

The Impact of Islamic Leadership and Islamic Work Ethics on MSE Employee Performance: A Mediation Analysis

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ABSTRACT

In recent years, Indonesia's human resources have shown a decline in competitiveness, as reflected in the suboptimal performance of employees in Micro and Small Enterprises (MSEs). This study investigates employee performance from an Islamic organizational behavior perspective, with the Islamic work environment as a mediating variable. Using a non-experimental, quantitative approach, data were collected from 245 Muslim MSE employees in Bandung City and analyzed using Partial Least Squares Structural Equation Modeling (PLS-SEM). The findings show that Islamic leadership, Islamic work ethics, Islamic work motivation, rewards, and the Islamic work environment have significant positive direct effects on employee performance. Moreover, the Islamic work environment partially mediates the influence of Islamic leadership, work ethics, motivation, and rewards on performance, although direct effects were stronger. These results suggest that MSEs have effectively applied Islamic values in their organizational practices, contributing to improved employee performance. The study also highlights a strong collaboration between leaders, employees, and the organizational environment, reflecting a comprehensive application of Islamic principles. This research contributes practical insights for business owners aiming to enhance employee performance, which can ultimately improve business competitiveness.

Keywords: Employee Performance, Islamic work environment, Organizational Behavior, MSEs.

1. INTRODUCTION

The World Bank states that Micro and Small Enterprises (MSEs) have opened more than 50% of jobs worldwide, provide great innovation, and even contribute to state income (GDP) up to an average of 40% in various developing countries (World Bank, 2019). This is in line with 65,5 million unit MSEs contribution to Indonesia's GDP until 2022, which is 61% or equal to IDR 9,580 trillion. And labor absorption in Indonesia is 97% of the total national workforce (Databoks, 2022; Kementerian Koordinator Bidang Perekonomian, 2023). With the various potentials owned and possible threats that will be faced by these MSEs, the world including the Indonesian government continues to encourage the development of MSEs as a top priority (ICSB, 2023).

The mismatch between the potential and the reality on the ground can be seen in the competitiveness of Indonesian MSEs, which lags behind other ASEAN countries. In addition, the Deputy for Entrepreneurship of the KemenKOP UKM, Siti Azizah, said that the contribution of MSEs to national exports in 2022 reached 14.4%, still lagging behind

when compared to Singapore (38.3%), Myanmar (23.7%), Thailand (28.7%), Malaysia (17.3%), and Vietnam (18.7%) (Mustika & Jatmiko, 2023). This indicates imperfect output from MSMEs, both domestically and internationally. One contributing factor is the lack of talented and skilled labor, which reduces productivity, efficiency, and output quality. Similar conditions occur in Indonesia, that internal company factors, both employee performance and other internal factors can affect the performance of MSEs (Hendratmoko, 2023).

The big picture of employee performance that affects MSEs can be seen through the competitiveness of human resources (HR) in Indonesia (Amelyawati et al., 2023). Due to the calculation of competitiveness, the World Talent Ranking, released by the Institute for Management Development (IMD) states that the competitiveness of Indonesian human resources in 2023 is still low in Southeast Asia, and has decreased and increased in the last 5 years with the best level of competitiveness in 2019 (Katadata, 2024). So, through this data, it indicates that there is a gap between the high number of employee absorption and the quality of Indonesian human resources which is still low and cannot balance the existing potential. This is proven by research conducted by Istikomah et al. (2022) that there was a decrease in the performance of MSE employees in Bandung City, which was influenced by the competence of the employees themselves and the management of employees carried out by the organization. So that MSEs must pay attention to their employees and human resource management to maximize the performance of their employees and organizations (Idrus et al., 2023).

