

Financing of The Medium, Small and Micro Enterprises Sector By Sharia Banking: Positive Effects on Economic Growth and Negative Effects on Income Inequality

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Abstract

This study aims to find empirical evidence that the financing provided by Islamic banking in Indonesia has a positive effect on economic growth and reduces income inequality. The method used in this study is analysis of Structural Equation Model PLS using WarpPLS. The analysis shows the empirical evidence that the financing of the MSMEs sector by Islamic banking has significant positive effect on economic growth and significant negative effect on income inequality. Economic growth has also been shown to have a negative effect on inequality. However, the results of the analysis show that the economic growth is unable to mediate the relationship between financing of MSMEs sector toward income inequality. This study concludes that financing the MSMEs sector by Islamic banking can increase economic growth in Indonesia and have an impact on reducing people's income. The contribution of this research is that the financing of the MSMEs sector by Islamic banking must be increased because it can increase economic growth and reduce income.

Keywords: *Sharia Banking, MSMEs, Economic Growth, and Income Inequality*

A. INTRODUCTION

Medium, Small and Micro Enterprises (MSMEs) in Indonesia are currently the backbone of Indonesian economy (Purwanto, 2019a). This condition can be seen from the large contribution of MSMEs in Indonesian economy. This contribution also can be seen from the large number and

absorption of labor and the large contribution of MSMEs in the formation of Gross Domestic Product (GDP) in Indonesia (Sofyan, 2017; Sudarno, 2011). The contribution of MSMEs to Gross Domestic Product (GDP) which reached 60.34 percent in the last five years (Purwanto, 2019a). Although MSMEs have a large role in the economy, their development is still experiencing various obstacles. One of the obstacles faced by MSMEs is limited access to financial services (Nursini, 2020).

Seeing this condition, Islamic banking has committed to channeling financing to the MSMEs sector. In December 2020, the number of financing disbursements to the MSMEs sector was projected to reach 23% of the total financing carried out by Indonesian Islamic banks (Putri, 2020). The commitment of Islamic banking to increase the amount of its financing in the MSMEs sector is in line with the mandate of Law no. 21 of 2008 concerning Islamic banking. Article 3 states that Islamic banking aims to support the implementation of national development in order to improve justice, togetherness, and equitable distribution of people's welfare. In addition to the necessity of banks to operate based on Islamic law, Islamic banks do not apply interest but adopt the principle of profit-sharing (Purwanto, 2021). Thus, the existence of Islamic banks in Indonesia should be able to realize equitable distribution of welfare through the implementation of financing, especially in the MSMEs sector (Purwanto, 2017).

In addition to these reasons, the distribution of financing to the MSME sector internally has a positive impact on the continuity of the sharia banking business because it can increase profitability (Afkar, 2017; Purwanto, 2019b; Sahputra, 2017; Wulandari et al., 2018). In addition, financing in the MSMEs sector has a lower NPF (Non-Performing Financing) compared to financing in the non- MSMEs sector (Purwanto, 2019b). This condition indicates that the provision of financing in the MSMEs sector has a lower risk if the non MSMEs sector. This low risk is one of the reasons for Islamic banking to choose the MSMEs sector in channeling financing.

In addition to the positive impact on the continuity of the sharia banking business, financing from sharia banking can also be used to develop businesses by increasing production capacity and using technology for MSMEs actors. This business development capability can ultimately reduce income inequality. The MSME sector requires capital for business development so that financing from Islamic banking can develop the business. Business development ultimately has an impact on increasing the number of workers. The workers who are absorbed in

the end earn income. It is in this context that the financing of the MSMEs sector by Islamic banking has an impact on reducing income inequality. The results of research conducted by Priyono, Pitriyan, & Maipita (2019). proves that credit in the MSMEs sector has a negative and significant impact on income inequality. The research results conducted by Nursini (2020) also prove that financing the MSME sector can reduce the gap. Thus, the greater the financing provided by Islamic banking in Indonesia in the MSMEs sector will improve the welfare of the community by reducing the level of income inequality.

A low level of inequality characterizes equitable social welfare, usually measured by the Gini Ratio (Todaro, 2003). The Gini Ratio value ranges from 0-1, the higher the Gini value, the higher the disparity of people's income. The results of research conducted by Ali, Rashid, & Khan (2014) show that MSMEs have an important role in poverty alleviation, so support from the government is needed in the form of funding for the MSMEs sector. For MSMEs, financing obtained from Islamic banking can be used to develop business. Business development ultimately has an impact on the number of workers. The workers who are absorbed in the end earn income. In this context, the financing of the MSMEs sector by Islamic banking has an impact on reducing income inequality. The research results conducted by Priyono, Pitriyan, & Maipita (2019) prove that credit in the MSMEs sector has a negative and significant impact on income. However, the results of a study conducted by Bonito, Daantos, Mateo, & Rosete (2017) dan Beck, Demirguc-Kunt, & Levine (2005) found evidence that MSMEs have an influence on income in the Philippines.

