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**Original Research**

# Asymptotic Theory and Finite Sample Properties of GMM Estimators in Dynamic Panel Settings with Persistent Regressors

Hafiz Zulkifli[1] and Syahir Nordin[2]

[1]Universiti Malaysia Pahang Al-Sultan Abdullah, Lebuhraya Tun Razak, Gambang, Malaysia.
[2]Universiti Malaysia Perlis, Pauh Putra Campus, Arau, Malaysia.

**Abstract**
Dynamic panel data models with persistent regressors present significant challenges for econometric estimation, particularly when the autoregressive parameter approaches unity and instruments exhibit weak correlation with endogenous variables. This paper develops a comprehensive asymptotic theory for Generalized Method of Moments (GMM) estimators in dynamic panel settings where regressors display high persistence, extending beyond the traditional framework of stationary processes. We establish the limiting distribution of both difference and system GMM estimators under sequences of local-to-unity asymptotics, demonstrating that standard asymptotic approximations fail when the autoregressive coefficient approaches one. Our theoretical analysis reveals that the rate of convergence deteriorates from the standard $\sqrt{NT}$ to $\sqrt{N}T^{-1/2}$ when persistence increases, fundamentally altering the statistical properties of conventional estimators. Through extensive Monte Carlo simulations across varying degrees of persistence, cross-sectional dimensions, and time series lengths, we document substantial finite sample biases that persist even in moderately large samples. The simulation results demonstrate that bias-corrected estimators and alternative identification strategies significantly improve performance in persistent settings. We propose a modified GMM framework that incorporates bias correction mechanisms and develops robust inference procedures that maintain adequate size control under high persistence. The practical implications extend to applications in macroeconomic panel studies where persistence is prevalent, offering guidance for empirical researchers working with dynamic panel models featuring near-unit root behavior.

## 1. Introduction

Dynamic panel data models constitute a fundamental framework in econometric analysis, particularly for studying adjustment processes, habit formation, and persistence in economic relationships [1]. The canonical dynamic panel model takes the form $y_{it} = \alpha y_{i,t-1} + x_{it}'\beta + \eta_i + \varepsilon_{it}$, where $y_{it}$ represents the dependent variable for cross-sectional unit $i$ at time $t$, $\alpha$ captures the autoregressive parameter, $x_{it}$ denotes a vector of strictly exogenous regressors, $\eta_i$ represents unobserved individual heterogeneity, and $\varepsilon_{it}$ is the idiosyncratic error term.

The estimation of dynamic panel models presents well-known challenges due to the correlation between the lagged dependent variable and the individual-specific effect, rendering standard fixed effects estimators inconsistent. The seminal contributions of Anderson and Hsiao, followed by the development of GMM-based approaches, established the theoretical foundation for consistent estimation in dynamic panel settings. However, these classical results rely critically on the assumption that the autoregressive parameter $\alpha$ lies strictly within the unit circle, ensuring stationarity of the underlying process.

In many empirical applications, particularly in macroeconomic contexts, the autoregressive parameter exhibits values close to unity, indicating high persistence in the data generating process. Such persistence arises naturally in models of consumption, investment, and other economic aggregates where adjustment costs or institutional constraints generate sluggish responses to shocks. When $\alpha$ approaches unity, the conventional asymptotic theory breaks down, leading to substantial deterioration in the finite sample performance of standard GMM estimators. [2]

The theoretical challenges associated with persistent regressors in dynamic panel models stem from the weakening of instrumental variables as the autoregressive parameter increases. In the difference GMM framework, lagged levels serve as instruments for the differenced equation, but their correlation with the differenced regressor diminishes as persistence increases. Similarly, in system GMM, the validity of level equations relies on the stationarity assumption, which becomes tenuous under near-unit root conditions.

This paper addresses these challenges by developing a comprehensive asymptotic theory for GMM estimators in dynamic panel settings with persistent regressors. Our theoretical framework extends the local-to-unity asymptotics, originally developed for time series analysis, to the panel data context. We consider sequences of data generating processes where the autoregressive parameter approaches unity at rate $T^{-1}$, capturing the empirically relevant case of high but not perfect persistence.

Our main theoretical contributions establish the limiting distribution of both difference and system GMM estimators under local-to-unity asymptotics. We demonstrate that the conventional $\sqrt{NT}$ rate of convergence deteriorates to $\sqrt{N}T^{-1/2}$ as persistence increases, fundamentally altering the statistical properties of the estimators. The limiting distributions exhibit non-standard forms that depend on functionals of Brownian motion processes, necessitating modified inference procedures. [3]

The finite sample analysis through Monte Carlo simulations reveals substantial biases in standard GMM estimators that persist even in moderately large samples. The bias patterns depend critically on the degree of persistence, with near-unit root processes exhibiting severe downward bias in the autoregressive parameter. These findings highlight the inadequacy of conventional asymptotic approximations in persistent settings and motivate the development of bias-corrected procedures.

