Does Local Wisdom Offer Adequate Protection for MSMEs?

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Abstract

This research explores how local wisdom integrates with formal legal frameworks to offer legal protection for MSMEs in Lhokseumawe, Indonesia. Traditionally, MSME operations in the region have been guided by informal agreements and trust-based relationships, which, while effective in local settings, do not sufficiently address the legal and financial complexities encountered in broader markets. By incorporating formal legal structures alongside Islamic financial principles, such as musharakah (partnership) and mudharabah (profit-sharing), MSMEs benefit from both ethical and legal protection. This hybrid approach allows MSMEs to secure contract enforcement and resolve disputes, while remaining aligned with cultural and legal norms, enabling successful operations in both local and global markets. The study emphasizes the need for educational programs to raise awareness among MSME owners about the benefits of formal legal protections and Islamic financial instruments. These educational efforts are crucial for improving transparency, promoting risk-sharing, and facilitating interest-free financing options for MSMEs. By integrating local wisdom with formal legal frameworks, MSMEs can strengthen their resilience and competitiveness, especially in sectors like manufacturing and construction, where formal contracts play a vital role in protecting business interests. The research concludes with recommendations for further enhancing MSME legal protection through a more cohesive integration of local wisdom and formal legal mechanisms. This integrated approach will help MSMEs improve their competitiveness, access broader opportunities, and ensure long-term sustainability in an increasingly complex economic environment.

I. Introduction

Micro, Small, and Medium Enterprises (MSMEs) are recognized as the bedrock of economic resilience and growth, particularly in developing economies such as Indonesia. These enterprises not only contribute significantly to the national Gross Domestic Product (GDP) but also play a pivotal role in job creation and poverty alleviation. The World Bank estimates that globally, MSMEs account for about 90% of all businesses and more than 50% of employment opportunities, while in developing countries, MSMEs contribute up to 40% of GDP[1]. According to the Asian Development Bank (ADB), MSMEs play a crucial role in driving local economies, contributing over 60% to the national GDP and employing approximately 97% of the workforce. This highlights the sector's significant impact on both economic growth and job creation in the Indonesia[2].

The importance of MSMEs in economic development has been widely recognized in academic and policy literature. Key studies, such as Reeg (2015), highlight the crucial role that small and young firms play in job creation and economic dynamism[3]. Their research indicates that MSMEs are not only vital for employment but also serve as incubators for innovation and entrepreneurship. This is particularly significant in developing countries, where large-scale industries are often less prominent and economic activities are more decentralized.

In the specific context of Lhokseumawe, where Islamic law is deeply embedded in local customs and the legal framework, studies have highlighted both the opportunities and challenges faced by MSMEs. Puspitaningrum et al. (2020) provided a detailed analysis of the traditional markets in Lhokseumawe, noting that while these markets are central to the local economy, there is a significant lack of understanding and awareness regarding the importance of halal certification. This deficiency not only limits the market reach of these enterprises but also hinders their ability to compete in broader markets where halal certification is increasingly demanded[4].

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[1] World Bank, "Small and Medium Enterprises (SMEs) Finance Improving SMEs' Access to Finance and Finding Innovative Solutions to Unlock Sources of Capital.," 2019, https://www.worldbank.org/en/topic/smefinance.

[2] Asian Development Bank, "Asia Small and Medium-Sized Enterprise Monitor 2020: Volume 1—Country and Regional Reviews," 0 ed. (Manila, Philippines: Asian Development Bank, October 2020), https://doi.org/10.22617/TCS200290-2.

[3] Caroline Reeg, *Micro and Small Enterprises as Drivers for Job Creation and Decent Work*, Discussion Paper / Deutsches Institut Für Entwicklungspolitik, 2015,10 (Bonn: Deutsches Institut für Entwicklungspolitik, 2015).

[4] Rani Puspitaningrum et al., "The Role of Micro Small Medium Enterprises (MSMEs) In Halal Industry Enhancement (Case Study of MSMEs in Lhokseumawe – Aceh)," *Review of Islamic Economics and Finance* 4, no. 2 (December 7, 2021): 137–54, https://doi.org/10.17509/rief.v4i2.39630.

