International Journal of Islamic Economics and Finance (IJIEF)
Vol. 7(1), page 73-94, January 2024

SMEs, Employment Generation, and Islamic Finance

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Article History
Received: June 10th, 2023
Revised: July 24th, 2023
August 10th, 2023
August 18th, 2023
January 13th, 2024
Accepted: January 23th, 2024

Abstract

Almost wherever the economy is growing, small and medium-sized businesses (SMEs) are the ones doing the heavy lifting. Who are these SMEs? How does the definition of SME differ across different countries? What are the contributions of SMEs in terms of employment and GDP? How can Islamic finance play a significant role in scaling up the business performance of SMEs and, subsequently, their contribution to employment and the economy? What are the issues and challenges faced by SMEs and Islamic finance that would resolve into greater employment generation? Addressing all these questions, this paper provides an overview of SMEs globally and their definitions in different countries as well as in Malaysia. Simultaneously, some issues and challenges are discussed. Furthermore, the paper presents Islamic finance as a better solution to the financial accessibility of SMEs in future economic activities. The paper thus attempts to illustrate a model or framework that would work well for SMEs to generate productive employment opportunities in their respective economies. To achieve the objectives of this paper, secondary data was used to present all the statistical figures and tables. For any generalizations, recommendations, or conclusions, an extensive review of literature from various sources was conducted.

Keywords: SMEs, Entrepreneurship, Islamic Finance, Employment.
JEL Classification: L25, G21, G32, J23, O17
Type of paper: Research Paper

DOI:
https://doi.org/10.18196/ijief.v7i1.18632

Web:
https://journal.umy.ac.id/index.php/ijief/article/view/18632

Citation:
Azam, M. S. E., & Abdullah, M. A. (2024). SMEs, Employment Generation, and Islamic Finance. ***International Journal of Islamic Economics and Finance (IJIEF),*** *7*(1), 73-94. DOI: https://doi.org/10.18196/ijief.v7i1.18632

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I. Introduction

A small and medium enterprise (SME) refers to a business that conducts its' business operations below a certain level for different criteria (e.g., assets, revenue, employee, capital, etc.) set by the definition of different economies globally. Thus, the definition of SMEs varies in different countries based on the criteria. It is important to identify and categorize SMEs in an economy accordingly, as they represent the largest segment (around 95%) of total establishments in almost all the economies in the world. In Malaysia, for example, SMEs constitute more than 98.5 percent of the total establishments. This figure is more or less similar to most of the countries across the world. Simultaneously, this large segment of a country contributes to the respective economy as well as to society in a number of ways. One of the significant contributions is in terms of employment generation. In Malaysia, the significance of SMEs can be recognized by their contribution to the GDP (38.4% in 2018) and employment generation (66.2% in 2018) (NESDC, 2019).

However, while generating employment and enhancing the GDP growth of an economy, SMEs also face many issues and challenges. One common and major challenge is financial accessibility, which has been identified and highlighted by many scholars, economists, and policymakers. A report by the World Bank shows that more than 70 percent of SMEs have issues and face challenges accessing finance in emerging markets. Whereas, in the same market, 70 percent of jobs are being created by SMEs (World Bank Group, 2015). In this regard, governments are taking initiatives to overcome this issue and upscale the performance of SMEs. Malaysia, as a leading country in the Islamic economy, offers a number of sources of Islamic finance, which is also available and practiced in other countries as well. As of 2019, Islamic finance has a global asset value of US$2.4 trillion (Dinar Standard, 2022). The options offered by Islamic finance are comprised of both asset-based and equity-based options. The profit-and-loss-sharing nature of equity-based finance is preferred by many customers as well as SMEs globally. Numerous benefits provided by Islamic finance make it less challenging for SMEs to access the required finances. Hence, Islamic finance can play a significant role in mitigating the issue of financial accessibility for SMEs and thus accelerating employment generation in an economy. However, while trying to serve as a better alternative financing solution, Islamic finance is facing a number of challenges to prove its' significant role and establish a stronger position in the economy dominated by conventional finance.

Therefore, this paper sets the objective of providing a global overview of SMEs in terms of their definition and the present status of SMEs in Malaysia. The second objective of the paper is to realize the role of SMEs in employment generation, their contributions to different economies, and the challenges they face. Finally, the paper aims to present Islamic finance as a better solution for SMEs in terms of financial accessibility.

The present conceptual paper is significant in its exploration of Islamic finance's role in alleviating financial accessibility challenges among SMEs for three distinct reasons. Firstly, it provides a global overview of SMEs, emphasizing their significance and role in diverse economies, with a focus on Malaysia. Secondly, it uniquely connects SMEs' vital employment generation with their financial limitations, spotlighting the urgency for effective solutions. Thirdly, the paper proposes Islamic finance as a robust alternative, leveraging its substantial global asset value of US$3.6 trillion in 2021. Focused on the Malaysian context, the paper's comprehensive approach employs secondary data and a literature review. This makes it a valuable contribution that navigates the complex landscape of SMEs' financial accessibility challenges and offers a credible solution through Islamic finance.

The organization of this paper unfolds systematically, with the introductory section presenting the problem statements, ongoing issues, and research objectives. The subsequent section outlines the adopted methodology, followed by a comprehensive review of relevant literature while engaging in discussions on pivotal topics. These topics encompass a global perspective on SMEs, a focus on SMEs in Malaysia, their role in employment generation, encountered challenges, and the significance of Islamic finance. The exploration extends to encompass aspects like the credit gap within Islamic finance for SMEs, available sources of Islamic finance, the SME development model, and the challenges encountered by Islamic finance in SMEs' context. The concluding section encapsulates the paper with a summary, reflection on limitations, and suggestions for prospective future research endeavours.

II. Methodology

The methodology employed in this paper involves a systematic review of secondary data and diverse literature sources, such as annual reports, research papers, news articles, books, and online reports. This approach was chosen to provide a comprehensive understanding of the global landscape of SMEs, focusing primarily on the Malaysian context. By analyzing a wide range of reliable and up-to-date sources, the paper ensures a robust foundation for its exploration of SME definitions, contributions to economies, challenges, and the potential of Islamic finance to address financial accessibility concerns. This methodology allows for the synthesis of diverse perspectives and insights, enabling a well-rounded and informed discussion on the subject matter.

III. Results and Discussions

SMEs Globally

There is no universal definition of SMEs or MSMEs (Micro, Small and Medium Enterprises). This is because of the diversity in the structure, culture, and politics of different economies around the world. Moreover, the definition may depend on the population size, business culture, level of global integration, industry type, etc. However, two common criteria have been used by many countries globally, which are also recommended by the World Bank. The criteria are '*annual asset turnover*' or '*annual sales turnover*', and '*number of employees*.' Considering these two parameters helps define MSMEs so that they are suited for specific schemes and programs offered by the respective governments. Some of the definitions and contribution of SMEs in different countries globally are presented in Table 1.

According to a study by the World Bank Group, presently there are about 365 to 445 million MSMEs in the emerging market globally (World Bank Group, 2015). This huge segment of the population in the global economy is also responsible for creating a greater spending chain among different levels of consumers in the respective economies. SMEs are one of the greater money-changing hands that enhance economic growth through better utilization of the money (finance) they get, which is exhibited by their business profit and employment generation.

