

Referee report for “The persistent institutional effect of liberal colonialism: evidence from China’s financial policies”

Summary

This paper aims at studying the effect of liberal colonialism on the capital allocation. Based on a survey firm level data set in 2005, the authors show that the liberal colonialism has a positive effect on the allocative efficiency of financial policies. The topic is interesting and important while the paper is still at a preliminary stage. I have my comments listed as follows. The paper would be more qualified and welcome if the authors can carefully address or finely explain the following issues.

Major comments

One major concern is that the authors fail to capture the colonialism properly. As the only main explanatory variable, the colonialism is captured as a dummy variable, which leads to severe bias. First, most of these colonised regions are coastal regions, which warn us that the geographic endogeneity needs to be carefully addressed. Using dummy fails to do so. For instance, how can we know that it is because the geographic advantage of these regions has a positive effect or the colonialism. Second, most of the regions are colonised by different countries, for example, western countries and Japan. As such, dichotomous choice cannot distinguish one institutional impact from the other. Third, the authors emphasize that they exploit the colonial history of China during 1896 to 1911 to measure the colonialism. However, the measurement for this period is missing. For example, as an extreme case, one can also argue that it is the *Han* or *Tang* Dynasty in this regions leaving favourable institution, exerting a long run positive impact on current economy. Therefore, to properly measure the colonialism is the key to improve this research.

Another major concern is that the usage of the IV estimation. First, it is not clear why the authors use IV analysis. The empirical analysis leads to a straight forward understanding: the colonialism is endogenous from the current allocative efficiency. If this is the case, it is confusing that the authors say “liberal colonialism as exogenous source of economic institutions in China” (Paragraph 2, Page 5). If this is not the case, it is also confusing. What kind of endogeneity the authors want to solve? Second, the selection of the IV is problematic.

The authors say, “the liberal colonialism affects the present development only through economic institutions” (paragraph 3, page 7). Therefore, we can easily understand that economic institution is an important factor for the present economy and omitting it may lead to severe estimation bias. However, as an IV the authors selected, institutional quality will not appear at the second stage estimation, leading to the bias issue. Following the authors’ logic, I see this more like a mediating effect. Capturing the mediating effect may be an option. Yet, this should be on the basis of the proper measurements for the colonialism.

Last concern is that the channel through which the colonialism affects the allocation of capital is missing, which decreases the quality of the paper.

Minor comments

1. The source of the colonized regions should be listed.
2. It would be better to list the colonized regions in a table.
3. Some sentences like, “liberal colonialism affects the present development only through economic institutions” in paragraph 3, page 7 should be with a reference or explanation.