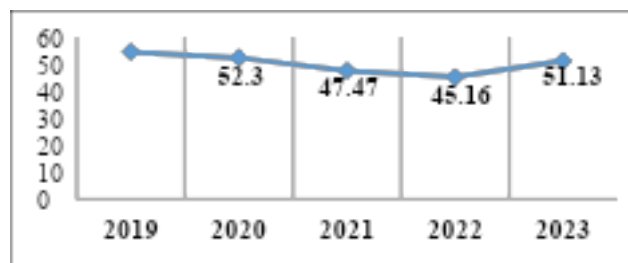


Figure 1. Competitiveness of Indonesian Human Resources according to the World Talent Ranking by IMD

Therefore, Organizational Behavior is the right theory to discuss this problem. Because organizational behavior is a field of study that investigates the impact that individuals, groups, and structures have on behavior in organizations, with the aim of applying that knowledge to improve organizational effectiveness (Robbins & Judge, 2013). In basic theory, to produce optimal employee performance, there needs to be balanced inputs and processes between individuals, groups, and organizations (Indrasari, 2017). Some of them are a combination of effective leadership, good work ethics, high motivation, commensurate rewards, and a conducive work environment in an organization.

Then, previous studies have identified several key factors influencing employee performance within micro and small enterprises (MSEs), particularly in developing countries like Indonesia. Motivational aspects, reward systems, and work environment have consistently been examined in relation to employee outcomes. For instance, Khotijah & Helmy (2021) stressed the importance of compensation and reward structures that align organizational goals with individual performance. In a similar vein, Shafagatova & Van

Looy (2020) found that performance-oriented employee evaluations and rewards significantly enhance performance when employee engagement is high. Moreover, Serhan et al. (2021) demonstrated that profit sharing and collective bargaining-based rewards positively correlate with team performance and cohesion, suggesting that well-structured reward systems can foster employee retention and organizational commitment.

However, contrasting results were reported by Sari et al. (2021), whose study in Lampung, Indonesia, revealed that rewards may negatively impact employee performance, while motivation and disciplinary measures (punishment) had a positive effect. In parallel, the work environment has also shown mixed influences. While Lillo-Bañuls et al. (2018) and Stamolampros et al. (2019) linked work hours and conditions to employee well-being and emotional intelligence, Deb et al. (2023) highlighted that leadership, salary, and workplace environment are essential to both employee satisfaction and organizational performance. Spiritual work environments—those incorporating religious values, training, and prayer groups—have been shown to enhance employee motivation and psychological well-being (Pariyanti et al., 2022; Sapta et al., 2021). Yet, Pawirosumarto et al. (2017) argued that workplace environment does not always yield a significant positive impact on employee performance, indicating inconsistencies that warrant further empirical investigation.

While previous studies have investigated individual aspects such as Islamic leadership or work motivation, few have integrated these variables into a single framework to assess their joint effects on performance in the MSE sector. This study fills that gap by incorporating the mediating role of the Islamic work environment. So based on the explanation, phenomena and theoretical concepts, researchers are interested in conducting this research with the title “The Impact of Islamic Leadership and Islamic Work Ethics on MSE Employee Performance: A Mediation Analysis”. This research was conducted to reduce the performance of MSE employees through human resource and environmental factors from an Islamic perspective. So the framework in this study is:

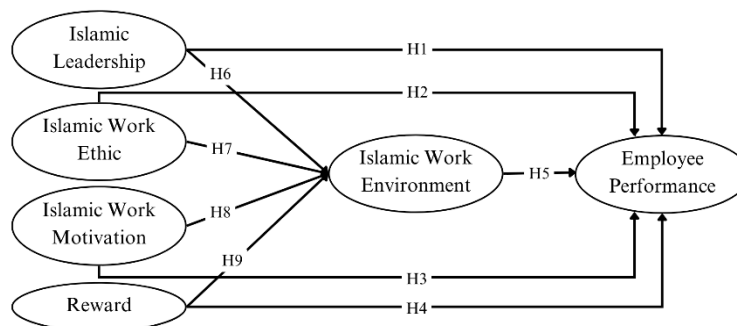


Figure 2. Research Framework

2. METHODS

This study employed a quantitative research method with a non-experimental, causal-descriptive design to examine the relationship between Islamic leadership, Islamic work ethics, Islamic work motivation, rewards, and employee performance, mediated by the Islamic work environment. The object of the study was employee performance in Micro and

