ARE CREDIT UNIONS TOO SMALL?

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Abstract—U.S. credit unions serve 93 million members, hold 10% of U.S. savings deposits, and make 13.2% of all nonrevolving consumer loans. Since 1985, the share of U.S. depository institution assets held by credit unions has nearly doubled, and the average (inflation-adjusted) size of credit unions has increased over 600%. We use a local-linear estimator, dimesion-reduction techniques, and bootstrap methods to estimate and make inference about ray scale and expansion-path scale economies. We find substantial evidence of increasing returns to scale among credit unions of all sizes, suggesting that further consolidation and growth among credit unions are likely.

I. Introduction

OVER the past three decades, advances in information processing and communications technology (IT) and changes in regulation have had a profound impact on the environment in which commercial banks and other depository institutions operate. IT advances have enabled the development of new bank services (from automated teller machines to Internet banking), financial instruments (such as various types of derivative securities), payments instruments (such as debit cards and automated clearinghouse payments), and credit evaluation and monitoring platforms.[1] The same period saw the deregulation of deposit interest rates and branch banking, the imposition of risk-based capital requirements, and numerous other regulatory changes affecting depository institutions.[2]

On balance, the recent changes in technology and regulation appear to have favored large institutions. The growth rates of larger banks, savings institutions, and credit unions have typically exceeded those of their smaller competitors. For example, adjusted for inflation, the average U.S. commercial bank was 4.3 times larger in 2006 than the average U.S. bank in 1985.[3] The average size of savings institutions and credit unions increased similarly.

Information technology has tended to favor larger institutions because of the relatively high fixed cost of information processing equipment and software and because these technologies have eroded some of the traditional benefits of small scale and close proximity to borrowers that enabled small lenders to outcompete larger institutions for some customers. For example, small business lending traditionally has been dominated by small community banks, where close proximity and personal relationships have been important for obtaining information about the creditworthiness of potential borrowers. However, Petersen and Rajan (2002) argue that advances in IT have reduced the value of soft information in small business lending by making quantifiable information about potential borrowers more readily available, implying that close proximity between borrowers and lenders has become less important than in the past.

Like community banks, credit unions traditionally have operated at small scale and specialized in relationship lending. Credit unions are mutual organizations that provide deposit, lending, and other financial services to a membership defined by an occupational, fraternal or other bond. A common bond is advantageous because it can reduce the cost of assessing the creditworthiness of potential borrowers and thereby facilitate unsecured lending on reasonable terms to the credit union's members. However, as with other lenders, recent advances in information processing and communications technology have lowered the cost of acquiring hard information about potential borrowers, and thereby have eroded some of the advantages of small scale and common bond that traditionally enabled credit unions to provide financial services at low cost to their members.[4]

Despite changes that seem to favor larger depository institutions, membership in credit unions, which traditionally have been much smaller in scale than other depository institutions, has continued to grow at a faster rate than the U.S. population. As of October 2009, credit unions served 93 million members, up from 52 million in 1985 and 80 million in 2000. The share of total industry assets held by credit unions has also increased rapidly since the 1980s, from 3.3% in 1985 to 6.0% in 2005. Much of this gain came at the expense of savings and loan associations and savings banks, which saw a decline in share from 30.1% to 15.9% over the same period. By contrast, the share of industry assets held by commercial banks rose from 66.1% to 78.1%. Credit unions appear to have gained market share as a result of the recent financial

[1] See Berger (2003) for details and analysis of the effects of technological progress on productivity growth in the banking industry and on the structure of the banking industry.

[2] See Spong (2000) for a summary of current U.S. banking regulations.

[3] In 1985, U.S. banks held an average of $189.5 million of assets. In 2006, banks held an average of $1,363 billion of assets ($815.5 million in constant 1985 dollars).

[4] Walter (2006) notes that advances in information processing technology facilitated the emergence and expansion of national credit reporting agencies in the 1970s, the increased use of credit cards, and the development of home equity lines of credit. Further, Walter argues that the extension of federal deposit insurance to credit unions in the 1970s also reduced the benefits of a common bond by weakening the incentive for credit union depositors to monitor and discipline borrowers.

crisis, however. For example, the share of home mortgages originated by credit unions rose from 3.6% in 2007 to 6.2% in 2008. Credit unions now hold some 10% of U.S. household savings deposits, 9% of all consumer loans, and 13.2% of nonrevolving consumer loans. Credit unions are increasingly also a source of business loans, and legislation pending in Congress would permit credit unions to offer even more business loans by increasing the cap for such loans from 12.25% of a credit union's total assets to 25%.[5] Commercial banks oppose legislation to expand credit union powers, contending that credit unions benefit unfairly from favorable tax treatment and less regulation.

As with banks and savings institutions, large credit unions have experienced faster growth in total assets, membership, and earnings than small credit unions (Goddard, McKillop, & Wilson, 2002). Adjusted for inflation, the average credit union held 6.5 times more assets in 2006 than the average credit union in 1985.[6] And like banks and savings institutions, the number of credit unions has declined sharply as the industry has consolidated. From a peak of 23,866 in 1969, the number of credit unions had fallen to just 8,662 in 2006. The Credit Union Membership Access Act of 1998 facilitated this consolidation by affirming the right of credit unions to accept members from unrelated groups. The number of credit unions characterized by multiple common bonds has since increased rapidly.[7]

The rapid consolidation and increasing average scale of credit unions have implications for U.S. banking market structure and for assessing competition in banking markets.[8] Some research finds that agency problems are greater at larger credit unions, suggesting that credit union members may be harmed by continued growth in the average size of credit unions (Leggett & Strand, 2002).[9] However, several studies have noted an inverse relationship between average operating expenses and credit union size (Emmons & Schmid, 1999a; Leggett & Strand, 2002; Wilcox, 2005), and Wilcox (2006) finds that the cost advantage of large credit unions has been increasing over time. Further, Goddard, McKillop, and Wilson (2008) find that larger credit unions have more opportunities for diversification into nontraditional product lines, such as business loans, credit cards, and mutual funds and that doing so has reduced the volatility of their earnings while providing their members with additional services.

This paper presents estimates of returns to scale for U.S. credit unions. We evaluate returns to scale in the context of a model of credit union cost, and unlike prior studies of credit unions, we investigate whether scale economies have expanded over time in line with the industry's consolidation and the increasing average size of credit unions.[10] Our data consist of more than 180,000 annual observations for 1989 to 2006 on all retail credit unions (except those with missing or implausible data).[11] We use a nonparametric, local-linear estimator to estimate our model, from which we derive estimates of returns to scale.[12] We augment the local-linear estimator with two additional kernel functions to (a) handle discrete dummy variables that indicate whether particular credit unions make commercial or real estate loans and (b) incorporate a discrete time variable. Our augmentation is similar to that of Racine and Li (2004), who use a Nadarya-Watson–type kernel estimator to smooth continuous covariates. However, the local-linear estimator we use to smooth along continuous dimensions has (asymptotically) less bias, with no more variance, than the Nadarya-Watson estimator.[13]

We employ three bandwidth parameters in our estimation: one for the continuous covariates (after prewhitening and using a dimension-reduction technique to mitigate the effects of the well-known curse of dimensionality), another for the two binary dummy variables, and a third for the discrete time variable. In addition, we use a bias-corrected bootstrap for inference. Only recently have bootstrapping and optimization of three bandwidths with more than 180,000 observations

[5] HR 3380, the Promoting Lending to America's Small Business Act, was introduced in Congress during July 2009 by Representative Paul Kanjorski. Data on credit union membership, deposits, and loans are available from the Credit Union National Association, http://www.cuna.org/.

[6] U.S. credit unions held an average of $84.6 million in assets in 2006 ($50.6 million in constant 1985 dollars) versus $7.8 million in 1985.

[7] As the advantages of a common bond were eroded, credit unions began to press for authority to expand their membership base. In 1982, the National Credit Union Administration (NCUA), the regulator of federal credit unions, ruled that a single credit union could serve employees of multiple employers even when not all employers were engaged in the same industrial activity. Commercial banks challenged the NCUA ruling, and in 1998 the Supreme Court ruled that the NCUA's interpretation was in violation of the Federal Credit Union Act, which limited membership in federally chartered credit unions to groups having a common bond of occupation or other association. Congress responded by enacting the Credit Union Membership Access Act of 1998. See Walter (2006) for more about the early history and regulation of credit unions in the United States.

[8] See Gilbert and Zaretsky (2003) for a discussion of competitive analysis and antitrust policy as applied to commercial banks, including the use of information about credit unions in assessing competition in banking markets. See Fried, Lovell, and Yaisawarng (1999) and Goddard, McKillop, and Wilson (2007) for evidence on the determinants and effects of credit union mergers.

[9] Other papers investigating agency problems in credit unions include Emmons and Schmid (1999b) and Frame et al. (2003).

[10] Wheelock and Wilson (2001) report evidence of an increase in the minimum efficient scale of commercial banks between 1985 and 1994, whereas Wheelock and Wilson (1999, 2009) find that on average, large banks have experienced larger increases in productivity over the past twenty years than small banks.

[11] Specifically, we omitted observations for which negative values of loans, interest rates, or factor prices were reported or for which all loans were 0. We also do not include data on corporate credit unions, which are organizations that provide payments and other services to retail credit unions.

[12] Many studies derive estimates of scale economies by fitting a translog cost function across all firms in an industry. However, the translog function has been found to misspecify many cost relationships, especially when firms are of widely varying sizes. In the appendix to this paper, we report results showing that the translog function also misspecifies cost relationships for U.S. credit unions.

[13] Regarding the direction of the bias, our estimator will tend to under-(over-) estimate the conditional mean function in regions where it exhibits sharp peaks (valleys). See Fan and Gijbels (1996) for details.

using least-squares cross-validation become computationally feasible at low cost.[14]

We estimate both ray scale economies and expansion-path scale economies. Our estimates of ray scale economies indicate rapidly increasing returns to scale for credit unions below the median size but near constant returns for larger credit unions. However, our estimates of expansion-path scale economies, which may better reflect scale economies near the combinations of inputs and outputs in actual credit union production, indicate that even the largest credit unions operate under increasing returns to scale. Thus, despite substantial industry consolidation and increase in average credit union size during the past two decades, the evidence suggests that more consolidation and increase in average size are likely, especially if legal restrictions on credit union membership or activities are eased further.

The remainder of the paper unfolds as follows. In the next section, we describe a model of credit union costs. Section III presents details of our estimation strategy. Results are presented in section IV, and our conclusions are discussed in section V.

II. A Model of Credit Union Costs

A. Baseline Model

To estimate scale economies, we must first specify a model of credit union costs. Credit unions use a number of inputs to produce a wide range of services; in studies of credit union performance, limited data and, in the case of nonparametric approaches, limits on the number of dimensions that can reasonably be examined force researchers to employ simplified models.

Following Frame, Karels, and McClatchey (2003) and Frame and Coelli (2001), we model credit unions as service providers that seek to minimize noninterest costs subject to the prices of labor and capital inputs, the prevailing production technology, and the level and types of output they produce.[15] For the baseline model, we specify four variable output quantities: real estate loans (Y_1), commercial loans (Y_2), consumer loans (Y_3), and investments (Y_4). Further, following Frame et al. (2003), we treat the average interest rates

on deposits (Y_5) and loans (Y_6) as additional, quasi-fixed outputs to capture the price dimension of service to credit union members. Also like Frame et al. (2003), our model includes the price of capital (W_1) and the price of labor (W_2) that every credit union faces. Finally, our model includes a discrete time variable (T) for each year in our data and two dummy variables, D_1 and D_2, that identify individual credit unions that make real estate or commercial loans, with

$$D_1 = \begin{cases} 1 \text{ if } Y_1 > 0; \\ 0 \text{ otherwise,} \end{cases} \tag{1}$$

and

$$D_2 = \begin{cases} 1 \text{ if } Y_2 > 0; \\ 0 \text{ otherwise.} \end{cases} \tag{2}$$

Table 1 lists the variables in our model and how each is defined in terms of call report items.[16]

Table 2 reports summary statistics for the variables in our model, as well as for total operating cost (expenditures on physical capital and labor inputs) and total assets. The mean values reported for D_1 and D_2 in table 2 indicate that over 1989 to 2006, about 63% of credit unions made real estate loans, whereas only about 14% made commercial loans. Our data consist of 184,279 annual (year-end) observations for all state- and federally chartered retail credit unions between 1989 and 2006; the numbers of observations for each of eighteen years are given in table 3.[17]

Figure 1 shows kernel density estimates for (inflation-adjusted) credit union total assets for 1989, 1997, and 2006. The densities for each year are skewed to the right (note the use of a log scale on the figure's horizontal axis). The density estimates also reveal that the distribution of credit union sizes has shifted to the right, reflecting the increase in average (and median) credit union size over time.

