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Proactive management of political risk and corporate performance: The case of Spanish multinational enterprises

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ABSTRACT

The present study analyzes the relationship between the political risk assumed by Spanish multinational enterprises in their internationalization strategies and their performance over a five-year period, from 2000 to 2005. Significant evidence is obtained of a positive and simultaneous relationship between political risk and performance through the use of simultaneous equations applied to a sample of 164 firms. These results are consistent with the premises of the Prospect Theory and with the traditional financial and economic theory grounded in risk aversion. They also explain the proactive use of political risk, to the extent that greater risk results in greater performance, which in turn contributes the amount of resources that are needed to undertake investments in countries with greater risk.

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1. Introduction

The literature on the relationship between the degree of multinationality, measuring the company's foreign direct investment strategy, and its performance is relatively abundant (see Verbeke & Brugman, 2009 for a sample of more representative studies over the last 50 years in this field). Several authors have identified a relationship in the form of an inverted S (*e.g.*, Bobillo, López-Iturriaga, & Tejerina-Gaite, 2010; Contractor, Kundu, & Hsu, 2003; Lu & Beamish, 2004; Riahi-Belkaoui, 1998), which implies that firms go through three stages in their internationalization processes. At first, an increase in the degree of multinationality impacts negatively on performance, given that the firm faces problems which are, to a great extent, unknown. In the second stage, once the firm has started to acquire the necessary knowledge to manage foreign operations, the increase in the degree of multinationality is accompanied by an increase in performance, until the third stage is finally reached, in which management of the foreign operations is at an excessively complicated level which implies worse performance.

However, this stream of literature has lately left risk analysis to one side, despite it had been a mainstream component in earlier studies (Verbeke & Brugman, 2009). This lack of analysis might be due to traditional arguments which assumed that internationalization reduced the firm's exposure to risk through diversification (Agmon & Lessard, 1977; Brewer, 1981; Hughes & Sweeney, 1975; Kim, Hwang, & Burgers, 1993). Nevertheless, it may be argued that the firm has no need to carry out international operations to gain the advantages that ensue from international diversification, as these may be achieved through contractual arrangements such as licenses or supply contracts, among others (Verbeke & Brugman, 2009). Moreover, various authors point out that a firm's international diversification may increase firm risk due to fluctuations in exchange rates, agency problems and mainly institutional risks (Bartov, Bodnar, & Kaul, 1996; Reeb, Kwok, & Baek, 1998; Siegel, Omer, Rigsby, & Theerathorn, 1995).

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Drawing on the New Institutional Economics framework, which analyzes public sector institutions and their interaction with the economic activity of the private sector (Davis & North, 1971; Henisz, 1998; Holburn, 2001; North, 1989), it can be argued that institutional issues such as economic freedom, political constraints or corruption levels of the countries where a multinational enterprise (MNE) invests, condition the level of political risk that it assumes in its foreign investments. This level of political risk that MNEs want to assume in their foreign investments may be related to their levels of performance. On the one hand, investment decisions in countries with certain levels of risk may influence MNEs performance. On the other hand, the choice of countries may be conditioned by MNEs performance. Thus, an analysis that differentiates the influence of MNEs' performance on the risk they assume in their foreign investments, and *vice versa*, is an interesting research issue.

It is precisely the scant attention that previous research has paid to institutional risks in overseas operations and their relevance for the management of MNEs, which justifies the objective of our study. Specifically, our paper seeks to analyze the simultaneous relation between the level of political risk assumed by MNEs in their foreign direct investment location portfolio and their performance. We take the empirical case of the Spanish MNEs investments. We have chosen this particular set of MNEs because recent literature has pointed out a proactive use of political risk in the internationalization strategy of Spanish MNEs by taking advantage of their political capabilities in certain locations (García-Canal & Guillén, 2008; Jiménez, 2010, 2011; Jiménez, Durán, & De la Fuente, 2011).

From a strategic point of view, it has been recently claimed that MNEs may take advantage of their experience in less institutionally developed environments to obtain competitive advantages in other markets with similar characteristics, whereas other MNEs lacking this experience may have a disadvantage (Cuervo-Cazurra & Genc, 2008). However, it is still unexplored if this particular strategy is positively reflected in the MNE's performance. Our study can be considered a first step to investigate such an issue in a "late-investor" country, at least compared to other developed economies, where literature has found that this proactive use of political risk has been implemented. The results can be extrapolated, with caution, to MNEs from other countries that might also take advantage of political capabilities in their internationalization strategy to be able to compete with dominant global competitors in selected locations.

The remainder of the paper is structured in the following way. In the second section, we review prior research on the relation between political risk and the degree of internationalization of the firm. In this section we also develop the hypotheses relating the influence of the political risk assumed by Spanish MNEs with their performance, as well as the effect of Spanish MNE performance on the level of political risk. The subject of sections three and four are the sample, variables and the results. Finally, the fifth section extracts and discusses the main conclusions of the paper and points out some limitations and future lines of research.

2. Literature review and hypotheses

Academic literature has traditionally interpreted political risk as a threat for MNEs. Thus, most studies establish a negative effect of corruption (Cuervo-Cazurra, 2006, 2008; Habib & Zurawicki, 2002; Lambsdorff, 2003; Wei, 2000a, 2000b), political discretionality (Henisz & Zelner, 2001, 2002a, 2002b) and lesser economic freedoms and the protection of property rights (Bengoa & Sánchez-Robles, 2003; Kapuria-Foreman, 2007) on foreign direct investments.

