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ABSTRACT

Despite the availability of more sophisticated methods, a popular way to estimate a Pareto exponent is still to run an OLS regression: log(Rank)=a-b log(Size), and take b as an estimate of the Pareto exponent. The reason for this popularity is arguably the simplicity and robustness of this method. Unfortunately, this procedure is strongly biased in small samples. We provide a simple practical remedy for this bias, and propose that, if one wants to use an OLS regression, one should use the Rank-1/2, and run log(Rank-1/2)=a-b log(Size). The shift of 1/2 is optimal, and reduces the bias to a leading order. The standard error on the Pareto exponent zeta is not the OLS standard error, but is asymptotically (2/n)^(1/2) zeta. Numerical results demonstrate the advantage of the proposed approach over the standard OLS estimation procedures and indicate that it performs well under dependent heavy-tailed processes exhibiting deviations from power laws. The estimation procedures considered are illustrated using an empirical application to Zipf's law for the U.S. city size distribution.

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1 Introduction

Last four decades have witnessed rapid expansion of the study of heavy-tailedness phenomena in economics and finance. Following the pioneering work by Mandelbrot (1960, 1963) (see also Fama, 1965, and the papers in Mandelbrot, 1997), numerous studies have documented that time series encountered in many fields in economics and finance are typically thick-tailed and can be well approximated using distributions with tails exhibiting the power law decline

$$P\Big(Z > s\Big) \sim Cs^{-\zeta}, \quad C, s > 0. \tag{1.1}$$

with a tail index $\zeta > 0$ (see the discussion in Gabaix, Gopikrishnan, Plerou and Stanley, 2003; Čížek, Härdle and Weron, 2005; Rachev, Menn and Fabozzi, 2005, and references therein). Here $f(s) \sim g(s)$ means that $f(s) = g(s)(1 + o(1))$ as $s \to \infty$. Throughout the paper, C denotes an absolute constant, not necessarily the same from one place to another. Let

$$Z_{(1)} \geq ... \geq Z_{(n)} \tag{1.2}$$

be decreasingly ordered observations from a population satisfying power law (1.1). Despite the availability of more sophisticated methods (see, among others, the reviews in Embrechts, Klüppelberg and Mikosch, 1997, and Beirlant, Goegebeur, Teugels and Segers, 2004), a popular way to estimate the Pareto exponent ζ is still to run the following OLS log-log rank-size regression with $\gamma = 0$:

$$\log\,(t - \gamma) = a - b \log\; Z_{(t)}, \tag{1.3}$$

or, in other words, calling t the rank of an observation, and $Z_{(t)}$ its size:

$$\log\,(\text{Rank} - \gamma) = a - b \log\,(\text{Size})$$

(here and throughout the paper, $\log(\cdot)$ stands for the natural logarithm).With N denoting the total number of observations, regression (1.3) with $\gamma = 0$ is motivated by the approximate linear relationships $\log\left(\frac{t}{N}\right) \approx \log(C) - \zeta \log\left(Z_{(t)}\right)$, $t = 1, ..., n$, implied by the empirical analogues of relations (1.1). The reason for popularity of the OLS approach to tail index estimation is arguably the simplicity and robustness of this method. In various frameworks, the log-log rank-size regressions of form (1.3) in the case $\gamma = 0$ and closely related procedures were employed, among other works, in Rosen and Resnick (1980), Alperovich (1989), Krugman (1996), Eaton and Eckstein (1997), Brakman, Garretsen, van den Berg and van Marrewijk (1999), Dobkins and Ioannides (2000), Davis and Weinstein (2002), Levy (2003), Levy and Levy (2003), Helpman, Melitz and Yeaple (2004), Soo (2005) and Klass, Biham, Levy, Malcai and Solomon (2006). Further examples and the discussion of the OLS approach to the tail index estimation are provided in Persky (1992), Gabaix et al. (2003), Eeckhout (2004), Gabaix and Ioannides (2004) and Rossi-Hansberg and Wright (2007).

Let $\hat{b}_n$ denote the usual OLS estimator of the tail index ζ using regression (1.3) with $\gamma = 0$ and let $\hat{b}_n^\gamma$ denote the OLS estimator of ζ in general regression (1.3).

It is known that the OLS estimator $\hat{b}_n$ in the usual regression (1.3) with $\gamma = 0$ is consistent for ζ. However, the standard OLS procedure has an important bias. This paper shows that the bias is reduced (up to leading order terms) with $\gamma = 1/2$. Hence, we propose that always, if one uses a log-log regression, one should use $\log(\text{Rank} - 1/2)$ rather than $\log(\text{Rank})$.

We further show that the standard error of the OLS estimator $\hat{b}_n^\gamma$ of the tail index ζ in general regression (1.3) is asymptotically $(2/n)^{1/2}\zeta$. The OLS standard errors in log-log rank-size regressions (1.3) considerably underestimate the true standard deviations of the OLS tail index estimators. Consequently, taking the OLS estimates of the standard errors at the face value will lead one to reject the true numerical value of the tail index too often.

The 1/2 shift actually comes from a more systematic result, in Theorem 1, which shows that it is optimal and further demonstrates that the following asymptotic expansion holds for the general OLS estimator $\hat{b}_n^\gamma$:

$$\hat{b}_n^\gamma/\zeta = 1 + \sqrt{\frac{2}{n}}\mathcal{N}(0,1) + \frac{(\log n)^2\,(2\gamma-1)}{4n} + o_P\Big(\frac{\log^2 n}{n}\Big)$$

(here and throughout the paper, $\mathcal{N}(0,1)$ stands for a standard normal random variable (r.v.)). We conclude that, for estimation of the tail index ζ with an OLS regression, one should always use the regression $\log(\text{Rank} - 1/2) = a - b\log(\text{Size})$, with the standard error of the OLS estimator $\hat{b}_n$ of the slope given by $\sqrt{\frac{2}{n}}\hat{b}_n$.

We further provide similar asymptotic expansions for the tail index estimator $\hat{d}_n^\gamma$ in the dual to (1.3) regression

$$\log(Z_{(t)}) = c - d\log(t-\gamma) \tag{1.4}$$

(that is, $\log(\text{Size}) = c - d\log(\text{Rank} - \gamma)$), with logarithms of ordered sizes regressed on logarithms of shifted ranks. As follows from Theorem 1, the approaches to the tail index inference using regressions (1.3) and (1.4) are equivalent in terms of the small sample biases and standard errors of the estimators. The paper also discusses asymptotic expansions in the analogues of regressions (1.3) and (1.4) with the logarithms of shifted ranks $\log(t-\gamma)$ replaced by harmonic numbers (Section 3).

Numerical results indicate that the proposed tail index estimation procedures perform well for heavy-tailed dependent processes exhibiting deviations from power law distributions (1.1) (see Section 4). They further demonstrate the advantage of the new approaches over the standard OLS log-log rank-size regressions (1.3) and (1.4) with $\gamma = 0$.

The tail index estimation methods proposed in the paper are illustrated using an empirical analysis of Zipf's power law for the U.S. city size distribution (Section 5).

In recent years, several studies have focused on the analysis of normality of the OLS tail index estimators in regressions (1.4) with $\gamma = 0$ and logarithms of ordered observations $\log(Z_{(t)})$ regressed on logarithms of ranks (see, among other works, the review in Ch. 4 in

Beirlant et al., 2004). Such approach to estimation of the tail shape parameters was introduced by Kratz and Resnick (1996) who refer to it as QQ-estimator. Nishiyama, Osada and Sato (2007) discuss asymptotic normality of the OLS tail index estimator in the regression of $\log(Z_{(t)})$ on $\log\ t$. Schultze and Steinebach (1999) consider closely related problems of least-squares approaches to estimation for data with exponential tails (see also Aban and Meerschaert, 2004, who discuss efficient OLS estimation of parameters in shifted and scaled exponential models). Kratz and Resnick (1996) establish consistency and asymptotic normality of the QQ-estimator in the case of populations with regularly varying tails. Their results demonstrate that in the case of populations in the domain of attraction of power law (1.1), the standard error of the QQ-estimator of the inverse $1/\zeta$ of the tail index based on n largest observations is asymptotically $\sqrt{2}/(\zeta\sqrt{n})$. Csörgő and Viharos (1997) prove asymptotic normality of the OLS estimators of the tail index in the case $\gamma = 0$ (see also Viharos, 1999; Csörgő and Viharos, 2006). Beirlant, Dierckx, Goegebeur and Matthys (1999) and Aban and Meerschaert (2004) indicate the possibility of modification of the QQ-estimator in which logarithms of ordered observations $\log(Z_{(t)})$ regressed on $\log(t - 1/2)$. Aban and Meerschaert (2004) mention in a remark without providing a proof that regressing logarithms of observations from a heavy-tailed population on logarithms of their ranks shifted by 1/2 reduces the bias of the QQ-estimator. Their remark seems to be motivated by simulations, not by the systematic understanding that Theorem 1 provides; in particular, they do not indicate that a shift of 1/2 is the best shift.

To our knowledge, general regressions (1.3) and (1.4) with $\gamma \neq 0$ and asymptotic expansions for them are considered, for the first time, in the present work. The modifications of the OLS log-log rank-size regressions with the optimal shift $\gamma = 1/2$ and the correct standard errors provided in this paper were subsequently used in the works by Hinloopen and van Marrewijk (2006) and Bosker, Brakman, Garretsen, de Jong and Schramm (2007).

2 Formal statement of the results

Throughout the paper, for variables $a_1, ..., a_n$, $\overline{a}_n$ stands for the sample mean $\overline{a}_n = \frac{1}{n}\sum_{t=1}^{n} a_t$.

Let $Z_{(1)} \geq Z_{(2)} \geq ... \geq Z_{(n)}$ be the order statistics for a sample from the population with the distribution satisfying the power law

$$P(Z > s) = \frac{1}{s^{\zeta}},\ s \geq 1, \zeta > 0. \tag{2.5}$$

Denote $y_t = \log(t - \gamma)$ and $x_t = \log(Z_{(t)})$. Let us consider the OLS estimator $\hat{b}_n^{\gamma}$ of the slope parameter b in log-log rank-size regression (1.3) with $\gamma < 1$ and logarithms of ordered observations regressed on logarithms of shifted ranks:

$$\hat{b}_n^{\gamma} = -\frac{\sum_{t=1}^{n}(x_t - \overline{x}_n)(y_t - \overline{y}_n)}{\sum_{t=1}^{n}(x_t - \overline{x}_n)^2} = -\frac{A_n^{\gamma}}{B_n}. \tag{2.6}$$

We will also consider the OLS estimator $\hat{d}_n^{\gamma}$ of slope in dual to (1.3) regression (1.4) with logarithms of ordered sizes regressed on logarithms of shifted ranks:

$$\hat{d}_n^{\gamma} = -\frac{\sum_{t=1}^{n}(x_t - \overline{x}_n)(y_t - \overline{y}_n)}{\sum_{t=1}^{n}(y_t - \overline{y}_n)^2} = -\frac{A_n^{\gamma}}{D_n}. \tag{2.7}$$

The following theorem provides the main result of the paper.

Theorem 1 *For any $\gamma < 1$, the following expansions hold:*

$$\hat{b}_n^{\gamma}/\zeta = 1 + \sqrt{\frac{2}{n}}\mathcal{N}(0,1) + \frac{(\log n)^2\,(2\gamma - 1)}{4n} + o_P\Big(\frac{\log^2 n}{n}\Big), \tag{2.8}$$

$$\zeta\hat{d}_n^{\gamma} = 1 + \sqrt{\frac{2}{n}}\mathcal{N}(0,1) + \frac{(\log n)^2\,(1 - 2\gamma)}{4n} + o_P\Big(\frac{\log^2 n}{n}\Big). \tag{2.9}$$

The arguments for Theorem 1 are presented in the appendix.