In addition to having an impact on income, financing in the MSME sector also has an impact on economic growth. This condition is because MSMEs have an important role in creating jobs, economic growth, and including in terms of financial services (Shahchera & Taheri, 2013). Several studies have empirically proven that financing from banks in the MSME sector significantly influences economic growth. Research, among others, was carried out by Katua (2014); Kira, (2013); Quaye, Abrokwah, Sarbah, & Osei, (2014); Uremadu et al., (2014); Riwayati (2017) financing for MSMEs has a positive influence on economic growth. The results of another study conducted by Purwanto & Yanuar (2017) also prove that the delivery of financing by Islamic banks has a positive effect on Gross Domestic Product in Indonesia. In addition to playing a role in economic growth, MSMEs also contribute greatly to labor absorption (Gunartin, 2017). Research conducted by Jahanshahi, Nawaser, Mohammad, Khaksar, & Kamalian

(2011) also proves that MSMEs contribute greatly to economic growth and employment.

By looking at the explanation above, financing in the MSMEs sector by Islamic banks can ultimately reduce people's income and increase economic growth. This is because the financing of the MSMEs sector can help MSME actors to develop their businesses by increasing their production capacity and using technology. The development of MSMEs can ultimately increase production and increase employment. In the context of this study, it was conducted to prove that the financing of the MSMEs sector by Islamic banks in Indonesia can reduce economic growth and growth. In addition, empirical research on the effect of financing the MSMEs sector by Islamic banking on the income received is still widely carried out. Research conducted by Priyono, Pitriyan, & Maipita (2019) on lending by conventional banks instead of Islamic banks. This research is relatively new because this study also analyzes how the influence of MSMEs sector financing on income inequality by making economic growth an intervening variable.

B. THEORITICAL

Sharia Banking Financing

Banking is a financial institution that plays a role in the economy in Indonesia and the world, including Islamic banking. Financial institutions, including Islamic banking, have an important position to carry out their main business by distributing financing and other services in financial activities whose operations are adjusted to Islamic law (Adalah & Fadllan, 2016). According to Wangsawidjaja (2012) financing is an activity carried out by Islamic banking to fund to support investment activities. So with the financing carried out by Islamic banking, economic activity will be able to run, in other words, the provision of financing can make it easier for people to carry out economic activities.

On the other hand, as an intermediary institution, Islamic banking must channel the funds it has collected to people in need. From the principles or contracts that can be used by Islamic banks in disbursing funds above, it is clear that the difference is clear from the credit disbursement carried out by conventional banks. If in conventional banks, all funds are credit, but the purpose of Islamic banking is seen from what customers apply for financing. In addition, conventional banking does not recognize socially oriented funds as is the case with *Qardh* contracts in Islamic banking. From the activities and funds carried out by banks, it will automatically move the economy.

In general, there are four principles that use Islamic banks in distributing financing, namely the principle of buying and selling, the principle of profit-sharing, the principle of lease, and complementary contracts (Wangsawidjaja, 2012). The explanation of each financing principle by Islamic banking is as follows:

The principle of buying and selling

The practice that is often carried out by Islamic banking in channeling financing with the principle of buying and selling consists of three contracts, namely *Murabahah*, *Salam*, *Istishna'* (Salman, 2012). *Murabahah* is a sale and purchase with additional profits agreed upon by Islamic banks with their customers. The main feature in the *Murabahah* contract is the transparency that the seller does not provide regarding the acquisition price and the amount of profit desired (Acarya & Yumanita, 2005).

Meanwhile, buying and selling with a *Salam* contract is a sale and purchase which is paid off at the beginning while the goods are delivered at a later time (Salman, 2012). In practice, the *Salam* contract is carried out in parallel where the Islamic bank at the time of getting the order, then the Islamic bank orders the goods to the seller with payment made in advance and within the specified delivery time (Acarya & Yumanita, 2005). The distribution of funds with the principle of buying and selling with *Istishna'* is a sale and purchase contract by placing an order in advance with predetermined specifications (Danupranata, 2013). Similar to the *Salam* contract, in practice *Istishna'* is also carried out in parallel.

Profit sharing principle

The distribution of funds with the principle of profit-sharing by Islamic banks is usually by using *Musyarakah* and *Mudharabah* (Ahmadiono, 2013). *Musyarakah* is a collaboration carried out by two or more parties to carry out or work on a business with each party contributing to capital or funds with the profits and losses being shared in accordance with the agreement (Sudarsono, 2008). *Mudharabah* is a form of cooperation between two parties, where one party is the owner of the capital and the other party acts as the manager of the capital then the profits and risks obtained are divided and borne according to the agreement (Karim, 2010).

Lease principle

The distribution of funds under the principle of rent usually uses the Ijarah scheme and the *Ijarah Muntahiya Bittamlik* scheme (Salman, 2012). *Ijarah* is a contract for the transfer of usufructuary rights to goods/services without any transfer of ownership (Antonio, 2009). Meanwhile, *Ijarah Muntahiya Bittamlik* is an agreement between two people, one as the owner of the goods and one as the lessee. When the lease expires, the owner of the goods can give the tenant the opportunity to own the goods that are fully leased to the tenant (Sriono, 2013). The scheme in the distribution of lease financing that is often carried out by Islamic banking is lease financing which then ends with a purchase.

