



Tax Incentives and the Formalization of Informal MSMEs in Indonesia

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Abstract

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Micro, Small, and Medium Enterprises (MSMEs) hold a vital role in Indonesia's economy, contributing over 60% to GDP and employing 97% of the labor force. However, the majority still operate informally with restricted access to financing, legal protection, and market participation. To address this, tax incentives such as the 0.5% final income tax stipulated in Government Regulation (PP) Number 23 of 2018 are introduced to foster formalization and growth of informal MSMEs. This study explores the contribution of tax incentives in promoting formality, enhancing productivity, and uncovering barriers to implementation. Adopting a qualitative design through literature review, secondary data from academic journals, government reports, and official regulations were analyzed using content analysis and triangulation. Findings reveal that tax incentives improve liquidity, competitiveness, and employment capacity of informal MSMEs, while facilitating formalization through simplified administration. Nevertheless, limited tax knowledge, bureaucratic hurdles, and insufficient dissemination weaken policy outcomes. Integrated efforts involving training, mentoring, and infrastructure are required to optimize impact toward inclusive and sustainable economic transformation.



1. Introduction

Micro, Small, and Medium Enterprises (MSMEs) occupy a crucial position in Indonesia's economy, serving as one of the main engines of national growth. This sector contributes more than 60% to the country's Gross Domestic Product (GDP) and absorbs around 97% of the total workforce. MSMEs have consistently demonstrated their role as stabilizers of the economy, especially during global financial turmoil or domestic disruptions. Beyond that, MSMEs act as catalysts for grassroots economic development, as they are widely spread across regions, including remote and underdeveloped areas. Their contribution extends beyond numerical economic value, encompassing job creation, income distribution, and the advancement of inclusive and sustainable growth (Pahlevi & Safitri, 2023). Despite their importance, most MSMEs in Indonesia remain within the informal sector. The informal sector is characterized by enterprises not officially recorded in government administrative systems such as taxation or licensing.

Informal MSMEs typically do not have a Taxpayer Identification Number (Nomor Pokok Wajib Pajak/NPWP), are not registered in the Online Single Submission (OSS) system, and generally lack formal bookkeeping practices. This condition restricts their ability to access financing, legal protections, or government assistance programs. Moreover, informal MSMEs face weak bargaining positions and are vulnerable to legal uncertainty and exploitation (Demirel & Danisman et al., 2019). Other issues include inadequate financial literacy, limited managerial capacity, and poor access to credit. Without formal recognition, many MSMEs are unable to participate in tenders, receive government subsidies, or collaborate with larger

corporations, thus hindering their growth. This lack of access to training and formal support ultimately weakens productivity and reinforces stagnation within the grassroots economy (Rahayu et al., 2023). To address these challenges, the Indonesian government has introduced a series of fiscal incentive measures aimed at driving MSMEs toward formality. One notable initiative is the implementation of a final income tax (Pajak Penghasilan/PPH) of 0.5% applied to MSME turnover, as mandated by Government Regulation (PP) No. 23 of 2018.

Complementary efforts include simplified NPWP registration, streamlined reporting requirements, and the promotion of tax literacy programs targeted at MSME operators. These strategies are designed to encourage informal businesses to enter the formal system and access the associated benefits (Orkaido & Beriso, 2020). Nevertheless, the degree of MSME formalization in Indonesia remains relatively low. Despite fiscal incentives, many operators still choose to function informally. This indicates that the impact of tax incentives in facilitating the shift from informal to formal sectors faces persistent challenges. A key obstacle is the limited awareness among MSME actors regarding the long-term advantages of formalization. For many, formality is perceived as costly, bureaucratic, and administratively burdensome, overshadowing its benefits, which include better access to financing, stronger legal protections, and opportunities for broader business cooperation.

In addition, questions remain about the true effectiveness of tax incentives in influencing MSME decisions to transition into the formal sector. Non-fiscal elements also play a significant role in shaping perceptions and behavior, such as the level of trust in governmental institutions, fear of tax audits, and negative

experiences with bureaucracy. Therefore, the role of tax incentives must be interpreted not solely through the lens of reduced tax burdens or easier procedures but also in the broader context of governance, trust, financial literacy, and other non-fiscal supports within the MSME ecosystem. From an academic perspective, much of the research on tax incentives has focused primarily on general taxpayer compliance. Very few studies have specifically investigated the relationship between tax policies and the formalization of informal MSMEs.