We propose several methodological innovations to address the challenges of persistent regressors. First, we develop a bias-corrected GMM estimator that accounts for the finite sample bias induced by weak instruments. Second, we establish modified inference procedures that maintain appropriate size control under high persistence. Third, we investigate alternative identification strategies, including the use of higher-order lags and external instruments, to strengthen identification in persistent settings. [4]

The paper is organized as follows. Section 2 presents the dynamic panel model and establishes the local-to-unity framework. Section 3 develops the asymptotic theory for GMM estimators under persistent regressors. Section 4 analyzes the finite sample properties through extensive Monte Carlo simulations. Section 5 proposes bias-corrected estimators and robust inference procedures. Section 6 examines alternative identification strategies. Section 7 discusses practical implications and provides guidance for empirical applications [5]. Section 8 concludes.

## 2. Model Framework and Local-to-Unity Asymptotics

Consider the dynamic panel data model:

$$y_{it} = \alpha y_{i,t-1} + x_{it}'\beta + \eta_i + \varepsilon_{it}$$

where $i = 1, \ldots, N$ indexes cross-sectional units, $t = 1, \ldots, T$ indexes time periods, $y_{it}$ is the scalar dependent variable, $x_{it}$ is a $k \times 1$ vector of strictly exogenous regressors, $\eta_i$ represents time-invariant individual effects, and $\varepsilon_{it}$ is the idiosyncratic error term.

To model high persistence in the data generating process, we adopt the local-to-unity framework where the autoregressive parameter is specified as:

$$\alpha = 1 + \frac{c}{T}$$

where $c$ is a fixed parameter that controls the degree of persistence. When $c = 0$, the process contains a unit root, while negative values of $c$ generate stationary but highly persistent processes. This parameterization captures the empirically relevant case where the autoregressive parameter is close to, but not exactly equal to, unity.

The local-to-unity framework provides several advantages over the traditional stationary analysis [6]. First, it generates limiting distributions that are informative about finite sample behavior when persistence is high. Second, it bridges the gap between stationary and unit root analyses, providing a unified theoretical framework. Third, it yields practically relevant results for empirical applications where persistence is a central concern.

Under the local-to-unity specification, the initial conditions play a crucial role in determining the asymptotic behavior. We assume that the initial observations $y_{i0}$ are drawn from a distribution that ensures proper scaling of the limiting process. Specifically, we assume:

$$y_{i0} = O_p(T^{1/2})$$

This scaling ensures that the contribution of initial conditions to the limiting distribution is non-negligible, reflecting the persistent nature of the underlying process. [7]

The error structure maintains the standard assumptions of dynamic panel models. The idiosyncratic errors $\varepsilon_{it}$ are assumed to be independently and identically distributed across both dimensions with $E[\varepsilon_{it}] = 0$, $E[\varepsilon_{it}^2] = \sigma_\varepsilon^2$, and finite higher-order moments. The individual effects $\eta_i$ are treated as fixed parameters, capturing unobserved heterogeneity that may be correlated with the regressors.

The exogenous regressors $x_{it}$ are assumed to be stationary with finite moments, maintaining the standard exogeneity condition $E[\varepsilon_{it}|x_{is}, s \leq t] = 0$. This assumption can be relaxed to accommodate predetermined regressors without fundamentally altering the main theoretical results.

The local-to-unity framework generates a data generating process where the dependent variable exhibits near-unit root behavior. The process can be decomposed as:

$$y_{it} = y_{i,t-1} + \frac{c}{T} y_{i,t-1} + x_{it}'\beta + \eta_i + \varepsilon_{it}$$

This decomposition highlights the dual nature of the model: the unit root component $y_{i,t-1}$ generates persistence, while the term $\frac{c}{T} y_{i,t-1}$ introduces mean reversion at a rate that vanishes as $T$ increases.

The implications of local-to-unity asymptotics extend beyond the theoretical properties of estimators. The framework provides insights into the practical challenges of estimating dynamic panel models with persistent data [8]. As the autoregressive parameter approaches unity, the signal-to-noise ratio in the identifying moment conditions deteriorates, leading to weak instrument problems that manifest as finite sample bias and imprecise estimation.

The local-to-unity specification also affects the validity of conventional pre-testing procedures. Standard unit root tests may lack power to distinguish between stationary and unit root processes when the autoregressive parameter is close to unity. This uncertainty about the true data generating process complicates the choice of appropriate estimation methods and inference procedures.

## 3. Asymptotic Theory for GMM Estimators

This section develops the asymptotic theory for GMM estimators in the local-to-unity framework. We consider both difference GMM and system GMM estimators, establishing their limiting distributions under sequences of data generating processes where the autoregressive parameter approaches unity.

### 3.1. Difference GMM Estimator

The difference GMM estimator is based on the first-differenced equation: [9]

$$\Delta y_{it} = \alpha \Delta y_{i,t-1} + \Delta x'_{it}\beta + \Delta \varepsilon_{it}$$

where $\Delta$ denotes the first difference operator. Under the local-to-unity specification, this becomes:

$$\Delta y_{it} = \left(1 + \frac{c}{T}\right) \Delta y_{i,t-1} + \Delta x'_{it}\beta + \Delta \varepsilon_{it}$$

The identification strategy relies on the orthogonality conditions between lagged levels and the differenced error term. For $t = 3, \dots, T$, the moment conditions are:

$$E[y_{is}\Delta\varepsilon_{it}] = 0, \quad s = 1, \dots, t-2$$

Under the local-to-unity framework, the strength of these instruments depends critically on the correlation between $y_{is}$ and $\Delta y_{i,t-1}$. As the autoregressive parameter approaches unity, this correlation weakens, leading to the weak instrument problem.

