

Corporate Tax Benefits from Hometown-Connected Politicians

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ABSTRACT: This study examines whether politicians exhibit hometown favoritism in assigning preferential corporate income tax rates. We find that firms with hometown connections to incumbent provincial leaders experience favorable tax treatment. This effect is more pronounced when those leaders have strong hometown preferences and weaker when they have a strong incentive to seek promotion, suggesting that social incentives are the primary drivers of the effects on corporate tax benefits of hometown favoritism by politicians. Moreover, this effect is intensified when members of senior management have personal connections with the provincial leader. The mechanism test reveals that the provincial governments tend to qualify connected firms for preferential tax policies under their jurisdictions. Overall, our results suggest that hometown favoritism by politicians promotes tax benefits for business entities.

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All remaining errors are our own.

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I. INTRODUCTION

Much of the tax research in accounting focuses on tax avoidance through managerial discretion (Wilde and Wilson 2018). By contrast, this study investigates the preferential tax treatments granted by politicians. As a main policy tool, governments worldwide implement policies to diversify tax revenues or create tax incentives to spur economic development; however, few studies examine the personal motivation of politicians in the determination of tax incentives.¹ We draw on a tax disclosure rule in China that allows us to identify firm-specific tax benefits and focus on tax policies resulting from favoritism by politicians toward their hometown, often referred to as hometown favoritism.² Specifically, we analyze whether hometown favoritism induces provincial leaders to grant tax benefits—by lowering the applicable tax rate—to connected local firms.

Hometown favoritism can be conceptualized using social identity theory, in terms of which individuals' economic choices are primarily motivated by their identities (Akerlof and Kranton 2000; Kranton 2016). Hometown identity is a special form of social identity and is defined as a strong conscious or unconscious connection with one's fellow townspeople and a sense of belonging to the hometown community (Ren, Sun, and Tang 2023). Several economic studies have documented the effects of political leaders practicing hometown favoritism on economic growth and public expenditures (e.g., Hodler and Raschky 2014; Do, Nguyen, and Tran 2017). The effects at the firm level are much less understood.³ Our study focuses on politicians engaging in hometown favoritism toward individual firms through corporate taxes, one of the most important economic policy instruments wielded by governments. This study documents a key determinant for firm-level tax expenses, thereby making an important contribution to the tax literature.

We test our research question using a sample of 24,403 firm-year observations from 2003 to 2019. Because China does not allow consolidated tax filings, our empirical analyses are based on the filings of parent companies. A hometown connection to a provincial leader exists when a firm's city of registration is the birthplace of the incumbent provincial Chinese Communist Party (CCP) secretary or governor. We measure the preferential tax rate as the difference between the top statutory income tax rate and the income tax rate applicable to a specific firm. The applicable tax rate is determined by government officials. It is important to note that a firm with a lower tax liability as a result of their proactive efforts to reduce their tax expenses (for example, by reducing taxable income) is distinct from a firm paying a relatively low rate; the latter is a direct manifestation of preferential tax policies, and the former is an example of more traditional tax avoidance behavior (Tang and Firth 2011; Na, Shevlin, Wang, and Yan 2019).

We find a positive relationship between being a hometown-connected firm and preferential tax rates. This relation is statistically significant and economically meaningful. Specifically, firms in favored cities enjoy a tax rate that is approximately 1.34 percent lower than in other cities, which is equivalent to approximately 5.4 percent of the top statutory rate.

We then examine the dynamic effect of hometown favoritism on corporate tax benefits by assessing political turnover for various periods and provinces to alleviate concerns that unobserved changes at the provincial level could affect tax policy preferences and the appointment of provincial leaders. Staggering events allow for better estimations than the use of single events and mitigate concerns regarding confounding effects. We use a difference-in-differences (DiD) research design and find that the impact of hometown favoritism on corporate tax benefits emerges as connected provincial leaders take office and persists during their tenure. This evidence helps negate the alternative explanation that the observed tax benefits are driven by ordinary shocks related, for example, to business cycles or time trends.⁴

¹ Although existing studies examine factors such as the role of tax regulators (authorities) (e.g., Hoopes, Mescall, and Pittman 2012), distance to the tax authority (e.g., Kubick, Lockhart, Mills, and Robinson 2017), and the role of financial regulators (e.g., Kubick, Lynch, Mayberry, and Omer 2015) in corporate tax planning activities, their focus is on individual tax compliance rather than preferential tax policies.

² Chinese tax laws require each business entity, including the parent firm and its subsidiaries, to separately disclose their applicable income tax rates. This tax disclosure rule facilitates our examination of whether provincial leaders confer tax benefits on the firms in their hometowns.

³ An increasing number of studies have documented managerial hometown favoritism as a factor in corporate decision-making. Yonker (2017) shows that CEOs are more likely to favor hometown workers, Jiang, Qian, and Yonker (2019) document that CEOs tend to acquire targets located in their home states, and Lai et al. (2020) find that CEOs working near their birthplace are less likely than nonlocal CEOs to make myopic decisions.

⁴ One may argue that the observed relationship between hometown favoritism and corporate tax benefits is an artifact of the endogenous appointment of provincial leaders. These are chosen on the basis of personal and regional characteristics that could simultaneously affect corporate taxation. However, this is considered a minor concern in our context because the central government appoints all provincial leaders. To curb localism and divide provincial leaders from their networks of local elites, leaders are often moved laterally to a new province every few years. Thus, the appointment of a provincial leader is exogenous to the firms within the jurisdiction.

Furthermore, we collect a unique dataset on subsidiary-level applicable tax rates to substantiate our results and generalize our conclusions. We find that subsidiaries with hometown connections benefit more from lower tax rates than unconnected subsidiaries affiliated with the same parent firm, which further supports our hypothesis.

Next, we conduct extensive cross-sectional analyses to shed light on the primary drivers of our results. First, we test the conditioning effect of the extent of the provincial leader's hometown preferences. Provincial leaders with strong hometown preferences are expected to offer greater tax benefits to firms associated with the same hometown. We use three proxies to measure the hometown preference of a provincial leader: (1) whether they have visited their hometown, (2) whether they were born in a city with a unique culture, and (3) whether their birthplace city has a recognized family tree (as indicated by the politician's surname). Our results show that the stronger a provincial leader's hometown preference, the greater the influence of hometown connections on corporate tax benefits, thereby affirming the hometown favoritism effect.

Second, we investigate the conditioning effect of individual firm management connections with provincial leaders. Hometown favoritism by politicians expressed through corporate tax benefits is expected to be heightened when a firm's senior management shares a personal connection with the provincial leader. We consider two important types of connections in China: political connections (Fan, Wong, and Zhang 2007; Hung, Wong, and Zhang 2012; Piotroski and Zhang 2014) and school ties (Guan, Su, Wu, and Yang 2016). The results confirm the expectation of a stronger positive relationship between a hometown connection and tax benefits when a personal connection exists between top management and the provincial leader.

We further examine how the promotion incentives facing provincial leaders moderate the association between hometown favoritism and tax benefits. Career-minded provincial officials are inclined to increase fiscal spending on infrastructure projects using tax revenue (Kung and Chen 2011; Chen, Tang, Wu, and Yang 2021). In addition, politicians with career concerns are expected to refrain from favoring hometown-connected firms to reduce the possibility of political rivals, nonconnected companies, and the general public accusing them of prioritizing personal gain over the welfare of the public (Chen, Guan, and Ke 2013; Jiang, Ke, Ru, and Xu 2023). We measure promotion incentives with reference to a province's gross domestic product (GDP) growth relative to the national level and the age of its political leader. When the province's GDP growth is lower than that at the national level or when the provincial leader is relatively young, he/she has a stronger incentive to enhance the economic performance for the sake of promotion (Li and Zhou 2005; Xu 2011; Chen, Cheng, Hao, and Liu 2020). Consistent with this prediction, we find that the tax benefits arising from hometown favoritism are weaker when provincial leaders keep their promotion incentives in mind.

We perform several additional tests to examine the possible mechanisms by which provincial leaders apply lower tax rates to firms with hometown connections. We find that these firms are more likely to be recognized as high- and new-technology enterprises (HNTEs) and consequently enjoy lower tax rates than those without hometown connections.⁵ We enhance the mechanism test by conducting two untabulated placebo tests and find that firms' hometown connections have little influence on their likelihood of being recognized as national software/circuit or western development region enterprises; these are not generally controlled by provincial leaders.

We also examine an alternative explanation for our findings. Existing studies show that political representatives may strategically allocate public resources to increase electoral support (see Golden and Min (2013) for a review of studies on pork barrel politics). Following this line of reasoning, rather than acting according to social preferences, politicians could exploit their control over tax policies in return for bribes or political support (Shleifer and Vishny 1994). However, election incentives are minimal because Chinese subnational and Communist Party officials are appointed by the central government, in the case of the former, and by the party at the national level, in the case of the latter. We find little evidence supporting the argument that our results are driven by politicians offering preferential treatment to firms in exchange for bribes.

Our study is related to literature on the determinants of corporate taxation. Unlike those focusing on firms' tax planning strategies (e.g., Desai and Dharmapala 2006; S. Chen, Q. Chen, Cheng, and Shevlin 2010; Minnick and Noga 2010; Armstrong, Blouin, Jagolinzer, and Larcker 2015; Edwards, Schwab, and Shevlin 2015; Law and Mills 2015; Dyreng and Markle 2016), we provide evidence of tax benefits unrelated to the tax policies of firms. Despite growing awareness of the effects of politics on the tax behavior of firms (e.g., Mills, Nutter, and Schwab 2012; Brown, Drake, and Wellman 2015; Kim and Zhang 2016; Tang, Mo, and Chan 2017), there is relatively little known about the geographic influence of political favoritism on corporate taxation. It is imperative that we develop a better understanding of the role of political leaders in corporate tax policy because governments globally intervene in markets through various forms of financial support, including tax incentives.

⁵ The recognition of HNTE status is mainly determined by provincial governments. See Section II for a detailed discussion.

Our study also contributes to the emerging literature on hometown favoritism by politicians. This literature focuses on the effects of favoritism on macro factors, such as infrastructure, schools, and population concentration (Hodler and Raschky 2014; Do et al. 2017), while paying little attention to the influence at the firm level. Faccio and Parsley (2009) find that the sudden death of a politician is associated with a significant decline in the value of companies headquartered in their hometown, suggesting a substantial firm-level influence. Guo, Shi, Tian, and Duan (2021) show that firms registered in the hometowns of governors exhibit higher investment expenditures than those not registered in those locations. This study complements these findings by taking advantage of a unique dataset on corporate tax benefits in China and examining the influence of the social identities of politicians on corporate tax benefits.

The remainder of this study is organized as follows. In Section II, we introduce the institutional background of the system of corporate income taxation in China, and in Section III, we develop our testable hypotheses. Section IV contains a description of the data and variables. We present the results of the main analysis and the robustness tests in Section V and, in Section VI, discuss the results of cross-sectional analyses. In Section VII, we examine the mechanism by which the main effect operates, and in Section VIII, we test an alternative explanation. We provide our concluding remarks in Section IX.

II. INSTITUTIONAL BACKGROUND

Corporate Income Tax Acts of China

Corporate income tax (CIT) is the second largest source of tax revenue in China after value-added tax (Xiao and Shao 2020). According to the *China Taxation Yearbook*, between 2003 and 2019, CIT accounted for 20 percent of China's tax revenue. A fundamental feature of the Chinese CIT system is that each legal entity is required to file a tax return in the province in which it is domiciled (Feng, Ke, and Zhu 2021). Further, consolidated tax returns are not permitted for holding companies with subsidiaries other than in special cases, but these are not publicly disclosed (Feng et al. 2021).