Small Enterprises (MSEs), while the population comprised all Muslim employees working in the culinary sector of MSEs in Bandung City. Purposive non-probability sampling was used, with selection criteria including being Muslim, residing in Bandung City, having worked for at least one year in the culinary sector of MSEs, and being aged between 15 and 43 years (classified as working-age under Article 69 of Law No. 13 of 2003). Based on Hair et al. (2017) sampling guidelines and G*Power calculations, the final sample included 245 qualified respondents.

Data were collected using a structured questionnaire distributed via Google Forms both online and in person. The questionnaire was developed based on theoretical constructs and prior literature, and consisted of operationalized variables measured reflectively using semantic differential scales. All instruments underwent validity and reliability testing using SPSS v21, confirming their adequacy. Validity was assessed using corrected item-total correlations, while reliability was evaluated using Cronbach's alpha, with all variables scoring above the acceptable threshold of 0.7.

Table 1. The Result of Validity Test

Variable	Average R Value	R Table	Explanation
Islamic Leadership	0,727	0,361	Valid
Islamic Work Ethic	0,771	0,361	Valid
Islamic Work Motivation	0,671	0,361	Valid
Reward	0,670	0,361	Valid
Islamic Work Environment	0,606	0,361	Valid
Employee Performance	0,770	0,361	Valid

Table 2. The Result of Reliability Test

Variable	Cronbach's Alpha	R Table	Explanation
Islamic Leadership	0,921	0,70	Reliable
Islamic Work Ethic	0,930	0,70	Reliable
Islamic Work Motivation	0,829	0,70	Reliable
Reward	0,906	0,70	Reliable
Islamic Work Environment	0,665	0,70	Reliable
Employee Performance	0,946	0,70	Reliable

Finally, data analysis was conducted using SmartPLS 4 with Partial Least Squares – Structural Equation Modeling (PLS-SEM) to examine both the measurement and structural models.

3. FINDINGS AND DISCUSSION

After the distribution, a total of 245 respondents were collected who are Muslim employees, whose work in micro and small businesses in Bandung City areas and are aged 15 to 43 years.

Table 3. Characteristics of Respondents

Respondent Characteristics	N	Percentage
Gender		
Male	137	56%
Female	108	44%
Age		
Z Generation	164	67%
Millenial Generation	81	33%
Last Education		
Elementary school	10	4%
Junior high school	27	11%
Senior high school	149	61%
Diploma	36	15%
Bachelor	21	9%
Magister	2	1%
Business Size		
Micro business	168	69%
Small business	77	31%
Salary		
<Rp2.000.000	107	44%
>Rp2.000.000 – Rp4.209.308	88	36%
Rp4.209.309	14	6%
>Rp4.209.309 – Rp6.000.000	26	11%
>Rp6.000.000	10	4%

Based on the respondent data that has been collected and processed carefully, it is also known that respondents who work in MSEs in the city of Bandung have high scores on each variable, namely Islamic leadership, Islamic work ethic, Islamic work motivation, reward, Islamic work environment, and employee performance.

Table 4. Category of each Variable

Variable	Category
Islamic Leadership	Respondents are included in the high category, meaning that Islamic leadership greatly influences employee/respondent performance, both in terms of justice, shared vision, wisdom, and honesty of the business owner.
Islamic Work Ethic	Respondents are included in the high category, meaning that Islamic work ethics greatly influence employee/respondent performance, both in terms of learning from experience, being active and cooperative, being diligent and professional, and employee honesty.
Islamic Work Motivation	Respondents are included in the high category, meaning that Islamic work motivation greatly influences employee/respondent performance, both in terms of need/materialistic motivation, faith motivation, worship motivation, and employee incentive motivation.

