) = x^2 + 2$, which does not depend on z (so that the same conditional function is estimated). We chose $z_1 = 0.2$ and $z_2 = -0.2$, and compared the estimation results. However, these did not differ substantially, the errors when estimating nonparametrically the functions $\beta_k(z)$ and $\rho(z)$ by local linear estimation had the most effect. Further, since only small values for M are required and $\rho(z)$ is comparatively large, the error when dividing by the small power of $\hat{\rho}(z_i)$ does not have much more effect than the error when estimating $\hat{\beta}_k(z_i)$.

Finally, in a different scenario under full joint normality of (X, W, Z) we compare the performance of the estimators (2.10) (which only uses conditional normality) and (2.15) (which exploits the full joint normality). In turns out that the estimator (2.15) performs only slightly better than the estimator (2.10), even though it takes stronger advantage of the distributional properties. Thus, in practice we recommend to choose the estimator (2.10) which has less stringent distributional assumptions.

4   Application

4.1   Empirical Specification

Neglecting the issue of preference heterogeneity for the moment, following BCK we simply assume that the there is a relationship m between a K-vector of dependent variables Y, in our case budget shares, and total expenditure X as well as a set of exogenous regressors Z such that

$$Y = m(X, Z) + U, \qquad \mathbb{E}\left[U|W, Z\right] = 0 \qquad (4.1)$$

holds, where W is disposable income. The reason that X is believed to be endogenous in demand analysis is that total expenditure and demand for individual goods are both believed to be parts of a general preference ordering of individuals which is partly incorporated in the error U (an example of how preference heterogeneity manifests itself in the error was given in section 2). Disposable income of individuals in contrast is believed to be exogenous, because the driving unobservables like ability are assumed to be independent of the preference orderings.

Of course, this assumption is questionable, but in this paper we follow the demand literature in assuming that this is the case. Additionally, we assume that preferences are such that they admit a sufficiently smooth demand relationship (e.g., preferences are strictly convex, with associated differentiable utility functions). We use household data, but abstract from any inter family allocation issues, which we feel is justified given the focus of this paper.

At the core of the paper is the joint normality of X and W, conditional on Z, which we argue to be a reasonable assumption in our application. Indeed, our approach aims at exploiting this knowledge about the distribution, or turned a bit more negatively, argues that even using this knowledge the situation is difficult. One advantage associated with this semiparametric element is the standard semiparametric one: It allows to mitigate the curse of dimensionality. This is however not the only feature we employ to make nonparametric analysis tractable in the high dimensional environment that we are working in. Specifically, when conditioning on household observables we use a low dimensional vector of principal components instead of the original high dimensional vector of household covariables. Like much of the demand literature we condition on some of them because we are working in a specific subpopulation, defined by household characteristics. However, in the original data there are more than 100 household covariates, many of which are discrete. Including them in an unrestricted nonparametric analysis is impossible. Instead, we have some consistency checks for our use of principal components. In a mild abuse of notation we refer to these components from now on also as Z. We now turn to a precise description of the data.

4.2   Data Description

For our analysis we employ the British FES. Every year, the FES reports the income, expenditures, demographic composition and other characteristics of about 7,000 households. The sample surveyed represents about 0.05% of all households in the United Kingdom. The information is collected partly by interview and partly by records. Records are kept by each household member, and include an itemized list of expenditures during 14 consecutive days. The periods of data collection are evenly spread out over the year. The information is then compiled and provides a repeated series of yearly cross-sections.

The category of goods we consider is food related, and consists of the subcategories food bought and catering, which are self explanatory. Together our food category accounts for 28% of expenditures on average. We removed outliers by excluding the upper and lower 2.5% of the population. Income is constructed as in the definition of the "household below average income study" (HBAI). It is roughly defined as net income after taxes, but including state transfers. This is done in both data sets to define nominal income. Real income is then obtained by dividing through the retail price indices. As mentioned, we stratify the population to obtain

a relatively homogeneous subpopulation, which is equivalent to controlling for the influence of discrete controls nonparametrically. Like much of the demand literature we focus on one subpopulation (namely two person households, both adults, at least one working and the head of household a white collar worker), to minimize measurement error.

4.3   Results

We first start by reporting the results for the test of conditional normality. The value of the test statistic $\widehat{\Gamma}_1$ is 0.13463 which corresponds to a p-value of the bootstrap distribution of 0.85. This indicates clearly that conditional normality is not rejected. The stronger hypothesis of joint normality, however, is rejected using a standard normality test with a p-value of virtually zero.

Since our analysis is nonparametric, much of our findings can be conveniently summarized in univariate graphs. We will be particularly concerned by the following issues, all of which will be illustrated by a comparative graph: Sensitivity of our results with respect to the choice of the truncation parameter M, variation across values of Z, comparison with the exogenous and the control function IV case, and the effect of assuming joint normality.

Start with the choice of M. Figures 3 and 4 illustrate the effect of variations in M, the degree of the polynomial. The first graph illustrate the Conditional Normal Estimator (henceforth CNE) when $M = 1$, respectively $M = 3$, while the second one shows what happens when going from $M = 3$ to $M = 4$, always at $Z = 0$. Clearly, the first picture shows that we obtain qualitatively similar results, while $M = 3$ reveals the additional structure of a stronger decay at low totexp which is masked by the linear specification.

Trying to be more complex, however, results in problems as demonstrated by figure 4. With only $M = 4$ components we obtain implausible structures like the upswing of the food budget share at higher levels of totexp. Indeed, for $M > 4$ this upswing increases further, rendering this method ineffective. This is in accordance with the simulation results, which show that the variance of the estimator increases significantly with increasing M, cf. Section 4.

All figures displayed up to now showed the behavior of the estimator at the center of Z distribution. With slightly varying Z, the behavior still remains acceptable. However, for $Z = -0.3$, the estimator shows an oscillation that is economically implausible (cf. figure 5). Here it has to be taken into account that the estimator is designed for estimation in $L_2(\mu_{X|Z=z})$, and thus cannot be expected to be very precise for values of Z that are far from the center of the data. Moreover, this suggests that different values of M, the degree of Hermite polynomial, are required for different values of Z, because even if a specification of $M = 3$ seems acceptable for $Z = 0$, for $Z = -0.3$ and the same M we end up with results that are implausible, and that further aggravate as Z increases.

The effect of correcting for endogeneity is analyzed in the following graph (figure 6), which shows a comparison of an exogenous nonparametric regression with our CNE. Moreover, an alternative way of controlling for endogeneity is displayed: control function IV. Indeed, we find only moderate evidence that correcting for endogeneity does affect the results too much. Certainly, the downward trend in food budget shares is unambiguous and very pronounced throughout the specifications. Correcting for endogeneity does seem to have a mitigating effect on the marginal effect. This effect is perhaps most pronounced when comparing exogenous with control function IV, while our CNE is somewhere in the middle. These findings seem to suggest that our estimators are robust to misspecification. However, they are not: If instead of conditional normality we employ joint normality, much less sensible results appear, cf. figure 7.

Indeed, we observe an implausible strong decline in food budget shares across the totexp range, which is in contradiction with virtually all findings in the literature. But then again, we already know that joint normality is rejected. We conclude that the CDE is sensitive to small changes in the specification. That this effect is not apparent when analyzing endogeneity in figure 6 is more of an indication that the effect of endogeneity is rather moderate in our application (which is in surprising contradiction to BCK, who used very similar data). How the estimator performs in a setting where the regressors are strongly endogenous remains to be determined.

