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LEVERAGING INITIAL CAPITAL AND INCOME THROUGH HR-DRIVEN INNOVATION: STRENGTHENING HUMAN RESOURCE MANAGEMENT EFFECTIVENESS IN MSMES

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Abstract

This study explores how initial capital, when strategically utilized through HR-driven innovation, enhances the effectiveness of human resource management (HRM) in Micro, Small, and Medium Enterprises (MSMEs). Drawing on data from 155 MSMEs and using multiple regression analysis, the findings reveal that initial capital, income, and HR-driven innovation significantly influence HRM effectiveness, particularly in areas such as talent development, employee motivation, and organizational adaptability. The interaction between initial capital and innovation indicates that financial readiness, when aligned with innovative HR practices, amplifies the capacity of MSMEs to manage and retain human capital effectively. Meanwhile, other variables such as age, number of dependents, working hours, business duration, monthly capital, monthly personal expenditure, education, marital status, and domicile showed no significant impact. These results underscore the importance of integrating financial strategy with human resource innovation to promote sustainable business growth.

Keywords: *Initial Capital, Income, HR-Driven Innovation, Human Resource Management Effectiveness, MSMEs, Financial and HR Strategy*

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Introduction

Micro, Small, and Medium Enterprises (MSMEs) are crucial drivers of global economic development, significantly contributing to employment and Gross Domestic Product (GDP). In Indonesia, MSMEs make up approximately 60.5% of the nation's GDP and provide employment to around 96.9% of the total workforce (BINUS UNIVERSITY, 2020). This substantial contribution underscores the essential role that MSMEs play in fostering economic growth and alleviating unemployment. However, despite their importance, many MSMEs face significant challenges, particularly in terms of accessing adequate financial resources (Ramadani et al., 2022). These financial constraints often limit their ability to invest in innovation, expand their operations, and maintain competitiveness in an increasingly dynamic business environment (Nguyen et al., 2022).

Access to capital is one of the key barriers hindering MSMEs' growth and innovation. A study by the International Finance Corporation (2022) emphasizes that as MSMEs grow, they tend to experience an increase in income and profitability, highlighting the critical role that sufficient capital plays in supporting business expansion. Without the necessary initial capital, MSMEs are less likely to invest in essential activities such as research and development (R&D), technology adoption, and human resource management (HRM) innovations. This lack of investment can hinder the ability of MSMEs to adapt to market changes, stifling their potential for growth and sustainability (Hameed et al., 2021).

Innovation has long been recognized as a vital factor in enhancing business competitiveness and sustainability (Ramdani et al., 2020). MSMEs that incorporate innovation into their products, services, and processes are better positioned to meet shifting market demands and differentiate themselves from competitors (Setyawan et al., 2023). Recent research indicates that the capacity for innovation has a direct positive correlation with MSME performance, suggesting that innovative practices can lead to increased profitability. MSMEs with innovative approaches to product development, customer engagement, and operational processes tend to perform better in competitive markets (López-Nicolás et al., 2020). As such, embracing HR-driven innovation is a powerful means of improving both organizational effectiveness and employee productivity.

The interaction between initial capital, income, and innovation is particularly significant in MSMEs's HRM Effectiveness. Adequate initial capital is not only necessary for day-to-day operations but also serves as a foundation for long-term strategic investments, such as research and development (R&D) activities and the adoption of innovative HR practices. Empirical evidence supports the notion that firms with robust initial investments and a focus on R&D are more likely to survive and thrive in the market (Choi et al., 2021). By fostering a culture of innovation within HR practices—such as talent development, employee motivation, and leadership development—MSMEs can enhance their internal capabilities, improve employee retention, and ultimately drive higher business performance (Cakar et al., 2020).

HR-driven innovation, a concept that integrates innovation into human resource management practices, is particularly relevant in this context. It refers to the development of creative and effective HR strategies that contribute to both employee satisfaction and organizational success (Amankwah, 2021). By leveraging HR-driven innovation, MSMEs can optimize their human capital, enhancing employee skills and fostering a work environment conducive to creativity and problem-solving (Susanti et al., 2020). This innovation can manifest in various forms, such as flexible work arrangements, employee training programs, and performance management systems that encourage innovation and collaboration.

