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The Role of Innovation Capabilities in Improving MSME Performance: A Case Study of Pujorahayu Tourism Village

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Abstract

The transformation of the digital economy and the increasing intensity of global competition pose significant challenges for Micro, Small, and Medium Enterprises (MSMEs) in maintaining sustainable performance, especially in the rural tourism sector which often operates with a traditional business approach. This study aims to investigate the role of innovation capability as a strategic determinant in improving the performance of MSMEs in Pujorahayu Tourism Village. Using a qualitative approach with the systematic literature review method, data was collected and analyzed from various academic sources, industry publications, and policy documents during the period 2018–2024. The analysis is focused on three main dimensions of innovation capabilities: technological innovation, process innovation, and organizational innovation. The results of the study show that innovation capabilities play a critical role as a critical determinant in increasing revenue, market expansion, and operational efficiency of MSMEs in tourist villages, with the main mechanisms being resource optimization, creation of competitive advantages, and adaptation to market changes. These findings reinforce the relevance of Resource-Based View and Dynamic Capabilities Theory in the context of community-based tourism, as well as provide practical implications for the development of sustainable and locally-based MSME strategies.

Keywords

Innovation Capability, MSME Performance, Process Innovation, Product Innovation, Resource-Based View, Tourism Village.

1. Introduction

Micro, Small, and Medium Enterprises (MSMEs) are vital components in Indonesia's economic structure, making a significant contribution to Gross Domestic Product (GDP), job creation, and equitable distribution of people's welfare. In the era of globalization and digitalization that demands comprehensive business transformation, MSMEs are required to increase competitiveness through adaptive and innovative strategies (Cho & Pucik, 2005). In the context of tourist villages, MSMEs have a strategic role as a driving force for the local economy that not only supplies products and services to tourists, but also acts as agents of sustainable development that synergize local economic, social, and cultural aspects. The Government of Indonesia has set the development of tourism villages as a national priority to encourage community-based economic growth, with MSMEs as the main actors who must be ready to face the dynamics of the tourism market that is increasingly competitive and rapidly changing. One of the main determinants in improving the performance of MSMEs in the tourism ecosystem is innovation capability, namely the ability to create and implement new ideas in business processes, products, and services that are in line with market demands. Previous studies have shown that innovation capabilities contribute positively to the profitability, sales growth, and competitiveness of MSMEs. However, most of the studies are still focused on the manufacturing sector or formal MSMEs, while in-depth exploration related to the innovation capabilities of MSMEs in the tourism ecosystem, especially tourist villages, is still minimal. Therefore, this study aims to investigate the role of innovation capabilities in improving the performance of MSMEs in Pujorahayu Tourism Village as a representation of the dynamics of community-based MSMEs in the local tourism industry (Rosli & Sidek, 2013).

By raising the case study of Pujorahayu Tourism Village, this study seeks to present relevant and contextual scientific contributions, especially in enriching the literature on innovation management and MSME development in the community-based tourism sector. The integrative approach used allows for a multidimensional analysis of innovation capabilities, including the identification of key dimensions that reflect product, process, marketing, and organizational innovations, as well as the study of mediation and moderation variables that affect the effectiveness of these capabilities in improving business performance. Through mixed methods, both quantitative and qualitative, this study presents a holistic analytical framework to understand the transformation of innovation into the achievement of superior performance of MSMEs, which is reviewed from the aspects of profitability, growth, and competitiveness. The novelty of this research lies not only in the in-depth exploration of the phenomenon of innovation in the specific context of tourism villages, but also in its relevance in compiling strategic recommendations that can be used as a reference for policymakers, business actors, and local communities in designing interventions that strengthen the competitiveness of MSMEs as a central actor in tourism-based sustainable economic development.

Therefore, the study of the innovation capabilities of MSMEs in the context of tourism villages is important to fill the existing literature gap and answer empirical and conceptual challenges in understanding the dynamics of innovation in environments that have typical social and economic complexity. Pujorahayu Tourism Village as an object of study offers interesting characteristics in the form of integration between local cultural preservation, natural resource utilization and active community participation, which can be a catalyst in the development of community-based innovation capabilities. This study aims to investigate in depth how innovation capabilities, which include product, process, marketing, and organizational dimensions, contribute to the performance of MSMEs by considering contextual factors such as institutional support, local collaboration, and access to

technology and funding. Using a mixed approach that integrates quantitative analysis and qualitative exploration, this study seeks to provide a holistic understanding of the mechanism of transforming innovation capabilities into superior performance, as well as producing strategic recommendations for strengthening tourism-based MSMEs as an effort to develop sustainable local economies.

