

## How Sharia Financing Can Improve the Welfare of MSMEs: An Analysis from The Behavioral Sharia Finance Perspective

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### ABSTRACT

Micro, Small, and Medium Enterprises (MSMEs) play a critical role in the economic development of many countries. Despite their importance, MSMEs face significant challenges, particularly in accessing appropriate financing. Sharia financing, grounded in Islamic principles such as profit-and-loss sharing and prohibition of interest (riba), offers a promising alternative. This study examines how sharia financing can improve the welfare of MSMEs through a behavioral finance lens, highlighting the impact of religious values, trust, and risk perception on financial decision-making. Using a qualitative literature review approach, this research synthesizes findings from reputable international and national journals. The results highlight that Sharia financing increases the welfare of MSMEs by aligning financial products with their religious beliefs and behavioral tendencies, thereby improving financial inclusion and business sustainability. Challenges such as low financial literacy and product awareness remain and require targeted interventions. The study offers theoretical and practical insights for Islamic financial institutions and policymakers seeking to promote Sharia-compliant financing for MSMEs.

**Keywords:** Sharia financing, MSMEs, behavioral finance, welfare, Islamic finance, financial inclusion

### INTRODUCTION

Micro, Small, and Medium Enterprises (MSMEs) play a vital role in promoting economic growth, generating employment, and supporting inclusive economic development, particularly in developing countries. In Indonesia, MSMEs constitute an important part of the national economy, contributing to economic activity and providing employment opportunities across various sectors. Their role makes improving MSME productivity, access to finance, and business sustainability important priorities for inclusive economic development (Badan Pusat Statistik [BPS], 2024).

Despite their significant economic contribution, MSMEs continue to face challenges in accessing formal financing, which may constrain business expansion, productivity, and long-term sustainability. Common barriers include limited collateral, inadequate financial records, and difficulties in meeting financial institutions' requirements (Ayyagari et al., 2017; World Bank, 2010). In Indonesia, the coexistence of conventional and Islamic banks within a dual banking system provides alternative financing arrangements for businesses (Zulkhibri & Sukmana, 2017). Within this context, Sharia financing offers an alternative based on Islamic contractual principles and ethical considerations.

Nevertheless, its potential to improve MSME welfare depends not only on financing availability but also on entrepreneurs' financial decisions, their understanding of Sharia-compliant products, and their ability to utilize financing productively.

The role of Islamic banks and financial institutions differs from that of conventional banks. Islamic banks and financial institutions offer interest-free financing, known as Sharia financing. Sharia financing, grounded in Islamic economic principles such as profit-and-loss sharing (PLS), the avoidance of *riba* (interest), and ethical risk management, is emerging as a viable alternative for MSMEs. Instruments like *mudharabah* (partnership financing) and *musyarakah* (joint venture financing) offer equitable risk-sharing arrangements (Dusuki & Abdullah, 2007).

However, the use of Islamic financial products is influenced not only by the product's technical design but also by behavioral factors. The increasing interest in utilizing Islamic financial products is driven by religiosity, ethical awareness, and alignment with personal values (Nazir & Saqib, 2024). Therefore, financial decision-making among Muslims cannot be understood solely from an economic perspective but also considers the moral and religious dimensions that guide their financial behavior (Hidayatullah et al, 2025).

Sharia-compliant financing is expected to provide broad access to capital for MSMEs, not only focusing on the retail, business services, and trade sectors, but also targeting other potential sectors, particularly productive sectors such as agriculture and manufacturing.

Previous studies have extensively analyzed the quantitative impact of Sharia financing on MSME performance (Waqas et al., 2025). Nevertheless, there is a research gap regarding how behavioral aspects influence MSMEs' adoption of Sharia financing and its effect on their welfare. This study fills this gap by qualitatively reviewing existing literature through the lens of behavioral Sharia finance, aiming to elucidate how Islamic values and psychological factors affect MSMEs' financial decisions and welfare outcomes.

## LITERATURE REVIEW

### MSMEs and Economic Welfare

MSMEs are the backbone of many economies, serving as engines for innovation, employment, and income generation. Welfare for MSMEs encompasses financial stability, sustainable business operations, and improved quality of life for entrepreneurs and their communities (Tambunan, 2019). Access to capital remains a major hurdle, often limiting their ability to scale and compete effectively.

Business development does not necessarily guarantee improvements in entrepreneurs' welfare, particularly when enterprises face limited capital, unstable cash flow, and inadequate financial management. Therefore, MSME welfare should be examined not only through business growth but also through the economic security and living conditions of entrepreneurs and their households (Hartanto et al., 2023; Rohmania et al., 2023).