To establish the asymptotic distribution, we first analyze the behavior of the sample moments. The key insight is that under local-to-unity asymptotics, the sample moments converge to limiting random variables rather than constants, reflecting the persistent nature of the underlying process. [10]

Let $Z_i$ denote the instrument matrix for unit $i$, containing lagged levels of the dependent variable and differences of exogenous regressors. The sample moment vector is:

$$g_N(\theta) = \frac{1}{N} \sum_{i=1}^{N} Z'_i \Delta\varepsilon_i(\theta)$$

where $\theta = (\alpha, \beta')'$ and $\Delta\varepsilon_i(\theta)$ is the vector of differenced residuals.

Under local-to-unity asymptotics, the limiting behavior of $g_N(\theta)$ depends on the convergence of quadratic forms involving near-unit root processes. The key technical challenge is establishing the joint convergence of these quadratic forms, which requires careful analysis of the stochastic properties of the underlying processes.

The main theoretical result establishes that under local-to-unity asymptotics:

$$\sqrt{N}T^{1/2}(\hat{\theta}_{DIF} - \theta_0) \Rightarrow \mathcal{N}(0, \Omega_{DIF})$$

where $\hat{\theta}_{DIF}$ is the difference GMM estimator, $\theta_0$ is the true parameter vector, and $\Omega_{DIF}$ is the asymptotic covariance matrix that depends on functionals of Brownian motion processes.

The convergence rate $\sqrt{N}T^{1/2}$ is slower than the standard $\sqrt{NT}$ rate, reflecting the deterioration in efficiency caused by weak instruments. This rate reduction has important implications for inference, as standard errors based on conventional asymptotics will be too small, leading to over-rejection of null hypotheses. [11]

The asymptotic covariance matrix $\Omega_{DIF}$ has a complex structure that depends on the local-to-unity parameter $c$. As $c$ approaches zero (perfect unit root), the covariance matrix becomes singular, indicating that the estimator loses consistency. This breakdown of consistency reflects the complete loss of identification in the unit root case.

### 3.2. System GMM Estimator

The system GMM estimator combines the differenced equation with the level equation:

$$y_{it} = \alpha y_{i,t-1} + x'_{it}\beta + \eta_i + \varepsilon_{it}$$

The additional moment conditions from the level equation are:

$$E[\Delta y_{i,t-1}(\eta_i + \varepsilon_{it})] = 0$$

These conditions are valid under the assumption that the initial deviations $(\eta_i + \varepsilon_{i1})$ are uncorrelated with the individual effects $\eta_i$. Under local-to-unity asymptotics, this assumption becomes more restrictive as the process approaches non-stationarity.

The system GMM estimator potentially offers efficiency gains over difference GMM by utilizing additional identifying information. However, under local-to-unity asymptotics, the validity of the level equation moments becomes questionable as the stationarity assumption is violated. [12]

The asymptotic analysis of system GMM requires joint treatment of both the differenced and level equations. The limiting distribution takes the form:

$$\sqrt{N}T^{1/2}(\hat{\theta}_{SYS} - \theta_0) \Rightarrow \mathcal{N}(0, \Omega_{SYS})$$

where $\Omega_{SYS}$ is the asymptotic covariance matrix for the system estimator. Under certain regularity conditions, $\Omega_{SYS}$ is smaller than $\Omega_{DIF}$ in the matrix sense, indicating efficiency gains from the additional moment conditions.

However, the efficiency gains diminish as persistence increases, and may be offset by specification errors if the level equation moments are invalid. The trade-off between efficiency and robustness becomes particularly important in highly persistent settings.

### 3.3. *Weak Instrument Diagnostics*

The weak instrument problem in dynamic panel models under local-to-unity asymptotics necessitates the development of appropriate diagnostic tests. Standard weak instrument tests developed for cross-sectional settings require modification to account for the panel structure and the specific nature of dynamic models. [13]

We develop a concentration parameter that measures the strength of identification in the dynamic panel context. The concentration parameter is defined as:

$$\mu = \frac{1}{NT}\sum_{i=1}^{N}\sum_{t=3}^{T} E[y_{i,t-2}^2] \cdot \frac{c^2}{T}$$

This parameter captures the signal-to-noise ratio in the identifying moment conditions. When $\mu$ is small, the instruments are weak, leading to the deterioration in finite sample performance documented in our simulation study.

The concentration parameter provides a useful diagnostic for assessing the reliability of GMM estimates in persistent settings. Values of $\mu$ below certain thresholds indicate that standard asymptotic inference may be unreliable, suggesting the need for alternative procedures.

## 4. Finite Sample Analysis

This section presents a comprehensive Monte Carlo analysis of the finite sample properties of GMM estimators in dynamic panel models with persistent regressors [14]. The simulation design varies key parameters including the degree of persistence, panel dimensions, and error structure to provide insights into the practical performance of different estimators.

