



# Retire in Peace: Officials' Political Incentives and Corporate Diversification in China\*

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## Abstract

We develop a theory of how state officials' political incentives can affect corporate behavior. In the pursuit of multiple goals, such as social stability and economic development, the state designs criteria to evaluate its officials' performance. Those officials may be motivated to prioritize different goals at different stages of their careers and to mobilize firms to help them achieve those goals. We test our theory in the context of Chinese publicly listed firms' diversification between 2001 and 2011, when the state faced economic and social ramifications of bankrupt state-owned enterprises (SOEs) laying off large numbers of workers. Our results show that when large layoffs occurred, some firms diversified into industries unrelated to their core business by acquiring bankrupt SOEs and reemploying their workers. This was more likely to occur when the governor of the firm's home province was closer to retirement, as social stability was more important than economic development for the retiring governor's career objective. The effect of career stage was weaker for Communist Party leaders, who more consistently prioritized social stability, and when a provincial state experienced intense collective actions that made social stability a stronger immediate focus. The effect was strengthened for firms more vulnerable to officials' influence, such as those with a strong socialist imprint and those dependent on government resources. Our study extends the Weberian state literature and the political economy research on incentives, and it offers a political explanation for corporate diversification in a major transitional economy.

**Keywords:** political economy, diversification in Chinese firms, market transition

Research in the past three decades has demonstrated the importance of the state in national economic development and its influence on corporate

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practices. The Weberian state literature has emphasized the impact of the state's autonomous goals and administrative capacity (Kalev, Shenhav, and De Vries, 2008; Guillén and Capron, 2016). A major strength of the state lies in providing predictable career paths for officials that align them with its goals (Evans and Rauch, 1999). Although officials play a key role in implementing the state's agenda, little attention has been paid to variations in their incentives. If their incentives differ, so will their priorities—and in turn their efforts to mobilize firms under their jurisdiction to achieve the state's goals. By ignoring the agency of state actors, theoretical explanations of the heterogeneity in corporate implementation of state objectives are necessarily limited (DiMaggio, 1988).

The Weberian view emphasizes the role of the bureaucracy—the set of administrative rules and hierarchical structures that stipulate officials' responsibilities—in providing a predictable career ladder such that officials are motivated by promotion to achieve national development objectives (Evans and Rauch, 1999), but it overlooks individual officials' career concerns and fails to explain variations in policy implementation. In comparison, political economists have demonstrated how officials apply state policies selectively to maximize career gains (Dewatripont, Jewitt, and Tirole, 1999) but have downplayed the role of state bureaucracy in shaping individuals' political incentives. Understanding how state bureaucracy influences policy outcomes and corporate practices through political incentives is the research gap we seek to fill (Ring et al., 2005).

We propose that as officials need to balance multiple state goals, their political incentives at different career stages may lead them to prioritize state goals and mobilize firms differently. The state designs performance evaluation and promotion systems to ensure that its multiple goals are accomplished. Given their limited resources and attention, officials may selectively pursue the state's goals according to their personal career stage. Senior officials who are close to retirement likely seek a peaceful transition to retirement (and want to reap opportunities thereafter), whereas their junior counterparts are more interested in advancing their careers. Such a difference can channel officials' attention to different state goals. If they prioritize a certain goal, they will mobilize firms under their jurisdiction to achieve it; if not, the pressure will be less. Political incentives thus are a key link between state goals and corporate behavior.

Furthermore, the effect of officials' career stage on firms' behavior is contingent on the state bureaucracy's priority and firms' vulnerability to officials' influence. To the extent that the state places priority on one goal, officials' personal career stage may have less effect because their political incentives converge to perform well on that one goal central to their evaluation. This can be the case if the state structures some types of officials' function to center around one overarching goal or if the state has to prioritize one goal in response to certain pressures. Meanwhile, political incentives may have a stronger impact on firms that are vulnerable to officials' influence, be it a result of the firms' political orientation or resource dependency. These firms tend to align with officials' goals more because compliance generates less internal organizational resistance and/or allows access to state resources.

We test our framework in the empirical context of Chinese publicly listed firms' diversification into new industries between 2001 and 2011, when the

state sought to balance economic growth and social stability and was confronted with massive policy-induced layoffs from bankrupt state-owned firms. The layoffs were a byproduct of the deepening market transition destined to stimulate economic growth, and they potentially threatened social stability. Hence some officials asked local firms to acquire bankrupt firms and reemploy the workers, which often involved entry into new industries. Political incentives to maintain social stability thus led to corporate diversification as a solution to an immense social problem.

The Chinese context is ideal to test our framework on officials' political incentives for several reasons. First, the state has maintained strong involvement in the country's economy and society, which results in the state having—and needing to reconcile—goals related to economic development and social stability (Su and He, 2010; Lin, 2011). To achieve such goals, the state is closely linked to and regularly intervenes in the business sector (Oi, 1995). Political influence thus can be particularly important for corporate strategies. Second, the heterogeneity and complexity in China's state bureaucracy allows us to test the structural boundary conditions for political incentives. Described as a "party-state," meaning ruled by a single party (Li and Zhou, 2005; Nee, Opper, and Wong, 2007; Lin, 2011), China's state bureaucracy nevertheless has power dualism within its elite (Lieberthal, 1995). Both its party officials and government officials are appointed and subject to the influence of the bureaucracy, but they have functional differentiation and hence different priorities (Zang, 2004). The regional diversity in China also gives rise to variation in provincial states' priorities in response to different pressures.

Our study contributes to research on the role of the state by identifying how political incentives affect corporate implementation of state objectives, using insights from political sociology and political economy (Pearce, Dibble, and Klein, 2009). This perspective extends the Weberian state literature by uncovering how state officials balance the state's multiple goals differently based on their political incentives. This helps to explain the unintended consequences of career structures and evaluation systems. It also adds to the political incentives literature in political economy by illuminating structural boundary conditions for individual officials' incentives. In addition, our study extends research on organizational responses to institutional complexity (Greenwood et al., 2011) by tapping a largely neglected source of heterogeneity in institutional pressures, i.e., political incentives. Lastly, our study contributes to research on corporate diversification by providing a political explanation. Unlike the institutional void perspective that views corporate diversification as a means to fill the void of market institutions in emerging/transitional economies (Khanna and Palepu, 2000), our study suggests that existing state institutions in these markets engender corporate diversification in unexpected ways.

### **THE STATE'S DUAL GOALS, SOE BANKRUPTCY, AND FIRMS' DIVERSIFICATION IN CHINA**

Since its 1978 market reform, China has witnessed phenomenal economic growth, but it has come at the cost of environmental degradation and rising social inequality (Chung, Lai, and Xia, 2006). A campaign for "Building a

Harmonious Socialist Society" in 2004 has become an important party resolution and government objective since then (Chan, 2010). The state has come to view maintaining social stability as a strategically important goal on a par with sustaining economic growth (Lin, 2011).

A major task for the state during the market transition has been restructuring and reforming state-owned enterprises (SOEs) to enhance economic competitiveness and growth (Lin, Cai, and Li, 1998), a process that accelerated after the 15th Congress of the Chinese Communist Party in 1997, when the state formalized a new plan—"Grab large and let go of small" (*zhuada fangxiao*)—as the guiding strategy for the reform of SOEs. A number of powerful SOEs owned by the central government or its various agencies were designated to receive major financial and administrative resources to become global companies, while smaller and insolvent SOEs, typically owned by local governments, were encouraged to declare bankruptcy. The latter represented the majority of SOEs, which had relied on government subsidies for survival. While this significantly relieved the fiscal burden (Lin, Cai, and Li, 1998), as SOEs went bankrupt across the country, massive layoffs occurred. In 2000, three years after implementation, layoffs from SOEs rose to a record 5.12 million, according to the state statistical bureau (Hung and Chiu, 2003).

Policy-induced unemployment became such a pressing issue that it threatened the legitimacy of the state. The laid-off workers suffered a huge reduction in income and had scant opportunity for reemployment in a competitive marketplace. While the state formulated several initiatives and policies, these often failed to address workers' long-term needs. For example, the state mandated that insolvent firms maintain a contractual relationship with workers and keep them on the payroll for three years after the official declaration of bankruptcy. The proceeds from liquidation were to be used first for compensating laid-off workers before paying creditors, as per the standard practice in cases of bankruptcy—a provision that was specially tailored to SOEs, given the state's responsibility for ensuring employment (Bai, Lu, and Tao, 2006). Nationwide reemployment projects were launched to assist laid-off workers with job search, but they often ended in failure due to a lack of funding, coordination, and demand for unskilled workers (Solinger, 2002). These chronically ineffective public policies also created an additional fiscal burden for local governments. Unsatisfied with such arrangements, some laid-off workers resorted to protests that they were the victims of market reform, threatening social stability (Solinger, 2002; Hung and Chiu, 2003).

To help absorb laid-off workers, some officials turned to local businesses. Top officials at the province level were particularly likely to influence local firms because of their power to grant local firms favorable policies, protection, and resources (Xu, 2011). As part of market reform, the central government delegated authority to provincial governments and provided strong incentives for them to grow (Li, 1998). As provincial states competed with one another for resources and prosperity (Montinola, Qian, and Weingast, 1995), they cultivated strong ties with local businesses to achieve provincial growth targets (Walder, 1995). Given the strong tradition of regionalism in China (Zhou, 2010), officials often urged firms headquartered in the same province to acquire the bankrupt SOEs. While local firms could purchase part of the assets of a bankrupt SOE at auction during the liquidation process, officials urged them to acquire the company with its laid-off workforce as one package (Wen, 2004).

But many local firms did not operate in the same industries as the bankrupt SOEs, many of which had been set up in strategically important industries (such as steel) during the planned economy era and were protected by high barriers to entry (Lin, Cai, and Li, 1998). Consequently, when approached by officials to acquire the bankrupt SOEs, local firms were obliged to diversify into new industries. For example, the Shaoneng Group, which specialized in hydroelectricity, acquired the state-owned machinery firm Shaodong Gear Company in the same city (Shaoguan City, Guangdong province) after it went bankrupt in 1997. Seven years later, it acquired a loss-making paper manufacturing firm owned by the city authorities. In another example, the Little Bee Tool company also engaged in multiple diversifications, and it explicitly linked this activity to the state's goal of social stability, as stated on the company website under "Corporate Culture": "Our company acquired several bankrupt SOEs in unrelated industries in 1999, 2003 and 2005, and absorbed 285 laid-off workers in total. Our efforts have effectively sustained the stable development of the county and relieved the unemployment pressure on the government."<sup>1</sup> Below we develop a framework that explains how state officials' political incentives can influence such firms' behavior.