Remark 1 *As follows from asymptotic expansions (2.8) and (2.9), the small sample biases of the OLS estimators $\hat{b}_n^{\gamma}$ and $\hat{d}_n^{\gamma}$ in regressions (1.3) and (1.4) involving logarithms of shifted ranks are both minimized under the choice $\gamma = 1/2$.*

Remark 2 *The proof of Theorem 1 implies that the order of the error terms in asymptotic expansions (2.8) and (2.9) is, in fact,* $O_P\big(\frac{(\log n)^{3/2}}{n}\big)$.

The proof of Theorem 1 is based on the following results and methods. First, it exploits the Rényi representation theorem to relate the order statistics for observations following power law 1.1 to the partial sums of scaled i.i.d. exponential r.v.'s (see the beginning of Step 3 in the proof). Then, we use martingale approximations to the bilinear that appear in the numerators of the statistics $\hat{b}_n^\gamma/\zeta - 1 = -(A_n^\gamma + \zeta B_n)/(\zeta B_n)$ and $\zeta \hat{d}_n^\gamma - 1 = -(\zeta A_n^\gamma + D_n)/D_n$ (relation (7.42) in Step 3 of the proof and relation (7.53) in Step 5 of the proof). Third, the arguments use strong approximations to partial sums of independent r.v.'s provided by relation (7.47) in Step 3 of the proof.

3 A related approach based on harmonic numbers

For $t \geq 1$, denote by $H(t)$ the $t-$th harmonic number: $H(t) = \sum_{i=1}^{t} \frac{1}{i}$. Further, let $H(0) = 0$. Consider the analogues of regressions (1.3) and (1.4) that involve logarithms of ordered sizes $y_t = \log(Z_{(t)})$ and the functions $\tilde{x}_t = H(t-1)$ of ranks of observations:

$$H(t-1) = a' - b' \log(Z_{(t)}). \tag{3.10}$$

$$\log(Z_{(t)}) = c' - d' H(t-1); \tag{3.11}$$

Similar to the proof of Theorem 1, one can show that the following asymptotic expansions hold for the tail index estimators $\hat{b}_n'$ and $\hat{d}_n'$ using regressions (3.10) and (3.11):

$$\hat{b}_n'/\zeta = 1 + \sqrt{\frac{2}{n}}\mathcal{N}(0,1) + O_P\Big(\frac{\log n}{n}\Big); \tag{3.12}$$

$$\zeta \hat{d}_n' = 1 + \sqrt{\frac{2}{n}}\mathcal{N}(0,1) + O_P\Big(\frac{\log n}{n}\Big). \tag{3.13}$$

Comparison of expansions (3.12) and (3.13) with (2.8) and (2.9) shows that, *ceteris paribus*, tail index estimation using regressions involving harmonic numbers is to be preferred, in terms of the small sample bias, to that based on the logarithms of shifted ranks $\log(t-\gamma)$ for any γ. On the other hand, regressions (1.3) and (1.4) are simpler to implement and more visual than estimation procedures based on (3.12) and (3.13). In particular, we are not aware of works that employed estimation approaches based on harmonic numbers similar to (3.12) and (3.13), while regressions (1.3) and (1.4) with $\gamma = 0$ are commonly used, as discussed in the introduction. Comparison of the asymptotic expansions for the tail index estimators using regressions (3.10) and (3.11) with the OLS tail parameter estimators in log-log rank-size regressions (1.3) and (1.4) also sheds light on the main driving force behind the small bias improvements using logarithms of shifted ranks $\log(Rank - 1/2)$. This driving force is, essentially, the fact that $\log(n-1/2)$ provides better approximation to the harmonic numbers $H(n-1)$ than does $\log(n)$ and, more generally, than $\log(n-\gamma)$, $\gamma < 1$. This is because (see Havil, 2003, pp. 73-79) $H(n-1) = C + \ln(n-\gamma) + (\gamma - 1/2)n^{-1} + O(n^{-2})$ as $n \to \infty$, where $C = \lim_{n\to\infty}(H(n) - \ln n)$ is Euler's constant, so the optimal choice of the shift γ in the sense of the best asymptotical approximation is 1/2.

4 Simulation results

In this section, we present simulation results on the performance of the traditional regression (1.3) with $\gamma = 0$ and the modified regression (1.3) with the optimal shift $\gamma = 1/2$ and the correct standard errors given by Theorem 1. We present the numerical results for the OLS Pareto exponent estimation procedures under dependence and under deviations from power laws (1.1). The results are provided for dependent heavy-tailed data that follow AR(1) processes $Z_t = \rho Z_{t-1} + u_t$, $t \geq 1$, $Z_0 = 0$, or MA(1) processes $Z_t = u_t + \theta u_{t-1}$, $t \geq 1$, with i.i.d. u_t's. The departures from power laws are modeled using the innovations u_t that have

Student t distributions with the number of degree of freedom $m = 2, 3, 4$ (Tables 2 and 4) or distributions exhibiting 2nd order deviations from Pareto tails in the Hall (1982) form

$$P(u > s) = s^{-\zeta}\left(1 + c(s^{-\alpha\zeta} - 1)\right), c \in [0, 1), s \geq 1, \tag{4.14}$$

(Tables 1 and 3). The choice of the number of degrees of freedom for Student t distributions is motivated by the recent empirical works on heavy-tailedness that indicate that, for many economic and financial time series, the tail index ζ lies in the interval $(2, 4)$ (see Loretan and Phillips, 1994 and Gabaix et al., 2003). The benchmark case $c = 0$ in (4.14) corresponds to the exact Pareto distributions (2.5), and the values $\rho = 0$ and $\theta = 0$ model i.i.d. observations Z_t. Similar to deviations of γ from 1/2 in (2.8) and (2.9), the term $c\left(s^{-\alpha\zeta} - 1\right)$ modeling the departures from the power laws in (4.14) creates a bias in the estimators $\hat{b}_n^\gamma$ and $\hat{d}_n^\gamma$ in regressions (1.3) and (1.4).

Tables 5-8 in the technical appendix available on our websites present simulation results for GARCH processes and for tail index estimators using harmonic numbers discussed in Section 3.

Tables 1 and 2 present the simulation results for the traditional OLS estimator $\hat{b}_n$ of the tail index using regression (1.3) with $\gamma = 0$. These tables also provide the comparisons of the OLS standard errors of the estimator with its true standard deviation. Tables 3 and 4 present the numerical results on the performance of the OLS estimator $\hat{b}_n^\gamma$ using modified regression (1.3) with $\gamma = 1/2$. In Tables 3 and 4, we also present the standard errors of $\hat{b}_n^\gamma$ with $\gamma = 1/2$ provided by expansion (2.8) and compare them to the true standard deviation of the estimator. The asterics in the tables indicate rejection of the true null hypothesis on the tail index $H_0 : \zeta = \zeta_0$ in favor of the alternative hypothesis $H_a : \zeta \neq \zeta_0$ at the 5% significance level using the reported standard errors.

For instance, consider the class of exact Pareto i.i.d. observations, which is the first row in Table 1 and Table 3, with $n = 50$ extreme observations included in estimation. Table 1

Table 1. Behavior of the usual OLS estimator $\hat{b}_n$ in the regression $\log(\text{Rank}) = a - b\log(\text{Size})$ for innovations deviating from power laws

	n	50	100	200	500
AR(1)		Mean $\hat{b}_n$ (OLS s.e) (SD $\hat{b}_n$)			
c	ρ				
0	0	0.924* (0.024) (0.185)	0.944* (0.014) (0.134)	0.961* (0.008) (0.098)	0.978* (0.004) (0.063)
0	0.5	1.082* (0.021) (0.296)	1.069* (0.012) (0.244)	1.073* (0.007) (0.195)	1.102* (0.004) (0.145)
0	0.8	1.373* (0.034) (0.520)	1.271* (0.019) (0.417)	1.235* (0.011) (0.343)	1.235* (0.006) (0.268)
0.5	0	0.925* (0.024) (0.181)	0.942* (0.014) (0.132)	0.960* (0.008) (0.098)	0.978* (0.004) (0.063)
0.5	0.5	1.082* (0.020) (0.301)	1.067* (0.012) (0.244)	1.074* (0.007) (0.194)	1.104* (0.004) (0.146)
0.5	0.8	1.379* (0.034) (0.512)	1.276* (0.019) (0.412)	1.226* (0.011) (0.343)	1.238* (0.006) (0.266)
0.8	0	0.925* (0.024) (0.186)	0.945* (0.014) (0.134)	0.960* (0.008) (0.097)	0.978* (0.004) (0.063)
0.8	0.5	1.084* (0.020) (0.297)	1.067* (0.012) (0.239)	1.069* (0.007) (0.195)	1.101* (0.004) (0.145)
0.8	0.8	1.378* (0.034) (0.520)	1.270* (0.019) (0.413)	1.227* (0.011) (0.342)	1.238* (0.006) (0.265)
MA(1)		Mean $\hat{b}_n$ (OLS s.e) (SD $\hat{b}_n$)			
c	θ				
0	0.5	0.988 (0.024) (0.261)	0.993 (0.014) (0.193)	1.003 (0.009) (0.142)	1.032* (0.004) (0.094)
0	0.8	0.989 (0.030) (0.275)	0.994 (0.017) (0.198)	1.011 (0.010) (0.146)	1.034* (0.005) (0.098)
0.5	0	0.926* (0.024) (0.182)	0.942* (0.014) (0.133)	0.961* (0.008) (0.099)	0.977* (0.004) (0.063)
0.5	0.5	0.988 (0.024) (0.259)	0.992 (0.014) (0.193)	1.007 (0.009) (0.142)	1.032* (0.004) (0.095)
0.5	0.8	0.988 (0.030) (0.274)	0.992 (0.017) (0.196)	1.005 (0.010) (0.145)	1.034* (0.005) (0.098)
0.8	0	0.925* (0.024) (0.184)	0.944* (0.014) (0.134)	0.960* (0.008) (0.095)	0.978* (0.004) (0.062)
0.8	0.5	0.991 (0.024) (0.258)	0.993 (0.014) (0.192)	1.005 (0.009) (0.140)	1.030* (0.004) (0.095)
0.8	0.8	0.990 (0.030) (0.276)	0.991 (0.017) (0.198)	1.006 (0.010) (0.145)	1.033* (0.005) (0.098)

Notes: The entries are the estimates of the tail index and their standard errors using regression (1.3) with $\gamma = 0$ for the AR(1) and MA(1) processes $Z_t = \rho Z_{t-1} + u_t$, $t \geq 1$, $Z_0 = 0$, and $Z_t = u_t + \theta u_{t-1}$, where i.i.d. u_t follow the distribution $P(u > s) = s^{-\zeta}\left(1 + c(s^{-\alpha\zeta} - 1)\right)$, $s \geq 1$, with $\zeta = \alpha = 1$ and $c \in [0, 1)$. For a general case $\zeta > 0$, one multiplies all the numbers in the table by ζ. "Mean $\hat{b}_n$" is the sample mean of the estimates $\hat{b}_n$ obtained in simulations, and "SD $\hat{b}_n$" is their sample standard deviation. "OLS s.e." is the OLS standard error in regression (1.3) with $\gamma = 0$. The asteric indicates rejection of the true null hypothesis $H_0 : \zeta = 1$ in favor of the alternative hypothesis $H_a : \zeta \neq 1$ at the 5% significance level using the reported OLS standard errors. The total number of observations $N = 2000$. Based on 10000 replications.