5 Are Nonparametric IV and Heterogeneous Populations Compatible in Empirical Work?

In the previous sections, we have shown that feasible nonparametric IV techniques can be proposed and implemented even in situations where the problem at hand is severely ill-posed. Since many continuous variables in economic applications are approximately normally distributed, our results are encouraging for the applicability of this method. However, at this point we would like to raise an issue which suggests to apply these type of methods with caution and only after careful deliberation, at least in some economic applications. This issue is unobserved heterogeneity, and the related question about the identification of structural parameters in a heterogeneous population. Indeed, we will argue in this section that the mean independence restriction we employ, namely $\mathbb{E}[U|W, Z] = 0$ is not likely to identify meaningful parameters of interest in a heterogeneous population.

We illustrate this issue with the model of BCK. We take their approach, because their paper is (to the best of our knowledge) the only successful attempt for application of the techniques put forward in the econometric literature on ill-posed inverse problems, and hence is most closely

related to our work. Also, the point we make can be illustrated best in the semiparametric specification they suggest. But it is by no means confined to their paper, and hence is not a specific drawback of their approach. Indeed, it will become obvious that if anything the point aggravates in the entirerly nonparametric approach. Moreover, the approach put forward in our paper does not really offer a means to circumvent this problem, it (only) allows to deal with observable heterogeneity in a slightly more general fashion.

But let us sketch the problem: *On individual level,* BCK consider the class of preferences giving rise to following model:

$$Y = h(X - Z'\theta_1) + Z'\theta_2, \tag{5.1}$$

where, in their semiparametric specification, $\theta = (\theta_1', \theta_2')'$ denotes a (individual specific) vector of coefficients, and h an unrestricted smooth function[2]. *On individual level,* this model can be shown to be in line with the economic theory, see Pendakur (1998). Of course, as much of microeconometrics BCK estimate their model with data coming from a heterogeneous population. BCK acknowledge this fact by appending an additive error U, and assuming that $\mathbb{E}[U|W, Z] = 0$ holds, motivating the need for an IV restriction by the correlation of total expenditure contained in X and unobserved preference heterogeneity contained in U.

The question one might ask is why an appended additive error captures preference heterogeneity at all? Starting from Brown and Walker (1983), the demand literature has questioned the use of an additive error as means of capturing unobserved heterogeneity. Indeed, when moving from the individual level model (5.1) to a heterogeneous population, it would be quite natural to consider

$$Y_i = h_i(X_i - Z_i'\theta_{1i}) + Z_i'\theta_{2i}, \qquad i = 1, \ldots, n. \tag{5.2}$$

Obviously, this model is distinct from the one considered in BCK. If the population were completely identical, i.e., $\forall i : h_i = h, \theta_i = \theta$, these common coefficients h, θ could be estimated from the data. But in this case there were also no residual U and no endogenous regressor. Returning to the unrestricted model defined through equation (5.2), in Hoderlein, Klemelä and Mammen (2007), the estimation of the distribution of coefficients f_θ in the much simpler model of the form $Y_i = Z_i'\theta_i$ is discussed, but model (5.2) is beyond the scope of their approach as it stands.

However, a distribution of marginal effects is not what is of interest in the nonparametric IV literature. Hence, in this section and throughout the rest of the paper, we assume that interest centers on some average or "typical" effect in a heterogeneous population. Since BCK are not explicit about this issue, we assume it is the mean value of the coefficient (denoted $\overline{\theta}$)

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[2]They consider an L-vector Y, but we restrit ourselves to the scalar case. For the point we raise, this is immaterial.

across the heterogeneous population[3]. From now on, for the rest of this section we will drop the subscript i on the coefficients, and assume that all variables other than the means $\overline{\theta}$ vary across the population. To make life simple, we assume that the model on individual level is the less general

$$Y = (X - Z'\theta_1)\theta_3 + Z'\theta_2,$$

where θ_3 is a scalar random coefficient, i.e. $h(\xi) = \theta_3\xi$. In loose analogy to the semiparametric efficiency literature, we could argue that the case with general h cannot be better than the worst parametric submodel. It is easy to show that we may rewrite this model as

$$Y = (X - Z'\overline{\theta}_1)\overline{\theta}_3 + Z'\overline{\theta}_2 + U,$$

with $U = \left(\theta_3 - \overline{\theta}_3\right)X + Z'\left\{\left(\theta_1 - \overline{\theta}_1\right)\overline{\theta}_3 + \left(\theta_3 - \overline{\theta}_3\right)\theta_1 + \left(\theta_2 - \overline{\theta}_2\right)\right\}$. The remaining question is now: How do we arrive at $\mathbb{E}\left[U|W, Z\right] = 0$?

To this end, we assume that we have instruments that are independent of unobserved preference heterogeneity. In our setup, assume that $(W, Z) \perp \theta$, which corresponds also to the economic motivation BCK provide. Then,

$$
\begin{aligned}
\mathbb{E}\left[U|W, Z\right] &= \mathbb{E}\left[\left(\theta_3 - \overline{\theta}_3\right)X|W, Z\right] + \mathbb{E}\left[\left(\theta_3 - \overline{\theta}_3\right)Z'\theta_1|W, Z\right] \\
&= Cov\left\{\theta_3, V + Z'\theta_1|W, Z\right\}
\end{aligned}
$$

where $V = X - \mathbb{E}\left[X|W, Z\right]$. Even full joint independence of (θ, V) from (W, Z) is not sufficient to reduce $\mathbb{E}\left[U|W, Z\right]$ to a constant, yet alone to zero. Consequently, we have to *assume* that $Cov\left\{\theta_3, V + Z'\theta_1|W, Z\right\} = 0$ holds for which there is no plausible economic reason. Of course, for any other parametric specification of h a similarly implausible untestable restriction were required to hold, and for the model with unknown infinite dimensional parameter h it would be the envelope of these restrictions. This effectively rules out that a model like $Y = h(X - Z'\theta_1) + Z'\theta_2$ holds on the individual level with meaningful heterogeneity in parameters across the population. If we believe the model with errors mean independent of instruments to be correct, then we have effectively assumed that the population shares the identical structural model defined by m, up to an additive shift parameter which varies and is endogenous. Needless to mention, this is restrictive.

This type of observation has predecessors: Other than Brown and Walker (1983), Lewbel (2001) has made a related observation for a heterogeneous "Almost Ideal" population in the purely exogenous setting. Moreover, in the literature in economic theory on aggregation, findings that are similar in spirit emerge, see Hildenbrand (1993). The deeper reason is that models defined by some type of conditional mean restriction implicitly aggregate across a heterogeneous population, and aggregation is a step by which many properties vanish. Instead,

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[3]We could consider the median or other quantities. Unsurprisingly, this would only make matters worse.

features of the aggregation process, in our example conditional covariances are introduced. And the nonparametric regression model involving an additive error U, and obeying a restriction $\mathbb{E}[U|W, Z] = 0$ is just a case in point.

What are the alternatives? If the goal is to get an overview of the distribution of the coefficients, one possible route is the afforementioned random coefficients model, Hoderlein, Klemelä and Mammen (2007). This framework can allow for preference heterogeneity, and regressors that are endogenous. However, the drawback is that it is, as of yet, limited to linear models on individual level. Another alternative are nonseparable models as in Hoderlein (2005, 2008), Hoderlein and Mammen (2007) or Imbens and Newey (2007), which can allow for endogenous regressors even in setups that are more general than the one considered by BCK.

The drawback of these alternative approaches is that they employ control function methods to correct for endogeneity, i.e., they require that the control functions V be correctly specified and hence require correct specification of the relationship that defines it, e.g., $V = X - \mathbb{E}[X|W, Z]$. It is the advantage of the ill-posed inverse literature that this equation need not be specified, and no risk of misspecification arises. But, as we have seen, there may be a price to pay in terms of economic foundation in a heterogeneous population.