Table 1 SME Definitions Across Different Economy Globally

INDONESIA			
Category	Net asset	Annual sales	Employees
Small	US$ 5,556 to US$ 55,556	US$33,334 to USD277,778	11 to <30
Medium	US$ 55,556 to US$ 1,111,111	US$277,778 to US$5,555,556	31 to <300
Source: Ministry of Investment (2022)			
SINGAPORE			
	Annual Sales Turnover		Employees
SMEs	< US$ 100 million		< 200
Source: Femri (2022)			
THAILAND			
	Capital	Employees	
Small	< US$ 158,000	< 50	
Medium	>US$ 158,000 to < US$ 632,350	51 to 200	
Source: Ahmad et al. (2017)			
PHILIPPINE			
	Asset value	Employees	
SMEs	US$ 58,600 to US$ 195,361	10 to 199	
Source: Nikki Natividad, (2017)			
BRUNEI			
	Employees		
Small	6 to 50		
Medium	51 to 100		
Source: Badar and Rahman, (2015)			
EUROPIAN UNION (EU)			
	Annual Turnover	Employees	
Micro	< €2 million	0 to < 10	
Small	< €10 million	10 to 49	
Medium	< €50 million	50 to <250	
Source: ((NESDC), 2021)			
UNITED KINGDOM (UK)			
	Employees		
Small	10 to 49		
Medium	50 to 249		

Source: Mort (2019)

SMEs in Malaysia

The definition of SMEs in Malaysia is given by SME Corporation Malaysia. It considers quantitative parameters such as the number of employees, sales turnover, total assets, or total capital. Hence, the definition varies according to these parameters and key sectors. For instance, in the manufacturing sector, small businesses are the companies that have employees of 5 to <75 or have a sales turnover of RM300,00 to RM15 million, while for services and other sectors, small companies are described as each company with 5 to <30 employees or a sales turnover of RM300,000 to RM3 million. Likewise, the definition of medium and micro enterprises is different for both manufacturing and services and other sectors (**Figure 1**).

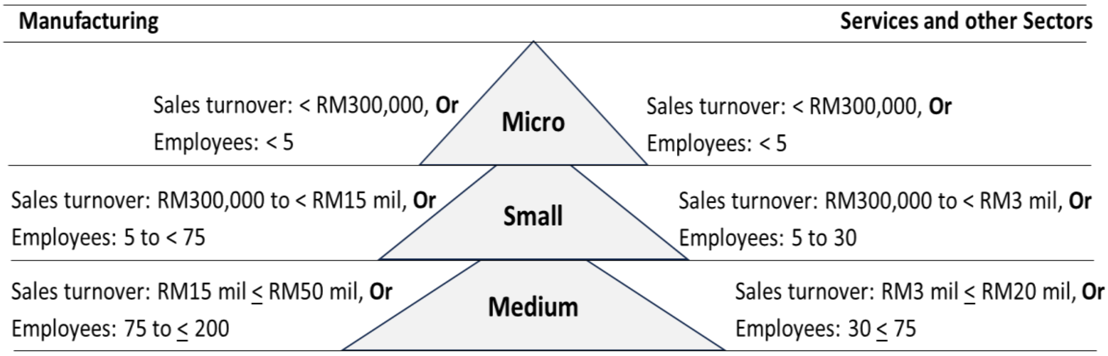

Figure 1 SME definition Malaysia
Source: SME Corporation Malaysia

In Malaysia, SMEs are also categorized based on different types of sectors. According to the economic census 2016, Table 2 shows the number and percentage of SMEs in the different sectors, where the reference year is 2015. The different sectors of SMEs have a significant contribution to the GDP of Malaysia. The total value added by SMEs to the GDP of Malaysia was 38.4% in 2018. As the size of different sectors of SMEs varies, the percentage of their contribution also varies. Figure 2 illustrates the GDP contribution by different sectors of SMEs from 2015 to 2018.

Table 2 Number of SMEs by sector and size in Malaysia

	Number of SME Establishments				Share of SMEs (%)
	Micro	Small	Medium	Total SMEs	
Services	649,186	148,078	11,862	809,126	89.2
Manufacturing	22,083	23,096	2,519	47,698	5.3
Construction	17,321	17,008	4,829	39,158	4.3
Agriculture	4,863	4,143	1,212	10,218	1.1
Mining and Quarrying	217	458	190	865	0.1
Total	693,670 (76.5%)	192,783 (21.2%)	20,612 (2.3%)	907,065 (100%)	100

Source: NESDC (2019)

The contribution of SMEs to Malaysia's development is also featured through innovation. SMEs are increasingly versatile, adaptable, and dynamic, and more delicate to shifts in demand compared to large enterprises. Malaysia's monetary improvement has been firmly connected to advancements in the worldwide economy because of the transparency of its economy and the predominance of exchange exercises. Asset-based items, for the most part from agribusiness and mining, contributed 60 percent to, generally speaking, mechanical development in the early long periods of freedom. It was found that the SMEs in the electrical and textile industries contributed close to nothing or deficiently to the development and augmenting of Malaysia's residential mechanical structure, while linkages with the remainder of the economy were not very strong. However, they should be considered overall in other sectors as well with regards to their job in giving a force to Malaysia's advancement inside the globalized economy (Razak et al., 2018).

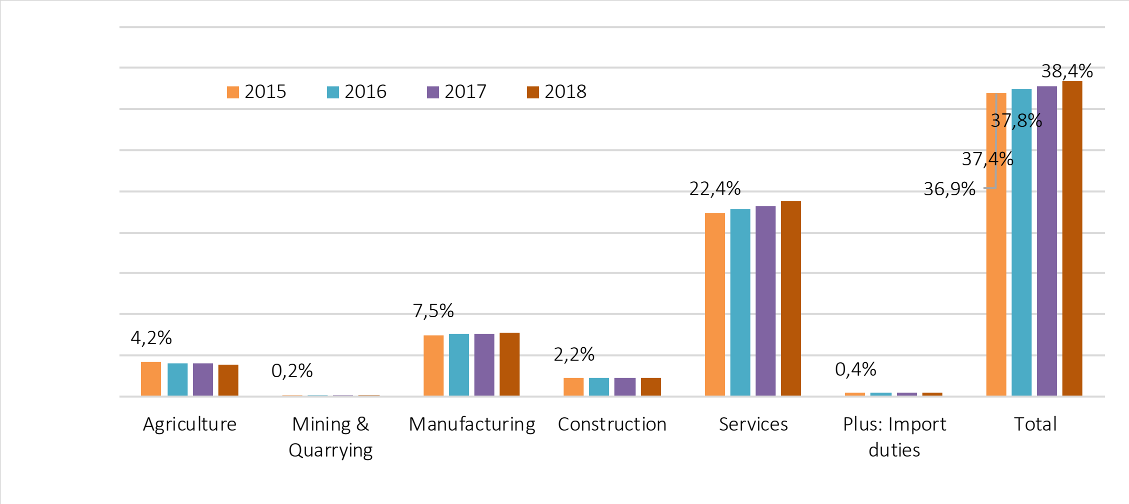

Figure 2 Sector-wise contribution of SMEs to the overall GDP of Malaysia
Source: NESDC (2019)

SMEs in Employment Generation

Do SMEs play any significant role in net employment generation? Net employment can be defined from the macro-level approach as the balance of employment generation in one side and employment losses on the other. Employment creation and losses are experienced because of the employment change in the existing SMEs, and entry or exit of SMEs (de Kok et al., 2011). Entrepreneurship is one of the most significant approaches to employment generation by SMEs. Entrepreneurship can play a vital role to reduce the unemployment rate which significantly higher (close to 30%) in MENA countries and even higher in some other countries.

In addition, a significant percentage of the youth population is hosted by OIC member countries, which is forecast to be 35 percent by 2030 (OIC, 2019). Unfortunately, this young population of OIC countries faces an unemployment rate of 16 percent, which is higher than the average rate of non-OIC developing and developed countries. However, in Asia, the unemployment rate is 5.47 percent and 3.36 percent in Malaysia. While Asia shows a better performance in terms of the unemployment rate, the Global Entrepreneurship Index (GEI) score is not that impressive compared to the top-ranked countries (Table 3). It is observable that the performance of Asian countries is very poor compared to the top ten countries globally and even MENA countries. Therefore, entrepreneurship has to be given more importance by empowering and facilitating SMEs in employment generation.