Table 2. Behavior of the usual OLS estimator $\hat{b}_n$ in the regression $\log(\text{Rank}) = a - b\log(\text{Size})$ for Student t innovations

	n	50	100	200	500
AR(1)		Mean $\hat{b}_n$			
m	ρ	(OLS s.e) (SD $\hat{b}_n$)			
2	0	1.810* (0.045) (0.349)	1.809* (0.026) (0.245)	1.768* (0.014) (0.160)	1.524* (0.010) (0.073)
2	0.5	1.993 (0.042) (0.454)	1.986 (0.024) (0.351)	1.932* (0.014) (0.247)	1.647* (0.011) (0.115)
2	0.8	2.433* (0.053) (0.787)	2.334* (0.031) (0.608)	2.199* (0.019) (0.429)	1.796* (0.015) (0.197)
3	0	2.560* (0.063) (0.473)	2.503* (0.036) (0.312)	2.342* (0.021) (0.192)	1.838* (0.016) (0.079)
3	0.5	2.852* (0.065) (0.589)	2.777* (0.037) (0.414)	2.597* (0.022) (0.262)	1.992* (0.019) (0.107)
3	0.8	3.632* (0.084) (1.021)	3.400* (0.049) (0.722)	3.044 (0.032) (0.448)	2.179* (0.024) (0.186)
4	0	3.151* (0.078) (0.546)	3.002* (0.043) (0.350)	2.729* (0.027) (0.205)	2.017* (0.021) (0.083)
4	0.5	3.523* (0.083) (0.661)	3.358* (0.047) (0.443)	3.024* (0.030) (0.259)	2.162* (0.024) (0.110)
4	0.8	4.546* (0.112) (1.101)	4.096 (0.065) (0.700)	3.516* (0.043) (0.417)	2.334* (0.030) (0.185)
MA(1)		Mean $\hat{b}_n$			
m	θ	(OLS s.e) (SD $\hat{b}_n$)			
2	0.5	1.927 (0.044) (0.446)	1.927* (0.025) (0.325)	1.869* (0.015) (0.220)	1.602* (0.011) (0.097)
2	0.8	1.978 (0.054) (0.524)	1.951 (0.031) (0.368)	1.894* (0.018) (0.242)	1.617* (0.012) (0.104)
3	0.5	2.774* (0.064) (0.569)	2.697* (0.036) (0.400)	2.519* (0.022) (0.245)	1.944* (0.018) (0.099)
3	0.8	2.916 (0.075) (0.707)	2.792* (0.042) (0.464)	2.587* (0.025) (0.283)	1.974* (0.019) (0.106)
4	0.5	3.430* (0.082) (0.649)	3.253* (0.045) (0.428)	2.944* (0.029) (0.244)	2.122* (0.023) (0.099)
4	0.8	3.649* (0.092) (0.790)	3.419* (0.052) (0.510)	3.035* (0.033) (0.287)	2.159* (0.025) (0.106)

Notes: The entries are estimates of the tail index and their standard errors using regression (1.3) with $\gamma = 0$ for the AR(1) and MA(1) processes $Z_t = \rho Z_{t-1} + u_t$, $t \geq 1$, $Z_0 = 0$, and $Z_t = u_t + \theta u_{t-1}$, where i.i.d. u_t have the Student t distribution with m degrees of freedom. "Mean $\hat{b}_n$" is the sample mean of the estimates $\hat{b}_n$ obtained in simulations, and "SD $\hat{b}_n$" is their sample standard deviation. "OLS s.e." is the OLS standard error in regression (1.3) with $\gamma = 0$. The asteric indicates rejection of the true null hypothesis on the tail index ζ of Z_t $H_0 : \zeta = m$ in favor of the alternative hypothesis $H_a : \zeta \neq m$ at the 5% significance level using the reported OLS standard errors. The total number of observations $N = 2000$. Based on 10000 replications.

Table 3. Behavior of the OLS estimator $\hat{b}_n^{\gamma}$ with $\gamma = 1/2$ in the regression $\log(\text{Rank} - 1/2) = a - b\log(\text{Size})$ for innovations deviating from power laws

	n	50	100	200	500
AR(1)		Mean $\hat{b}_n^{\gamma=1/2}$			
c	ρ	($\sqrt{2/n}\times$Mean $\hat{b}_n^{\gamma=1/2}$) (SD $\hat{b}_n^{\gamma=1/2}$)			
0	0	1.011 (0.202) (0.199)	1.001 (0.142) (0.139)	0.998 (0.100) (0.100)	0.998 (0.063) (0.063)
0	0.5	1.179 (0.236) (0.320)	1.131 (0.160) (0.257)	1.112 (0.111) (0.201)	1.124 (0.071) (0.147)
0	0.8	1.487 (0.297) (0.564)	1.340 (0.189) (0.439)	1.277* (0.128) (0.354)	1.258* (0.080) (0.272)
0.5	0	1.013 (0.203) (0.194)	0.999 (0.141) (0.137)	0.997 (0.100) (0.101)	0.998 (0.063) (0.064)
0.5	0.5	1.179 (0.236) (0.326)	1.129 (0.160) (0.257)	1.113 (0.111) (0.200)	1.127 (0.071) (0.147)
0.5	0.8	1.494 (0.299) (0.555)	1.344 (0.190) (0.434)	1.268* (0.127) (0.354)	1.262* (0.080) (0.270)
0.8	0	1.013 (0.203) (0.200)	1.003 (0.142) (0.139)	0.997 (0.100) (0.099)	0.998 (0.063) (0.063)
0.8	0.5	1.181 (0.236) (0.322)	1.129 (0.160) (0.251)	1.109 (0.111) (0.201)	1.123 (0.071) (0.147)
0.8	0.8	1.493 (0.299) (0.565)	1.338 (0.189) (0.435)	1.269* (0.127) (0.353)	1.262* (0.080) (0.269)
MA(1)		Mean $\hat{b}_n^{\gamma=1/2}$			
c	θ	($\sqrt{2/n}\times$Mean $\hat{b}_n^{\gamma=1/2}$) (SD $\hat{b}_n^{\gamma=1/2}$)			
0	0.5	1.078 (0.216) (0.281)	1.052 (0.149) (0.202)	1.041 (0.104) (0.146)	1.053 (0.067) (0.095)
0	0.8	1.078 (0.216) (0.296)	1.052 (0.149) (0.207)	1.049 (0.105) (0.149)	1.054 (0.067) (0.099)
0.5	0	1.014 (0.203) (0.195)	1.000 (0.141) (0.138)	0.999 (0.100) (0.101)	0.998 (0.063) (0.064)
0.5	0.5	1.078 (0.216) (0.279)	1.051 (0.149) (0.202)	1.046 (0.105) (0.146)	1.053 (0.067) (0.096)
0.5	0.8	1.076 (0.215) (0.295)	1.050 (0.148) (0.205)	1.043 (0.104) (0.149)	1.055 (0.067) (0.099)
0.8	0	1.013 (0.203) (0.198)	1.002 (0.142) (0.140)	0.998 (0.100) (0.098)	0.998 (0.063) (0.063)
0.8	0.5	1.081 (0.216) (0.277)	1.052 (0.149) (0.201)	1.043 (0.104) (0.144)	1.051 (0.066) (0.096)
0.8	0.8	1.079 (0.216) (0.297)	1.049 (0.148) (0.207)	1.044 (0.104) (0.149)	1.054 (0.067) (0.099)

Notes: The entries are estimates of the tail index and their standard errors using regression (1.3) with $\gamma = 1/2$ for the AR(1) and MA(1) processes $Z_t = \rho Z_{t-1} + u_t$, $t \geq 1$, $Z_0 = 0$, and $Z_t = u_t + \theta u_{t-1}$, where i.i.d. u_t follow the distribution $P(Z > s) = s^{-\zeta}\left(1 + c(s^{-\alpha\zeta} - 1)\right)$, $s \geq 1$, with $\zeta = \alpha = 1$ and $c \in [0, 1)$. For a general case $\zeta > 0$, one multiplies all the numbers in the table by ζ. "Mean $\hat{b}_n^{\gamma=1/2}$" is the sample mean of the estimates $\hat{b}_n^{\gamma}$ with $\gamma = 1/2$ obtained in simulations, and "SD $\hat{b}_n^{\gamma=1/2}$" is their sample standard deviation. The values $\sqrt{2/n}\times$Mean $\hat{b}_n^{\gamma=1/2}$ are the standard errors of $\hat{b}_n^{\gamma}$ with $\gamma = 1/2$ provided by Theorem 1. The asteric indicates rejection of the true null hypothesis $H_0 : \zeta = 1$ in favor of the alternative hypothesis $H_a : \zeta \neq 1$ at the 5% significance level using the reported standard errors. The total number of observations $N = 2000$. Based on 10000 replications.

Table 4. Behavior of the OLS estimator $\hat{b}_n^{\gamma}$ with $\gamma = 1/2$
in the regression $\log(\text{Rank} - 1/2) = a - b \log(\text{Size})$ for Student t innovations

	n	50	100	200	500
AR(1)		Mean $\hat{b}_n^{\gamma=1/2}$			
m	ρ	($\sqrt{2/n}\times$Mean $\hat{b}_n^{\gamma=1/2}$) (True s.e.)			
2	0	1.981 (0.396) (0.374)	1.918 (0.271) (0.255)	1.834 (0.183) (0.164)	1.552* (0.098) (0.074)
2	0.5	2.178 (0.436) (0.489)	2.104 (0.297) (0.367)	2.004 (0.200) (0.253)	1.678* (0.106) (0.116)
2	0.8	2.647 (0.529) (0.854)	2.465 (0.349) (0.639)	2.277 (0.228) (0.442)	1.827 (0.116) (0.200)
3	0	2.798 (0.560) (0.507)	2.651 (0.375) (0.325)	2.427* (0.243) (0.196)	1.870* (0.118) (0.080)
3	0.5	3.118 (0.624) (0.633)	2.941 (0.416) (0.431)	2.691 (0.269) (0.268)	2.026* (0.128) (0.108)
3	0.8	3.956 (0.791) (1.104)	3.592 (0.508) (0.756)	3.149 (0.315) (0.459)	2.215* (0.140) (0.189)
4	0	3.442 (0.688) (0.585)	3.177 (0.449) (0.364)	2.825* (0.282) (0.210)	2.051* (0.130) (0.084)
4	0.5	3.848 (0.770) (0.710)	3.553 (0.502) (0.461)	3.130* (0.313) (0.265)	2.198* (0.139) (0.112)
4	0.8	4.950 (0.990) (1.188)	4.323 (0.611) (0.732)	3.634 (0.363) (0.427)	2.370* (0.150) (0.188)
MA(1)		Mean $\hat{b}_n^{\gamma=1/2}$			
m	θ	($\sqrt{2/n}\times$Mean $\hat{b}_n^{\gamma=1/2}$) (True s.e.)			
2	0.5	2.106 (0.421) (0.480)	2.042 (0.289) (0.339)	1.939 (0.194) (0.225)	1.632* (0.103) (0.098)
2	0.8	2.157 (0.431) (0.564)	2.065 (0.292) (0.384)	1.963 (0.196) (0.248)	1.647* (0.104) (0.105)
3	0.5	3.032 (0.606) (0.612)	2.856 (0.404) (0.417)	2.610 (0.261) (0.251)	1.978* (0.125) (0.100)
3	0.8	3.180 (0.636) (0.761)	2.953 (0.418) (0.483)	2.679 (0.268) (0.289)	2.008* (0.127) (0.107)
4	0.5	3.747 (0.749) (0.697)	3.441 (0.487) (0.446)	3.048* (0.305) (0.249)	2.157* (0.136) (0.100)
4	0.8	3.977 (0.795) (0.849)	3.613 (0.511) (0.531)	3.140* (0.314) (0.293)	2.194* (0.139) (0.108)

Notes: The entries are estimates of the tail index and their standard errors using regression (1.3) with $\gamma = 1/2$ for the AR(1) and MA(1) processes $Z_t = \rho Z_{t-1} + u_t$, $t \geq 1$, $Z_0 = 0$, and $Z_t = u_t + \theta u_{t-1}$, where i.i.d. u_t have the Student t distribution with m degrees of freedom. For a general case $\zeta > 0$, one multiplies all the numbers in the table by ζ. "Mean $\hat{b}_n^{\gamma=1/2}$" is the sample mean of the estimates $\hat{b}_n^{\gamma}$ with $\gamma = 1/2$ obtained in simulations, and "SD $\hat{b}_n^{\gamma=1/2}$" is their sample standard deviation. The values $\sqrt{2/n}\times$Mean $\hat{b}_n^{\gamma=1/2}$ are the standard errors of $\hat{b}_n^{\gamma}$ with $\gamma = 1/2$ provided by Theorem 1. The asteric indicates rejection of the true null hypothesis on the tail index ζ of Z_t $H_0 : \zeta = m$ in favor of the alternative hypothesis $H_a : \zeta \neq m$ at the 5% significance level using the reported standard errors. The total number of observations $N = 2000$. Based on 10000 replications.

