# The Influence of Entrepreneurial Orientation and Innovation on Performance in MSMEs in Indonesia (Case Study of Generation Z MSMEs)

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*Abstract*

*This study aims to investigate the influence of entrepreneurial orientation and innovation on the performance of Micro, Small, and Medium Enterprises (MSMEs) operated by Generation Z in Indonesia. Using a quantitative approach, data were collected through a structured questionnaire distributed to 400 young MSME owners across various regions. The analysis was conducted using Partial Least Squares Structural Equation Modeling (PLS-SEM). The findings indicate that entrepreneurial orientation significantly and positively affects both innovation and business performance, while innovation also has a significant positive impact on performance. These results highlight the importance of fostering entrepreneurial behavior and innovation capabilities to enhance the competitiveness of Generation Z entrepreneurs. The study offers practical implications for policymakers, educators, and support institutions to strengthen youth-led MSMEs in the digital economy.*

## 1. Introduction

Micro, Small, and Medium Enterprises (MSMEs) play a crucial role in Indonesia's economic structure. According to data from the Coordinating Ministry for Economic Affairs of the Republic of Indonesia (2024), MSMEs comprise approximately 99% of all business units in Indonesia, contribute 60.51% to the national Gross Domestic Product (GDP), and employ nearly 97% of the workforce. MSMEs are a key driver of informal employment and contribute to creating income sources for those without access to the formal sector (Zahra Firdausya et al., 2023). At a macro level, MSMEs are a crucial instrument in reducing unemployment and promoting inclusive economic growth (Ministry of Finance of the Republic of Indonesia, 2023).

Amidst their significant contributions, demographic trends indicate that the younger generation, particularly Generation Z, has begun to take on roles as MSMEs. Generation Z is a group born between the mid-1990s and early 2010s, grew up in a digital environment, and possesses unique characteristics such as openness to technology, quick adaptation, and an orientation toward flexibility and innovation (kompas.com, 2024). In the context of entrepreneurship, Gen Z tends to utilize various digital platforms, such as Shopee, Tokopedia, and social media, to build and develop businesses (ukmindonesia.id, 2024). This indicates that digital orientation is a crucial foundation for entrepreneurship among this generation.

However, despite their high digital adaptability, Generation Z MSMEs still face significant structural challenges. One of the main obstacles is limited capital and business experience (Olivia et al., 2021). Furthermore, they must compete in an increasingly competitive business ecosystem, which demands the ability to act quickly, adapt, and innovate. In this context, entrepreneurial orientation is a crucial aspect that can drive their business success (Sari, 2024; Covin & Wales, 2019).

Entrepreneurial orientation itself is a multidimensional concept encompassing an individual's or organization's tendency to act innovatively, take risks, and be proactive in addressing market

opportunities (Miller in Cho & Lee, 2018). Recent research has even added new dimensions such as autonomy, competitiveness, passion, and perseverance (Astuti et al., 2024; Clark et al., 2024), further strengthening the understanding that entrepreneurship is not only about the ability to create a business, but also about mental attitude and resilience in managing uncertainty.

Besides entrepreneurial orientation, innovation is another key variable in supporting MSME performance. Innovation in the MSME context does not always mean high technology, but can take the form of product development, processes, business models, or adaptive marketing strategies (Judijanto et al., 2023; Iqtishodia, 2024). According to Gunjati & Adake (2020), innovation is a process that introduces new ideas or tools and has a significant impact on society and the market. Effective implementation of innovation can increase efficiency, expand markets, and provide a sustainable competitive advantage for small businesses.
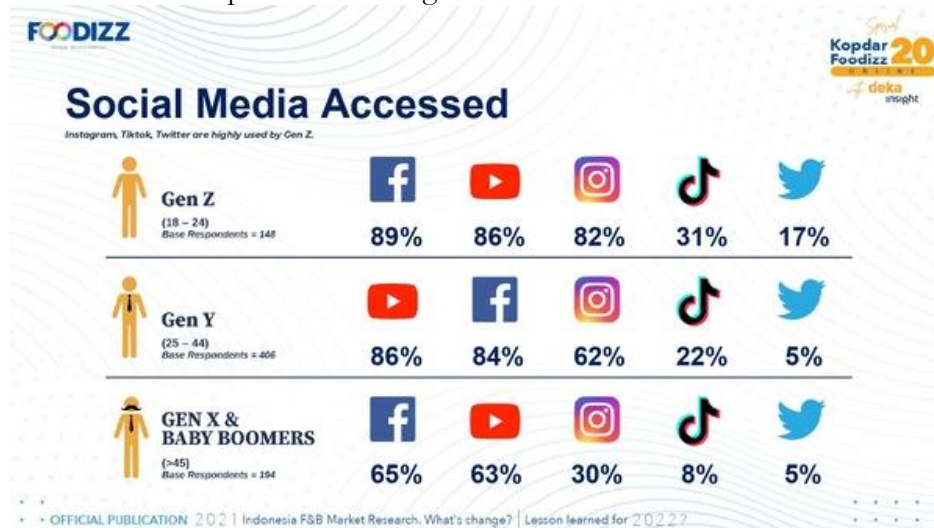


