

# Enhancing Sustainable Development through Environmental Taxation: Challenges and Policy Recommendations for Malaysia

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**Abstract:** *This paper explores the role of environmental taxation in promoting sustainable development, with a specific focus on Malaysia, a rapidly developing nation facing both industrialization and environmental challenges. Environmental taxes, often referred to as green taxes, are increasingly recognized as effective tools for integrating ecological concerns into economic policies. The paper discusses how environmental taxes and tax incentives, such as exemptions and deductions for green technologies, help internalize environmental costs while fostering innovation and sustainable growth. However, the implementation of these policies in developing economies like Malaysia faces significant challenges, including lack of awareness, bureaucratic complexity, financial constraints, and resistance from industry stakeholders. Despite these barriers, Malaysia has introduced various tax-based incentives, such as the Green Technology Financing Scheme and Green Investment Allowances, to encourage eco-friendly practices. While these measures reflect the country's commitment to sustainability, their effectiveness remains hindered by insufficient enforcement and underutilization. The paper suggests strategies to improve the impact of Malaysia's environmental tax policies, including enhancing public awareness, simplifying administrative procedures, building public trust, and ensuring continuous policy evaluation. By addressing these challenges, Malaysia can better leverage environmental taxation to drive long-term sustainable development and economic growth. This study contributes to understanding how developing countries can design and implement more effective environmental tax policies in pursuit of their environmental and economic goals.*

**Keywords:** Environmental, Carbon Tax, Green Investment Allowance

## 1. Introduction

The introduction of environmental taxation has garnered significant attention in recent years. Scholars and policymakers increasingly examine its potential to promote sustainable development and mitigate environmental degradation. Commonly known as the "Green Tax" internationally, environmental taxes serve as fiscal instruments that integrate ecological considerations into economic policies (Hernimawati et al., 2020). To be effective, these taxes must align with existing fiscal policies while being broadly applicable. Additionally, pollution taxes and direct regulations play a crucial role in fostering environmental responsibility.

However, their success depends on the presence of an efficient enforcement body capable of monitoring compliance (Bovenberg & Goulder, 1996).

Environmental taxation and tax incentives are essential tools for promoting sustainability in developing economies. Taxes on carbon emissions and pollution help internalize environmental costs, encouraging businesses and individuals to adopt eco-friendly practices (Stapleton et al., 2006). Conversely, tax incentives, such as exemptions and deductions, stimulate investments in green technologies and sustainable infrastructure. When strategically implemented, these measures drive environmental innovation and economic growth (Marron & Toder, 2014).

According to Dradra (2024), developing economies, where rapid industrialization often threatens environmental sustainability, well-structured environmental taxation policies help balance economic growth with ecological preservation. Malaysia, as a developing economy with a strong industrial base and rich biodiversity, has recognized the importance of environmental taxation in mitigating environmental challenges. Over the years, the Malaysian government has introduced various tax-based incentives and regulations to promote green technology, energy efficiency, and pollution control. Policies such as the Green Technology Financing Scheme (GTFS), carbon tax discussions, and excise duties on plastic and fossil fuel-intensive products reflect the nation's commitment to sustainable development. However, the effectiveness of these measures remains a subject of debate, given the complexities of policy enforcement, industry compliance, and economic trade-offs.

This paper examines the role of environmental taxation in developing countries, with a particular focus on Malaysia. It explores the key challenges and opportunities in implementing environmental taxes towards the impact on economic growth, corporate sustainability, and public welfare. By understanding Malaysia's approach to environmental taxation, this study aims to provide insights into how developing economies can enhance tax policies to support long-term environmental and economic goals.

## **2. Environmental Taxation and Tax Incentives**

The Organization for Economic Co-operation and Development (OECD) has strongly advocated for countries to implement environmental taxes to achieve both economic and sustainable growth. Environmental taxes are an effective tool for addressing a range of environmental issues (OECD, 2011). Additionally, a study by the United Nations Economic and Social Commission for Asia and the Pacific (UNESCAP) investigated the rationale for introducing environmental taxes in the Asia-Pacific region to support the achievement of the Sustainable Development Goals (SDGs) (UN, 2017).

