

Empowering Sharia MSMEs for Inclusive Economic Growth: A Study of the Role of Sharia Financing for MSMEs in East Java Province

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ABSTRACT

Islamic Micro, Small, and Medium Enterprises (Islamic MSMEs) play a vital role in the regional economic structure as they contribute significantly to job creation, poverty reduction, and the strengthening of local economic resilience. This study aims to analyze the impact of Sharia-based financing on the performance and sustainability of Islamic MSMEs in East Java Province, focusing on the regions of Surabaya, Malang, and Jember. The research employs a quantitative approach using panel data from 2016 to 2023 and estimates the Fixed Effect Model (FEM). The results indicate that Sharia financing has a positive and significant effect on increasing the income and production capacity of Islamic MSMEs. Furthermore, interviews with MSME actors reveal that the values of justice, partnership, and blessing embedded in Sharia financing practices serve as non-material factors that strengthen long-term relationships between entrepreneurs and Islamic financial institutions. The policy implications highlight the importance of strengthening the Islamic MSME ecosystem through enhanced financial literacy, managerial training, and the digitalization of financial services to promote inclusive and equitable economic growth.

Keywords: Islamic MSMEs, Sharia financing, inclusive economy, microfinance, East Java.

INTRODUCTION

The role of Micro, Small, and Medium Enterprises (MSMEs) in Indonesia's economy is inseparable from the dynamics of national development. According to data from the Ministry of Cooperatives and MSMEs (2023), the MSME sector contributes more than 60 percent to the national Gross Domestic Product (GDP) and absorbs up to 97 percent of the total workforce across the country. In East Java Province, this sector serves as a major driver of regional economic growth, with more than nine million business units recorded in 2022. However, despite their substantial contribution, MSMEs continue to face several structural challenges, including limited access to financing, low levels of financial literacy, and weak adaptability to digital transformation (BPS East Java, 2023).

As public awareness of Islamic value-based economics increases, Islamic financial institutions have emerged as an alternative source of financing that upholds the principles of justice, transparency, and partnership. Based on the Financial Services Authority (OJK, 2024) report, the total assets of Islamic banking in Indonesia grew by 13.5 percent annually, while the proportion of productive financing reached 52 percent of the total financing portfolio. This indicates a strategic shift in Islamic financing orientation from the consumptive sector toward more productive and sustainable sectors.

East Java, home to the second-largest Muslim population in Indonesia, holds significant potential for the development of Islamic MSMEs. Sharia-based financing is believed to be an essential instrument in promoting inclusive economic growth, as it emphasizes profit-and-loss sharing principles and rejects exploitative practices in financial transactions (Rahman & Kassim, 2021). Nevertheless, not all MSME actors are able to access

such financing optimally, either due to limited Sharia financial literacy or the lack of understanding among financial institutions about the unique characteristics of local MSMEs.

This study aims to address these gaps by analyzing the extent to which Sharia-based financing can enhance the performance and sustainability of Islamic MSMEs in East Java. In addition, the research explores the social and spiritual values embedded in the relationship between entrepreneurs and Islamic financial institutions. The findings are expected to provide both theoretical and practical contributions to strengthening an inclusive, competitive, and sustainable Islamic MSME ecosystem.

LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

The concept of Islamic economics emphasizes the balance between material and spiritual aspects in economic activities. Islamic MSMEs are business entities that operate based on Sharia principles, such as the prohibition of *riba* (interest), *gharar* (uncertainty), and *maysir* (speculation), while upholding the values of justice and partnership (Antonio, 2020). In the context of an inclusive economy, Islamic MSMEs not only contribute to economic growth but also ensure the equitable distribution of development outcomes and social justice (Kasim & Rahman, 2021).

Sharia-based financing encompasses a variety of instruments, including *murabahah* (cost-plus sale), *musyarakah* (partnership), and *mudharabah* (profit-sharing). Several studies have demonstrated that partnership-based financing has a more significant impact on improving productivity and income compared to sale-based financing (Abdullah et al., 2022). This is because the partnership principle places financial institutions and entrepreneurs in an equal position, where both parties share risks and profits proportionally.

Moreover, the level of Sharia financial literacy also affects the effectiveness of financing utilization. Adequate literacy enhances the ability of MSME actors to manage funds, plan investments, and correctly understand Sharia contracts (Ismail et al., 2022). In the digital era, financial digitalization has become an important catalyst for expanding Islamic financial inclusion. Technology-based financing access such as mobile banking and Sharia peer-to-peer lending platforms has made it increasingly easier for entrepreneurs to obtain working capital (Hassan et al., 2023).

