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

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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.
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?
- Precisely 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.
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. \[ Y(f,c,t) = a + b \cdot G(f,c,t) + c \cdot X(f,c,t) + u(f,c,t) \]
2. \[ G(f,c,t) = d \cdot Z(c) + e \cdot X(f,c,t) + e(f,c,t) \]

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

- 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,

- This paper tackles a big, central problem
  - Many of us struggle with this problem
  - Few have found a satisfying solution
- I have raised some questions:
  - Why?
  - Would it be valuable to devote more effort to exploring the mechanisms linking corporate governance–firm performance?
  - Do we not need a theory/conceptual foundation for the first-stage?
  - While firm performance might not affect the instrument, the instruments almost surely affect firm performance beyond governance. How does this affect interpretation?