Spatial Correlation Robust Inference in Linear Regression and Panel Models

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Abstract

We consider inference about a scalar coefficient in a linear regression with spatially correlated errors. Recent suggestions for more robust inference require stationarity of both regressors and dependent variables for their large sample validity. This rules out many empirically relevant applications, such as difference-in-difference designs. We develop a robustified version of the SCPC method of Müller and Watson (2022a) that addresses this challenge. We find that the method has good size properties in a wide range of Monte Carlo designs that are calibrated to real world applications, both in a pure cross sectional setting, but also for spatially correlated panel data. We provide numerically efficient methods for computing the associated spatial-correlation robust test statistics, critical values and confidence intervals.

Keywords: HAC, HAR, Matérn process
JEL: C12, C20

1 Introduction

This paper studies inference about linear regression coefficients estimated from spatially correlated data. In a simple version of the model

$$y_l = x_l\beta + e_l, \tag{1}$$

where all variables are scalars, $\mathbb{E}[e_l|x_l] = 0$ and (y_l, x_l, e_l) are associated with the observed spatial location $s_l \in \mathbb{R}^d$. Spatial correlation invalidates inference about β using the usual heteroskesdasticity-robust t-statistic. Several spatial-correlation methods based on robustified versions of the t-statistic have been proposed, with the most well-known method developed in Conley (1999). These approaches estimate $\sigma^2 = \text{Var}[n^{-1/2}\sum_{l=1}^n u_l]$ where $u_l = x_l e_l$ and n denotes the number of observations. In the usual time series model, the locations s_l are equidistant on a line, so $d = 1$, and σ^2 (or its limit as $n \to \infty$) is called the long-run variance of u. In that context, estimators for σ^2 are called HAC or HAR (Heteroskedastic and Autocorrelation Consistent/Robust). Spatial-correlation robust inference generalizes HAC and HAR time series methods to spatial settings.

As in the time series case, it is difficult to devise spatial correlation robust inference that continues to work well in small samples under empirically plausible degrees of spatial dependence; see Ibragimov and Müller (2010), Sun and Kim (2012), Bester, Conley, Hansen, and Vogelsang (2016), and Kelly (2019) for corresponding simulation evidence. This is especially true for approaches, such as Conley (1999), Kelejian and Prucha (2007), and Kim and Sun (2011), that rely on the standard normal critical value for the t-statistic by invoking a consistency argument for the estimator of σ^2. A more promising approach is to explicitly account for the sampling variability in the estimator of σ^2, and to correspondingly adjust the critical value, as in Bester, Conley, and Hansen (2011) and Sun and Kim (2012)—these are analogs of the fixed-b approach of Kiefer and Vogelsang (2005) and the projection approach of Müller (2004) to the spatial setting. However, the appropriate adjustment to the critical value is more complicated in the spatial setting: As demonstrated by Müller and Watson (2022a), the distribution of the locations in space also matters, even in large samples under weak

dependence. In particular, if the distribution of the locations is not uniform, then even under weak dependence, the asymptotic null distribution of spatial projection type t-statistics are not student-t, and fixed-b spatial t-statistics do not have the same asymptotic distribution as under i.i.d. sampling, invalidating the usual suggestions for determining the critical value. Müller and Watson (2022a) suggest the spatial correlation principal components (SCPC) method that addresses this challenge and provides explicit robustness under some empirically relevant forms of strong dependence.

In contrast to methods that rely on consistency of the estimator of σ^2, fixed-b type approaches (in time and space), including SCPC, rely on the *stationarity* of u_l for their large sample validity. What is more, the methods require that the asymptotic properties of weighted averages of $x_l \hat{e}_l$, with $\hat{e}_l$ the OLS residuals, behave like the weighted averages of the demeaned values of $u_l = x_l e_l$, which essentially requires (x_l, e_l) to be stationary and weakly dependent. Yet, in many empirical applications, the data may exhibit non-stationarities and/or strong dependence. A simple but important spatial example is when x_l is an indicator for a binary treatment, where treatment is more likely in one region (the 'north') than another region (the 'south'). This paper studies the finite-sample properties of spatial correlation inference procedures when x_l (and/or e_l) follow empirically relevant processes that may be non-stationary or strongly dependent. Our focus is on the SCPC method proposed in Müller and Watson (2022a) because of its desirable theoretical properties. We use the performance of a version of the Conley (1999) method as a benchmark. (A notable exception to the requirement of stationarity of u_l is the cluster-based method suggested by Ibragimov and Müller (2010), which remains asymptotically valid under many forms of variance heterogeneity. However, small sample simulations show that SCPC performs better under stationarity, and SCPC also avoids the issue of how to form the clusters (cf. Cao, Hansen, Kozbur, and Villacorta (2020)).)

We set the stage for the analysis in this paper by presenting finite-sample results for four data generation processes (DGPs). Each of the models uses a stationary Gaussian process for e_l, but differ in the DGP for x_l. Specifically, e_l is generated by a Gaussian process with covariance function $\text{Cov}(e_l, e_\ell) = \exp(-c||s_l - s_\ell||)$, where s_l and s_ℓ denote the spatial locations of e_l and e_ℓ, and $c > 0$ is a parameter that governs the strength of the spatial correlation. This process is the spatial analogue

Table 1: Rejection frequency of nominal 5% level tests

Model	HR	KERNEL	SCPC
1: $x_l = 1$, $e_l \sim \mathcal{G}_{\exp}(c_{0.03})$	0.51	0.11	0.05
2: $x_l \sim \mathcal{G}_{\exp}(c_{0.03}/2)$, $e_l \sim \mathcal{G}_{\exp}(c_{0.03}/2)$	0.52	0.14	0.08
3: $x_l \sim$ step function, $e_l \sim \mathcal{G}_{\exp}(c_{0.03})$	0.52	0.20	0.15
4: $x_l \sim$ demeaned random walk, $e_l \sim \mathcal{G}_{\exp}(c_{0.03})$	0.50	0.14	0.08

Notes: Null rejection frequencies using heteroskedastic robust (HR), spatial kernel (KERNEL), and SCPC inference about β in regression model $y_l = x_l\beta + e_l$ with $n = 250$ and $s_l \sim$ i.i.d. $U(0,1)$.

of the time series AR(1) model, with larger values of c implying less spatial correlation. This process will be used in many places in the paper, and from now on we use the shorthand $e_l \sim \mathcal{G}_{\exp}(c)$ to denote a Gaussian process with this exponential covariance function. We calibrate the value of c to induce a specific average pairwise correlation $\bar{\rho} = [n(n-1)]^{-1} \sum_{l,\ell \neq l} \operatorname{corr}(e_l, e_\ell)$, at the sample spatial locations, that is, $c = c_{\bar{\rho}}$ solves $[n(n-1)]^{-1} \sum_{l,\ell \neq l} \exp(-c_{\bar{\rho}}||s_l - s_\ell||) = \bar{\rho}$. Thus, if $e_l \sim \mathcal{G}_{\exp}(c_{0.03})$, then the average correlation of e_l and e_ℓ is 0.03 over the sample locations.

In each of the four models, spatial locations are randomly selected from the unit interval, so $d = 1$ and $s_l \sim$ i.i.d. $U(0,1)$. Thus, this can be viewed as a time series setting with irregular (random) sampling. We consider more interesting and empirically relevant spatial designs in Section 3, but this simple design serves as a useful introduction. The sample size is $n = 250$. We construct t-statistics using three estimators for σ. The first uses the standard Eicker-Huber-White heteroskedastic robust estimator (HR) that ignores spatial correlation. The second is a Bartlett kernel estimator (KERNEL)—this is Conley's (1999) spatial generalization of the well-known Newey-West (1987) HAC standard error. The third is the SCPC estimator proposed in Müller and Watson (2022a) which is analogous to projection based estimators used in time series regressions (e.g., Müller (2004), Phillips (2005), and Sun (2013)) but tailored to the particular spatial distribution of the data being studied. Standard normal critical values are used for HR and KERNEL; an 'oracle' bandwidth is used in the KERNEL method so the test's rejection frequency is as close as possible to its nominal level. The critical value for SCPC depends on $\bar{\rho}$ and the spatial locations in the sample; details are provided in Müller and Watson (2022a) and reviewed in Section 2 below.

Table 1 shows null rejection frequencies for tests with 5% nominal level for each of the four models

Table 2: Quantiles of conditional null rejection frequencies of nominal 5% level SCPC tests

Model	Quantile				
	0.05	0.25	0.50	0.75	0.95
1: $x_l = 1$, $e_l \sim \mathcal{G}_{\exp}(c_{0.03})$	0.05	0.05	0.05	0.05	0.05
2: $x_l \sim \mathcal{G}_{\exp}(c_{0.03}/2)$, $e_l \sim \mathcal{G}_{\exp}(c_{0.03}/2)$	0.05	0.06	0.07	0.09	0.11
3: $x_l \sim$ step function, $e_l \sim \mathcal{G}_{\exp}(c_{0.03})$	0.11	0.13	0.14	0.17	0.21
4: $x_l \sim$ demeaned random walk, $e_l \sim \mathcal{G}_{\exp}(c_{0.03})$	0.05	0.06	0.08	0.09	0.12

Notes: Quantiles of conditional null rejection frequencies of SCPC given $\{x_l, s_l\}_{l=1}^n$ for inference on β in regression model $y_l = x_l\beta + e_l$ with $n = 250$ and $s_l \sim$ i.i.d. $U(0,1)$.

and three methods. In the first model, $e_l \sim \mathcal{G}_{\exp}(c_{0.03})$ and $x_l = 1$. Here, and for the other models as well, HR exhibits a large size distortion, which is expected given the spatial correlation in the data. The KERNEL method has a rejection frequency of 11%, which is a substantial improvement over HR, but is still far from its 5% nominal value, even though the best possible bandwidth choice was made. The SCPC method is designed to have small sample validity in this setting, so the null rejection probability is exactly 5%.

In Model 2, x_l and e_l are independent and follow a $\mathcal{G}_{\exp}(c_{0.03}/2)$ processes. Here $u_l = x_l e_l$ is non-Gaussian but with the same covariance function as $\mathcal{G}_{\exp}(c_{0.03})$ process. Yet the rejection frequencies of both KERNEL and SCPC increase by 3%, which is primarily driven by the difference between $x_l \hat{e}_l$ and the demeaned version of $x_l e_l$.

In Models 3 and 4, $e_l \sim \mathcal{G}_{\exp}(c_{0.03})$ and x_l is non-stationary. In Model 3, x_l is a zero-mean step function with $x_l = -0.15$ for the 85% of the locations closest to $s = 0$ and $x_l = 0.85$ for the remaining locations closest to $s = 1$. This induces a further size distortion in both KERNEL and SCPC. In the final DGP, x_l follows a demeaned random walk, which results in rejection frequencies similar to Model 2.

Table 2, which focuses on SCPC, presents a more nuanced view of the rejection frequencies in Models 2-4 by summarizing rejection frequencies conditional on the values of x_l and s_l in each experiment. That is, in these experiments, (x_l, s_l) are sampled as described above, and rejection frequencies are computed over repeated draws of e_l. This process is repeated for many random draws of (x_l, s_l), and the table reports selected quantiles of the resulting distribution of rejection

frequencies. The 95th quantile indicates null rejection frequencies larger than 11% in Models 2-4: a researcher unluckily enough to observe these values of (x_l, s_l) and using a nominal 5% SCPC test, would in fact be using a test with conditional null rejection probability larger than 11%.

Taken together these experiments suggest that SCPC offers substantial improvements on methods that ignore spatial correlation (and improvements over KERNEL), but may exhibit quantitatively important size distortions for some DGPs. This raises two questions. First, how well does the method perform for the range of DGPs typically encountered in empirical work? And second, are there modifications that enhance its performance in situations where it performs poorly? We take up both questions in this paper.

To answer the first, we begin by augmenting the simple regression model to include additional control variables and allow clustering of observations by location. This setup covers panel data models with fixed effects, difference-in-difference designs, and clustered versions of spatial-correlation-robust standard errors. We model empirically relevant spatial designs by considering the spatial density of economic activity over the continental United States and the location of countries over the globe. We generate the sptatially correlated variables using parametric models, but also by sampling variables from the World Development Indicators (WDI) data set from the World Bank. This dataset contains hundreds of variables for many countries over several years, and thus provides a wide range of spatial patterns in both cross-section and panel-data regressions.

