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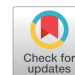
How corporate governance affects productivity in civil-law business environments: Evidence from Latin America



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A B S T R A C T

We examine the relationship between corporate governance and productivity in nonfinancial publicly traded firms based in Latin America. Using a sample of 670 firm-year observations from 2006 to 2014, we find that board size, gender diversity, institutional ownership, and the presence of independent directors affect firms' productivity. We find a statistically significant nonlinear relationship between board size and productivity. Institutional ownership increases productivity, while board independence decreases it. However, when the country's business friendliness and institutional ownership are controlled, the relationship between board independence and productivity turns positive and statistically significant. Finally, a higher proportion of female directors decreases productivity.

1. Introduction

Corporate governance has been central in the agendas of emerging market countries' policy makers, as recent research indicates that it is critical in generating development and growth in the private sector, with spillover effects on the whole economy. In recent years some Latin American countries have introduced several changes in laws and regulations whose intent is to improve general corporate practices and, in particular, to protect investors. Yet, according to some corporate governance rankings, the investment environment in a few countries in the region has deteriorated.

The finance and law literatures indicate that strong legal protection of investors improves the functioning of financial markets. LaPorta, Lopez-de-Silanes, and Shleifer (1999) find that the average firm in the world has high ownership concentration and, in most cases, the largest shareholder is highly involved in the management of the firm. LaPorta, Lopez-de-Silanes, Shleifer, and Vishny (1998) determine that ownership is more concentrated in countries with inferior shareholder protection (French civil law countries). The legal system also affects corporate values (Himmelberg, Hubbard, & Love, 2002; LaPorta, Lopez-de-Silanes, Shleifer, & Vishny, 2002).

Chong and López-de-Silanes (2007) find that in Latin America, where countries offer even less investor protection than the average protection in French civil law countries, investors' expropriation risk is more severe, the cost of capital is higher, firms pay less in dividends, and, in general, the level of financial development is relatively low. According to Johnston (2004), in a typical Latin American firm, only two shareholders hold more than 50% of the equity.

Studies demonstrate that a corporation's governance affects its financial performance (Eisenberg, Sundgren, & Wells, 1998;

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McConnell & Servaes, 1990; Morck, Shleifer, & Vishny, 1988; Yermack, 1996). While there is evidence for Latin American firms regarding how corporate governance affects value, performance, capital structure, and dividends (Bebczuk, 2007; Leal & Carvalhal-da-Silva, 2005), to our knowledge, there is no published research that directly examines the relationship among corporate governance, a Latin American's firm's productivity, and country-level governance characteristics including how business-friendly the country is. Analyzing this relationship is one of the main contributions of our research.

Chiang and Ling (2007) recognize that in the finance literature, Tobin's Q is the most common proxy of a firm's productivity. Leal and Carvalhal-da-Silva (2005) and Garay and González (2008) use Tobin's Q as a proxy of value or financial performance. But according to Hill and Snell (1989), total factor productivity is a better measure of efficiency than Tobin's Q, primarily because accounting conventions are subject to managerial discretion or an outright manipulation of the numbers that affect Tobin's Q. In the case of Latin America, we argue that Tobin's Q calculations could be especially misleading because they rely on market values, and the difference between a firm's market value and its intrinsic value, on average, is greater in emerging economies than in developed ones. In a second main contribution, we examine the relationship between total factor productivity and five proxies of corporate governance, including four that relate to the design of the board of directors; also, our research is more comprehensive than existing studies (Garay & González, 2008, on Venezuela; Leal & Carvalhal-da-Silva, 2005, on Brazil and Chile), as we cover companies trading in the primary Latin American markets.