The variables defined above and listed in table 1 suggest a mapping

$$(Y_1, \ldots, Y_6, W_1, W_2, T) \rightarrow C. \tag{3}$$

For estimation, we impose homogeneity of the cost function with respect to input prices by dividing both C and W_1 by W_2. In addition, because large numbers of observations on Y_2 and Y_3 are equal to 0 (as shown in the summary statistics in table 2), we combine these outputs with Y_1 by using the sum ($Y_1 + Y_2 + Y_3$) and the dummy variables D_1 and D_2 in

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[14] We use a high-throughput Condor pool operated by Clemson University for our computations. Condor systems, a form of grid computing, consist of a scheduler that sends jobs to machines in the pool when they are idle, thereby harvesting (or scavenging—hence the name "Condor") otherwise unused CPU cycles. Our bandwidth optimization and other computational problems are ideally suited for high-throughput computing systems (as opposed to high-performance computing systems such as vector machines and massively parallel machines, which involve considerable expense) since the problems are easily divided into independent pieces that can run on different machines and need no communication between tasks until the very end. Additional details on the development of Condor systems are available at http://www.cs.wisc.edu/condor/; details on the Condor system operated by Clemson University are available at http://ccit.clemson.edu/support/research/.

[15] See also Bauer (2008), Fried, Lovell, and Eeckaut (1993), Fried et al. (1999), and Smith (1984).

[16] Call report data for individual credit unions are available from the National Credit Union Administration (www.ncua.gov). We obtained our data from the Federal Reserve.

[17] We omitted observations where either $Y_1 < 0$, $Y_2 < 0$, $Y_3 < 0$, $Y_4 < 0$, $(Y_1 + Y_2 + Y_3) = 0$, $Y_5 \notin (0, 1)$, $Y_6 \notin (0, 1)$, $W_1 \notin (0, 1)$, or $W_2 \leq 0$. These observations reflected obviously incorrect values for one or more variables—usually one or both of the price variables—or 0 values for all loans.

TABLE 1.—DEFINITIONS OF VARIABLES

Y_1	Real estate loans: amount of first mortgage real estate loans (CUSA0243) + amount of other real estate loans (CUSA0244).
Y_2	Commercial loans: for years 1989–2003, amount of commercial loans (CUSA0257) + amount of acricultural loans to members (CUSA1235); for years 2004–2006, member business loans, total amount outstanding (CUSA4899).
Y_3	Consumer loans: total loans and leases, amount (CUSA1263) $-(Y_1 + Y_2)$.
Y_4	Investments: for years 1989–2005, total investments (less derivatives contracts) (CUSA4577); for year 2006, balances due from U.S. depository institutions (CUSA0082) + investments eligible for liquidity (CUSA0851) + membership capital at corporate credit unions (CUSAB158) + deposits in commercial banks, S&Ls, savings banks (total amount) (CUSA8632) + paid in capital at corporate credit unions (CUSAB148) + all other investments in corporate credit unions (CUSA1110) + U.S. Treasury securities — book value (excluding trading accounts) (CUSA0400) + U.S. government agency and corporation obligations — book value (excluding trading accounts) (CUSA0600) + mutual funds (CUSA8628) + shares, deposits, and certificates in other credit unions, total amount (CUSA1116).
Y_5	Savings pricing: [dividends on shares (CUSA4278) + interest on deposits (CUSA4279)]/total shares and deposits (CUSA2197).
Y_6	Loan pricing: interest and fee income on loans, total (CUSA4010/amount of total loans and leases (CUSA1263).
W_1	Price of capital: capital expenses, that is, gross occupancy expense (CUSA4210) + office operations expense (CUSA4209) + advertising expense (CUSA4143) + travel and conference expense (CUSA4207) + loan expenses (CUSA4152) + operating expenses fees, professional and outside services (CUSA4211) + other operating expenses (CUSA4240) + miscellaneous operating expenses (CUSA4526), divided by total shares and deposits (CUSA2197).
W_2	Price of labor: labor expenses, that is, officers and employee compensation (CUSA4137), divided by number of full-time credit union employees (CUSA6047) + (1/2 times) number of part-time credit union employees (CUSA6048).
M	Technical efficiency estimated using equation (7) (see section IIB for details).
T	Time: equals 1 for 1989, 2 for 1990, . . . , 18 for 2006.
D_1	Dummy variable: equals 1 if $Y_1 > 0$; 0 otherwise.
D_2	Dummy variable: equals 1 if $Y_2 > 0$; 0 otherwise.
C	Variable cost: capital expenses + labor expenses.

TABLE 2.—SUMMARY STATISTICS, 1989–2006

	Minimum	Q1	Median	Mean	Q3	Maximum	Number of Zero-value Observations
$COST$	1.68	66.34	223.20	1,219.00	796.70	598,100.00	0
Y_1	0.00	0.00	354.50	10,090.00	3,756.00	8,73,1000.00	67,172
Y_2	0.00	0.00	0.00	417.10	0.00	511,900.00	15,7261
Y_3	0.00	1,198.00	3,335.00	14,790.00	9,657.00	8,581,000.00	12
Y_4	0.00	564.40	2,117.00	12,230.00	7,267.00	62,600,0.000	94
Y_5	0.0000	0.0254	0.0351	0.0360	0.0449	0.3333	0
Y_6	0.0047	0.0805	0.0924	0.0958	0.1106	0.7778	0
W_1	0.0001	0.0124	0.0178	0.0189	0.0237	0.4583	0
W_2	0.0026	22.3100	29.8500	29.7700	36.9800	4,768.0000	0
X_1	9.95	1,892.00	6,071.00	34,550.00	20,790.00	17,440,000.00	0
X_2	0.50	1.50	4.00	16.62	11.50	5,282.00	0
M	0.00	0.12	0.18	0.17	0.23	0.75	15,324
T	1.00	4.00	9.00	8.81	13.00	18.00	0
D_1	0.00	0.00	1.00	0.63	1.00	1.00	67,172
D_2	0.00	0.00	0.00	0.14	0.00	1.00	157,261
$ASSETS$	11.95	2,201.00	6,955.00	39,550.00	23,540.00	22,840,000.00	0

$COST$, Y_1, Y_2, Y_3, Y_4, and $ASSETS$ are measured in thousands of (year 2000) dollars; Y_5, Y_6, and W_1 are dimensionless ratios, and W_2 is measured in thousands of (year 2000) dollars per full-time-equivalent employees. Columns labeled Q1 and Q3 give first and third quartiles for each variable, while the last column gives the number of observations where the variable equals 0.

our estimation. Then the mapping in equation (3) suggests a regression function

$$\left(\frac{C}{W_2}\right) = C(\mathbf{y}_1, \mathbf{w}_1) + \varepsilon, \quad (4)$$

where $\mathbf{y}_1 = [(Y_1 + Y_2 + Y_3) \ Y_4]$, $\mathbf{w}_1 = [Y_5 \quad Y_6 \quad W_1/W_2 \quad T \ D_1 \quad D_2]$, and ε is a random error term with $E(\varepsilon) = 0$. Given that the expectation of ε equals 0, $C(\mathbf{y}_1, \mathbf{w}_1) = E(C/W_2 \mid \mathbf{y}_1, \mathbf{w}_1)$ is a conditional mean function that can be estimated by various regression techniques.

B. Alternative Models

The regression function in equation (4) serves as a baseline model, which we refer to as model 1. Conceivably there are determinants of a credit union's variable costs besides

TABLE 3.—NUMBER OF OBSERVATIONS PER YEAR

Year	Number of Observations	Year	Number of Observations	Year	Number of Observations
1989	12,438	1995	10,766	2001	9,322
1990	12,213	1996	10,539	2002	8,970
1991	12,022	1997	10,389	2003	8,895
1992	11,727	1998	10,169	2004	8,574
1993	11,340	1999	9,935	2005	8,278
1994	11,065	2000	9,598	2006	8,039

those included in equation (3). In particular, management quality and the effectiveness of a credit union's accounting infrastructure or IT services would likely affect its ability to operate at lower cost. One might expect that larger credit unions would have better access to high-quality management and IT services, but some large credit unions might be poorly

FIGURE 1.—DENSITY OF TOTAL (LOG) ASSETS
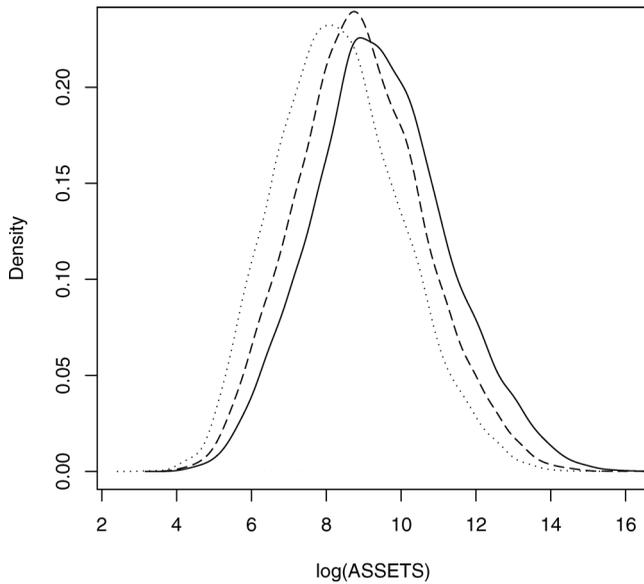
Kernel estimates of the density of (log) total assets for 1989, 1997, and 2006 are shown by the dotted, dashed, and solid curves, respectively. Total assets are measured in thousands of constant year 2000 dollars.

managed. In addition, smaller credit unions with savvy managers might be able to outsource some of their IT services to efficient providers. In an attempt to capture these factors, we also estimate a second model that includes an instrumental variable M, consisting of estimates of technical efficiency.[18]

To estimate technical efficiency, first consider the production set implied by equation (3),

$$\mathcal{P} = \{(\boldsymbol{u}, \boldsymbol{v}) \mid \boldsymbol{u} \text{ can produce } \boldsymbol{v})\}, \qquad (5)$$

where $\boldsymbol{u} \in \mathbb{R}_+^p$ is a vector of p input quantities and $\boldsymbol{v} \in \mathbb{R}_+^q$ is a vector of q output quantities. Here, $p = 2$ and $q = 6$. The input vector $\boldsymbol{u}$ includes capital (X_1) and labor (X_2) corresponding to the prices W_1 and W_2 defined above. The output vector $\boldsymbol{v}$ contains variables $Y_1, \ldots, Y_6$. Assuming the distribution of input and output vectors has bounded support over the production set $\mathcal{P}$, the directional distance function defined by

$$D(\boldsymbol{u}, \boldsymbol{v} \mid \boldsymbol{d}_u, \boldsymbol{d}_v) = \sup\{\beta \mid (\boldsymbol{u} - \beta \boldsymbol{d}_u, y + \beta \boldsymbol{d}_v) \in \mathcal{P}\} \geq 0, \qquad (6)$$

where $\boldsymbol{d}_u \in \mathbb{R}_+^p$ and $\boldsymbol{d}_v \in \mathbb{R}_+^q$ are predefined direction vectors, provides a (directional) measure of technical efficiency. A firm operating at a point $(\boldsymbol{u}, \boldsymbol{v})$ in the interior of $\mathcal{P}$ is technically inefficient; in principle, it could become technically efficient by moving to the boundary of $\mathcal{P}$ along the path $(\boldsymbol{u} - \beta \boldsymbol{d}_u, \boldsymbol{v} + \beta \boldsymbol{d}_v)$, $\beta > 0$. A technically inefficient firm operating at $(\boldsymbol{u}, \boldsymbol{v}) \in \mathcal{P}$ lying strictly below the upper boundary of $\mathcal{P}$ is dominated by any firm operating at $(\widetilde{\boldsymbol{u}}, \widetilde{\boldsymbol{v}}) \in \mathcal{P}$ where $\widetilde{\boldsymbol{u}} \leq \boldsymbol{u}$ and $\widetilde{\boldsymbol{v}} \leq \boldsymbol{v}$. Firms lying in the interior of $\mathcal{P}$ do not

[18] Wheelock and Wilson (1995, 2000) use estimates of technical efficiency as proxies for management quality in competing risks models of time to failure and time to acquisition for commercial banks.

perform optimally the task of converting inputs into outputs; they are technically inefficient. In the case of credit unions, firms may be inefficient due to managerial mistakes, poor IT operations, adverse labor market conditions, or something else.