MSME welfare can be conceptualised through four interrelated dimensions: business performance, financial security, business sustainability, and household well-being. Business performance encompasses changes in sales, profitability, and productive assets, while financial security concerns the ability to meet financial obligations and maintain adequate liquidity. Business sustainability reflects the capacity to continue

operations and withstand economic difficulties, whereas household well-being concerns the ability to meet basic needs, finance education and healthcare, and improve living standards. These dimensions are relevant because financial literacy and financial behaviour may influence how entrepreneurs manage their resources and achieve financial well-being (Rohmania et al., 2023).

From an Islamic economic perspective, welfare also involves ethical conduct, responsible wealth management, and the pursuit of benefits consistent with Islamic principles. The maqasid al-shariah perspective, particularly the protection of wealth (hifz al-mal), provides a normative foundation for assessing whether economic activities contribute to sustainable well-being rather than merely increasing short-term profits (Dusuki & Abozaid, 2007). Accordingly, this study defines MSME welfare as an improvement in business performance, financial security, business sustainability, and household well-being within an ethical and Sharia-oriented framework.

### **Sharia Financing for MSMEs**

Sharia financing provides access to financial resources through contractual arrangements governed by Islamic principles, including the prohibition of riba, contractual fairness, and compliance with Sharia requirements. Instruments such as mudharabah and musyarakah involve profit-sharing arrangements, while murabahah facilitates asset or goods acquisition through a sale contract and ijarah provides access to assets through leasing. These instruments have different contractual and risk characteristics, making the suitability of each arrangement an important consideration in financing decisions (Usmani, 2002).

Sharia financing can support MSME development by enabling entrepreneurs to obtain working capital, purchase raw materials, acquire productive assets, and expand business activities. A systematic literature review by Hartanto et al. (2023) found that Islamic finance practices have the potential to support MSME growth and business performance in Indonesia. Nevertheless, the benefits of financing depend on the productive use of funds, the suitability of contractual arrangements, and the entrepreneur's capacity to manage business operations and financial obligations.

The relationship between Sharia financing and welfare is therefore conditional rather than automatic. Financing may improve business performance and income generation, but its benefits can be constrained by weak financial management, inadequate financial literacy, and unstable cash flow. Research by Sumidartiny and Laela (2025) found that Islamic financial literacy and religiosity positively influenced MSMEs' compliance with Sharia financing contracts, although mental accounting did not significantly mediate these relationships. These findings suggest that financing effectiveness should be examined alongside the behavioural and financial-management practices that influence how entrepreneurs use capital and fulfil their obligations.

### **Behavioral Finance Perspective in Sharia Context**

The behavioural Sharia finance perspective explains how psychological, cognitive, and religious factors influence financial decisions and the utilisation of financing. Entrepreneurs do not evaluate financial products solely on the basis of capital availability or expected returns; their decisions may also be influenced by religious commitments, trust in financial institutions, financial knowledge, and perceptions of risk. Dusuki and Abdullah (2007) demonstrated the importance of understanding customers' motivations

and selection criteria in Islamic banking, while Sumidartiny and Laela (2025) provided evidence of the relevance of religiosity and Islamic financial literacy to MSMEs' compliance with Sharia financing contracts.

Five behavioural dimensions are particularly relevant to MSME financing. Religiosity may encourage entrepreneurs to prefer Sharia-compliant financial products, while trust may strengthen confidence in financial institutions and contractual arrangements. Islamic financial literacy helps entrepreneurs understand financing contracts and their associated obligations, whereas perceived risk influences how entrepreneurs evaluate uncertainty and repayment commitments. Finally, financial attitudes and decision-making shape budgeting, the allocation of business funds, and the management of household and business expenditures (Dusuki & Abdullah, 2007; Sumidartiny & Laela, 2025).

These behavioural dimensions may help explain why entrepreneurs receiving similar financing experience different outcomes. Rohmania et al. (2023) examined the relationship between Islamic financial literacy, Islamic financial behaviour, and MSME financial well-being, including the moderating role of electronic payment usage. Similarly, Sumidartiny and Laela (2025) found that religiosity and Islamic financial literacy were associated with compliance with Sharia financing contracts, but that religious commitment alone did not eliminate practical difficulties related to liquidity and financial management. Consequently, behavioural factors should be examined as potential facilitators or constraints in translating financing opportunities into improved welfare rather than assumed to have uniformly positive effects.

