

The Effect of Financial Literacy on MSMEs Performance in Indonesian Non-Agricultural Production Firms

The Effect of Financial Literacy on MSME Performance

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ABSTRACT

MSMEs play a vital role in driving local economic growth in emerging markets. However, many still struggle with performance issues, particularly due to weaknesses in financial management. This study aims to examine the effect of financial literacy on the performance of non-agricultural MSMEs in Demak Regency, Indonesia. A quantitative survey approach was employed, using structured questionnaires distributed to 120 MSME owners selected through purposive sampling. The data were analyzed using simple linear regression. The findings indicate that financial literacy has a positive and significant impact on MSME performance, reflected in increased revenue, improved cost efficiency, higher profitability, and enhanced business sustainability. Improved financial decision-making, effective cash flow management, and better access to formal financial services contribute to this performance improvement. This study contributes to the literature on MSMEs in developing countries by highlighting the link between financial literacy, financial inclusion, and local economic resilience. The results provide practical implications for local governments and development stakeholders in designing inclusive and sustainable MSME empowerment programs aligned with the Sustainable Development Goals.

Keywords: *Financial Inclusion, Financial Literacy, Local Economic Resilience, MSME Performance, Non-Agricultural Production.*

INTRODUCTION

In developing countries, Micro, Small, and Medium-sized Enterprises (MSMEs) play a crucial role in fostering regional economic growth and generating employment opportunities. They act as engines of local income, value creation, and social development, particularly in non-agricultural production sectors such as food processing, handicrafts, and small-scale manufacturing. In Indonesia, these non-agricultural MSMEs significantly contribute to local economies by creating jobs and increasing household incomes (Mutasowifin & Sutisna, 2023; Herissuparman et al., 2024). Despite their importance, many MSMEs still face internal challenges that limit their growth and sustainability. Among these, poor financial management practices remain a critical factor that hampers performance, profitability, and long-term survival (Lusardi & Mitchell, 2014; Nkwinika & Akinola, 2023).

Financial literacy has emerged as a key enabler for improving MSMEs performance. It allows business owners to plan for growth, manage cash flow effectively, and make informed financial decisions that enhance operational efficiency (Huston, 2010). Empirical studies support a positive relationship between financial literacy and business outcomes, including profitability, efficiency, and overall company growth (Bongomin et al., 2019; Adomako & Danso, 2021). These findings suggest that enhancing the financial knowledge and skills of MSMEs owners can directly influence their ability to make

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strategic decisions, allocate resources efficiently, and navigate financial challenges (Padi et al., 2025).

However, existing literature largely overlooks the specific context of non-agricultural production MSMEs at the local government level, particularly in developing countries like Indonesia. Most studies focus on MSMEs broadly, emphasizing service or trade sectors or analyzing cross-border and macroeconomic patterns, leaving a research gap in localized empirical evidence for production-based MSMEs (Adomako & Danso, 2021). Furthermore, while prior research has established that financial literacy influences SME performance, it often remains unclear whether it serves as a primary determinant or a supporting factor in the context of non-agricultural production enterprises. This gap highlights the need for targeted studies that explore the nuances of financial literacy's impact on locally embedded MSMEs.

In Demak Regency, Indonesia, recent studies indicate that financial literacy is a major factor supporting the performance of MSMEs in non-agricultural sectors. While it contributes positively to outcomes such as revenue growth, cost efficiency, profitability, and business sustainability, financial literacy has been observed more as a supportive factor rather than the sole determinant of success (Bongomin et al., 2019; Babajide et al., 2023). This underscores the importance of examining financial literacy alongside other contextual factors, such as local economic conditions, production capacity, and access to markets, to better understand its role in driving MSME performance.

From a broader development perspective, financial literacy is closely intertwined with financial inclusion, as it equips MSMEs with the capacity to access and utilize formal financial services effectively (Grohmann et al., 2021; Ozili, 2021). Enhancing financial literacy not only facilitates better financial management within firms but also contributes to the achievement of the Sustainable Development Goals (SDGs), particularly SDG 8, which focuses on decent work and economic growth, and SDG 9, which emphasizes industry, innovation, and infrastructure. By fostering financial inclusion and resilience among MSMEs, local governments and development stakeholders can implement policies that strengthen regional economies and mitigate the impacts of economic shocks.

