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COUNTRY GOVERNANCE SCORES AS MODERATORS OF ESG IMPACT ON FIRM PERFORMANCE IN THE EUROPEAN CONTEXT

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ABSTRACT

Purpose- Engaging in ESG activities entails significant costs that, without a doubt, impact the firm's financial performance and ultimately its market performance. However, it is believed that these costs are offset by the positive impact ESG brings in terms of improved reputation and public perception, including current and potential customers and investors. Research on the relationship between ESG scores and firm performance has produced mixed results, raising concerns about whether the positive effect of ESG is enough to counter the negative effect of associated costs, or whether there are other factors that may moderate this relationship. The purpose of this study is to explore the moderating effect of the World Bank's Governance Indicators on the relationship between a firm's ESG scores and its financial and market performance.
Methodology- To achieve the aim of the study, we have collected data for all listed firms from the European continent with ESG scores available on the Refinitiv database. After cleaning the data for missing values, we obtained an unbalanced and cross-sectional panel of 13,043 firm-year observations from the 2,083 firms used in the study. We have employed 2SLS Regression, using published financial information spanning over a period of 12 years, from 2011 to 2022.
Findings- The results suggest the World Bank's Worldwide Governance Indicators have a moderating effect on the relationship between ESG and firms' financial performance and market performance.
Conclusion- Our findings suggest that the positive impact of ESG activities on financial performance is more pronounced in countries rated higher in Worldwide Governance Indicators. The implementation of ESG practices is generally valued by investors affecting positively the market performance, however, this may not be as strong in countries with high Governance scores where expectations for sustainable business practices are already high.

Keywords: Europe, ESG, financial performance, market performance, World Bank Governance Indicators
JEL Codes: G30, H11, M14, O52, Q56

1. INTRODUCTION

Companies around the world are becoming increasingly aware of the importance of Environmental, Social, and Governance (ESG) factors, as they have become important criteria in measuring sustainability. In recent years, investor demand for sustainability and a growing regulatory emphasis on ethics have motivated companies to integrate ESG criteria into their strategies. Europe is one of the regions at the forefront of global efforts towards sustainable development. The continent's total Gross Domestic Product (GDP) was well over €16 trillion in 2023, highlighting its significant contribution to the global economy (Eurostat, 2024).

ESG scores are measured based on a company's performance in three areas: Environmental, Social, and Governance. The first area (E) refers to the impact on ecosystems, use of natural resources and waste management. The second area refers to aspects such as workforce diversity, fair labor practices and community engagement. The third area refers to the firm's leadership structure, transparency, ethics, and shareholder rights.

However, ESG's importance extends beyond ethical considerations. A growing body of research suggests that it can act as a driver of both financial performance and market competitiveness. (Clark et al., 2015; Khan et al., 2016). This performance advantage ca be attributed to several factors, such as reduced operational risk, higher efficiency, higher stakeholder trust and access to capital on more favorable terms.

The increasingly complex business environment and regulatory developments on sustainability, necessitate understanding how to integrate ESG activities without harming financial prospects. This study aims to investigate the impact of ESG activities on firm performance financial and market performance in the European continent. In doing so, we acknowledge that other factors may act as moderators, emphasising or mitigating this relationship. One such important factor is the World Bank's Governance Indicators.

2. LITERATURE REVIEW

How ESG practices affect firm performance remains a topic of intense research and debate. There is an extensive body of research exploring the complex relationship of ESG with firms' performance. The results presented by such research are inconclusive, with some studies suggesting a positive relationship, and others finding less clear evidence or even producing conflicting results.

According to Derwall et al. (2005 investing in firms with higher environmental efficiency ratings yielded higher returns compared to their peers with lower ratings. Albitar et al. (2020), found a positive influence of ESG disclosures on the financial performance of FTSE 350 firms. In a meta-study Clark et al. (2015) summarized the findings of over 200 studies revealing that sustainable practices lead to benefits like reduced cost of capital, improved operational performance, and better market performance. Alareeni and Hamdan (2020) revealed that ESG disclosures positively influenced firms' operational and financial performance, but had the opposite effect on their market performance. Khan et al. (2016) found that sustainable business practices and firm performance are positively related but highlighted that this relationship hinges on the materiality of such activities. Carnini et al. (2022) highlighted that higher ESG scores have the potential to boos sales, arguing that consumers favor buying products and services from businesses that engage in sustainable practices. Rahman et al. (2023) corroborated these findings, revealing that ESG as a composite score, as well as its individual dimensions (E, S, G) have a positive impact on financial performance. However, regarding the market performance, the composite ESG score and only its first two dimensions (E and S) have a significant positive effect.