Table 3 Top ten countries in GEI globally, MENA, and Asia

Global			MENA		ASIA	
Rank	Country	GEI Score	Country (Global rank)	GEI Score	Country (Global rank)	GEI Score
	USA	83.6	Israel (12)	67.9	Japan (26)	53.3
	Switzerland	80.4	UAE (25)	54.2	Singapore (27)	52.4
	Canada	79.2	Qatar (28)	51.6	China (34)	45.9
	Denmark	77.8	Bahrain (38)	43.8	Malaysia (43)	40.1
	UK	75.5	Oman (39)	43.6	Brunei (48)	36.5
	Australia	74.3	Saudi Arabia (42)	42.1	Thailand (54)	33.5
	Iceland	74.2	Kuwait (47)	37.4	Vietnam (73)	26

Global			MENA		ASIA	
Rank	Country	GEI Score	Country (Global rank)	GEI Score	Country (Global rank)	GEI Score
	Netherland	73.7	Tunisia (53)	34.1	Indonesia (75)	26
	Ireland	73.1	Lebanon (66)	28.8	India (78)	25.1
	Sweden	68.5	Algeria (88)	22.4	Philippine (86)	23

Source: Acs et al., (2020)

The SMEs contribution has been recognized globally in terms of GDP contribution as well as job creation. They represent around 90 percent of the business and more than 50 percent of the employment globally. Moreover, in the emerging markets, 70 percent of the jobs are created by SMEs globally (World Bank SME Finance, n.d.). **Figure 3** illustrates the contribution of SMEs in different countries globally in terms of their employment, GDP, and percent of total establishments. Simultaneously, Figure 4 presents the contribution of MSMEs in the region of South Asia and ASEAN. According to the world bank report, there will be a need of 600 million jobs by 2030 against the growing global workforce.

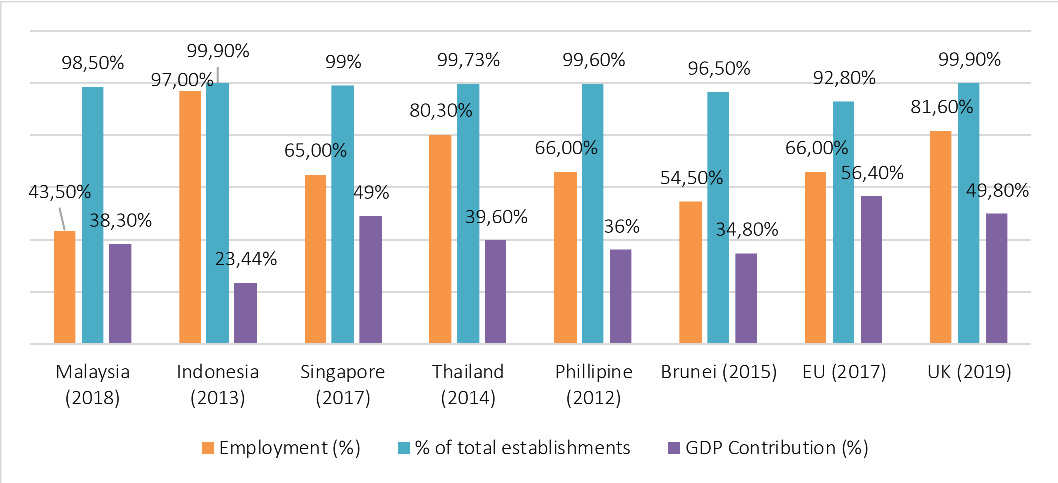

Figure 3 Contribution of MSMEs in different economies globally
Source: Refer to **Error! Reference source not found.**

In Malaysia, MSMEs employed 66.2 percent of the total employment during the year 2018, with a sustained growth rate of 3.2 percent from 2017 (3.4%). The maximum employment contribution is in the service sector, followed by manufacturing, agriculture, and construction (Figure 5). Such growth and contribution to employment generation by SMEs is driven by a few factors, including the provision of a conducive ecosystem, programs, and policies to influence self-employment and start new firms, particularly by micro-entrepreneurs and entrepreneurs.

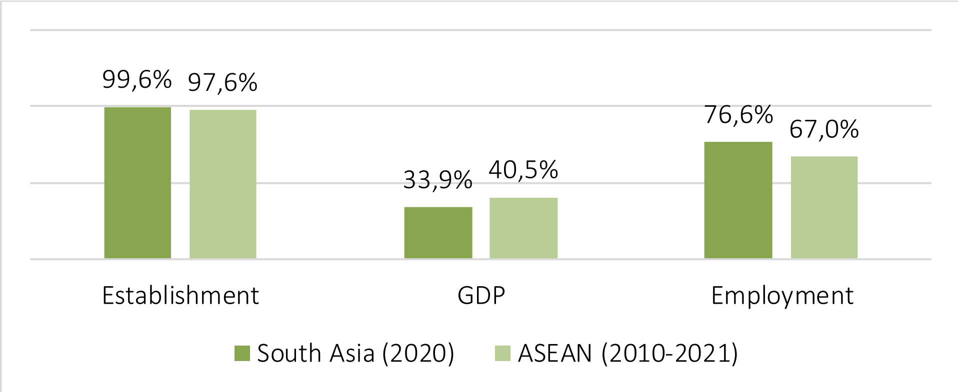

Figure 4 Contribution of MSMEs in South Asia and ASEAN (%)
Source: NESDC (2021)

Presently, in Malaysia, 100,000 jobs are being created against 260,000 youths who are finishing their studies every year (Bernama, 2019). Such an imbalance between the labor force and job opportunities has to be minimized. To do so, SMEs should be empowered, more facilitating programs should be implemented, and fresh graduates should be motivated and encouraged to become entrepreneurs.

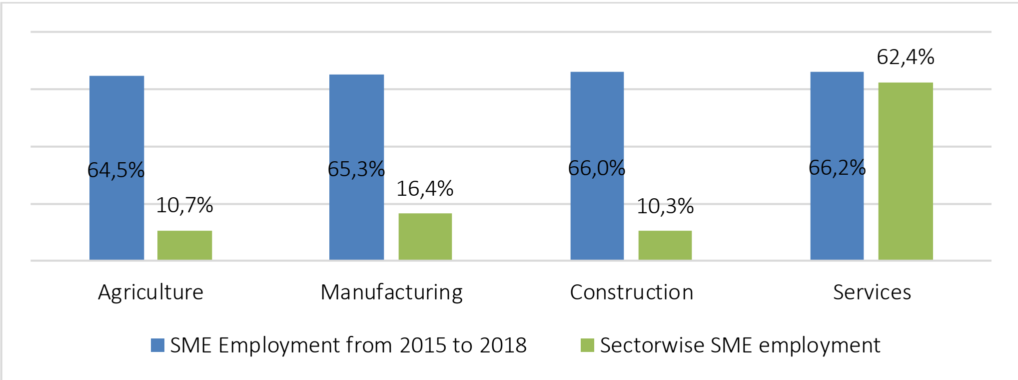

Figure 5 SMEs employment from 2015 to 2018 and Sector-wise SME employment
Source: NESDC (2021)

Issues and Challenges Faced by SMEs

It would be unjustified to say that the path of SMEs for such a contribution to the social and economic development of a country has been very smooth and barrier-free. Some of the major issues that were discussed and highlighted by previous studies are related to financing, training, financial literacy, emerging technology, and legislation matters. For example, a study by Bowen et al., (2009) conducted in Nairobi, Kenya, shows that about 60 percent of SMEs experience failure within a few years of their operation because they lack training in different fields of business. Training requirements for SMEs in different fields of business were also addressed by Khalique et al., (2011). They found SMEs in Malaysia lack skills in marketing techniques, exporting, branding, customer loyalty, and also lack of good contacts with other local and international enterprises.

Additionally, evidence from many studies has been provided to support the effectiveness of financial literacy, although, there are few studies on that. The study by Cole et al., (2009), conducted in two of the most populous countries in the world (Indonesia and India), showed that financial literacy is an important predictor of financial behavior in the developing world. This is why SMEs with poor financial literacy face problems in their business regarding proper accounting, forecasting, budgeting, record keeping, and analyzing figures (Ismail, 2002; Marriott & Marriot, 2000; Dorasamy et al., 2010).