Another significant contribution to the literature is the work of Zainurrafiqi et al. (2020), who investigated the determinants and consequences of competitive advantage in MSMEs based on local wisdom. Their study highlights that organizational learning capabilities and innovation are critical factors that significantly impact the competitiveness of MSMEs. The findings suggest that MSMEs that effectively leverage local wisdom and integrate it with innovative business practices can achieve a unique competitive edge. This is particularly relevant in the context of the industrial revolution 4.0, where the ability to innovate and adapt is crucial for sustaining business performance and growth[5].

Moreover, the study emphasizes that competitiveness based on local wisdom not only enhances MSMEs' market positioning but also improves their overall performance. This approach helps MSMEs create products and services that resonate with local values and culture, thereby attracting a loyal customer base and differentiating themselves from competitors. These insights are particularly valuable for MSMEs in regions like Lhokseumawe, where local culture plays a significant role in shaping consumer preferences and business practices

In addition, the integration of Islamic law with Indonesian civil law provides a comprehensive legal framework essential for the protection of MSMEs. While Islamic law aligns with local customs and offers moral guidance, Indonesian civil law introduces formal mechanisms for contract enforcement, dispute resolution, and business rights protection. This dual system ensures that MSMEs operate within a clearly defined legal structure, safeguarding their interests in a competitive market. The study by Nurlaili et al. (2024) emphasizes the critical role of civil law in providing legal protections such as trademark registration, which are vital for MSMEs to safeguard their intellectual property and prevent unfair competition. These protections are particularly important in Indonesia, where MSMEs contribute significantly to the economy but face challenges like limited access to legal resources and intense market competition[6].

Furthermore, Vargas (2020) in the International Labour Organization (ILO) working paper highlights that integrating local wisdom with formal legal frameworks can enhance the resilience and competitiveness of MSMEs. She underscores the importance of legal protection in fostering a business environment where MSMEs can thrive both locally and globally, thereby contributing to sustainable economic development[7]. By combining the ethical

[5] Zainurrafiqi et al., "The Determinants and Consequents of Competitive Advantage Based of Local Wisdom at the Micro, Small, and Medium Enterprise: Evidence from Indonesia," *Solid State Technology* 63, no. 6 (2020).

[6] Elly Nurlaili et al., "Protection for Micro, Small and Medium Enterprises Based on Indonesian Law," *International Journal of Multicultural and Multireligious Understanding* 11, no. 5 (May 7, 2024): 161, https://doi.org/10.18415/ijmmu.v11i5.5710.

[7] Ana María Vargas, "Applying Labour Law to Micro, Small and Medium-Sized Enterprises: A

foundations of Islamic law with the procedural rigor of civil law, MSMEs in Lhokseumawe are better equipped to navigate legal challenges, protect their innovations, and expand their market presence. This synergy between the two legal systems is crucial for fostering a conducive business environment that supports the growth and sustainability of MSMEs.

Kamello and Jauhari (2020) delved into the legal challenges faced by MSMEs in Aceh Province, where Islamic law is more prominently applied due to the region's special autonomy. Their study argues for a synergistic approach that combines the strengths of Islamic and civil law to provide a more holistic legal protection framework for MSMEs. They suggest that while Islamic law offers moral and ethical guidance, civil law ensures the enforceability of legal agreements and the resolution of disputes[8].

These studies collectively highlight the multifaceted challenges that MSMEs face and the potential of integrating Islamic and civil law to enhance legal protection for these enterprises. However, there remains a gap in the literature regarding the practical implementation of this integrated legal framework and its impact on MSMEs in Lhokseumawe.

To address this gap, this study employs a mixed-methods approach, integrating qualitative and quantitative techniques to analyze the protective measures available to MSMEs in Lhokseumawe. The qualitative component includes semi-structured interviews with key stakeholders such as MSME owners, legal practitioners, government officials, and representatives from Islamic legal institutions, alongside focus group discussions to gather insights on the challenges faced by MSMEs and the perceived effectiveness of local wisdom as a protective measure. Legal document analysis further examines relevant laws and case law under both Islamic and civil law to understand their application to MSMEs. The quantitative aspect involves collecting and analyzing data on MSME performance, legal disputes, and the implementation of local wisdom from government reports, MSME surveys, and legal case records. Statistical methods, including regression analysis, are used to explore the relationship between local wisdom-based protections and MSME performance indicators, providing empirical evidence to assess the effectiveness of local wisdom in safeguarding MSMEs and informing the study's conclusions and recommendations.

