

Tax Incentives and Business Performance: Impact on Sustainability of MSMEs in Surakarta City

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Abstract

This research aims to analyze the influence of tax incentives on MSMEs performance and sustainability in the city of Surakarta. Data was collected through a survey of MSMEs players and analyzed using the Partial Least Squares-Structural Equation Modeling (PLS-SEM) method. The research results show that tax incentives have a positive and significant influence on MSME performance (path coefficient = 0.506, $p < 0.001$) and business sustainability (path coefficient = 0.253, $p = 0.040$). In addition, the performance of MSMEs contributes significantly to sustainability (path coefficient = 0.381, $p = 0.002$). These findings underscore the importance of supportive fiscal policies, such as tax incentives, to improve operational efficiency, strengthen liquidity, and facilitate sustainable investment. The implications of this research include the need for more specific fiscal policies to encourage sustainability, educating MSMEs about the benefits of sustainability, and further research on less accessible sectors, such as the creative economy and technological innovation.

Keywords: Tax Incentives, MSME Performance, Sustainability

INTRODUCTION

A country's tax policy has a strategic role in influencing company performance, both directly through tax pressure and indirectly through impacts on operational aspects such as liquidity and organizational structure (Abuselidze, 2018; Nugaev et al., 2017). Excessively high taxes can be a burden on companies, reducing their capacity to invest and innovate. However, tax benefits in the form of incentives are often used as a tool to reduce this burden, encouraging companies to allocate resources to developing organizational competitiveness, such as increasing operational efficiency, reducing cash needs in the short term, and increasing profitability (Quoc & Van, 2020). In this case, tax incentives act as a driver of economic growth while maintaining business sustainability, especially for companies operating in strategic sectors.

Tax incentives can also be seen as a fiscal policy instrument designed to support economic development through mechanisms such as tax exemptions, reductions or rebates (Bechko et al., 2019; Gomes et al., 2019). This policy allows the government to encourage the growth of certain sectors by providing relevant stimulus to taxpayers (Jiménez & Podestá, 2009). For example, the manufacturing and technology sectors are often key targets because of their potential to create jobs and increase economic productivity. By providing tax incentives, the government not only reduces the fiscal burden on companies but also creates a conducive environment for innovation and investment. However, the effectiveness of this policy is highly dependent on its design and implementation, so there needs to be regular evaluation to ensure that tax incentives actually achieve the expected development goals.

Previous research has discussed the effectiveness of tax incentives as a tool to support certain economic sectors. Bechko et al. (2019) highlight that tax incentives can have a positive influence on increasing

investment in the manufacturing sector, which directly contributes to output growth and job creation. Gomes et al. (2016) also found that tax incentive policies have a significant impact in attracting foreign direct investment, which is one of the key factors in increasing a country's economic competitiveness. These findings underscore the important role of tax incentives as a fiscal policy tool that not only supports the growth of strategic sectors but also creates a more competitive investment climate.

However, despite its clear benefits, several studies have noted potential risks in the implementation of tax incentives. Jiménez and Podestá (2009) warn that this policy can lead to fiscal inefficiencies if not properly designed and supervised, such as reducing state revenues without significant impact on targeted investments. In addition, the lack of supervision in implementation often opens up opportunities for companies to use incentives unethically, which can reduce the overall effectiveness of the policy. This condition raises deep questions about the extent to which tax incentives can provide optimal results without sacrificing the country's fiscal stability and how the government can balance the need to attract investment with maintaining the sustainability of the state budget.

The issue of the relevance of tax incentives in developing countries is of concern because these countries face major challenges in creating effective fiscal policies to attract investment and encourage economic growth. One interesting aspect is how tax incentives are used to overcome political and economic risks that often act as a deterrent for foreign investors. In developing countries, tax incentives are often offered to attract investment to compensate for institutional uncertainty, weak legal enforcement, and high costs of capital. However, research shows that although these incentives increase the attractiveness of investment, their impact is often limited to certain sectors, such as extractives, and is less effective in non-manufacturing sectors that create more jobs (World Bank, 2024; IISD, 2024).

