

Aligning ESG Performance with Fiscal Policy: A Conceptual Review of Tax Incentives as Strategic Moderators

Siti Hirdayu Mohd Radzi^{1*}, Nadiyah Abdul Hamid², Rina Fadhilah Ismail²

¹ Faculty of Business and Accountancy, Universiti Poly-Tech Malaysia, Kuala Lumpur, Malaysia

² Faculty of Accountancy, Universiti Teknologi Mara (UiTM) Puncak Alam, Selangor, Malaysia

*Corresponding Author: siti_hirdayu@uptm.edu.my

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Abstract: *The increasing focus on Sustainability and Responsible Investing (SRI) attributes Environmental, Social and Governance (ESG) performance as a key determinant of a firm's corporate social responsibility and value creation over a longer horizon. Simultaneously, governments more and more use tax policy as a tool to encourage responsible corporate behaviour and advance a country's sustainable development goals. Nevertheless, the interaction of tax policy and ESG performance has been, paradoxically, the least understood. This paper integrates theory and evidence to explain how tax policies might reasonably buffer the relationship between ESG performance and corporate behaviour particularly in tax-motivated investment, expenditure, and sustainability disclosure. This conceptual paper employs stakeholder theory, legitimization theory, and institutional theory to construct a model to explain tax policies in a discretionary manner as (i) external market forces on corporations to adopt ESG policies and (ii) to improve the legal risk and discretionary tax policies of the corporation. This paper primarily focuses on public policy, sustainability and taxation in the ESG context. It identifies the evidence of the poor cross-disciplinary integration, the inconsistency in the ESG and the Incentives metrics, and the lack of focus on the developing countries. This paper aims by highlighting primary research directions that attempt to investigate how financially oriented public policies can better align with the ESG trajectories of corporations in developing countries. Empirical research based on the proposed conceptual model can assist policymakers in predicting tax incentive arrangements to help achieve sustainable developmental goals.*

Keywords: ESG performance, Tax Incentives, Fiscal Policy

1. Introduction

In recent years, incorporating Environmental, Social, and Governance (ESG) performance into corporate strategies had progressed significantly, especially with the sustained focus on the impacts of corporate development coming from investors, the public, and governmental authorities (Fu & Zhang, 2025; C. Huang et al., 2024a). ESG performance, encompassing the environment, the society, and governance, is now one of the essential elements of stakeholder assessments of the ethical and responsible behavior of corporations as well as their longevity (Sun et al., 2024; Zhang et al., 2025a). Still, integrating ESG goals and business regulations remains the most pressing issue in fostering sustainable business practices. The most effective means of integrating improved corporate ESG performance and business regulations is the proposed use of tax incentives as moderating variables. This conceptual review, therefore, aims

to delineate the scope of tax incentives in integrating ESG performance and business regulations, and demonstrates how such incentives may bring about the desired change in corporate behavior.

Tax incentives are pivotal in enhancing corporate ESG green activities by reducing financial constraints and fostering eco-friendly green developments (C. Huang et al., 2024a; Zhang et al., 2025a). Evidence in the literature suggests tax incentives enhance corporate financial performance (FP), which in turn elevates the ESG outcomes. For instance, the accelerated depreciation for fixed assets helps ease financing constraints, which increases (R&D) efforts directed toward green innovations (C. Huang et al., 2024a). Moreover, corporate tax pressures improve corporate sustainability by enhancing R&D directed toward innovation as tax pressures improve resource allocation, which increases investments in green R&D (Fu & Zhang, 2025). Thus, tax incentives present corporate executives with a most unique opportunity to embrace fiscal prudence with the broad integration of sustainability into corporate paradigms (Fu & Zhang, 2025). The relationship between tax incentives and ESG performance are also influenced by the cross-sector and organizational heterogeneity.

