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The Role of Islamic Social Finance in Driving Industrial Innovation and Inclusive Economic Growth

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ABSTRACT

In the current landscape of rapid digital and industrial advancement, Islamic social finance serves as a critical tool for fostering innovation and inclusive economic progress. This research explores the impact of zakat, *waqf*, and *qard hasan* on driving industrial innovation and economic inclusion among Indonesian micro-entrepreneurs. Utilizing a quantitative approach, the study gathered data from 213 micro-entrepreneurs in coastal and underserved areas via structured questionnaires, complemented by secondary data from National Board of Zakat (BAZNAS), Indonesian Waqf Board (BWI), and national statistics. Hypothesized relationships were evaluated using multiple regression analysis, mediation analysis, and Structural Equation Modeling. The findings demonstrate that zakat, *waqf*, and *qard hasan* significantly promote inclusive economic growth, with zakat exerting the most substantial influence on business development and economic inclusion. Additionally, the results indicate that innovation capability partially mediates the connection between Islamic social finance and inclusive growth; this suggests that these financial instruments stimulate entrepreneurial innovation, thereby facilitating product development, market expansion, increased income, and job creation. Furthermore, productive Islamic social finance programs are notably effective in empowering micro-entrepreneurs within underserved regions. Consequently, this study provides empirical evidence that Islamic social finance operates not merely as a mechanism for redistribution, but as a strategic driver of sustainable industrial development and inclusive economic transformation in Indonesia.

1. Introduction

In recent years, the pursuit of inclusive economic development has emerged as a dominant agenda among policymakers, economists, and international development institutions (Widianingsih et al., 2024). The emphasis on equity, sustainability, and shared prosperity reflects a growing awareness that economic growth must be broad-based and socially inclusive to be meaningful and sustainable (van Niekerk, 2020). One of the most promising pathways to achieving such

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development in Muslim-majority countries, particularly in Indonesia, is through the strategic mobilization of Islamic social finance (ISF), a system grounded in the principles of social justice, equity, and the redistribution of wealth. Instruments such as zakat, *waqf* and *qard hasan* represent foundational elements of ISF that not only address poverty and inequality but also hold the potential to catalyze industrial innovation and stimulate inclusive growth in underserved regions (Al-Roubaie, 2022).

The landscape of Indonesia's economy is marked by regional disparities, income inequalities, and a significant informal sector dominated by micro and small enterprises (MSEs) (Hudaefi et al., 2021). Despite government efforts to bridge development gaps, many coastal and rural communities remain marginalized from mainstream economic activities and financial systems. Simultaneously, the global digital transformation and Industry 4.0 have created new challenges and opportunities for small businesses to innovate and scale. In this context, Islamic social finance offers a unique and underutilized avenue for empowering micro-entrepreneurs by providing them with ethical, interest-free capital and support mechanisms aligned with Islamic values (Adinugraha et al., 2023). Unlike conventional financial instruments, ISF mechanisms prioritize social impact over profit, thus creating inclusive models of growth that resonate with both the *maqasid shariah* (objectives of Islamic law) and the United Nations' Sustainable Development Goals (SDGs).

Empirical and theoretical discourses have increasingly explored the potential of ISF in alleviating poverty, providing access to finance, and promoting social welfare (Widiastuti et al., 2022; Aprullah et al., 2025; Zuniar et al., 2026). However, there remains a significant gap in the literature concerning the transformative role of ISF in promoting industrial innovation and regional development. The relationship between zakat, *waqf*, and *qard hasan* with entrepreneurial creativity, technological adoption, and product diversification among MSEs remains underexplored. Furthermore, there is a lack of integrated frameworks that examine how ISF can be institutionalized to support innovation ecosystems in Indonesia's less-developed areas (Ascarya, 2022). This study addresses this gap by empirically investigating how Islamic social finance instruments contribute not only to socioeconomic inclusion but also to the industrial upgrading of micro-entrepreneurs, especially in Indonesia's coastal regions, where formal financial inclusion remains low.

Theoretically, this study is grounded in institutional theory and the resource-based view (RBV). Institutional theory explains how social and religious norms shape organizational behavior and resource mobilization in the context of Islamic finance (Ascarya, 2022). Meanwhile, RBV posits that the unique capabilities and resources provided by ISF, such as religious legitimacy, trust-based funding, and community support, can be leveraged as strategic assets for innovation and competitiveness in small businesses (Ramashar & Khairunnisa, 2025). The integration of these frameworks allows for a multidimensional analysis of how Islamic social finance operates as both a financial and socio-cultural institution that influences entrepreneurial behavior and industrial outcomes (Zamani, 2022).

Indonesia presents a compelling case study for this analysis due to its large Muslim population, vibrant microenterprise sector, and rapidly evolving Islamic finance industry. Institutions such as the National Board of Zakat (BAZNAS) and Indonesian Waqf Board (BWI) have initiated programs aimed at economic empowerment, yet their impact on innovation and regional development is not well documented (Adinugraha et al., 2023; Afifah et al., 2023). Moreover, with the Indonesian government's push towards achieving the SDGs and revitalizing the halal economy, there is an urgent need to reimagine the role of social finance in national development strategies. The use of ISF as an alternative financing model for grassroots industrial development not only aligns with Islamic ethical principles but also fills the financing gaps left by conventional systems (Hassan et al., 2021).

Utilizing a quantitative methodology, this research draws on structured survey data from micro-entrepreneurs located in Indonesia's coastal and marginalized areas. To contextualize the results, the empirical investigation integrates secondary data from national statistics and institutional reports. The study explores how Islamic Social Finance instruments, specifically zakat, *waqf*, and *qard hasan* in fostering business innovation by expanding access to capital, building entrepreneurial capabilities, and opening market avenues, thereby clarifying ISF's role in inclusive industrialization. Additionally, the research assesses the wider socio-economic influence of ISF on inclusive economic growth by analyzing metrics such as employment creation, income advancement, and regional development.

