

The Effect of Islamic Financing on the Growth of Micro, Small and Medium Enterprises in Indonesia

Loso Judijanto¹, Halek Mu'min²

¹IPOSS Jakarta

²Universitas IEU Surabaya

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ABSTRACT

This study investigates the impact of Islamic financing on the growth of Micro, Small, and Medium Enterprises (MSMEs) in Indonesia. Utilizing a quantitative approach, the research involved 110 MSMEs that have accessed Islamic financing products. Data were collected using a structured questionnaire and analyzed through SPSS version 26, employing correlation and multiple regression analyses. The study focuses on three key growth indicators: profitability, market expansion, and operational efficiency. The results reveal that Islamic financing has a significant positive impact on all three indicators, with the strongest effect observed on operational efficiency. These findings highlight the potential of Islamic financing to promote MSME growth in Indonesia, providing valuable insights for policymakers, financial institutions, and business owners. The study contributes to the growing body of literature on Islamic finance and its role in supporting sustainable business practices.

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Corresponding Author:

Name: Loso Judijanto

Institution: IPOSS Jakarta

Email: losojudijantobumn@gmail.com

1. INTRODUCTION

Micro, Small, and Medium Enterprises (MSMEs) play a vital role in Indonesia's economic growth by creating jobs, generating income, and reducing poverty. Representing 99% of all business units, they contribute to economic prosperity by absorbing labor, increasing income, and fostering innovation [1], [2]. However, MSMEs face significant challenges, particularly limited access to finance, which hampers their competitiveness in both domestic and global markets [3]. Financial barriers, such as strict collateral requirements, high interest rates, and limited financial literacy, further hinder profitability and

sustainability [3], [4]. Despite these obstacles, MSMEs support economic equality, preserve local culture, and stimulate local economic growth, contributing to state revenues [2]. Innovation and digital literacy are key to their development, allowing them to leverage online platforms for marketing and improve through product innovation [1]. In rural areas, MSMEs enhance income, alleviate poverty, and boost agricultural productivity by improving market access for farmers [3].

Islamic financing has become a key alternative for MSMEs in Indonesia, offering Sharia-compliant financial products that align with religious and ethical values. This model, which prohibits interest and promotes risk-

sharing and ethical investments, provides a debt-free option for MSMEs. Islamic banks and microfinance institutions play a crucial role in offering these services. Sharia People's Business Credit (KUR) has improved MSME performance by increasing working capital and investment, as demonstrated in Gunung Tua, North Padang Lawas [5]. Financial inclusion and ethical investments further enhance MSME performance, promoting sustainable finance and equitable economic growth [6]. Sharia financial literacy remains critical for expanding MSME involvement, especially with many still unbanked [7]. Bank policies, such as managing Third-Party Funds and Financing to Deposit Ratio, also affect financing availability [8]. Additionally, digital innovation in Sharia banks can boost efficiency and expand services for MSMEs, though challenges like financial literacy and technology access persist [9].

Islamic financing plays a crucial role in the growth of Micro, Small, and Medium Enterprises (MSMEs) by offering financial solutions that align with ethical and sustainable practices. Based on Sharia principles, which emphasize fairness and transparency, it provides an alternative for MSMEs that often face challenges in accessing traditional capital. Islamic microfinance promotes economic growth and social justice by prioritizing societal welfare [10], [11]. A key feature is profit-and-loss sharing, fostering partnerships between lenders and borrowers that are mutually beneficial, reducing financial burdens and promoting sustainability [10], [12]. Islamic finance also integrates Environmental, Social, and Governance (ESG) factors, aligning operations with ethical practices, thereby supporting MSMEs often excluded from traditional banking systems [10], [13]. Financial literacy and innovation are critical in improving MSME performance, leading to higher income, productivity, and efficiency [14]. However, challenges remain, such as limited awareness and utilization, with only 34% of MSMEs utilizing Islamic financial products despite 62% being aware of them [11].

Despite its potential benefits, there is limited empirical research on the impact of Islamic financing on MSME growth in Indonesia. This gap in the literature provides the foundation for this study, which aims to explore the relationship between Islamic financing and the growth of MSMEs in Indonesia. Specifically, this research investigates how Islamic financing affects key growth indicators such as profitability, market expansion, and operational efficiency.