Enterprises fully owned by the state, for example, show increased ESG sensitivity to taxation, driven by the need to reconcile public policy desires with the economic sustainability requirements (Fu & Zhang, 2025; Zhang et al., 2025a) Likewise, businesses in highly polluting industries show greater sensitivity to financial assistance because the adoption of ESG practices becomes necessary to avoid regulatory capture and maintain market dominance (Fu & Zhang, 2025). In addition, the positive association of green tax policies with ESG performance demonstrates the ability of such policies to promote ESG practices (Sun et al., 2024). These policies enhance the social and governance aspects of the responsibility of the manufacturing sector, in addition to the positive impact on the environment (Sun et al., 2024). The heterogeneity analysis suggests that the positive effect of tax incentives on ESG performance is larger in state-owned enterprises, non-polluting industries, and firms located in strong institutional environments (Zhang et al., 2025a).

The integration of ESG performance and tax policy through tax incentives represents an effective approach to encourage corporations to act sustainably. The research demonstrates the importance of tax incentives in improving corporate ESG performance by overcoming certain financial barriers, motivating innovations, and creating an ecosystem for the green practice of business (Fu & Zhang, 2025; C. Huang et al., 2024a; Zhang et al., 2025a). Business and government officials can formulate and execute tax incentive policies that catalyse economic development while ensuring protection of the environment, social responsibility, and good governance. Incorporating tax incentives into the other components of fiscal policy can create an environment where corporate financial performance and sustainability goals converge in mutually complementary ways, in the process helping achieve the United Nations Sustainable Development Goals (SDGs) (Fu & Zhang, 2025).

2. Literature Review

2.1 Environmental, Social and Governance (ESG) Performance

ESG performance involves rating the impact of a company's business practices through the lens of sustainability and ethicality. ESG consists of three components: the environment, social equity, and governance. The concept of ESG has changed over the years due to the increased emphasis on sustainable development and responsible investments. ESG practices seek to achieve a balance between short-term financial profits and long-term growth of society and the

environment (Du et al., 2024; Kengkathran, 2019). The impact of the corpus of ESG research concerning corporate sustainability, especially through the lens of the Triple Bottom Line and targeted UN Sustainable Development Goals (SDGs) is profound (Mishra & Pandey, 2025). The enhanced emphasis on the integration of environment performance with finance confirms the increasing importance of ESG in corporate governance and improving the approach toward investment (Al Azizah & Haron, 2025a).

Global Reporting Initiative (GRI) provides one of the most comprehensive frameworks for ESG reporting across the world (Setiarini et al., 2023). GRI provides a comprehensive ESG reporting framework that consolidates multiple reporting frameworks with a primary focus on ESG transparency and accountability (Setiarini et al., 2023). The influence of regulation on ESG reporting is manifested through the ESG evaluations of Malaysian companies offered by Bursa Malaysia via its FTSE4 Good Bursa Malaysia Index (Alam et al., 2022; Shahrin et al., 2023). KLD is one of the frontrunners in the provision of ESG ratings and National Associations of Securities Dealers (NASDAQ) ESG ratings are based on the KLD ESP scoring of ESG factors as a function of 56 indicators (Kilian, 2021). The ESG scores reflection that KLD assigns are based on potentially 'adjustable' factors and the inherent scoring framework for ESG makes ESG scores revisionable after KLD makes adjustments in ESG scores for factors after publication (Sahin et al., 2023). KLD and Refinitiv are regarded as the frontrunners in the provision of Estimation of ESG risks and components of ESG scores (risk and elements) and are thus regarded as innovators in the ESG reporting). These estimates overcome the inaccuracies of previous ESG reporting. These reporting frameworks enhance transparency, accountability and collaboration on ESG. Reporting frameworks on ESG provide a basis on which stakeholders can make informed decisions.