The findings of this research are expected to yield practical implications for policymakers, Islamic finance institutions, halal industry stakeholders, and development agencies. First, the results can inform the design of integrated ISF programs that go beyond welfare and are linked with real-sector outcomes. Second, they highlight the importance of governance, transparency, and institutional coordination in enhancing the developmental impact of Islamic social finance. Finally, by offering empirical evidence on the economic relevance of Islamic ethical finance, this study contributes to global debates on the Islamization of development and the reorientation of Islamic finance toward impact-driven goals. ISF, if effectively managed and strategically allocated, can be a powerful catalyst for industrial innovation and inclusive economic growth. Moving beyond the traditional focus on poverty alleviation, it positions ISF as an instrument of structural transformation, capable of mobilizing untapped human and economic potential in regions that are often overlooked by conventional development paradigms.

2. Literature Review

2.1. Islamic Social Finance: Concept and Mechanisms

ISF refers to a group of financial instruments and mechanisms rooted in Islamic economic principles, primarily intended to redistribute wealth, alleviate poverty, and promote social justice (Hasan, 2020). These include zakat (almsgiving), *waqf* (endowment), *sadaqah* (voluntary charity), and *qard hasan* (benevolent loan). Unlike conventional financial instruments, ISF operates under the principles of Shariah, prioritizing ethical obligations, non-interest-based transactions, and social welfare (Norchaeva, 2024). The literature on ISF has largely focused on its role in poverty alleviation and socioeconomic inclusion (Widiastuti et al., 2022).

Among Islamic Social Finance (ISF) instruments, zakat, *waqf*, and *qard hasan* are the three most widely studied in the literature (Nasution et al., 2024). Zakat, being one of the five pillars of Islam, is institutionalized in many Muslim-majority countries and plays a critical role in providing a safety net for the poor. Empirical studies in Indonesia and Malaysia have demonstrated zakat's ability to increase beneficiaries' income levels and reduce short-term poverty. However, its potential to support productive sectors, such as micro-enterprises and industrial innovation, remains relatively underexplored. *Waqf*, as a form of perpetual endowment, has shown promise in supporting sustainable development initiatives. Historical literature often highlights *waqf* institutions' roles in funding education, healthcare, and public infrastructure. Recent scholars argue for the revitalization of *waqf* as an instrument for economic empowerment, especially through cash *waqf*, corporate *waqf*, and *waqf*-linked microfinance. The emergence of modern *waqf* institutions, such as Dompet Dhuafa in Indonesia or Yayasan Wakaf Selangor in Malaysia, reflects growing institutional support for linking Islamic philanthropy with entrepreneurial development.

The third ISF instrument, *qard hasan*, provides interest-free loans based on trust and solidarity. Although often limited by sustainability concerns, *qard hasan* has been acknowledged in literature as a viable tool for microcredit and financial inclusion. In theory, *qard hasan* provides a more ethical alternative to microfinance institutions (MFIs), avoiding exploitative interest rates while empowering small businesses. However, empirical research examining its impact on innovation capacity remains minimal, partly due to its limited institutional scale and regulatory support (Lwesya & Mwakalobo, 2023). The literature affirms the redistributive and welfare-based roles of ISF but provides limited insight into its function as a strategic financial mechanism for industrial innovation and inclusive economic growth. There is a growing scholarly consensus that ISF should evolve beyond charity into a tool for productive development, yet empirical studies that link ISF to real-sector transformation are still nascent.

2.2. Inclusive Economic Growth: Definitions and Drivers

Inclusive economic growth constitutes a development strategy that fosters widespread engagement in economic endeavors, the fair allocation of resources, and continuous efforts to mitigate poverty, joblessness, and geographic imbalances (Priyanto et al., 2025). The Commission on Growth and Development characterizes inclusive growth as expansion that is both sustainable and diverse across sectors, effectively incorporating a significant segment of a nation’s workforce. Consequently, this model transcends traditional macroeconomic growth by prioritizing equal opportunity, financial accessibility, market participation, and productive employment. By integrating these factors, inclusive growth promotes enduring, sustainable development and ensures that prosperity is shared more equitably among all members of society.

Literature on inclusive growth identifies several drivers: financial access, education and skills development, entrepreneurship, and institutional quality (Mu’min & Iskandar, 2025). In the context of developing countries like Indonesia, inclusive growth is often hampered by informality, urban-rural divides, and underdeveloped infrastructure in coastal and rural areas. Several scholars argue for targeted public policies and grassroots financial empowerment to bridge these gaps.

The intersection between Islamic finance and inclusive growth has gained increasing scholarly attention. For instance, Anami and Ramadhani (2026) emphasize the potential for zakat to be institutionalized as a mechanism for promoting sustained economic participation among low-income populations. Similarly, initiatives such as productive *waqf* and *qard hasan* are seen as complementary to state-led development in promoting employment and enterprise development (Sugianto & Mohammad, 2024). However, most studies stop short of integrating innovation as a key mediator between ISF and inclusive outcomes, a gap this study seeks to address.

2.3. Industrial Innovation and Microenterprise Development

Innovation is widely acknowledged as a primary catalyst for productivity, competitiveness, and industrial evolution. Schumpeterian theory posits that innovation is the central engine of economic growth, with entrepreneurship acting as the conduit for new products, services, and operational processes. In the context of developing nations, innovation frequently manifests as incremental, frugal, and adaptive modifications, allowing businesses to function efficiently within resource-constrained environments (Ismail et al., 2025).

Microenterprises are essential to economic advancement, particularly in Indonesia, where they significantly contribute to employment and the gross domestic product. Despite this significance, these enterprises often confront enduring obstacles, such as inadequate access to capital, technology, skilled labor, and market access. Such limitations curtail their ability to innovate, thereby impeding long-term expansion. While resources like financial access, training, and networks are recognized as innovation drivers, traditional financial systems frequently overlook microenterprises, leading to a deficit in investments for productive innovation (Hindocha et al., 2021).