Developing countries face a unique dilemma when implementing environmental taxes. While such taxes discourage environmentally harmful activities, they may also impose financial burdens on businesses and consumers, potentially hindering economic growth (Shakerin et al., 2024). To mitigate this impact, many governments pair environmental taxes with tax incentives, such as exemptions, deductions, and subsidies for green technologies and sustainable practices. Research suggests that a balanced approach integrating environmental taxes with incentives enhances compliance and fosters green innovation without stifling economic growth (Uddin et al., 2023).

Tax incentives are commonly used to attract investment and stimulate economic growth. Developing nations often employ these incentives to reduce the tax burden on qualifying investment projects and businesses, promoting sectoral development, job creation, and export-driven activities (International Monetary Fund., 2024). However, the effectiveness of these incentives remains debated. While some studies suggest that tax incentives attract foreign direct investment, concerns persist regarding revenue losses and potential tax avoidance if not properly managed (OECD, 2022). Moreover, the introduction of a global minimum corporate tax rate poses new challenges, potentially diminishing the appeal of tax incentives as an investment promotion tool (OECD, 2022). For instance, in China and India, environmental tax policies are complemented by tax incentives for renewable energy investments, sustainable manufacturing, and carbon reduction initiatives (Masoud, 2024). These incentives help offset the financial impact of environmental taxes, encouraging businesses to adopt cleaner production methods. The success of such policies in developing nations depends on factors such as regulatory efficiency, institutional capacity, and public acceptance of taxation mechanisms (Ali & Kirikkaleli, 2024).

### **2.1 Environmental Taxation in Malaysia**

As a rapidly developing nation with rich biodiversity, Malaysia recognizes the significance of environmental taxation in addressing environmental challenges. The government has introduced various tax-based incentives and regulations to promote green technology, energy efficiency, and pollution control. Landmark policies such as the Environmental Quality Act of 1974 and Malaysia's ratification of the Kyoto Protocol in 2002 reflect its commitment to environmental protection. Additionally, public perception studies indicate a generally positive attitude toward carbon tax implementation, with trust in government playing a critical role in public support (Ahmad et al., 2024; Fan & Li, 2024). The purpose of implementing environmental taxes in Malaysia is to create financial incentives for individuals and businesses to adopt eco-friendly practices and reduce their carbon footprint. While direct environmental taxes have not been extensively implemented, Malaysia has utilized tax incentives and other economic instruments to promote environmental conservation, particularly in coastal areas (Hernimawati et al., 2020).

Several studies have examined the role of environmental taxation in Malaysia. The authors highlight that while Malaysia has not directly implemented environmental taxes, it has employed tax incentives and other economic instruments to promote environmental conservation, particularly in the coastal zone. Similarly, research on the policy of environmental taxes in Indonesia, a neighbouring country, has provided insights that may be relevant to the Malaysian context (Hernimawati et al., 2020). Public acceptance is a key determinant of environmental tax success. A nationwide empirical study in Malaysia found widespread support for carbon tax implementation, driven by factors such as perceived effectiveness in reducing emissions, willingness to pay for environmental protection, climate change awareness, and demographic factors (Muhammad et al., 2022; Uddin et al., 2023).

