

# THE CLASSICAL MULTIPLE LINEAR REGRESSION MODEL



## 2.1 INTRODUCTION

An econometric study begins with a set of propositions about some aspect of the economy. The theory specifies a set of precise, deterministic relationships among variables. Familiar examples are demand equations, production functions, and macroeconomic models. The empirical investigation provides estimates of unknown parameters in the model, such as elasticities or the effects of monetary policy, and usually attempts to measure the validity of the theory against the behavior of observable data. Once suitably constructed, the model might then be used for prediction or analysis of behavior. This book will develop a large number of models and techniques used in this framework.

The **linear regression model** is the single most useful tool in the econometrician's kit. Though to an increasing degree in the contemporary literature, it is often only the departure point for the full analysis, it remains the device used to begin almost all empirical research. This chapter will develop the model. The next several chapters will discuss more elaborate specifications and complications that arise in the application of techniques that are based on the simple models presented here.

## 2.2 THE LINEAR REGRESSION MODEL

The **multiple linear regression model** is used to study the relationship between a **dependent variable** and one or more **independent variables**. The generic form of the linear regression model is

$$\begin{aligned} y &= f(x_1, x_2, \dots, x_K) + \varepsilon \\ &= x_1\beta_1 + x_2\beta_2 + \dots + x_K\beta_K + \varepsilon \end{aligned} \tag{2-1}$$

where  $y$  is the dependent or **explained** variable and  $x_1, \dots, x_K$  are the independent or **explanatory** variables. One's theory will specify  $f(x_1, x_2, \dots, x_K)$ . This function is commonly called the **population regression equation** of  $y$  on  $x_1, \dots, x_K$ . In this setting,  $y$  is the **regressand** and  $x_k, k=1, \dots, K$ , are the **regressors** or **covariates**. The underlying theory will specify the dependent and independent variables in the model. It is not always obvious which is appropriately defined as each of these—for example, a demand equation,  $quantity = \beta_1 + price \times \beta_2 + income \times \beta_3 + \varepsilon$ , and an inverse demand equation,  $price = \gamma_1 + quantity \times \gamma_2 + income \times \gamma_3 + u$  are equally valid representations of a market. For modeling purposes, it will often prove useful to think in terms of "autonomous variation." One can conceive of movement of the independent

## 8 CHAPTER 2 ♦ The Classical Multiple Linear Regression Model

variables outside the relationships defined by the model while movement of the dependent variable is considered in response to some independent or exogenous stimulus.<sup>1</sup>

The term  $\varepsilon$  is a random **disturbance**, so named because it “disturbs” an otherwise stable relationship. The disturbance arises for several reasons, primarily because we cannot hope to capture every influence on an economic variable in a model, no matter how elaborate. The net effect, which can be positive or negative, of these omitted factors is captured in the disturbance. There are many other contributors to the disturbance in an empirical model. Probably the most significant is errors of measurement. It is easy to theorize about the relationships among precisely defined variables; it is quite another to obtain accurate measures of these variables. For example, the difficulty of obtaining reasonable measures of profits, interest rates, capital stocks, or, worse yet, flows of services from capital stocks is a recurrent theme in the empirical literature. At the extreme, there may be no observable counterpart to the theoretical variable. The literature on the permanent income model of consumption [e.g., Friedman (1957)] provides an interesting example.

We assume that each observation in a sample  $(y_i, x_{i1}, x_{i2}, \dots, x_{iK}), i = 1, \dots, n$ , is generated by an underlying process described by

$$y_i = x_{i1}\beta_1 + x_{i2}\beta_2 + \dots + x_{iK}\beta_K + \varepsilon_i.$$

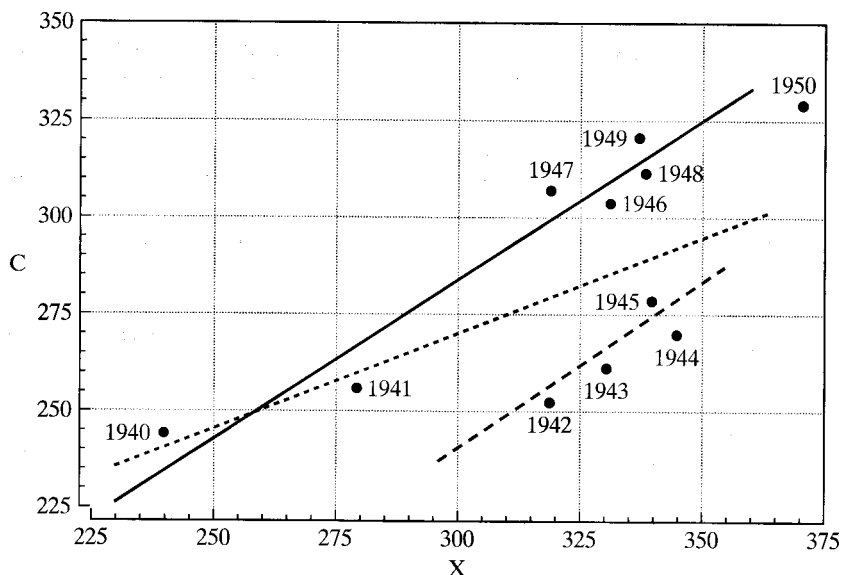
The observed value of  $y_i$  is the sum of two parts, a deterministic part and the random part,  $\varepsilon_i$ . Our objective is to estimate the unknown parameters of the model, use the data to study the validity of the theoretical propositions, and perhaps use the model to predict the variable  $y$ . How we proceed from here depends crucially on what we assume about the stochastic process that has led to our observations of the data in hand.

