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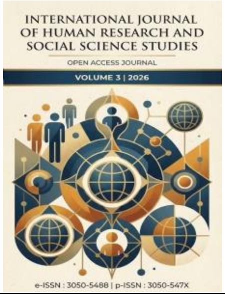

Strengthening SME Performance Through Integrated CSR, Innovation, and Competitiveness

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ABSTRACT: This study investigates the influence of Corporate Social Responsibility (CSR) and competitiveness on SME performance through innovation in Indonesia. Employing a quantitative approach, data were collected from 200 SMEs using structured questionnaires and analyzed through Structural Equation Modeling (SEM-AMOS). The analysis explores both direct and indirect relationships among CSR, innovation, competitiveness, and performance. The results demonstrate that CSR significantly influences innovation, and innovation significantly affects competitiveness. However, CSR does not have a direct impact on competitiveness or SME performance. Instead, competitiveness serves as a significant mediator between innovation and performance, while innovation mediates the relationship between CSR and competitiveness. This research provides an integrated framework connecting CSR, innovation, and competitiveness in driving SME performance, highlighting the pivotal role of innovation-driven CSR strategies. The findings underscore the need for SMEs to adopt CSR initiatives that foster innovation to enhance competitiveness and performance. Policymakers are also encouraged to design programs that support innovation-based CSR activities to promote regional economic growth. Despite its contribution, the study's scope is limited to SMEs in East Java, suggesting the need for future research across wider geographic contexts and with longitudinal data to validate and extend the proposed model.

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1. INTRODUCTION

Performance of Micro, Small, and Medium Enterprises (SMEs) refers to the ability of SMEs to achieve their business goals, reflecting the efficiency, effectiveness, and competitiveness of the company in conducting its business activities. Competitiveness and positive market reception. In addition, profitability demonstrates the efficiency with which SMEs convert sales into net income. High profitability indicates effective cost management and the ability to generate sustainable returns. Operational efficiency highlights how well an SME utilizes its resources such as labor, raw materials, and equipment—to produce goods or services. Firms that operate efficiently typically incur lower production costs, thereby enhancing their competitive advantage. Moreover, market share represents the extent to which an SME can capture and retain a portion of the market. An expanding market share signifies successful customer acquisition and strong positioning relative to competitors (Lombardi & Secundo, 2020). In the contemporary business landscape, increasing scholarly and managerial focus has been directed toward corporate sustainability, corporate social responsibility (CSR), social performance, and environmental stewardship. As sustainable practices are progressively recognized as critical to organizational resilience and longevity, the strategic integration of such initiatives is anticipated to serve as a catalyst for achieving and sustaining competitive advantage (Kļave & Bruksle, 2025).

Corporate Social Responsibility (CSR) refers to voluntary corporate initiatives aimed at enhancing societal and environmental welfare. Within the context of Micro, Small, and Medium Enterprises (SMEs), CSR serves as a strategic mechanism that can positively influence business performance. By engaging in socially responsible practices, SMEs are able to strengthen their public image and foster greater customer loyalty. A strong reputation not only enhances credibility among stakeholders but also contributes to increased consumer trust, thereby potentially boosting sales growth and expanding market share.

SMEs that effectively implement Corporate Social Responsibility (CSR) can achieve strategic differentiation in competitive markets. Firms that demonstrate strong commitment to social and environmental values are more likely to be favored by consumers over those that neglect such responsibilities. As consumer awareness of ethical and sustainable business practices continues to grow, SMEs that actively engage in CSR are better positioned to attract ethically conscious customers. This not only enhances their brand value but also enables them to penetrate emerging markets characterized by socially and environmentally aware communities.

Engagement in well-structured CSR activities allows SMEs to attract and retain skilled and motivated employees. Working for an organization that demonstrates genuine concern for social and environmental issues often enhances employees' job satisfaction and organizational pride, which in turn fosters greater productivity and long-term loyalty. Furthermore, governments frequently offer incentives and policy support to businesses that actively embrace CSR, recognizing their role in promoting sustainable development. By aligning their operations with social and environmental standards, SMEs also enhance their institutional legitimacy, facilitating smoother relationships with regulatory bodies and minimizing potential compliance-related risks.

The increasing emphasis on Corporate Social Responsibility (CSR) among Micro, Small, and Medium Enterprises (SMEs) has become a notable trend in countries such as Indonesia, Spain, and Vietnam. While many SMEs are initially founded to fulfill the financial needs of the owner's household, their objectives often evolve toward broader social purposes, including supporting community welfare. In many cases, SMEs engage in socially responsible practices informally, without explicitly labeling them as CSR. Some even take proactive steps to empower marginalized groups, such as economically disadvantaged individuals or women, thereby contributing to inclusive economic development at the grassroots level.

Although SMEs often generate meaningful social impact through their operations, such contributions are frequently informal, unstructured, and underreported. Given their close proximity and strong relational ties to local consumers and communities, SMEs tend to interact directly with their customer base on a daily basis. Unlike larger corporations, SMEs rarely maintain separate marketing or administrative offices apart from their production sites. A simplified survey indicates that 72% of consumers perceive SMEs as having a greater impact on local communities than larger enterprises. To leverage Corporate Social Responsibility (CSR) as a strategic tool for branding and market positioning, SMEs must systematically document and organize their ongoing socially responsible practices. This process requires active involvement from SME owners or managers to develop a coherent and well-defined CSR framework. Moreover, to strengthen sustainable development outcomes, particular attention should be directed toward innovation as a driving force for enhancing sustainability (Le et al., 2026).

Sustainability-oriented innovation refers to the purposeful integration of social, economic, and environmental considerations into the development of products, processes, and services (Baxter & Chipulu, 2023). This approach emphasizes the need for a balanced and strategic alignment of these dimensions in innovation activities, ensuring that sustainability is embedded in organizational design and operations (Baxter & Chipulu, 2023). High-performing SMEs often demonstrate strong capabilities in innovation and product or service differentiation, enabling them to gain a competitive edge in the marketplace. Innovation not only fosters distinctiveness but also enhances value creation. Moreover, customer satisfaction, recognized as a key indicator of SME performanceis typically driven by the quality and uniqueness of offerings. Satisfied customers are more likely to remain loyal and act as advocates for the business. In addition, SMEs that invest in employee development and provide avenues for skill enhancement signal effective human resource management, contributing positively to overall organizational performance (Martinez-Conesa et al, 2017).