On the other hand, tax incentive policies in developing countries can create regional competitive dynamics, such as a "race to the bottom", where countries compete to offer increasingly large tax incentives to attract investors. This can be detrimental to a country's fiscal stability, especially if the incentives are not accompanied by strengthening governance and reforming the overall business environment. For example, reliance on policies such as tax holidays or tax credits without effective risk compensation policies can lead to the loss of potential state revenues and create long-term fiscal inefficiencies. Therefore, tax incentive policies in developing countries require a balance between investment attraction and fiscal sustainability (IISD, 2024; World Bank, 2024).

The novelty of this research lies in exploring the impact of tax incentives on the sustainability of business strategies in non-traditional sectors such as information and communication technology (ICT). This research fills a gap in the literature that has so far focused more on traditional sectors such as manufacturing and foreign direct investment. Different from previous approaches, this research highlights how tax incentives affect operational efficiency, technological innovation, and long-term development, especially in developing countries that are accelerating digital transformation (Katz & Callorda, 2019; World Bank, 2022).

In particular, this research makes an important contribution by analyzing how reducing the tax burden or eliminating tariffs on imports of technological devices can increase the adoption of digital infrastructure, labor productivity, and economic growth. For example, incentive policies that support the provision of duty-free software in African countries have increased network investment and internet coverage by up to 14.7% (Katz & Jung, 2022; ITU, 2023). Thus, this research also addresses the potential gap between incentive policies and their economic impacts, especially in the context of developing countries that face fiscal challenges and uneven digitalization.

The purpose of this study is to explore how tax incentives can affect corporate decision-making in various economic sectors, analyze their impact on corporate performance, and evaluate the potential risks and opportunities resulting from the implementation of these policies. This study also aims to provide policy recommendations that can support fiscal sustainability while encouraging economic growth in developing countries.

LITERATURE REVIEW

Tax Incentives

Tax incentives are defined as fiscal policy tools to encourage certain economic behaviors, such as increasing investment or supporting specific sectors. Tax incentive theory refers to the government's approach to influencing corporate behavior by offering tax breaks or exemptions aimed at stimulating desired economic activity (Jiménez & Podestá, 2009). These incentives are often used to attract foreign direct investment (FDI) or encourage the adoption of green technologies (Gomes et al., 2019)

Tax incentives are designed to encourage certain economic activities by reducing the fiscal burden of companies, such as tax exemptions, tax rate reductions, or investment discounts. According to fiscal policy theory, governments use tax incentives as a tool to create a conducive economic environment to attract investment, accelerate innovation, or increase the competitiveness of certain sectors (Jiménez & Podestá, 2009). Gomes et al. (2016) state that these incentives are effective in increasing foreign direct investment (FDI), especially in developing countries, which often compete to attract foreign capital to spur economic growth. Furthermore, according to EY (2024), tax incentives also play an important role in encouraging sustainability, such as the implementation of green taxes or incentives for investment in renewable energy. This policy is one of the strategies to align fiscal policy with sustainable development goals.

Firm Performance

The theoretical basis for firm performance often refers to the Resource-Based View (RBV), which emphasizes the importance of leveraging a firm's internal resources to create competitive advantage. According to Bechko et al. (2019), tax incentives can improve a firm's liquidity, allowing firms to allocate funds to technology development, employee training, or other initiatives that improve operational efficiency and long-term profitability. In addition, tax incentives have been shown to improve a firm's ability to adapt to dynamic market conditions, such as through reduced capital costs and increased investment in productive assets (Abuselidze, 2018; Quoc & Van, 2020).

Sustainability

Sustainability in the corporate context includes not only environmental aspects, but also social and governance (ESG) aspects. Sustainability theory emphasizes the importance of integration between corporate policies, such as tax incentives, with long-term goals that include creating value for society and the environment. The Tax Sustainability Index (TSI) is one framework that helps companies assess the relationship between tax policies and strategic sustainability.

