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Adaptation of Islamic Finance to the Performance of MSMEs in The Halal Food Industry

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Abstract

Research Originality: The findings of this research will contribute to the Islamic finance literature by answering the research gap between the relationship between MSME adaptation of Islamic finance implementation and MSME performance and providing practitioner insight for policymakers and MSMEs in the halal food industry.

Research Objectives: This study aims to determine the adaptation of Islamic finance to the performance of MSMEs in the halal food industry.

Research Methods: The method used a quantitative and explanatory approach. The number of samples in this study was 212 MSME units taken by simple random sampling (SRS). The number of samples in this study is based on the needs of the analytical tools used. The analysis technique used is the structural equation model (SEM) approach with the help of the LISREL program.

Empirical Results: The main findings show that halal industry MSMEs that adapt to Sharia finance tend to have a higher level of innovation than those that do not. Data shows that financing by Sharia principles enables MSMEs to allocate their resources more effectively, strengthening their ability to innovate in products and services. Innovations carried out by halal industry MSMEs that adopt a Sharia financial approach are more consistent with Sharia values, which leads to increased acceptance by Muslim consumers.

Implications: MSME halal industry managers may consider adopting Islamic finance strategies as part of their business plans. This adoption includes using Sharia financing, investing according to Sharia principles, and managing their finances according to Sharia values. Managers also need to actively develop networks and collaborate with other stakeholders, including Sharia financial institutions, educational institutions, and other companies in the halal industry ecosystem.

Keywords:
halal food industry; Islamic finance; innovation; performance

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INTRODUCTION

Halal food is essential for Muslims. The word halal means broadly, which not only means it is suitable for consumption but also that the halal logo means that the product has met the requirements of sharia law for Muslims. In addition, for non-Muslims, the halal logo means the product's quality, safety, and cleanliness.

The development of the halal food industry in Indonesia increased significantly in 2019. Indonesia is not in the top 10 countries, but in 2021, Indonesia is ranked 4th in halal food out of 15 countries included in the top 15 global Islamic economy indicator score rank. This condition is because Indonesia is the highest Muslim-majority country in the world. Muslims in Indonesia account for 87.17% of the total population of 209.12 million people and 13% of the world's population (Rasyid & Dewi, 2019). Moreover, by 2030, the Muslim population is projected to be around 2.2 billion, about 26.4% of the global population (Hassan et al., 2021). Despite successfully improving the halal food sector, Indonesia has yet to become the world's leading producer, even though Indonesia is the main halal food consumer, ranking at USD 114 billion.

So, although Indonesia is still the largest consumer, it has yet to become the world's leading producer. Most non-Muslim countries still dominate the most significant halal food exports (Brazil, Indonesia, USA, Russia, and Argentina). Though the rapid development of the halal food industry globally will increase the demand for halal products, thus creating many opportunities for micro, small, and medium enterprises (MSMEs) in the halal food industry (Haji Shahlehi et al., 2024). MSMEs are essential contributors to the economies of many countries, especially in developing countries, and play an essential role in poverty alleviation and job creation. However, MSMEs often need help accessing financing, which limits their ability to grow and compete. Islamic finance has emerged as an alternative financing mechanism for MSMEs facing challenges in accessing traditional financing. Islamic finance is a system based on Sharia principles that prohibits interest-based transactions and promotes profit and risk sharing. The principles of Islamic finance are consistent with Islamic ethical and moral values, which emphasize the importance of social justice, fairness, and equality (Zayed et al., 2022).

This study identifies empirical gaps in the use of Islamic finance in Indonesia's halal food MSME industry. While recent research recognizes the potential benefits and government support, it also identifies significant barriers to broader implementation. These challenges include a lack of understanding and experience in the field of Islamic finance, inadequate regulations, cases of fraud, and limited reach of Islamic banks, especially in remote areas (Amer, 2024; Hartanto et al., 2023; Menne et al., 2022; Sabrina & Majid, 2020). Adaptation of Islamic Finance to MSME finance can positively or negatively impact company performance, so a mediator variable is needed to mediate between adaptation and MSME performance. The mediator that can be used is innovation, and further research is also needed to find out its function in helping the acceptance of Islamic finance ((Pusung et al., 2023; Sudjatmoko et al., 2023 in Hartanto et al., 2023). Apart from that, there is evidence that applying Islamic finance can create new market opportunities and improve business performance. However, a more comprehensive

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understanding of its impact on the growth of MSMEs in Indonesia needs to be more comprehensive. Therefore, this research aims to bridge this gap by examining the specific mechanisms used by Islamic finance to influence the development of MSMEs in the halal food sector, considering the challenges and opportunities (Menne et al., 2022).

