



مجلة جامعة المدينة العالمية المدكمة
AL-MADINAH INTERNATIONAL
UNIVERSITY JOURNAL (MAJMAA)

Vol. 56 Issue. 3 Year. 2026

السنة ٢٠٢٦

العدد ٣

المجلد ٥٦

ISSN: 2231_9735

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تصدرها

PUBLISHED BY

جامعة المدينة العالمية

AL-MADINAH
INTERNATIONAL UNIVERSITY



ISSN 2231-9735



9 772231 973002



The Role of Islamic Finance and Government Support in Enhancing the Financial Performance of SMEs in Libya

[دور التمويل الإسلامي والدعم الحكومي في تحسين الأداء المالي للمؤسسات الصغيرة والمتوسطة في ليبيا]

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DOI: <https://doi.org/10.63226/majmaa.v56i3.6101>

Abstract

Purpose – Islamic finance is a trending financing instrument in the Muslim and non-Muslim countries. However, limited studies addressed the impact of Islamic finance and the role of government support in boosting the performance of small and medium-sized enterprises (SMEs). Therefore, the purpose of this study is to examine the effect of Islamic finance on financial performance of SMEs in Libya. **Design/methodology/approach** – Drawing upon the Resource-Based View (RBV) and Islamic Finance Theory (IFT), the study employs a quantitative approach using survey data from 282 SME owners and managers. Smart PLS 4 is applied to test the direct effects of Islamic finance tools such Murabaha, Musharakah, and Mudarabah on SME financial performance, as well as the moderating influence of government support. **Findings** –The results reveal that all components of Islamic finance significantly and positively affect SME financial performance, with Murabaha exhibiting the strongest impact. Government support enhances the effectiveness of Murabaha, Musharakah, and Mudarabah on SMEs' financial performance. **Practical implications**– These findings suggest that Islamic financial tools function as strategic resources for SMEs when embedded within supportive institutional frameworks. **Originality/value**– The study advances understanding by integrating RBV and IFT in a post-conflict economy and introducing government support as a key contingent factor. The findings also offer actionable insights for policymakers and Islamic financial institutions to tailor support mechanisms and develop financing strategies that align with SME needs and sectoral priorities.

Keywords: Islamic finance, financial performance, Murabaha, Musharakah, Mudharaba, government support

Keywords: Journal, Quran and Sunnah, Education, Special Needs

ملخص البحث:

الهدف - يُعدّ التمويل الإسلامي أداة تمويل رائجة في الدول الإسلامية وغير الإسلامية. ومع ذلك، لا تزال الدراسات التي تناولت أثر التمويل الإسلامي ودور الدعم الحكومي في تعزيز أداء الشركات الصغيرة والمتوسطة محدودة. لذا، تهدف هذه الدراسة إلى بحث أثر التمويل الإسلامي على الأداء المالي للشركات الصغيرة والمتوسطة في ليبيا. المنهجية/التصميم/الأسلوب - بالاستناد إلى نظرية الموارد (RBV) ونظرية التمويل الإسلامي (IFT)، تستخدم الدراسة منهجاً كمياً بالاعتماد على بيانات استبيان من 282 من أصحاب ومديري الشركات الصغيرة والمتوسطة. تم تطبيق برنامج Smart PLS 4 لاختبار الآثار المباشرة لأدوات التمويل الإسلامي، مثل المراجعة والمشاركة والمضاربة، على الأداء المالي للشركات الصغيرة والمتوسطة، بالإضافة إلى التأثير المعدّل للدعم الحكومي. النتائج - تُظهر النتائج أن جميع مكونات التمويل الإسلامي تؤثر بشكل إيجابي وكبير على الأداء المالي للشركات الصغيرة والمتوسطة، مع كون المراجعة هي الأداة الأكثر تأثيراً. كما يُعزز الدعم الحكومي فعالية المراجعة والمشاركة والمضاربة على الأداء المالي للشركات الصغيرة والمتوسطة. الآثار العملية: تشير هذه النتائج إلى أن الأدوات المالية الإسلامية تُعدّ موارد استراتيجية للمؤسسات الصغيرة والمتوسطة عند دمجها ضمن أطر مؤسسية داعمة. الأصالة/القيمة: تُسهم هذه الدراسة في تعزيز الفهم من خلال دمج نظرية الموارد والقيمة ونظرية التمويل الإسلامي في اقتصاد ما بعد النزاع، وإبراز الدعم الحكومي كعامل أساسي. كما تُقدّم النتائج رؤى عملية لصانعي السياسات والمؤسسات المالية الإسلامية لتصميم آليات دعم مُلائمة ووضع استراتيجيات تمويلية تتوافق مع احتياجات المؤسسات الصغيرة والمتوسطة وأولويات القطاع.

الكلمات المفتاحية: التمويل الإسلامي، الأداء المالي، المراجعة، المشاركة، المضاربة، الدعم الحكومي

1. Introduction

Small and medium-sized enterprises (SMEs) are widely acknowledged as foundational pillars of economic development and sustainable growth in both developed and developing economies. SMEs contribute approximately 90% of global businesses and over 50% of employment worldwide, with their share in emerging markets reaching up to 60% of total employment and 40% of national income (The World Bank, 2021). Entrepreneurship literature increasingly recognizes that SMEs are essential not only for fostering innovation and creating job opportunities but also for achieving broader societal welfare (Bagorogoza and Nakasule, 2022). The SMEs ability to adapt quickly, generate employment, and stimulate value-added production makes them indispensable across all stages of economic development. Developed economies continue to support and empower SMEs due to their substantial role in economic diversification and societal transformation, where SMEs account for as much as 70–80% of economic and social progress (The World Bank, 2021).