Reward	Respondents are included in the high category, meaning that rewards greatly influence employee/respondent performance, both in terms of salary and bonuses, psychological and social recognition and appreciation, learning opportunities, and promotions received by employees.
Islamic Work Environment	Respondents are included in the high category, meaning that the Islamic work environment greatly influences employee/respondent performance, both in terms of relationships with coworkers, work regulations, religious programs, work facilities, and work development in the workplace.
Employee Performance	Respondents are included in the high category, meaning that respondents have high performance in the MSE where they work.

1.1. Outer Model Validity Test

1.1.1. Convergent Validity

The Outer Loading test aims to see the correlation between the item or indicator score and the variable score. Indicators are considered reliable if they have a correlation value above 0.7, but in the development stage a correlation of 0.50 is still acceptable (Ghozali, 2014).

Table 5. Outer Model

	Islamic Work Ethic	Islamic Leadership	Employee Performance	Islamic Work Environment	Islamic Work Motivation	Reward	AVE
EKI2	0.822						0.633
EKI3	0.794						
EKI4	0.798						
EKI5	0.806						
EKI8	0.758						
KI2		0.840					0.667
KI4		0.830					
KI5		0.840					
KI7		0.755					
KK2			0.816				0.635
KK4			0.789				
KK6			0.827				
KK7			0.754				
LK2				0.768			0.561
LK3				0.773			
LK6				0.756			

	Islamic Work Ethic	Islamic Leadership	Employee Performance	Islamic Work Environment	Islamic Work Motivation	Reward	AVE
LK8				0.696			
LK10				0.750			
MK2					0.746		0.536
MK3					0.738		
MK4					0.679		
MK5					0.724		
MK8					0.771		
PE2						0.767	0.589
PE4						0.790	
PE5						0.748	
PE7						0.765	

Based on Table 5, it can be concluded that the AVE value of each variable and the outer loading of each indicator have met the specified criteria.

1.1.2. Discriminant Validity

Discriminant validity is a test used in seeing the level of latent construct prediction against its indicator block. Discriminant validity is carried out to ensure that each concept of the latent model is different from other variables. Discriminant validity that can be analyzed is by looking at the Heterotrait-Monotrait Ratio (HTMT) table. HTMT is the average correlation between items measuring different variables and the correlation of items measuring the same variable. Henseler et al. (2015) state that the HTMT limit should not be greater than 0.90 or <0.90 .

Table 6. Heterotrait-Monotrait Ratio (HTMT)

	Islamic Work Ethic	Islamic Leadership	Employee Performance	Islamic Work Environment	Islamic Work Motivation	Reward
Islamic Work Ethic						
Islamic Leadership	0.813					
Employee Performance	0.815	0.763				
Islamic Work Environment	0.825	0.762	0.869			
Islamic Work Motivation	0.880	0.672	0.802	0.856		
Reward	0.828	0.868	0.835	0.866	0.818	

Based on the table above, it appears that all the resulting HTMT values are <0.90 . Therefore, it can be stated that the discriminant validity of this research model has a good value.

1.1.3. Composite Reliability

Composite reliability is a test conducted to measure internal consistency. Composite reliability is an alternative test to Cronbach's alpha, when compared to the test results, composite reliability is more accurate than Cronbach's alpha. In his book, Hair et al. (2017) states that the composite reliability value must be > 0.70 . The composite reliability value is in the range 0 to 1, and 1 indicates a very strong reliability estimate. The criteria for reliability from various sources can be stated as follows 0.70 is the minimum value of reliability in a study with a confirmation test of 0.80 or more indicating high reliability.

