

Sharia Finance Inclusion and Poverty Reduction In Palopo City: The Mediation Role of Small and Medium Micro Enterprises

Hamida Hamida ^a, Erwin Erwin ^b, Muhammad Nur Alam Muhajir ^a, Nur Ariani Aqidah ^a, & Andi Muh Almahdy ^a

^a Department of Islamic Banking, Faculty of Islamic Economics and Business, Universitas Islam Negeri Palopo, Indonesia; ^b Department of Development Economics, Faculty of Economics and Business, Universitas Negeri Makassar, Indonesia

KEYWORDS

Islamic financial inclusion; MSME performance; Palopo City; Poverty alleviation; Sharia finance

CORRESPONDING AUTHOR

The corresponding Author 's
Hamida
hamidah_pbs@uinpalopo.ac.id

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ABSTRACT

This study examines the effect of Islamic financial inclusion on poverty alleviation in Palopo City, Indonesia, with specific attention to the mediating role of Micro, Small, and Medium Enterprises (MSMEs). It addresses whether access to Sharia-compliant financial services can generate inclusive economic outcomes through MSME development in a secondary city context. A quantitative approach was used by surveying 100 MSME owners who utilize Islamic financial services in Palopo City. Respondents were selected through purposive sampling based on MSME registration, business experience, and use of Sharia financial products. The data were analyzed using Partial Least Squares Structural Equation Modeling (PLS-SEM) to test the direct and indirect relationships among Islamic financial inclusion, MSME performance, and poverty alleviation. The results show that Islamic financial inclusion has a positive and significant effect on poverty alleviation and MSME performance. However, MSME performance does not significantly affect poverty alleviation and does not mediate the relationship between Islamic financial inclusion and poverty alleviation. This indicates that Islamic financial inclusion may improve welfare directly, but MSME growth alone is insufficient to translate financial access into poverty reduction. This study contributes to Islamic finance and development economics by challenging the assumption that financial inclusion automatically reduces poverty through MSME performance. Focusing on Palopo City, it provides micro-level evidence that Sharia financial inclusion requires complementary business capacity, market access, and institutional support to become an effective poverty alleviation strategy.

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1. INTRODUCTION

Poverty remains a persistent global development challenge and continues to receive significant policy and scholarly attention, particularly in developing countries such as Indonesia. Poverty alleviation is also a central agenda of the Sustainable Development Goals (SDGs), which aim to eradicate extreme poverty and promote inclusive development by 2030 (Liu et al., 2020; Zhu et al., 2021). The problem of poverty is

experienced across different regional contexts, including Morocco and Tunisia (Qamruzzaman et al., 2023), Cambodia (Brown & Ledermann, 2023), South Africa (Ngepah et al., 2023), and other developing economies (Liu & An, 2023). Existing studies show that poverty is influenced by economic, institutional, social, and financial factors. Institutional quality (Dossou et al., 2021), economic growth (Kouadio & Gakpa, 2022), and financial inclusion (Essel-Gaisey & Chiang, 2022; Khan et al., 2023; Lee et al., 2023) have all been identified as important determinants of poverty reduction. Through access to savings, financing, payment services, and other formal financial products, financial inclusion may enhance household welfare, income-generating opportunities, and economic resilience.

In the Islamic economic framework, financial inclusion extends beyond access to financial services by emphasizing Sharia-compliant and ethical financial practices. Previous studies suggest that Islamic financial inclusion and Islamic microfinance contribute positively to poverty alleviation and community welfare (Tamanni & Haji Besar, 2019; Wijaya et al., 2020; Nabil & Herianingrum, 2022; Maouloud et al., 2023; Muhammad et al., 2023). However, despite growing interest in Islamic finance, empirical evidence explaining how Islamic financial inclusion contributes to poverty reduction remains limited. In particular, little attention has been given to the mechanisms through which financial access generates welfare outcomes, especially in the context of local economic development and small business activities.

Micro, Small, and Medium Enterprises (MSMEs) are widely recognized as important drivers of employment creation, income generation, and local economic development (Abisuga-Oyekunle et al., 2020; Azunu & Mensah, 2019). Several studies have found that MSMEs contribute to poverty reduction by expanding economic opportunities and strengthening household income (Ahmed et al., 2019; Bello, 2022; Marcus Garvey Orji et al., 2022; Manzoor et al., 2019). Nevertheless, empirical findings remain inconclusive. While some studies report positive effects of MSMEs on poverty alleviation, others show that MSME development does not necessarily reduce poverty, particularly when enterprises remain informal, low-productivity, and subsistence-oriented (Adviento et al., 2022; Emenike, 2023; Nursini, 2020). These mixed findings suggest that the poverty-reducing role of MSMEs may depend on access to productive financing, business capacity, market conditions, institutional support, and the ability of enterprises to move beyond survival-oriented activities.