(column $n = 50$, the first row) shows that the traditional OLS estimator using regression (1.3) with $\gamma = 0$ yields an average of 0.924 (whereas the true tail index is 1), and the OLS standard error is 0.024, very far from the true standard deviation, 0.185. By contrast, the OLS estimator using regression (1.3) with $\gamma = 1/2$ proposed in this paper (Table 3, column $n = 50$, the first row) and expansion (2.8) yield an average estimate of 1.011, and the standard error of 0.202, very close to the true standard deviation, 0.199.

More generally, the OLS estimates $\hat{b}_n$ of Pareto exponents ζ using traditional regression (1.3) with $\gamma = 0$ reported in Tables 1 and 2 are significantly different from the true tail indices, which means that $\hat{b}_n$ is biased in small samples. According to the same tables, the OLS standard errors in regression (1.3) with $\gamma = 0$ are consistently smaller than the true standard deviations. In most of the numerical results presented in the tables, the true null hypothesis on the tail index $H_0 : \zeta = \zeta_0$ is rejected in favor of the alternative hypothesis $H_a : \zeta \neq \zeta_0$ at the 5% significance level using the OLS standard errors.

In most of the entries in Tables 3 and 4, including dependence and deviations from power tail distributions, the standard errors in the regression with shifts $\gamma = 1/2$ are much closer to the true standard deviations than in the case of the OLS standard errors reported in Tables 1 and 2. Comparing to the traditional regression in Tables 1 and 2, the approach illustrated by Tables 3 and 4 rejects the true null hypothesis on the tail index $H_0 : \zeta = \zeta_0$ significantly less often.

The numerical results reported in Tables 5 and 6 in the technical appendix indicate that the modified OLS approach to the tail index estimation using regression (1.3) with $\gamma = 1/2$ also performs well in the case of GARCH(1, 1) processes, including IGARCH(1, 1) time series that have the GARCH coefficient (the coefficient at the lagged conditional variance) not too close to 1. For such processes, it also dominates, similar to the simulations discussed in this section, the traditional procedure based on regressions (1.3) with $\gamma = 0$. The OLS tail index estimation approach may be combined with GARCH filters (see, among others, Subsection 3.3 in Prigent 2003) to make inference on Pareto exponents under dependence and heavy-tailedness beyond those implied by conditional heteroskedasticity.

The comparison of Tables 3 and 4 with Tables 7 and 8 in the technical appendix shows that the performance of and the numerical results for the tail index estimator using harmonic numbers and regression (3.10) are very similar to those for the OLS estimator in regression (1.3) with the optimal shift $\gamma = 1/2$. All in all, the shifted OLS regression may be preferable, because it is arguably a more transparent and easier to use.

5 An empirical application: Zipf's law for cities

As an example, we study the distribution of city populations. This example is, historically, the first economic example of Zipf's law (Zipf, 1949). Helped by the relatively good availability of city size data, it has spawned a vast empirical and theoretical literature, surveyed by Gabaix and Ioannides (2004). As a U.S. example, we take, like Krugman (1996) and Gabaix (1999), all 135 American metropolitan areas listed in the Statistical Abstract of the United States in the year 1991, which includes all agglomerations with size above 250,000 inhabitants. The advantage is that "metropolitan area" represents the agglomeration of the cities (e.g., the metropolitan area of Boston includes Cambrige), which is commonly viewed as the correct economic definition.

We rank cities from largest (rank 1) to smallest (rank $n = 135$), and denote their sizes $S_{(1)} \geq ... \geq S_{(n)}$.

Regression (1.3) with $\gamma = 1/2$ estimated for the data is

$$\log\,(t - 0.5) = 10.846 - \underset{(0.128)}{1.050}\;\log\;S_{(t)}.$$

The number in the bracket is the standard error for the tail index (the slope coefficient $\hat{b}_n^{\gamma}$) given by $\sqrt{\frac{2}{n}}\hat{b}_n$ by Theorem 1.

Regression (1.4) with $\gamma = 1/2$ estimated for the data is

$$\log\ S_{(t)} = 10.244 - 0.930\ \log\left(t - 0.5\right),$$

producing the estimate of the tail index equal to $1/\hat{d}_n^{\gamma} \approx 1.075$ with the standard error given by $\sqrt{\frac{2}{n}}\frac{1}{\hat{d}_n} \approx 0.131$ by Theorem 1. The estimates of the tail index are not statistically different from 1 at the 10% significance level, so that Zipf's law for cities is confirmed in this dataset.

6 Conclusion and suggestions for future research

The OLS log-log rank-size regression $\log(\text{Rank}) = a - b\log(\text{Size})$ and related procedures are some of the most popular approaches to Pareto exponent estimation, with b taken as an estimate of the tail index. Unfortunately, these procedures are strongly biased in small samples. We provide a simple approach to bias reduction based on the modified log-log rank-size regression $\log(\text{Rank} - 1/2) = a - b\log(\text{Size})$. The shift of $1/2$ is optimal and reduces the bias to a leading order. We further show that the standard error on the Pareto exponent ζ in the above procedure is asymptotically $(2/n)^{1/2}\zeta$, and obtain similar results for the regression $\log(\text{Size}) = c - d\log(\text{Rank} - 1/2)$. The proposed estimation procedures are illustrated using an empirical analysis of the U.S. city size distribution. Simulation results indicate that the proposed tail index estimation procedures perform well under dependence and deviations from power law distributions. They further demonstrate the advantage of the new methods over the standard OLS log-log rank-size regressions.

An important open problem concerns asymptotic expansions for the OLS tail index estimators for dependent processes, including the autocorrelated time series considered in simulations. Combining the modified OLS estimation approach with block-bootstrap may be useful in developing Pareto exponent estimation procedures under dependence. In addition, unreported preliminary results suggest that the OLS approaches to Pareto exponent estimation are more robust than Hill's estimator of a tail index under deviations from power laws. Other important problems include the analysis of the optimal choice of the number n of extreme observations used in estimation and the study of the asymptotic bias of the OLS estimators when n is determined by minimizing the asymptotic mean square error. Analysis of these issues and comparisons of the OLS tail index estimators with other procedures are left for further research.

7 Appendix. Proof of Theorem 1

Let Z_t follow distribution (2.5), and let $Z'_t = Z_t^{\zeta}$. As in (1.2), denote by $Z'_{(1)} \geq ... \geq Z'_{(n)}$ decreasingly ordered variables Z'_t. We have $P(Z'_t > s) = P(Z_t > s^{1/\zeta}) = 1/s$, $s \geq 1$. Consequently, Z'_t follow distribution (2.5) with $\zeta = 1$. Evidently, for the logarithms of ordered observations $x_t = \log(Z_{(t)})$ and $x'_t = \log(Z'_{(t)})$ one has $x_t = x'_t/\zeta$. Therefore, we get that the OLS estimators $\hat{b}_n^{\gamma}$ and $\hat{d}_n^{\gamma}$ in (2.6) and (2.7) satisfy

$$\hat{b}_n^{\gamma}/\zeta = -\frac{\sum_{t=1}^n (x'_t - \overline{x}'_n)(y_t - \overline{y}_n)}{\sum_{t=1}^n (x'_t - \overline{x}'_n)^2}, \quad \zeta \hat{d}_n^{\gamma} = -\frac{\sum_{t=1}^n (x'_t - \overline{x}'_n)(y_t - \overline{y}_n)}{\sum_{t=1}^n (y_t - \overline{y}_n)^2}.$$

This implies that it suffices to prove Theorem 1 for the case $\zeta = 1$. This will be assumed throughout the proof.

Step 1. We will need several asymptotic relations involving sums of logarithms. Using Euler-Maclaurin summation formula with the remainder terms that are $O(1)$ for the sums considered below (see, e.g., Havil, 2003, p. 86), we have

$$\sum_{i=1}^{t} \log (i - \gamma) = \int_1^t \log (x - \gamma) dx + \frac{\log (t - \gamma)}{2} + O(1) =$$
$$t \log (t - \gamma) - t + \left(\frac{1}{2} - \gamma\right) \log (t - \gamma) + O(1), \tag{7.15}$$

$$\sum_{t=1}^{n}\log^2\,(t-\gamma)=(n-\gamma)\log^2\,(n-\gamma)-2(n-\gamma)\log\,(n-\gamma)+$$
$$2n+\frac{\log^2\,(n-\gamma)}{2}+O(1). \tag{7.16}$$

Denote $L_t=\frac{1}{t}\sum_{i=1}^{t}\log\,(i-\gamma)-\log(t-\gamma)+1-\Big(\frac{1}{2}-\gamma\Big)\frac{\log\,(t-\gamma)}{t}$. From (7.15) it follows that

$$M_n=\sum_{t=1}^{n-1}\Big[\frac{1}{t}\sum_{i=1}^{t}\log\,(i-\gamma)-\frac{1}{n}\sum_{i=1}^{n}\log\,(i-\gamma)-\log(t-\gamma)+\log(n-\gamma)\Big]^2 \tag{7.17}$$

satisfies

$$\begin{aligned}M_n=\sum_{t=1}^{n-1}\Big[L_t-L_n+\Big(\frac{1}{2}-\gamma\Big)\frac{\log\,(t-\gamma)}{t}-\Big(\frac{1}{2}-\gamma\Big)\frac{\log\,(n-\gamma)}{n}\Big]^2\leq\\ C\sum_{t=1}^{n-1}L_t^2+CnL_n^2+C\sum_{t=1}^{n-1}\Big[\frac{\log\,(t-\gamma)}{t}\Big]^2+C\Big[\frac{\log^2\,(n-\gamma)}{n}\Big]\leq\\ C\sum_{t=1}^{n-1}\frac{1}{t^2}+\frac{C}{n}+C\sum_{t=1}^{n-1}\Big[\frac{\log\,(t-\gamma)}{t}\Big]^2+C\Big[\frac{\log^2\,(n-\gamma)}{n}\Big]\leq C.\end{aligned} \tag{7.18}$$

Applying integral approximations to partial sums, it is easy to see that, for all $\gamma<1$,

$$\sum_{t=1}^{n}\frac{\log\,(t-\gamma)}{t}=\frac{(\log\,n)^2}{2}+o((\log\,n)^2). \tag{7.19}$$

From (7.15) and (7.19) we get that

$$G_n=\frac{1}{\sqrt{n}}\Big[n+\sum_{t=1}^{n}\frac{1}{t}\Big(\sum_{i=1}^{t}\log\,(i-\gamma)\Big)-\Big(\sum_{t=1}^{n}\log\,(t-\gamma)\Big)\Big] \tag{7.20}$$

satisfies

$$\begin{aligned}G_n=\frac{1}{\sqrt{n}}\Big[n+\sum_{t=1}^{n}\log\,(t-\gamma)-n+\Big(\frac{1}{2}-\gamma\Big)\sum_{t=1}^{n}\frac{\log\,(t-\gamma)}{t}-\\ n\log\,(n-\gamma)+n-\Big(\frac{1}{2}-\gamma\Big)\log\,(n-\gamma)+O(\log\,n)\Big]=\\ \frac{1}{\sqrt{n}}\Big[n\log\,(n-\gamma)-n+\Big(\frac{1}{2}-\gamma\Big)\log\,(n-\gamma)+\Big(\frac{1}{2}-\gamma\Big)\sum_{t=1}^{n}\frac{\log\,(t-\gamma)}{t}-\\ n\log\,(n-\gamma)+n-\Big(\frac{1}{2}-\gamma\Big)\log\,(n-\gamma)+O(\log\,n)\Big]=\\ \frac{1}{\sqrt{n}}\Big(\frac{1}{2}-\gamma\Big)\sum_{t=1}^{n}\frac{\log\,(t-\gamma)}{t}+O\Big(\frac{\log\,n}{\sqrt{n}}\Big)=\frac{(1-2\gamma)}{4}\frac{(\log\,n)^2}{\sqrt{n}}+o\Big(\frac{(\log\,n)^2}{\sqrt{n}}\Big).\end{aligned} \tag{7.21}$$