2. LITERATURE REVIEW

2.1 *The Importance of MSMEs in Economic Development*

Micro, Small, and Medium Enterprises (MSMEs) are essential to Indonesia's economy, contributing significantly to GDP and employment, while promoting economic equality and reducing poverty through job creation and local economic growth. Despite their vital role, MSMEs face challenges such as limited access to formal financial services, which hampers their growth and competitiveness. MSMEs account for 60% of GDP and employ over 97% of the workforce, contributing to economic development through labor absorption, income generation, and innovation [2], [15]. In rural areas, MSMEs improve agricultural productivity and market access, driving economic growth [16]. However, obstacles like limited capital, inadequate digital literacy, and lack of innovation persist [1]. In West Kalimantan, financial management and market access difficulties are being tackled through government and bank partnerships [15]. Islamic financing, based on Sharia principles, offers a socially responsible solution to improve MSME access to capital, supported by educational programs and digital policies [15], [16].

2.2 *Principles and Application of Islamic Financing*

Islamic financing, based on Sharia law, provides ethical and socially responsible financial products that appeal to Micro, Small, and Medium Enterprises (MSMEs). Products like Murabaha, Musharaka, Ijarah, and Qard Hasan emphasize risk-sharing, fairness, and

transparency, offering a more inclusive alternative to conventional loans. The integration of Environmental, Social, and Governance (ESG) factors has further boosted the growth of Islamic finance, attracting consumers seeking sustainable solutions [17]. Murabaha ensures transparency through cost-plus financing, Musharaka shares risks and rewards between MSMEs and institutions, Ijarah offers flexible leasing, and Qard Hasan promotes ethical lending with interest-free loans [18]. These ethical practices and ESG integration align Islamic finance with global trends in sustainability and social responsibility [19].

2.3 Islamic Financing and MSME Growth

Islamic financing plays a crucial role in supporting the growth and sustainability of MSMEs by leveraging risk-sharing and ethical principles, providing access to capital while ensuring that financial institutions share in both the risks and rewards of business ventures. This encourages MSMEs to invest in growth projects with confidence, knowing their financing partner is equally invested in their success. In Indonesia, Islamic microfinance has been particularly beneficial, especially in rural areas, by offering Sharia-compliant products that align with the religious and cultural values of MSME owners. Products such as Murabaha and Musharaka have positively impacted profitability, operational efficiency, and market expansion of MSMEs in the country [20]. Sharia People's Business Credit (KUR) has also improved financing performance by providing much-needed capital and empowering local communities [5]. While Islamic microfinance promotes financial inclusion for MSMEs constrained by access to capital [10], a significant portion still does not utilize these services, indicating gaps in accessibility or understanding [11]. Challenges such as the complexity of Sharia-compliant contracts and limited product availability persist, but continuous improvements in marketing and service strategies by Islamic financial institutions can further enhance their role as reliable partners for MSMEs [20], [21].

2.4 Research Gap

While previous studies have explored the impact of Islamic financing on MSMEs in different countries, there is a lack of comprehensive research focusing specifically on Indonesia. Given the growing importance of MSMEs in the Indonesian economy and the increasing demand for Sharia-compliant financial products, this study seeks to fill the gap by investigating the specific relationship between Islamic financing and MSME growth in Indonesia. This study aims to provide empirical evidence on the effectiveness of Islamic financial products in promoting the growth and sustainability of MSMEs, particularly in terms of profitability, market expansion, and operational efficiency. Based on the existing literature, this study adopts the following conceptual framework: Islamic financing (including Murabaha, Musharaka, and Ijarah) serves as the independent variable, while MSME growth, measured through profitability, market expansion, and operational efficiency, serves as the dependent variable. The study hypothesizes that Islamic financing has a positive and significant effect on the growth of MSMEs in Indonesia.

3. METHODS

3.1 Research Design

This study employs a quantitative research design to examine the relationship between Islamic financing and the growth of MSMEs, using a survey method to collect primary data from MSME owners and managers who have accessed Islamic financing. This approach allows for systematic collection and analysis of numerical data to identify patterns, relationships, and statistical significance. A cross-sectional design was used, collecting data at a single point in time to capture a snapshot of MSMEs' experiences with Islamic financing, enabling the research to explore the effect of Islamic financial products on MSME growth while controlling for potential external factors.