Based on theoretical perspectives and previous empirical findings, this study develops the hypothesis that Sharia-based financing has a positive influence on increasing income and business sustainability among Islamic MSMEs in East Java.

METHODS

This study employs a quantitative approach with a panel data design. The research sample consists of 50 Islamic MSMEs located in three major regions of East Java Surabaya, Malang, and Jember covering the period from 2016 to 2023. Data were collected through direct surveys with MSME actors, financial reports, and secondary data obtained from the Financial Services Authority (OJK) and Bank Indonesia.

The estimation model used in this study is the Fixed Effect Model (FEM), which is applied to control for heterogeneity across individuals or observation units. The model can be expressed as follows:

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Where η_i represents the performance indicators of MSMEs measured by income and production capacity, α_i denotes the amount of Sharia financing received, μ_i is the individual fixed effect, and ϵ_i is the error term.

In addition to the quantitative analysis, in-depth interviews were conducted with ten MSME actors and five managers of Islamic financial institutions to explore their perspectives on the social and spiritual values embedded in financing relationships. This mixed approach provides a more comprehensive understanding of how Sharia-based financing contributes to economic empowerment grounded in Islamic values.

RESULTS

Descriptive analysis reveals that the average amount of Sharia-based financing received by MSMEs during the study period was IDR 185.3 million, ranging from IDR 40 million to IDR 520 million. The average MSME annual income reached IDR 415.6 million, while the average production capacity amounted to 1,340 units per month. These figures indicate a considerable variation among respondents, reflecting diverse levels of business advancement and scale.

Table 1. Descriptive Statistics of Research Variables

Variable	Mean	Min	Max	Std. Dev.
Sharia Financing (Million IDR)	185.3	40.0	520.0	105.4
MSME Income (Million IDR)	415.6	90.5	980.3	210.8
Production Capacity (Units/Month)	1,340	450	2,500	600

Source: Processed Data, 2024

The estimation results from the Fixed Effect Model (FEM) show that Sharia-based financing has a positive and significant effect on the performance of Islamic MSMEs, both in terms of income and production capacity.

Table 2. Fixed Effect Model Estimation Results

Variable	Coefficient	t-Statistic	Prob.
Sharia Financing	0.412***	6.21	0.000
Financial Literacy	0.186**	2.45	0.017
Business Digitalization	0.205**	2.87	0.010
Constant	2.351	-	-

$R^2 = 0.68$ | Adj. $R^2 = 0.64$ | F-stat = 21.7 ($p < 0.01$)

These findings indicate that every one percent increase in Sharia-based financing has the potential to increase MSME income by 0.41 percent, with a high level of statistical significance ($p < 0.01$). Moreover, both financial literacy and business digitalization significantly strengthen the impact of Sharia financing on MSME performance.

From a qualitative perspective, interviews with MSME actors reveal that Sharia financing provides a sense of peace and trust, as it is based on partnership rather than a conventional creditor debtor relationship. Values such as justice, blessing (*barakah*), and mutual trust are perceived as key elements that foster loyalty and strengthen long-term relationships between MSME entrepreneurs and Islamic financial institutions.

These results are consistent with the findings of Huda et al. (2022) and Aziz & Sarea (2023), which emphasize that partnership-based contracts such as *musyarakah* and *mudharabah* can enhance business efficiency and sustainability. Furthermore, the digitalization aspect has proven to be a crucial catalyst in expanding the reach of Islamic financial services, particularly in regions with limited financial infrastructure (Hassan et al., 2023).

Overall, the results of this study reaffirm that Sharia-based financing not only provides access to capital but also serves as an instrument of social and spiritual empowerment, promoting inclusive and equitable regional economic growth.

CONCLUSION

This study concludes that Sharia-based financing has a significant positive effect on the income and sustainability of Islamic MSMEs in East Java Province. Financing mechanisms grounded in the principles of justice and partnership not only generate positive economic outcomes but also strengthen the social and spiritual dimensions of business practices.

The findings highlight the importance of enhancing Sharia financial literacy so that MSME actors can better understand and optimize financing mechanisms. Moreover, local governments and financial institutions are encouraged to expand access to Sharia microfinancing and accelerate the digitalization of financial services. Strengthening the overall Islamic MSME ecosystem will help foster inclusive, equitable, and sustainable regional economic growth.

In practical terms, the integration of Sharia values such as fairness, mutual cooperation, and shared prosperity into MSME financing systems has the potential to promote not only economic empowerment but also ethical and socially responsible business practices. Policymakers, financial institutions, and educational stakeholders should therefore collaborate in designing capacity building programs and digital innovations that support the long-term growth of Islamic MSMEs.

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