While Corporate Social Responsibility (CSR) and innovation are widely acknowledged as key drivers of SME performance, there remains a scarcity of empirical research that simultaneously examines their combined influence on business outcomes (Huong et al., 2025). Some scholars argue that CSR does not exert a direct impact on financial performance. However, when mediated by intangible assets such as reputation, employee commitment, or organizational culture CSR can significantly enhance a firm's financial outcomes by leveraging these non-physical resources to create value Kumar et al., 2025).

Firms that actively engage in Corporate Social Responsibility (CSR) initiatives often demonstrate superior performance outcomes (Kumar et al., 2025). However, the strength of this relationship is significantly influenced by the level of innovation within the organization. Enhanced innovation performance amplifies the positive impact of CSR on overall firm performance, as innovation facilitates the development of sustainable and responsible business solutions that also yield economic value. Consequently, it is essential for organizations to strategically align CSR efforts with innovation processes, embedding them within the broader corporate strategy to ensure long-term value creation and competitive advantage (Martinez-Conesa et al., 2017).

The effectiveness of CSR and innovation initiatives is heavily contingent upon the level of competitiveness within SMEs. Competitiveness serves as a foundational enabler for successful CSR implementation. According to (Huong et al., 2025), SMEs with higher competitive capacity are more likely to possess the financial and organizational resources necessary to support socially and environmentally responsible programs. A strong competitive position not only facilitates the allocation of sufficient time and budget for CSR activities but also allows firms to innovate in ways that generate unique, hard-to-replicate solutions for societal and environmental challenges. This, in turn, enhances both the strategic impact and operational efficiency of CSR efforts.

This study focuses on small and medium-sized enterprises (SMEs) due to their substantial role in the Indonesian economy, contributing approximately 61.97% to the national Gross Domestic Product (GDP). As reported by the Ministry of Cooperatives and SMEs, there were 64.19 million SMEs operating across various sectors in 2021, generating an estimated economic value of Rp 8.6 trillion. In light of the mixed results found in prior empirical studies, this research adopts a contingency-based theoretical framework that positions industry competitiveness as a moderating variable. Specifically, the model posits that increased engagement in CSR activities enhances innovation capacity among SMEs, and when supported by strong competitiveness, this synergy significantly boosts overall business performance.

There are three main contributions in this research. First, conceptualizing and empirically testing CSR and Competitiveness in SMEs in East Java, which has previously been underexplored. Second, examining innovation as a mediator between CSR and Competitiveness on SME Performance. Third, resolving and confirming previous research findings on how CSR and Competitiveness affect SME performance. This research is conducted in East Java, Indonesia. East Java is one of the provinces in Indonesia with significant growth potential. Several industries in East Java are currently undergoing significant expansion, presenting strong prospects for enhancing regional socio-economic welfare. As one of the key contributors to the national economy, East Java plays a strategic role alongside other provincial business sectors across Indonesia. Supported by abundant natural and human resources, East Java holds substantial potential to advance into a more economically developed region. Notably, East Java maintains the second-largest provincial economy in the country, following Jakarta. Its advantageous geographic position particularly its access to major maritime trade routes further reinforces its status, accounting for approximately 20% of Indonesia's total trade volume.

2. HYPOTHESIS DEVELOPMENT

Influence of Corporate Social Responsibility on innovation

Corporate Social Responsibility in Spain plays a strategic role in enabling firms to improve their innovation capabilities and optimize both effectiveness and efficiency in their operations (Martinez-Conesa et al., 2017). Several studies have attempted to identify CSR strategies that most support innovation (Sharma & Vredenburg, 1998; Shao et al., 2024). Vargas-Hernández et al., (2024) shows that by using supply and demand theory as a framework, implementing environmental practices that exceed legal requirements can encourage investment in research and development, resulting in process and product innovation. CSR-driven innovation aims to produce products and services with social purposes in value creation. However, Ayyoob & Sajeev, (2025) analyzed the bidirectional relationship between CSR and innovation, sustainable practices not only in value creation and innovation. The SME sector in Europe, Italy, and France shows a strong and positive correlation between several variables related to CSR and competitiveness in two aspects, namely innovation and intangible performance.

Innovative products and services are expected to play a vital role in determining business competitiveness in the years ahead. While implementing Corporate Social Responsibility (CSR) can be challenging for SMEs, fostering innovation presents an even greater difficulty. As businesses evolve toward greater awareness of corporate sustainability, SMEs are gradually recognizing the intrinsic connection between innovation and sustainable practices. Drawing inspiration from CSR models in developed nations, Indonesian SMEs can also adopt such strategies not only to retain skilled employees but also to enhance their capacity for innovation. This approach helps bridge the existing research gap on the complex interplay between intellectual capital and CSR’s influence on innovation. Notably, SMEs that are highly committed to CSR are often the ones achieving superior performance, as their innovation-driven CSR efforts contribute significantly to improving overall business outcomes. Innovation can help ensure a more responsible and profitable approach, therefore the focus is on integrating activities to generate value (Martinez-Conesa et al., 2017). The way to increase both value and corporate sustainability is inseparable from the competitiveness built by the company. Strong competitiveness is expected to drive CSR performance, thus having extraordinary innovation for business sustainability and ultimately improving company performance.

Hypothesis 1: CSR has a positive effect on innovation

Corporate Social Responsibility on Competitiveness

Corporate Social Responsibility (CSR) is not merely a tool to enhance a company's public image, but a strategic approach that serves as an intangible asset in building sustainable competitive advantage. For small and medium-sized enterprises (SMEs), CSR is reflected through social, environmental, and economic initiatives that support employee welfare, community development, and environmental preservation. According to Stakeholder Theory, organizations are expected to meet the expectations of various stakeholders, and CSR acts as a concrete manifestation of this responsibility. When SMEs consistently apply CSR principles, they gain social legitimacy, foster customer loyalty, and strengthen community relations, all of which contribute to enhancing their competitiveness. Numerous studies have confirmed the positive impact of CSR on a firm's competitive edge. For instance, pharmaceutical manufacturing companies have significantly improved their competitiveness by fulfilling social responsibilities, with strong internal controls and equity incentives playing key roles as mediating and moderating variables in this relationship (Huang, Wan, Elahi, Peng, & Li, 2023). CSR initiatives, such as environmental and social projects, contribute to a company's reputational capital, which in turn boosts its competitive position in the market. Companies that actively engage in CSR are better able to attract investments, establish stronger partnerships, and adapt to market changes (Reznik et al., 2026). While CSR implementation might temporarily affect short-term financial gains, it contributes significantly to long-term financial performance and competitive advantage. The experience of Stellantis Slovakia illustrates this, showing a clear correlation between CSR initiatives, solid financial performance, and favorable employee sentiment (Cincalova, Mataruka, Masarova, & Muzurura, 2024).

