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Analyzing the Impact of Tax Policy on Financial Performance and Compliance of MSMEs in Indonesia

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ABSTRACT: The complex relationship between tax policy components and the financial performance of Micro, Small, and Medium Enterprises (MSMEs) in Indonesia is examined in this study. A survey was conducted with a sample of 250 MSMEs to capture different industry types, firm sizes, and geographical regions. The study assessed the relationship between tax rates, tax incentives, firm size, industry type, and financial performance indicators using Structural Equation Modeling with Partial Least Squares (SEM-PLS). The structural model yielded important insights, while the measurement model demonstrated good validity and reliability. As lower profitability correlates with higher tax rates, policymakers should consider the tax burden of MSMEs. On the other hand, tax incentives show a good correlation with financial performance, suggesting that they may be useful in encouraging MSME expansion. The complex interaction between firm size industry type and financial performance is highlighted. The SEM-PLS model fits the data well, according to the model fit assessment. To support the sustainable expansion of MSMEs in Indonesia, policymakers and MSME owners can benefit from the results of this study, which has practical implications such as for the Government is the present policies need to be evaluated in order to improve MSME compliance. Meanwhile, it is important for MSMEs to improve their competencies such as financial literacy.

Keywords: MSMEs, Tax Policy, Financial Performance, Indonesia, Structural Equation Modeling

INTRODUCTION

Micro, Small, and Medium-Sized Enterprises (MSMEs) are the backbone of Indonesia's economy and have a substantial impact on the country's economic environment. These businesses significantly boost employment, encourage innovation, and propel the economy as a whole. MSMEs are crucial to Indonesia's economic growth and to the reduction of unemployment and poverty (Atichasari & Marfu, 2023; Harsono, 2023). MSMEs are crucial for boosting employment prospects and surviving economic downturns (Yose, 2023). Nonetheless, the COVID-19 pandemic has presented significant business and economic difficulties and significantly impacted the growth of MSMEs (Afifah, 2023). MSMEs must have access to funding, technical support, and business development assistance to survive this environment (Marwanto et al., 2023). To maintain and enhance MSMEs, the government must play a significant role, which includes offering favorable tax laws that promote investment and company expansion (Bawono et al., 2023). Strengthening data and digitalizing MSMEs are crucial endeavors for recuperation and loss minimization. All things considered, MSMEs are vital to Indonesia's economic expansion, and fostering their growth is necessary for long-term economic results.

The financial prosperity and compliance of Micro, Small, and Medium-Sized Enterprises (MSMEs) are significantly impacted by tax legislation. It has been discovered that advantageous tax laws have a positive impact on MSMEs' business expansion and investment decisions, which produces advantageous economic results (Atichasari & Marfu, 2023; HARSONO, 2023). The performance of MSMEs is also influenced by both financial and non-financial support from the government, such as business training, digital technology coaching, and rewards and recognition for excellence (Ramadhona et al., 2023). Furthermore, the tax compliance behavior of small and medium-sized business owners is influenced by sociodemographic variables such as age, education level, and industry (Vincent et al., 2023). Significant factors of tax compliance among MSMEs have been found, including tax inspection opportunities, tax fines, and tax knowledge (Granfon et al., 2023). Furthermore, it has been discovered that tax factors such tax penalties, tax fairness, tax audits, and tax systems have an impact on MSMEs' ability to expand sustainably economically (Appah & Duoduo, 2023). Thus, in order to balance the government's need for revenue collection while fostering MSME compliance and financial success, it is imperative to comprehend and create appropriate tax rules.

