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GOOD GOVERNANCE AND FIRMS PERFORMANCE IN PAKISTAN: A PANEL REGRESSION ANALYSIS

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Abstract

The governance of a country plays a pivotal role in the effective functioning and development of firms and economies. The regulatory framework, legal environment, and government policies impact the operations and strategic decision-making of the business enterprises. The matter of governance is more important for developing countries. Considering the importance of the phenomenon, this study examined the impact of good governance on firms' performance in a developing country. For this purpose, the study took a sample of non-financial firms from Pakistan. The study constructed a good governance index (GGI) by applying principal component analysis and with the help of six dimensions of good governance. The study then examined its impact on firms' performance by applying the panel regression model. The performance was measured through the proxy of return on assets (ROA). Control variables, i.e., Current Ratio (CR), Asset Turnover Ratio (TURN), Tangibility (TANG), Leverage (LEV), and Firm Size (SIZE), were added to the regression model. Secondary firm-level data of each variable was extracted from the annual reports of each firm. The results of the study showed a positive and significant effect of good governance on firms' performance in Pakistan. The effect of control variables was also found. Based on the findings, the study suggested measures for improving governance quality to strengthen firms' performance in the country.

Keywords: Governance, Performance, Firms, PCA, Panel Regression.

Introduction

Good governance involves the practices and processes that make an organization open and accountable in decision-making for the larger interest of its stakeholders. This could help to ensure that the operations of the organization are managed efficiently and ethically while aligning the interests of all stakeholders. This could also be helpful in developing a strong bond between the stakeholders, reducing

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uncertainties, and increasing productivity and the operational efficiency of the enterprises. Good governance can thus play a leading role in improving the confidence of investors and the performance of enterprises. The importance of good governance has long been recognized. However, it has been significantly realized during the last few decades. It has been emphasized that good governance practices should be adopted and implemented everywhere. It has been realized that good governance practices are key to the success, survival, and sustainability of enterprises. Good governance can attract foreign and local investors to invest in the country, which can enhance the productivity and performance of firms as well as facilitate the generation of employment opportunities in the country.

Firms are critical to a country's economic progression. Firms can play a significant part in the progress of modern technologies, developing new products and services and creating jobs for the public. Economic theory specifically proposes that institutions provide innovators with incentives to innovate and investors with incentives to invest. In developed countries, firms are involved in and encouraged to engage in business activity because of governance quality, rule of law, and enforcement of property rights (Baumol, 1990; North, 1990). In less-developed countries, there is a higher level of corruption and a distortionary regulatory environment, which contributes to weak business performance in these countries (Rajesh & Kunal, 2017). Corruption weakens productivity and shrinks the efficiency of industrial policies, which pushes businesses to function into unsanctioned sectors of the economy for tax violation and to avoid regulatory framework (Ades & Tella, 1997; Lambsdorff, 2003). Empirical evidence consistently demonstrated that improved institutions, characterized by reduced corruption and enhanced governance, are linked to various positive outcomes.

The government has a vital role in creating a well-established environment that is conducive to the operations of businesses. As suggested by Baumol (1990), a country's institutional framework can influence its business and entrepreneurial activities. Institutions provide the structural framework in which economic activities are conducted, and the way they enforce these rules can either motivate or limit the actions of economic participants (North, 1992, 2005; Peng, Wang, & Jiang, 2008). Institutions in a country can also impose controls on firms' strategy, which determines performance in combination with industry conditions and firm capabilities (Peng, 2002; Wright, Filatotchev, Hoskisson, & Peng, 2005). The quality and effectiveness of institutions vary across countries. Businesses in developing countries often function in an environment where institutions are underdeveloped. In Pakistan, the government has been attempting to implement initiatives aimed at enhancing institutional quality and promoting good governance within the country. Firms' growth is also important for developing countries like Pakistan. Firms can provide employment opportunities and contribute to the economic progression of a country. However, firms need a good environment to operate successfully.

This study examined the impact of good governance on the performance of firms in Pakistan. For this purpose, a sample of two hundred listed non-financial firms was selected. The secondary data of firm-level variables and good governance indicators were extracted from reliable published sources. The good governance index was constructed by applying principal component analysis, while panel regression was applied to check the impact of good governance on the performance of selected firms.