Technological improvement was identified as a key challenge for SMEs (Tan et al., 2009). Information and communication technologies (ITCs) and the use of the Internet have witnessed great development around the world, thus affecting the business practices of enterprises regardless of their sizes. In many cases, however, SMEs suffer from this development, and they need more assistance, especially regarding financial accessibility to adopt expensive machines and technologies (Industry 4.0 technologies). In this regard, the SME Annual Report 2019 by Bank Negara Malaysia suggests that SMEs should adopt IR4.0-related technologies to improve management practices and productivity.

With a much change of global economic trend and the new paradigm shift towards e-commerce, the internet of things and the 4th Industrial Revolution (4IR), SMEs' approach needs to be changed as well. The global trends that focus on automation and data exchange in industrial activities and manufacturing technologies including cyber-physical systems, the internet of things, cloud computing and cognitive computing with speed and fast are undoubtedly helping SMEs. The concept and significance of Industrial Revolution (4IR) (or IR 4.0) and the Internet of Things (IoT) as well as the concept of real-time human to cyber-physical systems communication cooperation via IoT in the value chain, be it internal or domestically and internationally, may contribute to this need eventuality. The transformation Industrial Revolution (4IR) which somehow created "smart factories" that allows efficient virtual integration between business management centers may positively affect SMEs.

Emerging technologies are those beyond automation, i.e., those related to the 4th Industrial Revolution (4IR). An example of emerging technology is the adoption of big data to better understand customers' demographics, which leads to insights being captured to further improve product development and marketing strategies. Other examples include the Internet of Things (IoT), blockchain, and artificial intelligence. Adopting Industry 4.0 is crucial for SMEs to become competitive in the global market, improve sustainability, and make efficient use of energy and resources. However, lack of technical skills and sufficient finance are the organizational barriers for SMEs to adopt IR 4.0 (Matt et al., 2019).

Legal matters and administrative burdens are significant deterrents for SMEs, as they are not well capable of dealing with arising guidelines and requirements from regulatory bodies. Therefore, cost should be minimized regarding access to information and the procedures needed to comply with the standards and requirements. Hassan (2013), in his study, enlisted a number of challenges faced by SMEs that include high transaction costs, insufficient human capital and expertise, access to technology, poor access to markets, product innovation, utilization of movable collateral with bank policies, poor communication amongst financial institutions on information sharing, and poor financial literacy. Additionally, one common and most significant challenge mentioned by almost all the studies is access to finance. The report, SME Competitiveness Outlook 2019 by the International Trade Centre (ITC), identified access to finance as the biggest challenge, along with a number of other challenges faced by SMEs in developing countries globally (Figure 6). Therefore, the following section of this paper discusses the issue in brief and presents Islamic finance as a better alternative solution to this problem.

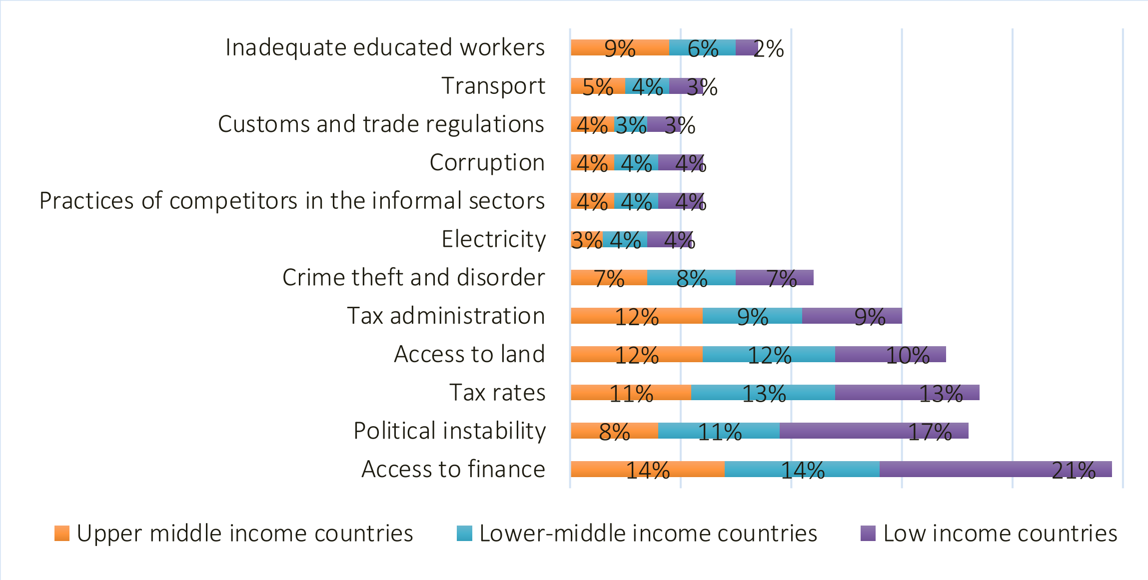

Figure 6 Challenges faced by SMEs in developing countries globally
Source: International Trade Centre (2019)

Access to finance

Even though SMEs contribute both to GDP growth and employment in an economy, they face the biggest challenge in terms of accessibility to finance. Challenges in finance faced by SMEs have been considered to be an obstacle globally. It must be addressed more systematically by different relevant parties and agencies (Malaysia's Islamic Finance Marketplace, 2016).

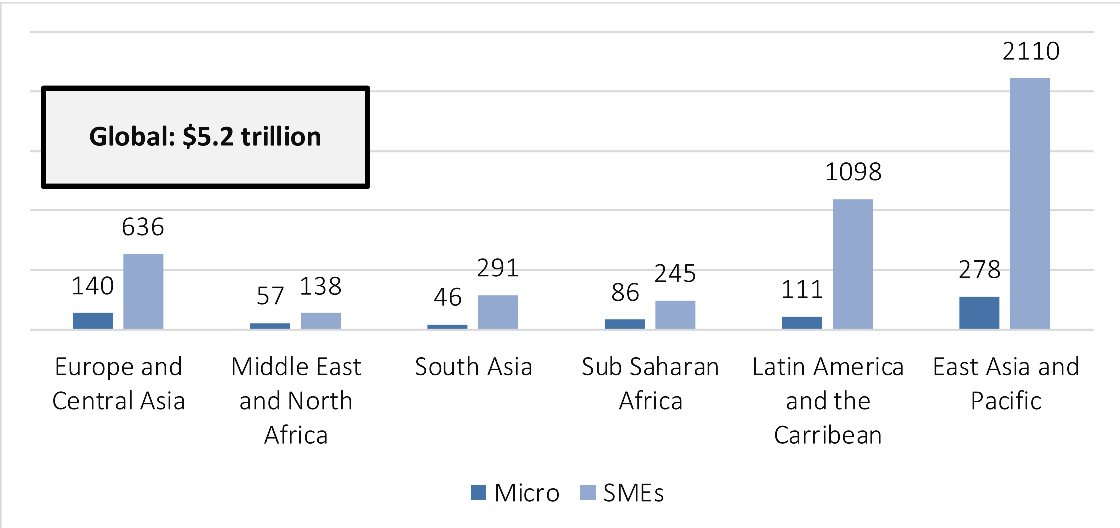

Figure 7 Financing Gap in Developing Countries Globally (US$ Billion)
Source: World Bank report; https://www.worldbank.org/en/topic/smefinance

The challenges of accessibility to finance are comprised of high interest rates, available sources, credit duration, adequacy, affordability, and ease of access. In the field of emerging markets, more than 70 percent of MSMEs lack access to credit, as reported by the World Bank study group. Whereas in the same emerging market, more than 70 percent of jobs are created by SMEs, and the World Bank estimates a need for more than 600 million jobs by 2030. Financing like microcredit can have a positive impact on the livelihood status of rural women as well (Azam, 2012). This implies a need for financing SMEs so that they can meet the demand for employment. Unfortunately, there is a significant financing gap for SMEs globally (Figure 7).

However, to mitigate this constraint, financial institutions and banks play a significant role as one of the vital sources of finance. Financial institutions in Malaysia are the backbone for financing SMEs. Such institutions include banks, government agencies, and development financial institutions that provide 97 percent of total lending to SMEs in Malaysia (NESDC, 2019). Figure 8 shows the different sources of funds and the percentage of financing by them for a total of RM6.08 billion during the year 2018.