Islamic financial innovation and literacy enable MSMEs to select Sharia-compliant financial instruments and manage their finances according to Sharia principles, leading to improved financial performance and sustainability (Haruna et al., 2024). This study aims to build an Islamic finance adaptation model for the performance of MSMEs in the Indonesia halal food industry. This study will explore the potential benefits of Islamic finance for MSMEs, the challenges faced by MSMEs in accessing and adapting to Islamic finance, and the Islamic finance regulatory framework in the halal food industry. The findings of this research will contribute to the Islamic finance literature by answering the research gap between the relationship between MSME adaptation of Islamic finance implementation and MSME performance and providing practitioner insight for policymakers and MSMEs in the halal food industry.

METHODS

This research was conducted through a survey on MSMEs in the food sub-sector in Palembang City. The growth of MSMEs in Palembang City, which continues to increase along with the end of the COVID-19 pandemic, has made people passionate about carrying out their economic activities. MSMEs in Palembang City have experienced a very rapid increase, especially in the culinary sector. The number of MSMEs in Palembang City has only reached 1,103, even though the number is predicted to reach 160,000. For this reason, this study uses the population recorded at the Palembang City Cooperative and MSME Office, which is 1,103 MSMEs. The research object studied to improve the performance of MSMEs in Palembang City involves three observation variables: MSME performance, innovation, and adaptability.

The sampling technique in this research was carried out purposively with criteria including: (1) MSMEs in the culinary sector registered with the Cooperative and MSME Office; (2) Have a number of employees from 10 to a maximum of 100 people; (3) MSMEs have been operating for at least three years. The questionnaire was distributed to 220 respondents (20% of the population), and those who could be further analyzed amounted to 212 MSMEs in Palembang City, which were taken by simple random sampling (SRS). The scale technique in this study uses the Likert scale with a score of 1 (strongly disagree) to a score of 7 (strongly agree) from respondents' perceptions of various statements on the instrument developed from operational definitions (Table 1).

The data analysis in this research is robust and reliable, employing both descriptive and inferential statistics. Descriptive statistics are used to explain variables univariately, while inferential statistics are employed to test hypotheses using structural equation methods (SEM) with the LISREL program package. The SEM analysis is conducted in two stages: measurement models and structural models. The measurement model is rigorously tested for validity and reliability through confirmatory analysis of indicators, ensuring the validity and reliability of the indicators (Gunarto, 2018; Hair et al., 2014). The structural model analysis is then carried out to draw conclusions on the tested hypothesis.

Table 1. Operational Definition of Research Variables

Variables and references	Operational Definition	Indicator	Scale
Adaptation (Bryndin, 2019; Maden-Eyiusta et al., 2022; Park & Park, 2019; Quansah et al., 2022; Soltani & Koechlin, 2022; Ward et al., 2018)	Ability to take advantage of opportunities, information, support, and resources.	1. Business Flexibility. 2. Access Information and Resources. 3. Availability of Reserve Funds 4. Networking and Collaboration 5. Responsiveness to market changes 6. Product or Service Innovation 7. Technology Utilization Rate 8. Reaction to Competition.	Scale 1-7
Innovation (Fang et al., 2021; Lee et al., 2020; Parkman et al., 2012; Zhang et al., 2016)	The company's level of ability to make significant product, process, and organizational improvements, such as specifications, components, and materials, use friendliness, or other functional characteristics of the product.	1. New or Improved Products 2. Efficient Production Process 3. Market Penetration Rate 4. Research and Development Cooperation 5. Customer Acceptance of Innovation 6. Rate of Organizational Change 7. Acquisition of Patent or Copyright 8. Employee Engagement Rate	Scale 1-7
MSME Performance (Alraja et al., 2022; Chigara, 2021; Effiom & Edet, 2020; Fang et al., 2021; Gunarto et al., 2021; Utami & Lantu, 2014)	The final result of various activities of the enterprise (Wheelen et al., 2015). Company Performance is also interpreted as a multidimensional concept that defines the success of a business, as well as the level of achievement of its business goals (Civelek et al., 2015).	1. Annual Sales Revenue 2. Sales Growth Rate 3. Number of Sales Transactions 4. Number of New Customers 5. Customer Retention Rate. 6. Customer Satisfaction Level. 7. Gross Profit 8. Profit Margin 9. ROI (Return on Investment)	Scale 1-7