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The study noticed a positive effect of good governance on the performance of firms in Pakistan. This research could be a significant addition to the literature pertaining to good governance and firms' performance in at least three ways. Firstly, the study applied standard globally applicable measures of good governance to formulate a good governance index, which could be helpful in uncovering the impact of good governance more comprehensively. Second, the study examined the impact of good governance on firms' performance in the country and generated useful information for decision-makers to improve and streamline the businesses. Thirdly, the outcome of the research could be helpful in devising suitable policies for institutional quality and the working of different industries in the country.

Rationale of the Study

Governance strongly determines a country's economic development and business functioning. For developing economies such as Pakistan, effective governance practices can have a transformative impact on creating strong, firm performance and attracting investment. To empirically check this phenomenon, this study develops a Good Governance Index (GGI) employing international benchmarks. It then applies panel regression to examine how good governance influences the performance of firms in Pakistan.

Problem Statement

Companies in LDCs still face a hostile business environment owing to poor governance structures, political vices, and, most crucially, bad policies. In Pakistan, though the government has tried to improve the quality of governance, various governance factors still contribute to constraining firms' performance. The absence of rigorous studies that map out all major aspects of good governance adds to the problem, as it puts policymakers in a situation where they cannot support changes with appropriate data.

Research Question

1. How does good governance affect the performance of non-financial firms that are listed on the Pakistan Stock Exchange?

Research Objective

- To investigate the impact of good governance on non-financial firms' performance in Pakistan.

Theoretical Framework

This study is based on the institutional theory coined by North (1990), which states that institutions are viewed as the rules of the game in economic engagements. From the institutional quality point of view, good governance decreases uncertainties, and transaction costs and creates a suitable climate for doing business. This theory forms the basis of the assumption that good governance enhances firms' performances.

Conceptual Framework

The conceptual framework involves:

Independent Variable: Good Governance Index (GGI)

Control Variables:

- **Current Ratio (CR)**: Measures liquidity.
- **Asset Turnover Ratio (TURN)**: Indicates efficiency.
- **Tangibility (TANG)**: Reflects asset structure.
- **Leverage (LEV)**: Represents debt utilization.
- **Firm Size (SIZE)**: Determines operational scale.

Dependent Variable: Return on Assets (ROA)

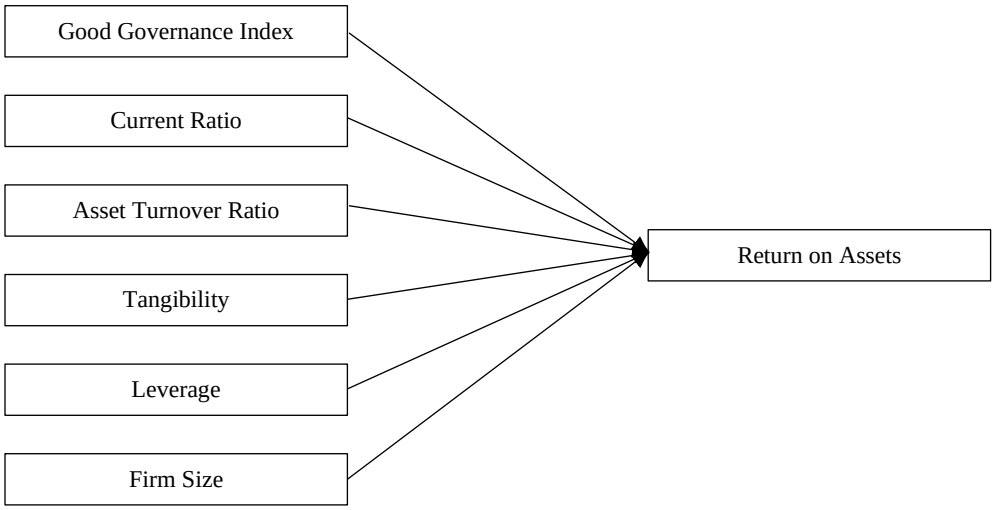


Figure 01: Conceptual Framework

Significance of Study

This research contributes to the literature in three ways:

- It formulates the Good Governance Index based on measures that are relevant internationally.
- This paper provides empirical evidence on governance and firms' performance in Pakistan; thus, it can help policymakers and stakeholders.

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- It provides guidance on enhancing the governance function and, as a result, the firms' economic and operational outcomes.