However, not all studies have reported a positive relationship between these variables. For instance, Demiraj et al. (2023) found a negative impact of ESG scores on financial performance among listed firms in the European tourism sector. A negative relationship was reported also by Wasiuzzaman et al. (2022), Junius et al. (2020) and Atan et al.

Our literature review shows that empirical findings on the relationship between ESG practices and firm performance are diverse, underscoring the need for further research in this area. Additionally, we observed that the World Bank's Governance Indicators are a rarely explored variable in the context of this relationship, which in our view is a crucial moderating variable that cannot be neglected. Therefore our hypotheses are formulated as follows:

H1: There is a positive relationship between ESG scores and the financial performance of listed European firms in the presence of robust public governance.

H2: There is a positive relationship between ESG scores and the market performance of listed European firms in the presence of robust public governance.

3. DATA AND METHODOLOGY

To test our hypotheses we used a 2SLS (2-stage Least Squares) regression model. This model is useful especially when results may be biased due to omitted variables or endogeneity. Data was retrieved from the Refinitiv database for all European listed firms with ESG scores available. Our final dataset was comprised of 2083 firms, yielding 13,043 observations spanning 12 years, from 2011 to 2022.

As shown in Table 1, the main variables in this study are the firms' ESG scores as the independent variable, and their financial performance (ROA) (Carnini et al., 2022; Demiraj et al., 2022; Dsouza et al., 2023; Habibniya et al., 2022) and market performance (Tobin'sQ) as independent variables (Alareeni & Hamdan, 2020; Singh et al., 2017). Additionally, the World Bank's Governance Indicators (voice and accountability, political stability no violence, government effectiveness, regulatory quality, rule of law, and control of corruption) are used as moderating variables, to examine whether the impact of ESG is amplified or mitigated in their presence. Finally, six additional variables were used as control variables: Liquidity, Leverage, Size, Tangibilty, GDP and Multinational. The latter is a dummy variable to account for firms operating across multiple countries, and therefore are affected by the governance indicators of more than one country. To address outliers in the sample, we applied winsorization at the 2% level instead of removing them.

Table 1: Variables

Dependent variables	Independent variable	Moderating Variables	Control Variables
ROA Tobin's Q	ESG	Voice and Accountability Political Stability No Violence Government Effectiveness Regulatory Quality Rule of Law Control of Corruption	Liquidity Leverage Size Tangibilty GDP Multinational

The model designed to test our hypothesis is outlined below:

$$PERFORMANCE = f(ESG, CONTROL\ VARIABLES, GOVERNANCE\ INDICATORS)$$

$$PERFORMANCEit = \propto it + \beta 1ESG + \beta 2CONTROL\ VARIABLES + \beta 3GOVERNANCE\ INDICATORS + \varepsilon it$$

Where Performance (ROA and Tobin'sQ) represents the firms' performance; ESG represents the environmental, social, and governance scores, acting as the independent variable; Control Variables include Liquidity, Leverage, Size, Tangibility, GDP, and whether the firm is Multinational; Governance Indicators comprising the World Bank's six governance indicators serve as moderating variables; εit denoted the error component.

4. FINDINGS

The pairwise variable correlation matrix showed a high correlation among all six governance indicators. To avoid the problem of multicollinearity we used these indicators in separate models, obtaining a total of 12 models, six for each performance proxy, ROA and Tobin'sQ. As for the other variables, the VIF values indicate that there was no issue with multicollinearity. In addition, the correlation matrix suggested a positive relationship between ESG and ROA and a negative one between ESG and Tobin'sQ. Despite these preliminary insights, we rely on the 2SLS regression results to conclude on the relationship between the main independent variable and the dependent variables, particularly in the presence of governance scores.

Table 2 summarizes the results of the 2SLS regression model with ESG scores as the main independent variable and ROA as the main dependent variable. We tested six models, each with a different governance indicator as a moderator.