This study focuses on Palopo City, a secondary urban center in South Sulawesi with growing Islamic financial services and a dynamic MSME sector. According to the Department of Industry, Cooperatives, and SMEs of Palopo City, there are 16,752 MSMEs consisting of 14,986 micro businesses, 1,570 small businesses, and 196 medium businesses. Despite this economic potential, poverty remains a significant development challenge. The number of poor residents increased to 29.335 thousand people, or 12.27% of the population, in 2021 after declining in previous years. This condition indicates that the expansion of MSMEs and financial services does not automatically translate into poverty reduction and therefore provides an important empirical context

for examining the relationships among Islamic financial inclusion, MSME performance, and poverty alleviation.

Although previous studies have examined poverty from perspectives such as education, health, income, economic growth, institutional quality, and financial inclusion (Dossou et al., 2021; Essel-Gaisey & Chiang, 2022; Khan et al., 2023; Kouadio & Gakpa, 2022; Lee et al., 2023), empirical studies integrating Islamic financial inclusion, MSME performance, and poverty alleviation within a single mediation framework remain limited, particularly at the city level in Indonesia. Furthermore, the traditional financial intermediation perspective often assumes that greater access to finance automatically improves business performance and reduces poverty. However, this assumption may overlook the absorptive capacity of small and subsistence-oriented enterprises. Therefore, this study investigates whether MSMEs function as an effective transmission channel between Islamic financial inclusion and poverty alleviation. Using Partial Least Squares Structural Equation Modeling (PLS-SEM), this study examines the direct effects of Islamic financial inclusion on poverty alleviation and MSME performance, the effect of MSME performance on poverty alleviation, and the mediating role of MSME performance. By providing micro-level evidence from Palopo City, this study contributes to the literature on Islamic finance, MSME development, and development economics while offering practical implications for policymakers, Islamic financial institutions, and MSME development agencies in designing more effective and inclusive poverty alleviation strategies.

2. LITERATURE REVIEW

2.1 Poverty Theory

The World Bank (2000) defines poverty as a deprivation of welfare, generally characterized by insufficient income to meet basic needs such as food, clothing, and shelter. According to Setiadi (2013) and Anwar and Hamid (2019), the poverty line represents the minimum income required to satisfy these essential needs. However, contemporary studies increasingly recognize poverty as a multidimensional phenomenon shaped by economic, institutional, social, educational, and environmental factors rather than income deprivation alone (Dossou et al., 2021; Kouadio & Gakpa, 2022; Liu & An, 2023; Ngepah et al., 2023; Qamruzzaman et al., 2023). Ravallion (1998) further explains that poverty measurement involves identifying welfare indicators, establishing minimum acceptable standards, and evaluating welfare distribution relative to the poverty line.

Accordingly, poverty assessment extends beyond income and incorporates broader dimensions of welfare, including access to education, healthcare, housing, food security, and economic opportunities (Brown & Ledermann, 2023; Liu et al., 2020; Ngepah et al., 2023; Zhu et al., 2021). Effective poverty alleviation therefore requires a comprehensive approach that combines individual achievement, community empowerment, social

capital, participatory development, and structural economic transformation. Previous studies have shown that sustainable poverty reduction is strongly associated with institutional quality, economic growth, social inclusion, and community-based development strategies (Azunu & Mensah, 2019; Dossou et al., 2021; Kouadio & Gakpa, 2022; Liu et al., 2020).

In the context of this study, poverty alleviation is viewed as a development outcome that may be influenced by Islamic financial inclusion and MSME performance. Financial inclusion can improve welfare by expanding access to financial services, strengthening entrepreneurship, and enhancing economic resilience among low-income households (Essel-Gaisey & Chiang, 2022; Khan et al., 2022; Khan et al., 2023; Lee et al., 2023). Likewise, MSMEs are widely recognized as important instruments for employment creation, income generation, and local economic development, thereby contributing to poverty reduction (Abisuga-Oyekunle et al., 2020; Bello, 2022; Manzoor et al., 2019; Nursini, 2020). Therefore, understanding the relationship among Islamic financial inclusion, MSMEs, and poverty alleviation is essential for evaluating local economic development in Palopo City.

2.2 Financial Inclusion Theory

Financial inclusion is defined by the World Bank as the availability of access to formal financial services for all segments of society, regardless of income level. Within the Sharia framework, financial inclusion extends beyond access by promoting financial practices free from *riba*, *gharar*, and *maysir*. This study is grounded in the Islamic socio-economic framework, which views the financial system not merely as a profit-oriented mechanism but also as an instrument for social welfare and justice through the principles of *Maqasid Shariah* (Ben Abdelkader & Mansouri, 2019; Muhammad et al., 2023; Tamanni & Haji Besar, 2019). Islamic financial inclusion supports equitable wealth distribution by enabling low-income groups and MSME actors to access financial resources. In addition, financial intermediation theory suggests that financial institutions facilitate productive economic activities by reducing information asymmetry and transaction costs, thereby improving access to capital for MSMEs (Ben Abdelkader & Mansouri, 2019; Ozturk & Ullah, 2022; Ratnawati, 2020).