### Officials' Political Incentives and Firms' Behavior

Political economists emphasize the heterogeneous incentives of officials who make choices to maximize their own career gains (Tirole, 1994). Due to information asymmetry, officials' constituents and superiors do not have complete information about their true ability; hence officials must constantly signal their competence and build their reputations by acting in the state's interests and achieving its goals. Such incentives prompt officials to allocate attention and resources strategically (Cyert and March, 1963; Ocasio, 1997) and attend to public policy outcomes that are tightly coupled with promotion or re-election prospects (Rogoff, 1990). While political economists pay attention to individual officials' political incentives, political sociologists focus on the structural characteristics of the state bureaucracy and their effectiveness in accomplishing state goals (Evans, Rueschemeyer, and Skocpol, 1985; Jessop, 2001). The state structures officials' incentives through meritocratic recruitment and predictable performance-based career ladders, which serve to align officials' interests with the state's goals (Skocpol, 1979; Evans, Rueschemeyer, and Skocpol, 1985; Evans, 1995; Block and Evans, 2005).

Integrating these two literatures, we propose that political incentives based on individuals' career concerns can affect how officials balance multiple state goals and in turn influence the firms in their jurisdiction. This is because officials have limited attention and resources and may not exert themselves to achieve the multiple performance targets equally. Those at an early stage of their career have more opportunities for advancement than those at a later stage and hence pay more attention to the performance targets that contribute to promotion. Those at the end of their career may be more concerned with a smooth transition to retirement and post-retirement opportunities and thus focus more on the performance targets conducive to such concerns. Consequently, while the

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<sup>1</sup> <http://xmftools.cn/html/qiyewenhua/6.html>, in Chinese, last accessed on Jan. 23, 2018.

state intends for officials to pursue its multiple goals, their career concerns lead to heterogeneity in their political incentives, which prioritize different goals.

Political incentives can remain stable across career stages in some circumstances, such as when the state prioritizes one main goal in evaluating officials. In most political systems, incumbents' functions and evaluations vary. In the Chinese political system, incumbents are appointed rather than elected, and the most important functional distinction at the top of the bureaucracy is between Communist Party leaders and government leaders. Communist Party leaders (called "party secretaries") are charged with a dominant goal of maintaining the legitimacy of the ruling party, and the social stability-related performance targets are central to their evaluations (Zang, 2004). Consequently, party leaders across all career stages may prioritize targets related to social stability, and their career stage may have less impact on their political incentives. In addition, the state may shift priority in response to pressures as a way of balancing multiple goals dynamically. When experiencing intense collective actions, the state may prioritize the goal of social stability, which may guide leaders' attention to the related performance targets accordingly, regardless of their career stage.

At the firm level, motivated state officials may elicit a response more easily from firms vulnerable to their power and influence. Institutional research suggests that organizational attributes can channel institutional pressures when under institutional complexity (e.g., Oliver, 1991; Greenwood et al., 2011). We propose that some organizational attributes can make firms vulnerable to officials' influence. If a motivated official pushes the state's goals selectively, a vulnerable firm will align with the official's priority due to its orientation toward adhering to government demands or its need for what the government can provide (e.g., Lounsbury, 2001; Okhmatovskiy and David, 2012). Officials with stronger incentives to achieve certain targets may leverage such firms' vulnerability to demand assistance.

### Provincial Government Leaders' Incentives and Firms' Diversification

As China transitioned from a centrally planned economy to a market-oriented one in the early 1980s, the Communist Party initiated a series of administrative reforms to build an effective state bureaucracy to bolster economic growth (Li, 1998; Bo, 2004). Through those reforms, the party strengthened the government's power and capacity significantly. The reforms mainly consisted of a further division of labor between the party and the government/administration, decentralization of power from central to local governments, a major shift in officials' evaluation and promotion criteria, and a mandatory retirement age (i.e., the provincial-level officials are required to retire at the age of 65). The transformed state bureaucracy has played a critical role in China's market transition and economic development (Li, 1998; Nee, Opper, and Wong, 2007; Lin, 2011).

The state bureaucracy has established clear goals, career paths, and evaluation and promotion criteria for government leaders such as the governor of a province. Government leaders have clear responsibility for implementing state policies, including those on economic development and social issues (i.e., Nie, Jiang, and Wang, 2013). They are recruited for their technical competencies,

and a cadre responsibility system evaluates them based on the extent to which they achieve the state's goals (Walder, 1995; Huang, 2002).

Government leaders are held accountable for the state's dual goals of economic growth and social stability through three categories of performance evaluation indicators: hard targets (*ying zhibiao*), targets with veto power (*yipiao fojue*), and soft targets (*yiban zhibiao*) (Edin, 2003). Hard targets refer to economic indicators such as local economic growth (GDP growth rate and tax revenues) and the amount of foreign direct investment (FDI) attracted. Targets with veto power are political tasks, among which maintaining social stability (i.e., Dickson, 2003: 3) and enforcing the one-child policy were the most important nationwide during the period of our study (Edin, 2003).<sup>2</sup> Soft targets include social welfare indicators such as improving education, providing health care, and alleviating environmental damage.

Behavioral research suggests that performing different tasks necessarily entails trade-offs: one goal is accomplished at the expense of another (Ocasio, 1997; Huang, 2002). Prior studies have pointed out that the types of goals more likely to attract attention are those tightly coupled with career prospects (Mezias, Chen, and Murphy, 2002) and those that are easily measurable (Kerr, 1975). For Chinese government leaders, the hard targets are the most important determinants of their political career advancement (Tsui and Wang, 2004). Empirically, studies have confirmed that provincial-level GDP growth rates positively predict provincial leaders' likelihood of promotion to central government positions (i.e., Chen, Li, and Zhou, 2005). Targets with veto power do not contribute to career advancement directly but confer veto power; if they are not met, achievements in other categories would be nullified in the annual evaluation (Edin, 2003). Compared with the hard and veto targets, soft targets are more difficult to quantify and are not immediately related to political career advancement. They have received much less attention from government leaders and have often failed to be implemented (Zhou, 2010: 19; Wu et al., 2013).

Government leaders may balance the dual goals and their related targets (hard targets and veto targets in particular) differently based on their political incentives at different career stages. Younger leaders with a relatively longer time horizon for promotion should tend to meet the veto-power targets at a minimum level so that they can focus their attention and resources on hard targets. Doing so allows them to maximize their chances of career advancement (O'Brien and Li, 1999; Guo, 2009; Wu et al., 2013). Although not exerting themselves for the veto targets may present some risks—if something unexpected happens and gives rise to large-scale social instability, leaders can be evaluated as having failed the veto targets—younger leaders may tolerate such risks more than retiring leaders and even view such risks as worthwhile to take. This is because after the veto targets have been met at a minimal level, additional efforts toward the hard targets can directly enhance their odds of promotion, whereas additional efforts spent on the veto targets cannot. Nie and colleagues (2013) found evidence that local government leaders traded off the dual goals and took risks of failing to meet the veto targets when coping with coal mine accidents. Based on their findings, provincial government leaders allowed a relatively high coal mine accident rate to boost economic growth, except right before important political conventions, when social instability would be viewed

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<sup>2</sup> The one-child policy was abolished in 2015.

as particularly disastrous to their political careers and they reduced production to keep the accident rate low. Thus younger leaders' strong incentive of career advancement can lead them to justify allocating more attention to the hard targets and taking some risks with the veto targets. Additionally, psychology research confirms that risk taking declines with age, and hence younger leaders may be more willing to tolerate the risks than retiring leaders are (Vroom and Pahl, 1971).

In contrast, for leaders approaching retirement age, targets with veto power rather than hard targets may occupy the center of their attention. The absence of promotion prospects reduces their incentive to focus on projects whose primary benefit is career advancement, whereas the risk of not meeting targets with veto power becomes their primary concern due to its potential to disrupt the transition to retirement. Empirical research has found that retiring leaders tend to focus on preserving reputation by maintaining a good political record in their last position (Besley and Case, 1995). In China, well-reputed officials can be appointed to a leadership position in the People's Congress (CPC) or People's Political Consultative Conference (CPPCC), the two major political bodies outside the government administration, after they reach the designated retirement age and are no longer eligible for administrative positions (O'Brien, 1994; Li and Zhou, 2005). Compared with outright retirement from a political career, serving in such leadership positions brings high social status and a better retirement package.

Accordingly, when confronted with massive layoffs from state-owned firms, government leaders may vary in how they address this problem depending on the incentives at their career stage. Massive layoffs reduce the social well-being of many citizens and could pose a threat to social stability if they lead to protests. Younger leaders, who are focused on career advancement and in turn hard targets, may be satisfied with simply gaining some control over this problem—meeting the veto target of maintaining social stability at the minimum level—rather than addressing the underlying cause. They may even treat the issue as related to the soft target of social welfare, especially in the absence of imminent threats of protests. In that case they may provide minimal social welfare benefits or monitor laid-off workers, rather than striving to find them sustainable employment, which takes far more effort and resources and diverts their attention from their main goal of achieving economic growth.

In contrast, for leaders close to retirement, large economic growth-enhancing projects such as building infrastructures tend to be relatively long term and will benefit their successors more than them, whereas focusing on addressing the problem of massive layoffs can minimize the risk of their escalating into a real hazard to social stability, which could single-handedly derail the evaluation received at the end of their political career. As described previously, an expedient and effective approach to addressing this problem was to mobilize local firms to acquire bankrupted SOEs. Relieved of the pressure of pursuing hard targets, leaders close to retirement can devote more attention and resources to ensuring a strong performance with the veto target through mobilizing local business, engaging in negotiations, and making detailed arrangements for laid-off workers.

Thus the presence of both the problem of massive layoffs and the retiring leader should give rise to the mobilization of local firms to acquire bankrupt SOEs, resulting in more firms under their jurisdiction diversifying into new

industries. A high level of layoffs is necessary to trigger the retiring leader's concern over not meeting the veto target of social stability. At a low level of layoffs, both retiring and younger leaders may treat the issue as related to the soft target of social welfare and dismiss it due to their need to juggle multiple demands. But even at a high level of layoffs, political incentives are critical in shaping how leaders balance the dual goals and cope with the threat to social stability. The incentive to ensure a peaceful transition to retirement can lead officials to treat massive layoffs as a political task and devote more attention to solving the problem, such as by pressuring local firms for assistance. But the incentive to pursue career advancement can lead them to pay less attention to this issue so as not to be distracted from their main efforts to meet the hard targets. We thus propose a positive interaction effect between layoffs and government leaders' career stage on the local firms' new industry entry:

**Hypothesis 1 (H1):** The more massive the layoffs in a province and the closer the provincial government leader is to retirement, the more new industries firms in the province will enter.