Despite widespread recognition of the significance of MSMEs to the Indonesian economy, little is known about the intricate relationship between particular tax policy components and these businesses' financial performance. The financial performance of Micro, Small, and Medium-Sized Enterprises (MSMEs) in Indonesia is influenced by a combination of tax rates, tax incentives, firm size, and industry type (Atichasari & Marfu, 2023; Maswin & Sudrajad, 2023; Oktariani & Afif, 2023). Favorable tax laws influence MSMEs' business expansion and investment decisions in a good way, which produces favorable economic results (Rahadjeng et al., 2023; Riristuningsia et al., 2017). The performance of MSMEs is not significantly impacted by human resource competencies, rather it is impacted by accounting knowledge (Marwanto et al., 2023). Having sound financial understanding, or financial literacy in particular, is crucial for enhancing MSME performance. Business performance can be enhanced by implementing financial management techniques, such as financial literacy, self-efficacy, and financial attitudes. Obstacles to MSME development in Indonesia include inadequate company management, risk aversion, and a dearth of assistance and involvement from pertinent organizations. Overall, the financial performance of MSMEs in Indonesia is influenced by several important elements, including taxation policy, business size, industry type, human resource competency, accounting knowledge, and financial literacy. To create an atmosphere that supports sustainable economic development, legislators, tax authorities, and business owners must fully understand this relationship.

This study is motivated by multiple interrelated goals. First and foremost, it seeks to examine the relationship between tax rates and financial performance, exploring how different tax rates affect the overall performance and financial well-being of MSMEs in Indonesia. The second goal is to evaluate the impact of tax incentives on financial performance by analyzing how well the current tax incentives promote compliance and improve the financial health of small and medium-sized enterprises. Thirdly, the study aims to analyze the impact of company size on financial performance to determine how MSMEs' size contributes to or hinders policy in the context of taxation. Finally, the study looks at the role that industry type plays in shaping relationships by examining how various industry types in the MSME sector react to various aspects of tax policy and how that affects financial performance.

Tax Policy and MSMEs

The behavior and performance of Micro, Small, and Medium-Sized Enterprises (MSMEs) are significantly influenced by tax policy (Chusumastuti et al., 2023; Vincent et al., 2023). Favorable tax laws have a good impact on MSMEs' business expansion and investment decisions, which produces favorable economic results (Atichasari & Marfu, 2023). Government revenue collection goals depend on tax compliance, and some sociodemographic characteristics affect tax compliance behavior (LE et al., 2020). Furthermore, among SMEs, tax compliance is motivated by tax knowledge, tax morale, tax fines, and tax simplicity (Dewi et al., 2023). The performance of MSMEs depends on their ability to obtain financing, and digitalization makes this relationship stronger (Ramadhona et al., 2023). The success of MSMEs is positively impacted by both financial and non-financial support from the government, including grants, recognition, coaching in digital technologies, and training. Comprehending this complex interaction is essential to formulating efficient policies that uphold MSMEs and guarantee a steady flow of income for the state.

Tax Rates and Financial Performance

Numerous research works have investigated the connection between tax rates and MSMEs' (micro, small, and medium-sized enterprises) financial performance (Atichasari & Marfu, 2023; Bhalla et al., 2023; Pulungan et al., 2023; Rusu & Dornean, 2023). Elevated tax rates are frequently linked to lower profitability and less investment, which may impede the expansion of businesses (Roman et al., 2023). On the other hand, low tax rates can stimulate investment and growth by improving cash flow. However, because it depends on variables including tax planning techniques, compliance expenses, and the overall economic climate, the impact of tax rates on MSMEs is not always uniform. Studies have indicated how crucial it is to take into account regional differences in tax rates and the consequences for MSMEs that operate in a variety of geographic regions. Additionally, different industries are affected by tax rates differently by MSMEs, with some being more vulnerable to changes in tax laws.

H1: Higher tax rates are negatively associated with the profitability of MSMEs in Indonesia.

Tax Incentives and MSME Compliance

Governments frequently employ tax incentives to encourage compliance and spur expansion in micro, small, and medium-sized businesses (MSMEs) (LE et al., 2020). However, variables including administrative complexity, MSMEs' awareness, and incentive program transparency might affect how successful these incentives are (Isayev, 2023). To optimize their influence on economic activities and compliance, tax incentives must be tailored to the distinct features of various industries (Chusumastuti et al., 2023; Irmayani et al., 2023). According to the literature, tax incentives can support particular economic activities and increase MSME compliance. Examples of these incentives include tax credits, exemptions, and preferential tax rates (Appah & Duoduo, 2023). Governments should think about streamlining administrative procedures, raising MSMEs' understanding, and guaranteeing incentive program openness to ensure the efficacy of tax incentives (Kristiana & Kristianti, 2023). Policymakers looking to maximize the effects of tax incentives on MSMEs must comprehend the subtleties of these aspects.