Hypothesis 2: CSR has a positive effect on Competitiveness

Corporate Social Responsibility on SME Performance

Strategically, Corporate Social Responsibility (CSR) is designed not merely to pursue profitability, but to foster sustainable competitive advantage ultimately driving long-term improvements in overall business performance (Tiep, Huan, & Hong, 2021). Since the 1990s, companies have increasingly demonstrated a clearer commitment to Corporate Social Responsibility (CSR), which has expanded to encompass not only business ethics and labor practices but also environmental impact reduction and various social initiatives. Examined CSR strategies among both multinational corporations and small and medium-sized enterprises (SMEs), revealing notable differences (Mousiolis, Zaridis, Karamanis, & Rontogianni, 2015). SMEs tend to adopt CSR as a means of encouraging the internal implementation of socially responsible practices, shaped by their organizational characteristics. In contrast, multinational firms often possess structural advantages that support external CSR communication and reporting, yet these same characteristics may constrain their internal CSR policies. Additionally, factors such as personnel commitment and organizational sensitivity to social issues play a significant role. Strategic decision-making within both types of enterprises is heavily influenced by the extent to which stakeholder engagement shapes managerial choices.

Hypothesis 3: CSR has a positive effect on SME Performance

Innovation on SME Performance

Strategic CSR aims not only for profitability but also for the company's competitive advantage, which in turn will sustainably enhance company performance (Tiep et al., 2021). Companies have shown the role of corporate social responsibility more clearly since the 1990s, and on a much larger scale, the concept of CSR includes business ethics, labor practices, reducing environmental damage from production, and other social activities. Mousiolis (2015) analyzed CSR strategies applied in multinational companies and SMEs, and the results showed that SMEs have several organizational characteristics, namely that CSR aims to promote the implementation of CSR-related practices. Conversely, multinational companies have some advantageous characteristics for promoting external communication and reporting on CSR, but at the same time limit the company's internal policies. Issues such as differences in personnel dedication and company sensitivity to social matters are also important, as critical management decisions between SMEs and multinational companies align with how stakeholder involvement affects strategic decision-making.

An industry is considered competitive if it has a Total Factor Productivity (TFP) level equal to or higher than its foreign competitors. Innovation remains imperative and crucial, encompassing various innovations from products to processes. The impact of these innovations on revenue and processes must be noted, especially innovations aimed at the SME sector itself. However, innovation also needs to be designed at a low cost, so the focus should be on product efficiency and differentiation, including feasibility and quality improvement. Product innovation is the cornerstone of competitiveness in the creative industry, where uniqueness and novelty often drive consumer interest. Zan et al., (2024) emphasize the importance of open innovation, suggesting that SMEs can enhance their innovative capabilities by collaborating with external partners. In the creative sector, this may involve partnerships with artists, designers, and other industry stakeholders. The works of Schumpeter et al, (2003) underline the role of innovation in economic development. SMEs actively engaged in product innovation not only differentiate themselves from competitors but also contribute to the overall dynamics of the creative ecosystem. Understanding the factors driving or inhibiting product innovation is crucial for SMEs in East Java to navigate the ever-evolving creative landscape.

Innovation involves identifying and seizing opportunities to develop novel products, processes, or services that offer greater value than those of competitors (Chege, Wang, & Suntu, 2020). Technological innovation in both products and processes is often driven by multiple factors, chief among them being the pursuit of enhanced organizational performance (Al-Samalek et al., 2024). Business growth is largely driven by the ability of entrepreneurs to leverage their skills and knowledge in generating fresh, value-creating ideas (Botella-Carrubi et al., 2025). Innovations reflect the ability of business actors to identify and capitalize on opportunities that enhance organizational performance (Lukhmanov & Tsakalerou, 2024). In increasingly competitive business environments, the rapid development of new products, services, processes, and business models has become a strategic imperative. Innovation speed is now recognized as a critical determinant of firm performance and long-term viability (Teece, 2007). Organizations that demonstrate high innovation velocity are better positioned to capitalize on emerging opportunities, respond to market dynamics, and gain first-mover advantages. Accelerated innovation processes enable firms to reduce time-to-market, enhance responsiveness to customer needs, and ultimately improve profitability and market share (Davila et al., 2006). Therefore, innovation speed not only reflects organizational agility but also serves as a key driver of sustainable competitive advantage (Satar et al., 2025).

Hypothesis 4: Innovation positively affects SME Performance

Innovation on Competitiveness

Innovation is widely acknowledged as a critical factor in building sustainable competitive advantage, particularly for small and medium-sized enterprises (SMEs) that operate under resource constraints and intense market pressures. It encompasses not only the creation of new products, but also the renewal of processes, services, and business models that enable SMEs to remain agile and responsive to shifting consumer demands. Viewed through the lens of the resource-based view (RBV), innovation represents a strategic, inimitable asset that contributes to long-term differentiation. SMEs that consistently engage in innovation are better positioned to deliver added value through more functional products, streamlined operations, and improved service delivery. Consequently, product and process innovation have been shown to significantly enhance competitiveness by increasing operational efficiency, reducing costs, and unlocking new market opportunities (Muftiadi et al., 2024). Enhancing competitiveness, process innovation contributes significantly by streamlining operations and minimizing cost structures, thereby enabling firms to achieve greater efficiency and performance consistency. (Muftiadi et al., 2024).

