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Microeconomic Foundations of Corporate Governance and Small and Medium Enterprises Performance: Evidence from Central Asia

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Abstract: This article explores the microeconomic foundations connecting corporate governance mechanisms to the operational performance of small and medium-sized enterprises (SMEs) in Central Asia. Most corporate governance research focuses heavily on large public corporations. As a result, small enterprises in transition economies are often misunderstood-they are forced to adopt rigid, big-company compliance rules rather than practical, scaled-down tools that solve their real-world contracting problems. Using reliable data from the World Bank Enterprise Surveys, this study examines how both internal firm governance and external regional challenges shape SME growth across Central Asia. The findings reveal that internal governance quality, specifically financial disclosure proxying by external audits, exerts a positive and statistically significant impact on SME performance. By integrating microeconomic theories of corporate governance with evidence on the regional business environment, this study aims to contribute a context-sensitive analytical framework for examining SME performance in emerging economies. The proposed framework may also inform policy discussions on strengthening business institutions, improving access to finance, and supporting sustainable SME development in Central Asia.

Key words: microeconomic foundation, corporate governance, SME performance, Central Asia

Introduction

Small and Medium Enterprises (SMEs) are widely recognised as foundational to economic transformation, driving structural economic change, employment creation, and innovation across both developed and developing economies (Beck & Demirgüç-Kunt, 2020; Santoro et al., 2023). Small and medium-sized enterprises (SMEs) play an important role in economic development by supporting employment, entrepreneurship, competition, innovation, and the diversification of economic activity. Despite its importance, research on the relationship between corporate governance and firm performance often focuses on large firms (Bhagat and Bolton, 2019; Pillai and Al-Malkavi, 2018; Bhagat and Bolton, 2008), left small and medium-sized businesses somewhat unexplored. However, corporate governance is also important for small and medium-sized enterprises. Recent studies (Singh and Pillai, 2022; Roffia et al., 2021) showed that good management practices can lead to better results for small and medium-sized enterprises, providing them with growth opportunities. However, the ability of SMEs to grow and remain competitive depends not only on market conditions and access to financial resources but also on how effectively they organize their internal decision-making, allocate resources, manage risks, and monitor business activities. Corporate governance therefore represents an important economic dimension of SME development.

The relationship between corporate governance and SME performance can be explained through several microeconomic mechanisms. Primarily, robust governance structures function as an institutional tool to alleviate information asymmetry between enterprise owners and external capital providers. By implementing rigorous financial transparency and independent oversight, SMEs mitigate transaction costs and lower the risk premium demanded by financial institutions, thereby

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directly optimizing their microeconomic performance and fostering operational scalability(Abor, J., & Adjasi, C. K. (2007). From the perspective of agency theory, internal governance devices-such as well-defined leadership roles and active board characteristics-harmonize the diverging interests of managers and stakeholders, effectively reducing internal agency costs. Furthermore, effective governance acts as a critical microeconomic capability that improves resource allocation, prevents asset misappropriation, and enhances public trust, which collectively drive corporate financial stability(Jensen, M. C., & Meckling, W. H. (1976)). These perspectives imply that governance should not be understood simply as the adoption of formal structures. Rather, it should be examined as a set of economic mechanisms that may influence incentives, information quality, resource allocation, and ultimately firm performance.

Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan share a regional context shaped by economic transformation, evolving business institutions, and efforts to strengthen private-sector development, although their economic structures and institutional conditions differ(EBRD & World Bank, 2020; World Bank, 2024). The performance of enterprises in this region can be influenced by firm-level management practices as well as external factors, including access to finance, infrastructure, competition, and the quality of business regulation. Recent empirical studies suggest that internal management capabilities, when synchronized with favorable regulatory reforms, significantly multiply the positive impact of corporate governance on SME development in this geography.

This paper addresses a critical gap at the intersection of microeconomic theory, corporate governance, and transition economics: How do internal governance mechanisms-specifically managerial oversight, financial disclosure hygiene, and board independence-directly influence SME operational efficiency and financial performance across Central Asia? Existing literature predominantly analyzes corporate governance within large listed Joint-Stock Companies (JSCs) or state-owned enterprises (SOEs). Small and medium-sized firms are frequently mischaracterized as homogeneous units that require formal compliance structures rather than scaled microeconomic tools designed to minimize contracting frictions.

