Local Government Tax Competition and Corporate Tax Avoidance

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Abstract

This study investigates the impact of local government tax competition on corporate tax avoidance within China's fiscal decentralization framework. Using panel data from A-share listed companies and prefecture-level cities (2002–2024) and employing a two-way fixed effects model, we systematically analyze their relationship and underlying mechanisms. Results show that tax competition significantly increases corporate tax avoidance, a finding robust across multiple stability tests. Mechanism analysis indicates that tax competition promotes tax avoidance primarily by weakening tax enforcement, increasing economic policy uncertainty, and intensifying local fiscal pressure. Heterogeneity tests reveal that state-owned enterprises and firms in central and western regions are more sensitive to these effects. This study highlights the role of institutional quality competition in shaping corporate tax avoidance and offers insights for improving tax governance and modernizing China's tax administration system.

Keywords

Local government tax competition, corporate tax avoidance, tax administration, economic policy uncertainty, fiscal pressure.

1. Introduction

In the pursuit of high-quality economic development, a clear contradiction has emerged: local governments, competing for mobile capital, often lower enterprises' effective tax burdens, inadvertently encouraging corporate tax avoidance. This contradicts classical theory, which suggests that tax competition reduces evasion incentives by lowering nominal tax rates. Yet, China's experience shows that relaxed regional tax enforcement may paradoxically stimulate avoidance. In the digital economy, where value creation is hard to trace, tax leakage is substantial-from 2002 to 2024, China's average tax leakage rate in the digital economy exceeded 58.7%, reaching 68.6% in digital product manufacturing. Corporate tax avoidance not only undermines public services but also exacerbates social inequality by distorting resource allocation, hindering economic transformation.

Why does existing theory struggle to explain this? Most literature focuses either on firm-level characteristics, such as capital structure, or national policies, like fair competition review reforms, while overlooking the meso-level behavior of local governments. Under China's fiscal decentralization and political centralization, local governments act as both tax collectors and regional competitors. This dual role is key to understanding corporate tax avoidance motives. However, existing research lacks a mechanistic analysis of how tax competition influences avoidance, leading to a policy dilemma: strict controls may stifle growth, while leniency invites disorder.

Thus, in the Chinese context, does local tax competition influence corporate tax avoidance? This paper integrates local government tax competition into a corporate tax avoidance framework, revealing its dual effects. Using A-share and prefecture-level city data (2002–2024), we find that tax competition significantly increases avoidance by weakening enforcement, raising policy uncertainty, and intensifying fiscal pressure.

This study contributes in two ways. Theoretically, it shifts from the traditional tax-rate-discount paradigm to an institutional quality competition framework, showing that tax competition can trigger a resource curse. Practically, it identifies precise policy targets for curbing avoidance, advocating digital tax reforms to break down regional barriers, thereby aiding the modernization of China's fiscal system and supporting high-quality development.

2. Literature Review

2.1. Conceptual Definition

Tax competition is generally viewed as a form of strategic measures taken by different regions to attract mobile factors of production and stimulate economic growth. Corporate tax avoidance, on the other hand, refers to the practice where companies exploit loopholes in tax laws. While these activities are legal in form, they contravene the legislative intent, with the primary aims of reducing tax liabilities and bolstering internal cash flows.

2.2. Impact Effects of Local Government Tax Competition

Tax competition influences regional development through factor mobility and industrial policies. On one hand, it can stimulate local economic vitality. Tian Shizhong and Chen Haopeng[13] found that tax incentives attract factors, bolstering economic resilience. However, such competition often worsens regional imbalances, leading to unequal capital flows and widened income gaps. It also distorts labor allocation, hampering regional coordination[12].

Regarding public governance and market environments, intense tax competition may divert fiscal resources toward investment attraction, crowding out public infrastructure and reducing capacity to bear public risks[1]. Overemphasis on attracting a mobile tax base can alienate policy-making from residents' needs, undermining governance. Conversely, Jiang Shiyin and Wang Yue[14] argue that moderate competition eases fiscal pressure and improves hidden debt management. Differing tax strategies can also hinder national market integration[5].

On innovation and productivity, effects are mixed. Wang Wenfu and Zhang Tong[16] note that tax incentives boost total factor productivity, but Zhu Deyun and Wang Hongzi[15] highlight efficiency losses: short-term growth incentives may over-allocate resources to quick-return investments, underfunding innovation and hindering technological progress[7].