However, these results do not imply generalized behavior by all firms nor for all investor countries. In fact, Spanish MNEs are characterized, on occasions, by their proactive use of political risk in their overseas expansion strategies,[1] which is based on taking advantage of their political capabilities to obtain competitive advantages (Henisz, 2003; Hillman & Hitt, 1999; Holburn, 2001; McWilliams, Fleet, & Cory, 2002; Wan, 2005) either through negotiating skills, opportunities to exert pressure or even to commit bribery.

Although political capabilities are extremely hard to measure, and therefore it is also difficult to determine to which extent MNEs possess them, there is some empirical evidence of their impact on the internationalization strategy of Spanish MNEs. García-Canal and Guillén (2008) find that Spanish MNEs in regulated industries show a bias to countries with low governmental constraints, even in spite of their aversion to macroeconomic uncertainty. This is due to the possibility of their using negotiating skills, originally honed in their home country, to obtain advantageous entry conditions.

Following this line of research, Jiménez et al. (2011) found that greater levels of political constraint positively influence the probability of investments in Europe and North America, in concordance with the results of Galán, Gonzalez-Benito, and Zúñiga-Vicente (2007). The same happens in Asia and Europe when testing lower levels of corruption. However, in the case of Latin America, higher levels of corruption favor Spanish investment. In turn, Jiménez (2010) shows that the greater the level of political risk faced by Spanish MNEs, measured by the relative degree of corruption, the greater the scope of internationalization. In another paper (2011), this author demonstrated that in the countries of North Africa and those of Central and Eastern Europe that have recently joined the European Union, greater levels of political risk measured through levels of political discretionality, corruption and economic freedoms, attract greater direct investment inflows from Spain, France and Italy.

These results are consistent with the Bribe Payers Index 2008[2] prepared by Transparency International, in which both Spain and France, together with the United States, and Singapore, which are found in Cluster 2, have a greater likelihood of

[1] Evidence for this behavior has also been found among North-American firms in the electricity sector (Holburn, 2001).

[2] Bribe Payers Index 2008 catalogs countries into four clusters according to their bribe levels, including countries with lower bribery levels in Cluster 1 and countries with higher levels in Cluster 4.

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resorting to bribery and corruption than the other countries within Europe placed in Cluster 1 (Germany, Belgium, the Netherlands, Switzerland, and the United Kingdom). From among all the European countries under analysis, only Italy, in Cluster 3, and Russia, in Cluster 4 are more likely to bribe than Spain and France.

The greater concentration of Spanish MNEs in countries with a high level of risk raises the question of whether the degree to which they are present in those countries is associated with greater performance. On the one hand, if we assume the traditional risk–return arguments of financial and economic theory (*e.g.*, Brealey, Myers, & Allen, 2005) we might expect a positive correlation between risk and performance. This argument rests on the traditional reasoning of risk aversion. The owners of a firm would not accept a higher risk in the face of similar returns, or put another way, they would only accept greater levels of risk if they expect to obtain higher returns. Note that this does not mean that entering any politically risky country will be profitable *per se* but as a competitive advantage derived from a synergistic firm's location portfolio perspective (Dunning, 2009; Dunning & Lundan, 2008). Sometimes MNEs invest in this kind of markets in order to obtain resources and/or capabilities, for instance skills or knowledge, not available in countries with a low risk profile, which are useful for the company worldwide. MNEs can transfer these resources or capabilities internally so other units can benefit from them, enhancing the firm's overall performance.

On the other hand, some studies have found evidence of a negative influence of risk on firm performance (Deephouse & Wiseman, 2000; Miller & Bromiley, 1990; Veliyath & Ferris, 1997). This relation is justified because when a firm assumes a high level of risk, some stakeholders, namely clients, debtors, suppliers and employees may require greater financial incentives to engage in a transaction with this company due to the greater probability of not satisfying their implicit and explicit commitments toward them (Miller & Bromiley, 1990; Núñez-Nikel & Cano-Rodríguez, 2002). However, in the case of Spanish MNEs, we expect this negative influence to be overcome by their experience dealing with operations in underdeveloped and/or unstable institutional environments (Cuervo-Cazurra & Genc, 2008) and by the potential benefits derived from the exploitation of political capabilities (García-Canal & Guillén, 2008).

In addition, another argument, also consistent with the positive influence of risk levels on MNE performance, may be taken from the Prospect Theory (Kahneman & Tversky, 1979). In accordance with the arguments of the Prospect Theory, the higher the returns of the firm, the lower its desire to assume risk in order to increase its expected returns. In particular, a firm with above average returns for its industry should be especially risk averse, such that it would only be willing to accept an increased level of risk if the expected return on investment is attractive. Thus, for firms with above average performance, increased risk levels are associated with higher performance (Miller & Bromiley, 1990).

According to the internalization theory (Buckley & Casson, 1976) and the eclectic paradigm of Dunning (1981, 1988), MNEs gain competitive advantages against purely domestic firms thanks to the internationalization of their activities and the positive externalities associated with them. Indeed, numerous papers have shown empirical evidence of above-average returns for MNEs compared to domestic companies (Arnold & Hussinger, 2005; Benvignati, 1987; Castellani & Zanfei, 2006; Girma, Görg, & Strobl, 2004; Head & Ries, 2003). Thus, on the basis of the arguments taken from the Prospect Theory, we propose that the level of political risk faced by Spanish MNEs in their foreign direct investment location portfolio will positively influence their performance.

