

From Government Policy to MSME Welfare: The Mediating Role of Business Development

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ABSTRACT

This study aims to examine the relationship between government policy and MSME welfare by incorporating business development as a mediating variable. Although various interventions have been implemented, their effectiveness in enhancing welfare through strengthening business capacity remains unclear. This research employs a quantitative approach using primary data collected from MSME actors in Bondowoso Regency, Indonesia, who received government assistance during 2022–2024. Data were analyzed using Partial Least Squares Structural Equation Modeling (PLS-SEM) to test direct and indirect relationships among variables. The results indicate that government policy has a direct effect on MSME welfare, and business development also plays an important role in improving welfare. However, government policy does not significantly influence business development, resulting in no significant mediating effect. These findings suggest that policy interventions tend to provide direct benefits rather than strengthening long-term business capacity.

INTRODUCTION

The Micro, Small, and Medium Enterprises (MSMEs) are acknowledged as vital engines for economic growth and social development, and in particular in developing nations, where they constitute the majority of the business sector and offer significant employment (Prasetyo, 2020; Putra et al., 2026; Taiwo et al., 2022). In addition to their economic contribution, MSMEs play a key role in improving livelihoods and reducing poverty at the community level (Akmatov et al., 2026; Cosa, 2025). This has led governments to increasingly seek policy interventions to boost MSMEs' capacity, ensuring these enterprises play a more significant role in welfare outcomes.

However, the relationship between government policy and MSME welfare is not always obvious. Previous studies have demonstrated that governmental interventions, such as financial aid, training programs, and business facilitation, have not necessarily increased the welfare of MSME actors (Asravor et al., 2025; Jalali, 2025; Jayeola et al., 2022; Papa Kwame Ofori-Baafi & Mustapha Osman Opoku, 2025; Zainuri et al., 2025). Such policies are effective in many circumstances only if they are internalized and transformed into company actions (Tete et al., 2024; Tumiwa & Nagy, 2021; Widjaja, 2024). In this respect, business development is an important approach, as it reflects the extent of improvement in the company's capacity, sustainability, and operational procedures resulting from external support.

The mediating function of business growth in the relationship between government policy and welfare outcomes has been empirically under-investigated, especially in local and regional contexts (Santos-Vijande et al., 2022; Wulandari et al., 2026). Most prior studies focus on firm-level performance indicators such as profit and productivity, or treat government policy as a direct determinant of welfare without adequately accounting for the intermediate processes involved (Chala et al., 2026; Quaye et al., 2024; Zhang & Ayele, 2022). This leaves a gap in understanding how policy interventions translate into actual benefits in the socio-economic well-being of MSME actors, especially in places where local institutional dynamics are important for policy implementation.

While traditional economic indicators such as income and business stability are commonly used to assess welfare, they may not fully capture the broader dimensions of well-being, especially in socio-religious contexts. This study expands the perspective by incorporating Islamic welfare principles, in which welfare (*falah*) encompasses material prosperity as well as spiritual, ethical, and social dimensions (Beik et al., 2021; Ichsan et al., 2025; Nurasyiah et al., 2024). By combining these viewpoints, the study conceptualizes MSME welfare as a multidimensional concept, encompassing both economic outcomes and value-based well-being. This approach is particularly relevant for MSMEs in Indonesia, where socio-religious values significantly influence economic behavior. The research explores how government policies affect MSME welfare and whether business development acts as a mediator. It aims to analyze both the direct effect of policies on welfare and the indirect effect via business development, using data from MSME aid beneficiaries in Bondowoso Regency.

This problem is especially pertinent in the case of local government actions. The Department of Cooperatives, Industry, and Trade (*Diskoperindag*) of Bondowoso Regency, East Java, Indonesia, has initiated several MSME assistance programs in 2022–2024. These programs provide business equipment, facilitation support, and capacity-building activities to boost MSME performance and enhance recipients' welfare. This shows a good commitment from local government, but there is no empirical evidence that these efforts are beneficial in boosting welfare, especially through business growth (Anggraeni et al., 2026; Edoho, 2015; Kurniawan et al., 2026).

Methodologically, Partial Least Squares Structural Equation Modelling (PLS-SEM) is used to analyse interactions among constructs and to examine the mediating impact of company development. This approach allows a holistic assessment of direct and indirect impacts, giving a more thorough understanding of the mechanisms via which policy interventions impact welfare outcomes (Guenther et al., 2023; Sasono et al., 2023; Tandilino et al., 2025).