2.3. Factors Influencing Corporate Tax Avoidance

Under external competitive pressure, firms tend to avoid more taxes. Ma Yongqiang and Chen Weizhong[2] found that industry technology competition raises financing needs and risks, prompting tax avoidance to retain cash. Zhao Chunming et al.[8] showed that import competition drives domestic firms to avoid taxes to alleviate cost pressures[9].

Conversely, easing resource constraints can curb avoidance. Ma Yong and Wu Xingyu[3] demonstrated that supply chain finance reduces avoidance by broadening financing, lowering risks, and enhancing transparency. Qian Aimin et al.[4] found that state capital participation reduces tax avoidance in private firms by easing financing constraints. Environmental management certification also indirectly reduces avoidance by improving financing and information environments[4].

Strong external governance and oversight deter avoidance. He Yong and Wu Ten[6] emphasized that big data enhances transparency, making avoidance easier to detect. Liu Qiliang et al.[10] found that government procurement improves internal governance and external oversight, dual constraints on avoidance. Macro-level reforms, such as explicit local government debt, also reduce informal avoidance by hardening budget constraints[11].

2.4. Literature Review

While existing studies have extensively explored the macroeconomic effects of local government tax competition and the micro-level motivations for corporate tax avoidance, research on the intrinsic connection between these two phenomena remains limited. This gap hinders a coherent explanation for China's tax paradox, where intense tax competition coexists with widespread tax leakage].

Specifically, two main shortcomings persist. First, there is a lack of direct evidence on how tax competition shapes corporate tax avoidance decisions by altering the tax burden pressure faced by firms. Second, the existing literature often overlooks the dual role of local governments and has yet to adequately incorporate tax competition into the analytical framework of corporate tax avoidance, leaving significant theoretical and policy-related questions unanswered.

This study contributes to the literature in two key aspects. First, it introduces local government tax competition as a core explanatory variable into the research on corporate tax avoidance. By constructing a meso-level transmission mechanism that encompasses tax enforcement, economic policies, and fiscal pressure, it addresses a critical gap by elucidating the institutional drivers of corporate tax avoidance. Second, it moves beyond the simplistic view of tax competition as merely involving preferential tax rates. It posits that, in the Chinese context, the essence of such competition lies in the quality of institutions. This perspective offers a novel theoretical lens for understanding the interaction between institutional environments and corporate behavior.

3. Research Hypotheses

We argue that local government tax competition influences corporate tax avoidance through several distinct mechanisms:

First, local governments indirectly encourage tax avoidance by deliberately weakening tax enforcement. In an effort to retain businesses in the short term, local officials may adopt a strategically lenient approach to tax oversight. This directly reduces the costs and perceived risks of tax avoidance while increasing its marginal benefits. As a result, profit-maximizing firms are inclined to pursue more aggressive tax avoidance strategies, and those previously adopting a wait-and-see stance become more likely to engage in such behavior.

Second, tax competition among local governments heightens economic policy uncertainty, leading firms to adopt short-term tax avoidance measures. Such competition often involves frequent and temporary tax incentives, which increase uncertainty in the tax policy environment. These recurring policy adjustments create transient arbitrage opportunities, encouraging firms to exploit regulatory ambiguities for tax avoidance. Moreover, policy uncertainty undermines firms' confidence in the benefits of tax compliance, leading them to treat tax avoidance as a form of insurance against future risks.

Finally, local government tax competition intensifies fiscal pressure, which in turn triggers precautionary tax avoidance by firms. As jurisdictions compete to attract businesses through excessive tax incentives, the local tax base becomes eroded. This fiscal deterioration signals to firms that local governments-facing budgetary shortfalls-are likely to strengthen tax enforcement in the future to recover lost revenues. To hedge against the anticipated rise in fiscal costs, firms engage in preemptive tax avoidance to mitigate potential future tax burdens.

Accordingly, we propose Hypothesis 1: Local government tax competition has a significantly positive impact on corporate tax avoidance.

