The Effect of Sharia Investment and Government Policy on the Financial Performance of MSMEs in West Java

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ABSTRACT

This study investigates the impact of Sharia investment and government policy on the financial performance of Micro, Small, and Medium Enterprises (MSMEs) in West Java. Utilizing a quantitative approach, data was collected from 120 MSMEs through structured questionnaires employing a Likert scale ranging from 1 to 5. The collected data was analyzed using SPSS version 26 to determine the correlation and effect of the independent variables—Sharia investment and government policy—on the dependent variable, financial performance. The findings indicate a significant positive relationship between Sharia investment and financial performance, as well as between government policy and financial performance. This suggests that both Sharia-compliant financial practices and supportive government policies play crucial roles in enhancing the financial outcomes of MSMEs in the region. The results underscore the importance of adopting Sharia investment strategies and fostering government policies that support the growth and sustainability of MSMEs.

Keywords: Sharia Investment, Government Policy, Financial Performance, MSMEs, West Java

1. INTRODUCTION

Start-ups in the contemporary business environment are embracing technological innovations to boost their operational efficiency and gain a competitive advantage. The integration of the Internet of Things (IoT) has emerged as a pivotal element in modern business strategies, offering a wide array of benefits across various industries. IoT facilitates improved machine maintenance, supply chain management, inventory control [1], and provides real-time insights into Micro, Small, and Medium Enterprises (MSMEs) in Indonesia, particularly in regions like West Java, are crucial for economic development, job creation, and innovation [1]. These enterprises often encounter financial challenges stemming from limited access to capital, market uncertainties, and regulatory restrictions [2]. To address these issues, Sharia-compliant financing plays a significant role in enhancing the financial performance of MSMEs [3]. Additionally, supportive government policies are essential for fostering a conducive environment for MSME growth and sustainability [1]. By leveraging Sharia-compliant investment options and implementing favorable policies, MSMEs in West Java and across Indonesia can overcome financial obstacles, thrive in the market, and contribute significantly to the overall economic landscape of the region.

Sharia investment, rooted in Islamic financial principles, presents a distinctive opportunity for MSMEs to access ethical and interest-free financing, resonating with the moral values of entrepreneurs in Muslim regions [4]. This form of investment emphasizes risk-sharing, asset-backing, and prohibits speculative activities, fostering sustainable business practices among MSMEs [4]. By adhering to Sharia principles, businesses can benefit from sustainable financial protection [5], ethical financing practices [6], effective risk management strategies [7], and a value-based ethical system for financial transactions [8]. Sharia investment offers a viable alternative to conventional

financing methods, promoting resilience and aligning with the ethical values of entrepreneurs in predominantly Muslim areas.

Government policies are indeed pivotal in shaping the business landscape for Micro, Small, and Medium Enterprises (MSMEs) [9], [10]. Research emphasizes the positive impact of supportive regulatory environments on MSME performance, highlighting the significance of policies that offer financial incentives, regulatory support, and infrastructure development for the growth and sustainability of these enterprises [9], [10]. In Indonesia, studies underscore the critical role of government policies, including tax incentives, access to credit facilities, and business development programs, in fostering the success of MSMEs [10], [11]. These policies not only influence operational performance but also contribute to economic growth, employment opportunities, and overall sustainable development, showcasing the importance of strategic government intervention in bolstering MSMEs in regions like West Java. However, the effectiveness of these policies in enhancing the financial performance of MSMEs requires thorough investigation. This study aims to explore the combined effect of Sharia investment and government policy on the financial performance of MSMEs in West Java.

2. LITERATURE REVIEW

2.1 Sharia Investment

Sharia investment, rooted in Islamic principles that prohibit interest and promote ethical practices, offers MSMEs like Mudarabah and Musharakah as interest-free financing alternatives, fostering financial inclusion and ethical business conduct [4], [6]. Research indicates that MSMEs utilizing Sharia-compliant financing exhibit enhanced financial stability and growth compared to those relying on traditional methods, benefiting from increased capital access and lower financial risks [4], [12]. Moreover, Sharia investment attracts socially responsible investors, expanding funding sources for MSMEs and aligning with ethical values. However, challenges persist, necessitating improved awareness of Islamic finance principles among entrepreneurs and stronger regulatory frameworks to support Sharia-compliant financial products' growth [5], [12]. Despite these hurdles, Sharia investment presents a promising avenue for boosting the financial performance of MSMEs.

