Maximum Likelihood Estimation

Motivation

Disadvantages of Least Squares Methods

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

If ε is large, it will have impacts on estimated coefficients.

To solve this problem,

- Transform the data.
- Apply another distribution – nonnormal.

Maximum Likelihood Estimation

Maximum Likelihood Estimation

Idea of Maximum Likelihood

- MLE stands for Maximum Likelihood Estimation

- Thus, the method is to try to maximize the likelihood function of the model.

- What is the likelihood function of the model?

- Distinctions between Probability Density function *(pdf)* and Likelihood function

Maximum Likelihood Estimation

Maximum Likelihood Estimation

Probability density function describes probability density for (y, X) treating θ as given

Likelihood function describes the situation when treating X and y as given and treating θ as variables.

$$L(\theta, y, X) \equiv p(y, X, \theta)$$

Example

$X_1 = 4$ and $X_2 = 6$

Estimate μ

Assume: Normal distribution and $\sigma = 1$

Pdf. $$f(X) = \frac{1}{\sqrt{2\pi\sigma^2}} e^{\left[-\frac{(X-\mu)^2}{2\sigma^2}\right]} = \frac{1}{\sqrt{2\pi}} e^{\left[-\frac{(X-\mu)^2}{2}\right]}$$

Likelihood function

$$L = \left(\frac{1}{\sqrt{2\pi}} e^{\left[-\frac{(4-\mu)^2}{2}\right]}\right)\left(\frac{1}{\sqrt{2\pi}} e^{\left[-\frac{(6-\mu)^2}{2}\right]}\right)$$

Example

μ	p(4|μ)	p(6|μ)	L	log L
3.5	0.3520	0.0175	0.0062	-5.0883
4.0	0.3989	0.0540	0.0215	-3.8383
4.5	0.3520	0.1295	0.0456	-3.0883
4.6	0.3332	0.1497	0.0499	-2.9983
4.7	0.3122	0.1713	0.0535	-2.9283
4.8	0.2896	0.1941	0.0562	-2.8783
4.9	0.2660	0.2178	0.0579	-2.8483
5.0	0.2419	0.2419	0.0585	-2.8383
5.1	0.2178	0.2660	0.0579	-2.8483
5.2	0.1941	0.2896	0.0562	-2.8783
5.3	0.1713	0.3122	0.0535	-2.9283
5.4	0.1497	0.3332	0.0499	-2.9983
5.5	0.1295	0.3520	0.0456	-3.0883
6.0	0.0540	0.3989	0.0215	-3.8383
6.5	0.0175	0.3520	0.0062	-5.0883

Example

$$L = -\frac{n}{2}\log(2\pi) - \frac{n}{2}\log\sigma^2 - \frac{1}{2\sigma^2}\sum_i\left(Y_i - \beta_1 - \beta_2 X_i\right)^2$$

MLE

β_2 =	0.5091	β_1 =	24.4545	log Likelihood	-16.1162294
σ^2=	42.1591			Likelihood	0.0000001002

OLS Result

β_2 =	0.50909	β_1 =	24.4545	r^2 =	0.96206156
var(β_2) =	0.00128	var(β_1) =	41.1371	σ^2=	42.15909091
se(β_2) =	0.03574	se(β_1) =	6.41382	se =	6.493003227
				log Likelihood	-16.1162294

Maximum Likelihood Estimation

Maximum Likelihood Estimation

Consider all cases: i = 1, 2, 3,…, n and assume independent for all x_i

$$L(y, X, \theta) = f(y_i, X_i | \theta) = \prod_{i=1}^{n} f(y_i, X_i, \theta)$$

Loglikelihood function can be defined as

$$l(\theta) = \log(L(\theta))$$

For example:

$$l(\beta, \sigma^2) = -\frac{n}{2}\log(2\pi) - \frac{n}{2}\log\sigma^2 - \frac{1}{2\sigma^2}(y - X\beta)'(y - X\beta)$$

Maximum Likelihood Computation

Maximum Likelihood Estimation

Numerical Aspects of Optimization

Non-linear Optimization:

Gradient: $$G = \frac{\partial l(\theta)}{\partial \theta} = \frac{1}{n}\sum_{i=1}^{n}\frac{\partial l_i}{\partial \theta}$$

Hessian: $$H = \frac{\partial^2 l(\theta)}{\partial \theta \partial \theta'} = \frac{1}{n}\sum_{i=1}^{n}\frac{\partial^2 l_i}{\partial \theta \partial \theta'}$$

Outer Product of Gradient:

$$\frac{1}{n}\sum_{i=1}^{n}\frac{\partial^2 l_i}{\partial \theta \partial \theta'} \approx E\left[\frac{\partial^2 l_i}{\partial \theta \partial \theta'}\right] = -E\left[\frac{\partial l_i}{\partial \theta}\frac{\partial l_i}{\partial \theta'}\right] \approx -\frac{1}{n}\sum_{i=1}^{n}\frac{\partial l_i}{\partial \theta}\frac{\partial l_i}{\partial \theta'}$$

Maximum Likelihood Computation

First-order condition: $G(\theta) = 0$

Linearized around given value θ_0

$$G(\theta) = G(\hat{\theta}_0) + H(\hat{\theta}_0)(\theta - \hat{\theta}_0) = 0$$

Then, $$H(\hat{\theta}_0)\theta - H(\hat{\theta}_0)\hat{\theta}_0 = -G(\hat{\theta}_0)$$

$$H(\hat{\theta}_0)\theta = H(\hat{\theta}_0)\hat{\theta}_0 - G(\hat{\theta}_0)$$

$$\theta = H(\hat{\theta}_0)^{-1} H(\hat{\theta}_0)\hat{\theta}_0 - H(\hat{\theta}_0)^{-1} G(\hat{\theta}_0)$$

$$\theta = \hat{\theta}_0 - H(\hat{\theta}_0)^{-1} G(\hat{\theta}_0)$$

Newton-Raphson Algorithm

$$\hat{\theta}_{t+1} = \hat{\theta}_t - H(\hat{\theta}_t)^{-1} G(\hat{\theta}_t)$$

ML Computation – Algorithm

$$\theta_{t+1} = \theta_t + \Delta$$

Newton-Raphson $\quad \Delta = H^{-1} G(\theta_t)$

Quadratic Hill-climbing (Goldfeld-Quandt) Methods

$$\Delta = \tilde{H}^{-1} G(\theta_t) \quad \text{where} \quad \tilde{H} = H(\theta_t) + \gamma I$$

Newton $\quad \Delta = K^{-1}(\theta_t) G(\theta_t)$ where $\quad K = (G'G) + H(\theta_t)$

Guass-Newton or BHHH $\quad \Delta = (G'G)^{-1} G(\theta_t)$

Marquardt $\quad \Delta = (G'G + \gamma\, diag(G'G))^{-1} G(\theta_t)$

Maximum Likelihood Estimation

Maximum Likelihood Estimation

ML in Linear Model

$$y = X\beta + \varepsilon, \qquad \varepsilon \sim N(0, \sigma^2 I)$$

Loglikelihood function:

$$l(\beta, \sigma^2) = -\frac{n}{2}\log(2\pi) - \frac{n}{2}\log\sigma^2 - \frac{1}{2\sigma^2}(y - X\beta)'(y - X\beta)$$

Maximize loglikelihood function by:

$$\frac{\partial l}{\partial \beta} = \frac{1}{\sigma^2} X'(y - X\beta) = 0$$

$$\frac{\partial l}{\partial \sigma^2} = -\frac{n}{2\sigma^2} + \frac{1}{2\sigma^4}(y - X\beta)'(y - X\beta) = 0$$

Maximum Likelihood Estimation

Maximum Likelihood Estimation

ML in Linear Model

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

$$s^2_{ML} = \frac{1}{n}(y - X\beta)'(y - X\beta) = \frac{n-k}{n} s^2_{OLS}$$

By assuming normality assumption ML and OLS provide the same results – unbiased $\hat{\beta}$, but not s^2 -- only when $n \to \infty$