### Example 2.1 Keynes's Consumption Function

Example 1.1 discussed a model of consumption proposed by Keynes and his *General Theory* (1936). The theory that consumption,  $C$ , and income,  $X$ , are related certainly seems consistent with the observed “facts” in Figures 1.1 and 2.1. (These data are in Data Table F2.1.) Of course, the linear function is only approximate. Even ignoring the anomalous wartime years, consumption and income cannot be connected by any simple **deterministic relationship**. The linear model,  $C = \alpha + \beta X$ , is intended only to represent the salient features of this part of the economy. It is hopeless to attempt to capture every influence in the relationship. The next step is to incorporate the inherent randomness in its real world counterpart. Thus, we write  $C = f(X, \varepsilon)$ , where  $\varepsilon$  is a stochastic element. It is important not to view  $\varepsilon$  as a catchall for the inadequacies of the model. The model including  $\varepsilon$  appears adequate for the data not including the war years, but for 1942–1945, something systematic clearly seems to be missing. Consumption in these years could not rise to rates historically consistent with these levels of income because of wartime rationing. A model meant to describe consumption in this period would have to accommodate this influence.

It remains to establish how the stochastic element will be incorporated in the equation. The most frequent approach is to assume that it is *additive*. Thus, we recast the equation in stochastic terms:  $C = \alpha + \beta X + \varepsilon$ . This equation is an empirical counterpart to Keynes's theoretical model. But, what of those anomalous years of rationing? If we were to ignore our intuition and attempt to “fit” a line to all these data—the next chapter will discuss at length how we should do that—we might arrive at the dotted line in the figure as our best guess. This line, however, is obviously being distorted by the rationing. A more appropriate

<sup>1</sup>By this definition, it would seem that in our demand relationship, only income would be an independent variable while both price and quantity would be dependent. That makes sense—in a market, price and quantity are determined at the same time, and do change only when something outside the market changes. We will return to this specific case in Chapter 15.



**FIGURE 2.1** Consumption Data, 1940–1950.

specification for these data that accommodates both the stochastic nature of the data and the special circumstances of the years 1942–1945 might be one that shifts straight down in the war years,  $C = \alpha + \beta X + d_{\text{war years}} \delta_w + \varepsilon$ , where the new variable,  $d_{\text{war years}}$  equals one in 1942–1945 and zero in other years and  $\delta_w < 0$ .

One of the most useful aspects of the multiple regression model is its ability to identify the independent effects of a set of variables on a dependent variable. Example 2.2 describes a common application.

### Example 2.2 Earnings and Education

A number of recent studies have analyzed the relationship between earnings and education. We would expect, on average, higher levels of education to be associated with higher incomes. The simple regression model

$$\text{earnings} = \beta_1 + \beta_2 \text{education} + \varepsilon,$$

however, neglects the fact that most people have higher incomes when they are older than when they are young, regardless of their education. Thus,  $\beta_2$  will overstate the marginal impact of education. If age and education are positively correlated, then the regression model will associate all the observed increases in income with increases in education. A better specification would account for the effect of age, as in

$$\text{earnings} = \beta_1 + \beta_2 \text{education} + \beta_3 \text{age} + \varepsilon.$$

It is often observed that income tends to rise less rapidly in the later earning years than in the early ones. To accommodate this possibility, we might extend the model to

$$\text{earnings} = \beta_1 + \beta_2 \text{education} + \beta_3 \text{age} + \beta_4 \text{age}^2 + \varepsilon.$$

We would expect  $\beta_3$  to be positive and  $\beta_4$  to be negative.

The crucial feature of this model is that it allows us to carry out a conceptual experiment that might not be observed in the actual data. In the example, we might like to (and could) compare the earnings of two individuals of the same age with different amounts of “education” even if the data set does not actually contain two such individuals. How education should be

measured in this setting is a difficult problem. The study of the earnings of twins by Ashenfelter and Krueger (1994), which uses precisely this specification of the earnings equation, presents an interesting approach. We will examine this study in some detail in Section 5.6.4.

