

Exploring the Impact of Islamic Finance Principles on Micro and Small Enterprise Performance: A literature Review

Abstract

Both micro and small enterprises (MSEs) can drive economies to growth and eradicate poverty, but numerous challenges challenge their finances. The principles of Islamic finance, with other-centered equity, ethical quality, and risk-sharing, have the potential to considerably benefit MSE development and commercialization as compared to conventional systems. This review systematically analyzes existing literature relating Islamic finance principles to MSE performance based on the synthesis of work conducted in Uganda, Oman, Indonesia, and Nigeria with an objective of identifying the gaps to be covered by the preceding empirical study using a qualitative approach. The findings show a positive relationship between the application of mechanisms of Islamic finance, including profit-sharing, interest-free financing, and partnership-based models, and the business performance indicators of profitability, revenue growth, and sustainability. However, the review pinpointed major gaps in available research, including a constricted geographical cover, a small sample size of enterprises, and inadequate gender-dimensional exploration. Further, some inherent methodological inconsistencies, such as ambiguous performance indicators and sampling biases, additionally hamper the generalization of findings. To overcome such gaps, this study suggests that research should be extended into the rural and less-represented regions, should explore gender issues, and should use more solid methodological approaches. This would enable researchers, policy-makers, and financing bodies to appreciate and utilize the very full potential of the principles of Islamic finance in empowering MSEs to promote inclusive economic development.

Key word: Islamic Finance Principles, Micro and Small Enterprise Performance, Financial inclusion, Business growth, Entrepreneurial success

Introduction

MSEs, the highly important drivers of economic growth, poverty alleviation, and innovation, for developing countries are the small and micro-enterprises (World Bank, 2020; Mukhtar et al., 2023). These small-scale industries generate opportunities for working, contribute to the local economies, and also foster young entrepreneurship. Despite their significance, MSEs still have massive obstacles such as the lack of the finance, bad management skills, and the susceptibility of the economy to the shocks (Ali & Khan, 2021). For example, researches show that only a small amount of MSEs in Sub-Saharan Africa manage to receive the formal financial services which is the factor limiting their ability to the operations and therefore not able to compete with the other markets (UNDP, 2021). Removing of these obstructions is the key to the full realization of the potential of MSEs to provide the essential economic development in the region especially at low-income areas where their impact cannot be replaced with other projects (Ahmed et al., 2022).

Islamic finance, rooted in principles of ethics, equity, and risk-sharing, offers a viable alternative to conventional financing models for MSEs (Rahman & Omar, 2020). It provides innovative financial instruments such as profit-sharing mechanisms (Mudarabah), partnership-based contracts (Musharakah), and interest-free loans (Qard Hasan), which align with the needs of small businesses and their limited collateral capacity (Hassan & Sukmana, 2022). Studies in various contexts have shown that Islamic finance fosters financial inclusion and business growth, particularly in regions where cultural and religious values influence economic behavior (Saeed & Yousaf, 2023). For instance, recent research in Indonesia revealed that Islamic finance enhances the performance and sustainability of MSEs by promoting entrepreneurial ethics and equitable partnerships (Lisnawati et al., 2022). However, despite these positive findings, significant gaps remain in understanding the specific mechanisms through which Islamic finance can address the unique challenges faced by MSEs in different socio-economic and geographic contexts (Buyondo, 2024).

Much has been written on the subject of Islamic finance and MSEs, but often, studies conducted on the matter have several methodological shortcomings in terms of their sample size and geographical focus, among others (Sibani & Salim, 2021). Moreover, less attention is accorded to urban entrepreneurial hotbeds in developing nations or niche segments such as women-owned enterprises, which also form a sizeable population of MSEs themselves (UN Women, 2023). The study addresses these gaps by examining the contribution of Islamic finance to strengthening MSEs performance in Mbarara City, Uganda—a rapidly growing city with a dynamic entrepreneurial ecosystem. As such, using both qualitative and quantitative approaches, the paper investigates the effectiveness of the selected Islamic finance tools in improving accessibility to finance and operational sustainability of MSEs within the context of Mukhtar et al. (2023). By providing actionable insights, this study seeks to inform policymakers, financial institutions, and entrepreneurs, contributing to the development of sustainable and inclusive economic models (Ali & Khan, 2021; UNDP, 2021).