Maximum Likelihood Estimation

Asymptotic Properties

Asymptotic Distribution of ML Estimators

$$\sqrt{n}(\hat{\theta}_{ML} - \theta_0) \xrightarrow{d} N(0, I_0^{-1})$$

Information Matrix:

$$I_n(\theta_0) = E\left[\frac{\partial l}{\partial \theta}\frac{\partial l}{\partial \theta'}\right] = -E\left[\frac{\partial^2 l}{\partial \theta \partial \theta'}\right]$$

Maximum Likelihood Estimation

Asymptotic Properties

Approximate Distribution for Finite Samples

$$\hat{\theta}_{ML} \approx N\left(\theta_0, I_n^{-1}(\hat{\theta}_{ML})\right)$$

Information Matrix – Second order cond.:

$$\frac{\partial^2 l}{\partial \beta \partial \beta'} = -\frac{1}{\sigma^2} X'X$$

$$\frac{\partial^2 l}{\partial \beta \partial \sigma^2} = -\frac{1}{\sigma^4} X'(y - X\beta)$$

$$\frac{\partial^2 l}{\partial \sigma^2 \partial \sigma^2} = \frac{n}{2\sigma^4} - \frac{1}{\sigma^6}(y - X\beta)'(y - X\beta)$$

Maximum Likelihood Estimation

Asymptotic Properties

Approximate Distribution for Finite Samples

Follows independent assumption:

$$I_n(\theta_0) = \begin{pmatrix} \frac{1}{\sigma^2} X'X & 0 \\ 0 & \frac{n}{2\sigma^4} \end{pmatrix}$$

Follows stability assumption 1*:

$$I_n(\theta_0) = \begin{pmatrix} \frac{1}{\sigma^2} Q & 0 \\ 0 & \frac{1}{2\sigma^4} \end{pmatrix}$$

Maximum Likelihood Estimation

Summary of Computations in ML

Step 1: Formulate the log-likelihood.

Step 2: Maximize the log-likelihood.

Step 3: Asymptotic tests.

Maximum Likelihood Estimation

Individual Test – z-test

In OLS case, individual test is performed by using t-test because the estimated parameters are t-distributed.

In MLE case, distribution of the estimated parameters are not always t-distributed depending on distribution of the regression model. Thus, individual test can be performed by using ***z-test:*** $H_0: \beta_i = 0$

$$z - test \approx \frac{\hat{\beta}_i}{s_{\hat{\beta}_i}} \sim N(0,1)$$

Maximum Likelihood Estimation

Likelihood Ratio (LR) Test

Based on the loss of log-likelihood that results if the restrictions are imposed.