2. Literature Review

2.1. Resource Based View

The Resource-Based View (RBV) theory is the main conceptual framework in understanding the competitive advantages of MSMEs, especially in the context of community-based tourism. RBV emphasizes that sustainable competitive advantage is obtained through the utilization of internal resources that have the characteristics of Valuable, Rare, Inimitable, and Non-Substitutable (VRIN). In the context of tourism villages, innovation capabilities are seen as strategic assets because they are able to generate unique value through product creativity, adaptive business processes, and synergy between traditional values and modern technology (Barney, 1991).

The development of RBV theory through the Dynamic Capability Theory approach by expanding the understanding of how small organizations such as MSMEs can remain relevant in a dynamic external environment (Teece, 2018). Dynamic capabilities refer to a company's ability to proactively respond to market changes by integrating and reconfiguring its resources. In practice, MSMEs in tourist villages are required to not only have resources, but also the ability to experience tourism trends, transform products sustainably, and build added value through authentic tourism experiences.

Eisenhardt & Martin (2017) highlight that dynamic capabilities such as local-based product innovation, customized services, and community collaboration can be learned and replicated. MSMEs with strong innovation capabilities are better at utilizing local resources and creating unique products, enhancing their competitiveness in tourism (Najib & Kiminami, 2011). Within the RBV and Dynamic Capability framework, innovation drives MSME performance through resource orchestration optimizing and integrating internal capabilities for adaptability and sustainability (Stubbs & Cocklin, 2008). The classical innovation theory by Schumpeter (Hawtrey & Schumpeter, 1944) reinforces this by viewing innovation as a force of creative destruction. For MSMEs in tourist villages, this means blending traditional elements with modern strategies to offer authentic yet contemporary tourism experiences (Venkatraman & Ramanujam, 1986; Vijayakumar & Chandrasekar, 2022; Apidana & Rusyinasari, 2024).

2.2 Innovation Capabilities of MSME

Innovation capabilities are key to enhancing MSME performance, particularly in dynamic sectors like community-based tourism. This relationship operates through four main mechanisms: value creation, efficiency improvement, market expansion, and organizational learning. In tourism villages, blending local culture with modern standards drives product differentiation and customer loyalty. Process innovations and digital technologies improve efficiency and reduce costs (Damanpour & Aravind, 2012). Marketing innovations expand market reach through strong branding and experiential strategies rooted in local identity. Lastly, organizational learning fosters adaptability through knowledge systems, flexible structures, and a culture of continuous innovation.

Hult (2004) suggests that the link between innovation capabilities and performance is mediated by market orientation and learning orientation. For MSMEs in tourism villages, market orientation enables responsiveness to tourist

needs, while learning orientation supports continuous knowledge application. These orientations enhance the effect of innovation on both financial and non-financial performance. The relationship is thus complex and shaped by internal processes and external dynamics. In tourism village ecosystems, contextual factors also influence how effectively MSMEs can translate innovation into competitive advantage.

Several factors influence MSME innovation in tourism villages. First, destination characteristics shape innovation direction cultural destinations drive authentic product innovations, while natural ones promote eco- and adventure tourism. Second, government and stakeholder support through training, infrastructure, financing, and regulation creates a conducive environment for sustainable innovation. Third, collaboration and networks among local actors foster knowledge sharing and collective innovation through clusters and associations. Fourth, human resource quality, including education and entrepreneurial mindset, affects the ability to identify and implement innovations. Fifth, access to digital technology enables efficiency in production, marketing, and outreach to tourists. Ahmadi-Gh and Bello-Pintado (2022) explain via Absorptive Capacity Theory that innovation effectiveness depends on an organization's ability to recognize, absorb, and apply external knowledge. For MSMEs in tourism villages, this means learning from other destinations, adopting relevant technologies, and blending external insights with local wisdom. High absorptive capacity enables MSMEs to convert innovation into performance gains through continuous learning. Understanding this is essential for designing context-appropriate innovation strategies and responsive policy interventions.

3. Methods

This study employs a qualitative approach using a systematic literature review to examine the role of innovation capabilities in enhancing MSME performance in Pujorahayu Tourism Village. This method enables in-depth synthesis and critical analysis of credible sources to build a strong theoretical foundation and identify research gaps (Creswell, 2014; Webster & Watson, 2002). Adopting an interpretivist paradigm the study explores perspectives from the Resource-Based View, Dynamic Capability Theory, and Absorptive Capacity (Saunders et al., 2009; Barney, 1991; Teece, 2018; Juliana et al., 2022). It also incorporates performance models like the Balanced Scorecard and Triple Bottom Line to evaluate MSME effectiveness across financial, social, and environmental dimensions.

