

# Institutional Governance Regimes and Firm-Level ESG Risk in Europe

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**Abstract:** This paper examines the relationship between national institutional governance and firm-level ESG risk in Europe. Using Worldwide Governance Indicators, countries are classified into institutional governance regimes through k-means clustering. Three regimes are identified: a mature regime including Northern and Western European countries and Czechia; an intermediate regime comprising Southern Europe and other Central and Eastern European (CEE) countries; and a low-capacity regime represented by Türkiye. Analysis of variance reveals statistically significant differences in ESG risk across governance regimes. Firms operating in mature institutional environments exhibit lower ESG risk, while higher risk is associated with weaker governance settings. Further mean comparison tests within the intermediate regime indicate that firms in CEE countries display significantly higher ESG risk than firms in Southern Europe, despite similar institutional classifications. The findings underline the role of institutional quality and regional heterogeneity in shaping ESG risk across Europe.

**Keywords:** ESG risk; institutional governance; Central and Eastern Europe; cluster analysis; sustainability

**JEL Classification codes:** G30, Q56, O43.

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## INTRODUCTION

The increasing relevance of environmental, social, and governance (ESG) risks has intensified interest in the institutional determinants of corporate sustainability outcomes in Europe. Despite regulatory harmonization efforts at the European level, firms continue to exhibit substantial cross-country variation in ESG risk exposure, suggesting that national institutional environments remain an important explanatory factor (Avram et al., 2025; Helfaya et al., 2023)

Institutional theory posits that governance structures shape firms' behavior through regulatory quality, enforcement capacity, and accountability mechanisms. Stronger institutional governance is expected to reduce ESG-related risks by constraining opportunistic behavior and promoting compliance with sustainability standards. However, much of the existing literature relies on predefined regional classifications or individual governance indicators, which may inadequately capture institutional heterogeneity across countries.

This study adopts a data-driven approach to identify institutional governance regimes based on the Worldwide Governance Indicators (WGI) and examines their association with firm-level ESG risk. Using k-means clustering, European countries and Türkiye are grouped into three institutional regimes reflecting differences in governance quality. The analysis then tests

whether ESG risk differs systematically across these regimes using analysis of variance (ANOVA). Given the observed heterogeneity within the intermediate governance regime, additional tests compare ESG risk between Southern European and Central and Eastern European firms operating under similar institutional conditions.

The findings reveal statistically significant differences in ESG risk across institutional governance regimes. Moreover, within the intermediate regime, firms in Central and Eastern Europe exhibit significantly higher ESG risk than their Southern European counterparts, indicating that institutional governance alone does not fully explain sustainability outcomes. These results highlight the importance of combining institutional quality with regional structural characteristics when assessing ESG risk in Europe.

## **1 LITERATURE REVIEW**

A substantial stream of sustainability and ESG research emphasizes the central role of country-level institutional environments in shaping corporate ESG performance and disclosure practices. While firm-specific characteristics remain relevant, increasing evidence suggests that external institutional pressures often exert a stronger and more systematic influence on ESG outcomes across countries (Shi & Mai, 2025).

Using a large cross-country sample of 14,174 firm-year observations from 2005 to 2012, (Baldini et al., 2016) show that national institutional characteristics, including political systems (legal framework and corruption control), labor systems (labor protection and unemployment), and cultural systems (social cohesion and equal opportunities), significantly affect firms' ESG disclosure practices. Importantly, their findings reveal substantial heterogeneity: institutional factors may either enhance or reduce disclosure levels, and their effects differ across the environmental, social, and governance pillars. This pillar-specific variation highlights the multidimensional nature of ESG and suggests that institutional drivers operate through distinct channels. Similarly, (Bhatia & Makkar, 2020) demonstrate that country-level governance indicators considerably influence sustainable development practices embedded within ESG performance, which may subsequently translate into favorable economic outcomes. However, the pace and depth of CSR and ESG reporting differ markedly across countries, particularly those characterized by varying levels of political stability and democratic maturity. These disparities indicate that institutional development stages shape not only the intensity but also the trajectory of ESG engagement. (Mooneeapen et al., 2022) provide nuanced evidence by showing that overall ESG performance can be higher in countries with lower levels of democracy and political stability, while governance performance improves in contexts characterized by stronger regulatory quality. Their component-level analysis further confirms significant differences across ESG pillars, reinforcing the view that institutional influences are complex and non-linear. Complementing this perspective, (Odera et al., 2016), in a systematic review of social and environmental disclosure (SED), highlight that corporate motivations vary widely across institutional contexts. Firms may disclose ESG information to enhance corporate image or to avoid government scrutiny, and substantial variation exists in both the quantity and quality of disclosures between developed, transition, and developing economies. The interaction between national institutions and market valuation is further examined by, who find that stronger country-level institutions promote greater CSR disclosure. However, the market valuation of unexpected CSR disclosures is higher in weaker institutional environments, suggesting that ESG engagement plays a stronger signaling role when formal institutional protections are less robust. Supporting a governance substitution perspective, (Lu & Wang, 2021) report a positive relationship between environmental performance and CSR disclosure, consistent with voluntary disclosure theory.

