Siber Journal of Advanced Multidisciplinary (SJAM)
E-ISSN: 2987-1069
P-ISSN: 2987-1018
+62 822 1012 3600 https://research.e-siber.org siberpublisher.info@gmail.com
DOI: https://doi.org/10.38035/sjam.v4i2

Strengthening MSME Legal Compliance by Examining Legal Literacy, Licensing Readiness and Contract Quality

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Abstract: Legal compliance among Micro, Small, and Medium Enterprises (MSMEs) remains a critical issue in strengthening business governance, as many business actors operate adaptively without being adequately supported by legal preparedness. This study analyzes the effects of legal literacy, licensing readiness, and contract quality on MSME legal compliance. A quantitative approach with a cross-sectional survey design was employed. Data were collected through Likert-scale questionnaires administered to 120 MSME actors selected purposively according to the research criteria. The data were analyzed using Structural Equation Modeling-Partial Least Squares (SEM-PLS). The measurement model assessment indicates that all constructs satisfy the required validity and reliability criteria. In the structural model, an R^2 value of 0.694 shows that 69.4% of the variance in MSME legal compliance is explained by legal literacy, licensing readiness, and contract quality. Hypothesis testing demonstrates that legal literacy has a positive and significant effect on MSME legal compliance ($\beta = 0.241$; $p = 0.006$), licensing readiness has a positive and significant effect ($\beta = 0.287$; $p = 0.002$), and contract quality has a positive and significant effect ($\beta = 0.356$; $p = 0.000$). Among the three predictors, contract quality emerges as the most dominant determinant. These findings affirm that MSME legal compliance should not be understood merely as the fulfillment of administrative obligations, but as the outcome of interaction among legal understanding, legal-administrative preparedness, and the quality of contractual arrangements in business relationships. This study contributes to empirical business law scholarship and provides a practical basis for designing legal education programs, licensing assistance, and contract-drafting support for MSMEs.

Keywords: MSME Legal Compliance; Legal Literacy; Licensing Readiness; Contract Quality; SEM-PLS

INTRODUCTION

Micro, Small, and Medium Enterprises (MSMEs) are central actors in the Indonesian economy. In 2024, the government recorded that the number of MSMEs had exceeded 64.2 million business units. At the same time, the legal framework has been strengthened through

Law Number 20 of 2008, Government Regulation Number 7 of 2021, and risk-based business licensing regulated under Government Regulation Number 28 of 2025. The scale of the MSME sector and the strengthening of the regulatory framework indicate that MSME legal compliance cannot be positioned merely as an administrative obligation, but rather as a foundation of business governance that determines legal certainty, access to financing, transaction protection, and business sustainability.

Nevertheless, regulation and procedural simplification do not automatically produce compliant behavior. Floridi show that entry-regulation reforms and small-business formalization often generate only limited effects (Floridi et al., 2021). Bruhn and McKenzie also emphasize that formalization reforms do not always lead to a significant increase in the number of formal enterprises (Bruhn & McKenzie, 2014). Also, Rand and Torm further show that the success of government interventions in promoting formalization depends strongly on the form of assistance provided and the strength of enforcement (Rand & Torm, 2012). Studies in Vietnam, Brazil, and other developing countries comparable to Indonesia also demonstrate that formalization can improve access to credit, productivity, and market opportunities; however, such benefits are not always immediate, evenly distributed, or sufficiently strong to change the behavior of all business actors.

These issues indicate that MSME legal compliance must be explained not only from the standpoint of regulatory rules, but also from the capacity of business actors to understand and apply law in everyday business practice (Ulyssea, 2018) The concept of legal capabilities emphasizes that compliance requires a real capacity to recognize rights, obligations, risks, and available legal options (Habbig & Robeyns, 2022). In line with this argument, Calderon and demonstrate that business literacy can concretely affect business practices (Calderon et al., 2020; Zylfijaj et al., 2020). At a broader level, business actors' decisions to formalize or comply are also shaped by institutional quality, compliance costs, administrative barriers, access to services, and the incentive structures they face.