To address these gaps, ISF has arisen as a viable alternative for promoting innovation and sustainable microenterprise growth. Utilizing mechanisms such as zakat, *waqf* and *qard hasan*, ISF delivers not only monetary resources but also social support and community-driven empowerment that bolster entrepreneurial resilience. Empirical research supports this potential; for instance, the Integrated Cash Waqf Micro Enterprise Investment model in Malaysia proved that combining cash *waqf* with micro-financing enhanced productivity and empowerment. Likewise, research in Indonesia indicates that productive zakat programs boost the innovation capacity and performance of beneficiaries. Nevertheless, these initiatives remain limited in scale, and the existing body of evidence regarding how ISF impacts industrial innovation is fragmented, highlighting the necessity for a more rigorous and systematic evaluation of this relationship (Kassa & Kegne, 2025).

2.4. Gaps in the Literature and Research Positioning

Despite growing interest in the role of ISF in development, several critical research gaps persist. First, much of the existing literature treats ISF primarily as a welfare-oriented mechanism, focusing on poverty alleviation, income redistribution, and social protection rather than productive and industrial development (Aprullah et al., 2025). Consequently, the potential contribution of ISF to industrial innovation and microenterprise development remains relatively underexplored (Widiastuti et al., 2022). There is insufficient empirical analysis linking ISF with industrial upgrading, product diversification, or technology adoption, especially in marginalized areas. Second, most existing studies adopt either macroeconomic or micro-welfare perspectives without integrating meso-level dynamics such as sectoral innovation, regional entrepreneurship, or supply-chain integration (Chatzinikolaou & Kubus, 2025). As a result, the role of ISF in stimulating innovation ecosystems, particularly in coastal and rural areas, remains conceptually and empirically underdeveloped. Third, there is a methodological gap. Existing research often relies on descriptive or case study approaches, lacking quantitative models that examine causal relationships or mediating mechanisms. Moreover, the few empirical studies available tend to focus on single ISF instruments, such as zakat, or limited geographical settings rather than adopting a holistic, multi-instrument approach across diverse contexts.

This study addresses these gaps by offering a multi-level empirical investigation of how zakat, *waqf* and *qard hasan* collectively influence industrial innovation and inclusive growth among micro-entrepreneurs in Indonesia’s coastal regions. It contributes to the literature by integrating insights from Islamic economics, innovation studies, and inclusive development, while employing robust survey and secondary data to evaluate measurable impacts. Furthermore, it introduces a framework that connects Islamic social finance with innovation performance metrics such as product novelty, production efficiency, and business expansion, key indicators often ignored in prior studies.

2.5. Theoretical Framework and Hypotheses Development

Drawing upon Institutional Theory and the Resource-Based View, this study examines how ISF contributes to inclusive economic growth through industrial innovation. Institutional Theory posits that economic behaviour is shaped by formal and informal institutions, including religious norms, social values, and governance structures. In the context of ISF, instruments such as zakat, *waqf* and *qard hasan* promote social justice, financial inclusion, and community empowerment by providing financial support to underserved entrepreneurs. These institutional mechanisms encourage productive economic participation and reduce barriers to business development, thereby fostering more inclusive economic growth.

From the perspective of the Resource-Based View, financial resources, trust, ethical values, and social networks generated through ISF constitute valuable, rare, and difficult-to-imitate resources that enhance the competitiveness and innovation capability of microenterprises. Access to ISF enables entrepreneurs to invest in new technologies, improve production processes, diversify products, and strengthen business resilience. Enhanced innovation capability, in turn, improves firm performance and contributes to broader inclusive economic growth. Therefore, this study hypothesizes that zakat, *waqf*, and *qard hasan* positively influence inclusive economic growth both directly and indirectly through industrial innovation as a mediating variable.

Based on the theoretical arguments and empirical evidence presented above, the following hypotheses are proposed:

H1: Zakat has a positive effect on innovation capability.

H2: Waqf has a positive effect on innovation capability.

H3: Qard hasan has a positive effect on innovation capability.

H4: Innovation capability has a positive effect on inclusive economic growth.

H5: Innovation capability mediates the positive relationship between Islamic Social Finance and inclusive economic growth.

3. Research Methodology

This study adopts a quantitative research design to empirically assess the impact of ISF, specifically zakat, *waqf, and qard hasan*, on industrial innovation and inclusive economic growth among micro-entrepreneurs in Indonesia. Given the focus on measurable outcomes such as income growth, employment expansion, and product innovation, a structured and statistically driven approach is appropriate to capture the causal relationships between variables. The research is cross-sectional in nature, utilizing data collected through structured questionnaires distributed to micro-entrepreneurs operating in selected coastal and underserved regions in Indonesia. The rationale for using a quantitative approach lies in its ability to generalize findings, quantify relationships among variables, and support data-driven policy recommendations. By leveraging statistical techniques such as multiple regression analysis and structural equation modeling (SEM), this study seeks to establish both the direct and mediating effects of Islamic social finance instruments on innovation outcomes and inclusive economic indicators.

3.1. Population and Sampling Technique

The population of this study consists of micro-entrepreneurs who have received financial support or participated in programs funded by Islamic social finance institutions, including zakat management organizations, *waqf* institutions, and Islamic cooperatives providing *qard hasan* financing. The study was conducted in selected coastal and rural districts in Riau, West Java, and Central Java, where Islamic philanthropic institutions actively support microenterprise development.

