

# The Multiple Linear Regression Model

## 1 Introduction

The multiple linear regression model and its estimation using ordinary least squares (OLS) is doubtless the most widely used tool in econometrics. It allows to estimate the relation between a dependent variable and a set of explanatory variables. Prototypical examples in econometrics are:

- Wage of an employee as a function of her education and her work experience (the so-called Mincer equation).
- Price of a house as a function of its number of bedrooms and its age (an example of hedonic price regressions).

The dependent variable is an interval variable, i.e. its values represent a natural order and differences of two values are meaningful. The dependent variable can, in principle, take any real value between  $-\infty$  and  $+\infty$ . In practice, this means that the variable needs to be observed with some precision and that all observed values are far from ranges which are theoretically excluded. Wages, for example, do strictly speaking not qualify as they cannot take values beyond two digits (cents) and values which are negative. In practice, monthly wages in dollars in a sample of full time workers is perfectly fine with OLS whereas wages measured in three wage categories (low, middle, high) for a sample that includes unemployed (with zero wages) ask for other estimation tools.

## 2 The Econometric Model

The multiple linear regression model assumes a linear (in parameters) relationship between a dependent variable  $y_i$  and a set of explanatory variables  $x'_i = (x_{i0}, x_{i1}, \dots, x_{iK})$ .  $x_i$  is also called an independent variable, a covariate or a regressor. The first regressor  $x_{i0} = 1$  is a constant unless otherwise specified.

Consider a sample of  $N$  observations  $i = 1, \dots, N$ . Every single observation  $i$  follows

$$y_i = x'_i \beta + u_i = \beta_0 + \beta_1 x_{i1} + \dots + \beta_K x_{iK} + u_i$$

where  $\beta$  is a  $(K + 1)$ -dimensional column vector of parameters,  $x'_i$  is a  $(K + 1)$ -dimensional row vector and  $u_i$  is a scalar called the error term.

The whole sample of  $N$  observations can be expressed in matrix notation,

$$y = X\beta + u$$

where  $y$  is a  $N$ -dimensional column vector,  $X$  is a  $N \times (K + 1)$  matrix and  $u$  is a  $N$ -dimensional column vector of error terms, i.e.

$$\begin{matrix} \begin{bmatrix} y_1 \\ y_2 \\ y_3 \\ \vdots \\ y_N \end{bmatrix} \\ N \times 1 \end{matrix} = \begin{matrix} \begin{bmatrix} 1 & x_{11} & \cdots & x_{1K} \\ 1 & x_{21} & \cdots & x_{2K} \\ 1 & x_{31} & \cdots & x_{3K} \\ \vdots & \vdots & \ddots & \vdots \\ 1 & x_{N1} & \cdots & x_{NK} \end{bmatrix} \\ N \times (K + 1) \end{matrix} \begin{matrix} \begin{bmatrix} \beta_0 \\ \beta_1 \\ \vdots \\ \beta_K \end{bmatrix} \\ (K + 1) \times 1 \end{matrix} + \begin{matrix} \begin{bmatrix} u_1 \\ u_2 \\ u_3 \\ \vdots \\ u_N \end{bmatrix} \\ N \times 1 \end{matrix}$$

The data generation process (dgp) is fully described by a set of assumptions. Several of the following assumptions are formulated in different alternatives. Different sets of assumptions will lead to different properties of the OLS estimator.

*OLS1: Linearity*

$$y_i = x_i' \beta + u_i \text{ and } E(u_i) = 0$$

OLS1 means that the linear specification is correct.

*OLS2: Independence*

$$\{x_i, y_i\}_{i=1}^N \text{ i.i.d. (independent and identically distributed)}$$

OLS2 means that the observations are independently and identically distributed. This assumption is in practice guaranteed by random sampling.

*OLS3: Exogeneity*

- a)  $u_i | x_i \sim N(0, \sigma^2)$
- b)  $u_i \perp x_i$  (independent)
- c)  $E(u_i | x_i) = 0$  (mean independent)
- d)  $cov(x_i, u_i) = 0$  (uncorrelated)

OLS3a assumes that the error term is independent of the explanatory variables and normally distributed. OLS3b means that the error term is independent of the explanatory variables. OLS3c states that the mean of the error term is independent of the explanatory variables. OLS3d means that the error term and the explanatory variables are uncorrelated. OLS3a is the strongest assumption and implies OLS3b to OLS3d. OLS3b implies OLS3c and OLS3d. OLS3c implies OLS3d which is the weakest assumption. Intuitively, OLS3 means that the explanatory variables contain no information about the error term.