## **RESEARCH METHOD**

This study employs a qualitative research design based on a systematic literature review. The data sources include peer-reviewed international journals, Indonesia accredited national journals (SINTA-indexed), books, and official reports from governmental and Islamic financial institutions. Literature was selected for relevance, credibility, and thematic alignment with the research objectives. The analysis involved synthesizing findings to identify key themes on how behavioral factors influence MSMEs' use of Sharia financing and subsequent welfare effects.

## **RESULTS**

### **Influence of Sharia Financing Principles on MSME Behavior**

The reviewed literature suggests that the principles underlying Sharia financing, particularly the prohibition of *riba*, contractual fairness, and profit-and-loss sharing, may influence MSME entrepreneurs' financial preferences and acceptance of Islamic financial institutions. These principles provide an ethical foundation that distinguishes Islamic financing from conventional interest-based arrangements. Dusuki and Abdullah (2007) highlight the importance of understanding customers' motivations for selecting Islamic banks, suggesting that financial decisions may reflect both religious considerations and practical expectations concerning financial services.

Transparency, contractual clarity, and confidence in Sharia compliance may further influence entrepreneurs' willingness to engage with Islamic financial institutions. However, the appeal of Sharia financing should not be attributed exclusively to religious values, because entrepreneurs also consider accessibility, financing costs, administrative requirements, and the suitability of financing products for their business needs. Consequently, the behavioural implications of Sharia financing depend on the

interaction between ethical preferences and economic considerations (Dusuki & Abdullah, 2007).

### **Behavioral Factors Affecting Adoption**

Religiosity, trust, financial literacy, and perceived risk represent important dimensions for understanding MSMEs' adoption of Sharia financing. Religious commitment may encourage entrepreneurs to seek financing consistent with Islamic principles, while trust in financial institutions may strengthen their willingness to enter into financing agreements. Nevertheless, religious preferences and trust do not necessarily translate into actual adoption when financing products are inaccessible or unsuitable for business requirements (Dusuki & Abdullah, 2007).

Financial literacy and perceived risk also influence how entrepreneurs evaluate financing alternatives. Limited understanding of Islamic contracts may create uncertainty regarding payment obligations, profit-sharing mechanisms, and the allocation of financial risks. Moreover, although profit-sharing arrangements may provide a different approach to allocating business risks, they do not eliminate commercial uncertainty or guarantee lower financial burdens in every situation. These considerations indicate that financial education and transparent communication are important for helping entrepreneurs make informed financing decisions (Usmani, 2002).

### **Impact of Sharia Financing on MSMEs Welfare**

Sharia financing may improve MSME welfare by providing capital for productive investment, supporting business expansion, and strengthening financial management. When financing enables entrepreneurs to purchase raw materials, acquire equipment, increase inventory, or improve production capacity, it may contribute to higher sales and profitability. Previous literature on Islamic finance practices in Indonesian MSMEs identifies business development as an important area through which Islamic financing may support enterprise growth (Hartanto et al., 2023).

Nevertheless, improvements in business performance do not automatically translate into better welfare. The resulting benefits depend on operating expenses, financing obligations, market conditions, and the entrepreneur's capacity to manage business and household finances. Therefore, the relationship between Sharia financing and welfare should be assessed through several dimensions, including business performance, financial security, business sustainability, and household well-being. This approach is consistent with research highlighting the relevance of Islamic financial literacy and financial behaviour to the financial well-being of MSMEs (Rohmania et al., 2023).

### **Challenges and Opportunities for Strengthening Sharia Financing**

Despite its potential, sharia financing for MSME welfare may be constrained by limited financial literacy, inadequate product suitability, administrative barriers, and difficulty accessing financial institutions. These constraints can prevent entrepreneurs from obtaining appropriate financing or using available resources effectively. The literature on Islamic finance practices among Indonesian MSMEs indicates the importance of examining institutional arrangements and the practical challenges that influence financing utilisation (Hartanto et al., 2023).

Digital financial services and more tailored financing products may expand access improve service delivery. Digital platforms can facilitate information dissemination, applications, payments, and communication between entrepreneurs and financial institutions. However, digitalisation alone does not guarantee improved welfare because

its effectiveness also depends on digital literacy, infrastructure, institutional reliability, and the suitability of financial products. Accordingly, expanding Sharia financing requires an integrated approach combining accessible financial services, financial education, transparent contracts, and appropriate business support (Rohmania et al., 2023).