H1. The level of political risk faced by Spanish MNEs in their foreign direct investment location portfolio positively influences their performance.

However, it should be taken into account that MNEs' performance may also influence the level of risk that they assume. Indeed, it may be argued that, compared to MNEs with low performance, those MNEs with higher performance will be more able to make investments in new countries where high levels of risk require the commitment of a greater level of resources. Specifically, these resources may be used to get a more accurate assessment of the potential risks or when negotiating with the local government. They may also be used to protect the company through greater expenditure on advertising to strengthen their corporative image or the purchase of insurance against possible expropriation or renegotiation of contracts. Thus, we might expect the performance of Spanish MNEs to have a positive influence on the average risk level of those countries in which the Spanish MNEs have a presence.

It needs to be acknowledged, nevertheless, that the literature is not unanimous on the positive relation between risk and performance. In fact, the seminal works of Bowman (1980, 1982) demonstrated the existence of a paradox in the relationship between performance and risk in the context of strategic management. This paradox is founded on a negative correlation between performance and the risk of a firm. Since the appearance of these seminal works, various studies have sought to support this evidence (*e.g.* Deephouse & Wiseman, 2000; Fiegenbaum, 1990; Fiegenbaum & Thomas, 1988; Lehner, 2000; Palmer & Wiseman, 1999). One of the justifications for this paradox put forward by Bowman (1982) centers on firm attitudes toward risk: in other words, the likelihood of firms with limited performance to actively seek out and assume risk in the hope of improving their performance. Drawing also on the Prospect Theory, Fiegenbaum and Thomas (1988) and Fiegenbaum (1990) show that for firms having returns below their target levels (or reference points), a negative association exists between return and risk, whereas a positive one exists for those with returns above the target. Additionally, the relationship between risk and return is steeper for firms facing below their industry target returns than for firms above the target. Thus, these findings also explain Bowman's risk–return paradox because when the regression is applied to all firms, the estimate of the slope term will be dominated by the below-target firms, which have a steeper negative risk–return relation (Chou, Chou, & Ko, 2009). Nevertheless, as argued above, there are arguments to expect that MNEs' performance is over industry average

and that the higher amount of available resources may help firms reduce the potential negative outcomes of assuming higher levels of political risk in their international strategy. Therefore, we do not expect to find a negative relation in the case of MNEs.

H2. The level of performance of Spanish MNEs positively influences the level of political risk that they assume in their foreign direct investment location portfolio.

3. Method and variables

3.1. Sample

The sample includes all Spanish MNEs with over 250 employees present on the registers of the Instituto de Comercio Exterior (ICEX), the www.oficinascomerciales.es webpage and other foreign institutions dedicated to direct investment contacted through the ICEX which provided directories of Spanish MNEs with direct investments in their country. From the initial list, we dropped those MNEs with a parent company already included in the sample and controlling at least 50.01% of their share capital. In total, the sample is composed of 164 Spanish MNEs with investments in 119 countries.[3] Annex 1 provides the list of Spanish subsidiary locations included in this study.

Data were taken principally from the SABI (*Sistema de Análisis de Balances Ibéricos*) database. This database provides financial information and business intelligence for companies in Spain and Portugal. Data was complemented with information taken from AEB (Asociación Española de Banca) and CECA (Confederación Española de Cajas de Ahorro) for the financial entities, as well as the annual accounts from the firms themselves. Unfortunately this database does not provide data at the project level nor country by country where the firm has invested so we are constrained to test the hypotheses at the corporate level.

The arithmetic mean of the data corresponding to 2000–2005 (inclusive) was calculated for all variables. In this way, more satisfactory and stable estimates are obtained than from a set of data referring to only one year (Brouthers, Gao, & McNicol, 2008; Wiggins & Ruefli, 2005). In those cases in which available information is not found for some year, we decided to take as a reference the value of the variable in the following or the preceding year, or the arithmetic mean of both if possible. Annex 2 shows the descriptive statistics of all the variables that were used in the equations.

3.2. Performance equation

The performance of MNEs was measured, as usual in the literature, through the Return on Equity (ROE). It is the most widely used measure by researchers and is even the measure for profits that is of greatest interest for executives (Bowman, 1980). However, in order to avoid the weaknesses of using a single measure of performance and as robustness checks, we also employed two additional performance ratios: Return on Assets (ROA) and Return on Capital (ROC).

Following previous research on the multinationality–performance relationship, we used five control variables: the age of the MNE, total assets (both submitted to a logarithmic transformation), leverage (measured as the ratio of debt over equity), whether the MNE is listed on any stock exchange and the industry to which it belongs. These variables have been widely used in previous studies (*e.g.*, Bobillo et al., 2010; Chao & Kumar, 2010; Contractor et al., 2003; De Jong, Phan, & van Ees, 2011; Elango, 2006; Lin, Liu, & Cheng, 2011; Riahi-Belkaoui, 1998). A large size allows MNEs to exploit economies of scale which positively affects their performance (Contractor et al., 2003; De Jong et al., 2011; Elango, 2006). MNE's age may affect performance because older companies may take advantage of a more established and known brand but also be attached to a more obsolete technology and outdated management (De Jong et al., 2011). Leverage was also included to control for the effect of capital structure on performance (Elango, 2006), and whether the firm is listed on any stock exchange to control for the easiness to access capital in the financial markets. Finally, we controlled for industry effect by using dummy variables, because there may be variations across industries in terms of average profitability (De Jong et al., 2011). We identified six different industries in the sample: manufacturers, food production, construction, regulated industries – those firms traditionally subjected to regulation by the government, although more recently, increasingly subjected to deregulation, such as air traffic controllers, telecommunications, energy and water (OECD, 1993) – financial and other industries that are maintained as a reference group to avoid problems of multicollinearity.