Corporate sustainability includes economic, social, and environmental aspects, with the aim of creating long-term value. In the context of tax incentives, sustainability is linked to a company's efforts to use tax savings to support environmentally friendly innovation or create social value. The Tax Sustainability Index (TSI) explains how tax practices can align with environmental, social, and corporate governance (ESG) objectives. Pillars such as tax governance, tax risk planning, and stakeholder engagement are the main focus to support sustainability through strategic fiscal policies.

METHOD

This research is a quantitative research, in the data analysis conducted in this study using statistical calculations to test the truth of the hypothesis. The population and sample in this study were 99 batik center UMKM in Surakarta City and the number of respondents as samples in this study were 78 UMKM. The data source used in this study is primary data. The data collection technique used a questionnaire by giving a set of written questions to respondents. Questionnaire assessment: using a 5-point Likert Scale (SS = 5; S = 4; N = 3; TS = 2; STS = 1). The data analysis used is SEM-PLS.

Table 1. Operational Definition and Measurement of Variables

Research Variables	Operational Definition	Indicators
Tax Incentives	Actions taken by the government as motivation for individuals and business actors to save funds and reduce the total taxes they have to pay.	<ol style="list-style-type: none"> 1. Understanding tax incentives 2. Ease of requirements 3. Use of tax incentives 4. Benefits of tax incentives 5. Timely tax reporting 6. Compliance with tax payments (Amah dkk, 2023)
Business Performance	Business performance is the perception of managers/company owners regarding the development of company performance compared to competitors.	<ol style="list-style-type: none"> 1. Increased sales 2. Increased profits 3. Increased business capital 4. Increased customers 5. Achieved business goals and targets 6. Profit ability to meet needs (Mokodompit dkk., 2019)
Sustainability	A condition or situation in which there are ways to develop, maintain and protect the business being run with the intention of continuing to make a profit.	<ol style="list-style-type: none"> 1. Profitability last 12 months 2. Sales volume last 12 months 3. Market share last 12 months 4. Customer base last 12 months 5. Asset growth last 12 months 6. Production rate last 12 months (Deyganto, 2022)

RESEARCH RESULTS AND DISCUSSION**Research result****Outer Model Evaluation**

The purpose of the Outer Model Evaluation is to test the validity and reliability of the constructs in the proposed model. The results of the convergent validity analysis show that all variable indicators produce outer loading > 0.7 so that all indicators are declared feasible.

Table 2. Convergent Validity Test

	Insentif Pajak	Kinerja UMKM	Sustainability
X1.1	0.828		
X1.2	0.924		
X1.3	0.834		
X1.4	0.851		
X1.5	0.896		
X1.6	0.857		

X2.1		0.833	
X2.2		0.882	
X2.3		0.845	
X2.4		0.850	
X2.5		0.874	
X2.6		0.866	
Y.1			0.837
Y.2			0.860
Y.3			0.845
Y.4			0.868
Y.5			0.867
Y.6			0.846

Outer Model Evaluation aims to measure the validity and reliability of the constructs in the research model. Validity is used to ensure that the indicators in each variable actually measure the concept to be measured, while reliability tests the consistency of measurement between indicators.

Convergent Validity Results

The convergent validity test is carried out by examining the outer loading of each indicator against its construct. In the table provided, all indicators have an outer loading value above 0.7, which is the minimum threshold to state that the indicator is convergently valid. This means that each indicator makes a significant contribution in explaining the latent variables being measured.

Tax Incentives (X1):

All indicators (X1.1 to X1.6) have outer loading values ranging from 0.828 to 0.924. This shows that each indicator is able to represent the tax incentive construct very well.

MSME Performance (X2):

The outer loading values of indicators X2.1 to X2.6 range from 0.833 to 0.882. This indicates that this indicator is valid for explaining MSME performance.

Sustainability (Y):

Indicators Y.1 to Y.6 have outer loading values between 0.837 and 0.868, indicating that all indicators are able to significantly explain the construct of business sustainability.