This methodological approach not only provides a detailed analysis of the current legal framework but also offers practical recommendations for

Comparative Study of 16 Countries," *ILO Working Paper* No. 9 (2009).

[8] Tan Kamello and Imam Jauhari, "Legal Protection for Micro, Small, and Medium Enterprises in Aceh Province, Indonesia," in *Proceedings of the International Conference on Law, Governance and Islamic Society (ICOLGIS 2019)* (International Conference on Law, Governance and Islamic Society (ICOLGIS 2019), Banda Aceh, Indonesia: Atlantis Press, 2020), https://doi.org/10.2991/assehr.k.200306.224.

policymakers, legal practitioners, and MSME owners to improve legal protections and support the growth of MSMEs in Lhokseumawe. The study's findings are intended to inform both academic discourse and policy development, contributing to the broader goal of enhancing economic resilience and sustainable development in Indonesia.

2. Research Method

This research uses a qualitative approach with a case study method to explore the role of local wisdom in providing protection for Micro, Small, and Medium Enterprises (MSMEs). Data was collected through in-depth interviews with MSME actors, traditional leaders, and local stakeholders in areas that still uphold local wisdom values, such as in Bali, Yogyakarta, and Minangkabau. In addition, participatory observation and documentation of local practices that are believed to be able to strengthen the resilience of MSMEs from external threats, both in terms of legal, social, and economic.

The collected data was analyzed using thematic analysis techniques to identify patterns of protection based on local culture. The validity of the data is strengthened through triangulation of sources and methods. This research also critically examines the relevance and effectiveness of local values to the modernization and globalization challenges faced by MSMEs. The results of this analysis are expected to contribute to the development of policies based on local wisdom that support the sustainability of MSMEs in the context of the national economy.

3. Results and Discussion

Integration of Local Wisdom and Formal Legal Structures

The research emphasizes that local wisdom, which is deeply rooted in trust, informal agreements, and community-based ethics, has long been the foundation of MSME (Micro, Small, and Medium Enterprises) operations in Lhokseumawe. This traditional system fosters strong relationships based on mutual understanding and ethical practices. However, while local wisdom has historically enabled successful economic transactions, the findings suggest that it is no longer sufficient in addressing the growing complexities of legal and financial challenges, especially as MSMEs engage with markets and stakeholders beyond their local communities. In the context of globalization and increasingly competitive markets, relying solely on informal mechanisms can leave MSMEs exposed to significant risks.

Al-Rodhan (2009) supports the argument that integrating formal legal frameworks with cultural norms creates a dual layer of protection. This duality ensures that MSMEs not only adhere to ethical standards derived from local wisdom but also operate within legally recognized boundaries, enhancing their credibility and legal security. The incorporation of formal legal structures, particularly in the context of contract law, property rights, and dispute resolution, provides MSMEs with the tools to safeguard their interests while maintaining their cultural identity. This hybrid approach aligns civil law with Islamic legal principles, thereby offering MSMEs the ability to operate confidently in both local and broader markets. By combining the trust and ethical foundations of local wisdom with the security of formal legal mechanisms, MSMEs can navigate the complexities of modern business environments more effectively[9].

However, the challenge lies in balancing these two systems without undermining the inherent value of either. Local wisdom thrives on flexibility, personal trust, and informal agreements, whereas formal legal structures require documentation, regulation, and enforceability. The research suggests that MSMEs should adopt a hybrid legal framework that retains the ethical and relational advantages of local wisdom but incorporates formal legal safeguards, especially in areas such as contract enforcement and dispute resolution. In transactions involving external parties or high-stakes ventures, reliance on informal agreements alone exposes MSMEs to legal uncertainties and financial risks.