4. Methodology

4.1. Data Description

This study selected A-share listed companies on the Shanghai and Shenzhen stock exchanges in China from 2002 to 2024 as the research sample. The sample underwent the following processing:

Excluded samples that experienced suspension of listing and those with less than one year of listing history; Excluded samples from the financial industry; Excluded ST and PT samples; Excluded samples with pre-tax profits $\leqslant 0$; Excluded samples with abnormal effective tax rates;

Ultimately yielding 34,471 sample observations. The core variable *local government tax competition* data sourced from Wind Financial Terminal database, while *corporate tax avoidance* data sourced from CSMAR database. To mitigate outlier effects, all continuous variables underwent tail trimming at the 1% and 99% percentiles.

4.2. Variable Definitions and Assessment

4.2.1. Corporate Tax Avoidance

This study measures corporate tax avoidance as the difference between the nominal and effective income tax rates, following the approach of Ye and Liu[18]. Due to the presence of tax rebates and the possibility of prolonged tax disputes between firms and tax authorities, relying exclusively on a single year's effective tax rate is inadequate. To address this, we adopt the method which uses a multi-period average to better capture tax avoidance behavior. Accordingly, the variable *LRATE_diff* is defined as the five-year average (from year t-4 to year t) of the difference between the nominal and effective tax rates. A higher value of *LRATE_diff* indicates a greater extent of corporate tax avoidance.

4.2.2. Local Government Tax Competition

Local government tax competition in China primarily involves the secondary and tertiary sectors, with limited relevance to the primary industry, which is generally subject to zero or minimal taxation. Following Tang Feipeng[17], this study constructs a measure of tax competition based on the sum of value-added tax, business tax, corporate income tax, and personal income tax revenues-all of which are closely tied to regional factor mobility-as a proportion of the total value added by the secondary and tertiary industries. The specific calculation is given by Equation (1):

$$Taxcom_{it} = 1 - \frac{VAT_{it} + CIT_{it} + PIT_{it}}{Y2_{it} + Y3_{it}} \tag{1}$$

Where VAT_{it}, CIT_{it}, PIT_{it} represent the VAT revenue, corporate income tax revenue, and personal income tax revenue of city i in year t, respectively; $Y2_{it}$ denotes the secondary industry value-added of city i in year t; $Y3_{it}$ denotes the tertiary industry value-added of city i in year t. A higher *Taxcom* indicates more intense local tax competition.

4.2.3. Control Variables

Based on existing literature, the following control variables were incorporated into the model: Firm Size (*Size*), equal to the natural logarithm of total assets; Debt-to-Asset Ratio (*Lev*), calculated as total liabilities divided by total assets; Return on Assets (*ROA*), calculated as net profit divided by total assets; Growth Rate (*Growth*), calculated as the annual growth rate of operating revenue; Proportion of Independent Directors (*Indep*), calculated as the number of independent directors divided by the total number of board members; Shareholding Concentration (*Top1*), calculated as the ratio of the largest shareholder's holdings to the total number of shares.

4.3. Model

To examine the impact of local government tax competition on corporate tax avoidance behavior, this paper constructs the following model (2):

$$LRATE\_diff_{it} = \beta_0 + \beta_1 Taxcom_{it} + \sum \beta_k \, controls_{it} + \lambda_t + \mu_i + \varepsilon_{it} \quad (2)$$

Where the dependent variable *LRATE_diffit* represents corporate tax avoidance, the independent variable *Taxcom* represents local government tax competition, *controls* denotes the set of control variables, *i* and *t* denote firm and year respectively, λ_t is the time fixed effect, and ε represents the random disturbance term.

5. Empirical Analysis

5.1. Descriptive Statistic Analysis

Table 1 reports the descriptive statistics for all variables. The mean value of corporate tax avoidance (*LRATE_diff*) is 0.001, suggesting that the average difference between the nominal and effective income tax rates for sample firms is approximately 0.1%. The maximum value of 0.267 indicates that some firms exhibit unusually high levels of tax avoidance. The mean value of local government tax competition (*Taxcom*) is 0.921, implying that the combined share of value-added tax, corporate income tax, and personal income tax revenues in the total value added of the secondary and tertiary industries is very low, reflecting intense tax competition among local governments. The descriptive statistics for the remaining control variables are consistent with those reported in prior studies and are not discussed further here.

