On relaxing the distributional assumption of stochastic frontier models

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Abstract

Stochastic frontier models have been considered as an alternative to deterministic frontier models in that they attribute the deviation of the output from the production frontier to both measurement error and inefficiency. However, such merit is often dimmed by strong assumptions on the distribution of the measurement error and the inefficiency such as the normal-half normal pair or the normal-exponential pair. Since the distribution of the measurement error is often accepted as being approximately normal, here we show how to estimate various stochastic frontier models with a relaxed assumption on the inefficiency distribution, building on the recent work of Kneip and his coworkers. We illustrate the usefulness of our method with data on Japanese local public hospitals.

Key words: frontier function, measurement error, inefficiency distribution, productivity analysis, stochastic frontier models

1 Introduction

Productivity analysis consists in a series of analytical methods that allow to measure the performance of production units in terms of output versus input. Efficiency in productivity

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analysis is often defined as the ratio of the actual achieved output to the maximum possible output from the input, assuming that the inefficiency of the unit is the cause of its production not reaching its maximum output. However, from the recognition that many uncontrolled factors need to be considered in efficiency analysis, Aigner and Chu (1968) and Meeusen and van den Broeck (1977) first proposed the stochastic frontier analysis, which allows for both unobserved variation in output, the technical inefficiency (u) of the production unit and the noise (v) which represents the effect of innumerable uncontrollable factors.

Although the initial stochastic frontier analysis has the advantage of considering the role of unforeseen/uncontrollable factors, it was assumed that the frontier function had a specific parametric form such as the Cobb-Douglas and translog function. In addition, often specific parametric distributions for the inefficiency and the error were assumed. Over the last 20 years, studies have been conducted to relax the assumption of a parametric form of the frontier function in stochastic frontier analysis and there have been some remarkable achievements such as Fan et al. (1996), Kumbhakar et al. (2007), Martins-Filho and Yao (2015). However, much less research has been done on relaxing the parametric assumption on the inefficiency and the noise. This is the starting point of our work. Since the distribution of the noise is often accepted as being approximately normal, here we focus on developing a method for estimating various stochastic frontier models with a relaxed assumption on the inefficiency distribution.

In general, it is known that the estimate of firm level efficiency proposed in Jondrow et al. (1982) is given by a monotonic function of the overall error ($\epsilon = v - u$) estimate when the noise (v) follows a normal distribution (see Ondrich and Ruggiero, 2001). Since the ranking of the estimates of the overall error (ϵ) can be obtained through ordinary least squares residuals as mentioned in Bera and Sharma (1999) and Parmeter and Kumbhakar (2014), if the rank of the individual inefficiency is the main concern, we do not have to pay much attention to the assumption on the inefficiency distribution. However, if our main interest lies in the value itself of the production function or the inefficiency function when the inefficiency is affected by other variables, then the appropriate modeling of the inefficiency distribution becomes important. Motivated by this observation we will discuss how to estimate the frontier function under relaxed assumptions on the inefficiency distribution so that the estimation results become less sensitive to the specification of the inefficiency distribution. The key idea of this paper is to extend the work in Kneip et al. (2015), who studied the estimation of the constant frontier under the setting of our interest. Actually, Hall and Simar (2002) considered a similar problem with a different method but their method has the uncorrected bias depending on the magnitude of the

noise variance in the estimation of the frontier function, even in large samples. In contrast, the method in Kneip et al. (2015) does not have such problem provided that the noise follows a normal distribution.

The rest of the paper is structured as follows. Section 2 briefly explains the method of Kneip et al. (2015), which is important for understanding our proposals. Section 3 introduces our methods as an extension of Kneip et al. (2015)'s work and provides some heuristics for the theoretical understanding of the proposed methods. We present the small sample performance of the proposed methods in Section 4 and illustrate how the proposed methods can be used for efficiency and productivity analysis in Section 5. Some conclusions are given in Section 6.

2 Background

In this section, following Kneip et al. (2015) we briefly review how the constant frontier can be reconstructed with a relaxed assumption on the inefficiency when the noise follows a normal distribution. Suppose that we have *i.i.d.* observations $Y_1, Y_2, \dots, Y_n$ from the model

$$Y_i = \tau \exp(-U_i) \cdot \exp(V_i), \quad i = 1, \dots, n, \quad (1)$$

where $\tau > 0$, U_i is a positive random variable that represents the inefficiency and whose density makes a jump at the origin, and where V_i follows a normal distribution with mean zero and unknown variance σ^2 . Note that Model (1) can be rewritten as

$$\log Y_i = \log \tau + V_i - U_i, \quad i = 1, \dots, n. \quad (2)$$

Kneip et al. (2015) proposed a method to estimate τ and σ^2 based on a penalized profile likelihood. The estimation procedure can be summarized as follows.