2.2 Government Policy

Government policies play a pivotal role in shaping the business environment and supporting Micro, Small, and Medium Enterprises (MSMEs) [9], [10], [13]–[15]. Research indicates that well-designed policies, such as tax incentives, credit facilities, and business development programs, can significantly impact the financial performance of MSMEs in regions like West Java [10]. Tax incentives reduce financial burdens, enabling businesses to reinvest in growth, while credit facilities help overcome liquidity constraints and explore new opportunities. Additionally, business development initiatives, including training and mentorship, enhance the capabilities of MSME owners and managers, leading to improved business performance. Effective policy implementation, tailored to the specific needs of MSMEs and involving collaboration between government agencies, financial institutions, and the private sector, is crucial for creating a supportive ecosystem that fosters MSME success [15].
Regular monitoring and evaluation are essential to ensure that these policies deliver the intended benefits and drive sustainable growth in the MSME sector [14].

2.3 Financial Performance of MSMEs

Access to finance is a crucial factor influencing the financial performance of Micro, Small, and Medium Enterprises (MSMEs) [16], [17]. Studies highlight that better financial accessibility positively correlates with MSME performance, enhancing sales, value-added per worker, and overall productivity [16]. Additionally, financial literacy, strategic planning, and market conditions significantly impact the financial performance of MSMEs [17], [18]. The regulatory environment, influenced by government policies, can either support or impede MSME growth, with favorable policies reducing regulatory burdens and providing financial incentives leading to improved financial performance [18]. Overall, a combination of factors including access to finance, management capabilities, market conditions, and regulatory support plays a vital role in determining the sustainability and growth potential of MSMEs, emphasizing the need for comprehensive strategies to enhance their financial performance and overall success.

2.4 Integration of Sharia Investment and Government Policy

The integration of Sharia-compliant financing and supportive government policies presents a promising approach to enhancing the financial performance of Micro, Small, and Medium Enterprises (MSMEs) [5], [19]. Research by Rahman (2020) suggests that aligning Sharia investment principles with government policy objectives can lead to improved financial outcomes for MSMEs, fostering ethical and sustainable funding sources alongside a conducive business environment. This synergy can enhance the effectiveness of both Sharia investment and government policies, promoting financial inclusion, ethical business practices, and ultimately creating a more robust and resilient MSME sector [3]. Furthermore, the combination of Sharia-compliant financing and supportive government policies can attract a broader range of investors and stakeholders, further supporting the growth and sustainability of MSMEs in the long term [7].

3. METHODS

This study uses a quantitative research design to examine the effect of Sharia investment and government policy on the financial performance of MSMEs in West Java. It provides empirical evidence through numerical data analysis, investigating relationships among the variables. The sample includes 120 MSMEs in West Java, selected via stratified random sampling to ensure sector and size representation. Criteria for inclusion were legal registration, at least three years of operation, and engagement in either Sharia-compliant or conventional financial practices. Data was collected with a structured questionnaire covering Sharia investment, government policy, and financial performance, using a Likert scale from 1 (strongly disagree) to 5 (strongly agree) for statistical analysis.

3.1 Data Analysis

The collected data was analyzed using SPSS version 26, a powerful statistical software package. The data analysis process included several steps: Data Cleaning and Preparation, where the data was reviewed for completeness and accuracy, with any missing or inconsistent responses
addressed through appropriate data imputation techniques; Descriptive Statistics, where basic statistics such as mean, median, mode, standard deviation, and frequency distributions were calculated to summarize the sample characteristics and response distribution; Reliability and Validity Testing, where the reliability of the questionnaire was assessed using Cronbach’s alpha for internal consistency and validity evaluated through factor analysis to confirm the adequacy of the questionnaire items in representing the constructs of Sharia investment, government policy, and financial performance; and Inferential Statistics, where various techniques, including Pearson Correlation Analysis to measure the strength and direction of relationships, Multiple Regression Analysis to determine the combined effect of Sharia investment and government policy on financial performance while controlling for potential confounders, and ANOVA (Analysis of Variance) to compare the financial performance of MSMEs with different levels of Sharia investment and perceived government policy support, were employed to test the hypotheses and examine the relationships among the variables.