Using (7.15), (7.16) and (7.19), it is not difficult to get that

$$\frac{1}{\sqrt{n}}\Big[\sum_{t=1}^{n}\log^2\,(t-\gamma)-\frac{1}{n}\Big(\sum_{t=1}^{n}\log\,(t-\gamma)\Big)^2+$$

$$\sum_{t=1}^{n}\frac{1}{t}\sum_{i=1}^{t}\log\,(i-\gamma)-\sum_{t=1}^{n}\log\,(t-\gamma)\Big]=\frac{1}{2}(\gamma-\frac{1}{2})\frac{\log^2\,n}{\sqrt{n}}+o(\frac{\log^2\,n}{\sqrt{n}}), \tag{7.22}$$

and

$$\frac{D_n}{n}=\frac{1}{n}\sum_{t=1}^{n}y_t^2-n\overline{y}_n^2=\frac{1}{n}\sum_{t=1}^{n}\log^2\,(t-\gamma)-n\Big(\sum_{t=1}^{n}\log\,(i-\gamma)\Big)^2=1+O\Big(\frac{\log^2\,n}{n}\Big). \tag{7.23}$$

Step 2. Relation (2.8) for $\zeta=1$ is a consequence of (2.6) and the following asymptotic expansions for the statistics A_n^γ and B_n under $\zeta=1$ that we establish in turn:

$$\frac{1}{\sqrt{n}}(A_n^\gamma+B_n)=\mathcal{N}(0,2)+\frac{(\log n)^2\,(1-2\gamma)}{4\sqrt{n}}+o_P\Big(\frac{\log^2 n}{\sqrt{n}}\Big), \tag{7.24}$$

$$\frac{B_n}{n}=1+O_P\Big(\frac{\log\,n}{\sqrt{n}}\Big). \tag{7.25}$$

Similarly, asymptotic expansion (2.9) for $\zeta=1$ is a consequence of (2.7), (7.23) and the relation

$$\frac{1}{\sqrt{n}}(A_n^\gamma+D_n)=\mathcal{N}(0,2)+\frac{(\log n)^2\,(2\gamma-1)}{4\sqrt{n}}+o_P\Big(\frac{\log^2 n}{\sqrt{n}}\Big). \tag{7.26}$$

that we prove below.

Step 3. We first focus on proving relation (7.24). By the Rényi representation theorem (see Beirlant et al., 2004, Sections 4.2.1 (iii) and 4.4), one has that, for the logarithms $x_t=\log\;Z_{(t)}$ of ordered observations from a population with the distribution satisfying power law (2.5), the transformations

$$\tau_t=t\big(x_t-x_{t+1}\big),\;\;t=1,...,n-1,$$

are i.i.d. exponential r.v.'s with parameter 1: $P(\tau_t>s)=\exp(-s)$, $s\geq 0$. That is, one can represent the regressors in (1.3) as weighted sums of exponential r.v.'s in the following way:

$$x_t=x_n+z_t,\;t=1,...,n,$$

where $z_n = 0$ and $z_t = \sum_{i=t}^{n-1} \frac{\tau_i}{i}$, $t = 1, ..., n-1$. We, therefore, get

$$B_n = \sum_{t=1}^{n} (x_t - \overline{x}_n)^2 = \sum_{t=1}^{n} (x_n + z_t - x_n - \overline{z}_n)^2 = \sum_{t=1}^{n} (z_t - \overline{z}_n)^2 = \sum_{t=1}^{n-1} z_t^2 - n\overline{z}_n^2, \tag{7.27}$$

and, similarly,

$$A_n^\gamma = \sum_{t=1}^{n} (x_t - \overline{x}_n)(y_t - \overline{y}_n) = \sum_{t=1}^{n} (z_t - \overline{z}_n)(y_t - \overline{y}_n) = \sum_{t=1}^{n-1} z_t y_t - n\overline{z}_n\overline{y}_n. \tag{7.28}$$

We further have

$$\sum_{t=1}^{n-1} z_t^2 = \sum_{t=1}^{n-1} \Big(\sum_{i=t}^{n-1} \frac{\tau_i}{i} \Big)^2 = \sum_{t=1}^{n-1} \sum_{i=t}^{n-1} \frac{\tau_i^2}{i^2} + 2 \sum_{t=1}^{n-1} \sum_{i=t}^{n-2} \frac{\tau_i}{i} \sum_{j=i+1}^{n-1} \frac{\tau_j}{j} =$$
$$\sum_{i=1}^{n-1} \frac{\tau_i^2}{i} + 2 \sum_{j=2}^{n-1} \frac{\tau_j}{j} \sum_{i=1}^{j-1} \tau_i. \tag{7.29}$$

In addition,

$$n\overline{z}_n^2 = \frac{1}{n} \Big(\sum_{t=1}^{n-1} \sum_{i=t}^{n-1} \frac{\tau_i}{i} \Big)^2 = \frac{1}{n} \Big(\sum_{i=1}^{n-1} \tau_i \Big)^2 = \frac{1}{n} \sum_{i=1}^{n-1} \tau_i^2 + \frac{2}{n} \sum_{i=2}^{n-1} \tau_i \sum_{j=1}^{i-1} \tau_j. \tag{7.30}$$

By (7.27), (7.29) and (7.30) we get

$$B_n = \sum_{t=1}^{n} (x_t - \overline{x}_n)^2 = \Big(\sum_{t=1}^{n-1} z_t^2 - n\overline{z}_n^2 \Big) =$$
$$\sum_{i=1}^{n-1} \frac{\tau_i^2}{i} + 2 \sum_{j=2}^{n-1} \frac{\tau_j}{j} \sum_{i=1}^{j-1} \tau_i - \frac{1}{n} \sum_{i=1}^{n-1} \tau_i^2 - \frac{2}{n} \sum_{i=2}^{n-1} \tau_i \sum_{j=1}^{i-1} \tau_j. \tag{7.31}$$

Similar to the above derivations, we have

$$\sum_{t=1}^{n-1} z_t y_t = \sum_{t=1}^{n-1} \log\,(t-\gamma) \Big(\sum_{i=t}^{n-1} \frac{\tau_i}{i} \Big) = \sum_{t=1}^{n-1} \frac{\tau_t}{t} \Big(\sum_{i=1}^{t} \log\,(i-\gamma) \Big), \tag{7.32}$$

$$n\overline{z}_n\overline{y}_n = \Big(\sum_{t=1}^{n-1} \sum_{i=t}^{n-1} \frac{\tau_i}{i} \Big) \Big(\frac{1}{n} \sum_{t=1}^{n} \log\,(t-\gamma) \Big) = \Big(\sum_{t=1}^{n-1} \tau_t \Big) \Big(\frac{1}{n} \sum_{t=1}^{n} \log\,(t-\gamma) \Big). \tag{7.33}$$

Relations (7.28), (7.32) and (7.33) imply

$$A_n^\gamma = \sum_{t=1}^{n-1} \frac{\tau_t}{t} \Big(\sum_{i=1}^{t} \log\,(i-\gamma) \Big) - \Big(\sum_{t=1}^{n-1} \tau_t \Big) \Big(\frac{1}{n} \sum_{t=1}^{n} \log\,(t-\gamma) \Big). \tag{7.34}$$

From (7.31) and (7.34) we get

$$\frac{1}{\sqrt{n}}(A_n^\gamma + B_n) = \frac{1}{\sqrt{n}}\Big[\sum_{t=1}^{n-1}\frac{\tau_t}{t}\Big(\sum_{i=1}^{t}\log\,(i-\gamma)\Big) - \Big(\sum_{t=1}^{n-1}\tau_t\Big)\Big(\frac{1}{n}\sum_{t=1}^{n}\log\,(t-\gamma)\Big) + \sum_{i=1}^{n-1}\frac{\tau_i^2}{i} + 2\sum_{j=2}^{n-1}\frac{\tau_j}{j}\sum_{i=1}^{j-1}\tau_i - \frac{1}{n}\sum_{i=1}^{n-1}\tau_i^2 - \frac{2}{n}\sum_{i=2}^{n-1}\tau_i\sum_{j=1}^{i-1}\tau_j\Big]. \quad (7.35)$$

Consider

$$\frac{2}{\sqrt{n}}\sum_{1\le i<j\le n-1}\frac{\tau_i\tau_j}{j} - \frac{2}{n^{3/2}}\sum_{1\le i<j\le n-1}\tau_i\tau_j = \frac{2}{\sqrt{n}}\sum_{1\le i<j\le n-1}\frac{(\tau_i-1)(\tau_j-1)}{j} + \frac{2}{\sqrt{n}}\sum_{1\le i<j\le n-1}\frac{\tau_j-1}{j} + \frac{2}{\sqrt{n}}\sum_{1\le i<j\le n-1}\frac{\tau_i-1}{j} + \frac{2}{\sqrt{n}}\sum_{1\le i<j\le n-1}\frac{1}{j} - \frac{2}{n^{3/2}}\sum_{1\le i<j\le n-1}(\tau_i-1)(\tau_j-1) - \frac{2}{n^{3/2}}\sum_{1\le i<j\le n-1}(\tau_j-1) - \frac{2}{n^{3/2}}\sum_{1\le i<j\le n-1}(\tau_i-1) - \frac{(n-1)(n-2)}{n^{3/2}}. \quad (7.36)$$

We have that

$$\frac{2}{\sqrt{n}}\sum_{1\le i<j\le n-1}\frac{1}{j} - \frac{(n-1)(n-2)}{n^{3/2}} = \sqrt{n} + O\Big(\frac{\log\,n}{\sqrt{n}}\Big)$$

and

$$\frac{2}{\sqrt{n}}\sum_{1\le i<j\le n-1}\frac{\tau_j-1}{j} - \frac{2}{n^{3/2}}\sum_{1\le i<j\le n-1}(\tau_i-1) - \frac{2}{n^{3/2}}\sum_{1\le i<j\le n-1}(\tau_j-1) = \frac{2}{\sqrt{n}}\sum_{j=1}^{n-1}(\tau_j-1) - \frac{2}{n^{3/2}}\sum_{j=1}^{n-1}(\tau_j-1)(n-j) - \frac{2}{n^{3/2}}\sum_{j=1}^{n-1}(\tau_j-1)j + O_P\Big(\frac{1}{\sqrt{n}}\Big) = O_P\Big(\frac{1}{\sqrt{n}}\Big).$$

From (7.36) it thus follows that

$$\frac{2}{\sqrt{n}}\sum_{1\le i<j\le n-1}\frac{\tau_i\tau_j}{j} - \frac{2}{n^{3/2}}\sum_{1\le i<j\le n-1}\tau_i\tau_j = \frac{2}{\sqrt{n}}\sum_{1\le i<j\le n-1}\frac{(\tau_i-1)(\tau_j-1)}{j} - \frac{2}{n^{3/2}}\sum_{1\le i<j\le n-1}(\tau_i-1)(\tau_j-1) + \frac{2}{\sqrt{n}}\sum_{1\le i<j\le n-1}\frac{\tau_i-1}{j} + \sqrt{n} + O_P\Big(\frac{\log\,n}{\sqrt{n}}\Big).$$