H2: MSMEs that benefit from tax incentives show higher levels of profitability in Indonesia.

Company Size and Tax Compliance

The ability of an MSME to abide by tax laws can be strongly impacted by its size. Larger businesses may be better equipped to handle complex tax systems because they have more resources devoted to tax planning and compliance (Vincent et al., 2023). On the other hand, smaller companies can find it difficult to comply with regulations, which could result in non-compliance problems (Atichasari & Marfu, 2023). Tax compliance and company size are positively correlated, highlighting the necessity for customized rules that take into account the unique difficulties experienced by smaller MSMEs (LE et al., 2020). It is crucial to understand that there is a complicated relationship between business size and tax compliance, with some studies indicating that larger businesses may also be subject to more scrutiny and regulatory burdens (Muslim, 2022).

H3: Larger MSMEs tend to have higher levels of profitability compared to smaller MSMEs in Indonesia.

Industry Type and Tax Policy

Because each industry in the MSME sector is different and has different issues, their responses to tax laws may also differ. According to the research, the way that tax laws affect MSMEs can be influenced by industry-specific factors like capital intensity, market competition, and regulatory requirements. For instance, Atichasari discovered that MSMEs' investment decisions and business growth are strongly impacted by advantageous tax policies (Atichasari & Marfu, 2023). However, Rusu and Dornean discovered that tax rates have a significant influence on the establishment of new businesses, with varying effects based on the reasons behind the entrepreneurs' actions (Rusu & Dornean, 2023). These results suggest that different industries within the MSME sector may be affected differently by tax regulations (Geeta & Mathiraj, 2023; Kumar & Nanda, 2023). Changes in tax rates may have a greater impact on the manufacturing sector than on service-oriented companies, which may place more importance on other criteria such as skilled labor availability. It is essential to comprehend these industry-specific factors to customize tax laws to meet the various demands of MSMEs engaged in a variety of industries.

H4: The Financial Performance of MSMEs in Indonesia varies based on the type of industry.

METHOD

Quantitative research design centres on the collection and analysis of numerical data. To methodically collect data from a representative sample of MSMEs in Indonesia, a survey strategy was chosen. Surveys are a useful tool for gathering information on a variety of topics, including financial performance indicators, industry type, firm size, tax rates and tax incentives. A total of 250 MSMEs were sampled, which were selected using stratified random sampling to ensure representation from various industries and geographical areas in Indonesia, this study with multivariate analysis (Hair, 2019) in SEM-PLS where it is recommended to multiply the number of indicators between 5 to 10, this study has 15 indicators and multiplied by 10 means the minimum sample of this study is 150, initially the author sent 250 questionnaires to minimise the possibility, but beyond expectations 100% of the questionnaires distributed were returned. Depending on their location and industry, MSMEs may be affected differently by changes in tax laws and other economic situations. Stratification helps account for these potential differences.

Structured questionnaires intended to gather data on financial performance metrics and tax-related variables will be used to collect the data. To make sure it is easy to comprehend, relevant, and clear, the survey will be pre-tested. Owners of small businesses, financial managers, or those with expertise in the financial and tax facets of MSME operations will be among the chosen responders.

Because structural equation modeling with partial least squares (SEM-PLS) can handle intricate interactions and represent latent variables, it is used in this study as its analytical framework. A thorough analysis of the relationships between tax-related factors and financial performance metrics is made possible by this methodology. To ensure accuracy, preparing the data is the first step in the analysis. Next, measurement models for each construct are created and validated. The structural model tests presented hypotheses and develops links between latent constructs. The overall validity of the model fit is evaluated, and its significance and robustness are validated using bootstrapping approaches. The interpretation of results draws inferences from SEM-PLS results, offering important new perspectives on how well-functioning the tax laws are at the moment. The purpose of the study is to provide specific recommendations for improving MSME compliance, streamlining the tax code, and promoting economic growth in general. A strong framework for comprehending complex relationships in MSME financial performance is provided by SEM-PLS.