Let $g(\cdot)$ and $f(\cdot)$ be the densities of the observed variable Y_i and the latent variable $X_i = \tau \exp(-U_i)$, respectively. Note that the density $f(\cdot)$ is defined on $[0, \tau]$ with $f(\tau) > 0$. As in Kneip et al. (2015), we use a sub-index 0 to indicate the true quantities. For all $y > 0$, we can write the true density of Y ,

$$g_0(y) = \frac{1}{\sigma_0 y} \int_0^1 h_0(t) \phi\left(\frac{1}{\sigma_0} \log \frac{y}{t\tau_0}\right) dt, \quad (3)$$

where $h_0(t) = \tau_0 f_0(t\tau_0)$ for $0 \leq t \leq 1$ and $\phi(\cdot)$ is the standard normal density. From expression (3), we consider the following probability density model to estimate τ_0 and σ_0^2 based on $Y_1, Y_2, \dots, Y_n$:

$$\{g_{h,\tau,\sigma}(\cdot) : h \text{ is a probability density on } [0, 1], \tau > 0, \sigma > 0\}, \quad (4)$$

where

$$g_{h,\tau,\sigma}(y) = \frac{1}{\sigma y} \int_0^1 h(t) \phi\left(\frac{1}{\sigma} \log \frac{y}{t\tau}\right) dt. \quad (5)$$

Since $g_{h,\tau,\sigma}(y)$ depends on the underlying density $h(\cdot)$, Kneip et al. (2015) considered the approximation of h by

$$\left\{ h_{\gamma}(t) = \gamma_1 I(t=0) + \sum_{k=1}^M \gamma_k I(q_{k-1} < t \leq q_k) : \gamma_k > 0 \text{ for all } k \text{ and } \sum_{k=1}^M \gamma_k = M \right\}, \quad (6)$$

where $q_k = k/M$ ($k = 0, 1, \dots, M$) and M is a pre-specified natural number. The final density model is

$$g_{h_{\gamma},\tau,\sigma}(y) = \frac{1}{\sigma y} \sum_{k=1}^M \gamma_k \int_{q_{k-1}}^{q_k} \phi\left(\frac{1}{\sigma} \log \frac{y}{t\tau}\right) dt. \quad (7)$$

Estimators $\hat{\tau}$ and $\hat{\sigma}$ of τ_0 and σ_0 are obtained by maximizing the following penalized likelihood:

$$(\hat{\tau}, \hat{\sigma}, \hat{\gamma}) = \arg \max_{\tau > 0, \sigma > 0, \gamma \in \Gamma} \left\{ n^{-1} \sum_{i=1}^n \log g_{h_{\gamma},\tau,\sigma}(Y_i) - \lambda \text{pen}(g_{h_{\gamma},\tau,\sigma}) \right\}, \quad (8)$$

where $\lambda \geq 0$ is a fixed value independent of n , $\text{pen}(g_{h_{\gamma},\tau,\sigma}) = \max_{3 \leq j \leq M} |\gamma_j - 2\gamma_{j-1} + \gamma_{j-2}|$ and $\Gamma = \left\{ \gamma = (\gamma_1, \dots, \gamma_M)^{\top} : \gamma_k > 0 \text{ for all } k \text{ and } \sum_{k=1}^M \gamma_k = M \right\}$. Note that the penalty is introduced to account for the smoothness of the function h_0 . Also note that λ can be taken equal to zero, which means that we consider both penalized and non-penalized estimators. However, it can be seen that the penalized estimator attains a better rate of convergence.

3 Our Proposals

In this section, building upon the work of Kneip et al. (2015), we propose how to estimate the frontier function with a relaxed assumption on the inefficiency for three stochastic frontier models. Additionally, we provide some heuristics for the theoretical understanding of the proposed methods.

3.1 Linear model

Assume the stochastic frontier model with a linear frontier function

$$Y_i = \beta_0 + \mathbf{X}_i^{\top} \boldsymbol{\beta} + \epsilon_i = \beta_0 + \mathbf{X}_i^{\top} \boldsymbol{\beta} + V_i - U_i, \quad i = 1, \dots, n, \quad (9)$$

where $\boldsymbol{\beta} = (\beta_1, \dots, \beta_p)^\top$ and $\mathbf{X}_i = (X_{1,i}, \dots, X_{p,i})^\top$. Concerning U_i and V_i , we make the same assumption as in Kneip et al. (2015). Our interest lies in estimating both β_0 and $\boldsymbol{\beta}$. Horrace and Parmeter (2011) considered the same model with the same assumption on V_i but they tried to estimate the density of U_i with a relaxed assumption on U_i , which is that the distribution of U_i is a member of the family of ordinary smooth densities (see Fan, 1991).