To answer the second question, we propose a modification of the SCPC method so that it also controls size, conditional on the regressors, for a particular conditionally heteroskedastic Gaussian model for e_l. The details are described below. While not offering perfect size control in all settings, this modification provides a quantitatively important improvement over SCPC in several of the models we consider.

The outline of the paper is as follows. In Section 2 we outline the spatial regression model and inference methods. Notably, the section presents a method for robustifying SCPC inference to control size after conditioning on the values of the regressors and locations. Section 3 presents experiments using the spatial distribution of economic activity in each of the 48 states making up

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the continental US and hundreds of variables chosen from the World Bank's WDI dataset. The results indicate that the conditional-SCPC method developed in Section 2.3 offers improved size control over SCPC, which in turn improves upon KERNEL for a wide range of empirically relevant process for both cross-section and panel-data regressions with clustered standard errors. Several of these results utilize $\mathcal{G}_{\exp}(c)$ processes for the error term, and Section 4 studies the robustness of the conclusions to other spatial processes, including conditional heteroskedasticity in the regression error. Section 5 takes up three issues. The first two are computational: evaluating the critical value for the spatial-correlation robust t-statistics and computing the statistics when n is very large. The third involves using SCPC in IV regressions. The final section offers some concluding remarks. Software for conducting conditional-SCPC inference for regression coefficients is available in STATA and Matlab. Links to the software is available at https://www.princeton.edu/~mwatson/.

2 Setup

This section has three purposes. First, it presents the spatial regression model used in our analysis. Second, it provides details for t-statistic inference using the SCPC and KERNEL methods. Finally, it proposes a robustification of the SCPC critical value so that the method controls size, conditional on the regressors and locations, for a particular heteroskedastic model that we describe.

2.1 Spatial regression model

The spatial regression model is

$$y_{i,l} = x_{i,l}\beta + z'_{i,l}\gamma + e_{i,l} \tag{2}$$

where $l = 1, ..., n$ indexes *clusters* (or *groups*, *entities*, etc.) and $i = 1, ..., m_l$ identifies the m_l individual observations in cluster l. The total number of observations is $N = \sum_{l=1}^{n} m_l$. The model with $m_l = 1$ for all l is the cross-section spatial regression model, and $m_l > 1$ allows for clustering and panel data. Cluster l is associated with location $s_l \in \mathbb{R}^d$. The variable $x_{i,l}$ is a scalar, and β is the parameter of interest. The $k \times 1$ vector $z_{i,l}$ allows for additional regressors that may include

fixed-effect indicators, and $e_{i,l}$ is the regression error.

The following notation will prove useful. The $m_l \times 1$ vector $x_l = (x_{1,l}, x_{2,l}, ..., x_{m_l,l})'$ collects the x-variables for cluster l, and the $N \times 1$ vector $\mathbf{X} = (x_1', x_2', ..., x_n')'$ collects the x-variables in the sample. The vectors and matrices z_l, e_l, $\mathbf{Z}$, $\mathbf{e}$ as well as the $n \times 1$ vector of locations $\mathbf{s}$ are defined analogously. We denote sample second-moments as $S_{xx} = n^{-1} \sum_{l=1}^{n} x_l' x_l$ and $S_{xy} = n^{-1} \sum_{l=1}^{n} x_l' y_l$, where dividing by n instead of N simplifies the formulae below. We assume (without loss of generality) that the regressors x have been residualized with respect to z so that $\mathbf{X}'\mathbf{Z} = 0$. (If $\mathbf{X}^o$ is the vector of untransformed versions of $x_{i,l}$ in (2) then $\mathbf{X} = (\mathbf{I} - \mathbf{Z}(\mathbf{Z}'\mathbf{Z})^{-1}\mathbf{Z}')\mathbf{X}^o$.) This simplifies the expressions for the OLS estimator for β and other statistics. Using this notation, the OLS estimator for β is $\hat{\beta} = S_{xx}^{-1} S_{xy} = \beta + S_{xx}^{-1} n^{-1} \sum_l u_l$, where $u_l = x_l' e_l$. The OLS residuals are $\hat{e}_{i,l}$, and $\hat{u}_l = x_l' \hat{e}_l$. These are collected in the vectors $\mathbf{u}$, $\hat{\mathbf{e}}$ and $\hat{\mathbf{u}}$.

Inference about β is based on the t-statistic

$$\tau = \frac{S_{xx}\sqrt{n}(\hat{\beta} - \beta_0)}{\hat{\sigma}} \tag{3}$$

where $\hat{\sigma}^2$ is an estimator of $\sigma^2 = \text{Var}\left(n^{-1/2} \sum_{l=1}^{n} u_l\right)$ and β_0 is the null value of β.

2.2 Two spatial correlation robust inference methods

The results summarized in Tables 1 and 2 rely on two inference methods. The KERNEL method estimates σ^2 by

$$\hat{\sigma}_K^2 = \frac{1}{n} \sum_{l,\ell} K\left(\frac{||s_l - s_\ell||}{b_n}\right) \hat{u}_l \hat{u}_\ell \tag{4}$$

where K is the Bartlett weighting function, $K(x) = 1 - |x|$ for $|x| \leq 1$ and $K(x) = 0$ otherwise, and $b_n > 0$ is a bandwidth parameter. Empirical researchers typically use standard normal critical values for the resulting t-statistic, relying on $\max_{l,\ell} ||s_l - s_\ell||/b_n \to \infty$ as $n \to \infty$ arguments in Conley (1999). We implement the 'oracle' version of this method that combines the standard normal critical value with the value of b_n that minimizes the small sample size distortion in each experiment. This choice of b_n is infeasible in practice, but yields a useful lower bound on size distortions associated

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with the method. (As specified in (4), $\hat{\sigma}_K^2 \geq 0$ is not guaranteed when $d > 1$. In the case of $d = 2$, Conley (1999) suggests using the product of two univariate Bartlett kernels based on distance in each of the two dimensions. This produces a positive semi-definite estimator of σ^2, but it is not invariant to rotation of the spatial axes. In our calculations we use the spectral decomposition of the Bartlett weights in (4) with negative eigenvalues set to zero.)

The SCPC method of Müller and Watson (2022a) is based on a principal component estimator of σ^2 based on a pre-specified 'worst-case' exponential covariance function conditional on the observed locations. Suppose that $u_l \sim \mathcal{G}_{\exp}(c)$, and let $\boldsymbol{\Sigma}(c)$ be the corresponding $n \times n$ covariance matrix of $\mathbf{u}$ evaluated at the sample locations $\mathbf{s}$, so that the l, ℓ th element of $\boldsymbol{\Sigma}(c)$ is $\Sigma_{l,\ell}(c) = \exp(-c||s_l - s_\ell||)$. Let $\bar{\rho}(c)$ denote the resulting average pairwise correlation $\bar{\rho}(c) = [n(n-1)]^{-1} \sum_l \sum_{\ell \neq l} \Sigma_{l,\ell}(c)$. Suppose a researcher desires a test that controls size for values $\bar{\rho}$ that may be as large as $\bar{\rho} = \bar{\rho}_{\max}$, for a given value of $\bar{\rho}_{\max}$. The results summarized in Tables 1 and 2 are based on $\bar{\rho}_{\max} = 0.03$, for instance. Let $c_{\min}$ satisfy $\bar{\rho}(c_{\min}) = \bar{\rho}_{\max}$, where the notation emphasizes that $\bar{\rho}(c)$ is a decreasing function of c. Note that $\boldsymbol{\Sigma}(c_{\min})$ is the worst case covariance matrix for $\mathbf{u}$ in the sense that it induces the largest value of σ^2 among all $\boldsymbol{\Sigma}(c)$ with $\bar{\rho} \leq \bar{\rho}_{\max}$.

The location model studied in Müller and Watson (2022a) is a special case of the spatial regression (2) with $m_l = 1$, $x_l = 1$ and $z_l = 0$ for all l. The corresponding residuals are $u_l - \bar{u}$. Let $\mathbf{1}$ denote a $n \times 1$ vector of 1s and $\mathbf{M}_1 = \mathbf{I}_n - \mathbf{1}(\mathbf{1}'\mathbf{1})^{-1}\mathbf{1}'$. The matrix $\mathbf{M}_1\boldsymbol{\Sigma}(c_{\min})\mathbf{M}_1$ denotes the associated covariance matrix of $\mathbf{u} - \bar{u}\mathbf{1}$. For inference about the mean, the SCPC estimator of σ^2 uses the weighted averages of $u_l - \bar{u}$ with weights constructed from the eigenvectors of $\mathbf{M}_1\boldsymbol{\Sigma}(c_{\min})\mathbf{M}_1$. These are the principal components of $\mathbf{u} - \bar{u}\mathbf{1}$ under $\mathcal{G}_{\exp}(c_{\min})$ evaluated at the observed locations $\mathbf{s}$. In the regression model considered in this paper, $u_l - \bar{u}$ cannot be computed from the data without imposing the true values of (β, γ) so $\hat{u}_l$ is used in place of $u_l - \bar{u}$; a straightforward calculation shows that this substitution is justified in large samples when (e_l, u_l) are stationary and weakly dependent.

Let $\mathbf{r}_j$ denote the eigenvector of $\mathbf{M}_1\boldsymbol{\Sigma}(c_{\min})\mathbf{M}_1$ corresponding to the jth largest eigenvalue, normalized so that $\mathbf{r}_j'\mathbf{r}_j/n = 1$ – see Figure 6 in Section 5.2 below for an example of these eigenvectors.

The SCPC estimator of σ^2, based the first q principal components, is

$$\hat{\sigma}^2_{\mathrm{SCPC}}(q) = \frac{1}{q}\sum_{j=1}^{q}(n^{-1/2}\mathbf{r}'_j\hat{\mathbf{u}})^2, \tag{5}$$

and the resulting t-statistic will be denoted as τ_{SCPC}. The critical value for τ_{SCPC} is denoted by $\mathrm{cv}_{\mathrm{SCPC}}$ and is chosen so that the t-test controls size for all values of $c \geq c_{\min}$ (equivalently, $\bar{\rho} \leq \bar{\rho}_{\max}$) in the asymptotically equivalent location model with $\mathbf{u} \sim \mathcal{N}(0, \boldsymbol{\Sigma}(c))$. Details for computing $\mathrm{cv}_{\mathrm{SCPC}}$ are provided in Section 5.1.

SCPC inference requires two parameters, q, the number of principal components used to construct $\hat{\sigma}_{\mathrm{SCPC}}$, and $\bar{\rho}_{\max}$ (or $c_{\min}$), the largest average spatial correlation for which size is controlled. For a given value of $\bar{\rho}_{\max}$, Müller and Watson (2022a) suggest choosing q to minimize the expected length of the 95% confidence interval under the i.i.d. model with $\boldsymbol{\Sigma} = \mathbf{I}_n$. The optimal value of q involves a tradeoff. With the critical value fixed, the expected length of the confidence interval falls as q increases. But, a larger q means that a larger critical value is needed to control coverage. This tradeoff worsens for larger values of $\bar{\rho}_{\max}$, so the optimal value of q is a decreasing function of $\bar{\rho}_{\max}$. Of course, there are other possible rules for choosing q. That said, as a practical matter it is useful to use the same value of q for tests with different significance levels, and for the location model, results in Müller and Watson (2022a) suggest that minimizing the expected confidence interval length under the i.i.d. benchmark yields a value of q that works well for a range of values of c.

The choice of $\bar{\rho}_{\max}$ requires more nuanced judgment. One useful guide is to consider the ratio of the standard deviation of $\hat{\beta}$ under spatial correlation to its value under i.i.d. sampling. This ratio is given by $\gamma_n = \sqrt{1 + (n-1)\bar{\rho}}$. The results reported in Table 1 used $\bar{\rho}_{\max} = 0.03$ with $n = 250$ and thus allowed for a value of γ_n as large as 2.9. To put this value in perspective, for the sample mean from an AR(1) time series model, $\gamma_n = 2.9$ corresponds to an AR coefficient equal to 0.79 and a local-to-unity coefficient equal to 53. Ultimately, the choice of $\bar{\rho}_{\max}$ is problem specific and requires the researcher to consider how much spatial correlation may be present in their application.