Given a sample $\{(\boldsymbol{u}_i, \boldsymbol{v}_i)\}_{i=1}^n$ of observed input-output vectors, an estimate of the directional distance function defined in equation (6) for firm i can be computed by solving

$$\widehat{D}(\boldsymbol{u}_i, \boldsymbol{v}_i \mid \boldsymbol{d}_{u,i}, \boldsymbol{d}_{v,i}) = \max_{\beta, \boldsymbol{q}} \{\beta \mid \boldsymbol{V}\boldsymbol{q} - \beta \boldsymbol{d}_{v,i} \geq \boldsymbol{v}_i, \boldsymbol{U}\boldsymbol{q}$$
$$+ \beta \boldsymbol{d}_{u,i} \leq \boldsymbol{u}_i, \quad \boldsymbol{i}_n'\boldsymbol{q} = 1, ; \boldsymbol{q} \geq 0\}, \qquad (7)$$

where the direction vectors $\boldsymbol{d}_{u,i}$ and $\boldsymbol{d}_{v,i}$ corresponding to firm i are given a priori, $\boldsymbol{q}$ is an $(n \times 1)$ vector of weights, $\boldsymbol{i}_n$ is an $(n \times 1)$ vector of ones, $\boldsymbol{U} = [\boldsymbol{u}_1, \ldots, \boldsymbol{u}_n]$ is a $(p \times n)$ matrix of input vectors, $\boldsymbol{V} = [\boldsymbol{v}_1, \ldots, \boldsymbol{v}_n]$ is a $(q \times n)$ matrix of output vectors, and β is a scalar. Solutions to equation (7) can be computed using linear programming methods; we use a revised simplex method described by Hadley (1962).[19]

Our instrumental variable M is constructed by computing estimates $\widehat{D}(\boldsymbol{u}_r i, \boldsymbol{v}_i \mid \boldsymbol{d}_{u,i}, \boldsymbol{d}_{v,i})$ for each credit union $i = 1, \ldots, n_t$ in year t. For each credit union i, we set $\boldsymbol{d}_{u,i} = \boldsymbol{u}_i$; the first four elements of $\boldsymbol{d}_{v,i}$ are set equal to the first four elements of $\boldsymbol{v}_i$ (corresponding to the variables $Y_1, \ldots, Y_4$), while the last two elements of $\boldsymbol{d}_{v,i}$ (corresponding to Y_5 and Y_6) are set to 0. Hence we estimate technical efficiency for each firm while holding the service outputs Y_5 and Y_6 constant at their observed values and while maintaining observed input and output ratios. The reference matrices $\boldsymbol{U}$ and $\boldsymbol{V}$ are constructed using all observed input-output vectors for a given year t. Our second model, model 2, is obtained by replacing $\boldsymbol{y}_1$ and $\boldsymbol{w}_1$ in equation (4) with $\boldsymbol{y}_2 = \boldsymbol{y}_1$ and $\boldsymbol{w}_2 = [Y_5 \quad Y_6 \quad W_1/W_2 \quad M \quad T \quad D_1 \quad D_2]$.

In both models 1 and 2, it is conceivable that loans and investments are endogenous with respect to costs. It is clear that costs are incurred by making loans and investments, but credit unions facing high (marginal) costs might also be reluctant to make additional loans or investments. Consequently, we also specify models 3 and 4 by replacing the loan and investment variables Y_1, Y_2, Y_3, and Y_4 (as well as the dummy variables D_1 and D_2) in models 1 and 2 with one-period lags. The lagged variables then serve as instruments for the loan and investment variables in models 1 and 2.

[19] Directional distance functions have been discussed in the context of microeconomic theory by Chambers, Chung, and Färe (1996, 1998) and Färe and Grosskopf (2000). When $\boldsymbol{d}_u = 0$ and $\boldsymbol{d}_v = \boldsymbol{v}$, $D(\boldsymbol{u}, \boldsymbol{v} \mid \boldsymbol{d}_u, \boldsymbol{d}_v) = \frac{1}{\lambda(\boldsymbol{u}, \boldsymbol{v})} - 1$ where $\lambda(\boldsymbol{u}, \boldsymbol{v})$ is the Shephard (1970) output distance function; when $\boldsymbol{d}_u = \boldsymbol{u}$ and $\boldsymbol{d}_v = 0$, $D(\boldsymbol{u}, \boldsymbol{v} \mid \boldsymbol{d}_u, \boldsymbol{d}_v) = 1 - \frac{1}{\theta(\boldsymbol{u}, \boldsymbol{v})}$ where $\theta(\boldsymbol{u}, \boldsymbol{v})$ is the Shephard (1970) input distance function. Consistency and rates of convergence of the estimator appearing in equation (7) have been proved by Kneip, Simar, and Wilson (2008) for these special cases. Wilson (2011) establishes similar properties for a hyperbolic estimator similar to equation (7) where efficiency is measured along a hyperbola passing through the point of interest. Intuition suggests that similar properties extend to the estimator in equation (7), but a formal proof is beyond the scope of this paper.

C. Measuring Returns to Scale

In each model j, $j \in \{1, 2, 3, 4\}$, the right-hand-side variables have been partitioned into an array $\boldsymbol{y}_j$ of variable outputs and an array $\boldsymbol{w}_j$ of quasi-fixed outputs, input prices, and other variables. For each model, we wish to examine returns to scale as the outputs in $\boldsymbol{y}_j$ are increased while holding fixed the variables in $\boldsymbol{w}_j$.

For a particular model j, consider a specific point $(\boldsymbol{y}_0, \boldsymbol{w}_0)$ in the space of $(\boldsymbol{y}, \boldsymbol{w})$, omitting subscripts j to streamline the notation. In our empirical analysis in section IV, we define $(\boldsymbol{y}_0, \boldsymbol{w}_0)$ by the medians of the variables in $\boldsymbol{y}$ and $\boldsymbol{w}$ in specific years. The set of points $\mathfrak{R}_0 = \{(\theta \boldsymbol{y}_0, \boldsymbol{w}_0) \mid \theta \in (0, \infty)\}$ comprises a ray along which the variable outputs in $\boldsymbol{y}$ are produced in constant proportion to each other. Ray scale economies can be evaluated by examining how expected cost varies along this ray, providing insight into returns to scale along the ray $\mathfrak{R}_0$. Returns to scale are frequently measured in terms of elasticities; the elasticity of cost (with respect to $\boldsymbol{y}$) at a particular point $(\boldsymbol{y}, \boldsymbol{w})$ along the ray $\mathfrak{R}_0$ is given by

$$\eta(\boldsymbol{y}, \boldsymbol{w}) \equiv \left. \frac{\partial \log C(\theta \boldsymbol{y}, \boldsymbol{w})}{\partial \log \theta} \right|_{\theta=1} = \sum_\ell \frac{\partial \log C(\boldsymbol{y}, \boldsymbol{w})}{\partial \log y_\ell}, \quad (8)$$

where ℓ indexes the elements of $\boldsymbol{y}$. The elasticity in equation (8) is the multiproduct analog of marginal cost divided by average cost on the ray $\mathfrak{R}_0$, with $\eta(\boldsymbol{y}, \boldsymbol{w})(<, =, >)1$ implying (increasing, constant, decreasing) returns to scale as outputs in $\boldsymbol{y}$ are expanded along the ray $\mathfrak{R}_0$. Credit unions for which $\eta(\boldsymbol{y}, \boldsymbol{w}) \neq 1$ are not competitively viable; if credit unions were subject to the normal rules of competitive behavior, either a smaller or a larger credit union could drive a credit union with $\eta(\boldsymbol{y}, \boldsymbol{w}) \neq 1$ from a competitive market.

The measure defined in equation (8) requires estimation of derivatives of the cost function. We employ fully nonparametric estimation methods, as discussed in section III. Because nonparametric estimates of derivatives of a function are typically noisier than estimates of the function itself,[20] we define the ratio

$$\mathcal{S}(\theta \mid \boldsymbol{y}_0, \boldsymbol{w}_0) \equiv \frac{C(\theta \boldsymbol{y}_0, \boldsymbol{w}_0)}{\theta C(\boldsymbol{y}_0, \boldsymbol{w}_0)}. \quad (9)$$

It is straightforward to show that

$$\frac{\partial \mathcal{S}(\theta \mid \boldsymbol{y}_0, \boldsymbol{w}_0)}{\partial \theta} \lesseqgtr 0 \iff \eta(\boldsymbol{y}_0, \boldsymbol{w}_0) \lesseqgtr 1, \quad (10)$$

that is, $\mathcal{S}(\theta \mid \boldsymbol{y}_0, \boldsymbol{w}_0)$ is decreasing (constant, increasing) in θ if returns to scale are increasing (constant, decreasing) at $(\theta \boldsymbol{y}_0, \boldsymbol{w}_0)$ along the ray $\mathfrak{R}_0$ passing through $(\boldsymbol{y}_0, \boldsymbol{w}_0)$. In addition, $\mathcal{S}(1 \mid \boldsymbol{y}_0, \boldsymbol{w}_0) = 1$ by definition. Thus, ray scale economies (RSE) along a ray $\mathfrak{R}_0$ can be examined by estimating $C(\boldsymbol{y}_0, \boldsymbol{w}_0)$ and $C(\theta \boldsymbol{y}_0, \boldsymbol{w}_0)$ for various values of θ and

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[20] This is particularly true for present case here, where we would require derivatives in several dimensions; in addition, bandwidth selection becomes problematic when estimating derivatives in more than one dimension.

FIGURE 2.—RSE AND EPSE MEASURES
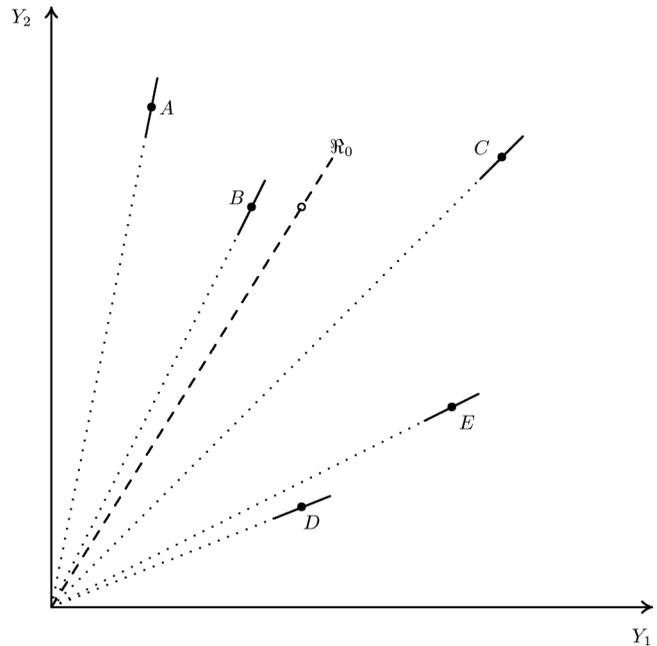
using confidence bands to determine whether $\mathcal{S}(\theta \mid \boldsymbol{y}_0, \boldsymbol{w}_0)$ is downward or upward sloping.

Of course, not all credit unions are located along the ray $\mathfrak{R}_0$; in fact, it is conceivable that none is located along $\mathfrak{R}_0$. RSE is a convenient measure of scale economies but may be misleading if most credit unions are located "far" from $\mathfrak{R}_0$. As an alternative to RSE, we also consider scale economies along each credit union's expansion path, holding the mix of outputs in $\boldsymbol{y}$ constant for each credit union. Consider the ith credit union operating at the point $(\boldsymbol{y}_i, \boldsymbol{w}_i)$, with cost $C(\boldsymbol{y}_i, \boldsymbol{w}_i)$. Let γ be a small, positive number, say 0.05, and consider how cost changes as we move from $((1 - \gamma)\boldsymbol{y}_i, \boldsymbol{w}_i)$ to $((1 + \gamma)\boldsymbol{y}_i, \boldsymbol{w}_i)$; along this path, the output mix remains constant in the sense that relative proportions are maintained. Now let $\theta(1 - \gamma)\boldsymbol{y}_i = (1 + \gamma)\boldsymbol{y}_i$; then $\theta = (1 + \gamma)/(1 - \gamma)$.