### 4.1. Simulation Design

The data generating process follows the local-to-unity specification:

$$y_{it} = \left(1 + \frac{c}{T}\right) y_{i,t-1} + \beta x_{it} + \eta_i + \varepsilon_{it}$$

where $x_{it} \sim \mathcal{N}(0,1)$, $\eta_i \sim \mathcal{N}(0,\sigma_\eta^2)$, and $\varepsilon_{it} \sim \mathcal{N}(0,\sigma_\varepsilon^2)$. The initial conditions are set as $y_{i0} = \frac{\eta_i}{1-\alpha} + \xi_i$ where $\xi_i \sim \mathcal{N}(0, T\sigma_\varepsilon^2)$ to ensure proper scaling under local-to-unity asymptotics.

The simulation parameters are chosen to cover empirically relevant scenarios: - Local-to-unity parameter: $c \in \{0, -2.5, -5, -10, -20\}$ - Panel dimensions: $(N,T) \in \{(100,10), (200,10), (500,10), (100,20), (200,20)\}$ - Signal-to-noise ratio: $\sigma_\eta^2/\sigma_\varepsilon^2 \in \{1,4,9\}$ - Coefficient on exogenous regressor: $\beta = 0.5$

Each experiment is replicated 5,000 times to ensure precise estimation of finite sample properties. The estimators considered include difference GMM, system GMM, bias-corrected variants, and several alternative procedures.

### 4.2. Bias and Efficiency Results

The simulation results reveal substantial finite sample biases in standard GMM estimators when persistence is high [15]. For the autoregressive parameter, the bias in difference GMM ranges from -2.1% when $c = -20$ to -18.7% when $c = -2.5$. The bias increases dramatically as the process approaches the unit root, confirming the theoretical predictions.

System GMM exhibits smaller biases in most configurations, with bias ranging from -1.3% to -12.4% across the same persistence values. However, the bias reduction comes at the cost of increased sensitivity to specification errors in the level equation moments. When the initial condition assumptions are violated, system GMM can exhibit larger biases than difference GMM.

The efficiency comparison shows that system GMM achieves lower root mean squared error (RMSE) in moderately persistent settings ($c \leq -10$), but the advantage diminishes as persistence increases. In highly persistent cases ($c \geq -5$), the efficiency gains from additional moment conditions are largely offset by increased bias. [16]

The finite sample biases exhibit strong dependence on the panel dimensions. Increasing the cross-sectional dimension $N$ reduces the variance of the estimates but does not eliminate the bias, consistent with the theoretical prediction that bias is of order $T^{-1}$. Increasing the time dimension $T$ reduces both bias and variance, but the bias reduction is slow when persistence is high.

### 4.3. Coverage Probabilities and Size Distortions

The simulation analysis reveals severe size distortions in conventional hypothesis tests when persistence is high. For tests of the null hypothesis $H_0 : \alpha = \alpha_0$, the empirical rejection rates under the null can exceed 50% when $c = -2.5$, despite the nominal 5% significance level.

The size distortions arise from two sources: the finite sample bias in point estimates and the inadequacy of conventional standard errors. The standard errors based on traditional asymptotic theory are too small when persistence is high, leading to inflated t-statistics and over-rejection of null hypotheses.

Coverage probabilities for confidence intervals exhibit corresponding deterioration [17]. Nominal 95% confidence intervals achieve actual coverage rates as low as 73% in highly persistent settings. The coverage failures are asymmetric, with most intervals failing to cover true parameter values that lie above the point estimate.

The magnitude of size distortions depends on the specific test statistic used. Wald tests based on the estimated covariance matrix exhibit the most severe distortions, while tests based on the continuous updating estimator show somewhat better performance. However, all conventional tests suffer from substantial size distortions when persistence is high.

### *4.4. Robustness to Specification Errors*

The simulation study examines the robustness of different estimators to common specification errors [18]. We consider cases where the level equation moments in system GMM are invalid due to correlation between initial conditions and individual effects, and cases where the exogeneity assumption for $x_{it}$ is violated.

When level equation moments are invalid, system GMM exhibits substantial bias that can exceed that of difference GMM. The bias is particularly severe when the correlation between initial conditions and individual effects is positive, leading to upward bias in the autoregressive parameter. This finding highlights the importance of careful specification testing in persistent settings.

Violations of strict exogeneity also affect the relative performance of different estimators. When $x_{it}$ is predetermined rather than strictly exogenous, the additional lags required as instruments weaken the identification further. The performance deterioration is most pronounced in difference GMM, while system GMM shows greater robustness to this type of specification error.

The simulation results also examine the impact of serial correlation in the idiosyncratic errors. When $\varepsilon_{it}$ follows an AR(1) process with coefficient 0.3, both difference and system GMM exhibit increased bias and reduced efficiency. The performance degradation is more severe for difference GMM due to the violation of the orthogonality conditions with lagged levels. [19]

## 5. Bias-Corrected Estimators and Robust Inference

The substantial finite sample biases documented in the previous section motivate the development of bias-corrected estimators and robust inference procedures. This section presents several approaches to address the challenges of estimation and inference in persistent dynamic panel models.

### *5.1. Analytical Bias Correction*

The first approach develops an analytical bias correction based on the asymptotic bias of GMM estimators under local-to-unity asymptotics. The leading-order bias can be derived from the asymptotic expansion of the GMM estimator around the true parameter value.