6   Conclusion and Outlook

This paper is concerned with analyzing issues in the application of nonparametric IV regression models, which lead to ill-posed inverse problems for economic questions. As an example of a simple setup in which rationality restrictions and economic behavior may be analyzed we take consumer demand. We establish that the relationship between nonparametric IV models and the recently emphasized issue of unobserved heterogeneity in structural models is tenuous at best for the case of consumer demand. As such, we believe that in such a problem a nonseparable control function approach is perhaps more suitable to deal with the issues of endogeneity and preference heterogeneity (see, e.g., Lewbel (2001) or Hoderlein (2005, 2008)). Still, the fact that approaches like the one put forward in this paper dispense with the requirement in the control function models that one has to specify the relationship that defines the control functions (i.e., the relationship between endogeneous regressors and instruments) make these models attractive. Therefore, approaches involving nonparametric IV which lead to ill-posed inverse problems may have some scope in demand analysis if one is not too concerned about unobserved heterogeneity.

The obvious following question is then: How do these models perform in practice? As in many applications that involve continuous endogenous regressors and instruments, it is also the case in consumer demand that these are approximately normally distributed. Unfortunately,

for the literature on inverse problems this is bad news, since a normal specification leads to a severely ill-posed inverse problem with very slow (in general only logarithmic) convergence rates. Moreover, an additional error is introduced when estimating the operator. To achieve the best possible performance and to construct a simple and transparent estimator, in this paper we show how knowledge of joint (conditional) normality may be incorporated when estimating these models semiparametrically, and we devise and analyze such an estimator. An interesting feature of our semiparametric approach is that it suggests a test of identification.

Both in our simulation, as well as in the application, we do find our estimator to perform reasonably well, at least when one takes into account that it is designed to provide a good fit in the center of the data (in the tails, the behavior is less satisfactory). However, the estimator turns out to be quite sensitive towards specification issues, like the choice of the truncation parameter, and to misspecification (e.g., the breakdown when wrongly assuming joint, instead of conditional normality). In particular, higher order Hermite polynomials in particular exhibit a high degree of variability. Choosing other basis functions may improve the performance of the estimator in finite sample situations, but at the cost of a more sophisticated estimator, and the precise performance still has to be investigated in our setup with continuous exogenuous covariates.

In summary, this paper has shown that estimation methods work reasonably well even in severely ill-posed problems, and as such may be a useful tool in those applications where the structural model is indeed given by a nonparametric model with additive error.

Proofs

For simplicity, we give the proof of Theorem 2 only for the conditionally normalized case (2.6). Estimating the error when standardizing is detailed in the proof of Theorem 3, and the case of Theorem 2 is quite similar. First we prove two lemmas.

Lemma 6.1. *Under the Assumptions 2 and 3, we have that*

$$\left(\sup_{z \in I} \sum_{k=0}^{M} \left| \frac{1}{\hat{\rho}^k(z)} - \frac{1}{\rho^k(z)} \right|^2 \right) = O_P \left(M^2 (2/\rho_{min})^{2(M+1)} n^{-2\epsilon_0} \right). \tag{6.1}$$

where ρ_{min} is as in Assumption 2. Further,

$$\left(\sup_{z \in I} \sum_{k=0}^{M} \left| \frac{1}{\hat{\rho}^k(z)} - \frac{1}{\rho^k(z)} \right| \right) = O_P \left(M (2/\rho_{min})^{M+1} n^{-\epsilon_0} \right). \tag{6.2}$$

Proof. From Assumptions 2 and 3, given $\delta > 0$ there is an n_0 such that for all $n \geq n_0$,

$$\mathbb{P}\left(|\hat{\rho}(z) - \rho(z)| > |\rho(z)/2| \, \forall z \in I \right) < \delta/2.$$

Hence
$$\mathbb{P}\big(|\hat{\rho}(z)| > \rho_{min}/2 \,\forall z \in I\big) < \delta/2. \tag{6.3}$$

Now, we have that $\hat{\rho}^{-k}(z) - \rho^{-k}(z) = -k\xi_{k,z}^{-k+1}(\hat{\rho}(z) - \rho(z))$, where $\xi_{k,z}$ is between $\hat{\rho}(z)$ and $\rho(z)$. Since $|\rho(z)| > \rho_{min}$, from (6.3) we get for $n \geq n_0$ with probability $> 1 - \delta/2$,
$$\left|\frac{1}{\hat{\rho}^k(z)} - \frac{1}{\rho^k(z)}\right|^2 \leq k^2 \left(\rho_{min}/2\right)^{-2(k+1)}|\hat{\rho}(z) - \rho(z)|^2.$$

From Assumption 3, given $\eta > 0$ we can choose n_0 so large that for $n \geq n_0$, we also have
$$\mathbb{P}\big(|\hat{\rho}(z) - \rho(z)|^2 > \eta/n^{2\epsilon_0} \,\forall z \in I\big) < \delta/2.$$

Using $\sum_{k=1}^M k^2 x^k \leq C\, M^2 x^{M+1}$ for some $C > 0$ we conclude that for $n \geq n_0$,
$$\mathbb{P}\Big(\sum_{k=0}^M \left|\frac{1}{\hat{\rho}^k(z)} - \frac{1}{\rho^k(z)}\right|^2 > C\eta\, M^2 (2/\rho_{min})^{2(M+1)} n^{-2\epsilon_0} \,\forall z \in I\Big) < \delta,$$

which proves (6.1). The proof of (6.2) proceeds along completely similar lines. $\qquad\square$

Lemma 6.2. *Under the assumptions of Theorem 2, there is a $C > 0$ such that for any $k \geq 0$ and any $z \in I$,*
$$\mathbb{E}\big(\hat{\beta}_k(z) - \beta_k(z)\big)^2 \leq Cn^{-4/5} \tag{6.4}$$

Proof. Using Assumptions 1 and 2 it is easy to show that the regression functions $\beta_k(z) = \rho^k(z)\alpha_k(z)$ have uniformly bounded second derivatives. When estimating $\beta_k(z)$, note that the distribution of the covariate Z is the same for all k. The conditional variance does depend on k, but it will be enough to show that it is uniformly bounded (in z and k). To this end, we estimate
$$\begin{aligned} Var\big(Y^2 H_k^2(W)|Z = z\big) &\leq \mathbb{E}\big(Y^2 H_k^2(W)|Z = z\big) \\ &\leq 2\Big(\mathbb{E}\big(m^2(X, Z)\, H_k^2(W)|Z = z\big) + \mathbb{E}\big(U^2\, H_k^2(W)|Z = z\big)\Big). \end{aligned}$$

Since m is uniformly bounded by Assumption 2, and we are under the conditionally normalized case,
$$\mathbb{E}\big(m^2(X, Z)\, H_k^2(W)|Z = z\big) \leq \|m^2\|_\infty \mathbb{E}\big(H_k^2(W)|Z = z\big) = \|m^2\|_\infty,$$

and
$$\mathbb{E}\big(U^2\, H_k^2(W)|Z = z\big) \leq \|\sigma^2\|_\infty \mathbb{E}\big(H_k^2(W)|Z = z\big) = \|\sigma^2\|_\infty.$$

Therefore, using results of Fan (1992) (Theorem 1 and Remark 1), under Assumptions 4 and 5 we have for the pointwise MSE that
$$\mathbb{E}\big(\hat{\beta}_k(z) - \beta_k(z)\big)^2 \leq Cn^{-4/5}$$

where $C > 0$ can be chosen independently of k and z. $\qquad\square$

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Proof of Theorem 2. First we prove (2.11). We have

$$\|\hat{m}_{sco}(\cdot,z) - m(\cdot,z)\|_{f_{X|Z=z}}^2 = \left\|\sum_{k=0}^{M}\frac{\hat{\beta}_k(z)}{\hat{\rho}^k(z)}H_k(\cdot) - \sum_{k\geq 0}\alpha_k(z)H_k(\cdot)\right\|_{f_{X|Z=z}}$$

$$= \sum_{k=0}^{M}\left|\frac{\hat{\beta}_k(z)}{\hat{\rho}^k(z)} - \frac{\beta_k(z)}{\rho^k(z)}\right|^2 + \sum_{k\geq M+1}|\alpha_k(z)|^2. \qquad (6.5)$$