Expansion-path scale economies (EPSE) for the ith credit union operating at $(\boldsymbol{y}_i, \boldsymbol{w}_i)$ are measured by

$$\begin{aligned} \mathcal{E}_i &= \frac{C(\theta(1 - \gamma)\boldsymbol{y}_i, \boldsymbol{w}_i)}{\theta C((1 - \gamma)\boldsymbol{y}_i, \boldsymbol{w}_i)} \\ &= \frac{C((1 + \gamma)\boldsymbol{y}_i, \boldsymbol{w}_i)}{\left(\frac{1+\gamma}{1-\gamma}\right) C((1 - \gamma)\boldsymbol{y}_i, \boldsymbol{w}_i)}. \end{aligned} \quad (11)$$

A credit union operating at $(\boldsymbol{y}_i, \boldsymbol{w}_i)$ experiences (decreasing, constant, increasing) returns to scale along the path from $((1 - \gamma)\boldsymbol{y}_i, \boldsymbol{w}_i)$ to $((1 + \gamma)\boldsymbol{y}_i, \boldsymbol{w}_i)$ as $\mathcal{E}_i(>, =, <)1$. Our measure $\mathcal{E}_i$ gives an indication of returns to scale faced by the ith credit union along the path from the origin through the credit union's observed output vector, starting at a level equal to $(1 - \gamma)\%$ of the quantities in $\boldsymbol{y}_i$ and continuing to a level equal to $(1 + \gamma)\%$ of the quantities in $\boldsymbol{y}_i$.

Figure 2 illustrates the differences between our RSE and EPSE measures. In figure 2, five hypothetical credit unions,

each producing two outputs and with other variables constant, are represented by the points labeled A through E. The median output vector is represented by an open circle along the dashed ray (labeled $\Re_0$) from the origin. The RSE measure defined in equation (9) measures returns to scale along the length of this ray as θ varies. The EPSE measure defined in equation (11), by contrast, measures returns to scale along each firm's expansion path, represented by the dotted rays from the origin through the points A to E. Moreover, by construction, EPSE measures returns to scale in the neighborhood of a given credit union's actual production, which is represented by the solid portion of the rays from the origin. As the example illustrates, some firms may operate far from any point along the ray $\Re_0$. Hence, EPSE may represent more accurately returns to scale that actual credit unions face.

Both our RSE and EPSE measures are defined in terms of a credit union's cost function. In the next section, we discuss a strategy for estimating the cost function nonparametrically, which allows us to estimate, and make inference about, our measures of scale economies.

III. Estimation Strategy

A. Parametric versus Nonparametric Estimation

Various approaches exist for estimating regression functions (that is, conditional mean functions) such as the one defined in equation (4). In parametric approaches, a translog specification is often used for the conditional mean function. It is important to note, however, that because the translog cost function is merely a quadratic specification in log space, the variety of shapes the cost function is permitted to take is limited. Further, because the translog is derived from a Taylor expansion of the cost function around the mean of the data, it makes little sense to use the translog specification to attempt inference about returns to scale over units of widely varying size. We find that the translog specification is easily rejected by our data (see the appendix for details).

Rejection of the translog functional form is hardly surprising. Several studies have noted that the parameters of a translog function are unlikely to be stable when the function is fit globally across units of widely varying sizes.[21] The problem points to the use of nonparametric estimation methods. Although nonparametric methods are less efficient in a statistical sense than parametric methods when the true functional form is known, nonparametric estimation avoids the risk of specification error when the true functional form is unknown, which, to our knowledge, is the case here.[22]

We use a fully nonparametric, local-linear estimator augmented to handle discrete covariates. Nonparametric regression models may be viewed as infinitely parameterized; as such, any parametric regression model (such as the translog cost function) is nested within a nonparametric regression model. Clearly, adding more parameters to a parametric model affords greater flexibility. Nonparametric regression models represent the limiting outcome of adding more parameters.[23]

B. Dimension Reduction

Most nonparametric regression methods suffer from the well-known curse of dimensionality, a phenomenon that causes rates of convergence to become slower, and estimation error to increase dramatically, as the number of continuous right-hand-side variables increases (the presence of discrete dummy variables does not affect the rate of convergence of our estimator). To help mitigate this problem, we use a dimension-reduction technique based on principal components. The idea is to trade a relatively small amount of information in the data for a reduction in dimensionality that will have a large (and favorable) impact on estimation error.

Let J_j denote the sum of the number of continuous variables on the right-hand side of model j, excluding the ordered categorical variable T and the binary variables D_1 and D_2. Then $J_j = 5$ for $j \in \{1, 3\}$ and $J_j = 6$ for $j \in \{2, 4\}$.

For an $(n \times 1)$ vector U, define the function

$$\psi_1(U) \equiv (U - n^{-1}i'U)[n^{-1}U'U - n^{-2}U'ii'U]^{-1/2}, \quad (12)$$

where i denotes an $(n \times 1)$ vector of 1s. The function $\psi_1(\cdot)$ standardizes a variable by subtracting its sample mean and then dividing by its sample standard deviation. Next, let A_j be an $(n \times J_j)$ matrix; for model 1, the columns of A_1 contain $\psi_1(\log(Y_1 + Y_2 + Y_3))$, $\psi_1(\log(1 + Y_4))$, $\psi_1(Y_5)$, $\psi_1(Y_6)$, and $\psi_1\left(\log\left(\frac{W_1}{W_2}\right)\right)$. The first five columns of A_2 are identical to the columns of A_1, and the sixth column of A_2 contains $\psi_1(M)$. For models 3 and 4, A_3 and A_4 are similar to A_1 and A_2, but with lagged variables replacing Y_1, Y_2, Y_3, Y_4, D_1, and D_2 (respectively). In each model, the three loan variables Y_1, Y_2, and Y_3 (or their lagged values) are summed since, as noted previously in section II, many credit unions do not make real estate or commercial loans. The dummy variables D_1 and D_2 (or their lags in models 3 and 4) retain some information that would otherwise be lost by identifying those credit unions that are observed to hold either real estate or commercial loans.

Let Λ_j be the $(J_j \times J_j)$ matrix whose columns are the eigenvectors of the $(J_j \times J_j)$ correlation matrix whose elements are

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[21] See, for example, Guilkey, Lovell, and Sickles (1983) and Chalfant and Gallant (1985) for Monte Carlo evidence, and Cooper and McLaren (1996) and Banks, Blundell, and Lewbel (1997) for empirical evidence involving consumer demand. Still others have found a similar problem while estimating cost functions for hospitals (Wilson & Carey, 2004) and for U.S. commercial banks (McAllister & McManus, 1993; Mitchell & Onvural, 1996; Wheelock & Wilson, 2001); both hospitals and banks vary widely in terms of size, as do credit unions.

[22] Härdle and Mammen (1993) describe a procedure for testing a parametric regression specification against a nonparametric alternative; one could

think of this as a very general specification test, as opposed to the specific specification tests described in the preceding paragraph. In this paper, however, it is trivial to reject the translog specification using the tests described in the appendix.

[23] See Fan and Gijbels (1996) and Härdle and Linton (1999) for good descriptions of nonparametric regression and the surrounding issues. Several possibilities for nonparametric regression exist.

the Pearson correlation coefficients for pairs of columns of A_j. Let λ_{jk} be the eigenvalue corresponding to the kth eigenvector in the kth column of $\mathbf{\Lambda}_j$, where the columns of $\mathbf{\Lambda}_j$ for a particular model j, and hence the corresponding eigenvalues, have been sorted so that $\lambda_{j1} \geq \ldots \geq \lambda_{j5}$. Then set $\mathbf{P}_j = A_j \mathbf{\Lambda}_j$. The matrix $\mathbf{P}_j$ has dimensions $(n \times J_j)$, and its columns are the principal components of A_j. Principal component vectors are orthogonal, and for each $k \in \{1, 2, \ldots, J_j\}$, the quantity

$$\phi_{jk} = \frac{\sum_{j=1}^{k} \lambda_j}{\sum_{\ell=1}^{J_j} \lambda_\ell} \tag{13}$$

represents the proportion of the independent linear information in A_j that is contained in the first k principal components, that is, the columns of $\mathbf{P}_j$ for each $j \in \{1, 2, 3, 4\}$.

Using our data, we find for model 1 $\phi_{1k} = 0.5012, 0.7665, 0.8986, 0.9757,$ and 1.0 for $k = 1, \ldots, 5$ respectively. For model 2, $\phi_{2k} = 0.4256, 0.6641, 0.8082, 0.9174, 0.9798,$ and 1.0 for $k = 1, \ldots, 6$; for model 3, $\phi_{3k} = 0.4982, 0.7618, 0.8979, 0.9740,$ and 1.0 for $k = 1, \ldots, 5$; and for model 4, $\phi_{4k} = 0.4244, 0.6669, 0.8044, 0.9170, 0.9785,$ and 1.0 for $k = 1, \ldots, 6$. Consequently, in our nonparametric estimation of the credit union cost function in each model, we use the first four principal components, omitting the last one in models 1 and 3 and the last two in models 2 and 4. In doing so, we sacrifice a relatively small amount of information—2.43%, 8.26%, 2.60%, and 8.30% of the independent linear information in the samples for models 1 to 4, respectively—in order to reduce the dimensionality of our estimation problem by one dimension in the space of the continuous covariates. Given the curse of dimensionality, this seems a good trade-off.[24]

C.   Estimating Returns to Scale

Because we use the first four columns of $\mathbf{P}_j$ for each model j, in the remainder of this section, we suppress the j subscript denoting a particular model; the following discussion applies to each of our four models if the reader remembers to substitute lagged variables for D_1 and D_2 for models 3 and 4.

Let $\mathbf{P}_{\cdot k}$ denote the kth column of the principal component matrix $\mathbf{P}$ and define

$$\psi_0(\mathbf{P}_{\cdot k}) \equiv \mathbf{P}_{\cdot k} \left[n^{-1} \mathbf{P}'_{\cdot k} \mathbf{P}_{\cdot k} - n^{-2} \mathbf{P}'_{\cdot k} \mathbf{i} \mathbf{i}' \mathbf{P}_{\cdot k} \right]^{-1/2}. \tag{14}$$

The transformation $\psi_0(\mathbf{P}_{\cdot k})$ has (constant) unit variance. Next, let z_i represent the row vector containing the ith observations on $\psi_0(\mathbf{P}_{\cdot 1})$, $\psi_0(\mathbf{P}_{\cdot 2})$, $\psi_0(\mathbf{P}_{\cdot 3})$, and $\psi_0(\mathbf{P}_{\cdot 4})$. We can now write our model as the following regression equation,

$$\mathcal{C}_i = m(z_i, T_i, D_{i1}, D_{i2}) + \varepsilon_i, \tag{15}$$

where the subscript i indexes observations, $\mathcal{C}_i = \psi_1\left(\log\left(\frac{C_i}{W_{i2}}\right)\right)$, ε_i is a random error term with $E(\varepsilon_i) = 0$, $\text{VAR}(\varepsilon_i) = \sigma^2(z_i)$, T_i represents the ith observation on the time variable, and D_{i1}, and D_{i2} represent the ith observations on D_1 and D_2. The function $m(z_i, T_i, D_{i1}, D_{i2}) = E(\mathcal{C}_i \mid z_i, T_i, D_{i1}, D_{i2})$ is a conditional mean function and can be estimated by nonparametric methods. Moreover, since the transformation from (C/W_2) to $\mathcal{C}$ can be inverted, given an estimated value $\widehat{m}(z, T, D_1, D_2)$, straightforward algebra leads to an estimate

$$\widehat{C}(\mathbf{y}, \mathbf{w}) = \exp[\psi_1^{-1}(\widehat{m}(z, T, D_1, D_2))]. \tag{16}$$

To estimate returns to scale for credit unions, we need merely estimate the measure $\mathcal{S}(\theta \mid \mathbf{y}_0, \mathbf{w}_0)$ defined earlier by replacing $C(\mathbf{y}_0, \mathbf{w}_0)$ and $C(\theta \mathbf{y}_0, \mathbf{w}_0)$ on the right-hand side of equation (9) with estimates $\widehat{C}(\mathbf{y}_0, \mathbf{w}_0)$ and $\widehat{C}(\theta \mathbf{y}_0, \mathbf{w}_0)$ obtained from equation (16).

In order to estimate the conditional mean function in equation (15), suppose (for the moment) that the time variable T and the binary dummy variables D_1, D_2 do not influence the value of the conditional mean function $m(z, T, D_1, D_2)$, so that we can write the conditional mean function on the right-hand side of equation (15) as $m(z)$. Both the Nadarya-Watson (Nadarya, 1964; Watson, 1964) kernel estimator and the local-linear estimator are special cases of local polynomial estimators; with the local-linear estimator, the local polynomial is of order 1, while with the Nadarya-Watson estimator, the local polynomial is of order 0. The local-linear estimator has less asymptotic bias but the same asymptotic variance as the Nadarya-Watson estimator.