Hypothesis 5: Innovation positively affects Competitiveness

Competitiveness on SME Performance

Competitiveness refers to a firm's ability to sustain and improve its market position through the strategic advantages it possesses. In the context of small and medium-sized enterprises (SMEs), competitiveness is reflected in their capacity to offer distinctive products or services, maintain operational efficiency, respond promptly to market demands, and adapt effectively to environmental changes. Enterprises with strong competitive capabilities are more likely to attract customers, expand market share, and ensure long-term business sustainability. This competitive edge ultimately contributes to improved SME performance, both financially through revenue growth and profitability and operationally, by enhancing efficiency and customer satisfaction. Market competition has also been shown to positively influence SME performance by stimulating investment, innovation, and production efficiency. For example, evidence from Russian manufacturing SMEs indicates that competition, whether from domestic or foreign firms, plays a pivotal role in driving performance improvement (Okrah, 2023). Di Ghana, persaingan pasar juga berkorelasi positif dengan kinerja UKM (Keelson et al., 2024).

Hypothesis 6: Competitiveness positively affects SME Performance

Based on the theoretical framework and the interrelationships among the variables, a conceptual model can be formulated to illustrate the relationship between Corporate Social Responsibility (CSR) and the performance of Small and Medium Enterprises (SMEs), mediated by innovation and competitive advantage. This model emphasizes the strategic role of innovation as a bridge linking social responsibility with business value creation, and highlights the importance of competitive advantage in enhancing the long-term performance of SMEs. This approach aligns with the core principles of stakeholder theory, which positions stakeholder expectation fulfillment as central to organizational sustainability and competitive excellence.

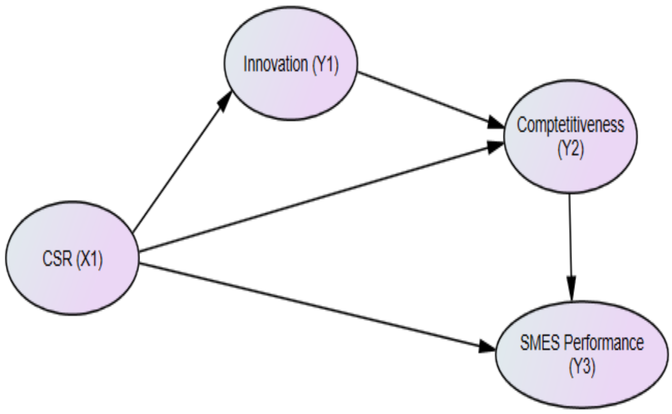

Figure 1. Conceptual framework.

3. DATA AND METHODS

This study aims to investigate the influence of CSR on MSME performance with Innovation and Competitiveness as mediating variables in SMEs in East Java. The research method uses a quantitative approach. The population consists of all SMEs in East Java, totaling 829,434 according to data from the Ministry of Cooperatives and SMEs in 2023. The research sample is a population of 238,687 SMEs. Because the sample is too large, and the analysis needs according to Sušić et al., (2023) recommend a sample size between 100 to 200, this study determines a sample size of 200 SMEs. The sample uses a simple random sampling technique taken from returned questionnaires, totaling 200 business actors. The data used are primary data, obtained directly from business actors. The demographic characteristics of the respondents are as follows: the majority of respondents are male (62.5%), while female respondents account for 37.5%. In terms of age, 45% of respondents are between 31–40 years old, 30% between 21–30 years old, 20% between 41–50 years old, and the remaining 5% are above 50 years old. Most respondents (54%) hold at least a bachelor's degree, while others have senior high school (28%), diploma (10%), or postgraduate education (8%). Regarding the business sector, 40% of the SMEs operate in food and beverage, 25% in fashion and crafts, 15% in services, and the rest in various other sectors. As for business age, 60% of SMEs have operated for more than five years, indicating an experienced group of entrepreneurs. In terms of scale, the majority employ 1–5 workers (68%), indicating that most SMEs in the sample are micro in size.

The research instrument is developed by defining the operational variables with indicators, which are then formulated into statements. Each variable is measured using an interval Likert scale with scores ranging from 1-5: a) Strongly Agree (SA) score 5, b) Agree (A) score 4, c) Neutral (N) score 3, d) Disagree (D) score 2, e) Strongly Disagree (SD) score 1. Validity and reliability tests are conducted using a pilot test (Anjaria, 2022). The data analysis method in this study will be conducted using Structural Equation Modeling (SEM-AMOS). Structural Equation Modeling is a model that explains the relationship between latent variables, hence SEM is often referred to as latent variable analysis or linear structural relationships (Cheah et al., 2024).

4. RESULTS

This study uses a questionnaire as the main tool to understand respondents' perceptions of the variables being studied. In this process, each respondent is encouraged to express their subjective views on the carefully detailed questionnaire items. Before conducting the SEM AMOS Hypothesis Test, the initial step is to test the feasibility of the Goodness Of Fit and SEM Assumptions, including tests of Validity, Reliability, Normality, and Outliers.

Table 1. Goodness Of Fit Test Results

Goodness of fit Index	Cut off value	Test result	Criteria
X^2 – Chi Square	≤α.df = 40 lebih kecil X^2 tabel = 55.758	43.236	*Good Fit*
Significance probability (p)	≥ 0.05	0.222	*Good Fit*
RMSEA	≤ 0.08	0.029	*Good Fit*
GFI	≥ 0.90	0.967	*Good Fit*
AGFI	≥ 0.90	0.931	*Good Fit*
CFI	≥ 0.90	0.995	*Good Fit*
NNFI/TLI	≥ 0.90	0.991	*Good Fit*
NFI	≥ 0.90	0.966	*Good Fit*

Validity Test

The validity test in this study uses Convergent Validity. Convergent Validity emphasizes that latent constructs should be correlated or have a high proportion of variance. The level of construct validity can be measured through factor loading. Two main criteria must be met: first, the factor loading must have statistical significance; second, the factor loading value or standardized loading estimate must be at least 0.5, ideally reaching 0.70 or more (Nonthing & Supakicco, 2021). The table 4 below shows the results of the standardized loading estimate output.

