

The Influence of Regulation and Tax Incentives on ESG Implementation in Financial Reporting of MSMEs in West Java, Indonesia

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ABSTRACT

This study aims to examine the influence of regulation and tax incentives on the implementation of Environmental, Social, and Governance (ESG) principles in the financial reporting of Micro, Small, and Medium Enterprises (MSMEs) in West Java, Indonesia. As global business practices shift toward sustainability, MSMEs face substantial challenges in adopting ESG frameworks due to limited knowledge, financial constraints, and fragmented policy support. Using a quantitative approach and survey method involving 100 qualified MSMEs, the findings reveal that both ESG regulation and tax incentives significantly affect ESG implementation. Multiple linear regression analysis shows that ESG regulations, tax incentives, as well as the perceived challenges and opportunities of ESG, collectively contribute to the extent to which ESG is integrated into MSMEs' financial reports. These insights provide valuable input for policymakers to develop more inclusive regulations and strategic incentives to support MSMEs in transitioning toward sustainable business practices.

Keywords : ESG; MSMEs; tax incentives; sustainability.

I. INTRODUCTION

Environmental, Social, and Governance (ESG) metrics are increasingly used to assess business sustainability and ethical impact. While commonly adopted in large enterprises, ESG implementation among MSMEs in Indonesia remains limited due to structural and informational constraints. Narula et al., (2024) found that companies with strong ESG performance tend to attract more investors and possess higher firm value. Similarly, Daugaard & Ding (2022) argued that the ESG paradigm has shifted global business expectations, but adoption within MSMEs is hindered by fragmented regulations and a lack of incentives. The implementation of ESG in SME financial reports is not only related to compliance with accounting regulations, but also to tax obligations. Carbon taxes, green incentives, and tax deductions for social activities are part of policies that are increasingly relevant to SMEs (Hanlon & Heitzman, 2010).

In Indonesia, ESG-related regulations remain fragmented and primarily target large firms. Although Otoritas Jasa Keuangan Indonesia (2023) has introduced sustainable finance guidelines, MSMEs often struggle to interpret and apply them. Recent pilot training programs, such as those by ITS Surabaya (Noer et al., 2024), indicate that ESG literacy improves with structured assistance. However, comprehensive policy and financial incentives remain

insufficient. Research by Rahmah (2024) and Kartika et al. (2023) has shown that ESG disclosure can significantly influence financial performance, yet MSMEs have been largely overlooked in such studies. If MSMEs do not start adopting ESG, they risk losing access to international funding and markets. A study by (Adi Cakranegara, 2021) shows that global investors are increasingly considering ESG as a major factor in investment decisions. Therefore, this research is important to examine how ESG taxation and regulatory policies can be optimized so that MSMEs can more easily adopt them.

This study aims to fill that gap by focusing on the role of regulatory frameworks and tax incentives in promoting ESG adoption among MSMEs. It contributes to the literature by addressing not only barriers but also potential opportunities such as reputational gain and access to green financing (Kräussl et al. (2024). Grounded in stakeholder theory (Freeman & McVea, 2005) and institutional theory (DiMaggio & Powell, 2010), this study proposes that both external pressures and internal motivations shape MSMEs' willingness to embrace ESG. The following research questions are posed: (1) Do ESG regulations influence the implementation of ESG in MSME financial reporting? (2) Do tax incentives affect ESG implementation? (3) What are the

challenges and opportunities faced by MSMEs in adopting ESG practices?
(4) To what extent do these factors simultaneously affect ESG adoption?

II. RESEARCH METHOD

This research adopts a quantitative approach using survey methods. The population includes MSMEs in West Java formally registered and reporting financial statements. Using purposive sampling, 100 respondents were selected based on criteria: minimum 2 years in operation and financial reporting. The Slovin formula with a 10% margin of error was used for sampling.

Data was collected through structured questionnaires using a 5-point Likert scale. Instrument validity was tested via Pearson product-moment correlation and reliability via Cronbach's Alpha. The study variables include ESG implementation (Y), ESG regulation (X1), tax incentives (X2), ESG challenges (X3), and ESG opportunities (X4). Data were analyzed using descriptive statistics and multiple regression with SPSS 27.

Regression assumptions such as multicollinearity ($VIF < 10$), heteroscedasticity (Glejser test), and autocorrelation (Durbin-Watson) were confirmed. According to Field (2024), regression is suitable for understanding how multiple independent variables simultaneously affect a dependent variable.

III. RESULTS AND DISCUSSION

Descriptive analysis shows ESG implementation among MSMEs is at a high level (78% in the "good" category). Regulations scored 54% and were also categorized as poor, indicating limited understanding and compliance. Tax incentives scored 59%, suggesting moderate awareness and impact. Challenges received 56% and opportunities 81%, highlighting MSMEs recognize ESG's potential but face barriers in execution.