Since $Y_i = (\beta_0 - E(U_i)) + \mathbf{X}_i^\top \boldsymbol{\beta} + (V_i - (U_i - E(U_i)))$ with $\epsilon_i^* = V_i - (U_i - E(U_i))$ having zero mean, we can estimate $\boldsymbol{\beta}$ and $\beta_0 - E(U_i)$ via least squares using the fact that $E(\epsilon_i^* | X_i) = 0$, provided that V_i and U_i are independent of X_i . Once we have obtained $\hat{\boldsymbol{\beta}}$, we calculate $Y_i - \mathbf{X}_i^\top \hat{\boldsymbol{\beta}}$, which is expected to be similar to $\beta_0 + V_i - U_i$. From the observation

$$\exp(Y_i - \mathbf{X}_i^\top \hat{\boldsymbol{\beta}}) \approx \exp(\beta_0) \exp(-U_i) \exp(V_i), \quad (10)$$

we apply the estimation method of Kneip et al. (2015) with $\exp(Y_i - \mathbf{X}_i^\top \hat{\boldsymbol{\beta}})$ to obtain the estimate of $\exp(\beta_0)$ and $\sigma_V = \sqrt{\text{Var}(V_i)}$. After obtaining $\widehat{\exp(\beta_0)}$, we can obtain $\hat{\beta}_0 = \log(\widehat{\exp(\beta_0)})$, $\widehat{E(U_i)} = \hat{\beta}_0 - \widehat{\beta_0 - E(U_i)}$, $\hat{\epsilon}_i = Y_i - (\hat{\beta}_0 + \mathbf{X}_i^\top \hat{\boldsymbol{\beta}})$. If we are only interested in ranking production units or in ranking firm-specific inefficiency estimates, the estimate $\hat{\boldsymbol{\beta}}$ is enough and we don't need to go further with the method of Kneip et al. (2015). However, if we have specific interest in firm level inefficiency, then it is necessary to have the estimate $\hat{\epsilon}_i$ for which the distributional assumption about the inefficiency is usually utilized. We propose here how to obtain $\hat{\epsilon}_i$ with the relaxed assumption on the inefficiency. Traditionally, one estimates the firm-specific inefficiency using the formula of $E(U_i | \epsilon_i)$ derived from the distributional assumption on U_i and V_i . In our case, instead of using the formula of $E(U_i | \epsilon_i)$ we use the best linear predictor of U_i given ϵ_i , $a + b\epsilon_i$, which was analyzed in detail in Waldman (1984). A simple calculation leads to $b = -\text{Var}(U_i) / (\text{Var}(U_i) + \text{Var}(V_i))$ and $a = E(U_i)(1 + b)$.

3.2 Partially linear model

Another stochastic frontier model that we would like to consider is the model that Parmeter et al. (2017) studied. They considered the same model as in Section 3.1 but assume that the inefficiency is directly influenced by observable exogenous determinants, Z_i :

$$Y_i = \beta_0 + \mathbf{X}_i^\top \boldsymbol{\beta} + \epsilon_i = \beta_0 + \mathbf{X}_i^\top \boldsymbol{\beta} + V_i - U_i, \quad i = 1, \dots, n, \quad (11)$$

where $V_i \sim N(0, \sigma_V^2)$, $U_i \geq 0$, $E(U_i | \mathbf{X}_i, Z_i) = E(U_i | Z_i) = g(Z_i)$. For simplicity, we assume that Z_i is a scalar. We will deal with the case where Z_i is a vector of dimension q in

Section 3.3. Model (11) can be rewritten as

$$Y_i = \beta_0 + \mathbf{X}_i^\top \boldsymbol{\beta} - g(Z_i) + \epsilon_i^* = \beta_0 + \mathbf{X}_i^\top \boldsymbol{\beta} - g(Z_i) + (V_i - (U_i - g(Z_i))). \quad (12)$$