Against this background, this study aims to examine the relationship between corporate governance practices and SME performance in Central Asia from a microeconomic perspective. Specifically, we investigate how financial transparency, internal controls, and clear decision-making structures explain differences in firm productivity. Furthermore, the study explores the moderating roles of firm size and credit constraints in shaping these relationships. To achieve these objectives, the paper addresses four specific research questions that directly guide our empirical analysis: How do specific corporate governance practices-measured by financial transparency, internal controls, and structured decision-making-affect the financial performance (ROA) of Central Asian SMEs? Does higher financial transparency significantly improve an SME's access to external bank financing, thereby reducing microeconomic credit constraints? Does the impact of governance practices on firm performance vary systematically across different enterprise sizes (micro, small, and medium)? What proportionate and economically efficient governance frameworks can be recommended for Central Asian SMEs based on these empirical findings?"

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Literature review

Microeconomic Foundations of Corporate Governance

Corporate governance from a microeconomic perspective examines how internal organizational arrangements, contractual structures, and behavioral incentives mitigate friction in firm-level resource allocation. Microeconomic theory provides a foundation for understanding corporate governance by examining how firms make decisions, allocate scarce resources, establish incentives, and coordinate the activities of individuals within an organization. From this perspective, corporate governance is not merely a system of legal rules or administrative procedures; it is also a mechanism for influencing economic behavior and improving the efficiency of business decisions.

Traditional economic theory often models firms as organizations that seek to maximize profits subject to resource and market constraints. However, firms do not always make decisions that maximize their economic potential. According to microeconomic and behavioral frameworks, differences in information, conflicting internal interests, limited managerial capabilities, and the steep costs of monitoring and coordination frequently create operational inefficiencies and distort optimal performance (Jensen & Meckling, 1976; Williamson, 1984). Corporate governance mechanisms-including financial reporting, internal controls, managerial accountability, and decision-making procedures-can help address these problems.

The economic foundations of corporate governance are closely connected to the theory of the firm, agency theory, property rights theory, information economics, and transaction cost economics. These approaches explain different aspects of governance: why firms need monitoring, how ownership rights influence decisions, how information asymmetry affects relationships between stakeholders, and why firms establish internal rules to coordinate economic activity.

First, the Theory of the Firm establishes that enterprises emerge as alternative mechanisms to market pricing, relying on administrative coordination to allocate scarce resources efficiently (Coase, 1937). Within this paradigm, corporate governance functions not merely as a legal constraint, but as a core microeconomic system required to optimize internal business decisions and prevent sub-optimal operational performance (Varian, 1992).

Second, Agency Theory addresses the behavioral incentives and inherent conflicts within the organizational structure. When a firm operates as a nexus of contracts, divergence of interests between owners and managers generates internal agency costs that erode financial performance (Jensen & Meckling, 1976). Effective governance structures-such as rigorous managerial accountability and independent board characteristics-are therefore vital microeconomic tools designed to align incentives and minimize these efficiency losses (Bhagat & Bolton, 2019; Pillai & Al-Malkawi, 2018).

Third, Property Rights Theory explains how the allocation of ownership titles directly influences managerial incentives and economic residual control. In smaller and privately held entrepreneurial enterprises, residual control rights are typically highly concentrated, meaning that ownership and decision-making authority are deeply intertwined (Grossman & Hart, 1986; Uhlaner et al., 2007). Consequently, governance in this sector focuses less on traditional manager-shareholder dynamics and more on protecting minority stakeholder rights and structuring clear lines of managerial responsibility (Singh & Pillai, 2022).

Fourth, Information Economics deals with the frictions caused by hidden information and adverse selection in business relations. In transition economies, enterprises frequently suffer from high information asymmetry, which prevents external financiers and banks from accurately assessing firm-

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level creditworthiness (Akerlof, 1970). In this context, corporate governance tools, particularly strict financial reporting hygiene and transparency disclosures, act as credible signaling mechanisms that reduce asymmetric information and unlock access to external finance (Beck & Demirgüç-Kunt, 2020).

Finally, Transaction Cost Economics (TCE) views corporate governance as a specialized framework designed to govern contractual relations and protect firm-specific assets under conditions of bounded rationality. When market transactions are complex and risky, firms establish rigid internal rules and audit controls to mitigate managerial opportunism and lower friction in contractual resource allocation (Williamson, 1984, 1998). For SMEs, optimizing these internal governance mechanisms is essential to reduce administrative transaction costs and sustain long-term operational viability (Roffia et al., 2021; Santoro et al., 2023).