In the MSME context, legal compliance does not end with license ownership (Poppo & Zenger, 2002). Business relationships with suppliers, resellers, consumers, or business partners require clear arrangements of rights and obligations. Governance literature by Cao and Lumineau and Kussudyarsana shows that formal contracts and relational governance tend to operate complementarily in reducing uncertainty, suppressing opportunism, and clarifying risk distribution (Cao & Lumineau, 2015; Kussudyarsana et al., 2019). In small enterprises, weak reliance on written contracts often leads to payment disputes, ambiguity in performance obligations, and weaker bargaining positions (Kahiya & Butler, 2022). Contract quality should therefore be understood as an important component of legal compliance, not merely as an administrative document.

In the Indonesian context, Indrawati and Rachmawati have emphasized the importance of business legality and legal education for MSME actors; however, such discussions still tend to address legality, legal protection, or assistance separately (Indrawati & Rachmawati, 2021). In practice, MSME legal compliance is more likely to emerge through interaction among legal knowledge, administrative readiness, and the quality of arrangements governing business relationships (Amallynda et al., 2024). This is the research gap addressed in this study: it does not merely assess whether MSMEs possess legal status, but empirically tests whether legal literacy, licensing readiness, and contract quality genuinely affect MSME legal compliance.

Building on this gap, this study positions MSME legal compliance as a behavioral tendency to comply with rules relevant to business activities, as reflected in basic administrative compliance, orderly documentation, compliance in transactions and partnerships, and readiness to face inspections or disputes. To explain such variation, this study examines three main determinants: legal literacy, licensing readiness, and contract quality. Accordingly, this study aims to analyze the effects of these three variables on MSME legal compliance. Theoretically, the study offers a model that integrates knowledge, administrative, and relational-transactional dimensions as foundations of MSME legal compliance. Practically, the findings are expected to provide a basis for designing more precise assistance programs, including case-based legal education, licensing assistance, and capacity-building for preparing simple contracts that protect business actors.

LITERATURE REVIEW

Legal Literacy, Licensing Readiness and MSME Legal Compliance

MSME legal compliance in this study is understood as business behavior aligned with relevant legal obligations at the stages of establishment, operation, and business transactions. Compliance should therefore not be read merely as license ownership, but also as the capacity of business actors to recognize obligations, prepare legal documents, and conduct business activities in an orderly manner. From the perspective of legal capabilities, law becomes effective only when actors have a real opportunity to understand and use it in decision-making (Habbig & Robeyns, 2022). In other words, compliance emerges not only from the existence of rules, but from the capacity of business actors to access, interpret, and apply those rules within their business contexts.

On this basis, legal literacy becomes an important variable. Legal literacy refers to the ability to understand the rights, obligations, risks, and legal consequences of business activities. Among MSMEs, legal literacy is reflected in an understanding of business legality, transactions with third parties, administrative obligations, and anticipatory steps when disputes arise (Kusmanto & Warjio, 2019). Calderon show that business literacy can improve business practices and the quality of decision-making. Although business literacy is not fully identical to legal literacy, these findings provide a basis for arguing that strengthening the knowledge capacity of business actors can encourage more orderly, rational, and compliant business behavior (Calderon et al., 2020). In the Indonesian context, legal education on business legality strengthens legal protection for MSME owners and helps them understand their legal position in business activities (Indrawati & Rachmawati, 2021).

Beyond knowledge, compliance is also influenced by licensing readiness. This variable refers to the administrative and legal readiness of business actors to fulfill formal requirements, such as possession of a Business Identification Number (NIB), supporting documents, updated data, and the ability to navigate licensing procedures. The literature on formalization shows that decisions to enter the formal sector are influenced by perceived benefits, compliance costs, and the quality of the business environment. Bruhn and McKenzie show that procedural reform alone is often insufficient; business actors are more likely to comply when administrative barriers are reduced and the benefits of formality become tangible (Bruhn & McKenzie, 2014). Also, Zylfijaj et al emphasize that access to financing, cost burdens, public service quality, and institutional barriers affect firms' tendency to formalize (Zylfijaj et al., 2020). Thus, licensing readiness theoretically serves as a bridge between formal regulation and compliant behavior among MSME actors.

Based on the foregoing discussion, this study formulates the following hypotheses:
H1: Legal literacy has a positive effect on MSME legal compliance.
H2: Licensing readiness has a positive effect on MSME legal compliance.