Table 2. Standardized Regression Weights

Description			Estimate
Y1	<---	X1	.694
Y2	<---	Y1	.883
Y2	<---	X1	.816
Y3	<---	Y2	.669
Y3	<---	X1	.534
Y3	<---	Y1	.715
X13	<---	X1	.821
X12	<---	X1	.520
X11	<---	X1	.575
Y11	<---	Y1	.537

Description			Estimate
Y12	<---	Y1	.789
Y13	<---	Y1	.811

Based on the results of the standardized loading estimate output above, all standardized loading estimates have shown significance and exceed the value of 0.5. Therefore, it can be concluded that the data used in this study has been validated.

Reliability Test

Reliability is an important measure for the internal consistency of a construct variable, reflecting the extent to which each indicator represents the overall construct. In this study, the method used is construct reliability, with a minimum reliability threshold of at least 0.70. However, reliability between 0.60 and 0.70 is still acceptable if the validity of indicators in the model is met (Nonthing & Supakicco, 2021).

Table 3. Construct Reliability calculation results

Variabel	Estimate	Standar Error	$\frac{\sum \lambda^2}{\sum \lambda i^2 + [\sum_{i=1}^{n} \delta i]^2}$		CR	Ket.
CSR	0.821 0.715 0.534	0.557 0.453 0.777	4.28 1.79	4.28 6.07	0.71	Reliabel
Innovation	0.52 0.575 0.537	0.238 0.206 0.244	2.66 0.69	2.66 3.35	0.79	Reliabel
Competitive ness	0.694 0.883 0.816 0.669	0.528 0.384 0.381 0.595	9.38 1.89	9.38 11.26	0.83	Reliabel
SME Performance	0.789 0.811	0.593 0.331	2.56 0.92	2.56 3.48	0.73	Reliabel

From the reliability testing results, it is evident that all dimensions or indicators forming the research construct have factor loadings ≥ 0.50, indicating good validity. Furthermore, with the overall Construct Reliability reaching ≥ 0.60, it can be concluded that all research variables, along with their dimensions or indicators, demonstrate adequate levels of reliability and validity.

Outliers Test

Outliers are observations with extreme values either univariately or multivariately. Detection of multivariate outliers is performed by examining the Mahalanobis Distance values. The criterion used is based on the Chi-Square value with degrees of freedom equal to the number of indicators at a significance level of $\rho < 0.01$ (Nonthing & Supakicco, 2021). The results of the outlier test show that the Mahalanobis d-squared value is smaller than the Chi-Square value, which is 43.236. This indicates that there are no outliers, or it can be said that there are no significant differences compared to other values within the data set. The next step is hypothesis testing, which involves examining the significance of direct and indirect effects to determine the magnitude of the direct and indirect relationships between variables.

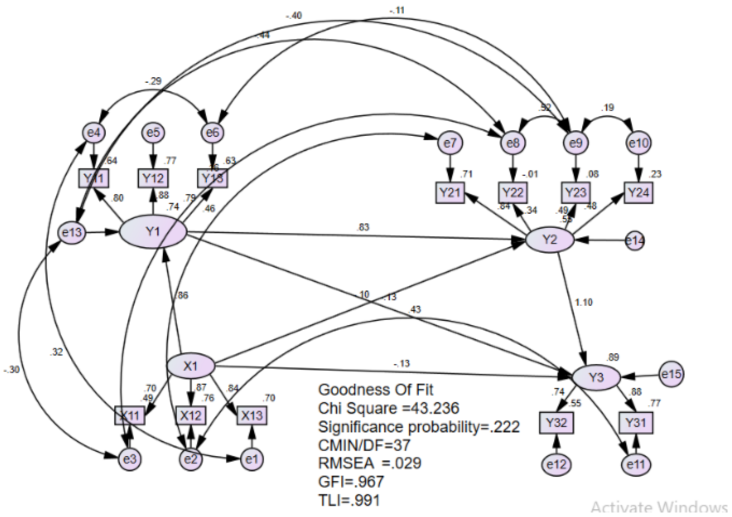

Figure 2. Hypothesis Test Results

The figure above shows that the structural equation model meets the model fit criteria. Therefore, the fundamental hypothesis of the SEM analysis in this study is accepted, meaning there is no significant difference between the covariance matrix of the observed variables and the covariance matrix of the specified model. This indicates that the two structural equations produced by the model in this study are capable of explaining the influence between exogenous and endogenous variables.

This study has 6 (six) proposed hypotheses to be tested. Hypothesis testing is conducted using the t-Value with a significance level of 0.05. The t-Value in AMOS 24 represents the Critical Ratio (C.R) in Regression Weight. If the Critical Ratio (C.R) ≥ 1.28 or the probability value ≤ 0.05, then the research hypothesis is accepted.

Table 4. Results of the First to Fifth Hypothesis Testing

Exogenous Variables And Endogenous Variables			Estimate	S.E.	C.R.	P	Desc
Y1	<--	X1	.925	.076	12.145	***	Accepted
Y2	<--	Y1	.807	.166	4.847	***	Accepted
Y2	<--	X1	-.101	.173	-.583	.560	Rejected
Y3	<--	Y2	1.246	.233	5.351	***	Accepted
Y3	<--	X1	-.150	.178	-.847	.397	Rejected
Y3	<--	Y1	-.141	.240	-.588	.557	Rejected

X_1= *Corporate Social Responsibility* (CSR)
Y_1= Innovation
Y_2= Competitiveness
Y_3 = SME performance

The results presented in Table 5 illustrate the outcomes of the hypothesis tests conducted. The first hypothesis examined the relationship between Corporate Social Responsibility (CSR) (X1) and Innovation (Y1). The t-value, or Critical Ratio (C.R), was 12.145, which is greater than 1.28, and the probability value was 0.000, which is less than 0.05. This indicates that the first hypothesis is accepted, suggesting that CSR has a positive impact on Innovation in SMEs in East Java. The second hypothesis investigated the effect of CSR (X1) on Competitiveness (Y2). The t-value for this relationship was -0.583, which is less than 1.28, and the probability value was 0.560, which is greater than 0.05. Consequently, the second hypothesis is rejected, implying that CSR does not have an impact on Competitiveness in SMEs in East Java.