Literature Review

The theoretical foundation for the impact of governance quality on firm performance can be found in institutional and political science, as the government is a political institution. One of the most widely used theories for this type of research scenario stems from the work of North (1991), who produced the concept of institutions as the rules of the economic game. From this perspective, the organizations are the players affected by the constraints imposed by the institutional environment (North, 1990). The institutional environment affects the conduct of individual market players by defining incentives and restrictions on individuals who operate in the economy. This is accomplished with the use of both informal and formal norms and rules. Furthermore, institutions can play a significant role in the economy by reducing uncertainty, making information more accessible, and shaping the conduct of other actors more predictable (North, 1991). The primary factors responsible for variations in capital accumulation and productivity among countries are disparities in the quality of governance in these countries (Hall & Jones, 1999). North (1994) also developed the economic transaction theory that included the notions of institutions, transaction costs, and neo-classical economic framework. The associated costs have an impact on the profitability of engaging in business transactions. It has an impact on decisions like whether to produce a specific item or some other kind of item or not produce a good at all.

Different researchers studied the impact of good governance from different domains and across different countries. Globerman and Shapiro (2002) reported that governance attracts foreign capital and constructs encouraging conditions under which multinational corporations can operate. Zhang (2006) found that firms working in countries with underprivileged investor protections make low dividend payments, show high cash holdings, and lower firm value. Olken and Pande (2011) noticed an adverse effect of corruption on production and investment decisions as it leads to higher expenses and prominent levels of unpredictability. Wang and You (2012) concluded that corruption contributes negatively to firm growth in China. Roxas, Chadee, and Erwee (2012) found that crime and theft have a main impact on business performance, followed by tax administration and corruption. The researchers, however, did not find a significant effect of political instability and the court system on business performance. LiPuma, Newbert, and Doh (2013) observed that better governance quality in the areas of the court system, government intervention and tax regulations are positively related to exporting. Chadee and Roxas (2013) reported that regulatory quality, rule of law, and corruption exert significant direct and adverse effects on firms' innovative capabilities and overall performance in Russia.

Extending the literature, Choi, Jiang, and Shenkar (2015) found a positive and significant relationship between regional government quality and firm performance in China while controlling for the location of firm and firm-level governance variables. Chakraborty (2016) revealed that judicial quality is a crucial factor in the performance of firms in India in terms of both sales and exports. Rajesh and Kunal (2017) found that governmental corruption had a negative impact on a firm's productivity in India.

Other governance variables, on the other hand, appear to have a weak influence on firms' performance. This is contrary to the findings of Ayaydin and Hayaloglu (2014), who discovered that engaging in corrupt payments made to officials depicted a favorable impact on firm growth in Türkiye. Similarly, Mendoza, Lim, and Lopez (2015) showed a substantial and positive correlation between corruption and sales growth in the Philippines. Imran, Ejaz, Spulbar, Birau, and Nethravathi (2020) observed that governance indicators and the stock market share a positive relationship, and high-quality governance brings higher returns on stocks. The study concluded that intuitional quality is a precondition for financial development in any country. Manolopoulos, Bitzenis, and Tatoğlu (2020) reported a significant positive correlation between governance quality and foreign firms' performance in Türkiye. Hussen and Çokgezen (2020) observed that the quality of regional institutions notably influences the innovative performance of companies. Demir and Hu (2020) found that in areas with stronger institutions, Chinese companies are more likely to enter the market and thrive. Tan and Tusha (2023) reported the negative effect of corruption and inspections on the productivity of firms in Moldova. The negative effect of inspections was, however, moderated by corruption. Abdullah, Chowdhury, Karmaker, Fuszder, and Shahriar (2022) reported a positive effect of political stability on the performance of firms in Bangladesh.

The researchers also examined the phenomenon by taking a broader sample of firms from multiple countries. In a cross-country study, Bota-Avram (2014) found a significant influence of government effectiveness and regulatory quality on the registration and operation of a new business. Controlling corruption and regulating the law were observed to be detrimental factors to the business environment. Williams and Kedir (2016) reported that corruption significantly enhanced productivity and increased annual sales of firms selected from African countries. Ricotta (2019) observed that corruption and quality of services positively impact firms' total factor productivity. The researcher concluded that differences in governance quality do affect firms' performance. Priya and Sharma (2023) found that corruption and financial constraints have a negative effect on the growth, productivity, employment, and innovation of firms selected from different developing economies. Chen, Pinar, and Stengos (2024) observed some mixed evidence regarding the effect of bribery and regulation on the performance of firms selected from a wide range of developing countries. The researchers concluded that firm performance improves in response to limiting the firm level of bribery. Sundarasen, Ibrahim, Alsmady, and Krishna (2024) found a positive relationship between corruption and firms' performance in high-income countries. This association, however, remained negative for firms selected from upper-middle- and low-income countries. Chang (2023) found a positive influence of institutional quality on firms' value and total factor productivity in a sample of forty-one countries. The researcher suggested that the development of a conducive investment environment, reducing corruption and strengthening resource allocation efficiency are critical to improving firms' productivity and value. Junior, Junior, and Carvalho (2023) documented a positive relationship between governance quality and the performance of firms in a sample of nine countries. The researchers also observed a positive moderating role of culture in most cases.