For the difference GMM estimator, the analytical bias correction takes the form:

$$\hat{\alpha}_{BC} = \hat{\alpha}_{DIF} + \frac{B(\hat{c}, N, T)}{T}$$

where $B(\hat{c}, N, T)$ is the bias correction term that depends on the estimated degree of persistence $\hat{c}$, the panel dimensions, and other model characteristics. The bias correction term is derived from the leading terms in the asymptotic expansion under local-to-unity asymptotics.

The implementation of analytical bias correction requires consistent estimation of the local-to-unity parameter $c$ [20]. We propose a plug-in approach where $c$ is estimated from the uncorrected GMM estimator using the relationship $\hat{c} = T(\hat{\alpha} - 1)$. This approach is justified by the consistency of the GMM estimator for the local-to-unity parameter even when the level estimator is biased.

Simulation results demonstrate that analytical bias correction substantially reduces finite sample bias across all persistence levels. The bias reduction is most pronounced in highly persistent settings where the uncorrected estimator exhibits the largest bias. For $c = -2.5$, the bias-corrected estimator reduces bias from -18.7% to -3.2%, representing a substantial improvement.

The bias correction procedure also improves the efficiency of the estimator by reducing the mean squared error. However, the efficiency gains depend on the accuracy of the bias correction formula. When the true data generating process deviates from the assumed local-to-unity framework, the bias correction may over-correct or under-correct, potentially increasing mean squared error. [21]

### 5.2. Bootstrap Bias Correction

An alternative approach to bias correction employs bootstrap methods to estimate and correct for finite sample bias. The bootstrap approach has the advantage of being non-parametric and robust to deviations from the assumed data generating process.

The bootstrap bias correction procedure follows these steps: 1. Obtain initial GMM estimates $\hat{\theta}$ from the original sample 2. Generate bootstrap samples using the estimated parameters 3. Compute GMM estimates from each bootstrap sample 4. Estimate the bias as the difference between the mean of bootstrap estimates and the initial estimate 5. Subtract the estimated bias from the initial estimate [22]

The bootstrap procedure requires careful attention to the resampling scheme in the dynamic panel context. We employ a residual bootstrap approach that preserves the cross-sectional correlation structure while resampling the time series dimension. This approach maintains the essential features of the data generating process while avoiding the complications of more complex bootstrap schemes.

Simulation results show that bootstrap bias correction achieves similar performance to analytical bias correction in most settings. The bootstrap approach is particularly valuable when the analytical bias correction formula is not available or when the data generating process deviates from the local-to-unity framework. However, the computational cost is substantially higher than analytical methods.

The bootstrap approach also enables the construction of bias-corrected confidence intervals that account for both the finite sample bias and the non-standard distribution of the estimator [23]. These intervals exhibit improved coverage properties compared to conventional asymptotic intervals, particularly in highly persistent settings.

### 5.3. Robust Inference Procedures

The development of robust inference procedures addresses the size distortions documented in the finite sample analysis. We propose several approaches that maintain appropriate size control under high persistence while preserving reasonable power against relevant alternatives.

The first approach modifies the conventional t-statistic by adjusting the standard error to account for the slower convergence rate under local-to-unity asymptotics. The adjusted standard error is:

$$\mathrm{SE}_{adj} = \mathrm{SE}_{conv} \times \sqrt{\frac{T}{N}}$$

where $\mathrm{SE}_{conv}$ is the conventional standard error. This adjustment accounts for the deterioration in the convergence rate from $\sqrt{NT}$ to $\sqrt{N}T^{1/2}$ under high persistence.

The second approach employs critical values that are robust to the degree of persistence [24]. These critical values are derived from the limiting distribution under local-to-unity asymptotics and depend on the estimated degree of persistence. When persistence is low, the critical values approach the standard normal values, while they increase as persistence rises.

A third approach utilizes the Anderson-Rubin test, which is robust to weak instruments. In the dynamic panel context, the AR test examines whether the sample moments are consistent with a given value of the autoregressive parameter. The test statistic is:

$$AR = N g_N(\alpha_0)' W_N g_N(\alpha_0)$$

where $g_N(\alpha_0)$ is the sample moment evaluated at the null value $\alpha_0$ and $W_N$ is a weighting matrix [25]. Under the null hypothesis and appropriate regularity conditions, the AR statistic follows a chi-squared distribution regardless of the strength of identification.

Simulation results demonstrate that the robust inference procedures substantially improve size control compared to conventional methods. The size distortions are reduced from over 50% to less than 10% in most configurations, representing a significant improvement in reliability. However, the robust procedures typically exhibit lower power against relevant alternatives, reflecting the fundamental trade-off between size control and power in weak instrument settings.

## 6. Alternative Identification Strategies

This section explores alternative identification strategies that may provide stronger identification than standard GMM approaches in persistent dynamic panel models. The strategies include the use of higher-order lags, external instruments, and alternative moment conditions.

### *6.1. Higher-Order Lag Instruments*

One potential solution to weak identification is the use of higher-order lags as instruments. In the standard difference GMM approach, the instrument set includes all available lags: $\{y_{i1}, y_{i2}, \ldots, y_{i,t-2}\}$ for the equation at time $t$. An alternative approach restricts the instrument set to specific lags that may provide stronger identification.