This research gap is particularly important, considering the considerable potential contribution of the informal sector to national economic performance if successfully integrated into the formal system. The absence of empirical evaluations on how fiscal measures influence transitions from informal to formal status, as well as their overall effect on MSME productivity and economic outcomes, underscores the necessity of further scholarly attention. Against this backdrop, the present study seeks to critically assess the effectiveness of tax incentives in fostering MSME formalization. Specifically, it aims to evaluate the extent to which fiscal policies contribute to enhancing productivity and microeconomic growth among informal MSMEs. Furthermore, the study will explore barriers that hinder successful implementation while identifying opportunities for improvement. Ultimately, it seeks to develop strategic recommendations to strengthen fiscal policy design and ensure the sustainable integration of informal MSMEs into Indonesia's formal economic framework.

2. Methods

This research adopts a qualitative approach using a library research method with the objective of examining in depth the relationship between tax incentive policies for MSMEs and the development of the informal sector. A qualitative design was selected because it enables a holistic, contextual, and interpretive analysis of social phenomena and public policies using pre-existing data. The study relies on secondary data, which are obtained indirectly rather than from direct interaction with research subjects. These secondary sources consist of credible and relevant references, including academic books, peer-reviewed journals, research reports, policy papers, and official documents concerning fiscal policies, taxation, MSMEs, and informal sector issues. In addition, the research makes use of legal regulations, statistical publications from the Central Statistics Agency (*Badan Pusat Statistik*/BPS), as well as reports released by the Ministry of Cooperatives and SMEs, the Directorate General of Taxation, and Bank Indonesia. The analysis centers on two principal variables. The independent variable is tax incentive policy for MSMEs, encompassing fiscal measures such as reduced tax rates, simplified compliance procedures, exemptions for specific turnover thresholds, and streamlined tax administration.

Meanwhile, the dependent variable is informal sector growth, analyzed through the transition of informal enterprises into the formal economy, productivity improvements, and broader participation of MSMEs within the formal economic system as a result of fiscal incentives. For data analysis, the study employs content analysis to review and interpret collected literature, identifying major themes, inter-

variable relationships, and patterns of policy influence. Findings from previous studies are synthesized to contrast theoretical arguments and empirical evidence, allowing conclusions to be drawn about the role of incentives in encouraging formalization and informal MSME growth. Data credibility is reinforced through source triangulation, comparing evidence across references to ensure reliability and consistency. This approach provides a comprehensive understanding of the effectiveness of tax incentives in supporting informal sector transformation, while contributing academically and practically to inclusive fiscal policy formulation.

3. Results

3.1. The Role of Tax Incentives in Strengthening Informal MSME Sustainability and Employmen

Tax incentive policies exert a crucial influence on the sustainability and advancement of micro-enterprises within the informal sector. According to Deyganto (2022), the implementation of the 0.5% final Income Tax (*Pajak Penghasilan*/PPH) rate provides significant tax relief for informal MSMEs, especially during times of crisis such as the COVID-19 pandemic. By lowering tax obligations, informal business operators including street vendors, home-based craftsmen, and small shop owners are able to redirect funds toward essential operational expenditures, including the purchase of raw materials, equipment maintenance, or product quality enhancement. Pahlevi and Safitri (2023) further highlight that tax relief is vital for MSMEs in the informal sector that typically operate with narrow profit margins. This form of fiscal support strengthens their competitiveness in

domestic markets, enabling them to better rival formal enterprises and imported products that often benefit from economies of scale.

Tax incentives also enhance the resilience of informal MSMEs against external economic pressures such as inflation or reduced consumer purchasing power, which disproportionately affect them due to their restricted access to financial resources. Beyond ensuring business continuity, these incentives improve liquidity, a critical element for enterprise development. Demirel and Danisman (2019) argue that policies such as temporary tax exemptions or reduced rates allow micro-entrepreneurs to reinvest in their businesses. For example, additional funds may be allocated to acquire simple technologies, such as sewing machines for craftsmen or digital devices to support online marketing, thereby enhancing efficiency and expanding market reach. Adegbe (2020) emphasizes that tax incentives bolster working capital, directly increasing productivity and strengthening the contribution of the informal sector to the broader economy.