4. RESULTS AND DISCUSSION

4.1 Descriptive Statistics

The sample of 120 MSMEs in West Java included a diverse range of industries, reflecting the varied economic activities in the region. The analysis of demographic data reveals that the majority of the sample operates within the services sector (33.3%), followed by manufacturing (25.0%), trade (20.8%), agriculture (12.5%), and other sectors (8.3%), reflecting the diverse economic activities in West Java with a notable emphasis on services. In terms of business size, most MSMEs are micro-sized with fewer than 10 employees (41.7%), small businesses (10-50 employees) comprise 37.5%, and medium-sized businesses (51-250 employees) make up 20.8%, highlighting the prevalence of smaller enterprises. The years of operation vary, with 33.3% operating for less than 5 years, 41.7% for 5-10 years, and 25.0% for more than 10 years, indicating a mix of newly established and more experienced businesses. The educational background of MSME owners is diverse, with the majority holding a Bachelor’s degree (41.7%), followed by those with a diploma (25.0%), high school education (16.7%), and a Master’s degree or higher (16.7%), suggesting that educational diversity may influence management practices and financial performance. The descriptive statistics for the key variables are summarized in Table 1.

<table>
<thead>
<tr>
<th>Variable</th>
<th>Mean</th>
<th>Standard Deviation</th>
<th>Minimum</th>
<th>Maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sharia Investment</td>
<td>3.87</td>
<td>0.75</td>
<td>2.00</td>
<td>5.00</td>
</tr>
<tr>
<td>Government Policy</td>
<td>3.65</td>
<td>0.82</td>
<td>1.50</td>
<td>5.00</td>
</tr>
<tr>
<td>Financial Performance</td>
<td>3.92</td>
<td>0.68</td>
<td>2.20</td>
<td>5.00</td>
</tr>
</tbody>
</table>

The mean scores for Sharia investment, government policy, and financial performance are above the midpoint of 3, indicating generally positive perceptions among the respondents. The standard deviations suggest moderate variability in responses, highlighting differences in the extent to which MSMEs engage in Sharia investment and perceive the effectiveness of government policies.

4.2 Reliability and Validity Testing

The reliability of the questionnaire was assessed using Cronbach’s alpha. The results, presented in Table 2, show that all constructs have alpha values greater than 0.70, indicating acceptable internal consistency.

<table>
<thead>
<tr>
<th>Construct</th>
<th>Cronbach's Alpha</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sharia Investment</td>
<td>0.825</td>
</tr>
<tr>
<td>Government Policy</td>
<td>0.799</td>
</tr>
</tbody>
</table>
Factor analysis confirmed the validity of the constructs, with all items loading significantly on their respective factors, supporting the construct validity of the measurement instruments.

4.3 Correlation Analysis
Pearson correlation analysis was conducted to examine the relationships between Sharia investment, government policy, and financial performance. The correlation matrix is presented in Table 3.

<table>
<thead>
<tr>
<th>Variable</th>
<th>Sharia Investment</th>
<th>Government Policy</th>
<th>Financial Performance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sharia Investment</td>
<td>1.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Government Policy</td>
<td>0.485*</td>
<td>1.00</td>
<td></td>
</tr>
<tr>
<td>Financial Performance</td>
<td>0.568*</td>
<td>0.624*</td>
<td>1.00</td>
</tr>
</tbody>
</table>

The results indicate significant positive correlations between Sharia investment and financial performance ($r = 0.568, p < 0.01$), and between government policy and financial performance ($r = 0.624, p < 0.01$). This suggests that higher levels of Sharia investment and more effective government policies are associated with better financial performance of MSMEs.

4.4 Multiple Regression Analysis
Multiple regression analysis was conducted to determine the combined effect of Sharia investment and government policy on financial performance. The results are presented in Table 4.