Table 1. Descriptive statistic

Variable	Obs	Mean	Std. Dev.	Min	Max
LRATE diff	34471	0.001	0.079	-0.328	0.267
Taxcom	45239	0.921	0.174	0.000	0.998
Top1	57209	0.346	0.151	0.074	0.758
Size	58282	22.065	1.300	19.247	26.452
Lev	58282	0.424	0.206	0.027	0.990
ROA	58275	0.038	0.067	-0.375	0.255
Growth	58246	0.152	0.383	-0.737	3.808
Indep	57351	37.09	5.763	0.000	60.00

5.2. Baseline Estimate

Table 2 presents the results of the main regression tests. Specifically, Column (2) includes no fixed effects, Column (3) controls only for time fixed effects, Column (4) controls only for individual fixed effects, and Column (5) controls for both individual and time fixed effects. The regression coefficients for local government tax competition on corporate tax avoidance in columns (1) to (5) are 0.0056, 0.0088, 0.0060, 0.0164, and 0.0077, respectively, all significant at the 5% or 1% level. This indicates that local government tax competition significantly promotes corporate tax avoidance behavior. In economic terms, based on Column (5), holding other factors constant, a one-standard-deviation increase in local government tax competition (*Taxcom*) the corporate tax avoidance rate (*LRATE_diff*) changes by an average of 0.14% (0.0078 × 0.174) standard deviations. This represents a potential fluctuation range of 135.72% (0.0078 × 0.174 / 0.001) in corporate tax avoidance. These results indicate that local government tax competition significantly promotes corporate tax avoidance both statistically and economically, validating Hypothesis 1.

Table 2. Basic results: the effect of Taxcom on LRATE_diff

	(1)	(2)	(3)	(4)	(5)
	LRATE_diff	LRATE_diff	LRATE_diff	LRATE_diff	LRATE_diff
Taxcom	0.0056**	0.0090***	0.0059**	0.0164***	0.0078***
	(0.00)	(0.00)	(0.00)	(0.00)	(0.00)
Size		0.0057***	0.0062***	0.0032***	0.0108***
		(0.00)	(0.00)	(0.00)	(0.00)
Lev		-0.0598***	-0.0639***	-0.0350***	-0.0508***
		(0.00)	(0.00)	(0.00)	(0.00)
ROA		0.3309***	0.3174***	0.3299***	0.3174***
		(0.01)	(0.01)	(0.01)	(0.01)
Top1		0.0021	0.0008	0.0171***	0.0143***
		(0.00)	(0.00)	(0.01)	(0.01)
Growth		-0.0011	0.0006	-0.0031***	-0.0031***
		(0.00)	(0.00)	(0.00)	(0.00)
Indep		0.0001	0.0001	-0.0001	0.0000
		(0.00)	(0.00)	(0.00)	(0.00)
_cons	-0.0051**	-0.1299***	-0.1299***	-0.0895***	-0.2308***
	(0.00)	(0.01)	(0.01)	(0.01)	(0.02)
N	29329	29299	29299	29299	29299
R^2	0.000	0.071	0.082	0.042	0.061
Year FE	No	No	Yes	No	Yes
Firm FE	No	No	No	Yes	Yes

Standard errors in parentheses
* $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$

5.3. Robustness Tests

5.3.1. Additional Control Variables

To address potential endogeneity due to omitted variables, we conduct robustness tests by incorporating a set of corporate governance and financial characteristics. In Table 3, Column (1) adds Tobin's Q (*TobinQ*) to control for the effects of investment opportunities and market valuation on tax avoidance. Column (2) further includes Board size, Firm Age, and a Big Five auditor indicator (*Big5*) to account for corporate governance structure and audit quality. As shown in both columns, the coefficient on local government tax competition (*Taxcom*) remains positive and significant at the 1% level, with a magnitude comparable to the baseline estimates. This confirms that the positive relationship between tax competition and corporate tax avoidance is robust to the inclusion of these additional controls, further supporting Hypothesis 1.

5.3.2. Clustered Standard Errors

Given the existence of correlations among enterprises within the same province, cluster adjustment of standard errors at the provincial level is necessary. Specifically, based on a two-way fixed-effects model, this study clusters standard errors at the provincial level (*Province*) to control for estimation biases potentially caused by correlations among enterprises within the same province. The regression results are shown in Column (3) of Table 3. The coefficient for the core explanatory variable, local government tax competition (*Taxcom*), remains significantly positive at the 1% level. This indicates that even after accounting for intra-provincial clustering correlations, tax competition continues to exert a highly significant positive effect on corporate tax avoidance behavior. This finding is consistent with the previous empirical conclusions.