A large literature has been devoted to an intriguing question on this subject. Education is not truly “independent” in this setting. Highly motivated individuals will choose to pursue more education (for example, by going to college or graduate school) than others. By the same token, highly motivated individuals may do things that, on average, lead them to have higher incomes. If so, does a positive  $\beta_2$  that suggests an association between income and education really measure the effect of education on income, or does it reflect the effect of some underlying effect on both variables that we have not included in our regression model? We will revisit the issue in Section 22.4.

## 2.3 ASSUMPTIONS OF THE CLASSICAL LINEAR REGRESSION MODEL

The classical linear regression model consists of a set of assumptions about how a data set will be produced by an underlying “data-generating process.” The theory will specify a deterministic relationship between the dependent variable and the independent variables. The assumptions that describe the form of the model and relationships among its parts and imply appropriate estimation and inference procedures are listed in Table 2.1.

### 2.3.1 LINEARITY OF THE REGRESSION MODEL

Let the column vector  $\mathbf{x}_k$  be the  $n$  observations on variable  $x_k$ ,  $k = 1, \dots, K$ , and assemble these data in an  $n \times K$  data matrix  $\mathbf{X}$ . In most contexts, the first column of  $\mathbf{X}$  is assumed to be a column of 1s so that  $\beta_1$  is the constant term in the model. Let  $\mathbf{y}$  be the  $n$  observations,  $y_1, \dots, y_n$ , and let  $\boldsymbol{\varepsilon}$  be the column vector containing the  $n$  disturbances.

**TABLE 2.1** Assumptions of the Classical Linear Regression Model

**A1. Linearity:**  $y_i = x_{i1}\beta_1 + x_{i2}\beta_2 + \dots + x_{iK}\beta_K + \varepsilon_i$ . The model specifies a linear relationship between  $y$  and  $x_1, \dots, x_K$ .

**A2. Full rank:** There is no exact linear relationship among any of the independent variables in the model. This assumption will be necessary for estimation of the parameters of the model.

**A3. Exogeneity of the independent variables:**  $E[\varepsilon_i | x_{j1}, x_{j2}, \dots, x_{jK}] = 0$ . This states that the expected value of the disturbance at observation  $i$  in the sample is not a function of the independent variables observed at any observation, including this one. This means that the independent variables will not carry useful information for prediction of  $\varepsilon_i$ .

**A4. Homoscedasticity and nonautocorrelation:** Each disturbance,  $\varepsilon_i$  has the same finite variance,  $\sigma^2$  and is uncorrelated with every other disturbance,  $\varepsilon_j$ . This assumption limits the generality of the model, and we will want to examine how to relax it in the chapters to follow.

**A5. Exogenously generated data:** The data in  $(x_{j1}, x_{j2}, \dots, x_{jK})$  may be any mixture of constants and random variables. The process generating the data operates outside the assumptions of the model—that is, independently of the process that generates  $\varepsilon_i$ . Note that this extends **A3**. Analysis is done conditionally on the observed  $\mathbf{X}$ .

**A6. Normal distribution:** The disturbances are normally distributed. Once again, this is a convenience that we will dispense with after some analysis of its implications.

The model in (2-1) as it applies to all  $n$  observations can now be written

$$y = x_1\beta_1 + \cdots + x_K\beta_K + \varepsilon, \tag{2-2}$$

or in the form of Assumption 1,

$ASSUMPTION: \quad y = \mathbf{X}\beta + \varepsilon.$

(2-3)

**A NOTATIONAL CONVENTION.**

Henceforth, to avoid a possibly confusing and cumbersome notation, we will use a boldface  $\mathbf{x}$  to denote a column or a row of  $\mathbf{X}$ . Which applies will be clear from the context. In (2-2),  $\mathbf{x}_k$  is the  $k$ th column of  $\mathbf{X}$ . Subscripts  $j$  and  $k$  will be used to denote columns (variables). It will often be convenient to refer to a single observation in (2-3), which we would write

$$y_i = \mathbf{x}_i\beta + \varepsilon_i. \tag{2-4}$$

Subscripts  $i$  and  $t$  will generally be used to denote rows (observations) of  $\mathbf{X}$ . In (2-4),  $\mathbf{x}_i$  is a column vector that is the transpose of the  $i$ th  $1 \times K$  row of  $\mathbf{X}$ .

Our primary interest is in estimation and inference about the parameter vector  $\beta$ . Note that the simple regression model in Example 2.1 is a special case in which  $\mathbf{X}$  has only two columns, the first of which is a column of 1s. The assumption of linearity of the regression model includes the additive disturbance. For the regression to be linear in the sense described here, it must be of the form in (2-1) either in the original variables or after some suitable transformation. For example, the model

$$y = Ax^\beta e^\varepsilon$$

is linear (after taking logs on both sides of the equation), whereas

$$y = Ax^\beta + \varepsilon$$

is not. The observed dependent variable is thus the sum of two components, a deterministic element  $\alpha + \beta x$  and a random variable  $\varepsilon$ . It is worth emphasizing that neither of the two parts is directly observed because  $\alpha$  and  $\beta$  are unknown.