Structural conditions also affect political incentives. The state's evaluation system varies in the prominence given to the social stability goal and the related performance targets with veto power. While government leaders at different career stages may trade off goals of economic growth and social stability, party leaders may not be able to, because their primary responsibility is to ensure social stability (Dickson, 2003). The social stability goal has been the overarching concern for the Chinese Communist Party (CCP) since the new millennium, because social instability threatened the party's legitimacy to rule (Knight, 2013). Shirk (2007: 55) reported that the term "social stability" appeared 700–800 times each year in *People's Daily*, the CCP's official newspaper, after 2000.

In the dual power structure of China's party-state, the government leader is subordinate to the party leader at each level of the political system (Lieberthal, 1995). Since the market transition, there has been a further division of labor between party and government leaders (Zang, 2004). Party leaders are responsible for upholding political principles, making key policies, and maintaining the legitimacy and rule of the party (Guo, 2012; Yao and Zhang, 2015), whereas government leaders are responsible for implementing policies and carrying out administrative tasks in both economic and social domains.

This division of labor leads to differences in the priority given to the social stability-related targets in the evaluation of party and government leaders. While the three categories of performance indicators are also officially mentioned for party leaders, it is unlikely that party leaders far from retirement would prioritize hard targets (i.e., economic growth) over veto targets (i.e., social stability), as their counterparts in the government do, because maintaining social stability is the overarching function of the party and takes priority in the evaluation of party leaders. Edin (2003) found that the party secretary was assessed mainly based on veto targets such as maintaining social order, whereas the government leader was evaluated based on hard targets such as industrial development and tax collection in a township. Given the unambiguous priority of the social stability goal for party leaders, they are likely to attach

great importance to the targets with veto power irrespective of their career stage.

When confronted with massive layoffs, party leaders are likely to perceive a heightened threat to their ability to meet the veto power target. This problem is likely to gain such prominence and urgency for party leaders across career stages that they will mobilize local firms to acquire bankrupt SOEs. Although we have argued that in general retiring government leaders have a stronger incentive than non-retiring ones to focus on the veto power targets and hence address the layoffs, we would not expect such a distinction to exist for party leaders. Hence the retirement effect is stronger for government leaders than for party leaders when confronted with large layoffs. More formally:

**Hypothesis 2 (H2):** The positive interaction effect between layoffs in a province and the provincial government leader's closeness to retirement on firms' new industry entry will be stronger than such an interaction between layoffs and the provincial party leader's closeness to retirement.

The priority given to the social stability goal also varies among provincial states, which may experience different pressures from collective actions over time. In response to intense pressures, the local government typically prioritizes performance targets with veto power, thus reducing the impact of career stage for government leaders. Research has found differences in regional governments' priorities (i.e., Greenwood et al., 2010). Given the decentralization and regional diversity in China, provinces diverge in their priorities, which should shift the weight attached to officials' evaluation criteria.

With the deepening of the market transition, despite calls by the central government for a balance between the dual goals of economic growth and social stability, provincial governments vary hugely in how they maintain social stability. They are more short-term oriented than the central government: in view of the immediate benefits of economic growth, they downplay social issues such as environmental sustainability and corporate social responsibility (Luo, Wang, and Zhang, 2017). But they may become more attentive to the goal of social stability if the region experiences heightened collective actions.

Collective mobilizations have increased rapidly in China (Cai, 2008), where both urban and rural inhabitants express grievances and demand legitimate redress on issues such as compensation and social welfare, land encroachment, environmental degradation and pollution, and political leaders' malfeasance or corruptions (Elfstrom, 2017). Some are relatively peaceful, in the forms of sit-ins, petitions, or demonstrations, but violent protests such as blocking public transportation facilities, attacking policemen or officials, or committing suicide in public also occur (Chung, Lai, and Xia, 2006). In response, provincial governments are likely to prioritize the goal of social stability for two reasons. First, collective actions challenge the legitimacy of the provincial government, forcing it to adjust its management. Second, such actions can attract attention and intervention from the central government (Cai, 2008; Su and He, 2010), as they signal the local government's failure to maintain control over society. This can jeopardize the evaluations of local leaders: failing the target with veto power can negatively affect promotion as well as the retirement package (Nie, Jiang, and Wang, 2013).

When the provincial government prioritizes social stability, evaluation becomes heavily focused on this, as will the attention of leaders, regardless of career stage. Policy-induced massive layoffs may be viewed as having the potential to trigger or exacerbate existent collective mobilization in the region, as the activists involved in protests could leverage such events to cause further instability (Chung, Lai, and Xia, 2006). Hence even non-retiring government leaders may make social stability the priority and attend to massive layoffs with urgency and concerted efforts to preempt further challenges to the legitimacy of the local government and intervention from the central government.

In contrast, in the absence of intense collective actions, local governments tend not to attach high priority to social stability, as economic growth can yield more short-term gains. Leaders may therefore be more influenced by their own career stage in setting priorities. Non-retiring leaders may focus on the hard targets to maximize their chances of promotion and not view the layoffs as a real challenge to social stability in their region. Leaders close to retirement, relieved of the pursuit of hard growth targets, may attempt to avoid any risk of massive layoffs turning into a social stability hazard. We thus propose:

**Hypothesis 3 (H3):** The positive interaction effect between the layoffs in a province and the provincial governor's closeness to retirement on firms' new industry entry will be weaker in provinces that experience more intense collective actions.

Government leaders' incentives are more likely to lead them to put pressure on firms with higher vulnerability to officials' influence. In China, firms are more vulnerable to that influence if they already have an orientation to treat government's demands as an obligation or are more dependent on the government for resources. Given the gradual transition from a socialist planned economy to a market-oriented one (Peng, 2003), firms that had IPOs in the early stage of the transition were more imprinted with the socialist legacy than those in the later stage. Critical environmental conditions such as those associated with founding or an IPO can become imprinted on organizational routines and culture and have a long-lasting impact on firms' subsequent behavior (Stinchcombe, 1965). Firms founded in former socialist regimes, for example, exhibit a strong socialist imprint and have more difficulty developing new knowledge routines and capabilities required by the market economy (Kogut and Zander, 2000; Kriauciunas and Kale, 2006). They are less likely to adopt the new governance practice of corporate social responsibility (CSR) reporting, despite its global diffusion (Marquis and Qian, 2014), but perform better in CSR related to social benefits and employee welfare, which were emphasized in the socialist era and practiced by these firms earlier (Raynard, Lounsbury, and Greenwood, 2013).

Similarly, firms that had an IPO during the market transition in China experienced a gradual loosening of government control and the growing importance of market forces. When the first stock market exchange was established in Shanghai in 1990, firms had to go through "a planned economy style of share issuance" (Wang, 2009: 1), in which an annual quota was put in place and IPO decisions were based on administrative approval by the China Securities Regulatory Commission (CSRC) (Pistor and Xu, 2005). The CSRC stipulated the number of shares issued to the public and distributed a quota to each province after negotiation. Provincial governments then recommended companies to

apply for approval by the CSRC. Gradually the quota system became less important and was formally abandoned in 2001, when a new system—the ex-ante review and approval system—was put forth. In 2004, a more market-oriented sponsorship system was introduced to take advantage of the newly emerged market intermediaries, i.e., investment banks and securities companies. These market actors have since become more important in assessing firms' qualifications over time.

Imprinted more with the socialist legacy, firms that launched IPOs earlier in the market transition process may have a stronger orientation toward acquiescing to government demands. The primary importance of obtaining local government recommendations and satisfying government requirements is likely to remain even when the environment has changed (Kriauciunas and Kale, 2006). These firms may thus be more likely to treat government as the most important stakeholder in their ecosystem, prioritize the need to meet the government's expectations, and maintain good relationships with government by responding to officials' requests. In comparison, firms that had IPOs when market-based evaluations rose in importance are likely to be more imprinted with the market mechanisms. They may view their market-based performance as equally important as winning approval from government. Hence they are less likely to yield to officials' requests without weighing the impact on their market performance. We propose:

**Hypothesis 4 (H4):** The positive interaction effect between the layoffs in a province and the provincial governor's closeness to retirement on firms' new industry entry will be stronger for firms with a stronger socialist imprint.

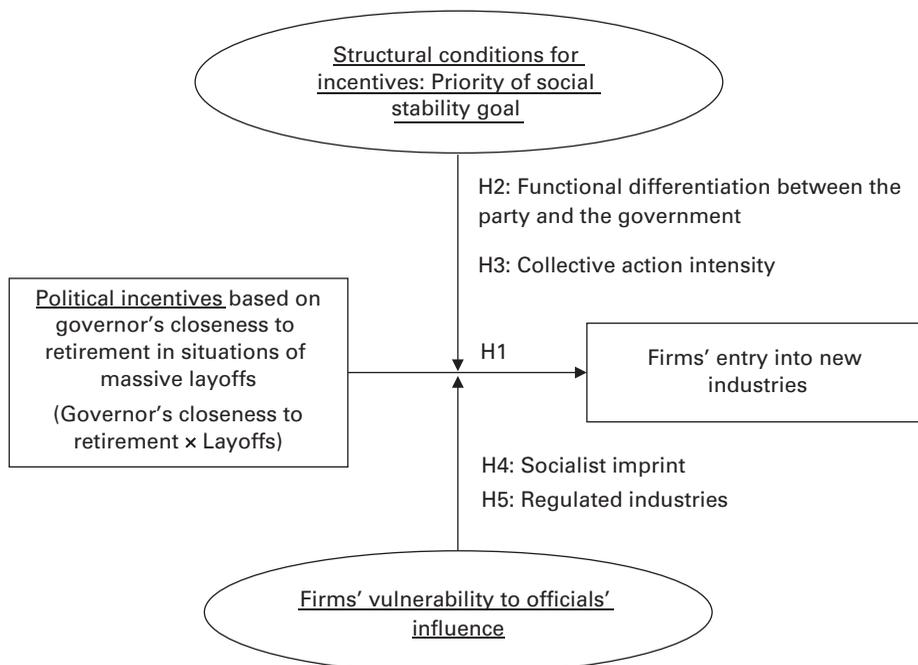
Firms operating in highly regulated industries depend on government policies and government-controlled resources for their daily operation and survival (Henisz, 2000). The government has great power over these firms as it can alter the rules of the game and shape their competitive environment. The government controls entry and operating licenses, sets product standards and production requirements, and specifies ownership structures, among other things. Such control can create huge policy risks and uncertainties, rendering regulated firms vulnerable to the government's demands. Studies have found that the greater dependence of regulated firms led them to engage more in political activities and that they gained more benefits from such activities (Hillman and Hitt, 1999; Peng and Luo, 2000). We suggest that firms in highly regulated industries may be more responsive to government leaders' requests for assistance due to their vulnerability.