Previous studies define financial inclusion as the availability and accessibility of financial services for all segments of society, particularly low-income communities (Chen & Yuan, 2021). Financial inclusion is commonly measured through four dimensions: access, usage, quality, and well-being. In the context of Islamic finance, access refers to the ease of reaching Islamic financial institutions, usage reflects the intensity of utilizing Sharia-compliant financial products, quality represents the transparency and reliability of services, and well-being captures the economic benefits generated through financial access. These dimensions have been widely applied to evaluate the effectiveness of financial inclusion programs in promoting economic participation and social welfare (Akhtar, 2020; Chen & Yuan, 2021; Ozturk & Ullah, 2022).

Financial inclusion also plays an important role in supporting economic growth, entrepreneurship development, household welfare, and poverty reduction by expanding access to savings, financing, and risk-management instruments (Akhtar, 2020; Essel-Gaisey & Chiang, 2022; Holle, 2019; Khan et al., 2022; Khan et al., 2023; Lee et al., 2023; Ozturk & Ullah, 2022; Ratnawati, 2020). In the Islamic context, access to ethical and Sharia-compliant financial services may further reduce dependence on informal and exploitative financial practices (Muhammad et al., 2023; Nabil & Herianingrum, 2022; Wijaya et al., 2020).

Although Islamic financial inclusion is theoretically expected to support poverty reduction, its effectiveness may depend on financial literacy, institutional quality, regulatory support, and social capital (Chen & Yuan, 2021; Dossou et al., 2021; Mujiatun et al., 2023; Ozturk & Ullah, 2022). Limited understanding of Sharia-compliant financial products may reduce the ability of MSME actors to utilize Islamic financial services effectively. Nevertheless, empirical evidence generally indicates that Islamic financial inclusion, Islamic microfinance, and Sharia-compliant financial products contribute positively to household welfare, economic resilience, and poverty alleviation among low-income communities (Maouloud et al., 2023; Muhammad et al., 2023; Nabil & Herianingrum, 2022; Tamanni & Haji Besar, 2019; Wijaya et al., 2020). Based on this literature, the first hypothesis is formulated as follows:

H1. Islamic financial inclusion affects poverty

Apart from poverty alleviation, financial inclusion can also improve MSME performance. By expanding access to financial services, financial inclusion encourages entrepreneurship, job creation, business expansion, productivity improvement, stronger financial management, and greater market competitiveness among MSMEs (Chen & Yuan, 2021; Mujiatun et al., 2023; Ozturk & Ullah, 2022; Usman et al., 2021). Ratnawati (2020) further argues that financial inclusion supports MSME growth through improved access to capital and financing for long-term business development. In addition, financial inclusion enhances business sustainability and strengthens the ability of MSMEs to respond to economic challenges through better access to financial resources and services (Akhtar, 2020; Ratnawati, 2020; Usman et al., 2021). In the Islamic context, Islamic microfinance and Sharia-compliant financial services can improve community welfare and support MSME development by providing ethical financing, encouraging productive economic activities, and strengthening financial inclusion among underserved communities (Ben Abdelkader & Mansouri, 2019; Maouloud et al., 2023; Muhammad et al., 2023; Mujiatun et al., 2023; Wijaya et al., 2020). Therefore, the second hypothesis is formulated as follows:

H2. Islamic financial inclusion affects the performance of MSMEs

2.3 Micro, Small and Medium Enterprises

Micro, Small, and Medium Enterprises (MSMEs) play an important role in employment creation, income generation, and local economic development across various sectors, particularly in regions where large-scale industries are limited (Abisuga-Oyekunle et al., 2020; Azunu & Mensah, 2019). This role is especially relevant in secondary cities such as Palopo, where economic activities are strongly supported by micro and small businesses. Within this context, Islamic financial inclusion is expected not only to contribute directly to poverty alleviation but also to support welfare improvement through MSME development. Previous studies have highlighted the strategic role of MSMEs in promoting inclusive growth, strengthening local economies, and improving household livelihoods (Abisuga-Oyekunle et al., 2020; Azunu & Mensah, 2019; Marcus Garvey Orji et al., 2022).

MSMEs serve as important vehicles for income generation and wealth distribution among low-income communities. Their contribution to poverty alleviation occurs through employment creation, business expansion, productivity improvement, household income growth, and economic resilience (Ahmed et al., 2019; Bello, 2022; Manzoor et al., 2019). Access to adequate financial support enables MSMEs to acquire raw materials, improve production capacity, expand market reach, and increase profitability, thereby enhancing household welfare and reducing poverty. Compared with large firms, MSMEs are generally more labor-intensive and closely connected to local markets, allowing the benefits of business growth to extend beyond business owners to workers, suppliers, and surrounding communities through multiplier effects (Abisuga-Oyekunle et al., 2020; Marcus Garvey Orji et al., 2022; Nursini, 2020).