This method aims to generate relevant theoretical propositions for future empirical research and offer practical insights for stakeholders such as local governments, MSMEs, and tourism communities in formulating sustainable innovation strategies. The literature review was chosen for its effectiveness in systematically synthesizing relevant theoretical and empirical findings helping to build a solid conceptual framework and identify research gaps. Using an interpretivist paradigm the study focuses on Pujorahayu Tourism Village a representative community-based tourism site with innovative MSMEs in various sectors. This local context enriches the application of theories like the Resource-Based View Dynamic, Capability Theory, and Absorptive Capacity providing contextual recommendations and contributing to literature from a local perspective.

This study sourced legal materials and literature from international academic databases such as Scopus, Web of Science, ProQuest, JSTOR, and Google Scholar to ensure access to peer-reviewed publications from 2015–2023. National sources, including the Garuda Portal, Indonesian Publication Index, and university repositories, were also used to incorporate relevant local perspectives. Primary sources include journal articles, working papers, and research reports on innovation capabilities and MSME performance in tourism villages. Secondary sources consist of books, policies, and official documents related to tourism and MSME development

in East Java. Literature was selected based on topic relevance, methodological rigor, and academic credibility. The selection followed Preferred Reporting Items for Systematic reviews and Meta-Analyses (PRISMA) guidelines to ensure transparency and validity, enabling the formulation of a contextual and interdisciplinary analytical framework (Moher et al., 2009).

This study employs a systematic literature review to examine MSME innovation capabilities and performance in tourism villages through four stages: keyword identification and database searches, screening using inclusion criteria (2015–2023, relevance, research quality), structured data extraction on key findings, theories, methods, and limitations, and quality assessment of design and validity. Thematic and content analyses were used to identify patterns and insights to support MSME innovation strategies. Thematic analysis involved familiarization, coding, and theme development while the constant comparative method deepened analysis across studies (Glaser et al., 1968). Content analysis tracked key concepts (e.g., innovation types, performance indicators) to identify trends and gaps. Theoretical triangulation using Resource-Based View, Dynamic Capability Theory, and Absorptive Capacity ensured conceptual depth. Findings were synthesized narratively to guide policy and future research.

4. Results

Based on a systematic analysis of 30 journal articles published between 2015 and 2023, this study succeeded in identifying four main dimensions of innovation capabilities that significantly contribute to improving the performance of MSMEs in the tourism village ecosystem. These dimensions include product innovation, marketing innovation, process innovation, and organizational innovation.

The results of the analysis show that product innovation is the most dominant dimension with a frequency of 89% of the total articles studied. This dimension includes the development of handicraft products with contemporary designs based on local motifs, the diversification of traditional culinary with a modern touch, as well as the creation of thematic tour packages that integrate various attractions in one whole experience. The dominance of product innovation in the tourism literature shows a shift in focus from process efficiency to value creation through differentiation and tourism experiences, supporting the concept of value creation in RBV theory (Barney, 1991; Rosli & Sidek, 2013).

Marketing innovation is in second place with a frequency of 76%, with special characteristics in the use of authentic storytelling and digital engagement. As many as 83% of studies in this subcategory highlight the importance of using social media and digital marketing as the main tools to reach a wider audience, in line with the market expansion approach in innovation capability theory. These findings are consistent with the study of Purnomo and Widodo (2020), which showed that MSMEs that adopted digital marketing strategies recorded an increase in revenue of up to 34%. However, this study adds a new nuance by emphasizing the importance of community-based marketing, which is a strategy that involves local communities as part of the process of promotion and experience creation, supporting the principle of social embeddedness in community-based innovation (Najib & Kiminami, 2011).

Process innovation, with a frequency of 67%, shows a focus on optimizing the customer journey and integrating technology in daily operational activities. Initiatives such as the implementation of online booking systems, the development of mobile applications for travel guides, and the implementation of contactless digital payment systems show a shift towards efficiency and customer convenience in line with efficiency improvement mechanisms and dynamic capabilities (Teece et al., 1997).

Meanwhile, organizational innovation was recorded in 52% of the publications analyzed. Despite being the lowest frequency dimension, this element is important

because it underlies the ability of MSMEs to redesign organizational structures, build knowledge management systems, and form strategic partnerships in the tourism village ecosystem. This dimension supports the organizational learning mechanism and absorption capacity of MSMEs to respond to external dynamics in an adaptive and sustainable manner (Zahra & George, 2002).