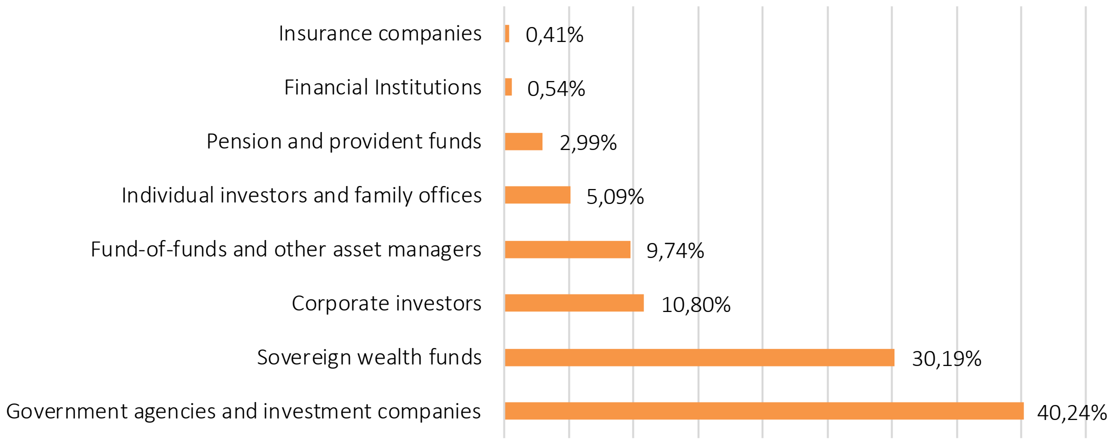

Figure 8 SME financing by different sources of funds (Total RM6.08 billion)
Source: SME Annual Report 2019, Bank Negara Malaysia

Additionally, according to the SME annual report 2019 by Bank Negara Malaysia, a total of RM307.3 billion was disbursed to 123,600 accounts of SMEs during the year 2018. The report also shows that 47 percent of the business financing outstanding was for SMEs, and 87 percent of the business accounts were SME accounts. Additionally, for the year 2019, Malaysia plans 33 different financing programs for SMEs with the aim of providing better access to finance. The disbursable amount under these programs was RM13.1 billion, and the number of targeted beneficiaries was 434,502.

Furthermore, to assist the SMEs with their accessibility to finance a number of different companies, and governmental agencies are leading different financing schemes and programs. The maximum fund of RM3.9 billion is provided by the Credit Guarantee Corporation (CGC) under six different financing schemes for 8,500 targeted SMEs. Access to finance by SMEs in Malaysia is further enhanced by the source of equity crowdfunding. During the year 2016 to 2018, there were 51 successful campaigns that raised RM48.8 million which was invested by 94 percent Malaysian and 6 percent foreign investors (NESDC, 2019).

Despite introducing such financing schemes and programs SMEs still perceive access to finance as a major challenge and often an obstacle to new entrepreneurs and upscaling business performance of existing SMEs. The challenge is due to the high interest rate and the condition of providing collateral guarantees imposed by conventional banks. Such requirements are easy to meet by the large firms which makes them less risky to deal with by the banks (Elasrag, 2016a). Under these circumstances, a number of researchers, scholars, and economists stated Islamic finance as a promising and effective solution to facilitate financial accessibility by SMEs.

Islamic Finance

The concept of Islamic finance is founded on the prime objective of *sharia'h,* which is human welfare. Human welfare is ensured by the five objectives of *Maqasid-al-sharia'h,* which are to preserve faith, life, human intellect, lineage, and wealth. Islamic finance is inspired by the fifth objective of *sharia'h,* which is to ensure proper distribution of wealth through the concept of creating wealth by sharing both risks and profits and eliminating *riba* (interest) from the financing transaction. The negative impact of debt financing, which is mainly caused by interest, has been discussed by many scholars globally and realized by consumers as well. That is why the concept of Islamic finance has been accepted globally, especially among the Muslim community, and the market is growing steadily. The demand is higher where consumers seek only *sharia'h* compliant financing products. For example, in Saudi Arabia, more than 90 percent of SMEs avoid financing products that are not *sharia'h* compliant. Whereas, in countries like Iraq, Pakistan, Jordan, Tunisia, Morocco, Yemen, Saudi Arabia, Lebanon, and Egypt, more than 35 percent of SMEs are diverted to conventional options due to the lack of Islamic banking facilities (Elasrag, 2016a).

Islamic finance is the driving force behind the banking growth of Malaysia as well as a fast-becoming force in OIC countries. According to the Thompson Reuters report for 2018–2019, the penetration of Islamic finance through banking is on the rise globally, and in 2017, it took over conventional loans in Malaysia. The global asset value of Islamic finance was valued at US$3.6 trillion in 2021 and projected to grow to US$4.9 trillion by 2025 (Dinar Standard, 2022). In terms of the Global Islamic Economy Indicator (GIEI) score, Malaysia is leading out of the top 15 countries globally in Islamic finance (Figure 9). Abdullah et al., (2020), in their book "Halal Entrepreneurship," have stated Islamic finance as the major source of finance for entrepreneurs in the global halal industry, which is one of the fastest-growing markets in the world.

Islamic banking and finance promote entrepreneurship to contribute to social and economic development with its' asset-backed and risk-sharing nature of financing. The asset-based concept ensures that the financing is being done for real economic activity which has a close association with the assets. On the other side, equity-based nature ensures a relationship between the entrepreneurs and financiers sharing both profits and risks which results in an increased interest in both parties as well as higher risks. This nature of equity-based financing is preferred by SMEs, start-ups, and entrepreneurs. That's is why the demand for Islamic finance, especially by SMEs, is increasing day by day (World Bank & Islamic development bank, 2015).

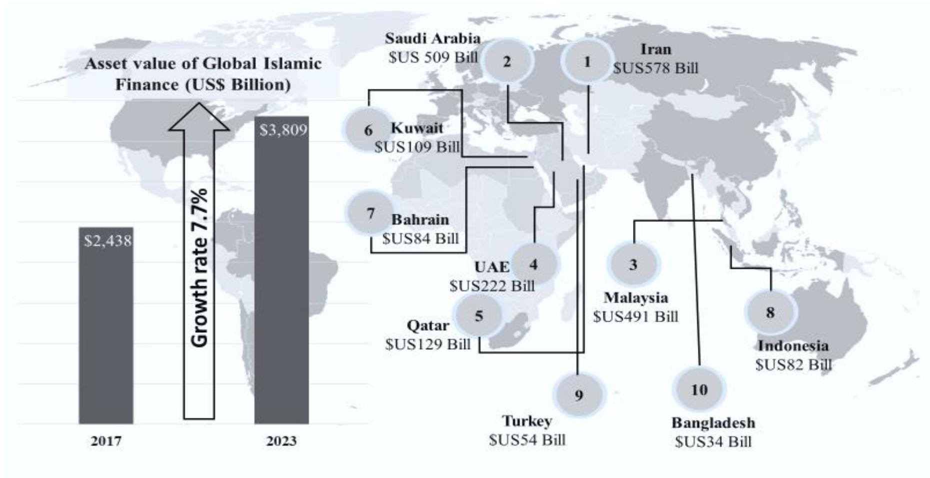

Figure 9 Top ten Islamic finance markets in assets globally.
Source: Thompson Reuters (2018)

Credit gap in Islamic finance for SMEs

The size of the Islamic banking and finance industry is relatively smaller than conventional finance. However, the industry has shown a significant growth rate and global outreach during the last few years (Thomson Reuters and Dinar Standard, 2018). From the earlier discussion, it was found that as of 2019, there is a US$5.2 trillion credit gap for SMEs globally (Figure 7). Simultaneously, this gap is also observable in Islamic finance for SMEs. The gap implies a significant demand for Islamic financing by SMEs against a shortage of supply.