Figure 1.1 Social Media Preferences by Generation in Indonesia
source:mix.co.id/marcomm/news-trend/youtube-dan-facebook-promo-kuliner-efektif-bagi-lintas-generasi/

Based on Figure 1.2, Generation Z is recorded as the most active group in accessing social media platforms, with Facebook (89%), followed by YouTube (86%), Instagram (82%), TikTok (31%), and Twitter (17%).(mix.co.id, 2021).

Although Gen Z is known to be more adept at leveraging technology in business, they still face challenges, one of which is limited capital. Currently, despite the vast business opportunities available to this generation, the available capital is often insufficient to start a business.(Olivia et al., 2021). In addition, with limited experience, Generation Z is required to be able to compete in a competitive business environment.(Pohan & Novien Rialdy, 2024)Therefore, to survive in this competition, it is important for Gen Z to have a competitive attitude. As expressed by(Clark et al., 2024), competitiveness is one of the important dimensions of entrepreneurial orientation which describes the extent to which individuals are ready to face the challenges of competition in the context of a competitive environment.

However, previous research on the relationship between entrepreneurial orientation, innovation, and MSME performance has shown inconsistent findings. Several studies, such as those by Astuti et al. (2024) and Gomes et al. (2022), found that entrepreneurial orientation significantly influences innovation and business performance. Conversely, Yaskun et al. (2023) showed that while entrepreneurial orientation significantly influences performance, innovation has no significant impact. Sisi (2019) even stated that innovation is not always an effective mediating factor between entrepreneurial orientation and MSME performance.

These differences in results indicate that the relationship between these three variables is highly contextual and dependent on the social, cultural, and demographic conditions of the business actors. Therefore, it is important to further examine how entrepreneurial orientation and innovation influence the performance of MSMEs owned by Generation Z in Indonesia. Given the

unique characteristics of this generation and the strategic role of MSMEs in the economy, this study aims to explore in depth the role of entrepreneurial orientation and innovation in improving business performance, as measured by profitability, sales growth, and return on investment (ROI) indicators (Galib et al., 2018).

With a focus on Generation Z MSMEs, this research is expected to provide theoretical and practical contributions in developing entrepreneurial strategies that are relevant to the developments of the times and characteristics of Indonesia's young generation.

## 2. Literature Review

### 2.1. Entrepreneurial Orientation

Entrepreneurial orientation is a multidimensional construct that reflects an individual's or organization's strategic behavioral tendencies in pursuing business opportunities proactively, innovatively, and with a willingness to take risks. According to Covin and Wales (2019), entrepreneurial orientation encompasses three main dimensions: proactiveness, innovativeness, and risk-taking. This orientation is a crucial foundation that influences decision-making, strategy development, and value creation for the organization.

Gerschewski et al. (2016) then developed an entrepreneurial orientation approach by adding two important elements: passion and perseverance, as individual factors that strengthen consistency and determination in running a business. Meanwhile, Clark et al. (2024) emphasized the need for a holistic measurement of individual entrepreneurial orientation (IEO) for more accurate analysis of individual entrepreneurial performance.

In the context of MSMEs, entrepreneurial orientation has been shown to be positively correlated with business success, particularly in creating competitive advantage and adapting to market changes (Cho & Lee, 2018; Hidayat, 2024). Taan et al. (2023) even stated that entrepreneurial orientation significantly contributes to improving the performance of small and medium-sized enterprises through synergy with an adaptive and dynamic organizational culture.

### 2.2. Innovation

Innovation is a crucial element for business sustainability in the digital economy. Gunjati and Adake (2020) define innovation as the process of transforming ideas into valuable products or services that meet market needs. In the context of MSMEs, innovation can be realized in the form of product development, packaging, production systems, distribution, and customer service.