The third hypothesis explored the effect of CSR (X1) on SME Performance (Y3). The t-value was -0.847, which is below 1.28, and the probability value was 0.397, exceeding 0.05. Therefore, the third hypothesis is rejected, indicating that CSR does not affect SME Performance in East Java. The fourth hypothesis examined the impact of Innovation (Y1) on SME Performance (Y3). The t-value was -0.588, which is less than 1.28, and the probability value was 0.557, greater than 0.05. Thus, the fourth hypothesis is rejected, suggesting that Innovation does not influence SME Performance in East Java. The fifth hypothesis looked at the relationship between Innovation (Y1) and Competitiveness (Y2). The t-value was 4.847, which is greater than 1.28, and the probability value was 0.000, less than 0.05. This means the fifth hypothesis is accepted, indicating that Innovation has a positive effect on Competitiveness in SMEs in East Java.

The sixth hypothesis assessed the effect of Competitiveness (Y2) on SME Performance (Y3). The t-value was 5.351, which is above 1.28, and the probability value was 0.000, below 0.05. Therefore, the sixth hypothesis is accepted, showing that Competitiveness positively affects SME Performance in East Java. Additionally, mediation testing was conducted to examine the indirect effects or mediating role of Innovation and Competitiveness in the relationship between CSR and SME Performance.

Table 5. Results of the Sixth and Seventh Hypothesis Testing

Exogenous Variables	Mediating Variables	Endogenous Variables	Standardized Coefficient of Direct Influence	Standardized Coefficient of Indirect Influence	Standardized Coefficient of Total Influence	Description
X_1	Y1	Y_2	-.096	.708	.612	Mediate
X_1	Y_2	Y_3	-.126	.566	.440	Mediate
Y_1	Y_2	Y_3	-.125	.909	.784	Mediate

X_1= *Corporate Social Responsibility* (CSR)
Y_1= Innovation
Y_2= Competitiveness
Y_3 = SME performance

Based on Table 8, the findings reveal the role of mediating variables in the study. The analysis compares the direct effects of exogenous variables on endogenous variables with their indirect effects and total effects. Firstly, the indirect effect of Corporate Social Responsibility (CSR) on Competitiveness through Innovation is 0.708, which surpasses the direct effect of CSR on Competitiveness, which is -0.096. This indicates that Innovation significantly mediates the relationship between CSR and Competitiveness.

Secondly, the indirect effect of CSR on SME Performance through Competitiveness is 0.566, which is higher than the direct effect of CSR on SME Performance, which is -0.126. This suggests that Competitiveness plays a crucial mediating role in the impact of CSR on SME Performance. Lastly, the indirect effect of Innovation on SME Performance through Competitiveness is 0.909, exceeding the direct effect of Innovation on SME Performance, which is -0.125. This highlights that Competitiveness effectively mediates the influence of Innovation on SME Performance.

5. DISCUSSION

Corporate Social Responsibility on innovation

CSR initiatives that encompass social and environmental dimensions have been shown to foster an organizational culture conducive to innovation. For instance, community empowerment programs enhance employee motivation and loyalty, which, in turn, increase the generation of creative ideas for product and service development. Additionally, SMEs engaged in environmental stewardship such as adopting eco-friendly materials or waste reduction technologies tend to be more responsive to changing consumer preferences, particularly those favoring sustainable products. This environmental sensitivity drives product innovation that is not only functional but also ethical and environmentally sustainable.

From an operational perspective, CSR contributes to process innovation. The adoption of energy-efficient technologies and environmentally friendly production methods, as part of the planet dimension of CSR, leads to improved efficiency and product quality. In East Java, for example, many SMEs have adopted LED lighting, repurposed organic waste, and implemented eco-packaging innovations. These efforts not only reduce operational costs but also create new product opportunities aligned with sustainability goals. Moreover, CSR fosters a collaborative business ecosystem. SMEs actively engaging with communities and stakeholders are more likely to benefit from knowledge sharing, access to training, and participation in government-supported innovation programs. East Java's strategic economic position, with its access to maritime trade routes and dynamic industrial growth, further amplifies the potential of CSR to serve as a gateway for SMEs to expand innovation capacity through cross-sectoral and regional collaborations.

These findings are consistent with previous studies by Martinez-Conesa et al. (2017;Shao et al., 2024), which emphasize that CSR enhances innovation capabilities by strengthening reputation, enabling knowledge exchange, and promoting organizational learning. In this regard, CSR functions as an intangible asset that supports an innovation-oriented strategic posture. Within the framework of stakeholder theory (Freeman et al., 2001), CSR reflects a firm's accountability to multiple stakeholders and fosters social legitimacy, thereby accelerating the adoption and diffusion of innovations.

In conclusion, CSR investment emerges as a long-term strategic approach that enhances SMEs' innovation capacity while contributing to sustainable business practices. For policymakers and SME support institutions in East Java, these findings underscore the importance of integrating CSR and innovation in development strategies to strengthen competitiveness and ensure SME resilience in an increasingly sustainability-driven market landscape.

Corporate Social Responsibility on Competitiveness

This finding underscores that, although CSR is often theoretically linked to enhanced competitiveness through improved corporate image, customer loyalty, and market differentiation, such effects have not been fully realized in the context of SMEs. One possible explanation is the inherent characteristics of SMEs, which frequently face resource constraints including limited financial capital, workforce capacity, and underdeveloped managerial systems. In many SMEs across East Java, CSR practices are implemented informally and are not systematically documented or strategically integrated. Common activities such as providing community assistance, involving local residents in production, or independently managing waste are often carried out without a clear understanding that these efforts fall within the scope of CSR. As a result, these practices have yet to be leveraged as differentiation strategies capable of strengthening market competitiveness. Additionally, low managerial literacy and limited awareness of CSR's strategic value render these initiatives reactive rather than proactive in nature.

Nevertheless, the mediation analysis offers critical insights, demonstrating that CSR indirectly influences competitiveness through innovation. In this pathway, CSR enhances a firm's capacity for innovation, which in turn significantly contributes to the development of competitive advantage. When CSR is oriented toward broader value creation such as energy efficiency, social engagement, and sustainable product development it fosters the emergence of new ideas, process improvements, and the reinforcement of unique organizational capabilities. These are essential components of competitive strategy.