In comparison, firms operating in less regulated industries are less subject to the power of government and tend to attend to competitive market pressures. To survive, they have to enhance their market-based competences, such as product innovation, marketing campaigns, or operation optimization. Studies have consistently found that firms operating in highly competitive markets are less likely to engage in political activities (Schuler, Rehbein, and Cramer, 2002). Hence their lack of vulnerability can render them less responsive to officials' demands, and officials may in turn be less likely to approach them for assistance.

**Hypothesis 5 (H5):** The positive interaction effect between the layoffs in a province and the provincial governor's closeness to retirement on firms' new industry entry will be stronger for firms in highly regulated industries.

Figure 1 summarizes our theoretical framework. Our main argument is that as government leaders' incentives based on career stage lead them to balance the state's dual goals differently, political incentives can explain the heterogeneous corporate implementation of the state goals. Retiring leaders' desire for a peaceful transition to retirement leads them to prioritize the social stability goal and push firms in their jurisdiction to help solve the massive layoffs by absorbing SOEs and entering into new industries. Hence there is a positive interaction effect between government leaders' closeness to retirement and massive layoffs on the unrelated diversification of firms in the jurisdiction of the retiring leaders (H1). This interaction effect is contingent on the structural conditions of the state, as the impact of career stage can depend on the extent to which the state prioritizes social stability (H2 and H3). When the state prioritizes this goal, as reflected in the different function of party leaders and the pressure from intense collective actions, the effect of an individual official's career stage is reduced. Moreover, the interaction effect in H1 is also contingent on firms' vulnerability. The impact of career-stage-based incentives can be accentuated in firms with a strong orientation toward acquiescing to the government's expectations or with high resource dependency on the government (H4 and H5). Such firms are more likely to respond to the motivated leaders' social stability goal.

**Figure 1. Impact of officials' political incentives on corporate behavior.\***



\* Unobserved concepts are underlined.

## METHOD

### Data

The sample consists of all Chinese firms listed on the Shenzhen or Shanghai stock exchanges from 2001 to 2011. We chose this time frame for two reasons. First, it was the first decade after the 1997 SOE restructuring plan of “grab large and let go of small” (*zhuada fangxiao*), when a growing number of layoffs occurred. Second, the data quality on listed firms significantly improved after 2001: the China Securities Regulatory Commission (CSRC) started to require firms to systematically report their industry segments after 2001. We used WIND and the China Stock Market and Accounting Research Database (CSMAR) for firm-level information. These databases are the major sources for studying Chinese listed firms and have been widely used in management studies (e.g., Zhang, Marquis, and Qiao, 2016; Haveman et al., 2017; Luo, Wang, and Zhang, 2017). After excluding firms with missing information on key variables, such as industry segments, we obtained 7,940 firm-year observations pertaining to 1,557 unique firms.

We focused on the provincial level of the state to construct the data set for two major reasons. First, the provincial-level state plays a significant role in corporate activities, particularly for the publicly listed firms in our sample. Recommendations for IPOs used to be made by the provincial government, which also controls policy making and access to many key resources relevant to these firms. Second, information on layoffs was recorded only at the provincial level. We manually collected the résumés of governors and provincial party secretaries of all the provinces between 2001 and 2011, which are available online and contain detailed background information. In total 93 governors and 88 party secretaries served during this time period. We collected information on the number of laid-off workers from SOEs at the provincial level from statistics yearbooks published by the Chinese Statistics Bureau. Data on other macroeconomic information, such as the marketization index, were obtained from the National Economic Research Institute (NERI).

### Measurements

**Dependent variable.** The dependent variable is the number of new unrelated industries a firm entered. Given that we were interested in the change in the industry portfolio as a result of acquiring bankrupted SOEs to address massive layoffs, the appropriate dependent variable should be the industries entered rather than the change in the overall diversification level, which could result from both industry entries and exits. The China Securities Regulatory Commission (CSRC) has its own numeric system of industry coding, which is different from the Standard Industrial Classification (SIC system) used in the U.S. (Li et al., 2012). But such numeric coding is available only for each firm’s main operating industry, while firms reported information on their detailed business segments with product classification and sales percentages only in Chinese (available from WIND). There was huge variation in the extent of the details firms reported about their business segments, some at the equivalent of the 4-digit SIC level and others at that of the 2-digit level. For consistency across firms and over time, we coded the business segments, manually matching the business segment description in Chinese with the U.S. 2-digit SIC code

system. In total, our sampled firms spanned 46 distinct SIC 2-digit codes, and 69 percent of them were diversified. On average, firms in our sample operated in 2.4 industries.

To construct the variable of new-industry entry, we compared a firm's industry portfolio at year  $t$  and  $t+3$ , based on the 2-digit SIC code, and counted the number of industries that were present at  $t+3$  but not at  $t$ . We chose the three-year window because it is a reasonable time span for the necessary activities and procedures involved in an acquisition, such as the government-led negotiations, due diligence, and the acquiring firm's subsequent industry restructuring.<sup>3</sup> The number of new industries entered ranges from 0 to 9, with an average of 0.99. There were 314 firms (20.17 percent of the sample firms) that did not enter any new industries in this time period.

Our coding based on unrelated industries (i.e., the 2-digit SIC codes) means that we did not include cases in which firms diversified into related industries as a result of acquiring bankrupt SOEs, though political leaders could solicit help from firms that operated in industries related to the bankrupt SOEs. Hence our analysis may underestimate the influence of political incentives on firms' behavior and can be viewed as a conservative test. Nevertheless, focusing on unrelated-industry entry has important advantages in our context. First, it allows us to test our proposed mechanism of political influence more cleanly, because acquiring bankrupt SOEs in related industries (and thus entering related industries) might also be driven by economic efficiency considerations such as deploying excessive capabilities (Teece, 1982; Montgomery and Wernerfelt, 1988) or achieving economies of scale (Chatterjee, 1986). Second, unrelated-industry entry represented the majority of the cases in which firms diversified as a result of acquiring bankrupt SOEs, because many SOEs were set up in strategically important industries with high entry barriers due to the legacy from the socialist planned economy. Third, as explained above, firms' inconsistent reporting of their business segments means that we could not obtain consistent information about related diversification for the majority of firms.<sup>4</sup> We could collapse the detailed segment information (equivalent of 4-digit SIC) to broad categories (2-digit SIC), but not the other way around.

**Independent variables and moderators at the province level.** Top officials in provincial governments—governors and provincial party secretaries—are required to retire at the age of 65, and their political careers are structured as the number of political terms. In China, political cycles follow the convening of the Communist Party Central Congress, which takes place every five years (in 2002 and 2007 during our study period). The political terms a leader can serve depend on how many Congresses one can experience before one reaches the age of 65 (Li and Zhou, 2005; Li, 2011).<sup>5</sup> We coded *retiring governor* as 1 if the

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<sup>3</sup> As a robustness check, we also used a two-year window, and the results remained qualitatively similar but with a reduced significance level.

<sup>4</sup> For example, in 2004, only 33.02 percent of the firms reported all their segments as detailed as the 4-digit SIC codes, but they did not necessarily report such detailed information in later years.

<sup>5</sup> In a few cases, when a leader simultaneously held a position in the central authority (e.g., the Central Politburo of the Party), the retirement age could be extended to 70. We coded these cases accordingly. For a robustness check, we also used a leader's actual age (see the Further Analyses section).

governor could serve only one existent political term in a given year before the next Congress (i.e., is on one's last political term), 0 otherwise. Hence it is a time-varying variable (changes from 0 to 1) for a relatively young leader who could serve multiple terms. We coded *retiring party secretary* in the same way. *Laid-off workers* was measured as the logged number of laid-off workers from the SOEs that went bankrupt in a given year in a province.

To measure the extent to which a provincial state prioritizes the social stability goal in response to collective actions, we coded *collective action intensity* as the number of instances of labor protests and strikes that took place in the focal province each year. Labor mobilization has been the most frequent type of collective action that led to social instability in China in recent years (Cai, 2008; Silver and Zhang, 2009). We obtained the data from the website called "*China Strikes*," which maintains the record of publicly reported instances of workers' strikes across China by province from 2003 to 2012. This source is considered the most comprehensive for publicly reported incidents of labor movements to date (Elfstrom, 2017).<sup>6</sup> Causes for the labor mobilization included demanding higher wages and other social benefits, appealing unjust fines, fighting against discrimination, and resisting corruption (Elfstrom and Kuruvilla, 2014). These collective actions usually led to serious social unrest and disruption. The higher the number of such incidents in a province, the more likely the provincial state will respond by prioritizing the social stability goal and activating the related veto power target as prominent for leaders' evaluation. Because the data on collective actions were available only after 2003, we used the value in each province in 2003 for 2001 and 2002. We also tried other ways of imputing values for the missing years, and our results were consistent.<sup>7</sup>

A firm was assigned the value of the province where it was headquartered for the provincial-level variables, following prior research (Wang and Qian, 2011). Although firms may operate across different provinces, they are influenced most by the government and market conditions of their headquartered province. The majority of Chinese firms' operations were heavily concentrated in their local provinces, partly due to the strong regionalism in China, and strategic decisions such as new industry entry are usually made by the headquarters (Collis, Young, and Goold, 2007).

**Moderators at the firm level.** *Socialist imprint* was measured as the number of years between 1990 and the year a firm had an IPO. We then reverse coded the result obtained so that the greater the value of this variable, the

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<sup>6</sup> There are no official statistics on collective actions in China, and scholars have usually gathered data through news reports in either domestic or overseas media (Elfstrom and Kuruvilla, 2014). Scholars acknowledge that the number of instances should be higher than the data recorded from media but suggest that media reports capture the general trend as well as the significant cases of collective actions in China (Elfstrom, 2017). Using publicly reported incidences fits our purpose, because they were more visible and influential, thus pressing provincial leaders to give high priority to social stability.