Using the previous relation, from (7.35) we now obtain

$$\frac{1}{\sqrt{n}}(A_n^\gamma + B_n) = \frac{1}{\sqrt{n}}\sum_{t=1}^{n-1}(\tau_t-1)\Big[\frac{1}{t}\Big(\sum_{i=1}^{t}\log\,(i-\gamma)\Big) - \Big(\frac{1}{n}\sum_{i=1}^{n}\log\,(i-\gamma)\Big) + 2\frac{1}{t}\sum_{i=1}^{t-1}(\tau_i-1) - \frac{2}{n}\sum_{i=1}^{t-1}(\tau_i-1) + 2\sum_{j=t+1}^{n-1}\frac{1}{j}\Big] + G_n + \Big[\frac{1}{\sqrt{n}}\sum_{i=1}^{n-1}\frac{\tau_i^2}{i} - \frac{1}{n^{3/2}}\sum_{i=1}^{n-1}\tau_i^2\Big] + O_P\Big(\frac{\log\,n}{\sqrt{n}}\Big), \quad (7.37)$$

where G_n is defined in (7.20). We have $E\Big[\sum_{i=1}^{n-1}\frac{\tau_i^2}{i}\Big] = O(\log\ n)$ and $E\Big[\sum_{i=1}^{n-1}\tau_i^2\Big] = O(n)$. These relations imply

$$\frac{1}{\sqrt{n}}\sum_{i=1}^{n-1}\frac{\tau_i^2}{i} = O_P\Big(\frac{\log\ n}{\sqrt{n}}\Big), \tag{7.38}$$

$$\frac{1}{n^{3/2}}\sum_{i=1}^{n-1}\tau_i^2 = O_P\Big(\frac{1}{\sqrt{n}}\Big). \tag{7.39}$$

In addition, it is not difficult to see that $Var\Big[\sum_{t=1}^{n-1}\frac{\tau_t-1}{t}\sum_{i=1}^{t-1}(\tau_i-1)\Big] = O\Big(\sum_{t=1}^{n}\frac{1}{t}\Big) = O(\log\ n)$. This implies that

$$\frac{1}{\sqrt{n}}\sum_{t=1}^{n-1}\frac{\tau_t-1}{t}\sum_{i=1}^{t-1}(\tau_i-1) = O_P\Big(\frac{(\log\ n)^{1/2}}{\sqrt{n}}\Big). \tag{7.40}$$

Similarly, since $Var\Big[\sum_{t=1}^{n-1}(\tau_t-1)\sum_{i=1}^{t-1}(\tau_i-1)\Big] = O(n^2)$, we get

$$\frac{1}{n^{3/2}}\sum_{t=1}^{n-1}(\tau_t-1)\sum_{i=1}^{t-1}(\tau_i-1) = O_P\Big(\frac{1}{\sqrt{n}}\Big). \tag{7.41}$$

Using relations (7.21) and (7.37)-(7.41), one obtains

$$\begin{aligned}
\frac{1}{\sqrt{n}}(A_n^\gamma + B_n) = \frac{1}{\sqrt{n}}\sum_{t=1}^{n-1}(\tau_t-1)\Big[\frac{1}{t}\Big(\sum_{i=1}^{t}\log\ (i-\gamma)\Big) - \\
\Big(\frac{1}{n}\sum_{i=1}^{n}\log\ (i-\gamma)\Big) + 2\sum_{j=t+1}^{n-1}\frac{1}{j}\Big] + \frac{2}{\sqrt{n}}\sum_{t=1}^{n-1}\frac{\tau_t-1}{t}\sum_{i=1}^{t-1}(\tau_i-1) - \\
\frac{2}{n^{3/2}}\sum_{t=1}^{n-1}(\tau_t-1)\sum_{i=1}^{t-1}(\tau_i-1) + G_n = \frac{1}{\sqrt{n}}\sum_{t=1}^{n-1}(\tau_t-1)\Big[\frac{1}{t}\Big(\sum_{i=1}^{t}\log\ (i-\gamma)\Big) - \\
\Big(\frac{1}{n}\sum_{i=1}^{n}\log\ (i-\gamma)\Big) + 2\sum_{j=t+1}^{n-1}\frac{1}{j}\Big] + G_n + O_P\Big(\frac{(\log\ n)^{1/2}}{\sqrt{n}}\Big) = \\
\frac{1}{\sqrt{n}}\sum_{t=1}^{n-1}(\tau_t-1)\Big[\frac{1}{t}\Big(\sum_{i=1}^{t}\log\ (i-\gamma)\Big) - \Big(\frac{1}{n}\sum_{i=1}^{n}\log\ (i-\gamma)\Big) + 2\sum_{j=t+1}^{n-1}\frac{1}{j}\Big] \\
+\frac{(1-2\gamma)}{4}\frac{(\log\ n)^2}{\sqrt{n}} + o_P(\frac{(\log\ n)^2}{\sqrt{n}}) = \\
-\frac{1}{\sqrt{n}}\sum_{t=1}^{n-1}(\tau_t-1)\log\ (t/n) + \frac{1}{\sqrt{n}}\sum_{t=1}^{n-1}(\tau_t-1)\Big[\frac{1}{t}\Big(\sum_{i=1}^{t}\log\ (i-\gamma)\Big) - \\
\Big(\frac{1}{n}\sum_{i=1}^{n}\log\ (i-\gamma)\Big) + 2\sum_{j=t+1}^{n-1}\frac{1}{j} + \log\ (t/n)\Big] + \\
\frac{(1-2\gamma)}{4}\frac{(\log\ n)^2}{\sqrt{n}} + o_P\Big(\frac{(\log\ n)^2}{\sqrt{n}}\Big).
\end{aligned} \tag{7.42}$$

Let us show that

$$U_n = \frac{1}{\sqrt{n}} \sum_{t=1}^{n-1} (\tau_t - 1) \Big[\frac{1}{t} \Big(\sum_{i=1}^{t} \log\,(i-\gamma) \Big) -$$

$$\Big(\frac{1}{n} \sum_{i=1}^{n} \log\,(i-\gamma) \Big) + 2 \sum_{j=t+1}^{n-1} \frac{1}{j} + \log\,(t/n) \Big] = O_P\Big(\frac{1}{\sqrt{n}} \Big). \tag{7.43}$$

We have

$$Var(\sqrt{n}U_n) = \sum_{t=1}^{n-1} \Big[\frac{1}{t} \Big(\sum_{i=1}^{t} \log\,(i-\gamma) \Big) - \Big(\frac{1}{n} \sum_{i=1}^{n} \log\,(i-\gamma) \Big) - \log(t-\gamma) +$$

$$\log(n-\gamma) + 2 \sum_{j=t+1}^{n-1} \frac{1}{j} + 2 \log\,(t/n) + \log\big(1-\gamma/t\big) - \log\big(1-\gamma/n\big) \Big]^2 \le$$

$$C\Big(M_n + \sum_{t=1}^{n-1} \Big[\log\big(1-\gamma/t\big) - \log\big(1-\gamma/n\big) \Big]^2 + \sum_{t=1}^{n-1} \Big[\sum_{j=t+1}^{n-1} \frac{1}{j} + \log\,(t/n) \Big]^2 \Big) =$$

$$C(M_n + Q_n + R_n),$$

where M_n is defined in (7.17), $R_n = \sum_{t=1}^{n-1} \Big[\sum_{j=t+1}^{n-1} \frac{1}{j} + \log\,(t/n) \Big]^2$, and

$$Q_n = \sum_{t=1}^{n-1} \Big[\log\big(1-\gamma/t\big) - \log\big(1-\gamma/n\big) \Big]^2. \tag{7.44}$$

Using the inequalities $x - x^2/2 \le \log\,(1-x) \le x$, $x > 0$, one easily obtains that

$$Q_n = O(1). \tag{7.45}$$

In addition, since, for all t and n, $\Big| \sum_{j=t+1}^{n-1} \frac{1}{j} + \log\,(t/n) \Big| \le \frac{C}{t}$, we get that $R_n = O(1)$. Using (7.18) and the above relations, we conclude that $Var(\sqrt{n}U_n) = O(1)$. Thus, (7.43) indeed holds. We now provide the argument for the relation

$$-\frac{1}{\sqrt{n}} \sum_{t=1}^{n-1} (\tau_t - 1) \log\,(t/n) = \sqrt{2}\mathcal{N}(0,1) + O_P\Big(\frac{(\log\ n)^{3/2}}{\sqrt{n}} \Big) \tag{7.46}$$

using strong approximations to partial sums of r.v.'s by Brownian motion.

Using partial summation similar to the proof of Lemma 2.3 in Phillips (2001), we get (below, $S_t = \sum_{i=1}^{t} u_i$ and $u_i = \tau_i - 1$)

$$-\frac{1}{\sqrt{n}} \sum_{t=1}^{n} u_t \log\,(t/n) = -\frac{1}{\sqrt{n}} \sum_{t=1}^{n} u_t \log\ t + \log\ n \frac{1}{\sqrt{n}} \sum_{t=1}^{n} u_t =$$

$$\Big[-\log\ n\frac{S_n}{\sqrt{n}}+\sum_{t=2}^{n}\big(\log\ t-\log\ (t-1)\big)\frac{S_{t-1}}{\sqrt{n}}\Big]+\log\ n\frac{S_n}{\sqrt{n}}=$$

$$\sum_{t=2}^{n}\big(\log\ t-\log\ (t-1)\big)\frac{S_{t-1}}{\sqrt{n}}.$$

By the strong approximation to partial sums of independent r.v.'s that holds under the assumption of existence of moment generating function in a neighborhood of zero (see, e.g., Komlós, Major and Tusnády, 1975, 1976; Csörgő and Révész, 1981, Theorem 2.6.1), one can expand the probability space as necessary to set up a partial sum process that is distributionally equivalent to S_t and the standard Brownian motion $W(\cdot)$ on the same space such that

$$\sup_{1\le t\le n}\Big|\frac{S_{t-1}}{\sqrt{n}}-W\big(\frac{t-1}{n}\big)\Big|=O\Big(\frac{\log\ n}{n}\Big)\ \ (a.s.). \tag{7.47}$$

As conventional, throughout the rest of the proof we suppose that that the probability space on which the random sequences considered are defined has been appropriately enlarged so that relation (7.47) holds. From (7.47) we get

$$\sum_{t=2}^{n}\Big(\log\ t-\log\ (t-1)\Big)\frac{S_{t-1}}{\sqrt{n}}=\sum_{t=2}^{n}\Big(\log\ t-\log\ (t-1)\Big)W\Big(\frac{t-1}{n}\Big)+$$

$$O\Big(\frac{\log\ n}{n}\Big)\sum_{t=2}^{n}\Big(\log\ t-\log\ (t-1)\Big)=\sum_{t=2}^{n}\Big(\log\ t-\log\ (t-1)\Big)W\Big(\frac{t-1}{n}\Big)+O\Big(\frac{\log^2\ n}{n}\Big).\ \ (a.s.)$$

Let us consider the difference between

$$\sum_{t=2}^{n}\Big(\log\ t-\log\ (t-1)\Big)W\Big(\frac{t-1}{n}\Big)=\sum_{t=2}^{n}\Big[\log\ \Big(n\frac{t}{n}\Big)-\log\ \Big(n\frac{t-1}{n}\Big)\Big]W\Big(\frac{t-1}{n}\Big)$$

and $\int_0^1 W(r)d\log\ (nr)$. We have

$$\Big|\sum_{t=2}^{n}\Big(\log\ t-\log\ (t-1)\Big)W\Big(\frac{t-1}{n}\Big)-\int_0^1 W(r)d\log\ (nr)\Big|=$$

$$\Big|\sum_{t=2}^{n}\Big[\Big(\log\ t-\log\ (t-1)\Big)W\Big(\frac{t-1}{n}\Big)-\int_{(t-1)/n}^{t/n}W(r)d\log\ (nr)\Big]\Big|\le$$

$$\sum_{t=2}^{n}\int_{(t-1)/n}^{t/n}\Big|W(r)-W\Big(\frac{t-1}{n}\Big)\Big|d\log(nr)\le$$

$$\sup_{t_1,t_2:|t_2-t_1|\le 1/n}\big|W(t_2)-W(t_1)\big|\sum_{t=2}^{n}\int_{(t-1)/n}^{t/n} d\log(nr)=$$

$$\sup_{t_1,t_2:|t_2-t_1|\le 1/n}\big|W(t_2)-W(t_1)\big|\sum_{t=2}^{n}\big(\log\ t-\log\ (t-1)\big)=\log\ n\sup_{t_1,t_2:|t_2-t_1|\le 1/n}\big|W(t_2)-W(t_1)\big|.$$

According to the results on the modulus of continuity for Brownian sample paths (Karatzas and Shreve, 1991, pp. 114-116),

$$\sup_{t_1,t_2:|t_2-t_1|\le 1/n}\big|W(t_2)-W(t_1)\big|=O\Big(\frac{\sqrt{\log\ n}}{\sqrt{n}}\Big)\ \ (a.s.).$$

This, together with integration by parts, implies that

$$-\frac{1}{\sqrt{n}}\sum_{t=1}^{n}\log\ (t/n)u_t=\int_0^1 W(r)d\log\ (nr)+O_P\Big(\frac{(\log\ n)^{3/2}}{\sqrt{n}}\Big)=$$
$$-\int_0^1 \log\ s\ dW(s)+O_P\Big(\frac{(\log\ n)^{3/2}}{\sqrt{n}}\Big).$$

Since $\int_0^1 \log\ \ sdW(s)=_d W\Big(\int_0^1 \log^2\ \ sds\Big)=W(2)$, we get that (7.46) indeed holds. Relations (7.42), (7.43) and (7.46) imply (7.24).