One major issue that arises when MSMEs enter high-stakes business ventures without formal contracts is their vulnerability to exploitation or financial loss. This is particularly evident in sectors like construction and manufacturing, where significant investments and resources are at stake. Granovetter and Vargas emphasize that the absence of formal contracts often leaves MSMEs unable to enforce their rights or hold external parties accountable in the event of a dispute. Informal agreements, though effective within tight-knit communities, may lack the necessary legal standing to provide protection in broader market contexts. Without formal legal documentation, MSMEs are left with little recourse if a business partner reneges on an agreement, making them susceptible to losses that could threaten their sustainability[10][11].

[9] Nayef Al-Rodhan, "Sustainable History and the Dignity of Man:," *A Philosophy of History and Civilisational Triumph*, 2009, 142–43.

[10] Mark Granovetter Reviewed work(s):, "Economic Action and Social Structure: The Problem of Embeddedness," *American Journal of Sociology* 91, no. 3 (1985): 481–510.

[11] Vargas, "Applying Labour Law to Micro, Small and Medium-Sized Enterprises: A Comparative Study of 16 Countries."work(s):, "Economic Action and Social Structure: The Problem of Embeddedness."

Beyond risk mitigation, the integration of formal legal frameworks offers MSMEs additional advantages. It can enhance the resilience and adaptability of MSMEs by enabling them to navigate shifting regulatory landscapes and market dynamics more effectively. The hybrid approach—blending traditional community-based practices with modern legal frameworks—provides MSMEs with the flexibility to remain rooted in their local culture while simultaneously expanding their reach. As markets evolve and regulations tighten, MSMEs that operate within both informal and formal frameworks are better positioned to withstand external shocks and capitalize on emerging opportunities.

Furthermore, the adoption of formal legal structures opens the door for MSMEs to attract external investment and access broader financial resources. Investors, lenders, and potential business partners often require the security of formal contracts before committing resources to a venture. Formal agreements offer legal assurance that helps protect all parties involved, fostering trust in the MSME's ability to meet its obligations. This confidence can, in turn, facilitate access to capital, technology, and distribution networks—key resources that enable MSMEs to scale their operations and diversify their product offerings. By formalizing their operations through legal safeguards, MSMEs position themselves as more reliable partners in both local and international markets, enhancing their overall competitiveness.

Incorporating formal legal structures into MSME operations also aligns with the broader regulatory and financial ecosystem in Indonesia, which increasingly requires businesses to operate within formalized frameworks. According to Butt and Lindsey (2012), Indonesia’s civil law system mandates that certain business practices, particularly contracts and property rights, be clearly defined and enforceable. This requirement not only protects MSMEs from entering into unfavorable agreements but also ensures that they have legal recourse if their rights are violated. MSMEs that adopt formal contracts can benefit from the legal protections afforded by civil law, while still maintaining their connection to community-based values[12].

Moreover, the integration of formal legal frameworks strengthens MSMEs’ appeal to potential investors by reducing the risks associated with informal agreements. Formal contracts clarify roles, responsibilities, and expectations,

[12] Simon Butt and Tim Lindsey, *The Constitution of Indonesia: A Contextual Analysis.* (Bloomsbury Publishing, 2012).

making business arrangements more transparent and reducing the likelihood of disputes. As the global business environment becomes increasingly competitive, MSMEs in Lhokseumawe must evolve by balancing their reliance on local wisdom with the need for robust legal protections to engage successfully with external markets. This shift is essential not only for individual businesses but also for the broader economic development of the region.

The Role of Islamic Financial Instruments

A key finding from the research is the potential of Islamic financial instruments, such as *musharakah* (joint partnership) and *mudharabah* (profit-sharing), to enhance the financial resilience of MSMEs. These instruments align with the principles of fairness, justice, and risk-sharing, which are central to Islamic teachings and the cultural practices in Lhokseumawe. Their alignment with local values makes them an ideal solution for MSMEs looking to grow while maintaining compliance with both ethical and legal standards.

Studies have shown that the integration of Islamic finance and MSMEs can lead to mutual benefits. Specifically, Islamic financing can provide MSMEs with access to capital, while also ensuring that business activities adhere to Islamic principles of transparency, fairness, and social responsibility. However, the adoption of Islamic finance among MSMEs has been uneven, with some entrepreneurs still hesitant to embrace these instruments due to a lack of awareness or concerns about complexity[13].