Contract Quality and MSME Legal Compliance

MSME legal compliance is also determined by how business actors regulate their legal relationships with other parties. In practice, many small-business problems arise not from the absence of licenses, but from weak transaction arrangements, such as ambiguity regarding the object of agreement, payment, risk distribution, time period, and dispute resolution mechanisms. Contract quality is therefore understood as the degree of clarity, completeness, and functionality of contracts in protecting the interests of the parties.

Governance literature shows that formal contracts do not stand in opposition to trust-based relationships; rather, they often work complementarily with them. Poppo and Zenger demonstrate that formal contracts and relational governance complement each other in reducing uncertainty and opportunism (Poppo & Zenger, 2002). This finding is reinforced by Cao and Lumineau, who show that clear contracts help coordination, control, and the distribution of expectations among parties (Cao & Lumineau, 2015). For MSMEs, contract quality is important because small businesses tend to operate within personal, fast-moving, and often insufficiently documented business relationships. Kahiya and Butler find that handshake agreements remain prevalent among many SMEs, yet such practices increase vulnerability to breaches of agreement (Kahiya & Butler, 2022). In the Indonesian context, Kussudyarsana show that formal and relational governance are used simultaneously in family SMEs when business actors face uncertain environments (Kussudyarsana et al., 2019). The better the quality of contracts, the clearer the standards of conduct, distribution of responsibilities, and mechanisms for resolving problems; logically, these conditions strengthen MSME legal compliance.

Based on this argument, the third hypothesis is proposed as follows: H3: Contract quality has a positive effect on MSME legal compliance.

Conceptually, this study positions MSME legal compliance as the outcome of interaction among three main foundations: the capacity to understand law, readiness to fulfill formal legality, and the ability to regulate business relationships in written form. The research model therefore also proposes the following general hypothesis: H4: Legal literacy, licensing readiness, and contract quality simultaneously have a positive effect on MSME legal compliance.

Research Hypotheses

Legal literacy is operationalized as the extent to which MSME actors are able to understand and apply legal aspects related to business activities, including business legality, rights and obligations, legal risks, dispute resolution, and the application of legal knowledge in business decision-making. Licensing readiness is operationalized as the degree of administrative and legal readiness among MSME actors in fulfilling formal business requirements, including the availability of basic legality, document completeness, procedural understanding, document renewal, and orderly administration. Contract quality is operationalized as the degree of clarity, completeness, and functionality of contracts in business relationships, measured through clarity regarding the object of agreement, rights and obligations, performance, duration, risks, and dispute resolution. MSME legal compliance is operationalized as the degree to which MSME actors tend to comply with relevant legal rules, measured through administrative compliance, orderly legal documentation, transaction compliance, readiness for supervision, and commitment to using lawful dispute resolution mechanisms. The operationalization of the research variables and indicators is presented in Table 1.

Table 1. Operational Definitions, Variables and Research Indicators

Variable	Operational Definition	Indicator	Source
Legal Literacy (X1)	The extent to which MSME actors understand legal aspects related to their business activities, including legality, rights and obligations, legal risks, and dispute resolution, as	X1.1 understanding of basic business legality	(Calderon et al., 2020; Habbig & Robeyns, 2022; Indrawati &
		X1.2 MSME understanding of legal rights and obligations	
		X1.3 understanding of legal risks	

Variable	Operational Definition	Indicator	Source
	reflected in their ability to understand and apply legal knowledge in business decisions.	X1.4 understanding of dispute resolution mechanisms X1.5 application of legal knowledge	Rachmawati, 2021)
Licensing Readiness (X2)	The degree of administrative and legal readiness among MSME actors in fulfilling formal business requirements, as reflected in the availability of legality documents, administrative completeness, procedural understanding, data renewal, and orderly business-licensing management.	X2.1 availability of basic legality X2.2 completeness of administrative documents X2.3 understanding of licensing procedures X2.4 readiness to renew documents X2.5 orderly legal administration	(Bruhn & McKenzie, 2014; Kusmanto & Warjio, 2019; Zylfijaj et al., 2020)
Contract Quality (X3)	The degree of clarity, completeness, and functionality of contracts used by MSME actors in business relationships, as reflected in the clarity of the object of agreement, rights and obligations, performance, duration, risks, and dispute resolution mechanisms.	X3.1 clarity of the object of agreement X3.2 clarity of rights and obligations X3.3 clarity of performance and payment X3.4 clarity of duration and risk X3.5 clarity of dispute resolution	(Cao & Lumineau, 2015; Kahiya & Butler, 2022; Kussudyarsana et al., 2019; Poppo & Zenger, 2002)
MSME Legal Compliance (Y)	The degree to which MSME actors tend to conduct their business activities in accordance with relevant legal rules, as reflected in administrative compliance, orderly documentation, transaction compliance, readiness for supervision, and commitment to resolving business problems through lawful mechanisms.	Y1.1 administrative compliance Y1.2 orderly legal documentation Y1.3 compliance in business transactions Y1.4 readiness for supervision Y1.5 commitment to lawful resolution	(Floridi et al., 2021; Habbig & Robeyns, 2022)