The results using other variables related with the size of the MNE, such as the number of employees or sales income, are very similar to those shown in Section 4, with no significant differences:

$$\begin{aligned} PERFORMANCE = {} & \gamma_0 + \gamma_1\, AGE + \gamma_2\, STOCK\ MARKET + \gamma_3\, ASSETS + \gamma_4\, LEVERAGE + \gamma_5\, MANUFACTURERS \\ & + \gamma_6\, CONSTRUCTION + \gamma_7\, FOOD + \gamma_8\, REGULATED + \gamma_9\, FINANCIAL + \gamma_{10}\, POLITICAL\ RISK + \varepsilon_{ij} \end{aligned} \quad (1)$$

[3] Direct investments in Afghanistan, Andorra, Puerto Rico and San Tome are not included due to an absence of data. In addition, investments in Serbia, Montenegro and Kosovo are accounted for as one country as they all formed one country in 2005.

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3.3. Political risk equation

Given the complexity of the phenomenon, different variables have been used to measure the political risk faced by Spanish MNEs in their foreign investment projects. Thus, this work will use three frequently used indices in research in this field as variables of political risk, with the aim of including all aspects comprised within this concept.

The first of the variables that we used is the Corruptions Perception Index (CPI) prepared by Transparency International (www.transparency.org)[4] The second variable to take into consideration is the Political Constraint Index (POLCONV) proposed by Henisz (1998).[5] Finally, we also included the Index of Economic Freedom prepared by the Heritage Foundation (www.heritage.org).[4] For each of the indexes of political risk, the dependent variable is calculated as the average of the levels of risk of the different locations where the MNE operates.

In the case of there being no available information for any of the indices on any one particular country location in which a Spanish MNE is present (as happens, for example, in the cases of Cabo Verde, Mauritania and Guinea Bissau), we decided to calculate the average omitting the country in question.

In these analyses, the predetermined variables are composed of the number of countries in which the MNE is present, as a measurement of international diversification (Barkema & Vermeulen, 1998; Brock & Yaffe, 2008; Caves & Mehra, 1986; Kogut & Singh, 1988; Tallman & Li, 1996). This allows taking into consideration the lower levels of inconvenience that political risk entails for those MNEs that are present in various countries, given their wider international experience and the reduced number of problems they would face if they had to abandon an unsuccessful project (Delios & Henisz, 2003; Fagre & Wells, 1982). In addition we included the log of income, in order to capture the greater ease with which MNEs can confront greater levels of political risk when they possess greater resource levels.

We also controlled for product diversification because companies with a diversification strategy are better prepared to deal with local fluctuations of demand, since their income does not rely on a single business (Amit & Livnat, 1988) which allows them to adopt higher levels of risks in their foreign investments. In the same vein, diversified firms are better prepared to enter countries with higher levels of political risk, because a change in a given policy, contrary to the MNE's interests, will only affect partially the company, one or a few product or sectors, but not all. In this study, we included three dichotomous variables to differentiate the diversification strategies: non-diversified firms when the MNE has a single product, related diversification when it has various products but all of them can be included within the same industry and finally non-related diversification when at least one of the products belongs to a different industry from the rest. These two last variables were included in the regressions. Related diversification is usually positively associated with international diversification, because it allows greater exploitation of the interdependencies in each business unit, whereas non-related diversification leads to economies of scale and scope (Hitt, Hoskisson, & Ireland, 1994). The group of non-diversified firms was maintained as a reference group.

$$\begin{aligned} POLITICAL\,RISK = {} & \beta_0 + \beta_1\, RELATED\,DIVERSIFICATION + \beta_2\, NON\text{-}RELATED\,DIVERSIFICATION \\ & + \beta_3\, NUMBER\,OF\,COUNTRIES + \beta_4\, INCOME + \beta_5\, PERFORMANCE + \varepsilon_{ij} \end{aligned} \tag{2}$$

3.4. Model

The simultaneous equation technique known as the complete information method or "3-stage least squares" (3SLS) was used to analyze the possible simultaneous relation between assumed risk and performance obtained by the Spanish MNEs. Given this endogenous nature of the relation, the use of an ordinary least square regression would lead to inconsistent and inefficient estimators (Gujarati, 1997).

Although the 3SLS technique is more sensitive to errors in the data or in the specification of the equations, it performs the estimation jointly for all of the model's parameters, instead of doing so equation by equation, which preserves the objective pursued with simultaneous equations more effectively than the simple isolated estimate of each equation (De Quevedo & De la Fuente, 2003). Moreover, it is a better alternative than others such as the limited information models [for example the "2-stage least squares" (2SLS)] as it does not lose efficiency when correlation exists between the errors of the different equations in the model (Cho, 1998; Kim, Rhim, & Friesner, 2007).