### **DISCUSSION**

The synthesis of the reviewed literature indicates that the relationship between Sharia financing and MSME welfare involves more than the provision of capital. Sharia principles may shape entrepreneurs' financial preferences, while trust, religiosity, financial literacy, and risk perceptions influence their engagement with financial institutions. These behavioural factors provide a useful explanation for why access to similar financing arrangements may produce different outcomes across enterprises (Dusuki & Abdullah, 2007; Hartanto et al., 2023).

An important insight is the distinction between financing adoption and financing effectiveness. Adoption concerns whether entrepreneurs choose or use Sharia financing, whereas effectiveness concerns whether the financing generates meaningful improvements in business performance and welfare. An entrepreneur may prefer Sharia financing because of religious commitments but still experience limited business improvement because of inadequate managerial capabilities, insufficient market demand, or unsuitable financing terms. Therefore, evaluating financing effectiveness requires attention to the subsequent utilisation of funds and the conditions under which business benefits are realised (Hartanto et al., 2023; Rohmania et al., 2023).

The behavioural perspective further suggests that financial literacy and responsible financial management may help entrepreneurs translate financing into productive outcomes. Understanding contractual obligations, maintaining financial records, managing cash flow, and allocating funds appropriately can support better financial decisions. However, these individual capabilities cannot fully compensate for institutional barriers or unfavourable business conditions. Financial literacy should therefore be understood as one component of an enabling environment that includes appropriate financing products, institutional transparency, and adequate business support (Rohmania et al., 2023; Sumidartiny & Laela, 2025).

The findings also highlight the need to evaluate welfare beyond short-term business growth. Increased sales or productive assets may represent positive outcomes, but they do not necessarily indicate improved financial security or household living standards. A more comprehensive assessment should consider whether entrepreneurs can maintain business continuity, meet financial obligations, build savings, and improve their households' socioeconomic conditions. This multidimensional perspective strengthens the analytical connection between Sharia financing and sustainable MSME welfare (Hartanto et al., 2023; Rohmania et al., 2023).

From a practical perspective, Islamic financial institutions should not focus exclusively on increasing financing distribution. They should also improve product suitability, provide clear contractual information, strengthen financial education, and consider the different capabilities and risks faced by MSMEs. Digital services may support these efforts, but their contribution depends on accessibility, digital literacy, and institutional reliability. These implications suggest that the effectiveness of Sharia financing is shaped by the interaction between financing arrangements, entrepreneurial behaviour, and institutional support rather than by capital provision alone (Dusuki & Abdullah, 2007; Rohmania et al., 2023).

Overall, this review advances the argument that Sharia financing can contribute to MSME welfare when its ethical and contractual characteristics are accompanied by appropriate financial decision-making, productive capital utilisation, and supportive institutional arrangements. Its contribution is therefore best understood as a conditional process in which financing opportunities are translated into business performance, financial resilience, and household well-being. This integrated perspective provides a basis for future research examining how behavioural factors influence the relationship between Sharia financing and multidimensional MSME welfare (Hartanto et al., 2023; Rohmania et al., 2023; Sumidartiny & Laela, 2025).

## **CONCLUSION**

This study concludes that Sharia financing can contribute to improving the welfare of micro, small, and medium enterprises (MSMEs) not merely through access to capital, but also through its ethical principles, contractual transparency, and support for productive business activities. However, its contribution to MSME welfare is not automatic, as it depends on the suitability of financing products, the productive utilization of funds, business management capabilities, and prevailing market conditions.

From the behavioral Sharia finance perspective, religiosity, trust, Islamic financial literacy, and perceived risk play important roles in shaping entrepreneurs' financing preferences and decisions. While religiosity may encourage the adoption of Sharia-compliant financing, trust and financial literacy can support informed financial decision-making and effective financing utilization. These behavioral factors interact with institutional conditions, including financing accessibility, contractual clarity, and product suitability, in determining whether Sharia financing can support business performance, financial stability, and household well-being.

This study contributes to the literature by integrating Sharia financing characteristics, behavioral factors, and multidimensional MSME welfare within a single analytical framework. It highlights the importance of strengthening Islamic financial literacy, improving financing transparency, developing products tailored to MSME needs, and providing appropriate business mentoring. Future empirical research should examine how behavioral factors shape the relationship between Sharia financing and MSME welfare across different financing contracts and business contexts.

## **Recommendations**

Based on the results of this study, the following are recommendations to improve the welfare of MSMEs:

1. Islamic financial institutions should prioritize financial literacy and outreach programs tailored for MSMEs.
2. Policymakers should foster supportive regulations and incentives to encourage Sharia financing innovations for MSMEs.
3. Future research should incorporate empirical, field-based studies to deepen understanding of behavioral dynamics in Sharia financing adoption.

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