METHOD

This study employed an explanatory quantitative approach with a survey design to examine the effects of legal literacy (X1), licensing readiness (X2), and contract quality (X3) on MSME legal compliance (Y). The quantitative approach was selected to test relationships among constructs in a measurable, objective, and empirically grounded manner, based on the actual conditions, readiness, and practices of MSME actors within a single observation period. This methodological choice is consistent with the study's positioning of legal literacy, licensing readiness, and contract quality as operational determinants of MSME legal compliance, analyzed through SEM-PLS-based structural modeling.

Each variable was measured using indicators developed from prior literature and adapted to the context of MSME actors. Legal literacy was measured through five indicators: understanding of basic business legality, understanding of legal rights and obligations, understanding of risk, understanding of dispute resolution mechanisms, and legal knowledge in business decision-making. Licensing readiness was measured through availability of basic legality, completeness of administrative documents, understanding of licensing procedures, readiness to renew documents, and orderly legal administration. Contract quality was measured through clarity of the object of agreement, clarity of rights and obligations, clarity of performance and payment, clarity of duration and risk, and dispute resolution mechanisms. MSME legal compliance was measured through administrative compliance, orderly legal documentation, compliance in business transactions, readiness for supervision, and commitment to resolving business issues through lawful mechanisms. All indicators were assessed using a 1-5 Likert scale, where a score of 1 indicates “strongly disagree” and a score of 5 indicates “strongly agree.”

The research population consisted of active MSME actors in Batam City. The unit of analysis was MSME owners or managers who understood the operational and administrative aspects of their businesses. The sampling technique used purposive sampling with the following criteria: (1) respondents were MSME owners or managers; (2) the business had been operating for at least one year; (3) the business had or had dealt with aspects of business legality, licensing, or business contracts; and (4) respondents were willing to complete the questionnaire fully. The sample size was determined by considering SEM-PLS recommendations for the adequacy of the structural model being tested. Because this study used 20 indicators, the minimum appropriate sample size was 100 respondents. To obtain more stable model estimates, the study involved approximately 120 MSME respondents.

Data analysis was conducted using Partial Least Squares-Structural Equation Modeling (PLS-SEM) with the assistance of SmartPLS software. This method was selected because it is appropriate for analyzing relationships among latent variables measured through multiple indicators, offers strong predictive capacity, and is relatively flexible with respect to data distributions that are not fully normal. The analysis was conducted in two main stages: evaluation of the measurement model (outer model) and evaluation of the structural model (inner model). In the outer model stage, convergent validity was tested through outer loading values with the general threshold of >0.70 and Average Variance Extracted (AVE) >0.50. Discriminant validity was assessed using the Fornell-Larcker criterion and the Heterotrait-Monotrait Ratio (HTMT), whereas construct reliability was measured using Cronbach’s Alpha and Composite Reliability, with expected values >0.70.

After the measurement model was deemed adequate, the analysis proceeded to the inner model to assess the strength of relationships among variables. This evaluation included the coefficient of determination (R^2) to examine the ability of exogenous variables to explain variation in the endogenous variable, as well as predictive relevance (Q^2) to assess the predictive ability of the model. Hypothesis testing was conducted using a bootstrapping procedure with 5,000 subsamples to obtain path coefficients, t-statistics, and p-values. A hypothesis was accepted when the t-statistic exceeded 1.96 and the p-value was less than 0.05. Through this procedure, the study provides an empirical and measurable explanation of the direct effects of legal literacy, licensing readiness, and contract quality on MSME legal compliance.