<sup>7</sup> The incidents increased dramatically over the years (Chung, Lai, and Xia, 2006), from a total across the whole country of 28 and 24, respectively, in 2003 and 2004 to 100 in 2008. Hence it was reasonable to supply the missing values by using those in neighboring years. As alternatives, we tried (1) using the mean of 2003 and 2004 values for 2002 and the mean of 2002 and 2003 values for 2001; (2) coding missing values as 0 for 2001 and 2002; and (3) excluding 2001 and 2002 from our analysis. We obtained similar results.

stronger the socialist imprint. Prior studies have considered finance, banking, electricity, water, oil and gas, petroleum, telecommunication, and pharmaceutical industries as regulated industries (García-Canal and Guillén, 2008; Fernández-Méndez, García-Canal, and Guillén, 2015). Studies in the Chinese context have suggested that in addition to these industries, real estate is regulated as well (Fan, Wong, and Zhang, 2007). *Regulated industry* was thus coded as 1 if a firm's main industry was in one of these industries and 0 otherwise.

**Control variables.** We controlled for other firm-, industry-, and province-level factors that prior studies have shown to influence corporate industry entry. At the firm level, new industry entry may be affected by industry exit activities, given a firm's resource constraints (Chung and Luo, 2008), so we controlled for *the number of industries a firm exited* during the same time span, coded as the number of industries that were present in a firm's portfolio at  $t$  but not at  $t+3$ . Because of inertia, older firms may be less likely to engage in restructuring (Hannan and Freeman, 1984), so we controlled for *firm age*. Firm size can influence organizational structure: large size enhances the tendency toward diversification (Chandler, 1990). We measured *firm size* as number of employees (logged). We controlled for the *fixed asset ratio*, as firms with a low level of fixed assets may use acquisition to expand and grow (Kim, Haleblan, and Finkelstein, 2011). Firms that specialize in technologies and marketing activities are less likely to diversify, especially into unrelated industries, given the difficulty of redeploying tacit and specific resources (Teece et al., 1994). We controlled for *advertising intensity*, measured as advertising expenditures divided by total sales. Firm performance can affect the available financial resources for diversification (Chatterjee and Wernerfelt, 1988), but very poor performance can lead to a search for outside opportunities to ensure survival (Guthrie, 1997). We used *ROS* (return on sales) and the amount of *corporate tax* (in billions) to indicate firm performance. We also considered whether a firm received a *Special Treatment warning* from the China Securities Regulatory Commission, which indicates that the firm reported losses for two consecutive years and was under pressure to improve or be delisted.

We also controlled for corporate governance structure. *Private ownership* was coded 1 if a firm's largest shareholder was not government or its agencies, 0 otherwise. To account for the potential influence from foreign owners, given the national differences in corporate diversification (Kogut, Walker, and Anand, 2002), we controlled for the percentage of *foreign shares* in a firm. We further controlled for firms' *political connection*, coded as 1 if the chairman or CEO of a firm served as the delegate at the People's Congress or People's Political Consultative Conference (e.g., Ma and Parish, 2006; Marquis and Qian, 2014).

At the industry level, we controlled for the average number of new industries entered, to account for peer influence (Fligstein, 1985). At the province level, we controlled for the development of market institutions with the *marketization index*, which is a composite score to capture the market's institutional development (Fan, Wang, and Zhu, 2011). Based on the institutional void perspective, weak market institutions may necessitate diversification as a way to provide an efficient internal market as a substitute (Khanna and Palepu, 2000).

**Estimation.** We used firm fixed-effect Poisson models with cluster-robust standard errors (Cameron and Trivedi, 2009). All independent and moderator variables were measured at time  $t$  (from 2001 to 2008), while the dependent variable was measured as the new industries entered between time  $t$  and  $t+3$  (from 2004 to 2011). Two variables, *socialist imprint* and *regulated industries*, were dropped due to their lack of variability over time, but the interaction terms involving these variables remained and represented tests of the related hypotheses (Wooldridge, 2010). In addition, firms with only one year of observation were dropped from the analysis, and hence the results in the tables were based on 5,952 observations pertaining to 1,072 unique firms. For H1 and H2, we tested a two-way interaction effect between political leaders' closeness to retirement and number of laid-off workers. A significant interaction effect can confirm that firms' entry into new industries was prompted by leaders' incentives to address large layoffs. For H3 through H5, we tested three-way interactions to examine whether the two-way interaction effect tested in H1 differed significantly under different levels of collective action intensity and firms' vulnerability. All continuous variables used in the interaction terms were centered.

## RESULTS

Table 1 presents the main descriptive statistics and correlations of the variables. Table A1 in the Online Appendix (<http://journals.sagepub.com/doi/suppl/10.1177/0001839218786263>) presents the full table, including two- and three-way interactions. Overall, the magnitude of the correlations between variables is small.<sup>8</sup> Table 2 presents the firm fixed-effect Poisson models predicting the number of new industries entered to test H1 and H2. Model 1 is the baseline with control variables and the main effects of our interaction variables. Model 2 adds the interaction between retiring governor and number of laid-off workers to test H1. The maximum likelihood ratio test shows a significant improvement in model fit over model 1 ( $p < .05$ ), suggesting the importance of considering the interplay between governors' incentives and the aggravating social problem in explaining corporate diversification. Model 3 adds the interaction between retiring party secretary and number of laid-off workers. Model 4 presents the full model to compare the effects of the two interactions to test H2.

H1 posits a positive interaction effect between a governor's closeness to retirement and the number of layoffs on a firm's new industry entry. In model 2 of table 2, this interaction is positive ( $p < .05$ ). Given the concern over interaction effects in nonlinear models, we conducted further tests to verify the significance of the interaction effect. Following Zelner's (2009) simulation approach, we calculated the confidence intervals based on simulation and confirmed that the differences in firms' new industry entries under retiring and non-retiring governors were statistically significant at all representative values of the other control variables. H1 thus receives strong support.

The lack of significance for the main effects of laid-off workers and retiring governor also suggests the importance of the co-presence of massive layoffs and the leader's incentive in triggering the corporate response. The number of

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<sup>8</sup> The only exception is the correlation between firm age and socialist imprint (.47). But our results were robust to the control or removal of firm age.

**Table 1. Means, Standard Deviations, Maximums, Minimums, and Correlations\***

Variable	Mean	S.D.	Min.	Max.	1	2	3	4	5	6	7
1. Industry entry	1.10	1.15	.00	9.00							
2. Layoffs (ln)	7.93	5.16	.00	13.38	-.01						
3. Retiring governor	.68	.47	.00	1.00	-.04*	.18*					
4. Retiring party secretary	.50	.50	.00	1.00	-.01	-.06*	-.13*				
5. Collective action intensity	3.25	7.74	.00	45.00	.01	.14*	.18*	-.24*			
6. Socialist imprint	-8.24	3.97	-18.00	.00	.04*	-.09*	-.11*	-.07*	.02		
7. Regulated industry	.31	.46	.00	1.00	-.02	-.06*	-.02	-.01	.05*	.08*	
8. Industry exit	.98	1.12	.00	9.00	.22*	-.03*	.00	-.02	.02	.12*	-.01
9. Firm age	11.22	4.81	1.00	58.00	.05*	.14*	.02	-.15*	.26*	.47*	.08*
10. Firm size (ln)	7.23	1.41	1.39	12.95	-.03	.09*	.06*	.03*	.01	-.11*	-.14*
11. Fixed asset ratio	.29	.18	.00	.95	-.07*	.05*	.03*	.03*	-.04*	-.06*	-.10*
12. Advertising intensity	.06	.07	.00	.41	-.02	-.01	-.03*	.00	.01	.00	.12*
13. ROS	.25	.16	-.08	.77	-.02	-.02	-.01	.02	.04*	-.06*	.16*
14. Corporate tax (in billions)	.02	.05	-.03	.40	.01	-.03*	-.06*	.00	.03	-.07*	.10*
15. Special Treatment warning	.08	.27	.00	1.00	.04*	.02	.01	.01	.01	.14*	-.00
16. Private ownership	.33	.47	.00	1.00	.00	.06*	.08*	-.07*	.07*	-.11*	.03*
17. Foreign shares	.01	.05	.00	.80	-.04*	.01	-.01	-.06*	.08*	-.10*	-.02
18. Political connection	.07	.25	.00	1.00	-.02	.05*	.05*	.00	.00	-.11*	-.02
19. Industry average industry entered	.59	.33	.00	4.00	.17*	-.05*	-.04*	.04*	-.04*	.10*	-.02
20. Marketization index	7.85	2.04	.63	11.16	.03*	-.19*	-.02	-.32*	.29*	.02	.06*

Variable	8	9	10	11	12	13	14	15	16	17	18	19
9. Firm age	.09*											
10. Firm size (ln)	-.09*	-.12*										
11. Fixed asset ratio	-.07*	-.11*	.27*									
12. Advertising intensity	-.01	.00	-.03*	-.08*								
13. ROS	-.04*	-.04*	-.14*	.02	.41*							
14. Corporate tax (in billions)	-.05*	-.05*	.25*	.06*	-.08*	.13*						
15. Special Treatment warning	.09*	.12*	-.17*	.00	.09*	-.05*	-.06*					
16. Private ownership	.05*	.14*	-.18*	-.16*	.13*	.08*	-.09*	.11*				
17. Foreign shares	-.03*	.03*	.01	-.01	.01	-.03*	-.01	.00	.09*			
18. Political connection	-.05*	-.11*	.12*	.03*	.08*	.03*	.07*	-.06*	.06*	.02		
19. Industry average industry entered	.12*	.01	-.11*	-.14*	-.05*	.01	-.05*	.01	-.01	-.04*	-.03*	
20. Marketization index	.01	.29*	-.07*	-.15*	-.07*	-.04*	.10*	-.06*	.08*	.09*	-.01	-.06*

\*  $p < .05$ .

\* Number of observations = 5,952 (for 1,072 firms).

laid-off workers has a marginally positive effect ( $p < .10$ ) in the baseline model and becomes insignificant in models including the interaction with the governor (model 2). This indicates that the effect of layoffs on firms' new industry entry mainly comes from the presence of governors who had a strong incentive to address this social issue. In addition, retiring governors on average were not different from non-retiring ones in pushing firms under their jurisdiction to enter new industries. Only when confronted with large layoffs were retiring governors significantly more likely to be associated with corporate new industry entry than non-retiring officials, consistent with our argument that retiring governors' political incentives to achieve a smooth transition to retirement led them to attend to this social issue more by enlisting corporate help.