Since $E(\epsilon_i^* | \mathbf{X}_i, Z_i) = 0$ provided V_i is independent of (X_i, Z_i) , we can estimate $\boldsymbol{\beta}$ and $g(\cdot)$ using estimation techniques for partially linear models. More precisely, the conditional mean function $g(\cdot)$ representing the inefficiency can be estimated up to a constant because it is mixed up with the intercept β_0 . Parmeter et al. (2017) discussed that the intercept β_0 cannot be separately identified from $g(Z_i)$ but this is not a concern as differences between $g(Z_i)$ across firms can be used as measures of relative inefficiency. However, if we would like to evaluate the exact impact of the exogenous determinants on the inefficiency, we have to know the value of β_0 so that we can estimate the function $g(\cdot)$ consistently. Here we try to estimate the exact level of β_0 and $g(\cdot)$ applying the method in Kneip et al. (2015). The idea is to calculate $Y_i - \mathbf{X}_i^\top \boldsymbol{\beta} = \beta_0 + V_i - U_i$. Let $\hat{\boldsymbol{\beta}}$ be the estimator of $\boldsymbol{\beta}$ obtained from the partial linear model fitting of Model (11). Then, since $\hat{\boldsymbol{\beta}}$ is $\sqrt{n}$ -consistent under appropriate regularity conditions, $Y_i - \mathbf{X}_i^\top \hat{\boldsymbol{\beta}}$ is expected to be similar to $\beta_0 + V_i - U_i$. So we apply the method of Kneip et al. (2015) to estimate β_0 and $\sigma_V = \sqrt{\text{Var}(V_i)}$ with $\exp(Y_i - \mathbf{X}_i^\top \hat{\boldsymbol{\beta}})$ as in Section 3.1. In our simulation, we implemented the method in Speckman (1988) to estimate the partially linear model but used two smoothing parameters as proposed in Aneiros-Pérez et al. (2004). We chose the two smoothing parameters based on generalized cross-validation.

3.3 Partially linear single-index model

In this section, we consider a similar stochastic frontier model to the one in Section 3.2 but we assume that there is more than one observable determinant which affects the inefficiency, *i.e.* $\mathbf{Z}_i = (Z_{1,i}, \dots, Z_{q,i}) \in \mathbb{R}^q$. In this case, we could consider various models for $g(\mathbf{Z}_i)$ such as additive models, single-index models and so on. Here we consider the single-index model where $g(\mathbf{Z}_i)$ can be expressed as $g_1(\mathbf{Z}_i^\top \boldsymbol{\alpha})$ for a certain univariate function $g_1(\cdot)$ and a q -dimensional vector $\boldsymbol{\alpha}$. Specifically, our stochastic frontier model can be written as

$$Y_i = \beta_0 + \mathbf{X}_i^\top \boldsymbol{\beta} + \epsilon_i = \beta_0 + \mathbf{X}_i^\top \boldsymbol{\beta} + V_i - U_i, \quad i = 1, \dots, n, \quad (13)$$

where $E(U_i | \mathbf{X}_i, \mathbf{Z}_i) = E(U_i | \mathbf{Z}_i) = g_1(\mathbf{Z}_i^\top \boldsymbol{\alpha})$. A more convenient form for estimation is

$$Y_i = \beta_0 + \mathbf{X}_i^\top \boldsymbol{\beta} - g_1(\mathbf{Z}_i^\top \boldsymbol{\alpha}) + \epsilon_i^* = \beta_0 + \mathbf{X}_i^\top \boldsymbol{\beta} - g_1(\mathbf{Z}_i^\top \boldsymbol{\alpha}) + (V_i - (U_i - g_1(\mathbf{Z}_i^\top \boldsymbol{\alpha}))). \quad (14)$$

Since $E(\epsilon_i^* | \mathbf{X}_i, \mathbf{Z}_i) = 0$ provided V_i is independent of (X_i, Z_i) , we can estimate $\boldsymbol{\beta}$, $g_1(\cdot)$ (up to a constant) and $\boldsymbol{\alpha}$ using estimation techniques for partially linear single-index models.

Following the same idea as in Sections 3.1 and 3.2, we can estimate β_0 and $\sigma_V = \sqrt{\text{Var}(V_i)}$ from application of the method of Kneip et al. (2015) to $\exp(Y_i - \mathbf{X}_i^\top \hat{\beta})$. In our simulation, we implemented the method in Liang et al. (2010) to estimate the partially linear single-index model. We used 5-fold cross-validation to choose the bandwidth for the single-index estimation.

3.4 Theoretical understanding of the proposed methods

Let us now look at some asymptotic properties of the proposed estimators. Following the results in Kneip et al. (2015) we first need to show that $H^2(\hat{g}, g_0) = O_P(M_n^{-2})$ (see their Theorem 3.1), where for any densities g_1 and g_2 the Hellinger distance $H^2(g_1, g_2)$ is defined by

$$H^2(g_1, g_2) = \frac{1}{2} \int (\sqrt{g_1(y)} - \sqrt{g_2(y)})^2 dy,$$

and where $\hat{g} = g_{h_{\hat{\gamma}}, \hat{\tau}, \hat{\sigma}}$ and $M = M_n$ is the number of grid points used to estimate the function h . To prove that Theorem 3.1 in Kneip et al. (2015) remains valid in our context, we need to check what changes in the proof of this theorem when Y_i is replaced by $Y_i - \mathbf{X}_i^\top \hat{\beta}$. Since $\hat{\beta}$ converges to β with parametric rate, it can be seen that $\hat{\beta}$ does not disturb the rate of $H^2(\hat{g}, g_0)$, and so the result of Theorem 3.1 in Kneip et al. (2015) remains valid provided the regularity conditions (A1)-(A4) hold true. Next, Theorem 3.2 in Kneip et al. (2015), which states the main result of the paper, namely that

$$\hat{\sigma}_V - \sigma_V = O_P((\log n)^{-2}) \quad \text{and} \quad \hat{\beta}_0 - \beta_0 = O_P((\log n)^{-3/2})$$

remains valid in our context since it only requires that the result of Theorem 3.1 is valid. In particular, our estimator $\hat{\beta}_0$ has a logarithmic rate of convergence, as in the case where the variance σ_V^2 would be known.