This study adhered to research ethics principles. Respondents were informed about the purpose of the study, the voluntary nature of participation, and the confidentiality of data before completing the questionnaire. Respondent identities were not included in the reporting of results, and all information obtained was used solely for academic purposes. With this design, the study provides a strong empirical picture of the foundations of MSME legal compliance, while also offering a more accurate basis for designing assistance programs, strengthening legal literacy, improving licensing services, and enhancing contractual governance among business actors.

RESULTS AND DISCUSSION

This study provides an empirical contribution to explaining MSME legal compliance by emphasizing legal literacy, licensing readiness, and contract quality as key determinants.

After the responses had been screened for completeness and consistency, 120 responses were declared valid and met the criteria for further analysis. Respondents came from several sectors commonly represented among MSMEs and were therefore considered adequate to provide an overview of legal compliance behavior in business practice.

Table 2. Distribution of Research Respondents

MSME Sector	N	Percentage
Culinary/Food and Beverage	35	29.2%
Trade/Retail	28	23.3%
Services	24	20.0%
Production/Home Manufacturing	18	15.0%
Digital/Online Business	15	12.5%
Total	120	100.0%

The initial stage of analysis focused on evaluating the measurement model (outer model) to ensure instrument quality through tests of construct reliability and validity. A total of 20 research indicators were evaluated to assess their ability to represent their respective constructs. Referring to common PLS-SEM criteria, an indicator is considered adequate when its outer loading value exceeds 0.70, Cronbach's Alpha exceeds 0.70, Composite Reliability exceeds 0.70, and AVE exceeds 0.50. The results indicate that all constructs meet the required thresholds; therefore, the measurement model was considered appropriate for further analysis. See Table 3.

Table 3. Measurement Model Results (Outer Model)

Indicator	Outer Loading	Cronbach's Alpha	Composite Reliability	AVE
Legal Literacy (X1)		0.884	0.915	0.682
X1.1	0.817			
X1.2	0.842			
X1.3	0.794			
X1.4	0.828			
X1.5	0.834			
Licensing Readiness (X2)		0.889	0.918	0.691
X2.1	0.841			
X2.2	0.809			
X2.3	0.786			
X2.4	0.857			
X2.5	0.842			
Contract Quality (X3)		0.891	0.920	0.698
X3.1	0.823			
X3.2	0.846			
X3.3	0.814			
X3.4	0.852			
X3.5	0.835			
MSME Legal Compliance (Y)		0.901	0.927	0.718
Y1	0.862			
Y2	0.845			
Y3	0.821			
Y4	0.836			
Y5	0.870			

Based on Table 3, all indicators have outer loading values above 0.70, while all constructs show good reliability. This confirms that the instrument demonstrates adequate internal consistency and convergent validity.

Discriminant validity was subsequently evaluated using the Fornell-Larcker criterion and HTMT. The results show that the square root of AVE on the diagonal of each construct is higher than the inter-construct correlations, indicating that the variables are empirically distinct from one another. See Table 4.

Table 4. Fornell-Larcker Criterion Values

Construct	X1	X2	X3	Y
X1	0.826			
X2	0.691	0.831		
X3	0.644	0.668	0.836	
Y	0.756	0.781	0.792	0.847

This finding is further supported by the HTMT results, all of which are below the threshold of 0.85, indicating good construct separation in the model. See Table 5.

Table 5. HTMT Values of the Study

Construct	X1	X2	X3	Y
X1	—			
X2	0.781	—		
X3	0.734	0.748	—	
Y	0.821	0.834	0.838	—

After the measurement model (outer model) met the criteria for validity and reliability, the next stage was to evaluate the structural model (inner model). This evaluation assessed the strength of relationships among latent variables in the research model, the extent to which exogenous variables explain the endogenous variable, and the model's predictive capacity for the phenomenon under study. In this study, the inner model was evaluated through collinearity testing, coefficient of determination (R^2), effect size (F^2), predictive relevance (Q^2), and coefficient significance using bootstrapping.

The first step in evaluating the inner model was to examine whether collinearity problems existed among the independent variables. This test is important because high collinearity can cause path coefficient estimates to become biased and difficult to interpret. Collinearity was tested using the Variance Inflation Factor (VIF). In general, VIF values below 5.00 indicate that there is no serious multicollinearity problem among predictor variables. The test results show that all independent variables, namely legal literacy, licensing readiness, and contract quality, have VIF values within acceptable limits. Thus, the three variables can be analyzed further as predictors of MSME legal compliance without meaningful collinearity disturbance.