As discussed in Müller and Watson (2022a) the SCPC method has several desirable properties

for inference in the location model. We list four. First, size is controlled in the Gaussian model for $u_l \sim \mathcal{G}_{\exp}(c)$ for any value of $c \geq c_{\min}$. Second, in large-n samples, size control is not limited to Gaussian $\mathcal{G}_{\exp}(c)$ settings, but holds more generally in covariance stationary models with weak dependence. (In the context of the spatial regression model, the asymptotic arguments let n, the number of clusters, grow large. There is no restriction on cluster size or on the number of additional regressors, such as fixed effects, beyond the requirement that $u_l = x_l' e_l$ is covariance stationary and weakly dependent.) Third, in finite-sample settings, size control extends to Gaussian models with spectra that are weakly less steep than that of $\mathcal{G}_{\exp}(c_{\min})$, and SCPC confidence intervals enjoy a near optimality property in terms of their expected length for confidence intervals that control coverage for this class of spectra.

These results suggest that SCPC inference will perform well in an important class of spatial regression models. Of course, the finite-sample results hold only up to the approximation error in $\hat{u}_l \approx u_l - \overline{u}$, but the large-$n$ sample results – including size control for models outside the $\mathcal{G}_{\exp}(c)$ class – hold under stationarity and weak dependence. That said, the simulations reported in the introduction suggest non-negligible size distortions in finite-sample settings with stationary, but spatially persistent data (Model 2), and more concerning size distortions when x_l is non-stationary (Model 3). As it turns out, these size distortions can be eliminated or mitigated by using an alternative critical value chosen to control size after conditioning on the regressors. We outline that modification in the next subsection.

2.3   Conditional SCPC inference

The required modification is straightforward: instead of computing the critical value for τ_{SCPC} so that size is controlled in the location model under $\mathbf{u} \sim \mathcal{N}(0, \boldsymbol{\Sigma}(c))$, $c \geq c_{\min}$, we additionally impose that size is also controlled in the regression model under a set of conditional distributions of $\mathbf{u}$ (and $\hat{\mathbf{u}}$) given $\mathbf{V} = (\mathbf{X}, \mathbf{Z})$ (and in both cases, also conditional on the locations $\mathbf{s}$). This amounts to specifying the distribution of $\mathbf{e}$ given $\mathbf{V}$, which we assume to be Gaussian, $\mathbf{e}|\mathbf{V} \sim \mathcal{N}(0, \boldsymbol{\Sigma}_{\mathbf{e}|\mathbf{V}})$. To motivate our parameterization of $\boldsymbol{\Sigma}_{\mathbf{e}|\mathbf{V}}$, note that randomness in $\hat{\beta}$ is driven by the random variable

$n^{-1/2}\sum_l u_l$, with conditional variance equal to

$$\text{Var}\left(n^{-1/2}\sum_l u_l|\mathbf{V}\right) = n^{-1}\sum_{l,\ell} x_l'\mathbb{E}[e_l e_\ell'|\mathbf{V}]x_\ell. \tag{6}$$

This highlights two distinct issues: first, how to parameterize the covariance of e between clusters $(l\neq\ell)$, and second, how to parameterize within-cluster covariation.

To focus on the first issue, consider the cross-section regression ($m_l = 1$ for all l), so that x_l and e_l are scalars and between-cluster covariation is the only relevant issue. A straightforward modification of the SCPC formulation assumes that $e_l|\mathbf{V} \sim \mathcal{G}_{\exp}(c)$, so that e_l is independent of $\mathbf{V}$. Examination of (6) shows that, using this formulation, realizations with $x_l x_\ell < 0$ result in a lower value of $\text{Var}\left(n^{-1/2}\sum_l u_l|\mathbf{V}\right)$ than realizations with x's of the same magnitude with $x_l x_\ell > 0$. This formulation lacks robustness in this respect. A more robust formulation sets $e_l = \text{sign}(x_l)\cdot a_l$, where $a_l|\mathbf{V} \sim \mathcal{G}_{\exp}(c)$; this yields $\text{Var}\left(n^{-1/2}\sum_l u_l|\mathbf{V}\right) = n^{-1}\sum_{l,\ell}|x_l x_\ell|\exp(-c||s_l - s_\ell||)$ in the model with $m_l = 1$.

We extend this to the panel-data regression model using

$$e_l = x_l^s a_l, \tag{7}$$

where $x_l^s = x_l/(x_l'x_l)^{1/2}$ and a_l is scalar with $a_l \sim \mathcal{G}_{\exp}(c)$. This yields $\text{Var}\left(n^{-1/2}\sum_l u_l|\mathbf{V}\right) = \sum_{l,\ell}(x_l'x_l)^{1/2}(x_\ell'x_\ell)^{1/2}\exp(-c||s_l - s_\ell||)$. Note that this expression for the variance reduces to that of the cross-section regression when $m_l = 1$ for all l.

This formulation has several desirable features. First, it is a tractable extension of SCPC, leading to computations that are no harder than those of the baseline SCPC method irrespective of the cluster sizes m_l (we discuss computational issues in Section 5.1). Second, as $c \to \infty$ it yields $\text{Var}\left(n^{-1/2}\sum_l u_l|\mathbf{V}\right) = \sum_{l=1}^{n}\sum_{i=1}^{m_l}x_{i,l}^2$ which coincides with the variance in the model where $\mathbf{e} \sim \mathcal{N}(0,\mathbf{I}_N)$. Third, while the conditionally singular within-cluster model for e_l might look restrictive at first glance, it plays no role in analysis beyond its effect on the variance u_l. Furthermore, a straightforward calculation shows that the conditionally singular model in (7) yields the largest

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Table 3: Distribution of conditional null rejection frequencies of nominal 5% C-SCPC tests

| Model | $c_{\min}$ | Avg | Quantile | | | | |
			0.05	0.25	0.50	0.75	0.95
$x_l = 1,\ e_l \sim \mathcal{G}_{\exp}(c_{0.03})$	$c_{0.03}$	0.05	0.05	0.05	0.05	0.05	0.05
$x_l \sim \mathcal{G}_{\exp}(c_{0.03}/2),\ e_l \sim \mathcal{G}_{\exp}(c_{0.03}/2)$	$c_{0.03}/2$	0.04	0.03	0.03	0.04	0.04	0.05
$x_l \sim \mathcal{G}_{\exp}(c_{0.03}/2),\ e_l \sim \mathcal{G}_{\exp}(c_{0.03}/2)$	$c_{0.03}$	0.06	0.04	0.05	0.06	0.06	0.07
$x_l \sim$ step function, $e_l \sim \mathcal{G}_{\exp}(c_{0.03})$	$c_{0.03}$	0.05	0.04	0.04	0.05	0.05	0.05
$x_l \sim$ demeaned random walk, $e_l \sim \mathcal{G}_{\exp}(c_{0.03})$	$c_{0.03}$	0.05	0.05	0.05	0.05	0.05	0.05

Notes: Quantiles of conditional null rejection frequencies of C-SCPC given $\{x_l, s_l\}_{l=1}^n$ for inference on β in regression model $y_l = x_l\beta + e_l$ with $n = 250$, $s_l \sim$ i.i.d. $U(0,1)$. $c_{\min}$ denotes the lower bound on c used in the construction of the C-SCPC critical value.

variance of u_l among all models with $\text{tr}[\text{Var}(e_l|\mathbf{V})] = 1$, and in this sense maximizes the effect of within-cluster covariation on the variance of $\hat{\beta}$. We note that a potential limitation of the formulation in both the cross section and panel regression is the assumption that e_l is mean independent of the entire set of regressors $\mathbf{V}$.

We use (7) to modify the critical value for SCPC as follows. First, we compute cv_{SCPC} as in the last subsection. We then also compute a new critical value, say $\text{cv}_{\mathbf{V}}$, chosen so that the t-test controls size for all values of $c \geq c_{\min}$ (equivalently, $\bar{\rho} \leq \bar{\rho}_{\max}$) in the regression model with $a_l|\mathbf{V} \sim \mathcal{G}_{\exp}(c)$. The conditionally-robust critical value for SCPC is then the larger of cv_{SCPC} and $\text{cv}_{\mathbf{V}}$,

$$\text{cv}_{\text{C-SCPC}} = \max(\text{cv}_{\text{SCPC}}, \text{cv}_{\mathbf{V}}).$$

Section 5.1 provides details for computing $\text{cv}_{\mathbf{V}}$ and $\text{cv}_{\text{C-SCPC}}$. We stress that, by conditioning on $\mathbf{V}$, the C-SCPC critical value robustifies τ_{SCPC} inference to allow for arbitrary non-stationary behavior in the regressors.

In what follows we will investigate rejection frequencies of τ_{SCPC} using cv_{SCPC} and using $\text{cv}_{\text{C-SCPC}}$. We will refer to these methods as SCPC, and C-SCPC, respectively.

Table 3 shows the performance of C-SCPC for the four models considered in Tables 1 and 2, which reported results for SCPC. Recall that these models are cross-section regressions, so $m_l = 1$ for all l, and in Model 2, $x_l \sim \mathcal{G}_{\exp}(c_{0.03}/2)$ and $e_l \sim \mathcal{G}_{\exp}(c_{0.03}/2)$ so that $u_l = x_l e_l$ has a exponential covariance function with parameter $c_{0.03}$. Table 3 shows the rejection for Model 2 with $\text{cv}_{\text{C-SCPC}}$

computed using $c_{0.03}/2$ (which is the DGP of e_l) and using $c_{0.03}$ (which is the correlation of u_l). In both cases, and in the other models, C-SCPC offers improved size control, across the range of x_l realizations. Note that in the models in Table 3, $e_l \sim \mathcal{G}_{\exp}(c)$, which is different than the model used to compute $\text{cv}_{\text{C-SCPC}}$, namely (7). This provides a hint about the robustness properties of C-SCPC over alternative DGPs, something that we investigate more fully in following sections.

We find the results summarized in Tables 1-3 both enlightening and encouraging. That said, they are based on what are arguably contrived designs and do not feature panel data. The next section examines the performance of the methods in more empirically relevant designs.

3 Size control of spatial-correlation robust t-statistics

The various t-statistics discussed above have probability distributions that depend on two distinct features of the population under study: (i) the spatial process that generates $(y(s), x(s), z(s))$ for arbitrary locations $s \in \mathbb{R}^d$, and (ii) the probability distribution that governs which locations are sampled, that is the spatial distribution of s. This section reports results from a variety of experiments in which we choose both features to mimic empirically plausible settings.

In particular, we consider two sets of spatial distributions. The first involves drawing locations from each of the 48 continental US states where the spatial density is proportional to economic activity within the state, and where economic activity is proxied by the intensity of light measured from space. These experiments yield 48 distinct spatial densities with different support (the boundaries for the states) and shapes (the concentration of economic activity within the state), and was used previously in Müller and Watson (2022a). The second set of experiments uses data from countries scattered over the globe.

We use two methods for generating realizations of $(y(s), x(s), z(s))$. The first, used in the US states designs, generates data from parametric models like those used in the experiments already discussed. The second, used in the country designs, uses actual data sampled from the World Bank's World Data Indicators (WDI) dataset.

Figure 1: Spatial densities for four U.S. states

California   Florida

South Carolina   Montana
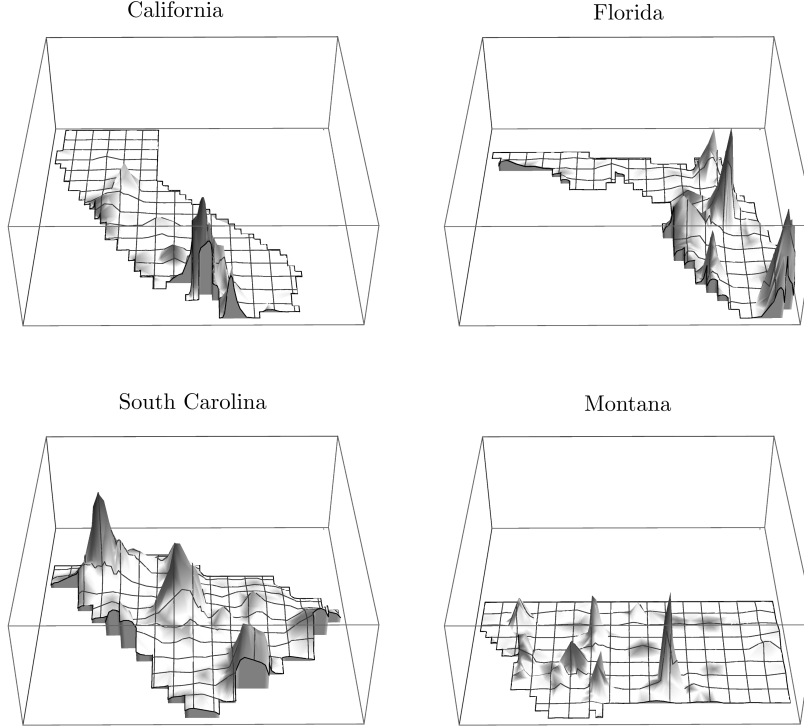
Notes: These are densities of light, as measured from space, estimated from data provided in Henderson, Squires, Storeygard, and Weil (2018).