Reliability Test Results

The reliability of the research model was evaluated using Cronbach's Alpha and Composite Reliability (CR), both of which are indicators to measure the internal consistency of the construct. With a minimum threshold of ≥ 0.7 , the analysis results show that the Tax Incentive construct (X1) has a Cronbach's Alpha value of 0.915 and a Composite Reliability of 0.936, reflecting a high level of reliability and good consistency between indicators. The MSME Performance construct (X2) recorded a Cronbach's Alpha value of 0.903 and a Composite Reliability of 0.930, indicating very good measurement consistency. The Sustainability construct (Y) also met the criteria with a Cronbach's Alpha value of 0.899 and a Composite Reliability of 0.927, confirming that all indicators in this construct are reliable. Based on these results, all constructs in the research model are declared reliable and worthy of supporting further analysis because they meet the established reliability criteria.

Inner Model Evaluation

The purpose of Inner Model Evaluation is to test the structural model by predicting causal relationships between latent variables.

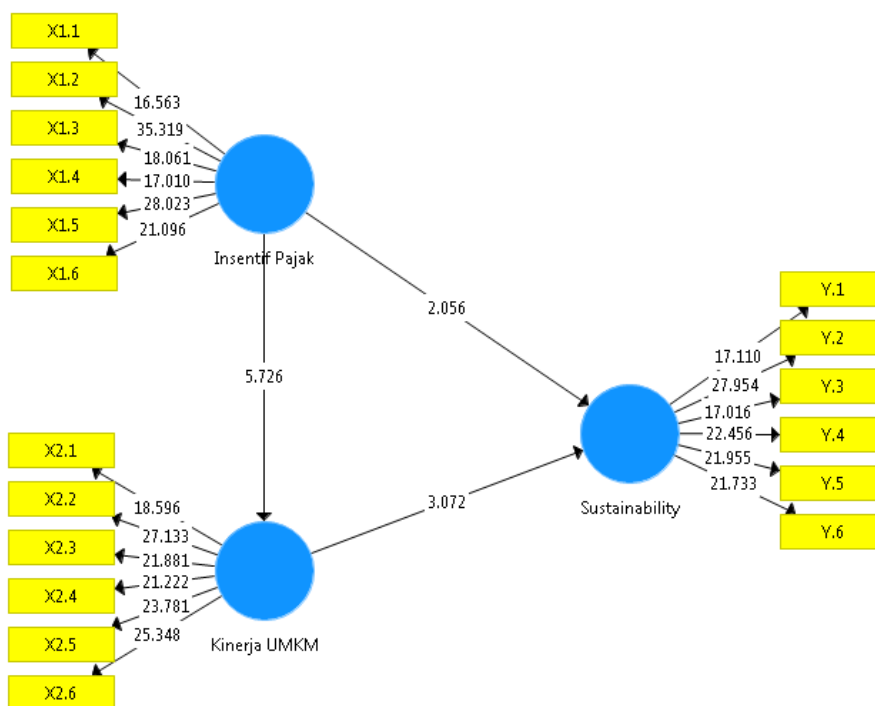


Figure 1. Inner Model Results

The figure illustrates the relationship between constructs, namely Tax Incentives (X1), MSME Performance (X2), and Sustainability (Y). The arrows connecting the constructs indicate the direction of the causal relationship in the structural model. Each construct has several indicators measured using outer loading, with fairly high values (>0.7), indicating the validity of the indicators in representing the construct.

- 1) Tax Incentives (X1): This construct has six indicators (X1.1 to X1.6), each showing a high outer loading value (16,563–35,319).
- 2) MSME Performance (X2): This construct also has six indicators (X2.1–X2.6) with outer loading values ranging from 18,596–25,348.
- 3) Sustainability (Y): This construct has six indicators (Y.1–Y.6), with strong outer loading values, ranging from 17,016–21,955.