Judijanto et al. (2023) emphasized that innovation is key to the sustainability of MSMEs amidst technological disruption and changing consumer preferences. Innovation-driven digital transformation also encourages MSMEs to accelerate their adaptation to an increasingly competitive market (Iqtishodia, 2024).

However, previous research has shown that the influence of innovation on MSME performance is not always consistent. Yaskun et al. (2023) found that although entrepreneurial orientation significantly influences performance, innovation does not always directly contribute to improved business performance. This contrasts with the findings of Astuti et al. (2024) who stated that innovation is an important mediator between entrepreneurial orientation and business performance.

### 2.3. MSME Performance

MSME performance reflects the results of implementing short- and long-term business strategies. According to Galib et al. (2018), business performance can be measured through profitability, sales growth, and return on investment (ROI). In the context of this research, the performance of Generation Z MSMEs is measured based on the level of operational efficiency and effectiveness achieved through entrepreneurial orientation and innovation.

According to Gomes et al. (2022), organizational performance is influenced by the synergy between entrepreneurial orientation, organizational learning capabilities, and service innovation. This finding provides insight into the understanding that MSME performance is

not influenced by a single factor but rather the result of the integration of various interrelated managerial strategies.

**2.4. Relevance of Previous Research**

Research by Astuti et al. (2024) confirms that the five dimensions of individual entrepreneurial orientation (innovativeness, risk-taking, proactiveness, autonomy, and competitiveness) can be used to improve MSME performance through innovation as a mediator. Meanwhile, a study by Ullah Khan et al. (2024) confirms the positive impact of several dimensions of entrepreneurial orientation on MSME performance. On the other hand, Yaskun et al. (2023) state that innovation does not always have a significant effect on performance, which demonstrates the importance of empirical testing in different contexts—including Generation Z MSMEs in Indonesia.

3. **Research methodology**

3.1 Types and Approaches of Research

This research uses a quantitative approach based on the philosophy of positivism. The quantitative method was chosen because it can objectively measure the relationships between variables using numerical data and statistical analysis to test previously formulated hypotheses (Sugiyono, 2023). According to Sugiyono (2015), in a quantitative approach, phenomena are studied through causal relationships, thus making this research explanatory or causal in nature. This research is cross-sectional because data collection was conducted over a specific period of time, and the unit of analysis in this study is individual MSME actors from Generation Z.

3.2 Operationalization of Variables

The variables in this study consist of:

- Independent variable: Entrepreneurial Orientation
- Mediating variable: Innovation
- Dependent variable: MSME performance

Each variable is broken down into several sub-variables and indicators measured using a Likert scale of 1–5 (strongly disagree to strongly agree). According to Sugiyono (2023), the Likert scale is used to measure the attitudes, opinions, and perceptions of individuals or groups toward a social object used as a research variable.

3.3 Population and Sample

The population in this study is MSME actors in Indonesia who come from Generation Z (born 1997–2012), with a total of 6,583,256 actors based on data from Katadata Databoks (August 2023).

The sample size was determined using the Slovin formula, with an error rate (e) of 5%, resulting in a sample of 400 respondents. The sampling technique used was non-probability sampling with a purposive sampling approach, where respondents were specifically selected based on the criteria of Generation Z who own and operate MSMEs.

Hardani MSi et al., (2020)A sample is defined as a portion of a population selected through a specific sampling technique. This study used a non-probability sampling technique, which is purposive, meaning that respondents are specifically selected based on the research objectives.Sugiyono, (2023)states that non-probability sampling is a sample selection method in which each element or member in the population does not have an equal opportunity to be selected as part of the sample.

According to(Sugiyono, 2017), the Slovin formula was applied to calculate the number of samples in this study. The steps for using the Slovin formula are as follows:

$$n = \frac{N}{1+N(e)^2}$$

Slovin's Formula, Source:*Sugiyono, (2017)*
n = Sample size
N = Population size

e = Tolerance limit error (sample error)

Using the mentioned formula and considering a sampling error tolerance limit of 5%, the following results were obtained based on the existing sample:

$$N = \frac{6.583.256}{1 + 6.583.256(0,05^2)}$$
$$N \approx 399.97 = 400$$

Thus, the minimum number of respondents used as a sample, after being rounded up, is 400 MSMEs in Indonesia owned by Generation Z.

3.4 Data Collection Techniques

Data was collected using a questionnaire distributed online (Google Form) to respondents. According to Sugiyono (2023), questionnaires are an efficient data collection method for reaching respondents spread across a wide geographical area. The questionnaire consists of three main sections representing each variable.

