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World Governance Indicators and Corporate Profitability in the MENA Economies

Abstract

This paper examines the effect of institutional changes on corporate financial performance. The effect is examined into this dimension: the effect of World governance indicators (WGIs) on earnings yield. The paper includes the non-financial firms listed in the stock exchanges of the MENA region countries: Bahrain, Egypt, Iraq, Jordan, Lebanon, Morocco, Oman, Saudi Arabia, Tunisia and United Arab Emirates. The total number of firms included in the study was 301 for MENA countries, the data are collected for the period 2018 – 2020. Overall, the results revealed that there is a significant and positive association between the WGIs and the corporate profitability in the MENA region.

Key Words: World Governance Indicators, MENA countries, Corporate Profitability

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مؤشرات الحوكمة العالمية وربحية الشركات فى اقتصاديات دول الشرق الأوسط وشمال أفريقيا

ملخص البحث

تبحث هذه الورقة البحثية تأثير التغييرات المؤسسية على الأداء المالي للشركات. هذا التأثير تم فحصه من خلال هذا البعد: تأثير مؤشرات الحوكمة العالمية (WGIS) على عائد الأرباح. يتناول البحث الشركات غير المالية المدرجة فى بورصات دول منطقة الشرق الأوسط وشمال أفريقيا: البحرين، ومصر، والعراق، والأردن، ولبنان، والمغرب، وعمان، والمملكة العربية السعودية، وتونس، والإمارات العربية المتحدة. وقد بلغ العدد الإجمالي للشركات المشمولة بالدراسة 301 شركة فى دول الشرق الأوسط وشمال أفريقيا، حيث تم جمع البيانات عن الفترة 2018 – 2020. وقد أظهرت النتائج أن هناك ارتباطاً قوياً وإيجابياً بين مؤشر الحوكمة العالمية وربحية الشركات فى دول منطقة الشرق الأوسط وشمال أفريقيا.

الكلمات المفتاحية: مؤشرات الحوكمة العالمية، دول منطقة الشرق الأوسط وشمال أفريقيا، ربحية الشركات

1-Introduction

Performance is a measure of an organization's ability to obtain and allocate resources in a range of methods in order to achieve a competitive advantage (Iswatia and Anshoria, 2007). According to Ostroff and Schmidt (1993), who also added that performance is a difficult concept to define and measure, as the performance of the firms has been defined as the outcome of activity, and the type of company determines the appropriate measure to assess the corporate performance and the goals to be attained through that evaluation. Company performance is a result achieved by a person or group of people working for an organization in connection to their authority and obligation in reaching the objective legitimately, not illegally, and in line with morality and ethics, therefore the company performance regarded necessary by management (Almajali *et al.*, 2012).

The financial performance of a company is directly affected by its market position. Profitability can be decomposed into its main components: net profit margin and net turnover. According to Ross *et al.*, (1996), both can occasionally have an impact on a company's profitability. A higher profit margin indicates that the company has significant market power if a high turnover rate indicates better utilization of company resources and consequently greater efficiency. Risk and growth are the two other significant factors that have an impact on a company's financial performance. Because the company's performance determines market value, the level of risk can create fluctuations in that value (Fruhan 1979). Another factor that aids in improving one's standing on the financial markets is economic growth because market value also accounts for anticipated future gains (Varaiya *et al.* 1987).

The Worldwide Governance Indicators (WGI) measure how a nation exercises its authority through its norms and institutions. This encompasses the method by which governments are chosen, monitored, and changed; the government's ability to devise and effectively implement sound policies; and the respect of individuals and the state for the institutions that regulate economic and social relations among them (World bank 2018).

For more than 200 countries and territories between 1996 and 2017, the Worldwide Governance Indicators provided information on six major aspects of governance: Voice and Accountability, Political Stability and Absence of Violence, Government Effectiveness, Regulatory Quality, Rule of Law and Control of Corruption. The six composite WGI indicators can be used to assess broad changes over time and make large cross-country comparisons. They are frequently an inadequate instrument for crafting particular governance improvements in particular national situations, though. Such reforms, as well as the assessment of their success, require considerably more in-depth and country-specific diagnostic data that can pinpoint the pertinent governance restrictions in a given country's conditions.