4 Simulation Evidence

In this section, we present the small sample performance of the proposed methods.

4.1 Simulation setup

Our data generating process follows the simple stochastic frontier model:

$$Y_i = \beta_0 + \beta_1 \log I_{1,i} + \beta_2 \log I_{2,i} + V_i - U_i, \quad i = 1, \dots, n,$$

where $X_{1,i} = \log I_{1,i}$, $X_{2,i} = \log I_{2,i}$. For all the settings below, V_i is distributed i.i.d. $N(0, \sigma_V^2)$. The vector $(I_{1,i}, I_{2,i}, W_{1,i}, W_{2,i})$ is i.i.d. multivariate normal with all the correlations being $\rho = 0.5$. The mean vector for the covariates is $(4, 8, 0, 0)$ and all four random variables have unit variance. We define observable determinants as $Z_{1,i} = \Phi(W_{1,i})$ and $Z_{2,i} = \Phi(W_{2,i})$, where $\Phi(\cdot)$ is the distribution function of a standard normal variable. To generate the inefficiency U_i , we consider a positive random variable U_i^* , which follows an exponential distribution $\text{Exp}(a)$ or a half-normal distribution $N^+(\mu, \sigma^2)$. Here, $U_i^* \sim \text{Exp}(a)$ means that the density of U_i^* is

$$f_{U^*}(u) = a^{-1} \exp(-a^{-1}u) I(u > 0),$$

and $U_i^* \sim N^+(\mu, \sigma^2)$ means that the density of U_i^* is given as

$$f_{U^*}(u) = \frac{\Phi^{-1}(\mu/\sigma)}{\sqrt{2\pi}\sigma} \exp\left\{-\frac{1}{2}\left(\frac{u-\mu}{\sigma}\right)^2\right\} I(u > 0).$$

We consider three scenarios for U_i^* : (1) $N^+(0, 0.5^2)$ (2) $N^+(0.25, 0.4^2)$ (3) $\text{Exp}(0.3014)$. Depending on the type of model of interest, we define U_i as a function of U_i^* , $Z_{1,i}$ and $Z_{2,i}$. Finally, we set the vector of β 's as $\beta_0 = 5$, $\beta_1 = 1.5$ and $\beta_2 = 2$ and choose $\sigma_V = \rho_{nts}\sigma_U$ with $\rho_{nts} = 0.05, 0.25, 0.5$ and $\sigma_U = \sqrt{\text{Var}(U_i)}$.

4.1.1 Linear model

For this model, we simply let $U_i = U_i^*$.

4.1.2 Partially linear model

In this model, we define the inefficiency U_i as $U_i = 0.2 \exp(Z_{1,i}) U_i^*$. Hence, $g(Z_{1,i}) = E(U_i | \mathbf{X}_i, Z_{1,i}) = 0.2 E(U_i^*) \exp(Z_{1,i})$ provided U_i^* is independent of $(\mathbf{X}_i, Z_{1,i})$.

4.1.3 Partially linear single-index model

In this model, we define the inefficiency U_i as $U_i = \sin(\sqrt{2}Z_{1,i} + \sqrt{2}Z_{2,i}) U_i^*$. Hence, $g(Z_{1,i}, Z_{2,i}) = E(U_i | \mathbf{X}_i, Z_{1,i}, Z_{2,i}) = E(U_i^*) \sin(\sqrt{2}Z_{1,i} + \sqrt{2}Z_{2,i})$ provided U_i^* is independent of $(\mathbf{X}_i, Z_{1,i}, Z_{2,i})$.

