

Political Connections, Business Strategy and Tax Aggressiveness: Evidence from China

Authors : Liqiang Chen

Abstract : This study investigates the effects of political connections on the association between firms' business strategy and their tax aggressiveness in an emerging economy such as China. By studying all public Chinese firms in the period from 2011 to 2017, we find that firms adopting innovative business strategy are more tax aggressive overall, but innovative firms with political connections are less tax aggressive compared to those without political connections. Moreover, we document several channels through which political connections affect the association between innovative business strategy and tax aggressiveness. In particular, we show that the mitigation effect of political connections on tax aggressiveness is stronger for innovative firms located in areas with a lower marketization index and for innovative firms with a lower leverage level or with less earnings management. Our results are robust to an instrumental variable approach to account for possible endogenous bias. Our study contributes to the understanding of firms' tax behaviors in an emerging economy setting and suggests that there are costs associated with political connections, such as foregone tax saving opportunities, which are understudied in the prior literature.

Keywords : tax aggressiveness, business strategy, political connections, emerging economy

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