Despite their global prominence, SMEs face persistent challenges, particularly in accessing finance. The (The World Bank, 2021) projects that by 2030, approximately 600 million new jobs will be needed to absorb the growing global workforce. However, many SMEs struggle with limited access to funding, high operational risk, and weak financial infrastructure. The COVID-19 pandemic significantly amplified the existing vulnerabilities of SMEs globally, with nearly half facing temporary closures and 60% at risk of exhausting financial reserves. These challenges have made it difficult for many SMEs to maintain stable operations and sustain employment. Limited financial resources also reduce their ability to invest in technology, expand their businesses, and respond effectively to economic shocks. As a result, strengthening SMEs' access to finance is essential for promoting business resilience and supporting sustainable job creation. Improving financial support and infrastructure can therefore play a significant role in enabling SMEs to contribute more effectively to global economic growth. (Akpan et al., 2022; Ramdan et al., 2022; Yu et al., 2022). Libyan SMEs already faced institutional instability, limited funding choices, and insufficient digital infrastructure, but the epidemic exacerbated operational interruptions and financial hardship (Elkrghli, 2016). These issues highlighted the need for robust, ethical, and inclusive financial institutions like Islamic banking that reflect local beliefs and economic reality. Islamic finance mechanisms like Qard Hasan, Murabaha, and Mudarabah provide debt-free liquidity, risk-sharing, and asset-backed frameworks to help SMEs survive crises (Aziz and Mohamad, 2016). These products benefit from institutional backing including regulatory clarity, credit guarantees, and digital financial access. Libya's infrastructure was insufficient, whereas Malaysia and Indonesia swiftly built Shariah-compliant stimulus instruments (Iqbal et al., 2020). Thus, Libya may institutionalize Islamic financing in SME support post-pandemic to promote economic resilience and recovery (Shibani, 2021). To address these concerns, several governments have integrated Islamic financing in SME aid programs. Equity, shared risk, and ethical investing make Islamic banking a viable and socially acceptable alternative to traditional finance (Ashraf et al., 2021). Many entrepreneurs in Muslim-majority societies value its prohibition of interest (riba) and speculative transactions (gharar) and reliance on asset-backed and profit-and-loss-sharing mechanisms like Murabaha, Mudarabah, and Musharakah (Naim, 2020). Islamic finance not only facilitates access to capital in a Shariah-compliant manner but also contributes to social justice and inclusive growth by empowering

individuals to realize their economic potential within a morally grounded framework (Chetioui et al., 2024).

In Libya, despite the presence of a large number of SMEs, their contribution to GDP remains marginal at approximately 5% and they account for only 6% of employment, far below global standards (Lawhaishy et al., 2024). Limited access to finance remains one of the most significant constraints on Libyan SMEs. While conventional banking systems have historically underserved this segment, the transformation of Libya's financial sector through the adoption of Islamic banking mandated by Law No. 1 of 2013 (Atnishah et al., 2025). However, empirical information on Islamic finance's impact on Libyan SME financial performance is rare (Esaudi et al., 2021; Lawhaishy et al., 2024).

Islamic finance can play an important role in promoting SME growth by providing Shariah-compliant financing and alternative funding mechanisms. However, a critical factor that can strengthen the role of Islamic finance in supporting SME growth is government support. Government policies, financial incentives, and regulatory frameworks can improve SMEs' access to Islamic financial services. In addition, government-backed financing programmes can reduce the risks faced by Islamic financial institutions when providing funding to SMEs. Such support can encourage greater collaboration between governments, Islamic financial institutions, and SMEs, contributing to sustainable business development and employment creation. (Alhabashi, 2015). Government regulatory facilitation, financial incentives, training, loan guarantees, and awareness campaigns can help SMEs succeed with Islamic finance (Khaliq et al., 2022). Other research imply such support can regulate or promote Islamic financing and its influence on organisational financial performance (Park et al., 2020; Ramanathan et al., 2014; Saberi and Hamdan, 2019). This study examines the effects of Islamic finance on Libyan SMEs' financial performance and how government support moderates this effect. The quantitative analysis offers policymakers, financial institutions, and SME players employing Islamic finance to support Libyan economic growth theoretical and practical advice.

2. Literature review

2.1 Theoretical Framework

This study uses Islamic Financing Theory (IFT) and Resource-Based View (RBV). These theories allow academics to study how Islamic financial instruments affect SMEs' financial performance, notably in Libya, and how government support might mitigate this effect. IFT states that the Qur'an and Sunnah prohibit interest (riba), excessive uncertainty (gharar), and speculative behavior (maysir) and promote ethics, risk-sharing, and social equality. These principles provide a distinctive foundation for financing SMEs while encouraging responsible financial practices and productive economic activities. Islamic financing instruments such as mudarabah, musharakah, and murabahah can provide SMEs with financing alternatives that are consistent with Shariah principles. By emphasizing fairness, transparency, and risk-sharing, Islamic finance may help SMEs manage financial challenges and improve their ability to sustain and expand their businesses. Furthermore, the application of IFT in the Libyan context can help explain how Shariah-compliant financing mechanisms may contribute to the financial performance and long-term development of SMEs. (Guizani,

2020). These financial systems include cost-plus sales, profit-sharing, joint ventures, and interest-free borrowing (Ahmed and El-belihy, 2017). These tools provide SMEs with equitable, interest-free financing, transparency, accountability, and long-term partnerships (Sciences et al., 2011). These techniques match SMEs with cultural and religious values and promote fair growth to increase confidence and financial inclusion in unstable nations like Libya.