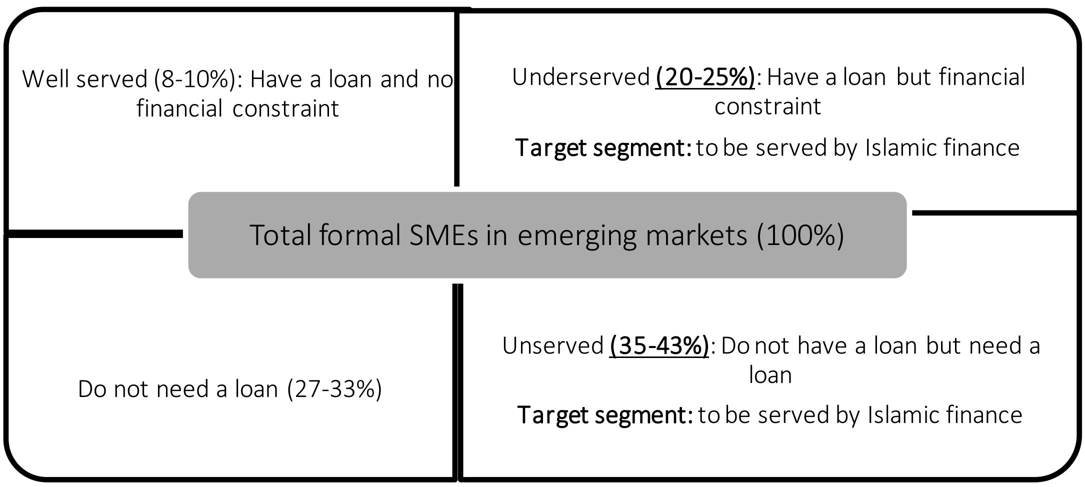

Figure 10 Percentage of formal SMEs to be served in emerging markets.
Source: World Bank & Islamic development bank (2015)

Research shows that about 55 to 68 percent of SMEs in emerging markets are underserved or unserved by banks and financial institutions (Figure 10). Islamic banks and financial institutions are to tap into this segment of SMEs globally.

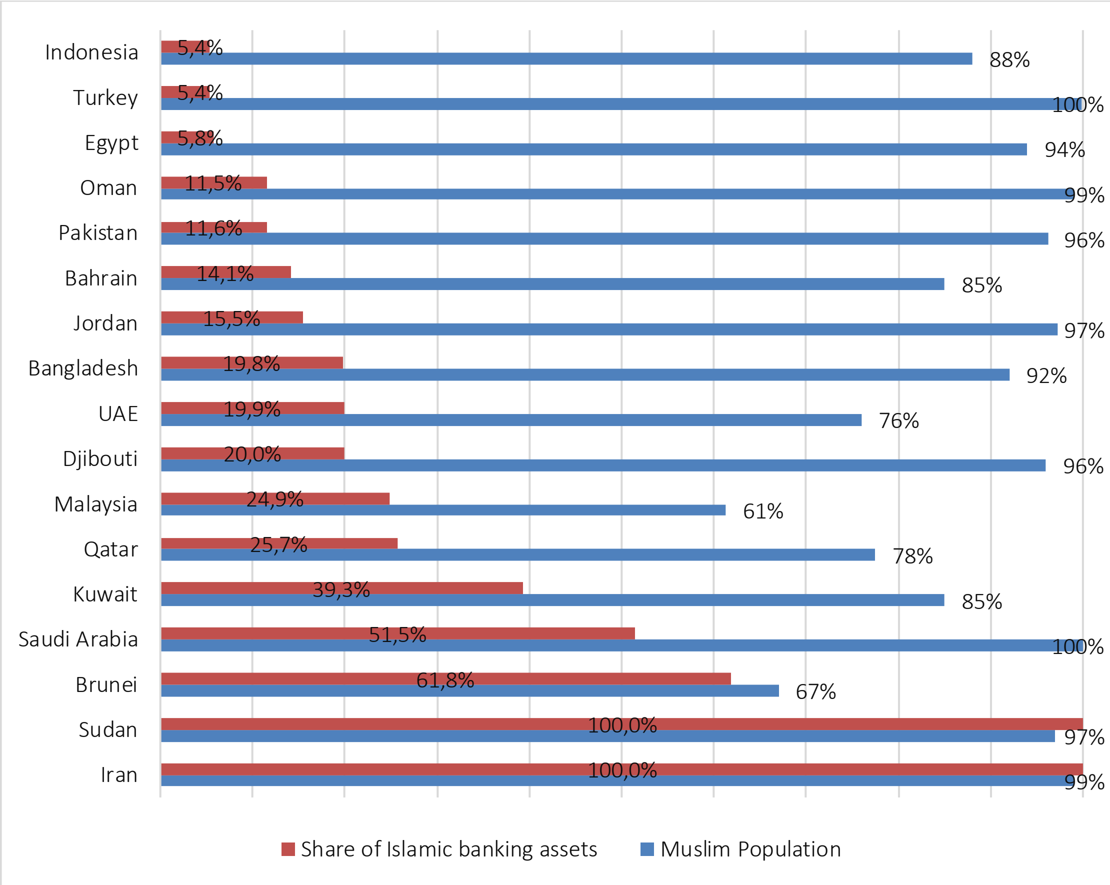

Figure 11 Top 17 countries by share of Islamic banking assets and their Muslim population percentage
Source: IFSB (2018); and http://www.muslimpopulation.com/

The demand and supply gap in Islamic finance can be realized in various aspects. Firstly, the share of Islamic banking market assets against the Muslim population size (2.25 billion) globally is increasing at a 1.84% growth rate (http://www.muslimpopulation.com/). **Figure 11** illustrates the share of Islamic banking assistance in the domestic market in different countries globally against their Muslim population percentage. It is observed that Brunei maintains a significant domestic market share (61.8%) while Iran and Sudan remain the only countries to provide fully *sharia'h*-compliant banking services. The other countries show a huge gap in market share compared to the percentage of the Muslim population.

The second way to see the gap in Islamic financing for SMEs is to compare the percentage of Islamic finance for SMEs to their demand of *sharia'h* compliant finances. For example, **Figure 12** shows that in Egypt, Islamic finance for SMEs provided is only 7% whereas the demand for such products is 20 percent. The gap is somewhat similar in other countries globally and even more in Saudi Arabia.

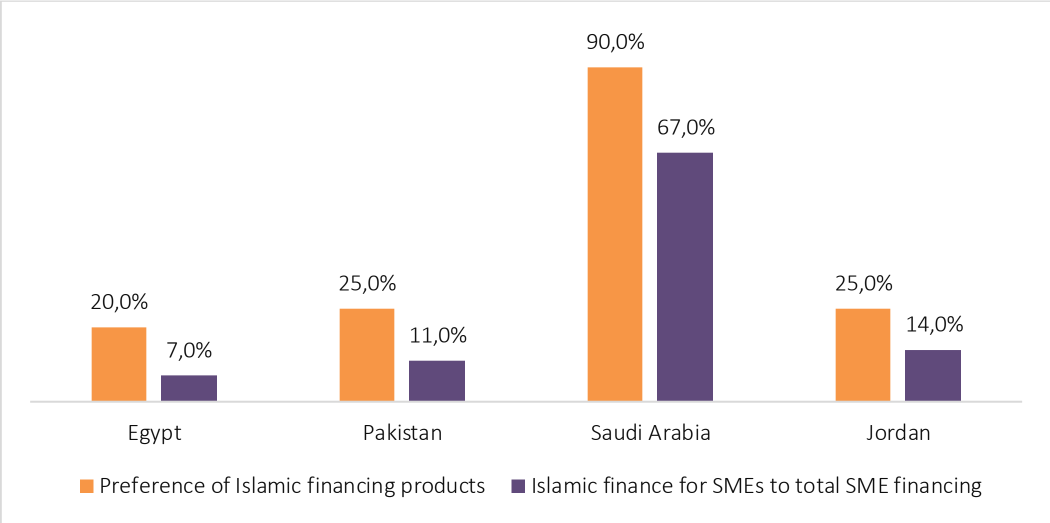

Figure 12 Realizing the demand and supply side of Islamic finance for SMEs.
Source: Hassan, 2013; World Bank Group, 2015)