RESULTS AND DISCUSSION

A survey was conducted on 212 MSMEs, and respondents were distributed. Most respondents (82%) became owners and managers of MSMEs. Most respondents have employees < 10 employees (76%), a turnover of < 50 million rupiah (90%), and 5-10 years of business experience (54%).

Analysis of the measurement model uses confirmatory factor analysis (CFA) by looking at the value of the loading factor with a minimum number of ≥0.5. The results

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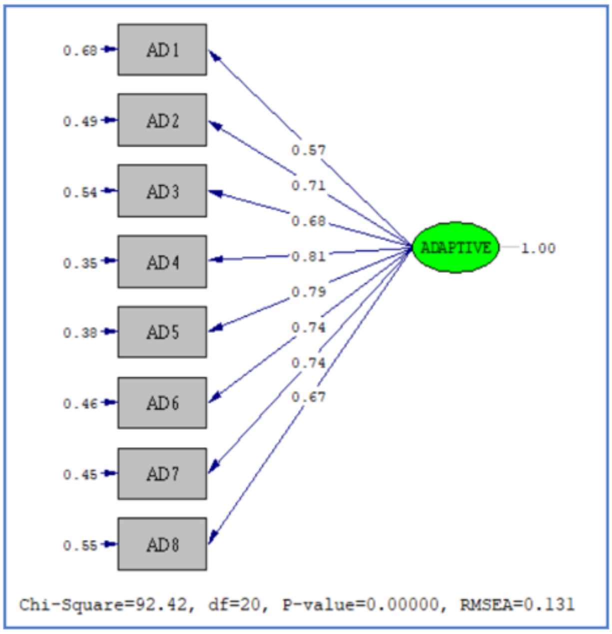
of the loading factor test on the Islamic financial adaptation variable found that all indicators had a value above 0.5, so eight indicators on the measurement of the Islamic financial adaptation variable were declared all valid, and the most dominant indicator for this variable is networking and collaboration Therefore, networking and collaboration are the most dominant factors that shape adaptation in its implications for the halal food industry at 65.61%. The final value of the loading factor in this study is shown in Figure 1.

Figure 1. Results of the Islamic Financial Adaptation Variable Measurement Model



The results of the loading factor test on the Islamic financial adaptation variable found that all indicators had values above 0.5, so eight indicators on the measurement of the innovation variable were declared all valid, and the most dominant factor innovation variable is the rate of organizational change at 68.89%. The final value of the loading factor in this study is shown in Figure 2.

The results of the loading factor test on MSME performance variables found that all indicators had values above 0.5, so nine indicators on the measurement of innovation variables were declared valid. The most dominant indicator that shapes MSME performance is the percentage of sales transactions, 77.44%. The final value of the loading factor in this study is shown in Figure 3.

The results of the loading factor test on the Islamic financial adaptation variable found that all indicators had values above 0.5, indicating that eight indicators on the measurement of the innovation variable were declared all valid. A construct is considered reliable if the construct reliability (CR) value is> 0.7 and the average value of variance extracted (AVE) is> 0.5. The results of the reliability test showed that the variables of Islamic financial adaptation (CR = 0.87 and AVE = 0.62), the variables of Innovation

(CR = 0.92 and CR = 0.70), and the variables of MSME Performance (CR = 0.88 and AVE = 0.67) all met these criteria, leading to the declaration of the measurement model in this study as reliable. This should instill confidence in the robustness of our research.