Other studies reinforce the importance of formal institutional quality find that CSR disclosure is positively associated with investor protection, democratic governance, regulatory efficiency, government effectiveness, and press freedom. Similarly, identify a robust association between CSR ratings and adherence to the rule of law in firms' countries of origin, highlighting the foundational role of legal institutions.

Political dynamics also emerge as significant determinants of ESG performance. (Yang et al., 2023) show that higher political turnover, reflecting greater uncertainty, leads to lower ESG performance, particularly in emerging markets. In contrast, (Xue et al., 2023) demonstrate that municipal government centralization can significantly enhance corporate ESG performance, suggesting that stronger coordination and administrative authority may facilitate sustainability-oriented policies. At the regional level, (Qi et al., 2022) provide evidence that government-led initiatives, such as the development of "civilized cities," encourage firms to improve ESG practices, especially in environmental dimensions. Comparative analyses further underscore the dominance of country-level drivers over firm-level characteristics. (Cai et al., 2016), examining over 2,600 firms from 36 countries, find that firm-specific factors explain only a limited portion of variation in corporate social performance (CSP), whereas country-level variables, including economic development, culture, and institutions, account for a substantial share of cross-country differences. Similarly, (Arminen et al., 2017) report that institutional quality and economic development are strongly associated with CSP, while industry effects appear relatively weak. (Martiny et al., 2024), in a recent systematic literature review, confirm that ESG measurement frameworks, legal origin, and informal institutions such as culture are critical determinants of ESG performance, identifying institutional factors as one of the most influential external drivers.

Moreover, (Crace & Gehman, 2022) emphasize that the regional environments in which organizations are embedded significantly shape ESG outcomes, reinforcing the multilevel nature of institutional influence. While internationalization can enhance CSR engagement, as shown by (Attig et al., 2014), the positive relationship is particularly strong when firms operate in countries with well-functioning political and legal institutions. This finding further highlights the enabling role of institutional quality in translating strategic expansion into stronger sustainability performance.

Overall, the literature converges on the conclusion that institutional environments, formal and informal, play a decisive role in shaping ESG performance (Ortas et al., 2018; Rau & Yu, 2023). Although internal firm characteristics such as size and financial performance remain relevant, cross-country evidence consistently suggests that external institutional factors often exert a stronger explanatory power (Fu et al., 2023; Rau & Yu, 2023). Nonetheless, the effects remain heterogeneous, pillar-specific, and contingent upon political stability, regulatory quality, cultural norms, and stages of economic development. These findings point to the importance of adopting a multilevel and context-sensitive approach when analyzing ESG performance across countries.

## **2 METHODOLOGY**

### **2.1 Research Design and Data**

This study adopts a quantitative cross-country research design, grounded in institutional theory, to investigate the association between differences in national institutional governance environments and firm-level ESG risk. It integrates country-level governance indicators from the Worldwide Governance Indicators with firm-level ESG risk scores from Sustainalytics for listed companies across various industries for 2023. The final sample comprises firms operating in European countries and Türkiye, subject to data availability.

Institutional governance quality is proxied using the Worldwide Governance Indicators for the same year, which capture key dimensions of the regulative institutional environment (Honcharenko-Zakrevska et al., 2020; Kraay et al., 2010). The analysis incorporates six WGI dimensions: rule of law, control of corruption, government effectiveness, regulatory quality, political stability, and voice and accountability. These indicators are widely used in institutional and governance research as measures of enforcement capacity, regulatory credibility, and institutional stability (Kraay et al., 2010; Nikzad, 2021). All indicators are standardized before analysis. ESG risk reflects firms' exposure to material environmental, social, and governance risks and the extent to which these risks are managed. Higher ESG risk scores indicate greater unmanaged sustainability risk. ESG risk is used as the dependent variable in the empirical analysis.