The linearity assumption is not so narrow as it might first appear. In the regression context, *linearity* refers to the manner in which the parameters and the disturbance enter the equation, not necessarily to the relationship among the variables. For example, the equations  $y = \alpha + \beta x + \varepsilon$ ,  $y = \alpha + \beta \cos(x) + \varepsilon$ ,  $y = \alpha + \beta/x + \varepsilon$ , and  $y = \alpha + \beta \ln x + \varepsilon$  are all linear in some function of  $x$  by the definition we have used here. In the examples, only  $x$  has been transformed, but  $y$  could have been as well, as in  $y = Ax^\beta e^\varepsilon$ , which is a linear relationship in the logs of  $x$  and  $y$ ;  $\ln y = \alpha + \beta \ln x + \varepsilon$ . The variety of functions is unlimited. This aspect of the model is used in a number of commonly used functional forms. For example, the **loglinear model** is

$$\ln y = \beta_1 + \beta_2 \ln x_2 + \beta_3 \ln x_3 + \cdots + \beta_K \ln x_K + \varepsilon.$$

This equation is also known as the **constant elasticity** form as in this equation, the elasticity of  $y$  with respect to changes in  $x$  is  $\partial \ln y / \partial \ln x_k = \beta_k$ , which does not vary

## 12 CHAPTER 2 ♦ The Classical Multiple Linear Regression Model

with  $x_k$ . The loglinear form is often used in models of demand and production. Different values of  $\beta$  produce widely varying functions.

### Example 2.3 The U.S. Gasoline Market

Data on the U.S. gasoline market for the years 1960–1995 are given in Table F2.2 in Appendix F. We will use these data to obtain, among other things, estimates of the income, own price, and cross-price elasticities of demand in this market. These data also present an interesting question on the issue of holding “all other things constant,” that was suggested in Example 2.2. In particular, consider a somewhat abbreviated model of per capita gasoline consumption:

$$\ln(G/pop) = \beta_1 + \beta_2 \ln income + \beta_3 \ln price_G + \beta_4 \ln P_{newcars} + \beta_5 \ln P_{usedcars} + \varepsilon.$$

This model will provide estimates of the income and price elasticities of demand for gasoline and an estimate of the elasticity of demand with respect to the prices of new and used cars. What should we expect for the sign of  $\beta_4$ ? Cars and gasoline are complementary goods, so if the prices of new cars rise, *ceteris paribus*, gasoline consumption should fall. Or should it? If the prices of new cars rise, then consumers will buy fewer of them; they will keep their used cars longer and buy fewer new cars. If older cars use more gasoline than newer ones, then the rise in the prices of new cars would lead to higher gasoline consumption than otherwise, not lower. We can use the multiple regression model and the gasoline data to attempt to answer the question.

A **semilog** model is often used to model growth rates:

$$\ln y_t = \mathbf{x}'_t \boldsymbol{\beta} + \delta t + \varepsilon_t.$$

In this model, the autonomous (at least not explained by the model itself) proportional, per period growth rate is  $d \ln y / dt = \delta$ . Other variations of the general form

$$f(y_t) = g(\mathbf{x}'_t \boldsymbol{\beta} + \varepsilon_t)$$

will allow a tremendous variety of functional forms, all of which fit into our definition of a linear model.

The linear regression model is sometimes interpreted as an approximation to some unknown, underlying function. (See Section A.8.1 for discussion.) By this interpretation, however, the linear model, even with quadratic terms, is fairly limited in that such an approximation is likely to be useful only over a small range of variation of the independent variables. The translog model discussed in Example 2.4, in contrast, has proved far more effective as an approximating function.

### Example 2.4 The Translog Model

Modern studies of demand and production are usually done in the context of a **flexible functional form**. Flexible functional forms are used in econometrics because they allow analysts to model **second-order effects** such as elasticities of substitution, which are functions of the second derivatives of production, cost, or utility functions. The linear model restricts these to equal zero, whereas the loglinear model (e.g., the Cobb–Douglas model) restricts the interesting elasticities to the uninteresting values of  $-1$  or  $+1$ . The most popular flexible functional form is the **translog** model, which is often interpreted as a second-order approximation to an unknown functional form. [See Berndt and Christensen (1973).] One way to derive it is as follows. We first write  $y = g(x_1, \dots, x_K)$ . Then,  $\ln y = \ln g(\dots) = f(\dots)$ . Since by a trivial transformation  $x_k = \exp(\ln x_k)$ , we interpret the function as a function of the logarithms of the  $x$ 's. Thus,  $\ln y = f(\ln x_1, \dots, \ln x_K)$ .