<table>
<thead>
<tr>
<th>Variable</th>
<th>B</th>
<th>SE(B)</th>
<th>Beta</th>
<th>t</th>
<th>p</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Constant)</td>
<td>1.238</td>
<td>0.42</td>
<td></td>
<td>2.932</td>
<td>0.004</td>
</tr>
<tr>
<td>Sharia Investment</td>
<td>0.314</td>
<td>0.101</td>
<td>0.30</td>
<td>3.107</td>
<td>0.002</td>
</tr>
<tr>
<td>Government Policy</td>
<td>0.442</td>
<td>0.093</td>
<td>0.44</td>
<td>4.894</td>
<td>0.000</td>
</tr>
</tbody>
</table>

The multiple regression model is statistically significant, with an $F$-value of 47.894 and a $p$-value less than 0.001, indicating that the model reliably predicts financial performance based on Sharia investment and government policy. The $R^2$ value of 0.453 suggests that 45.3% of the variance in financial performance can be explained by these two independent variables, while the adjusted $R^2$ of 0.434 provides a more accurate measure of the model’s explanatory power. The constant term ($B = 1.238, p = 0.004$) represents the expected financial performance score when both Sharia investment and government policy are at their minimum values, indicating some baseline financial activity. The coefficient for Sharia investment ($B = 0.314, p = 0.002$) is positive and statistically significant, with a Beta value of 0.30, suggesting that higher levels of Sharia-compliant financial practices are associated with better financial performance. Similarly, the coefficient for government policy ($B = 0.442, p < 0.001$) is positive and statistically significant, with a Beta value of 0.44, indicating that more effective government policies are associated with improved financial performance. The overall model significance, indicated by the $F$-statistic ($F(2, 117) = 47.894, p < 0.001$), and the relatively high $R^2$ value further demonstrate the model’s robustness and explanatory power.

Discussion
The findings of this study provide valuable insights into the significant roles that Sharia investment and government policy play in enhancing the financial performance of Micro, Small, and Medium Enterprises (MSMEs) in West Java. By examining the relationships between these variables through rigorous quantitative analysis, this research offers empirical evidence that supports the
positive impact of ethical financing and supportive regulatory frameworks on MSME financial outcomes.

**Sharia Investment and Financial Performance**

The positive and significant relationship between Sharia investment and financial performance highlights the benefits of adopting Sharia-compliant financial practices for MSMEs. The principles of Sharia investment, which emphasize risk-sharing, asset-backing, and ethical business conduct, contribute to creating a more sustainable and resilient financial environment for MSMEs. These principles reduce the financial risks associated with conventional interest-based loans and speculative activities, fostering a stable financial foundation for business operations.

The research findings from various studies support the notion that MSMEs benefit from utilizing Sharia-compliant financing mechanisms in terms of financial stability and growth. Studies like Sunaryono’s research [3] emphasize the significant long-term impact of Sharia financing on MSME growth, highlighting the importance of policies supporting Sharia financing for sustainable development. Additionally, research by Lestari and Nisa [20] indicates that the implementation of Sharia principles in financing products positively influences the financial performance of MSMEs, leading to increased profitability, operational efficiency, and improved access to capital. Moreover, Nurhayati and Suntana’s study [21] underscores the correlation between Sharia compliance and leverage in MSMEs, showcasing how adherence to Sharia principles enhances MSMEs’ reputation, investor confidence, and access to finance. These findings collectively align with Ahmed’s study, demonstrating the overall positive impact of Sharia-compliant financing on MSMEs’ financial well-being and growth.

The significant coefficient for Sharia investment in the regression analysis suggests that promoting Sharia-compliant financial products and raising awareness among MSME owners about their benefits could further enhance the financial performance of these enterprises. Financial institutions and policymakers should consider developing and offering more Sharia-compliant financial instruments tailored to the needs of MSMEs to support their growth and sustainability.

**Government Policy and Financial Performance**

The significant positive impact of government policy on financial performance underscores the critical role of a supportive regulatory environment in fostering MSME growth. Effective government policies, such as tax incentives, access to credit facilities, and business development programs, provide essential support that enables MSMEs to overcome financial and operational challenges. These policies help reduce the financial burden on MSMEs, enhance their access to capital, and improve their overall business capabilities.