Step 4. We now turn to proving (7.25). By (7.27), (7.29) and (7.30),

$$\frac{B_n}{n}=\frac{1}{n}\sum_{t=1}^{n-1}z_t^2-\overline{z}_n^2=\frac{1}{n}\sum_{i=1}^{n-1}\frac{\tau_i^2}{i}+\frac{2}{n}\sum_{j=2}^{n-1}\frac{\tau_j}{j}\sum_{i=1}^{j-1}\tau_i-\frac{1}{n^2}\Big(\sum_{i=1}^{n-1}\tau_i\Big)^2. \qquad (7.48)$$

Since, by the central limit theorem, $\frac{1}{n}\sum_{i=1}^{n-1}\tau_i=1+O_P(\frac{1}{\sqrt{n}})$, we have

$$\frac{1}{n^2}\Big(\sum_{i=1}^{n-1}\tau_i\Big)^2=1+O_P\Big(\frac{1}{\sqrt{n}}\Big). \qquad (7.49)$$

In addition,

$$\frac{2}{n}\sum_{j=2}^{n-1}\frac{\tau_j}{j}\sum_{i=1}^{j-1}\tau_i=\frac{2}{n}\sum_{t=2}^{n-1}\frac{\tau_t-1}{t}\sum_{i=1}^{t-1}\tau_i+\frac{2}{n}\sum_{t=2}^{n-1}\frac{1}{t}\sum_{i=1}^{t-1}(\tau_i-1)+\frac{2}{n}\sum_{t=2}^{n-1}\frac{1}{t}\sum_{i=1}^{t-1}1=$$
$$\frac{2}{n}\sum_{t=1}^{n-1}\frac{\tau_t-1}{t}\sum_{i=1}^{t-1}\tau_i+\frac{2}{n}\sum_{t=1}^{n-1}\frac{1}{t}\sum_{i=1}^{t-1}(\tau_i-1)+2+O_P\Big(\frac{\log\ n}{n}\Big)=$$
$$F_n^{(1)}+F_n^{(2)}+2+O_P\Big(\frac{\log\ n}{n}\Big). \qquad (7.50)$$

It is easy to see that $Var(F_n^{(1)})=O\Big(\frac{1}{n^2}\sum_{t=1}^{n}\frac{1}{t^2}E\Big(\sum_{i=1}^{t-1}\tau_i\Big)^2\Big)=O\Big(\frac{1}{n}\Big)$ and, thus,

$$F_n^{(1)}=O_P\Big(\frac{1}{\sqrt{n}}\Big). \qquad (7.51)$$

Besides, as it is not difficult to observe, $Var(F_n^{(2)}) = O\Big(\frac{1}{n^2}\sum_{t=1}^{n}\Big(\sum_{i=t}^{n}\frac{1}{i}\Big)^2\Big) = O\Big(\frac{\log^2 n}{n}\Big)$ and, consequently,

$$F_n^{(2)} = O_P\Big(\frac{\log\ n}{\sqrt{n}}\Big). \tag{7.52}$$

From (7.38) and (7.48)-(7.52) it clearly follows that (7.25) indeed holds.

Step 5. It remains to prove relation (7.26). Using (7.34), we get, as in (7.42),

$$\begin{aligned}\frac{1}{\sqrt{n}}(A_n^{\gamma}+D_n) = \frac{1}{\sqrt{n}}\Big[\sum_{t=1}^{n-1}\frac{\tau_t}{t}\Big(\sum_{i=1}^{t}\log(i-\gamma)\Big) - \Big(\sum_{t=1}^{n-1}\tau_t\Big)\Big(\frac{1}{n}\sum_{t=1}^{n}\log(t-\gamma)\Big) + \\ \sum_{t=1}^{n}\log^2(t-\gamma) - \frac{1}{n}\Big(\sum_{t=1}^{n}\log(t-\gamma)\Big)^2\Big] = \frac{1}{\sqrt{n}}\sum_{t=1}^{n-1}(\tau_t-1)\log(t/n) + \\ \frac{1}{\sqrt{n}}\sum_{t=1}^{n-1}(\tau_t-1)\Big[\frac{1}{t}\Big(\sum_{i=1}^{t}\log\ (i-\gamma)\Big) - \Big(\frac{1}{n}\sum_{t=1}^{n}\log\ (t-\gamma)\Big) - \log(t/n)\Big] + \\ \frac{1}{\sqrt{n}}\Big[\sum_{t=1}^{n}\log^2\ (t-\gamma) - \frac{1}{n}\Big(\sum_{t=1}^{n}\log\ (t-\gamma)\Big)^2 + \\ \sum_{t=1}^{n}\frac{1}{t}\sum_{i=1}^{t}\log\ (i-\gamma) - \sum_{t=1}^{n}\log\ (t-\gamma)\Big].\end{aligned} \tag{7.53}$$

Let us show that

$$\begin{aligned}V_n = \frac{1}{\sqrt{n}}\sum_{t=1}^{n-1}(\tau_t-1)\Big[\frac{1}{t}\Big(\sum_{i=1}^{t}\log\ (i-\gamma)\Big) - \Big(\frac{1}{n}\sum_{t=1}^{n}\log\ (t-\gamma)\Big) - \log(t/n)\Big] = \\ O_P\Big(\frac{1}{\sqrt{n}}\Big).\end{aligned} \tag{7.54}$$

Similar to the arguments for (7.43), we get that the variance of V_n satisfies

$$\begin{aligned}Var(\sqrt{n}V_n) = \sum_{t=1}^{n-1}\Big[\frac{1}{t}\Big(\sum_{i=1}^{t}\log\ (i-\gamma)\Big) - \Big(\frac{1}{n}\sum_{i=1}^{n}\log\ (i-\gamma)\Big) - \log\ (t/n)\Big]^2 \leq \\ C(M_n+Q_n),\end{aligned}$$

where M_n is defined in (7.17) and Q_n is defined in (7.44). Using (7.18) and (7.45), we thus get that $Var(\sqrt{n}V_n) = O(1)$. Consequently, (7.54) indeed holds. Relations (7.22), (7.46), (7.53) and (7.54) imply (7.26).

Step 6. We conclude that relations (7.24)-(7.26) indeed hold. As indicated in Step 2, these relations, together with (7.23) imply (2.8) and (2.9). ■

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Technical appendix: Simulation results for GARCH processes and the approach using harmonic numbers

This technical appendix provides simulation results for GARCH processes and estimators of the tail index using harmonic numbers discussed in Section 3. Tables 5 and 6 present the numerical results on the performance of OLS estimators in regressions (1.3) with $\gamma = 0$ and $\gamma = 1/2$ for GARCH(1, 1) processes $Z_t = \sigma_t \epsilon_t$, where $\sigma_t^2 = \beta + \lambda Z_{t-1}^2 + \delta \sigma_{t-1}^2$, and ϵ_t are i.i.d. standard normal errors. The choice of the parameter values for β, λ and δ follows that in the simulation results presented by Kokoszka and Wolf (2004) who focused on subsampling approaches to estimating the mean of heavy-tailed observations. The corresponding values of the tail index ζ_0 of GARCH processes considered are provided in the same paper. The GARCH processes were simulated using the UCSD GARCH toolbox for Matlab by Kevin Sheppard. The IGARCH processes were simulated using the code by Mico Loretan.

Tables 7 and 8 provide simulation results for the Pareto exponent estimators in regression (3.10) for AR(1) and MA(1) processes driven by heavy-tailed innovations exhibiting deviations from power laws in form (4.14) and Student t distributions.

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Table 5. Behavior of the usual OLS estimator $\hat{b}_n$ in the regression
$\log(\text{Rank}) = a - b\log(\text{Size})$ for GARCH(1, 1) innovations

n	50	100	200	500
		Mean $\hat{b}_n$ (OLS s.e) (SD $\hat{b}_n$)		
$\beta = 1,\ \lambda = 1.3,$ $\delta = 0.05,\ \zeta_0 \approx 1.19$	1.375* (0.035) (0.417)	1.294* (0.019) (0.328)	1.234* (0.011) (0.252)	1.139 (0.006) (0.159)
$\beta = 1,\ \lambda = 1.1,$ $\delta = 0.1,\ \zeta_0 \approx 1.43$	1.587* (0.040) (0.465)	1.511* (0.022) (0.366)	1.411 (0.013) (0.276)	1.297* (0.007) (0.164)
$\beta = 1,\ \lambda = 0.9,$ $\delta = 0.15,\ \zeta_0 \approx 1.83$	1.926* (0.047) (0.534)	1.839* (0.026) (0.411)	1.761 (0.015) (0.305)	1.534 (0.010) (0.162)
$\beta = 1,\ \lambda = 0.9,$ $\delta = 0.1,\ \zeta_0 = 2$	2.057 (0.050) (0.530)	1.979 (0.028) (0.407)	1.881* (0.016) (0.296)	1.628* (0.011) (0.151)
$\beta = 1,\ \lambda = 0.5,$ $\delta = 0.5,\ \zeta_0 = 2$	2.315* (0.059) (0.665)	2.136* (0.033) (0.528)	1.983 (0.019) (0.391)	1.630* (0.013) (0.202)
$\beta = 1,\ \lambda = 0.1,$ $\delta = 0.9,\ \zeta_0 = 2$	3.799* (0.104) (0.880)	3.235* (0.060) (0.701)	2.677* (0.038) (0.546)	1.855* (0.022) (0.303)

Notes: The entries are the estimates of the tail index and their standard errors using regression (1.3) with $\gamma = 0$ for GARCH(1, 1) processes $Z_t = \sigma_t \epsilon_t$, where $\sigma_t^2 = \beta + \lambda Z_{t-1}^2 + \delta \sigma_{t-1}^2$, and ϵ_t are i.i.d. standard normal errors. "Mean $\hat{b}_n$" is the sample mean of the estimates $\hat{b}_n$ obtained in simulations, and "SD $\hat{b}_n$" is their sample standard deviation. "OLS s.e." is the OLS standard error in regression (1.3) with $\gamma = 0$. The value ζ_0 is the true tail index of Z_t. The asteric indicates rejection of the true null hypothesis $H_0 : \zeta = \zeta_0$ in favor of the alternative hypothesis $H_a : \zeta \neq \zeta_0$ at the 5% significance level using the reported OLS standard errors. The total number of observations $N = 2000$. Based on 10000 replications.