Complementary contract

Several types of complementary contracts usually exist in Islamic banking, namely *Rahn*, *Wakalah*, *Qard*, and *Kafalah* (Ahmadiono, 2013). *Rahn* or pawn is an act to withhold collateral from the borrower so that another institution or person can provide a certain amount of funds (Antonio, 2009). The next complementary contract is *Wakalah*. *Wakalah* is the transfer of authority to another person to complete or carry out something (Salman, 2012). *Qard* is a loan agreement with no obligation to return with certain additions (Soemitra, 2009). In essence, *Qard* is a socially oriented distribution of funds without expecting profit. Meanwhile, *Kafalah* means the transfer of the responsibility of the second party to the third party to solve the problem to the first party (Sudarsono, 2008).

Micro, Small and Medium Enterprises (MSMEs)

In Law Number 20 of 2008 concerning MSMEs, it is stated that MSMEs are productive businesses owned by individuals and/or business entities from individuals who have all the criteria for micro-enterprises. MSMEs with various limited scales actually have a number of strengths, namely the ability to exercise flexibility in facing various environmental challenges. Business activities based on the calculation of economies of scale do not allow a large corporation to in principle become a strength for small businesses (Rosidi et al., 2021).

The criteria for MSMEs are distinguished according to the amount of capital they have. The criteria for MSMEs, according to Fathurrahman & Fadilla (2019) are as follows:

1. Micro-enterprises are productive businesses owned by individuals or individual business entities with total assets of up to IDR 50 million and income of up to IDR 300 million every year.

2. Small business is a productive business that stands alone and is carried out by individuals not branches of companies owned, either directly or indirectly from medium or large businesses between IDR 50 million rupiah to IDR 500 million with a total income of around IDR 300 million to IDR 300 million IDR 2.5 every year.
3. Medium Enterprises are productive businesses that stand-alone, which are carried out by individuals who are not subsidiaries or not branches of companies that are owned, controlled, or become part either directly or indirectly of medium-sized businesses or large businesses whose business assets value between IDR 500 million to 10 billion with total annual revenue ranging from IDR 2.5 to 50 billion every year.

From the MSMEs criteria above, businesses that have a net worth of more than IDR 10 billion and have sales of more than IDR 50 billion are no longer included in the MSMEs criteria. Businesses that fall into this criterion are included in large businesses or are commonly referred to as non- MSMEs. As an intermediary institution for Islamic Commercial Banks and Sharia Business Units of course, they can channel their financing to MSMEs or Non-MSMEs, as long as the business being financed does not conflict with sharia principles.

Economic Growth

Currently, Islamic banking has become the largest sector in the Islamic finance industry, with total assets of USD 1.72 trillion. This total asset contributes 71% of the total assets of the Islamic finance industry (Bendriouch et al., 2020). The rapid development of Islamic banking then raises many questions from many researchers, how is the relationship between the Islamic financial system and economic growth.

Economic growth is economic development is the development of an economic activity that applies from time to time and causes an increase in national income. The rate of economic growth shows the percentage increase in real income of a country or region in a certain year when compared to real national income in the previous year (Sukirno, 2012). Thus, economic growth is an achievement of an economic development of a country or region in a certain period. Economic growth is related to the ability of a country or region to produce goods and services. This increased ability is caused by the addition of production factors both in quantity and quality.

The economic growth of a country is usually seen from the Gross Domestic Product (GDP). If it is carried out to carry out the economic growth

within a country, it is known as the Gross Regional Domestic Product (GRDP). Various studies related to economic growth often use GDP or GRDP as a variable that reflects economic growth (Anwar et al., 2020). GRDP, according to BPS is defined as the added value generated by the entire business sector in a certain area (Susanti, 2013). There are two ways to describe the GRDP of a region, namely on the basis of prices and on the basis of constant prices. The depiction of GRDP on the basis of current prices is the added value of services and goods which is calculated according to the prices prevailing at the time the GRDP is calculated. Meanwhile, GRDP at constant base prices is the calculation of the value of goods and services in an area with a constant choice of prices. In this study, the constant price used is the 2010 constant price. GRDP which is calculated using constant prices is usually used to determine the economic growth of an area from time to time and is usually calculated annually. Meanwhile, the calculation of GRDP using prices that are usually used to determine the economic structure of a region (Susanti, 2013).

So the higher the GRDP of an area, the better the economic condition of a region. In order to increase the added value of an area, the role of financing from the banking sector is needed. In order to increase the production of the community, an area requires capital so that the financing provided by Islamic banking using the principles of buying and selling, profit sharing, rental or complementary contracts can ultimately add to the value of production in an area.

Income Inequality

Income inequality is an unfavorable phenomenon, so reducing or even eliminating it is one of the socio-economic goals of most countries, including Indonesia (Shahabadi et al., 2018). This is because of the inequality in the initial economy of income (Ghofur, 2018). In an effort to reduce this, Islam strongly prohibits the application of usury because it can overcome income inequality and injustice in obtaining profits (Bozik, 2019).