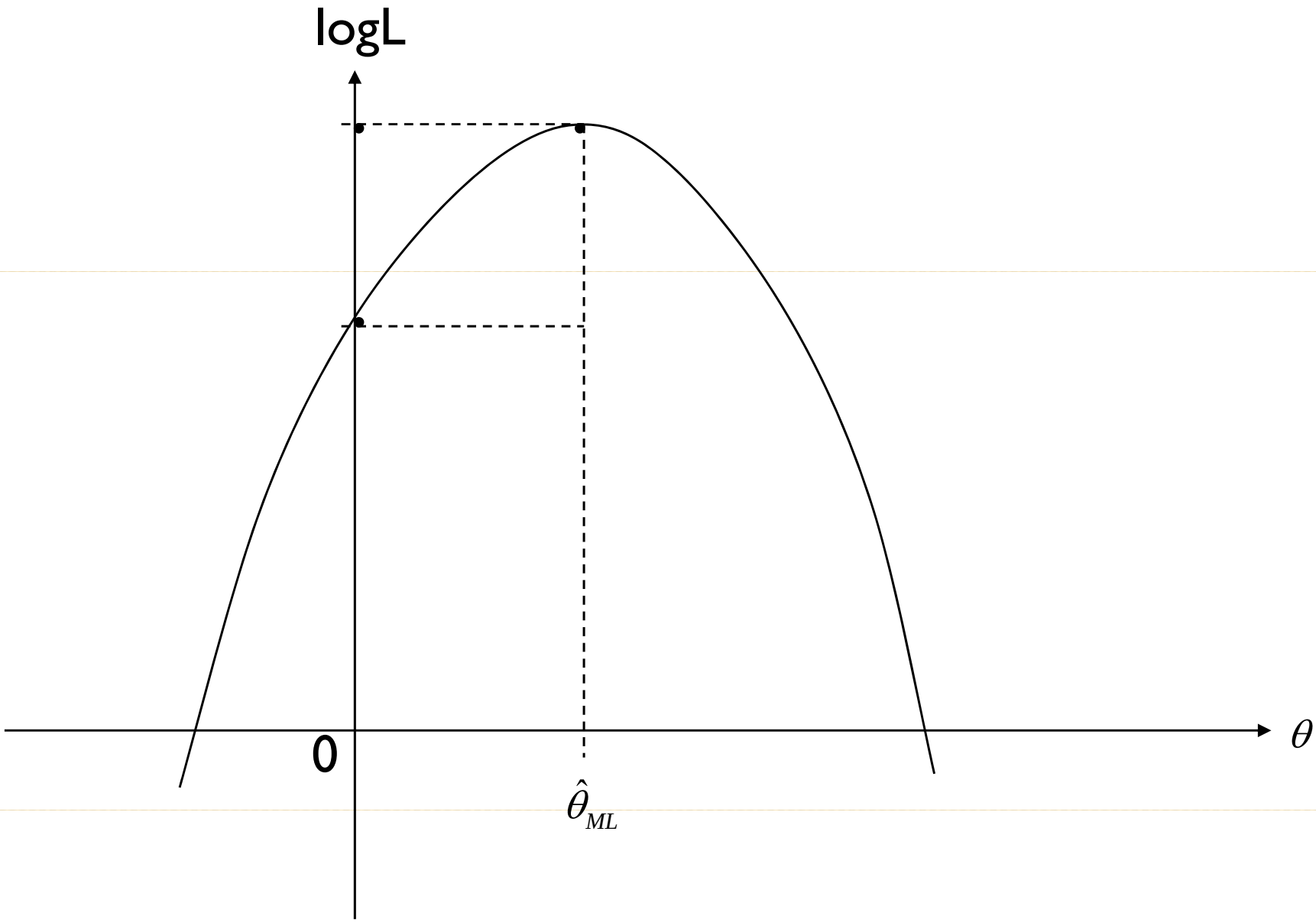
$$LR = 2\log(L(\hat{\theta}_1)) - 2\log(L(\hat{\theta}_0)) = 2l(\hat{\theta}_1) - 2l(\hat{\theta}_0)$$