Data from the Ministry of Cooperatives and SMEs (2023) underscores this, noting that MSMEs including informal ones account for 60.5% of Indonesia's Gross Domestic Product (GDP) and absorb 97% of the national workforce. Tax incentives thus provide momentum for informal MSMEs to expand, such as opening new outlets or boosting production capacity, reinforcing their position as a backbone of grassroots economic activity (Ahmad & Patra, 2023). Another critical outcome of tax incentive policies is their impact on employment generation, a hallmark of the informal sector. Marchese (2021) finds that approximately 89% of MSME workers are employed within informal enterprises, representing low- to medium-skilled

laborers with limited access to formal job opportunities. Through the support of tax incentives, these enterprises can expand operations by hiring more employees or extending business hours, thereby directly creating new jobs.

Orkaido and Beriso (2020) assert that such policies indirectly help reduce unemployment rates, particularly among informal workers like casual laborers, micro-traders, and freelancers. Complementary initiatives, such as the People's Business Credit (*Kredit Usaha Rakyat*/KUR), which is frequently linked with tax incentives, further accelerate informal MSME development. By offering lower interest rates and simplified access to financing, KUR enables informal businesses to expand for instance, by opening new stalls or enlarging inventory. According to Bank Indonesia (2023), KUR has successfully reached millions of informal MSME participants, contributing significantly to lowering unemployment levels across both rural and urban areas while simultaneously strengthening local community resilience.

3.2. Challenges and Strategic Roles of Tax Incentives in the Informal Sector

Despite the substantial advantages offered, the execution of tax incentive policies within the informal sector continues to encounter notable obstacles. According to Suryahadi (2021), one of the most pressing challenges is the low level of tax literacy among informal business actors. A significant number of informal MSME participants, including rural artisans or traditional market traders, are unfamiliar with how tax incentives function or lack awareness regarding their eligibility for such schemes. This lack of knowledge significantly reduces the utilization and impact of fiscal relief efforts. Complicated administrative processes combined with limited policy outreach, especially in rural or remote regions, further

diminish the effectiveness of tax incentive initiatives. Compounding these issues, the unregistered status of many MSMEs as taxpayers excludes them altogether from benefitting from these incentives, since taxpayer identification is often a prerequisite for access.

In light of these challenges, researchers and policymakers suggest adopting more proactive strategies to improve the dissemination of information. Accessible socialization through community-level initiatives, trader associations, or even the use of widely adopted digital platforms such as messaging applications can provide clearer and more direct communication to informal actors. Additional support from tax officials, financial institutions, and non-governmental organizations is also critical, as these intermediaries can help MSME participants understand, access, and utilize the available incentives. Beyond awareness, however, tax incentives serve an important strategic purpose by encouraging business actors to shift from the informal to the formal sector, which is essential in building a more resilient and structured economy. Moore (2023) highlights that simplified administration and reduced tax burdens, like the final Income Tax (PPh) system, offer strong motivation for informal entrepreneurs to register formally as taxpayers.

This registration opens doors to broader opportunities, including integration into formal financing systems, wider market access, and even potential entry into export-oriented activities, all of which improve the competitiveness of MSMEs. The role of tax incentives as a bridge to formalization is further emphasized by Awasthi and Engelschalk (2018), who argue that once informal business operators begin experiencing tangible benefits from tax relief, their willingness to comply with tax

regulations increases substantially. The transition from informal to formal not only bolsters individual businesses but also strengthens the sector's overall role within the national economy. Formalized MSMEs can more easily join government procurement programs or be integrated into global supply chains, creating multiplier effects that extend beyond local communities. The contribution of tax incentives is not limited to compliance alone but extends to broader goals of economic fairness. Mahesh et al. (2022) stress the relevance of fiscal incentives in rural economies where informal MSMEs dominate. They demonstrate that targeted tax benefits applied to groups such as farmers, artisans, or small-scale traders help to elevate production capacities and expand access to new markets, thereby reducing the economic divide between rural and urban areas.