Research has demonstrated that environmental taxes can reduce pollution and encourage sustainable practices. For example, identified the carbon tax as a viable strategy to address environmental issues while also increasing government revenue. By giving tax incentives companies can take advantage of this to improve green technology (Muhammad et al., 2023)

### **2.2 Environmental Taxation Incentive in Malaysia**

Malaysia offers various tax incentives for manufacturing projects under the Promotion of Investments Act of 1986 and the Income Tax Act of 1967. The main incentives include Pioneer

Status, Investment Tax Allowance, Reinvestment Allowance, incentives for High Technology Industries, incentives for Strategic Projects, and incentives for establishing International or Regional Service-based Operations (Ministry of Development Authority, 2020)

MIDA, established under the Malaysian Industrial Development Authority Act of 1967, is a government agency dedicated to promoting the manufacturing and services sectors in Malaysia. MIDA assists companies looking to invest in these sectors and facilitates the implementation of their projects. The agency offers a wide range of services, including providing information on investment opportunities and helping companies find joint venture partners. One of MIDA's key roles is serving as a one-stop processing centre for applications for tax incentives

The IRBM, or Inland Revenue Board of Malaysia, is one of the primary revenue-collecting agencies under the Ministry of Finance. To encourage investment in the country, the IRBM provides various tax incentives, including tax exemptions and allowances based on capital expenditures, as well as enhanced tax deductions. Companies that have unutilized allowances can generally carry them forward until they are fully utilized. These tax incentives are typically available for tax-resident companies. Regarding incentives aimed at promoting a green environment, Malaysia concentrates on three key areas: renewable energy and fuels, material resources and waste, and pollution and ecosystems (Saad et al., 2024).

The tax incentives provided by the Malaysian government vary significantly based on the specific needs of different industries and businesses. These incentives are regularly updated, modified, or withdrawn to address the challenges and requirements of the Malaysian economy. The government's goal is to achieve 20 percent of energy consumption from renewable resources by 2025 and to reduce greenhouse gas emission intensity by 45 percent by 2030.

i. Green Investment Tax Allowance (GITA) for projects.

GITA supports companies by offering a 100% tax allowance on qualifying capital expenditures related to green technology projects, such as renewable energy, energy efficiency, green building development and retrofitting, and integrated waste management up to 5 years to 10 years. Companies that undertake green technology projects must be approved by the Malaysian Investment Development Authority (MIDA), while companies that acquire or install green technology assets must meet the criteria set by the Malaysian Green Technology and Climate Change Corporation (MGTC). This tax allowance can be used to offset 70%/ 100% depending on Tier of a company's statutory income and any unutilized allowances can be carried forward to subsequent years of assessment (YAs) until fully absorbed. By reducing the financial burden on firms, these incentives aim to accelerate the adoption of green technologies and promote low-carbon economic growth (Muhammad et al., 2023).

ii. Green Investment Tax Allowance (GITA) for assets.

The purchase of green technology assets as listed in MyHIJAU Directory can qualify for this tax incentive. Businesses investing in green technology assets for their own use can benefit from a 100% investment tax allowance on qualifying capital expenditure. The allowance can be set off against 70% of the statutory income and any unutilized allowances can be carried forward to subsequent years of assessment (YAs) until fully absorbed, encouraging the adoption of environmentally friendly technologies.

iii. Green Income Tax Exemption (GITE) for services.

The GITE Services incentive is available to companies listed in the MyHIJAU Directory that provide green technology services for clients engaging in green technology-related projects.

According to the MyHIJAU Directory and MIDA Guidelines, qualifying green technology services include system design, feasibility studies, advisory and consultancy services, as well as testing and commissioning in various sectors. These sectors encompass renewable energy, energy efficiency, electric vehicles, green buildings, green townships, green data centres, and more. A green technology service provider can apply for a tax exemption on income generated from these qualifying services, subject to approval from MIDA. The tax exemption amounts to 70% of the statutory income earned from providing eligible green services and is applicable for a period of three assessment years.

iv. Green Income Tax Exemption (GITE) for Solar Leasing.