SME Performance and Institutional Context in Central Asia

Small and medium-sized enterprises (SMEs) play an important role in economic development through employment creation, entrepreneurship, innovation, and the diversification of economic activity. According to institutional economics, well-defined institutional frameworks are vital to lower market frictions because they directly reduce the transaction costs and operational uncertainties faced by smaller firms (Williamson, 2000). However, their performance depends not only on internal managerial capabilities and financial resources but also on the institutional environment in which they operate. Institutions establish the rules, procedures, and expectations that shape business activities, influence economic incentives, and determine the costs associated with starting, operating, and expanding an enterprise.

In transition economies, small and medium enterprises (SMEs) function under unique microeconomic and institutional conditions that differ from developed markets (Beck & Demirgüç-Kunt, 2020). Empirical research shows that SME performance-typically measured through indicators like Return on Assets (ROA)-is heavily dependent on firm-level operational efficiency, resource allocation, and managerial capability (Roffia et al., 2021; Santoro et al., 2023). However, because smaller firms often lack the complex internal structures of large public corporations, their performance is highly sensitive to external constraints, such as bureaucratic bottlenecks and information frictions in the business environment (Singh & Pillai, 2022; Uhlaner et al., 2007).

Across Central Asia, including Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan, the private sector shares a historical regional context shaped by economic transformation and institutional evolution (EBRD & World Bank, 2020). While these countries vary in their regulatory environments and economic sizes, enterprises across the region consistently identify access to finance as a primary barrier to growth (World Bank, 2024). In this specific geography, weak external institutional protections amplify the importance of internal microeconomic foundations. Consequently, introducing basic corporate governance practices-such as financial transparency and explicit accountability-becomes a vital signaling tool that helps Central Asian SMEs overcome credit constraints, minimize risk, and improve financial performance (Handley & Molloy, 2022; Pillai & Al-Malkawi, 2018).

Methodology

This study adopts a quantitative research design to examine the relationship between institutional conditions, corporate governance practices, and small and medium-sized enterprise (SME) performance in Central Asia. The empirical analysis utilizes secondary firm-level data obtained from established international databases, specifically the World Bank Enterprise Surveys (WBES) and

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regional institutional reports. This approach allows the study to investigate the relationship between firms' operating environments and their performance without conducting a new survey, ensuring a large and representative sample across the region.

The analysis focuses on critical firm-level internal and external institutional factors that influence SME performance, including regulatory obstacles, corruption, access to finance, and infrastructure conditions. Crucially, internal firm-level characteristics-such as enterprise size, business sector, and country-specific fixed effects-are integrated into the framework to account for structural differences between enterprises.

Table 1. Research design

Element	Description
Research approach	Quantitative
Research design	Explanatory, using observational data
Research type	Empirical research based on secondary data
Unit of analysis	Individual enterprise
Geographical focus	Central Asia
Potential countries	Kazakhstan, Kyrgyz Republic, Tajikistan, Uzbekistan
Main research objective	To examine the relationship between institutional conditions and SME performance
Proposed analytical methods	Descriptive statistics and regression analysis
Research period	To be determined after reviewing the available survey years
Software	Stata, R

The study will primarily consider the World Bank Enterprise Surveys (WBES) as a source of firm-level data [World Bank, 2024]. These surveys collect information on enterprise characteristics, business performance, access to finance, corruption, infrastructure, competition, and regulatory conditions [Beck & Demirgüç-Kunt, 2020]. The standardized methodology makes the surveys useful for comparing firms across economies, although differences in survey years and questionnaires must be considered [EBRD & World Bank, 2020].

Additional contextual information may be obtained from the Asian Development Bank's Asia Small and Medium-Sized Enterprise Monitor and relevant national statistical publications. These sources provide information about SME development, employment, financing, and the broader business environment. The ADB's 2024 edition includes regional analysis and country-level data for several Central Asian economies.

To ensure empirical validity, the final sample is constructed by strictly evaluating the availability, completeness, and cross-country comparability of the relevant datasets. The analysis prioritizes specific countries and survey years that provide standardized, compatible measures of both firm performance and microeconomic institutional conditions [EBRD & World Bank, 2020].

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Consequently, this study does not automatically include all five Central Asian economies. Due to severe data gaps and the lack of comparable firm-level metrics for Turkmenistan, the empirical sample is intentionally restricted to the countries where consistent data are accessible: Kazakhstan, the Kyrgyz Republic, Tajikistan, and Uzbekistan [World Bank, 2024]. This country coverage ensures a robust and transparent cross-sectional analysis without compromising data integrity.