H_0: $\theta = 0$

$$LR \overset{d}{\rightarrow} \chi^2(g)$$

Maximum Likelihood Estimation

Likelihood Ratio (LR) Test



Maximum Likelihood Estimation

Wald Test

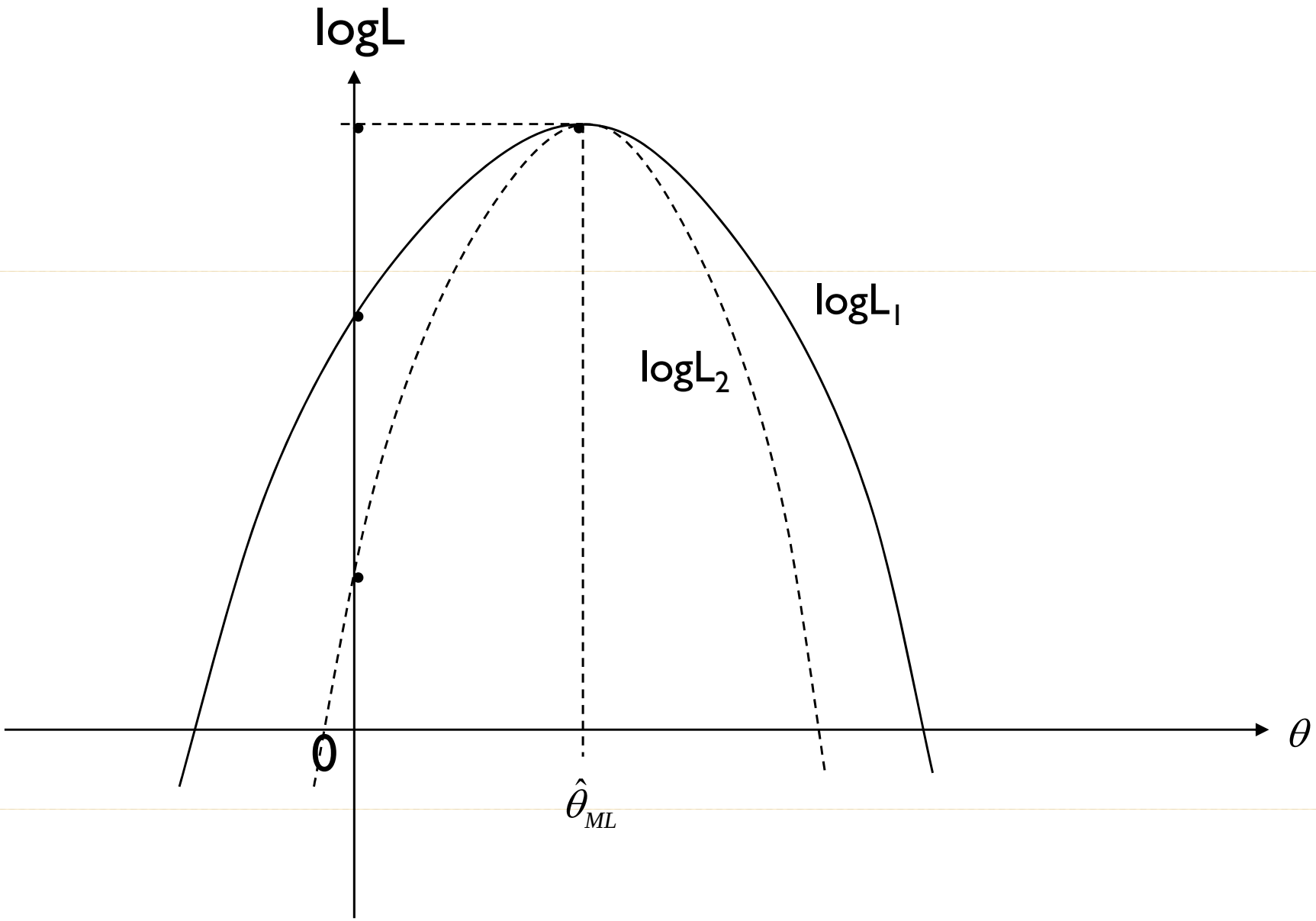
Based on unrestricted model alone.

$H_0: \theta = 0$

$$W = \hat{\theta}_1^2 \left(-\frac{d^2 l}{d\theta^2} \right) \approx \left(\frac{\hat{\theta}_1}{s_{\hat{\theta}_1}} \right) \approx \chi^2(1)$$