A purposive sampling technique was employed to select respondents who met the predefined eligibility criteria. Specifically, respondents were required to have operated a microenterprise for at least one year, have received support in the form of zakat capital, *waqf*-based assets or *qard hasan* financing within the previous 12–24 months, and be willing to provide information regarding business performance, innovation capability, and socio-economic outcomes. Potential respondents were identified with the assistance of local Islamic social finance institutions and community coordinators based on beneficiary records. Eligible participants were invited to participate voluntarily after the purpose of the study had been explained. Prior to completing the questionnaire, respondents were screened to ensure that they satisfied all inclusion criteria.

The minimum sample size was determined using Cohen's formula for multiple regression with an anticipated effect size of 0.15, statistical power of 0.95, and five predictors, resulting in a minimum required sample of 138 respondents. To improve statistical robustness and minimize the potential effects of non-response bias, 250 structured questionnaires were distributed. Data were collected using face-to-face, paper-based questionnaires administered by the researchers, yielding 213 valid responses and an overall response rate of 85.2%.

3.2. Data Collection Instruments

Primary data was collected using a structured questionnaire developed based on validated instruments from prior research, with adaptation to the context of ISF and microenterprise innovation. The questionnaire was divided into five main sections:

i. Demographic profile: age, gender, education level, business type, years in business, and monthly income.
ii. Access to Islamic social finance: types of financial support received (zakat, *waqf, qard hasan*), duration, amount, and delivery mechanism.
iii. Innovation capability was operationalized using a four-dimensional framework adapted from the OECD Oslo Manual, specifically encompassing product innovation, process improvement, marketing innovation, and the integration of digital technologies. Measurement items included statements such as “My business has introduced new or significantly improved products during the past two years”, “My business has improved production or service delivery processes to enhance efficiency”, “My business has adopted new marketing methods or promotional strategies” and “My business uses digital technologies to support business operations and marketing." Participants evaluated these items using a five-point Likert scale, ranging from 1 (strongly disagree) to 5 (strongly agree).
iv. Inclusive economic growth was assessed through four key metrics: income enhancement, job creation, market access, and regional economic integration. Survey instruments included items such as: “My business income has increased since receiving support from Islamic Social Finance programs”, “My business has created additional employment opportunities in the local community”, “My business has gained access to new markets or customers” and “My business has expanded its business networks and market linkages beyond the local area”. Participants rated each statement on a five-point Likert scale (1–5).
v. To gauge the contribution of ISF programs, beneficiaries’ views on the relevance, adequacy, and impact of ISF support regarding business growth and community welfare were assessed. These measurement items were synthesized from existing research on ISF and social impact evaluation. Representative questionnaire items included: “The Islamic Social Finance program has provided financial support that is relevant to my business needs”; “The financial support received from the ISF program has been sufficient to support my business development”; “The ISF program has contributed to the growth and sustainability of my business”; and “The ISF program has improved the economic well-being of my family and community”. Responses for all items were captured using a five-point Likert scale (1 = strongly disagree to 5 = strongly agree).

All items were measured using a 5-point Likert scale (1 = strongly disagree to 5 = strongly agree). The questionnaire was pre-tested with 25 micro-entrepreneurs to ensure clarity, reliability, and validity before full-scale distribution. Secondary data was also used to supplement the analysis, including institutional reports from BAZNAS, BWI, and Bappenas, as well as macroeconomic indicators from the Central Statistics Agency (BPS) relevant to regional development and entrepreneurship.

3.3. Variable Operationalization

The variables in this study are categorized into independent, mediating, and dependent variables, operationalized as follows:

Table 1. Variable operationalization

Variable	Type	Indicators	Sample Measurement Items
Zakat	Independent	Amount received, frequency, delivery mode, business usage	"The zakat funds received were sufficient to support my business activities."; "I used zakat funds for productive business purposes."
Waqf	Independent	Access to *waqf*-based assets or capital, *waqf* empowerment programs	"The *waqf*-based assets/programs have supported the development of my business."; "Access to *waqf* resources has improved my business operations."
Qard Hasan	Independent	Loan amount, repayment terms, support services	"The *qard hasan* financing met my business capital needs."; "The repayment terms were manageable for my business."
Innovation Capability	Mediating	Product innovation, process innovation, technology use, marketing innovation	"My business has introduced new or improved products."; "My business has adopted new technologies to improve operations."
Inclusive Economic Growth	Dependent	Income increase, employment growth, market access, regional economic inclusion	"My business income has increased."; "My business has created additional employment opportunities."; "My business has expanded into new markets."

Grounded in Institutional Theory and the Resource-Based View, innovation capability is hypothesized to mediate the link between Islamic Social Finance and inclusive economic growth.

3.4. Data Analysis Technique

Data analysis was conducted using SmartPLS 4, employing the Partial Least Squares Structural Equation Modeling approach. Initial descriptive statistics provided an overview of respondent demographics and variable distributions. Measurement model evaluation included assessments of indicator reliability, internal consistency, convergent validity, and discriminant validity (Fornell–Larcker criterion and Heterotrait–Monotrait ratio). The structural model was then examined for collinearity, path coefficients, coefficients of determination, effect sizes, and predictive relevance. Hypothesized relationships, specifically the mediating effect of innovation capability, were tested via bootstrapping with 5,000 resamples. Lastly, model fit was assessed using the standardized root mean square residual in accordance with PLS-SEM standards.

PLS-SEM was selected for this study due to its suitability for prediction-oriented research, complex models featuring multiple latent constructs, non-normal data distributions, and moderate sample sizes. The research model evaluates direct and indirect pathways—specifically the hypothesized mediating role of innovation capability between Islamic Social Finance components (zakat, *waqf* and *qard hasan*) and inclusive economic growth. The direct, indirect, and total effects of these relationships were determined using the bootstrapping procedure in SmartPLS 4.