The statutory CIT rates vary significantly across time and business types.⁶ The current tax system was established in 1994 with the pronouncement of the Tax System Reform Act, which sought to align the tax system with the needs of a market-oriented economy. Before 1994, domestic businesses faced considerably higher rates of statutory CIT than enterprises that were wholly foreign owned. For example, the maximum tax rate for state-owned enterprises (SOEs) and privately owned domestic enterprises was 55 percent and 60 percent, respectively; the rate for eligible foreign enterprises was 33 percent. The 1994 tax reform unified the statutory tax rates and specified a common rate of 33 percent for domestic (including state-owned, privately owned, and collective enterprises) and foreign businesses, with the latter receiving other tax incentives (e.g., two-year exemptions and three-year halved rates) that lowered their applicable rate to less than 25 percent. In 2008, China further unified its CIT, adopting a rate of 25 percent for both foreign and domestic enterprises. This marked a fundamental change in tax policy from a system of preferential taxation for foreign firms to neutral taxation across all businesses regardless of ownership type.

Under the Chinese tax system, tax revenues are classified into central and local taxes, and these are separately collected by the state and provincial tax bureaus. From 1994 to 2001, state tax bureaus were responsible for collecting CIT from central SOEs. Taxes collected were then allocated exclusively to the central government. Local tax bureaus, by contrast, collected CIT from local SOEs and collective and private firms, with the revenue distributed to the local government.⁷ The relative scope and share in taxation of the state and local tax bureaus were adjusted in 2002. Specifically, all companies established on or after January 1, 2002, must pay income taxes to the state tax bureau, whereas those registered before that date remit taxes to the local bureau.

Following the 2002 tax reform, most CIT revenue was shared between the central and local governments, with a 50:50 ratio of central:local CIT revenue; after 2002, this ratio changed to 60:40 in favor of the central government, based on the annual increment of CIT revenue relative to the local tax revenue in 2001 (the base year).⁸

⁶ Feng et al. (2021) provide a summary of the evolution of statutory CIT rates in China (see Table 3).

⁷ In an untabulated analysis, we find that at the city and provincial levels, the amount of fiscal expenditure in a year is positively related to the lagged amount of fiscal revenue. This finding implies that tax revenue has an impact on government expenditures. We thank an anonymous reviewer for this suggestion.

⁸ For example, assuming that the CIT revenue of a local government was \$200 in 2001 and \$300 in 2002, the CIT revenue to which the local government is entitled would then be \$250 (\$200 in the base year + $(300 - 200) \times 50\%$) in 2002.

Preferential Corporate Income Tax Policies in China

Although the legislative power to impose taxation is largely concentrated in the central government (Tang et al. 2017), fiscal decentralization and the need for competition among local governments allow room for substantial discretion and create incentives to bolster local economies by taking advantage of these tax policies (Wu and Yue 2009; Lin, Mills, Zhang, and Li 2018; Na et al. 2019). An example is the preferential CIT rates granted to HNTEs, which account for the largest proportion of all tax incentives granted to Chinese-listed firms. Of the 13,684 firm-year observations in our sample for which preferential tax rates are recorded, 9,649 (70.5 percent) were afforded these because of their HNTE status. For a firm to be recognized as an HNTE, government policy requires a firm to meet eight criteria.⁹ However, most of these are flexible, allowing provincial leaders considerable discretion.

The role of provincial officials in HNTE recognition is confirmed by our interviews with experts, managers, and local officials who have experience with HNTE recognition.¹⁰ The following key points emerge from these interviews: (1) the provincial government is directly responsible for the approval of HNTE status, (2) the provincial government appoints the experts who evaluate firms' applications, and (3) the decision of the accreditation institution can, at least potentially, be affected by provincial leaders (see Online Appendix I for the interview results).

III. HYPOTHESIS DEVELOPMENT

Main Hypothesis: Social Identity Hypothesis

Hometown favoritism is a concept developed in social identity theory. In introducing this theory to economics, Akerlof and Kranton (2000) argue that identity is bound to social categories—individuals identify with people in some categories and differentiate themselves from people in others. Identity economics suggests that individuals benefit from affiliating with social groups and providing benefits within the group with no personal material reward (Akerlof and Kranton 2000, 2005; Fowler and Kam 2007). Place identity (i.e., how people identify according to where they spend their lives) is a strong social identity, and scholars argue that individual decision-making depends on various geographical factors (Hernández, Hidalgo, Salazar-Laplace, and Hess 2007). Relph (1976) argues that the hometown is “the central reference point of human experience.” In this study, we focus on the hometown identity of politicians who play crucial roles in the allocation of economic resources (Faccio and Parsley 2009; Burgess, Jedwab, Miguel, Morjaria, and Padró i Miquel 2015). Specifically, we propose that hometown identity leads to hometown favoritism on the part of politicians, which, in turn, translates into tax benefits for local firms.

Hometown identity results in hometown favoritism through two channels: the labeling effect and place attachment. Specifically, labeling theory holds that individuals are willing to favor those with whom they share a label (Chen and Li 2009; Goette, Huffman, and Meier 2012). In particular, a shared hometown is a natural marker of belonging for those originating from a specific location and results in a strong labeling effect (Guo et al. 2021). Similarly, place attachment is a mutual and enduring bond that individuals establish with specific areas (Low and Altman 1992; Hidalgo and Hernández 2001). Evidence has shown that place attachment provides a variety of psychological benefits, such as a state of belonging through the symbolical connection of individuals to their ancestors or cultures (Mazumdar and Mazumdar 2004; Billig 2006) or the reinforcement of social ties and community membership (Fried 1963; Hidalgo and Hernández 2001). Furthermore, place attachment offers memory support that connects individuals to past events and people (Twigger-Ross and Uzzell 1996) and provides emotional and cognitive restoration from stressors (Hartig, Kaiser, and Bowler 2001). These benefits can strengthen social capital and promote hometown favoritism (Perkins and Long 2002; Manzo and Perkins 2006).

In the context of our research hypothesis, the labeling effect guides politicians toward actions that are consistent with the preferences of residents of their hometown, whereas place attachment provides psychological benefits that motivate the practice of hometown favoritism by politicians. Residents prefer a high standard of living, and these preferences serve as objectives for hometown politicians who behave similar to local residents to enhance their sense of belonging.

Granting tax benefits to local firms can be an effective method for hometown-connected politicians to achieve the objectives they establish on the basis of hometown favoritism. Increased prosocial conduct through employment, donations, or other philanthropic actions is a significant indicator of hometown favoritism (Arendt and Matthes 2016; Yonker 2017; Lai, Li, and Yang 2020; Baskaran and da Fonseca 2021; Vu and Yamada 2021).¹¹ Hometown-connected politicians

⁹ The detailed policies regarding the criteria and procedures for recognizing HNTEs are available at http://www.gov.cn/gongbao/content/2016/content_5076985.htm

¹⁰ Ethics approval for all interviews in our study was granted by the university affiliated with one author.

¹¹ This body of evidence suggests that politicians tend to implement policies that favor their hometown communities and employees. For example, Vu and Yamada (2021) show that employment in firms increases in the hometown districts of politicians after they resume office. Based on German data, Baskaran and da Fonseca (2021) show that municipalities that include the residence of a minister experience a higher annual growth rate in state government employment.

may use preferential tax policies to encourage local firms to undertake socially responsible activities, which, in turn, benefit local residents. Compared with conventional corporate investments, financing corporate social responsibility (CSR) activities through external funding is difficult because these activities often generate obscure payoffs, low collateral value, and insufficient pledgeable income (Chang, Jin, Yang, and Zhang 2023), making internal funds a more practical and important source for CSR activities (Kaplan, Serafeim, and Tugendhat 2018).¹²

Tax benefits increase the internal funds available to firms (Atanassov and Liu 2020; Blouin, Fich, Rice, and Tran 2021), enhancing their ability to fulfill their social responsibilities. This is analytically and empirically supported by existing studies. For example, based on analytical models, Chen, Hung, and Wang (2018) suggest that a reduction in the CIT burden boosts the demand for human capital in the local labor market, thereby increasing employment. A more recent study by Chang et al. (2023) documents that CSR performance is significantly improved following tax cuts, especially for firms with tighter financial constraints.

Hometown favoritism by politicians is pervasive in China for cultural and political reasons. The renowned Chinese sociologist Fei (1948) notes that Chinese society is a system of networks in which each individual is connected through kinship and regional affinities. Hometown ties, as critical elements of social identity, influence the social preferences of provincial leaders, motivating them to favor their preferred regions. For example, politicians may show interest in their hometowns because their ancestors are entombed there and are thus respected and venerated by local residents. It is thus expected that when they take office, officials will channel some favors back to the regions with which they are connected.

China's structure as a "regionally decentralized authoritarian system" (Xu 2011) gives provincial leaders considerable autonomy and authority in running local economies (Bai, Hsieh, and Song 2014). The significant power of provincial leaders facilitates their engagement in hometown favoritism. The literature suggests that, in authoritarian regimes, politicians allocate a disproportionate share of resources to their hometowns (Hodler and Raschky 2014; Burgess et al. 2015; Kramon and Posner 2016; Do et al. 2017).

Given these arguments, we expect that firms with hometown connections to provincial leaders would benefit from favorable tax policies that reduce their tax burdens, which is termed the social identity hypothesis.¹³

The Moderating Effect of Political Incentives

Promotion incentives of politicians can weaken the effect of social identity on tax benefits for several reasons. First, the Chinese political system is highly centralized, with strong top-down mandates. Personnel decisions are concentrated in the hands of the central government, and economic performance is a crucial criterion for cadre promotion (Li and Zhou 2005).¹⁴ Career-minded provincial leaders have a tendency to increase fiscal spending on infrastructure projects to demonstrate their economic achievements, and this can quickly increase aggregate demand and economic growth (Kung and Chen 2011; Chen et al. 2021).¹⁵ To fund those projects, officials must reduce budgetary constraints and expand fiscal resources. According to the *China Taxation Yearbook*, CITs contributed 20 percent to the tax revenue of China between 2003 and 2019. Hence, officials may have incentives to increase tax revenues by reducing tax benefits.¹⁶

Second, the top leadership in China tends to have a "sufficiently encompassing interest" in generating long-term growth and preventing large-scale collective action that would threaten the regime (McGuire and Olson 1996). As a result, the central government promotes provincial leaders who are adept at generating growth and collecting taxes. Tax revenue ranking is a key method of assessing the performance of provincial leaders and bolstering the ranking of cadres within the party (Xu 2011; Shih, Adolph, and Liu 2012), thereby weakening the impact of social identity on the tax decisions of these provincial leaders.

Finally, several scholars express the concern that government officials maintain their hometown ties merely to build profitable connections with businesses or secure promotion opportunities (Fisman, Shi, Wang, and Xu 2018). China's

¹² Kaplan et al. (2018) study a large number of CSR programs and find that firms rely primarily on internal funds to support these.

¹³ Our hypothesis does not rely on the assumption that hometown-connected politicians directly intervene in helping local firms. Subordinates could attempt to ingratiate themselves with the politician by voluntarily offering benefits to hometown firms, irrespective of whether they favor such actions. We are grateful to an anonymous reviewer for pointing out this possibility.

¹⁴ Under China's system of meritocratic cadre selection, the central government tightly controls key positions at the provincial level (Xu 2011). Increasing the odds of being promoted to a higher rank in the hierarchy of the CCP requires that local government officials have a demonstrable record of economic achievements during their tenure (Maskin, Qian, and Xu 2000; Li and Zhou 2005).

¹⁵ Prior research has shown that local officials who are adept at improving infrastructure and public services have a significantly higher chance of promotion (Kung and Chen 2011; Wu, Deng, Huang, Morck, and Yeung 2014).