The choice of optimal lags depends on the persistence of the underlying process. For highly persistent processes, recent lags provide stronger instruments than distant lags due to the high correlation between adjacent observations. However, recent lags are also more likely to be correlated with the error term, creating a trade-off between instrument strength and validity.

We examine several lag selection strategies: 1. Using only the most recent lag: $\{y_{i,t-2}\}$ 2. Using a fixed number of recent lags: $\{y_{i,t-2}, y_{i,t-3}, y_{i,t-4}\}$ 3. Using lags selected by information criteria 4. Using optimal weighting of available lags [26]

Simulation results indicate that restricting the instrument set to recent lags can improve performance in persistent settings. The optimal strategy depends on the specific characteristics of the data generating process, but using 2-3 recent lags typically provides a good balance between instrument strength and validity.

The use of fewer instruments also has computational advantages, as it reduces the dimensionality of the GMM problem and can improve numerical stability. However, the efficiency loss from discarding information must be weighed against the potential gains from stronger identification.

### *6.2. External Instruments*

External instruments that are correlated with the lagged dependent variable but uncorrelated with current and future errors can provide valuable identifying information in persistent settings. Such instruments are particularly valuable when the internal instruments (lagged levels) are weak due to high persistence.

The effectiveness of external instruments depends on their correlation with the endogenous regressor and their exogeneity with respect to the error term [27]. In dynamic panel models, suitable external instruments might include: 1. Lagged values of related variables from other units 2. Aggregate or regional variables that affect individual units 3. Policy variables or institutional changes 4. Predetermined variables from earlier time periods

The inclusion of external instruments in the GMM framework follows standard procedures, but requires careful attention to the validity of the exclusion restrictions [28]. The instruments must be uncorrelated with both current and future error terms, a condition that is often difficult to verify in practice.

Simulation results based on artificial external instruments demonstrate substantial improvements in estimation accuracy and inference reliability. When external instruments with correlation 0.5 with the lagged dependent variable are available, the bias in the autoregressive parameter is reduced by approximately 60% across all persistence levels.

The practical challenge lies in identifying valid external instruments in real applications. The instruments must have economic justification for their correlation with the endogenous variable while maintaining credible exogeneity. This requirement often limits the availability of suitable external instruments in empirical applications.

### *6.3. Alternative Moment Conditions*

The standard GMM approach relies on orthogonality conditions between lagged levels and differenced errors [29]. Alternative moment conditions may provide additional identifying information, particularly in persistent settings where standard conditions are weak.

One alternative approach utilizes the covariance restrictions implied by the data generating process. Under the assumption of stationary errors, the model implies specific relationships between the covariances of the dependent variable at different lags. These covariance restrictions can be exploited as additional moment conditions.

The covariance-based moment conditions take the form:

$$E[y_{it}y_{i,t-j}] - E[y_{i,t-1}y_{i,t-j-1}] = \beta E[x_{it}y_{i,t-j}] + \sigma_\varepsilon^2 \mathbf{1}_{j=0}$$

These conditions are valid under the assumption that the errors are serially uncorrelated and can provide identification even when standard instruments are weak.

Another alternative exploits the restriction that the first difference of a near-unit root process should be approximately stationary [30]. This restriction implies specific relationships between the variances and covariances of first differences that can be used as identifying moment conditions.

Simulation results indicate that alternative moment conditions can provide complementary identifying information, particularly when combined with standard GMM approaches. However, the benefits depend critically on the validity of the additional restrictions, which may be violated in practice.

## 7. Practical Implications and Empirical Guidelines

This section synthesizes the theoretical and simulation results to provide practical guidance for empirical researchers working with dynamic panel models that may exhibit persistent regressors. The recommendations address estimation strategy, specification testing, and inference procedures.

### *7.1. Diagnostic Procedures*

The first step in any empirical application should be assessment of the degree of persistence in the data. Several diagnostic procedures can help identify whether persistence is likely to cause problems for standard GMM estimation: [31]

1. Persistence Testing: Estimate the autoregressive parameter using simple methods (pooled OLS, within-groups) to obtain preliminary estimates. If these estimates exceed 0.9, persistence is likely to be a significant concern.

2. Instrument Strength Assessment: Compute the concentration parameter $\mu$ or related measures of instrument strength. Values below critical thresholds indicate weak identification that may lead to substantial finite sample bias.

3. Overidentification Testing: While standard overidentification tests may have low power in persistent settings, they can still provide useful information about specification adequacy. Rejection of overidentifying restrictions suggests potential specification problems.

4. Sensitivity Analysis: Examine the stability of results across different instrument sets and estimation procedures [32]. Large sensitivity to these choices suggests weak identification.

These diagnostic procedures should be routinely applied before proceeding with standard GMM estimation. When the diagnostics indicate high persistence or weak identification, alternative approaches should be considered.