The bias term $\sum_{k\geq M+1}|\alpha_k(z)|^2$ can be easily estimated using Assumption 1 as $O(M^{-2\gamma+1})$. Now let us turn to the variance term in (6.5). We have

$$\sum_{k=0}^{M}\left|\frac{\hat{\beta}_k(z)}{\hat{\rho}^k(z)} - \frac{\beta_k(z)}{\rho^k(z)}\right|^2 \leq 2\sum_{k=0}^{M}|\hat{\beta}_k(z)|^2\left|\frac{1}{\hat{\rho}^k(z)} - \frac{1}{\rho^k(z)}\right|^2 + 2\sum_{k=0}^{M}\left|\frac{\hat{\beta}_k(z) - \beta_k(z)}{\rho^k(z)}\right|^2. \qquad (6.6)$$

In order to bound the second term on the right in (6.6), we estimate by using (6.4) that for any $z \in I$,

$$\mathbb{E}\Big(\sum_{k=0}^{M}\left|\frac{\hat{\beta}_k(z) - \beta_k(z)}{\rho^k(z)}\right|^2\Big) \leq \rho_{min}^{-2M}\sum_{k=0}^{M}\mathbb{E}|\hat{\beta}_k(z) - \beta_k(z)|^2$$

$$\leq C M n^{-4/5}\rho_{min}^{-2M},$$

where ρ is as in Assumption 2 and $C > 0$ does not depend on z. Thus, we also get convergence in probability with constant not depending on z.

In order to bound the first term on the right in (6.6), we estimate

$$\sum_{k=0}^{M}|\hat{\beta}_k(z)|^2\left|\frac{1}{\hat{\rho}^k(z)} - \frac{1}{\rho^k(z)}\right|^2 \leq \max_{k=0}^{M}|\hat{\beta}_k(z)|^2 \sum_{k=0}^{M}\left|\frac{1}{\hat{\rho}^k(z)} - \frac{1}{\rho^k(z)}\right|^2.$$

We have

$$\left|\max_{k=0}^{M}\hat{\beta}_k(z)^2 - \max_{k=0}^{M}\beta_k(z)^2\right| \leq \left|\max_{k=0}^{M}\big(\hat{\beta}_k(z)^2 - \beta_k(z)^2\big)\right|$$

$$\leq \max_{k=0}^{M}|\hat{\beta}_k(z) - \beta_k(z)| \max_{k=0}^{M}|\hat{\beta}_k(z) + \beta_k(z)|$$

Further,

$$\sup_{z\in I}\mathbb{E}\Big(\max_{k=0}^{M}|\hat{\beta}_k(z) - \beta_k(z)|^2\Big) \leq \sup_{z\in I}\sum_{k=0}^{M}\mathbb{E}|\hat{\beta}_k(z) - \beta_k(z)|^2 \leq C M n^{-4/5}.$$

Therefore, we get $\max_{k=0}^{M}|\hat{\beta}_k(z) - \beta_k(z)|^2 = O_P(M n^{-4/5})$, where the constant in O_P does not depend on z, and therefore also

$$\max_{k=0}^{M}|\hat{\beta}_k(z) - \beta_k(z)| = O_P(M^{1/2} n^{-2/5}),$$

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where the constant in O_P does not depend on z. Moreover, since the $\beta_k(z)$ are bounded uniformly in k and z, we furthermore get that

$$\max_{k=0}^{M} |\hat{\beta}_k(z) + \beta_k(z)| = O_P(1).$$

Combining these estimates and (6.1), we get that

$$\sum_{k=0}^{M} |\hat{\beta}_k(z)|^2 \left| \frac{1}{\hat{\rho}^k(z)} - \frac{1}{\rho^k(z)} \right|^2 = O_P(1)O_P\left(M^2 (2/\rho_{min})^{2(M+1)} n^{-2\epsilon_0} \right),$$

where the constants do not depend on z. Therefore, we get that

$$\|\hat{m}_{sco}(\cdot, z) - m(\cdot, z)\|_{f_{X|Z=z}}^2 = O_P\left(n^{-\min(4/5, 2\epsilon_0)} M^2 (2/\rho_{min})^{2(M+1)} \right) + O(M^{-2\gamma+1}), \qquad (6.7)$$

where the constants in O_P and O do not depend on z. Letting $M = c \log n$ for sufficiently small c, we get (2.11).

Remark: The additional nonparametric regression on Z does not occur in the final rate, but it occurs in the estimate (6.7) (in the term $n^{-min(4/5, \epsilon_0)}$ instead of the typical n^{-1}). For the severely ill-posed case under consideration here, for properly chosen M the bias term $O(M^{-2\gamma+1})$ dominates the variances, and therefore the nonparametric rate $n^{-min(4/5, \epsilon_0)}$ does not occur in the final rate (2.11). In contrast, in the mildly ill-posed case as studied in Hall and Horowitz (2005), both terms are balanced, and therefore the regression on Z also enters the final estimate.

The proof of (2.12) proceeds along similar lines. We start with

$$
\begin{aligned}
|\hat{m}_{sco}(x, z) - m(x, z)| &\leq \left| \sum_{k=0}^{M} \frac{\hat{\beta}_k(z)}{\hat{\rho}^k(z)} H_k(x) - \sum_{k \geq 0} \frac{\beta_k(z)}{\rho^k(z)} H_k(x) \right| \\
&\leq \sum_{k=0}^{M} \left| \frac{\hat{\beta}_k(z)}{\hat{\rho}^k(z)} - \frac{\beta_k(z)}{\rho^k(z)} \right| |H_k(x)| + \sum_{k \geq M+1} |\alpha_k(z)| |H_k(x)|. \qquad (6.8)
\end{aligned}
$$

On any compact subset, the $H_k(x)$ are uniformly bounded. In fact, one even has that

$$|H_k(x)| \leq C(J)(k+1)^{-1/4}, \qquad x \in J, \quad k \geq 0,$$

cf. Szegö (1959, p. 242), and note that this also hold for the Hermite polynomials (not only the Hermite functions) since $e^{x^2/2}$ is also bounded on a compact set J. Therefore, using Assumption 1 the second term in (6.8) can be bounded by

$$\sum_{k \geq M+1} |\alpha_k(z)| |H_k(x)| \leq C(J) \sum_{k \geq M+1} k^{-(\gamma+1/4)} \leq C M^{-\gamma+3/4}.$$

Furthermore, arguing as above by using (6.2) one can show that

$$\sum_{k=0}^{M} \left| \frac{\hat{\beta}_k(z)}{\hat{\rho}^k(z)} - \frac{\beta_k(z)}{\rho^k(z)} \right| |H_k(x)| \leq C(J) \sum_{k=0}^{M} \left| \frac{\hat{\beta}_k(z)}{\hat{\rho}^k(z)} - \frac{\beta_k(z)}{\rho^k(z)} \right| = O_P\left(n^{-\min(2/5, \epsilon_0)} M (2/\rho_{min})^{M+1} \right),$$

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where the constant in O_P does not depend on z. Therefore, for any $z \in I$,

$$\max_{x \in J} \left| \hat{m}_{sco}(x, z) - m(x, z) \right| = O_P\left(n^{-\min(2/5, \epsilon_0)} M \left(2/\rho_{min}\right)^{M+1}\right) + O\left(M^{-\gamma+3/4}\right),$$

where the constants in O_p and O do not depend on z. Letting once more $M = c\log n$ for sufficiently small c gives (2.12).