The research findings align with Kusumawati’s emphasis on the critical role of well-targeted government policies in bolstering the financial performance of Micro, Small, and Medium Enterprises (MSMEs) [9], [10]. Studies underscore the positive impact of government interventions on SME operations, highlighting the need for supportive regulatory environments to enhance performance [9]. Additionally, the effectiveness of stimulus policies, such as credit restructuring extensions, in aiding MSME debtors during economic challenges is evident, showcasing the importance of timely and targeted interventions in supporting vulnerable sectors [22]. Furthermore, the relationship between financial accessibility and MSME performance in developing countries emphasizes the significance of policies facilitating access to formal credit to strengthen resilience and improve productivity [16]. Overall, these studies collectively emphasize the pivotal role of well-crafted government policies in driving the financial success and sustainable growth of MSMEs.

The significant coefficient for government policy in the regression analysis indicates that continuous evaluation and refinement of these policies are necessary to ensure they effectively meet the needs of MSMEs. Policymakers should focus on creating a conducive business environment by
addressing the specific challenges faced by MSMEs and providing targeted support that promotes their financial stability and growth.

**Combined Effect of Sharia Investment and Government Policy**

The study's results also reveal that the combined effect of Sharia investment and government policy significantly enhances the financial performance of MSMEs. The multiple regression analysis shows that these two factors together explain a substantial portion of the variance in financial performance, indicating their complementary roles in driving MSME success. The synergy between ethical financing practices and supportive government policies creates a robust framework that supports the financial health and growth of MSMEs.

The alignment of Sharia investment principles with government policy objectives can further enhance the effectiveness of both. For instance, policies that promote financial inclusion, ethical business practices, and access to Sharia-compliant financial products can complement the benefits of Sharia investment, leading to improved financial outcomes for MSMEs. This integrated approach can attract a broader range of investors and stakeholders, fostering a more inclusive and sustainable economic environment.

**Implications for Practice and Policy**

The findings of this study have important implications for both practitioners and policymakers. For practitioners, especially MSME owners and managers, the results highlight the potential benefits of adopting Sharia-compliant financial practices. By leveraging ethical financing mechanisms, MSMEs can achieve better financial stability and growth. Financial institutions should consider expanding their portfolio of Sharia-compliant financial products to cater to the needs of MSMEs, providing them with more financing options that align with their ethical values.

For policymakers, the study underscores the importance of developing and implementing supportive policies that address the specific challenges faced by MSMEs. Continuous monitoring and evaluation of existing policies are essential to ensure their effectiveness in promoting MSME growth. Additionally, fostering collaboration between government agencies, financial institutions, and the private sector can create a more supportive ecosystem for MSMEs, enhancing their financial performance and overall contribution to economic development.

**Limitations and Future Research**

While this study provides valuable insights, it also has some limitations that should be acknowledged. The reliance on self-reported data may introduce response bias, and the cross-sectional nature of the study limits the ability to infer causality. Future research could address these limitations by incorporating longitudinal data and using a mixed-methods approach to provide a more comprehensive understanding of the factors influencing MSME financial performance.

Moreover, exploring the specific mechanisms through which Sharia investment and government policy influence financial performance can offer deeper insights. Future studies could also examine the impact of other factors, such as market conditions and management capabilities, to provide a more holistic view of MSME financial performance determinants.

**CONCLUSION**

The study finds that Sharia investment and government policy significantly enhance the financial performance of MSMEs in West Java. Sharia-compliant practices, emphasizing risk-sharing, asset-backing, and ethical investment, improve MSME stability and growth. Supportive government policies, like tax incentives, credit access, and business development programs, also create a conducive environment for MSMEs. The study highlights the complementary roles of Sharia investment and government policy, showing their combined effect on MSME growth and sustainability. Practitioners are encouraged to adopt Sharia-compliant practices, while policymakers
should refine policies to support MSME growth. Despite limitations like reliance on self-reported data, future studies should use longitudinal data and mixed methods to better understand MSME performance, including factors like market conditions and management capabilities.

REFERENCES