3.5 Validity and Reliability Test

Validity testing was conducted by examining the correlation value of each indicator against the total construct score. An indicator is considered valid if the correlation value (calculated r) is greater than the table r (0.361). Based on the test results, all indicators in the Entrepreneurial Orientation, Innovation, and Performance variables were declared valid, except for one item in the innovation variable (I6), which was eliminated because it did not meet validity requirements.

Reliability testing was conducted using Cronbach's Alpha. A construct is considered reliable if its alpha value is greater than 0.6. The Cronbach's Alpha values for all variables in this study were above 0.7, indicating a good level of reliability (Riyanto & Hatmawan, 2020; Sugiyono, 2022).

3.6 Data Analysis Techniques

Data analysis in this study was conducted using the Partial Least Square - Structural Equation Modeling (PLS-SEM) method operated through SmartPLS 4 software. According to Hair et al. (2021), PLS-SEM is suitable for use in exploratory research with a complex number of indicators and is capable of testing latent relationships between variables simultaneously.

PLS-SEM is carried out in two main stages:
1. Outer model: to test the convergent, discriminant, and reliability validity of the construct.
2. Inner model: to test the influence between constructs (path coefficient), R-square, and mediation testing.

## 4. Results and Discussion

### 4.1 Respondent Characteristics

This study involved 402 respondents who were Micro, Small, and Medium Enterprises (MSMEs) from Generation Z in Indonesia. This generation is defined as individuals born between 1997 and 2012 and is a productive age group highly familiar with digital technology.

The majority of respondents were female (61.7%), indicating that women from Generation Z dominate as entrepreneurs in this study. Based on geographical distribution, the majority of respondents came from Java (48.7%), followed by Kalimantan and Bali-Nusa Tenggara (11.1% each), Sumatra (9.8%), Sulawesi (8.5%), Maluku (5.8%), and Papua (5%). This composition reflects a fairly broad geographic representation and is relevant to the national MSME population spread throughout Indonesia.

In terms of business type, 54.5% are micro-enterprises, 39.3% are small businesses, and only 6.2% are medium-sized. The most popular business sectors are culinary, fashion, crafts, and digital creative services. This reinforces the argument that Generation Z tends to start businesses in sectors that require relatively low capital and can be run using digital technology and social media.

### 4.2 Structural Model Test Results (Inner Model)

The research model was tested using the Structural Equation Modeling approach with the Partial Least Squares (SEM-PLS) method through SmartPLS 4 software. Testing was carried out in two stages: outer model (validity and reliability) and inner model (influence between constructs).

**Table 1 Hypothesis Test Results**

| Hypothesis | Relationship between variables | t-statistic value | p-value | Information |
|---|---|---|---|---|
| H1 | Entrepreneurship Orientation → Innovation | 10,799 | 0.000 | Significant |
| H2 | Entrepreneurship Orientation → MSME Performance | 0.611 | 0.542 | Not Significant |
| H3 | Innovation → MSME Performance | 7,634 | 0.000 | Significant |

The R-square value indicates that the model has very high predictive power: 99.3% of the variance of innovation can be explained by entrepreneurial orientation, and 97.8% of the variance of MSME performance is explained by the combination of entrepreneurial orientation and innovation.

## 4.3 Discussion

### 4.3.1 Entrepreneurial Orientation Influences Innovation

The results of this study indicate that entrepreneurial orientation has a positive and significant influence on innovation. This means that Generation Z MSMEs who are proactive, innovative, and willing to take risks and compete (competitiveness) tend to be more capable of producing innovations in the form of products, services, and business processes.

This finding is consistent with the study by Astuti et al. (2024), which emphasized that the five dimensions of individual entrepreneurial orientation—including autonomy and competitiveness—have a positive impact on the innovation capacity of MSMEs. Furthermore, Clark et al. (2024) emphasized the important role of passion and perseverance in supporting the innovative process of young entrepreneurs.

Generation Z is known to be highly engaged with digital technology, thus strengthening their entrepreneurial orientation, particularly in the context of digital marketing, packaging, the use of AI, and short video content as promotional media (kompas.com, 2024). Therefore, this study supports the theory that entrepreneurial orientation is a crucial foundation for fostering sustainable innovation among young entrepreneurs.

### 4.3.2 Entrepreneurial Orientation Does Not Have a Direct Influence on MSME Performance

In contrast to initial expectations, the results of the study show that entrepreneurial orientation does not directly influence the performance of Generation Z MSMEs. This finding indicates that having an entrepreneurial attitude alone is not enough to directly improve business performance if it is not accompanied by the implementation of real innovation in the business.