This study aims to address these research gaps by investigating the effect of financial literacy on the performance of SMEs engaged in non-agricultural production in Demak Regency, Indonesia. By focusing on a localized context, this research contributes both theoretically and practically. By enriching the literature on MSMEs in emerging markets, and practically, by providing insights for designing inclusive and sustainable regional development programs that integrate financial literacy, financial inclusion, and local economic resilience. Ultimately, this study seeks to demonstrate how strengthening financial capabilities can enhance MSMEs' performance and support the stability and growth of local economies.

LITERATURE REVIEW & HYPOTHESIS DEVELOPMENT

Financial Literacy

Financial literacy is an essential competence for the sustainability and growth of MSMEs. Entrepreneurs with high financial literacy can effectively manage cash flows, understand and leverage credit facilities, create accurate budgets, and make strategic investment decisions (Irikefe & Opusunju, 2021; Dekamini et al., 2024; Habtamu, 2025). Inadequate financial knowledge often leads to mismanagement of resources, poor risk assessment, and missed opportunities for growth, which can threaten business survival (Karyna, 2024). Moreover, MSME owners who understand the principles of financial record-keeping and financial statement analysis are better equipped to forecast business performance, identify inefficiencies, and prepare for economic uncertainties (Selvi et al., 2024). Training programs and workshops focusing on financial literacy have been shown to significantly improve MSME operational efficiency and decision-making, particularly in budgeting, cost control, and cash management (Susanti & Zuliansyah, 2025).

Beyond operational benefits, literate entrepreneurs are more likely to utilize diverse financial products and services, such as microloans, insurance, and investment

opportunities, which can enhance capital availability for expansion and innovation (Alafifi et al., 2019). Additionally, financial literacy contributes to long-term resilience, enabling MSMEs to navigate market fluctuations, reduce dependency on informal lending, optimize investment returns, and build sustainable competitive advantages (Maravilla & Flores, 2025). As global markets become increasingly complex, MSMEs owners with strong financial knowledge are better positioned to make informed strategic decisions, attract investors, and ensure regulatory compliance (Dwyanti, 2024). Therefore, cultivating financial literacy is not merely an educational goal but a strategic necessity for sustaining MSMEs growth, operational stability, and competitiveness in dynamic economic environments (Molosiwa & Molosiwa, 2025).

MSME Performance

The performance of MSMEs is a multidimensional concept encompassing both financial and non-financial metrics. Financial indicators often include revenue growth, profitability, return on assets, and operational efficiency, which reflect an enterprise's ability to generate income and manage resources effectively (Bogićević et al., 2016; Ahmad & Jamil, 2020). Non-financial indicators, such as product quality, customer satisfaction, innovation capability, and market responsiveness, also play a crucial role in assessing long-term sustainability and competitiveness (Rusli & Surjadi, 2021; Vuong, 2025). Integrating these measures provides a holistic understanding of enterprise performance, aligning short-term profitability with strategic growth objectives. Research indicates that MSMEs that leverage balanced scorecard approaches, combining financial and non-financial indicators, achieve higher adaptability and resilience in dynamic market conditions (Dobrovic et al., 2018; Tarigan et al., 2025).

Furthermore, social and environmental factors, such as corporate social responsibility practices and resource optimization, increasingly influence performance outcomes (Munthal & Logasakthi, 2024; Rahmawati et al., 2025). By systematically monitoring these indicators, MSME managers can make informed decisions to enhance operational efficiency, maintain competitiveness, and ensure sustainable growth. Consequently, performance measurement frameworks that incorporate both financial and non-financial metrics are critical for supporting MSME development and long-term success. This integrated approach also enables MSMEs to better adapt to dynamic market conditions and stakeholder expectations.