Numerous studies have investigated the link between ESG performance and financial performance and the findings have been inconclusive. One line of literature suggests a positive correlation and a financial benefit can be derived from strong ESG performance as it mitigates financing barriers a firm may face, enhances its reputation, and helps the firm garner valuable resources (Chen & Fan, 2024; Cherian & Seranmadevi, 2024; Luo et al., 2024). Firms that scored higher on ESG also exhibited stronger financial performance as evidenced by higher ROE and Tobin's Q (Al Azizah & Haron, 2025b; Shahrin et al., 2023). On the other hand, some studies point to a slight or a positive correlation between the variables to developing countries with weak ESG regulations (Maya et al., 2024; Shroff & Soni, 2024). These findings are a clear call for research to unpack the intricate relationship between ESG performance and financial performance in the context of different countries (D. Z. X. Huang, 2021; Rosley et al., 2023).

Improved corporate environmental, social, and governance (ESG) scores correlate with less corporate fraud and violations, as those corporate practices improve information transparency, mitigate financing accessibility, and increase media coverage (Sun et al., 2025; J. Wang et al., 2024). Furthermore, corporate debt financing costs and supply chain financing optimization improve corporate ESG performance, fostering green technology and sustainable development (Gao et al., 2025; Li & Rasiyah, 2024). In non-state-owned companies and those with greater uncertainty perceptions, the effects of corporate ESG practices are more significantly observed (Qian, 2024; Sun et al., 2025). These results certainly show the importance of ESG practices in the promotion of responsible corporate behavior and the achievement of sustainable corporate growth. Corporate ESG performance reflects the incorporation of environmental,

social, and governance (ESG) criteria as integral components of corporate strategy - an essential paradigm for evaluating corporate social responsibility (CSR).

Corporate sustainability has become an evolving and expanding field of study, as evidenced by the growth of the ESG framework within Corporate Social Responsibility (CSR). Nevertheless, primary ESG measurement frameworks, including Refinitiv, MSCI, GRI, and Bursa Malaysia, offer approximate consistency in evaluating ESG Corporate Social Responsibility. The relationship between ESG and corporate finance, while complicated, exhibits inconsistency across various contexts. Despite this, corporate behavior transformations attributed to ESG practices are observable, including improvements in risk management and innovation. The adoption of standardized ESG performance metrics will encourage further sustainable corporate governance to align with responsible corporate behavior initiatives, fostering innovation in risk management and sustainable corporate governance.

2.2 Fiscal Policy and Tax Incentives

Fiscal policy focuses on the economic policy of a government, where one of the key elements that shape the policy are tax incentives. Economically, tax incentives motivate spending, while politically, tax incentive distribution shape investments. Tax incentives are of many forms. In the word of OECD, these include 'tax holidays, investment tax credits, accelerated depreciation, and ecologically based tax incentives.' Each type is used for various and economic purposes. Tax holidays are temporary relief of tax on corporate income, which is used for attracting foreign direct investment and stimulating infrastructure improvements (Atikah et al., 2014; Huat & Halkyard, 2012). Investment tax credit (ITC) provides tax liability for specific investment which reduces is used for long term capital investments on the acquisition of various machineries, equipment, and in research and development (R&D) (Houndonougbo & Mohsin, 2016; Yu, 2011). Investment in assets are also encouraged through accelerated allowances which are provisioned for businesses where depreciation is rapid, thus, taxable income reduces in the short term (Yu, 2011). Tax credits and deductions are provided for the sake of 'green incentives' which include taxation on the ecologically harmful practices and activities, leading to reduction of CO₂ as well as promoting renewable energy (Namovicz et al., 2007; Shafi et al., 2023; Xin et al., 2025). The economic, political and institutional aspects of tax incentive usage are what makes it theoretically justified. Tax incentives reduce the cost of capital which makes investments more economically appealing and thus spurs economic growth and creation of new jobs (Anastassiou, 2006; Huat and Halkyard, 2012). In terms of politics, tax incentives are an effective means through which governments demonstrate their economic prowess and proactive economic management (Thrall and Jensen, 2025). In terms of the economy, tax incentives are more effective in achieving certain economic goals more quickly, like improving innovation, subsidizing small and medium-sized enterprises (SMEs), and promoting green investments (J. Wang and Li, 2025; Xin et al., 2025; Zhao et al., 2025). However, based on the economic cycle, the effectiveness of tax incentives is often more pronounced during times of economic growth (Kang et al., 2023). Misuse of tax incentives though their primary goal is to economically aid a country is a very real and common problem. Coyne and Moberg (2015) discuss the risk of resource misallocation and how certain incentives directed toward specific types of industries and/or firms can result in inefficiencies and result in distortion of the market. There is also the risk of cronyism and rent-seeking behavior due to firms lobbying for certain tax advantages that result in inequitable market conditions (Coyne and Moberg, 2015). In addition, poorly structured incentives in themselves can lead to negative outcomes, such as an increase in tax avoidance or a decrease in overall tax compliance (Lisi 2022, 2023). As regards incentives, such as in the case of electric vehicles (EVs), the difference in policies enacted at the state level regarding tax incentives for electric vehicles have had a