Figure 2. Results of the innovation variable measurement model

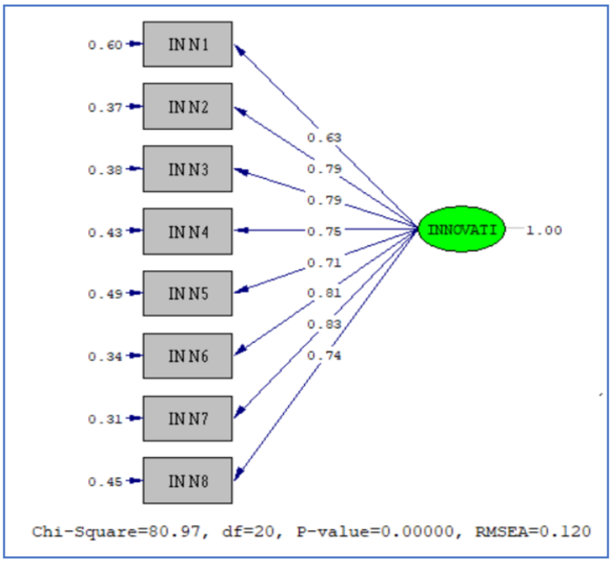
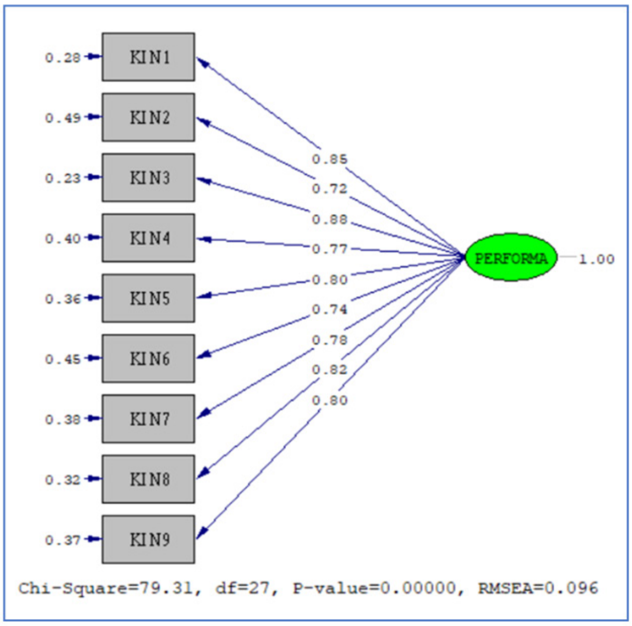


Figure 3. Results of MSME Financial Variable Measurement Model



Structural Model Analysis, the results of the formation of the overall model (Figure 4) show the magnitude of the influence of each exogenous variable on endogenous and show the value of loading factors on each construct-forming indicator. Figure 4. shows that Islamic financial adaptation positively affects MSME innovation by 0.84. There is

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a positive influence between Islamic financial adaptation and MSME performance of 0.43 and a positive influence between MSME innovation and MSME performance of 0.49. Figure 5 shows test results from measurement models and structural models. In the structural model, the path diagram between latent variables is shown.