Income inequality is basically the distribution of income received by people in a country. The higher the increase means the distribution of income in the community is getting more unequal. This condition will eventually enlarge the gap between people with relatively good economic levels and low incomes (Amri, 2017). One of the commonly used ways to find out the level of income is to look at the Gini ratio (Shahabadi et al., 2018). The Gini Ratio value ranges from 0-1, the higher the Gini value, the higher the disparity of people's income. If the Gini coefficient is less than 0.30, it is included in the lower position. If the Gini

coefficient ranges from 0.31-0.40, it is a moderate condition. Meanwhile, if the Gini coefficient is greater than 0.40, it is considered a high condition (Munandar & Fikriah, 2016).

Another measure that can be used to measure the income level of the population is the World Bank Criteria. This measure divides the population into three income groups: the 40 percent of the lowest income group, the 40 percent of the middle-income group, and the highest 20 percent of the income group. According to the World Bank Criteria, happiness is rewarded by the large share of income enjoyed by the lowest-income 40 percent of the population. The limitations of this Criterion are 1) Low level if the lowest 40 percent of the population receives more than 17 percent of the total income. 2) The rate increases if the lowest 40 percent of the population receives between 12 and 17 percent of the total income. 3) High level if 40 percent of the lowest income population receives less than 12 percent of total income (Heryanah, 2017).

Hypothesis Development

In accordance with the theory of economic growth above, the hypotheses developed are as follows:

The Effect of MSMEs Sector Financing on Income Inequality

The Law Number 21 of 2008 concerning Islamic banking shows that Islamic banking is a hope in minimizing income inequality. This is in Article 3 of Law Number 21 of 2008 which stated that Islamic banking aims to support the implementation of national development to improve justice, togetherness, and equitable distribution of people's welfare. From this goal, the emergence of Islamic banking in Indonesia should at least be able to realize welfare distribution through financing distribution activities (Purwanto, 2017).

As an intermediary institution for Islamic banking, the MSMEs sector is one of the targets in distribution of the financing. It is because the financing in the MSMEs sector has lower NPF (Non Performing Financing) when it is compared to the financing in the non MSMEs sector (Purwanto, 2019b). This condition shows that the distribution of funding in the MSMEs sector has lower risks when it is compared to the non MSMEs sector. This low risk is a logical reason for Islamic banks to choose the MSMEs sector in distribution of the financing.

The distribution of financing to the MSME sector internally has positive impacts on the continuity of the Islamic banking business, because it can increase

profitability (Afkar, 2017; Purwanto, 2019b; Sahputra, 2017; Wulandari et al., 2018). For MSMEs, the financing which is obtained from Islamic banking can be utilized to develop business by increasing production capacity and using technology. The capability of business development can ultimately reduce income inequality. The results of research which was conducted by Priyono, Pitriyan, & Maipita (2019) prove that the credit in the MSMEs sector has negative and significant impacts on income inequality. The MSMEs sector need capital to develop its business, so that the financing from Islamic banking can be used to develop businesses. Business development ultimately has an impact on increasing the number of workers. The absorbed labor ultimately earns income. In this context, the financing of the MSMEs sector by Islamic banking gives impacts on reducing income inequality.

H1: There is a negative influence between MSMEs sector financing on income inequality.

The Effect of SMEs Sector Financing on Economic Growth

Nowadays, MSME is a business category which dominates economic activities in Indonesia and even in the world. MSMEs have greatly contributed to the provision of goods and services to the community (Riwayati, 2017) as well as contributed greatly to the absorption of the workforce. Thus, MSMEs have an important role in creating jobs, in economic growth, and in financial services (Shahchera & Taheri, 2013). In addition, MSMEs play an important role in increasing competition and entrepreneurship, productivity and innovation in the economy (Uremadu et al., 2014).

To maximize its role in the economy, MSMEs need capital to expand their businesses. One of the sources of capital which can be obtained by MSMEs is from Islamic banking. Islamic banking has made the MSMEs sector in the distribution of funds. The question is whether the financing which is provided by Islamic banks in the MSMEs sector can influence economic growth or not. There are various studies which have empirically proven that the financing from banks in the MSMEs sector has significant effects on economic growth. The research which was conducted by (Katua, 2014; Kira, 2013; Quaye, Abrokwah, Sarbah, & Osei, 2014; Uremadu et al., 2014; Riwayati, 2017) showed that the financing at MSMEs has positive effects on economic growth. The financing of the MSMEs sector by Islamic banks can ultimately affect economic growth because MSMEs

have wider opportunities to increase production capacity and expand markets. From the description above, the hypothesis proposed in this study is as follows:

H2: There is a positive influence between MSMEs sector financing on economic growth.

The Effect of Economic Growth on Income Inequality

As an intermediary institution, the role of Islamic banking is the same of conventional banks, namely distributing funds from people who have excess funds to those who lack funds (Purwanto & Yanuar, 2017). From this function, basically Islamic banking has an important role in economy of a region. Financing is a very important role of Islamic banking (Aniga & Hariyanto, 2016), because financing can drive the economic activities of a region. The economy of a region is expected to not only move, but also it is expected to experience the growth. Economic growth is defined as an increase in PDRB regardless of whether the increase is greater or smaller than the rate of population growth, or whether the changes in economic structure in the country occur or not (Hasan & Aziz, 2018). So, the higher the PDRB of an area, the better the economic condition of a region.