*OLS4: Identifiability*

$$\text{rank}(X) = K + 1 < N$$

OLS4 assumes that the regressors are not perfectly collinear, i.e. no variable is a linear combination of the others. For example, there can

only be one constant. Intuitively, OLS4 means that every explanatory variable adds additional information.

*OLS5: Error Variance*

- a)  $V(u_i | x_i) = \sigma^2 < \infty$  (homoscedasticity)
- b)  $V(u_i | x_i) = \sigma_i^2 = g(x_i) < \infty$  (conditional heteroscedasticity)

OLS5a (homoscedasticity) means that the variance of the error term is a constant. OLS5b (conditional heteroscedasticity) allows the variance of the error term to depend on the explanatory variables.

*OLS6: Identifying Variation*

$$E(x_i x_i') = Q_{XX} \text{ is positive definite and finite}$$

OLS6 assumes that all regressors (but the constant) have non-zero variance and not too many extreme values.

### 3 Estimation with OLS

Ordinary least squares (OLS) minimizes the squared distances between the observed and the predicted dependent variable  $y$ :

$$S(\beta) = \sum_{i=1}^N (y_i - x_i' \beta)^2 = (y - X\beta)'(y - X\beta) \rightarrow \min_{\beta}$$

The resulting OLS estimator of  $\beta$  is:

$$\hat{\beta} = (X'X)^{-1} X'y$$

Given the OLS estimator, we can predict the dependent variable by  $\hat{y}_i = x_i' \hat{\beta}$  and the error term by  $\hat{u}_i = y_i - x_i' \hat{\beta}$ .  $\hat{u}_i$  is called the *residual*.

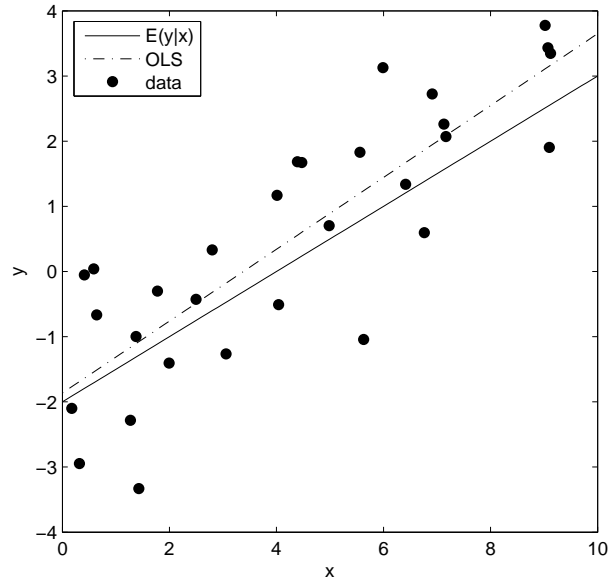


Figure 1: The linear regression model with one regressor.  $\beta_0 = -2$ ,  $\beta_1 = 0.5$ ,  $\sigma^2 = 1$ ,  $x \sim \text{uniform}(0, 10)$ ,  $u \sim N(0, \sigma^2)$ .

#### 4 Goodness-of-fit

The goodness-of-fit of an OLS regression can be measured as

$$R^2 = 1 - \frac{SSR}{SST} = \frac{SSE}{SST}$$

where  $SST = \sum_{i=1}^N (y_i - \bar{y})^2$  is the total sum of squares,  $SSE = \sum_{i=1}^N (\hat{y}_i - \bar{y})^2$  the explained sum of squares and  $SSR = \sum_{i=1}^N \hat{u}_i^2$  the residual sum of squares.  $R^2$  lies by definition between 0 and 1 and reports the fraction of the sample variation in  $y$  that is explained by the  $x$ s.

Note:  $R^2$  is in general not meaningful in a regression without a constant.  $R^2$  increases by construction with every (also irrelevant) additional regressors and is therefore not a good criterium for the selection of regressors.

#### 5 Small Sample Properties

Assuming *OLS1*, *OLS2*, *OLS3a*, *OLS4*, *OLS5* and *OLS6*, the following properties can be established for finite, i.e. even small, samples.

- The OLS estimator of  $\beta$  is *unbiased*:

$$E(\hat{\beta}|X) = \beta$$

- The OLS estimator is normally distributed:

$$\hat{\beta}|X \sim N(\beta, V(\hat{\beta}|X))$$

with variance  $V(\hat{\beta}|X) = \sigma^2 (X'X)^{-1}$  under homoscedasticity (*OLS5a*) and  $V(\hat{\beta}|X) = \sigma^2 (X'X)^{-1} [X'\Omega X] (X'X)^{-1}$  under known heteroscedasticity (*OLS5b*). Under homoscedasticity (*OLS5a*) the variance  $V$  can be *unbiasedly* estimated as

$$\hat{V}(\hat{\beta}|X) = \hat{\sigma}^2 (X'X)^{-1}$$

with

$$\hat{\sigma}^2 = \frac{\hat{u}'\hat{u}}{N - K - 1}.$$

- Gauß-Markov-Theorem: under homoscedasticity (*OLS5a*),

$\hat{\beta}$  is BLUE (best linear unbiased estimator)

Table 1 provides a systematic overview of assumptions and their implied properties.