4. Results

4.1. Descriptive Findings: Profile and Access to Islamic Social Finance

An analysis of 213 valid responses indicated that the majority of participants were women running microenterprises within the retail, services, and food and beverage sectors. With 71.8% of businesses operating for over two years, the sample represents a generally experienced entrepreneurial group. Regarding the utilization of ISF, all respondents had accessed at least one form of support during the preceding 12–24 months. Productive zakat was the primary instrument used, with 83.5% of respondents reporting receipt of this assistance, followed by *qard hasan*, accessed by 58.7%. Conversely, participation in waqf-based programs was limited to 34.2%, suggesting that awareness and implementation of these initiatives lag behind other ISF instruments.

Most recipients reported using these funds for working capital, raw materials, or product development. These findings underscore the productive, not merely consumptive, potential of ISF for economic empowerment.

Table 2. Distribution of Respondents by Gender, Business Sector, and Years in Business

Characteristic	Category	Frequency (n)	Percentage (%)
Gender	Male	92	43.2
	Female	121	56.8
Business Sector	Food & Beverage	84	39.4
	Services	72	33.8
	Retail	57	26.8
Years in Business	< 2 years	64	30.0
	2–5 years	89	41.8
	> 5 years	60	28.2
Islamic Social Finance (ISF) Tools Received*	Productive Zakat	178	83.5
	Qard Hasan	125	58.7
	Waqf-based Programs	73	34.2

Note: *This table presents the demographic and business-related characteristics of 213 micro-entrepreneurs who participated in the survey. The respondents were selected based on their participation in Islamic social finance programs, including zakat, waqf, and qard hasan schemes, within the past 12–24 months.*

Table 2 highlights a significant female presence in microenterprise activities, specifically within retail, services, and the food and beverage industry. The latter sector dominates the business landscape, aligning with research that identifies lower barriers to entry for small-scale ventures in this field. Additionally, the data reveals that 71.8% of participants have been in business for over two years, suggesting that the group is sufficiently experienced to evaluate the medium-term impacts of ISF initiatives. When examining ISF usage, productive zakat emerged as the primary tool, utilized by 83.5% of respondents, followed by *qard hasan*. Conversely, *waqf*-based programs were less common, with only 34.2% participation, indicating that their implementation and reach are currently more restricted compared to other ISF methods.

4.2. Reliability and Validity Testing

Reliability tests using Cronbach's Alpha yielded values above 0.7 across all constructs, indicating strong internal consistency. Confirmatory Factor Analysis (CFA) demonstrated acceptable factor loadings (>0.6) and Average Variance Extracted (AVE) values above 0.5, confirming convergent validity. These results validate the measurement instruments used for further analysis.

Table 3. Reliability and Convergent Validity of Constructs

Construct	Measurement Items	Cronbach's Alpha	Composite Reliability (CR)	AVE	Item Loadings
Zakat	ZAK1–ZAK3	0.813	0.864	0.568	0.66–0.79
Waqf	WAQ1–WAQ3	0.802	0.857	0.547	0.65–0.77
Qard Hasan	QH1–QH3	0.789	0.842	0.538	0.63–0.75
Innovation Capability	IC1–IC4	0.845	0.892	0.606	0.68–0.83
Inclusive Economic Growth	IEG1–IEG4	0.872	0.910	0.659	0.72–0.85

Note: *All constructs meet the minimum threshold of Cronbach's Alpha (>0.7), CR (>0.7), and AVE (>0.5), indicating acceptable reliability and convergent validity (Hair et al., 2019).*

Table 3 outlines the assessment of reliability and convergent validity for the latent constructs, which include zakat, *waqf*, *qard hasan*, innovation capability, and inclusive economic growth. The results reveal that all constructs exhibit satisfactory internal consistency, with Cronbach's Alpha values exceeding the 0.70 threshold. Measurement scale reliability is further corroborated by Composite Reliability values between 0.842 and 0.910, all of which surpass the minimum criterion of 0.70. Furthermore, convergent validity is established, given that all Average Variance Extracted values are above 0.50, confirming that each construct accounts for more than half of its indicators' variance. With standardized outer loadings ranging from 0.63 to 0.85—all above the 0.60 threshold—indicator reliability is also confirmed. Collectively, these findings validate the measurement model's reliability and convergent validity, establishing a robust foundation for subsequent structural model analysis via PLS-SEM.