¹⁶ A counterargument is that the government can cut taxes to encourage corporate investments, thereby spurring regional economic development. However, local officials are primarily promoted based on their area's GDP. Firm's capital expenditures are not as conducive to GDP growth as government spending on urban infrastructure, and these expenditures are not available to the supervisors conducting performance evaluations (Chen et al. 2021).

central government has long frowned on the use of connections in these ways. Consequently, provincial leaders may avoid favoring hometown-connected firms to minimize the potential that their political opponents, nonconnected firms, or the general public will accuse them of pursuing their own personal benefit over the public interest (Chen et al. 2013; Jiang et al. 2023).

The above arguments suggest that provincial leaders with strong promotion incentives are less likely to relieve the tax burden of hometown-connected firms by means of favorable tax policies.

IV. SAMPLE, DATA, AND VARIABLES

Sample and Data

Our initial sample includes all companies listed on the Shenzhen and Shanghai Stock Exchanges between 2003 and 2019. The sample period begins in 2003 because politicians' demographic information was not widely available before that year. The endpoint of 2019 was chosen because it was the last year of availability of data for a number of outcome variables, including politician characteristics, city-level variables, and recognition as an HNTE. Our primary data source is the China Stock Market and Accounting Research (CSMAR) database, from which we retrieve accounting, financial, and macroeconomic data. We remove financial firms because of their unique accounting information and corporate tax practices and exclude firms controlled by the central government because these are unlikely to be affected by the tax policies of local governments. We further delete observations for firms tagged as special treatment (ST or *ST) by the China Securities Regulatory Commission; this reflects that the firms are facing financial conditions different from those of the average firm.¹⁷ We exclude foreign-owned businesses because before 2008, there were differences in the statutory tax rates applicable to these firms and their domestic counterparts. When calculating the control variables, we delete observations with insufficient data.

We manually collect information on provincial leaders from various sources, including local government websites, press releases, <http://www.people.com.cn/>, and other public announcements. The personal information retrieved includes tenure in office, birthplace, career history, and other demographic characteristics. We use the applicable income tax rates for firms recorded in the WIND database and use Internet searches to supplement ambiguous corporate information (see Online Appendix II for a detailed description of data sources).

This procedure yields a final sample of 24,403 firm-year observations. Online Appendix III, Panel A describes the sample distribution by province. As is the case in existing studies (Piotroski, Wong, and Zhang 2015),¹⁸ Guangdong and Zhejiang account for the largest number of observations (3,483 and 2,312, respectively). Online Appendix III, Panel B presents the sample distribution by year. The number of observations per year increases from 824 in 2003 to 2,419 in 2019. We Winsorized all continuous variables at the 1st and 99th percentiles to minimize the effects of outliers.

Measuring Tax Benefits and Hometown Connections

In this study, we focus on the CIT rate.¹⁹ Our main dependent variable (tax benefit) is the *FATR* (the difference between the top statutory CIT rate in China and the CIT rate applicable to a parent firm).²⁰ In our sample, the top statutory CIT rate has time series variations of 33 percent between 2003 and 2007 and 25 percent after 2007. The CIT rates applicable to parent firms show cross-firm and time series variations. A higher value for *FATR* indicates greater tax benefits or a more preferential CIT rate for the firm.

Chinese firms prepare their financial statements on a consolidated basis, but taxes are levied separately for each legal entity, whether a parent or a subsidiary (Shevlin, Tang, and Wilson 2012); this is required by the Chinese tax law, which, unlike other tax codes, requires that entities file their applicable income tax forms as independent entities (see the example in Online Appendix IV). This disclosure requirement allows for a direct and precise estimate of tax benefits (Tang and Firth 2011). For example, although the current statutory income tax rate for Chinese domestic firms is 25 percent, a

¹⁷ The CSRC mandates that if a listed firm reports a loss for two consecutive years, its stock trading shall be specially treated (ST). This imposes considerable costs on the company. For example, the semiannual report of an ST firm must be audited, which is not required for non-ST firms.

¹⁸ Using a sample of A-listed Chinese firms from 1993 to 2011, Piotroski et al. (2015) find that Guangdong (12.6 percent) and Shanghai (11.8 percent) account for the largest fractions of firm-year observations.

¹⁹ We focus on CIT rather than business and value-added taxes for the following reasons: (1) the central government largely determines the preferential rates of these other taxes, with local government officials having limited discretion (as they do regarding preferential CIT rates); and (2) Chinese listed firms disclose the applicable CIT rate for the parent and subsidiaries separately, however, these are taken together when disclosing the applicable value-added and business tax rates, making it difficult to calculate the corresponding tax benefits.

²⁰ In our main analysis, we focus on the preferential tax rate of parent firms because the vast majority of subsidiaries are unlisted, and their financial and accounting information is thus unavailable. As a robustness check, we repeat our main regression using subsidiary firms, and the results are qualitatively similar. The results are reported in Table 4.

firm may be eligible for a reduced rate of 15 percent if it is a high-tech enterprise or is located in a special economic development zone. This 10 percent reduction in CIT is considered a tax benefit; as such, the lower tax rate is purely a result of preferential tax policies.

In our study, political leaders are defined as provincial party secretaries or governors.²¹ Empowered with decision-making rights on key political and economic matters, the Communist Party Committee Secretary (party secretary) is the *de facto* “first-in-command” of a province and is empowered to make decisions on key political and economic matters (Kung and Chen 2011; Persson and Zhuravskaya 2016). Provincial governors determine economic policies and influence the tax benefits granted to firms.

The primary independent variable in our study is an indicator (*Connection*), which assumes a value of 1 if the firm’s city of registration is the birthplace of the local provincial CCP secretary or governor and is 0 otherwise.²² For example, if Wuhan City of the Hubei province is the birthplace of either the CCP secretary or the governor of that province (in service as of year t), then *Connection* takes the value of 1 in year t for all firms registered in Wuhan City.

Descriptive Statistics

Table 1 presents the descriptive statistics for the variables used in our main analyses, with the definitions contained in Appendix A. For parent-level observations, the mean *FATR* is 6.42 percent, which suggests that Chinese firms, on average, enjoy a tax reduction of 6.42 percent relative to the top statutory CIT rate (33 percent before 2008 and 25 percent during and after 2008). The fraction of firms with tax benefits in relation to their recognition as an HNTE (*Dum (HNTE)*) is 39.5 percent. *Connection* is the key explanatory variable of interest, with a mean value of 0.107, suggesting that 10.7 percent of the firms are connected to provincial political leaders via the birthplace of those leaders.

The subsidiary-level observations show a mean *FATR_Sub* of 1.88 percent and a mean *Connection_sub* of 0.11, suggesting that 11 percent of the subsidiaries are connected to provincial political leaders via the birthplace of those leaders. For the sake of brevity, we do not interpret the statistics of the other variables.

V. MAIN RESULTS

Baseline Results

We test the effect of hometown connections on tax benefits using the following lead-lag regression model:

$$FATR_{it+1} = \alpha_0 + \alpha_1 Connection_{it} + \sum_k \beta_k Control_{it}^k + \sum_t \gamma_t Year_t + \sum_i \delta_i Firm_i + \varepsilon_{it}, \quad (1)$$

where i is firm, t is year, *FATR* is the measure of tax benefits in year $t+1$, and *Connection* is the measure of hometown connections between firms and provincial leaders in year t (defined in Section IV). The vector of the control variables reflects firm, regional, and politician characteristics that could plausibly be related to corporate tax rates.

Specifically, we follow prior studies (Kim and Zhang 2016; Bradshaw, Liao, and Ma 2019) and control for the following firm characteristics: *Ln (total assets)* (the natural logarithm of total assets), *Leverage* (total liabilities divided by total assets), *Sales growth* (sales in year t minus sales in year $t-1$ divided by sales in year $t-1$), *Fixed assets* (net property, plant, and equipment divided by total assets), *Loss* (a dummy variable set to 1 if net income is negative and 0 otherwise), *Return on assets* (net profit divided by total assets), *SOE* (a dummy variable set to 1 for SOEs and 0 otherwise), *STA* (a dummy variable that equals 1 if the tax collector of the firm is the state tax authority and 0 if the tax collector is the local taxation authority), and *Support* (a dummy variable that equals 1 when the firm is domiciled in a special economic zone or operates in a nationally prioritized industry according to the national five-year plan).²³

We account for regional variations in economic development and the legal environment by including *Per capita GDP* (provincial GDP per capita), *Deficit* (provincial government expenditure divided by government revenue), and *Marketization* (the National Economic Research Institute marketization index for the province). We control for the effect of political dynamics on tax avoidance (Chen et al. 2021) by controlling for the politician’s work experience. *First Year* is a variable that equals 1 if the dependent variable is measured in the year immediately after the new provincial

²¹ We perform an additional analysis by defining hometown connections based on provincial governors. We find a positive relationship between politician-firm connections via provincial governors’ hometowns and corporate tax benefits.

²² In China, a registration location of a firm is the location of its main office Chen et al. (2018).

²³ *Support* mainly measures the preferential tax policies applied to special economic zones and industries. For example, a firm can enjoy preferential tax rates if it is domiciled in a special zone, including a high-tech industry or economic development zone, or if it belongs to the agriculture, energy supply, or information technology industries.