3.1 48 US states

The first set of experiments use data generated from designs that capture the spatial distribution of economic activity in the 48 continental United States. Economic activity is proxied by light intensity which is estimated using the fine grid of light measurements reported in Henderson, Squires, Storeygard, and Weil (2018). States differ by their shape and spatial concentration of economic activity, and Figure 1 shows four examples. Looking across 48 states allows us to study the behavior of the test statistics under a wide range of empirically-relevant spatial distributions.

In the 48-states experiments, realizations of $(y(s), x(s), z(s))$ are generated from parametric models that focus on stylized characteristics of data used in empirical work. We begin by discussing experiments for cross-section regressions ($m_l = 1$ in equation (2)) and then discuss panel regressions. Table 4 summarizes the experiments for cross-section regressions. The first experiment is a benchmark with $x_l = 1$, $e_l \sim \mathcal{G}_{\exp}(c_{0.03})$ and no additional control variables. In Experiments 2-6, x_l and e_l are generated by independent $\mathcal{G}_{\exp}(c)$ models, where the experiments differ in the values

Table 4: Spatial regression designs using U.S. states spatial distributions of locations

Design	a_l	x_l	z_l
1	$\mathcal{G}_{\exp}(c_{0.03})$	1	none
2	$\mathcal{G}_{\exp}(c_{0.03})$	$\mathcal{G}_{\exp}(c_{0.03})$	1
3	$\mathcal{G}_{\exp}(c_{0.03})$	$\mathcal{G}_{\exp}(c_{0.03})$	none
4	$\mathcal{G}_{\exp}(c_{0.03})$	$\mathcal{G}_{\exp}(c_{0.03})$	$[1, \mathcal{G}_{\exp}(c_{0.03})^3]$
5	$\mathcal{G}_{\exp}(c_{0.03})$	$\text{iid}\mathcal{N}(0,1)$	1
6	$\mathcal{G}_{\exp}(c_{0.03})$	$\text{iid}\mathcal{N}(0,1)$	$[1, \mathcal{G}_{\exp}(c_{0.03})^3]$
7	$\mathcal{G}_{\exp}(c_{0.03})$	$\text{Step}(0.50)$	1
8	$\mathcal{G}_{\exp}(c_{0.03})$	$\text{Step}(0.15)$	1
9	$\mathcal{G}_{\exp}(c_{0.03})$	$\text{Step}(0.50)$	$[1, \mathcal{G}_{\exp}(c_{0.03})^3]$
10	$\mathcal{G}_{\exp}(c_{0.03})$	$\text{Step}(0.15)$	$[1, \mathcal{G}_{\exp}(c_{0.03})^3]$
11	$\mathcal{G}_{\exp}(c_{0.03})$	$(1+w_l)v_l,\ w_l \sim \text{Step}(0.5),\ v_l \sim \mathcal{G}_{\exp}(c_{0.03})$	1
12	$\mathcal{G}_{\exp}(c_{0.03})$	$(1+w_l)v_l,\ w_l \sim \text{Step}(0.15),\ v_l \sim \mathcal{G}_{\exp}(c_{0.03})$	1
13	$\mathcal{G}_{\exp}(c_{0.03})$	random walk	1
14	$\mathcal{G}_{\exp}(c_{0.03})$	random walk	$[1, \mathcal{G}_{\exp}(c_{0.03})^3]$

Notes: The regression model is $y_l = x_l\beta + z_l'\gamma + e_l$ with $e_l = a_l$ or $e_l = \text{sign}(x_l) \cdot a_l$, with $s_l \sim$ i.i.d. from a U.S. state-specific density with examples given in Figure 1. All $\mathcal{G}_{\exp}$ processes are mutually independent. In Designs 7-12, $\text{Step}(\lambda)$ is a step function that is equal to 0 for the southern most $\lfloor \lambda n \rfloor$ observations and 1 otherwise. Random walk x_l are approximated by $\mathcal{G}_{\exp}(c)$ for a small c. $\mathcal{G}_{\exp}(c)^3$ in the z_l column denotes 3 independent realizations of a $\mathcal{G}_{\exp}$ process. x_l is residualized with respect to z_l in all models. All models use $n = 250$.

of c and whether additional control variables are included. In Experiments 7-10, x_l is generated by a step function with a shift between southern and northern locations; these regressors are stylized versions of spatially correlated binary treatments. In Experiments 11 and 12, x_l is generated by a $\mathcal{G}_{\exp}(c)$ model with spatial heteroskedasticity, and in 13 and 14, x_l follows a spatial random walk. In all experiments reported in this paper, the x_l regressor is projected off the control regressors to ensure $\sum_{l=1}^n x_l'z_l = 0$. We present results for $e_l \sim \mathcal{G}_{\exp}(c)$ and $e_l = \text{sign}(x_l) \cdot a_l$ with $a_l \sim \mathcal{G}_{\exp}(c)$, the latter model is used to compute the critical value of C-SCPC. All simulations use $n = 250$. The rejection frequency of nominal 5% level tests is analytically computed for each draw of $\{x_l, z_l, s_l\}_{l=1}^n$, which yields a distribution of rejection frequencies for each experiment.

Figure 2 shows the 5th and 95th quantiles, and the mean of these conditional null rejection probabilities. Results are shown for KERNEL, SCPC and C-SCPC. The SCPC critical value is computed using $c_{0.03}$ in all experiments. (In Experiments 2-6, x and e follow independent $\mathcal{G}_{\exp}(c)$ processes so that $u_l = x_l e_l$ has the $\mathcal{G}_{\exp}(2c)$ covariance function. Thus, the c-value used to compute cv is smaller than the c-value used to generate for u in these experiments. A smaller critical value (and larger rejection frequency) results when $2c$ is used to compute cv.) The critical value of C-

Figure 2: Rejection frequencies for 5% nominal tests: spatial regressions, 48-states experiments
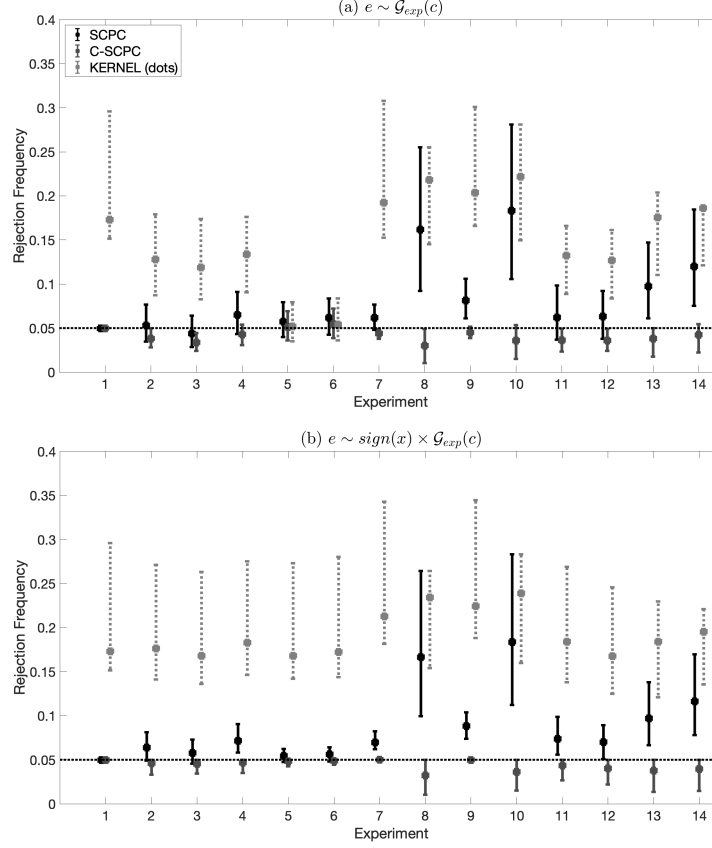
Notes: The bars show the 5th through 95th quantiles of the distribution of rejection frequencies conditional on the regressors for nominal 5% tests. Squares denote the mean of the distribution, which is the unconditional rejection frequency. See Table 4 and the text for a description of the experiments.

SCPC is computed using the value of c that generated e_l. Figure 2 does not show results for the usual heteroskedasticity-robust version of the t-statistic that ignores spatial correlation; suffice it to say the resulting test yields null rejection frequencies that greatly exceed its nominal 5% level.

The results for this rich set of spatial designs is similar to what we found earlier in the simple $U(0,1)$ spatial design. We highlight four results.

First, despite the optimal choice of bandwidth, the KERNEL method suffers from substantial size distortions. This is consistent with a large body of research that finds similar size distortions in time series regressions using HAC standard errors together with standard normal critical values. (These size distortions were documented in an early contribution by den Haan and Levin (1997). Lazarus, Lewis, Stock, and Watson (2018) provide a recent set of simulations and references.)

Second, SCPC does a reasonably good job controlling size in several designs, but has uncomfort-

ably large size distortions in some cases. For example, the mean null rejection frequency of SCPC is over 0.15 when x_l is generated by a step function in Experiments 8 and 10.

The third result is that C-SCPC has much improved size control, both for models for which the critical value was designed (that is when $e_l = \text{sign}(x_l)a_l$ with $a_l|\mathbf{V} \sim \mathcal{G}_{\text{exp}}(c)$ as in panel (b)) but also when $e_l|\mathbf{V} \sim \mathcal{G}_{\text{exp}}(c)$ (panel (a)); this is consistent with the results from the $s_l \sim$ i.i.d. $U(0,1)$ designs previously shown in Table 3. One might wonder about the rejection frequencies below 5% evident in panel (b) for some realizations of $\{(x_l, z_l, s_l)\}_{l=1}^n$. These arise when the size constraint is binding for a value of c other than $c_{\min}$, reflecting the fact that size is also controlled for processes that are *less* spatially correlated than the DGP used in the experiment.

Finally, the fourth result is that the rejection frequencies for KERNEL and SCPC are somewhat larger in panel (b) than in panel (a). This reflects the increase in spatial correlation that motived the construction of the C-SCPC critical value, that is replacing $x_l x_\ell$ (which is sometimes negative) with $|x_l x_\ell|$.

Figure 3 summarizes results from a panel version of these designs with $m_l = 4$ observations in each of $n = 250$ clusters. The panel data models differ from their non-panel counterparts in three ways. First, these designs rely on a cluster version of the $\mathcal{G}_{\text{exp}}(c)$ model, which we now describe. Let w_l denote an $m \times 1$ vector of variables associated with location s_l; in our applications w represents e, x, or one column of z. Within-cluster covariance is generated by an AR(1) structure with AR parameter ϕ, and between-cluster covariation generated by the exponential covariance function used above. This results in the covariance function $\text{cov}(w_{i,l}w_{j,\ell}) = \phi^{|i-j|} \exp(-c||s_l - s_\ell||)$. The results shown in panel (a) of Figure 3 use data generated as described in Table 4 with $\phi = 0.9$ for within-cluster covariation and the values of c shown in the table for between-cluster covariation (unreported results show little sensitivity to the choice of ϕ). Results in panel (b) use the same regressors but with e_l generated by (7), that is $e_l = x_l^s a_l$ where $a_l \sim \mathcal{G}_{\text{exp}}(c)$ is a scalar process. The second difference is that cluster-specific fixed effects are included as controls in all models; this eliminates Experiment 1 in which $x_l = 1$. The third difference concerns the step-function regressor designs in Experiments 8-12. In the panel data models these step functions are used to generate the regressors

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Figure 3: Rejection frequencies for 5% nominal tests: spatial panel regressions, 48-states experiments
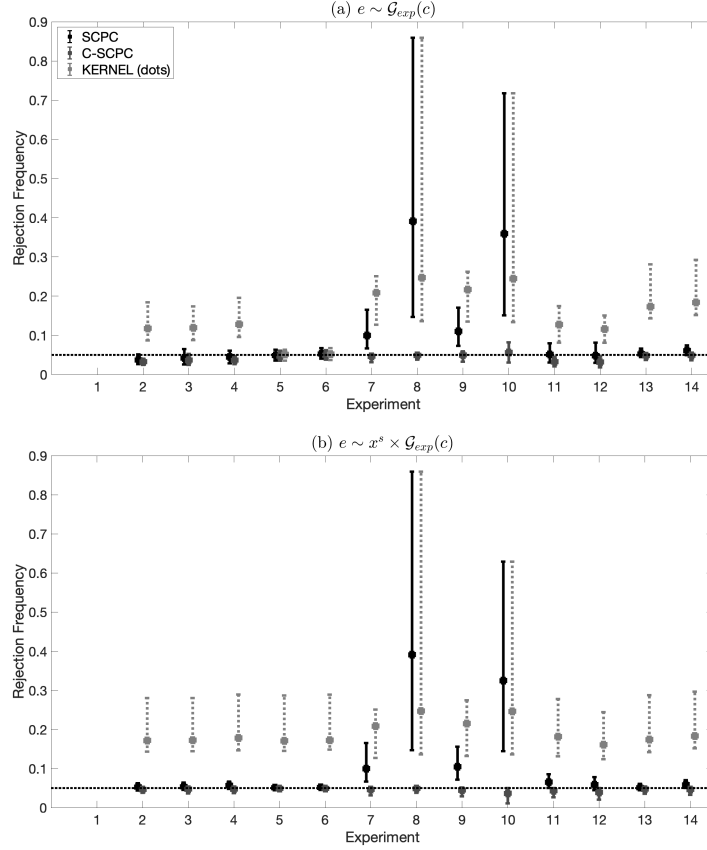
Notes: See notes to Figure 2. The inclusion of fixed effects eliminates Experiment 1 from the spatial panel regressions.

for the final two observations in each cluster ($i = 3$ and 4); observations for $i = 1$ and 2 are set to zero. This produces a differences-in-differences design where treatment occurs in the north during the final two time periods and the observations in the south are untreated throughout.