Table 6. Behavior of the usual OLS estimator $\hat{b}_n$ in the regression
$\log(\text{Rank} - 1/2) = a - b\log(\text{Size})$ for GARCH(1, 1) innovations

n	50	100	200	500
		Mean $\hat{b}_n^{\gamma=1/2}$ ($\sqrt{2/n}\times$Mean $\hat{b}_n^{\gamma=1/2}$) (SD $\hat{b}_n^{\gamma=1/2}$)		
$\beta = 1,\ \lambda = 1.3,$	1.495	1.366	1.277	1.159
$\delta = 0.05,\ \zeta_0 \approx 1.19$	(0.299) (0.453)	(0.193) (0.346)	(0.128) (0.260)	(0.073) (0.162)
$\beta = 1,\ \lambda = 1.1,$	1.727	1.596	1.492	1.321
$\delta = 0.1,\ \zeta_0 \approx 1.43$	(0.345) (0.505)	(0.226) (0.386)	(0.149) (0.285)	(0.084) (0.166)
$\beta = 1,\ \lambda = 0.9,$	2.097	1.943	1.823	1.562
$\delta = 0.15,\ \zeta_0 \approx 1.83$	(0.419) (0.580)	(0.275) (0.432)	(0.182) (0.314)	(0.099) (0.164)
$\beta = 1,\ \lambda = 0.9,$	2.243	2.091	1.951	1.658*
$\delta = 0.1,\ \zeta_0 = 2$	(0.449) (0.585)	(0.296) (0.424)	(0.195) (0.308)	(0.105) (0.150)
$\beta = 1,\ \lambda = 0.5,$	2.512	2.271	2.051	1.658*
$\delta = 0.5,\ \zeta_0 = 2$	(0.502) (0.721)	(0.321) (0.555)	(0.205) (0.398)	(0.105) (0.203)
$\beta = 1,\ \lambda = 0.1,$	4.116*	3.405*	2.745*	1.884
$\delta = 0.9,\ \zeta_0 = 2$	(0.823) (0.948)	(0.482) (0.740)	(0.274) (0.566)	(0.119) (0.307)

Notes: The entries are the estimates of the tail index and their standard errors using regression (1.3) with $\gamma = 1/2$ for GARCH(1, 1) processes $Z_t = \sigma_t \epsilon_t$, where $\sigma_t^2 = \beta + \lambda Z_{t-1}^2 + \delta \sigma_{t-1}^2$, and ϵ_t are i.i.d. standard normal errors. "Mean $\hat{b}_n^{\gamma=1/2}$" is the sample mean of the estimates $\hat{b}_n^{\gamma}$ with $\gamma = 1/2$ obtained in simulations, and "SD $\hat{b}_n^{\gamma=1/2}$" is their sample standard deviation. The values $\sqrt{2/n}\times$Mean $\hat{b}_n^{\gamma=1/2}$ are the standard errors of $\hat{b}_n^{\gamma}$ with $\gamma = 1/2$ provided by Theorem 1. The value ζ_0 is the true tail index of Z_t. The asteric indicates rejection of the true null hypothesis $H_0 : \zeta = \zeta_0$ in favor of the alternative hypothesis $H_a : \zeta \neq \zeta_0$ at the 5% significance level using the reported standard errors. The total number of observations $N = 2000$. Based on 10000 replications.

Table 7. Behavior of the OLS estimator $\hat{b}'_n$ in the regression
$\log(H(t-1)) = a' - b' \log(\text{Size}_t)$ for innovations deviating from power laws

	n	50	100	200	500
AR(1)		Mean $\hat{b}'_n$			
c	ρ	($\sqrt{2/n}\times$Mean $\hat{b}'_n$) (SD $\hat{b}'_n$)			
0	0	1.002 (0.200) (0.195)	0.998 (0.141) (0.140)	0.995 (0.100) (0.100)	0.996 (0.063) (0.062)
0	0.5	1.167 (0.233) (0.318)	1.122 (0.159) (0.253)	1.105 (0.110) (0.201)	1.123 (0.071) (0.147)
0	0.8	1.462 (0.292) (0.555)	1.337 (0.189) (0.435)	1.266* (0.127) (0.346)	1.252* (0.079) (0.269)
0.5	0	0.997 (0.199) (0.194)	0.966 (0.141) (0.139)	0.995 (0.100) (0.099)	0.995 (0.063) (0.064)
0.5	0.5	1.161 (0.232) (0.324)	1.120 (0.158) (0.249)	1.105 (0.110) (0.200)	1.122 (0.071) (0.149)
0.5	0.8	1.471 (0.294) (0.557)	1.336 (0.189) (0.444)	1.268* (0.127) (0.345)	1.257* (0.080) (0.268)
0.8	0	1.004 (0.201) (0.198)	0.995 (0.141) (0.138)	0.996 (0.100) (0.099)	0.995 (0.063) (0.063)
0.8	0.5	1.162 (0.232) (0.324)	1.121 (0.159) (0.252)	1.106 (0.111) (0.199)	1.121 (0.071) (0.147)
0.8	0.8	1.475 (0.295) (0.556)	1.340 (0.189) (0.436)	1.266* (0.127) (0.351)	1.253* (0.079) (0.268)
MA(1)		Mean $\hat{b}'_n$			
c	θ	($\sqrt{2/n}\times$Mean $\hat{b}'_n$) (SD $\hat{b}'_n$)			
0	0.5	1.066 (0.213) (0.279)	1.047 (0.148) (0.201)	1.039 (0.104) (0.145)	1.052 (0.067) (0.095)
0	0.8	1.067 (0.213) (0.294)	1.043 (0.147) (0.206)	1.041 (0.104) (0.149)	1.052 (0.067) (0.097)
0.5	0	0.999 (0.200) (0.194)	0.996 (0.141) (0.140)	0.995 (0.100) (0.100)	0.995 (0.063) (0.063)
0.5	0.5	1.068 (0.214) (0.277)	1.042 (0.147) (0.200)	1.039 (0.104) (0.143)	1.049 (0.066) (0.096)
0.5	0.8	1.075 (0.215) (0.296)	1.049 (0.148) (0.211)	1.043 (0.104) (0.150)	1.051 (0.066) (0.098)
0.8	0	1.001 (0.200) (0.196)	0.996 (0.141) (0.138)	0.995 (0.100) (0.099)	0.995 (0.063) (0.063)
0.8	0.5	1.068 (0.214) (0.279)	1.045 (0.148) (0.197)	1.042 (0.104) (0.144)	1.049 (0.066) (0.095)
0.8	0.8	1.071 (0.214) (0.291)	1.046 (0.148) (0.209)	1.040 (0.104) (0.148)	1.051 (0.066) (0.098)

Notes: The entries are estimates of the tail index and their standard errors using regression (3.10) for the AR(1) and MA(1) processes $Z_t = \rho Z_{t-1} + u_t$, $t \geq 1$, $Z_0 = 0$, and $Z_t = u_t + \theta u_{t-1}$, where i.i.d. u_t follow the distribution $P(Z > s) = s^{-\zeta}\left(1 + c(s^{-\alpha\zeta} - 1)\right)$, $s \geq 1$, with $\zeta = \alpha = 1$ and $c \in [0, 1)$. For a general case $\zeta > 0$, one multiplies all the numbers in the table by ζ. "Mean $\hat{b}'_n$" is the sample mean of the estimates $\hat{b}'_n$ obtained in simulations, and "SD $\hat{b}'_n$" is their sample standard deviation. The values $\sqrt{2/n}\times$Mean $\hat{b}'_n$ are the standard errors of $\hat{b}'_n$ provided by expansion (3.12). The asteric indicates rejection of the true null hypothesis $H_0 : \zeta = 1$ in favor of the alternative hypothesis $H_a : \zeta \neq 1$ at the 5% significance level using the reported standard errors. The total number of observations $N = 2000$. Based on 10000 replications.

Table 8. Behavior of the OLS estimator $\hat{b}_n$ in the regression
$\log(H(t-1)) = a' - b' \log(\text{Size}_t)$ for Student t innovations

	n	50	100	200	500
AR(1)		Mean $\hat{b}'_n$			
m	ρ	$(\sqrt{2/n}\times$Mean $\hat{b}'_n)$ (SD $\hat{b}'_n$)			
2	0	1.959 (0.392) (0.370)	1.911 (0.270) (0.252)	1.827 (0.183) (0.165)	1.550* (0.098) (0.074)
2	0.5	2.153 (0.431) (0.488)	2.082 (0.295) (0.362)	1.995 (0.200) (0.253)	1.675* (0.106) (0.115)
2	0.8	2.634 (0.527) (0.843)	2.437 (0.345) (0.636)	2.253 (0.225) (0.443)	1.822 (0.115) (0.202)
3	0	2.763 (0.553) (0.501)	2.631 (0.372) (0.323)	2.417* (0.242) (0.194)	1.869* (0.118) (0.080)
3	0.5	3.077 (0.615) (0.629)	2.922 (0.413) (0.433)	2.683 (0.268) (0.270)	2.022* (0.128) (0.109)
3	0.8	3.921 (0.784) (1.103)	3.569 (0.505) (0.757)	3.141 (0.314) (0.463)	2.214* (0.140) (0.188)
4	0	3.409 (0.682) (0.588)	3.160 (0.447) (0.365)	2.820* (0.282) (0.204)	2.048* (0.130) (0.083)
4	0.5	3.813 (0.763) (0.706)	3.530 (0.499) (0.463)	3.116* (0.312) (0.266)	2.196* (0.139) (0.111)
4	0.8	4.897 (0.979) (1.168)	4.317 (0.610) (0.748)	3.617 (0.362) (0.428)	2.369* (0.150) (0.189)
MA(1)		Mean $\hat{b}_n$			
m	θ	$(\sqrt{2/n}\times$Mean $\hat{b}'_n)$ (SD $\hat{b}'_n$)			
2	0.5	2.097 (0.419) (0.480)	2.025 (0.286) (0.336)	1.935 (0.193) (0.224)	1.631* (0.103) (0.099)
2	0.8	2.141 (0.428) (0.565)	2.064 (0.292) (0.379)	1.962 (0.196) (0.249)	1.645* (0.104) (0.107)
3	0.5	3.002 (0.600) (0.620)	2.850 (0.403) (0.441)	2.605 (0.261) (0.253)	1.976* (0.125) (0.098)
3	0.8	3.156 (0.631) (0.752)	2.956 (0.418) (0.491)	2.677 (0.268) (0.290)	2.006* (0.127) (0.107)
4	0.5	3.715 (0.743) (0.691)	3.431 (0.485) (0.442)	3.038* (0.304) (0.255)	2.156* (0.136) (0.100)
4	0.8	3.943 (0.789) (0.847)	3.590 (0.508) (0.527)	3.128* (0.313) (0.296)	2.191* (0.139) (0.108)

Notes: The entries are estimates of the tail index and their standard errors using regression (3.10) for the AR(1) and MA(1) processes $Z_t = \rho Z_{t-1} + u_t$, $t \geq 1$, $Z_0 = 0$, and $Z_t = u_t + \theta u_{t-1}$, where i.i.d. u_t have the Student t distribution with m degrees of freedom. "Mean $\hat{b}'_n$" is the sample mean of the estimates $\hat{b}'_n$ obtained in simulations, and "SD $\hat{b}'_n$" is their sample standard deviation. The values $\sqrt{2/n}\times$Mean $\hat{b}'_n$ are the standard errors of $\hat{b}'_n$ provided by expansion (3.12). The asteric indicates rejection of the true null hypothesis $H_0 : \zeta = m$ in favor of the alternative hypothesis $H_a : \zeta \neq m$ at the 5% significance level using the reported standard errors. The total number of observations $N = 2000$. Based on 10000 replications.