The effectiveness of HRM in MSMEs is directly influenced by the financial readiness of the business. Financial capital enables MSMEs to implement HR-driven innovation strategies that can transform their workforce and improve operational efficiency. In turn, an innovative HR approach can help attract and retain skilled employees, boost morale, and improve organizational adaptability. The synergy between initial capital, income, and HR-driven innovation creates a dynamic environment where human resources are not only managed effectively, but are also empowered to contribute to the organization's growth and success.

Alongside financial capital, innovation, and income, other variables such as age, number of dependents, business duration, working hours, education level, marital status, domicile, monthly capital, and monthly capital expenditures have been examined in previous studies. These factors have yielded mixed results regarding their impact on MSME profitability and HRM effectiveness. For instance, some studies have suggested that older entrepreneurs with more experience are better at managing resources, while others have found that factors like education level and business size are more indicative of HRM success. Therefore, a comprehensive understanding of how these variables interact with capital and innovation is essential for developing effective strategies to enhance MSME performance.

This study aims to investigate the dynamic relationship between initial capital, income and HR-driven innovation in shaping HRM effectiveness within MSMEs. By analyzing data collected from 155 MSMEs, the research seeks to provide insights into how financial capital, when strategically invested in HR innovation, can optimize human resource management practices and improve organizational outcomes. The study will also explore other factors—such as as age, number of dependents, education, marital status, domicile, working hours, business duration, monthly capital, and monthly personal expenditures —that may influence the effectiveness of HRM in MSMEs.

The findings from this research will contribute to the broader literature on HRM in MSMEs and offer practical recommendations for entrepreneurs, policymakers, and financial institutions. By highlighting the importance of combining initial capital with innovative HR strategies, the study aims to inform the development of policies and financial products that support MSME growth and sustainability. Furthermore, the results will provide a clearer understanding of how HR-driven innovation can be leveraged to enhance workforce productivity, employee engagement, and overall business performance.

Ultimately, the integration of financial strategy with HR-driven innovation represents a promising approach to promoting sustainable growth in MSMEs. As MSMEs continue to play a central role in global economies, especially in developing countries like Indonesia, understanding the interplay between capital and innovation will be crucial for fostering their long-term success. Through this research, it is hoped that a roadmap for enhancing MSME competitiveness and profitability can be established, providing valuable guidance for businesses looking to thrive in an increasingly competitive marketplace.

Literature Review

Micro, Small, and Medium Enterprises (MSMEs) are critical to global and national economic development, particularly in emerging economies such as Indonesia. They contribute approximately 60.5% of the nation’s GDP and provide employment to around 96.9% of the workforce (BINUS University, 2020). Despite their economic relevance, MSMEs often encounter resource limitations, especially in terms of initial capital and strategic innovation capacity. These constraints pose significant challenges in managing human resources effectively, which in turn impacts business growth, competitiveness, and sustainability.

Initial capital is widely regarded as a foundational enabler for business development. In the context of HRM, adequate initial capital allows MSMEs to invest in talent acquisition, employee training, compensation systems, and technology that supports workforce development. The International Finance Corporation (2022) reported that firms with stronger capital foundations tend to have more structured HR systems and are more resilient in managing workforce challenges. In MSMEs, where resource constraints are common, initial capital can determine the extent to which HRM is formalized or remains informal and reactive.

However, capital alone is not sufficient. The role of innovation, particularly *HR-driven innovation*, has become increasingly significant in optimizing human resource practices. HR-driven innovation refers to creative approaches initiated by or integrated within HR functions, such as adaptive learning systems, digital recruitment strategies, or flexible work policies (Kraus et al., 2021). López-Nicolás et al. (2020) emphasized that innovation within HR practices enhances not only employee satisfaction and productivity but also organizational agility in competitive environments. MSMEs that apply innovation through their HR strategies are more likely to create inclusive, productive, and adaptive workplaces.