The relationships between constructs are indicated by three main paths: Tax Incentives → MSME Performance (with a coefficient of 5,726), Tax Incentives → Sustainability (2,056), and MSME Performance → Sustainability (3,072).

Table 3. Path Coefficient

	Original Sample (O)	Sample Mean (M)	Standard Deviation (STDEV)	T Statistics (O/STDEV)	P Values
Tax Incentives -> MSME Performance	0.506	0.521	0.088	5.726	0.000
Tax Incentives -> Sustainability	0.253	0.266	0.123	2.056	0.040
MSME Performance -> Sustainability	0.381	0.374	0.124	3.072	0.002

The table provides statistical details for each causal path in the model:

- 1) Tax Incentives → MSME Performance: This path has a coefficient of 0.506 with a T Statistics value of 5.726 and a p-value of 0.000. This means that tax incentives have a significant positive effect on MSME performance.
- 2) Tax Incentives → Sustainability: This path shows a coefficient of 0.253 with a T Statistics value of 2.056 and a p-value of 0.040. This indicates that tax incentives also contribute positively to business sustainability, although their effect is smaller than that of MSME performance.
- 3) MSME Performance → Sustainability: With a coefficient of 0.381, T Statistics 3.072, and a p-value of 0.002, this relationship shows that MSME performance has a significant and positive effect on business sustainability.

Overall Interpretation: Both the figure and the table show that all paths in the model have a positive and significant influence, with T Statistics values that meet the criteria (>1.96) and p-value <0.05 . This indicates that the structural model used is able to explain the relationship between variables validly and reliably. Thus, Tax Incentives not only contribute directly to Sustainability, but also through MSME Performance as a mediating variable. This model is worthy of further analysis related to the influence of tax policy on business performance and sustainability.

Discussion

Relationship between Tax Incentives and MSME Performance

The results of the analysis show that tax incentives have a positive and significant effect on the performance of MSMEs in Surakarta City with a path coefficient value of 0.506 ($p < 0.001$). This finding strengthens the view that tax incentive policies, such as tax rate reductions, tax exemptions, or other tax facilities, can help MSMEs improve their operational performance. These incentives contribute to increasing efficiency, improving liquidity, and expanding investment capacity, allowing companies to focus more on innovation and business expansion.

These results are in line with research by Gomes et al. (2016), which states that tax incentives can have a significant impact on business performance by reducing the fiscal burden. Likewise, research by Abuselidze (2018) shows that tax incentives help improve a company's financial position and increase operational efficiency, especially in facing liquidity challenges. Previous research also highlights that tax relief can increase investment opportunities in strategic sectors, including MSMEs.

However, this study highlights the context of MSMEs in developing countries, especially in Indonesia, which have specific challenges such as limited access to financial resources and lack of sustainable regulatory support. This study also highlights that the impact of tax incentives is more pronounced in efforts to improve operational performance than in the long-term investment sector, different from the focus of Gomes et al. (2016) which focuses more on foreign direct investment (FDI). In addition, this study examines the relationship in the local context of Surakarta, providing more specific insights into tax policies at the regional level.

This study finds that tax incentives have a significant impact on several important aspects of MSME management, namely increasing operational efficiency, improving liquidity, and increasing investment capacity. With tax incentives, MSMEs are able to allocate more resources for production and innovation, manage cash flow better, and expand productive assets to support business development. However, these benefits can only be achieved optimally if accompanied by appropriate regulations, ensuring that the funds saved are actually used for business development. The implications of this study include the importance of local governments to expand the scope of tax incentives targeted at MSMEs with high growth potential, as well as encouraging MSMEs to be more proactive in utilizing these incentives to increase competitiveness through technology investment, human resource capacity development, or market expansion. In addition, these findings open up opportunities for further research to explore the influence of tax incentives on other dimensions, such as digital innovation or their impact

on specific non-manufacturing sectors.