## **2.2 Cluster Analysis and ANOVA**

A k-means cluster analysis is performed on the standardized WGI indicators to identify institutional governance regimes. This approach is suitable for grouping observations based on continuous variables and delineating homogeneous institutional environments (Abderraouf et al., 2024; Chueca & Kim, 2006). Theoretical considerations and empirical fit support retaining three clusters, representing distinct levels of institutional governance quality.

A one-way analysis of variance was conducted to assess differences in ESG risk across the identified institutional governance regimes, with ESG risk as the dependent variable and cluster membership as the grouping variable. The results reveal statistically significant differences in ESG risk across the three clusters, indicating that firms' ESG risk profiles vary systematically according to institutional governance quality. This data-driven approach aligns with institutional theory by empirically capturing institutional heterogeneity rather than imposing it a priori. Ultimately, combining WGI-based clustering with ANOVA enables the clear identification of governance regimes and their links to ESG risk outcomes.

## **2.3 Limitations**

This research encounters several limitations. Firstly, institutional governance quality is proxied by the Worldwide Governance Indicators, which chiefly encompass the regulative pillar of institutions and may inadequately capture normative and cognitive dimensions (Honcharenko-Zakrevska et al., 2020; Kraay et al., 2010). Secondly, the cluster analysis draws exclusively on country-level governance metrics, thereby overlooking intra-country institutional variations. Thirdly, the cross-sectional design constrains the establishment of causality between institutional governance regimes and ESG risk. Lastly, classifying Türkiye as a standalone cluster acknowledges its unique institutional evolution but potentially diminishes comparability with European Union nations. Future investigations could mitigate these shortcomings through the adoption of longitudinal datasets, diverse institutional proxies, and firm-specific controls to more rigorously examine the interplay between institutional governance and ESG performance.

# **3 RESULTS AND DISCUSSION**

## **3.1 Stage one analysis - clustering**

Institutional theory posits that countries can be classified into distinct institutional regimes that shape firm behavior through regulatory enforcement, legitimacy expectations and governance credibility. The k-means cluster analysis based on WGI empirically identifies exactly three stratified regimes, rather than imposing them a priori. This data-driven classification reflects functional institutional similarity rather than geographic proximity. The mature institutional governance regime comprises Northern and Western European countries as well as Czechia, reflecting high levels of regulatory effectiveness, rule of law, and control of corruption. The

intermediate regime includes Southern European countries together with other Central and Eastern European economies, such as Poland and Romania, characterized by moderate institutional performance and uneven enforcement capacity. The low-capacity regime is represented by Türkiye, reflecting comparatively weaker governance quality and a distinct institutional trajectory.