5.3.3. High-Dimensional Fixed Effects

We further introduce industry and province fixed effects to control for unobserved, time-invariant heterogeneity across sectors and regions. Column (4) of Table 3 incorporates industry fixed effects to capture differences in technological intensity, policy sensitivity, and market structure that may jointly influence local tax competition and corporate tax avoidance. Column (5) adds province fixed effects to absorb time-invariant provincial characteristics, such as resource endowments, institutional legacies, and tax administration practices. In both specifications, the coefficient on Taxcom remains significantly positive at the 1% level, indicating that the main finding is robust to the inclusion of these high-dimensional fixed effects.

Table 3. Robust tests results

	(1)	(2)	(3)	(4)	(5)
	LRATE_diff	LRATE_diff	LRATE_diff	LRATE_diff	LRATE_diff
Taxcom	0.0078***	0.0078***	0.0164***	0.0075***	0.0078***
	(0.00)	(0.00)	(0.00)	(0.00)	(0.00)
controls	Yes	Yes	Yes	Yes	Yes
N	29299	29283	29299	29299	29299
R^2	0.061	0.061	0.042	0.072	0.061
Year FE	Yes	Yes	No	Yes	Yes
Firm FE	Yes	Yes	Yes	Yes	Yes
Ind FE	No	No	No	Yes	No
Pro FE	No	No	No	No	Yes

Standard errors in parentheses

* $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$

5.4. Heterogeneity Analysis

State-owned enterprises (SOEs) and private firms differ in their sensitivity to local tax competition. SOEs maintain inherent property rights linkages and political connections with local governments, making them more responsive to local policy signals. In an environment of intensified tax competition, local governments may extend implicit preferential treatment to SOEs as a gesture of support. This, in turn, provides SOEs with stronger incentives and greater latitude to engage in tax avoidance in alignment with local policy goals. By contrast, private firms typically lack comparable government ties and are less integrated into formal tax bargaining mechanisms, reducing their sensitivity to local tax competition and weakening their motivation for tax avoidance. Consistent with this reasoning, we find that SOEs exhibit a stronger behavioral response to tax competition than private firms. As shown in Column (1) of Table 4, the coefficient on *Taxcom* is positive and statistically significant at the 1% level for the SOE subsample, supporting our expectation.

We further explore regional heterogeneity, given China's uneven economic development. In the more developed eastern region, where market institutions are mature, legal systems are stronger, and tax administration is more efficient, local governments tend to employ more diversified and standardized policy tools-relying less exclusively on tax incentives to attract firms. As a result, tax competition in the east has a weaker effect on corporate tax avoidance. In contrast, the central and western regions face greater developmental pressure and often compete for investment through more direct forms of enforcement leniency and non-compliance tolerance. These practices raise the marginal benefit of tax avoidance for firms operating in these regions. We therefore expect tax competition to have a stronger effect on tax avoidance in the central and western regions, where institutional environments are weaker and fiscal pressures are more acute. The regression results in Columns (3) to (5) of Table 4 confirm this pattern: the coefficient on *Taxcom* is insignificant in the eastern region, significant at the 5% level in the central region, and significant at the 1% level in the western region.

Table 4. Sub-sample results

	(1)	(2)	(3)	(4)	(5)
	LRATE_diff	LRATE_diff	LRATE_diff	LRATE_diff	LRATE_diff
Taxcom	0.0226***	-0.0014	0.0003	0.0193**	0.0179***
	(0.01)	(0.00)	(0.00)	(0.01)	(0.01)
controls	Yes	Yes	Yes	Yes	Yes
_cons	-0.2858***	-0.1872***	-0.1939***	-0.3129***	-0.3100***
	(0.03)	(0.02)	(0.02)	(0.05)	(0.05)
N	13263	16036	20205	4985	3968
R^2	0.076	0.054	0.049	0.081	0.113
Year FE	Yes	Yes	Yes	Yes	Yes
Firm FE	Yes	Yes	Yes	Yes	Yes

Standard errors in parentheses

* p < 0.1, ** p < 0.05, *** p < 0.01

5.5. Mediation Analysis

The preceding theoretical analysis hypothesizes that local government tax competition erodes tax enforcement capacity and amplifies fiscal stress, thereby fostering corporate tax avoidance. This study empirically investigates these indirect pathways via the following sequence: Local Government Tax Competition → Tax Enforcement and Fiscal Pressure → Corporate Tax Avoidance.