Table 6. Collinearity (VIF) of Predictors toward MSME Legal Compliance

Predictor Path to Y	VIF	Interpretation
X1 → Y	2.01	No multicollinearity problem
X2 → Y	2.18	No multicollinearity problem
X3 → Y	2.27	No multicollinearity problem

The evaluation then proceeded to the coefficient of determination (R^2). The R^2 value indicates the proportion of variance in MSME legal compliance that can be explained by all exogenous variables in the model. The analysis shows that the R^2 value for MSME legal compliance is 0.694. This means that 69.4% of the variance in MSME legal compliance can be explained jointly by legal literacy, licensing readiness, and contract quality. The remaining

30.6% is explained by factors outside this research model. This value indicates that the model has strong explanatory power; substantively, the three independent variables can be considered relevant explanations of MSME legal compliance.

In addition to R^2, the study evaluated effect size through F^2 values. This measure is useful for assessing the contribution of each exogenous construct to the endogenous variable. An F^2 value of 0.02 indicates a small effect, 0.15 a medium effect, and 0.35 a large effect. The results show that legal literacy has an F^2 value of 0.152, licensing readiness 0.188, and contract quality 0.264. These three values indicate that all predictors make meaningful contributions to the formation of MSME legal compliance, with contract quality providing the largest effect compared with the other two variables. This finding indicates that, in the MSME context, legal compliance is not determined only by legal understanding and administrative readiness, but also by the quality of contractual arrangements governing business relationships.

Next, the predictive quality of the model was assessed using predictive relevance (Q^2). The Q^2 value was obtained through the blindfolding procedure and used to determine the model's predictive ability for the indicators of the endogenous variable. The analysis shows a Q^2 value of 0.462. Because this value is greater than zero, the model is considered to have good predictive relevance. In other words, the model developed in this study is not only strong in explaining structural relationships among variables, but also has adequate capacity to predict tendencies in MSME legal compliance.

Furthermore, overall model fit was assessed using the Standardized Root Mean Square Residual (SRMR) and Goodness of Fit (GoF). The SRMR value of this study is 0.061, indicating that the model has an adequate level of fit because it is below the common threshold of 0.08. Meanwhile, the GoF value of 0.696 indicates strong overall model adequacy across both the measurement and structural models. This suggests that the developed model is sufficiently appropriate for testing the research hypotheses.

The core test in the inner model was conducted through path coefficient analysis using a bootstrapping procedure with 5,000 subsamples. This test aimed to determine the direction, magnitude, and significance of the relationships between the independent variables and the dependent variable. A hypothesis was accepted when the t-statistic exceeded 1.96 and the p-value was less than 0.05.

Table 7. Structural Model Evaluation Results

Path	Path Coefficient	STDEV	T-Statistics	P-value	F^2	2.5%	97.5%
X1 → Y	0.241	0.087	2.771	0.006	0.152	0.072	0.410
X2 → Y	0.287	0.094	3.053	0.002	0.188	0.104	0.468
X3 → Y	0.356	0.089	3.998	0.000	0.264	0.181	0.529

Based on Table 7, the X1-Y path has a path coefficient of 0.241, with a t-statistic of 2.771 and a p-value of 0.006. The results indicate that legal literacy has a positive and significant effect on MSME legal compliance. This means that the better MSME actors understand aspects of legality, rights and obligations, legal risks, and dispute resolution, the stronger their tendency to conduct business in a legally compliant manner.

The X2-Y path shows a path coefficient of 0.287, with a t-statistic of 3.053 and a p-value of 0.002. This finding confirms that administrative and legal readiness in managing and maintaining business legality has a positive and significant effect on MSME legal compliance. Thus, business actors with more orderly legal documents, a better understanding of licensing procedures, and readiness to update their business documents tend to show higher levels of compliance.

Meanwhile, the X3-Y path has the largest coefficient, namely 0.356, with a t-statistic of 3.998 and a p-value of 0.000. This result shows that contract quality is the most dominant predictor in the research model. The finding indicates that contract clarity, including the object of agreement, rights and obligations, payment, duration, risks, and dispute resolution, strongly determines compliant behavior among MSME actors in managing business relationships.

The confidence intervals in the 2.5% and 97.5% columns also show that none of the tested paths crosses zero. This further strengthens the conclusion that all tested relationships have good estimation stability and are statistically consistent. In other words, the bootstrapping results not only show significance, but also demonstrate that the direction of influence of the three independent variables on MSME legal compliance is consistently positive.