Ferreira, Pessôa, and Veloso (2013) argue that government intervention and industrial policy, among other exogenous factors, affect productivity levels in Latin America; and these policies differ significantly in the level and frequency of intervention in the economy. There is ample evidence concerning the effect of a country's business environment on market efficiency, firm financial performance, and how firms organize their economic activity including corporate governance. Aggarwal, Klapper, and Wysocki (2005) find that country-level policies, such as stronger accounting standards, shareholder rights, and legal frameworks, affect the country level of investments by the global mutual fund industry. Increased capital inflows into Latin American countries should increase firms' productivity. For a sample of British firms, Sinha (2006) finds that differences in regulation of corporate acquisitions by financial vs. nonfinancial firms affect company-specific variables like management turnover, and that outside directors are less effective in disciplining management in banks than in nonfinancial firms because bank regulation creates a less competitive market for corporate control. In a related study using a sample of Latin American companies, Pablo (2009) presents evidence that better economic and business-friendly conditions in the countries where a target firm operates increase the likelihood of a cross-border merger. The threat of acquisition could also affect the efficiency and productivity of Latin American firms.

Şeker and Yang (2014) find that bribery significantly distorts firm growth in Latin America and the Caribbean. Gonzalez, Molina, Pablo, and Rosso (2017) confirm that if the largest shareholder in a Latin American firm bases its operations in a common-law country, the company's dividend is higher because better governance standards. Finally, Garay and González (2008) examine the relationship between corporate governance and firm value, analyzing a sample of firms based in Venezuela, where investor protection levels are weaker than the average Latin American levels. They find that better governance policies at the firm level are associated with higher dividend payouts, market-to-book ratio, and Tobin's Q. Still, there is a lack of research regarding how corporate governance affects productivity in countries whose business policies are not friendly to corporations or whose legal systems make enforcing contracts difficult and costly. Addressing this topic is the third major contribution of our analysis.

Specifically, after controlling for the country business environment, we analyze how board size, the degree of board independence, CEO duality, gender diversity on the board, and institutional ownership affect productivity levels in a sample of publicly traded companies in Latin America. We study how company-specific board-related governance proxies relate to productivity under different country-level business policies, classifying countries as business-friendly or business-unfriendly by using the Distance to Frontier (DTF) indexes created by the World Bank to construct its annual Easiness of Doing Business ranking.

We organize the remainder of the paper as follows. Section 2 reviews the literature and develops hypotheses. Section 3 describes the procedure we followed to gather and select the data and explains the construction of variables. Section 4 explains the main results, while Section 5 discusses the issue of endogeneity. Finally, Section 6 offers our conclusions.

2. Literature review and hypotheses development

There is ample evidence in the finance literature that corporate governance affects firms' financial performance. Recently, that relationship has been analyzed in developed countries different from the U.S. and in emerging market countries, where collecting data on corporate governance is more difficult. Reddy, Locke, Scrimgeour, and Gunasekarage (2008) analyze the effect of corporate governance practices on the financial performance of a sample of small-capitalization New Zealand companies. They find that greater board independence and the existence of audit committees in small publicly traded firms improve financial performance, proxied by Tobin's Q, ROA, and operating income. Similarly, Shan and McIver (2011) find that board independence improves the financial performance of large publicly traded nonfinancial Chinese firms, measured by the firm's Tobin's Q. This relationship, however, does not exist for smaller firms. Allan Chang and Shazali (2005) find that a dominant chief executive officer influences the ROE of Malaysian firms. Shahwan (2015) finds not only that the quality of corporate governance in Egypt is low, but also that the relationship between governance and financial performance is nonexistent. Shahwan measures financial performance using Tobin's Q and constructs a corporate governance index (CGI) based on the level of disclosure and transparency, the composition of the board of directors, shareholders' rights and investor relations, and the firm's ownership and control structure.

To address some shortcomings associated with the calculation of Tobin's Q and other financial performance proxies, some studies have analyzed the relationship between corporate governance and the firm's productivity measured by the firm's total factor productivity (TFP). Pretax income, the numerator of some financial ratios, is extremely sensitive to the selection of the depreciation

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