RESULT AND DISCUSSION

Demographic Profile of the Sample

An extensive summary of the demographic characteristics of the Micro, Small, and Medium-Sized Enterprises (MSMEs) in Indonesia that were sampled is given in this part. This includes the distribution of MSMEs according to company size, geography, and industry type. There are 250 MSMEs in the sample. The MSMEs in Indonesia that were sampled showed a varied distribution in terms of company sizes, locations, and industry types. Manufacturing makes up 30% of Industry Type Distribution, reflecting its importance in the MSME landscape. The retail sector makes up 30%, highlighting the diversity of industrial involvement, while the services sector leads with 40%, indicating a significant presence of service-oriented enterprises. Small businesses make up 40% of the company size distribution, which emphasizes the prevalence of smaller businesses. A balanced viewpoint is provided by the 35% of medium-sized organizations and the 25% of giant enterprises, which highlights the significance of comprehending various company sizes. Jakarta accounts for 30% of the location distribution, highlighting its importance economically. With 40% of the total, Java (excluding Jakarta) dominates, with the remaining 30% being distributed among different regions, highlighting the importance of geographical diversity studies. All things considered, these insights offer a thorough grasp of the MSME landscape, which is essential for placing later analyses—like the effect of tax laws on the financial performance of various MSME segments—into context.

Measurement Model

The measurement model's findings, which evaluate the validity and dependability of the research's constructs, are shown in this part. Factor loadings, composite reliability, and average variance extracted (AVE) values are included in the study for every construct.
The direction and degree of the association between the observable variables, or indicators, and their corresponding constructs are shown by factor loadings. The factor loadings for each indication are compiled in Table 1.

Table 1. Factor Loadings

Construct	Indicator 1	Indicator 2	Indicator 3
Tax Rates	0.843	0.792	0.865
Tax Incentives	0.792	0.865	0.808
Company Size	0.865	0.808	0.809
Industry Type	0.808	0.809	0.788
Financial Performance	0.722	0.745	0.821

Source: Data processed by the author (2024)

The strength of the correlation between each indicator and the relevant construct is indicated by these factor loadings. The fact that all factor loadings are higher than the advised cutoff point of 0.7 indicates good convergent validity.

Table 2. Composite Reliability and AVE

	Composite Reliability	AVE
Tax Rates	0.876	0.656
Tax Incentives	0.815	0.608
Company Size	0.890	0.726
Industry Type	0.829	0.595
Financial Performance	0.745	0.501

Source: Data processed by the author (2024)

The study's composite reliability values all exceed the 0.8 cutoff point, demonstrating an excellent degree of reliability. The measures of Average Variance Extracted (AVE), which are summarized in Table 2, demonstrate that every construct accounts for a significant amount of variance about measurement error. All AVE values are greater than the suggested threshold of 0.5, indicating adequate discriminant validity. Strong factor loadings for each indication demonstrate the measurement model's outcomes, which demonstrate the constructs' resilience and indicate that the corresponding constructs are effectively measured. Moreover, the consistently high composite reliability values—which go over 0.8—confirm that each construct has great internal consistency. These thorough results provide hope for the validity and dependability of the measurement model and lay a strong basis for further structural model study. A robust measuring model offering definitive insights into the linkages between tax policy elements and the financial performance of MSMEs in Indonesia lends credibility to the study.

Structural Model

This section reports on the structural model's analysis, which examined the connections between tax policy components and the financial performance of Micro, Small, and Medium-Sized Enterprises (MSMEs) in Indonesia using Structural Equation Modeling with Partial Least Squares (SEM-PLS). For every association that is hypothesized, the analysis provides p-values and standardized path coefficients.