significant tax impact on lower-income taxpayers which may have resulted in the policy's social and environmental benefits being negated (Alexander et al., 2025).

Considerable amount of research exists pointing to the lack of a clear impact when it comes to tax incentives. According to Houndonougbo & Mohsin (2016), some incentives include tax credits which lead to positive consequences regarding the economy, investments, and economic performance. However, tax holidays do not always provide positive consequences. Klemm and van Parys state this in 2012. The overall economic and fiscal incentives regarding the economy and tax incentives are other economic factors as well (Noparumpa & Saengchote, 2017; Zhang et al., 2024). For example, fiscal subsidies and tax incentives together can synergistically enhance productivity of the enterprise (Zhang et al., 2024).

Tax incentives are a flexible device in fiscal policy. When thoughtfully designed, tax incentives drive investment and economic growth. With tax incentives, the economic, political, and institutional context are carefully considered. With tax incentives, the potential misuse and unintended consequences must be taken seriously. With tax incentives, continual evaluation and modifications must be done to improve the potential of tax incentives and reduce the negative consequences.

2.3 Tax Incentives to promote ESG practices

Tax incentives offered by governments worldwide promote sustainability for various reasons. First, these benefits subsidize the costs of supporting environmentally sustainable business practices by overcoming the market failure caused by the negative externalities of business activities (Dinis et al., 2023; Tang & Guo, 2025). For example, environmental taxes lower the costs of pollution by increasing the costs of environmentally damaging practices for businesses (Liu et al., 2023). Further, the benefits offered encourage the investments needed for the technological advancements and the green investments necessary for the subsidized ends to be sustainable in the longer term (Huang et al., 2024b; Zhang et al., 2025a). Sustainable business practices become economically feasible for businesses and the genuine alignment of private profit and the subsidized ends of public policy is achieved by the tax benefits. (Dinis et al., 2023).

Corporations tend to react favorably to financial stimuli that encourage sustainability efforts. Tax-relief policies can ease budgetary restrictions for businesses and allow for expenditure on R&D activities that underpin green innovations (Dinis et al., 2023). This is especially notable for the policies that allow for the quick write-off of expenses for depreciating fixed assets; these policies also improve corporate ESG performance by enhanced financial performance with the subsequent ability to spend in more R&D (Dinis et al., 2023). Furthermore, tax-relief policies promote ESG performance of companies through improved corporate governance and the establishment of synergetic effects (Dinis et al., 2023). For state-owned enterprises and in non-polluting industries, the effects of tax-relief policies on the companies' ESG performance is even more significant (Zhang et al., 2025a). This indicates that businesses are more likely to show stronger effects to fiscal stimuli when they are coupled with other broader institutional and regulatory structures.

The effectiveness of ESG-linked tax incentives have been demonstrated with significant evidence around the globe, like the tax incentives in China which have been shown to improve corporate ESG performance in state owned enterprises and non-polluting industries (Zhang et al., 2025a). In the UK, ESG performance and effective tax rate (ETR) positive correlation profits the ESG performing entities pay higher taxes suggesting ESG tax transparency and

better social tax practices (Binhadab, 2025). In the United States, the ESG-linked executive compensation has improved ESG performance, thus, suggesting that the alignment of managerial discretion with sustainability targets is effective (Eliwa et al., 2025; P. Lee et al., 2025).