Table 1: Properties of the OLS estimator.

Case	[1]	[2]	[3]	[4]	[5]	[6]
<i>Assumptions</i>						
OLS1: linearity	✓	✓	✓	✓	✓	✓
OLS2: independence	✓	✓	✓	✓	✓	✓
OLS3a: normality	✓	×	×	×	✓	×
OLS3b: independent	✓	✓	×	×	✓	×
OLS3c: mean indep.	✓	✓	✓	✓	✓	×
OLS3d: uncorrelated	✓	✓	✓	✓	✓	✓
OLS4: full rank	✓	✓	✓	✓	✓	✓
OLS5a: homoscedastic	✓	✓	✓			
OLS5b: heteroscedastic				✓	✓	✓
OLS6: $V(x_i)$ p.d.	✓	✓	✓	✓	✓	✓
<i>Small sample properties of <math>\hat{\beta}</math></i>						
unbiased	✓	✓	✓	✓	✓	×
normally distributed	✓	×	×	×	✓	×
efficient	✓	✓	✓	×	×	×
$t$ -test, $F$ -test	✓	×	×	×	×	×
<i>Large sample properties of <math>\hat{\beta}</math></i>						
consistent	✓	✓	✓	✓	✓	✓
approx. normal	✓	✓	✓	✓	✓	✓
asymptotically efficient	✓	✓	✓	×	×	×
$z$ -test, Wald test	✓	✓	✓	✓*	✓*	✓*

Notes: ✓ = fulfilled, × = violated, \* = corrected standard errors

## 6 Tests in Small Samples

Assume *OLS1*, *OLS2*, *OLS3a*, *OLS4*, *OLS5a* and *OLS6*.

A simple null hypotheses of the form  $H_0 : \beta_k = q$  is tested with the  $t$ -test. If the null hypotheses is true, the  $t$ -statistic

$$t = \frac{\hat{\beta}_k - q}{\widehat{se}(\hat{\beta}_k)} \sim t_{N-K-1}$$

follows a  $t$ -distribution with  $N - K - 1$  degrees of freedom. The standard error  $\widehat{se}(\hat{\beta}_k)$  is the square root of the element in the  $(k + 1)$ -th row and  $(k + 1)$ -th column of  $\widehat{V}(\hat{\beta}|X)$ . For example, to perform a two-sided test of

$H_0$  against the alternative hypotheses  $H_a : \beta_k \neq q$  on the 5% significance level, we calculate the  $t$ -statistic and compare its absolute value to the 0.975-quantile of the  $t$ -distribution. With  $N = 30$  and  $K = 2$ ,  $H_0$  is rejected if  $|t| > 2.052$ .

A null hypotheses of the form  $H_0 : R\beta = q$  with  $J$  linear restrictions is jointly tested with the  $F$ -test. If the null hypotheses is true, the  $F$ -statistic

$$F = \frac{(\widehat{R\beta} - q)' \left[ R\widehat{V}(\hat{\beta}|X)R' \right]^{-1} (\widehat{R\beta} - q)}{J} \sim F_{J, N-K-1}$$

follows an  $F$  distribution with  $J$  numerator degrees of freedom and  $N - K - 1$  denominator degrees of freedom. For example, to perform a two-sided test of  $H_0$  against the alternative hypotheses  $H_a : R\beta \neq q$  at the 5% significance level, we calculate the  $F$ -statistic and compare it to the 0.95-quantile of the  $F$ -distribution. With  $N = 30$ ,  $K = 2$  and  $J = 2$ ,  $H_0$  is rejected if  $F > 3.35$ . We cannot perform one-sided  $F$ -tests.

Only under homoscedasticity (*OLS5a*), the  $F$ -statistic can also be computed as

$$F = \frac{(SSR_{restricted} - SSR)/J}{SSR/(N - K - 1)} = \frac{(R^2 - R^2_{restricted})/J}{(1 - R^2)/(N - K - 1)} \sim F_{J, N-K-1}$$

where  $SSR_{restricted}$  and  $R^2_{restricted}$  are, respectively, estimated by restricted least squares which minimizes  $S(\beta)$  s.t.  $R\beta = q$ . Exclusionary restrictions of the form  $H_0 : \beta_k = 0, \beta_m = 0, \dots$  are a special case of  $H_0 : R\beta = q$ . In this case, restricted least squares is simply estimated as a regression were the explanatory variables  $k, m, \dots$  are excluded.