4.2 Evaluation of the performance of $\hat{\beta}_0$ and $\hat{\sigma}_V$

For the three simulation models, we perform 500 Monte Carlo experiments with n equal to 100, 200 or 400, and ρ_{nts} equal to 0.05, 0.25 or 0.5. We calculate the Root Mean Squared

Error (RMSE) of $\hat{\beta}_0$ and $\hat{\sigma}_V$ over the grid $\log_{10} \lambda = -4, -3, -2, -1, 0, 1, 2, 3, 4$. For the sake of space, we only display the smallest RMSEs of $\hat{\beta}_0$ and $\hat{\sigma}_V$ in each model (Table 1 to Table 3) but the whole results can be found in the supplementary material. For the number of bins, we used the rule $M = \max(3, 2 \times \text{round}(n^{1/5}))$ as in Kneip et al. (2015). Here, $\text{round}(a)$ means the nearest integer to a . The tables show that the performance is as expected: when the sample size increases the performance of the estimators improves for both β_0 and σ_V . When increasing the noise from $\rho_{nts} = 0.05$ to 0.50, the performance deteriorates. This effect is stronger for estimating β_0 than for estimating σ_V as observed in Kneip et al. (2015). Finally, the selection of the penalty parameter λ seems not to be crucial for the performance (see the supplementary material). This phenomenon will also be observed in our data analysis in Section 5.

		$U_i^* \sim N^+(0, 0.5^2)$		$U_i^* \sim N^+(0.25, 0.4^2)$		$U_i^* \sim \text{Exp}(0.3014)$	
		$\hat{\beta}_0$	$\hat{\sigma}_V$	$\hat{\beta}_0$	$\hat{\sigma}_V$	$\hat{\beta}_0$	$\hat{\sigma}_V$
$\rho_{nts} = 0.05$	$n = 100$	0.5021	0.0365	0.4927	0.0431	0.5282	0.0206
	$n = 200$	0.3440	0.0273	0.3346	0.0387	0.3515	0.0144
	$n = 400$	0.2467	0.0203	0.2341	0.0310	0.2549	0.0095
$\rho_{nts} = 0.25$	$n = 100$	0.5352	0.0357	0.5096	0.0424	0.5493	0.0307
	$n = 200$	0.3609	0.0222	0.3479	0.0327	0.3661	0.0200
	$n = 400$	0.2584	0.0155	0.2458	0.0289	0.2647	0.0122
$\rho_{nts} = 0.50$	$n = 100$	0.5881	0.0395	0.5548	0.0393	0.6084	0.0436
	$n = 200$	0.4233	0.0191	0.3799	0.0219	0.4048	0.0308
	$n = 400$	0.2607	0.0136	0.2668	0.0158	0.2883	0.0200

Table 1: RMSEs of $\hat{\beta}_0$ and $\hat{\sigma}_V$ in the linear model

4.3 Estimation of the firm level inefficiency

One of the merits of the proposed method is that one can calculate the firm level inefficiency in the relaxed models. To illustrate this aspect, we did a small simulation study to estimate the firm level efficiency U_i of the linear model in Section 4.1.1 with $U_i \sim N^+(0, 0.5^2)$ and $U_i \sim \text{Exp}(0.3014)$. We present the result only when $\rho_{nts} = 0.25$ but the results with other ρ_{nts} values were more or less similar in trend. We estimate U_i by using the best linear predictor $\hat{U}_i$ given ϵ_i as described in Section 3.1. For estimation of β_0 , we use the average value of all $\hat{\beta}_0(\lambda)$ over the grid $\log_{10} \lambda = -4, -3, -2, -1, 0, 1, 2, 3, 4$. Table 4 shows the average of the RMSEs between $\hat{U}_i$ and U_i over 500 repetitions for

		$U_i^* \sim N^+(0, 0.5^2)$		$U_i^* \sim N^+(0.25, 0.4^2)$		$U_i^* \sim \text{Exp}(0.3014)$	
		$\hat{\beta}_0$	$\hat{\sigma}_V$	$\hat{\beta}_0$	$\hat{\sigma}_V$	$\hat{\beta}_0$	$\hat{\sigma}_V$
$\rho_{nts} = 0.05$	$n = 100$	0.2204	0.0096	0.2265	0.0101	0.2265	0.0091
	$n = 200$	0.1537	0.0085	0.1595	0.0089	0.1595	0.0080
	$n = 400$	0.1218	0.0064	0.1214	0.0075	0.1214	0.0065
$\rho_{nts} = 0.25$	$n = 100$	0.2659	0.0312	0.2616	0.0323	0.2616	0.0256
	$n = 200$	0.1970	0.0208	0.1846	0.0249	0.1846	0.0178
	$n = 400$	0.1384	0.0123	0.1388	0.0220	0.1388	0.0142
$\rho_{nts} = 0.50$	$n = 100$	0.3298	0.0451	0.3294	0.0574	0.3294	0.0422
	$n = 200$	0.2464	0.0346	0.2421	0.0501	0.2421	0.0339
	$n = 400$	0.1720	0.0271	0.1801	0.0411	0.1801	0.0261

Table 2: RMSEs of $\hat{\beta}_0$ and $\hat{\sigma}_V$ in the partially linear model