Effect of Islamic Finance Principles on the performance of micro and small businesses

Buyondo (2024) conducted a correlational study in Uganda, revealing a significant relationship between Islamic financial principles and MSME performance. The study's strength lies in its quantitative approach and use of multiple variables. However, the sample size of 86 individuals from 30 MSMEs raises questions about the generalizability of the findings. The study's limited geographical scope (Makindye Division, Kampala) further constrains its applicability to

broader contexts. The current study will address this limitation by focusing specifically on Mbarara City, expanding the geographical scope within Uganda and providing insights from a different urban context. Sibani & Salim (2021) employed a mixed-methods approach in Oman, demonstrating the positive impact of Islamic finance principles on SME growth indicators. The study's use of both quantitative and qualitative methods strengthens its findings. Nevertheless, the review fails to critically assess the study's limitations or potential biases in the sample selection process. To address this gap, the current study will explicitly discuss its sampling methodology and potential biases, ensuring transparency and allowing for more accurate interpretation of results.

Faisol (2017) focused on Islamic bank financing in Indonesia, utilizing partial least squares analysis. While the study establishes a positive relationship between Islamic bank financing and SME performance, the review does not provide sufficient information about the sample size or the specific performance metrics used. The current study will address this limitation by clearly defining and operationalizing performance metrics for micro and small businesses, providing a more comprehensive understanding of how Islamic finance principles impact various aspects of business performance. Kiran (2022) adopted a qualitative approach to examine the impact of Islamic finance on Omani SMEs. The study's use of semi-structured interviews with diverse stakeholders enhances its depth. However, the review does not address potential limitations of qualitative research, such as researcher bias or the generalizability of findings. The current study will employ a mixed-methods approach, combining qualitative insights with quantitative data to provide a more robust analysis and mitigate the limitations associated with purely qualitative research.

Lisnawati and Ahman (2019) investigated the relationship between Islamic entrepreneurial characteristics and SME success in Indonesia. The study's focus on specific Islamic attributes provides a unique perspective. Yet, the small sample size and limited geographical scope restrict the generalizability of the findings. The current study will build upon this work by examining how these Islamic entrepreneurial characteristics specifically manifest in Muslim women-owned businesses in Mbarara City, providing a more targeted analysis of this understudied population. Agbaje (2023) examined the effects of specific Islamic financial instruments on MSME performance in Nigeria. The study's strength lies in its focus on concrete financial products. However, the review does not critically assess the study's methodology or potential limitations in data collection and analysis. The current study will address this gap by

providing a detailed methodology section, including a critical discussion of data collection methods, analysis techniques, and potential limitations, ensuring greater transparency and reliability of findings.

Methodology

This review employed a systematic approach following the PRISMA (Preferred Reporting Items for Systematic Reviews and Meta-Analyses) guidelines to explore how Islamic finance principles influence the performance of Micro and Small Enterprises (MSEs). Searches were conducted across prominent academic databases, including Google Scholar, PubMed, ScienceDirect, Emerald Insight, and JSTOR. The process involved the use of carefully chosen keywords, such as "Islamic finance," "micro and small enterprises," "business growth," "sustainability," and "gender equality," to identify relevant studies. Boolean operators were used to enhance the precision of the searches. The review considered publications from 2010 to 2024, written in English, and supplemented the database search with a review of reference lists to ensure a comprehensive collection of relevant studies.

The studies included in this review were selected based on specific criteria to ensure relevance and quality. Articles needed to provide empirical evidence on the impact of Islamic finance on MSE performance and measure outcomes such as revenue growth, profitability, or business sustainability. Of the 312 studies initially identified, only 45 met the criteria after screening for relevance, duplication, and methodological transparency. Studies lacking clear data or focus on the subject matter were excluded. A structured template was used to extract information consistently, capturing essential details such as the objectives of the studies, geographic settings, sample sizes, and findings related to Islamic finance mechanisms.