The question is whether the economic growth can affect income inequality? Kuznetz found a relationship between income levels and inverted U-shaped distribution of income, so that, in certain periods the economic growth could have positive effects (Niyimbanira, 2017), So, there is no agreement on whether economic growth has positive or negative effects on income inequality. The results of research which was conducted by (Wahiba & Weriemmi, 2014) prove that the economic growth can be positive for income inequality. However, the results of research which was conducted by Alam (2018), Yasa & Arka (2015) dan Agusalm (2016) prove that the economic growth has negative effects on income inequality. In other words, the economic growth can reduce income inequality. From the description above, the hypothesis proposed in this study is as follows:

H3: There is a negative influence between economic growth on income inequality.

The Effect of Economic Growth act as Mediators on the Relationship Between MSMEs Sector Financing and Income Inequality

Financing of the MSMEs sector by Islamic banking can help the development of MSMEs by increasing production capacity and using technology. The development of MSMEs can ultimately affect the economic growth (Katua, 2014; Kira, 2013; Quaye, Abrokwah, Sarbah, & Osei, 2014; Uremadu et al., 2014; Riwayati, 2017) and income inequality (Priyono et al., 2019). Thus, there is a possibility that the influence of financing of the MSMEs sector by Islamic banks can affect inequality indirectly, but it must through the economic growth. So, the research hypothesis proposed is as follows:

H3: Economic growth has a significant mediator's effect on the relationship between MSMEs sector financing and income inequality.

C. METHODOLOGY

Sample and Data Collection

This study is a type of explanatory research. This type of research is conducted to examine the causal relationship (causality) of a research variable (Gudono, 2006; Yin, 2008). The sample in this research is in the form of MSMEs sector financing data that commercial banks and sharia business units distribute in the period 2015-2018, economic growth data, and the gini ratio data for all provinces in Indonesia in the 2015 -2018 period. The researcher collected secondary data from searching the available literature reviews.

Research Variable

There are three variables in this study, namely MSMEs sector financing, economic growth, and income inequality. MSMEs sector financing is measured using two indicators namely MSMEs sector financing in the form of investment and MSMEs sector financing in the form of working capital. Economic growth is measured using two indicators, namely the growth rate of Gross Domestic Revenue which is based on constant prices and the growth rate of Gross Domestic Revenue which is based on current prices. Furthermore, income inequality is measured by two indicators, namely the Gini ratio of urban areas and the Gini ratio of rural areas.

Analysis Method

The data analysis in this study will use the analysis Structural Equation Modeling (SEM) using WarpPLS. PLS is one method to implement SEM. This PLS model is used when the basic theory of designing is a weak model and measurement indicators do not fulfill the ideal measurement model. PLS can be used with many not large samples and can be applied at all data scales (Ghozali & Latan, 2012). The stage which needs to be passed in conducting data analysis is the test of validity and reliability. Validity test is conducted by convergent validity and discriminant validity test. An indicator fulfills the convergent validity if it has a composite reliability which is greater than 0.7 and the average variance extracted (AVE) which is greater than 0.5 (Zhang et al., 2014). The assessment of an indicator which fulfills discriminant validity can be seen from the cross-loading value of each indicator. The value of each indicator has a higher value when it is compared with indicators on other variables criterion (Chawla & Joshi, 2018). In addition, discriminant validity can also be seen by looking at the correlation between variables of Fornell-Larcker criterion with AVE squared. If the correlation is higher when it is compared with other variable correlations, then an indicator fulfills the Fornell-Larcker criterion (Chawla & Joshi, 2018). Meanwhile, to assess whether the variable has been measured with a reliable indicator, it is assessed using Cronbach. If Cronbach has a value which is greater than 0.6, the indicators used are reliable (Gottens et al., 2018).

D. RESULTS AND DISCUSSION

To analyse the data of this research, the researchers use PLS structural equation model (SEM) analysis. The SEM PLS is used in this research because the indicators are relatively not well established, and the SEM PLS can be used on data which require normal distribution (Henseler et al., 2009).

Descriptive Research Variables

The study involved 31 provinces throughout Indonesia with a four-year observation period of 2015-2018. Thus, the amount of data analysed in this study is 124 ($31 \times 4 = 124$). The data can be described in table 4.I.

Table 4.I Descriptive Research Variables

| Construct | Minimum | Maximum | Mean | Std. Deviation |
|-----------|-----------|---------------|-------------|----------------|
| MSMEs1 | 4.605.952 | 6.331.503.761 | 899.115.602 | 1.390.394.004 |
| MSMEs2 | 7.501.591 | 3.188.454.601 | 463.601.330 | 628.393.672 |

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| | | | | |
|-------|--------|--------|-------|----------|
| GINII | 0,299 | 0,441 | 0,373 | 0,035 |
| GINI2 | 0,250 | 0,401 | 0,314 | 0,033 |
| PDRBI | -4,560 | 21,760 | 5,410 | 2573670 |
| PDRB2 | -4,250 | 41,580 | 9,557 | 4,605614 |

Information:

MSMEs1 : Financing the MSMEs sector in the form of Working Capital

MSMEs2 : Financing the MSMEs sector in the form of investment

GINII : Urban area Gini Ratio

GINI2 : Rural area Gini Ratio

PDRBI: Growth rates based on constant prices

PDRB2: Growth rate based on current prices

The results of description above show that in the 2015-2018 timeframe years, the amount of financing which is distributed by Islamic banking in MSMEs sector in the form of working capital on average IDR. 899.115.602. The maximum or the largest amount of IDR. 6.331.503.761 is in 2017 in West Java Province and the smallest number of dealers is IDR. 4.605.952 in 2018 in Maluku Province. The financing which was distributed by the Islamic banking in MSMEs sector in the form of an average investment of IDR.463. 601. 3 30. The maximum or the largest amount of IDR. 3.188.454.601 is in 2015 in the province of West Java and the smallest number of dealers is IDR. 7.501.591 in 2018 in the Province of West Sulawesi.

From table 4.I, income inequality (Gini Ratio) for urban areas in the 2015-2018 period averaged of 0, 373. The largest Gini Ratio of 0, 441 in 2017 is in Yogyakarta Province and the lowest Gini Ratio for urban areas occurred in 2015 in North Maluku Province with a Gini Ratio of 0.299. The income inequality (Gini Ratio) of rural areas is on average of 0, 314. The largest Gini ratio is 0, 401 in 2017 in Papua Province, and the lowest Gini Ratio for the lowest rural areas occurred in 2016 in North Maluku Province with Gini Ratio of 0, 250.

From table 4.I, it can also be seen that the economic growth which is based on constant prices in the 2015-2018 period averaged of 5,410. The highest growth rate amounted to 21.760 in 2015 in the province of West Nusa Tenggara, and the lowest growth rate occurred in 2018 in the province of West Nusa Tenggara at a growth rate of minus 4,560. Meanwhile, the rate of economic growth in the 2015-2018 period which is based on prevailing price is an average of 9.557. The province with the highest economic growth rate which is based on

constant prices is West Java in 2016 with a growth rate of 41,580. The province with the lowest economic growth rate which is based on prevailing prices is East Kalimantan in 2015 with a growth rate of minus 4,250.

Estimation of Measurement and Structural Model

The variables which are used in this study are latent variables, so the manifest variables are needed to measure them. Therefore, the manifest variables used must be tested for the level of validity and reliability. To assess the level of validity of a manifest variable, the convergent validity and discriminant validity tests are performed. The Convergent validity is determined by the value of composite reliability and average variance extracted (AVE). A manifest variable fulfils the convergent validity if it has a greater composite reliability of 0.7, and an average variance extracted (AVE) is greater than 0.5 (Zhang et al., 2014). The test results in the table as can be seen in table 4.2 shows that all variables have composite reliability value which are greater than 0.7, and the average variance extracted (AVE) is greater than 0.5. The results show that all variables have been measured with manifest variables which fulfil the convergent validity criteria.

The validity test which is based on discriminant validity criteria is assessed by the value of cross-loading and fornell-larcker criterion (Chawla & Joshi, 2018). A variable is said to fulfil the discriminant validity criteria if the cross-loading value of the manifest variable on the latent variable is higher than the other variables. The test results show if the cross-loading value of the manifest variable on each latent variable is higher when it is compared to other variables (See table 4.3. The results of the fornell-larcker criterion test also show the correlation between variables with AVE squared. This value is higher when it is compared to the correlation of other variables (See table 4.2.) From the results of this test, the research variables have fulfilled the criteria of discriminant validity both the cross-loading value and the fornell-larcker criterion in this study.

Table 4.2 Convergent and Discriminant Validity

| Construct | Composite Reliability | Cronbach α | (AVE) | <i>Fornell-Larcker criterion</i> | | |
|-----------|-----------------------|-------------------|-------|----------------------------------|--------------|--------------|
| | | | | MSMEs | GINI | PDRB |
| MSMEs | 0.991 | 0.982 | 0.982 | 0.991 | | |
| GINI | 0.839 | 0.616 | 0.772 | -0.143 | 0.850 | |
| PDRB | 0.913 | 0.809 | 0.840 | 0.045 | -0.207 | 0.916 |

Source: Processed research data

Notes: Diagonal values are squared roots of AVE; off-diagonal values are the estimates of the inter-correlation between the latent constructs.

Table 4.3 Measurement Model Cross Loadings

| Constructs | MSMEs | GINI | PDRB |
|------------|--------|--------|--------|
| MSMEsI | 0.989 | -0.140 | 0.053 |
| MSMEs2 | 0.989 | -0.143 | 0.035 |
| GINI1 | -0.328 | 0.931 | -0.162 |
| GINI2 | 0.065 | 0.970 | -0.234 |
| PDRBI | -0.085 | -0.212 | 0.973 |
| PDRB2 | 0.171 | -0.190 | 0.967 |

The good manifest variable not only fulfils the validity, but also it must fulfil the reliability criteria. A manifest variable is said to meet the reliability criteria if it has a Cronbach α value above 0.7 (Lin & Huang, 2008). Based on the test results, it is found that the Cronbach α value of all variables are greater than 0.7 (see table 4.2).