To illustrate the local-linear estimator, momentarily ignore the discrete covariates in equation (15) and write the conditional mean function as $m_*(z)$. The local-linear estimator follows from a first-order Taylor expansion of $m_*(z)$ in a neighborhood of an arbitrary point z_0:

$$m_*(z) \approx m_*(z_0) + \frac{\partial m_*(z_0)}{\partial z}(z - z_0). \tag{17}$$

This suggests estimating the conditional mean function at z_0 by solving the locally weighted least squares regression problem,

$$[\widehat{\alpha}_0 \quad \widehat{\alpha}]' = \operatorname*{argmin}_{\alpha_0, \alpha} \sum_{i=1}^{n} [\mathcal{C}_i - \alpha_0 - (z_i - z_0)\alpha]^2 \\ \times K(|\mathbf{H}|^{-1}(z_i - z_0)), \tag{18}$$

where $K(\cdot)$ is a piece-wise continuous multivariate kernel function satisfying $\int \cdots \int_{\mathbb{R}^\ell} K(\mathbf{u}) \, d\mathbf{u} = 1$ and $K(\mathbf{u}) = K(-\mathbf{u})$, $\mathbf{u} \in \mathbb{R}^\ell$; $\mathbf{H}$ is an $\ell \times \ell$ matrix of bandwidths; α_0 is a scalar; and α is an ℓ-vector.

The solution to the least squares problem in equation (18)

$$[\widehat{\alpha}_0 \quad \widehat{\alpha}']' = (\mathbf{Z}' \mathbf{\Phi} \mathbf{Z})^{-1} \mathbf{Z}' \mathbf{\Phi} \mathcal{C}, \tag{19}$$

---

[24] The convergence rate of our local linear estimator is $n^{1/(4+\ell)}$, where ℓ is the number of continuous right-hand-side variables. With $n = 184,279$ observations and $\ell = 4$ continuous right-hand-side variables, we achieve an order of estimation error that would require 3,817,301 observations with six continuous right-hand-side variables and 17,375,290 observations with seven continuous right-hand-side variables.

where $\boldsymbol{\mathcal{C}} = [\mathcal{C}_1, \ldots, \mathcal{C}_n]'$, $\boldsymbol{\Phi} = \text{diag} \, [K(|\boldsymbol{H}|^{-1}(z_i - z_0))]$, and $\boldsymbol{Z}$ is an $n \times (\ell + 1)$ matrix with ith row given by $[1 \quad (z_i - z_0)]$. The fitted value $\widehat{\alpha}_0$ provides an estimate $\widehat{m}_*(z_0)$ of the conditional mean function $m_*(z_0)$ at an arbitrary point z_0.[25]

D. Estimation with Discrete Covariates

Introduction of the binary dummy variables D_{i1} and D_{i2} into the analysis requires some modification. One possibility is to split the sample into four subsamples according to the values of the discrete variables and then estimate the model on each group separately while treating time as a continuous variable. However, in our application, some of these subsamples would be very small since only about 63% of credit unions make real estate loans and only about 14% make commercial loans. Moreover, this approach would not make efficient use of the data to the extent that each subsample contains some information that would be useful in estimation on the other subsamples.

Alternatively, we can accommodate discrete variables by modifying the weighting matrix $\boldsymbol{\Phi}$ introduced in equation (19). The idea involves smoothing across time periods as well as over the four categories defined by the two binary dummy variables, and letting the data determine how much smoothing is appropriate.[26] Let $\boldsymbol{u}_i$ represent a vector of observations on k binary dummy variables, and consider an arbitrary Bernoulli vector $\boldsymbol{u}_0$ of length k. Then let $\delta(\boldsymbol{u}_i, \boldsymbol{u}_0) = (\boldsymbol{u}_i - \boldsymbol{u}_0)'(\boldsymbol{u}_i - \boldsymbol{u}_0)$, and define the discrete kernel function

$$G_1(\boldsymbol{u}_i \mid \boldsymbol{u}_0, \lambda_1) = \lambda_1^{k - \delta(\boldsymbol{u}_i, \boldsymbol{u}_0)}(1 - \lambda_1)^{\delta(\boldsymbol{u}_i, \boldsymbol{u}_0)}, \quad (20)$$

where $h_1 \in [\frac{1}{2}, 1]$ is a bandwidth parameter.

Note that $\lim_{h_1 \to 1} G_1(\boldsymbol{u}_i \mid \boldsymbol{u}_0, h_1)$ equals 1 or 0, depending on whether $\boldsymbol{u}_0 = \boldsymbol{u}_i$ or $\boldsymbol{u}_0 \neq \boldsymbol{u}_i$, respectively. If $h_1 = 1$, the procedure is equivalent to splitting the sample into the four subgroups suggested by the dummy variables and estimating independently on each of four subsamples. Alternatively, if $h_1 = \frac{1}{2}$, then $G_1(\boldsymbol{u}_i \mid \boldsymbol{u}_0, h_1) = 1$ regardless of whether $\boldsymbol{u}_0 = \boldsymbol{u}_i$ or $\boldsymbol{u}_0 \neq \boldsymbol{u}_i$; in this case, there is complete smoothing over the four subgroups, and including the dummy variables has no effect on the estimation.

[25] The fitted values in $\widehat{\alpha}$ provide estimates of elements of the vector $\partial m(z_0)/\partial z$. However, if the object is to estimate first derivatives, mean square error of the estimates can be reduced by locally fitting a quadratic rather than a linear expression (see Fan & Gijbels, 1996, for discussion); this increases computational costs, which are already substantial for the local linear fit. Moreover, determining the optimal bandwidths becomes more difficult and computationally more burdensome for estimation of derivatives. See Härdle (1990) for a discussion of some of the issues that are involved with bandwidth selection for derivative estimation.

[26] Aitchison and Aitken (1976) discuss the use of a discrete kernel for discrimination analysis. Bierens (1987) and Delgado and Mora (1995) suggest augmenting the Nadarya-Watson estimator with a discrete kernel and prove that the estimator remains consistent and asymptotically normal. Racine and Li (2000) establish convergence rates for the Nadarya-Watson estimator with mixed continuous-discrete data; the rate with continuous and discrete covariates is the same as the rate with the same number of continuous variables but no discrete variables. Thus, introduction of discrete covariates does not exacerbate the curse of dimensionality, at least in the limit.

Next, consider the ordered, categorical variable T_i which takes values in the set $\mathbb{T} = \{1, 2, , T_{\max}\}$, and let $T_0 \in \mathbb{T}$. Define a kernel function

$$G_2(T_i \mid T_0, h_2) = h_2^{|T_i - T_0|}, \quad (21)$$

where $h_2 \in [0, 1]$ is a third bandwidth parameter. For $h_2 < 1$, as the difference $|T_i - T_0|$ increases, $G_2(T_i \mid T_0, h_2)$ becomes smaller. In other words, for $h_2 < 1$, observations from time periods further from T_0 receive less weight than observations from time periods that are closer to T_0.

We specify the kernel function $K(\cdot)$ as an ℓ-variate spherically symmetric Epanechnikov kernel,

$$K(\boldsymbol{u}) = \frac{\ell(\ell + 2)}{2S_\ell}(1 - \boldsymbol{u}\boldsymbol{u}')I(\boldsymbol{u}\boldsymbol{u}' \leq 1) \quad (22)$$

where $I(\cdot)$ is the indicator function, $S_\ell = 2\pi^{\ell/2}/\Gamma(\ell/2)$, $\Gamma(\cdot)$ denotes the gamma function, $\boldsymbol{u} = |\boldsymbol{H}|^{-\ell}(z_i - z_0)$, and $\boldsymbol{H}$ is an $(\ell \times \ell)$ matrix of bandwidths. The spherically symmetric Epanechnikov kernel is optimal in terms of asymptotic minimax risk (see Fan et al., 1997, for details and a proof).

Incorporating the discrete covariates, an estimate $\widehat{m}(z_0, T_0, D_{01}, D_{02})$ of the conditional mean function in equation (14) at an arbitrary point $(z_0, T_0, D_{01}, D_{02}) \in \mathbb{R}^\ell \times \mathbb{T} \times \{0, 1\}^2$ is given by $\widehat{\alpha}_0$ obtained from

$$
\begin{aligned}
[\widehat{\alpha}_0 \quad \widehat{\boldsymbol{\alpha}}]' = \underset{\alpha_0, \boldsymbol{\alpha}}{\text{argmin}} \sum_{i=1}^n & [\mathcal{C}_i - \alpha_0 - (z_i - z_0)\boldsymbol{\alpha}]^2 \\
& \times K(|\boldsymbol{H}|^{-1}(z_i - z_0))G_1(\boldsymbol{w}_i \mid \boldsymbol{w}_0, \lambda_1) \\
& \times G_2(T_i \mid T_0, \lambda_2),
\end{aligned}
\quad (23)
$$

where $T_0 \in \{1, 2, \ldots, 18\}$ and $\boldsymbol{w}_0$ is a (2×1) Bernoulli vector. The solution to the least squares problem in equation (23) is given by

$$[\widehat{\alpha}_0 \quad \widehat{\boldsymbol{\alpha}}]' = (\boldsymbol{Z}'\boldsymbol{\Omega}\boldsymbol{X})^{-1}\boldsymbol{Z}\boldsymbol{\Omega}\boldsymbol{\mathcal{C}}, \quad (24)$$

where $\boldsymbol{Z}$ is defined as in equation (19) and the weighting matrix is given by

$$
\begin{aligned}
\boldsymbol{\Omega} = \text{diag}[&K(h(z_0)^{-\ell}(z_i - z_0)G_1(\boldsymbol{w}_i \mid \boldsymbol{w}_0, \lambda_1) \\
& G_2(T_i \mid T_0, \lambda_2)].
\end{aligned}
\quad (25)
$$

Here, the determinant of the bandwidth matrix $\boldsymbol{H}$ has been replaced by an adaptive bandwidth $h(z_0)$ raised to the ℓth power; since the principal components transformation prewhitens the data and the principal components are orthogonal, we use the same bandwidth in each direction, with off-diagonal elements of $\boldsymbol{H}$ equal to 0.

E. Bandwidth Selection and Inference

To implement our estimator, we must choose values for the bandwidths $h(z_0)$, h_1, and h_2. For the discrete data, we

employ (globally) constant bandwidths, while for the continuous data, we use an adaptive, nearest-neighbor bandwidth. We define $h(z_0)$ for any particular point $z_0 \in \mathbb{R}^\ell$ as the maximum Euclidean distance between z_0 and the κ nearest points in the observed sample $\{z_i\}_{i=1}^n$, $\kappa \in \{2, 3, 4, \ldots\}$. Thus, given the data and the point z_0, the bandwidth $h(z_0)$ is determined by κ and varies depending on the density of the continuous explanatory variables locally around the point $z_0 \in \mathbb{R}^\ell$ at which the conditional mean function is estimated. This results in a relatively large value for $h(z_0)$ where the data are sparse (and where more smoothing is required) and smaller values of $h(z_0)$ in regions where the data are relatively dense (where less smoothing is needed). The discrete kernels in equation (25) in turn give more (or less) weight to observations among the κ nearest neighbors that are close (or far) away along the time dimension or that are in the same (or different) category determined by the combination of binary dummy variables.