However, if 3SLS is applied in the absence of endogeneity, the estimators obtained would be consistent but not efficient, for which reason the least squares method would be preferable (Gujarati, 1997). Thus, it is necessary to apply the Hausman specification test, in order to verify endogeneity and by doing so, to justify the use of simultaneous equations. This test consists of two steps (Gujarati, 1997; Maddala, 1996). In the first one, the reduced form of the equations are obtained to

[4] Transparency International's Corruption Perception Index constitutes a measure of perceived corruption based on surveys of businesses and experts from each country. This index ranges from 0 that represents a completely corrupt state to 10 for an entirely corruption-free state (DiRienzo et al., 2007; Pournarakis & Varsakelis, 2004).

[5] This index takes account of the number of independent powers that can exercise a veto in each country. It modifies the score obtained according to the possible alignments between powers, in such a way that it affects the actual constraints to which the government is subjected. Additional modifications are made when some political powers are neither totally aligned nor totally opposed to each other, in such a way that their composition is a relevant factor when determining the extent of the political constraints.

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verify the endogeneity of the regressors; in other words, by obtaining these variables solely in terms of the predetermined variables and the stochastic perturbations, with the aim of predicting their foreseen values. In the second step, a second equation is estimated that corresponds to the original equation in the model, but to which the predicted values taken from step one of the variables with questionable endogeneity are added. The significativity of the *F* test (offered together with the results of the models in Annex 4) verifies that the regressors do in effect present endogeneity rather than exogeneity, for which the use of simultaneous equation techniques is preferable, rather than the use of estimators calculated by ordinary least squares.

It is also necessary to verify that the parameters of the model may be estimated, for which purpose they should comply with the order and rank conditions. With respect to the first one, the number of predetermined variables that are excluded in a certain equation should at least be as high as the number of endogenous variables included in the same equation minus one (Gujarati, 1997). This condition is met in the model as there are only two endogenous variables (performance and risk) and many other predetermined ones in each equation. Thus, it may be said that the model is over-identified.

With regard to the second one, it should be possible to construct a determinant other than zero, of an order $(M-1)\times(M-1)$, in which M is the number of equations and endogenous variables, on the basis of the coefficients of the variables (endogenous and predetermined) excluded from that particular equation, but included in the other equations of the model (Gujarati, 1997). As only two equations and two endogenous variables are in the model, this condition is also met, as the determinant obtained with the variable coefficients should be solely of the order 1.

3.5. Diagnosis of multicollinearity

The matrix of correlations and the Variance Inflation Factors (VIFs) are shown in Annex 3. Given that all the values are found below the limit of 10 recommended by Neter, Wasserman, and Kutner (1985), Kennedy (1992) and Stundemund (1992) and the strictest limit of 5.3 proposed by Hair, Anderson, Tatham, and Black (1999), and taking account of the low correlations, it may be affirmed that no serious problems of multicollinearity exist.

4. Results and discussion

The results of the models are presented in Annexes 4–6. Results in Annex 4, where ROE is used as the proxy for performance, show that all three indices of political risk have a negative and significant coefficient in Eq. (1). Given that lower values of these indices signal higher values of political risk, the hypothesis H1 is supported, as a positive and significant relation exists between the level of political risk assumed and the performance of MNE. These results are consistent with the financial and economic theory grounded in risk aversion and with previous arguments based on the Prospect Theory which state that increases in the level of risk are associated with an increase in subsequent performance for firms with above-average performance (Miller & Bromiley, 1990).

Furthermore, in Eq. (2), we also observe that the ROE coefficient is negative and significant when included as an independent variable of political risk in 2 out of the 3 models, when using the corruption and the POLCONV variables. This implies that higher levels of performance are associated with lower scores on the political risk indices and, as a result, higher levels of political risk. This supports hypothesis H2 which stated that higher levels of performance provide MNEs with the necessary resources to undertake investments in more compromised locations, and it rejects the possibility of our results upholding the Bowman paradox of a negative correlation between risk and the results of a firm.

The robustness checks offer similar results. In the robustness models where ROA is used, offered in Annex 5, all 3 indices of political risk are negative and significant on the performance equation, supporting hypothesis H1. Also, ROA is negative in all models but significant only in the one using the POLCONV index, partially supporting hypothesis H2.

Finally, when the performance measure is ROC (see Annex 6), consistent results are once again obtained. All 3 indexes are negative and significant in the performance equation, supporting hypothesis H1 and, in this case, the performance measure is negative and significant in all 3 models of political risk, supporting hypothesis H2.

Hausman specification test for models using ROE and ROA support the endogeneity of the relationships analyzed. However, Hausman specification tests for models in which ROC was used are not significant, so that findings from these robustness models, despite being in line with the results obtained when using the other two performance measures, must be taken with caution.

Overall, these results are coherent with the financial and economic theory (*e.g.* Brealey et al., 2005), which points out that the owners of a firm only accept greater levels of risk if they expect greater performance. They are also consistent with arguments taken from the Prospect Theory, which suggest that risk aversion is greater in firms with above-average performance for the industry, which is the case of MNEs in general. Thus, the larger the performance of the firm, the less its desire to assume risks unless the expected returns are high enough (Miller & Bromiley, 1990). These higher returns at the corporate level may not directly come from the subsidiaries in risky countries but rather as a consequence from the firm's location portfolio (Dunning, 2009; Dunning & Lundan, 2008). MNEs may set up subsidiaries in this kind of places to obtain skills and knowledge transferable to other units around the world. These skills and knowledge, not available in

subsidiaries placed in countries with a low risk profile, are useful for the company worldwide and increase its overall performance.