From the results of validity and reliability test, it can be concluded that all latent variables have been measured with manifest variables which fulfil the validity and reliability criteria. Thus, all variables in this study are feasible to use because they have valid and reliable manifest variables.

Assessment of the Significance of the Structural Model

Hypothesis 1 states that the financing of Islamic banking in the MSMEs sector has positive effect on economic growth. This result is confirmed by the results of hypothesis test as it is shown in table 4.4. MSMEs sector financing has significant positive effect on economic growth ($\beta = 0.33$, P Value = 0,000, and it supports hypothesis 1. Table 4.4 also shows that there is a significant negative effect between MSMEs sector financing to income inequality ($\beta = -0.24$, P Value = 0.003) Therefore, hypothesis 2 is also in accordance with the proposed hypothesis. The other test results prove that economic growth has a significant negative effect on income inequality ($\beta = -0.18$, P Value = 0.017). In hypothesis 4, it is found that there is no evidence that MSMEs sector financing affected to income inequality through economic growth ($\beta = -0.06$, P Value = 0.169). Thus, hypothesis 4 is not proven in the study. The results of hypothesis test completely can be seen in Table 4.4.

Table 4.4 Structural Relationship

| Hypothesis | Beta | P Value | Results |
|-------------------------|-------|---------|----------|
| H1: UMKM -> PDRB | 0.33 | 0.000 | Accepted |
| H2: UMKM -> GINI | -0.24 | 0.003 | Accepted |
| H3: PDRB -> GINI | -0.18 | 0.017 | Accepted |
| H4: UMKM -> PDRB-> GINI | -0.06 | 0.169 | Reject |

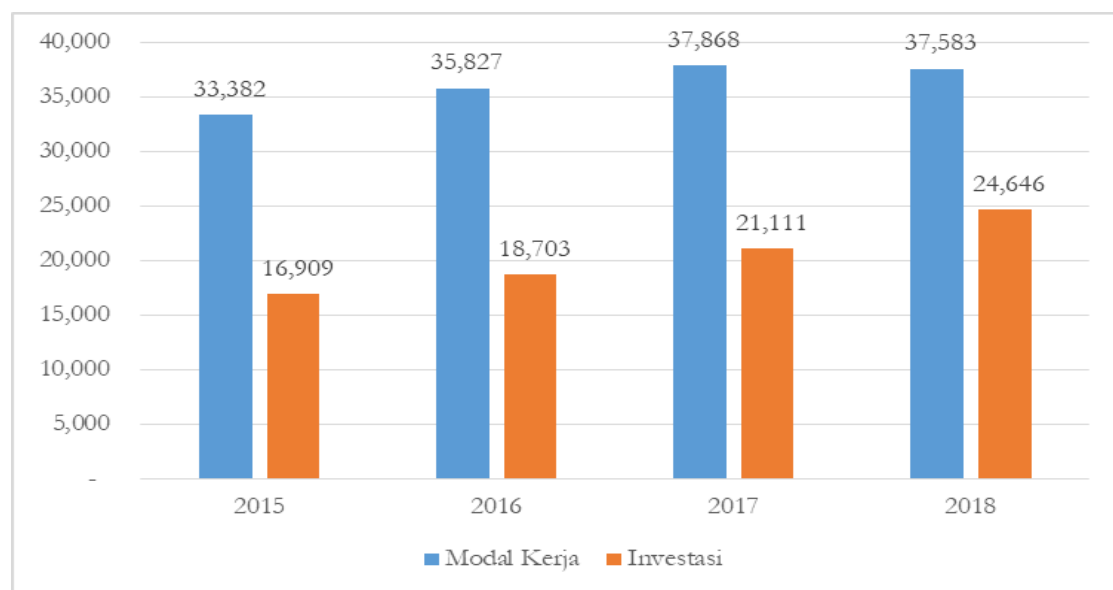
The Effect of MSME Sector Financing on Economic Growth

The hypothesis results prove that the financing of the MSMEs sector by Islamic banks has significant effects on economic growth. The coefficient which is resulted is positive, so it can be concluded that the financing of the MSMEs sector by Islamic banks can increase economic growth in Indonesia. Thus, this study supports the research which was conducted by Katua, (2014); Kira, (2013); Quaye, Abrokwah, Sarbah, & Osei, (2014); Uremadu et al., (2014); Riwayati, (2017).

The results of this study prove that Islamic banking can play an important role in improving the Indonesian economy. The problem of financing is still a major obstacle for MSMEs to develop businesses, but the presence of Islamic banking can help MSMEs to develop their businesses. The commitment of Islamic banking to support the MSMEs sector is seen in the Indonesian Islamic economic master plan, in which the government has prepared four main programs 1) Establishment of an education program for micro businesses. 2) Integrated financing facilities for MSMEs. 3) Development of the MSMEs database and 4) Establishment of the MSMEs literacy program (Badan Perencanaan Pembangunan Nasional, 2018). This program seems to be realized because the financing in the MSMEs sector by Islamic banks always experiences positive trend. This increase can be seen in Figure 4.I.