Sources of Islamic Finance for SMEs

Islamic finance offers a number of options as a source of finance for SMEs, allowing them to experience better access to finance. The financing products are comprised of both asset-based and equity-based modes, which ensure that a significant financing gap for SMEs has been managed. Asset-based options (*murabahah*, *ijrah*, and *slalm*) ensure real economic activity with a close association with the financed assets, which is an essential requirement of Islamic financing. Simultaneously, the equity-based products (*musharakah*, diminishing *musharakah*, and *mudarabah*) are mainly for start-ups that depend on venture capital. Here, the profits and losses are shared between finance providers and entrepreneurs. Such a mode of Islamic finance promotes entrepreneurship, *harmonising* the interests of both parties, and higher risk sharing. The Islamic banks also offer some other micro-financing products like *Ar-Rahnu*, *Waqaf*, BBA, etc. However, the three most popular financing products amongst SMEs globally are *Murabahah*, *Mudarabah*, and *Musharakah*. Figure 13 shows the total Islamic financing amount (US$) in different countries and the percentage under these three financing products from 2013 to 2017.

From Figure 13, it can be seen that the most widely utilized financing mode is *Murabahah* financing. Previous studies by different scholars and reports from different institutions also suggest that *Murabahah* has been the most popular financing mode, although it is asset-based (Razak & Abdul-Wahab, 2018; Elasrag, 2016b; Nawaz, 2019; World Bank & Islamic Development Bank, 2015). The reason for its popularity is its simple implementation process and similar criteria compared to conventional financing for SMEs. Additionally, Islamic banks still do not have the full capacity to serve SMEs because of their seeming losses, collateral matters, and credit record. For instance, a significant percentage (32%) of SMEs are not served by formal banking services as they lack *sharia'h*-compliant financing products. However, the unmet demand could be addressed by extending equity-based (profit and loss sharing) financing instruments like *Musharakah* and *Muadarabah*. Unfortunately, the banks have been unable to do so (Bank Negara Malaysia, 2016). Moreover, Islamic banks prefer to provide short-term financing, which has made it difficult for SMEs who are looking for long-term financing sources to access finances. Additionally, there are some other challenges faced by Islamic finance in the Islamic banking industry that need to be addressed.

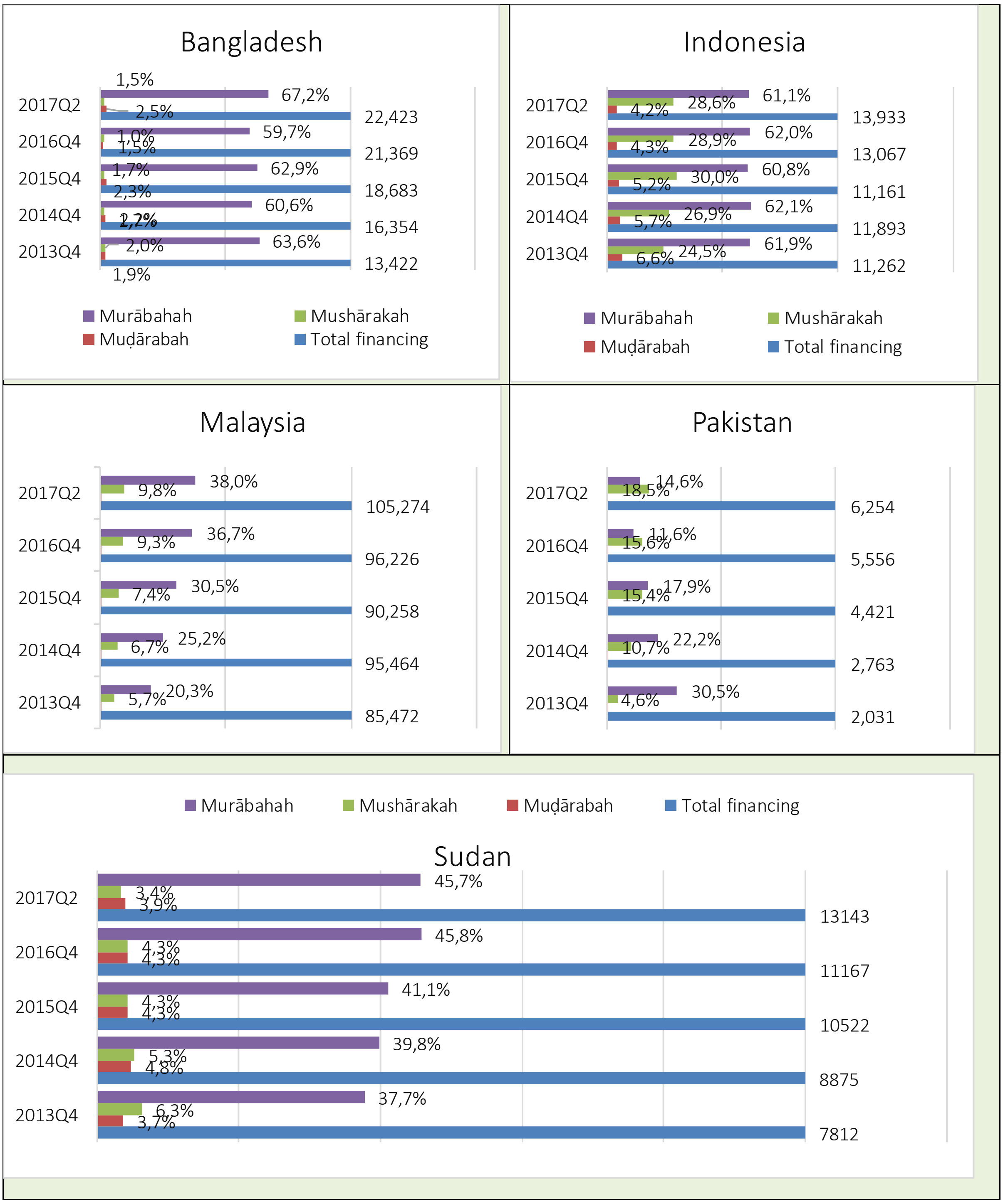

Figure 13 Financing under Mudarabah, Musharakah, and Murabahah compared to total financing in different countries from 2013 to 2017 (US$)
Source: Razak & Abdul-Wahab, (2018)

SME development model

Based on the above discussion, access to Islamic finance, in particular, is one of the biggest deterrent factors for SMEs. Figure 14 provides a conceptual framework or model for expanding the provision of Islamic finance for MSMEs that can be efficiently realized with regards to employment generation. The framework visualizes Islamic finance as playing a prime role in meeting the SME credit gap and providing greater access to finance by making the options of Islamic finance available for SMEs. Such mitigation in the difficulties of accessing capital for SMEs will lead to mitigation of their challenges in other fields as well, e.g., emerging technology, IR 4.0, e-commerce, training and skill of employees, high transaction costs and tax rates, access to markets, R&D for product innovation, etc., that are affected due to a lack of or poor access to finance. As a result, sufficient financial capacity and greater access to capital will enhance the growth and development of SMEs, which will create high demand for physical and human capital investment and ultimately lead to greater employment generation. The demand for more employment will also be instigated when there is high productivity, efficiency, and a greater spending chain by SMEs, which will be possible by making them financially confident and alleviating the issues and challenges they are facing in different fields of business. Consequently, the overall impact of this huge segment (the MSMEs) of an economy will be realized through enhanced economic growth and development.