Despite their potential, empirical evidence regarding the relationship between MSMEs and poverty reduction remains mixed. Emenike (2023) found that MSMEs contribute to poverty reduction, while studies in Indonesia also report a positive role of MSMEs in alleviating poverty (Nursini, 2020). However, MSMEs often face structural constraints, including limited capital, weak managerial capability, low financial literacy, restricted technology adoption, and limited market access, which may prevent them from transitioning from subsistence-oriented activities to productive and growth-oriented enterprises (Adviento et al., 2022; Bello, 2022; Emenike, 2023; Nursini, 2020). These findings suggest that the poverty-reducing role of MSMEs depends on their capacity to achieve sustainable growth and generate broader economic benefits. Based on the previous literature, the third hypothesis is formulated as follows:

H3. Micro, small and medium enterprises influence poverty

2.4 Micro, Small and Medium Enterprises (MSMEs) as Mediation

Based on previous studies, MSMEs can be hypothesized to mediate the relationship between Islamic financial inclusion and poverty alleviation. This mediation logic is based on the assumption that Islamic financial inclusion increases access to financial services,

which subsequently improves MSME performance and contributes to poverty reduction. In this perspective, MSMEs function as a transmission mechanism that converts financial access into economic welfare. Access to finance enables MSME actors to improve business performance, expand operations, strengthen financial management, and create employment opportunities, while Sharia-compliant financing provides capital support consistent with religious and ethical values (Ben Abdelkader & Mansouri, 2019; Mujiatun et al., 2023; Ratnawati, 2020; Usman et al., 2021).

The mediating role of MSMEs extends beyond the provision of liquidity and reflects their ability to transform financial access into productive capacity. Islamic financial inclusion may improve productivity through investments in equipment, technology, and raw materials; facilitate market integration through business expansion and improved management practices; and strengthen business continuity by reducing dependence on informal financing and supporting income stability among micro-entrepreneurs (Ben Abdelkader & Mansouri, 2019; Maouloud et al., 2023; Muhammad et al., 2023; Mujiatun et al., 2023; Ratnawati, 2020). Through these mechanisms, MSMEs may generate broader socioeconomic outcomes, including income growth, employment creation, household resilience, and poverty reduction (Ahmed et al., 2019; Bello, 2022; Manzoor et al., 2019; Nursini, 2020).

However, the mediating role of MSMEs may not occur automatically. The effectiveness of MSMEs as a transmission channel depends on whether financial access is utilized productively and supported by adequate managerial capacity, financial literacy, market access, and institutional support. When MSMEs remain informal, low-productivity, and subsistence-oriented, their contribution to poverty reduction may be limited despite improved access to finance (Adviento et al., 2022; Bello, 2022; Emenike, 2023; Nursini, 2020). Therefore, the mediating role of MSMEs in the relationship between Islamic financial inclusion and poverty alleviation requires empirical verification. Based on this argument, the following hypothesis is proposed:

H4. MSMEs mediate the relationship between Islamic financial inclusion and poverty

3. METHODOLOGY

This study employed a quantitative research design to examine the relationships among Islamic financial inclusion, MSME performance, and poverty alleviation in Palopo City, Indonesia. Primary data were collected through a structured questionnaire distributed to MSME owners selected using purposive sampling. Respondents were required to be registered with the local Cooperative and Trade Office, have at least five years of business experience, and utilize Islamic financial services. A total of 100 MSME owners participated in the study. Palopo City was selected because it represents a secondary urban area with a growing Islamic financial sector and a dynamic MSME ecosystem, making it an appropriate context for examining the role of Islamic financial inclusion in supporting MSME development and poverty alleviation. Consistent with previous

studies, Islamic financial inclusion was measured using four dimensions—access, usage, quality, and well-being (Akhtar, 2020; Chen & Yuan, 2021; Ozturk & Ullah, 2022). Poverty alleviation was measured through rice consumption level, income level, and welfare level, reflecting household economic conditions and welfare outcomes (Anwar & Hamid, 2019; Liu et al., 2020; Zhu et al., 2021). MSME performance was assessed using sales growth, customer growth, and profit growth, which are widely recognized indicators of business development and sustainability (Ahmed et al., 2019; Manzoor et al., 2019; Nursini, 2020). All questionnaire items were measured using a five-point Likert scale ranging from strongly disagree to strongly agree.

Data were analyzed using Partial Least Squares Structural Equation Modeling (PLS-SEM), which is appropriate for predictive and exploratory studies involving latent constructs, relatively small sample sizes, and mediation analysis. The sample size satisfied the minimum requirement based on the 10-times rule (Barclay et al., 1995). The analysis consisted of measurement model and structural model evaluations. The measurement model was assessed through outer loadings, Cronbach's Alpha, Composite Reliability (CR), and Average Variance Extracted (AVE) to ensure reliability and convergent validity. The structural model was evaluated using Variance Inflation Factor (VIF), path coefficients, t-statistics, p-values, and mediation analysis to test the proposed hypotheses. Following recommendations for PLS-SEM studies, full-collinearity VIF values below 3.3 were used to assess multicollinearity and common method bias. Ethical considerations were maintained throughout the study by ensuring voluntary participation, informed consent, and respondent confidentiality.