TABLE 1
Summary Statistics

	<u>No. of Observations</u>	<u>Mean</u>	<u>Std. Dev.</u>	<u>p25</u>	<u>Median</u>	<u>p75</u>
Dependent Variables						
<i>FATR</i> _{<i>t</i>+1}	24,403	6.419	6.402	0.000	10.000	10.000
<i>FATR_Sub</i> _{<i>t</i>+1}	356,284	1.882	4.603	0.000	0.000	0.000
<i>Dum(HNTE)</i> _{<i>t</i>+1}	24,403	0.395	0.489	0.000	0.000	1.000
<i>Dum(HNTEsub)</i> _{<i>t</i>+1}	344,914	0.008	0.087	0.000	0.000	0.000
<i>LnHNTE_City</i> _{<i>t</i>+1}	2,591	2.805	1.756	1.386	2.773	4.060
<i>%HNTE_City</i> _{<i>t</i>+1}	2,591	0.097	0.162	0.019	0.039	0.084
Test Variables						
<i>Connection</i> _{<i>t</i>}	24,403	0.107	0.309	0.000	0.000	0.000
<i>Connect_sub</i> _{<i>t</i>}	356,284	0.109	0.312	0.000	0.000	0.000
<i>Connect_parent</i> _{<i>t</i>}	356,284	0.077	0.267	0.000	0.000	0.000
<i>Visit</i> _{<i>t</i>}	23,541	0.358	0.479	0.000	0.000	1.000
<i>Cul_Distance</i> _{<i>t</i>}	24,403	0.801	0.400	1.000	1.000	1.000
<i>Genealogy</i> _{<i>t</i>}	24,403	0.479	0.500	0.000	0.000	1.000
<i>CEO/Chair PC</i> _{<i>t</i>}	24,403	0.317	0.465	0.000	0.000	1.000
<i>CEO/Chair school</i> _{<i>t</i>}	24,403	0.027	0.163	0.000	0.000	0.000
<i>Low GDP growth</i> _{<i>t</i>}	24,403	0.207	0.405	0.000	0.000	0.000
<i>Young leader</i> _{<i>t</i>}	24,403	0.900	0.300	1.000	1.000	1.000
<i>Connect_city</i> _{<i>t</i>}	2,591	0.019	0.138	0.000	0.000	0.000
<i>HighCorrupt</i> _{<i>t</i>}	9,494	0.576	0.494	0.000	1.000	1.000
<i>Treat</i> _{<i>t</i>}	5,452	0.153	0.360	0.000	0.000	0.000
<i>Post2012</i> _{<i>t</i>}	5,452	0.524	0.499	0.000	1.000	1.000
Control Variables						
<i>Ln (total assets)</i> _{<i>t</i>}	24,403	21.844	1.156	20.993	21.707	22.540
<i>Leverage</i> _{<i>t</i>}	24,403	0.440	0.201	0.283	0.441	0.592
<i>Sales growth</i> _{<i>t</i>}	24,403	0.198	0.423	-0.005	0.130	0.307
<i>Fixed assets</i> _{<i>t</i>}	24,403	0.238	0.168	0.104	0.206	0.342
<i>Loss</i> _{<i>t</i>}	24,403	0.071	0.257	0.000	0.000	0.000
<i>Return on assets</i> _{<i>t</i>}	24,403	0.035	0.058	0.013	0.034	0.062
<i>SOE</i> _{<i>t</i>}	24,403	0.399	0.490	0.000	0.000	1.000
<i>STA</i> _{<i>t</i>}	24,403	0.258	0.437	0.000	0.000	1.000
<i>Support</i> _{<i>t</i>}	24,403	0.344	0.475	0.000	0.000	1.000
<i>Per capita GDP</i> _{<i>t</i>}	24,403	5.419	3.165	2.881	5.047	7.535
<i>Deficit</i> _{<i>t</i>}	24,403	1.741	0.686	1.218	1.400	2.201
<i>Marketization</i> _{<i>t</i>}	24,403	7.316	1.489	6.340	7.531	8.409
<i>First year</i> _{<i>t</i>}	24,403	0.393	0.488	0.000	0.000	1.000
<i>Nonlocal turnover</i> _{<i>t</i>}	24,403	0.775	0.418	1.000	1.000	1.000
<i>Sub GDP growth</i> _{<i>t</i>}	356,284	0.087	0.023	0.072	0.080	0.099
<i>Sub deficit</i> _{<i>t</i>}	356,284	1.759	0.725	1.215	1.428	2.202
<i>Sub marketization</i> _{<i>t</i>}	356,284	6.952	1.420	6.120	7.119	7.980
<i>Sub first year</i> _{<i>t</i>}	356,284	0.389	0.488	0.000	0.000	1.000
<i>Sub nonlocal turnover</i> _{<i>t</i>}	356,284	0.786	0.410	1.000	1.000	1.000
<i>GDP growth_city</i> _{<i>t</i>}	2,591	0.121	0.086	0.072	0.111	0.181
<i>Consumption_city</i> _{<i>t</i>}	2,591	0.367	0.108	0.298	0.360	0.437
<i>Area_city</i> _{<i>t</i>}	2,591	9.451	0.886	8.954	9.419	9.890

Table 1 shows summary statistics of the variables used in the main analysis. All variables, except dummies, are Winsorized at the 1 and 99 percent levels.

Variables are defined in [Appendix A](#).

TABLE 2
Baseline Regression Results

Dependent Variable	<i>FATR</i> _{<i>t</i>+1}	
	(1)	(2)
Test Variable		
<i>Connection</i> _{<i>t</i>}	1.145*** (3.90)	1.343*** (4.43)
Control Variables		
<i>Ln (total assets)</i> _{<i>t</i>}		0.268* (1.74)
<i>Leverage</i> _{<i>t</i>}		-0.442 (-0.71)
<i>Sales growth</i> _{<i>t</i>}		-0.348*** (-4.62)
<i>Fixed assets</i> _{<i>t</i>}		0.711 (1.02)
<i>Loss</i> _{<i>t</i>}		0.085 (0.63)
<i>Return on assets</i> _{<i>t</i>}		2.399** (2.31)
<i>SOE</i> _{<i>t</i>}		-0.240 (-0.55)
<i>STA</i> _{<i>t</i>}		-2.328*** (-6.74)
<i>Support</i> _{<i>t</i>}		0.558* (1.78)
<i>Per capita GDP</i> _{<i>t</i>}		-0.037 (-0.40)
<i>Deficit</i> _{<i>t</i>}		0.324 (0.82)
<i>Marketization</i> _{<i>t</i>}		0.311*** (2.68)

(continued on next page)

leaders take office and 0 otherwise, and *Nonlocal Turnover* equals 1 if the parent firm is located in a province where the incumbent leader worked in another province before their current position and 0 if they were promoted from within their current province.²⁴ Finally, we include year and firm fixed effects. Including firm fixed effects allows us to control for static firm characteristics. For example, if firm A has a lower tax rate than firm B because the former operates in an industry or region that is officially supported by economic policies, then that effect would be captured by the firm-fixed effects.²⁵

Table 2 presents the OLS regression results for the impact of hometown connections on preferential tax rates. Columns (1) and (2), which include firm- and year-fixed effects, respectively, and all control variables, show that *FATR* is positively associated with *Connection*, and this relationship is significant at the 1 percent level. These results are economically meaningful. For example, as shown in column (2), favored firms enjoy a tax rate that is approximately 1.343 percent lower than that of firms in other cities, which is approximately 5.4 percent (= 1.343/25) of the top statutory rate. Overall, these findings support the presence of hometown favoritism in the form of provincial leaders choosing tax policies that benefit firms in their favored cities.

²⁴ We thank an anonymous reviewer for suggesting these two additional control variables.

²⁵ We ensure that our results remain robust after accounting for time-varying, unspecified province and industry heterogeneity using a sensitivity test that includes province × year and industry × year fixed effects. Our results remain qualitatively similar.

TABLE 2 (continued)

Dependent Variable	$FATR_{t+1}$	
	(1)	(2)
$First\ Year_t$		0.177*** (3.70)
$Nonlocal\ turnover_t$		-0.427*** (-3.22)
Intercept	6.297*** (200.74)	-1.457 (-0.39)
Firm, Year FEs	Yes	Yes
Observations	24,403	24,403
Adjusted R^2	0.595	0.601

***, **, * Indicate significance at the 1 percent, 5 percent, and 10 percent levels, respectively.

Table 2 shows the OLS regression results for the impact of hometown favoritism on corporate tax benefits. $FATR_{t+1}$ is China's top statutory corporate tax rate minus the rate applicable to a firm in year $t+1$. $Connection_t$ is an indicator variable that equals 1 if the registered city of the firm is the birthplace of the local provincial CCP secretary or governor (measured in year t) and 0 otherwise. Control variables are lagged by one year. All variables except dummies are Winsorized at the 1 and 99 percent levels. The t-statistics (in parentheses) are calculated using robust standard errors, corrected for heteroscedasticity, and clustered at the firm level.

Variables are defined in [Appendix A](#).

The signs of the coefficients on the control variables are generally consistent with expectations, with larger firms and firms in supported industries and regions enjoying relatively more tax benefits and firms domiciled in regions with a higher marketization value receiving more tax benefits than those in less developed regions, as evidenced by the significantly positive coefficient on *Marketization*. We also find that firms in provinces governed by leaders who are promoted from other provinces obtain relatively fewer tax benefits, as indicated by the negative coefficient on *Nonlocal Turnover*.

The Dynamic Impact of Hometown Favoritism

We alleviate concerns that unobserved changes might affect tax policy preferences and the appointment of local political leaders by exploring the dynamics of hometown favoritism in more detail, following [Hodler and Raschky \(2014\)](#). We first estimate a specification with several year dummy variables, the values of which depend on whether the dependent variable is measured before or after the leader's first year of tenure—that is, one year before tenure of the provincial leader in the region ($Connection(-1)$), the year the leader takes office ($Connection(0)$), the first year after the initial year ($Connection(1)$), and the second or subsequent years ($Connection(2+)$) after the leader is installed.

[Table 3](#) shows the results of the above analysis. The estimates show that the coefficients for $Connection(-1)$ and $Connection(0)$ are statistically nonsignificant, whereas those for $Connection(1)$ and $Connection(2+)$ are significantly positive. These outcomes suggest that firms only receive tax benefits from the first year after the connected provincial leader takes office and that this effect persists throughout the leader's tenure.

Furthermore, we construct a dummy variable to estimate the effects after the end of the particular leader's tenure (i.e., a dummy variable that equals 1 if the tax benefit is measured in the year after the departure of a leader and 0 otherwise ($Connection_loss(1)$)). The results are set out in [Table 3](#), column (3), and reveal that the coefficient of $Connection_loss(1)$ is negative but nonsignificant (-0.26, t-statistic = -1.15). A negative coefficient indicates that firms receive lower tax benefits after the departure of the political leader. An insignificant coefficient denotes that existing tax benefits continue briefly after the political leader leaves because the tax policies favoring a given firm are often in effect for more than one year (see [Online Appendix IV](#) for examples).

These findings collectively support the idea that firms located in a favored city enjoy greater tax benefits because of their geographical ties to the provincial leader (rather than confounding factors). This should mitigate concerns regarding the endogeneity of the leader regions.

Hometown Favoritism and Tax Benefits of Subsidiaries

In this subsection, we extrapolate our main findings on parent firms and report additional results at the subsidiary level. In the Chinese tax system, the tax rate applicable to a subsidiary is determined by the government officials of the province where the subsidiary is located (not by the officials of the province where the parent is located). This allows us

TABLE 3
The Dynamic Impact of Hometown Connections on Corporate Tax Benefits

Dependent Variable	<i>FATR</i> _{<i>t</i>+1}		
	(1)	(2)	(3)
Test Variable			
<i>Connection</i> (-1)	0.361 (0.50)	0.468 (0.65)	0.433 (0.60)
<i>Connection</i> (0)	0.568 (0.91)	0.567 (0.91)	0.531 (0.84)
<i>Connection</i> (1)	2.363*** (4.26)	1.914*** (3.64)	1.868*** (3.55)
<i>Connection</i> (2+)	1.455*** (5.35)	1.539*** (5.52)	1.492*** (5.21)
<i>Connection_loss</i> (1)			-0.260 (-1.15)
Control Variables			
<i>Ln (total assets)</i> _{<i>t</i>}		0.268* (1.74)	0.267* (1.73)
<i>Leverage</i> _{<i>t</i>}		-0.435 (-0.70)	-0.438 (-0.71)
<i>Sales growth</i> _{<i>t</i>}		-0.340*** (-4.51)	-0.340*** (-4.50)
<i>Fixed assets</i> _{<i>t</i>}		0.713 (1.02)	0.715 (1.03)
<i>Loss</i> _{<i>t</i>}		0.078 (0.58)	0.077 (0.57)
<i>Return on assets</i> _{<i>t</i>}		2.345** (2.26)	2.345** (2.26)
<i>SOE</i> _{<i>t</i>}		-0.236 (-0.54)	-0.236 (-0.54)
<i>STA</i> _{<i>t</i>}		-2.155*** (-6.52)	-2.190*** (-6.37)
<i>Support</i> _{<i>t</i>}		0.516 (1.64)	0.512 (1.63)
<i>Per capita GDP</i> _{<i>t</i>}		-0.018 (-0.20)	-0.015 (-0.16)
<i>Deficit</i> _{<i>t</i>}		0.361 (0.92)	0.365 (0.93)

(continued on next page)

to document within-parent firm variations in the CIT rates applicable to subsidiaries. Specifically, for a subsidiary located in the birthplace of the provincial leader, our control group consists of other subsidiaries located in other provinces (i.e., not having any hometown connection) but affiliated with the same parent firm.

We use hand-collected subsidiary-level CIT rate data and exclude parent entities to avoid comparing a parent with its subsidiaries; the *FATR_Sub* value for different subsidiaries under the same parent are more comparable. The fundamental data available on subsidiaries only allow for control variables related to regional variation in the province where a subsidiary is registered; these variables include *Sub GDP Growth*, *Sub Deficit*, *Sub Marketization*, *Sub First Year*, and *Sub Nonlocal Turnover*.