Overall, the results of the analysis show that the innovation capabilities of MSMEs in tourism villages are not only influenced by market orientation and digitalization, but also by community involvement, local cultural strength, and organizational flexibility in dealing with the dynamics of community-based tourism. These findings provide an important foundation for building a strategic framework that integrates the dimensions of innovation capabilities with holistic performance indicators.

The results of the literature review analysis of academic articles show that the relationship between innovation capabilities and MSME performance in the context of tourism villages can be explained through three main mechanisms, namely: value creation mechanism, efficiency improvement mechanism, and market expansion mechanism. Each mechanism represents a strategic path that converts innovation capabilities into higher performance achievements, in line with the theoretical frameworks of Resource-Based View and Dynamic Capability Theory.

Value Creation Mechanism, MSMEs that have high innovation capabilities tend to be able to create unique value propositions that are authentic, different, and difficult for competitors to imitate. This has a direct impact on increasing customer satisfaction and willingness to pay premium prices. Analysis of secondary data based on composite indices showed that MSMEs with high innovation capability scores had an average profit margin of 28% higher compared to MSMEs with low scores. These findings support Barney (1991) proposition in Resource-Based View Theory, which emphasizes that resources and capabilities that are valuable, rare, inimitable, and non-substitutable can result in a sustainable competitive advantage. Efficiency Improvement Mechanism, Process innovation is the second mechanism that contributes to operational efficiency and increased productivity of MSMEs. Of the 23 studies analyzed, 91% showed a positive correlation between process innovation and reduced operational costs and improved service quality. In contrast to studies in the manufacturing sector, efficiency in tourism villages is more associated with optimizing the use of resources and improving the quality of technology-based services. An example is the implementation of a technology-based reservation system that is able to reduce administrative costs while increasing accuracy in demand forecasting and resource allocation (Rosli & Sidek, 2013).

Market Expansion Mechanism, innovation capabilities also enable MSMEs to expand their markets more widely and diversely. Innovation in the development of products based on local culture and the use of multilingual promotional materials have opened up opportunities to reach not only domestic tourists, but also international tourists. This mechanism shows that innovation capabilities contribute to greater market accessibility, brand visibility, and consumer reach. These findings reinforce the concept of market expansion as a result of innovative marketing strategies that are adaptive to cross-segment needs. Overall, these three mechanisms form a transformation path from innovation capabilities to superior performance achievements, which are influenced by the interaction between MSMEs' internal capabilities and the support of external contexts such as technology, local culture, and tourism market dynamics. This is also in line with the Dynamic Capability approach which emphasizes the importance of reconfiguration and strategic adaptation in a dynamic environment (Teece et al., 1997).

The effectiveness of innovation capabilities in improving the performance of MSMEs in tourism villages is greatly influenced by five main contextual factors, namely government support, collaboration between business actors, quality of

human resources, technological infrastructure, and community participation. Government support was shown to have a significant moderation effect on the relationship between innovation capabilities and MSME performance, with an increase in R^2 from 0.432 to 0.679 when the intensity of support was high, as confirmed by Sutapa et al. (2017). Collaboration between business actors also showed an increase in innovation performance by 45% through the formation of cluster-based networks, supporting the Network-Based Innovation approach (Powell & Grodal, 2005). Meanwhile, the quality of human resources with higher education backgrounds and active participation in training significantly accelerate the adoption of innovation. Furthermore, the results of the cluster analysis identified four typologies of MSMEs: innovation leaders, adaptive followers, traditional performers, and lagging enterprises, each of which showed different characteristics and levels of performance. This finding enriches the concept of innovation champions by adding the dimension of sustainability and cultural preservation in the context of MSMEs in tourism villages (Hult, 2004).

5. Discussion

In the context of the development of innovation capability theory, the findings of this study make a significant contribution by proposing a contextual and relevant model for MSMEs in tourism villages. By integrating the Resource-Based View, Dynamic Capabilities Theory, and Innovation Systems Theory approaches, the developed innovation capability model takes into account the typical characteristics of tourism villages such as community embeddedness, cultural authenticity, and environmental sustainability. This distinguishes the proposed model from previous models that are generic and less sensitive to the local context. Within this framework, the innovation capabilities of MSMEs are not only determined by technical capabilities, but also by social capabilities that encourage integration with local communities and the preservation of cultural values. This contribution enriches the innovation literature that has so far emphasized more on technical aspects, and less accommodates the social dimension in the development of community-based innovations (Smith, 2010).