Examining the impact of different domains of good governance on firms' performance remained a debatable area among researchers all over the world. The researchers conducted different individual country, multi-country, and cross-country

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analyses to uncover the phenomenon. Researchers in Pakistan have also contributed to this domain. In one such study, Khan, Hussain, and Waheed (2021) notice an adverse effect of corruption on the performance of firms in Pakistan. The researchers proposed taking strong measures to reduce corruption in the country. Similarly, Ali, Iftikhar, Ahmad, Hussain, and Ali (2022) observed a negative relationship between corruption and firm performance in Pakistan. The effect remained pronounced for larger size, directly exporting, and younger firms. The bureaucratic complexities, however, raised the firms' performance. Kazmi, Imran, Farooqi, and Shahid (2022) also noticed the reduced investment of firms in human capital in response to corruption and political instability. The researchers suggested a reduction of corruption to boost firms' investment in human capital. The studies in Pakistan mostly addressed the corruption and political stability components of good governance only. Examining the impact of good governance, covering its all-broader dimensions, remained largely unaddressed. This study attempted to examine this phenomenon for which it is hypothesized:

H_1: Good governance has a positive and significant effect on the firm's performance in Pakistan.

Research Methodology

To check the effect of good governance on the performance of firms, the study first constructed a good governance index. This was done with the help of principal component analysis and by considering the six dimensions of governance, i.e., government effectiveness (GE), political stability (PS), voice and accountability (VOA), regulatory authority (RQ), rule of law (ROI), control of corruption (COC). These indicators were selected by consulting the studies done by researchers in the past (Boulanouar, Alqahtani, & Hamdi, 2021; Kaufmann & Lafarre, 2020; Nawaz, Iqbal, & Khan, 2014; Sabir, Rafique, & Abbas, 2019; Shah & Afridi, 2015). The computation of good governance was done in the following form.

$$GI_t = W_1 GE_t + W_2 PS_t + W_3 VOA_t + W_4 RQ_t + W_5 ROL_t + W_6 COC_t$$

Regarding firms' performance, the study took return on assets, measured as net income to total assets ratio. Many researchers in the past used this proxy to measure the performance of firms in different countries (Al-Qudah, 2017; Anwar & Tabassum, 2011; Khidmat & Rehman, 2014; Nurlaela, Mursito, Kustiyah, Istiqomah, & Hartono, 2019; Rostami, Rostami, & Kohansal, 2016). The study used measures of liquidity, efficiency, tangibility, leverage, and size as control variables. For the selection of control variables in the regression model, the study followed the past studies (Azad, Raza, & Zaidi, 2018; Khidmat & Rehman, 2014; Kikhia, 2014; Kumar & Zattoni, 2016; Naimah & Hamidah, 2017; Nurlaela et al., 2019). The panel regression model of the study took the following form.

$$ROA_{it} = \beta_0 + \beta_1 GGI + \beta_2 CR_{it} + \beta_3 TURN_{it} + \beta_4 TANG_{it} + \beta_5 LEV_{it} + \beta_6 SIZE_{it} + €_{it}$$

For empirical analysis, the study took a sample of two hundred firms from the non-financial sector and listed on the Pakistan Stock Exchange. The non-financial firms were selected based on their significant contribution to the country's economy. The selection of firms was based on the size of the firms and the availability of

consistent data. The secondary data for variables related to each sample firm were taken from the annual reports for the period 2006-2019. For the good governance index, the data for each indicator was extracted from the World Bank's website. The study first determined the basic data characteristics with the help of descriptive statistics, correlation analysis and multicollinearity analysis. The study then applied the likelihood ratio and Hausman test to select the appropriate model. After the selection of the appropriate model, the regression analysis was applied to check the impact of good governance on the performance of the selected firms.

Analysis and Interpretation

The study examined the basic data characteristics. To examine the pattern of the dataset, the descriptive statistics were checked, and its results are given in Table 1.