Table 7. Composite Reliability and Cronbach's Alpha values

	Cronbach's alpha	Composite reliability (rho c)
Islamic Work Ethic	0.855	0.896
Islamic Leadership	0.834	0.889
Employee Performance	0.808	0.874
Islamic Work Environment	0.805	0.865
Islamic Work Motivation	0.791	0.852
Reward	0.769	0.852

Based on Table 7, it can be concluded that all latent variables in this study are said to be reliable and the model built has a good level of reliability.

1.2. Hypothesis Testing (Resampling Bootstrapping)

In this test, testing is carried out from the research hypothesis that has been made previously. Hypothesis testing uses a significant level of 5% so that the t-table value used is 1.65. In accordance with the results of the bootstrapping test using SmartPLS 4.0 software, the t-statistic value for Islamic leadership variables, Islamic work ethics, Islamic work motivation, rewards, Islamic work environment can be seen in Figure 3.

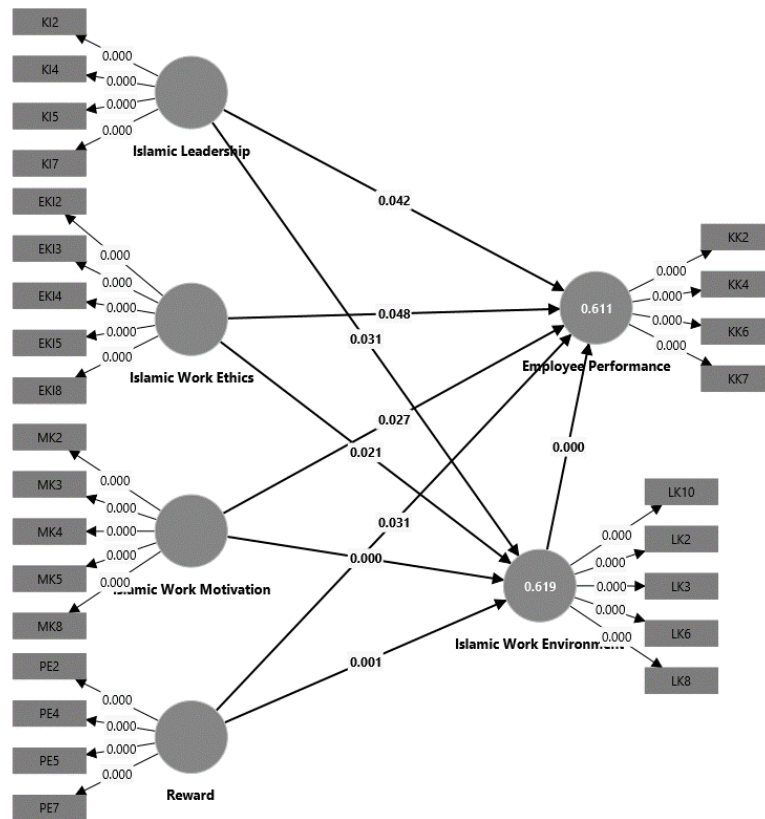


Figure 3. Bootstrapping Output of SEM-PLS Research Model

Source: Smart-PLS processing results

To see the acceptance or rejection of the hypothesis can be seen from the bootstrapping report in Table 8 below:

Table 8. Path Coefficients

	Original sample (O)	T statistics (O/STDEV)	P values
Islamic Leadership > Employee Performance	0.124	1.733	0.042
Islamic Work Ethics > Employee Performance	0.170	1.665	0.048
Islamic Work Motivation > Employee Performance	0.168	1.923	0.027
Reward > Employee Performance	0.154	1.866	0.031
Islamic Work Environment > Employee Performance	0.284	3.391	0.000
Islamic Leadership > Islamic Work Environment > Employee Performance	0.040	1.680	0.047
Islamic Work Ethics > Islamic Work Environment > Employee Performance	0.053	1.987	0.023
Islamic Work Motivation > Islamic Work Environment > Employee Performance	0.088	2.503	0.006
Reward > Islamic Work Environment > Employee Performance	0.074	2.152	0.016

Source: SmartPLS Processing Results

The analysis results show that most of the hypotheses are supported by looking at Table 8 which shows the p value <0.05 . Looking at the original sample value shows that the direction of influence of the exogenous latent variable is positive because the original sample value is positive.