		$U_i^* \sim N^+(0, 0.5^2)$		$U_i^* \sim N^+(0.25, 0.4^2)$		$U_i^* \sim \text{Exp}(0.3014)$	
		$\hat{\beta}_0$	$\hat{\sigma}_V$	$\hat{\beta}_0$	$\hat{\sigma}_V$	$\hat{\beta}_0$	$\hat{\sigma}_V$
$\rho_{nts} = 0.05$	$n = 100$	0.5057	0.0294	0.4785	0.0359	0.5120	0.0228
	$n = 200$	0.3611	0.0213	0.3114	0.0225	0.3382	0.0137
	$n = 400$	0.2377	0.0121	0.2134	0.0156	0.2321	0.0089
$\rho_{nts} = 0.25$	$n = 100$	0.5266	0.0308	0.4933	0.0315	0.5318	0.0300
	$n = 200$	0.3744	0.0206	0.3418	0.0199	0.3513	0.0184
	$n = 400$	0.2487	0.0131	0.2195	0.0115	0.2424	0.0126
$\rho_{nts} = 0.50$	$n = 100$	0.5812	0.0393	0.5502	0.0377	0.5899	0.0477
	$n = 200$	0.4175	0.0280	0.3927	0.0238	0.3900	0.0254
	$n = 400$	0.2769	0.0219	0.2441	0.0182	0.2729	0.0192

Table 3: RMSEs of $\hat{\beta}_0$ and $\hat{\sigma}_V$ in the partially linear single-index model

$n = 100, 200$ and 400 when $\rho_{nts} = 0.25$. Our method seems to be able to estimate the firm level efficiency under the relaxed assumption about the inefficiency. Our finding is also supported by the scatter plots between $\hat{U}_i$ and U_i in Figure 1.

	$U_i \sim N^+(0, 0.5^2)$			$U_i \sim \text{Exp}(0.3014)$		
	$n = 100$	$n = 200$	$n = 400$	$n = 100$	$n = 200$	$n = 400$
average of the RMSEs	0.0927	0.0851	0.0810	0.0972	0.0885	0.0857

Table 4: Average of the RMSEs for the linear model when $\rho_{nts} = 0.25$.

Figure 1: One instance of the scatter plots between $\hat{U}_i$ and U_i with $U_i^* \sim N^+(0, 0.5^2)$ and $U_i^* \sim \text{Exp}(0.3014)$. The solid line is $y = x$.

4.4 Comparison with the fully nonparametric method

For estimation of the frontier function in the linear model of Section 4.1.1, we can consider the fully-nonparametric estimation method proposed by Kneip et al. (2015), which relies on some “local linear” approximation of the frontier function. Hence, we would like to compare our proposal with their method. For comparison, we consider the same model as in Section 4.1.1. In our method, we first obtain the estimates $\hat{\beta}_0$ and $\hat{\beta}$ and construct the estimate of the frontier function as $\hat{\tau}(\mathbf{X}_i) = \hat{\beta}_0 + \mathbf{X}_i^\top \hat{\beta}$. In contrast, Kneip et al. (2015) estimate nonparametrically the frontier function at a given point $\mathbf{X}_i$ combining the idea of local linear approximation and the recovery of a constant frontier function in the presence of measurement error. Since both function estimators are presumably expected to have the same logarithmic rates of convergence, one may think that our method and the method of Kneip et al. (2015) will not show a significant difference in estimation performance. To check this, we estimate the frontier function at every data point $\mathbf{X}_i$ and calculate $n^{-1} \sum_{i=1}^n (\hat{\tau}(\mathbf{X}_i) - \tau(\mathbf{X}_i))^2$ as a measure of performance. The sample size n equals 100, 200 or 400 and ρ_{nts} is fixed to 0.5. For the inefficiency we use $U_i \sim N^+(0, 0.5^2)$. The other components of the model are the same as in the model of Section 4.1.1. Finally, we display the performance measure for the two estimation methods over the grid $\log_{10} \lambda = -4, -3, -2, -1, 0, 1, 2, 3, 4$ in Table 5 (the quantity $\log_{10} \lambda^*$ is the value of $\log_{10} \lambda$ that gives the best performance). The results suggest that our method has better performance than Kneip’s method when the frontier function is linear. However, the difference in performance gets smaller as the sample size increases.

		$\log_{10} \lambda$									$\log_{10} \lambda^*$
		-4	-3	-2	-1	0	1	2	3	4	
$n = 100$	Kneip's method	0.0322	0.0310	0.0287	0.0117	0.0110	0.0110	0.0110	0.0113	0.0141	0.0110
	our method	0.0354	0.0143	0.0143	0.0105	0.0083	0.0083	0.0083	0.0083	0.0093	0.0083
$n = 200$	Kneip's method	0.0032	0.0014	0.0016	0.0033	0.0016	0.0016	0.0016	0.0016	0.0025	0.0014
	our method	0.0031	0.0006	0.0023	0.0011	0.0004	0.0004	0.0004	0.0004	0.0011	0.0004
$n = 400$	Kneip's method	0.0322	0.0157	0.0058	0.0006	0.0007	0.0007	0.0007	0.0007	0.0005	0.0005
	our method	0.0314	0.0068	0.0083	0.0004	0.0006	0.0006	0.0006	0.0006	0.0006	0.0004

Table 5: Comparison between the performance of our method and that of Kneip's method when the frontier function is linear.