1-1 Objectives

This paper aims at fulfilling the objectives that follow.

- 1- Examine the effect of voice and accountability on corporate profitability.
- 2- Examine the effect of political stability on corporate profitability
- 3- Examine the effect of government effectiveness on corporate profitability
- 4- Examine the effect of regulatory quality on corporate profitability
- 5- Examine the effect of rule of law on corporate profitability.
- 6- Examine the effect of corruption on corporate profitability.

2- Literature Review

This section reviews the substantive theoretical and methodological contributions regarding the relationship between world governance indicators and the corporate financial performance. It consists of eight sections: a general review of the corporate financial performance literature, a general review of the world governance indicators (WGI), a review of each indicator and the corporate financial performance: Voice & Accountability and corporate financial performance literature, Political Stability and Absence of Violence and corporate financial performance literature, Government effectiveness and corporate financial performance literature, Regulatory Quality and corporate financial performance

literature, Rule of Law and corporate financial performance literature, Control of Corruption and corporate financial performance literature.

2-1 Corporate Financial Performance

Company performance is a result achieved by an individual or group of individuals in an organization in connection to their authority and obligation in reaching the objective legitimately, not illegally, and in line with morality and ethics, and is therefore regarded necessary by management (Almajali *et al.*, 2012). The ability of a company to acquire and allocate resources using a variety of strategies in order to gain a competitive edge is often measured by performance (Iswatia and Anshoria, 2007). The two categories of performance are financial performance and non-financial performance, with financial performance placing more focus on factors that are directly related to the financial report. According to Walker, (2001), the effectiveness of the firm's performance is evaluated on the basis of three factors. The company's efficiency, or how well it converts inputs into outputs, is the first factor. The second factor is profitability, or how much a business is profitable relative to its costs. The third factor is the market premium, or how much a company's market value surpasses its book value. The five primary types of ratios used to evaluate a firm's performance are liquidity ratios, asset management ratios, debt management ratios, profitability ratios, and market value ratios, according to Diana's (1989). The rate of return for a firm and its shareholders, as well as the rate at which the firm can grow at a sustainable rate, can be determined by combining these ratios. By including information about the success of the company's stock market, the analyst will acquire understanding of how financial investors see the company's performance.

Valentin, (2014) has stated that the analysis of corporate financial performance is particularly important for management in their efforts to keep the business stable and grow its market share. By achieving positive financial performance, company managers' effectiveness and resource efficiency have a direct impact on the growth of the state in which they work. Financial performance was only judged by how profitable it could be. As a result of this evolving throughout time, there are currently various definitions of performance depending on the user's perspective of financial data. The managerial role of an organization is centered on cor-

porate performance. According to Ilesanmi (2011), performance is the output or outcome of actions taken in relation to the objectives pursued. Its objective is to increase how well businesses accomplish their objectives.

The financial health and existence of a company are dependent on its financial performance. The effectiveness and efficiency with which a company manages its resources for operating, investment, and finance operations is reflected in its high performance (Naser and Mokhtar, 2004). According to Valentin, (2014) a firm can be deemed to be performing well on a global scale if it can meet the needs and interests of all stakeholders: Owners want to increase the value of the company's stock in order to maximize their wealth. Despite the risks they take, current and potential shareholders view performance as the company's ability to distribute dividends in exchange for capital investment. Managers are interested in obtaining profit even though their work is valued accordingly. Employees want a stable job and high material benefits; the ability of the firm to repay debts on time (solvency) is what credit institutions look for when evaluating performance; commercial partners evaluate performance in terms of the company's stability and solvency; the state is looking for a firm that can be productive, pay its taxes, and aid in the creation of new jobs.

Management uses financial indicators to evaluate, analyze, and improve a company's performance. The assessment must be based on a balanced multidimensional system that contains both financial and non-financial data in order to determine an economic entity's worldwide status at a specific period (Gaur and Lu, 2007; Acquaah and Yasai-Ardekani, 2008). Every stakeholder is interested in researching the factors that affect a company's financial performance, especially investors. The economic outcomes of a corporation are split into classic and modern financial performance indicators in the scientific literature.