CHAPTER 2 ♦ The Classical Multiple Linear Regression Model 13

Now, expand this function in a second-order Taylor series around the point  $\mathbf{x} = [1, 1, \dots, 1]'$  so that at the expansion point, the log of each variable is a convenient zero. Then

$$\ln y = f(\mathbf{0}) + \sum_{k=1}^K [\partial f(\cdot) / \partial \ln x_k]_{\ln \mathbf{x}=\mathbf{0}} \ln x_k + \frac{1}{2} \sum_{k=1}^K \sum_{l=1}^K [\partial^2 f(\cdot) / \partial \ln x_k \partial \ln x_l]_{\ln \mathbf{x}=\mathbf{0}} \ln x_k \ln x_l + \varepsilon.$$

The disturbance in this model is assumed to embody the familiar factors and the error of approximation to the unknown function. Since the function and its derivatives evaluated at the fixed value  $\mathbf{0}$  are constants, we interpret them as the coefficients and write

$$\ln y = \beta_0 + \sum_{k=1}^K \beta_k \ln x_k + \frac{1}{2} \sum_{k=1}^K \sum_{l=1}^K \gamma_{kl} \ln x_k \ln x_l + \varepsilon.$$

This model is linear by our definition but can, in fact, mimic an impressive amount of curvature when it is used to approximate another function. An interesting feature of this formulation is that the loglinear model is a special case,  $\gamma_{kl} = 0$ . Also, there is an interesting test of the underlying theory possible because if the underlying function were assumed to be continuous and twice continuously differentiable, then by Young's theorem it must be true that  $\gamma_{kl} = \gamma_{lk}$ . We will see in Chapter 14 how this feature is studied in practice.

Despite its great flexibility, the linear model does not include all the situations we encounter in practice. For a simple example, there is no transformation that will reduce  $y = \alpha + 1/(\beta_1 + \beta_2 x) + \varepsilon$  to linearity. The methods we consider in this chapter are not appropriate for estimating the parameters of such a model. Relatively straightforward techniques have been developed for nonlinear models such as this, however. We shall treat them in detail in Chapter 9.

2.3.2 FULL RANK

Assumption 2 is that there are no exact linear relationships among the variables.

ASSUMPTION: $\mathbf{X}$ is an $n \times K$ matrix with rank $K$ .	(2-5)
--	-------

Hence,  $\mathbf{X}$  has full column rank; the columns of  $\mathbf{X}$  are linearly independent and there are at least  $K$  observations. [See (A-42) and the surrounding text.] This assumption is known as an **identification condition**. To see the need for this assumption, consider an example.

**Example 2.5 Short Rank**

Suppose that a cross-section model specifies

$$C = \beta_1 + \beta_2 \text{ nonlabor income} + \beta_3 \text{ salary} + \beta_4 \text{ total income} + \varepsilon,$$

where *total income* is exactly equal to *salary* plus *nonlabor income*. Clearly, there is an exact linear dependency in the model. Now let

$$\beta'_2 = \beta_2 + a,$$

$$\beta'_3 = \beta_3 + a,$$

and

$$\beta'_4 = \beta_4 - a,$$

## 14 CHAPTER 2 ♦ The Classical Multiple Linear Regression Model

where  $a$  is any number. Then the exact same value appears on the right-hand side of  $C$  if we substitute  $\beta'_2, \beta'_3,$  and  $\beta'_4$  for  $\beta_2, \beta_3,$  and  $\beta_4$ . Obviously, there is no way to estimate the parameters of this model.

If there are fewer than  $K$  observations, then  $\mathbf{X}$  cannot have full rank. Hence, we make the (redundant) assumption that  $n$  is at least as large as  $K$ .

In a two-variable linear model with a constant term, the full rank assumption means that there must be variation in the regressor  $x$ . If there is no variation in  $x$ , then all our observations will lie on a vertical line. This situation does not invalidate the other assumptions of the model; presumably, it is a flaw in the data set. The possibility that this suggests is that we *could* have drawn a sample in which there was variation in  $x$ , but in this instance, we did not. Thus, the model still applies, but we cannot learn about it from the data set in hand.

### 2.3.3 REGRESSION

The disturbance is assumed to have conditional expected value zero at every observation, which we write as

$$E[\varepsilon_i | \mathbf{X}] = 0. \quad (2-6)$$

For the full set of observations, we write Assumption 3 as:

ASSUMPTION:  $E[\mathbf{e} | \mathbf{X}] = \begin{bmatrix} E[\varepsilon_1 | \mathbf{X}] \\ E[\varepsilon_2 | \mathbf{X}] \\ \vdots \\ E[\varepsilon_n | \mathbf{X}] \end{bmatrix} = \mathbf{0}.$

(2-7)