1.3. Discussion

Based on the results of the path coefficient output in Table 8, it can be seen that the Islamic leadership variable has a positive test direction seen from the original sample value and is significant. Thus, the hypothesis accepted, meaning that the Islamic leadership variable has a positive effect on employee performance and the Islamic work environment mediates Islamic leadership on the performance of Bandung City MSE employees, although the mediation value is lower than the direct relationship. This means that leaders who apply Islamic leadership will inspire employees to exercise control over their work behavior. This leadership can emerge as an important variable that can proactively advance change in the organization, by voicing constructive ideas from subordinates (Kundu et al., 2019). In Islamic leadership, Islamic leadership qualities can promote organizational development by performing different managerial activities based on ethical standards and can positively influence follower attitudes by bringing higher levels of satisfaction, motivation, performance, positive energy and organizational loyalty (Zaim et al., 2022). This is due to the three characteristics of leadership according to Islam, namely deliberation, fairness and free thinking. So that employees feel valued for their existence and enthusiasm at work so that they can improve their performance (Muzaki & Supriyanto, 2021). Therefore, the results of this study support previous research which states a positive relationship between Islamic leadership and employee performance (Abdelwahed et al., 2022; Aini, 2020; Candra et al., 2022; Yusuf, 2017) and is inversely related to research conducted by Marjaya & Pasaribu (2019) at PDAM Tirta Deli, Deli Serdang, Indonesia.

Based on the results of the path coefficient output in Table 8, it can be seen that the hypothesis accepted, meaning that the Islamic work ethics variable has a positive effect on employee performance and the Islamic work environment mediates Islamic work ethics on employee performance of Bandung City MSEs, although the mediation value is lower than the direct relationship. According to Robbins & Judge (2013), organizational behavior is influenced by the culture and values adopted by individuals in the organization. In the context of Islamic work ethics, these values create a work environment based on strong spiritual and moral awareness. Employees who practice Islamic work ethics tend to exhibit a positive and proactive attitude, which arises from a willingness and self-awareness to contribute to a common goal. This creates a collaborative work environment, where each individual strives to achieve optimal performance not only for personal benefit but also for the spread of wealth and social welfare. Thus, the application of work ethics based on Islamic values can play an important role in improving employee motivation and performance, which ultimately has a positive impact on the overall success of the organization. Therefore, high Islamic work ethics can affect the work results or performance of an employee in accordance with several previous studies that obtained similar results (Aini, 2020; Efrina, 2019; Hamzah et al., 2021; Hassi et al., 2021; Mohammad et al., 2018;

Zia et al., 2022) and in contrast to the results of research conducted by Shafissalam & Azzuhri (2016).

Based on the results of the path coefficients output in Table 8, it can be seen that the accepted hypothesis, meaning that the Islamic work motivation variable has a positive effect on employee performance and the Islamic work environment mediates Islamic work motivation on the performance of Bandung City MSE employees. A Muslim will consider work as a devotion, so he will try to utilize all his wealth, thoughts, and thoughts to become a servant of Allah SWT as well as possible through improving his performance (Hakim, 2012). This correlation is also an actual condition in the field, that employees who have high Islamic work motivation in themselves will find it easier to achieve maximum performance. With this correlation, it can be stated that this research is in line with several studies conducted on several groups of people in organizations to prove it and the results show a positive relationship between the two (Abdelwahed et al., 2024; Aflah et al., 2021; Armini et al., 2024; Rahmawati, 2020; Srimulyani et al., 2023). However, this is not in line with the research of Aryadi & Rahmawati (2019) which states a negative relationship between employee performance and Islamic work motivation.