Note that we use a nearest-neighbor bandwidth, not a nearest-neighbor estimator. We use the bandwidth inside a kernel function, and the kernel function integrates to unity. Loftsgaarden and Quesenberry (1965) use this approach in the density estimation context to avoid nearest-neighbor density estimates (as opposed to bandwidths) that do not integrate to unity.[27]

As a practical matter, we set $\kappa = [h_0 n]$, where $h_0 \in (0, 1)$, n represents the sample size and $[a]$ denotes the integer part of a. We optimize the choice of values for the bandwidth parameters by minimizing the least squares cross-validation function; that is, we select values

$$[\widehat{h}_0 \quad \widehat{h}_1 \quad \widehat{h}_2]' = \underset{h_0,h_1,h_2}{\operatorname{argmin}} \sum_{i=1}^n [\mathcal{C}_i - \widehat{m}_{-i}(z_i, T_i, D_{i1}, D_{i2})]^2,$$
(26)

where $\widehat{m}_{-i}(z_i, T_i, D_{i1}, D_{i2})$ is computed the same way as $\widehat{m}(z_i, T_i, D_{i1}, D_{i2})$, except that the ith diagonal element of $\mathbf{\Psi}$ is replaced with 0. The least squares cross-validation function approximates the part of mean integrated square error that depends on the bandwidths.[28]

Once we have selected appropriate values of the bandwidth parameters, we can estimate the conditional mean function at any point $(z_0, T_0, D_{01}, D_{02}) \in \mathbb{R}^\ell \times \mathbb{T} \times \{0,1\}^k$. We then estimate the RSE and EPSE measures defined in equations (9) and (11) by replacing the cost terms with estimates obtained from the relation (16). We use the wild bootstrap proposed by Härdle (1990) and Härdle and Mammen (1993) to make inferences about RSE and EPSE. First, we obtain bootstrap estimates $\widehat{m}_b^*(\cdot)$, which we then substitute into equations (9)

and (11) to obtain bootstrap values $\widehat{\mathcal{S}}_b^*$ and $\widehat{\mathcal{E}}_b^*$ for particular values of z and D_1, D_2, with $b = 1, \ldots, B$.[29]

Next, we use the bias-correction method described by Efron and Tibshirani (1993) to make inference about $\mathcal{S}$. In particular, we estimate $(1 - \alpha) \times 100\%$ confidence intervals by $(\widehat{\mathcal{S}}^{*(\alpha_1)}, \widehat{\mathcal{S}}^{*(\alpha_2)})$, where $\widehat{\mathcal{S}}^{*(\alpha)}$ denotes the α-quantile of the bootstrap values $\widehat{\mathcal{S}}_b^*$, $b = 1, \ldots, B$, and

$$\alpha_1 = \Phi\left(\widehat{\varphi}_0 + \frac{\widehat{\varphi}_0 + \varphi^{(\alpha/2)}}{1 - \widehat{\varphi}_0 + \varphi^{(\alpha/2)}}\right),$$
(27)

$$\alpha_2 = \Phi\left(\widehat{\varphi}_0 + \frac{\widehat{\varphi}_0 + \varphi^{(1-\alpha/2)}}{1 - \widehat{\varphi}_0 + \varphi^{(1-\alpha/2)}}\right).$$
(28)

$\Phi(\cdot)$ denotes the standard normal distribution function, $\varphi^{(\alpha)}$ is the $(\alpha \times 100)$th percentile of the standard normal distribution, and

$$\widehat{\varphi}_0 = \Phi^{-1}\left(\frac{\#\{\widehat{\mathcal{S}}_b^* < \widehat{\mathcal{S}}\}}{B}\right),$$
(29)

with $\Phi^{-1}(\cdot)$ denoting the standard normal quantile function (for example, $\Phi^{-1}(0.95) \approx 1.6449$).

For RSE, we sort the values in $\{(\widehat{\mathcal{S}}_b^* - \widehat{\mathcal{S}})\}_{b=1}^B$ by algebraic value, delete $(\frac{\alpha}{2} \times 100)\%$ of the elements at either end of this sorted array, and denote the lower and upper end points of the remaining, sorted array as $-b_\alpha^*$ and $-a_\alpha^*$, respectively. Then a bootstrap estimate of a $(1 - \alpha)\%$ confidence interval for $\mathcal{S}$ is

$$\widehat{\mathcal{S}} + a_\alpha^* \leq \mathcal{S} \leq \widehat{\mathcal{S}} + b_\alpha^*.$$
(30)

The idea underlying equation (30) is that the empirical distribution of the bootstrap values $(\widehat{\mathcal{S}}_b^* - \widehat{\mathcal{S}})$ mimics the unknown distribution of $(\widehat{\mathcal{S}} - \mathcal{S})$, with the approximation improving as $n \to \infty$. As $B \to \infty$, the choices of $-b_\alpha^*$ and $-a_\alpha^*$ become increasingly accurate estimates of the percentiles of the distribution of $(\widehat{\mathcal{S}}_b^* - \widehat{\mathcal{S}})$ (we set $B = 1,000$). Any bias in $\widehat{\mathcal{S}}$ relative to $\mathcal{S}$ is reflected in the bias of $\widehat{\mathcal{S}}^*$ relative to $\widehat{\mathcal{S}}$. The estimated confidence interval may not contain the original estimate $\widehat{\mathcal{S}}$ if the bias is large because the estimated confidence interval corrects for the bias in $\widehat{\mathcal{S}}$. We estimate confidence intervals for the EPSE measures similarly.

IV. Empirical Results

We estimated models 1 to 4 and obtained similar results, qualitatively and quantitatively, across the four specifications. As an additional robustness check, we also estimated the four different models with time T treated as a continous variable. This too made almost no difference in the results. Here, we report results for the models estimated with time treated as a discrete variable, with particular focus on results from model

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[27] See Pagan and Ullah (1999) for additional discussion. Fan and Gijbels (1994, 1996) discuss nearest-neighbor bandwidths in the regression context.

[28] Choice of κ by cross-validation has been proposed by Fan and Gijbels (1996) and has been used by Wheelock and Wilson (2001), Wilson & Carey (2004), and others.

[29] Ordinary bootstrap methods are inconsistent in our context due to the asymptotic bias of the estimator. See Mammen (1992) for additional discussion.

TABLE 4.—EXPANSION-PATH SCALE ECONOMIES: DISCRETE TIME, MODELS 1 AND 2

Quartile	Model 1				Model 2				Number of Observations
	Median	IRS	CRS	DRS	Median	IRS	CRS	DRS	
1989									
1	0.9313	3,111	0	0	0.9238	3,111	0	0	3,111
2	0.9386	3,110	1	0	0.9358	3,111	0	0	3,111
3	0.9420	3,106	0	0	0.9411	3,106	0	0	3,106
4	0.9461	3,110	0	0	0.9456	3,109	1	0	3,110
1997									
1	0.9356	2,599	0	0	0.9298	2,599	0	0	2,599
2	0.9402	2,597	0	0	0.9401	2,596	1	0	2,597
3	0.9441	2,596	0	0	0.9437	2,595	1	0	2,596
4	0.9465	2,597	0	0	0.9458	2,597	0	0	2,597
2006									
1	0.9400	2,008	2	0	0.9359	2,005	5	0	2,010
2	0.9418	2,004	6	0	0.9428	1,998	12	0	2,010
3	0.9460	2,001	8	0	0.9470	1,992	17	0	2,009
4	0.9462	2,010	0	0	0.9483	2,008	2	0	2,010

TABLE 5.—EXPANSION-PATH SCALE ECONOMIES: DISCRETE TIME, MODELS 3 AND 4

| Quartile	Model 3				Model 4				Number of Observations
	Median	IRS	CRS	DRS	Median	IRS	CRS	DRS	
1990									
1	0.9324	2,950	0	0	0.9239	2,950	0	0	2,950
2	0.9388	2,948	1	0	0.9363	2,949	0	0	2,949
3	0.9420	2,949	0	0	0.9417	2,949	0	0	2,949
4	0.9459	2,950	0	0	0.9448	2,950	0	0	2,950
1997									
1	0.9357	2,532	0	0	0.9294	2,532	0	0	2,532
2	0.9405	2,532	0	0	0.9398	2,532	0	0	2,532
3	0.9442	2,531	0	0	0.9437	2,530	1	0	2,531
4	0.9468	2,531	1	0	0.9460	2,532	0	0	2,532
2006									
1	0.9405	1,984	2	0	0.9369	1,982	4	0	1,986
2	0.9427	1,981	5	0	0.9433	1,979	7	0	1,986
3	0.9466	1,986	0	0	0.9471	1,979	7	0	1,986
4	0.9469	1,986	0	0	0.9477	1,986	0	0	1,986

2 where the management variable M described in section IIB has been added to the baseline model (model 1) described in section IIA. (Results from estimation of the models with time treated as continuous are available from the authors on request.)

As we discussed in section IIIE, values for the three bandwidth parameters h_0, h_1, and h_2 are needed for estimation. Using the Nelder and Mead (1965) simplex algorithm with the credit union data to optimize the least squares cross-validation function in equation (26) yields $\widehat{h_0} = 0.004488$, 0.003365, 0.004976, and 0.004356 for models 1 to 4, respectively (corresponding to $\widehat{\kappa} = 827$, 620, 836, and 732). Similarly, we obtain values $\widehat{h_1} = 0.9409$, 0.9283, 0.9427, and 0.9458, as well as $\widehat{h_2} = 0.4394$, 0.3889, 0.4861, and 0.4562. The bandwidths can be expected to differ across the four models due to differences in numbers of observations (for models 1 and 2, we have 184,279 observations, but for models 3 and 4, we have only 168,055 observations due to the use of lagged variables), as well as the inclusion of M in models 2 and 4. Nonetheless, the variation in selected bandwidths across the four models appears rather small. Recalling

the discussion following equations (20) and (21), the data and selected bandwidths indicate that little smoothing should be used across the categories determined by the dummy variables D_1 and D_2 and that moderate smoothing should be done across time periods.

We used the selected bandwidth values to estimate the EPSE measure defined in equation (11) for each credit union represented in our data for 1989, 1997, and 2006 for each model. In addition, we estimated corresponding (95%) confidence intervals using the bias-corrected bootstrap described in section IIIE. For each year, we divide credit unions into quartiles of total assets. Table 4 reports the median value of the EPSE estimates obtained from models 1 and 2 across credit unions in each quartile year. The table also reports the numbers of estimates that are significantly less than 1 (hence, indicating increasing returns to scale) in the column labeled "IRS," insignificantly different from 1 (and hence failing to reject constant returns to scale) in the column labeled "CRS," and significantly greater than 1 (indicative of decreasing returns to scale) in the column labeled "DRS." The last column of table 4 gives the number of observations in each

FIGURE 3.—EXPANSION-PATH SCALE ECONOMIES BY ASSET SIZE QUARTILE: DISCRETE TIME, MODEL 2, 1989
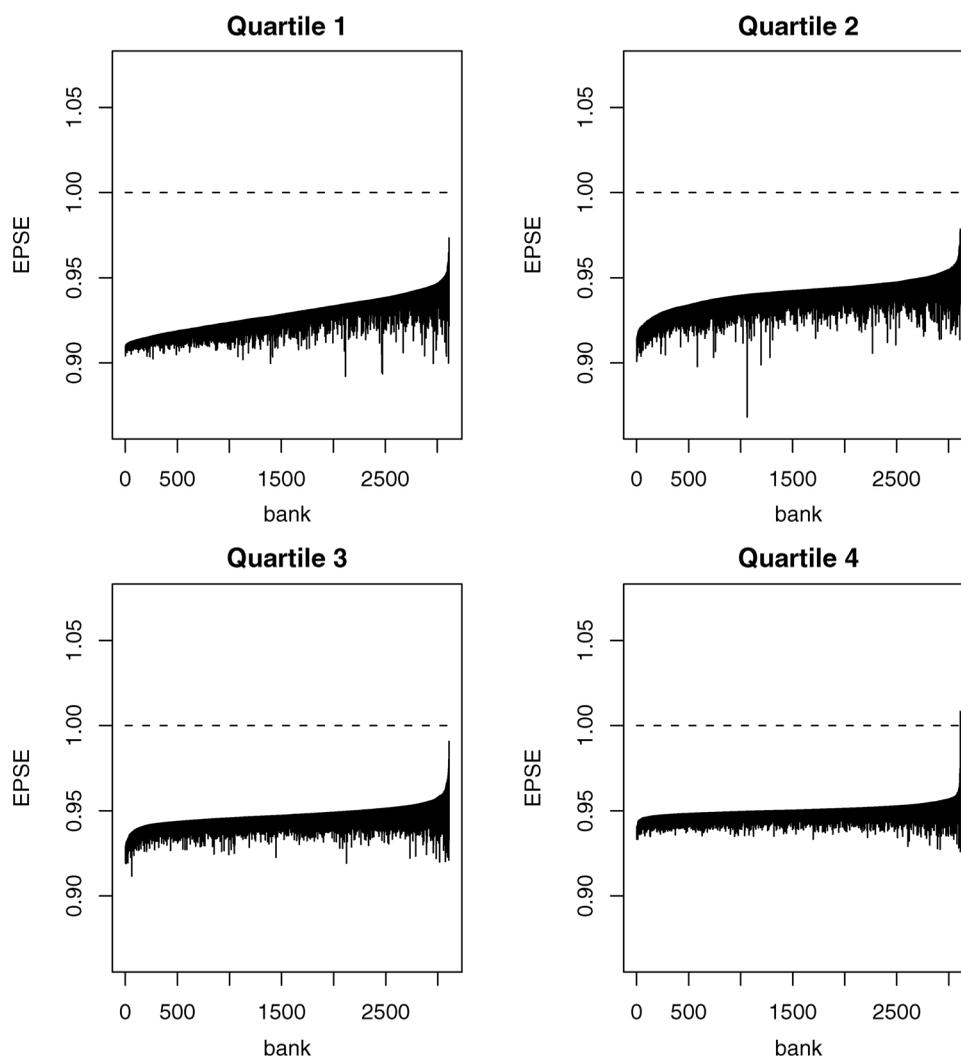
quartile year. Table 5 reports similar information obtained from estimation of models 3 and 4.