Table 2: 2SLS Results for the ESG - ROA Relationship

Dependent: ROA	**Gov_Ind_1** Voice & Accountability	**Gov_Ind_2** Political Stability	**Gov_Ind_3** Government Effectiveness	**Gov_Ind_4** Regulatory Quality	**Gov_Ind_5** Rule of Law	**Gov_Ind_6** Control of Corruption
ESG	-0.00179***	-0.000752***	-0.000793***	-0.000529	-0.000404	-0.000683***
ESG x Gov_Ind_1/2/3/4/5/6	0.00150***	0.00138***	0.000689***	0.000489**	0.000402**	0.000544***
Gov_Ind_1/2/3/4/5/6	-0.0771***	-0.0852***	-0.0302***	-0.0101	-0.0131	-0.0235***
Observations	13,043	13,043	13,043	13,043	13,043	13,043
R-squared	0.048	0.051	0.048	0.048	0.047	0.048

*** p<0.01, ** p<0.05, * p<0.1

From the regression results, it can be observed that the ESG standalone effect on ROA is negative and significant in 4 out of 6 models, suggesting that the costs associated with ESG implementations are not offset by the expected ESG benefits. Also, the Governance Indicators standalone effect on ROA is negative and significant in 4 out of 6 models, suggesting that stricter public regulations and oversight translate into increased compliance costs, regulatory burdens, and operational restrictions for firms impacting their financial profitability at least in the short term. However, when both variables are considered together, meaning ESG with the moderating effect of Governance Indicators, the relationship with ROA turns positive, suggesting that strong governance enhances the effectiveness and benefits of ESG practices, leading to better financial performance. Essentially, good governance can offset the costs or challenges associated with ESG initiatives, turning them into a strategic advantage that improves firms' returns. These results support our hypothesis that the relationship between ESG scores and the financial performance of listed European firms in the presence of robust public governance is positive.

Table 3 summarizes the results of the 2SLS regression model with ESG scores as the main independent variable and Tobin'sQ as the main dependent variable. As in the case of ROA models we ran six models, each with a different governance indicator as a moderator.

Table 3: 2SLS Results for the ESG – Tobin'sQ Relationship

Dependent: Tobin'sQ	**Gov_Ind_1** Voice & Accountability	**Gov_Ind_2** Political Stability	**Gov_Ind_3** Government Effectiveness	**Gov_Ind_4** Regulatory Quality	**Gov_Ind_5** Rule of Law	**Gov_Ind_6** Control of Corruption
ESG	0.0208***	0.0155***	0.0155***	0.0215***	0.0192***	0.0174***
ESG x Gov_Ind_1/2/3/4/5/6	-0.00714***	-0.00552***	-0.00275**	-0.00671***	-0.00518***	-0.00375***
Gov_Ind_1/2/3/4/5/6	0.882***	0.663***	0.506***	0.740***	0.562***	0.465***
Observations	13,043	13,043	13,043	13,043	13,043	13,043
R-squared	0.184	0.183	0.187	0.186	0.184	0.187

*** p<0.01, ** p<0.05, * p<0.1

From the regression results it can be observed that the ESG standalone effect on Tobin's Q is positive and significant in all of the 6 models, suggesting that the improved public perception and firm reputation associated with ESG implementations leads to enhanced market performance. Also, the Governance Indicators' standalone effect on Tobin's Q is positive and significant in all of the 6 models, suggesting that the public in countries with stricter public regulations and oversight value ESG activities more. However, when ESG with the moderating effect of Public Governance are considered together, the relationship with Tobin's Q turns negative. One possible explanation is that while both ESG and strong governance are individually valued, their combination may impose additional costs or constraints on the firm that the market perceives negatively. Another suggestion would be that the public in countries with strong governance has already high expectations of firms regarding sustainable practices, therefore the ESG effect is not as strong as to offset the costs associated with these activities. These results do not support our hypothesis that the relationship between ESG scores and the market performance of listed European firms in the presence of robust public governance is positive.

5. CONCLUSION

In this study, we investigated the impact of ESG activities on firm financial and market performance considering the World Bank's Governance Indicators as moderators. The 2SLS regression results suggest that even though ESG initially negatively influence financial performance due to increased costs, its effect turns positive in the presence of strong scores across all six Governance Indicators dimensions, and this relationship is statistically significant. On the other hand, ESG standalone coefficients indicate that market players value ESG activities, positively influencing firms' market performance. However, this effect may not be as pronounced in countries with high expectations for sustainable business practices, as shown by the interaction with high Governance Scores. It also appears that the increased costs associated with ESG activities combined with the costs and constraints associated with stronger governance, are not favorably received by the market players.

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