Functions of ESG Incentives in ASEAN. The ESG-related incentives within the ASEAN region are also noteworthy. For instance, the Green Investment Tax Credit (GITA) in Malaysia is meant to promote the creation of green technology that has been shown to positively affect financial performance (L.-C. Lee et al., 2023). Moreover, in Southeast Asia, the ESG practices have been associated with a lower cost of capital, especially in the well-governed and less corrupt countries (Ekawati et al., 2025). This suggests that the government's efficiency is fundamental in optimizing the advantages of ESG-related incentives. Additionally, the adoption of clean energy and green financing in the ASEAN countries has been recognized as the major factors for the ESG practices that in turn help to meet the Sustainable Development Goals (SDGs) (Setiarini et al., 2023).

Promoting sustainability through tax incentives is one of the most effective methods for addressing failures in the market, fostering green investments, and reconciling the support of the private sector with the goals of the public sector. Corporations tend to react positively to the aforementioned economic signals, particularly when they reduce financial constraints and strengthen the governance structures of the corporation. The effect of these ESG-linked incentives is recognized in numerous countries, with ample documentation from both developed and developing countries, including those in ASEAN. These findings highlight the importance of designing fiscal policies to promote the response from the business sector that encourages the adoption of sustainable business practices.

3. Methodology

This research adopts the descriptive method for the conceptual framework and undertakes an extensive study of scholarship, journals, texts, research documents, and other relevant materials on tax incentives and the performance of ESG. The data should have been collated from literature, where the research for articles would have been guided using the criteria synthesized, and the articles selected were analyzed for tax concessionally and the performance of ESG. In the case of the popular literature repositories, Web of Science, Scopus, and Google Scholar, documents were sought using the keywords ESG, performance of the firm, value of ESG, and tax benefits for ESG. There were no arbitrary frame timelines for the search, despite the intent being collection for the documents concerning ESG since its inception and up to the time the search was being carried out.

The second of the three stages observed saw the articles target of identification being loaded onto the reference management software for Mendeley. The articles were appraised based on title, abstract, and to some level the content in primary full form to enable one to determine how relevant the article was to the study. In the third stage of the process, the selected articles were synthesized to delayer the context for the interrelation of elements of the content to the then current knowledge system to be expressed and analyzed. The outputs to the exercises were materially studied to book the first conceptual framework around tax incentives and ESG performance. Table 1 illustrates the major contributions from each paper related to ESG performance, fiscal policy, and tax incentives, and the findings of each paper.