**Table 2. Firm Fixed-effect Poisson Models Predicting Number of New Industries Entered (at t+3) by Chinese Publicly Listed Firms: Governors and Party Secretaries (N = 5,952)\***

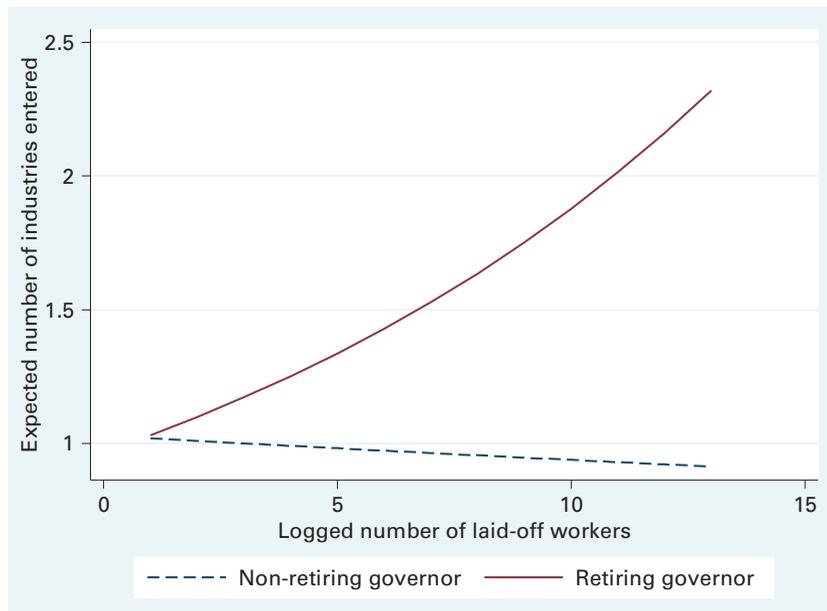
Variable	(1)	(2)	(3)	(4)
Industry exit	-.001 (.019)	-.001 (.019)	-.001 (.019)	-.001 (.019)
Firm age	-.018 (.023)	-.005 (.025)	-.017 (.023)	-.005 (.024)
Firm size (ln)	-.039 (.029)	-.039 (.029)	-.038 (.029)	-.038 (.029)
Fixed asset ratio	-.233 (.151)	-.245 (.152)	-.226 (.151)	-.239 (.151)
Advertising intensity	1.122** (.396)	1.129** (.394)	1.122** (.394)	1.129** (.393)
ROS	-.145 (.162)	-.145 (.161)	-.142 (.162)	-.142 (.161)
Corporate tax	.808 (.553)	.800 (.552)	.800 (.553)	.793 (.552)
Special Treatment warning	.145* (.070)	.147* (.070)	.141* (.070)	.143* (.070)
Private ownership	-.167* (.077)	-.171* (.077)	-.171* (.077)	-.174* (.077)
Foreign shares	-.926+ (.498)	-.952+ (.490)	-.895+ (.497)	-.924+ (.490)
Political connection	-.131 (.125)	-.128 (.125)	-.135 (.126)	-.132 (.125)
Industry average industry entered	.207** (.043)	.204** (.042)	.208** (.043)	.205** (.043)
Marketization index	.014 (.052)	-.003 (.053)	.015 (.051)	-.001 (.053)
<i>Independent variables</i>				
Number of layoffs (ln)	.007+ (.004)	-.002 (.006)	.010* (.005)	.002 (.006)
Retiring governor	-.007 (.050)	.022 (.054)	-.007 (.050)	.021 (.054)
Retiring party secretary	.004 (.043)	.003 (.043)	.006 (.043)	.004 (.043)
Collective action intensity	.006* (.003)	.005 (.003)	.006+ (.003)	.004 (.003)
<i>Hypothesis testing</i>				
Retiring governor × Layoffs (H1)		.062* (.031)		.058+ (.031)
Retiring party secretary × Layoffs (H2)			-.042 (.030)	-.036 (.030)
Log likelihood	-5232.171	-5229.913	-5231.174	-5229.194
Chi-squared	69.245	74.318	71.038	75.244

+  $p < .10$ ; \* $p < .05$ ; \*\* $p < .01$ ; two-tailed tests.

\* Standard errors are in parentheses.

Figure 2 illustrates the difference between retiring and non-retiring governors (other variables were set at the mean). For retiring governors, the number of new industry entries increases steadily as the logged number of laid-off workers increases (the actual range for this value in our data was from 0 to 13). In contrast, for non-retiring governors, the number of industries does not

**Figure 2. Predicted number of industries entered under retiring and non-retiring governors (other variables at their mean).**



change much as the number of laid-off workers increases. At low levels of layoffs, retiring and non-retiring governors were associated with similar numbers of corporate new industry entry. Their divergence at higher levels of layoffs is consistent with the influence of their different political incentives.

H2 proposed that the positive interaction effect between the governor's closeness to retirement and layoffs is stronger than that between the party secretary's closeness to retirement and layoffs. In model 3 of table 2, the interaction between retiring party secretary and layoffs is negative and not significant, implying that, when confronted with large layoffs, the retiring party secretary does not differ from the non-retiring party secretary in pushing firms to help address the issue through new industry entry. Model 4 presents the full model, where the significance level of the interaction with retiring governor is reduced to the  $p < .10$  level.<sup>9</sup> We formally tested H2 by performing a Wald test (two-tailed test). Results show that we can reject the null hypothesis that the two interactions are equal ( $p = .0255$ ). Hence H2 receives strong support: the retirement effect is stronger for governors than for party secretaries when there are large layoffs. This is consistent with our argument that party secretaries are entrusted with the dominant function of maintaining social stability, and hence their career stage has less influence on enlisting corporate assistance to employ laid-off workers.

Table 3 presents models with three-way interactions to test H3 through H5. Models 1 through 3 include the relevant three-way interaction term, as well as the other related two-way interactions as controls. The maximum likelihood ratio tests show that the model fit of each of these models containing three-way interactions significantly improved over that of the baseline model in table

<sup>9</sup> This is probably due to the high correlation (.49) between the two interaction terms.

**Table 3. Firm Fixed-effect Poisson Models Predicting Number of New Industries Entered (at t+3) by Chinese Publicly Listed Firms: Governors (N = 5,952)\***

Variable	(1)	(2)	(3)	(4)
Industry exit	-.002 (.019)	-.000 (.019)	.001 (.019)	.001 (.018)
Firm age	-.002 (.024)	-.006 (.024)	-.004 (.024)	-.005 (.024)
Firm size (ln)	-.040 (.029)	-.040 (.029)	-.040 (.029)	-.041 (.029)
Fixed asset ratio	-.250+ (.152)	-.253+ (.152)	-.258+ (.151)	-.269+ (.152)
Advertising intensity	1.141** (.396)	1.119** (.394)	1.130** (.394)	1.129** (.397)
ROS	-.156 (.161)	-.130 (.160)	-.142 (.160)	-.140 (.161)
Corporate tax	.810 (.551)	.810 (.555)	.757 (.547)	.772 (.550)
Special Treatment	.147* (.069)	.140* (.070)	.148* (.070)	.143* (.070)
Private ownership	-.171* (.077)	-.169* (.076)	-.174* (.077)	-.172* (.076)
Foreign shares	-.943+ (.486)	-.910+ (.489)	-.920+ (.472)	-.879+ (.470)
Political connection	-.125 (.125)	-.131 (.124)	-.123 (.124)	-.122 (.123)
Industry average industry entered	.215** (.044)	.206** (.042)	.204** (.043)	.216** (.044)
Marketization index	-.017 (.053)	-.001 (.052)	-.004 (.052)	-.011 (.052)
<i>Independent variables</i>				
Number of layoffs (ln)	.012 (.008)	.006 (.008)	-.003 (.006)	.015 (.009)
Retiring governor	.062 (.056)	-.002 (.052)	-.051 (.061)	-.030 (.064)
Collective action intensity	-.018 (.014)	.005 (.003)	.004 (.003)	-.013 (.014)
<i>Hypothesis testing</i>				
Retiring governor × Layoffs	-.003 (.038)	.027 (.037)	.031 (.035)	-.056 (.045)
Retiring governor × Collective action intensity	.193+ (.109)			.162 (.110)
Layoffs × Collective action intensity	.199* (.092)			.174+ (.094)
Retiring governor × Layoffs × Collective action intensity (H3)	-.231* (.104)			-.220* (.107)
Layoffs × Socialist imprint		-.059+ (.034)		-.052 (.034)
Retiring governor × Socialist imprint		.137* (.066)		.126+ (.065)
Retiring governor × Layoffs × Socialist imprint (H4)		.074* (.037)		.063+ (.038)
Layoffs × Regulated industry			.023 (.059)	.029 (.060)
Retiring governor × Regulated industry			.266* (.114)	.234* (.113)

(continued)

**Table 3. (continued)**

Variable	(1)	(2)	(3)	(4)
Retiring governor × Layoffs × Regulated industry (H5)			.110+	.107
			(.066)	(.066)
Log likelihood	-5226.921	-5225.131	-5221.810	-5215.171
Chi-squared	75.135	82.315	85.043	97.751

+  $p < .10$ ; \* $p < .05$ ; \*\* $p < .01$ ; two-tailed tests.

\* Standard errors are in parentheses.

2 ( $p = .001$ ). Model 4 presents the full model with the three sets of three-way interactions.

H3 posited that the interaction effect between governors' closeness to retirement and laid-off workers is weaker when the provincial government places higher priority on the social stability goal because of more intense collective actions. In model 1 of table 3, the three-way interaction among retiring governors, laid-off workers, and intensity of collective actions is negative and significant ( $p < .05$ ). Hence H3 receives support.

To better interpret the findings, we further split the sample and presented the results graphically. Figure 3a illustrates the difference between retiring and non-retiring governors given a high level of intensity of collective actions (the top 25th percentile), while figure 3b graphs such a difference given a low level of intensity of collective actions (the bottom 25th percentile). The contrast between the two types of governors is higher at a low level of collective actions (figure 3b) than at a high level (figure 3a). At a high level of collective actions, even non-retiring governors mobilize firms to diversify to address large layoffs; see the upward line for non-retiring governor in figure 3a.