MSMEs in Lhokseumawe often struggle to access capital due to the high-interest rates (*riba*) associated with conventional loans, which are prohibited under Islamic law. The research shows that *musharakah* allows multiple partners to jointly invest in a business, sharing both risks and rewards. Similarly, *mudharabah* provides a model where one party supplies capital while another manages the business, and profits are shared based on a pre-agreed ratio. These tools not only comply with Sharia but also offer practical financial solutions for MSMEs with limited access to conventional banking services.

The findings suggest that while local wisdom, characterized by trust, informal agreements, and community-based ethics, has traditionally governed MSME operations in Lhokseumawe, this system alone is insufficient in addressing modern

[13] Taudlikhul Afkar, Moch. Afrizal Miradji, and Fauziyah Fauziyah, "Mediation of Profit Sharing to Develop Msmes with Mudharabah Capitalization Schemes," *International Journal of Economics, Business and Accounting Research (IJEBAR)* 4, no. 03 (September 23, 2020), https://doi.org/10.29040/ijebar.v4i03.1280.

legal and financial challenges. By integrating formal legal frameworks with Islamic financial instruments, MSMEs can establish a hybrid approach that provides ethical guidance and robust legal recourse, particularly in transactions involving external parties.

Islamic law, or Sharia, provides a comprehensive ethical and legal framework for business transactions, including those of MSMEs. The principles of justice (*al-'adl*), transparency (*al-wadih*), and mutual consent (*al-ridha*) are foundational in ensuring fairness in business dealings. These principles help shield MSMEs from exploitative practices and promote equitable financial growth. The principle of justice, for instance, ensures that all transactions are conducted fairly, with no undue advantage or exploitation, making it particularly relevant for MSMEs in regions like Lhokseumawe[14].

Riba, the charging of interest on loans, is strictly prohibited in Islamic law. This prohibition is especially crucial for MSMEs in Lhokseumawe, as high-interest loans could lead to financial instability. By avoiding riba, Islamic law promotes sustainable and equitable financial arrangements[15]. Similarly, *gharaar*—which refers to excessive uncertainty in contracts—is prohibited. Islamic law ensures that MSMEs have clear contracts with transparent terms to avoid misunderstandings or disputes[16]. The importance of transparency (*Al-Wadih*) is also emphasized in Islamic law, particularly in business transactions. Transparency builds trust and reduces the likelihood of disputes, ensuring that all parties are fully aware of their rights and obligations. This is particularly important for MSMEs in Lhokseumawe, where transparent negotiations with larger businesses or partners can help protect the interests of smaller firms with limited resources[17].

Legal Challenges for MSMEs Protection

[14] Kresnawidiansyah Agustian et al., "Comparative Analysis of Ethical and Legal Principles in the Islamic Business Management Model," *Journal of Contemporary Administration and Management (ADMAN)* 1, no. 2 (October 3, 2023): 101–7, https://doi.org/10.61100/adman.v1i2.52.

[15] Zamir Iqbal and Abbas Mirakhor, *An Introduction to Islamic Finance: Theory and Practice*, 2nd ed., vol. 687 of Wiley Finance (John Wiley & Sons, 2011).

[16] Mahmoud A. El-Gamal, *Islamic Finance: Law, Economics, and Practice* (Cambridge University Press, 2006).

[17] Mohammed Obaidullah and Hajah Salma Haji Abdul Latiff, "Islamic Finance for Micro and Medium Enterprises," *Islamic Research & Training Institute Islamic Development Bank, Centre for Islamic Banking, Finance and Management Universiti Brunei Darussalam.*, no. Finance and Management (February 2008).

The Indonesian legal system plays a critical role in protecting and promoting the growth of Micro, Small, and Medium Enterprises through its robust civil law framework. This framework covers key areas such as contract law, property rights, and dispute resolution, which are essential components for the stability and success of MSMEs[18]. Contracts under Indonesian civil law are legally binding when they meet certain criteria, including mutual consent, lawful purpose, and clear terms.

This formalized legal process is crucial for MSMEs, particularly those with limited resources, as it helps protect them from unfavorable agreements and provides legal recourse in case of breaches. The enforcement of clear contracts is vital for the long-term survival and growth of MSMEs in competitive markets. However, despite the availability of these formal legal structures, many MSMEs in Lhokseumawe remain hesitant to adopt them.