Based on the Resource-Based View (RBV), the MSME's performance and sustainability are influenced not only by external factors but also by internal resources, such as human and social capital (Abraham & Mallatt, 2022; Balog & Demidova, 2021; Bykova et al., 2024; Ekici & Koydemir, 2014; El Nemar et al., 2025; Lukovszki et al., 2021; P. Klein et al., 2025; Ramon-Jeronimo et al., 2019; Stanojević & Stokanić, 2014; Timothy, 2022; Wijaya & Sofiatul Wardah, 2025). These resources are intangible assets that can help MSMEs build capabilities, adapt to the environment, and maintain long-term competitiveness. Thus, understanding MSME welfare cannot be based solely on government policy but also on the role of internal resources within firms (Asravor et al., 2025; N. A. O. Dela Cruz et al., 2025). These resources are intangible assets that enable MSMEs to build capabilities, respond to environmental changes, and maintain their long-term competitiveness. Therefore, the welfare of MSMEs cannot depend solely on government policy; it must also account for the role of internal MSME-level resources.

This work contributes to the literature in multiple ways. First, it contributes to the current literature by recognizing business development as a mediating mechanism between government policy and MSME welfare. Second, it offers empirical evidence from a regional Indonesian context that remains underrepresented in MSME policy research. Third, this study underscores the role of public policy in fostering community well-being, not only commercial performance, by focusing on welfare outcomes.

METHOD

Research Type

The population of this study comprises Micro, Small, and Medium Enterprises (MSMEs) in Bondowoso Regency, East Java, Indonesia that received business assistance from the Department of Cooperatives, Industry, and Trade (Diskoperindag) during 2022-2024. The sample was selected using purposive sampling based on the following criteria: MSME actors who received government aid from Diskoperindag in 2022-2024, were actively running a business at the time of the survey, and were willing to participate in the research. The total number of respondents included in the final analysis was 150.

Population and Sample

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The sample was selected using purposive sampling, with the following criteria: MSME actors who received government assistance from Diskoperindag between 2022 and 2024, were actively operating businesses at the time of the survey, and were willing to participate in the study. A total of 150 respondents were included in the final analysis.

Research Location

This study was conducted in Bondowoso Regency, East Java, Indonesia. Bondowoso is an area where MSMEs have become leading actors in the local economy, and the government has been actively intervening to support firm growth. The choice of this place is essential because Diskoperindag has a structured MSME support program that provides an appropriate setting to examine the impact of government policies on business development and welfare outcomes.

Instrumentation or Tools

Data were obtained through a standardized questionnaire developed from prior literature and tailored to the context of MSME development and government policy intervention. The questionnaire was based on three major constructs. Six indicators were used to measure Government Policy (GP). The indicators measured policy support, accessibility, and quality of implementation. The indicators included the relevance of assistance programs, ease of access, administrative clarity, fairness, and post-aid guidance. Business Development (BD) was measured using indicators of improvements in business capacity, operations, and sustainability, including the capability to increase business activities, improve production processes, and sustain business continuity. This study measures the welfare construct (WF) using indicators inspired by Islamic welfare principles that cover both material and non-material aspects. These indicators include income growth, sustainable business practices, and perceived well-being aligned with ethical and spiritual values. This approach embodies the Islamic economic concept of *falah*, emphasizing a holistic understanding of welfare (Beik et al., 2021; Ichsan et al., 2025; Nurasyiah et al., 2024; Ridho & Harahap, 2025). Items were measured on a five-point Likert scale from 1 (strongly disagree) to 5 (strongly agree). The instrument was pretested before the main data collection to assess its clarity, reliability, and suitability for the local MSME environment.

Data Collection Procedures

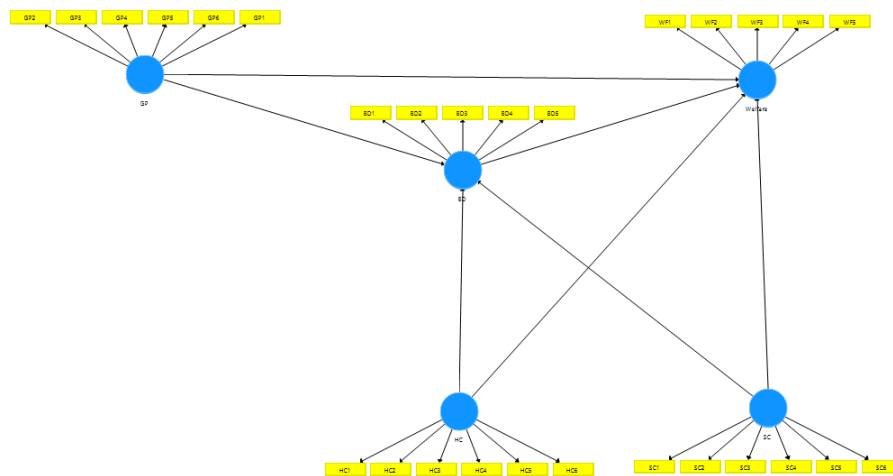
Data were collected through a survey administered to MSME actors in Bondowoso Regency over approximately two months. Respondents were approached directly and through coordination with local institutions to ensure adequate participation. Prior to completing the questionnaire, all participants were informed of the study's purpose and provided consent to participate. The questionnaires were then completed either in person or through assisted data collection to ensure the accuracy and completeness of the responses.