East Java's dynamic economic landscape, particularly in the manufacturing and creative sectors, presents a significant opportunity for SMEs to position CSR-driven innovation as the foundation of their competitive edge. When CSR initiatives are directly linked to product quality improvements, operational efficiency, and responsiveness to increasingly sustainability-conscious consumers, the resulting innovations offer high added value that is difficult for competitors to imitate. For instance, SMEs in the food and beverage sector in regions such as Malang and Jember that adopt CSR practices—such as using locally sourced ingredients and eco-friendly packaging—are beginning to demonstrate competitive advantages. Innovations arising from such CSR initiatives not only enhance the aesthetic and functional value of their products but also strengthen brand reputation and customer loyalty.

The implication of these findings is the necessity of a strategic approach to CSR that is integrated with innovation orientation. Local governments and SME support institutions should provide training and capacity-building programs to help SMEs manage CSR systematically and utilize it as a catalyst for innovation. In doing so, CSR will not merely function as a social obligation but will serve as a powerful mechanism for developing sustainable competitive advantage among SMEs in East Java. This finding aligns with previous literature, particularly the works of (Baxter & Chipulu, 2023), which suggest that the impact of Corporate Social Responsibility (CSR) becomes significant when mediated by strategic elements such as innovation or other intangible assets.

Corporate Social Responsibility on SME Performance

This result suggests that although CSR is frequently associated with improved organizational performance through enhanced reputation, increased customer loyalty, or market differentiation such direct effects are not fully realized in the SME context, particularly in East Java.

One of the main reasons behind the non-significant direct effect is the inherent nature of SMEs, which often face limited access to capital, human resources, and formal organizational structures. Many SMEs continue to operate with a short-term survival mindset, focusing on daily operations rather than long-term strategic planning. As a result, CSR activities if conducted at all tend to be informal, undocumented, and reactive. Common CSR practices such as supporting local communities, using local raw materials, or reducing waste are usually carried out without a strategic framework that aligns these actions with measurable performance outcomes.

This finding is consistent with the study by Kumar et al., (2025), which emphasizes that the effect of CSR on firm performance is often indirect, mediated by intangible assets such as innovation, reputation, employee commitment, and social capital. In the case of SMEs in East Java, CSR becomes effective only when it contributes to the development of these strategic assets especially innovation which can then translate into improved performance outcomes, both operationally and financially.

Furthermore, the study also supports the findings of Martinez-Conesa et al. (2017), who demonstrate that CSR's impact on firm performance is mediated by innovation. Their research showed that the direct effect of CSR on performance diminishes when innovation is included as a mediating variable, indicating that without innovation, CSR alone may not be sufficient to enhance business performance.

This aligns well with the conditions of SMEs in East Java, which are mostly oriented toward short-term production and often lack the capacity to integrate CSR into long-term strategic planning. As a result, CSR activities are not yet positioned as tools for enhancing operational efficiency, increasing profitability, or strengthening customer retention. Even when CSR is implemented, its impact remains minimal without the support of structured innovation processes. Therefore, it is crucial for SME stakeholders and supporting institutions such as local government agencies, cooperatives, and business incubators in East Java to not only promote CSR implementation but also ensure that CSR initiatives are strategically aligned with innovation-driven efforts. For instance, CSR programs can be integrated into sustainable product development, environmentally friendly production systems, or employee training programs that lead to operational efficiency. Such actions will reinforce the link between CSR and performance through a relevant and applicable innovation pathway tailored to the local SME ecosystem.

Innovation on SME Performance

Although innovation is widely recognized in the literature as a key driver of business growth, efficiency, and differentiation (Lukhmanov & Tsakalerou, 2024), this result indicates that the benefits of innovation may not be immediately reflected in the short-term performance of SMEs, particularly within developing regions.

This outcome is particularly relevant to the characteristics of SMEs in East Java, the majority of which operate at a micro or small scale with limited infrastructure, financial access, and managerial capacity. Innovation practices among these SMEs are typically incremental and focused on basic improvements such as packaging modifications, minor product adjustments, or using locally sourced materials to reduce costs. While such initiatives are indeed innovative, they are often insufficient to generate substantial improvements in financial or operational performance in the near term.

These findings are consistent with those of Martinez-Conesa et al. (2017), who argue that innovation’s impact on firm performance becomes significant only when it is supported by strategic capabilities, organizational readiness, and a conducive external environment. Similarly, Muftiadi et al. (2024), in their research on Indonesian SMEs during the post-pandemic recovery phase, emphasize that innovation alone is not enough to enhance business performance unless it contributes to strengthening the firm's competitiveness. Thus, innovation should not be treated as an isolated objective, but rather as an integral part of a broader competitive strategy.

Importantly, this study’s mediation analysis demonstrates that innovation indirectly influences SME performance through competitiveness. This implies that innovation becomes truly effective when it leads to competitive advantages such as product uniqueness, operational efficiency, or faster market responsiveness. In this context, competitiveness acts as a critical pathway through which innovation translates into measurable performance outcomes. For example, SMEs in the culinary sector in Malang that adopt digital innovations in ordering systems and social media marketing may not experience immediate financial gains. However, these innovations enhance customer engagement, brand differentiation, and long-term market positioning, which ultimately contribute to sustained performance improvements.

These insights suggest that innovation must be aligned with strategic efforts to enhance competitiveness. For policymakers and SME development stakeholders in East Java, this implies that innovation support programs should go beyond technical training or product development. They must also facilitate market access, branding strategies, digital transformation, and partnership building. By doing so, innovation is positioned not merely as a creative endeavor but as a key enabler of sustainable SME performance through the enhancement of competitive capabilities. In conclusion, while innovation may not yield immediate performance outcomes for SMEs, its strategic integration into competitive frameworks holds significant long-term potential. This reinforces the importance of innovation as an indirect, yet essential, contributor to SME growth and success in emerging economies such as Indonesia.

Innovation on Competitiveness

This finding highlights the critical role of innovation in enhancing the competitive position of SMEs in increasingly dynamic and uncertain markets. Innovative SMEs are better equipped to respond swiftly to market demands, differentiate their products or services, and improve operational efficiency elements that collectively strengthen their competitiveness. In the context of SMEs in East Java, which are primarily concentrated in sectors such as food and beverage, handicrafts, and fashion, innovation extends beyond new product development. It also encompasses process innovations, service enhancements, and business model adaptations. Many SMEs have begun adopting simple technologies to increase productivity, such as small-scale automation tools, online ordering systems, or digital marketing strategies via social media platforms. These innovation efforts enable SMEs to react more quickly to consumer trends, reduce production costs, and deliver enhanced customer experiences.