Figure 5. Test Results on Measurement and Structural Models

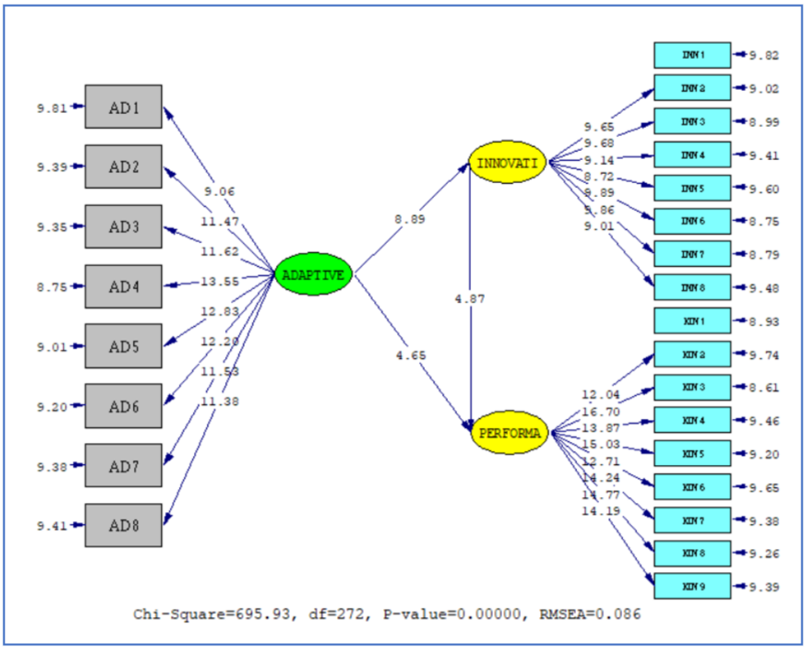

Figure 5 explains the result of the t-value in this research. In summary, the results of hypothesis testing are presented in Table 2. Table 2 shows the results of hypothesis testing, which explains the direct relationship of exogenous variables to endogenous variables. The estimated value shows the magnitude of the influence of each exogenous variable on the endogenous, and all relationships show a positive and significant influence. The significance value is determined from the t-value, greater than the t-table value of 1.96.

Table 2. Results of testing research hypotheses on direct influence

Hypothesis	Relationship	Estimate	S.E.	t-value	Label
H_1	Adaptive → Innovati	0.84	0.094	8.89	sign
H_2	Adaptive → Performa	0.43	0.093	4.65	sign
H_3	Innovati → Performa	0.49	0.10	4.87	sign

Note: sign= significant, S.E.= Standart Error

The test results in H4 were carried out by looking at the amount of Standardized Indirect Effects, namely the influence of Islamic financial adaptation on MSME performance through innovation of 0.41. Because the amount of direct influence is greater than indirect, innovation is not an excellent mediating variable for the adaptation relationship with MSME performance.

Based on the results, The adaptation of Islamic finance has proven to have a positive influence on innovation in various economic sectors. The most significant implementation factor that forms the adaptation variable in the halal food industry is networking and collaboration at 65.61%; the innovation factor that forms the most significant innovation variable is the rate of organizational change at 68.89%, and the highest factor that shapes the performance of Halal food MSMEs is the number of sales transactions of 77.44%. The influence of Islamic finance adaptation on innovation refers to a paradigm shift in the financial system that encourages creative and sustainable change. Adapting Islamic finance, based on ethical principles and Islamic values, has provided an important impetus for innovation in various aspects of the economy (Lumpkin & Dess, 2001). Sharia principles that avoid the practices of usury, gharar, and maysir not only create a fairer basis for transactions but also encourage the creation of an environment that supports sustainable economic growth (Setiawan, 2021). Ultimately, this environment creates conditions that support stronger and more sustainable innovation. In the conventional financial system, interest constraints and inherent risks can often restrict MSMEs and individual innovators from accessing capital and innovating (Alraja et al., 2022; Effiom & Edet, 2020; Utami & Lantu, 2014). However, through Islamic financial instruments such as mudharabah (profit sharing) and musharakah (cooperation), risks and benefits are shared fairly between capital owners and entrepreneurs. This condition reduces pressure on MSMEs and innovators, giving them the confidence to explore new ideas and innovate in products, services, or business processes.

The adaptation of Islamic finance encourages greater involvement in the real sector of the economy, which in turn fuels demand for new and innovative solutions. In addition, Islamic financial adaptation can create a conducive climate for research and development. Because Sharia principles emphasize ethics and integrity in business, innovators are encouraged to focus on solutions that are not only economically beneficial but also compatible with the values of justice and humanity. It encourages innovation that is more sustainability-oriented and positively impacts society and the environment. Islamic finance principles emphasizing risk and profit sharing provide a stronger safety net for innovators. Innovation often involves risk, and Islamic finance encourages an environment where risk can be faced with more confidence.