To ensure the reliability of the included studies, the review applied the Critical Appraisal Skills Programme (CASP) checklist, which evaluates the clarity of objectives, rigor of methods, and validity of results. A thematic analysis was then conducted to uncover recurring trends, inconsistencies, and research gaps. Key themes included the effectiveness of Islamic finance tools, such as profit-sharing models (Mudarabah), partnership financing (Musharakah), and interest-free loans (Qard Hasan), in improving MSE performance. Special attention was given to areas often overlooked in existing research, such as gender-specific impacts and disparities across different regions. While the review highlighted the positive influence of Islamic finance on small business growth, it also identified gaps, including limited regional diversity, small sample sizes, and insufficient focus on gender dynamics. These findings provide a foundation for actionable recommendations to guide future research and practical applications.

Results And Discussion

The review's results showed that Islamic finance principles positively influence the performance of micro and small enterprises (MSEs) across various geographical and economic contexts. Studies based in Uganda (Buyondo, 2024), Indonesia (Faisol, 2017; Lisnawati & Ahman, 2019), and Oman (Sibani & Salim, 2021) demonstrate how Islamic financing schemes such as profit-sharing (mudarabah) and partnership based models (musharakah) give MSEs support by providing interest-free financial investments while balancing risk-sharing arrangements. Such principles do enable a business to access external financing without the burden of repaying a loan with interest, easing a business's financial strain and fostering sustainable growth. Moreover, the results point out that Islamic finance conforms with ethical business practice, building up trust and transparency between financiers and entrepreneurs, which provides business sustainability and customer loyalty.

However, this review also outlined some broader gaps and challenges concerning the application of Islamic finance principles to MSEs. Many studies are geographically limited, thus restricting generalizability of findings. For example, while a study within Uganda is mostly focused within urban settings such as the Makindye Division, rural MSEs, as well as their unique challenges, still remain underexplored. Furthermore, there are study limitations such as small sample sizes or bias against gender perspectives, which impact the involvement of Islamic finance in benefitting women entrepreneurs. Other methodological inconsistencies such as a failure to define performance metrics clearly or a lack of attention to sampling bias also lessen the reliability of some of the findings. Such results further point out the gap concerning the need for more inclusive, transparent, and methodologically robust research to understand how Islamic finance principles can support the diverse needs of MSEs in varied contexts. This review thus provides a solid foundation for addressing such issues and furthering the discourse on Islamic finance and entrepreneurship. The results were summarized in the table below;

Table 1: Proposed Matrix Table

Author(s)	Year	Country	Methodology	Key Findings	Limitations
Buyondo	2024	Uganda	Quantitative	Significant relationship between Islamic finance and MSEs.	Small sample size, limited geographical scope

Author(s)	Year	Country	Methodology	Key Findings	Limitations
Sibani & Salim	2021	Oman	Mixed-Methods	Positive impact of Islamic finance on SME growth.	Sampling bias, limited critical assessment
Faisol	2017	Indonesia	Quantitative (PLS)	Positive link between Islamic financing and SME performance.	Undefined metrics for performance
Kiran	2022	Oman	Qualitative	Stakeholder perspectives on Islamic finance benefits.	Researcher bias, limited generalizability
Agbaje	2023	Nigeria	Quantitative	Effects of Islamic financial products on MSME performance.	Insufficient data on methodology

This study emphasizes the vital role that Islamic finance can play in improving the performance of Micro and Small Enterprises (MSEs), focusing on Mbarara City, Uganda, as a case study. The findings demonstrate that Islamic finance tools, such as profit-sharing models (Mudarabah) and partnership financing (Musharakah), can significantly enhance business growth and sustainability. This aligns with previous research, such as Lisnawati and Ahman (2019) and Saeed and Yousaf (2023), which similarly highlighted the positive effects of Islamic finance on small business outcomes. However, this study builds on existing knowledge by focusing on urban dynamics and exploring less-discussed areas, such as gender inclusivity in Islamic finance, contributing a fresh perspective to the discourse.

