Comments on: “Law, governance, & growth” by Valentina Bruno and Philip English

This paper:

- Contributes to a central question in corporate governance:
  - How does governance affect firm performance?
  - $Y(f,c,t) = b*G(f,c,t) + c*X(f,c,t) + u(f,c,t)$

Specifically, the paper seeks to

1. improve the drawing of accurate, causal inferences.
   - $Y(f,c,t) = a + b*G(f,c,t) + c*X(f,c,t) + u(f,c,t)$
   - This is difficult.
   - Many of us have faced this challenge.

2. assess the usefulness of a standard index of governance in explaining firm performance across countries.

In my comments, I first

Ignore the econometrics – simultaneity, omitted variables, & measurement – and focus on finance

I am uncertain about interpreting G

- $Y(f,c,t) = a + b*G(f,c,t) + c*X(f,c,t) + u(f,c,t)$
- G: Summation of 44 governance attributes
    - Board (25), Audit (3)
    - Anti-takeover (6), Compensation (10)
  - What does G mean?
    - What are the attributes, exactly?
    - Is summation appropriate, conceptually?
  - Could appropriate G differ across firms?
  - Do we need to disaggregate G to really learn about
    - Governance?
    - The differential impact of specific governance mechanisms across countries and firms?

Therefore, how to interpret b?

- $Y(f,c,t) = a + b*G(f,c,t) + c*X(f,c,t) + u(f,c,t)$
- If G is an index of good governance, then
  - isn't a positive coefficient tautological?
  - isn't good governance the type of governance that will lead to good performance?
- <u>Precisely</u> interpreting $b<0$, then is difficult
- Rather than focusing on whether "governance" works should we focus on
  - which particular governance mechanisms work and
  - in what contexts do they work? (firm, market, industry, country traits)

More on G and b?

- $Y(f,c,t) = a + b*G(f,c,t) + c*X(f,c,t) + u(f,c,t)$
- Theory suggests that b differs across firms:
  - Ownership
  - Competition in product markets
  - Opacity
  - Legal system efficiency
- The theoretical heterogeneity of b seems central in understanding the mechanisms linking governance and performance.

Final questions on G and b?

- If G enters negatively, therefore, does this
  - Imply the conclusion drawn by the authors:
    - "… there are country-level equilibria in governance that make cross-country transfer of corporate governance guidelines or laws inappropriate"
    - Can we draw this conclusion without measuring the transfer of corporate governance guidelines?
- $b<0$ could reflect
    - Differences in average firms in different countries
    - Differences in country traits
    - Differences in processes for selecting G

Now,

Some questions about the econometrics

Exogeneity and simultaneity

1. $Y(f,c,t) = a + b*G(f,c,t) + c*X(f,c,t) + u(f,c,t)$
2. $G(f,c,t) = d*Z(c) + e*X(f,c,t) + e(f,c,t)$

- Valid instrument:
  - Correlated with the G
  - Uncorrelated with u
- The paper argues that
  - Y does not affect Z (simultaneity),
  - which is necessary but insufficient
- But, Z could affect Y beyond G,
  - making Z correlated with u and
  - invalidating the instrument.

Exogeneity and simultaneity

1. $Y(f,c,t) = a + b*G(f,c,t) + c*X(f,c,t) + u(f,c,t)$
2. $G(f,c,t) = d*Z(c) + e*X(f,c,t) + e(f,c,t)$

- OIR and other tests are insufficient.
  - Exogeneity is an identifying assumption that must be made prior to analysis of the data.
    - It is an assumption based on theory
    - must be justified conceptually.
- OIR etc tells us, do the estimates change when selecting different subsets of instruments?
    - But acceptance could arise with invalid instruments
    - Need to justify instruments conceptually

Aggregate nature of instruments

1. $Y(f,c,t) = a + b*G(f,c,t) + c*X(f,c,t) + u(f,c,t)$
2. $G(f,c,t) = d*Z(c) + e*X(f,c,t) + e(f,c,t)$

- Given the excluded instrument, Z, identification primarily comes at the country level.
- This bring me back to my earlier question:
  - Is it not desirable to explore the mechanisms through which governance affects performance at a more disaggregated, more theoretically structured, level?

In sum,