According to the RBV, a firm's competitive advantage stems from its VRIN resource acquisition and use. These resources are valuable, rare, difficult to imitate, and non-substitutable, allowing firms to develop capabilities that competitors may struggle to replicate. For SMEs, such resources may include financial capital, managerial expertise, technological capabilities, strong business networks, and access to reliable financial services. The effective use of these resources can improve operational efficiency, strengthen innovation, and enhance overall financial performance. Therefore, RBV provides a useful framework for understanding how SMEs can utilize Islamic financing and other strategic resources to build sustainable competitive advantage. (Barney, 1991). Islamic financial instruments are strategic resources that boost fund and ethical legitimacy and stakeholder confidence, says this research. Financial institution-supported and firm-integrated technology can help SMEs address unanticipated markets and financial restrictions (Pan et al., 2015). Islamic banks' expertise can help SMEs (Donnellan and Rutledge, 2019). The merger of IFT and RBV shows how Shariah-compliant financial instruments may boost organizational performance. Government support including regulatory facilitation, loan guarantees, and capacity-building increases SMEs' access to Islamic finance and its influence, according to this study. Post-conflict economies like Libya have institutional instability and lack of financing, making government intervention in the form of support of legislations, loan, training, and tax are essential.

2.2 Islamic Banking

Islamic banking promotes ethics, social justice, and risk-sharing. It prohibits interest, uncertainty, and speculative transactions and encourages tangible asset-backed, economic activity-based transactions. Profit-sharing and joint ventures replace interest-based loans, enhancing transparency and economic value. These principles can provide SMEs with financing arrangements that are more closely linked to real business activities and productive investments. Islamic banking also encourages greater accountability between financial institutions and businesses by linking financing to actual assets, projects, or commercial activities. As a result, SMEs may benefit from more equitable financing relationships that support business sustainability, reduce excessive financial risk, and contribute to long-term economic development. (Meslier et al., 2020). Islamic finance is increasing rapidly worldwide. Global Islamic finance assets reached USD 2.88 trillion by 2020 due to demand for ethical financial options (Haddad and Alali, 2021). Islamic banking is popular in Muslim-majority countries like Saudi Arabia, Malaysia, and the UAE, but it has also grown in non-Muslim countries like the UK and Singapore, reflecting its appeal to a wider market interested in socially responsible finance (Amuda and Al-Nasser, 2024). Islamic banks employ a suite of Shariah-compliant tools, including Ijara (leasing), Murabaha (cost-plus financing), and Salam

(forward sales), and actively exclude investments in prohibited sectors like gambling and alcohol, reinforcing their ethical orientation (Shatnawi et al., 2021).

In Libya, Islamic banking has emerged as a core element of the post-revolutionary financial reform agenda. Its development reflects the growing demand for Shariah-compliant financial services and the need to diversify the country's financial system. Islamic banking can provide alternative financing mechanisms for SMEs that face difficulties in accessing conventional sources of finance. Through instruments based on asset financing, trade, and profit-sharing, Islamic banks can support productive investment and business development. Strengthening Islamic banking in Libya may therefore contribute to improving financial inclusion, supporting SMEs, and promoting broader economic diversification and sustainable growth. (Alghamati et al., 2024). Following the 2011 uprising, Libya initiated a transition toward a free-market economy, culminating in the enactment of Law No. 1 of 2013, which mandated the elimination of interest-based banking by 2015 (Erhoma, 2024). This shift left Islamic banking the only legal financial middleman. The Muslim majority in Libya prefers Shariah-compliant finance for religious and ethical reasons (AS Abusloun et al., 2024). Banks use Islamic instruments like Murabaha, Mudarabah, and Ijara to boost financial inclusion and growth. These instruments provide SMEs with alternative financing options that are structured according to Shariah principles and linked to genuine economic activities. Murabaha can support the purchase of goods and business assets, while Mudarabah allows entrepreneurs and financial institutions to share profits based on an agreed arrangement. Ijara, on the other hand, enables businesses to obtain the use of assets through leasing arrangements without relying on conventional interest-based loans. By offering diverse financing mechanisms, Islamic banks can help SMEs overcome funding constraints, expand their operations, and improve their contribution to employment and economic development. (Al-Jundi et al., 2024). Ethical consumers and enterprises can borrow more from Libyan Islamic banks (Lemhishi and Mahaini, 2024). The study examines how government-backed Islamic financing affects Libyan SMEs' finances.

2.3 Islamic Finance

For SMEs, Islamic finance provides a reliable and ethical alternative to traditional banking. It forbids interest (riba), encourages risk-sharing, and links financial transactions to Islamic Shariah economic activities (Alshamrani, 2014). This paradigm benefits SMEs financially and morally via fairness, openness, and shared accountability. Islamic financing gives SMEs instruments to prosper without exploitative financial conditions like restricted loans and excessive interest rates. Interest-free loans (Qard Hasan), profit-and-loss sharing (Mudarabah and Musharakah), and trade-based finance are essential (Al Arif and Ihsan, 2024; Lawhaishy et al., 2024; Miah et al., 2024). Socially responsible Islamic finance involves beneficent lending (Qard Hasan). Unprofitable financing fulfils urgent commercial or societal demands. Bay' al-'inah, a delayed payment transaction that mimics lending without breaching Shariah, creates liquidity (Maulidizen, 2019). Qard Hasan transfers asset depreciation risk to the lender and helps ethical and socially responsible SMEs (Farooq and El-Ghattis, 2015).