4. RESULTS

4.1 Demographic Respondents

Table 1. Demographic Respondents

Profile	Total	Percentage
Gender		
Male	57	57%
Female	43	43%
Age		
18-25	11	11%
26-35	46	46%
36 and above	53	53%
Education		
S1/S2/S3	34	34%
SMA/SMK/MA	52	52%
Elementary/Middle School/MTs	14	14%

Source: Primary data processing, Smart PLS 4

Based on data collected from 100 respondents collected from various MSME actors in Palopo City, it is known that the majority of respondents in this study were male, namely 57 people (57%), while the number of female respondents was 43 people (43%). The number of respondents who filled out the questionnaire was dominated by MSMEs

aged over 36 years, namely 53 people (53%). Meanwhile, from the educational aspect, the majority of respondents in this study had a SMA/SMK/MA educational background, 52 people (52%).

4.2 Statistic Descriptive

Table 2. Statistic Descriptive

Variabel	Mean	Median	Standar Deviasi	Minimum	Maksimum
Islamic Financial Inclusion	31.43	32	1.59	27	35
Poverty Alleviation	31.98	32	1.77	27	35
MSMES	31.52	32	1.76	27	35

Source: Processed by the Author, 2023

The descriptive statistical analysis of the three primary variables Sharia Financial Inclusion, MSME Performance (MSMES), and Poverty Alleviation reveals high levels of engagement and positive outcomes among the 100 surveyed entrepreneurs in Palopo City. Sharia Financial Inclusion (IKS) recorded a mean score of 31.43 (SD = 1.59), indicating a strong and consistent utilization of Sharia-compliant financial services, as evidenced by its low dispersion. MSME Performance (MSMES) followed with an average of 31.52 (SD = 1.76), suggesting that most respondents perceive a significant improvement in their business growth and operational stability. Notably, Poverty Alleviation (PA) achieved the highest mean score of 31.98 (SD = 1.77), reflecting a robust optimistic perception regarding household economic stability. All three variables shared a median of 32.00 and a range from 27.00 to 35.00, demonstrating that while there is minor variation in individual experiences, the overall trend points toward a high degree of synergy between financial inclusion, business performance, and perceived welfare within the studied population.

4.3 Measurement (Outer) Model Calculation

Table 3. Measurement (Outer) Model Calculation

Konstruk	Item	Loading	α (≥ 0.7)	CR (≥ 0.7)	AVE (≥ 0.7)
Islamic Financial Inclusion	Physical & digital service access	0,712	0,812	0,865	0,562
	Availability of financing products	0,845			
	Ease of administrative procedures	0,788			
	Service quality & transparency	0,756			
Poverty Alleviation	Understanding of Sharia contracts	0,802	0,845	0,891	0,615
	Daily income sufficiency	0,734			
	Quality food fulfillment	0,812			
	Access to health & education	0,882			
MSMEs	Decency of housing conditions	0,795	0,828	0,880	0,594
	Asset ownership & savings	0,766			
	Increase in sales volume	0,705			
	Net profit growth	0,788			
MSMEs	Market reach expansion	0,856	0,812	0,880	0,594
	Increase in operational capacity	0,812			
MSMEs	Business independence & resilience	0,745	0,745	0,880	0,594
	Business independence & resilience	0,745			

Source: Processed by the Author, 2023

The measurement model evaluation demonstrates that all constructs—Sharia Financial Inclusion (IKS), Poverty Alleviation (PA), and MSME Performance (MSMES) possess robust validity and reliability. The outer loading factors for all indicators exceed the recommended threshold of 0.70, ensuring strong indicator reliability, while the Average Variance Extracted (AVE) values for all variables are above 0.50, confirming adequate convergent validity. Furthermore, the internal consistency of the model is well-established, as evidenced by Cronbach's Alpha and Composite Reliability (CR) values that significantly surpass the 0.70 benchmark across all latent variables. Specifically, the CR values ranging from 0.865 to 0.891 indicate a high level of reliability, confirming that the instruments used are consistent and capable of providing accurate measurements for the structural model analysis.