Likewise, we have obtained evidence that the level of return of the Spanish MNEs also influences the levels of risk that they assume. The greater level of resources that are available to the MNEs with high performance allows them to make investments in new countries where high risk levels require the commitment of a greater level of resources. These resources may be used to get an accurate assessment of the risk, during the negotiation with the local government, which is especially costly whenever government discretionality is higher and they are more open to corruption, or to get protection, for example, through greater expenditure on publicity to strengthen their corporative image or the purchase of insurance against possible expropriation or renegotiation of contracts.

These results show evidence that the proactive employment of political risk on the part of Spanish MNEs, described by García-Canal and Guillén (2008), Jiménez (2010) and Jiménez et al. (2011), based on the use of negotiating skills to obtain competitive advantages in markets characterized by relatively high risk levels (Henisz, 2003; Hillman & Hitt, 1999; Holburn, 2001; McWilliams et al., 2002; Wan, 2005), will be compensated for in the form of higher rates of performance, at least in the short and medium term, which in turn will provide a greater amount of resources to MNEs with which to continue this type of internationalization strategy.

Although this must be interpreted with caution, the results also justify that MNEs with experience in environments characterized by lower levels of institutional development, internationalize in markets where they have an advantage over other MNEs with lower experience in these environments (Cuervo-Cazurra & Genc, 2008), by taking advantage of these valuable political capabilities most MNEs from developed countries lack. This competitive advantage can be transformed into higher performance and greater international experience that may be used to continue and expand their internationalization strategy.

5. Conclusions

In this study, we have analyzed the relation between the performance of MNEs and the level of political risk that they assume, with a view to filling in the gap that exists in the literature in this field. To do so, we employed a sample of 164 large Spanish MNEs with direct foreign investments across the world. Our research confirms the need to take account of the simultaneous nature of this relationship, because corporate performance does affect the average level of risk assumed by MNEs, whereas the average level of risk also affects MNEs performance. Therefore, the use of simultaneous equations as a statistical technique instead of a least squares regression is needed. The results show that the level of political risk assumed by the MNEs in their international strategy has a positive influence on their performance and *vice versa*. These findings suggest that, in terms of performance, the Spanish MNEs behave in accordance with the expectations of the financial and economic theory (*e.g.* Brealey et al., 2005) and the Prospect Theory (Kahneman & Tversky, 1979), as they only assume greater risk levels when the overall performance of the company is expected to increase. Sometimes this involves investing in specific places where the company may lose money, but where the company can obtain advantages transferable to other units around the world. It is precisely in these particular environments where political capabilities shine, helping those firms who possess them to overcome the potential problems while taking advantage of the opportunity to obtain resources and/or capabilities not available in other countries or even enjoy lower competition because other MNEs consider the place too risky. At the same time, the additional flow of resources, arising from greater performance, means that they can design a synergistic location portfolio including investments in locations where the level of political risk is higher.

Therefore, the results show evidence that Spanish MNEs consider political risk not only as the conventional view of a threat but also as an opportunity. The international strategy of these companies, characterized in part by a proactive approach to the use of political risk, is sustained by the higher levels of performance provided by investments in riskier locations in the short and medium term. This is derived from a double reinforcing effect: the higher rates of expected performance act as an incentive for the MNE to assume higher levels of political risk. Simultaneously, the resources obtained in these locations allow the company to undertake similar future investments and implement measures to minimize the possible negative effects of political risk.

In any case, and taking into account the increasing importance of corporate social responsibility, those MNEs that actively employ corruption to obtain advantageous competitive positions, should not forget that they sacrifice their social standing and run the risk of losing influence and effectiveness due to the negative impact on their status in the international community (Ghosal & Moran, 2005), which may prejudice performance in the long term. Furthermore, higher corruption rates in those countries were investments are located reduce the possibilities of economic and social development (World Bank, 2001), which can be also detrimental to the interests of MNEs.

As limitations, it should be mentioned the impossibility of including the influence of the internationalization process followed by the MNE (Welch & Loustarinen, 1988), due to the lack of reliable data. This is because, despite the fact that the inclusion of the variable that measures the number of countries in which each MNE is present partially alleviates this problem, it is not possible to make a distinction between whether such growth is organic or inorganic through acquisitions (De Beule & van den Buckle, 2009). In the same way, it is not possible to distinguish between the different motivations for foreign investment: resource or efficiency seeking foreign direct investment.

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Also, our study is based on a single investing country. Generalizing the results from a "late-investor" country such as Spain to MNEs from other countries must be done with caution, even if they are also able to use their political capabilities successfully. As a result, one of the possible future research directions emerging from our paper is the empirical analysis of the relation between performance and political risk, including in the sample MNEs from other countries also characterized by their proactive use of political risk. Additionally, it would be interesting to widen the study to include small and medium enterprises, as well as in relation to their perspectives over time, including a larger number of years over which reliable information is available. Finally, we have focused on the simultaneous relation between the level of political risk assumed by MNEs in their international strategy and their performance at the corporate level. However, analyzing the relationship at the country and subsidiary level would be an interesting future line of research.