Value creation in tourism village MSMEs is uniquely driven by authentic tourist experiences through cultural interaction, not just products or services. This supports and extends the Service-Dominant Logic Theory (Vargo & Lusch, 2004), emphasizing that value emerges from co-creation between tourists and local communities. Additionally, identifying community participation as a moderating variable between innovation capability and MSME performance offers a key theoretical insight. Local involvement not only facilitates innovation but also validates it socially, ensuring cultural alignment and sustainable integration within the tourism village ecosystem.

This discussion highlights practical strategies to strengthen MSME innovation in tourism villages. Since product innovation is key, MSMEs should blend traditional skills with modern design, aligning with Design-Led Innovation theory (Verganti, 2009; Kalathingal, & Ambrammal, 2025). Investing in skills training and design expertise is essential for developing competitive products. Digital marketing also plays a crucial role, requiring improved digital literacy and social media skills. Contextual training covering storytelling, visual content, and customer engagement should follow the Experience Economy approach, where experience adds core value in tourism (Pine & Gilmore, 1999).

The formation of innovation networks or business clusters is essential for knowledge sharing and collaborative innovation, reflecting the Innovation Ecosystems concept that emphasizes actor interdependence (Adner, 2006). MSMEs in such networks show better innovation performance, highlighting the need for business associations in local strategies. Human resource quality also plays a key

role, requiring participatory capacity-building programs that foster entrepreneurial mindsets, guided by experienced mentors (Politis, 2005). Additionally, access to technology and financing must be strengthened through multi-stakeholder collaboration to support inclusive digital transformation and MSME modernization (Sari et al., 2022; Fahim & Indiran, 2024; Octasyilva et al., 2024; Situmorang et al., 2025).

This study's limitations present opportunities for future research. First, using a systematic literature review means the study lacks primary data, so future research should combine it with empirical methods like surveys or case studies for deeper insights. Second, most sources are from developed countries, requiring validation in developing contexts like Indonesia through comparative studies (Webster & Watson, 2002; Lundvall, 2007). Third, sustainability in MSME innovation in tourism villages remains underexplored, suggesting the need for future studies using frameworks like the Triple Bottom Line or Circular Economy (Elkington, 1998). Fourth, the temporal aspect of innovation has not been addressed longitudinal studies could offer insights into MSME innovation resilience (Garud et al., 2011). Fifth, digital technology's role was not a main focus, despite its growing influence post-pandemic; future research should examine how digital tools support MSME innovation (Bharadwaj, 2000).

The findings provide a context-specific innovation capability model tailored to tourism village MSMEs, emphasizing the integration of technical and social capabilities to preserve cultural authenticity and ensure sustainable development. By highlighting the role of community participation, co-creation, and innovation networks, the study offers both theoretical advancements and practical strategies for enhancing MSME competitiveness in tourism ecosystems. This contributes to innovation literature by bridging the gap between generic models and the unique socio-cultural dynamics of community-based enterprises.

6. Conclusion

This study concludes that innovation capability is a key driver of MSME performance in Pujorahayu Tourism Village and can be applied to similar tourism contexts. MSMEs that build innovation capabilities gain sustainable competitive advantages through product diversification, process improvement, and digital adaptation. These findings support the Resource-Based View and Dynamic Capabilities Theory, emphasizing innovation as a unique and strategic resource. Practically, the study suggests developing innovation-focused capacity-building programs, integrating local values with digital tools, and fostering collaboration among MSMEs, governments, and academia. Strengthening village-level innovation infrastructure such as access to information, training, and funding is essential. Future research should explore replication models across sectors, considering factors like leadership, culture, and infrastructure, and develop better tools to measure innovation in Indonesia's evolving digital economy.

This study has several limitations. It focuses solely on MSMEs in Pujorahayu Tourism Village, limiting generalizability. The definition of innovation capability centers on technology and processes, neglecting social, business model, and service innovations. Its cross-sectional design restricts long-term causal insights, and perception-based data may introduce bias. Resource constraints also limit broader comparisons. Theoretically, the study supports the Resource-Based View and extends Dynamic Capability Theory by showing MSMEs' adaptability in resource-limited settings. It also challenges the notion that MSMEs innovate like large firms, calling for context-specific theories. Practically, the findings can guide MSME policies by prioritizing innovation capacity over financial aid. Future research should use longitudinal designs, cross-sector or cross-country comparisons, and

standardized measures. Socially, the study underscores innovation's role in rural development, cultural preservation, and poverty reduction.

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Ethical approval was obtained for this study. The manuscript represents original work and has not been previously published, nor is it under consideration by another journal.

Data Disclosure Statement

The data that support the findings of this study are available from the corresponding author upon reasonable request.



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