4.4 Multicollinearity Assessment

Table 4. Multicollinearity Assessment

Variabel	VIF Value	Status
Sharia Financial Inclusion (IKS)	1.425	No Multicollinearity
MSME Performance (MSMES)	1.425	No Multicollinearity

Source: Processed by the Author, 2023

To ensure the structural model's integrity and address potential multicollinearity issues, this study evaluated the Variance Inflation Factor (VIF) for all predictor variables. According to Hair et al. (2017), a VIF value exceeding 5.0 indicates significant multicollinearity, while a more stringent threshold of 3.3 is often used to detect Common Method Bias (CMB) in PLS-SEM. The analysis results show that the VIF values for Sharia Financial Inclusion (IKS) and MSME Performance (MSMES) are both 1.425, which is well below the conservative threshold of 3.3. Consequently, it can be concluded that there is no critical multicollinearity among the constructs, and the model is free from Common Method Bias, ensuring that the estimated path coefficients are reliable and stable.

4.5 Hypothesis Testing

Tabel 5. Hypothesis testing

Hypothesis/Paths	P-Values	Hypothesis
Islamic Financial Inclusion => Poverty Alleviation	0,000	H1: Accepted
Islamic Financial Inclusion => MSMEs	0,000	H2: Accepted
MSMEs => Poverty Alleviation	0.774	H3: Rejected
Islamic Financial Inclusion => MSMEs => Poverty	0.796	H4: Rejected
Islamic Financial Inclusion => MSMEs => Poverty Alleviation	0.773	H5: Rejected

Source: Processed by the Author, 2023

The hypothesis testing results are presented in Table 5. The findings show that Islamic financial inclusion has a significant effect on poverty alleviation, as indicated by a p-value of 0.000. Since this value is below the significance threshold of 0.05, H1 is accepted. This result indicates that greater access to and use of Islamic financial services can contribute to poverty alleviation among MSME actors in Palopo City.

The results also show that Islamic financial inclusion has a significant effect on MSME performance, with a p-value of 0.000. Therefore, H2 is accepted. This finding suggests that the use of Sharia-compliant financial services supports MSME development by improving access to financing, financial management, and business operational capacity.

In contrast, MSME performance does not have a significant effect on poverty alleviation, as shown by a p-value of 0.774, which is higher than 0.05. Thus, H3 is rejected. This result indicates that improvements in MSME performance do not necessarily translate into poverty alleviation in the observed sample.

Furthermore, the mediation test shows that MSME performance does not mediate the relationship between Islamic financial inclusion and poverty alleviation. The indirect effect has a p-value above 0.05, indicating that the mediation effect is statistically insignificant. Therefore, H4 is rejected. This finding suggests that although Islamic financial inclusion directly contributes to poverty alleviation and improves MSME performance, MSME performance does not function as an effective transmission mechanism in this relationship.

Overall, the results indicate that Islamic financial inclusion plays an important direct role in poverty alleviation and MSME development. However, the absence of a significant mediating effect suggests that financial inclusion alone is insufficient to reduce poverty through MSME performance unless it is supported by business capacity, market access, innovation, and institutional assistance.

5. DISCUSSION

The findings of this study provide empirical evidence on the relationship between Islamic financial inclusion, MSME performance, and poverty alleviation in Palopo City. This study is not intended to be statistically generalized across Indonesia, but rather to provide micro-level insights into the dynamics of Islamic financial inclusion in a local context with specific socio-economic characteristics. Palopo City has distinctive features as a secondary city in South Sulawesi, where local religiosity, community networks, and the growing presence of Islamic financial institutions may influence the adoption of Sharia-compliant financial services. In addition, as a trading center in Tana Luwu, MSME activities in Palopo are strongly shaped by local supply chains, informal business practices, and regional government policies aimed at strengthening the real sector. These characteristics make Palopo City a relevant setting for examining whether Islamic financial inclusion can support poverty alleviation directly and indirectly through MSME performance.

The results show that Islamic financial inclusion has a positive and significant effect on poverty alleviation. This finding indicates that greater access to and use of Sharia-compliant financial services may improve the welfare of MSME actors in Palopo City. Islamic financial inclusion can help individuals and business owners access

savings, financing, payment facilities, and other formal financial services that support household financial stability. Through these services, people are better able to manage income, save for future needs, reduce dependence on informal lenders, and maintain consumption during economic difficulties. This result supports the argument that financial inclusion can reduce poverty by enabling individuals to save, invest, and manage financial risks more effectively (Khan et al., 2022; Lee et al., 2023). In the Islamic finance context, this finding is also consistent with previous studies showing that Islamic financial inclusion and Islamic microfinance can contribute to poverty reduction and welfare improvement (Maouloud et al., 2023; Muhammad et al., 2023; Nabil & Herianingrum, 2022; Tamanni & Haji Besar, 2019).

The significant effect of Islamic financial inclusion on poverty alleviation suggests that Sharia-compliant financial services may function not only as instruments for business financing but also as mechanisms for improving household welfare and economic security. For MSME actors, access to Islamic financial products can strengthen financial confidence, increase the ability to manage daily financial needs, and reduce vulnerability to unexpected economic shocks. This is particularly important in secondary cities where informal financial practices and limited access to formal financing may still influence the economic behavior of small business actors. Therefore, Islamic financial inclusion can be understood as a welfare-enhancing mechanism that operates through both productive and protective financial functions (Essel-Gaisey & Chiang, 2022; Ozturk & Ullah, 2022).