The Effect of Financial Literacy on MSME Performance

Financial literacy plays a pivotal role in shaping the performance of MSMEs, as entrepreneurs with higher financial knowledge are better equipped to make strategic decisions regarding budgeting, investment, and risk management. Entrepreneurs with strong financial literacy are able to manage cash flow more effectively, optimize the allocation of resources, and reduce financial inefficiencies, which directly contributes to business growth and sustainability (Klapper et al., 2011; Gunawan et al., 2023). Research by Lubis and Irawati (2022) shows that MSMEs that adopt structured financial planning practices report higher profitability, improved operational efficiency, and greater resilience during economic fluctuations. In addition, financial literacy enhances the ability of MSME owners to access formal financial services such as loans, credit, and grants, which are crucial for expanding operations and investing in new business opportunities (Astrini & Puspitasari, 2022; Aritonang et al., 2022). Knowledge in areas such as interpreting financial statements, managing debts, and evaluating investment options significantly reduces the risk of financial mismanagement and poor decision-making (Irikefe & Opusunju, 2021).

Furthermore, financial literacy combined with digital literacy increasingly influences MSME performance, as it facilitates the use of financial technology tools for bookkeeping, transaction monitoring, and reporting (Mangawing et al., 2023; Fikri & Nahda, 2023). The integration of digital financial tools enables entrepreneurs to track financial performance in real time, make data-driven decisions, and respond more rapidly to

market changes. Financial literacy is not only a knowledge-based asset but also a practical driver of improved MSMEs performance, fostering sustainable growth, competitive advantage, and long-term business success in dynamic and challenging economic environments (Hasan et al., 2024).

H1: Financial literacy has a positive effect on the MSMEs performance.

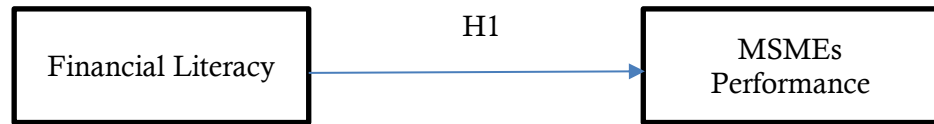


Figure 1. Conceptual Framework

Figure 1 illustrates the direct relationship between financial literacy and MSMEs performance. The arrow indicates that financial literacy is hypothesized to have a positive influence on the performance of MSMEs. This suggests that higher levels of financial literacy among business owners or managers are expected to lead to better decision-making, more efficient resource management, and ultimately enhanced overall business performance. The figure serves as a simplified conceptual framework for understanding the role of financial knowledge in driving MSME success.

RESEARCH METHODS

The research methodology used in this study was quantitative, with surveys serving as the main means of data collection. MSMEs that are involved in the non-agricultural production sector in Demak Regency, Indonesia, were the main emphasis because they are crucial to the local economy. A total of 120 MSMEs were chosen as the sample via purposive sampling, while the population for this study comprised all currently operating MSMEs in this industry. By ensuring that each participating MSME had been in business for at least two years, the selection criteria made it possible to evaluate financial practices and business performance with more accuracy.

To gather the necessary information, a structured questionnaire was designed, containing items measured on a five-point Likert scale ranging from 1 (strongly disagree) to 5 (strongly agree). The questionnaire focused on key aspects of financial literacy and MSME performance. Financial literacy, treated as the independent variable, was operationalized through indicators such as financial recordkeeping, cash flow management, budget planning, and understanding of financial products. Meanwhile, MSME performance, the dependent variable, was measured using indicators including revenue growth, cost efficiency, profitability, and business sustainability.

Using SPSS software, the data were meticulously processed and examined after collection to guarantee accuracy and rigor. First, validity and reliability tests were conducted to ensure that the questionnaire items were appropriate, consistent, and capable of accurately measuring the intended constructs. Subsequently, classical assumption tests were performed, including normality, heteroscedasticity, and multicollinearity tests, to confirm that the data met the necessary requirements for regression analysis. These tests are essential to ensure that the regression model produces unbiased and reliable estimates.

After fulfilling these assumptions, a simple linear regression analysis was carried out to investigate the relationship between financial literacy and MSME performance. The regression analysis was guided by the conceptual framework, with financial literacy as the independent (predictor) variable and MSME performance as the dependent (outcome) variable. By applying this analytical approach, the study was able to determine whether improving MSME owners' financial literacy has a positive impact on their business performance, including growth and sustainability. The following is the regression equation used in this study:

$$Y = \alpha + \beta X + \varepsilon$$

Remarks:

Y = MSME Performance

X = Financial Literacy

α = Constant

β = Financial literacy regression coefficient

E = Error term.