$\square$

Proof of Theorem 3. Let $\tilde{m}_{JN}(x, z)$ denote the estimator (2.15), where the true values for the parameters σ_1, σ_2 and ρ are used. We first bound the difference between this estimator and m, even in expectation. Assume $\rho > 0$. Compute

$$\mathbb{E}\|\tilde{m}_{JN} - m\|^2_{L_2(\mu_{XZ})} = \sum_{j \geq 0} \sum_{k \geq M_2+1} |\alpha_{j,k}|^2 + \sum_{j \geq M_1} \sum_{k \leq M_2} |\alpha_{j,k}|^2 \qquad (6.9)$$
$$+ \frac{1}{n} \sum_{j=0}^{M_1} \sum_{k=0}^{M_2} \frac{\mathbb{E}_1^2 H_j^2(W_1 - \rho_{WZ}Z_1)H_k^2(Z_1) - \beta_{j,k}^2}{\rho^{2j}}$$

First consider the bias terms in (6.9). These can be estimated by using Assumption 6. as follows.

$$\sum_{j \geq 0} \sum_{k \geq M_2+1} |\alpha_{j,k}|^2 + \sum_{j \geq M_1} \sum_{k \leq M_2} |\alpha_{j,k}|^2 = O\left(M_2^{-2\delta+1} + M_1^{-2\gamma+1}\right).$$

Using Assumption 7, we have for the variance

$$\mathbb{E}Y_1^2 H_j^2(W_1 - \rho_{WZ}Z_1)H_k^2(Z_1) - \beta_{j,k}^2 \leq 2\mathbb{E}\left(\left(m^2(X_1, Z_1) + U_1^2\right)H_j^2(W_1 - \rho_{WZ}Z_1)H_k^2(Z_1)\right)$$
$$\leq 2\left(\|m\|_\infty^2 + \sigma^2\right).$$

Hence

$$\frac{1}{n} \sum_{j=0}^{M_1} \sum_{k=0}^{M_2} \frac{\mathbb{E}Y_1^2 H_j^2(W_1 - \rho_{WZ}Z_1)H_k^2(Z_1) - \beta_{j,k}^2}{\rho^{2j}} \leq \frac{2}{n} \sum_{j=0}^{M_1} \sum_{k=0}^{M_2} \frac{\|m\|_\infty^2 + \|\sigma^2\|_\infty}{\rho^{2j}}$$
$$\leq \frac{C}{n}\left(M_2 + 1\right)\rho^{-2(M_1+1)}.$$

Hence, we get that

$$\mathbb{E}\|\tilde{m}_{JN} - m\|^2_{L_2(\mu_{XZ})} = O\left(n^{-1}\left(M_2 + 1\right)\rho^{-2(M_1+1)} + M_2^{-2\delta+1} + M_1^{-2\gamma+1}\right).$$

Letting $M_1 = c\log n$ for sufficiently small $c > 0$ and $M_2 = n^{-\epsilon}$ for small ϵ gives the rate in (2.16), since the term $M_1^{-2\gamma+1}$ dominates.

Now we bound the difference between $\hat{m}_{JN}$ and $\tilde{m}_{JN}$ using Assumption 8. Start with

$$\|\hat{m}_{JN} - \tilde{m}_{JN}\|^2_{L_2(\mu_{XZ})} \leq 2\left\| \sum_{j \leq M_1} \sum_{k \leq M_2} \frac{\hat{\beta}_{j,k}}{\hat{\rho}^j}(\hat{\psi}_{j,k} - \psi_{j,k})\right\|^2_{L_2(\mu_{XZ})} \qquad (6.10)$$
$$+ 2\left\| \sum_{j \leq M_1} \sum_{k \leq M_2} \left(\frac{\hat{\beta}_{j,k}}{\hat{\rho}^j} - \frac{\beta_{j,k}}{\rho^j}\right)\psi_{j,k}\right\|^2_{L_2(\mu_{XZ})}$$

We start by estimating the second term. Compute

$$\Big\| \sum_{j \le M_1} \sum_{k \le M_2} \Big(\frac{\hat{\beta}_{j,k}}{\hat{\rho}^j} - \frac{\beta_{j,k}}{\rho^j}\Big) \psi_{j,k} \Big\|^2_{L_2(\mu_{XZ})} = \sum_{j \le M_1} \sum_{k \le M_2} \Big| \frac{\hat{\beta}_{j,k}}{\hat{\rho}^j} - \frac{\beta_{j,k}}{\rho^j} \Big|^2$$

$$\le 2 \sum_{j \le M_1} \sum_{k \le M_2} \Big| \frac{\hat{\beta}_{j,k} - \beta_{j,k}}{\hat{\rho}^j} \Big|^2 + 2 \sum_{j \le M_1} \sum_{k \le M_2} \beta^2_{j,k} \Big| \frac{1}{\hat{\rho}^j} - \frac{1}{\rho^j} \Big|^2.$$

The second term is estimated similarly as in Lemma 6.1 as follows

$$\Big\| \sum_{j \le M_1} \sum_{k \le M_2} \Big(\frac{\hat{\beta}_{j,k}}{\hat{\rho}^j} - \frac{\beta_{j,k}}{\rho^j}\Big) \psi_{j,k} \Big\|^2_{L_2(\mu_{XZ})} = O_P\big(M_2^2(2/\rho)^{2(M_1+1)}n^{-1}\big) = O_P\big(n^{-\delta}\big).$$

For the first term, we estimate using $H'_j(x) = j H_{j-1}(x)$ that

$$\begin{aligned}
|\hat{\beta}_{j,k} - \beta_{j,k}| &= \Big| \frac{1}{n} \sum_{i=1}^n Y_i H_k(Z_i) \Big(H_j\big(\frac{W_i - \hat{\rho}_{WZ}Z_i}{\hat{\sigma}_2}\big) - H_j\big(\frac{W_i - \rho_{WZ}Z_i}{\sigma_2}\big) \Big) \Big| \\
&= \Big| \frac{1}{n} \sum_{i=1}^n Y_i H_k(Z_i) j H_{j-1}(\xi_i) Z_i \Big(\frac{\rho_{WZ}}{\sigma_2} - \frac{\hat{\rho}_{WZ}}{\hat{\sigma}_2} \Big) \Big| \\
&= O_P\big(j n^{-1/2}\big),
\end{aligned}$$

where the intermediate values ξ_i can be chosen identically distributed. Hence,

$$\sum_{j \le M_1} \sum_{k \le M_2} \Big| \frac{\hat{\beta}_{j,k} - \beta_{j,k}}{\hat{\rho}^j} \Big|^2 = O_P\big(M_1^3(2/\rho)^{2(M_2+1)}n^{-1}\big) = O_P(n^{-\delta}).$$

Now we consider the first term in (6.10). We have

$$\Big\| \sum_{j \le M_1} \sum_{k \le M_2} \frac{\hat{\beta}_{j,k}}{\hat{\rho}^j} (\hat{\psi}_{j,k} - \psi_{j,k}) \Big\|^2_{L_2(\mu_{XZ})} \le \Big(\sum_{j \le M_1} \sum_{k \le M_2} \Big| \frac{\hat{\beta}_{j,k}}{\hat{\rho}^j} \Big| \big\| \hat{\psi}_{j,k} - \psi_{j,k} \big\|_{L_2(\mu_{XZ})} \Big)^2.$$

Estimate

$$\begin{aligned}
\big\| \hat{\psi}_{j,k} - \psi_{j,k} \big\|^2_{L_2(\mu_{XZ})} &= \int \int \Big| H_j\big((x - \hat{\rho}_{XZ}z)/\hat{\sigma}_1\big) - H_j\big((x - \rho_{XZ}z)/\sigma_1\big) \Big|^2 |H_k(z)|^2 \, d\mu_{XZ} \\
&= \int \int \Big| j H_{j-1}(\xi_{x,z}) \frac{\rho_{XZ}}{\sigma_1} - \frac{\hat{\rho}_{XZ}}{\hat{\sigma}_1} z^2 |H_k(z)|^2 \, d\mu_{XZ} \\
&= O_P(j^2 n^{-1}).
\end{aligned}$$