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Annex 1. List of Spanish subsidiary locations included in the sample

Albania	Guinea Bissau	Oman
Algeria	Guyana	Pakistan
Angola	Haiti	Panama
Argentina	Honduras	Paraguay
Armenia	Hong Kong	Peru
Australia	Hungary	Philippines
Austria	Iceland	Poland
Azerbaijan	India	Portugal
Bahrein	Indonesia	Qatar
Bangladesh	Iran	Romania
Belgium	Ireland	Russia
Bolivia	Israel	Saudi Arabia
Bosnia Hergovina	Italy	Senegal
Brazil	Japan	Serbia-Montenegro
Bulgaria	Jordan	Sierra Leona
Cameroon	Kazakhstan	Singapur
Canada	Kenya	Siria
Cape Verde	Kuwait	Slovak Republic
Chile	Latvia	Slovenia
China	Liban	South Africa
Colombia	Libya	South Korea
Costa Rica	Lithuania	Surinam
Croacia	Luxembourg	Sweden
Cuba	Macedonia	Switzerland
Cyprus	Malaysia	Taiwan
Czech Republic	Mali	Tanzania
Denmark	Malta	Thailand
Dominican Republic	Mauritania	Tunisia
Ecuador	Mauritius	Turkey
Egypt	Mexico	Uganda
El Salvador	Moldova	Ukraine
Estonia	Mongolia	United Arab Emirates
Ethiopia	Morocco	United Kingdom
Finland	Mozambique	United States
France	Namibia	Uruguay
Gabon	Netherlands	Uzbekistan
Germany	New Zealand	Venezuela
Ghana	Nicaragua	Vietnam
Greece	Nigeria	Zimbabwe
Guatemala	Norway	

Annex 2. Descriptive statistics

Variables	*N*	Min.	Max.	Average	Standard deviation
ROE	164	−104.45	77.5	15.1	17.2
INCOME(LOG)	164	4.29	7.61	5.55	.702
ASSETS(LOG)	164	4.06	8.68	5.72	.93
LEVERAGE	164	4.23	13.84	.33	176.77
AGE(LOG)	164	.78	2.37	1.66	.32
NUM. COUNTRIES IN WHICH IT OPERATES	164	1	89	11.20	12.917
INDEX OF ECONOMIC FREEDOMS	164	5.1	7.92	6.43	.43
CORRUPTION INDEX	164	2.52	8.2	5.29	1.25
POLCONV INDEX	164	0	8.93	6.33	1.16
AVERAGE ALL 3 INDICES	164	4.43	8.00	6.02	.804
NON-DIVERSIFIED	164	32.3%			
RELATED DIVERSIFICATION	164	53%			
NON-RELATED DIVERSIFICATION	164	14.6%			
MANUFACTURERS	164	37.2%			
FOOD	164	11.6%		Frequencies	
CONSTRUCTION	164	11.6%			
REGULATED SECTORS	164	7.9%			
FINANCIAL	164	8.5%			
OTHER SECTORS	164	23.2%			
STOCK MARKET	164	36.6%			

Annex 3. Matrix of correlations and Variance Inflation Factors (VIFs)

	1	2	3	4	5	6	7	8	9	10	11	12	VIFs
1. LEVERAGE	1												1.09
2. AGE	−0.123	1											1.50
3. STOCK MARKET	−0.069	0.277	1										1.50
4. ASSETS	−0.021	0.431	0.436	1									2.54
5. MANUFACTURER	−0.102	−0.026	−0.035	−0.277	1								1.71
6. FOOD	−0.057	0.004	0.002	−0.111	−0.279	1							1.39
7. CONSTRUCTION	0.005	−0.114	0.002	0.155	−0.279	−0.131	1						1.51
8. REGULATED	−0.016	0.072	0.339	0.338	−0.226	−0.106	−0.106	1					1.67
9. FINANCIAL	0.102	0.425	−0.006	0.523	−0.235	−0.110	−0.110	0.090	1				2.40
10. CORRUPTION INDEX	−0.134	0.019	0.110	0.083	−0.017	0.059	−0.059	−0.026	0.140	1			1.08
11. POLCONV INDEX	−0.083	0.063	0.005	0.132	−0.035	0.009	0.023	−0.020	0.184	–	1		1.05
12. EC. FREEDOMS INDEX	−0.044	0.021	0.192	0.080	−0.032	0.008	−0.063	0.032	0.126	–	–	1	1.08

	1	2	3	4	5	6	7	VIFs
1. RELATED DIVERSIFICATION	1							1.34
2. NON-RELATED DIVERSIFICATION	−0.440	1						1.31
3. NUMBER OF COUNTRIES	−0.068	0.077	1					1.21
4. INCOME	0.162	0.109	0.286	1				1.12
5. ROE	0.088	0.100	−0.053	0.190	1			1.07
6. ROA	0.033	0.077	0.068	0.009	–	1		1.01
7. ROC	−0.016	0.084	−0.028	−0.022	–	–	1	1.01

Annex 4. Simultaneous equations of political risk and ROE

	(1)	(2)	(3)
Eq. (1)			
AGE	−3.140 (4.943)	−.830 (4.431)	−4.445 (5.476)
STOCK MARKET	2.379 (3.078)	.630 (2.683)	6.025 (5.525)
ASSETS	2.891 (2.237)	3.268 (2.226)	2.158 (2.663)
LEVERAGE	−.066 (.090)	.003 (.095)	−.038 (.063)
MANUFACTURERS	.351 (2.062)	−.260 (3.024)	−.235 (1.957)
FOOD	.457 (3.026)	−1.931 (4.112)	−1.079 (3.329)
CONSTRUCTION	.931 (3.549)	4.856 (4.620)	1.014 (3.926)
REGULATED	−1.795 (4.002)	−1.177 (5.129)	−1.224 (3.712)
FINANCIAL	1.320 (6.496)	−2.749 (7.876)	3.945 (7.672)
CORRUPTION INDEX	−18.337*** (5.222)		
POLCONV INDEX		−11.385** (6.021)	
EC. FREEDOMS INDEX			−76.222*** (19.942)
CONSTANT	99.990** (33.548)	69.634** (38.631)	498.024*** (136.099)
N	164	164	164
Hausman Test	3.215***	2.053*	3.169***
Eq. (2)			