The results of this analysis are presented in Table 4. The dependent variable *FATR_Sub*_{*t*+1} is the preferential tax rate observed for a subsidiary in year *t*+1 (i.e., the statutory tax rate minus the CIT applicable to the subsidiary). Our main independent variable is the indicator *Connect_sub*_{*t*}, as measured in year *t*, and is equal to 1 if the subsidiary is located in the city where the political leader was born (here, “leader” refers to the governor or secretary of the province where the subsidiary is

TABLE 3 (continued)

Dependent Variable	$FATR_{t+1}$		
	(1)	(2)	(3)
$Marketization_t$		0.351*** (2.98)	0.353*** (2.99)
$First\ year_t$		0.164*** (3.49)	0.163*** (3.47)
$Nonlocal\ turnover_t$		-0.483*** (-3.65)	-0.478*** (-3.62)
Intercept	6.276*** (228.11)	-1.896 (-0.51)	-1.898 (-0.51)
Firm, Year FEs	Yes	Yes	Yes
Observations	24,403	24,403	24,403
Adjusted R^2	0.596	0.602	0.602

***, **, * Indicate significance at the 1 percent, 5 percent, and 10 percent levels, respectively.

Table 3 presents the impact of changes in provincial leadership on corporate tax benefits. The dependent variable, $FATR_{t+1}$, is China's top statutory income tax rate minus the applicable income tax rate of a firm in year $t + 1$. $Connection(-1)$ is an indicator variable that equals 1 if the dependent variable ($FATR_{t+1}$) is measured in the year immediately before the year in which the hometown-connected provincial leader takes office. $Connection(0)$ is an indicator variable that equals 1 if the dependent variable is measured in the same year in which the connected provincial leader started working in the province (i.e., the initial year). $Connection(1)$ is an indicator variable that equals 1 if the dependent variable is measured in the first year after the initial year in office for the connected provincial leader. $Connection(2+)$ is an indicator variable that equals 1 if the dependent variable is measured in the period in which the connected provincial leader has been in office for two or more years after the initial year. $Connection_loss(1)$ is an indicator variable equal to 1 if the dependent variable is measured in the first year after the connected provincial leader leaves office. The t-statistics (in parentheses) are calculated using robust standard errors, corrected for heteroscedasticity, and clustered at the firm level.

Variables are defined in Appendix A.

TABLE 4

Hometown Favoritism and Tax Benefits of Subsidiaries

Dependent Variable	$FATR_Sub_{t+1}$			
	(1)	(2)	(3)	(4)
Test Variables				
$Connect_sub_t$	0.168*** (4.07)	0.173*** (4.15)	0.158*** (3.06)	0.164*** (3.15)
$Connect_parent_t$			0.020 (0.35)	0.019 (0.32)
Control Variables				
$Sub\ GDP\ growth_t$	0.620 (0.81)	0.657 (0.85)	0.630 (0.82)	0.666 (0.86)
$Sub\ deficit_t$	-0.565*** (-8.02)	-0.570*** (-8.01)	-0.565*** (-8.02)	-0.570*** (-8.01)
$Sub\ marketization_t$	-0.089*** (-4.12)	-0.087*** (-4.02)	-0.089*** (-4.11)	-0.087*** (-4.02)
$Sub\ first\ year_t$	-0.025** (-2.29)	-0.024** (-2.20)	-0.025** (-2.28)	-0.024** (-2.20)
$Sub\ nonlocal\ turnover_t$	0.049** (2.06)	0.052** (2.16)	0.049** (2.06)	0.052** (2.15)
Intercept	3.391*** (15.80)	3.383*** (15.65)	3.390*** (15.78)	3.381*** (15.64)

(continued on next page)

TABLE 4 (continued)

Dependent Variable	<i>FATR_Sub_{t+1}</i>			
	(1)	(2)	(3)	(4)
Subsidiary, Year FEs	Yes	Yes	Yes	Yes
Parent firm FEs	No	Yes	No	Yes
Observations	356,284	356,284	356,284	356,284
Adjusted R ²	0.646	0.642	0.646	0.642

***, **, * Indicate significance at the 1 percent, 5 percent, and 10 percent levels, respectively.

Table 4 shows the OLS regression results for the impact of hometown favoritism on corporate tax benefits at the subsidiary level. *FATR_Sub_{t+1}* is the country's top statutory income tax rate minus a subsidiary firm's applicable income tax rate in year *t+1*. *Connect_sub_t* is an indicator variable that equals 1 if the subsidiary's registered city is the birthplace of the local provincial CCP secretary or governor and 0 otherwise. *Connect_parent_t* is an indicator variable that equals 1 if the registered city of the parent firm is the birthplace of the provincial CCP secretary or governor (here, the leader refers to the governor or secretary of the province where the subsidiary firm is located) and 0 otherwise. All variables except dummies are Winsorized at the 1 and 99 percent levels. The t-statistics (in parentheses) are calculated using robust standard errors, corrected for heteroscedasticity, and clustered at the subsidiary firm level.

Variables are defined in [Appendix A](#).

located). *Connect_parent_t*, measured in year *t*, equals 1 if the parent firm of the subsidiary is located in the city of birth of the political leader (defined as described above). In columns (1) and (3), we control for subsidiary- and year-fixed effects. In columns (2) and (4), we rely on additional parent-firm-fixed effects to identify within-parent variations.

Columns (1) and (2) of [Table 4](#) show significant and positive coefficients for *Connect_sub_t*, suggesting that the leaders of the province where the subsidiary is located determine whether it pays a preferential tax rate. Columns (3) and (4) indicate that the coefficient for *Connect_parent_t* is statistically nonsignificant, implying that subsidiaries do not receive tax benefits as a result of an indirect hometown connection through their parent firm (i.e., the parent firm of the subsidiary has a hometown connection).

Another implication of our subsidiary-level analysis is that hometown favoritism is unlikely to be driven by corruption. Chinese parent companies tend to directly manage or influence the major decisions of their subsidiaries ([Griffin, Liu, and Shu 2021](#)). If a parent company has a hometown connection with the leader of the province where the subsidiary is located, the bribery explanation implies that the parent company will bribe the connected provincial leader in exchange for tax benefits for the subsidiary. If this were the case, the coefficient for *Connect_parent* would be significantly positive; however, this coefficient is insignificant in both columns (3) and (4) of [Table 4](#). This result to some extent excludes bribery as an alternative explanation. We provide a more detailed assessment of the role of corruption in our framework in [Section VIII](#).

VI. CROSS-SECTIONAL ANALYSES

Provincial leaders may favor their hometown cities as a result of emotional and psychological attachments. This effect may be intensified by hometown preferences and personal connections with firm managers. However, this result is moderated when leaders are affected by promotional incentives. We test these scenarios by performing several cross-sectional analyses.

The Conditioning Effect of Hometown Preference

We first test variations in the strength of provincial leaders' hometown preferences, that is, their emotional and psychological attachments to their hometowns. Following the social identity hypothesis, this attachment should increase the impact of hometown connections on tax benefits. We measure the hometown preferences of provincial leaders using three proxies.

The first variable is derived from provincial leaders' visits to their respective hometowns.²⁶ Previous research shows a positive relationship between hometown visits and the strength of a leader's place attachment ([Rijnks and Strijker 2013](#)).

²⁶ We thank a referee for recommending this measure to us. We obtained the data by searching articles mentioning the names of leaders using a Python script (from all news in the Baidu search engine). We then supplemented these results with financial news articles included in the CSMAR dataset. There is a caveat to this measure. The ideal proxy for social preference is the personal visits by the leader to their hometown, which are a purer reflection of their preference. However, due to limitations on data regarding personal visits, we can only use the visits reported in news articles.

Specifically, we define an indicator that takes the value of 1 if a provincial leader visited their hometown more than once in the period up to year t and 0 otherwise ($Visit_t$).²⁷

In respect of the second variable, we consider whether a provincial leader was born in a city that is not part of the same dialect area as the provincial capital ($Cul_Distance_t$). An individual's place attachment increases with a location's distinctiveness and uniqueness (Low and Altman 1992). Provincial leaders of areas that are culturally distinct from the mainstream likely have strong affinities for the area, are more likely to adopt measures that favor the location, and derive higher utility from favoring connected firms. Following Gao and Long (2016), we use dialect as a proxy for the uniqueness of the local culture. Specifically, a city is considered culturally distinct from the mainstream if it does not share the regional dialect of the capital city of the related province.

For the third variable, we consider whether the birthplace city of a provincial leader (either a provincial CCP secretary or governor) is connected to a famous family tree based on the last name of that leader ($Genealogy_t$). The assumption is that people tend to have a stronger hometown preference for their birthplace when they inherit this from their parents or grandparents (i.e., when there is an extensive family tree in their birthplace city). We collect the family tree data from the "Clan Culture Database" provided by the Chinese Research Data Services Platform, which contains family trees based on surnames for each city in China.

Table 5 presents the results of this analysis. We interact these three proxies for hometown preference ($Visit_t$, $Cul_Distance_t$, and $Genealogy_t$) with the $Connection$ dummy and find significantly positive interaction effects in all three cases. These results suggest that the effect of hometown connections on corporate tax benefits is more pronounced when provincial leaders have a stronger social preference for hometown businesses over those located elsewhere. Therefore, a provincial leader's hometown preferences appear to be an important driver in the granting of tax benefits to firms with hometown connections.²⁸

TABLE 5

The Conditioning Effect of Hometown Preference of Provincial Leaders

Dependent Variable	$FATR_{t+1}$		
	(1)	(2)	(3)
Test Variables			
$Connection_t$	0.022 (0.03)	0.940** (2.30)	0.228 (0.61)
$Connection_t \times Visit_t$	1.473** (2.12)		
$Visit_t$	0.750*** (5.55)		
$Connection_t \times Cul_Distance_t$		1.140** (2.04)	
$Cul_Distance_t$		0.350* (1.78)	
$Connection_t \times Genealogy_t$			2.361*** (4.24)

(continued on next page)

²⁷ In an untabulated test, we divided the hometown visit variable into two indicator variables: $Visit_firms$, which equals 1 if a provincial leader visited the hometown firms and 0 otherwise, and $Visit_other$, which equals 1 if a provincial leader made other visits to their hometown and 0 otherwise. The results in Table 5, column (1) are generated by these other visits, which helps rule out bribery as an alternative explanation.

²⁸ The coefficients for the hometown preference variables are significantly positive, suggesting that the inherent hometown preference of provincial leaders is a significant driving force behind corporate tax benefits, irrespective of whether those politicians have hometown connections with the firms in question. This finding could be explained by the fact that when provincial leaders have a strong attachment to their place of birth or experience feelings of nostalgia, they tend to extend this emotional connection to their work location, which is often considered a second hometown for individuals in China.