Therefore

$$\Big\| \sum_{j \le M_1} \sum_{k \le M_2} \frac{\hat{\beta}_{j,k}}{\hat{\rho}^j} (\hat{\psi}_{j,k} - \psi_{j,k}) \Big\|^2_{L_2(\mu_{XZ})} = O_P\big(M_1^4(2/\rho)^{2(M_1+1)}M_2^2 n^{-1}\big).$$

Collecting terms, this concludes the proof of Theorem 3. $\square$

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Tables and Figures

Spectral cut-off regularization					
truncation parameter		$M = 0$	$M = 1$	$M = 2$	$M = 3$
weighted MISE	median	9.67	0.01	0.04	0.21
	upper quartile	9.70	0.01	0.11	0.51
	0.95 quantile	9.76	0.07	0.43	1.85
unweighted MISE	median	109.70	0.04	0.56	2.41
	upper quartile	109.82	0.11	1.55	5.59
	0.95 quantile	110.15	0.70	6.04	19.51
coefficient		$\beta_0(z_1)$	$\beta_1(z_1)$	$\beta_2(z_1)$	$\beta_3(z_1)$
	median	-0.08	-3.16	-0.02	0.09
	IQR	0.18	0.09	0.36	0.80
	0.95-quantile	0.14	-3.02	0.48	1.23
	0.05-quantile	-0.31	-3.31	-0.51	-1.05

Table 1: Results for estimation of m_1 at z_1

Spectral cut-off regularization					
truncation parameter		$M = 0$	$M = 1$	$M = 2$	$M = 3$
weighted MISE	median	0.45	0.46	0.06	0.14
	upper quartile	0.45	0.49	0.12	0.31
	0.95 quantile	0.47	0.55	0.38	1.07
unweighted MISE	median	6.54	6.87	0.68	1.84
	upper quartile	6.85	7.24	1.54	4.14
	0.95 quantile	7.33	7.91	5.48	13.25
coefficient		$\beta_0(z_1)$	$\beta_1(z_1)$	$\beta_2(z_1)$	$\beta_3(z_1)$
	median	1.50	0.19	0.79	0.18
	IQR	0.10	0.17	0.31	0.57
	0.95-quantile	1.63	0.38	1.31	1.08
	0.05-quantile	1.38	-0.03	0.41	-0.50

Table 2: Results for estimation of m_2 at z_1

Spectral cut-off regularization					
truncation parameter		$M = 0$	$M = 1$	$M = 2$	$M = 3$
weighted MISE	median	0.22	0.02	0.01	0.02
	upper quartile	0.22	0.03	0.02	0.05
	0.95 quantile	0.22	0.03	0.06	0.19
unweighted MISE	median	2.71	0.29	0.12	0.28
	upper quartile	2.74	0.34	0.26	0.67
	0.95 quantile	2.80	0.44	0.86	2.16
coefficient		$\beta_0(z_1)$	$\beta_1(z_1)$	$\beta_2(z_1)$	$\beta_3(z_1)$
	median	1.07	-0.43	0.12	-0.01
	IQR	0.05	0.06	0.13	0.24
	0.95-quantile	1.13	-0.36	0.30	0.31
	0.05-quantile	1.02	-0.52	-0.08	-0.38

Table 3: Results for estimation of m_3 at z_1

Spectral cut-off regularization					
truncation parameter		$M = 0$	$M = 1$	$M = 2$	$M = 3$
weighted MISE	median	0.44	0.44	0.01	0.02
	upper quartile	0.44	0.44	0.01	0.03
	0.95 quantile	0.44	0.44	0.03	0.07
unweighted MISE	median	6.62	6.61	0.08	0.20
	upper quartile	6.70	6.69	0.17	0.39
	0.95 quantile	6.80	6.81	0.39	0.85
coefficient		$\beta_0(z_1)$	$\beta_1(z_1)$	$\beta_2(z_1)$	$\beta_3(z_1)$
	median	1.49	0.05	0.69	0.02
	IQR	0.02	0.07	0.11	0.20
	0.95-quantile	1.52	0.13	0.82	0.27
	0.05-quantile	1.46	-0.03	0.56	-0.10

Table 4: Results for estimation of m_2 at z_1, where z_1 is fixed, i.e. without exogenous component.
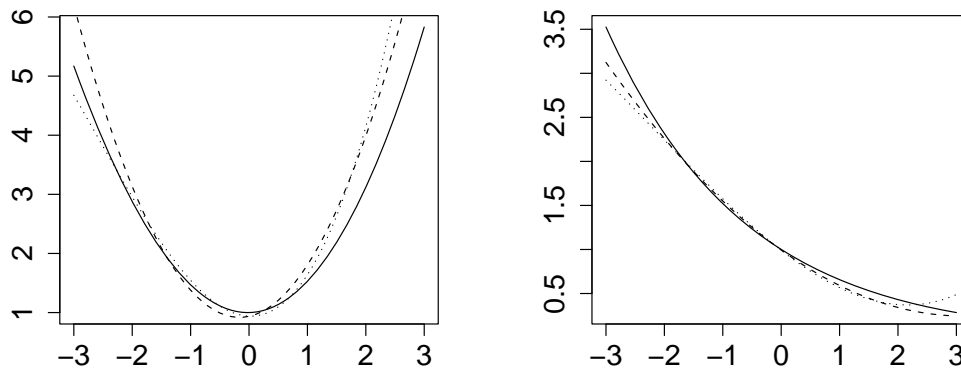
Figure 1: Left: True target function m_2 (solid line) and estimates with spectral cut-off regularization scheme with $M = 2$ (dashed line) and $M = 3$ (dotted line). Right: True target function m_3 (solid line) and estimates with spectral cut-off regularization scheme with $M = 2$ (dashed line) and $M = 3$ (dotted line).