Table 1. Descriptive Statistics of Variables

Var.	Classification Score (%)	Interpretation
Y	78%	Good
X1	54%	Poor
X2	59%	Moderate
X3	56%	Moderate
X4	81%	Good

Source: Primary Data Processed with SPSS v27.

The instrument's validity was established with all item correlations exceeding $r = 0.361$ at $p < 0.05$. Reliability tests show Cronbach's Alpha values > 0.6 for all variables, confirming internal consistency.

Table 2. Summary of Instrument Validity and Reliability

Var	Valid Items	r-value Range	Cronbach's Alpha	Status
X1	5	0.463–0.985	0.886	Reliable
X2	5	0.518–0.931	0.861	Reliable
X3	5	0.589–0.808	0.777	Reliable
X4	5	0.529–0.862	0.684	Reliable
Y	5	0.618–0.798	0.689	Reliable

Source: Primary Data Processed with SPSS v27.

Multiple linear regression results show that that not only ESG regulations (X1) and tax incentives (X2), but also ESG challenges (X3) and ESG opportunities (X4), have statistically significant partial effects on ESG implementation. The positive coefficient of X3 ($\beta = 0.314$, sig = 0.004) implies that awareness of ESG challenges motivates MSMEs to improve their reporting practices, possibly as a risk management response. Meanwhile, ESG opportunities (X4) yield the second strongest coefficient ($\beta = 0.439$, sig = 0.000), emphasizing that reputational benefits, access to funding, and competitive advantage are strong incentives for ESG adoption.

Table 3. Results of Multiple Linear Regression Analysis

Var.	Coefficient (β)	t-value	Sig. (p-value)
Constant	1.342	-	-
X1	0.486	4.225	0.000
X2	0.392	3.672	0.001
X3	0.314	2.925	0.004
X4	0.439	4.523	0.000

Source: Primary Data Processed with SPSS v27.

These findings are in line with previous research, such as Momtaz & Parra (2024), who demonstrate that ESG disclosure enhances SME performance, and Meiklejohn (2020), who links ESG commitment with transparency and tax compliance. This supports the premise that responsible business practices can reduce risk exposure and improve long-term financial outcomes.

The results can be explained using Stakeholder Theory (Freeman & McVea, 2005), which posits that businesses must respond to the expectations of a wide range of stakeholders, not just shareholders. MSMEs that adopt ESG practices are better positioned to meet investor expectations, align with government agendas, and satisfy customer preferences for sustainable products. Institutional Theory (DiMaggio & Powell, 2010) further clarifies that organizational behavior is shaped by social norms and regulatory frameworks. In the context of this study, MSMEs that perceive ESG as a path toward legitimacy and institutional alignment are more likely to integrate ESG into their operations.

However, the challenge remains in converting external pressure into actionable adoption. While training initiatives (Noer et al., 2024) have shown promising outcomes in raising ESG awareness, these efforts are still isolated and lack national consistency. Similarly, the lack of coherent incentives and fragmented ESG policy designs hamper MSMEs' ability to respond effectively. As highlighted by (Daugaard & Ding, 2022), ESG performance is highly dependent on accessible policy frameworks. Moreover, although the ESG market is growing globally (Narula et al., 2024; Kräussl et al., 2024), MSMEs in developing countries like Indonesia

still face contextual and structural limitations, as emphasized by Kartika et al. (2023) and Rahmah (2024).

This study's empirical evidence underscores that a strategic approach, combining clear regulation, effective incentive mechanisms, and institutional support, is crucial to improving ESG integration in the MSME sector. Given that ESG-related opportunities (such as funding access and improved branding) scored highest in this study, there is a clear incentive for policymakers to design more inclusive ESG frameworks tailored to the realities of MSMEs.

IV. CONCLUSION

This study sheds new light on the pressing question: Can ESG be more than just a corporate trend and truly become a practical, value-generating framework for MSMEs? The answer, based on empirical evidence from 100 MSMEs in West Java, is a cautious but optimistic yes. Regulations and tax incentives are not merely background variables, they are pivotal levers in transforming ESG from concept to practice. Although the level of ESG implementation remains low, this study confirms that when MSMEs are equipped with clear regulatory guidance and accessible fiscal support, their adoption of ESG significantly improves.

More importantly, this research highlights a powerful

message for policymakers and sustainability advocates: MSMEs are not resistant to change, they are simply underserved by current institutional arrangements. By anchoring this study in Stakeholder Theory and Institutional Theory, we underline the systemic need for legitimacy, pressure, and support to enable ESG integration at the grassroots level.

Thus, this research goes beyond diagnosis, it offers direction. It calls for a rethinking of how ESG frameworks are designed and communicated in Indonesia. For a country whose economy relies heavily on MSMEs, unlocking the ESG potential of this sector is not a peripheral issue, it is central to sustainable development. Future research should build on this foundation by exploring longitudinal impacts, sector-specific policies, and the lived experiences of MSMEs navigating ESG transformation.

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