TABLE 5 (continued)

Dependent Variable	$FATR_{t+1}$		
	(1)	(2)	(3)
<i>Genealogy_t</i>			0.269** (2.37)
Control Variables in Table 2	Yes	Yes	Yes
Firm, Year FEs	Yes	Yes	Yes
Observations	23,541	24,403	24,403
Adjusted R ²	0.614	0.602	0.604

***, **, * Indicate significance at the 1 percent, 5 percent, and 10 percent levels, respectively.

Table 5 examines the moderating effect of hometown preference of provincial leaders on the main result. The dependent variable, $FATR_{t+1}$, is the country's top statutory income tax rate minus the applicable income tax rate for a firm in year $t+1$. Social preference is measured by the following three proxies measured in year t : (1) *Visit_t*, an indicator variable that equals 1 if a provincial leader visited their hometown more than once up to year t and 0 otherwise; (2) *Cul_Distance_t*, an indicator variable that equals 1 if the birthplace city of the provincial leader (either a provincial CCP secretary or governor) is not part of the same dialect area as the provincial capital city and 0 otherwise; and (3) *Genealogy_t*, an indicator variable that equals 1 if the birthplace city of the provincial leader (either a provincial CCP secretary or governor) has a famous family tree based on the surname of the leader and 0 otherwise. *Connection_t*, is an indicator variable that equals 1 if the registered city of the firm is the birthplace of the local provincial CCP secretary or governor and 0 otherwise. All variables except dummies are Winsorized at the 1 and 99 percent levels. The t-statistics (in parentheses) are calculated using robust standard errors, corrected for heteroscedasticity, and clustered at the firm level.

Variables are defined in Appendix A.

The Conditioning Effect of Personal Connections between Firm Management and Provincial Leaders

Several studies have shown that personal ties between politicians and firm managers or directors represent valuable firm resources (Fan et al. 2007; Claessens, Feijen, and Laeven 2008; Faccio and Parsley 2009; Hung et al. 2012; Piotroski and Zhang 2014; Kim and Zhang 2016). In this subsection, we examine how the relationship between the practice of hometown favoritism by provincial leaders and tax benefits to firms in that place varies when there is a personal connection between the leader and the firms' managers.

We consider two types of politician-manager connections in China. The first, *CEO/Chair PC_t*, captures the political connections of a firm's manager or chair (Fan et al. 2007; Hung et al. 2012; Piotroski and Zhang 2014).²⁹ This variable takes the value of 1 if the CEO or chair is any of the following: a former government official, a current or former member of the People's Congress, or a current or former member of the People's Political Consultative Conference.

The second variable, *CEO/Chair school*, captures connections between managers or chairs and politicians through common educational backgrounds, an essential basis for social ties in China (Guan et al. 2016). This variable takes the value of 1 if the CEO or chair graduated from the same university as a provincial leader (either a CCP secretary or governor) of the province in which the firm is located and 0 otherwise.

Table 6 reports the empirical results of this analysis. We find a significant and positive interaction effect in both cases. The results indicate that the positive impact of the hometown connection on tax benefits is more pronounced when top management has prior work experience in government or graduated from the same university as the provincial leader. The personal connections of the CEO/chair have a positive but statistically insignificant impact on the tax benefits enjoyed by the firm. Overall, our results highlight the significant cross-firm variation in tax benefits received from the government, which can be at least partially attributed to personal connections between top management and provincial leaders.³⁰

²⁹ We focus on the CEO and the board chair because, in most Chinese companies, it is the latter, rather than the former, that is the more important position (Conyon and He 2012). For example, Jack Ma is the chair of Alibaba, and its CEO is Daniel Zhang, with whom very few people are unfamiliar. In the untabulated analyses, we use the data for the CEO or chair; the results are qualitatively the same.

³⁰ We gain further insights into the significance of social connections between firms and politicians through a survey of firm management. We distributed questionnaires to executives through the WeChat online survey platform and allowed them to respond using their mobile phones. We received responses from 19 executives representing various firms. The results indicate that a personal connection between top management and provincial leaders could influence the abilities of companies to receive tax benefits. Specifically, the respondents suggested that politicians help connected firms obtain tax benefits by providing encouragement, additional information, or reducing administrative and other barriers that could hinder them in applying them for preferential tax treatments; the survey evidence is available in Online Appendix V.

TABLE 6
The Conditioning Role of Personal Connections between Firm Management and Provincial Leaders

Dependent Variable	$FATR_{t+1}$	
	(1)	(2)
Test Variable		
$Connection_t$	0.925*** (2.77)	1.293*** (4.24)
$Connection_t \times CEO/Chair PC_t$	1.179** (2.54)	
$CEO/Chair PC_t$	0.087 (0.40)	
$Connection_t \times CEO/Chair school_t$		2.088** (2.21)
$CEO/Chair school_t$		-0.128 (-0.44)
Control Variables in Table 2	Yes	Yes
Firm, Year FEs	Yes	Yes
Observations	24,403	24,403
Adjusted R ²	0.602	0.601

***, **, * Indicate significance at the 1 percent, 5 percent, and 10 percent levels, respectively.

Table 6 examines the moderating effect of the CEO/Chair's personal connections with provincial leaders on the association between hometown connection and tax benefits. $Connection_t$ is an indicator variable that equals 1 if the registered city of the firm is the birthplace of the local, provincial CCP secretary or governor (measured in year t) and 0 otherwise. $CEO/Chair PC_t$ is an indicator variable that equals 1 if the CEO or the chair of the board is a former government official and 0 otherwise. $CEO/Chair school_t$ is an indicator variable that equals 1 if the CEO or the chair graduated from the same university as a provincial leader (either CCP secretary or governor) and 0 otherwise.

The Conditioning Effect of the Promotion Incentives of Provincial Leaders

In China, political leaders consider their career development when making decisions. These career development concerns could limit their granting of tax benefits to connected firms. In this subsection, we examine how the relationship between hometown favoritism of provincial leaders and tax benefits varies when those leaders have strong promotion incentives.

First, we measure promotion incentives using local GDP growth relative to growth at the national level. When local growth is lower than the national level, leaders have a strong incentive to enhance their performance to achieve promotion (Li and Zhou 2005; Xu 2011; Chen et al. 2020), and we expect the hometown effect to be less pronounced. Second, we measure promotion incentives using the age of provincial leaders. Younger leaders have stronger incentives than older politicians to enhance their performance in furtherance of their careers (Li and Zhou 2005; Xu 2011; Chen et al. 2020), and we expect the hometown effect to be less prominent when leaders are relatively young.

We test the above prediction by constructing two indicator variables. The first, denoted as *Low GDP Growth*, equals 1 if the GDP growth of the province is lower than the national level and 0 otherwise. With respect to the second variable *Young Leader*, we follow the methods of Chen et al. (2020) and use 60 as the threshold defining a "young" governor and 65 as the threshold for party secretaries, who are of a higher rank and generally older (Li and Zhou 2005); the variable thus takes the value of 1 if a provincial governor is 60 or younger or the provincial party secretary is 65 or younger and 0 otherwise. Using rank-dependent thresholds to define the age grouping of politicians allows us to better identify young politicians.

The results of this assessment are shown in Table 7. Column (1) reveals that the coefficient for the interaction term $Connection \times Low GDP Growth$ is significantly negative at the 1 percent level, suggesting that the hometown effect is less pronounced when leaders are faced with inferior local growth. Column (2) shows that the $Connection \times Young Leader$ interaction coefficient is significantly negative at the 1 percent level, indicating that the hometown effect is less evident when leaders are younger. Overall, our results suggest that provincial leaders with strong promotion incentives tend to offer fewer corporate tax benefits out of a sense of hometown favoritism.

TABLE 7
The Moderating Effect of Promotion Incentives

Dependent Variable	<i>FATR</i> _{<i>t</i>+1}	
	(1)	(2)
Test Variable		
<i>Connection</i> _{<i>t</i>}	1.719*** (5.10)	4.001*** (4.32)
<i>Connection</i> _{<i>t</i>} × <i>Low GDP Growth</i> _{<i>t</i>}	-1.566*** (-5.42)	
<i>Low GDP Growth</i> _{<i>t</i>}	0.104 (0.66)	
<i>Connection</i> _{<i>t</i>} × <i>Young Leader</i>		-2.718*** (-3.06)
<i>Young Leader</i>		-0.477*** (-4.24)
Control Variables in Table 2	Yes	Yes
Firm, Year FEs	Yes	Yes
Observations	24,403	24,403
Adjusted R ²	0.602	0.602

***, **, * Indicate significance at the 1 percent, 5 percent, and 10 percent levels, respectively.

Table 7 examines the moderating effect of the promotion incentives of provincial leaders on the association between hometown connection and tax benefits. *Connection*_{*t*} is an indicator variable that equals 1 if the registered city of the firm is the birthplace of the local provincial CCP secretary or governor (measured in year *t*) and 0 otherwise. *Low GDP Growth*_{*t*} is an indicator variable that equals 1 if the province's GDP growth is below the overall GDP growth of China in the year and 0 otherwise. *Young Leader* is an indicator variable that equals 1 if the provincial governor (of the firm's province) is 60 years old or younger or if the provincial party secretary is 65 years or younger and 0 otherwise.

VII. MECHANISM TEST: HOMETOWN CONNECTION AND SPECIFIC TAX BENEFITS

In this section, we analyze the detailed mechanisms through which hometown favoritism affects corporate tax benefits. As discussed in Section II, provincial leaders may grant tax benefits to connected firms in the form of approving their specific preferential tax treatment. We test this theory by using a large dataset of firm-specific tax abatements.

An important discretionary tax benefit is the preferential tax rate afforded to firms that are recognized as HNTEs. As discussed in Section II, HNTE recognition is largely determined by provincial governments; therefore, it is reasonable to expect that hometown-connected firms are more likely than unconnected firms to be recognized as HNTEs.

Table 8, Panel A presents the regression results at the parent-firm level. In column (1), the dependent variable is *Dum(HNTE)*_{*t*+1}, which is an indicator variable that equals 1 if the firm is designated as an HNTE in year *t*+1 and 0 otherwise. The positive coefficient for *Connection*_{*t*} in column (1) suggests that firms with hometown connections to local provincial leaders are more likely to receive tax benefits through HNTE recognition in the next year than those without connections.³¹ This effect is statistically and economically significant at 0.035 (t-statistic = 2.15).

Following previous research (Mayew, Sharp, and Venkatachalam 2013; Maksymov and Nelson 2017), we conduct a mediation analysis for columns (2) and (3) to determine the power of HNTE status in explaining the hometown effect. In our baseline model, reflected in column (2) of Panel A, the coefficient of *Connection*_{*t*} is 1.343. In our model extended to include an indicator of HNTE status (*Dum(HNTE)*_{*t*+1}) as a control variable, this coefficient decreases to 1.102 (an 18 percent reduction). Therefore, the tax benefits associated with HNTE status are approximately 18 percent of the original effect of *Connection*.

The Sobel test (z-value = 3.496, p-value < 0.00) indicates that granting HNTE status is a significant factor in the relationships identified. The coefficient of *Connection*_{*t*} continues to be significant after controlling for *Dum(HNTE)*_{*t*+1},

³¹ Table 8, Panel A, column (1) shows the following two alternative settings from the untabulated analysis: (1) the replacement of the dependent variable with a continuous variable that captures the magnitude of the tax benefit resulting from HNTE status (that is, *TB_HNTE*, which is determined as the statutory income tax rate of the firm minus the preferential tax rate associated with HNTE recognition and equals 0 if the firm is not recognized as an HNTE) and (2) the restriction of the sample to firms that meet the minimum research and development (R&D) expense requirements as stated in the government guidelines to ensure that the results better reflect the discretion exerted by political leaders rather than the eligibility of the firms (i.e., the R&D expense scaled by total assets is at least 3 percent).