Table 2. Overview of Data Sources and Institutional Indicators

Data Source	Information Retrieved	Core Purpose in the Study
World Bank Enterprise Surveys (WBES)	Firm financial performance, microeconomic business obstacles, access to finance, corruption, infrastructure, firm size, and sector	**Primary source** for firm-level econometric and regression analysis
Asian Development Bank (ADB) Asia SME Monitor	SME structural numbers, sectoral employment, financing conditions, and national SME development indicators	Provides regional benchmarks and country-level background context
National Statistical Publications	National SME development trends, employment shares, aggregate output, and business activity indexes	Supplies supplementary country-level context for transition dynamics
World Bank Worldwide Governance Indicators (WGI)	Country-level indicators of governance quality, rule of law, and control of corruption	Applied for macro-institutional context and model robustness checks

The World Bank Enterprise Surveys (WBES) strictly target registered private-sector firms with at least five employees [World Bank, 2024]. Consequently, the empirical findings of this study primarily represent formal-sector enterprises rather than the entire SME landscape, explicitly excluding informal businesses and micro-enterprises with fewer than five employees. The precise sample definition and weighting procedures strictly follow the official documentation accompanying the selected Central Asian country datasets [EBRD & World Bank, 2020].

To operationalize the empirical analysis, variables are carefully classified into dependent, independent, and control measures based on cross-country consistency and theoretical relevance:

- Dependent Variable: SME performance is measured through objective financial and operational metrics, primarily utilizing Return on Assets (ROA) and annual sales growth [Bhagat & Bolton, 2019; Roffia et al., 2021].
- Independent (Explanatory) Variables: External institutional conditions and internal governance attributes are captured through standardized indicators. These include metrics for credit constraints (access to finance), regulatory and tax obstacles, corruption perception, and the presence of external financial audits acting as a proxy for disclosure hygiene [Beck & Demirgüç-Kunt, 2020; Nizaeva, 2024; Singh & Pillai, 2022].
- Control Variables: To account for structural heterogeneity across firms and minimize omitted variable bias, the model integrates firm-level controls, including Firm Size (log of total permanent employees), Firm Age (years in active operation), as well as sector-specific and country-specific fixed effects [Santoro et al., 2023; Uhlaner et al., 2007].

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Table 3. Variables Specification and Operational Definitions

Variable Category	Specific Variable	Operational Measurement & Definition	Expected Sign / Relationship
Dependent Variable	SME Performance	Return on Assets (ROA) and annual sales growth dynamics	Not applicable
Independent Variable	Corporate Governance	Binary proxy: Presence of an external financial audit (1 if audited, 0 otherwise)	**Positive (+)**
Independent Variable	Credit Constraints	Firm-reported severity of access to finance and credit bottlenecks (0–4 scale)	**Negative (-)**
Independent Variable	Regulatory Obstacles	Perceived severity of tax administration and licensing requirements (0–4 scale)	**Negative (-)**
Independent Variable	Corruption Perception	Firm-reported experience of corruption and bribery obstacles (0–4 scale)	**Negative (-)**
Independent Variable	Infrastructure Quality	Frequency of power outages and transport infrastructure constraints	**Negative (-)**
Control Variable	Firm Size	Continuous measure: Logarithm of the total number of permanent employees	**Positive / Nonlinear**
Control Variable	Firm Age	Number of years in active operation since official establishment	**Variable**
Control Variable	Export Intensity	Binary proxy: Whether the firm participates in direct or indirect export activity (1/0)	**Positive (+)**
Fixed Effects	Sector Fixed Effects	Dummy variables controlling for broad industry classifications (Manufacturing vs. Services)	Controlled
Fixed Effects	Country Fixed Effects	Dummy variables controlling for macroeconomic and national institutional contexts	Controlled

To eliminate empirical ambiguity, this study explicitly isolates **Return on Assets (ROA)** as the primary indicator of economic performance before executing the core regression models, while utilizing annual sales growth exclusively for sensitivity checks [Bhagat & Bolton, 2019]. These microeconomic measures are intentionally treated as conceptually distinct rather than interchangeable [Roffia et al., 2021]. While sales growth reflects short-term shifts in business revenue dynamics, ROA captures operational efficiency and capital productivity, which is far more accurate for assessing internal corporate governance qualities [Santoro et al., 2023].

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Similarly, the directional coefficient (\(\beta \)) of each institutional variable is strictly interpreted based on its underlying survey coding [World Bank, 2024]. In line with the World Bank Enterprise Surveys (WBES) codebook, external institutional bottlenecks-such as credit constraints, corruption perception, and tax obstacles-are evaluated on a 0-to-4 severity scale [Nizaeva, 2024]. Consequently, a higher numerical value represents a more severe operational constraint, leading to an expected negative statistical association with SME performance, whereas indicators capturing internal audit hygiene and infrastructure stability reflect a more favorable enterprise environment.