These results support the findings of Astuti et al. (2024), who stated that entrepreneurial orientation will only have a significant impact on performance if mediated by innovation. Furthermore, Yaskun et al. (2023) also found that the direct effect of entrepreneurial orientation on performance is not always significant in digital-based MSMEs, as its effectiveness is highly dependent on strategy implementation.

This finding strengthens the argument that in the digital era and highly competitive markets, the success of MSMEs is not only determined by the psychological characteristics of business actors, but also by how these characteristics are converted into concrete business strategies, one of which is innovation.

### 4.3.3 Innovation Influences MSME Performance

The research results show that innovation has a positive and significant impact on MSME performance. This means that Generation Z MSMEs that actively innovate in products, services, marketing, and technology utilization will perform better in terms of profitability, sales growth, and operational efficiency.

These results align with research by Gomes et al. (2022), which states that service innovation and strategy have a strong correlation with business performance, particularly in the service and creative sectors. Innovation enables MSMEs to adapt to market changes, increase customer satisfaction, and create value-added product differentiation (Judijanto et al., 2023; Iqtishodia, 2024).

In the context of Generation Z, innovation is also accelerated by their ability to utilize digital data, read social media trends, and be flexible in trying new business models (Ullah Khan et al., 2024). Therefore, these results emphasize the importance of making innovation a primary strategy in developing MSMEs owned by the younger generation.

## 5. Conclusions and Implications

### 5.1 Conclusion

This study aims to examine the influence of entrepreneurial orientation on innovation and performance of Generation Z MSMEs in Indonesia, and to examine the mediating role of innovation in this relationship. Based on the analysis of 402 Generation Z MSMEs using the Structural Equation Modeling (SEM-PLS) method, several key conclusions were obtained, as follows:

1. Entrepreneurial orientation has a positive and significant influence on innovation. This means that the higher the level of individual entrepreneurship—reflected in dimensions such as proactiveness, innovativeness, risk-taking, autonomy, competitiveness, passion, and perseverance—the higher the capacity of MSMEs to generate product, process, and business model innovations.
2. Entrepreneurial orientation does not have a significant direct impact on MSME performance. This indicates that entrepreneurial characteristics do not necessarily improve business performance if they are not supported by innovation as a concrete action in responding to market opportunities and challenges.
3. Innovation has a positive and significant impact on MSME performance. Businesses that actively implement innovation have been shown to increase profitability, sales growth, and operational efficiency. Innovation is a crucial element in bridging the entrepreneurial orientation toward achieving optimal performance.
4. Innovation mediates the effect of entrepreneurial orientation on performance. In other words, entrepreneurial characteristics will only impact performance improvement if accompanied by the implementation of innovation. This mediation is full, as the direct effect of entrepreneurial orientation on performance is insignificant without innovation.

Overall, this study confirms the importance of innovation as a key variable in strengthening the relationship between entrepreneurial orientation and MSME performance, especially among Generation Z who have extensive access to digital technology.

### 5.2 Implications

Theoretical Implications

This study contributes to the literature on entrepreneurship and MSME management by integrating the concepts of entrepreneurial orientation, innovation, and performance in the context of Generation Z MSMEs. The finding that entrepreneurial orientation does not directly influence performance, but is mediated by innovation, enriches understanding of the importance of concrete actions in translating entrepreneurial characteristics into measurable business performance. This supports and complements the findings of previous studies (Astuti et al., 2024; Yaskun et al., 2023; Gomes et al., 2022).

Practical Implications

1. For Generation Z MSMEs: Improved skills in systematically managing and implementing business innovation are necessary. Having an entrepreneurial orientation alone is insufficient without the ability to translate it into innovative products, services, and strategies.
2. For the Government and MSME Development Institutions: The results of this study serve as a basis for designing innovation-based entrepreneurship training, especially for Generation Z. Business incubation programs, digital marketing training, and product innovation mentoring should be a priority in supporting young MSMEs.
3. For Education and Academics: These findings support the importance of integrating entrepreneurship curricula with innovative, practice-based approaches. Students need to be equipped not only with entrepreneurial theory but also with the skills to design and implement business innovations.
4. For Investors and Funding Platforms: Assessment of the business feasibility of young MSMEs should not only be based on entrepreneurial spirit, but also on the ability to actualize innovation that can be developed sustainably.

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