Data Analysis

The data were analyzed using Partial Least Squares Structural Equation Modeling (PLS-SEM) to examine the relationships among variables and to test the mediating role of business development (Hair & Alamer, 2022; Islami Rahayu et al., 2024; Munir Is'adi & Rakhman

Wijaya, 2026; Putra et al., 2022, 2026). The analysis was conducted in two stages. First, the measurement model (outer model) was evaluated to assess the reliability and validity of the constructs using indicator loadings, composite reliability (CR), average variance extracted (AVE), and discriminant validity. Second, the structural model (inner model) was assessed by examining path coefficients, the coefficient of determination (R^2), effect sizes (f^2), and predictive relevance (Q^2). The mediating effect of business development was further tested using bootstrapping, with resampling procedures to assess the significance of the indirect effect. This study initially considers a broader set of constructs related to MSME development and welfare. However, the present analysis focuses specifically on government policy, business development, and MSME welfare, in line with the core research objective of examining the mediating mechanism. This approach follows a theory-driven model specification, with variables selected for their relevance to the research question. In addition to the main variables, this study includes human and social capital as control variables, based on the Resource-Based View (RBV). These variables are included to control for firm-level capabilities and internal resources that may influence business development and MSME welfare. The overall research model, including the main and control variables, is illustrated in Figure 1.

Figure 1. Conceptual Model of the Study



Source: Author’s elaboration

RESULTS AND DISCUSSIONS

RESULTS

Respondent Characteristics

Table 1. Distribution of Respondents by Year and Type of Government Assistance

Type of Assistance	2022	2023	2024	Total	Percentage (%)
Production Equipment	26	18	30	74	38.9%
Business Facilities	22	25	13	60	31.6%
Service/ Workshop Equipment	6	24	8	38	20.0%
Infrastructure Support	4	5	9	18	9.5%
Total	58	72	60	190	100%

Source: Primary data

Table 1 presents the distribution of respondents by year of assistance and type of government support received. In 2022, most respondents received production equipment and business facilities. In 2023, help was more evenly distributed, with a significant increase in assistance for services and workshops. In 2024, a larger share of respondents received assistance with production equipment and infrastructure.

In general, the data suggest that the government interventions over the three years were largely aimed at real operational support, mainly in the form of production equipment and business facilities. But there is also some indication of slow diversification in the types of help provided, especially in 2023 and 2024, with a greater emphasis on service-based support and business infrastructure.

Measurement Model (Outer Model)

Table 2. Measurement Model Evaluation (Outer Model)

	Outerloadings	VIF
Government Policy (GP); CR = 0.89 AVE = 0.57		
BD1	0.911	3.907
BD2	0.922	4.279
BD3	0.912	3.851
BD4	0.917	4.205

BD5	0.916	4.003
Business Development (BD); CR = 0.94 AVE = 0.76		
GP1	0.832	2.26
GP2	0.811	2.066
GP3	0.811	2.195
GP4	0.784	1.959
GP5	0.796	2.006
GP6	0.805	1.994
MSME Welfare (WF); CR = 0.93 AVE = 0.74		
WF1	0.892	3.265
WF2	0.905	3.558
WF3	0.898	3.452
WF4	0.886	3.165
WF5	0.87	2.887

Source: Primary data (processed using SmartPLS)

The results of the measurement model evaluation are presented in Table 2. All indicator loadings exceed the recommended threshold of 0.70, indicating adequate indicator reliability across all constructs (Hair & Alamer, 2022). Specifically, the loadings for Government Policy range from 0.784 to 0.832, while Business Development and MSME Welfare demonstrate higher loadings exceeding 0.87, suggesting strong representation of the latent variables. In terms of internal consistency, the Composite Reliability (CR) values for all constructs are above the acceptable threshold of 0.70, with values of 0.89 for Government Policy, 0.94 for Business Development, and 0.93 for MSME Welfare.