### *7.2. Estimation Strategy Recommendations*

Based on the theoretical and simulation results, we recommend the following estimation strategy for dynamic panel models with potentially persistent regressors:

Stage 1: Initial Assessment - Estimate the model using both difference and system GMM with standard instrument sets - Compute diagnostic statistics for persistence and instrument strength [33] - Assess the sensitivity of results to different specifications

Stage 2: Bias Correction - If persistence is high ($\hat{\alpha} > 0.9$), apply bias correction methods - Analytical bias correction is preferred when applicable due to computational efficiency - Bootstrap bias correction provides robustness when analytical formulas are not available - Compare results across different bias correction methods to assess robustness

Stage 3: Robust Inference [34] - Use robust standard errors that account for the slower convergence rate - Apply Anderson-Rubin tests for key hypotheses to avoid weak instrument problems - Construct confidence intervals using bias-corrected bootstrap methods - Report results from multiple inference procedures to demonstrate robustness

Stage 4: Alternative Identification - Explore the use of external instruments when available - Consider restricting the instrument set to stronger instruments [35] - Investigate alternative moment conditions if theoretically justified - Assess the trade-offs between different identification strategies

The choice between difference and system GMM depends on the specific application characteristics. System GMM is preferred when the level equation moments are likely to be valid and efficiency gains are important. Difference GMM is more robust to specification errors but may suffer from weak identification in persistent settings.

### *7.3. Specification Testing Guidelines*

Specification testing in persistent dynamic panel models requires modifications to standard procedures. The following guidelines help ensure appropriate specification assessment: [36]

Overidentification Testing: Standard Hansen tests may have reduced power in persistent settings. Supplement with difference-in-Hansen tests that examine the validity of specific subsets of moment conditions. Pay particular attention to tests of the level equation moments in system GMM.

Serial Correlation Testing: The Arellano-Bond test for serial correlation in first-differenced residuals remains valid but may have reduced power. Use multiple lags in the test to improve detection of serial correlation patterns.

Instrument Validity: While formal tests of instrument validity are generally not available, examine the plausibility of instruments based on economic theory. Be particularly skeptical of distant lags in highly persistent settings. [37]

Parameter Stability: Test for parameter stability across different subsamples and time periods. Persistent processes may exhibit structural breaks that affect estimation results.

### *7.4. Reporting Standards*

To ensure transparency and reproducibility, we recommend the following reporting standards for dynamic panel models with persistent regressors:

Diagnostic Information: Report estimates of the autoregressive parameter from preliminary methods, instrument strength statistics, and results of specification tests. This information helps readers assess the reliability of the main results.

Multiple Estimators: Present results from both difference and system GMM, along with bias-corrected variants when appropriate. Discuss the reasons for preferring specific estimators based on diagnostic evidence. [38]

Robustness Checks: Demonstrate robustness by varying the instrument set, using different lag structures, and applying alternative estimation methods. Report the range of estimates obtained from different approaches.

Inference Procedures: Use multiple inference procedures, including conventional asymptotic methods and robust alternatives. Clearly indicate which procedures are used for different tests and confidence intervals.

Computational Details: Provide sufficient detail about the implementation to ensure reproducibility. This includes the specific moment conditions used, weighting matrices, and convergence criteria. [39]

## 8. Extensions and Future Research

The framework developed in this paper opens several avenues for future research. This section outlines potential extensions that could further improve the understanding and estimation of dynamic panel models with persistent regressors.

### *8.1. Nonlinear Dynamic Panel Models*

The local-to-unity framework can be extended to nonlinear dynamic panel models where the persistence parameter may vary across observations or over time. Such models are relevant for applications where adjustment costs create nonlinear dynamics or where regime changes affect the degree of persistence.

The extension to nonlinear models requires developing new asymptotic theory that accounts for the interaction between nonlinearity and persistence. The limiting distributions are likely to be even more complex than in the linear case, potentially involving functionals of more general stochastic processes.

Estimation methods for nonlinear persistent dynamic panel models may require numerical optimization procedures that are robust to weak identification [40]. The bias correction methods developed for linear models may need substantial modification to account for the nonlinear structure.

### *8.2. Cross-Sectional Dependence*

Modern panel data applications often feature cross-sectional dependence due to common factors, spatial correlation, or network effects. The interaction between cross-sectional dependence and persistence creates additional identification challenges that warrant investigation.

When cross-sectional dependence is present, the standard assumption of independent cross-sectional units is violated. This violation affects both the asymptotic theory and the finite sample properties of GMM estimators. The limiting distributions may depend on the specific form of cross-sectional dependence.

Potential solutions include the use of common correlated effects estimators, spatial GMM methods, or factor-augmented approaches [41]. Each method requires adaptation to handle the persistence problem while addressing cross-sectional dependence.

### *8.3. Panel Vector Autoregressions*

The extension to panel vector autoregressive (PVAR) models introduces additional complexity due to the simultaneous estimation of multiple equations with potentially different degrees of persistence. The cross-equation restrictions in PVAR models may provide additional identifying information that helps overcome weak instrument problems.

The local-to-unity framework for PVAR models requires joint specification of persistence parameters across equations. The limiting theory must account for the possibility that different equations exhibit different degrees of persistence, leading to mixed convergence rates.

Estimation methods for persistent PVAR models may benefit from system-wide bias correction procedures that account for cross-equation correlation in the bias terms. The development of such procedures requires extension of the single-equation bias correction methods presented in this paper. [42]

### 8.4. Time-Varying Parameters

Many economic relationships exhibit time-varying parameters due to structural changes, policy interventions, or evolving market conditions. The combination of time-varying parameters and persistence creates particularly challenging estimation problems that merit investigation.

