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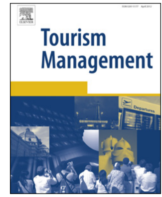

# Corporate governance, tourism growth and firm performance: Evidence from publicly listed tourism firms in five Middle Eastern countries

Basil Al-Najjar*

*Department of Management, School of Business, Economics and Informatics, Birkbeck, University of London, London WC1E 7HX, UK*

## HIGHLIGHTS

- This study investigates relationships between corporate governance and firm performance in tourism related firms.
- Board independence is positively related to firm performance and stock performance.
- Large boards enhance firm profitability, but small boards are more efficient in stock performance.
- We support the tourism growth led hypothesis in the Middle East context.

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## ABSTRACT

This study explores the under-researched relationship between corporate governance and firm performance in tourism companies. We employ instrumental variable modelling using 2SLS for publicly listed firms in five countries in the Middle East. Board independence is found to be positively related to firm performance and stock performance, suggesting that having independent directors among board members will improve overall firm performance. Board size shows opposing results: large boards enhance firm profitability; however, small boards exhibit more efficient stock performance. Finally, we support the tourism-led-growth hypothesis in our selected sample. These findings have empirical implications for policy makers, governments and academics.

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## 1. Introduction

Recent research has been devoted to examining the possible impact of good governance practices on firms' performance, and boards of directors have been the subject of much of the debate in the literature (e.g., Adams, Hermalin, & Weisbach, 2010; Iwasaki, 2008). According to Boone, Field, Karpoff, and Raheja (2007), there are two arguments concerning board characteristics. First is the inefficient board hypothesis, which assumes that a board is inefficiently structured and hence there is a need to regulate the board to improve firm value. Alternatively, the board is considered to be related to the firm and its managerial-related characteristics; in this view, what Boone et al. refer to as the economic hypothesis, boards should be structured based on the environment of the firm. It is therefore important to investigate board characteristics within the tourism environment and to shed the light on the effect of these internal tools in such a context.

From an economic perspective, Chen (2010) argues that firms are highly linked to economic status and that corporate performance is associated with business cycle expansion. It is also suggested that in the tourism sector, hotels can be considered a "cyclical industry". In other words, tourism is a perceptive sector with respect to economic status (for more details, please see Chen, 2010). There are a handful of studies examining the relationship between tourism growth and corporate performance (Chen, 2010; Dritsakis, 2004; Proenca & Soukiazis, 2008). These studies argue that tourism growth leads to enhanced financial performance. For example, Chen (2007) provides evidence that tourism growth improves economic conditions and in turn boosts firm performance.

This study examines the effect of corporate governance, the state of the economy and tourism growth on firm performance. We followed different streams of literature in defining financial performance using three financial indicators: return on assets (Chen, 2010; Ross, Westerfield, & Jordan, 2008), return on equity

* Tel.: +44 (0) 207 631 6774.
*E-mail address:* b.al-najjar@bbk.ac.uk.

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(Athanasouglou, Brissimis, & Delis, 2008; Chen, 2010), and stock returns (Chen, 2010; Chen, Kim, & Kim, 2005). These indicators provide accounting- and market-based measures for the selected sample.

Our study, therefore, contributes to the extant literature in different ways. First, this study is the first to investigate the relationship between board characteristics and corporate performance within the tourism context. We are interested in both board size and independence as two important and debatable firm internal control mechanisms. Despite the ample evidence of firm performance in this sector, board characteristics and structure have not been investigated in these studies (e.g., Chen, 2010; Chen et al., 2005). Second, we use a unique data set from five countries in the Middle East for the period spanning from 2005 to 2010. These include three countries in the Gulf region (Bahrain, Kuwait and Oman) that are popular destinations for Gulf citizens because of the entertainment facilities as well as the business exhibitions they hold. We also include Egypt and Jordan as two well-known destinations due to their World Heritage sites (including the Pyramids and Petra). To the best of our knowledge, this study is the first to conduct such cross-country analysis within the tourism context.

Finally, we expand the work of Chen (2010) by including a new economic factor that may affect the tourism industry (corruption index) as well as a new tourism growth factor (total expenditures of foreign tourists). Finally, we include the impact of the financial crisis period in our analysis.

The reminder of this study is organised as follows: Section 2 provides a review of the relevant literature; Section 3 describes the theoretical framework; Section 4 presents the data and methodology employed; Section 5 discusses the regression results; Section 6 provides further analysis; and finally, Section 7 concludes.