Furthermore, the Average Variance Extracted (AVE) values for all constructs exceed 0.50, confirming that the constructs have sufficient convergent validity. The results also indicate that the Variance Inflation Factor (VIF) values for all indicators are below the critical threshold, suggesting no multicollinearity among the indicators (Hair & Alamer, 2022). Overall, these findings confirm that the measurement model meets the criteria for reliability,

convergent validity, and multicollinearity and is therefore appropriate for further structural model analysis.

Structural Model (Inner Model)

	Original Sample	Sample Mean	Stdev	t-statistics	p-value	Result
Direct Effect on Business Development						
R-Square = 0.537; Adj. R-Square = 0.529						
GP -> BD	-0.04	-0.034	0.057	0.71	0.478	Not Significant
Direct Effect on MSMEs' Welfare						
R-Square = 0.404; Adj. R-Square = 0.392						
BD -> Welfare	0.332	0.327	0.081	4.074	0.000	Significant
GP -> Welfare	0.314	0.314	0.066	4.758	0.000	Significant
Indirect Effect						
GP -> BD -> Welfare	-0.013	-0.012	0.019	0.691	0.49	Not Significant

Source: Primary data (processed using SmartPLS)

The structural model was assessed to explore relationships among variables and to determine its explanatory power. The results show that the model explains 53.7% of the variance in business development. ($R^2 = 0.537$; Adj. $R^2 = 0.529$), indicating moderate explanatory power. Meanwhile, the model accounts for 40.4% of the variance in MSME welfare ($R^2 = 0.404$; Adj. $R^2 = 0.392$), indicating a moderate level of predictive capability.

In terms of direct effects, the results indicate that government policy has no significant effect on business development ($\beta = -0.040$; $t = 0.710$; $p = 0.478$). This suggests that government interventions do not significantly contribute to improving business capacity or development.

On the other hand, business development has a significant positive effect on MSME welfare ($\beta = 0.332$; $t = 4.074$; $p < 0.001$), indicating that improvements in business capacity and operational performance lead to better welfare outcomes. Similarly, government policy has a

significant direct effect on MSME welfare ($\beta = 0.314$; $t = 4.758$; $p < 0.001$), suggesting that policy interventions directly enhance MSME actors' welfare.

The mediation analysis further reveals that the indirect effect of government policy on MSME welfare through business development is not significant ($\beta = -0.013$; $t = 0.691$; $p = 0.490$). This indicates that business development does not mediate the relationship between government policy and welfare. Therefore, the influence of government policy on MSME welfare occurs primarily through a direct pathway rather than through business development.

DISCUSSION

Interpretation of Key Findings

These study results should be understood through the lens of Islamic welfare, which considers enhancements not only in financial results but also in perceived well-being and social-ethical fulfilment (Beik et al., 2021; Ichsan et al., 2025; Nurasyiah et al., 2024; Ridho & Harahap, 2025). Therefore, the findings provide valuable insights into how government policy, business growth, and MSME welfare are interconnected. The structural model results indicate that government policy has a significant positive effect on MSME welfare ($\beta = 0.314$; $t = 4.758$; $p < 0.001$). This suggests that policy interventions implemented by local governments—such as the provision of business equipment, facilitation support, and capacity-building initiatives—can directly improve the economic conditions and well-being of MSME actors (Chala et al., 2026; Kurniawan et al., 2026; Tete et al., 2024). In the context of Bondowoso Regency, these findings suggest that government programs are effective at improving short-term welfare outcomes among MSME beneficiaries.

In addition, the results show that business development has a significant positive effect on MSME welfare ($\beta = 0.332$; $t = 4.074$; $p < 0.001$). This indicates that improvements in business capacity, operational efficiency, and sustainability contribute substantially to better welfare outcomes (Asravor et al., 2025; Tandilino et al., 2025; Tumiwa & Nagy, 2021). MSMEs that experience stronger development in their business activities tend to achieve more stable income and improved living conditions.

However, an unexpected finding emerges in the relationship between government policy and business development. The analysis reveals that government policy does not significantly influence business development ($\beta = -0.040$; $t = 0.710$; $p = 0.478$). This result indicates that although government interventions directly enhance welfare, they do not necessarily translate into improvements in business capacity or long-term enterprise development. This suggests that policy interventions may be more oriented toward immediate support rather than strengthening sustainable business growth (N. A. O. Dela Cruz et al., 2025; Pavico, 2026; Tumiwa & Nagy, 2021).