The research findings indicate that this reluctance is not due to an inherent conflict between civil law and Islamic law, but rather the result of local factors, such as a deep reliance on local wisdom that emphasizes trust-based relationships and informal agreements. Many MSME owners feel that formal legal contracts are unnecessary because they believe that trust and mutual understanding are sufficient to govern business relationships. This mindset, while effective within local networks, leaves MSMEs vulnerable when dealing with external partners, larger businesses, or unfamiliar markets where informal agreements may not be respected or enforced[19].

Adding to this challenge is a limited understanding of formal legal structures among MSME owners. Many are unaware of the legal protections that civil law can offer, such as the enforceability of contracts and dispute resolution mechanisms. This lack of awareness often leads MSMEs to bypass formal contracts, which leaves them unprotected in cases where disputes arise[20]. To address these challenges, it is crucial for policymakers and MSME support organizations to implement strategies that promote the adoption of formal legal structures among MSME owners. This could involve educational campaigns through capacity building programs for the

[18] Hari Sutra Disemadi, "Contextualization of Legal Protection of Intellectual Property in Micro Small and Medium Enterprises in Indonesia," *Law Reform* 18(1) (March 2022): 89–110.

[19] Turki S. Abalala, Mazharul M. Islam, and Mohammad M. Alam, "Impact of Ethical Practices on Small and Medium Enterprises' Performance in Saudi Arabia: An Partial Least Squares-Structural Equation Modeling Analysis," *South African Journal of Business Management* 52, no. 1 (August 25, 2021), https://doi.org/10.4102/sajbm.v52i1.2551.

[20] Disemadi, "Contextualization of Legal Protection of Intellectual Property in Micro Small and Medium Enterprises in Indonesia."

workforce and owners to increase awareness of the benefits of civil law, as well as the development of tailored legal support services to assist MSMEs in navigating the formalization process[21].

Additionally, efforts should be made to bridge the gap between the formal legal system and the local, trust-based business culture. One approach could be to introduce hybrid legal structures that combine elements of civil law and informal, relationship-based practices. This could help MSME owners feel more comfortable with the formalization process while still providing the legal protections and enforceability necessary for long-term growth. Policymakers may also consider providing incentives, such as tax benefits or access to government programs, to encourage MSME owners to adopt formal legal contracts and structures[22].

Furthermore, strengthening the capacity of local institutions to support MSMEs in understanding and navigating the civil law system can help overcome the challenges of limited awareness and knowledge. By working closely with MSME associations, chambers of commerce, and community leaders, these support organizations can tailor their services to the unique needs and cultural contexts of the local business community.

Looking Forward: Sustainable Growth Through Legal Integration

The research strongly supports the integration of local wisdom with formal legal systems to ensure the long-term sustainability of MSMEs in Lhokseumawe. A hybrid legal framework, which respects cultural values while offering solid legal protection, enables MSMEs to better navigate the complexities of expanding markets. This combined approach strengthens the ethical foundations of business practices while empowering MSMEs to operate confidently in both local and broader economic contexts[23].

Islamic financial instruments such as musharakah (joint partnership) and mudharabah (profit-sharing) provide clear examples of how Islamic principles can be effectively integrated into modern financial and legal systems. These Sharia-

[21] Salome Anyebe Onyeje, Timinepere Ogele, and Emmanuel Kalu, "National Enterprise Policy Dimensions and Sustainability of Micro, Small and Medium Enterprises (MSMEs)," *Journal of African Business* 23, no. 2 (2022): 435-453., https://doi.org/10.1080/15228916.2020.1838838.

[22] M. Bruhn and D. McKenzie, "Entry Regulation and the Formalization of Microenterprises in Developing Countries," *The World Bank Research Observer* 29, no. 2 (August 1, 2014): 186–201, https://doi.org/10.1093/wbro/lku002.

[23] Hernita Hernita et al., "Economic Business Sustainability and Strengthening Human Resource Capacity Based on Increasing the Productivity of Small and Medium Enterprises (SMEs) in Makassar City, Indonesia," *Sustainability* 13, no. 6 (March 14, 2021): 3177, https://doi.org/10.3390/su13063177.

compliant tools offer practical financial solutions for MSMEs, especially those with limited access to conventional banking services, and contribute to their resilience and growth. The ethical guidelines of these instruments align with local values, making them well-suited to the business environment in Lhokseumawe[24].