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Source: (OJK, 2019)

Figure 4.I Development of MSMEs Sector Financing by Islamic Banks
(In Billion Rupiah)

These results indicate that the theory of economic growth according to Schumpeter can be confirmed. It is because the economic development is determined by the existence of initiatives from innovative entrepreneur group. They are a group of people who organize and develop the factors of production to create goods which are needed by the community. They create innovation or renewal in the economy (Hasan & Aziz, 2018). Innovation which is carried out by the existence of entrepreneurial activities is a necessity. It will affect the economic sector of a country (Arwan et al., 2018). Innovation or renewal can be in the form of 1) Introducing a new item. 2) The use of new ways of producing goods. 3) Expanding the market. 4) Developing new sources of raw materials. 5) Carrying out a reorganization in a company or industry (Hasan & Aziz, 2018). Thus, the financing of the MSMEs sector by Islamic banks can increase the initiative of MSMEs actors to develop the business.

The Effect of MSMEs Sector Financing on Income Inequality

Income inequality is a condition in which there is a gap or income gap in an area. Income inequality is generally measured by the Gini Ratio (Todaro, 2003). The value of the Gini Ratio ranges from 0-1. The higher the value of the

Gini Ratio, the higher the level of community income disparity (Purwanto, 2017). The results showed that the financing in the MSMEs sector which is carried out by Islamic banks has negative impacts on income inequality. It means that the higher the amount of financing for the MSMEs sector, it can reduce the income inequality of the community. The results of this study support the results of the research which was conducted by Priyono, Pitriyan, & Maipita (2019) proving that the credit in the MSMEs sector has negative and significant impact on income inequality.

As previously stated, the MSMEs have large role in Indonesian economy. So that, the financing of the MSMEs sector by Islamic banks can help MSME actors to obtain the financing. At the end, MSMEs can experience the development. Business development ultimately has an impact on increasing the number of workers. The absorbed labor ultimately earns income. In this context, the financing of the MSMEs sector by Islamic banking gives impacts on reducing income inequality. The contribution of MSMEs to GRDP has increased from year to year. In 2017, MSMEs contributed IDR 7,704,635.9 billion. Its total contribution to GDP reaches 60 percent of the total effort. The biggest contributor is micro business with 36.82 percent. It is followed by medium businesses with 13.57 percent, and small businesses with 9.61 percent. Micro, small, and medium enterprises are the key to reducing the unemployment rate. This economic sector absorbs a workforce of 116,673,416 people or 97.02 percent of all business sectors in Indonesia. Micro businesses absorb 89.17 percent, and small businesses absorb 4.74 percent. While medium-sized businesses absorb 3.11 percent or 3.7 million workers (Badan Perencanaan Pembangunan Nasional, 2018). Thus, financing the MSMEs sector by Islamic banking can help MSMEs to exist in the economy in Indonesia.

The Effect of Economic Growth on Income Inequality

The economic growth in this study has been shown to have significant negative effects on income inequality. The economic growth is defined as an increase in GRDP regardless of whether the increase is greater or smaller than the rate of population growth, or whether the changes in economic structure in the country occur or not (Hasan & Aziz, 2018). So, the higher the GRDP of an area, the better the economic condition of a region. A growing economy indicates the economic activity is improving.

According to Solow-Swan, economic growth depends on the additional supply of factors of production (population, labor, and capital accumulation) and the level

of technological progress. In other words, the economy will develop depending on population growth or labor productivity, capital accumulation, and technological progress (Apriansyah & Bachri, 2006). So, the higher economic growth can ultimately reduce income inequality. It is because economic growth can basically be seen from the increasing development process. The increase in the development process is the causes of labor absorption.

The Effect of Economic Growth act as Mediators on the Relationship Between MSMEs Sector Financing and Income Inequality

This study shows that the relationship between MSMEs sector financing by Islamic banks and income inequality occurs directly without going through economic growth. Thus, financing the MSMEs sector by Islamic banks can reduce income inequality without going through economic growth. Economic growth is a process of increasing per capita output in the long run which covers three aspects, namely: process, per capita output, and long term. Economic growth is a process, not an economic picture currently. It can be seen the dynamic aspects of an economy, namely how an economy develops or changes from time to time. The emphasis is on the change or the development (Boediono, 1999). Therefore, the economic growth will last for a long time.

Thus, the effects of the MSMEs financing by Islamic banks cannot be immediately assessed. So, the effect of financing distribution on the MSMEs sector on income inequality is a direct effect. When the financing is distributed by Islamic banking, the MSMEs actors can use the fund to develop business and increase production capacity. This development can ultimately increase the added value and increase employment.

E. CONCLUSION

The results show that the distribution of financing to the MSMEs sector by Islamic banking has positives effects on economic growth and has negative effects on income inequality. Financing in the MSMEs sector by Islamic banking has effects on economic growth. It is because the MSMEs actors can increase production capacity with the financing. Moreover, it will increase the added value and employment. Financing in the MSMEs sector by Islamic banking has also been proven to have negative effects on income inequality. It shows that financing in the MSMEs sector by Islamic banking can help MSMEs actors to increase production capacity.

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