Some studies have utilized a traditional ratios to assess the performance of firms, these ratios include the rates of return (return on sales, return on assets, and return on investment), the current ratio, net profit margin, debt ratio, gross profit margin, and acid test ratio (Asiedu, 2002; Acquaah and Yasai-Ardekani, 2008).

Since it affects the share price, return on equity (ROE), a financial performance ratio, is regarded as the most significant ratio in accounting literature (Graham, 2007). Modern financial ratios used and applied for the evaluation of corporate financial performance, such as profit per share (EPS), the market value ratio, and dividend yield, are more relevant than traditional indicators because they are linked to the idea of creating value, such as economic value added (EVA) and market value added (MVA). There are other contemporary indicators available to assess an organization's financial performance. Branch and Gale (1983) contend that many elements, including the firm's current profitability, risks, and economic growth, which is important for a firm's future earnings, influence the worth of shareholders, or a company's market value.

Net turnover and net profit margin are the two primary elements of profitability, both can have a one-time impact on a company's profitability (Ross *et al.*, 1996). A bigger profit margin shows that the company has significant market power, just as a high turnover rate shows that the company's resources are being used more effectively. Risk and growth are two other crucial factors that affect a company's financial performance. Because market value is dependent on the company's performance, the level of risk exposure may create fluctuations in that value (Fruhan, 1979). As market value takes into account anticipated future profits, Varaiya *et al.*, (1987) contend that economic growth is another aspect that helps in reaching a higher financial market position.

2-2 Worldwide Governance Indicators (WGI)

The World Bank's Worldwide Governance Indicators database, according to Kaufmann *et al.*, (2011), contains the most recent, time-varying indicators that assess country-level governance effectiveness. These indicators, which are gathered for over 200 countries and territories and updated annually to reflect current reforms, strengthen the validity of any study results. Due to the fact that, in comparison to previous studies, which used widely-known, outdated, and time-constant measures to quantify a particular institutional setting (e.g., La Porta *et al.*, 1998; Djankov *et al.*, 2007, 2008). Furthermore, according to Kaufmann *et al.* (2011), country governance is the process by which authority is exercised on behalf of the citizens in the management of a nation's social and economic re-

sources for growth, as permitted by a variety of preexisting traditions, laws, and institutions. The worldwide governance indicators represented governance and use six indicators to evaluate it (WGIs).

Since 1996, the WGIs have covered more than 200 nations. These indicators include voice and accountability, political stability and absence of violence/terrorism, government effectiveness, regulatory quality, rule of law, and control of corruption. These indicators capture the perspectives of governance as expressed by survey respondents, providers of commercial business information, non-governmental organizations, and public sector organizations globally. These indicators are based on hundreds of variables collected from 31 different data sources (Kaufmann *et al.*, 2011).

According to a growing literature, the characteristics of financial markets, the taxation system, and bankruptcy laws (Rajan and Zingales, 1995), financial institutions (Demirgüç-Kunt and Maksimovic, 1999), investor security (Alves and Ferreira, 2011; Cho *et al.*, 2014), legal origin and corruption (Fan *et al.*, 2012), as well as the rule of law and regulatory effectiveness, are institutional factors that affect firm financing decisions (Awartani *et al.*, 2016). However, earlier studies have only concentrated on a few aspects of how a particular institutional environment affects firm financing decisions. As a result, we examine the effects of governance indicators, such as freedom of expression and accountability, political stability and the absence of violence and terrorism, government effectiveness, regulatory quality, rule of law, and corruption, as suggested by Kaufmann *et al.*, (2011), in order to analyze the effects of the institutional environment on the capital structure more thoroughly. By demonstrating how businesses employ cash in financing decisions, Seifert and Gonenc (2016) study the impact of general country governance on companies' cash-holding requirements. Also, Saona *et al.* (2020) examine the reasons why firms continue to pursue a debt-free approach, their study shows that when country governance improves, firms are more likely to avoid debt in their capital structure. Çam and Özer, (2021) suggest that companies operating in economies with better governance, experience a decrease in leverage while an increase in the maturity of their debt.