A practical example is a rural weaver who can allocate tax savings to acquire modern looms or adopt digital marketing platforms, enabling them to grow personal income while also enhancing the economic resilience of the wider community. In this manner, tax incentive policies become tools for inclusive economic development that distribute the fruits of national growth more equitably. From a long-term perspective, the transformative potential of tax incentive policies lies in their ability to reshape the informal sector's economic structure. By systematically fostering productivity, competitiveness, and progressive formalization, the informal economy can gradually integrate more fully into national frameworks. Wen et al. (2021), however, caution that achieving these long-term goals requires more than fiscal measures alone. Complementary interventions, such as vocational training, digital literacy programs, and infrastructural development particularly internet access

and transportation facilities are necessary to amplify and sustain the positive impacts of tax incentives. Without these integrated efforts, tax relief may remain a short-term measure that temporarily alleviates burdens without triggering deeper structural change.

For instance, an informal business actor receiving tax relief but lacking exposure to digital marketing training will likely remain at a disadvantage in today's increasingly digital marketplace, limiting growth potential. Tax incentive policies exert multidimensional impacts on the informal MSME sector, encompassing competitiveness, liquidity, resilience, and job creation. These policies strengthen the grassroots economy by sustaining small-scale businesses and equipping them to withstand external shocks. However, to maximize effectiveness, structural barriers must be addressed. Low literacy levels, bureaucratic complexity, and gaps in outreach remain key issues that hinder full adoption and utilization. Thus, consistent efforts in policy socialization, capacity building, and stakeholder collaboration are urgently required.

Looking forward, tax incentive policies hold the potential to evolve into catalysts for broader reform. By encouraging formalization and supporting equitable development, these initiatives contribute not only to business survival but also to the inclusive and sustainable growth of Indonesia's economy. Success, however, depends on ensuring that fiscal incentives are implemented alongside comprehensive programs designed to empower informal actors with skills, technology, and institutional trust. With strong coordination and holistic interventions, tax incentives can indeed serve as a powerful mechanism to transform

the informal sector into a dynamic and fully integrated component of the national economic system.

4. Conclusion

Tax incentive policies for MSMEs have been proven to significantly support the sustainability and advancement of Indonesia's informal sector. Incentives such as the 0.5% final Income Tax (PPh), temporary exemptions, and simplified administrative procedures provide informal MSME actors with greater fiscal flexibility to maintain and expand their businesses. These forms of relief enable more efficient allocation of resources, improve liquidity, and enhance competitiveness, especially when facing challenges like the COVID-19 pandemic, inflationary pressures, and restricted access to financing. In addition, tax incentives contribute positively to job creation, as the informal sector has long served as the backbone of workforce absorption in the country. Increased liquidity allows MSMEs to scale up operations and boost productivity, which in turn directly or indirectly reduces unemployment.

More broadly, the integration of tax incentives with supporting schemes such as the People's Business Credit (KUR) fosters business growth and bolsters local economic resilience in both rural and urban areas. Nevertheless, the effectiveness of these policies is hampered by persistent challenges. Barriers such as low tax literacy, lack of accessible information, administrative complexity, and uneven dissemination prevent many informal MSME actors from fully benefiting from available incentives. This highlights the urgent need for more inclusive institutional assistance and

outreach strategies through community-based platforms to effectively engage informal entrepreneurs. Beyond delivering short-term relief, tax incentives also possess the long-term potential to drive structural transformation of the informal sector toward formality. By offering affordable tax rates and simplified compliance, these measures encourage informal business actors to register as taxpayers and become part of the formal economy. Such formalization expands opportunities to access financial institutions, larger markets, as well as government procurement and export programs.

Over time, this process strengthens the informal sector's contribution to national GDP while advancing equitable development, particularly in underdeveloped and marginalized areas. In conclusion, tax incentive policies for MSMEs function not only as instruments to ease fiscal burdens but also as strategic tools to promote economic transformation, employment creation, and the reinforcement of national economic structures. To optimize their impact, these incentives must be supported by integrated efforts combining fiscal policy, MSME empowerment, tax education, and infrastructure development that extends to remote regions. With these synergies, tax incentives can become a pivotal foundation for transitioning the informal sector into a more inclusive, resilient, and sustainable component of Indonesia's economy.

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