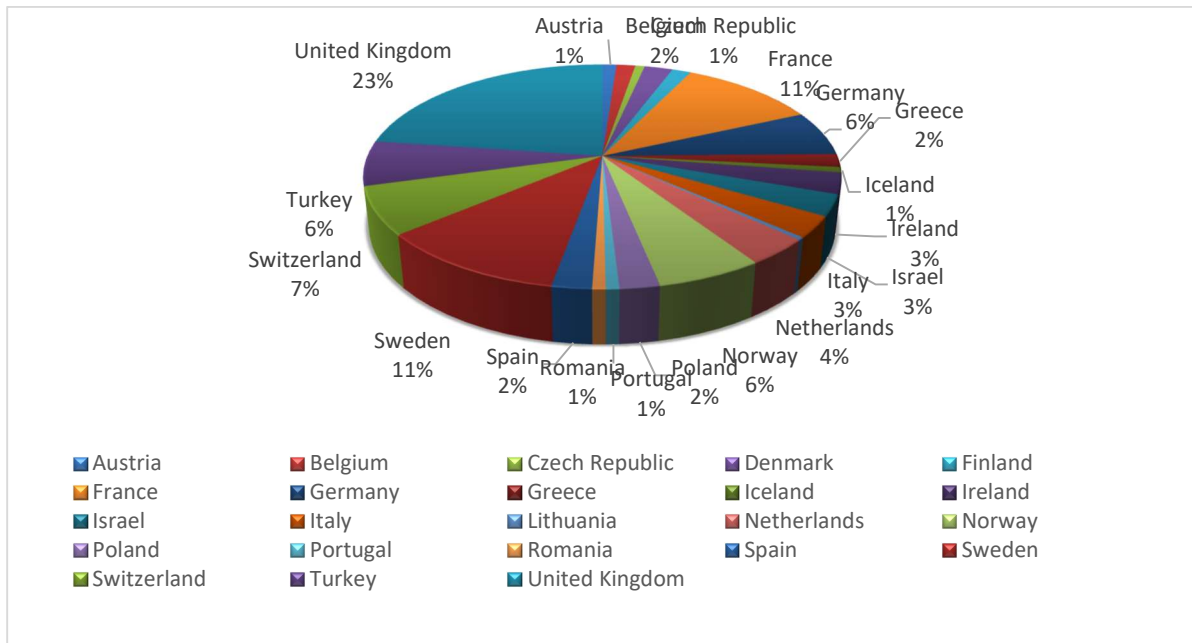
**Tab. 1 Final Cluster Centers**

	Cluster		
	1	2	3
Control of Corruption: Estimate	1.67	-.50	.55
Government Effectiveness: Estimate	1.4317	-.2479	.6384
Regulatory Quality: Estimate	1.5416	-.2295	.7571
Rule of Law: Estimate	1.5230	-.5120	.5719
Voice and Accountability: Estimate	1.4244	-.8606	.9053
Political Stability and Absence of Violence/Terrorism: Estimate	.6558	-1.0111	.0378

Source: Author's calculation

Table 1 reports the cluster centroids of the Worldwide Governance Indicators. Cluster 1 exhibits consistently high scores across all governance dimensions, indicating a mature institutional governance regime. Cluster 2 is characterized by negative values across all indicators, reflecting an intermediate institutional environment with weaker enforcement capacity and lower institutional stability. Cluster 3 displays comparatively lower and less consistent governance performance, particularly with respect to political stability, justifying its classification as a low-capacity institutional governance regime.

**Fig. 1 Sample Composition: Frequency of Firms by European Country**



Source: Author's calculation

Cluster 1 includes listed companies from Austria, Belgium, Czech Republic, Denmark, Finland, France, Germany, Iceland, Ireland, Netherlands, Norway, Sweden, Switzerland, United Kingdom. In this group from CEE countries is also included the Czech Republic, performing better than the other group countries in WGI. These countries have built a strong regulatory pillar, high enforcement credibility and internalized governance norms, not merely imposed. Cluster 2 includes Turkey, with all indicators negative, showing a high institutional volatility. Cluster 3, showing a fragmented regulatory framework, lower predictability, and a distinct institutional trajectory, includes Southern Europe countries (Italy, Spain, Portugal, Greece) and some CEE countries (Poland, Hungary, Romania, Bulgaria) and Israel.

### 3.2 Stage two analysis - ANOVA

To assess differences in ESG risk across the three institutional governance regimes derived from the cluster analysis, a one-way ANOVA was conducted. Descriptive statistics reveal mean differences of 4 to 5 units between regimes, which this test evaluates for statistical significance.

	N	Mean	Std. Deviation	Std. Error	95% Confidence Interval for Mean		Min	Max
					Lower Bound	Upper Bound		
1	209	22.74067	7.295522	.504642	21.74580	23.73554	7.100	48.100
2	17	29.80000	12.011817	2.913294	23.62409	35.97591	13.600	52.400
3	37	24.20270	9.031841	1.484826	21.19134	27.21407	10.200	43.800
Total	263	23.40266	8.085174	.498553	22.42098	24.38434	7.100	52.400

Source: Author calculations

### Tab. 3 ANOVA results

	Sum of Squares	df	Mean Square	F	Sig.
Between Groups	811.014	2	405.507	6.462	.002
Within Groups	16315.934	260	62.754		
Total	17126.948	262			

Source: Author calculations

To determine whether ESG risk varies across the institutional governance regimes, a one-way ANOVA was performed with ESG risk as the dependent variable. The results reveal statistically significant differences in ESG risk across the three clusters ( $F(2, 260) = 6.462$  ;  $p = 0.002$ ).

Firms operating in mature institutional governance regimes are subject to intensified coercive and normative pressures, which result in diminished ESG risk. Those in intermediate regimes display elevated ESG risk owing to inconsistent enforcement and incomplete

institutionalization. Firms within low-capacity regimes confront the most limited governance constraints, thereby incurring the greatest ESG risk exposure.

These results demonstrate that firms' ESG risk profiles differ systematically according to the quality of their national institutional governance environment, manifesting lower risk in more advanced regimes.

The descriptive statistics indicate a relatively high standard deviation for ESG risk in cluster 3, which represents the intermediate governance regime. This substantial variation warrants further analysis within the cluster. Although these countries exhibit similar governance indicators overall, the descriptives reveal a roughly 9-unit difference in ESG risk between firms operating in Southern European countries and those in Central and Eastern European countries.