With these differences, the panel data results in Figure 3 look a lot like its non-panel counterpart in Figure 2. The most obvious difference are the more pronounced size distortions for KERNEL and SCPC in Experiments 8 and 10. These arise because the differences-in-differences design results in a much smaller effective sample size because only 15% of the clusters are treated.

One might wonder how the power of the different tests compare. Since the SCPC and C-SCPC methods are based on the same t-statistic τ_{SCPC}, and only differ in their critical values, the size-adjusted power (or, equivalently, average length of confidence intervals) of SCPC and C-SCPC are identical. The critical value of the C-SCPC method not only depends on the observed locations s_l, but also on the observed regressors (x_l, z_l), and is "conditional" in this sense. The cost of insisting

on such conditional size control is small: An unreported comparison of the C-SCPC method in design (7) used to compute $\text{cv}_{\text{C-SCPC}}$ with an unconditionally (over (s_l, x_l, z_l)) size-adjusted version of SCPC reveals small differences in average confidence interval lengths. Finally, comparing SCPC (or C-SCPC) with the size-adjusted KERNEL method reveals the KERNEL method to be somewhat more efficient. This is because $\hat{\sigma}_K^2$ is relatively less variable than $\hat{\sigma}_{\text{SCPC}}^2$, so after the size-adjustment that adjusts for the larger bias in $\hat{\sigma}_K^2$, the KERNEL method is akin to the oracle t-test that uses the true value of σ^2 in the denominator. In practice, of course, this size adjustment is not feasible, so we do not interpret this as a reason to prefer the KERNEL method.

3.2   World Development Indicators

In this section we report results from experiments using data that are drawn from the World Bank's World Development Indicators (WDI) database. Using these series as regressors and/or error terms allows us to investigate test performance in settings with data that closely matches empirical applications. We begin with a short description of the dataset, and then describe the experiments.

The WDI is a panel data set containing over 1400 socioeconomic variables for 266 countries. The dataset includes typical economic measurements like GDP, balance of payments and national debt, but also measurements of education, health and infrastructure. For our purposes, the data present three challenges: they are measured in a variety of units, some variables have missing values for some years and countries, and many series contain large outliers. To address these challenges, we use logarithms for several of the variables, discard series that cover fewer than 100 countries, and treat large outliers as missing data. The Supplementary Materials describes these steps in detail. We construct two datasets from the WDI. The first contains decadal differences for each variable, say $w_{2015,l} - w_{2005,l}$, where $w_{t,l}$ denotes the value of variable w in year t for country l. We used these 2015-2005 differences in cross section regressions. The second dataset is a balanced panel containing 10 years of data, from 2006 through 2015; these data are used for the panel data regressions. There are 749 variables in the cross section dataset and 644 variables in the panel dataset. We compute distances between countries via the great-circle formula.

Table 5: Spatial Regression Designs Using the WDI dataset

| Design	Panel	z
1	N	1
2	N	[1, 3 WDI variables]
3	Y	Country Fixed Effects
4	Y	Country and Year Fixed Effects
5	Y	[Country Fixed Effects, 3 WDI variables]
6	Y	[Country and Year Fixed Effects, 3 WDI variables]

Notes: Experiments 1 and 2 use each of the 749 variables in the 2015-2005 dataset as x_l. Experiments 3-6 use each of the 644 variables in the 2006-2015 panel dataset as x. x_l is residualized with respect to z_l in all models. $e_l \sim \mathcal{G}_{\exp}(c_{0.03})$ (with within cluster AR(1) covariances with $\phi = 0.9$ in the panel data models) or $e_l = x_l^s a_l$ with $a_l \sim \mathcal{G}_{\exp}(c_{0.03})$.

3.2.1 Mixed empirical and parametric models

The first set of experiments use the WDI variables as regressors with error terms generated by the parametric models used in the 48-states experiments. Six experiments are run. The first two use cross-section datasets, using each the dataset's 749 variables, one at a time, as the x_l regressor. The first experiment includes only a constant as a control, and the second adds three additional series chosen at random from the WDI. The other four experiments use the panel dataset, where each of the 644 series is used as x_l. The panel regressions include country fixed effects, and the four experiments differ in their inclusion of additional series selected at random from the WDI and time fixed effects. As in the 48-states experiments, the error terms are generated as $e|\mathbf{V} \sim \mathcal{G}_{\exp}(c_{0.03})$ with within-cluster covariance parameterized by the AR(1) model with $\phi = 0.9$ for the panel data experiments, or as $e_l = x_l^s a_l$ where $a|\mathbf{V} \sim \mathcal{G}_{\exp}(c_{0.03})$. Table 5 provides a summary.

Results are depicted in Figure 4 and suggest two conclusions. First, size distortions are evident for KERNEL and SCPC, although they are not as severe as in some of the 48-states designs. Evidently, the regressors in the WDI exhibit less spatial correlation than those generated for some of the 48-states experiments. Indeed, for the WDI experiments, the mean rejection frequency for SCPC is less than 0.10 in all of the experiments and close to its nominal 0.05 value in the panel regressions. That said, null rejection frequencies exceed 0.10 for more than 5% of the regressors chosen from the WDI datasets. The second conclusion is that C-SCPC has null rejection frequencies close to 0.05 in all experiments and regressors. This is consistent with the earlier experiments and provides reassuring

Figure 4: Rejection frequencies for 5% nominal tests: spatial regressions, WDI experiments

(a) $e \sim \mathcal{G}_{exp}(c)$

(b) $e \sim x^s \times \mathcal{G}_{exp}(c)$
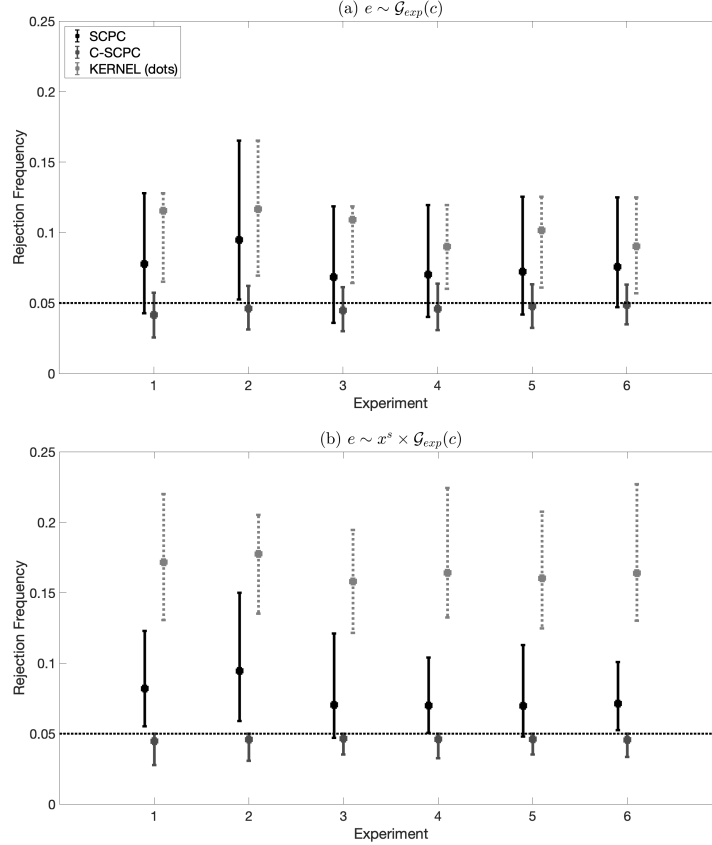
Notes: See Table 5 for a description of the experiments and the notes to Figure 2.

evidence about size control C-SCPC.

3.2.2 Empirical models for both regressor and dependent variable

In a final exercise we generate both regressors and dependent variables from the WDI dataset. This requires some care to ensure that (i) we have a well-defined population with known regression coefficient, and (ii) we control the degree of spatial correlation in the exercise. The idea is to generate simulated data by a discrete Markov chain that more likely selects countries that are geographically close to the previously selected country. With an appropriate restriction of the transition matrix, the stationary distribution is uniform across countries, so that the population regression simply becomes the regression using all countries in the WDI dataset. Furthermore, by varying the degree of preference for conditionally closer countries, we can control the induced average pairwise correlation.

The details are as follows. Suppose we select series labelled y, x, and (if relevant) z from the WDI

dataset, and suppose that the resulting (x_l, y_l, z_l) provide data for $l = 1, ..., M$ countries. Think of these countries as defining a population. The population regression is then the OLS regression using data for these M countries; let $u_{(l)} = x'_{(l)} e_{(l)}$ with $e_{(l)}$ the residual from this population regression. We will compute the various HR, KERNEL, SCPC, and C-SCPC tests using random samples drawn from this population. The challenge is to devise a sampling scheme that (i) puts uniform weight $(1/M)$ on each of the locations and (ii) induces a pre-specified average spatial correlation. We do this using a Markov chain, which we now describe.

Let Π be an $M \times M$ Markov transition matrix. As is well known, if Π is doubly stochastic (so that columns and rows sum to 1), then the stationary distribution is uniform. For a given value of c, let $\tilde{\Pi}(c)$ be the $M \times M$ transition matrix such that in row l, the transition probability is proportional to $\exp(-c||s_l - s_\ell||)$, $\ell \neq l$, except that the diagonal of $\tilde{\Pi}(c)$ is zero; thus locations closer to s_l are assigned a higher probability than more distant locations. Let $\Pi(c)$ be the resulting doubly stochastic matrix after appropriate diagonal scaling, that is, $\Pi(c) = \Lambda \tilde{\Pi}(c) \Lambda$ for a numerically determined diagonal matrix Λ (which is unique up to scale). We generate a sample of size n of country indices $L_i \in \{1, 2, \ldots, M\}$, $i = 1, \ldots, n$ from the stationary Markov chain with transition matrix $\Pi(c)$, with the first index L_1 drawn uniformly.

The average pairwise correlation of $u_{(L_i)}$ and $u_{(L_{i+k})}$ depends on the parameter c and is easily calculated. For all $i \geq 1$ and $k \geq 0$, we have

$$\mathbb{E}[u_{(L_i)} u_{(L_{i+k})}] = M^{-1} \sum_{l=1}^{M} \sum_{\ell=1}^{M} [\Pi(c)^k]_{l\ell} u_{(l)} u_{(\ell)}$$

where $[\Pi(c)^k]_{l\ell}$ is the l,ℓ th element of $\Pi(c)^k$. The average pairwise correlation $u_{(L_i)}$ and $u_{(L_{i+k})}$ is therefore given by

$$\begin{aligned}
\bar{\rho} &= \frac{2}{n(n-1)} \sum_{k=1}^{n-1} (n-k) \frac{\mathbb{E}[u_{(L_1)} u_{(L_{1+k})}]}{\mathbb{E}[u_{(L_1)}^2]} \\
&= \frac{2}{n(n-1)} \sum_{k=1}^{n-1} (n-k) \frac{M^{-1} \sum_{l=1}^{M} \sum_{\ell=1}^{M} [\Pi(c)^k]_{l\ell} u_{(l)} u_{(\ell)}}{M^{-1} \sum_{l=1}^{M} u_{(l)}^2}.
\end{aligned}$$

Table 6: Rejection frequency of nominal 5% level tests using WDI-Markov-Chain design

Model	Panel	5th, 50th, and 95th quantiles			
		HR	KERNEL	SCPC	C-SCPC
1	N	0.20, 0.26, 0.33	0.10, 0.15, 0.24	0.09, 0.14, 0.21	0.04, 0.08, 0.14
2	N	0.21, 0.27, 0.36	0.11, 0.17, 0.27	0.10, 0.17, 0.27	0.03, 0.08, 0.18
3	Y	0.23, 0.27, 0.33	0.08, 0.14, 0.21	0.06, 0.10, 0.18	0.04, 0.08, 0.12
4	Y	0.23, 0.27, 0.32	0.08, 0.15, 0.22	0.07, 0.11, 0.19	0.04, 0.08, 0.14

Notes: See text for description of the design. Models 1 and 2 include constants as control variables and Models 3 and 4 include country fixed effects; Models 2 and 4 include 3 additional regressors selected at random from the WDI datasets.