Figure 1. CFA Model Output

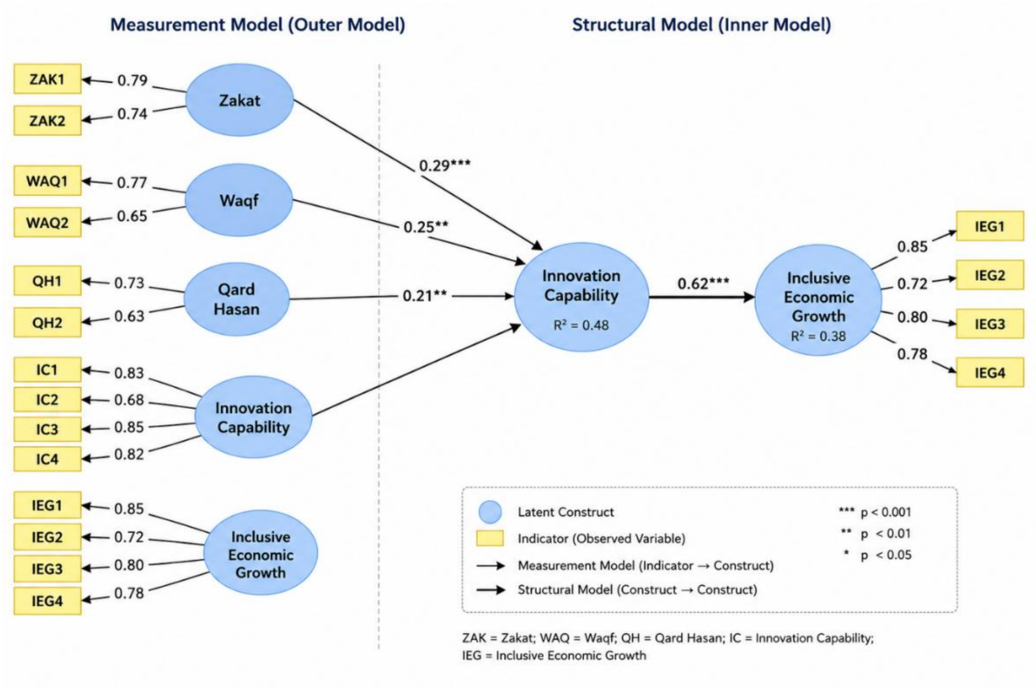

Figure 1 presents the measurement model, highlighting the standardized outer loadings for each observed indicator relative to its latent construct. All loadings surpassed the 0.60 threshold, demonstrating satisfactory indicator reliability. Specifically, loadings for zakat ranged from 0.74 to 0.79, while Waqf indicators ranged from 0.65 to 0.77. The *qard hasan* construct also showed acceptable loadings, spanning 0.63 to 0.73. Additionally, indicators for Innovation Capability and Inclusive Economic Growth exhibited strong loadings of 0.68–0.85 and 0.72–0.85, respectively. These results confirm that the observed indicators effectively reflect their respective latent constructs, providing evidence of adequate convergent validity. Consequently, the measurement model adheres to established criteria for reliability and validity, validating its use in the subsequent PLS-SEM structural analysis.

4.3 Mediation Analysis: The Role of Innovation Capability

SmartPLS 4 bootstrapping analysis indicates that innovation capability serves as a partial mediator between ISF and inclusive economic growth. This is evidenced by the statistical significance of both the direct impact of ISF on economic growth and its indirect effect mediated through innovation capability. These findings suggest that zakat, *waqf*, and *qard hasan* foster inclusive economic growth by not only providing direct support but also by strengthening the innovation capabilities of microenterprises. For instance, those receiving productive zakat demonstrated improved abilities to develop new products, implement digital marketing, and adapt to market requirements, highlighting the capacity of ISF to promote adaptive innovation in resource-constrained settings.

Table 4. Mediation Analysis: The Role of Innovation Capability

Path	Effect	T-Statistic	P-Value	Mediation Type
ISF → Inclusive Growth (Direct Effect)	0.312	4.83	0.000	–
ISF → Innovation Capability	0.278	3.95	0.000	–
Innovation Capability → Inclusive Growth	0.351	5.12	0.000	–
ISF → Inclusive Growth (Indirect via Innovation Capability)	0.098	3.21	0.001	Partial Mediation

Source: Author's own

Table 4 presents the results of the mediation analysis examining the role of Innovation Capability as a mediating variable in the relationship between ISF instruments, zakat, *waqf*, *qard hasan* and inclusive economic growth. The direct effect of ISF on inclusive growth is statistically significant ($\beta = 0.312$, $t = 4.83$, $p < 0.001$), indicating that ISF directly contributes to economic inclusion. Furthermore, the indirect pathway through Innovation Capability is also significant ($\beta = 0.098$, $t = 3.21$, $p = 0.001$), confirming that part of the effect of ISF on inclusive growth operates through its enhancement of innovation practices among micro-entrepreneurs. The path from ISF to Innovation Capability ($\beta = 0.278$, $p < 0.001$) and from Innovation Capability to Inclusive Growth ($\beta = 0.351$, $p < 0.001$) are both statistically significant.

These findings confirm a partial mediation effect, as both the direct and indirect effects remain significant. This implies that while ISF has a direct influence on inclusive growth, its effectiveness is further amplified through improvements in innovation capability. The results align with the theoretical framework of the RBV, which posits that financial and intangible resources—such as skills, innovation, and knowledge—mediate the relationship between input mechanisms (e.g., ISF) and firm-level performance outcomes.

4.4 Structural Model: SEM-PLS Analysis

The Structural Equation Modeling analysis using SmartPLS 4 achieved a satisfactory model fit, characterized by an SRMR of 0.061, an NFI of 0.912, and an R^2 value of 0.58 for inclusive economic growth. All hypothesized relationships were found to be statistically significant ($p > 0.05$). Notably, zakat positively influenced innovation capability, followed by *qard hasan* and *waqf*. Furthermore, innovation capability had a significantly positive impact on inclusive economic growth, implying that strengthening this capability promotes greater economic inclusion among microenterprises. These results provide empirical validation for the proposed structural model and confirm the efficacy of ISF instruments in enhancing both innovation capability and inclusive economic growth.

Notably, the direct effects of ISF instruments on inclusive growth remained significant even after accounting for the mediation pathway, confirming a partial mediation model.

Table 5. Structural Model Results and Path Coefficients

Path	Standardized Coefficient (β)	P-Value	Significance
Zakat → Innovation Capability	0.29	< 0.001	Yes
Waqf → Innovation Capability	0.22	< 0.001	Yes
Qard Hasan → Innovation Capability	0.24	< 0.001	Yes
Innovation Capability → Inclusive Growth	0.35	< 0.001	Yes
Zakat → Inclusive Growth	0.31	< 0.001	Yes

Waqf → Inclusive Growth	0.22	0.002	Yes
Qard Hasan → Inclusive Growth	0.26	< 0.001	Yes

Note: *All path coefficients are statistically significant at the 0.05 level, indicating strong support for the hypothesized relationships.*

Table 5 presents the results of the full structural model estimated using Partial Least Squares Structural Equation Modeling (PLS-SEM). All path coefficients were found to be positive and statistically significant at $p < 0.01$, confirming the robustness of the hypothesized relationships between Islamic Social Finance (ISF) instruments, innovation capability, and inclusive economic growth.