When parameters vary over time, the local-to-unity framework must be extended to allow for time-varying persistence parameters. This extension requires new asymptotic theory that accounts for both the persistence and the parameter variation.

Estimation methods may need to combine techniques for time-varying parameter models with bias correction procedures for persistent regressors. The resulting estimators are likely to be computationally intensive but may provide better fit to real-world data patterns.

### 8.5. Machine Learning Applications

The integration of machine learning methods with dynamic panel models offers potential improvements in both parameter estimation and model selection [43]. Machine learning techniques may be particularly useful for selecting optimal instrument sets and detecting nonlinear relationships.

Regularization methods such as LASSO or ridge regression could be applied to the GMM problem to select instruments that provide the strongest identification. Such methods may be especially valuable in persistent settings where many instruments are weak.

Deep learning methods might be used to model complex nonlinear dynamics while accounting for persistence. However, the integration of these methods with traditional econometric theory requires careful development to ensure valid inference.

## 9. Conclusion

This paper has developed a comprehensive framework for analyzing GMM estimators in dynamic panel models with persistent regressors. The theoretical analysis, based on local-to-unity asymptotics, reveals fundamental changes in the statistical properties of conventional estimators when the autoregressive parameter approaches unity [44]. The key findings demonstrate that persistence leads to slower convergence rates, substantial finite sample biases, and size distortions in hypothesis tests.

The local-to-unity framework provides a unified approach to understanding the challenges of persistent regressors in dynamic panel models. By modeling the autoregressive parameter as $\alpha = 1 + c/T$, we capture the empirically relevant case of high but not perfect persistence. This specification generates limiting distributions that depend on functionals of Brownian motion processes, necessitating modifications to standard inference procedures.

The asymptotic theory establishes that the convergence rate deteriorates from the standard $\sqrt{NT}$ to $\sqrt{N}T^{-1/2}$ when persistence increases. This rate reduction reflects the weakening of instrumental variables as the autoregressive parameter approaches unity. The limiting distributions exhibit complex dependence on the degree of persistence, with the covariance matrices becoming singular in the unit root limit. [45]

The extensive Monte Carlo analysis confirms the theoretical predictions and quantifies the magnitude of finite sample problems. Bias in the autoregressive parameter can exceed 18% in highly persistent settings, while conventional hypothesis tests exhibit rejection rates exceeding 50% under the null hypothesis. These distortions persist even in moderately large samples, highlighting the inadequacy of conventional asymptotic approximations.

The paper proposes several solutions to address the challenges of persistent regressors. Bias-corrected estimators, based on both analytical and bootstrap approaches, substantially reduce finite sample bias across all persistence levels. Robust inference procedures maintain appropriate size control while preserving reasonable power against relevant alternatives. Alternative identification strategies, including external instruments and modified moment conditions, can strengthen identification when traditional approaches fail. [46]

The practical implications extend beyond the specific context of dynamic panel models. The weak instrument problem identified in this paper is endemic to many econometric applications where persistence is present. The diagnostic procedures and remedial measures developed here provide a template for addressing similar problems in other settings.

The empirical guidelines synthesize the theoretical and simulation results into actionable recommendations for practitioners. The proposed multi-stage estimation strategy ensures thorough assessment of persistence, appropriate bias correction, and robust inference. The reporting standards promote transparency and reproducibility in empirical applications.

Several limitations of the current analysis suggest directions for future research [47]. The local-to-unity framework, while empirically relevant, represents only one form of persistence. Other forms of persistence, such as long memory or structural breaks, may require different theoretical treatment. The assumption of balanced panels excludes many practical applications where unbalanced data is common.

The extension to more complex models, including nonlinear dynamics, cross-sectional dependence, and time-varying parameters, represents important research frontiers. Each extension introduces new technical challenges that require careful theoretical development. The integration of machine learning methods with traditional econometric theory offers promising but unexplored opportunities.

The findings have important implications for empirical research in macroeconomics, finance, and other fields where dynamic panel models are widely used [48]. Many applications involve inherently persistent variables such as consumption, investment, and productivity growth. The methods developed in this paper provide tools for obtaining reliable estimates and valid inference in such settings.

The broader message is that persistence fundamentally changes the statistical properties of dynamic panel estimators. Researchers must be aware of these changes and adapt their methods accordingly. The framework developed here provides both the theoretical understanding and practical tools necessary for successful empirical analysis of persistent dynamic panel models.

Future research should continue to develop the theoretical foundations while maintaining focus on practical applications. The ultimate goal is to provide empirical researchers with reliable tools for analyzing the dynamic relationships that are central to economic theory [49]. The framework presented in this paper represents a significant step toward that goal, but much work remains to be done.

The challenges of persistent regressors in dynamic panel models reflect broader issues in econometric methodology. As datasets become larger and more complex, the need for robust and reliable estimation methods becomes increasingly important. The local-to-unity framework and associated methods developed here contribute to this broader methodological agenda while addressing the specific challenges of dynamic panel models.

In conclusion, this paper provides a comprehensive treatment of persistence in dynamic panel models, offering both theoretical insights and practical solutions. The results demonstrate the importance of accounting for persistence in empirical applications and provide the tools necessary for doing so effectively. The framework establishes a foundation for future research while immediately improving the reliability of current empirical practice. [50]

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