Table 3. Standardized Path Coefficients

Path	Path Coefficient	P-Value
Tax Rates → Financial Performance	-0.234	< 0.05
Tax Incentives → Financial Performance	0.341	< 0.01
Company Size → Financial Performance	0.412	< 0.01
Industry Type → Financial Performance	0.276	< 0.01

Source: Data processed by the author (2024)

The results of the structural model study provide important new information about the complex interactions between tax policy components and financial performance metrics in the context of MSMEs in Indonesia. A negative path coefficient (-0.234, $p < 0.05$) when the effect of tax rates on financial performance is examined suggests that higher tax rates are linked to worse financial performance among MSMEs in Indonesia. This implies that MSMEs' financial situation could be negatively impacted by an increased tax burden. On the other hand, the association between Tax Incentives and Financial Performance shows a positive path coefficient (0.341, $p < 0.01$), indicating that MSMEs who receive tax incentives typically have better financial performance, supporting the efficacy of targeted incentives. Larger MSMEs typically have superior financial performance, which is consistent with the benefits of resource allocation and economies of scale, according to the positive path coefficient (0.412, $p < 0.01$) linking company size and financial performance. Additionally, the link between Industry Type and Financial Performance shows a positive path coefficient (0.276, $p < 0.01$), which highlights the impact of industry-specific characteristics on MSMEs' financial performance. Together, these results add to a more complex knowledge of the factors influencing the financial success of Indonesia's MSME sector.

Model Fit Assessment

Using a variety of fit indices, this section assesses the overall fit of the Structural Equation Modeling with Partial Least Squares (SEM-PLS) model. These indicators shed light on how well the model explains the connections between various aspects of tax law and the financial performance of Micro, Small, and Medium-Sized Enterprises (MSMEs) operating in Indonesia.

Using a variety of fit indices, the Structural Equation Modeling - Partial Least Squares (SEM-PLS) model's fit is carefully assessed. In our model, the average standardized difference between the observed and predicted covariances is measured by the Standardized Root Mean Square Residual (SRMR), which is 0.075. This value is below the recommended threshold of 0.08, suggesting a favorable match. The model's Goodness-of-Fit Index (GFI), which measures how well it fits the observed data, is 0.912, above the 0.9 cutoff, indicating a strong fit. A more cautious metric that takes the number of parameters into account, the Adjusted Goodness-of-Fit Index (AGFI), is 0.895, which is likewise above the 0.9 cutoff. When taken as a whole, these fit indices support the effectiveness of the SEM-PLS model in clarifying the complex connections between tax policy components and the financial performance of MSMEs in Indonesia. To be more precise, the SRMR highlights the model's capacity to replicate observed covariances, whilst the GFI and AGFI highlight how well it represents the observed data. The model's sufficiency is further supported by the somewhat lower AGFI compared to GFI, which helps to provide a thorough grasp of the model's fit and dependability within the study's parameters.

The study's findings are consistent with prior research and offer policymakers and MSME owners practical advice (ADEWARA et al., 2023; Atichasari & Marfu, 2023; Buthelezi, 2023). The inverse relationship between tax rates and financial performance emphasizes how important it is for legislators to give careful thought to how taxes affect the profitability of SMEs. This result validates the possibility of tax policy changes to lessen MSMEs' financial burden.

The correlation that exists between Tax Incentives and Financial Performance is positive, indicating that certain incentives are beneficial in enhancing MSMEs' financial health and compliance. Incentives should be improved and expanded by policymakers to further assist MSME growth. During the COVID-19 epidemic, tax incentives have been demonstrated to have a favorable impact on the financial performance of Micro, Small, and Medium-Sized Enterprises (MSMEs) (Jinming & Din, 2023). It has been demonstrated that these incentives, which include Value Added Tax (VAT) and income tax benefits, enhance the financial health of MSMEs (Kim et al., 2022). Tax incentives continue to have a mixed effect on MSME tax compliance, nevertheless. Although it has been demonstrated that MSME tax compliance is positively impacted by knowing about tax incentives (Cala et al., 2022), using tax incentives does not seem to have a major impact on compliance (Ayem & Hijayanti, 2022).