There is a subtle point in this discussion that the observant reader might have noted. In (2-7), the left-hand side states, in principle, that the mean of each  $\varepsilon_i$  *conditioned on all observations*  $\mathbf{x}_i$  is zero. This conditional mean assumption states, in words, that no observations on  $\mathbf{x}$  convey information about the expected value of the disturbance. It is conceivable—for example, in a time-series setting—that although  $\mathbf{x}_i$  might provide no information about  $E[\varepsilon_i | \cdot]$ ,  $\mathbf{x}_j$  at some other observation, such as in the next time period, might. Our assumption at this point is that there is no information about  $E[\varepsilon_i | \cdot]$  contained in any observation  $\mathbf{x}_j$ . Later, when we extend the model, we will study the implications of dropping this assumption. [See Wooldridge (1995).] We will also assume that the disturbances convey no information about each other. That is,  $E[\varepsilon_i | \varepsilon_1, \dots, \varepsilon_{i-1}, \varepsilon_{i+1}, \dots, \varepsilon_n] = 0$ . In sum, at this point, we have assumed that the disturbances are purely random draws from some population.

The zero conditional mean implies that the unconditional mean is also zero, since

$$E[\varepsilon_i] = E_{\mathbf{x}}[E[\varepsilon_i | \mathbf{X}]] = E_{\mathbf{x}}[0] = 0.$$

Since, for each  $\varepsilon_i$ ,  $\text{Cov}[E[\varepsilon_i | \mathbf{X}], \mathbf{X}] = \text{Cov}[\varepsilon_i, \mathbf{X}]$ , Assumption 3 implies that  $\text{Cov}[\varepsilon_i, \mathbf{X}] = 0$  for all  $i$ . (Exercise: Is the converse true?)

In most cases, the zero mean assumption is not restrictive. Consider a two-variable model and suppose that the mean of  $\varepsilon$  is  $\mu \neq 0$ . Then  $\alpha + \beta x + \varepsilon$  is the same as  $(\alpha + \mu) + \beta x + (\varepsilon - \mu)$ . Letting  $\alpha' = \alpha + \mu$  and  $\varepsilon' = \varepsilon - \mu$  produces the original model. For an application, see the discussion of frontier production functions in Section 17.6.3.



But, if the original model does not contain a constant term, then assuming  $E[\varepsilon_i] = 0$  could be substantive. If  $E[\varepsilon_i]$  can be expressed as a linear function of  $\mathbf{x}_i$ , then, as before, a transformation of the model will produce disturbances with zero means. But, if not, then the nonzero mean of the disturbances will be a substantive part of the model structure. This does suggest that there is a potential problem in models without constant terms. As a general rule, regression models should not be specified without constant terms unless this is specifically dictated by the underlying theory.<sup>2</sup> Arguably, if we have reason to specify that the mean of the disturbance is something other than zero, we should build it into the systematic part of the regression, leaving in the disturbance only the unknown part of  $\varepsilon$ . Assumption 3 also implies that

$$E[\mathbf{y} | \mathbf{X}] = \mathbf{X}\boldsymbol{\beta}. \quad (2-8)$$

Assumptions 1 and 3 comprise the *linear regression model*. The **regression** of  $\mathbf{y}$  on  $\mathbf{X}$  is the conditional mean,  $E[\mathbf{y} | \mathbf{X}]$ , so that without Assumption 3,  $\mathbf{X}\boldsymbol{\beta}$  is *not* the conditional mean function.

The remaining assumptions will more completely specify the characteristics of the disturbances in the model and state the conditions under which the sample observations on  $\mathbf{x}$  are obtained.

### 2.3.4 SPHERICAL DISTURBANCES

The fourth assumption concerns the variances and covariances of the disturbances:

$$\text{Var}[\varepsilon_i | \mathbf{X}] = \sigma^2, \quad \text{for all } i = 1, \dots, n,$$

and

$$\text{Cov}[\varepsilon_i, \varepsilon_j | \mathbf{X}] = 0, \quad \text{for all } i \neq j.$$

Constant variance is labeled **homoscedasticity**. Consider a model that describes the profits of firms in an industry as a function of, say, size. Even accounting for size, measured in dollar terms, the profits of large firms will exhibit greater variation than those of smaller firms. The homoscedasticity assumption would be inappropriate here. Also, survey data on household expenditure patterns often display marked **heteroscedasticity**, even after accounting for income and household size.

Uncorrelatedness across observations is labeled generically **nonautocorrelation**. In Figure 2.1, there is some suggestion that the disturbances might not be truly independent across observations. Although the number of observations is limited, it does appear that, on average, each disturbance tends to be followed by one with the same sign. This “inertia” is precisely what is meant by **autocorrelation**, and it is assumed away at this point. Methods of handling autocorrelation in economic data occupy a large proportion of the literature and will be treated at length in Chapter 12. Note that nonautocorrelation does not imply that observations  $y_i$  and  $y_j$  are uncorrelated. The assumption is that *deviations* of observations from their expected values are uncorrelated.