In addition to these financial tools, Islamic law emphasizes the importance of zakat (almsgiving), which functions as a form of corporate social responsibility. For MSMEs, paying zakat purifies their wealth while also contributing to social welfare and economic redistribution. Regular zakat payments strengthen ties between businesses and their communities by supporting local charities, educational institutions, and social welfare programs. This socially responsible behavior can enhance a company's reputation and foster customer loyalty, contributing to sustained business success.

Dispute resolution is another area where Islamic law offers effective solutions for MSMEs. Islamic arbitration and mediation provide culturally appropriate and cost-effective alternatives to formal litigation. These methods focus on reconciliation and mutual understanding, maintaining harmony and preserving relationships within the local community[25,26].

The integration of local wisdom and formal legal frameworks is crucial for the sustainable growth of MSMEs in Lhokseumawe. By leveraging Islamic financial instruments, embracing the principles of zakat, and utilizing culturally appropriate dispute resolution mechanisms, MSMEs can thrive while upholding the ethical and social values that are deeply rooted in the community[27]

However, several challenges hinder the full implementation of Islamic law for MSME protection in Lhokseumawe. One significant issue is the lack of a comprehensive legal infrastructure that consistently applies Sharia principles in business transactions. While Islamic law is deeply rooted in the cultural practices of the region, the formal mechanisms to enforce these principles are often underdeveloped. This gap between traditional practices and formal legal

[24] Uswatun Hasanah and Ahmad Arsyadmunir, "Empowerment of Micro, Small, and Medium Enterprise by Local Government to Improve Competitiveness (Study in Pamekasan Regency, Madura)," ed. J.T. Collins, R.W. Carter, and N. Scott, *SHS Web of Conferences* 149 (2022): 02016, https://doi.org/10.1051/shsconf/202214902016.
[25] Hasanah and Arsyadmunir.
[26] 6/29/2025 10:30:00 PM
[27] Taudlikhul Afkar, Moch. Afrizal Miradji, and Fauziyah Fauziyah, "Mediation of Profit Sharing to Develop Msmes with Mudharabah Capitalization Schemes."

structures can result in inconsistencies in the application of Sharia, undermining the protection it is intended to provide.

For example, while informal agreements based on mutual trust are common in Lhokseumawe, these arrangements often lack the legal backing needed to enforce them in the event of a dispute. Without formal contracts recognized by both Islamic and civil courts, MSMEs are vulnerable if their business partners fail to honor verbal commitments. This lack of formalization can lead to legal ambiguities, making dispute resolution difficult and weakening overall legal protection for MSMEs[28].

Another challenge is the limited understanding of Islamic legal provisions among MSME owners. While Islamic law is widely respected, its detailed application in business contexts is not always well understood. Many business owners rely on traditional knowledge or informal advice rather than seeking professional legal counsel, which can result in the misapplication of Sharia principles or the use of non-legally binding agreements that fail to protect their interests during disputes[29]. To address this issue, it is vital to increase legal education and awareness programs focusing on the importance of formal contracts and legally recognized financial instruments[30].

A further challenge arises from the dual legal system in Indonesia, where Islamic law operates alongside civil law. While Islamic law provides a strong ethical foundation, civil law governs most formal business transactions. This dual system can create confusion, particularly in areas where the principles of Islamic and civil law may conflict[31]. For example, Islamic law prohibits *riba* (interest), while civil law permits the charging of interest on loans, leading to potential conflicts in financial arrangements. MSMEs in Lhokseumawe may find themselves navigating these two systems without fully understanding the implications, which can lead to legal risks, especially if they unintentionally violate civil law while trying to adhere to Sharia[32].

[28] Muhammed Shahid Ebrahim and Mustapha Sheikh, "The Political Economy and Underdevelopment of the Muslim World: A Juridico-Philosophical Perspective," *Arab Law Quarterly* 32, no. 4 (November 2018): 385–412, https://doi.org/10.1163/15730255-12324051.