Service providers offering solar leasing services can receive a 70% income tax exemption on statutory income derived from these activities. The qualifying activity of providing solar photovoltaic system leasing services is in relation to the implementation of Net Energy Metering Scheme for sales of electricity or solar photovoltaic system leasing. This measure is designed to promote the growth of renewable energy services in Malaysia.

v. Further Tax Deduction for Carbon Projects (FTC)

Further tax deduction of up to RM300,000 will be granted to companies that incur expenses on Measurement, Reporting and Verification (MRV) and activities related to the development of Carbon Projects. This incentive is applicable to companies that submit applications to Malaysian Green Technology and Climate Change Corporation (MGTC) from 1 January 2024 to 31 December 2026. The further tax deduction is deductible from the carbon credit income derived from trading at the Bursa Carbon Exchange (BCX).

vi. Carbon Tax

Malaysia is also exploring the feasibility of a carbon tax as part of its long-term climate strategy. While a full-fledged carbon pricing mechanism has yet to be implemented, discussions are ongoing regarding its potential impact on industries and economic competitiveness. Policymakers are considering mechanisms that would align carbon taxation with existing green tax incentives to ensure that businesses are not overburdened while still meeting national climate targets. A well-structured carbon tax, supported by targeted incentives, could enhance Malaysia's efforts in reducing greenhouse gas emissions and transitioning toward a low-carbon economy (Christine et al, 2022)

vii. Tax Deduction for ESG-Related Expenditures

A tax deduction of up to RM50,000 per year is available from the year of assessment 2024 to 2027 for expenditures related to ESG initiatives. This includes costs associated with enhancing sustainability reporting frameworks, climate risk management, and implementing e-invoicing systems. The deduction is applicable to public listed companies, micro, small, and medium enterprises (MSMEs), and financial institutions, encouraging a broad spectrum of businesses to integrate ESG considerations into their operations.

viii. Tax Deduction for Contributions to Environmental Projects

Companies contributing to or sponsoring tree planting projects or environmental preservation and conservation awareness initiatives, verified by the Forest Research Institute Malaysia (FRIM), are eligible for tax deductions. This incentive, effective from January 1, 2024, to December 31, 2026, encourages corporate social responsibility (CSR) activities focused on environmental sustainability.

#### ix. Extension of Tax Incentives for Electric Vehicle (EV) Adoption

To promote the use of electric vehicles, companies renting non-commercial EVs can claim tax deductions of up to RM300,000. This incentive is effective from the year of assessment 2023 until 2027, supporting Malaysia's transition to cleaner transportation options.

### 3. Challenges in Policy Implementation

Malaysia has introduced several environmental tax initiatives, including the Green Technology Financing Scheme (GTFS), carbon tax considerations, and incentives for renewable energy adoption (Malaysian Investment Development Authority [MIDA], 2022). The Sustainable Energy Development Authority (SEDA) has played a key role in promoting green incentives, particularly through feed-in tariffs and tax exemptions for green investments. However, existing research suggests that Malaysia's environmental taxation framework remains fragmented and underutilized compared to global benchmarks (Simeh & Smallwood, 2024). Studies indicate a general lack of awareness among Malaysian companies regarding available environmental tax incentives. Peng et al., (2019) found that while many firms acknowledge rising production costs and environmental issues, most are unaware of government-offered tax incentives aimed at promoting sustainable practices. This lack of awareness contributes to the underutilization of such incentives, hindering their potential impact on environmental conservation efforts

The implementation of environmental tax incentives in Malaysia faces several significant challenges. One of the primary issues is bureaucratic complexity. The administrative processes involved in applying for and claiming tax incentives are often cumbersome, discouraging businesses from taking advantage of them. Peng et al., (2019) note that time consuming procedures and complicated application processes deter companies from applying for tax incentives. Additionally, the perceived benefits may not outweigh the administrative burdens, leading to low participation rates. Another challenge is the lack of clear guidelines and inconsistent enforcement. Studies indicate that ambiguities in tax policies create confusion among businesses regarding eligibility criteria and the application process (Hasnu et al., 2022). Without well-defined regulatory frameworks and clear implementation procedures, businesses may struggle to comply, leading to underutilization of incentives.