The study also found that Islamic financial inclusion has a positive and significant effect on MSME performance. This result suggests that the use of Islamic financial services can support the development of MSMEs in Palopo City. Access to Islamic financial institutions enables MSME actors to obtain capital, manage business transactions, improve financial planning, and support operational activities. For many small business owners, access to Sharia-compliant financial products is important because it provides financing alternatives that are consistent with religious and ethical values. This finding confirms that financial inclusion can support entrepreneurship, strengthen business activities, and improve MSME performance by providing access to capital and financial services (Mujiatun et al., 2023; Ratnawati, 2020; Usman et al., 2021).

In this study, Islamic financial inclusion appears to strengthen MSMEs by improving access to financial resources and encouraging more structured financial behavior among business actors. Sharia-compliant financing may also increase the willingness of Muslim entrepreneurs to use formal financial services because the products are perceived as more aligned with their religious values. This alignment may increase trust, reduce psychological barriers to formal financing, and encourage MSME actors to engage more actively with Islamic financial institutions. These findings are consistent with the view that Islamic financial services can improve welfare and support MSME development through ethical financing, risk-sharing principles, and financial intermediation

mechanisms (Ben Abdelkader & Mansouri, 2019; Ozturk & Ullah, 2022; Wijaya et al., 2020).

However, the results show that MSME performance does not have a significant effect on poverty alleviation in Palopo City. This finding indicates that improvements in MSME performance do not necessarily translate into meaningful poverty reduction among the observed respondents. Although MSMEs are generally expected to improve household income, create employment, and support local economic development, their actual contribution to poverty alleviation may depend on the scale, productivity, and sustainability of the business. Many MSMEs in secondary cities operate at a micro or subsistence level, where business income is mainly used to maintain daily household consumption rather than to generate significant wealth accumulation. Therefore, even when MSMEs experience some improvement in sales, customers, or profit, the increase may not be strong enough to reduce poverty substantially. This finding supports the argument that the poverty-reducing role of MSMEs depends on business scale, productivity, market access, and the broader institutional environment (Adviento et al., 2022; Nursini, 2020).

The insignificant effect of MSME performance on poverty alleviation may also reflect structural constraints faced by MSMEs in Palopo City. These constraints may include limited access to wider markets, low innovation capacity, weak managerial skills, limited digital adoption, and dependence on small-scale local demand. In such conditions, MSMEs may improve business continuity but not necessarily generate sufficient income growth to lift households out of poverty. This finding differs from studies showing that MSMEs can reduce poverty through employment creation and income generation, but it is consistent with the view that MSMEs may fail to reduce poverty when they remain informal, low-productivity, and survival-oriented (Abisuga-Oyekunle et al., 2020; Emenike, 2023; Manzoor et al., 2019).

The finding that MSME performance does not significantly affect poverty alleviation highlights that MSME development should not be understood only in terms of the number of business units or access to capital. Instead, the quality of business growth, productivity improvement, market integration, and value-added capacity are essential for transforming MSMEs into effective instruments of poverty alleviation. MSMEs may contribute more strongly to poverty reduction when they are able to expand beyond subsistence activities, generate stable profits, create employment, and access broader markets. Without these conditions, MSME performance may improve at the business level but remain insufficient to produce significant welfare transformation at the household level (Ahmed et al., 2019; Bello, 2022; Marcus Garvey Orji et al., 2022).

The mediation test further shows that MSME performance does not mediate the relationship between Islamic financial inclusion and poverty alleviation. This finding is theoretically important because it challenges the common assumption that financial inclusion reduces poverty mainly through MSME development. In this study, Islamic financial inclusion has a direct significant effect on poverty alleviation, but the indirect path through MSME performance is not significant. This means that the welfare benefits

of Islamic financial inclusion may operate through channels other than MSME performance. For example, Islamic financial inclusion may improve household welfare through savings behavior, access to emergency financing, consumption smoothing, financial security, and reduced dependence on informal or high-cost borrowing. These mechanisms suggest that financial inclusion may provide direct protection and stability for low-income households even when MSME performance does not significantly reduce poverty (Handayani et al., 2023; Mukhlis et al., 2021).

The absence of mediation in this study suggests that access to Islamic financial services is a necessary but not sufficient condition for poverty reduction through MSMEs. Financial inclusion can provide access to capital, but capital alone cannot guarantee business growth or poverty alleviation if MSMEs lack managerial capacity, market access, innovation, and institutional support. This result confirms that the relationship between Islamic financial inclusion and poverty alleviation is more complex than a simple linear transmission from financial access to business performance and then to poverty reduction. Therefore, the effectiveness of Islamic financial inclusion in reducing poverty through MSMEs depends on whether financial access is supported by productive capacity, business mentoring, market integration, and institutional coordination (Chen & Yuan, 2021; Mujjatun et al., 2023; Ozturk & Ullah, 2022).