Based on several previous studies, one of the factors of corporate financial performance that is found to be affected by the world governance indicators (WGIs) is the dividends payout. As Benavides *et al.*, (2016) argued that the dividends payout ratio is positively associated with the world governance indicators, where it was found that the dividends payout of the firms increased in the countries with higher governance scores, thus firms pay less volatile dividends in high governance countries. Also, the findings of Mitton, (2004) show similar evidence from developing markets that the dividends payout has a positive effect on the governance indicators at the country level. Another study conducted by Gao and Wang, (2011) for firms in US, provided evidence that geographic proximity increases the conformity of payout policy of dividends between firms.

Hofmann, (2018) found in his empirical studies that the governance of the countries, which is measured by the world governance indicator, is significantly associated with the dividends payout of the firms, since the WGIs contain factors such as governmental effectiveness and political stability, these factors are found to be one of the reasons of this association. Another study conducted by Fama and French, (1998) provided evidence that the tax environment, which is measured by the world governance indicators, significantly affects the corporate dividends payout and debts.

Another factor of the corporate financial performance is found to be affected by the world governance indicators (WGIs) is the long-term debts. Awartani *et al.*, (2016) found in a study of MENA countries, that higher-quality institutions lead to more dependence on long-term debt. Thus, a greater use of long-term borrowing by MENA corporations is associated with high rule of law, better regulatory quality, and government effectiveness. On the contrary, expropriation of investors by managers and corporations is simpler in countries with weak rule of law. This is likely to increase the usage of short-term debt because it is more difficult for borrowers to expropriate creditors (Diamond, 1991, 2004, and Awartani *et al.*, 2016).

As Awartani *et al.*, (2016) added that the more corruption in a country, the lower the long-term debt that firms can depend on. This is likely to the widespread

corruption may raise the cost of long-term loans by requiring firms to disburse to bankers and/or government officials in order to get risky loans. Another study conducted by Nifo *et al.*, (2018) showed that an improvement in the institutions leads to a decrease in the number of firms that take loans, implying that institutional quality has a negative association with corporate debts.

Based on the aforementioned, which illustrates that there is an influence of overall country governance on corporate financial performance, in the following part the research will focus on the effect of each of the six indicators separately of the worldwide governance indicators (WGIs) on the corporate financial performance.

3- Data and Methodology

A complete profile of the methodology that is followed in this paper includes the research hypotheses, the method of data collection, the sampling design, the statistical analysis, the dependent and independent variables used in the research and the econometrics model specifications used to test the research hypotheses are presented.

3-1 Research Hypotheses

This paper examines the hypotheses that follow.

- A significant relationship exists between voice and accountability and corporate profitability.
- A significant relationship exists between political stability and corporate profitability.
- A significant relationship exists between government effectiveness and corporate profitability.
- A significant relationship exists between regulatory quality and corporate profitability
- A significant relationship exists between rule of law and corporate profitability.
- A significant relationship exists between corruption and corporate profitability

3-2 Data and Sample of Firms

Corporate data includes the non-financial firms listed in the major indices the MENA region countries: Bahrain, Egypt, Iraq, Jordan, Lebanon, Morocco, Oman, Saudi Arabia, Tunisia and United Arab Emirates. Since data for some countries within the MENA region such as Algeria and Kuwait are not available on Investing.com, and so those countries are omitted from the study sample. This paper examines a total study sample of 301 non-financial listed firms from the ten MENA countries mentioned above. The data cover the years 2018 – 2020.

The data for the WGIs are obtained at World Bank Government Governance Indicators (<http://info.worldbank.org/governance/wgi/>). All data are annual.

Standard statistical tests are carried out namely, linearity versus non-linearity, Fixed and Random tests and cross section estimation technique.

3-3 Dependent Variable

The dependent variable examined in this paper is Earnings Yield which a prominent profitability measure.

3-4 Independent Variable

The independent variables include the institutional indicators (WGIs): Voice and accountability, Political Stability and no violence, Government Effectiveness, Regulatory Quality, Rule of Law, and Control of Corruption.