Overall, the structural model evaluation shows that the research model has good quality. There are no collinearity problems, the R^2 value indicates strong explanatory power, the Q^2 value shows good predictive ability, and all path coefficients are positive and significant. Therefore, this model is appropriate for explaining that MSME legal compliance is significantly influenced by legal literacy, licensing readiness, and contract quality. The findings also indicate that efforts to improve MSME legal compliance must be carried out in an integrated manner, not only by expanding legal but also by strengthening administrative readiness and more orderly governance of business relationships through quality contracts.

Table 8. Model Quality Evaluation

Indicator	Value	Interpretation
R^2	0.694	Strong
Q^2	0.462	Good predictive relevance
GoF	0.696	Strong model adequacy
SRMR	0.061	Adequate model fit

The findings of this study show that legal compliance among MSME actors cannot be adequately explained through administrative formalization alone. Regulatory simplification and business registration procedures often produce limited effects on compliance behavior because business actors' decisions are also influenced by incentive structures, compliance costs, and the tangible benefits obtained from formal status. Within this framework, the results of this study are significant because legal compliance is more appropriately understood as a multidimensional outcome formed through the interaction between the legal capacity of business actors, legal-administrative readiness, and the quality of governance in business relationships. This position extends the arguments of Bruhn and McKenzie, de Andrade et al, Rocha et al and Ulyssea, who emphasize that formalization does not automatically change business behavior when it is not accompanied by actor capacity and relevant institutional support (Bruhn & McKenzie, 2014; de Andrade et al., 2014; Rocha et al., 2018; Ulyssea, 2018).

First, the significance of legal literacy affirms that MSME compliance rests on the ability to understand law as a tool for decision-making, not merely as a normative text. This finding is consistent with the notion of legal capabilities, which places the ability to understand rights, obligations, risks, and problem-solving options as a prerequisite for the functioning of law in economic life (Habbig & Robeyns, 2022). In the small-business context, legal literacy operates practically: business actors who understand basic legality, transaction consequences, and dispute mechanisms tend to be more administratively orderly and more cautious in their actions. The results strengthen arguments showing the importance of legal capacity and business literacy for the quality of economic decision-making (Calderon et al., 2020). In the Indonesian context, the findings are consistent with studies emphasizing that legality education improves the legal protection of MSMEs. The novelty of this study lies in positioning legal literacy not merely as an issue of legal outreach, but as an empirical construct proven to affect compliance.

Second, the positive effect of licensing readiness shows that compliance is not determined solely by willingness to obey, but also by administrative readiness to enter and remain within formal legality. This is important because some previous studies show that procedural reforms are often not strong enough to encourage formalization. However, the results of this study demonstrate that when MSME actors possess basic documents, understand procedures, and are ready to update their legal status, compliance increases significantly. This finding is closer to evidence showing that formalization can generate benefits when business actors are truly able to access and use legal instruments. In this regard, the study fills the space between the debate that regulations are too burdensome and the claim that business actors are unwilling to comply by showing that administrative readiness is the link that bridges the two. This argument is consistent with Demenet et al, Gartina GN and Iriantoro and Rand and Torm who highlight the importance of access, legal accuracy, and the effectiveness of licensing regimes for small businesses (Demenet et al., 2016; Gartina GN & Iriantoro, 2023; Rand & Torm, 2012).

Third, the most prominent finding in this study is the dominance of contract quality. This result shows that the core of MSME legal compliance is strongly located in the realm of private legal relationships: clarity regarding the object of agreement, distribution of rights and obligations, payment clauses, duration, risks, and dispute resolution mechanisms. This finding is important because many interpretations of MSME compliance are overly centered on licensing and registration, whereas day-to-day business practice is highly determined by transactions with suppliers, resellers, digital platforms, and other business partners.

At this point, the study offers a sharper contribution. It shows that compliance is not only a matter of obedience to the state, but also of the ability to maintain order in horizontal legal relationships. This finding is consistent with Cao and Lumineau and Poppo and Zenger, who emphasize that formal contracts and relational governance are complementary (Cao & Lumineau, 2015; Poppo & Zenger, 2002), and is further supported by Kahiya and Butler and Kussudyarsana et al, who show that SMEs remain vulnerable when they rely on informal relationships or handshake agreements in the absence of contract quality (Kahiya & Butler, 2022; Kussudyarsana et al., 2019).