<sup>2</sup>Models that describe first differences of variables might well be specified without constants. Consider  $y_t - y_{t-1}$ . If there is a constant term  $\alpha$  on the right-hand side of the equation, then  $y_t$  is a function of  $\alpha t$ , which is an explosive regressor. Models with linear time trends merit special treatment in the time-series literature. We will return to this issue in Chapter 19.

The two assumptions imply that

$$E[\boldsymbol{\varepsilon}\boldsymbol{\varepsilon}' | \mathbf{X}] = \begin{bmatrix} E[\varepsilon_1\varepsilon_1 | \mathbf{X}] & E[\varepsilon_1\varepsilon_2 | \mathbf{X}] & \cdots & E[\varepsilon_1\varepsilon_n | \mathbf{X}] \\ E[\varepsilon_2\varepsilon_1 | \mathbf{X}] & E[\varepsilon_2\varepsilon_2 | \mathbf{X}] & \cdots & E[\varepsilon_2\varepsilon_n | \mathbf{X}] \\ \vdots & \vdots & \ddots & \vdots \\ E[\varepsilon_n\varepsilon_1 | \mathbf{X}] & E[\varepsilon_n\varepsilon_2 | \mathbf{X}] & \cdots & E[\varepsilon_n\varepsilon_n | \mathbf{X}] \end{bmatrix}$$

$$= \begin{bmatrix} \sigma^2 & 0 & \cdots & 0 \\ 0 & \sigma^2 & \cdots & 0 \\ & & \ddots & \\ 0 & 0 & \cdots & \sigma^2 \end{bmatrix},$$

which we summarize in Assumption 4:

ASSUMPTION: $E[\boldsymbol{\varepsilon}\boldsymbol{\varepsilon}'   \mathbf{X}] = \sigma^2\mathbf{I}$ .	(2-9)
--	-------

By using the variance decomposition formula in (B-70), we find

$$\text{Var}[\boldsymbol{\varepsilon}] = E[\text{Var}[\boldsymbol{\varepsilon} | \mathbf{X}]] + \text{Var}[E[\boldsymbol{\varepsilon} | \mathbf{X}]] = \sigma^2\mathbf{I}.$$

Once again, we should emphasize that this assumption describes the information about the variances and covariances among the disturbances that is provided by the independent variables. For the present, we assume that there is none. We will also drop this assumption later when we enrich the regression model. We are also assuming that the disturbances themselves provide no information about the variances and covariances. Although a minor issue at this point, it will become crucial in our treatment of time-series applications. Models such as  $\text{Var}[\varepsilon_t | \varepsilon_{t-1}] = \sigma^2 + \alpha\varepsilon_{t-1}^2$ —a “GARCH” model (see Section 11.8)—do not violate our conditional variance assumption, but do assume that  $\text{Var}[\varepsilon_t | \varepsilon_{t-1}] \neq \text{Var}[\varepsilon_t]$ .

Disturbances that meet the twin assumptions of homoscedasticity and nonautocorrelation are sometimes called **spherical** disturbances.<sup>3</sup>

### 2.3.5 DATA GENERATING PROCESS FOR THE REGRESSORS

It is common to assume that  $\mathbf{x}_i$  is nonstochastic, as it would be in an experimental situation. Here the analyst chooses the values of the regressors and then observes  $y_i$ . This process might apply, for example, in an agricultural experiment in which  $y_i$  is yield and  $\mathbf{x}_i$  is fertilizer concentration and water applied. The assumption of nonstochastic regressors at this point would be a mathematical convenience. With it, we could use the results of elementary statistics to obtain our results by treating the vector  $\mathbf{x}_i$  simply as a known constant in the probability distribution of  $y_i$ . With this simplification, Assumptions A3 and A4 would be made unconditional and the counterparts would now simply state that the probability distribution of  $\varepsilon_i$  involves none of the constants in  $\mathbf{X}$ .

Social scientists are almost never able to analyze experimental data, and relatively few of their models are built around nonrandom regressors. Clearly, for example, in

<sup>3</sup>The term will describe the multivariate normal distribution; see (B-95). If  $\Sigma = \sigma^2\mathbf{I}$  in the multivariate normal density, then the equation  $f(\mathbf{x}) = c$  is the formula for a “ball” centered at  $\boldsymbol{\mu}$  with radius  $\sigma$  in  $n$ -dimensional space. The name *spherical* is used whether or not the normal distribution is assumed; sometimes the “spherical normal” distribution is assumed explicitly.