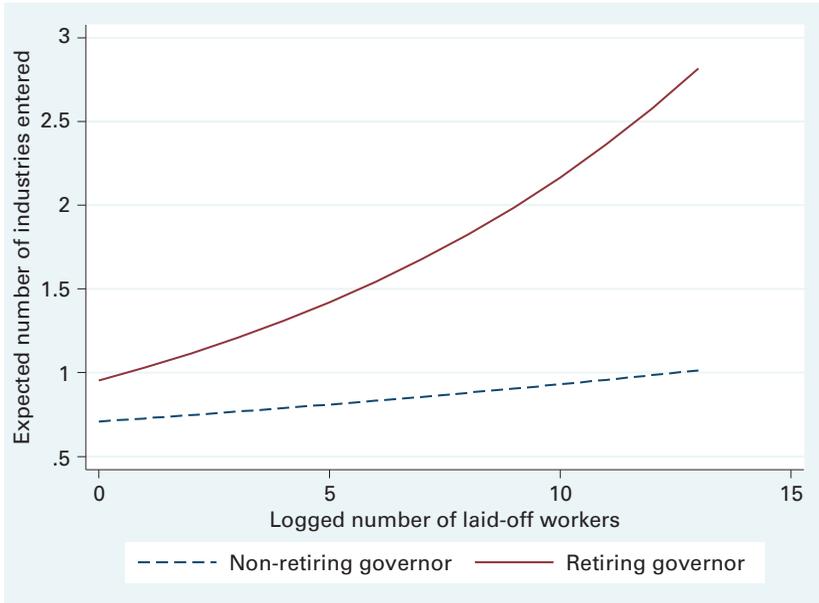
H4 suggests that the interaction effect between governors' closeness to retirement and laid-off workers is stronger for firms with a stronger socialist imprint. In model 2 of table 3, the three-way interaction among retiring governors, laid-off workers, and socialist imprint is positive ( $p < .05$ ). This means that when confronted with large layoffs, firms with a stronger socialist imprint are more likely to respond to local retiring governors' requests for help through new industry entry than firms with a weaker socialist imprint. H4 is supported.

Figure 4 illustrates the difference between firms with a strong socialist imprint (above the mean, i.e., firms listed before 1998) and a weak socialist imprint (listed after 1998) in provinces with retiring governors. With the rise of layoffs, firms with a strong socialist imprint enter more new industries than those with a weak socialist imprint.

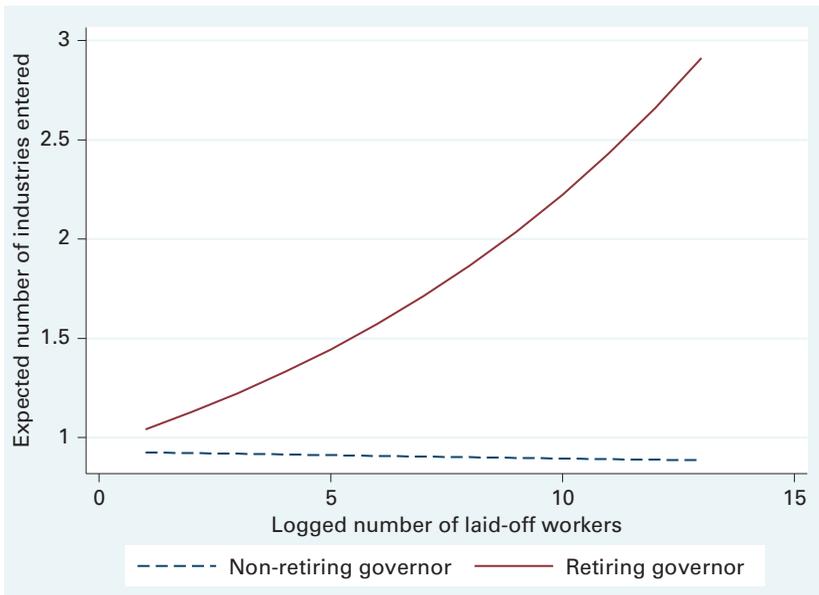
H5 posited that the interaction effect between governors' closeness to retirement and laid-off workers is stronger for firms operating in regulated industries. In model 3 of table 3, the three-way interaction among retiring governor, number of layoffs, and regulated industry is positive but only marginally significant at  $p < .10$ . H5 receives weak support.

Figure 5 illustrates the difference between regulated and non-regulated firms in provinces with retiring governors. When the number of layoffs increases, the number of new industries entered increases more for regulated firms than for

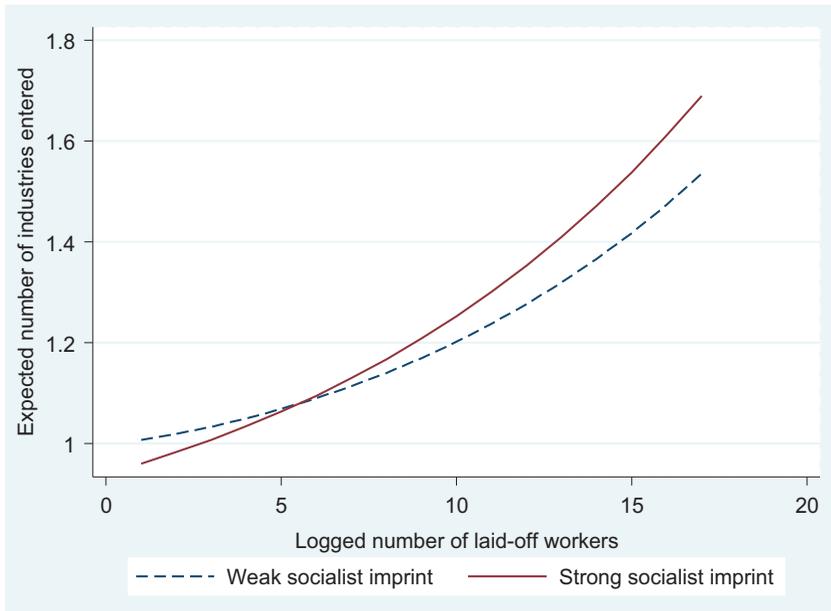
**Figure 3a. Predicted number of industries entered under retiring and non-retiring governors under high collective-action intensity (other variables at their mean).**



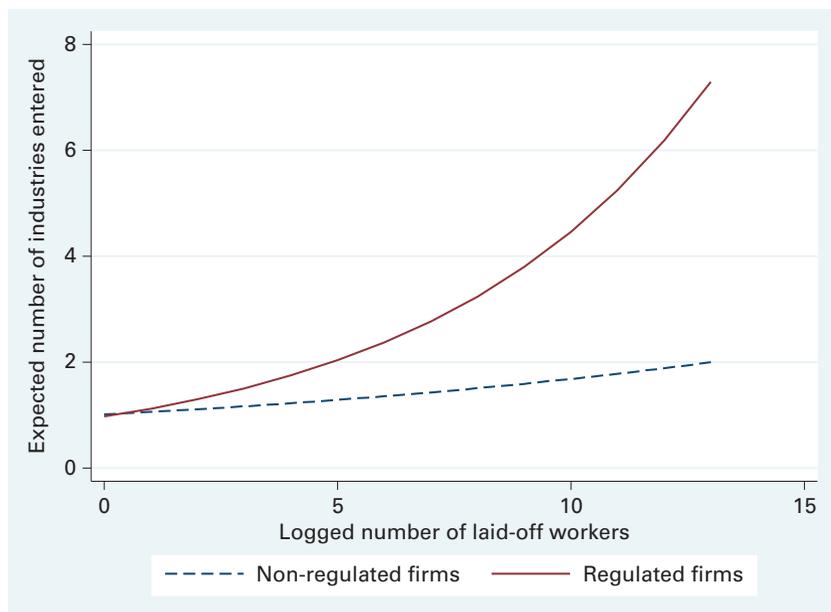
**Figure 3b. Predicted number of industries entered under retiring and non-retiring governors under low collective-action intensity (other variables at their mean).**



**Figure 4. Predicted number of industries entered under retiring governors for firms with strong and weak socialist imprint (other variables at their mean).**



**Figure 5. Predicted number of industries entered under retiring governors for regulated firms and non-regulated firms (other variables at their mean).**



non-regulated ones, indicating that regulated firms are more responsive to the motivated officials' attempts to address policy-induced layoffs, especially when the number of layoffs reaches a high level.

Model 4 in table 3 presents the full model with all three-way interactions as well as their associated two-way interactions. Among the three-way interactions, the one involving collective action intensity remains significant, but the significance level of the other two (i.e., those involving socialist imprint and regulated industries, respectively) is reduced, possibly due to the high multicollinearity caused by including many interaction terms in one regression.

With regard to control variables (based on the baseline model in table 2), contrary to our expectation, advertising intensity has a positive effect on new industries entered ( $p < .01$ ). This may indicate that marketing capabilities could have a positive reputation spillover effect on firms so that they may diversify into new industries to benefit from such reputations. Private firms on average engage less in new industry entries than SOEs ( $p < .05$ ), probably due to their pursuit of a more focused strategy. Foreign ownership has a negative effect on industry entry ( $p < .10$ ), implying that foreign investors may prefer a more focused growth strategy than domestic owners. Firms that received a Special Treatment warning diversify into more new industries ( $p < .05$ ). Threatened by the prospect of becoming delisted, they probably attempt to seek drastic change by exploring outside opportunities. New industry entries by firms in the same industry has a positive effect on a focal firm's new industry entries ( $p < .01$ ), consistent with the mimetic influence from peers (Fligstein, 1985). The effect of marketization index is positive but not significant. A high level of collective actions in a province is associated with more industry entries of firms headquartered in that province ( $p < .05$ ). This may be related to political leaders' efforts to mobilize firms to address layoffs through new industry entry, as intense collective actions give rise to a provincial state's placing high priority on the social stability goal.<sup>10</sup>

### Further Analyses

We conducted a set of additional analyses to check the robustness of our findings. We used the age of provincial governors to proxy closeness to retirement (Li, 2011). Our argument would suggest that the older a governor, the lower the incentive for career promotion and the higher the incentive for a peaceful transition to retirement. The results from firm fixed-effect models showed similar patterns as in our main models, but the magnitude of the effects was smaller and the significance levels were reduced. This suggests that incentives may be closely tied to political terms rather than following a continuous path of change (Besley and Case, 1995). Hence the categorical measurement may better capture the difference in political incentives at different career stages (Li and Zhou, 2005).