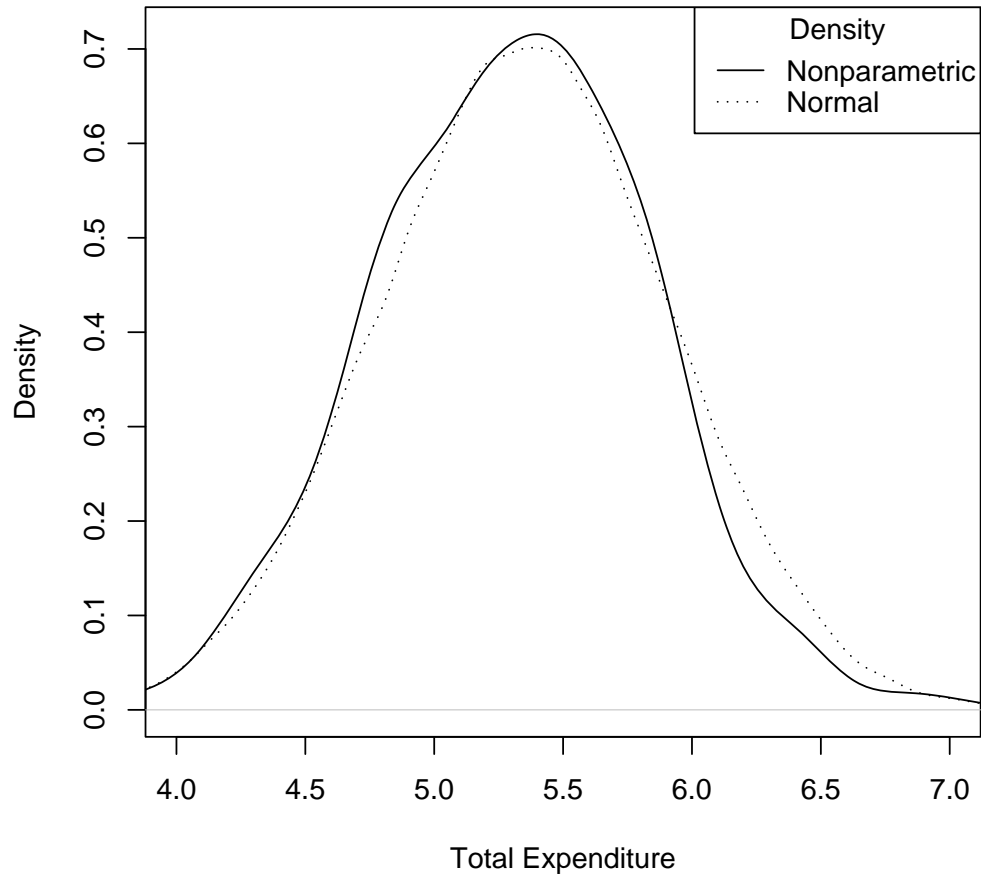## Comparison Nonparametric Density to Normal
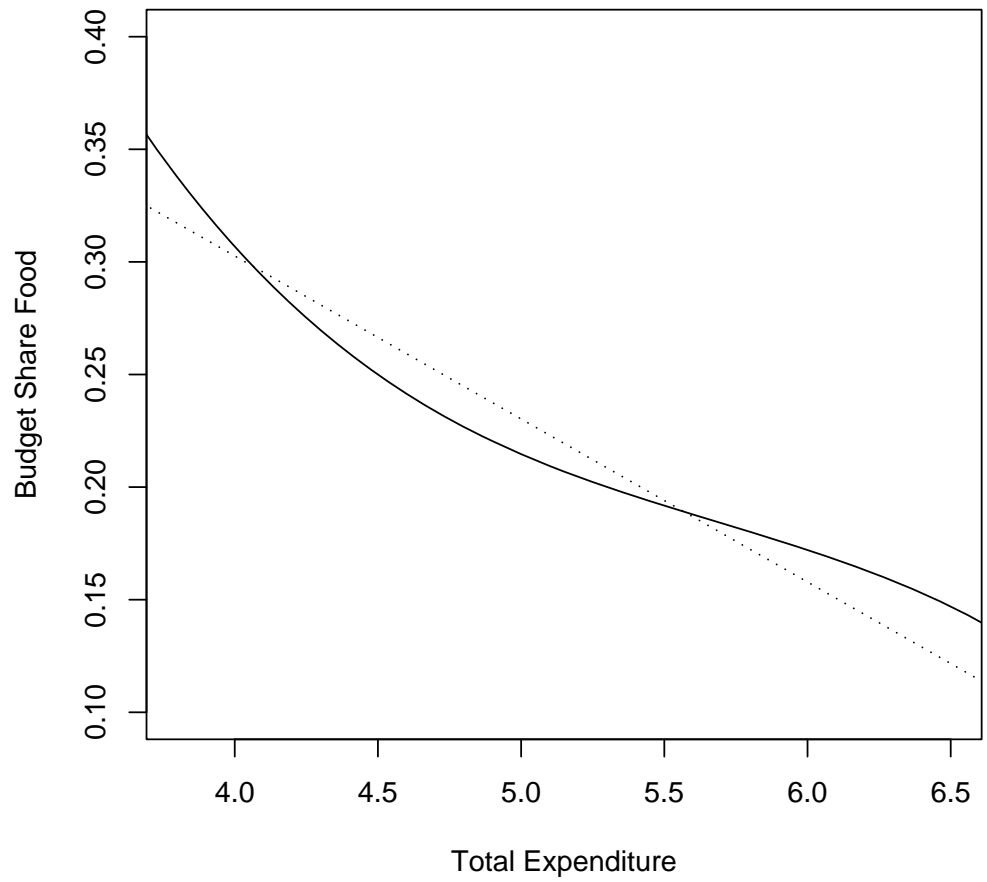

Figure 2: Marginal Density Comparison.

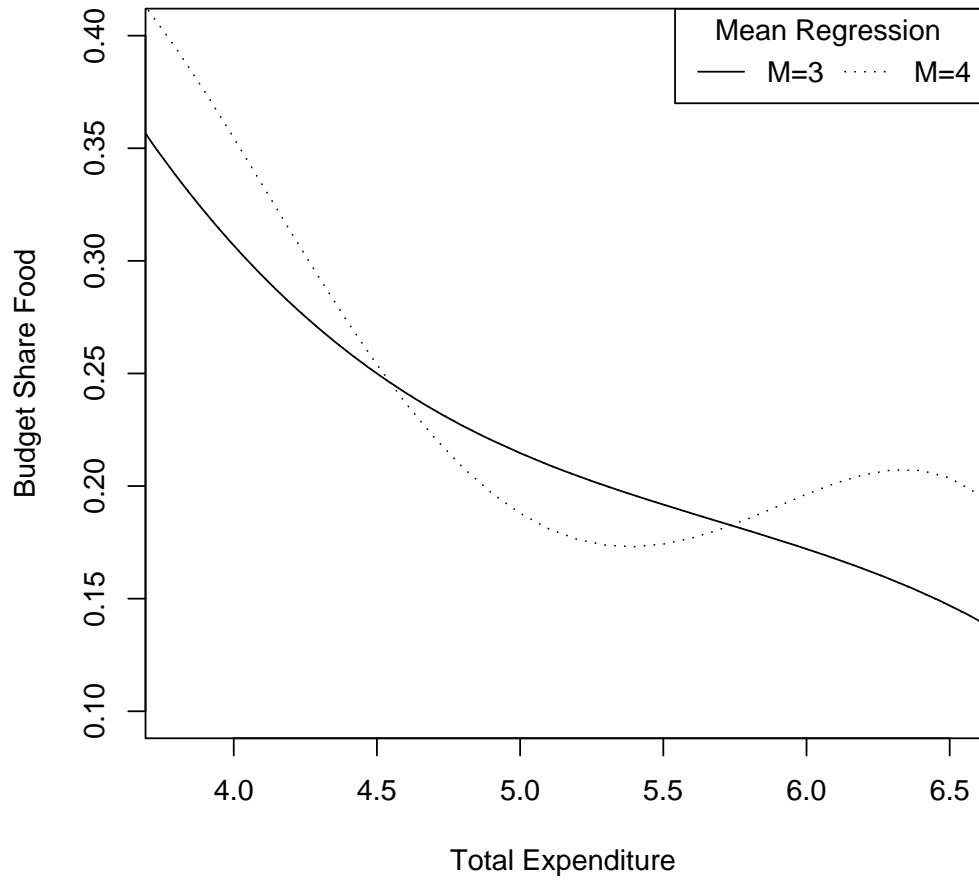Figure 3: CN-Estimator with varying choice of the truncation parameter M ($M = 1$ and $M = 3$).