The mediating variable for tax enforcement (*Prefer*) is measured as the ratio of tax refunds to the sum of tax refunds and taxes paid. Local fiscal pressure (L) is operationalized as the natural logarithm of the general public budget gap (revenue minus expenditure) divided by revenue, where a higher value indicates more severe pressure.

Table 5 presents the results of the mechanism analysis. Column (1) examines the pathway of weakened tax enforcement. The coefficient for *Taxcom* is 0.0141 and significant at the 1% level, indicating that local tax competition significantly undermines the intensity of corporate tax enforcement. Consistent with prior research, a lower intensity of tax enforcement is significantly associated with a higher level of corporate tax avoidance. These results confirm that weakened tax enforcement serves as a significant mediating mechanism in the relationship between local government tax competition and corporate tax avoidance.

Column (3) tests the fiscal pressure mechanism. The coefficient of *Taxcom* is 0.0621 and significantly positive at the 1% level, suggesting that tax competition places significant fiscal strain on local governments. As shown in prior studies, governments under fiscal pressure may be inclined to adopt a more lenient approach to tax enforcement, thereby facilitating tax avoidance. That is, greater fiscal pressure is correlated with increased corporate tax avoidance. These findings validate that heightened fiscal pressure is a significant mediator in the relationship between local tax competition and corporate tax avoidance.

Table 5. Testing of Mediating Mechanisms

	(1)	(2)
	Prefer	L
Taxcom	0.0141***	0.0621***
	(0.00)	(0.02)
controls	Yes	Yes
_cons	0.1301***	5.7109***
	(0.03)	(0.12)
N	44955	35091
R^2	0.092	0.686
Year FE Firm FE	Yes Yes	Yes Yes

Standard errors in parentheses
* p < 0.1, ** p < 0.05, *** p < 0.01

6. Conclusion and Policy Suggestions

This study systematically examines the impact of local government tax competition on corporate tax avoidance and its underlying mechanisms, using panel data from Chinese A-share listed companies and prefecture-level cities from 2002 to 2024. The baseline regression results show that local government tax competition significantly promotes corporate tax avoidance. This finding remains robust across a series of tests, including the inclusion of additional control variables, clustering of standard errors, and the introduction of high-dimensional fixed effects. These results demonstrate that tax competition serves as a stable institutional driver of corporate tax avoidance.

Mechanism tests further reveal that tax competition influences corporate tax avoidance mainly through three channels: weakening tax enforcement, increasing economic policy uncertainty, and intensifying local fiscal pressure. Specifically, local governments tend to relax tax enforcement to attract investment, which lowers the perceived risk of tax avoidance. At the same time, frequent policy changes and persistent fiscal resource outflows lead firms to anticipate future tax increases, motivating them to engage in preventive tax avoidance. Heterogeneity analysis shows that the effect of tax competition is more pronounced among state-owned enterprises, highlighting the role of government–business relationships in tax avoidance decisions. Regionally, the effect is stronger in central and western China than in the eastern region, indicating that differences in institutional environments and fiscal conditions significantly shape the impact of tax competition.

Based on these findings, this paper proposes the following policy recommendations: First, promote digital tax administration and cross-regional information sharing to limit the discretionary power of local governments in tax collection and mitigate the weakening of enforcement induced by tax competition. Second, adopt differentiated regional governance by enhancing fiscal transfers and providing targeted tax policy guidance to central and western regions, so as to avoid the vicious cycle of tax competition–fiscal depletion–rising tax avoidance. Finally, continue to strengthen the rule of law in taxation and improve policy transparency to help stabilize corporate tax expectations and reduce incentives for preventive tax avoidance. These measures will not only help address current challenges in governing corporate tax avoidance but also contribute to building a sustainable modern fiscal and tax system and improving the overall business environment.

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