## 2. Literature review

Board characteristics have received much attention in the literature. Boards of directors play two key roles: advising and monitoring (Adams & Ferreira, 2007; Raheja, 2005). Jensen (1993) argues that boards are not fairly active and that their role becomes more significant when firms face financial difficulties, which indicates that boards are proactive mechanisms for improving the corporate governance of firms. However, in the stream of literature investigating the role of boards in improving firm performance, there is no consensus regarding whether large or small boards are better for firms. Jensen (1993) and Lipton and Lorsch (1992) argue that if the board size increases beyond a certain threshold, the disadvantages will offset the advantages of having large boards, and in turn, lower firm performance is expected. Haniffa and Hudaib (2006), Hermalin and Weisbach (2003) and Yermack (1996) support a negative relationship between board size and firm performance. On the other hand, Adams and Merhan (2005) and Dalton and Dalton (2005) suggest that better performance is associated with large boards.

It is well documented in the literature that independent directors provide better monitoring and thus better overall performance, Fama and Jensen (1983) support the active role of outside directors (independent), as they bring their expertise and connections to firms and hence improve firm performance. In contrast, Ozkan (2006) suggests that because independent directors are unfamiliar with a given firm, they are not as active as they are assumed to be. In the same vein, Hermalin and Weisbach (2003) indicate that outside directors do not have a positive impact on firm performance but play a positive role in other tasks. Guest (2008) and Vafeas and Theodorou (1998) have reached a similar conclusion. To recapitulate, the impact of board size and structure is debatable, and the opposing arguments motivate the investigation of these internal governance tools in tourism firms.

The other dimension of interest in this paper is the role of tourism growth in firm performance. Previous related studies have supported a positive relationship between tourism growth and economic growth. Gunduz and Hatemi-J (2005) investigate this issue in Turkey and support a positive impact of tourism development on economic growth. Kim, Chen, and Jang (2006) examine the link between tourism expansion and GDP growth in Taiwan and report a positive relationship between economic expansion and tourism improvement. Additionally, an upsurge in the number of foreign visitors is found to be positively related to economic status. Using the Taiwanese context, Chen, Kim, and Liao (2009) find that foreign ownership is important in the tourism industry as it boosts stock performance and minimises the risk associated with stock returns.

From a developmental economy perspective, Balaguer and Cantavella-Jorda (2002) provide evidence of the relationship between tourism development and the state of the Spanish economy. They report a long-term relationship between "tourism receipts" and the Spanish GDP. Dritsakis (2004) finds similar evidence of this relationship in the Greek context.

In a cross-country analysis, Lee and Chang (2008) note that in the long run, tourism development can enhance economic growth in OECD countries. Lee and Chang also report a cointegrated relationship between tourism development and GDP in a global context.

From the perspective of corporate performance, Chen (2010) argues that tourism development can be linked to firm performance because tourism growth can improve earnings/sales and thus boost hotels' financial performance. Chen's results support a positive relationship between the increase in foreign tourism and financial performance in the Taiwanese hotel industry. Chen (2007), however, finds an insignificant relationship between tourism expansion and stock returns.

To summarise, the development of tourism-related industries is found to positively affect firm performance because tourism growth can enhance the state of the investigated economy and in turn improve firm performance in the tourism sector. Although the results of the discussed papers show a positive link between economic status and tourism development, the findings regarding the relationship between tourism development and firm performance are inconclusive.

We also show that there is limited evidence of cross-country analysis in Middle Eastern studies. Additionally, no evidence is reported about the role of board structure in the tourism sector. We aim to bridge this gap in the literature by investigating board characteristics, tourism development and firm performance using cross-country analysis in five selected Middle Eastern countries. This study also incorporates the impact of the current financial crisis in the empirical analysis.

## 3. Theoretical framework

### 3.1. Agency theory

The separation of ownership and management in corporations leads to a principal–agent relationship. Supporters of agency theory argue that each party acts based on self-interest and aims to maximise its utility (Berle & Means, 1967; Jensen & Meckling, 1976). It is worth noting that agency theory is a popular theoretical framework of research in finance, economics and corporate governance. This theory is based on the conflict of interests between agents and principals (e.g., Eisenhardt, 1989; Lambert, 2001).

This conflict leads to agency problems and, in turn, agency costs, including monitoring costs due to the observation of managers' actions and bonding costs for convincing managers to act in the interest of shareholders (Jensen & Meckling, 1976). There are

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