The adaptation of Islamic finance promotes sustainable business models, instilling a sense of responsibility and long-term planning among MSMEs. It ensures MSMEs have easier and fairer access to financing, helping them overcome financial barriers and obtain the necessary capital to grow their businesses (Alraja et al., 2022; Fang et al., 2021; Utami & Lantu, 2014). Islamic finance principles, such as the prohibition of riba and speculation, encourage MSMEs to focus on business practices that are fair, transparent, and guided by social justice values. This creates a better reputation for MSMEs in the business community and can help increase the trust of customers and business partners. Since financing in Islamic finance is often related to investment in real assets and productive projects, MSMEs are encouraged to produce products or services that have long-term added value. It encourages innovation in products,

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processes, and business strategies, which can improve MSMEs' competitiveness and long-term performance. The adaptation of Islamic finance creates a more collaborative business community. Involvement in Islamic financial institutions, such as Islamic banks or Islamic cooperatives, often brings MSMEs into a wide business network. This opens up opportunities to collaborate with other business people, share knowledge and experience, and access new opportunities for growth and expansion (Adam & Gunarto, 2021; Grewal et al., 2006; Ismail et al., 2021).

Overall, Islamic financial adaptation has a significant positive impact on the performance of MSMEs. Implementation adaptation toward From fairer access to financing to encouraging better business ethics, Islamic finance creates an environment that supports sustainable growth and empowerment of MSMEs. Through principles oriented towards justice, sustainability, and moral values, Islamic financial adaptation becomes a powerful tool to improve the performance and contribution of MSMEs in the economy. The results of this study state that Islamic financial administration can play an important role in improving the performance of MSMEs through one of its performance measures in the form of increased innovation (Bae & Yoo, 2015; Banks et al., 2000; Alexander & Contreras, 2016; Grewal et al., 2006; Marques & Ferreira, 2009; Parmentier & Mangematin, 2014; Prahalad & Ramaswamy, 2000; Shah, 2006; von Hippel, 2009; Von Hippel & Katz, 2002).

Empirically, this result can be understood because very rapid technological developments encourage business actors' competence to adapt. Adaptability will create innovation for MSME players, so it boils down to product creation and development. However, it does not directly increase sales growth as a measure of organizational performance and the growth of successful new products in the market as a measure of operational performance. For this reason, researchers examine more deeply how adaptation competence is a driver for the creation of innovation and its impact on the performance of MSMEs. Based on the contingency model that became a novelty in this study, it was found that innovations that developed in the MSME environment were not able to significantly moderate the relationship between adaptability and MSME performance so adaptability that initially did not contribute positively to performance achievement became able to positively influence 37% on improving MSME performance in Palembang City.

CONCLUSION

Islamic financial adaptation has emerged as a pivotal factor in driving innovation and enhancing the performance of MSMEs, particularly within the halal industry. By facilitating easier access to sharia-compliant financing, it not only empowers MSMEs to explore novel ideas and revamp their products, services, and operational methodologies, but also fosters increased access to capital. This phenomenon not only bolsters the reputation and competitiveness of MSMEs but also underscores their commitment to halal principles. Moreover, the positive impact of Islamic financial adaptation extends

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beyond mere innovation, as it encourages participation in tangible economic ventures, and promotes more effective risk management strategies. The resultant innovations within the halal industry have significantly contributed to the improved performance of MSMEs, offering higher-quality products imbued with halal values. Consequently, Islamic financial adaptation not only serves as a direct catalyst for enhancing MSME performance but also fuels the development of sustainable innovation to meet market demands and societal needs. Furthermore, this research holds promise in enriching Islamic financial literacy by deepening the understanding of financial practices aligned with Islamic principles. By addressing knowledge gaps in this field, it lays the groundwork for advancing Islamic finance theory and fostering greater financial inclusivity.

Based on these findings, policy implementation should prioritize expanding networking and collaboration support, encouraging cooperation and information sharing, and fostering organizational change innovations that promote sustainability-oriented innovation. Implementing these policy recommendations allows policymakers to capitalize on the favorable effects of Sharia-compliant financial adaptation on MSME performance, supporting long-term growth, innovation, and empowerment in the MSME sector. This method not only boosts the halal business but also improves Islamic financial literacy by improving understanding of Islamic-compliant financial practices and encouraging broader financial inclusion.

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