Table 1: Studies on ESG performance, tax incentives and fiscal policy

No	Key Focus	Findings	Relevance to ESG, Fiscal Policy, and Tax Incentives
1	Tax incentives and ESG performance	Tax incentives significantly promote corporate ESG performance, especially in state-owned firms and non-polluting industries.	Highlights the role of tax incentives in enhancing ESG performance.
2	Tax incentives and ESG performance	Tax incentives alleviate financing constraints and intensify R&D efforts, leading to improved ESG performance.	Demonstrates the positive impact of tax incentives on ESG through financial and R&D mechanisms.
3	Environmental protection tax and ESG	Environmental protection tax improves ESG performance, especially in heavily polluting firms.	Shows how environmental taxes can enhance ESG performance.
4	Green tax and energy efficiency	Green tax policies and energy efficiency initiatives positively impact ESG performance.	Explores the role of green taxes in driving sustainable business practices.
9	ESG performance and tax behavior	Positive correlation between ESG performance and cash effective tax rates (ETRs), with variations between financial and non-financial firms.	Examines the relationship between ESG performance and tax strategies.
11	Environmental Protection Tax Law	The tax significantly enhances ESG performance, particularly in nonstate-owned enterprises.	Provides evidence of the positive impact of environmental taxes on ESG outcomes.
12	Local government debt (LGD) and ESG	Expansion of LGD reduces ESG performance by crowding out corporate credit resources.	Discusses the negative impact of fiscal policy (LGD) on ESG performance.
13	Green Public Procurement (GPP)	GPP significantly improves ESG performance by encouraging green investments.	Highlights the effectiveness of GPP as a fiscal policy tool for enhancing ESG performance.
14	Tax pressures and ESG outcomes	Tax pressures positively affect corporate sustainability performance by enhancing R&D investment and alleviating capital constraints.	Demonstrates how fiscal obligations can drive ESG performance.
15	Government fiscal and tax incentives	Government subsidies and tax incentives positively impact green technology innovation and enterprise growth.	Shows the role of fiscal and tax incentives in promoting green technologies and ESG performance.
18	Green credit policy and ESG	Green credit policies improve ESG performance, especially in green credit-restricted industries.	Explores the impact of green credit policies on ESG performance.
19	ESG principles and macroeconomic policies	Investment and tax incentives are used to encourage green investment, with the UK leading in ESG-related financial tools.	Discusses the use of fiscal policies and tax incentives to promote ESG practices globally.

4. Discussion and Conclusion

The reviewed literature shows how important tax incentives are to corporate ESG performance. Tax incentives remove some of the financial burdens and encourage the spending of R&D funds that are necessary for the creation of green innovations and the enhancement of ESG performance (Fu & Zhang, 2025; Huang et al, 2024c). The connection between tax incentives and ESG performance appears to be the strongest in state-owned entities and within industries

that are heavily polluted because of regulatory adherence and a lack of market competition where sustainable practices are used (Fu & Zhang, 2025; Zhang et al, 2025b). In addition, green taxes and green tax policies in relation to energy efficiency improvements ESG performance positively and green tax mediates the effectiveness of energy efficiency improvements (Sun et al, 2024). This shows that tax policies can be used as powerful means to promote corporate ESG performance and sustainability.

Additionally, the diversity concerning how much tax incentives impact ESG performance on a sectoral and regional basis should drive the creation of customized fiscal policies (Zhang et al., 2025a). For example, tax incentives impact state-owned enterprises and firms that are in non-polluting industries more positively to a greater extent. This exemplifies that tax incentives, while generally effective, require more thoughtful sectoral and regional design and implementation to enhance more effective outcomes from the system. Also, the impact of environmental taxation on ESG performance that is especially on the highly polluting firms is a clear signal of the need to combine fiscal policies and environmental policies to attain the desired advancement of the SDGs (Gao et al., 2025; Liu et al., 2023).

In conclusion, the synergy of ESG performance with fiscal policy through tax incentives offers an innovational mechanism in advocating for corporate sustainability as a strategy. The studies confirm what has been suggested in theory that tax incentives stimulate financial performance by removing barriers to financing and promote, as well, ESG performance (Huang et al., 2024a). The dual outcome of tax incentives clearly indicates the level of potential tax incentives to be strategic levers in promoting transition to desired sustainable business practices.

These findings also underscore the relevance of sectoral and regional aspects while formulating fiscal policies. Custom-design tax incentives fitting the challenges and opportunities of specific sectors and regions are likely to be more effective in fostering ESG (economic, social, and governance) performance (Liu et al, 2023; Zhang et al, 2025a). This demonstrates the need for policymakers to concentrate on these elements when formulating fiscal policies designed to protect and promote sustainable development alongside economic activity.

This conceptual review legitimizes strengthening ESG (economic, social, and governance) performance in policies and the potential of tax incentives to do so. This should be a springboard to more innovative and sustainable business models, guidance for regulators, and corporate and sustainability practitioners. Future studies should focus on the connection between different fiscal policies and ESG performance to ease refinements and value augmentation in these interventions.

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Conflict of Interest Statement

The authors declare that there is no conflict of interest regarding the publication of this study.

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