Maximum Likelihood Estimation

Wald Test



Maximum Likelihood Estimation

Lagrange Multiplier (LM) Test

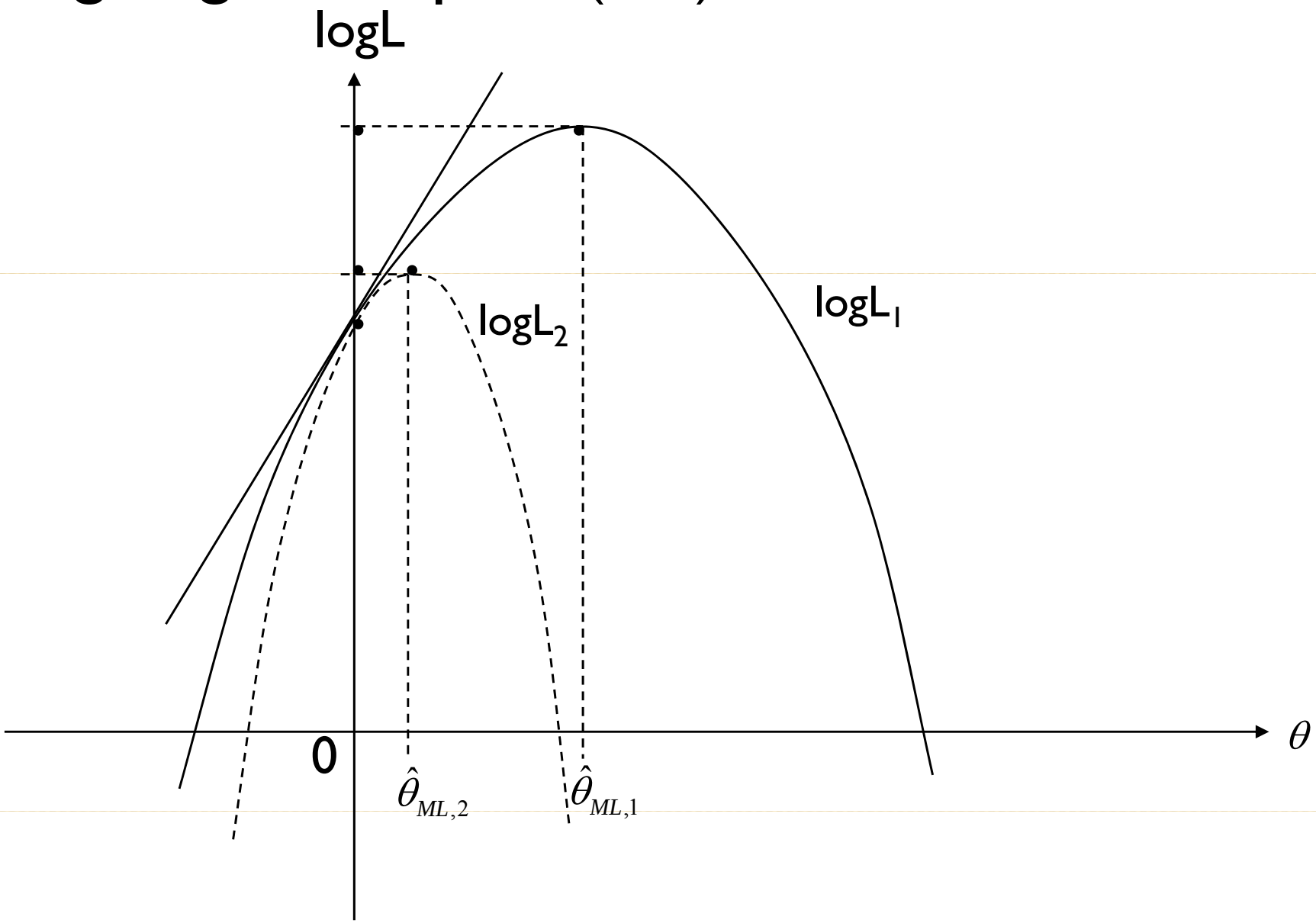
Score test considers whether the gradient (also called the 'score') of the unrestricted likelihood function is sufficiently close to zero at the restricted estimate θ.

$$H_0: \theta = 0$$

$$LM = \frac{(\partial l/\partial \theta)^2}{-\partial^2 l/\partial \theta^2} = \left(\frac{\partial l}{\partial \theta}\right)' \left(-E\left[\frac{\partial^2 l}{\partial \theta \partial \theta'}\right]\right)^{-1} \left(\frac{\partial l}{\partial \theta}\right) \approx \chi^2(g)$$