The interplay between initial capital and innovation is also a critical consideration. Choi et al. (2021) found that firms with both substantial initial capital and a high innovation orientation show better organizational performance, including effective human resource utilization. In other words, while capital provides the means, innovation guides the strategic use of those resources (Wibowo et al., 2021). In the context of HRM, this synergy can result in better employee engagement, higher retention, and stronger organizational culture—factors that are essential for sustainable MSME development.

Another important element is income. While often treated as an outcome variable, income also reflects a firm's resource-generating capacity, which in turn supports operational investments including HR initiatives. MSMEs with higher income can afford to allocate budgets for training, incentives, and employee well-being programs. Although not always a direct driver, income supports the sustainability of HRM practices by reducing financial vulnerability.

Prior research has also examined the influence of other demographic and operational factors, such as age, number of dependents, education, marital status, domicile, working hours, business duration, monthly capital, and monthly personal expenditure. However, the impact of these variables on HRM effectiveness in MSMEs has shown inconsistent results (IFC, 2022). Therefore, this study focuses on more strategic variables—capital, innovation, and income—that can be actively managed and leveraged.

Grounded in the resource-based view (RBV), which argues that competitive advantage arises from the effective combination of valuable, rare, inimitable, and organized resources, this study investigates how initial capital, HR-driven innovation, and income interact to influence Human Resource Management Effectiveness in MSMEs. The RBV provides the theoretical lens to understand how financial and innovative capabilities translate into HR outcomes.

Based on the literature and theoretical underpinning, the following hypotheses are proposed:

H1: Initial capital has a significant positive effect on HRM effectiveness.

H2: HR-driven innovation has a significant positive effect on HRM effectiveness.

H3: Income has a significant positive effect on HRM effectiveness.

H4 = Education has a significant positive effect on HRM effectiveness.

H5 = Domicile has a significant positive effect on HRM effectiveness.

H6 = Marital Status has a significant positive effect on HRM effectiveness.

H7 = Number of Dependents has a significant positive effect on HRM effectiveness.

H8 = Monthly Personal Expenditure has a significant positive effect on HRM effectiveness.

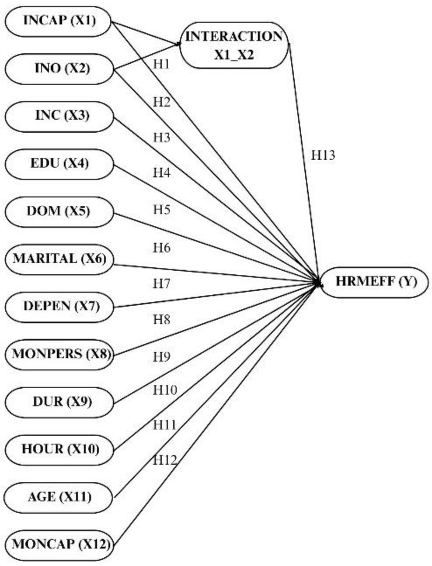
H9 = Business Duration has a significant positive effect on HRM effectiveness.

H10 = Working Hours has a significant positive effect on HRM effectiveness.

H11 = Age has a significant positive effect on HRM effectiveness.

H12 = Monthly Capital has a significant positive effect on HRM effectiveness.

H13: There is a significant interaction effect between initial capital and HR-driven innovation on HRM effectiveness.



Picture 1. Conceptual Framework

Accordingly, the conceptual framework for this research positions initial capital, HR-driven innovation, income, education, domicile, marital status, number of dependents, monthly personal expenditures, business duration, working hours, age, and monthly capital as independent variables influencing HRM effectiveness. The interaction between initial capital and HR-driven innovation is included as a moderating effect, positing that innovation enhances the impact of capital on HRM. This framework emphasizes strategic alignment between financial readiness and innovation culture as key to human resource success in MSMEs.

Methodology

This research employs a quantitative explanatory approach using a cross-sectional survey design. The primary aim is to investigate the relationship between initial capital, HR-driven innovation, and income on the effectiveness of Human Resource Management (HRM) in Micro, Small, and Medium Enterprises (MSMEs), including the interaction effect between initial capital and innovation. This study adopts a causal-comparative framework to test hypotheses and draw conclusions regarding the influence and interaction among variables.