Islamic banking uses Mudarabah and Musharakah. These processes foster accountability, risk-sharing, and entrepreneurship. Mudarabah includes the financier providing capital and the entrepreneur contributing talents and effort. The financier absorbs all losses and distributes

gains according to a pre-agreed percentage. This strategy favours SMEs with uncertain income but great growth potential. It allows entrepreneurs to access capital without relying on fixed interest payments that may place additional pressure on their cash flow. At the same time, the arrangement encourages both parties to focus on the success and profitability of the underlying business activity. By linking returns to actual business performance, Mudarabah can support innovation, entrepreneurship, and the sustainable growth of SMEs. (Miah et al., 2024). However, Musharakah includes two people investing capital and dividing earnings and losses. It encourages costly initiatives and long-term partnerships (Sciences et al., 2011). Both promote financial inclusion, risk-taking, innovation, and company success.

Murabaha is one of the most common Islamic financing methods used for SMEs. In a cost-plus sale, the Islamic bank purchases an asset or commodity requested by the SME and then resells it to the business at an agreed markup, with payment made either immediately or on a deferred basis. This structure replaces the conventional interest-based loan with a clearly defined profit margin agreed upon by both parties. The transaction also provides greater transparency because the original cost of the asset and the bank's profit are disclosed to the SME. As a result, Murabaha can help SMEs finance equipment, inventory, and other business assets while maintaining compliance with Shariah principles. (Ashraf et al., 2021). Murabaha suits equipment, raw supplies, and working capital. Easy operation, consistent reward, and predictability make it popular. Financier asset ownership and risk raise ethics (Haron et al., 2015). Murabaha may expose SMEs to price swings, but its widespread use and circumstances make it a viable financing alternative (Tlemsani et al., 2020). Islamic finance improves SME performance, ethics, and inclusivity (Shah and Niazi, 2019). Each tool meets specific demands and is Islamic, making them viable SME growth tools in new and existing Islamic finance systems.

2.4 Conceptual Framework and Hypotheses

We employ IFT and the RBV to explore how Islamic financial instruments impact Libyan SMEs' financial performance. By banning interest (riba), uncertainty (gharar), and speculation (maysir), IFT encourages risk-sharing, social responsibility, and ethical, equitable, and Shariah-compliant financial transactions. However, RBV highlights that enterprises achieve competitive advantage by strategically using uncommon, precious, unique, and non-substitutable resources. Islamic financial tools like Murabaha, Mudarabah, and Musharakah, help SMEs access capital ethically, build financial resilience, and grow, especially in environments with limited conventional credit options. Government support through regulatory facilitation, loan guarantees, training, and awareness programs is expected to moderate the link between Islamic financing and SME performance in the study's conceptual model.

2.4.1 Musharakah and Financial Performance

Musharakah is an equity-based Islamic financing arrangement in which the financial institution and the SME jointly contribute capital and share profits according to an agreed ratio, while losses are distributed in proportion to their respective capital contributions. This risk-sharing structure can improve SMEs' access to finance, reduce dependence on interest-bearing debt, and support productive investment and business expansion (Lawhaishy et al.,

2024; Miah et al., 2024). From the Resource-Based View, Musharakah provides SMEs with not only financial capital but also potential managerial guidance, monitoring, and financial expertise from their financing partners. These resources can strengthen operational capabilities, improve financial resilience, and enhance financial performance. Therefore, the following hypothesis is proposed:

H1: Musharakah improves the financial performance of SMEs in Libya.

2.4.2 Mudarabah and Financial Performance

Mudarabah is an equity-based Islamic financing arrangement in which the financial institution provides the required capital, while the SME contributes entrepreneurial expertise, managerial effort, and business knowledge. Profits are distributed according to a predetermined ratio, whereas financial losses are borne by the capital provider unless they result from the entrepreneur's negligence, misconduct, or breach of contractual obligations (Islam & Ahmad, 2020). This risk-sharing structure enables financially constrained SMEs to undertake productive activities without relying on interest-bearing debt, thereby supporting financial inclusion and entrepreneurial development (Haruna et al., 2024; Islam & Ahmad, 2020). From the Resource-Based View, Mudarabah provides SMEs with access to valuable financial resources that can be combined with their internal managerial and entrepreneurial capabilities to support investment, business expansion, and financial resilience. Its partnership structure may also promote financial discipline, information disclosure, and accountability between SMEs and financial institutions, potentially improving resource utilisation and financial outcomes (Islam & Ahmad, 2020). Mudarabah may therefore be particularly relevant to Libyan SMEs that face restricted access to conventional financing and substantial institutional constraints (Lawhaishy et al., 2024). Accordingly, the following hypothesis is proposed:

H2: Mudarabah has a positive effect on financial performance of Libyan SMEs.

2.4.3 Murabaha and Financial Performance

Murabaha, the most common Islamic financing mechanism, is a cost-plus contract in which a financial institution buys things for a client and resells them at a markup with deferred payment. This arrangement provides SMEs with access to financing for purchasing goods, equipment, and other assets needed for their business activities. The cost of the asset and the agreed profit margin are disclosed to the client in advance, creating greater transparency and certainty regarding the total amount to be paid. Unlike conventional interest-based financing, Murabaha is structured around the sale and purchase of a real asset rather than the lending of money for interest. This makes it a widely used financing option for SMEs seeking Shariah-compliant funding to support their operations and business expansion. (Moosa, 2023). Murabaha is a systematic, transparent, and predictable financing method for SMEs buying real assets or inventory without relying on interest-based financing. Under this arrangement, the Islamic financial institution purchases the required asset and then resells it to the SME at an agreed profit margin. The total cost and payment schedule are clearly determined in advance, allowing SMEs to plan their cash flows and manage their financial obligations more

effectively. This structure can be particularly useful for SMEs that need financing for equipment, raw materials, inventory, or other productive assets. By linking financing to real economic transactions, Murabaha can provide SMEs with a practical and Shariah-compliant alternative to conventional credit. (Haron et al., 2015). Murabaha-financed assets can increase a firm's operating capabilities and long-term production capacity. By providing SMEs with access to equipment, machinery, inventory, and other productive assets, Murabaha financing enables firms to expand their operations and improve the efficiency of their business activities. These assets can help SMEs increase output, improve product quality, and respond more effectively to growing market demand. In the long term, greater access to productive assets can strengthen the firm's competitive position and support sustainable business growth. Therefore, Murabaha financing can contribute not only to meeting immediate financing needs but also to enhancing the overall productive capacity and financial performance of SMEs. (Tlemsani et al., 2020). Murabaha's contractual clarity supports Islamic justice and fair dealing, boosting confidence and financial stability (Shah and Niazi, 2019). Therefore, the following is hypothesized:

H3: Murabaha has a positive effect on financial performance of Libyan SMEs.