These findings are consistent with those of Muftiadi et al. (2024), who emphasize that innovation is a critical determinant of SME competitiveness in Indonesia, particularly in the post-pandemic recovery period. Similarly, Kim et al., (2024) found that product and process innovations significantly contribute to strengthening the competitiveness of SMEs in manufacturing sectors. In your study, this concept is further reinforced through the resource-based view (RBV), which considers innovation as a strategic, inimitable resource that creates sustainable competitive advantage.

The competitive advantage derived from innovation is especially relevant in East Java's business landscape. The province offers a large domestic market and wide distribution access, especially through major trade routes and ports such as in Surabaya. SMEs that successfully leverage innovation to differentiate their offerings are better positioned to scale their businesses and expand to broader markets both regionally and nationally. For example, SMEs in the fashion and batik industries in Banyuwangi have gained competitive advantages by blending traditional batik motifs with modern designs tailored to global fashion trends. This product innovation, combined with cultural storytelling, creates strong market differentiation and enhances brand value, allowing them to compete more effectively with larger commercial brands.

The implication of these findings is that strengthening innovation must become a core strategy in enhancing SME competitiveness. Local governments, business incubators, and SME support institutions in East Java should focus on developing an enabling innovation ecosystem. This includes training in product design, support for digital transformation, and the formation of creative industry clusters. With such initiatives, innovation can be embedded as an organizational culture rather than a reactive tactic serving as a sustained driver of growth and competitiveness.

In conclusion, innovation plays a fundamental role in shaping the long-term competitiveness of SMEs. Policymakers and practitioners must not only encourage innovation but also integrate it into strategic development frameworks to ensure that SMEs are resilient, adaptive, and capable of thriving in evolving market environments.

Competitiveness on SME Performance

This result underscores the role of competitiveness as a critical factor that contributes to improved financial and operational outcomes for SMEs. Firms with higher levels of competitiveness reflected in product uniqueness, responsiveness to market changes, operational efficiency, and strong brand identitytend to perform better in dynamic business environments. In the context of East Java, SME competitiveness is not solely based on low-cost strategies but is increasingly driven by value-added differentiation, product innovation, customer engagement, and effective branding. Many SMEs in this region have leveraged local identity and cultural narratives to create market distinction, such as using indigenous raw materials, incorporating traditional designs, and promoting cultural heritage in their branding. These attributes are often difficult to replicate, creating a sustainable source of competitive advantage.

This finding is consistent with the study by Alimova (2017), which identified competitiveness as a key determinant of business performance, particularly in emerging markets characterized by volatility and rapid change. Similarly, Keelson et al. (2024) emphasize that SMEs with innovation-driven and efficiency-oriented competitive strategies are more likely to thrive in competitive markets. In your study, this relationship is further reinforced by the resource-based view (RBV) framework, where competitiveness is considered the outcome of internally developed, unique, and inimitable capabilities that contribute to sustained performance. In East Java, sectors such as food and beverage, fashion, processed agriculture, and handicrafts provide practical evidence of how competitiveness drives performance. For example, SMEs in the food and beverage sector that focus on product quality, attractive and eco-friendly packaging, and consistent digital marketing often report higher sales and profit margins. Likewise, fashion SMEs that follow market trends and develop strong brand stories demonstrate greater customer loyalty and improved sales performance.

Market responsiveness is another vital component of competitiveness. SMEs that adapt their products, services, or marketing strategies in alignment with shifting consumer preferences show significantly better performance outcomes than those that are slow to adapt. This flexibility is especially crucial in the post-pandemic era, where market conditions and consumer behaviors have changed rapidly. The implications of this finding are highly relevant for policymakers, SME development agencies, and business support institutions in East Java. Efforts to enhance competitiveness must go beyond financial assistance and technical training. Strategic support should include value-added development, digital branding initiatives, broader market access, and the cultivation of strong local brands. Competitiveness should not merely be viewed as a means for survival but as a strategic imperative for sustainable growth. In conclusion, competitiveness plays a fundamental role in shaping SME performance. By investing in internal capabilities and differentiation strategies, SMEs in East Java can build resilient, high-performing businesses capable of navigating complex and competitive markets.

6. CONCLUSION AND SUGGESTIONS

Conclusion

This study provides empirical evidence on the complex relationship between Corporate Social Responsibility (CSR), innovation, competitiveness, and the performance of SMEs in East Java. The findings demonstrate that while CSR does not directly influence SME performance, its effect is channeled through innovation and, subsequently, through competitiveness. Innovation alone does not have a direct impact on performance, yet it plays a critical mediating role by enhancing competitiveness. Competitiveness, in turn, has a significant and positive influence on SME performance, confirming its role as a key strategic asset in today's dynamic business environment. These results highlight the importance of embedding CSR practices within innovation-driven and competitiveness-oriented strategies. For SMEs, especially in emerging economies such as Indonesia, CSR should not be perceived merely as a compliance mechanism or philanthropic activity, but as a catalyst for innovation that strengthens market positioning. Competitiveness serves as the bridge through which CSR initiatives contribute to measurable improvements in business outcomes, including increased customer trust, operational efficiency, and financial performance.

Suggestions

This study contributes to the SME literature by emphasizing the pivotal role of competitiveness in transforming CSR efforts into tangible performance gains. It also offers practical implications for SME owners, policymakers, and development institutions, suggesting that fostering a culture of innovation and sustained competitiveness is essential for maximizing the benefits of CSR in small business contexts.

Future research should aim to overcome the limitations of this study by extending the observation period, enlarging the sample size, and including SMEs from diverse regions to enhance generalizability. Additionally, re-evaluating CSR indicators that are tailored to the SME context may yield more precise insights. Recognizing the multifaceted nature of SME performance, future investigations should also consider external variables such as market conditions, regulatory environments, and managerial competencies. Ultimately, SMEs that continuously adapt and strategically integrate CSR and innovation into their competitive framework will be better positioned to achieve sustainable growth and long-term success.

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