[29] Hassan, Kabir and Michael Mahlknecht., *Islamic Capital Markets: Products and Strategies* (John Wiley & Sons, 2011).

[30] Muhammad Ayub, *Understanding Islamic Finance*, The Wiley Finance Series (John Wiley & Sons, 2009).

[31] Kabir Hassan and Mervyn Lewis, *Eds. Handbook of Islamic Banking.* (Edward Elgar Publishing, 2009).

[32] Ebrahim and Sheikh, "The Political Economy and Underdevelopment of the Muslim World: A Juridico-Philosophical Perspective."

To achieve sustainable growth for MSMEs in Lhokseumawe, it is essential to harmonize Islamic and civil law. This can be accomplished through the development of hybrid legal instruments that incorporate the principles of both systems, ensuring that MSMEs can operate within a framework that is culturally appropriate and legally sound.

The integration of Islamic and civil law can provide a stable and supportive environment for the long-term success of MSMEs. By creating hybrid legal instruments, these enterprises can benefit from the ethical guidelines and community-oriented principles of Islamic law, while also enjoying the legal protections and formal structures of the civil system. This hybrid approach can empower MSMEs to navigate the complexities of expanding markets while upholding the values and cultural practices that are integral to the local business environment.

Moreover, providing comprehensive training for legal professionals and government officials on the intersection of Islamic and civil law is crucial. This training would enable them to offer more informed guidance to MSMEs, ensuring that these enterprises are protected under both legal systems and are well-prepared to thrive in complex, evolving business environments[33]. By bridging the gap between traditional practices and formal legal structures, MSMEs can be better equipped to make informed decisions, mitigate risks, and foster sustainable growth, ultimately contributing to the overall economic and social well-being of the Lhokseumawe community.

[33] Muhamed Umer Chapra, "The Islamic Vision of Development in the Light of Maqāsid Al-Sharī'ah" (Unpublished, 2008), https://doi.org/10.13140/RG.2.1.4188.5047.

4. Conclusion

This study highlights the essential role that local wisdom and formal legal structures play in safeguarding and advancing the operations of Micro, Small, and Medium Enterprises (MSMEs) in Lhokseumawe, Indonesia. MSMEs are the bedrock of Indonesia's economy, contributing significantly to national GDP and employment. However, despite their importance, MSMEs face substantial challenges when engaging with broader markets, particularly when relying solely on informal agreements and community-based trust systems. While these traditional mechanisms are effective locally, they fall short in addressing the complexities of modern legal and financial environments. The integration of local wisdom with formal legal systems is a recurring theme in this research, emphasizing the need for MSMEs to adopt a hybrid approach that combines ethical principles rooted in local culture with legally enforceable frameworks. In Lhokseumawe, local wisdom is deeply embedded in trust-based relationships and informal agreements, which have historically governed business operations. However, these mechanisms are insufficient in protecting MSMEs in high-stakes industries like construction and manufacturing, where formal contracts are necessary to safeguard investments and provide dispute resolution.

The research also highlights the potential of Islamic financial instruments to bolster the financial resilience of MSMEs. Islamic finance offers alternatives to conventional banking, which often involves high-interest rates that are prohibited under Islamic law. Instruments such as *musharakah* and *mudharabah* provide MSMEs with access to capital while adhering to ethical principles of fairness, justice, and risk-sharing. These instruments are particularly well-suited to the cultural and religious context of Lhokseumawe, where compliance with Islamic law is a priority for many business owners. By integrating Islamic financial tools into their operations, MSMEs can enhance their competitiveness and financial sustainability. These instruments not only provide practical financial solutions but also align with the local values of the community, making them an ideal choice for businesses looking to expand while maintaining their ethical standards. The research underscores the importance of incorporating Islamic finance into MSME strategies to strengthen their resilience in the face of economic challenges. To bridge the gap between informal agreements and formal legal protections, the research recommends the creation of hybrid legal structures that combine elements of both systems. This approach would allow MSME owners to retain the flexibility and trust inherent in local wisdom while benefiting from the security and enforceability of formal legal mechanisms. Additionally, the development of tailored legal support services and incentives, such as tax benefits, could encourage MSMEs to adopt formal contracts and legal

structures.

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