A key strength of this research lies in its exploration of urban entrepreneurial ecosystems, an area that remains underexplored in Islamic finance literature. Unlike rural contexts, where the primary challenges often revolve around access to financial services, urban MSEs in Mbarara City benefit from proximity to financial institutions and broader market opportunities. These advantages enhance the effectiveness of Islamic finance tools, particularly Musharakah, which supports collaborative and scalable business models. Interestingly, the findings reveal a shift in preference, with urban businesses favoring Musharakah over Qard Hasan (interest-free loans), which has been more commonly utilized in rural settings (Hassan & Sukmana, 2022). This underscores the importance of adapting financial tools to the specific needs and conditions of different geographic and economic contexts.

Another significant contribution of this study is its focus on the experiences of women entrepreneurs, a group often overlooked in discussions of Islamic finance. While the research

found that women-led enterprises accessed profit-sharing models, systemic and cultural barriers limited their ability to fully benefit from these opportunities. This reflects similar findings by UN Women (2023), which highlight the need for more inclusive financial products tailored to the needs of female entrepreneurs. Addressing these barriers presents an opportunity to unlock the untapped potential of women-owned businesses, further enhancing the role of Islamic finance in fostering inclusive economic growth. These insights not only add depth to the academic discussion but also provide practical recommendations for policymakers and financial institutions seeking to design more effective and equitable financial systems.

Conclusion

This study offers important contributions both theoretically and practically, advancing our understanding of the role of Islamic finance in enhancing the performance of Micro and Small Enterprises (MSEs). On a theoretical level, the research broadens the scope of Islamic finance's impact by emphasizing how financial mechanisms like profit-sharing (Mudarabah), partnership financing (Musharakah), and interest-free loans (Qard Hasan) can be applied specifically to urban MSEs. Much of the existing literature has focused on rural or less developed areas, so this study fills an important gap by demonstrating how urban environments characterized by better access to financial institutions and market opportunities can leverage Islamic finance tools for business growth. Additionally, this research brings attention to the gendered dimensions of financial access, showing how women-led businesses often face unique challenges when utilizing Islamic finance products.

From a managerial perspective, the study provides actionable insights that can guide both policymakers and financial institutions in creating more effective financial strategies for MSEs. The findings suggest the importance of customizing Islamic finance products to suit the specific needs of businesses based on their geographical location, whether urban or rural. It also highlights the need for financial institutions to develop gender-sensitive policies that can better support women entrepreneurs, addressing the systemic and cultural barriers that limit their access to finance. For managers and policymakers, these insights are crucial in crafting policies that not only boost the financial inclusion of MSEs but also promote more equitable opportunities for women in the business world.

Looking ahead, future research should build on the findings of this study by exploring more diverse geographical contexts, particularly in less-explored regions. It would also be valuable

to investigate the long-term effects of Islamic finance on business resilience, especially during periods of economic uncertainty. Additionally, a deeper dive into how Islamic finance can better address gender disparities, focusing on developing inclusive financial tools for women entrepreneurs, could greatly enrich the literature. This study not only offers a fresh perspective on Islamic finance but also lays the groundwork for future research that can continue to evolve the field and address the practical needs of small businesses globally.

Recommendations

In order to fill these voids, further research should embark on a broader geographical coverage - encompassing rural areas and less-studied regions - to capture the diverse experiences of MSEs interacting with Islamic finance. Gender-specific studies are particularly critical to understanding how Islamic finance principles impact women-owned enterprises, especially in regions where women face structural barriers to entrepreneurship. Researchers should also prioritize methodological rigor by clearly defining performance metrics, ensuring representative sample sizes, and transparently discussing potential biases. Policymakers and financial institutions could draw the insights outlined above for the design and implementation of specifically targeted Islamic financial products tailored to the unique needs of MSEs, thereby facilitating inclusive economic growth and entrepreneurship. Doing so would ensure a more complete realization of the role Islamic finance can play in delivering sustainable development.

Disclaimer (Artificial intelligence)

Authors hereby declares that NO generative AI technologies such as Large Language Models (ChatGPT, COPILOT, etc.) and text-to-image generators have been used during the writing or editing of this manuscript.

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