TABLE 8

Mechanism Test: Hometown Connections and Specific Tax Benefits

Panel A: Hometown Favoritism and Specific Corporate Tax Benefits at the Parent Firm Level

Dependent Variables	$Dum(HNTE)_{t+1}$	$FATR_{t+1}$	$FATR_{t+1}$
	(1)	(2)	(3)
Test Variables			
$Connection_t$	0.035**	1.343***	1.102***
	(2.15)	(4.43)	(4.09)
$Dum(HNTE)_{t+1}$			6.981***
			(28.85)
Reduction in the coefficient of $Connection_t$			18%
Sobel test			3.496***
Control Variables in Table 2	Yes	Yes	Yes
Firm, Year FEs	Yes	Yes	Yes
Observations	24,403	24,403	24,403
Adjusted R ²	0.709	0.601	0.684

Panel B: Hometown Favoritism and HNTE Tax Benefits at the Subsidiary Level

Dependent Variable	$Dum(HNTEsub)_{t+1}$	
	(1)	(2)
Test Variable		
$Connect_Sub_t$	0.003***	0.003***
	(3.07)	(3.00)
Control Variables		
$Sub\ GDP\ Growth_t$	0.014	0.015
	(0.82)	(0.87)
$Sub\ Deficit_t$	-0.002	-0.002
	(-1.50)	(-1.61)
$Sub\ Marketization_t$	-0.000	-0.000
	(-0.21)	(-0.12)
$Sub\ First\ Year_t$	0.000	0.000
	(0.88)	(0.87)
$Sub\ Nonlocal\ Turnover_t$	0.000	0.000
	(0.35)	(0.39)
Intercept	0.010**	0.010**
	(2.33)	(2.29)
Subsidiary, Year FEs	Yes	Yes
Parent Firm FEs	No	Yes
Observations	344,914	344,914
Adjusted R ²	0.112	0.103

(continued on next page)

implying the involvement of other mechanisms. Although HNTE seems the strongest source of tax benefits, other tax benefits together explain the remaining share (approximately 80 percent) of the impact of connected provincial leaders on the *FATR*.

Table 8, Panel B presents the analysis of subsidiary-level HNTE recognition. To perform this test, we hand-collect the subsidiary-level HNTE recognition data.³² The dependent variable is $Dum(HNTEsub)_{t+1}$, which equals 1 if the

³² We collect the HNTE recognition data for each subsidiary because the preferential tax rate is determined by the leaders of the province where the subsidiary is located. Therefore, HNTE recognition should be determined independently for the parent firm and its subsidiaries. As shown in Online Appendix IV, the HNTE status is awarded to subsidiaries and parent firms independently.

TABLE 8 (continued)

Panel C: Hometown Favoritism and HNTe Recognition at the City Level

Dependent Variables	$LnHNTe_City_{t+1}$ (1)	$\%HNTe_City_{t+1}$ (2)
Test Variable		
$Connect_City_t$	0.671*** (2.88)	0.086** (2.07)
Control Variables		
$GDP_Growth_City_t$	1.575*** (3.28)	0.244*** (3.92)
$Consumption_City_t$	3.116*** (3.61)	0.651*** (4.89)
$Area_City_t$	-0.216*** (-2.78)	-0.035*** (-3.40)
Intercept	3.501*** (4.58)	0.155* (1.80)
Province, Year FEs	Yes	Yes
Observations	2,591	2,591
Adjusted R ²	0.584	0.266

***, **, * Indicate significance at the 1 percent, 5 percent, and 10 percent levels, respectively.

Table 8 presents the results of testing the mechanisms through which a hometown connection affects corporate tax benefits. Panel A reports the OLS regression results for the impact of a hometown connection on a specific tax benefit and related path analysis of preferential tax rates at the parent firm level (the unit of analysis is a parent firm-year observation). $Dum(HNTe)_{t+1}$ is an indicator variable that equals 1 if the firm is designated as HNTe in year $t+1$ and 0 otherwise. $FATR_{t+1}$ is the top statutory income tax rate minus the rate applicable to the firm in year $t+1$. $Connection_t$ is an indicator variable that equals 1 if the registered city of the firm is the birthplace of the local provincial CCP secretary or governor in year t and 0 otherwise. Panel B reports the OLS regression results of the impact of hometown favoritism on corporate HNTe tax benefits at the subsidiary level (the unit of analysis is subsidiary-year observations). $Dum(HNTesub)_{t+1}$ is an indicator variable that equals 1 if the subsidiary firm is designated as HNTe in year $t+1$ and 0 otherwise. $Connect_sub_t$ is an indicator variable that equals 1 if the registered city of the subsidiary is the birthplace of the local provincial CCP secretary or governor and 0 otherwise. Panel C reports the OLS regression results of the impact of a hometown connection on the number and fraction of firms designated as HNTes at the city level (the unit of analysis is a city-year observation). $LnHNTe_City_{t+1}$ is the natural log of firms recognized as HNTes in the city in year $t+1$. $\%HNTe_City_{t+1}$ is the ratio of firms recognized as HNTes in the city to all HNTes in the province in year $t+1$. $Connect_city_t$ is an indicator variable that equals 1 if the city is the birthplace of the local provincial CCP secretary or governor in year t and 0 otherwise. All variables except dummies are Winsorized at the 1 and 99 percent levels. The t-statistics (in parentheses) are calculated using robust standard errors, corrected for heteroscedasticity, and clustered at the parent firm level (in Panel A), the subsidiary firm level (in Panel B), and the city level (in Panel C). Variables are defined in Appendix A.

subsidiary firm is designated as an HNTe firm in year $t+1$ and 0 otherwise. We find a significant and positive coefficient for $Connect_sub_t$, suggesting that local provincial leaders grant tax benefits to subsidiaries with hometown connections through HNTe recognition. Overall, our results indicate that there is considerable cross-subsidiary variation in the tax benefits allocated based on the location of the subsidiary, which determines the hometown connection.

In Panel C, we provide additional evidence at the city-year level. We find that the number (in log) ($LnHNTe_City$) and percentage ($\%HNTe_City$) of recognized HNTes in a city are higher when the provincial leader was born in that city.

In the untabulated analysis, we present a placebo test based on two types of tax benefits that are not controlled by provincial leaders. We first offer an overview of the main benefit types by providing the statistics for firms receiving a particular kind of tax benefit. In our sample, we determine that 13,684 parent firm-year observations receive preferential tax rates, accounting for 56 percent of our full sample. Of these, 9,649 (70.5 percent), 1,808 (13.2 percent), and 176 (1.3 percent) receive tax abatements for their status as HNTes, western development region enterprises, and national software/circuit enterprises, respectively.³³

³³ Both national key software enterprises and integrated circuit design enterprises are recognized by the central government, whereas the western development region enterprises are recognized by county-level governments. We combine the first two groups because both are controlled by the central government. We refer to this combination as the national software/circuit recognition, which has no overlap with the high-new-tech recognition status.

Recognition as a national software/circuit or western development region enterprise is determined at the central and county levels, respectively; these enterprises are thus ideal candidates for the placebo test. Further, being recognized as an enterprise from the western development region does not change unless the main business of the specified firm changes (unlike HNTTE recognition, which mandates periodic reassessment). The discretion of provincial leaders in the recognition and renewal process for these firms is considerably lower than in our main case. Our results show that hometown-connected provincial leaders have little influence on the recognition of a firm as a national software/circuit or western development region enterprise.³⁴

Our results above indicate that provincial leaders are consistent in the extent to which they grant tax abatements for hometown-connected firms; this is not the case for tax abatements that are out of their direct control.³⁵

VIII. AN ALTERNATIVE EXPLANATION: CORRUPTION-BASED MOTIVES

Shleifer and Vishny (1994) study the interplay between firms and politicians, showing that firms react to and help shape the political environment while politicians exploit their control over regulatory policies by favoring cronies from whom they receive bribes. Their study implies that corruption may mediate hometown favoritism and corporate tax benefits. However, corruption is difficult to detect and accurately quantify. We empirically test this alternative explanation through the following analyses.

First, we perform a cross-sectional analysis by interacting *Connection* with an SOE indicator. SOE executives show less incentive to bribe hometown-connected politicians than those of non-SOEs because their ability to personally benefit from such bribery is limited, and they would bear the full negative consequences of this behavior. Thus, if corruption is a relevant factor, the effect of the politician-leader connection on tax benefits should be stronger for non-SOEs than for SOEs. Column (1) of Table 9 reports the interaction results; the interaction term $Connection_t \times SOE_t$ has an insignificant coefficient (0.171, t-statistic = 0.32), whereas $Connection_t$ remains positive and significant.³⁶

Second, we test whether the main effect varies with corruption at the provincial level. We restrict this particular test to the sample before the period between 2003 and 2012, before the government's anticorruption efforts and a time when the corruption-based explanation could prove more relevant. *HighCorrupt* is an indicator variable that equals 1 if the firm is located in a high-corruption province (i.e., the number of officials in the province convicted for corruption is above the sample median) and 0 otherwise. If the corruption explanation is valid, we expect firms in high-corruption provinces to exhibit strong relationships between *FATR* and *Connection*. Column (2) of Table 9 reports that the coefficient for the interaction term $Connection_t \times HighCorrupt$ is insignificant (0.473, t-statistic = 0.48), whereas that for $Connection_t$ remains significantly positive.

Third, we follow the methods of Ke, Liu, and Tang (2016) and conduct a DiD analysis with respect to the anticorruption campaign launched in China in December 2012. *Treat* is an indicator variable that equals 1 if the firm has a hometown connection with local provincial leaders in 2010 and 2011 and 0 otherwise. *Post2012* is an indicator variable that equals 1 if the dependent variable is measured after 2012 and 0 otherwise. We use firms outside the treatment group as control firms and restrict the analysis to a range close to the 2012 event (i.e., 2011–2014). The intuition is that if the corruption explanation is valid, firms that had hometown connections before 2012 should, at that time, have experienced more significant decreases in *FATR* than the control firms.

In addition, we implement a triple difference analysis by interacting the province-level corruption variable *HighCorrupt* with the treatment and post-event indicators. If the corruption explanation is sound, we expect the DiD effect to be stronger in high-corruption provinces than in noncorrupt provinces. Column (3) of Table 9 shows that the

³⁴ In particular, we conduct the following tests in an untabulated analysis. We construct two alternative dependent variables. *TB_SOFT* (*TB_WEST*) indicates the statutory income tax rate of a firm minus the preferential applicable income tax rate associated with national software/circuit enterprise recognition (western development region enterprise recognition). *TB_SOFT* and *TB_WEST* are 0 if the firm does not receive tax benefits associated with the corresponding recognitions. We regress the tax benefits due to these two types of recognitions on the hometown connection indicator variable of the firms. To the extent that *TB_SOFT* and *TB_WEST* are not controlled by provincial leaders, they serve as counterfactuals to the case of province-level HNTTE recognition. To restrict the analysis to firms eligible for the corresponding status, we only include firms located in western districts that operated in industries eligible for national software/circuit enterprise recognition, thereby reducing the sample sizes to 3,084 and 5,415, respectively. We find that the hometown effect becomes marginally nonsignificant for recognition of enterprises as being in the western development region (t-statistic = 1.13) and completely disappears in the case of the national software/circuit status (t-statistic = 0.18).

³⁵ It is likely that hometown connections lead to more leniency in tax enforcement, reducing the tax rates of connected firms. To test this possibility, we follow the procedures of Lin et al. (2018) and Chen et al. (2021) and measure tax enforcement using three variables: the probability of tax audits, the expertise of tax officers, and the outcome of tax audits. We also conduct an indirect test of tax aggressiveness, as weak tax enforcement on connected companies may lead to aggressive tax avoidance. We do not find any significant results. Overall, the results suggest that tax enforcement may not be a primary channel through which connected politicians benefit their hometowns. For brevity, we do not tabulate these results. We thank two anonymous reviewers for this insight.

³⁶ We thank an anonymous reviewer for this suggestion.