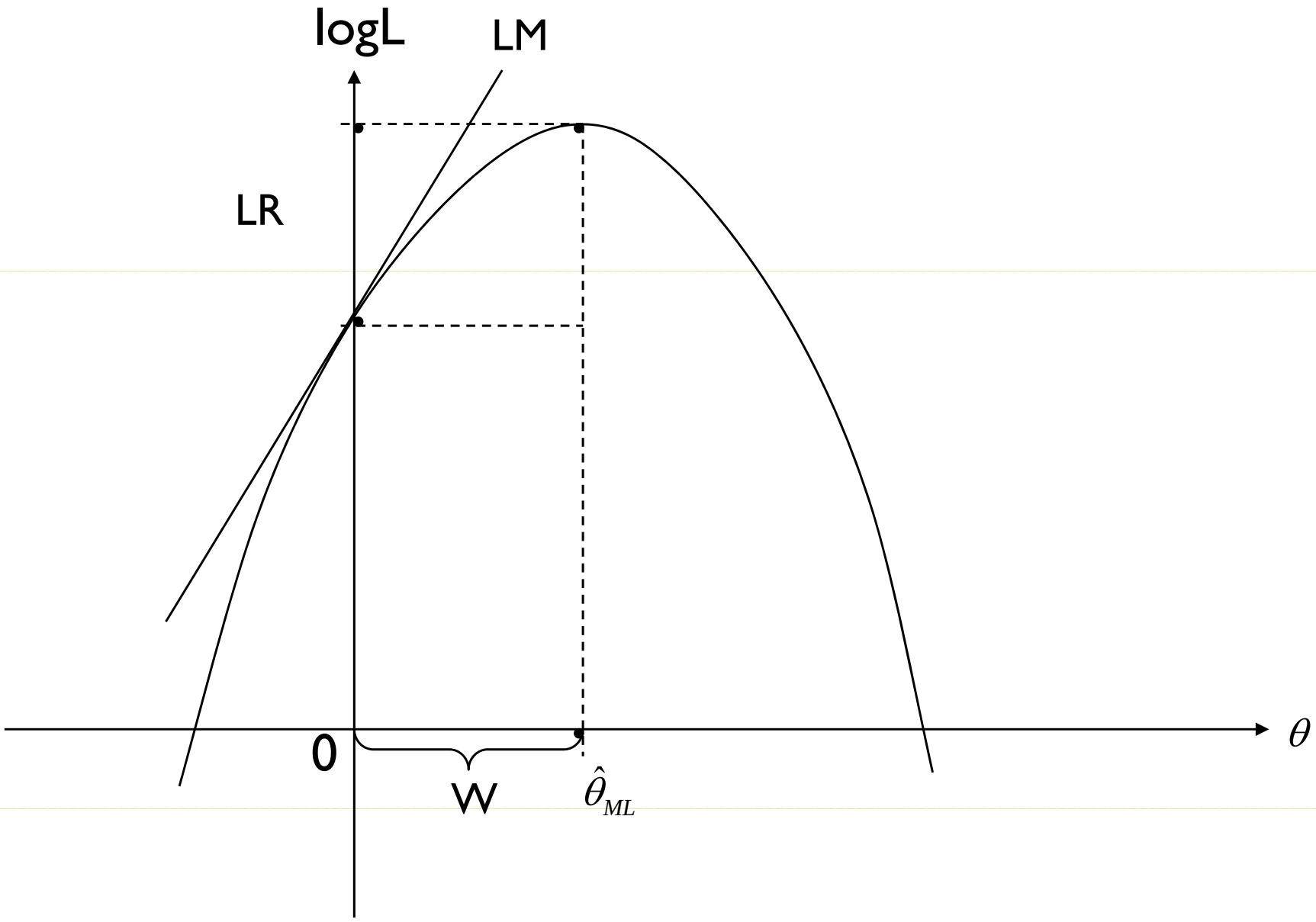
Maximum Likelihood Estimation

Lagrange Multiplier (LM) Test



Maximum Likelihood Estimation

Comparison of Three Tests



Maximum Likelihood Estimation

Comparison of Three Tests

	LR	Wald	LM
Estimated models	2 models	1 Unrestricted	1 Restricted
Advantage	Optimal power	Restricted model is complicated	Simple computations
Disadvantage	Needs 2 optimizations	Test depends on parameterization	Power may be small

$$LM \leq LR \leq W$$