2.4.4 The Moderating Role of Government Support

Islamic finance needs government support, especially in developing states like Libya with regulatory, financial, and informational restrictions. Government involvement can help establish a clear and supportive regulatory framework that enables Islamic financial institutions to operate effectively and provide suitable financing to SMEs. Public financial programmes and guarantees can also reduce financing risks and improve SMEs' access to Islamic funding. In addition, governments can strengthen financial literacy and provide information about available Islamic financing instruments, particularly for small businesses with limited financial knowledge. Such measures can create a more supportive environment for Islamic finance and enhance its contribution to SME development, investment, and sustainable economic growth. (Lawhaishy et al., 2024). Loan guarantees, tax exemptions, capacity-building, and public awareness campaigns can lower transaction costs, reduce perceived risks, and improve SMEs' access to Islamic financing. Loan guarantees can encourage financial institutions to provide funding by reducing the potential losses associated with SME financing. Tax exemptions and other fiscal incentives can also reduce the financial burden on SMEs and make Islamic financing more affordable and attractive. Capacity-building programmes can strengthen the financial and managerial skills of SME owners, enabling them to better understand and use Islamic financing instruments. Furthermore, public awareness campaigns can increase knowledge and trust in Islamic finance, helping more SMEs identify suitable financing opportunities and supporting their long-term business growth. (Shibani, 2021). Prior studies found that such support moderates the financing strategy-company performance relationship. Government support can strengthen the positive effect of appropriate financing strategies on firms' financial and operational performance. By reducing financial constraints, regulatory barriers, and uncertainty, government assistance may enable SMEs to use Islamic financing more effectively. This support can also improve firms' ability to invest in productive assets, expand their operations, and manage financial risks. Therefore, the effectiveness of Islamic financing in improving SME performance may

depend partly on the availability and adequacy of government support. (Park et al., 2020; Ramanathan et al., 2014; Saberi and Hamdan, 2019). The study implies that government support can enhance the effectiveness of Islamic financing in Libya, particularly as conventional credit systems continue to expand. Government policies and institutional support may help Islamic financial institutions compete more effectively by reducing regulatory barriers, improving access to financing, and increasing SMEs' awareness of Shariah-compliant financial products. Such support can also strengthen the relationship between Islamic financing and SME performance by creating a more favorable business and financial environment. Therefore, government support may serve as an important moderating factor in determining the extent to which Islamic financing contributes to SME growth and financial performance. Therefore, the following hypotheses are proposed.

H4: Government support moderates the effect of Musharakah financing on financial performance of SMEs in Libya.

H5: Government support moderates the effect of Mudarabah on financial performance of SMEs in Libya.

H6: Government support moderates the effect of Murabaha on financial performance of SMEs in Libya.

3. Research Methodology

This study is a quantitative that deals with the impact of Islamic finance on Libyan SMEs' financial performance and the moderating role of government support. Based on IFT and RBV, a framework was developed and a set of hypotheses were proposed. To test this framework, the population of the study was determined to include the SMEs in the capital of Libya i.e., Tripoli where more than 55,000 SMEs are operating in this area. The study uses a simple random sampling ensured generalizability and no selection bias in the study. Using the formula of Krejcie and Morgan (1970), the sample size of this study is 384. Therefore, the study used a questionnaire for collecting the data. The questionnaire was adopted from prior studies and part of the questionnaire was refined after validation and pilot study. Measurements of Musharakah, Murabahah, and Mudarabah were adopted from (Baba et al., 2019). Measurement of government support was adopted from Zhang and Merchant (2020), and measurement of financial performance was adopted from Tseng (2016).

Four experts validated the questionnaire and the result of pilot study showed that the measurement are reliable. A total of 35 valid responses were collected for pilot study. Musharakah (7 items) scored an alpha of 0.863, Mudarabah (7 items) scored 0.866, Murabaha (9 items) scored 0.840, government support (7 items) scored 0.821, and SME financial performance (6 items) scored 0.814. These values exceed the threshold of 0.70 recommended by Sekaran and Bougie (2019), indicating that the instrument is statistically reliable for full-scale data collection.

The questionnaire was distributed electronically via Google Forms through email and social media platforms such as LinkedIn and Facebook. To account for SMEs located in areas with limited digital access or lower digital literacy, hard-copy versions of the questionnaire were also hand-delivered. Data collection was conducted in phases and supported by reminder

emails and phone calls to non-respondents to maximize participation. A total of 296 valid responses were collected, comprising 250 electronic submissions and 46 paper-based submissions. All responses were meticulously reviewed for completeness and consistency. Incomplete or illogical responses were excluded from the dataset. The final responses were coded and entered into a secured database for subsequent statistical analysis.