TABLE 9
Alternative Explanation Related to Corruption

Dependent Variable	<i>FATR</i> _{<i>t</i>+1}		
	(1)	(2)	(3)
Test Variables			
<i>Connection</i> _{<i>t</i>}	1.268*** (3.38)	1.629** (2.24)	
<i>Connection</i> _{<i>t</i>} × <i>SOE</i> _{<i>t</i>}	0.171 (0.32)		
<i>SOE</i> _{<i>t</i>}	-0.256 (-0.58)		
<i>Connection</i> _{<i>t</i>} × <i>HighCorrupt</i>		0.473 (0.48)	
<i>Treat</i> × <i>Post2012</i>			-0.169 (-0.86)
<i>Treat</i> × <i>HighCorrupt</i>			0.009 (0.02)
<i>HighCorrupt</i> × <i>Post2012</i>			-0.038 (-0.26)
<i>Treat</i> × <i>HighCorrupt</i> × <i>Post2012</i>			0.090 (0.21)
Control Variables in Table 2	Yes	Yes	Yes
Firm, Year FEs	Yes	Yes	Yes
Observations	24,403	9,494	5,452
Adjusted R ²	0.601	0.605	0.887

***, **, * Indicate significance at the 1 percent, 5 percent, and 10 percent levels, respectively.

Table 9 presents the interaction effects of variables proxying for corruption. *FATR*_{*t*+1} is the top statutory corporate tax rate minus the applicable income tax rate for a firm in year *t*+1. *SOE*_{*t*} is an indicator variable that equals 1 if the firm is a state-owned enterprise and 0 otherwise. *HighCorrupt* is an indicator variable that equals 1 if the firm is located in a high-corruption province (i.e., if the number of officials sued for corruption is above the sample median) and 0 otherwise. *Treat* is an indicator variable that equals 1 if the firm has a hometown connection with local provincial leaders in both 2010 and 2011 and 0 otherwise. *Post2012* is an indicator variable that equals 1 if the dependent variable is measured after 2012 and 0 otherwise. In column (2) (3), which is designed to test the effect of the anticorruption event in November 2012, the sample range of the dependent variable is 2003 to 2012 (2011 to 2014). All variables except dummies are Winsorized at the 1 and 99 percent levels. The t-statistics (in parentheses) are calculated using robust standard errors, corrected for heteroscedasticity, and clustered at the firm level. Variables are defined in Appendix A.

coefficients of the interaction terms *Treat* × *Post2012* (-0.169, t-statistic = -0.86) and *Treat* × *HighCorrupt* × *Post2012* are insignificant (0.09, t-statistic = 0.21); therefore, these factors provide little evidence for the corruption explanation.

These findings indicate that our main results are not driven by government officials exercising favoritism in exchange for bribes. As such, corruption is an unlikely explanation for our findings on hometown favoritism. However, we acknowledge that our empirical proxies for corruption may underestimate actual levels.

IX. CONCLUSION

We examine the influence of politicians' hometown connections on corporate tax benefits in China and find that firms domiciled in the hometown of the incumbent provincial political leader or the city in which the leader spent most of their career receive significantly greater tax benefits than those without this connection. This effect is stronger when provincial leaders have stronger hometown preferences and when top-level firm managers share personal connections with the provincial leaders. However, the effect is attenuated when the leader has strong promotion incentives, implying that government officials face a trade-off between political and social incentives.

Our study contributes to a wide range of subjects, including hometown favoritism, corporate tax behavior, and political connections. Our research has broad implications for academics, investors, and policymakers. For academics, its key message is that politics plays a central role in corporate taxation in emerging economies, such as that of China. Investors interested in Chinese stock markets should be aware of the risks and benefits of government intervention. For policymakers, especially those at the national level, it is imperative to understand that although fiscal decentralization may fuel economic growth, it creates room for local politicians to provide unjustified support to firms or individuals from favored regions.

The literature has explored various other aspects of this problem, such as overall economic development and employment. We focus on the preferential CIT rate as a means for hometown-connected politicians to confer tax benefits on firms in their hometown. However, we acknowledge that the observed outcomes concerning tax rates may not necessarily benefit the cities and their inhabitants. It is possible that there are alternatives (both tax and nontax benefits) that could be used by politicians to enact favoritism, and these represent opportunities for future research.

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APPENDIX A

Variable Definitions

Variable	Definition
Dependent Variables	
$FATR_{t+1}$	The top statutory income tax rate in China minus the applicable income tax rate for a parent firm in year $t+1$.
$FATR_Sub_{t+1}$	The top statutory income tax rate in China minus the applicable income tax rate of the subsidiary firm in year $t+1$.
$Dum(HNTE)_{t+1}$	An indicator variable that equals 1 if the firm is designated as HNTE in year $t+1$ and 0 otherwise.
$Dum(HNTEsub)_{t+1}$	An indicator variable that equals 1 if the subsidiary firm is designated as HNTE in year $t+1$ and 0 otherwise.
$LnHNTE_City_{t+1}$	The natural log of firms recognized as HNTEs in the city in year $t+1$.
$\%HNTE_City_{t+1}$	The ratio of firms recognized as HNTEs in the city to all HNTEs in the province in year $t+1$.
Test Variables	
$Connection_t$	An indicator variable that equals 1 if the registered city of the firm is the birthplace of the local provincial CCP secretary or governor in year t and 0 otherwise.
$Connection(-1)$	A dummy variable that equals 1 if the dependent variable ($FATR_{t+1}$) is measured in the year immediately before the year when the hometown-connected provincial leader takes office and 0 otherwise.
$Connection(0)$	An indicator variable that equals 1 if the dependent variable is measured in the year when the connected provincial leader started working in the province (i.e., initial year) and 0 otherwise.
$Connection(1)$	An indicator variable that equals 1 if the dependent variable is measured in the first year after the initial year of the connected provincial leader and 0 otherwise.
$Connection(2+)$	An indicator variable that equals 1 if the dependent variable is measured when the connected provincial leader has been in office for two or more years after the initial year and 0 otherwise.

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APPENDIX A (continued)

Variable	Definition
<i>Connection_loss</i> (1)	An indicator variable that is equal to 1 if the dependent variable is measured in the first year after the connected provincial leader leaves office.
<i>Connect_sub</i> _{<i>t</i>}	An indicator variable that equals 1 if the registered city of the subsidiary is the birthplace of the local provincial CCP secretary or governor and 0 otherwise.
<i>Connect_parent</i> _{<i>t</i>}	An indicator variable that equals 1 if the registered city of the parent firm is the birthplace of the provincial CCP secretary or governor (here, the leader refers to the governor or secretary of the province where the subsidiary firm is located) and 0 otherwise.
<i>Visit</i> _{<i>t</i>}	An indicator variable that equals 1 if a provincial leader visited their hometown more than once up to year <i>t</i> and 0 otherwise.
<i>Cul_Distance</i> _{<i>t</i>}	An indicator variable that equals 1 if the birthplace city of the provincial leader (either provincial CCP secretary or governor) is not part of the same dialect area as the provincial capital city and 0 otherwise.
<i>Genealogy</i> _{<i>t</i>}	An indicator variable that equals 1 if the birthplace city of the provincial leader (either provincial CCP secretary or governor) has a famous family tree based on the surname of the provincial leader and 0 otherwise. For example, Qibao Liu, CCP secretary of Sichuan Province from 2007 to 2012 (birthplace Anqin City of Anhui Province): if there is a genealogy based on the surname of Liu in Anqin City, then <i>Genealogy</i> _{<i>t</i>} takes the value of 1 for firms in the province led by Qibao Liu).
<i>CEO/Chair PC</i> _{<i>t</i>}	An indicator variable that equals 1 if the CEO or chair is any of the following: (1) a former government official, (2) a current or former member of the People's Congress, or (3) a current or former member of the People's Political Consultative Conference and 0 otherwise.
<i>CEO/Chair school</i> _{<i>t</i>}	An indicator variable that equals 1 if the CEO or the chair graduated from the same university as the provincial leader (either CCP secretary or governor) and 0 otherwise.
<i>Low GDP growth</i> _{<i>t</i>}	An indicator variable that equals 1 if the GDP growth of the province is below the overall GDP growth of China in the year and 0 otherwise.
<i>Young leader</i> _{<i>t</i>}	An indicator variable that equals 1 if the provincial governor (of the firm's province) is 60 years of age or less or if the provincial party secretary is less than 65 years of age and 0 otherwise.
<i>Connect_city</i> _{<i>t</i>}	An indicator variable that equals 1 if the city is the birthplace of the local provincial CCP secretary or governor and 0 otherwise.
<i>HighCorrupt</i> _{<i>t</i>}	An indicator variable that equals 1 if the firm is located in a high-corruption province (i.e., the number of officials in the province sued for corruption is above the sample median) and 0 otherwise.
<i>Treat</i> _{<i>t</i>}	An indicator variable that equals 1 if the firm has a hometown connection with local provincial leaders in both 2010 and 2011 and 0 otherwise.
<i>Post2012</i> _{<i>t</i>}	An indicator variable that equals 1 if the dependent variable is measured after 2012 and 0 otherwise.
Control Variables	
<i>Ln (total assets)</i> _{<i>t</i>}	Natural log of the book value of total assets at the end of the year.
<i>Leverage</i> _{<i>t</i>}	Total debts divided by total assets at the end of the year.
<i>Sales growth</i> _{<i>t</i>}	(Current year sales – prior year sales) / prior year sales.
<i>Fixed assets</i> _{<i>t</i>}	Net property, plant, and equipment divided by total assets at the end of the year.
<i>Loss</i> _{<i>t</i>}	An indicator variable that equals 1 if the previous net profit is negative and 0 otherwise.
<i>Return on assets</i> _{<i>t</i>}	Operating net profit divided by total assets at the end of the year.
<i>SOE</i> _{<i>t</i>}	An indicator variable that equals 1 if the firm is ultimately controlled by the state and 0 otherwise.
<i>STA</i> _{<i>t</i>}	An indicator variable that equals 1 if the tax collector is the state taxation administration and 0 if the tax collector is the local taxation administration.
<i>Support</i> _{<i>t</i>}	An indicator variable that equals 1 if a firm experiences a preferential tax rate because it belongs to a high-tech industry, is domiciled in an economic development zone (which can receive preferential tax rates), or belongs to an agricultural (A), energy supply (D), or information technology (I) industry (which is eligible for preferential tax rates) and 0 otherwise.
<i>Per capita GDP</i> _{<i>t</i>}	The per capita GDP (RMB 10,000) of the province where the firm is located.
<i>Deficit</i> _{<i>t</i>}	The ratio of provincial budgetary expenditures to budgetary revenues.

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APPENDIX A (continued)

Variable	Definition
<i>Marketization_t</i>	The National Economic Research Institute marketization index of the province where the firm is located.
<i>First Year_t</i>	An indicator variable that equals 1 if a parent firm-year observation is in year $t+1$, where year t is the year in which new provincial leaders take office, and 0 otherwise.
<i>Nonlocal turnover_t</i>	An indicator variable that equals 1 if a parent firm is located in a province where the provincial leaders worked in other provinces before taking their current position and 0 otherwise.
<i>Sub GDP growth_t</i>	The GDP growth rate of the province where the subsidiary is located.
<i>Sub deficit_t</i>	The deficit ratio of the province where the subsidiary is located.
<i>Sub marketization_t</i>	The marketization index of the province where the subsidiary is located.
<i>Sub first year_t</i>	An indicator variable that equals 1 if the subsidiary-year observation is in year $t+1$, where year t is the year when new provincial leaders take office, and 0 otherwise.
<i>Sub nonlocal turnover_t</i>	An indicator variable that equals 1 if a subsidiary is located in a province where the provincial leaders worked in other provinces before taking their current position and 0 otherwise.
<i>GDP growth_{city,t}</i>	Annual percentage change in city GDP.
<i>Consumption_{city,t}</i>	Total retail sales of consumer goods divided by the GDP of the city.
<i>Area_{city,t}</i>	Natural log of city land area.