From a theoretical perspective, these findings contribute to the Islamic financial inclusion and development economics literature by identifying a boundary condition in the financial inclusion–poverty nexus. Islamic financial inclusion can directly support poverty alleviation, but MSME performance does not automatically become an effective transmission channel. This suggests that financial intermediation theory should be complemented with a more contextual understanding of MSME capacity and local economic structure. In the case of Palopo City, many MSMEs may still function as survival-oriented businesses rather than growth-oriented enterprises. As a result, Islamic financial inclusion may improve welfare more directly through household financial stability than indirectly through business expansion (Ben Abdelkader & Mansouri, 2019; Tamanni & Haji Besar, 2019; Wijaya et al., 2020).

From a policy perspective, the findings suggest that Islamic financial inclusion programs should not focus solely on expanding access to Sharia-compliant financial services. Although access is important, it must be accompanied by programs that strengthen MSME productivity and competitiveness. Local governments, Islamic financial institutions, and MSME development agencies need to integrate Islamic financing with business mentoring, financial literacy, digital adoption, product innovation, market access, and regulatory support. Without these complementary interventions, Islamic financial inclusion may improve short-term welfare but may not fully transform MSMEs into effective instruments of poverty alleviation. This recommendation is consistent with prior studies emphasizing the importance of institutional support, financial literacy, and MSME capacity building in strengthening the developmental impact of financial inclusion (Akhtar, 2020; Holle, 2019; Ratnawati, 2020).

Overall, this study shows that Islamic financial inclusion plays an important role in poverty alleviation and MSME development in Palopo City. However, the non-significant effect of MSME performance on poverty alleviation and the absence of mediation indicate that MSMEs require stronger institutional and business ecosystem support to become an effective poverty reduction channel. Therefore, poverty alleviation strategies in secondary cities should combine Islamic financial inclusion with broader MSME upgrading policies, including capacity building, business formalization, digital transformation, and access to sustainable markets. This integrated approach is necessary to ensure that Sharia-compliant financial services contribute not only to financial access but also to inclusive and sustainable local economic development (Khan et al., 2022; Lee et al., 2023; Maouloud et al., 2023).

6. CONCLUSION

This study examined the effect of Islamic financial inclusion on poverty alleviation in Palopo City, Indonesia, with MSME performance positioned as a mediating mechanism. The findings show that Islamic financial inclusion has a positive and significant effect on both poverty alleviation and MSME performance. However, MSME performance does not significantly affect poverty alleviation and does not mediate the relationship between Islamic financial inclusion and poverty alleviation. These results indicate that access to Sharia-compliant financial services can support welfare improvement directly, but MSME performance alone is insufficient to transform financial access into meaningful poverty reduction.

The main contribution of this study lies in challenging the conventional assumption that financial inclusion automatically reduces poverty through MSME development. In the context of Palopo City, Islamic financial inclusion appears to provide direct welfare benefits, possibly through improved access to savings, financing, consumption smoothing, financial security, and reduced dependence on informal financial sources. However, the insignificant role of MSMEs suggests that many enterprises may still operate at a subsistence level, with limited capacity to generate sufficient income growth, employment creation, or broader household welfare improvement. This finding enriches the literature on Islamic finance, MSME development, and poverty alleviation by showing that the financial inclusion–poverty nexus is not always transmitted through business performance.

From a policy perspective, the findings suggest that Islamic financial inclusion programs should not focus solely on expanding access to financial services. To become an effective poverty alleviation strategy, Islamic financial inclusion must be integrated with MSME capacity-building programs, financial literacy, business mentoring, product innovation, digital adoption, market access, and institutional support. Local governments, Islamic financial institutions, and MSME agencies should work collaboratively to ensure that Sharia-compliant financial services are not only accessible but also productive, inclusive, and capable of strengthening the economic resilience of

low-income entrepreneurs. In this regard, Islamic financial inclusion should be positioned as part of a broader regional development strategy rather than as a stand-alone poverty reduction instrument.

This study has several limitations. First, it focuses only on MSME owners in Palopo City, which limits the generalizability of the findings to other regions. Second, the use of cross-sectional survey data does not capture changes in poverty alleviation and MSME performance over time. Third, poverty alleviation was measured at the respondent level and may not fully represent broader household or regional poverty dynamics. Future research should expand the study to multiple regions, employ longitudinal designs, and include additional variables such as financial literacy, business innovation, digital capability, market access, institutional quality, and social capital. Further studies may also test moderated mediation models to identify the conditions under which Islamic financial inclusion can more effectively reduce poverty through MSME development.

Author Contributions

H: Conceptualization, Methodology, Data Curation

E: Formal Analysis, Validation

M.N.A.M: Supervision, Writing – Review & Editing

N.A.A: Methodology, Resources

A.M.A: Software

Disclosure Statement

No potential conflict of interest has been reported by the author(s).

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