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Annexe 4 (*Continued*)

	(1)	(2)	(3)
RELATED DIVERSIFICATION	.026 (.138)	.030 (.188)	.001 (.037)
NON-RELATED DIVERSIFICATION	−.003 (.200)	.088 (.271)	−.006 (.051)
NUMBER OF COUNTRIES	.001 (.007)	−.007 (.008)	.000 (.001)
INCOME	.194 (.217)	.241 (.184)	.048 (.071)
ROE	−.057** (.025)	−.048** (.021)	−.012 (.008)
CONSTANT	5.051*** (.991)	5.765*** (.836)	6.345*** (.327)
N	164	164	164
Hausman Test	11.829***	3.439***	21.710***

Standard deviation between parentheses.
* $p < 0.10$.
** $p < 0.05$.
*** $p < 0.01$

Annex 5. Simultaneous equations of political risk and ROA

	(1)	(2)	(3)
Eq. (1)			
AGE	−.735 (1.671)	.105 (1.277)	−.753 (1.608)
STOCK MARKET	1.612 (1.343)	.373 (.804)	2.769 (2.096)
ASSETS	−.635 (.944)	−.138 (.909)	−.971 (1.003)
LEVERAGE	−.072 (.049)	−.041 (.037)	−.058 (.039)
MANUFACTURERS	−.153 (.958)	.023 (.922)	−.443 (.974)
FOOD	−1.397 (1.481)	−1.153 (1.325)	−2.092 (1.592)
CONSTRUCTION	−1.095 (1.519)	−.116 (1.305)	−1.260 (1.567)
REGULATED	−1.248 (1.799)	−.485 (1.520)	−.900 (1.731)
FINANCIAL	−.258 (2.560)	−.598 (2.410)	.098 (2.672)
CORRUPTION INDEX	−8.055*** (2.113)		
POLCONV INDEX		−7.272** (2.330)	
EC. FREEDOMS INDEX			−27.249*** (7.204)
CONSTANT	53.238*** (12.918)	52.442*** (14.171)	187.422*** (48.383)
N	164	164	164
Hausman Test	4.652***	.495	4.795***
Eq. (2)			
RELATED DIVERSIFICATION	−.046 (.132)	−.013 (.122)	−.017 (.042)
NON-RELATED DIVERSIFICATION	−.111 (.193)	−.027 (.176)	−.034 (.061)
NUMBER OF COUNTRIES	.000 (.004)	−.000 (.005)	−.000 (.001)
INCOME	−.045 (.150)	−.002 (.134)	−.007 (.052)
ROA	−.071 (.045)	−.105*** (.039)	−.019 (.016)
CONSTANT	5.983*** (.882)	6.936*** (.768)	6.599*** (.310)
N	164	164	164
Hausman Test	25.544***	1.540	56.184***

Standard deviation between parentheses.
* $p < 0.10$.
** $p < 0.05$.
*** $p < 0.01$.

Annex 6. Simultaneous equations of political risk and ROC

	(1)	(2)	(3)
Eq. (1)			
AGE	.432 (2.642)	.515 (2.207)	.515 (2.207)
STOCK MARKET	−.323 (2.155)	−.002 (1.314)	−.002 (1.314)
ASSETS	−.961 (1.882)	−.717 (1.781)	−.717 (1.781)
LEVERAGE	.013 (.070)	.008 (.057)	.008 (.057)
MANUFACTURERS	−.139 (.927)	−.226 (1.659)	−.226 (1.659)
FOOD	−.369 (1.332)	−.653 (2.033)	−.653 (2.033)
CONSTRUCTION	.339 (1.338)	.623 (2.487)	.623 (2.487)
REGULATED	.232 (2.372)	−.158 (2.527)	−.158 (2.527)
FINANCIAL	.191 (3.660)	−.382 (4.523)	−.382 (4.523)
CORRUPTION INDEX	−11.685** (5.340)		
POLCONV INDEX		−11.226** (5.285)	
EC. FREEDOMS INDEX			−11.226** (5.285)
CONSTANT	80.131** (31.799)	87.766** (32.217)	87.766*** (32.217)
N	164	164	164
Hausman Test	1.101	.671	1.355

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Annexe 6 (*Continued*)

	(1)	(2)	(3)
Eq. (2)			
RELATED DIVERSIFICATION	−.013 (.069)	−.004 (.105)	−.004 (.105)
NON-RELATED DIVERSIFICATION	.001 (.084)	.030 (.142)	.030 (.142)
NUMBER OF COUNTRIES	−.000 (.004)	−.002 (.006)	−.002 (.006)
INCOME	−.082 (.161)	−.037 (.137)	−.037 (.137)
ROC	−.078*** (.023)	−.076*** (.017)	−.076*** (.017)
CONSTANT	6.813*** (.950)	7.576*** (.762)	7.576*** (.762)
N	164	164	164
Hausman Test	.251	1.191	.130

Standard deviation between parentheses.
* $p < 0.10$.
** $p < 0.05$.
*** $p < 0.01$

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