Table 01: Descriptive Statistics

	ROA	GGI	CR	TURN	TANG	LEV	SIZE
Mean	0.531	-0.001	1.477	1.070	0.559	1.188	15.500
Median	0.127	-0.344	1.107	0.950	0.574	0.340	15.442
Max.	31.357	4.333	12.453	9.353	0.999	34.405	20.458
Min.	-7.552	-2.288	0.001	0.008	0.000	-9.826	10.472
Std. Dev.	2.015	1.777	1.326	0.777	0.225	3.424	1.638

The descriptive statistics reported above exhibit the uppermost mean value of size while the highest dispersion in the value of leverage. The size was measured by taking the natural log of total assets, while leverage was the debt-to-equity ratio. The lowest mean value of the good governance index was found, which was measured by applying principal component analysis. Similarly, the lowest dispersion was observed in assets turnover, which was measured by the sales-to-assets ratio. The results show a normal data distribution without the presence of any significant abnormality and outliers. After examining the data distribution, the study checked the correlation among the study variables, and its results are in Table 2.

Table 02: Correlation Analysis

	ROA	GGI	CR	TURN	TANG	LEV	SIZE
ROA	1.000						
GGI	0.012	1.000					
CR	-0.017	0.010	1.000				
TURN	0.157	-0.098	0.045	1.000			
TANG	-0.096	0.047	-0.378	-0.467	1.000		
LEV	-0.034	0.084	0.004	-0.007	0.025	1.000	
SIZE	-0.283	-0.015	0.034	-0.167	0.113	0.058	1.000

The results of the correlation analysis show a positive association between good governance and asset turnover with the firms' performance. On the other hand,

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liquidity, tangibility, leverage, and size were found to be negatively associated with firms' performance. The results showed that all the explanatory variables have a fragile association with each other, which means that there is no significant issue of multicollinearity in the regressors. The variables can, therefore, be used for further analysis. For further confirmation, the multicollinearity analysis was checked with the help of the variance inflation factor. Table 03 presents its results.

Table 03: Multicollinearity Analysis

	Coefficient Variance	Centered VIF
GGI	0.000	1.026
CR	0.001	1.206
TURN	0.003	1.341
TANG	0.042	1.573
LEV	0.000	1.054
SIZE	0.001	1.036

The results reported above showed less than 3 centered VIF values for each variable. This indicates that there is not an issue of multicollinearity among the regressors, even by following the most rigid threshold level. The regression analysis can, therefore, be applied confidently. The study then analyzed the suitable model for regression analysis by applying the likelihood ratio and Hausman test. The significant value of the likelihood ratio test and the insignificant value of the Hausman test supported the application of the random effect model for regression analysis. The results of regression analysis are presented in Table 4.

Table 04: Regression Analysis

	Coefficient	Std. Error	t-Statistic	Prob.
C	5.558	0.658	8.445	0.000
GGI	0.062	0.022	2.851	0.004
CR	-0.068	0.034	-2.043	0.041
TURN	0.454	0.068	6.661	0.000
TANG	-0.415	0.247	-1.679	0.093
LEV	-0.001	0.011	-0.123	0.902
SIZE	-0.333	0.039	-8.456	0.000
Dependent Variable: ROA				

The results showed a significant positive impact of good governance on the performance of the firms. The findings are in line with the results of many earlier studies (Abdallah & Ismail, 2017; Blagojevic & Damijan,2013; LiPuma et al., 2013; O'Toole & Tarp, 2014). These findings suggest that good governance in a country could be beneficial for the working and performance of the firms. The results further showed a significant negative effect of liquidity and size on the firm's performance. Contrary to this, the effect of asset turnover remained positive and significant. The inverse relationship between liquidity and profitability has been supported theoretically and empirically as the return on highly liquid assets is too low, and cash is considered an idle resource in a firm that has the highest liquid assets. The higher

proportion of tangible assets also exerts a negative influence on the profitability and performance of the firms. The negative effect of leverage might be due to the bankruptcy and agency costs involved. The effect of tangibility and leverage, however, did not remain significant. These results of the control variable are in line with the findings of many earlier studies (Bardia, 2004; Dawar, 2014; De Jong, Kabir, & Nguyen, 2008; Eljelly, 2004; Onaolapo & Kajola, 2010; Mateev, Poutziouris & Ivanov, 2013; Narware, 2004; Pratheepan, 2014; Vintila & Nenu, 2015).