Relationship between Tax Incentives and MSME Sustainability

The results of the analysis show that tax incentives have a significant direct effect on MSME sustainability, with a path coefficient value of 0.253 ($p = 0.040$). Although the impact is not as large as the effect of tax incentives on MSME performance, these results confirm that tax incentives still make an important contribution to strengthening the resilience of MSMEs, especially in the face of economic pressures. The intended business sustainability includes the ability of MSMEs to survive in the long term through the adoption of environmentally friendly technology, increased energy efficiency, or the implementation of socially responsible business practices.

This study is in line with the views of Jiménez and Podestá (2009), which show that tax incentives play a role in encouraging companies to adopt sustainability strategies, such as more efficient use of resources and reducing carbon emissions. In addition, the study by Bechko et al. (2019) emphasized that tax incentives can motivate companies to develop business models that support sustainable growth. However, this study provides a unique contribution in the context of MSMEs in developing countries, especially in Surakarta, which face different challenges compared to large companies in developed countries. Previous studies have focused more on the manufacturing sector or large companies, while this study highlights that tax incentives can help MSMEs in non-traditional sectors to contribute to sustainability, for example through investment in digital innovation or small-scale waste management. This study shows that tax incentives have a significant contribution to the economic resilience of MSMEs, enabling them to face challenges such as market fluctuations and policy changes. These incentives also encourage MSMEs to adopt sustainability strategies, albeit on a smaller scale than large companies, through investment in green technologies and sustainable product innovations that are tailored to local needs. The implication is that the government can develop fiscal policies that focus on sustainability, such as incentives for renewable energy investment or the use of environmentally friendly local raw materials. In addition, education to raise MSMEs' awareness of the benefits of sustainability strategies is essential to improve their long-term competitiveness. This study also opens up opportunities for further exploration of the influence of tax incentives on less accessible sectors, such as technology-based services or the creative economy, and their impact on social and environmental dimensions in the long term.

Relationship between MSME Performance and Sustainability

MSME performance significantly affects business sustainability, with a path coefficient value of 0.381 ($p = 0.002$), indicating that MSMEs with better financial performance have a greater ability to integrate sustainability aspects into their business strategies. This is in line with the findings of Jiménez and Podestá (2009), who stated that strong profitability allows companies to allocate resources to environmentally friendly initiatives and responsible social practices. Similarities with previous studies are seen in the recognition that financial strength drives sustainable investment, as also conveyed by Gomes et al. (2016), who emphasized the relationship between economic performance and environmental initiatives in the corporate sector. However, this study provides a new contribution by highlighting MSMEs in developing countries, which often have limited resources but are still able to achieve sustainability with innovative approaches, such as the efficient use of local materials or community collaboration.

The implication is that the government and supporting institutions can strengthen MSME development programs by targeting sectors that have financial potential and are oriented towards sustainability, while providing incentives to support sustainable resource management. In addition, these results open up opportunities for further research on the relationship between MSME economic performance and sustainability in the context of changes in environmental regulations or technological innovation.

CONCLUSIONS

The conclusion of this study shows that tax incentives, MSME performance, and sustainability have a significant and mutually influential relationship. First, tax incentives are proven to have a positive impact on MSME performance, which includes increasing operational efficiency, improving liquidity, and increasing investment capacity. Second, good MSME performance has a significant contribution to sustainability, allowing MSMEs to integrate environmentally and socially friendly aspects into their business strategies. In addition, tax incentives also contribute directly to MSME sustainability, although on a smaller scale compared to their influence on performance.

This study confirms that effective fiscal policy can be an important tool to encourage MSME growth while creating sustainable business practices. However, the successful implementation of tax incentives requires proper regulation and supervision so that the funds saved are actually used for business development and sustainability. The implication is that the government needs to develop more targeted and specific incentives, such as supporting environmentally friendly sectors and digital innovation, while MSMEs must utilize these incentives to increase competitiveness and create long-term impacts on society and the environment.

These findings open up opportunities for further research, particularly in exploring the influence of tax incentives on specific sectors and their impact on other dimensions of sustainability, such as technological innovation and social impact across regional contexts.

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