The population for this study includes MSMEs operating in various sectors in East Java, Indonesia. Using purposive sampling, 155 MSME owners or HR-related decision-makers were selected as respondents. The inclusion criteria were that the MSMEs must have been operational for at least one year and employed at least three workers.

Data were collected through structured questionnaires distributed both online and offline. The questionnaire was divided into several sections, including demographic data (age, education level, marital status, number of dependents, and domicile), business profile (business duration and working hours), financial aspects (initial capital, income, monthly capital, and monthly capital expenditures), and HRM-related indicators (training, talent development, motivation, adaptability, and innovation in HR processes). All indicators were measured using a 5-point Likert scale, ranging from 1 (strongly disagree) to 5 (strongly agree).

This study examines the influence of several key variables on the effectiveness of Human Resource Management (HRM) within Micro, Small, and Medium Enterprises (MSMEs). The independent variables include initial capital (X1), HR-driven innovation (X2), and income (X3). Initial capital refers to the amount of financial resources invested at the early stage of the business, representing the entrepreneur's capacity to finance basic operations and HR functions. HR-driven innovation reflects the implementation of innovative human resource practices within MSMEs, such as the use of digital recruitment tools, flexible work arrangements, employee training initiatives, and strategies for enhancing workforce engagement. Income denotes the monthly income generated by the enterprise, serving as an indicator of business performance and financial stability. Then, there are other independent variables such as education (X4), domicile (X5), marital status (X6), number of dependents (X7), monthly personal expenditures (X8), business duration (X9), working hours (X10), age (X11), and monthly capital (X12). The model also incorporates an *interaction term (*X1*X2) to explore whether the effect of initial capital on HRM effectiveness is moderated or amplified by HR-driven innovation.

The dependent variable, HRM effectiveness (Y), is defined as the degree to which HR strategies and practices support key outcomes such as employee development, motivation, retention, and organizational adaptability. This concept reflects the overall quality and strategic alignment of HR functions in sustaining business performance.

Additionally, the study includes several variables to account for individual and business characteristics that may influence HRM effectiveness. These include the business duration, marital status, educational background, and domicile, as well as firm-specific attributes such as the number of years in operation, the number of employees, and working hours. These independent variables are incorporated to ensure that the relationships observed between the main variables are not confounded by external demographic or operational factors.

Before analysis, the questionnaire underwent content validation by three academic experts in MSME studies and HRM. A pilot test was conducted with 30 MSMEs. Results showed that all items met the minimum acceptable values for validity (r > 0.3) and reliability (Cronbach's Alpha > 0.70).

The collected data were processed using SPSS version 26. Descriptive statistics were used to summarize the demographic characteristics and business profiles of respondents. To test the research hypotheses, multiple linear regression analysis was employed. The model tested both direct effects and interaction effects using the following regression equation:

$$Y = \beta_0 + \beta_1 X_1 + ... \beta_2 X_{12} + \beta_{13}(X_1 * X_2) + \varepsilon$$

Where:

Y = HRM Effectiveness
X_1 = Initial Capital
X_2 = HR-Driven Innovation
X_3 = Income
X_4 = Education
X_5 = Domicile
X_6 = Marital Status
X_7 = Number of Dependents
X_8 = Monthly Personal Expenditure
X_9 = Business Duration
X_{10} = Working Hours
X_{11} = Age
X_{12} = Monthly Capital
$X_1 * X_2$ = Interaction Term
β_0 = Constant
ε = Error Term

The regression model was evaluated based on R^2, Adjusted R^2, F-test significance, and p-values for each coefficient. Additionally, classical assumption tests were conducted, including normality, multicollinearity (VIF), heteroscedasticity (Breusch-Pagan), and autocorrelation (Durbin-Watson).