The results are striking, and remarkably robust across the four specifications. The results indicate that nearly all credit unions in each quartile year faced increasing returns to scale. For example, the results for model 2 indicate that we reject the hypothesis of constant returns to scale for all but 1 credit union in 1989, for all but 2 credit unions in 1997, and for all but 36 credit unions, or less than 0.5% of 8,039 operating credit unions, in 2006. Moreover, for models 1 to 4, we find no evidence that any credit unions faced decreasing returns to scale. These results suggest that further consolidation of the industry and increasing average size of individual credit unions are likely.

Figures 3 to 5 show estimated 95% confidence intervals for EPSE corresponding to each credit union in each quartile year based on model 2. The estimated confidence intervals are represented by vertical line segments; observations within each quartile year have been sorted by the estimated upper

bound.[30] Although the number of line segments in each panel of figures 3 to 5 is too large to permit viewing of individual line segments, the plots show the overall pattern. In particular, the figures reveal that in the few cases where constant returns to scale cannot be rejected, the estimated confidence intervals are considerably wider than in most cases where constant returns is rejected. In addition, the upper bounds in the first quartile for each year are typically smaller in magnitude than the upper bounds in the largest quartile. Apparently while returns to scale are increasing throughout the range of credit union sizes, smaller credit unions face greater potential gains than larger credit unions, as one might expect. Finally, comparing the second and third quartiles across years, it is evident that credit unions in the middle of the size distribution in each year have, over time, moved slightly closer to constant returns; in the panels labeled "Quartile 2" and "Quartile

[30] The results are very similar across all four models. We will provide figures based on results from models 1, 3, and 4 on request.

FIGURE 4.—EXPANSION PATH SCALE ECONOMIES BY ASSET SIZE QUARTILE: DISCRETE TIME, MODEL 2, 1997
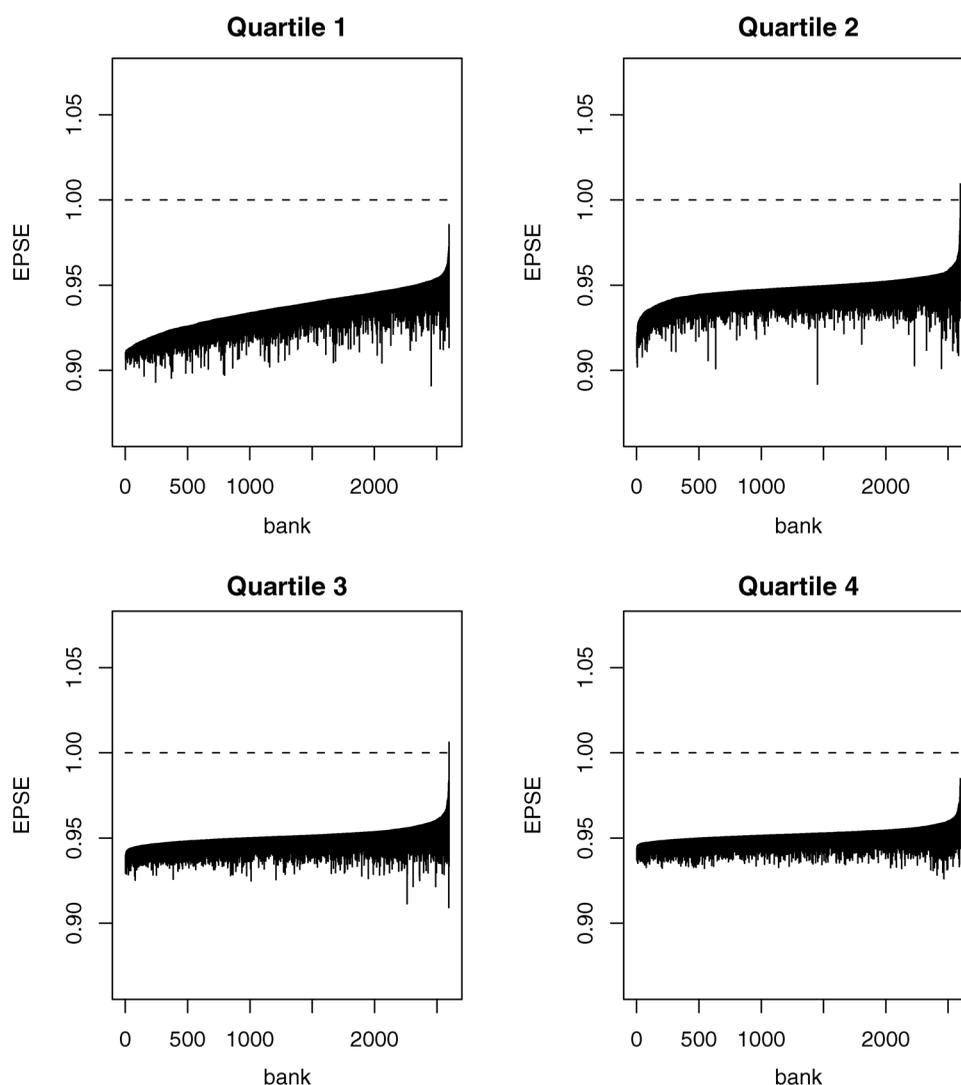
3," the estimated confidence intervals in 1997 have shifted upward relative to 1989, and those in 2006 have shifted upward still more. This result is consistent with the shift over time of the density of (log) total assets shown in figure 1.

We also estimated the RSE measure defined in equation (9) for $\theta \in \{0.05, 0.10, 0.15, \ldots, 0.95, 1.0, 2.0, \ldots, 25.0\}$, with $(\mathbf{y}_0, \mathbf{w}_0)$ given by the medians of each variable, setting T equal to 1, 9, or 18 (corresponding to the first, middle, and last years of our observation period—1989, 1997, and 2006). We chose this range of values for θ after noting that total assets in our sample range from about 0.05 times median assets to about 25 times median assets.

Results for estimation of RSE using model 2 are illustrated in figure 6, which contains a 3×4 matrix of plots of our RSE measure as a function of θ.[31] The four columns in figure 6 correspond to the four combinations of values for the dummy

variables D_1 and D_2. The three rows in the figure correspond to 1989, 1997, and 2006. In each plot, we use a log-scale for θ on the horizontal axis and connect the plotted points with solid lines. In addition, we used the bias-corrected bootstrap described in section IIIE to estimate 95% confidence intervals corresponding to each estimate of $\mathcal{S}(\theta \mid \mathbf{y}_0, \mathbf{w}_0)$; upper and lower bounds are indicated by the dashed curves in figure 6.[32]

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[31] Again, the results are very similar across all four models. We will provide figures based on the results from models 1, 3, and 4 on request.

[32] Note that in each panel of figure 6, estimates of $\mathcal{S}(\theta \mid \mathbf{y}_0, \mathbf{w}_0)$ (indicated by the solid curve) for the smallest and the largest values of θ lie outside corresponding estimated 95% confidence intervals (indicated by the dashed curves). This reflects the fact that the local-polynomial estimator used to estimate the cost function in equation (15) is only weakly consistent and is asymptotically biased. In addition, estimates of cost $\widehat{C}(\mathbf{y}, \mathbf{w})$ obtained from equation (16) involve a nonlinear transformation of fitted values from estimates $\widehat{C}$ of the dependent variable in equation (15). Furthermore, estimation of the RSE measure in equation (9) involves further nonlinear transformations of estimates $\widehat{C}$. Thus, even if the local-polynomial regression estimator yielded unbiased estimates, estimates of the RSE measure would be biased. As we discussed in section IIIE, our bootstrap method involves a bias correction and hence estimates of $\mathcal{S}(\theta \mid \mathbf{y}_0, \mathbf{w}_0)$ sometimes lie outside the corresponding estimated confidence intervals.
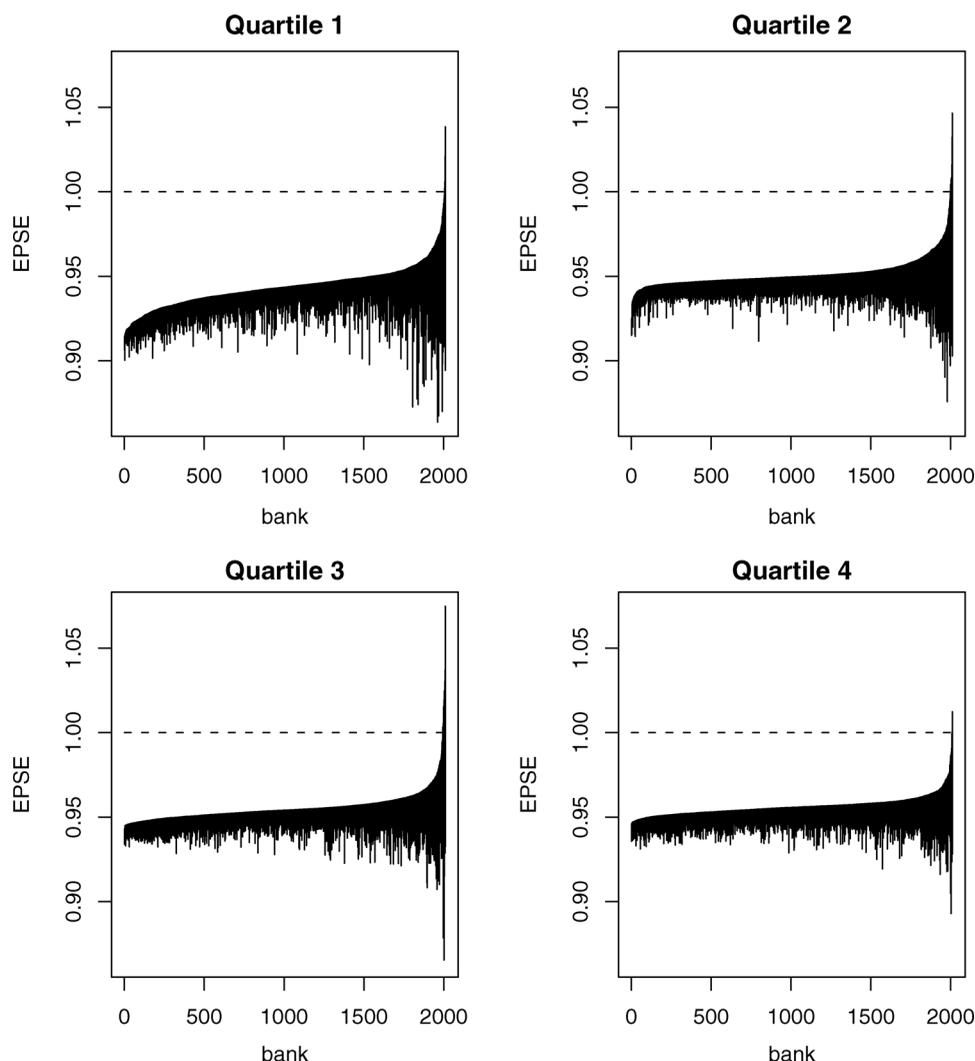
Recalling the discussion in section II, downward slopes for the RSE measure as a function of θ indicate increasing returns to scale along the ray from the origin through the medians of the continuous variables. The results illustrated in figure 6 indicate sharply increasing returns to scale up to about the median-size credit union (corresponding to θ = 1). Beyond the median size, the RTS measure yields little evidence of increasing returns, in contrast to evidence obtained from estimation of the EPSE measure discussed above. RSE measures returns to scale along a single path through the medians of the continuous covariates, however, whereas EPSE captures returns to scale along the observed expansion paths for each credit union. To the extent that there are nonlinear relationships among the right-hand-side continuous variables, the ray from the origin through the medians is likely to lie far from where most credit unions actually operate; that is, there may be no observations near this ray. Moreover, given the nature of our estimator and use of adaptive bandwidths, much more smoothing is required in regions where data are sparse, which

tends to flatten estimates of the conditional mean function in equation (16). This would tend to make rejection of constant returns to scale less likely for larger credit unions because the size distribution of credit unions is skewed to the right, as shown in figure 1. Hence, the EPSE measure seems more relevant, especially for larger credit unions, than the RSE measure.