This pattern is further confirmed by the mediation analysis. The indirect effect of government policy on MSME welfare through business development was not significant ($\beta = -0.013$; $t = 0.691$; $p = 0.490$). This implies that business development does not mediate the relationship between government policy and welfare (N. A. Dela Cruz et al., 2023; N. A. O. Dela Cruz et al., 2025; Tumiwa & Nagy, 2021; Widjaja, 2024). In other words, the impact of government policy on MSME welfare occurs primarily through a direct pathway, rather than through enhancing business development. This finding highlights a critical gap in policy effectiveness: government programs may provide immediate economic relief but fail to strengthen MSMEs' long-term productive capacity.

Furthermore, the explanatory power of the model indicates that business development accounts for 53.7% of the variance ($R^2 = 0.537$), while MSME welfare accounts for 40.4% of the variance ($R^2 = 0.404$). These values suggest that the model has moderate explanatory power and that business development plays a substantial role in shaping welfare outcomes, even though it is not influenced by government policy.

Comparison with Previous Studies

The finding that government policy directly affects MSME welfare is consistent with previous studies that emphasize the role of public intervention in supporting small-business actors and improving livelihood conditions (Asravor et al., 2025; Pavico, 2026; Takeda et al., 2024; Widjaja, 2024; Zainuri et al., 2025). Government assistance programs, particularly those involving direct support such as equipment provision and facilitation, are often associated with immediate economic benefits and increased income stability.

However, the absence of a significant relationship between government policy and business development contrasts with studies that highlight institutional support as a key driver of firm capability enhancement (Tete et al., 2024; Yonis et al., 2018). This discrepancy may be attributed to the nature of local government programs, which tend to prioritize the short-term distribution of resources over long-term capability building. As a result, policy interventions may be effective in addressing immediate welfare needs but less effective in promoting sustainable business development.

The findings also reinforce the importance of internal business improvement as a determinant of welfare. The significant effect of business development on welfare aligns with perspectives that emphasize the role of firm-level capacity and operational strength in generating long-term economic benefits. This suggests that sustainable welfare improvements among MSMEs depend not only on external support but also on enterprises' ability to enhance their internal capabilities (Abraham & Mallatt, 2022; Bykova et al., 2024; Ekici & Koydemir, 2014; P. Klein et al., 2025; Yonis et al., 2018).

Limitations and Cautions

Despite its contributions, this study has several limitations. First, the use of a cross-sectional design limits the ability to establish causal relationships between variables. Second, the reliance on self-reported data may introduce bias, as respondents may overestimate the effectiveness of government programs or their own business performance. Third, the study is limited to MSME actors in Bondowoso Regency, which may affect the generalizability of the findings to other regions with different economic structures and policy environments.

This study also focuses on a subset of variables within a broader conceptual framework. While other constructs may also influence MSME development and welfare, they were excluded from the main analysis to maintain focus on the specific research objective. This limitation suggests that future research may explore a more comprehensive model incorporating additional variables to provide a more holistic understanding of MSME performance and welfare outcomes.

Recommendations for Future Research

Future research should explore the long-term effects of government policy using longitudinal approaches to better capture changes in business development and welfare over time. In addition, further studies could examine the role of policy design, particularly the balance between short-term assistance and long-term capacity-building programs. Expanding the research to different regions and incorporating qualitative methods would also provide deeper insights into how MSME actors utilize government support and why some interventions fail to strengthen business development.

CONCLUSION

This study investigated the effect of government policy on MSME welfare and examined the mediating role of business development among MSME actors in Bondowoso Regency. It aimed to analyse both the direct influence of government policy on welfare and its indirect effect through business development.

The findings showed that government policy has a significant direct effect on MSME welfare, while business development also significantly contributes to improving welfare outcomes. However, government policy does not significantly influence business development, so no mediation occurs. These results indicate that policy interventions in the studied context are more effective at generating immediate welfare improvements than at fostering long-term business capacity.

Notably, the study provides context-specific evidence that government support programmes, particularly those focused on tangible assistance, may not be sufficient to strengthen business development. Instead, internal capabilities and resources play a crucial role in shaping business outcomes. These findings underscore practical and theoretical implications, suggesting that policymakers should design more comprehensive support programmes that go

beyond direct assistance and emphasise long-term capacity building and capability development among MSMEs.

While this study provides valuable insights into the relationship between government policy, business development, and MSME welfare, several limitations should be acknowledged. First, the cross-sectional design limits the ability to establish causal relationships. Second, the study relies on self-reported data, which may introduce response bias. Third, the research is confined to a specific regional context, limiting the generalisability of the findings.

Future research should employ longitudinal approaches to better capture dynamic changes in MSME development and welfare over time. Additionally, further studies could explore the role of internal resources, institutional quality, and digital capabilities in enhancing business development. Expanding the research to different regions and sectors would also provide a more comprehensive understanding and inform more effective policy frameworks and development strategies.

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