Results and Findings

Table 1. Model Summary

Model Summary[b]				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	,473[a]	,223	,145	,45233

Source: SPSS

a.Predictors: (Constant), INCAP_INO, EDU, HOU AGE, MONCAP, INC, MONPERS, DOM, MARIT INCAP, DEPEN, INO, DUR

b. Dependent Variable: HRMEFF

Table 2. Anova

Anova[a]						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	8,184	14	,585	2,857	,001[b]
	Residual	28,439	139	,205		
	Total	36,623	153			

Source: SPSS

Table 3. Coefficients

Coefficients[a]						
	Unstandardized Coefficients		Standardized Coefficients			
Model	B	Std. Error	Beta	t	Sig.
1 (Constant)	-2,722	3,752		-,725	,469
EDU	-1,349 E-5	,034	,000	,000	1,000
DOM	-,380	,250	-,124	-1,520	,131
MARITAL	,050	,132	,040	,382	,703
DEPEN	-,028	,053	-,057	-,529	,598
MONPERS	-,022	,035	-,050	-,616	,539
INCAP	1,018	,397	,875	2,568	,011
MONCAP	,052	,078	,052	,668	,505
INC	,508	,095	,418	5,325	,000
INO	2,452	1,033	2,107	2,373	,019
AGE	-,123	,111	-,089	-1,108	,270
DUR	-,395	,881	-,872	-,448	,655
HOUR	-,643	1,630	-,112	-,394	,694
INCAP_INO	-,532	,217	-2,336	-2,449	,016

Source: SPSS

From the table above, the dependent variable is HRMEFF (Human Resource Management Effectiveness) and the independent variables are:

a. EDU: Education
b. DOM: Domicile
c. MARITAL: Marital Status
d. DEPEN: Number of Dependents
e. MONPERS: Monthly Personal Expenditures
f. INCAP: Initial Capital
g. MONCAP: Monthly Capital
h. INC: Income
i. INO: HR-Driven Innovation
j. AGE: Age
k. DUR: Business Duration
l. HOUR: Working Hours
m. INCAP_INO: Interaction between Initial Capital and Innovation

This study investigates the factors influencing the profitability of Micro, Small, and Medium Enterprises (MSMEs), using a multiple linear regression approach. The model shows an R Square value of 0.223, meaning that 22.3% of the variation in MSME profitability (HRMEFF) can be explained by the predictors used in the analysis. Although moderate, this level of explanatory power is quite reasonable for social and behavioral research, where business performance is influenced by numerous external factors. The F-test result from the ANOVA table shows a value of 2.857 with a significance level of p = 0.001, indicating that the overall regression model is statistically significant. This means the collective effect of all independent variables meaningfully predicts profitability, justifying further interpretation of individual predictors. Among the most critical predictors is income (p = 0.000), which has a strong and statistically significant positive impact on profitability. The unstandardized coefficient for income is 0.508, suggesting that an increase in income is directly associated with increased profit. This is in line with research conducted by Fajariyah (2022) and Ulfa et al. (2023). It is consistent with the economic logic that higher sales turnover strengthens business margins and financial outcomes.

Initial capital (p = 0.011) also plays a crucial role in determining MSME profitability. With a coefficient of 1.018, businesses that began with more substantial financial capital tend to achieve higher profit levels. The same results were also found in a study by Zakaria et al. (2024). This reflects how access to resources at startup allows MSMEs to invest in assets, processes, and staff that contribute to efficient and scalable operations. Equally significant is the variable innovation (p = 0.019), which represents HR-driven innovations such as digital recruitment, flexible work arrangements, and engagement strategies. The positive coefficient (2.452) shows that firms implementing such innovations tend to enhance their profitability. This is supported by research written by Akpa et al. (2024) and Saputra et al. (2024). This underlines the importance of adapting human resource practices to changing business environments and workforce expectations.

The model also includes an interaction term between initial capital and innovation (INCAP_INO, p = 0.016). Interestingly, the coefficient for this interaction is negative (-0.532), suggesting a moderating effect: while both capital and innovation independently enhance profit, their combined effect does not necessarily produce a proportional gain. In some cases, excess capital may lead to inefficient or misaligned innovation spending, reducing returns. This interaction effect can also be interpreted as a diminishing return: firms with limited capital may benefit more from innovation due to necessity-driven optimization, while those with ample resources may invest in innovation without precise alignment to business needs, thus decreasing efficiency. This finding emphasizes the need for strategic alignment between financial and innovation decisions in HR and operations.