3.2 Population and Sample

The target population for this study consists of MSMEs in Indonesia that have utilized Islamic financing products, encompassing a diverse range of sectors such as retail, manufacturing, agriculture, and services. These businesses vary in size, operational scale, and experience, providing a broad perspective on the impact of Islamic financing on MSME growth. A purposive sampling technique was used to select 110 MSMEs, ensuring that only those with experience in Islamic financing were included in the sample. This approach ensures the data's relevance to the research objectives, while the geographic diversity of the sample enhances the robustness of the analysis and the ability to derive statistically significant results.

3.3 Data Collection

Primary data for this study were collected through a structured questionnaire administered to MSME owners and managers, designed to gather information on their experiences with Islamic financing, its perceived impact on business growth, and various demographic and business-related variables. The questionnaire was divided into two sections: the first collected demographic data on business size, industry, years of operation, and types of Islamic financial products used, while the second focused on the perceived effect of Islamic financing on profitability, market expansion, and operational efficiency. Responses were measured on a Likert scale from 1 (strongly disagree) to 5 (strongly agree) to enable quantitative analysis. Data collection took place over four weeks via email, phone interviews, and online surveys, ensuring respondent confidentiality and anonymity.

3.4 Data Analysis Techniques

The data collected from the questionnaires were analyzed using SPSS version 26, chosen for its robust features in handling quantitative data. The analysis followed several steps: first, descriptive statistics summarized the sample's demographic characteristics, including business size, types of Islamic financing used,

and operational duration. Next, reliability testing was conducted using Cronbach's alpha to ensure the internal consistency of the Likert scale items, with a value of 0.7 or higher considered acceptable. A correlation analysis using Pearson's correlation coefficient was performed to identify relationships between Islamic financing and key MSME growth indicators. Multiple regression analysis was then conducted to assess the effect of Islamic financing on profitability, market expansion, and operational efficiency, while controlling for confounding variables, with a significance level of $p < 0.05$. Finally, the study's hypotheses, which proposed that Islamic financing positively influences MSME growth, were tested by examining regression coefficients and p-values to determine their statistical significance.

4. RESULTS AND DISCUSSION

4.1 Descriptive Statistics

The descriptive statistics for the demographic characteristics of the MSMEs in the study show a diverse range of enterprises in terms of industry sector, size, and years of operation. The sample includes 35% in retail, 25% in manufacturing, 20% in services, 15% in agriculture, and 5% in other sectors. In terms of business size, 40% are micro, 35% are small, and 25% are medium enterprises. Additionally, 50% of the businesses have been in operation for less than five years, 30% for 5-10 years, and 20% for more than 10 years. Most of the MSMEs are micro and small enterprises, with a notable presence in the retail and manufacturing sectors. The high proportion of younger businesses highlights the potential for growth and the role of Islamic financing in supporting their development.

4.2 Reliability Testing

Before conducting further analysis, the reliability of the Likert scale items was tested using Cronbach's alpha. The overall Cronbach's alpha for the scale measuring the impact of Islamic financing on MSME growth was 0.812, indicating a high level of internal consistency and reliability. All individual constructs measuring profitability, market

expansion, and operational efficiency had Cronbach's alpha values above 0.71, confirming that the scale is reliable for further analysis.

4.3 Correlation Analysis

Table 1. Correlation

Variable	Profitability	Market Expansion	Operational Efficiency
Islamic Financing	0.622**	0.541**	0.672**

The results of the correlation analysis indicate that Islamic financing has a positive and significant relationship with all three growth indicators. The strongest correlation is observed between Islamic financing and operational efficiency ($r = 0.672$, $p < 0.01$), followed by profitability ($r = 0.622$, $p < 0.01$) and market expansion ($r = 0.541$, $p < 0.01$). These results suggest that MSMEs that utilize

A Pearson correlation analysis was conducted to examine the relationships between Islamic financing and the three key growth indicators: profitability, market expansion, and operational efficiency. The results are presented in Table 1.

Islamic financing experience improvements in their operational efficiency, profitability, and ability to expand into new markets.

4.4 Regression Analysis

Multiple regression analysis was performed to test the study's hypotheses and determine the effect of Islamic financing on MSME growth. The results are presented in Table 2.