Thus, it is straightforward to numerically obtain the value of c that induces a given value of $\bar{\rho}$.

With $\Pi(c)$ determined in this fashion, we generate 5,000 random samples of countries and corresponding sample regressors and dependent variable using $n = 50$ and $\bar{\rho} = 0.03$. Each set of (y, x, z) from the WDI corresponds to a different population, with associated rejection frequencies for the HR, KERNEL, SCPC, and C-SCPC tests. (To insure that the Markov chain can attain $\bar{\rho} = 0.03$ without re-sampling the same locations frequently, we restrict attention to (y, x, z) variables in the WDI that exhibit spatial correlation. Specifically we use data in which the kernel-estimated variance of u_l with a bandwidth of 0.3 of the largest distance in the data set is at least three times larger than the HR-estimated variance.) We construct two experiments using spatial regressions from the 2015-2005 dataset; the first includes (y, x), a constant and no additional controls, and the second adds three randomly selected additional series as controls. Similarly we construct two experiments using panel regressions from the 2006-2015 dataset, where fixed country effects are included the first, and the second adds three additional randomly selected series. Table 6 shows the 5th, 50th, and 95th quantiles of rejection frequencies across 200 populations generated in this fashion.

These experiments differ from those reported earlier in two distinct ways. First, as emphasized above, the values of both e and x correspond to real-world data; so, for example, neither is generated by a Gaussian model as in the earlier experiments. Second, earlier experiments used $n = 250$, while these use $n = 50$, where the smaller sample size reflects the fact that many of the series in the WDI are available for as few as $M = 100$ countries. The rejection frequencies for these experiments share some of the features of the earlier experiments, but there are notable differences. For example, the

smaller sample size means that HR rejects less frequently; the rejection frequencies fall from around 50% in Table 1 to half that value in Table 6. KERNEL and SCPC improve on HR, but (as in some of the previous experiments) exhibit quantitatively important size distortions. C-SCPC does better, with a median rejection frequency of 8% – close the nominal 5% value – although for 5% of the DGPs, the rejection frequency exceeds 0.15 for the spatial (non-panel) regressions.

4   Conditional size control in more general models

In this section we carry out three exercises to investigate the size properties of C-SCPC under alternative processes for the regression errors. The first considers processes with covariance functions with different decay properties than the exponential $\mathcal{G}_{exp}(c)$ processes. The second considers regression errors that are conditionally heteroskedastic. The third considers errors that exhibit excess spatial correlation with $\bar{\rho} > \bar{\rho}_{\max}$. We end this section by discussing how

4.1   Size control with alternative spatial covariance functions

We carry out a straightforward but instructive exercise. Specifically, we carry out C-SCPC inference as in the other experiments — that is using $\bar{\rho}_{\max} = 0.03$ and using the critical value cv chosen so that conditional size is controlled for $e_l = x_l^s a_l$ where $a_l \sim \mathcal{G}_{\exp}(c)$ for $c \geq c_{\bar{\rho}_{\max}}$ — however, we now use non-$\mathcal{G}_{\exp}$ stochastic processes to generate the errors e_l or a_l. In particular, we generate the errors from five different Matérn processes and study the robustness for all values of $\bar{\rho} \leq \bar{\rho}_{\max}$ for each of these five processes.

The Matérn class of stochastic processes is indexed by the parameter $\theta = (\nu, c)$, where ν and c are positive constants. If a follows a Matérn process, its covariance function $\sigma_a(r - s)$ depends on the locations only through $\Delta = ||r - s||$, with $\sigma_a(\Delta) \propto (c\Delta)^\nu K_\nu(c\Delta)$, where K_ν is modified Bessel function of the second kind. When $\nu \in \{1/2, 3/2, 5/2, \infty\}$, the expression for the covariance simplifies:

- $\nu = 1/2$: $\sigma_a(\Delta) \propto \exp[-c\Delta]$

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- $\nu = 3/2$: $\sigma_a(\Delta) \propto (1 + \Delta c) \exp[-c\Delta]$

- $\nu = 5/2$: $\sigma_a(\Delta) \propto (3 + 3\Delta c + \Delta^2 c^2) \exp[-c\Delta]$

- $\nu = \infty$: $\sigma_a(\Delta) \propto \exp[-c^2\Delta^2/2]$.

So $\nu = 1/2$ is the exponential model used throughout the paper but the other processes have different decay. We consider these four processes together with the process with $\nu = 1/4$. Gneiting (2013) shows that for $\nu > 1/2$, the Matérn covariance function is not positive definite when distances are measured by the great-circle formula. So in this section, we instead map each country's location on the surface of the earth into a point in $\mathbb{R}^3$, and then use the Euclidian norm to compute distances. This effectively also changes the covariance matrices for $\nu = 1/2$, providing an additional degree of separation from the baseline specification.

We re-run the 48-states and WDI experiments from Figures 2-4 using the same regressors but with errors generated by the Matérn processes with $\nu \in \{1/4, 1/2, 3/2, 5/2, \infty\}$. For each process we find a range of values of c to trace out values of $\bar{\rho} \in (0.001, \bar{\rho}_{\max})$ with $\bar{\rho}_{\max} = 0.03$, and generate errors for each value of c. We record the largest rejection frequency over each of the processes and c-values. As in the previous experiments, this generates a distribution of rejection frequencies over realizations of $\{x_l, z_l, s_l\}$ but now the rejection frequencies represent the largest rejection frequency over this Matérn class with $\bar{\rho} \leq \bar{\rho}_{\max}$. Figure 5 summarizes the results, showing for each experiment the 5th, 50th and 95th quantiles.

The results are reassuring: the 95th percentile of the rejection frequency across all values of $\{x_l, z_l, s_l\}$ is less that 0.09 across all five Matérn models, for all values of $\bar{\rho} \in (0.001, \bar{\rho}_{\max})$ and for all of the experiments shown in the figure. In most experiments the 95th percentile rejection frequency is less than 0.07. We conclude that C-SCPC inference is robust for this class of DGPs.

Figure 5: Largest rejection frequency across a set of Matérn processes
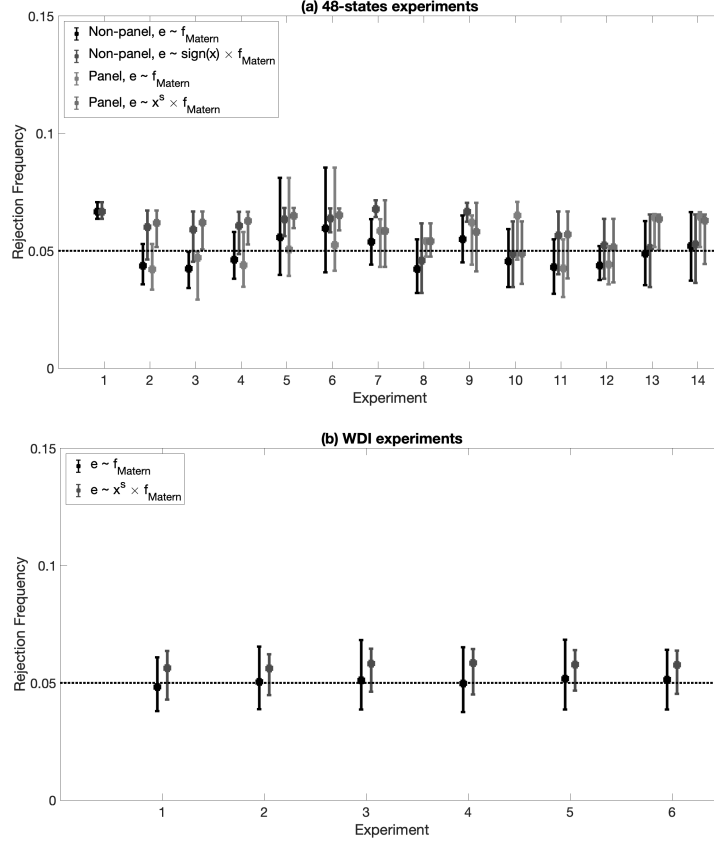
Notes: See the text for a description of the experiments and the notes to Figure 2.

4.2 Size control with an alternative form of conditional heteroskedasticity

The construction of the critical value $\text{cv}_\mathbf{V}$ for C-SCPC was based on a particular form of heteroskedasticity (7). Here we investigate the effect of an alternative form of heteroskedasticity. To be specific, let $\boldsymbol{\Sigma}_0$ denote the covariance matrix for $\mathbf{e}$ from the models summarized in panels (a) of Figures 2-4. We used heteroskedastic versions of these error processes with $\mathbf{e}|\mathbf{X} \sim \mathcal{N}(0, \mathbf{D}\boldsymbol{\Sigma}_0\mathbf{D}')$ where $\mathbf{D}$ is a diagonal matrix whose ith element for the lth cluster is $(1 + x_{i,l})^{1/2}$, and where the regressors for each experiment are scaled so that $N^{-1}\sum_{i,l} x_{i,l}^2 = 1$.

Detailed results are presented in the Supplementary material, but the key takeaways can be gleaned from a few summary statistics from the models in Figure 2(a). For the 13 models with spatial variation in x, the average rejection frequency in the baseline (7) models for the 5% level C-SCPC tests is 0.04; this increases only slightly to 0.06. The largest rejection frequency is obrerved in

Model 8, with an average rejection frequency of 0.10. These results indicate that after averaging over realizations of x, size distortions associated with conditional heteroskedasticity of the sort studied here are relatively minor. That said, the results in Supplementary material indicate more dispersion in the rejection frequencies after conditioning on x, so size distortions are larger for some realizations of the regressors.

4.3 Size control and expected length of confidence intervals as a function of $\overline{\rho}_{\max}$

SCPC and C-SCPC are designed to control size for processes with average pairwise correlation bounded above by $\overline{\rho}_{\max}$. But what if a user misjudges the spatial correlation in the process under study and chooses a value of $\overline{\rho}_{\max}$ that is too small? A simple experiment highlights some of the key issues. In particular, we re-ran the experiments summarized in panel (a) of Figures 2-4, computing the C-SCPC test statistics and critical values as we did previously, that is with $\overline{\rho}_{\max} = 0.03$, but we generated the regression errors using the exponential model with $\overline{\rho} = 0.10$, so they exhibited substantially more spatial correlation than the models in Section 3.

Again, detailed results are presented in the Supplementary material, but summary statistics from the models in Figure 2(a) tell much of the story. For the 13 models with spatial variation in x, the average rejection frequency shown in Figure 2(a) is 0.04; this increases only slightly to 0.07 when the errors are generated from the model with $\overline{\rho} = 0.10$. This somewhat surprising result occurs because the C-SCPC rejection frequency is determined by the spatial correlation in $u = x'e$, which may exhibit substantially less spatial correlation than e. However, in the location model with $x = 1$, $u = e$ and the rejection frequency increases to 0.15 in the model with $\overline{\rho} = 0.10$ and $\overline{\rho}_{\max} = 0.03$.