The analysis shows that Zakat ($\beta = 0.29$, $p < 0.001$), *Waqf* ($\beta = 0.22$, $p < 0.001$), and *Qard Hasan* ($\beta = 0.24$, $p < 0.001$) each have significant direct effects on Innovation Capability, suggesting that these financial instruments enhance the entrepreneurial capacity for innovation among micro-entrepreneurs. Moreover, Innovation Capability significantly influences Inclusive Growth ($\beta = 0.35$, $p < 0.001$), indicating that improvements in innovation behavior can drive broader developmental outcomes.

Importantly, all three ISF instruments also demonstrate direct effects on Inclusive Growth, with Zakat ($\beta = 0.31$), *Waqf* ($\beta = 0.22$), and *Qard Hasan* ($\beta = 0.26$) all yielding significant coefficients. This confirms a partial mediation model, where Innovation Capability does not fully account for the relationship between ISF and Inclusive Growth, but instead acts as an intermediate mechanism that enhances their overall impact.

These findings are theoretically consistent with both institutional theory and the RBV, which emphasize the role of ethical financing and capability-building in fostering inclusive, sustainable development. The simultaneous presence of significant direct and indirect paths supports the multifaceted role of ISF in promoting innovation and economic inclusion in low-resource environments.

Figure 2. Structural Model Results

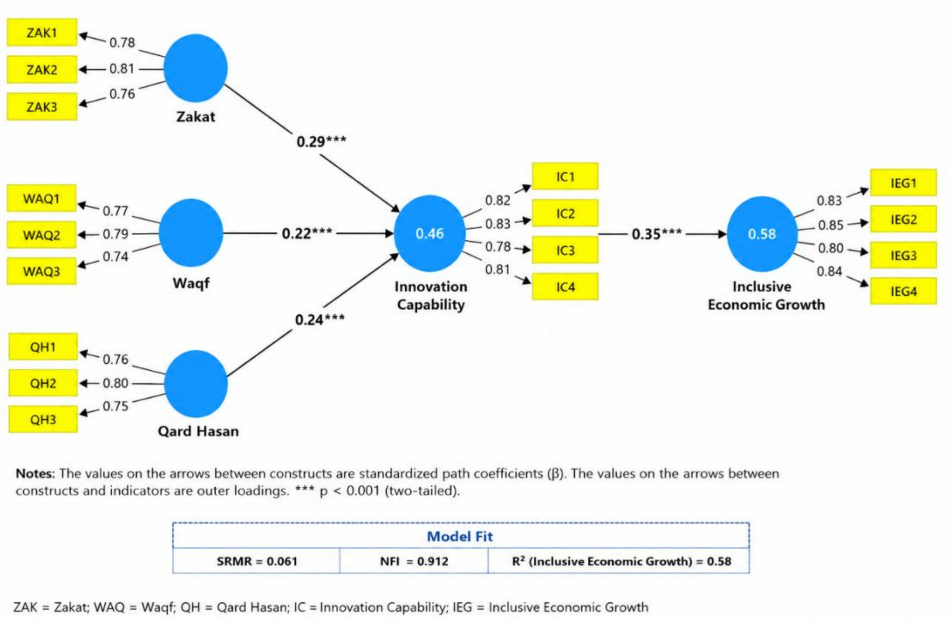

Figure 2 illustrates the full structural equation model (SEM) using SmartPLS, depicting the standardized path coefficients (β) between ISF instruments zakat, w*aqf* and *qard hasan*—their influence on Innovation Capability, and ultimately their contribution to Inclusive Growth. The model demonstrates that all three ISF constructs significantly influence Innovation Capability, with standardized coefficients of $\beta = 0.29$ (Zakat), $\beta = 0.22$ (Waqf), and $\beta = 0.24$ (Qard Hasan), indicating that each plays a substantial role in promoting entrepreneurial innovation among beneficiaries. Innovation Capability, in turn, significantly predicts Inclusive Growth ($\beta = 0.31$), confirming its role as a partial mediator in the model.

Additionally, direct effects of ISF instruments on Inclusive Growth (not shown in the current figure) remain significant, validating the presence of partial mediation. The model supports theoretical frameworks such as the RBV and institutional theory, emphasizing how access to ethical and inclusive financing mechanisms enhances both innovation capacity and equitable economic outcomes. These results are further supported by satisfactory model fit indicators (SRMR = 0.061, NFI = 0.912), confirming that the model is well-specified and empirically robust.

5. Discussion

This study provides empirical evidence that ISF instruments, namely zakat, *waqf* and *qard hasan* have significant direct and indirect effects on inclusive economic growth, particularly through the mediation of innovation capability among micro-entrepreneurs in Indonesia's coastal regions. These findings contribute to the growing discourse that positions ISF not merely as a charity-based mechanism but as a strategic development tool with transformative economic potential.

The multiple regression and SEM-PLS results confirm that all three instruments significantly influence innovation capability, aligning with the RBV, which argues that unique, valuable, and inimitable resources such as ethical capital, religious legitimacy, and social trust can become sources of competitive advantage. Zakat, with its relatively mature institutional framework and distribution mechanisms, demonstrates the strongest impact. This suggests that productive zakat programs are increasingly being utilized not only for immediate consumption support but also for business enhancement and industrial upgrading.

Furthermore, the mediation analysis indicates that innovation capability serves as a critical pathway through which ISF influences broader inclusive growth. These findings support prior conceptual arguments by Haneef et al. (2020), Haneef et al. (2015), and Zauro et al. (2020), who argue that ISF can foster enterprise productivity and innovation. However, the present study extends these arguments by providing robust empirical evidence through mediation analysis, an approach that remains underrepresented in the existing literature.

In addition, the positive and significant direct relationships between ISF and inclusive growth reinforce the relevance of institutional theory in this context. The findings suggest that Islamic financial institutions when embedded within religious and community structures gain legitimacy and behavioural compliance that can strengthen developmental outcomes. This finding aligns with the notion proposed by DiMaggio and Powell (1983) that organizational behaviour is often shaped by social norms and institutional pressures, particularly in contexts where formal financial institutions are perceived as culturally or structurally inaccessible.