We estimated random-effect models, and all our results remained substantively the same. We coded the dependent variable as the number of new industries entered between  $t$  and  $t+2$  and obtained qualitatively similar results with reduced significance levels, suggesting that it took time for firms to engage in strategic restructuring.

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<sup>10</sup> Consistently, the main effect of collective actions becomes insignificant in models with interactions with layoffs.

We also examined an alternative dependent variable, the number of domestic acquisitions made by firms in our sample, as we argued that firms' industry entry resulted from their acquisition of bankrupt state-owned firms. We obtained the data from the SDC Mergers and Acquisitions Database, which contains information on announcement date, completion status, the name of acquirer and target firms, and deal-related details. Then we matched the database with the firms in our sample. But because the SDC database did not provide systematic information on the ownership and financial status of the target firms (many of which were not publicly listed), our measure of acquisitions, which included acquisitions of bankrupt state-owned firms as well as other acquisitions, was rather crude for the purposes of our study. Nevertheless, using this variable yielded consistent results for all our hypotheses except for H5 (results are available from the authors). This provided some support for the link between political incentives and firms' new industry entry in our argument.

## DISCUSSION AND CONCLUSION

Our study was motivated by a gap in the literature: the absence of attention to state officials' political incentives as a link between the state and corporate behavior. We have developed a theory whereby officials' political incentives based on state career structures affect how they engage firms to accomplish their priorities. Using the empirical context of firms' entries into new industries in China during a period when the state was challenged by policy-induced large layoffs, we found evidence consistent with our theory.

Confronted with large layoffs from bankrupt SOEs, firms in provinces with retiring governors entered more unrelated industries than those in provinces with non-retiring governors, after controlling for firm-relevant factors and provincial market development. This is consistent with our explanation emphasizing the different priorities of government leaders at different career stages given their need to balance the dual goals of the state. Because retiring governors prioritized the state goal of social stability to ensure a smooth transition to retirement, they mobilized firms in their jurisdiction to acquire the bankrupt SOEs and reemploy the laid-off employees, resulting in new industry entries by the acquiring firms. Moreover, between retiring and non-retiring party leaders, there was no significant difference in the new industry entries made by firms in their jurisdiction, and the impact of governors' career stage was weakened in provinces that had experienced intense collective actions. These two results are consistent with our argument on the structural conditions for political incentives: the impact of career stage diminishes when the state prioritizes social stability as the dominant goal in officials' evaluation, as in the case of party leaders or provinces that experienced intense collective actions. Moreover, retiring governors were more likely to mobilize those firms more vulnerable to their influence, such as those with a stronger socialist imprint and regulated firms, to address the issue of massive layoffs.

There are several efficiency-based explanations for diversification. One is that diversification may add value to firms, though the value from such unrelated diversification might be less observable. We examined the firms' financial performance (Tobin's Q and ROA) two years after new industry entry, while controlling other relevant factors. We found a negative effect of industry entry on ROA. Given that new industry entry obviously did not enhance firms' value

in our context, the fact that firms in provinces with retiring governors (and large layoffs) were still more likely to engage in such activity suggests that firms were driven by governors' political incentives for social stability.

The other efficiency-based explanation is informed by the institutional void perspective (Khanna and Palepu, 1997), in which diversification is viewed as a corporate response to underdeveloped market institutions such as inefficient capital markets, lack of contract enforcement, and uncertain policy changes. Firms diversify to develop a more efficient internal market for resource allocation (Fauver, Houston, and Naranjo, 2003). This perspective would predict more unrelated diversification by firms in provinces with less developed market institutions, but because we did not find a significant effect of the marketization index, we did not see strong evidence that corporate diversification was driven by the underdevelopment of market institutions. More importantly, after controlling for the market institutional development, we still found a strong effect of political incentives on corporate diversification.

This study has some limitations. First, the dependent variable (new industry entries) is a result of acquiring bankrupted SOEs, and we did not measure such acquisitions directly. The provincial statistical bureau does not systematically disclose information on bankrupt SOEs, and hence we were not able to match the number of laid-off workers with their previous employers, nor could we identify the specific bankrupted SOEs the focal firms acquired. We could only get the aggregate number of laid-off employees from bankrupt SOEs in a province in a given year to indicate the severity of the challenge facing the provincial government. Although firms' new industry entry could result from actions other than acquiring bankrupt SOEs, all the tested effects were observed using interaction terms (i.e., in the presence of a large number of laid-off workers) to ensure that we captured industry entries to acquire bankrupt SOEs. Second, given our focus on officials' incentives in this study, we did not analyze firm leaders' characteristics carefully. Some firm leaders may be more likely to embrace the officials' social stability goal priority. Future research can extend our perspective to examine the interaction between state officials and firm leaders. Third, it is important to acknowledge the boundary condition of this study: our argument applies to a strong state with a capable bureaucracy. Our findings may not be generalizable to countries where the Weberian characteristics of the state bureaucracy are not present (Evans, 1995; Evans and Rauch, 1999).

Nevertheless, our study contributes to the literature on the role of the state by identifying a novel mechanism of political incentives to understand how the state affects corporate behavior. Our perspective on political incentives highlights the agency of individual officials and helps to further open the "black box" of how state goals are implemented (Guillén and Capron, 2016). Prior research has either emphasized the regulative and normative pressures from the state (Meyer and Rowan, 1977; DiMaggio and Powell, 1983; Campbell and Lindberg, 1990; North, 1990; Dobbin and Dowd, 1997) or stressed the agency of the state as a whole, including its autonomous goals and administrative capacity (Kalev, Shenhav, and De Vries, 2008; Guillén and Capron, 2016). Although scholars have increasingly recognized the complexity of the state and the agency of various organizations within the state, such as different levels of government (Choi, Jia, and Lu, 2014; Zheng, Singh, and Mitchell, 2015; Luo, Wang, and Zhang, 2017), branches (Hiatt and Park, 2013), and rival political

parties (Siegel, 2007; Kozhikode and Li, 2012; Zhu and Chung, 2014), the agency of individual officials has not become central to the analysis.

By understanding why and how incentives differ for officials who implement state policies, our study extends the Weberian state literature, which assumes that high-quality bureaucratic structures can shape officials' incentives equally effectively and hence focuses only on the empirical relationship between bureaucratic features and a country's macro-economic outcomes (e.g., Evans and Rauch, 1999). Our study reveals that differences in individual officials' incentives lead to their different ways of balancing the dual goals of the state. The same social problem (e.g., large layoffs) can be addressed differently by leaders because they prioritize different state goals due to their different incentives. To the extent that non-retiring governors did not respond as much as their retiring counterparts to the potential threat to social stability, the central government failed in ensuring that targets with veto power be met with concerted efforts in each province. This unintended consequence cannot be anticipated without taking into account officials' career-stage-based incentives. Our view of political incentives thus helps to better explain when and why the state goals can be fully accomplished or not.

By understanding the structural contingencies for individual officials' incentives, our study also extends the research on political incentives in political economics. Whereas this literature has focused on individual officials' calculations, we show how the functional differentiation between party and government leaders and the local state's priority in response to high pressures can shape such individual concerns. These findings underscore the importance of the state's characteristics in shaping the extent to which political incentives depend on personal career stage. Specifically, our study suggests that multiplicity of goals is an important structural condition for individual discretion and career-stage-based incentives. The dominance of one goal can limit individual discretion and lead to convergence of political incentives across career stages.

Although situated in China, our study has implications for how institutional arrangements in Western democracies may affect political incentives. In these contexts the legislative and administrative branches of the government function differently (e.g., Hiatt and Park, 2013). In addition, elected politicians succumb to the pressures from voters and election cycles, while appointed administrators are evaluated by relatively stable performance targets. Our findings on the difference between party and government leaders indicate that the career-stage-based incentives may apply more to appointed government administrators than to elected politicians.<sup>11</sup> Future research can extend our study to different state bureaucracies to further understand the role of political incentives.

In addition, our study contributes to research on organizational responses to institutional complexity (Greenwood et al., 2011). First, our study reveals a previously neglected source of heterogeneity in institutional pressures on organizations: state officials' political incentives. As officials prioritize state goals differently based on their incentives, they vary in the extent to which they implement specific state targets on firms in their jurisdiction, resulting in the firms' heterogeneous responses to the state pressures. Second, our study suggests a different role for organizational attributes in affecting firms' responses

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<sup>11</sup> We thank one of the reviewers for this insight.

to conflicting institutional pressures. While previous studies have emphasized how organizational attributes can channel firms' attention toward one of the pressures or expose firms to intense conflicts (Greenwood et al., 2011), we show that some attributes expose firms to the influence of motivated officials. This explains why these firms exhibit compliance with the state objective prioritized by the motivated officials. For example, we find that vulnerable firms (e.g., firms with a socialist imprint and regulated firms) did not always come to the state's rescue when confronted with large layoffs by entering into a new industry to acquire bankrupt SOEs. Instead, these firms responded only when the local officials had strong incentives to solve this social problem. By observing the response of firms vulnerable to the motivated officials' influence, our study broadens understanding about the role of organizational attributes in shaping organizational responses to multiple state goals and pressures.

Our study also contributes to the corporate diversification literature by providing a political account. Unrelated diversification is prevalent in emerging markets (Khanna and Palepu, 2000). For instance, in China, over 60 percent of publicly listed firms operate in unrelated industries (Delios, Zhou, and Xu, 2008). Strategy research has focused on firm-level factors and market conditions to explain firms' diversification (Teece, 1982; Chatterjee, 1986; Montgomery and Wernerfelt, 1988). In particular, the institutional void perspective emphasizes the impact of lack of market-based institutions on firms' diversification (Khanna and Palepu, 1997). Our study demonstrates the purposeful impact of the political institutions in transitional economies. In our context we found evidence that firms were pressured by political leaders to enter unrelated industries to solve the state's social problems, without apparent value-enhancing consequences. Firms are embedded in complex institutional and political environments, and their strategies are shaped by important stakeholders in their environment in addition to their efficiency-driven choices.

The mechanisms through which the state influences corporations have been quite narrowly defined in the existing literature. By building a theory about how state officials' political incentives serve as a key link between the state's autonomous goals and corporate behaviors in a transitional economy, our study adds a novel mechanism that deepens our existing understanding of interactions between the firm and the state.

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## Supplemental Material

Supplemental material for this article can be found in the Online Appendix at <http://journals.sagepub.com/doi/suppl/10.1177/0001839218786263>.

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