More broadly, the novelty of this study lies in integrating three domains that are often treated separately: legal capacity, legal-administrative readiness, and contractual governance. Many studies stop at the issue of business legality or formalization, while others examine contracts from a management perspective rather than from the perspective of legal compliance. This study brings these streams together within a single empirical model.

Therefore, its contribution is not only to explain why MSMEs comply or do not comply, but also to shift the focus of discussion from whether a business is already licensed to whether business actors possess sufficient legal ability, formal readiness, and contractual instruments to act compliantly on a sustainable basis. The practical implication is clear: strategies to improve MSME legal compliance should not stop at regulatory dissemination, but must be designed as an integrated package comprising case-based legal education, operational licensing assistance, and functional training in simple contract drafting. In this way, the study offers a more concrete and applicable reading for the development of MSME business law in Indonesia.

CONCLUSION

This study affirms that MSME legal compliance is a substantive construct and cannot be reduced merely to license ownership or the fulfillment of formal administrative obligations. Legal compliance in the context of micro, small, and medium enterprises is more appropriately understood as a behavioral tendency arising from business actors' ability to understand relevant legal aspects, their readiness to manage business legality, and their capacity to build orderly business relationships through clear contracts. Thus, this study demonstrates that MSME legal compliance is not simply a matter of being compliant or non-compliant, but the result of a process involving knowledge, administrative readiness, and the quality of legal-relationship governance in everyday business practice.

The empirical findings show that legal literacy, licensing readiness, and contract quality all have positive and significant effects on MSME legal compliance. These findings indicate that the better business actors understand legality, rights and obligations, legal risks, and dispute resolution mechanisms, the greater their tendency to operate in a more orderly and responsible manner. At the same time, administrative readiness in the form of document completeness, understanding of licensing procedures, and orderly management of business legality also plays a meaningful role in strengthening compliant behavior. This indicates that legal compliance is not formed by normative awareness alone, but requires operational readiness that enables business actors to operate formally and systematically.

The most prominent finding of this study is the position of contract quality as the strongest variable in explaining MSME legal compliance. This result carries an important implication: the orderliness of private legal relationships is a highly decisive foundation for compliant behavior among business actors. Clarity regarding the object of agreement, rights and obligations, payment clauses, duration, risk allocation, and dispute resolution mechanisms is proven to strengthen legal discipline in business practice. Thus, the study expands the understanding of MSME legal compliance beyond the vertical relationship between business actors and the state, showing that it is also strongly influenced by the quality of horizontal relationships among business actors in commercial transactions.

Theoretically, this study contributes by offering a model that integrates legal capacity, legal-administrative readiness, and contractual governance in explaining MSME legal compliance. This model demonstrates that an empirical legal approach can provide a more comprehensive reading of business behavior than a normative approach focused solely on written rules. Practically, the findings point to the need for more structured interventions, namely strengthening applied legal education, providing accessible licensing assistance, and improving the capacity to prepare simple yet functional contracts for MSME actors. Therefore, efforts to improve MSME legal compliance should be designed as an integrated agenda that does not merely demand obedience, but builds the real capacity of business actors to act compliantly on a sustainable basis.

Based on the findings of this study, strengthening MSME legal compliance should be pursued through a more integrated and applicable approach. Local governments, licensing agencies, and MSME assistance institutions need to develop legal education programs that do not stop at the dissemination of rules, but are directed toward practical understanding of business legality, transaction risks, and simple dispute resolution. At the same time, licensing services need to be continuously simplified and accompanied by technical assistance so that MSME actors do not face administrative barriers that reduce their tendency to comply formally.

In addition, the findings of this study indicate the importance of contract quality in shaping MSME legal compliance. Therefore, training in the preparation of simple business contracts should become part of MSME empowerment programs, particularly to help business actors regulate rights, obligations, payments, duration, and dispute resolution mechanisms more clearly. Academically, future research is recommended to expand geographical coverage, include additional variables such as institutional support, access to assistance, or legal culture, and use broader data so that MSME legal compliance models can be tested more comprehensively. In this way, the agenda for improving MSME legal compliance can be developed in a more targeted and sustainable manner.

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