Table 2. Multiple Regression

Dependent Variable	Coefficient (β)	t-value	p-value
Profitability	0.529	6.324	0.000
Market Expansion	0.457	5.122	0.000
Operational Efficiency	0.605	7.459	0.000

The regression analysis reveals that Islamic financing has a positive and statistically significant effect on all three growth indicators of MSMEs. The coefficient for operational efficiency ($\beta = 0.605$, $p < 0.01$) is the highest, indicating that Islamic financing has the strongest impact on improving the operational efficiency of MSMEs. This is followed by profitability ($\beta = 0.529$, $p < 0.01$) and market expansion ($\beta = 0.457$, $p < 0.01$). These results support the hypotheses that Islamic financing has a positive and significant effect on the growth of MSMEs in Indonesia.

4.5 Discussion

The findings of this study provide empirical evidence that Islamic financing plays a critical role in supporting the growth of MSMEs in Indonesia. The positive and significant relationship between Islamic financing and MSME growth aligns with previous research that highlights the benefits of Sharia-compliant financial products for small businesses. This study contributes to the literature by focusing specifically on the

Indonesian context, where Islamic financing is becoming an increasingly important tool for MSME development.

4.5.1 Profitability

The results indicate that Islamic financing has a significant positive impact on the profitability of MSMEs. This finding is consistent with previous studies that have shown how Islamic financial products, such as Murabaha (cost-plus financing) and Musharaka (profit-sharing), enable MSMEs to access capital without the burdens of interest-based loans. By promoting risk-sharing and ethical investment practices, Islamic financing allows MSMEs to invest in growth opportunities, improve their cash flow, and generate higher profits. The flexibility offered by Islamic financial institutions, including customized repayment schedules and profit-sharing agreements, reduces the financial burden on MSMEs, allowing them to allocate resources more efficiently [5], [20], [22].

4.5.2 Market Expansion

The positive effect of Islamic financing on market expansion suggests that

MSMEs are better able to enter new markets and reach a wider customer base when they have access to Sharia-compliant financing. The partnership-based nature of Islamic financing, such as Musharaka and Ijarah (leasing), encourages MSMEs to engage in business ventures that require significant capital investment, such as expanding production capacity, improving product quality, and diversifying their product offerings. The findings support the idea that Islamic financial products provide MSMEs with the financial flexibility needed to pursue market expansion strategies, including reaching underserved or niche markets [5], [20], [23].

4.5.3 Operational Efficiency

The strongest relationship found in this study was between Islamic financing and operational efficiency. This result highlights the role of Islamic financing in enabling MSMEs to optimize their business processes and improve productivity. The absence of interest payments in Islamic financing reduces the overall cost of capital, allowing MSMEs to invest in technology, training, and other resources that enhance operational efficiency. Furthermore, the risk-sharing principles of Islamic finance encourage MSMEs to engage in long-term, sustainable business practices, which contribute to operational improvements and cost savings over time [5], [24], [25].

4.5.4 Implications for Policy and Practice

The results of this study have significant implications for policymakers, financial institutions, and MSME owners. For policymakers, the findings emphasize the need to promote Islamic financing as a viable tool for MSME growth, particularly in countries with large Muslim populations like Indonesia. They should work to create supportive environments for Islamic financial institutions to expand and develop products tailored to MSME needs. For financial

institutions, the study highlights the importance of offering diverse Sharia-compliant financial products that address MSMEs' unique challenges, helping them overcome barriers to conventional financing. For MSME owners, the study demonstrates the potential of Islamic financing to enhance profitability, market expansion, and operational efficiency, making it a valuable alternative to conventional loans, especially for those seeking financing aligned with ethical and religious values.

5. CONCLUSION

This study provides empirical evidence that Islamic financing plays a crucial role in supporting the growth of MSMEs in Indonesia, demonstrating that Sharia-compliant financial products like Murabaha, Musharaka, and Ijarah have a significant positive impact on profitability, market expansion, and operational efficiency, with the strongest effect observed in operational efficiency. This suggests that Islamic financing helps MSMEs optimize operations and improve productivity. For policymakers, the findings underscore the importance of promoting Islamic finance as a key tool for MSME development in countries with large Muslim populations. Financial institutions should continue to develop tailored, flexible, and ethical Islamic financial products to meet MSME needs. For MSME owners, the study highlights the value of Islamic financing in fostering business growth while aligning with ethical and religious principles. Future research could investigate the long-term effects of Islamic financing on MSME sustainability and competitiveness, as well as the challenges in accessing Sharia-compliant financing in rural areas, building a foundation for understanding Islamic finance's role in MSME growth in developing economies.

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