A related question involves the effect of the choice of $\overline{\rho}_{\max}$ on the expected length of confidence intervals. Suppose a researcher constructs a C-SCPC confidence interval using a large value of $\overline{\rho}_{\max}$ (say $\overline{\rho}_{\max} = 0.10$) to guard against under-coverage, when in fact the data are generated by a model where $\overline{\rho}$ is much smaller than $\overline{\rho}_{\max}$. What is the cost of this extra robustness in terms of increased average length of the C-SCPC confidence interval? We consider the extreme version of this where

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the data is generated by the i.i.d. model $\mathbf{e} \sim \mathcal{N}(0, \mathbf{I}_n)$, and consider $\overline{\rho}_{\max} = 0.1, 0.03, 0.01, 0.003$. We find that the average ratio of the C-SCPC interval length over the oracle $\pm 1.96\sigma$ interval length is approximately 1.55, 1.20, 1.10 and 1.05 in most of the designs, respectively. The cost of the default value $\overline{\rho}_{\max} = 0.03$ is thus about a 20% increase in confidence interval lengths. See the supplementary appendix for further details.

5 Critical values, IV regression and computation

5.1 Computing $\mathrm{cv}_{\mathbf{SCPC}}$ and $\mathrm{cv}_{\mathbf{V}}$ critical values

Let $\boldsymbol{\Sigma}(c)$ denote the $n \times n$ covariance matrix using an exponential covariance function with parameter c evaluated at the sample locations $\mathbf{s}$. Let $\mathbf{R}$ denote the $n \times q$ matrix whose columns are the eigenvectors of $\mathbf{M}_1 \boldsymbol{\Sigma}(c_{\min}) \mathbf{M}_1$ corresponding the largest q eigenvectors. These eigenvectors are used to compute $\hat{\sigma}^2_{\mathrm{SCPC}}$ (see (5)). The rejection region for the τ_{SCPC} test using a critical value cv corresponds to values of $\mathbf{u}$ that satisfy $|\tau_{\mathrm{SCPC}}| > \mathrm{cv}$, or equivalently

$$\mathbf{u}' \mathbf{1} \mathbf{1}' \mathbf{u} - \mathrm{cv}^2 \, q^{-1} \hat{\mathbf{u}}' \mathbf{R} \mathbf{R}' \hat{\mathbf{u}} > 0. \tag{8}$$

The critical values $\mathrm{cv}_{\mathrm{SCPC}}$ and $\mathrm{cv}_{\mathbf{V}}$ use this expression to compute rejection frequencies under different probability laws for $\mathbf{u}$. We discuss these in turn.

The $\mathrm{cv}_{\mathrm{SCPC}}$ critical value uses $u_l \sim \mathcal{G}_{\exp}(c)$, so that $\mathrm{Var}(\mathbf{u}|\mathbf{s}) = \boldsymbol{\Sigma}(c)$. It uses the regression model with $x_l = 1$ and $z_l = 0$ so that $\hat{u}_l = u_l - \bar{u}$. Because the columns of $\mathbf{R}$ are eigenvectors of $\mathbf{M}_1 \boldsymbol{\Sigma}(c_{\min}) \mathbf{M}_1$, $\mathbf{R}' \mathbf{1} = 0$, so $\mathbf{R}' \hat{\mathbf{u}} = \mathbf{R}' \mathbf{u}$; this implies that the values of $\hat{\mathbf{u}}$ in (8) can be replaced with $\mathbf{u}$.

Let $\mathbf{h} = \mathbf{W}' \mathbf{u}$ with $\mathbf{W} = [\mathbf{1}, \mathbf{R}]$, and let $\boldsymbol{\Omega}(c) = \mathbf{W}' \boldsymbol{\Sigma}(c) \mathbf{W}$ denote its $(q+1) \times (q+1)$ covariance

matrix. The rejection region can then be written as $\mathbf{h}'\mathbf{D}(\mathrm{cv})\mathbf{h} > 0$, where

$$\mathbf{D}(\mathrm{cv}) = \begin{bmatrix} 1 & 0 \\ 0 & -\mathrm{cv}\, q^{-1}\mathbf{I}_q \end{bmatrix}.$$

The rejection frequency under normality is $\mathbb{P}(\mathbf{h}'\mathbf{D}(\mathrm{cv})\mathbf{h} > 0)$ with $\mathbf{h} \sim \mathcal{N}(0, \boldsymbol{\Omega}(c))$. This probability can be efficiently computed using a formula in Bakirov and Székely (2005). (See Lemma 1 in Müller and Watson (2022a).) The critical value $\mathrm{cv}_{\mathrm{SCPC}}$ is chosen to satisfy

$$\mathbb{P}^{\mathrm{Normal}}_{c \geq c_{\bar{\rho}_{\max}}} (\mathbf{h}'\mathbf{D}(\mathrm{cv}_{\mathrm{SCPC}})\mathbf{h} > 0) = \alpha$$

where α is the desired size of the test.

The $\mathrm{cv}_{\mathbf{V}}$ critical value uses $u_l = x_l' e_l$ with $e_l = x_l^s a_l$ where $a_l|(\mathbf{X}, \mathbf{Z}, \mathbf{s}) \sim \mathcal{G}_{\exp}(c)$ and computes the probability of (8) conditional on $(\mathbf{X}, \mathbf{Z}, \mathbf{s})$. Some new notation helps explain the details of the calculation. Let $\boldsymbol{\Xi}$ denote the $N \times n$ matrix

$$\boldsymbol{\Xi} = \begin{bmatrix} x_1 & 0 & \cdots & 0 \\ 0 & x_2 & & 0 \\ \vdots & & \ddots & \\ 0 & 0 & & x_n \end{bmatrix}$$

and let $\boldsymbol{\Xi}_s$ denote the analogous matrix using x_l^s in place of x_l. Then $\mathbf{e} = \boldsymbol{\Xi}_s \mathbf{a}$ and $\mathbf{u} = \boldsymbol{\Xi}' \mathbf{e} = \boldsymbol{\Xi}' \boldsymbol{\Xi}_s \mathbf{a}$. Let $\mathbf{M}_{\mathbf{V}} = \mathbf{I}_N - \mathbf{V}(\mathbf{V}'\mathbf{V})^{-1}\mathbf{V}$ with $\mathbf{V} = (\mathbf{X}, : \mathbf{Z})$. Then $\hat{\mathbf{e}} = \mathbf{M}_{\mathbf{V}} \mathbf{e}$ and $\hat{\mathbf{u}} = \boldsymbol{\Xi}' \hat{\mathbf{e}} = \boldsymbol{\Xi}' \mathbf{M}_{\mathbf{V}} \mathbf{e} = \boldsymbol{\Xi}' \mathbf{M}_{\mathbf{V}} \boldsymbol{\Xi}_s \mathbf{a}$.

Paralleling the discussion of $\mathrm{cv}_{\mathrm{SCPC}}$, let $\tilde{\mathbf{h}} = \tilde{\mathbf{W}}' \mathbf{a}$ with $\tilde{\mathbf{W}} = [\boldsymbol{\Xi}_s' \boldsymbol{\Xi} \mathbf{1}, \boldsymbol{\Xi}_s' \mathbf{M}_{\mathbf{V}} \boldsymbol{\Xi} \mathbf{R}]$. Under $\mathbf{a}|(\mathbf{X}, \mathbf{Z}, \mathbf{s}) \sim \mathcal{N}(0, \boldsymbol{\Sigma}(c))$, $\tilde{\mathbf{h}}|(\mathbf{X}, \mathbf{Z}, \mathbf{s}) \sim \mathcal{N}(0, \tilde{\boldsymbol{\Omega}}(c))$ with $\tilde{\boldsymbol{\Omega}}(c) = \tilde{\mathbf{W}}' \boldsymbol{\Sigma}(c) \tilde{\mathbf{W}}$. The remaining calculations are identical to those of $\mathrm{cv}_{\mathrm{SCPC}}$ with $(\tilde{\mathbf{h}}, \tilde{\boldsymbol{\Omega}})$ replacing $(\mathbf{h}, \boldsymbol{\Omega})$.

5.2 Computing SCPC eigenvectors for large n

The SCPC estimator for σ^2 given in (5) relies on the eigenvectors, $\mathbf{r}_i$, of the $n \times n$ matrix $\mathbf{M}_1 \mathbf{\Sigma}(c_{\min}) \mathbf{M}_1$. When n is large (say, n is much larger than 3500) computing these eigenvectors is a challenging computational task. However, it is possible to accurately approximate $\mathbf{r}_i$ by first computing eigenvectors using only $\tilde{n} < n$ randomly selected locations then extending these to encompass all n locations. This is a version of the so-called Nyström method (see, for instance, Rasmussen and Williams (2005) for discussion and references).

The idea of the extension is most easily explained if we initially ignore the demeaning by $\mathbf{M}_1$. So for now, suppose we seek the eigenvectors $\mathbf{v}_i$ of the $n \times n$ matrix $\mathbf{K} = \mathbf{\Sigma}(c_{\min})$ with (l, ℓ) element $k(s_l, s_\ell) = \exp\left(-c_{\min}||s_l - s_\ell||\right)$ corresponding to the q largest eigenvalues λ_i. Since $\mathbf{K}\mathbf{v}_i = \lambda_i \mathbf{v}_i$, we trivially have $\mathbf{v}_i = \lambda_i^{-1} \mathbf{K}\mathbf{v}_i$ for $\lambda_i > 0$. If we put the original locations in random order, then the first $\tilde{n}$ locations $\{\tilde{s}_l\}_{l=1}^{\tilde{n}}$ are a random subset of size $\tilde{n} < n$ of all n observed locations. Let $\tilde{\mathbf{K}}$ be the corresponding $\tilde{n} \times \tilde{n}$ matrix computed from the first $\tilde{n}$ locations, with ith eigenvalue-eigenvector pair $(\tilde{\lambda}_i, \tilde{\mathbf{v}}_i)$, where $\tilde{n}^{-1} \tilde{\mathbf{v}}_i' \tilde{\mathbf{v}}_i = 1$. One natural way to extend the $\tilde{n} \times 1$ vector $\tilde{\mathbf{v}}_i$ to the $n \times 1$ vector $\mathbf{v}_i$ is via $\mathbf{v}_i \approx \hat{\mathbf{v}}_i = \tilde{\lambda}_i^{-1} \tilde{\mathbf{K}}_0 \tilde{\mathbf{v}}_i$, where the $n \times \tilde{n}$ matrix $\tilde{\mathbf{K}}_0$ has (l, ℓ) element $k(s_l, s_\ell)$, $l = 1, \ldots, n$, $\ell = 1, \ldots, \tilde{n}$. Note that the first $\tilde{n}$ elements of $\hat{\mathbf{v}}_i$ are identical to $\tilde{\mathbf{v}}_i$, and for $l > \tilde{n}$,

$$\hat{\mathbf{v}}_{i,l} = \tilde{\lambda}_i^{-1} \sum_{\ell=1}^{\tilde{n}} \tilde{\mathbf{v}}_{i,l} k(s_l, s_\ell), \tag{9}$$

so this method approximates the value of $\mathbf{v}_l$ at the additional locations by a weighted average of the kernel k, with weights proportional to the eigenvector computed from the first $\tilde{n}$ locations.

We now show that this approach is asymptotically justified. We assume that the (non-stochastic) sequence of locations $\{s_l\}_{l=1}^{n}$ is such that the empirical distribution function G_n converges in distribution to the continuous distribution G, where G has compact support $\mathcal{S} \subset \mathbb{R}^d$. A calculation shows that under this assumption, also $\sup_{s \in \mathcal{S}} |G_{\tilde{n}}(s) - G(s)| \xrightarrow{p} 0$ as $\tilde{n}, n \to \infty$, where the probability is induced by the randomness in the subset $\{\tilde{s}_l\}_{l=1}^{\tilde{n}}$. It therefore suffices to argue that convergence in distribution of G_n induces convergence of the eigenvectors in a suitable sense.

To this end, let $\mathcal{L}_G^2$ denote the Hilbert space of functions $\mathcal{S} \mapsto \mathbb{R}$ with inner product $\langle f_1, f_2 \rangle = \int f_1(s) f_2(s) dG(s)$. Then by Mercer's Theorem, k has the representation $k(s, r) = \sum_{i=1}^{\infty} \lambda_i \varphi_i(s) \varphi_i(r)$, where $(\lambda_i, \varphi_i) \in \mathbb{R} \times \mathcal{L}_G^2$ are eigenvalues and eigenfunctions of k, with eigenvalues ordered from largest to smallest, normalized so that $\int \varphi_i(s) \varphi_j(s) dG(s) = \mathbf{1}[i = j]$ and $\varphi_i(\cdot) = \lambda_i^{-1} \int k(\cdot, r) \varphi_i(r) dG(r)$ for $\lambda_i > 0$. Now proceeding as in Rosasco, Belkin, and Vito (2010), Müller and Watson (2022a) and Müller and Watson (2022b) shows that if the eigenvalue λ_i is unique, then $\sup_{s \in \mathcal{S}} ||\tilde{\varphi}_i(s) - \varphi_i(s)|| \overset{p}{\to} 0$, where $\tilde{\varphi}_i(\cdot) = \tilde{\lambda}_i^{-1} \sum_{\ell=1}^{\tilde{n}} k(\cdot, s_\ell) v_{i,\ell}$. These authors also develop corresponding results for non-unique eigenvalues.