4. Findings

4.1 Data examination

This study conducted a series of preliminary data analyses to ensure the quality and readiness of the dataset for advanced statistical testing. First, a missing value analysis was performed on all 49 questionnaire items using SPSS. A total of eight responses were deleted due to the fact that more than 50% missing data. This yielded 288 valid responses. Outlier identification using boxplots removed six more extreme responses, leaving 282 valid responses. Skewness and kurtosis values were within acceptable levels (± 2), and histogram examination showed bell-shaped distributions, confirming normal distribution as shown in Table 1. Finally, tolerance and variance inflation factor (VIF) values assessed multicollinearity. All Tolerance values surpassed 0.10 and VIF values were below 10, suggesting no major independent variable multicollinearity as shown in Table 1.

Table 1: Assessment of Normality and Multicollinearity

Variable	Normality		Multicollinearity	
	Skewness	Kurtosis	Tolerance	VIF
Musharakah	-0.573	-0.375	0.868	1.152
Mudarabah	-0.956	0.045	0.717	1.395
Murabaha	-0.511	-0.292	0.645	1.551
Government Support	-0.778	-0.515	0.907	1.103
Financial Performance	-0.750	-0.662	-	-

4.2 Profile of the Respondents

This study provides useful insight into Libyan SME decision-makers' demographic and professional profiles. The sample was 85.1% male and 14.9% female, reflecting Libya's male-dominated corporate sector. With 25.5% of respondents under 30, 31–40 and 51–60 age groups had 19.9% each, while 41–50 and above 60 age groups had 17.7% and 17.0%, respectively. This distribution shows that SME management is dynamic, with both younger and older people involved. The majority of respondents (63.1%) had a bachelor's degree, 25.5% a master's, and 11.3% a diploma, indicating that SME leaders have a high level of formal education and can use complex financial tools like Islamic finance.

Professionally, the majority of respondents identified as managers (71.3%), followed by company owners (17.4%) and board members (11.3%), suggesting that the insights gathered reflect both operational and strategic perspectives within SMEs. Most of the surveyed enterprises employed between 5 and 49 employees (77.3%), consistent with the typical size of

small enterprises, while micro-enterprises (fewer than five employees) and medium-sized firms (50–250 employees) constituted 14.2% and 8.5% of the sample, respectively. The sectoral distribution showed a predominance of service-based firms (60.3%), followed by education (17.0%), tourism (11.3%), agriculture (8.5%), and industry (2.8%), mirroring the structure of the Libyan economy, where services are the mainstay of SME activity. Notably, 100% of the respondents indicated that their firms use financial tools, which confirms the study's focus and relevance to Islamic financing practices. This widespread engagement in financial mechanisms underscores the practical significance of examining how Islamic finance contributes to SME financial performance in the Libyan context.

4.3 Level of the Variables

The descriptive analysis of the main variables as shown in Table 2 reveals that all constructs fall within the moderate level based on the classification adapted from Tameemi and Hasballah (2015), where a mean score between 2.34 and 3.67 is considered moderate. Specifically, the Musharakah recorded a mean of 3.15 with a standard deviation of 0.86, indicating a neutral to moderately positive perception among SME managers. The Mudarabah scored a mean of 3.34, reflecting a moderate level of agreement on the fairness and collaborative nature of these financial tools. The Murabaha achieved a slightly higher mean of 3.37, suggesting it is relatively more accepted or commonly practiced compared to other Islamic finance instruments. With regard to the government support variable, the mean score was 3.35, showing that respondents moderately agree with the government's role in facilitating SME financing, particularly in terms of regulation, incentives, and capacity building. Lastly, the financial performance variable registered a mean of 3.58, which also falls within the moderate range, indicating that while SMEs perceive their financial outcomes as reasonably stable and positive, there remains room for growth and enhancement, especially in connection with Islamic financing mechanisms.

Table 2: Descriptive Statistics of Variables

Variable	Mean Score	Standard Deviation	Level
Musharakah	3.16	0.86	Moderate
Mudarabah	3.32	0.86	Moderate
Murabaha	3.37	0.87	Moderate
Government Support	3.35	0.94	Moderate
Financial Performance	3.58	0.99	Moderate

4.4 Measurement Model

The assessment of the measurement model in Table 3 confirms the reliability and validity of the constructs used in the study. All constructs demonstrated strong internal consistency, as evidenced by Cronbach's Alpha values exceeding 0.70. Composite reliability (CR) values were also well above the recommended threshold of 0.70, indicating high internal stability across indicators. The Average Variance Extracted (AVE) for each construct exceeded 0.50,

confirming convergent validity. Discriminant validity was established through the Fornell-Larcker Criterion, where the square root of each construct's AVE was greater than its correlations with other constructs. Additionally, HTMT ratios were all below 0.85, further validating discriminant separation. These results collectively affirm that the measurement model is both statistically sound and suitable for subsequent structural model analysis.

Table 3: Assessment of Measurement Model

Construct	Cronbach's Alpha	Composite Reliability	AVE	Fornell-Larcker Criterion ($\sqrt{\text{AVE}}$)	HTMT < 0.85
Musharakah	0.907	0.915	0.660	0.812	Yes
Mudarabah	0.906	0.908	0.725	0.851	Yes
Murabaha	0.902	0.905	0.617	0.785	Yes
Government Support	0.901	0.907	0.718	0.852	Yes
Financial Performance	0.894	0.922	0.705	0.840	Yes

4.5 Structural model

The assessment of the structural model in this study was conducted through a systematic examination of its explanatory power, effect sizes, and path significance to validate the proposed hypotheses. Figure 1 shows that the R-squared (R^2) values indicated a high degree of explanatory strength, particularly when both the dimensions of Islamic finance and government support were incorporated into the model. The most comprehensive model, which included the moderating role of government support on the relationship between Islamic finance tools and financial performance, accounted for 79.8% of the variance in the dependent variable. This substantial R^2 value demonstrates that the model is highly predictive and robust in explaining financial performance among SMEs in Libya. In addition to explanatory power, the study assessed the magnitude of influence of each predictor using Cohen's f-squared (f^2) effect size criteria. The results revealed large effect sizes for key Islamic finance dimensions. All the paths exceed the values of 0.02.