## 7 Confidence Intervals in Small Samples

Assuming *OLS1*, *OLS2*, *OLS3a*, *OLS4*, *OLS5a* and *OLS6*, we can construct confidence intervals for a particular coefficient  $\beta_k$ . The  $(1 - \alpha)$

confidence interval is given by

$$\left( \beta_k - t_{(1-\alpha/2), (N-K-1)} \widehat{se}(\widehat{\beta}_k), \beta_k + t_{(1-\alpha/2), (N-K-1)} \widehat{se}(\widehat{\beta}_k) \right)$$

where  $t_{(1-\alpha/2), (N-K-1)}$  is the  $(1-\alpha/2)$  quantile of the  $t$ -distribution with  $N-K-1$  degrees of freedom. For example, the 95 % confidence interval with  $N=30$  and  $K=2$  is  $\left( \beta_k - 2.052 \widehat{se}(\widehat{\beta}_k), \beta_k + 2.052 \widehat{se}(\widehat{\beta}_k) \right)$ .

## 8 Asymptotic Properties of the OLS Estimator

Assuming *OLS1*, *OLS2*, *OLS3d*, *OLS4*, *OLS5a* or *OLS5b* and *OLS6* the following properties can be established for large samples.

- The OLS estimator is consistent:

$$\text{plim } \widehat{\beta} = \beta$$

- The OLS estimator is asymptotically normally distributed:

$$\sqrt{N}(\widehat{\beta} - \beta) \xrightarrow{d} N(0, \Sigma)$$

where  $\Sigma = \sigma^2 [E(x_i x_i')]^{-1} = \sigma^2 Q_{XX}^{-1}$  under *OLS5a* and  $\Sigma = [E(x_i x_i')]^{-1} [E(u_i^2 x_i x_i')] [E(x_i x_i')]^{-1} = Q_{XX}^{-1} [E(u_i^2 x_i x_i')] Q_{XX}^{-1}$  under *OLS5b*.

- The OLS estimator is approximately normally distributed

$$\widehat{\beta} \overset{A}{\sim} N\left(\beta, \widehat{Avar}(\widehat{\beta})\right)$$

where the asymptotic variance  $\widehat{Avar}(\widehat{\beta}) = N^{-1} \Sigma$  can be consistently estimated under *OLS5a* (homoscedasticity) as

$$\widehat{Avar}(\widehat{\beta}) = \widehat{\sigma}^2 (X'X)^{-1}$$

with  $\widehat{\sigma}^2 = \widehat{u}'\widehat{u}/N$  and under *OLS5b* (heteroscedasticity) as the

*robust* or *Eicker-White* estimator (see handout on “Heteroscedasticity in the linear Model”)

$$\widehat{Avar}(\widehat{\beta}) = (X'X)^{-1} \left[ \sum_{i=1}^N \widehat{u}_i^2 x_i x_i' \right] (X'X)^{-1}$$

Note: In practice we can almost never be sure that the errors are homoscedastic and should therefore always use robust standard errors.

Table 1 provides a systematic overview of assumptions and their implied properties.

## 9 Asymptotic Tests

Assume *OLS1*, *OLS2*, *OLS3d*, *OLS4*, *OLS5a* or *OLS5b* and *OLS6*.

A simple null hypotheses of the form  $H_0 : \beta_k = q$  is tested with the  $z$ -test. If the null hypotheses is true, the  $z$ -statistic

$$z = \frac{\widehat{\beta}_k - q}{\widehat{se}(\widehat{\beta}_k)} \overset{A}{\sim} N(0, 1)$$

follows approximately the standard normal distribution. The standard error  $\widehat{se}(\widehat{\beta}_k)$  is the square root of the element in the  $(k+1)$ -th row and  $(k+1)$ -th column of  $\widehat{Avar}(\widehat{\beta})$ . For example, to perform a two sided test of  $H_0$  against the alternative hypotheses  $H_a : \beta_k \neq q$  on the 5% significance level, we calculate the  $z$ -statistic and compare its absolute value to the 0.975-quantile of the standard normal distribution.  $H_0$  is rejected if  $|z| > 1.96$ .