3-5 Statistical Tests

Since the data are cross section–time series panel, the Hausman specification test (Hausman, 1978; Hausman and Taylor, 1981) is required to determine whether the fixed or random effects model should be used. The test looks for the correlation between the observed and the unobserved, thus is run under the hypotheses that follow.

H_0 :covariance(x_{it}, η_k) insignificant, H_1 :covariance(x_{it}, η_k) significant

Where x_{it} = regressors, and η_k =error term. The estimating equation of the random effect linear model that follows.

$$y_{tk} = \alpha_k + \sum_{i=1}^k \beta_{ik} X_{itk} + \varepsilon_{tk} \tag{1}$$

Where $t = 1, \dots, n$

$k =$ number of firms in each group; y_{tk} = Corporate profitability (Earnings yield);

X_{itk} = Six pillars of World Governance Indicators; ε_{tk} = Random error.

3-5-1 Descriptive Statistics

In this section, descriptive statistics such as mean, standard deviation, minimum, and maximum are presented for all the variables.

Table 1: Descriptive Statistics for the MENA Countries

Descriptive Statistics					
	N	Minimum	Maximum	Mean	Std. Deviation
Earnings Yield	903	0.0294	2.38	-2.92	18.12
Voice and Accountability	903	3.34	34.11	45.35	9.9612
Political Stability No Violence	903	1.56	61.25	12.11	12.34
Government Effectiveness	903	7.29	46.39	25.34	13.22
Regulatory Quality	903	7.11	51.69	25.99	14.54
Rule of Law	903	2.63	57.21	33.25	15.233
Control of Corruption	903	4.21	62.92	34.36	14.19

Table 2: The Results for the normality Test: MENA Countries

Variable	N	Shapiro-Wilk W test	V	z	Prob>z
Earnings Yield	903	0.3598	829.1	11.41	0.00000

3-5-2 Hausman Test

The test is run under the hypotheses that follow. Ho: difference in coefficients not systematic; H1: difference in coefficients is systematic

Table 3: The Results for the Hausman test

Earnings yield		
Chi ² Stat. (Prob>Chi ²)	MENA	67.93 (0.00)

The results reported in table above show that the best model for fitting the data is fixed effect model as the p-value associated with the test is less than 5%.

3-5-3 Multicollinearity Test (VIF test)

Table 4: The Results for the Multicollinearity Test: MENA Countries

	Earnings yield
Voice & Accountability	5.62
Political Stability no Violence	5.04
Government Effectiveness	6.15
Regulatory Quality	8.01
Rule of Law	5.99
Control of Corruption	8.83

4-Data Analysis and Discussion

This section discusses and analyzes the results of the pillars of WGI on corporate earnings yield

Table 5: The WGI Determinants of Corporate Profitability

Independent Variables (WGIs)	Profitability (Earnings Yied)
Constant	0.0193 (0.004)
Voice & Accountability	0.782*** (0.0193)
Political Stability no Violence	-0.495** (0.025)
Government Effectiveness	0.981** (0.006)
Regulatory Quality	0.769** (0.0471)
Rule of Law	0.561** (0.0677)
Control of Corruption	0.486*** (0.089)
N	903
Adjusted R square (\bar{R}^2)	0.361
Root MSE	0.589

*** p<0.01, ** p<0.05, * p<0.1, Robust standard errors in parentheses

4-1 Voice and Accountability

In table (5), in the first model, after conducting the analysis, the results of MENA region show that the relationship is positive at a 99% confidence level. This means an increase in voice and accountability leads to an increase in corporate profitability. As mentioned before, the difference between G8 countries and MENA region in the results is due to the low ranking of MENA region in WGI.

4-2 Political Stability, No Violence

In table (5), in the second model, the MENA region show that the relationship between political stability and corporate profitability is negative at a 99% confidence level. It means when the political stability increases the corporate profitability increases. The researcher argues that political instability increases the return and the earnings yield of the corporations. This is in line with studies conducted by Girard and Sinha, (2008) and Desbordes, (2010) who found that the high political risk is associated with higher expected return and increase in corporate profitability, which seemingly is because of the increase of uncertainty about the future return. In addition, another study supported the previous results conducted by Kriel, (2012) who argues that there is a positive relationship between political risk and earnings yield. In other words, an increase in political stability leads to a decrease in earnings yield.