RESULTS

The findings of the data analysis carried out to investigate the impact of financial literacy on MSMEs performance in Demak Regency's non-agricultural output sector are presented in this chapter. Quantitative techniques, such as basic linear regression analysis, validity and reliability testing, and traditional assumption tests, were used in the analysis. The study had 120 MSMEs in total, and structured questionnaires with a five-point Likert scale were used to collect data.

The instrument testing, which verifies the validity and reliability of all financial literacy and MSME performance metrics, is the main emphasis of the first section of the results. The traditional assumption tests, such as heteroscedasticity, multicollinearity, and normality, are then provided to verify that the data satisfy the prerequisites for regression analysis. The chapter concludes by summarizing the findings of the linear regression analysis and the coefficient of determination (R^2), which shed light on the importance and strength of the connection between MSME success and financial literacy. This methodical presentation guarantees the quality and robustness of the results while facilitating a clear understanding of how financial literacy affects company performance.

Table 1. Validity & Reliability Test

Variable	R-count range	Cronbach Alpha	Information
Financial Literacy	0.765-0.812	0.845	Valid & Reliable
MSMEs Performance	0.794-0.832	0.862	Valid & Reliable

The results of the validity and reliability tests are summarized in Table 1. For the financial literacy variable, the correlation values (r-count) of the indicators ranged from 0.765 to 0.812, with a Cronbach's alpha of 0.845, indicating that all questionnaire items are valid and reliable in measuring the construct consistently. Similarly, the MSMEs performance variable showed r-count values ranging from 0.794 to 0.832, with a Cronbach's alpha of 0.862, confirming that the indicators measuring revenue growth, cost efficiency, profitability, and business sustainability are both valid and reliable. These findings demonstrate that the research instruments meet the required standards of validity and reliability, providing a strong foundation for further data analysis.

Table 2. Normality Test

Indicator	Value
N	120
Sig.	0.200
Normality Status	Data is normally distributed.

The Kolmogorov-Smirnov method was used to test the research data for normality, and the findings are shown in Table 2. The significant value is 0.200, the data can be regarded as regularly distributed since the significance value is higher than 0.05. This shows that one of the fundamental classical assumptions of linear regression analysis is met, guaranteeing that the regression model's residuals have a normal distribution.

Table 3. Multicollinearity & Heteroscedasticity Test

Indicator	Value
Variable	Financial Literacy
VIF	1.042
Tolerance	0.960
Glejser Sig.	0.317
Information	No multicollinearity and heteroscedasticity

Table 3 provides a summary of the multicollinearity and heteroscedasticity test results. The tolerance value for the financial literacy variable is 0.960, and the Variance Inflation Factor (VIF) value is 1.042. Given that a tolerance above 0.10 and a VIF below 10 signify the absence of multicollinearity, both numbers fall well within acceptable bounds. This guarantees that the regression coefficients can be estimated with accuracy because the independent variable does not have a strong linear relationship with other variables in the model.

Furthermore, the significant value of 0.317 obtained from the Glejser test is higher than the 0.05 cutoff. This demonstrates that there is no heteroscedasticity, meaning that the residuals' variance is constant at all independent variable levels. The results verify that the regression model satisfies the traditional presumptions, offering a solid basis for examining how financial literacy affects MSME performance.

Table 4. Linear Regression Test Results

Variable	Coefficient (β)	t-statistic	Sig.	R-Square
Constant	1.245	4.12	0.000	0.42
Financial Literacy	0.536	7.89	0.000	

Table 4 displays the outcomes of the linear regression analysis. With a t-statistic of 4.12 and a p-value of 0.000, the regression model's constant (intercept) of 1.245 is statistically significant. This suggests that the baseline level of MSME performance is still good and significant even when financial literacy is taken into account. With a significance level of 0.000 and a t-statistic of 7.89, the financial literacy coefficient is 0.536. This indicates that financial literacy improves MSME performance in a positive and statistically meaningful way. Put another way, MSME owners' business performance, including revenue growth, cost effectiveness, profitability, and sustainability, tends to improve when their level of financial literacy rises. A significant predictor in improving the operational outcomes of MSMEs is financial literacy, as evidenced by the significance level below 0.05, which verifies that this link is not the result of chance. According to the determination coefficient (R^2) of 0.42, 42% of the variation in MSME performance can be explained by financial literacy, with the remaining portion being impacted by variables not included in the model.