Based on the results of the path coefficients output in Table 8, it can be seen that the hypothesis accepted, meaning that the reward variable has a positive effect on employee performance and the Islamic work environment mediates the reward on the performance of Bandung City MSE employees, although the mediation value is lower than the direct relationship. The implementation of explicitly process-oriented assessments and rewards throughout the organization for process owners, process improvement teams, and employees who carry out the process (Shafagatova & Van Looy, 2020). Regardless of how strong the relationship is, if individuals perceive it as weak, the result will be low performance, decreased job satisfaction, and increased turnover and absenteeism (Robbins & Judge, 2013). So this assumption can be said to be in accordance with the results of previous research that rewards have a positive and significant effect on improving employee performance in various organizations in the world (Serhan et al., 2021; Shafagatova & Van Looy, 2020; Sumadi & Santoso, 2022; Taba, 2018; Tarigan et al., 2022). However, this contrasts with the findings of research conducted by Sari et al. (2021) in Lampung, Indonesia, which found that rewards negatively impact employee performance, while motivation and punishment positively impact employee performance.

Based on the results of the path coefficients output in Table 8, it can be seen that the hypothesis accepted, meaning that the Islamic work environment variable mediates the reward on the performance of Bandung City MSE employees, although the mediation value is lower than the direct relationship. This can happen because a conducive work environment can provide opportunities for employees to play a role, achieve and self-actualize so that they get appreciation and appreciation that is channeled properly for use (Suswardana, 2022). For example, employees who receive promotions can be provided with training and development to help them succeed in their new roles (Saleh & Utomo, 2018). So a positive response to the work environment is needed so that the reward can reach the point where employees are grateful, interpret, and improve their performance. So it can be concluded that there is a relationship between these three variables and is

supported by several previous studies on different organizational conditions (Apriyanti et al., 2021; Bakti, 2021; Handayni & Aima, 2021; Nurjiasih & Sudarnaya, 2023).

The study's findings align with organizational behavior theory, highlighting that individual and group behavior in organizations is shaped by leadership, ethics, motivation, rewards, and a supportive work environment. Incorporating Islamic values in these areas not only enhances spiritual aspects but also leads to measurable improvements in employee performance, demonstrating that a values-based organizational culture fosters sustainable and optimal outcomes. So, this study provides practical implications for micro and small business owners and managers in Bandung to pay greater attention to the implementation of Islamic values in leadership, work ethics, work motivation, and reward systems within their workplaces. By strengthening these dimensions and creating a work environment aligned with Islamic principles, employee performance can be significantly improved. The findings can also serve as a foundation for developing human resource policies oriented towards Islamic values as an effort to enhance business competitiveness sustainably in the era of global competition.

4. CONCLUSION

This study strongly indicate that the application of Islamic values in leadership, work ethics, motivation, and reward systems has a significant positive impact on employee performance in micro and small businesses in Bandung. These results reinforce the principles of organizational behavior theory, highlighting the important role of leadership style, ethical behavior, intrinsic and extrinsic motivation, and a supportive work environment in shaping individual and group behavior within an organization. By embedding Islamic values into workplace practices, organizations not only enhance the spiritual and moral dimensions of their employees but also foster a strong, values-based organizational culture that contributes significantly to sustainable competitive advantage in an increasingly globalized marketplace.

However, this study is not without limitations. The geographic focus in Bandung and the concentration on micro and small businesses limit the generalizability of the findings to other regions or larger industries. Furthermore, the cross-sectional nature of the research design limits the ability to infer causality or observe changes over time. Future research is encouraged to expand its geographic and sectoral scope, as well as to distribute questionnaires beyond employees. It could also incorporate a longitudinal study design to track the development and long-term impact of Islamic values on organizational behavior, and consider additional variables such as individual personality traits and external environmental influences. Such efforts could yield more comprehensive insights into how religious and cultural values can be effectively integrated into workplace management to promote employee well-being and organizational success.

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