any model of the macroeconomy, it would be difficult to defend such an asymmetric treatment of aggregate data. Realistically, we have to allow the data on  $\mathbf{x}_i$  to be random the same as  $y_i$  so an alternative formulation is to assume that  $\mathbf{x}_i$  is a random vector and our formal assumption concerns the nature of the random process that produces  $\mathbf{x}_i$ . If  $\mathbf{x}_i$  is taken to be a random vector, then Assumptions 1 through 4 become a statement about the joint distribution of  $y_i$  and  $\mathbf{x}_i$ . The precise nature of the regressor and how we view the sampling process will be a major determinant of our derivation of the statistical properties of our estimators and test statistics. In the end, the crucial assumption is Assumption 3, the uncorrelatedness of  $\mathbf{X}$  and  $\boldsymbol{\varepsilon}$ . Now, we do note that this alternative is not completely satisfactory either, since  $\mathbf{X}$  may well contain nonstochastic elements, including a constant, a time trend, and dummy variables that mark specific episodes in time. This makes for an ambiguous conclusion, but there is a straightforward and economically useful way out of it. We will assume that  $\mathbf{X}$  can be a mixture of constants and random variables, but the important assumption is that the ultimate source of the data in  $\mathbf{X}$  is unrelated (statistically and economically) to the source of  $\boldsymbol{\varepsilon}$ .

ASSUMPTION: $\mathbf{X}$ may be fixed or random, but it is generated by a mechanism that is unrelated to $\boldsymbol{\varepsilon}$ .	(2-10)
---	--------

### 2.3.6 NORMALITY

It is convenient to assume that the disturbances are **normally distributed**, with zero mean and constant variance. That is, we add normality of the distribution to Assumptions 3 and 4.

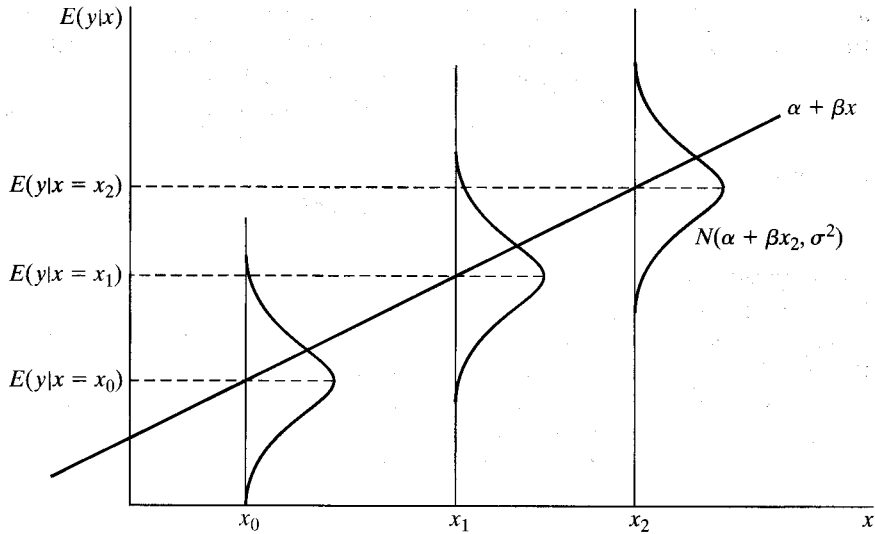
ASSUMPTION: $\boldsymbol{\varepsilon}   \mathbf{X} \sim N[\mathbf{0}, \sigma^2 \mathbf{I}]$ .	(2-11)
---	--------

In view of our description of the source of  $\boldsymbol{\varepsilon}$ , the conditions of the central limit theorem will generally apply, at least approximately, and the normality assumption will be reasonable in most settings. A useful implication of Assumption 6 is that it implies that observations on  $\varepsilon_i$  are statistically independent as well as uncorrelated. [See the third point in Section B.8, (B-97) and (B-99).] **Normality** is often viewed as an unnecessary and possibly inappropriate addition to the regression model. Except in those cases in which some alternative distribution is explicitly assumed, as in the stochastic frontier model discussed in Section 17.6.3, the normality assumption is probably quite reasonable.

Normality is not necessary to obtain many of the results we use in multiple regression analysis, although it will enable us to obtain several exact statistical results. It does prove useful in constructing test statistics, as shown in Section 4.7. Later, it will be possible to relax this assumption and retain most of the statistical results we obtain here. (See Sections 5.3, 5.4 and 6.4.)

## 2.4 SUMMARY AND CONCLUSIONS

This chapter has framed the linear regression model, the basic platform for model building in econometrics. The assumptions of the classical regression model are summarized in Figure 2.2, which shows the two-variable case.



**FIGURE 2.2** The Classical Regression Model.

### Key Terms and Concepts

- Autocorrelation
- Constant elasticity
- Covariate
- Dependent variable
- Deterministic relationship
- Disturbance
- Exogeneity
- Explained variable
- Explanatory variable
- Flexible functional form
- Full rank
- Heteroscedasticity
- Homoscedasticity
- Identification condition
- Independent variable
- Linear regression model
- Loglinear model
- Multiple linear regression model
- Nonautocorrelation
- Nonstochastic regressors
- Normality
- Normally distributed
- Population regression equation
- Regressand
- Regression
- Regressor
- Second-order effects
- Semilog
- Spherical disturbances
- Translog model