These ideas and results extend to the problem of consideration here, where we seek to approximate the eigenvectors $\mathbf{r}_i$ of a demeaned version of $\mathbf{K}$, namely $\mathbf{M}_1 \mathbf{K} \mathbf{M}_1$. Define

$$\hat{k}_n(r, s) = k(r, s) - n^{-1} \sum_{l=1}^{n} k(s_l, s) - n^{-1} \sum_{\ell=1}^{n} k(r, s_\ell) + n^{-2} \sum_{l=1}^{n} \sum_{\ell=1}^{n} k(s_l, s_\ell),$$

so that the (l, ℓ) element of $\mathbf{M}_1 \mathbf{K} \mathbf{M}_1$ is equal to $\hat{k}_n(s_l, s_\ell)$. Let $(\tilde{\omega}_i, \tilde{\mathbf{r}}_i)$ with $\tilde{n}_i^{-1} \tilde{\mathbf{r}}_i' \tilde{\mathbf{r}}_i = 1$ be the eigenvalues and eigenvectors of the corresponding matrix $\tilde{\mathbf{M}}_1 \tilde{\mathbf{K}} \tilde{\mathbf{M}}_1$ computed from the first $\tilde{n}$ locations. Then in analogy to (9), we extend the $\tilde{n} \times 1$ vector $\tilde{\mathbf{r}}_i$ to $\hat{\mathbf{r}}_i \approx \mathbf{r}_i$ via

$$
\begin{aligned}
\hat{\mathbf{r}}_{i,l} &= \tilde{\omega}_i^{-1} \sum_{\ell=1}^{\tilde{n}} \hat{k}_{\tilde{n}}(s_l, s_\ell) \tilde{r}_{i,\ell} \\
&= \tilde{\omega}_i^{-1} \sum_{\ell=1}^{\tilde{n}} \left(\exp[-c_{\min} ||s_l - \tilde{s}_\ell||] - \tilde{n}^{-1} \sum_{j=1}^{\tilde{n}} \exp[-c_{\min} ||\tilde{s}_\ell - \tilde{s}_j||] \right) \tilde{r}_{i,\ell}
\end{aligned}
\tag{10}
$$

where the second equality exploits $\sum_{l=1}^{\tilde{n}} \tilde{r}_{i,l} = 0$.

The above mentioned convergence results are not directly applicable, since the demeaned kernel $\hat{k}_n$ is a function of the observed locations $\{s_l\}_{l=1}^{n}$, and hence not fixed. However, one would expect that as $n \to \infty$, $\hat{k}_n$ is well approximated by the population demeaned kernel

$$\bar{k}(r, s) = k(r, s) - \int k(u, s) dG(u) - \int k(r, u) dG(u) + \int \int k(u, t) dG(u) dG(t),$$

Figure 6: Spatial density and eigenfunctions for Texas

(a) Spatial Density   (b) 1st Eigenfunction

(c) 2nd Eigenfunction   (d) 5th Eigenfunction
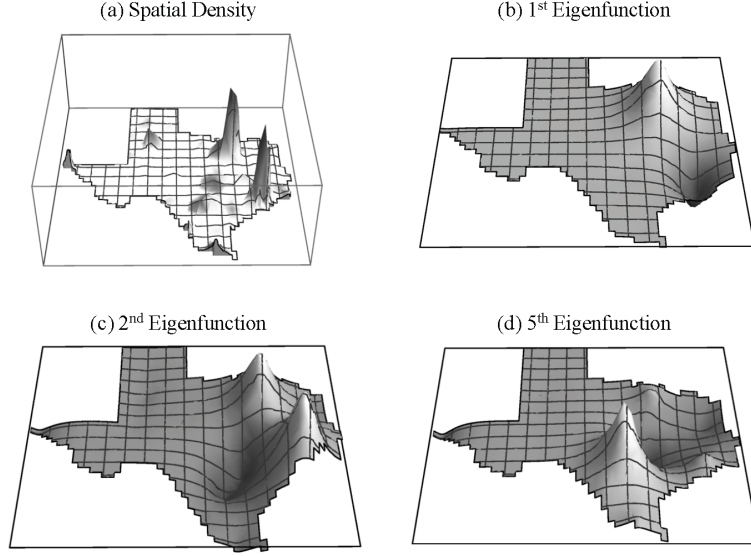
Notes: Panel (a) shows the spatial density of light in Texas. Panels (b)-(d) show three of the estimated eigenfunctions of the kernel $\bar{k}$ using $c_{0.03}$.

with eigenvalue-eigenfunction representation $\bar{k}(s,r) = \sum_{i=1}^{\infty} \omega_i \phi_i(s)\phi_i(r)$. Lemma 5 in Müller and Watson (2022b) shows that this is indeed the case, and it implies that if ω_i is unique, then $\sup_{s \in \mathcal{S}} ||\tilde{\phi}_i(s) - \phi_i(s)|| \xrightarrow{p} 0$ as $n, \tilde{n} \to \infty$, where $\tilde{\phi}_i(\cdot) = \tilde{\omega}_i^{-1} \sum_{\ell=1}^{\tilde{n}} \hat{k}_{\tilde{n}}(\cdot, s_\ell) r_{i,\ell}$. Figure 6 depicts three of the resulting estimated eigenfunctions $\tilde{\phi}_i$ for the U.S. state of Texas.

This shows that the numerical approximation $\mathbf{r}_{i,l} \approx \hat{\mathbf{r}}_{i,l}$ in (10) is formally justified under $n, \tilde{n} \to \infty$ asymptotics, and numerical experiments suggest that results become fairly stable with $\tilde{n} = 1000$. In practice, the approximation (10) can be carried out for several random subsets of $\tilde{n}$ locations, followed by a (sample) principle component analysis to extract the best approximation to the space spanned by the first q eigenvectors. This further improves the accuracy of the approximation, and reduces the artificial randomness induced by the selection of $\tilde{n}$ locations. The resulting algorithm has $O(n)$ running time, which compares favorably to the $O(n^2)$ running time of a basic implementation of a kernel variance estimator. This algorithm is implemented in the STATA and Matlab code for C-SCPC mentioned in Section 1.

5.3 SCPC and C-SCPC for IV regression

Consider a version of (2) in which ζ is the coefficient on a scalar endogenous regressor, say $p_{i,l}$:

$$y_{i,l} = p_{i,l}\zeta + z'_{i,l}\gamma + e_{i,l}$$

where $p_{i,l}$ is potentially correlated with $e_{i,l}$. Suppose $x_{i,l}$ is a scalar instrument for $p_{i,l}$, $z_{i,l}$ is a vector of exogenous regressors and $v_{i,l} = (x_{i,l}, z_{i,l})$ satisfies the assumptions discussed in the previous sections. Minor modifications of the methods discussed above provide SCPC and C-SCPC inference for ζ.

Weak-instrument robust inference about ζ utilizes the Anderson and Rubin (1949) regression

$$y_{i,l} - p_{i,l}\zeta_0 = x_{i,l}\beta + z'_{i,l}\gamma + e^0_{i,l} \tag{11}$$

where the null hypothesis $\zeta = \zeta_0$ corresponds to $\beta = 0$ in the regression (11). Spatial correlation robust SCPC/C-SCPC tests of the $\beta = 0$ null proceed as described in Sections 2.2 and 2.3. Note that C-SCPC inference for $\beta = 0$ in (11) (equivalently $\zeta = \zeta_0$) produces valid inference in Section 2.3's heteroskedastic Gaussian model conditional on the instrument and exogenous regressors $(\mathbf{X}, \mathbf{Z})$.

When $x_{i,l}$ is known to be a strong instrument, spatial correlation robust inference can be carried out using the IV t-statistic constructed with the SCPC estimator for σ. The IV estimator is $\hat{\zeta}^{IV} = S_{xp}^{-1}S_{xy}$ (recall that x and z are uncorrelated in the sample, so $\mathbf{X}'\mathbf{Z} = 0$) so $\hat{\zeta}^{IV} = \zeta + S_{xp}^{-1}n^{-1}\sum_{l=1}^n x'_l e_l$. The resulting IV t-statistic has the same form as (3) with $\hat{\zeta}^{IV}$ replacing the OLS estimator $\hat{\beta}$ and S_{xp} replacing S_{xx}. SCPC inference then follows as in Section 2.2 with $\hat{u}_l^{IV} = x'_l \hat{e}_l^{IV}$ where $\hat{e}_{i,l}^{IV} = y_{i,l} - p_{i,l}\hat{\zeta}^{IV} - z'_{i,l}\hat{\gamma}^{IV}$.

The case is more complicated for conducting C-SCPC inference using the τ_{SCPC} IV t-statistic. The complication arises because the IV residuals are given by $\hat{\mathbf{e}}^{IV} = \mathbf{Me}$ with $\mathbf{M} = \mathbf{I}_N - [\mathbf{P}\ \mathbf{Z}](\mathbf{V}'[\mathbf{P}\ \mathbf{Z}])^{-1}\mathbf{V}'$, so that $\mathbf{M}$ depends on the (potentially endogenous) regressors $\mathbf{P}$. Under the C-SCPC heteroskedastic model, $e_l = x_l^s a_l$, so $\mathbf{e} = \mathbf{\Xi}_s\mathbf{a}$ and $\hat{\mathbf{e}}^{IV} = \mathbf{M}\mathbf{\Xi}_s\mathbf{a}$. Thus, if $a_l|(\mathbf{P}, \mathbf{X}, \mathbf{Z}) \sim \mathcal{G}_{\exp}(c)$ for $c \geq c_{min}$, then C-SCPC has guaranteed size control conditional on

$(\mathbf{P}, \mathbf{X}, \mathbf{Z})$. That said, if $\mathbb{E}(e_{i,l}|p_{i,l}, x_{i,l}, z_{i,l}) \neq 0$, that is, if p is endogenous, then a_l is not independent of $(\mathbf{P}, \mathbf{X}, \mathbf{Z})$ invalidating the small-sample conditional size control of C-SCPC.

This discussion has assumed that $x_{i,l}$ is a scalar. When there are multiple instruments, say $\widetilde{x}_{i,l}$, then SCPC inference based on $\hat{\beta}^{IV}$ can be conducted using the scalar instrument $x_{i,l} = \hat{w}'\widetilde{x}_{i,l}$, where $\hat{w}$ is a vector of weights computed, for example, by 2SLS.

6   Concluding remarks

This paper has studied the properties of spatial-correlation robust t-statistics in linear regression and panel models using data generating processes designed to mimic spatial correlation patterns relevant for empirical work in economics. We find significant size distortions (i.e., over-rejections of the null hypothesis) using standard kernel-based spatial correlation robust standard errors and standard normal critical values. Size is improved using a projection-based standard error (called SCPC) and critical value proposed in Müller and Watson (2022a). That said, the experiments find uncomfortably large size distortions for SCPC in some settings, particularly with non-stationary regressors. In this paper we propose a modification of the SCPC method (called C-SCPC), which is designed to induce validity also conditional on the sample values of the regressors. The results indicate that C-SCPC has good size control in a wide variety of empirically relevant settings.

The analysis has focused on inference for a single regression coefficient. Of course, kernel-based methods are readily extended to test vector-value regression coefficient coefficients. But, as in the scalar case, these kernel-based tests will exhibit significant size distortions when used with large-sample χ^2 critical values and applied to spatially correlated data of the sort studied here. The multivariate extension of SCPC is conceptually straightforward: principal components under a 'worst-case' benchmark spatial model can be used to estimate the relevant covariance matrix, and the critical value of the resulting test statistic can be constructed to guarantee coverage with spatial correlation less than or equal to the worst-case level. In practice, implementing such a test requires the non-trivial tasks of specifying the multivariate worst-case benchmark model and numerically

determining the critical value. The extension to C-SCPC is less clear-cut as it requires specifying an appropriate multivariate extension of the heteroskedastic model for e_l given in (7). We leave the multivariate extensions SCPC and C-SCPC to future work.

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Supplementary Materials

The supplementary materials include (1) a description of the World Developments Indicator dataset and additional simulation results referenced in Section 4 of the paper and (2) replication files for results reported in the paper.

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