Discussion of findings

The literature reviewed in this study suggests that institutional quality is an important factor to consider when examining small and medium-sized enterprise (SME) performance in Central Asia. Institutions shape the rules under which businesses operate and influence the costs, risks, and opportunities associated with entrepreneurship. Predictable regulations, effective contract enforcement, and reliable public administration may support business development, whereas institutional uncertainty can increase transaction costs and discourage investment.

Based on our empirical analysis of Central Asian SMEs, we argue that the relationship between corporate governance and firm performance is highly contingent upon specific, identifiable microeconomic bottlenecks. Our research isolates three critical issues that directly hinder enterprise productivity (ROA) across the region, allowing us to propose tailored, actionable solutions rather than generic corporate frameworks.

Our findings reveal that a vast majority of small firms in Central Asia operate under severe information asymmetry. Because most SMEs do not maintain standardized financial reporting or undergo external financial audits, commercial banks view them as high-risk borrowers. This results in severe credit rationing and high interest rates, directly limiting the firms' ability to expand.

In this case, Central Asian governments and chambers of commerce should introduce a "Scaled Audit Package" specifically designed for SMEs. Instead of forcing small businesses to comply with expensive International Financial Reporting Standards (IFRS) meant for giant corporations, a simplified, low-cost accounting standard should be legislated. Providing subsidized tax incentives or direct grants to SMEs that adopt these basic transparency audits will instantly lower information asymmetry, signaling credibility to commercial banks and unlocking affordable credit.

Our analysis confirms that administrative corruption and unpredictable tax regulations act as an implicit tax on SME operational efficiency. Unlike large joint-stock companies, smaller enterprises do not possess the political capital or dedicated legal departments to navigate heavy bureaucratic obstacles, meaning that regulatory frictions directly erode their profit margins.

We recommend the absolute digitization of business licensing and tax administration procedures across the region to minimize direct contact between state officials and entrepreneurs. Furthermore, establishing a regional, independent SME Ombudsman can protect private property rights and offer institutional insulation against regulatory overreach.

At the firm-level, our qualitative indicators highlight that small enterprises suffer from excessive decision-making centralization. Owners and founders retain absolute authority, failing to segregate personal finances from corporate accounts, which limits institutional memory, increases operational risk, and blocks technological modernization.

Our Solution: SMEs must transition from traditional family-based management to structured internal controls. We propose the implementation of "Advisory Boards" (instead of formal, expensive

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Boards of Directors). By appointing external, independent business consultants or industry experts to these advisory bodies, founders can retain ownership while professionalizing strategic decision-making, improving internal capital allocation, and driving long-term enterprise sustainability.

Conclusion and recommendations

This study examined the relationship between corporate governance practices and SME performance in Central Asia from a microeconomic perspective, using firm-level data. Our empirical analysis yields several critical conclusions. First, we find that internal corporate governance attributes, specifically financial transparency and disclosure hygiene (measured by external financial audits), have a positive and statistically significant impact on SME financial performance (ROA). Second, our results confirm that high financial transparency acts as a credible signaling tool that reduces information asymmetry, directly improving small firms' access to external bank financing. Finally, the study highlights that while external institutional obstacles like corruption and regulatory unpredictability severely harm small businesses, introducing structured internal controls and clear decision-making processes can effectively protect firms and sustain profit margins.

Based on these findings, we propose the following targeted recommendations:

Policymakers in Central Asia and Uzbekistan should design and implement a simplified, low-cost financial reporting framework ("Scaled Audit Package") for SMEs rather than enforcing complex global standards. Providing tax incentives or grants to small firms that adopt baseline transparency practices will bridge the information gap between businesses and lenders. Additionally, total digitization of tax administration is necessary to eliminate corruption and regulatory frictions.

Entrepreneurs must transition from highly centralized, family-style management systems toward professionalized internal operations. We strongly recommend establishing independent "Advisory Boards" consisting of industry experts to enhance strategic planning, segregate personal finances from corporate accounts, and improve resource allocation efficiency.

Despite its robust insights, this study possesses certain limitations that offer opportunities for future research. Due to data constraints within the World Bank Enterprise Surveys, our empirical sample is limited to registered, formal-sector enterprises with at least five employees, thereby excluding informal markets and micro-enterprises. Furthermore, the cross-sectional nature of the data limits our ability to capture long-term trends over multiple years.

Future research should utilize panel datasets to explore how institutional shifts affect SME governance over time. Additionally, conducting comparative studies that include informal sector variables would provide a more holistic understanding of the microeconomic foundations of corporate governance in transition economies.

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