5 Data Analysis

In this section, we illustrate how the proposed methods can be used for efficiency and productivity analysis. We will analyze an administrative dataset for financial variables and selected characteristics of Japanese local public hospitals, which is available in the R package *rDEA*, and we will estimate the inefficiency function of the observable environmental variable using the method described in Section 3.2.

The dataset contains anonymous observations for 958 local public hospitals, identified by a researcher-generated variable “firm-id”. The output variable (Y_i) is the logarithm of the sum of the annual number of inpatients and outpatients, where an inpatient is a hospital patient who occupies a bed for at least one night and an outpatient is a patient who receives treatment at a hospital but does not spend the night there. The two input variables ($X_{1,i}$ and $X_{2,i}$) are the logarithm of the total labor cost per year (total number of employees times per capita annual salary) and the logarithm of the total capital cost (total number of beds times the sum of depreciation and interest per bed). The environmental variable (Z_i) is the number of examinations per patient, which represents the severity of the illness in which each hospital is primarily responsible for treatment. We assume the following partially linear model in Section 3.2 for this dataset:

$$\begin{aligned}
 Y_i &= \beta_0 + \beta_1 X_{1,i} + \beta_2 X_{2,i} + V_i - U_i \\
 &= \beta_0 + \beta_1 X_{1,i} + \beta_2 X_{2,i} - g(Z_i) + (V_i - (U_i - g(Z_i))) \\
 &\equiv \beta_0 + \beta_1 X_{1,i} + \beta_2 X_{2,i} - g(Z_i) + \epsilon_i^*,
 \end{aligned} \tag{15}$$

where U_i is the inefficiency, $V_i \sim N(0, \sigma_V^2)$ is the noise that is supposed to be independent of $(X_{1,i}, X_{2,i}, Z_i)$ and $E(U_i | \mathbf{X}_i, Z_i) = E(U_i | Z_i) = g(Z_i)$ is the inefficiency function. Since some hospitals are known to have characteristics that are different from those of other hospitals in this dataset, we conduct outlier detection and remove 26 observations before fitting Model (15). The method used for outlier detection consists in first obtaining the residuals by fitting the partially linear median regression model to the data $(Y_i, X_{1,i}, X_{2,i}, Z_i)$, and then doing univariate outlier detection based on the residuals applying the methods available in the R package *extremevalues*.

First, we estimate β_1 and β_2 using the method in Speckman (1988), which yields $\hat{\beta}_1 = 0.240$ and $\hat{\beta}_2 = 0.500$. Then, we estimate β_0 using the method outlined in Section 3.2 and obtain the estimates of β_0 given in Table 6, depending on the tuning parameter λ . After estimating β_0 by the average value of all $\hat{\beta}_0(\lambda)$, which is -3.106, we estimate the inefficiency function $g(\cdot)$ using local linear regression. In Figure 2, we plot the estimate of the inefficiency function $g(Z_i)$ using our method (solid curve) and the method of Parmeter

$\log_{10} \lambda$	-4	-3	-2	-1	0	1	2	3	4
$\hat{\beta}_0(\lambda)$	-3.184	-2.283	-3.309	-3.257	-3.184	-3.184	-3.184	-3.184	-3.184

Table 6: The estimates of β_0 depending on the tuning parameter λ . Figure 2: The estimates of the inefficiency function $g(\cdot)$. The solid curve is obtained using our method and the dotted one is from Parmeter et al. (2017) assuming $\beta_0 = 0$.

et al. (2017) assuming $\beta_0 = 0$ (dotted curve). As expected, in both cases the inefficiency function increases as the severity of illness increases (actually, the two estimated curves have only a constant difference). The result suggests that if we ignore β_0 by assuming that $\beta_0 = 0$, then we overestimate the level of the inefficiency function. Hence, if one is interested in the exact level of the inefficiency function and is not sure that β_0 is zero, we recommend to use our method as a safer option.

6 Conclusion

This paper proposes a new method to estimate various stochastic frontier models with a relaxed assumption on the inefficiency distribution. Previous research relied on the work of Hall and Simar (2002), which is known to work well in low noise settings only. Instead, we proposed estimators building on the recent work of Kneip and his coworkers and showed in the numerical study that the proposed methods work well for various levels of the noise.

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