DISCUSSION

The result shows that financial literacy has a significant effect on MSME performance. The findings of this study are consistent with Adomako and Danso (2021) and Mayndarto (2025), which demonstrate that financial literacy has a positive and significant effect on the performance of non-agricultural production MSMEs in emerging markets. The empirical results indicate that MSME owners with higher levels of financial knowledge are better able to manage business resources, make informed decisions, and enhance overall operational outcomes. By understanding key financial information, they can engage in strategic planning, optimize cash flow, and implement effective cost control measures, leading to improved revenue growth, profitability, and business sustainability.

Huston (2010) and Lusardi and Mitchell (2011) further support this view, noting that financial literacy equips business owners with the ability to interpret and utilize financial data for both daily operations and long-term planning. Similarly, Bongomin et al. (2019) emphasize that better financial decision-making, efficient cash flow management, and careful cost monitoring are important mechanisms through which financial literacy

translates into stronger MSME performance. These findings reinforce the idea that financial knowledge not only enhances managerial capabilities but also drives business growth, particularly in the context of developing countries where access to professional financial guidance may be limited.

Grohmann et al. (2021) and Ozili (2021) highlight the link between financial literacy and financial inclusion, showing that MSMEs with higher financial knowledge are more likely to access and effectively use formal financial services, including bank credit, savings, and digital financial products. This access facilitates operational expansion, investment in production capacity, and smoother business transactions, all of which contribute positively to firm performance. Financial literacy, therefore, plays a dual role: improving internal financial management while enabling better integration into formal financial systems, supporting inclusive economic development.

The findings also align with Sarma and Pais (2021) regarding the contribution of financially capable SMEs to broader development goals. By strengthening MSME performance and sustainability, financial literacy contributes to SDG 8 (Decent Work and Economic Growth) and SDG 9 (Industry, Innovation, and Infrastructure). Enhanced financial knowledge enables businesses to generate employment, increase value-added production, and support local economic resilience, particularly in non-agricultural production sectors that are deeply embedded in regional economies. These results suggest that promoting financial literacy among MSME owners is not only a pathway to improved firm performance but also an effective strategy for advancing sustainable and inclusive economic development.

These findings suggest that local governments and development agencies should prioritize financial literacy programs for MSME owners. Training in recordkeeping, budgeting, cash flow management, and financial product use can help owners make informed decisions, improve efficiency, and increase profitability. Coupled with access to formal financial services, such initiatives enhance MSME competitiveness, support inclusive growth, and contribute to sustainable regional development and the achievement of the SDGs.

CONCLUSION

The results of this study indicate that financial literacy has a positive and significant effect on the performance of MSMEs in the non-agricultural production sector in Demak Regency. This finding demonstrates that a strong understanding of financial management can enhance operational efficiency and support the long-term sustainability of micro, small, and medium enterprises. In other words, MSMEs with higher financial literacy are better able to manage capital, expenses, and revenues effectively, which in turn positively impacts business growth and stability.

These findings carry important implications for various stakeholders. Local governments should strengthen their role in implementing financial education and mentoring programs for MSME owners, while universities and financial institutions can contribute by providing training, advisory services, and access to financial management resources. A collaborative effort between government, academia, and the financial sector is expected to increase the capacity of MSMEs to address business challenges and capitalize on market opportunities effectively.

However, this study has several limitations. It focuses exclusively on the non-agricultural production sector in Demak, meaning the results may not be fully generalizable to other sectors or regions. In addition, other factors potentially affecting MSME performance, such as financial digitalization, access to capital, and product innovation, were not explored in depth. Therefore, future research is recommended to include these additional variables to provide a more comprehensive understanding of the determinants of MSME performance.

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