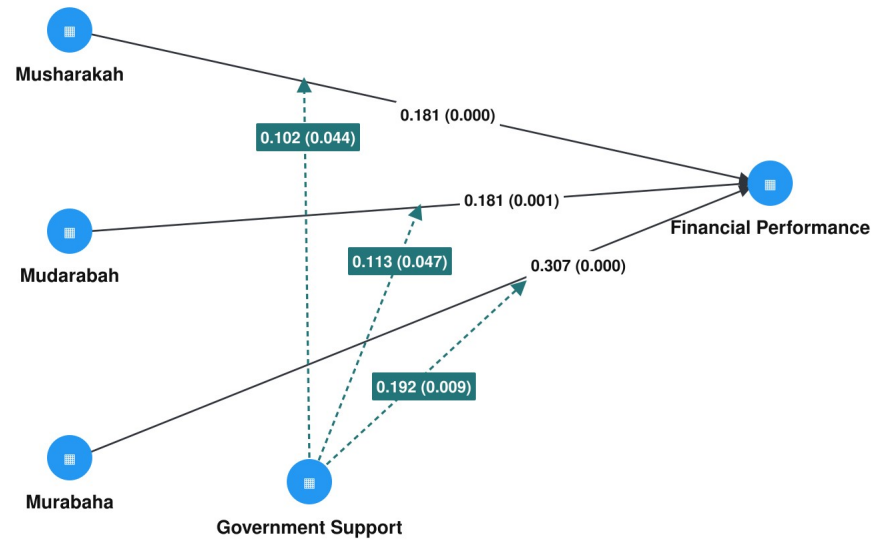


Figure 1: Structural Model

Path coefficient analysis confirmed the statistical significance of all three direct relationships hypothesized in the model. The effect of Musharakah was proposed to have a positive effect on financial performance (H1) was proposed to have a positive effect a significant effect on performance ($\beta = 0.181$, $p < 0.001$). Similarly, Hypothesis H2 concerning Mudarabah was supported ($\beta = 0.181$, $p = 0.001$), as was Hypothesis H3 related to Murabaha financing ($\beta = 0.307$, $p < 0.001$). These results indicate that each component of Islamic finance plays a meaningful and distinct role in enhancing SME financial outcomes.

The study also tested three moderation hypotheses concerning the role of government support. H4, which assessed the moderation effect of government support on Musharakah, was supported ($\beta = 0.102$, $p = 0.044$), suggesting a significant interaction. Hypothesis H5, exploring the moderation effect on the relationship between Mudarabah and financial performance of SMEs, was supported ($\beta = 0.113$, $p = 0.047$), indicating a moderate interaction effect. Hypothesis H6 presented the most robust moderating relationship, showing that government support significantly strengthened the effect of Murabaha on financial performance ($\beta = 0.192$, $p = 0.009$). These findings collectively emphasize that while Islamic finance significantly contributes to financial performance, its effectiveness is further amplified by targeted government support especially in the case of Murabaha.

Table 4: Results of Hypotheses Testing

Hypothesis	β	T-Value	p-Value	Decision
H1: Musharakah $\rightarrow$ Financial Performance	0.181	4.084	0.000	Supported
H2: Mudarabah $\rightarrow$ Financial Performance	0.181	2.515	0.001	Supported
H3: Murabaha $\rightarrow$ Financial Performance	0.307	4.071	0.000	Supported
H4: Gov. Support $\times$ Musharakah $\rightarrow$ FP	0.102	3.624	0.044	Not Supported

H5: Gov. Support × Mudarabah → FP	0.113	2.018	0.047	Supported
H6: Gov. Support × Murabaha → FP	0.192	2.799	0.009	Supported

5. Discussion

This study examined how Islamic finance affects Libyan SMEs' financial performance, focusing on government support. The study analysed direct and moderated relationship using quantitative data from 282 SME owners and managers' structured questionnaires. The results showed that Islamic finance improved SME financial performance statistically. Islamic finance mechanisms include Musharakah, Mudarabah, and Murabaha positively affected financial results. Though moderated, government support strengthened these relationships.

According to the RBV and IFT, Islamic financing has a significant beneficial impact on SME performance in Libya. RBV claims that Islamic financing tools give SMEs strategic and ethical resources that boost competitiveness, especially in environments with restricted conventional funding. The study showed that IFT promotes financial inclusion, openness, and risk-sharing. Profit and loss sharing are ethical development mechanisms along with pecuniary ones. They support past studies and emphasize the necessity for context-specific financial product creation in Libya's post-conflict economy.

Due to its asset-backed structure, clear pricing, predictability, and Shariah compliance, Murabaha improved financial performance the most. Musharakah was useful for startups and asset-intensive businesses, but infrastructure restrictions hampered its efficacy. Risk-sharing models were intriguing, but legislative and operational issues limited their impact. These variances emphasize the need for financial solutions tailored to SME operations.

Government support moderated the impact of Islamic finance on financial performance of SMEs. It considerably improved the impact of Islamic finance on financial performance. These findings show that interventions must match the structural characteristics and adoption challenges of each financing tool. With focused government policies that match the demands of each financial instrument, Islamic financing may significantly boost SME performance in Libya.