Figure 4: CN-Estimator with varying choice of M ($M = 3$ and $M = 4$)
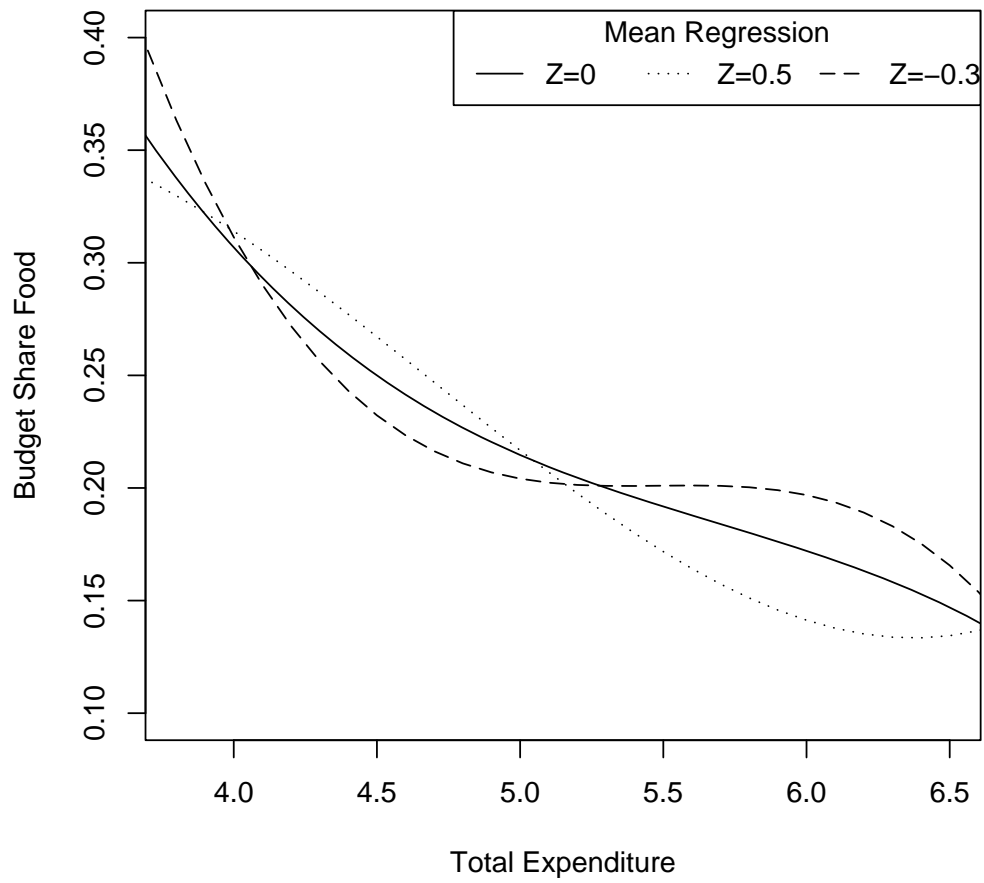
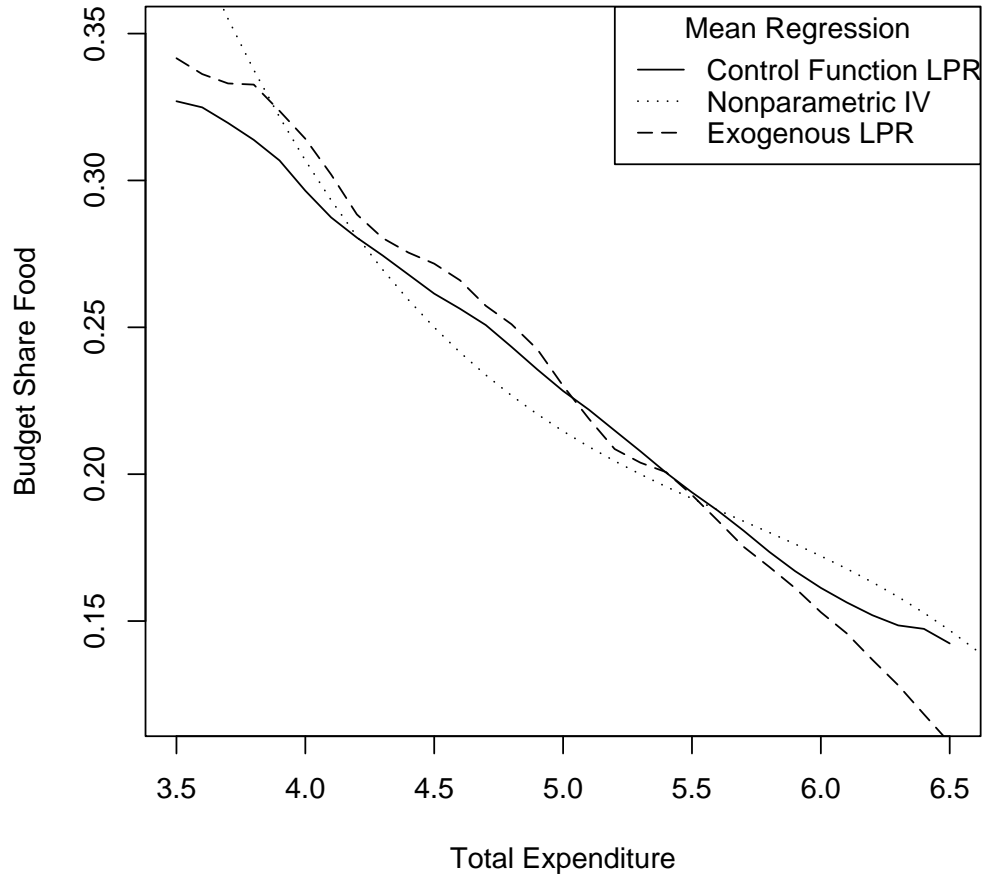Figure 5: CN-Estimator at Different Values of Z.
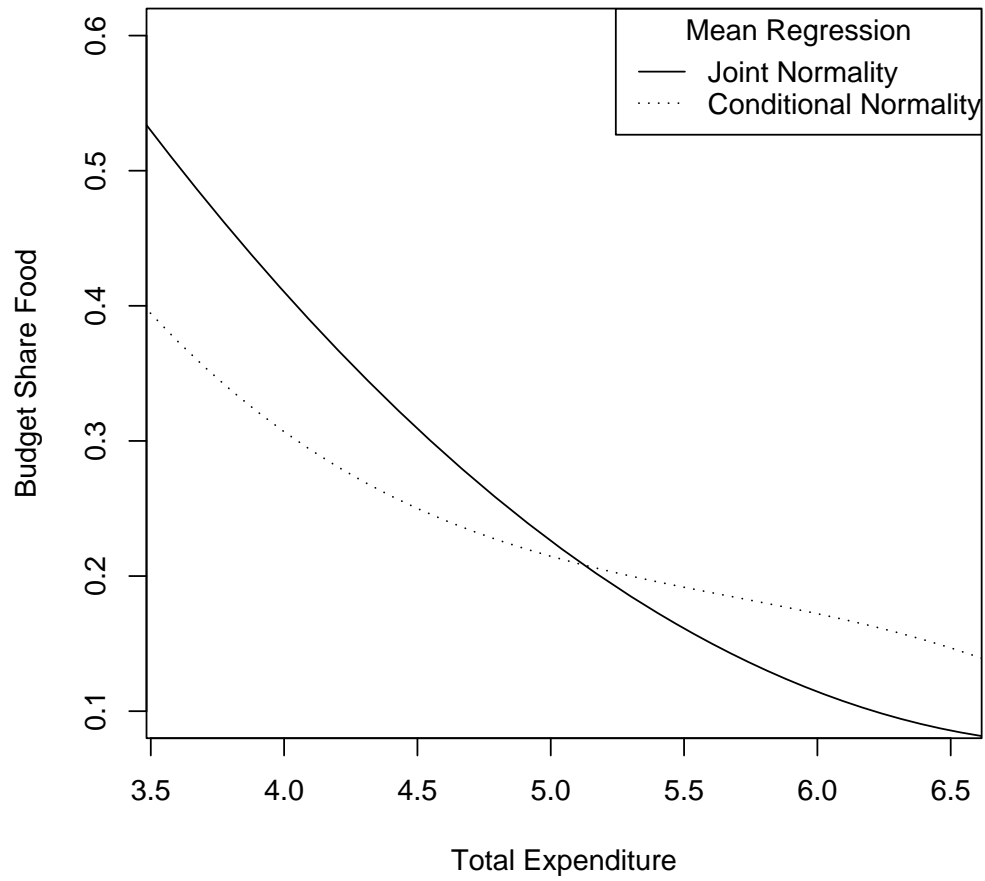
Figure 6: Effect of correcting for Endogeneity

Figure 7: Estimation under conditional and joint normality.