Financial constraints and perceived cost-benefit imbalances also hinder the effectiveness of environmental tax incentives. Small and medium-sized enterprises (SMEs), which form a significant portion of Malaysia's economy, often lack the financial resources to invest in green technologies, even with tax incentives in place. These businesses may view the initial investment as too costly relative to the perceived long-term benefits, limiting their willingness to participate in sustainability initiatives. Additionally, the lack of stringent enforcement mechanisms weakens the impact of environmental tax policies. While tax incentives are designed to encourage green practices, the absence of strict monitoring and compliance measures allows some businesses to exploit loopholes without genuinely reducing their environmental footprint (Saad et al., 2024) Implementing more rigorous enforcement strategies and periodic policy evaluations could help address this issue.

Furthermore, resistance from industry stakeholders poses another barrier. Industries with high carbon footprints, such as manufacturing and energy production, often lobby against environmental tax policies, arguing that they increase operational costs and reduce competitiveness (Muhammad et al., 2023). Such resistance slows down policy implementation and may lead to compromises that dilute the effectiveness of tax incentives. Comparative

studies suggest that Malaysia can learn from the experiences of other countries in implementing environmental taxes. For instance, China's approach to green taxation, which combines tax incentives with strict enforcement of environmental regulations, has been effective in promoting green innovation and reducing pollution. Adopting a similar balanced approach could enhance the effectiveness of Malaysia's environmental tax policies.

#### **4. Recommendation For Policy Enhancement**

To improve the effectiveness of environmental taxation incentives in Malaysia, several actionable steps are necessary. Firstly, increasing awareness through comprehensive campaigns is essential to educate businesses and the public about the availability and benefits of environmental tax incentives. These campaigns should be tailored to different audience segments, ensuring clarity and accessibility of information (Schaffer, 2021). Secondly, simplifying the procedures for applying and benefiting from tax incentives is critical. Streamlining bureaucratic processes and providing clear, step-by-step guidelines can reduce the administrative burden on businesses, making it easier for them to participate. The effectiveness of Malaysia's current tax incentives in promoting environmental sustainability has been questioned. (Saad et al., 2024) argue that the existing incentives may not sufficiently encourage green practices among businesses. The government should provide more tax incentives for corporations to decarbonize their operational emissions and invest in new technologies (Muhammad et al., 2022). They should propose an optimal green tax framework that includes both incentives and penalties, environmental education, continual legislative review, and technological innovation to enhance the effectiveness of environmental taxation policies.

Furthermore, enhancing public trust in the government's management of environmental taxation is vital. Saad et al., (2024) highlight that higher trust levels correlate with increased public support for carbon tax policies in Malaysia. Trust in government significantly affects public acceptance of environmental taxes. This can be achieved by maintaining transparency about how tax revenues are utilized and ensuring that they fund impactful environmental initiatives. Demonstrating accountability and engaging stakeholders in decision-making processes can foster a sense of collective ownership. Adopting a balanced approach that incorporates both incentives for sustainable practices and penalties for environmentally harmful activities can create a fair and effective framework. This dual approach not only rewards compliance but also discourages detrimental behaviours. Lastly, continuous evaluation and adaptation of tax policies are necessary to keep them aligned with evolving environmental and economic goals. Establishing mechanisms for regular feedback, impact assessments, and legislative reviews can ensure that policies remain relevant and effective. By implementing these recommendations, Malaysia can maximize the potential of environmental taxation incentives to promote sustainable development and build a greener economy.

#### **5. Conclusion**

In summary, while both developed and developing countries use environmental tax incentives to drive sustainability, the effectiveness of these measures varies based on economic and regulatory conditions. Malaysia's approach reflects a growing commitment to sustainable development, but continued policy enhancements and enforcement mechanisms are necessary to maximize the impact of these incentives. Environmental taxation incentives in Malaysia have the potential to significantly contribute to sustainable development. However, challenges such as lack of awareness, bureaucratic hurdles, and limited public trust hinder their

effectiveness. By addressing these issues and adopting a more balanced and transparent approach, Malaysia can enhance the impact of its environmental tax policies and promote a greener economy.

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