**Tab. 4 Descriptives of ESG risk of companies in the intermediate governance regime**

	classification	N	Mean	Std. Deviation	Std. Error Mean
ESG score	SE	21	19.61905	5.883249	1.283830
	CEE	11	28.53636	9.156448	2.760773

Source: Author calculations

**Tab. 5 Independent Samples Test**

		Levene's Test for Equality of Variances		t-test for Equality of Means				
		F	Sig.	t	df	Sig. (2-tailed)	Mean Difference	Std. Error Difference
ESG risk score	Equal var	2.507	0.124	-3.354	30	0.002	-8.91732	2.658566
	Not Equal var			-2.929	14.455	0.011	-8.91732	3.044682

Source: Author calculations

Due to the substantial variability in ESG risk scores within the intermediate institutional governance cluster, an independent samples t-test was conducted to compare firms headquartered in Southern Europe and Central and Eastern Europe. Levene's test confirmed the assumption of equal variances. The results indicate a statistically significant difference between the regions ( $t(30) = -3.354$ ,  $p = 0.002$ ). Firms based in Central and Eastern Europe exhibited markedly higher ESG risk than their Southern European counterparts, with a mean difference of 8.92 points. These results demonstrate substantial regional heterogeneity in ESG risk even within a single institutional governance regime, underscoring the influence of supplementary external factors.

## CONCLUSIONS

*Policy Implications* The findings of this study carry important implications for policymakers operating across heterogeneous institutional governance contexts. First, the results emphasize

that mere formal alignment with supranational regulatory frameworks, such as those of the European Union, is insufficient to ensure lower ESG risk. Instead, the effectiveness of enforcement mechanisms and the credibility of institutions emerge as decisive factors. Policymakers, particularly in intermediate governance regimes, should therefore prioritize strengthening regulatory enforcement capacity, reducing institutional inconsistencies, and enhancing transparency and accountability mechanisms.

Second, the observed heterogeneity within the intermediate regime suggests that “one-model-fits-all” policy approaches may be ineffective. Countries in Central and Eastern Europe, despite similar formal governance structures to Southern European nations, exhibit higher ESG risk levels. This indicates that policy design must account for region-specific structural conditions, including historical transition paths, economic composition, and exposure to environmental vulnerabilities. Tailored policy interventions that integrate these contextual factors are more likely to yield substantive improvements in corporate ESG performance.

Finally, in low-capacity institutional environments, such as those identified in the study, improving political stability and institutional credibility should be considered foundational priorities. Without these, ESG-related regulations risk remaining symbolic rather than transformative. Overall, the findings call for a more nuanced and context-sensitive policy framework that moves beyond formal institutional metrics to address deeper structural and governance-related constraints.

*Stakeholder Implications* From a managerial perspective, this study highlights the critical importance of aligning corporate ESG strategies with the specific institutional governance context in which firms operate. Companies in mature institutional regimes benefit from strong regulatory frameworks and stakeholder pressures that incentivize substantive ESG integration. Managers in these contexts should therefore focus on advancing beyond compliance, leveraging ESG practices as a source of competitive advantage and long-term value creation.

In contrast, firms operating in intermediate governance regimes face more ambiguous institutional pressures, where formal requirements coexist with weaker enforcement. In such environments, there is a heightened risk of adopting selective or symbolic ESG practices. However, the findings suggest that firms that proactively internalize ESG principles, beyond minimum compliance, can mitigate risk exposure and strengthen their credibility with international investors and stakeholders.

For firms in low-capacity institutional contexts, the challenge is even more pronounced. Limited institutional support and weaker governance structures increase exposure to ESG risks, making internal governance mechanisms and voluntary standards particularly important. Managers should therefore consider adopting internationally recognized ESG frameworks and strengthening internal controls to compensate for external institutional deficiencies.

Across all regimes, the results underscore that ESG risk is not solely firm-specific but is deeply embedded in broader institutional environments. Consequently, managers and investors must incorporate institutional regime analysis into their risk assessment and strategic decision-making processes, recognizing the interplay between governance quality, regional characteristics, and corporate sustainability outcomes.

Future research should expand the empirical scope by incorporating longitudinal data to examine how changes in institutional governance over time influence ESG risk dynamics and corporate adaptation strategies. Additionally, integrating firm-level internal governance variables with macro-institutional indicators could provide a more comprehensive understanding of the interaction between organizational practices and broader structural environments.

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