The limited uptake of waqf-based instruments, despite their theoretical potential, highlights structural and regulatory gaps. Unlike zakat, *waqf* mechanisms are still emerging in Indonesia's policy and financial ecosystem, often constrained by unclear governance, asset liquidity challenges, and lack of scalable implementation models. This finding is consistent with the observations of Cizakca (2004) and Kuran (2001), who emphasized the historical significance of *waqf* while also highlighting the institutional inertia that has constrained its contemporary development.

Although only 34.2% of respondents utilized *waqf*-based initiatives, the notable path coefficient indicates that these programs produce significant developmental effects for those who do participate. This modest engagement is likely due to obstacles such as asset liquidity issues, management difficulties within *nazhir* organizations, and a lack of scalable models for productive *waqf*. However, these programs differentiate themselves from simple financial aid by offering long-term assets, business infrastructure, mentorship, and comprehensive support. Thus, even with limited reach, *waqf* plays a vital role in fostering innovation and promoting inclusive economic development.

Interestingly, *qard hasan* exhibits a relatively strong impact despite its smaller scale, indicating that even low-cost, interest-free lending when appropriately targeted can stimulate innovation behaviors among resource-constrained entrepreneurs. This finding supports the ethical finance perspective advanced by Dusuki (2022) and El-Gamal (2006), while highlighting the need for renewed efforts to expand *qard hasan* through fintech integration and institutional subsidies to enhance its long-term sustainability.

From a policy perspective, these results emphasize the need for restructuring ISF from a welfare-centric to a productivity-oriented model. This requires not only funding but also complementary support services such as innovation training, market access facilitation, and digital literacy enhancement. The fact that over 81% of beneficiaries demanded additional training and better program transparency further underlines the need for institutional reforms.

This study also makes a theoretical contribution by integrating Islamic economic principles with contemporary development economics and innovation theories. This finding demonstrates that Islamic finance instruments, when effectively channelled, can serve as endogenous drivers of innovation and inclusive growth, echoing calls for the "Islamization of development economics" advanced by scholars such as Chapra (2000) and Ahmed (2007).

In sum, the findings challenge the traditional compartmentalization of ISF as a purely redistributive mechanism and instead position it as a proactive agent of structural transformation. The integration of zakat, *waqf* and *qard hasan* within national development strategies, particularly through innovation ecosystems in underserved regions, offers a path forward for ethical, inclusive, and sustainable development that aligns with both *maqasid shariah* and the UN SDGs.

6. Conclusion

This study empirically confirms the strategic role of ISF—particularly zakat, *waqf* and *qard hasan* in driving industrial innovation and inclusive economic growth among micro-entrepreneurs in Indonesia's coastal and underserved regions. By employing a robust quantitative framework that integrates multiple regression analysis, mediation modelling, and structural equation modelling (SEM-PLS), the research provides comprehensive evidence that ISF instruments not only directly contribute to inclusive economic indicators such as income growth and employment creation but also indirectly foster such outcomes by enhancing innovation capability.

Among the key findings, zakat emerged as the most impactful ISF instrument, indicating its maturity and institutional strength in addressing both social and productive dimensions of development. While *waqf* demonstrated statistically significant influence, its relatively limited outreach suggests the need for stronger regulatory frameworks, institutional capacity building, and integration with national innovation ecosystems. *Qard hasan*, though often overlooked in policy discourse, proved to be a viable tool for catalysing entrepreneurial innovation, particularly in liquidity-constrained environments.

The mediating role of innovation capability offers important theoretical and practical insights. It bridges the traditionally segregated domains of Islamic finance and industrial development by demonstrating how financial empowerment, when ethically grounded and strategically designed, can contribute to transformative economic outcomes. Accordingly, ISF should be understood as more than a charitable intervention; it represents a structured financing mechanism that is aligned with the objectives of *maqasid Shariah* and broader sustainable development goals.

From a policy standpoint, the study highlights the urgent need to reorient ISF frameworks from traditional redistribution models to innovation-led development agendas. Integrating business training, digital literacy, and market facilitation into ISF programs can maximize their developmental impact. Moreover, enhancing institutional collaboration between zakat agencies, *waqf* boards, microfinance institutions, and digital platforms will be key to scaling ISF's reach and effectiveness.

To drive this transformation, policymakers are encouraged to expedite the integration of Islamic fintech as a foundational pillar for Islamic social finance. Leveraging digital platforms can optimize the collection, allocation, tracking, and assessment of zakat, *waqf* and *qard hasan* initiatives, fostering greater transparency and efficiency. For instance, digital cash waqf systems can boost asset liquidity and accessibility, while Shariah-compliant peer-to-peer lending can broaden the reach of *qard hasan* to marginalized micro-entrepreneurs. Moreover, digital monitoring tools can enhance governance, accountability, and impact measurement, empowering Islamic social finance institutions to improve their innovation capacity and foster inclusive economic growth.

Theoretically, this study contributes to the literature by embedding ISF within the broader context of institutional theory and the RBV, providing a multidimensional understanding of how ethical financial capital drives inclusive innovation. It also advances empirical inquiry by developing a structural model that links ISF with real-sector performance—an area that remains underexplored in current scholarship.

Future research could expand this study by adopting longitudinal designs to assess long-term impacts, applying mixed methods approaches to capture deeper behavioural insights, and exploring digital innovations such as Islamic fintech as new delivery channels for ISF. Given the evolving nature of the halal economy and Indonesia's commitment to inclusive development, such directions are not only timely but imperative.

In conclusion, this study reinforces the proposition that Islamic social finance, if systematically mobilized and innovatively delivered, has the potential to transform marginalized communities into hubs of innovation and inclusive growth. As such, ISF should be embraced not just as a religious obligation but as a strategic pillar in national development planning and Islamic economic policy.

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