A null hypotheses of the form  $H_0 : R\beta = q$  with  $J$  linear restrictions is jointly tested with the Wald test. If the null hypotheses is true, the Wald statistic

$$W = (R\widehat{\beta} - q)' \left[ R \widehat{Avar}(\widehat{\beta}) R' \right]^{-1} (R\widehat{\beta} - q) \overset{A}{\sim} \chi_J^2$$

follows approximately an  $\chi^2$  distribution with  $J$  degrees of freedom. For example, to perform a test of  $H_0$  against the alternative hypotheses  $H_a : R\beta \neq q$  on the 5% significance level, we calculate the Wald statistic and compare it to the 0.95-quantile of the  $\chi^2$ -distribution. With  $J = 2$ ,  $H_0$  is rejected if  $W > 5.99$ . We cannot perform one-sided Wald tests.

Under *OLS5a* (homoscedasticity) only, the Wald statistic can also be computed as

$$W = \frac{(SSR_{restricted} - SSR)}{SSR/N} = \frac{(R^2 - R_{restricted}^2)}{(1 - R^2)/N} \stackrel{A}{\approx} \chi_J^2$$

where  $SSR_{restricted}$  and  $R_{restricted}^2$  are, respectively, estimated by restricted least squares which minimizes  $S(\beta)$  s.t.  $R\beta = q$ . Exclusionary restrictions of the form  $H_0 : \beta_k = 0, \beta_m = 0, \dots$  are a special case of  $H_0 : R\beta = q$ . In this case, restricted least squares is simply estimated as a regression were the explanatory variables  $k, m, \dots$  are excluded.

Note: the Wald statistic can also be calculated as

$$W = J \cdot F \stackrel{A}{\approx} \chi_J^2$$

where  $F$  is the small sample  $F$ -statistic. This formulation differs by a factor  $(N - K - 1)/N$  but has the same asymptotic distribution.

## 10 Confidence Intervals in Large Samples

Assuming *OLS1*, *OLS2*, *OLS3d*, *OLS4*, *OLS5a* or *OLS5b* and *OLS6*, we can construct confidence intervals for a particular coefficient  $\beta_k$ . The  $(1 - \alpha)$  confidence interval is given by

$$\left( \beta_k - z_{(1-\alpha/2)} \widehat{se}(\widehat{\beta}_k), \beta_k + z_{(1-\alpha/2)} \widehat{se}(\widehat{\beta}_k) \right)$$

where  $z_{(1-\alpha/2)}$  is the  $(1 - \alpha/2)$  quantile of the standard normal distribution. For example, the 95 % confidence interval is  $\left( \beta_k - 1.96 \widehat{se}(\widehat{\beta}_k), \beta_k + 1.96 \widehat{se}(\widehat{\beta}_k) \right)$ .

## 11 Small Sample vs. Asymptotic Properties

The  $t$ -test,  $F$ -test and confidence interval for small samples depend on the normality assumption *OLS3d* (see Table 1). This assumption is strong and unlikely to be satisfied. The asymptotic  $z$ -test, Wald test and the confidence interval for large samples rely on much weaker assumptions. Although most statistical software packages report the small sample results by default, we would typically prefer the large sample approximations. In practice, small sample and asymptotic tests and confidence intervals are very similar already for relatively small samples, i.e. for  $(N - K) > 30$ . Large sample tests also have the advantage that they can be based on heteroscedasticity robust standard errors.

## 12 Implementation in Stata 10.0

Stata performs OLS estimation of the multiple linear regression model by the command

```
regress depvar [indepvars] [if] [in]
```

where *depvar* is the dependent variable and *indepvars* is a list of explanatory variables. For example,

```
webuse auto.dta
regress price mpg weight rep78
```

regresses the price of a car on its mileage, weight and repair record. Stata automatically adds a constant if not suppressed by the option `noconst`.

We can use the post-estimation command `test` to perform  $F$ -tests for 1 or more restrictions. For example

```
test mpg
```

tests  $H_0 : \beta_1 = 0$  against  $H_a : \beta_1 \neq 0$ ,

```
test mpg weight
```

tests  $H_0 : \beta_1 = 0$  and  $\beta_2 = 0$  against  $H_a : \beta_1 \neq 0$  or  $\beta_2 \neq 0$ , and

```
test mpg = weight
```

tests  $H_0 : \beta_1 = \beta_2$  against  $H_0 : \beta_1 \neq \beta_2$ . Stata always provides small sample statistics and  $p$ -values.

The post-estimation command `predict` generates in-sample and out-of-sample predictions. For example

```
regress price mpg weight rep78 if _n < 50
predict price_hat_in if e(sample)
predict price_hat_out if !e(sample)
```

uses the first 50 observations to estimate the linear regression model and predicts the values for the remaining observations.

## References

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