4-3 Government Effectiveness

In table (5), in the third model, the results of MENA region show that the relationship is positive at a 95% confidence level. Therefore, the higher the government effectiveness the higher corporate earnings yield. This difference is due to the low ranking of MENA region in WGI.

4-4 Regulatory Quality

In table (5), in the fourth model, the results in MENA region show that the relationship is positive at a 95% confidence level, which means an increase in regulatory quality leads to an increase in corporate profitability. This result is in line with the findings of Li *et al.*, (2017) who indicated that the increase of strict regulations from the government, means an increase in the quality of regulations,

and consequently, an improvement in the environmental performance of the firm, which leads to improving the corporate profitability.

4-5 Rule of Law

In table (5) in the fifth model, the results in MENA region showed that the relationship is positive at a 95% confidence level. Accordingly, an increase in rule of law leads to an increase in corporate profitability.

4-6 Control of Corruption

In table (5) in the last model, the results of MENA region show that the relationship is positive at a 99% confidence level, which means an increase in control of corruption leads to an increase in corporate profitability. As mentioned before, this difference is due to the low ranking of MENA region in WGI.

5- Conclusion

The paper provides several conclusions that may be drawn from the findings of this paper. This study is examined the institutional determinants of corporate financial performance in developing countries. The analysis revealed that the state institutions which are measured by the worldwide governance indicators (WGI) have an effect on the corporate financial performance. The WGI has six dimensions of governance, which are voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, rule of law, and control of corruption. Further, corporate financial performance is measured by the profitability measurement.

Table 6: Corporate Profitability (Earnings Yield)

Measurements of financial performance	MENA countries
Voice and Accountability	Positive
Political Stability, no Violence	Negative
Government Effectiveness	Positive
regulatory quality	Positive
Rule of Law	Positive
Control of Corruption	Positive

Regarding the first indicator of the WGI which is the voice and accountability, the results showed that the voice and accountability has a significant influence on the firm financial performance measurement, therefore, it is clear that the voice and accountability is among one of the institutional determinants of the corporate financial performance. As the authors found that in the corporate profitability, the results showed that the impact is positive between voice and accountability and the corporate profitability in MENA countries.

Further, for the second indicator which is the political stability and no violence, the results showed that the political stability has a significant impact on the corporate financial performance, thus, the political stability indicator is one of the institutional determinants of the corporate financial performance. In the corporate profitability, the results showed that the impact of political stability is negative on the profitability of firms in MENA countries.

With regards to the government effectiveness which is the third indicator of the world governance indicators, the findings of the research showed that the government effectiveness has a significant effect on the corporate financial performance, thus, the government effectiveness is one of the institutional determinants of the corporate financial performance.

As the authors found that in MENA countries, which is the corporate profitability, the results showed that an increase in government effectiveness leads to an increase in the profitability of firms in MENA countries. Since the authors found that, in the MENA countries, the results showed the reverse association between the regulatory quality and the firm profitability.

Regarding the rule of law which is the fifth indicator of the world governance indicators, the findings revealed that the rule of law has a significant impact on the corporate financial performance, which means that the rule of law is one of the institutional determinants of the corporate financial performance. As the authors report that the rule of law, the findings showed that the profitability of firms in the MENA countries is positively influenced by the rule of law.

Regarding the sixth and last indicator of the world governance indicators, which is the control of corruption, the findings showed that the control of corruption

has a significant influence on the corporate financial performance. Thus the control of corruption is considered as one of the institutional determinants of the financial performance of the firm.

In the MENA countries, the results show the higher the control of corruption, the higher the firm profitability.

Overall, the difference of the results in MENA countries is likely due to the low ranking of MENA countries in the world governance indicators. On the other hand, the weak institutions should work to increase their score of voice and accountability indicator by improve and increase the democracy, the political rights and the transparency of government policymaking in the country, thus, an improvement of the corporate financial performance will occur, as shown in the results of the developed countries.

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