6. Implications

By examining how Islamic finance impacts SME financial performance in developing economies, this study contributes to the theory and practices. It connects the RBV with IFT to show that Murabaha, Mudarabah, and Musharakah are strategic financial resources that boost competitiveness and sustainability. The study also adds government support as a moderating institutional variable to context-contingent resource performance theory. This contradicts the idea that Islamic financial instruments perform similarly, showing that institutional infrastructure, policy alignment, and risk profiles affect their performance. Empirical data from the study supports integrating contextual factors like governmental support and post-conflict economic situations into Islamic finance effectiveness theories. Recent research asks for more dynamic, culturally informed financial theories for developing and transitional economies.

The results offers policymakers, financial institutions, and development organizations in Libya and comparable economies with a complete framework. First, it shows Murabaha as a realistic, scalable Islamic financing technique that increases SME financial performance when supported by government credit guarantees or subsidized profit rates. Second, it emphasises personalizing policy instruments rather than broad aid, notably for institutional trust and risk reduction techniques like Mudarabah and Musharakah. Financial institutions might create mixed profit and loss sharing schemes with graded risk exposure or digital interest-free microloans. Financial literacy, digital readiness, and contract negotiation capacity-building can help SMEs maximise Islamic finance benefits. These findings can assist international development organizations integrate ethical finance with inclusive growth in post-conflict or underbanked Muslim-majority areas.

7. Conclusion

This study analysed how Islamic finance affects Libyan SMEs' financial performance and how government support moderates these effects. The findings showed that Musharakah, Mudarabah, and Murabaha boost SME performance. Because of its structure, assets, and government-endorsed protocols, Murabaha was the best financing alternative. The effect of Islamic finance tools on financial performance was moderated by government support, but not interest-free financing. The results advise contextualizing Islamic finance within institutional and legal frameworks. Islamic financing can increase SME competitiveness and resilience, especially in post-conflict, resource-constrained economies, with proper governmental interventions. The study reveals that government support moderated Islamic financial instruments' strategic significance and underlines the need for different policy frameworks to improve SME financial performance.

Although insightful, this study has significant limitations. First, its cross-sectional approach limits causality and dynamic changes over time. Second, the study only examines official Islamic financing techniques including Murabaha, Musharakah, and Mudarabah which may be useful to SMEs. Third, the study only covered metropolitan Libya, ignoring rural or conflict-affected areas where informal finance is more common. The study used self-reported data from SME owners and managers, which may have biased results. The model does not account for business age, industry disparities, owner experience, digital preparedness, or macroeconomic variables like inflation and currency volatility. Finally, government support focused on financial and credit mechanisms rather than institutional and physical aspects.

Based on the findings of this study and the limitations, future studies are recommended conduct longitudinal studies to understand the dynamic and causal links between Islamic financing, government support, and SME financial performance. Second, increasing sample size and geographical and sectoral variety will improve generalizability. Financial inclusion difficulties can be better understood by include rural or marginalized SMEs. Third, future research should include Ijarah, Salam, and Sukuk to assess their relevance to SME environments. Future models should include financial literacy, entrepreneurial inclination, technology adoption, and regulatory quality as moderators. Mixing quantitative surveys with qualitative interviews or case studies may reveal implementation challenges and important predictors of financial performance of SMEs. Finally, researching digital Islamic financial

services and fintech platforms' role in promoting Shariah-compliant finance is crucial, especially in post-conflict or low-infrastructure countries like Libya.

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TRANSLITERATION

a. Consonant

Arabic	Latin	Example	
		Arabic	Latin
ء	‘	فَأَرْ	fārun
أ	(a,i,u)	أَحْكَام	aḥkāṃ
ب	b	بَابُ	bābun
ت	t	تَمْرُ	tamr
ث	th	ثَلَاثُ	thalātha
ج	j	جَبَلُ	Jabal
ح	ḥ	حَدِيثُ	ḥadīth
خ	kh	خَالِدُ	khālīd
د	d	دِينُ	dīn
ذ	dh	مَذْهَبُ	madhhab
ر	r	رَاهِبُ	rāhib
ز	z	زَكِي	zakī
س	s	سَلَامُ	salām
ش	sh	شَرَبُ	sharaba
ص	ṣ	صَدْرُ	ṣodrun
ض	ḍ	ضَارُ	ḍār
ط	ṭ	طَهْرُ	ṭahura
ظ	ẓ	ظَهْرُ	ẓohr
ع	‘	عَبْدُ	‘abdun
غ	gh	غَيْبُ	ghayb
ف	f	فَاتِحَةُ	Fātiḥah
ق	q	قَبَسُ	qabas
ك	k	كِتَابُ	kitāb
ل	l	لَيْلُ	layl
م	m	مُنِيرُ	munīr

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ن	n	نِقَابٌ	niqāb
و	w	وَعَدَ	wa ^c ada
هـ	h	هَدَفُ	hadaf
ي	y	يُوسُفُ	Yūsuf

b. Short Vowel

Arabic	Latin	Example	
		Arabic	Latin
اَ	a	كَتَبَ	kataba
اِ	i	عَلِمَ	°alima
اُ	u	غُلِبَ	ghuliba

c. Long Vowel

Arabic	Latin	Example	
		Arabic	Latin
اَ ، اِ ، اِوْ	ā	عَالَمٌ ، فَتَى	°ālam , fatā
اِي	ī	عَلِيمٌ ، دَاعِي	°alīm , dā°ī
اُو	ū	عُلُومٌ ، اُدْعُو	°ulūm , °ud°ū

d. Diphthong

Arabic	Latin	Example	
		Arabic	Latin
أَوْ	aw	أَوْلَادٌ	aulād
أَيَّ	ay	أَيَّامٌ	ayyam
إِيَّ	iy	إِيَّاکَ	iyyāka