V. Conclusion

Credit unions hold a small but growing share of total U.S. depository institution assets. Moreover, like commercial banks, the average size of credit unions has increased sharply during the past two decades, suggesting that changes in regulation and technology have favored larger credit unions over their smaller competitors. Researchers have found evidence of expanding returns to scale for commercial banks and that large banks have experienced larger increases in productivity than small banks. However, we are unaware

FIGURE 6.—RAY SCALE ECONOMIES, MODEL 2
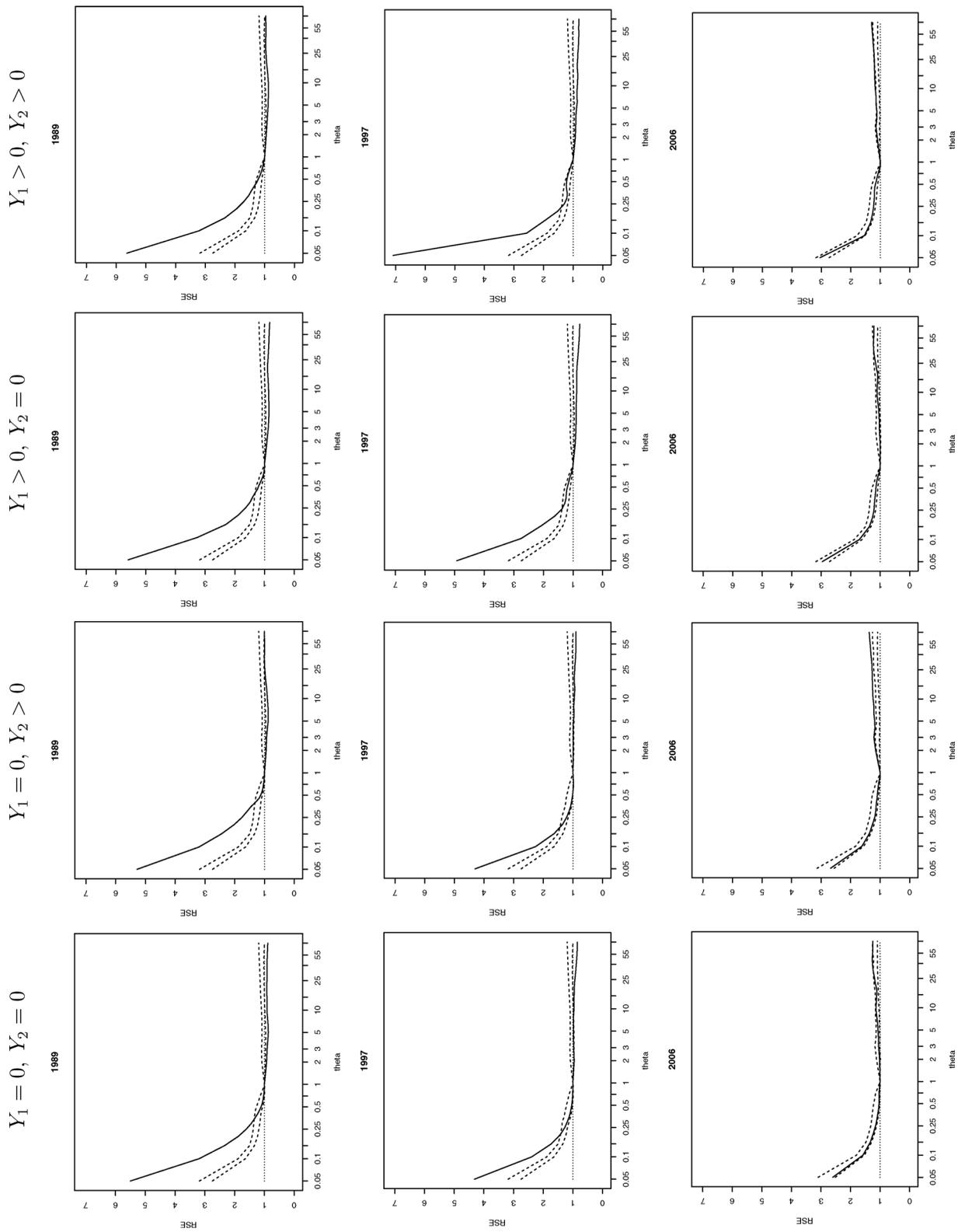
of studies investigating returns to scale rigorously for credit unions.

This paper uses a nonparametric local-linear estimator to estimate a model of credit union costs, from which we derive estimates of returns to scale. As other studies have found using data on commercial banks and other types of firms, we test and reject as a misspecification even a comparatively flexible translog cost function for credit unions. Our nonparametric estimator avoids the difficulty of specifying and estimating a parametric cost function such as a translog function. Further, we employ a dimension-reduction technique to reduce estimation error that can arise when nonparametric estimators are used to estimate high-dimension models.

We use annual data on all U.S. retail credit unions (except those with missing or implausible data) for 1989 to 2006 to estimate both ray scale and expansion-path scale economies. Although most studies focus on ray scale economies, we also examine expansion-path scale economies to better estimate scale economies near the combinations of inputs and outputs that reflect actual credit union production. We find that throughout the sample period, the vast majority of credit unions—almost all, in fact—operated under increasing returns to scale, as reflected in our estimates along observed expansion paths. Thus, despite considerable industry consolidation and growth in average credit union size, it appears that as recently as 2006, most credit unions were too small to fully exploit possible scale economies. Competitive pressures among credit unions and from other types of depository institutions are thus likely to encourage further growth in the average size of U.S. credit unions, as would further relaxation of legal restrictions on credit union membership or permissible activities.

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APPENDIX

Specification Test for Translog Cost Function

In order to test a translog specification for the credit union cost function, for each year represented in our sample, 1989 to 2006, we computed median total assets and created two subsamples of observations. In subsample 1 are all observations for a particular year where total assets are less than or equal to median assets for that year, while in subsample 2 are all observations for the given year where total assets are greater than median assets for that year. Next, we use each subset to estimate the translog cost function corresponding to model m, $m \in \{1, 2, 3, 4\}$. For model 1, the translog specification is

$$
\begin{aligned}
\log(C/W_2) = {} & \beta_1 + \beta_2 \log(Y_1 + Y_2 + Y_3) + \beta_3 \log(1 + Y_4) + \beta_4 \log Y_5 \\
& + \beta_5 \log Y_6 + \beta_6 \log(W_1/W_2) + \beta_7 D_1 + \beta_8 D_2 \\
& + \beta_9 \log(Y_1 + Y_2 + Y_3) \log(Y_1 + Y_2 + Y_3) \\
& + \beta_{10} \log(Y_1 + Y_2 + Y_3) \log(1 + Y_4) \\
& + \beta_{11} \log(Y_1 + Y_2 + Y_3) \log Y_5 \\
& + \beta_{12} \log(Y_1 + Y_2 + Y_3) \log Y_6
\end{aligned}
$$

$$
\begin{aligned}
& + \beta_{13} \log(Y_1 + Y_2 + Y_3) \log(W_1/W_2) \\
& + \beta_{14} \log(1 + Y_4) \log(1 + Y_4) + \beta_{15} \log(1 + Y_4) \log Y_5 \\
& + \beta_{16} \log(1 + Y_4) \log Y_6 + \beta_{17} \log(1 + Y_4) \log(W_1/W_2) \\
& + \beta_{18} \log Y_5 \log Y_5 + \beta_{19} \log Y_5 \log Y_6 \\
& + \beta_{20} \log Y_5 \log(W_1/W_2) + \beta_{21} \log Y_6 \log Y_6 \\
& + \beta_{22} \log Y_6 \log(W_1/W_2) + \beta_{23} \log(W_1/W_2) \log(W_1/W_2) \\
& + \beta_{24} D_1 \log(Y_1 + Y_2 + Y_3) + \beta_{25} D_1 \log(1 + Y_4) \\
& + \beta_{26} D_1 \log Y_5 + \beta_{27} D_1 \log Y_6 + \beta_{28} D_1 \log(W_1/W_2) \\
& + \beta_{29} D_2 \log(Y_1 + Y_2 + Y_3) + \beta_{30} D_2 \log(1 + Y_4) \\
& + \beta_{31} D_2 \log Y_5 + \beta_{32} D_2 \log Y_6 + \beta_{33} D_2 \log(W_1/W_2) \\
& + \varepsilon,
\end{aligned}
\tag{A1}
$$

$E(\varepsilon) = 0$. Note that dividing cost (C) and the price of capital (W_1) by the price of labor (W_2) ensures homogeneity with respect to input prices. In addition, it is necessary to add a constant to Y_4 due to a small number of observations with 0 values for this variable. Our treatment of Y_1, Y_2, and Y_3 is similar to that in our nonparametric estimation and avoids taking logs of 0 due to the large number of observed 0 values for Y_2 and Y_3.

For model 2, additional terms,

$$
\begin{aligned}
& \beta_{34} \log(1 + M) + \beta_{35} \log(1 + M) \log(Y_1 + Y_2 + Y_3) \\
& \quad + \beta_{36} \log(1 + M) \log(1 + Y_4) + \beta_{37} \log(1 + M) \log(Y_5) \\
& \quad + \beta_{38} \log(1 + M) \log(Y_6) + \beta_{39} \log(1 + M) \log(W_1/W_2) \\
& \quad + \beta_{40} \log(1 + M) \log(1 + M) + \beta_{41} D_1 \log(1 + M) \\
& \quad + \beta_{42} D_2 \log(1 + M),
\end{aligned}
$$

are added to the right-hand side of equation (A1). For models 3 and 4, Y_1, Y_2, Y_3, and Y_4 are replaced by their lagged counterparts. The number of parameters K_j in model j is 33 for $j \in \{1, 3\}$ and 42 for $j \in \{2, 4\}$.

For subsample ℓ containing n_ℓ observations in model m and a given year, $\ell \in \{1, 2\}$, let $\boldsymbol{\beta}_{m\ell} = [\beta_1 \quad \ldots \quad \beta_{K_j}]'$, and let $\boldsymbol{X}_{m\ell}$ be the $(n_{m\ell} \times K_j)$ matrix containing the right-hand-side variables in equation (A1); the first column of $\boldsymbol{X}_{m\ell}$ consists of a vector of 1s. In addition, let $\boldsymbol{Y}_{m\ell}$ represent the $(n_{m\ell} \times 1)$ matrix containing the $n_{m\ell}$ observations on the left-hand-side variable in equation (A1), so that the model can be written (for model j and subsample ℓ in a given year) as

$$
\boldsymbol{Y}_{m\ell} = \boldsymbol{X}_{m\ell} \boldsymbol{\beta}_{m\ell} + \boldsymbol{\varepsilon}_{m\ell},
\tag{A2}
$$

where $\boldsymbol{\varepsilon}_{m\ell}$ is an $(n_{m\ell} \times 1)$ matrix of disturbances with 0 mean.

Using data for each subsample $\ell = 1, 2$ in model j for a given year, we estimate equation (A1) using OLS, yielding $\widehat{\boldsymbol{\beta}}_{m\ell}$ and $\widehat{\boldsymbol{\varepsilon}}_{m\ell} = \boldsymbol{Y}_{m\ell} - \boldsymbol{X}_{m\ell} \widehat{\boldsymbol{\beta}}_{m\ell}$. Next, we compute White's (1980) heteroskedasticity-consistent covariance matrix estimator

$$
\widehat{\boldsymbol{\Sigma}}_{m\ell} = (\boldsymbol{X}'_{m\ell} \boldsymbol{X}_{m\ell})^{-1} (\boldsymbol{X}'_{m\ell} \boldsymbol{E}_{m\ell} \boldsymbol{X}_{m\ell}) (\boldsymbol{X}'_{m\ell} \boldsymbol{X}_{m\ell})^{-1}
\tag{A3}
$$

for each subsample, where $\boldsymbol{E}_{m\ell}$ is the $(n_{m\ell} \times n_{m\ell})$ diagonal matrix with elements of $\widehat{\boldsymbol{\varepsilon}}_{m\ell}$ along the principal diagonal. Under the null hypothesis $H_0 : \boldsymbol{\beta}_{m1} = \boldsymbol{\beta}_{m2}$, asymptotic normality of OLS estimators ensures that the Wald statistic

$$
\widehat{W} = (\widehat{\boldsymbol{\beta}}_{m1} - \widehat{\boldsymbol{\beta}}_{m2})' (\widehat{\boldsymbol{\Sigma}}_{m1} + \widehat{\boldsymbol{\Sigma}}_{m2})^{-1} (\widehat{\boldsymbol{\beta}}_{m1} - \widehat{\boldsymbol{\beta}}_{m2}) \xrightarrow{d} \chi^2(K_j).
\tag{A4}
$$

We computed the Wald statistic in equation (A4) for models 1 and 2 for each of the eighteen years represented in our sample, and for models 3 and 4 for all but the first year (due to the lagged variables in models 3 and 4). Over the seventy different tests, we obtained values of the Wald statistic ranging from 530.95 to 4,688.52; the largest p-value among the seventy different tests was 2.024×10^{-61}. Hence, the translog specification in equation (A1) is rejected at any reasonable level of significance for each model we considered and for each year represented in our sample.