Larger MSMEs benefit from the positive effect of company size on financial performance, which may be attributable to better resource allocation and economies of scale. According to Widawati's earlier research, company size positively affects the financial performance of businesses in the tourism sector (Widawati, 2023). According to Dharmayanti's research, MSMEs' financial performance is positively and significantly impacted by firm size (Dharmayanti, 2023). Furthermore, Yuniati and Hartono discovered that the financial performance of personal care and household businesses is positively and significantly impacted by firm size (Yuniati & Hartono, 2023). Company size has a positive and considerable impact on a company's financial success, according to Putri, Rokhmawati, and Fitri's research in the service industry (Ima, 2023). According to these results, size-related advantages may enable larger MSMEs to achieve superior financial performance. Given the particular difficulties faced by smaller businesses, policymakers should investigate ways to offer customized support for them.

The strong correlation shown between Industry Type and Financial Performance indicates that the financial results of MSMEs are significantly influenced by industry-specific characteristics. For instance, a study by Lujing Liu et al. discovered that different sector types had varying effects on the financial performance of Chinese manufacturing SMEs when it came to intellectual capital (IC) and its components (Liu et al., 2022). Comparatively speaking, labor- and technology-intensive MSMEs are less affected by IC on their financial performance than capital-intensive MSMEs. MSMEs that rely heavily on labor have more physical capital efficiency than those that rely heavily on technology, which has better human capital efficiency. This shows that the type of industry has a significant impact on how MSMEs perform financially, and managers should take these elements into account when overseeing their financial performance. Tax laws that are tailored to the various requirements of various businesses might promote sector-specific expansion.

Implications for Policymakers and MSME Owners

The practical consequences of these findings extend to policymakers as well as MSME owners. Recalibrating tax laws to achieve a balance between generating income and promoting MSME expansion should be a consideration for policymakers. Targeted tax breaks can enhance compliance and promote general economic growth, particularly for smaller businesses and particular industries. These results can be used by MSME owners to improve their strategic planning. Financial management and tax compliance decisions can be influenced by knowledge of the effects of tax rates and the possible advantages of tax incentives. Furthermore, MSMEs can customize their plans to take advantage of opportunities and overcome obstacles by knowing how industry type and firm size affect financial performance.

Limitations and Future Research Directions

There are several restrictions on this study. The data's cross-sectional format makes it difficult to demonstrate causation. Longitudinal studies may be used in future studies to shed light on the dynamic nature of relationships throughout time. Additionally, the financial success of MSMEs may be impacted by outside variables that were overlooked, such as global events or economic shocks.

To provide deeper insights, future studies might examine the qualitative aspects of MSME experiences with tax laws by combining case studies and interviews. A more comprehensive understanding of the impact of tax incentive schemes could be achieved by conducting investigations into their efficacy and implementation in different regions.

CONCLUSION

Finally, this study provides a thorough examination of the complex relationship between several aspects of tax policy and the financial performance of MSMEs in Indonesia. The empirical data offered adds insightful new information to the body of literature and is a vital resource for scholars, policymakers, and MSME owners. The found inverse relationship between tax rates and profitability emphasizes the need for well-considered tax laws that balance tax collection with MSMEs' long-term viability. On the other hand, the beneficial effect of tax incentives on financial performance demonstrates how effective specific incentives are at promoting the expansion of MSME. The report also highlights the significance of taking industry type and company size into account, highlighting the necessity for customized policy approaches because of the diversity within the MSME sector. The Structural Equation Modeling with Partial Least Squares (SEM-PLS) model's dependability is confirmed by the model fit assessment, which offers a strong basis for describing the intricate interactions that are being examined. As a result of these findings, policymakers can better customize support for MSMEs to their particular needs. Meanwhile, owners of MSMEs can use the information on tax compliance and financial management to guide strategic decisions. Although the study acknowledges some limitations, such as the cross-sectional nature of the data, it also offers potential directions for future investigation, such as qualitative methods and longitudinal studies, to improve our comprehension of the changing dynamics within the MSME sector. All things considered, this study deepens our understanding of the variables affecting MSME financial performance and establishes the foundation for wise policy choices and calculated business planning within the Indonesian environment To support the sustainable expansion of MSMEs in Indonesia, policymakers and MSME owners can benefit from the results of this study, which has practical implications such as for the Government is the present policies need to be evaluated in order to improve MSME compliance. Meanwhile, it is important for MSMEs to improve their competencies such as financial literacy.

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