In contrast, several demographic and operational variables—such as age (p = 0.270), number of dependents (p = 0.598), education (p = 1.000), marital status (p = 0.703), and domicile (p = 0.131)—did not show significant influence on profitability. This suggests that an entrepreneur's personal background may be less important than business-related strategic decisions in driving financial performance. Operational aspects such as working hours (p = 0.694), business duration (p = 0.655), and monthly capital (p = 0.505), and monthly personal expenditure (p = 0.539) also failed to reach statistical significance. This indicates that simply operating longer or working more hours is not enough to secure profitability; instead, targeted strategies involving capital use and HR innovation are more critical for performance outcomes.

In this study, we explored the intricate relationship between various factors influencing profitability in Micro, Small, and Medium Enterprises (MSMEs), with a focus on initial capital, income, innovation, and their interaction effects. The findings indicate a clear path where income, initial capital, and innovation emerge as central determinants of profitability. Income stands out as the most influential predictor, supporting previous research by Rojas et al. (2022), which emphasizes the significant role of sales and turnover in sustaining MSME performance. Additionally, the positive impact of initial capital (p = 0.011) reflects the capital structure theory, which suggests that a strong financial foundation enhances business stability and growth (Meyer & Pindado, 2023).

Interestingly, the analysis highlights the interaction between initial capital and innovation as a significant moderator. While initial capital facilitates the introduction of innovative practices, the negative coefficient for their interaction term suggests diminishing returns when both factors are excessively pursued. This finding resonates with previous work by Patel and McLean (2021), who argued that an overinvestment in innovation, without strategic alignment, may lead to inefficiency and reduced profitability. Thus, it is essential for MSME owners to adopt a balanced approach, leveraging their initial capital judiciously to fund innovative HR practices that align with their business needs and capacity.

Innovation (p = 0.019) itself is an important driver of profitability, confirming the relevance of HR-driven innovation as a competitive advantage. As pointed out by Choi and Kim (2020), innovation in HR practices, such as flexible work models and digital recruitment, can contribute to employee satisfaction, retention, and overall business success. The adoption of innovation in HR processes can enhance the adaptability and efficiency of MSMEs, ultimately improving their profit margins.

The results also suggest that demographic factors, such as age, education, marital status, and domicile, do not significantly influence profitability. These findings are consistent with recent studies (Chen et al., 2023; Mottola & Zhang, 2022) that argue personal characteristics of entrepreneurs might have less direct influence on business outcomes compared to strategic decisions such as investment in capital and innovation. This reinforces the idea that profitability hinges more on **business strategies** than on the entrepreneur's background or personal characteristics.

The non-significance of other operational variables, such as business duration, working hours, and expenses, further strengthens the argument that profitability is not simply a function of time spent or resource outlay. Instead, strategic decisions on capital deployment and innovation adoption play a pivotal role in driving MSME success. This aligns with the resource-based view (RBV), which posits that sustainable competitive advantage derives from the effective use of resources, including financial capital and human resources (Barney, 2021).

Conclusion

In conclusion, the study's findings suggest a complex yet coherent pathway from initial capital, income, and HR-innovation driven to HRM Effectiveness, with the interaction between these factors acting as a key moderator. MSME owners must **strategically manage both their financial and human resources to foster innovation** that aligns with their business capabilities. By doing so, they can ensure that capital and innovation work together synergistically to drive sustainable profitability. The role of the government through the Cooperative and MSEs Ministry is very much needed to provide capital for MSMEs to run their businesses, with selection criteria that need to be tightened so that the funds are not misdirected. In order for the capital to be used efficiently and drive innovation, intensive training or empowerment is needed for MSME owners.

The study highlights that profitability in MSMEs is most strongly influenced by income, initial capital, innovation, and the interplay between these elements. A key takeaway is that financial resources and modern HR strategies should not be applied in isolation but in a coordinated and context-specific manner. Additionally, the limited role of demographic and operational factors emphasizes that entrepreneurial success is more closely tied to smart business strategies than to personal traits or background characteristics.

Future research could further explore how different types of innovation—such as process or product innovations—impact profitability in specific MSME sectors, providing deeper insights into how innovation can drive sector-specific success.

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