Discussion

The regression result shows that some of the independent variables have a significant effect on ROA. Out of the independent variables, the Good Governance Index (coefficient = 0.062, p = 0.004) links positively with ROA. This evidence of the study provides empirical backing for the proposed hypothesis that better governance raises the performance of firms. The existing literature holds that sound governance leads to better financial results (Ahmed, 2019). However, the Current Ratio (CR) has a negative relationship with ROA (coefficient = -0.068, p = 0.041), which implies that a high liquidity position as an indicator of low efficiency in capital utilization may not be beneficial to firms. This is consistent with the study carried out by Olayinka and Abiola (2020), who pointed out that a high level of liquidity might be a signal of inefficiency.

The results also establish that Turnover (TURN) has a positive and significant impact on the dependent variable, ROA (coefficient = 0.454, p = 0.000). This result supports the premise that higher turnover implies increased aptitude for firms to make profits, as postulated in the relationship between sales and financial performance (Peters & Song, 2018). On the other hand, Tangibility (TANG), the proportion of physical assets, has a negative but insignificant relationship with the dependent variable (coefficient = -0.415, p = 0.093). This goes a long way in indicating that companies with greater tangible assets are still likely to struggle to raise profitability because tangible asset maintenance costs are always high and their turnover rates optimal (Smith & Watson, 2017).

Leverage (LEV) itself has no significant impact on ROA (coefficient = -0.001, p = 0.902). More importantly, the above finding implies that in the context of this study, capital structure does not affect firm profitability. Last of all, there is a negative relationship between firm Size (SIZE) and ROA (coefficient = - 0.333, p = 0.000). On drawing this, it can be implied that large firms may experience declining marginal returns, largely caused by problems associated with firm size (Johnson, 2016).

An analysis of the multiple regression results indicates that governance practices, liquidity, turnover and size have a stronger bearing on the firm's performance than the other variables. Also, aspects such as an organization’s tangibility and leverage remain less influential or secondary to profitability. The results of this study should be useful to policymakers and other relevant stakeholders who need information to strengthen corporate governance and financial management practices in their respective countries to achieve the desired firm performance.

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Conclusion

The main purpose of this study was to determine the impact of good governance on firms' performance in Pakistan. For this purpose, the study selected the period of 2006-2019. The selected period was very suitable because, during this period, Pakistan witnessed three democratic government transitions with different political parties, which is remarkable in the history of the country. These different political parties came to power with their manifesto and mandate for governance. For empirical analysis, the study first constructed a good governance index based on six commonly used dimensions. Then, its impact on firms' performance was examined using the proxy of return on assets. The study also took certain control variables in the regression model. The study applied principal component analysis for the good governance index while panel regression with a random effect model to determine the impact of good governance on firms' performance. The study examined the basic data characteristics and established data normality with the help of certain diagnostic tests. The results of the panel regression analysis show a positive and significant effect of good governance on firms' performance in Pakistan. The effect of some control variables was also found, which remained negative in most cases, excluding asset turnover.

The findings of the study reveal that good governance is beneficial for the performance of firms in Pakistan. Weak governance can lead to corruption, unfair competition, and instability, all of which can negatively affect the performance of firms operating within the country. A conducive governance environment is pivotal to fostering a thriving business ecosystem and ensuring the success of firms in a country. It also gives a strong explanation that countries with better governance environments have better return on investment opportunities. Federal and provincial governments should try to bring reforms that can enhance governance in the country, which is crucial to the performance of businesses. This could also create a favorable environment for the establishment of new firms to meet the challenges of unemployment and poverty in the country. The input and issues of the business sector should be considered in decision-making. Regulatory bodies should encourage firms and help resolve the issues that firms are facing to attract domestic and international investors in the country. Investors and owners should also focus on lobbying to influence the governments to bring reforms and implement already brought reforms that can improve the governance quality in the country. This study addressed the outcomes of good governance for firms in Pakistan and could be extended in the future with a broader sample and cross-country analysis.

Recommendations

- **Policy Improvements:** BC and federal governments should improve their governance structures by reducing corruption and rationalizing regulations.
- **Institutional Strengthening:** Appoint or form new organizations that will exercise oversight on compliance with governance benchmarks.
- **Corporate Governance Training:** Better practices in corporate governance are brought about through regular training programs.

- **Future Research:** Estimate the analysis of financial firms and make cross-country comparisons to increase generality.

Limitations of the Study

- The study sample comprises firms in the Pakistani market listed on the PSX but has excluded the financial sector.
- The utility of secondary data may bring in different forms of inconsistencies.
- The results could also be limited by the fact that the study period (2006-2019) might not have captured the latest governance reforms and corresponding shifts in the economic reforms.

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