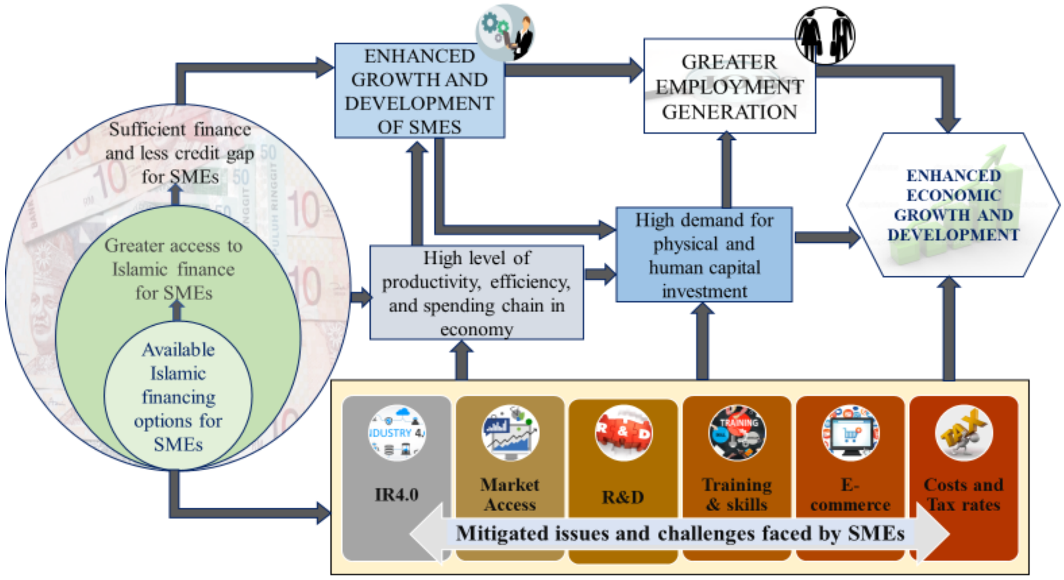

Figure 14 A Model of Expanding Provision of Islamic Finance for MSMEs
Source: Authors' generated framework

The proposed model for expanding the provision of Islamic finance for MSMEs introduces a distinctive approach in comparison to existing SME development models. While existing models (Berezhnytska, 2019; Qamruzzaman & Jianguo, 2018; Wiklund et al., 2009) generally focus on multiple factors contributing to SME growth and development, the proposed model emphasizes the critical role of Islamic finance in addressing the significant challenge of SMEs' limited access to capital. In essence, the uniqueness of the proposed model lies in its targeted emphasis on Islamic finance as a catalyst for comprehensive SME development. By addressing the critical challenge of access to capital and its cascading effects on various dimensions of SME operations, the model offers a strategic and impactful approach to fostering employment generation and economic growth within the MSME sector.

Challenges of Islamic Finance for SMEs

Islamic finance, as an industry, had a market value of more than US$2.4 trillion in 2018 which showed a sustainable growth rate (7.7%) from previous years. However, the growth has been slowed down by a number of issues and problems faced by the industry globally. Some of the highlighted issues are discussed below-

Lack of *sharia'h* compliant product: One of the reasons for the credit gap in Islamic financing for SMEs is the lack of diverse product offerings by Islamic banks. That is why the SMEs tend to be skewed more towards debt-financing, *Murabahah*. Additionally, such a lack of Islamic financing products raises the controversy of mimicking conventional financing practices and decreases consumers' confidence to subscribe to Islamic financing products.

Lack of talent: The lack of expertise and talent has been a major obstacle for the industry to grow globally. Saudi Arabia, for example, has only 24 education providers in Islamic finance, although its asset (US$509 billion) in Islamic finance is more than that of Malaysia. On the contrary, the Islamic finance asset (US$491 billion) of Malaysia is less than that of Saudi Arabia, despite having two times more education providers than Saudi Arabia (Thomson Reuters and Dinar Standard, 2018).

Increased transaction costs: The asset-based approach of Islamic financing makes the overall transaction expensive for SMEs, with increased costs and double taxation compared to conventional financing modes (NESDC, 2021; Fadul, 2019; Mole & Namusonge, 2016).

Unutilized moveable collateral: There is a lack of an effective legal framework to utilize the moveable assets of SMEs as collateral. Such a lack in Islamic banks makes them reluctant to accept the moveable assets of SMEs for financing (Tagoe et al., 2005; Woldie et al., 2018).

Lack of a robust *sharia'h* governance body: Islamic finance faces a couple of issues in the application of *sharia'h*-compliant contracts due to the differences in conventional laws across different countries as well as different Islamic schools of thought. A robust *sharia'h* governance regime is needed to ensure the integrity of *sharia'h* compliance and minimize the image risks of Islamic financial institutions (Ariff & Mohamad, 2018; Bank Negara, 2016; OIC and SESRIC, 2019).

V. Conclusion and Recommendation

Conclusion

The present study provides the definition of SMEs in different countries globally and identifies the criteria to be considered while defining SMEs. Simultaneously, the significant contribution of SMEs has been realized globally as well as in Malaysia in terms of their value-added to GDP and employment generation. While realizing the significance of SME contributions, the paper identifies access to finance as the biggest challenge faced by SMEs in the emerging market. The other challenges include lack of training, financial literacy, technology improvement, legal matters and administrative burdens, product innovation, research and development, etc. As of 2019, there is a credit gap of US$5.2 trillion globally. Financial institutions and banks play a vital role as the source of finance for SMEs.

However, the challenge is still there in terms of transaction cost, high interest rate (*riba*), and complex process. Although the profit and loss sharing concept of equity-based financing has been demanded by SMEs in many countries, the statistic shows that the maximum amount of financing was recorded under the *Muranahah* product. Islamic banks still do not have the full capacity to serve SMEs because of their seeming losses, collateral matter, and credit record. For instance, a significant percentage (32%) of SMEs are not served by formal banking services as they lack *sharia'h*-compliant financing products. However, the unmet demand could be addressed by extending equity-based (profit and loss sharing) financing instruments like *Musharakah* and *Muadarabah.* In this regard, the paper provides a model for SME development, showing how Islamic finance can play a central role in mitigating the challenges faced by SMEs by providing greater access to finance. Simultaneously, government bodies, financial institutions, and policymakers should come together and address the challenges faced by Islamic finance in the market. The key role in the development of Islamic finance by producing qualified human capital is to be played by the universities and professional training providers in the respective countries.

Recommendation

Establishments of non-banking financial institutions should get support to provide more equity-based finances like *ijarah, musharakah,* and *mudarabah.* Additionally, practical training and education are needed on risk management techniques to offer diverse *sharia'h*-compliant financing products. A robust *sharia'h* governance regime has to be established that will develop the taxation framework and relevant laws for leveraging the taxes of Islamic financing products. Simultaneously, the legal framework will ensure secured transactions, including movable assets for SMEs.

Finally, to improve the knowledge of financial, institutions as well as SMEs on Islamic finance a platform on Islamic finance is strongly recommended in every economy. Such a platform will ensure the development and recognition of universal *sharia'h* standards, documentation, and operation manuals for Islamic finance according to the different schools of thought of Islam. Simultaneously, the platform should allow interactions among practitioners and provide a database of case studies in the field of Islamic finance, including the best examples to follow.

It is important to acknowledge certain limitations within this paper. Firstly, while the methodology encompasses a wide array of secondary data sources, the depth of primary research is limited. This may affect the paper's ability to capture nuanced, real-time trends and developments. Additionally, the focus primarily on the Malaysian context might limit the generalizability of the findings to other economies. Furthermore, the scope of the paper is concentrated on SMEs' financial accessibility through Islamic finance, potentially overlooking other influential factors. Despite these limitations, the paper strives to offer a comprehensive and valuable perspective on the intersection of SMEs, Islamic finance, and employment generation.

Future studies in this domain could consider conducting in-depth comparative analyses of SMEs and their financial accessibility across various economies. Exploring the effectiveness of specific Islamic finance instruments in addressing SMEs' financial needs and enhancing employment generation would provide valuable insights. Additionally, investigating the evolving challenges and opportunities faced by Islamic finance in different economic contexts could shed light on its potential to reshape the SME financing landscape. Lastly, the study should examine the effectiveness of implementing the proposed model in this study on SMEs' growth and employment outcomes.

Author Contributions

Conceptualization, Abdullah, M.A.

Acknowledgement

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Conflicts of Interest

The authors declare no conflict of interest.

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