



Chinese SMEs' location choice and political risk: The moderating role of legitimacy

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ABSTRACT

International business studies show that multinational enterprises generally invest in locations with fewer political risks, but that this may not always apply to emerging-market multinational enterprises, due to the specific characteristics of their home countries. In this paper, we examine the impact of political risk on the location decisions of Chinese small and medium-sized enterprises (SMEs), and explore the legitimacy of firms from China in different host countries as a moderator of the relationship between political risk and location choice. Our empirical investigation is based on an original database of 617 foreign direct investment (FDI) location-choice decisions made by 240 Chinese SMEs between 2006 and 2017. The results show that political risk deters Chinese SMEs from choosing certain locations, but political and economic legitimacy positively mitigate this relationship. Combining the political institutions approach and legitimacy-based view of political risk, we contribute novel insights into the role of legitimacy of firms from the same country of origin in emerging market SMEs' strategic choices of FDI location.

1. Introduction

Political risk plays a vital role in the location choice of multinational enterprises (MNEs), and has been an enduring topic in international business (IB) research. A high level of political risk generates uncertainty in terms of cost, return, property rights, and access to local resources (Rothaermel, Kotha, & Steensma, 2006). Therefore, the assumption in IB literature has been that MNEs avoid or minimize their exposure to politically risky environments (Delios & Henisz, 2003; Dunning & Lundan, 2008; Henisz & Delios, 2001). However, the location choices of firms from emerging markets have increasingly challenged this conventional wisdom. Research on emerging market MNEs (EMNEs), especially those from China, has found that these enterprises tend to be less sensitive to, or even show an appetite for, politically risky environments when expanding abroad (Buckley et al., 2007; Buckley, Yu, Liu, Munjal, & Tao, 2016; Quer, Claver, & Rienda, 2012). This may be attributed to support – such as finance and diplomatic assistance – provided by their home government (Gammeltoft & Cuervo-Cazurra, 2021; Panibratov & Michailova, 2019) and to capabilities honed by the experience of navigating an underdeveloped political and regulatory environment at home (Holburn & Zelner, 2010; Luo & Tung, 2018). However, while insights have been gained on the relationship between

political risk and location choice for large MNEs and/or state-owned enterprises (SOEs) from emerging markets (Duanmu, 2014; Quer et al., 2012), we know little about the impact for their SME counterparts.

Previous research has examined the role of external environmental factors, including home-country institutional voids (Boisot & Meyer, 2008), home- and host-country institutional and psychic distance (Couper, 2019; Puthuserry, Child, & Rodrigues, 2014), national cultural values (Dimitratos, Petrou, Plakoyiannaki, & Johnson, 2011), religious affiliation (Richardson, 2014), and industrial dynamism (Qian, Li, & Qian, 2018) in SMEs' location decisions. A core message from this literature is that SMEs may be more sensitive to uncertainty in the external institutional environment because of their scarcity of resources and their lack of influence on home- and host-government policies when internationalizing (see Child, Karmowska, & Shenkar, 2022 for review). This could be particularly important for SMEs from emerging markets like China, as resources and home-government support are mostly devoted to the international expansion of national champions (Ramamurti & Hillemann, 2018). Thus, SMEs are likely to be more wary of political risk, as they have less capability to manage political risk after entry into a new international market and would therefore look for ways to assess such risk before entering. Although research on SMEs has assumed that political risk represents an obstacle in the external

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environment (Child et al., 2022), the impact of political risk on SMEs' choices of which foreign markets to enter has received limited attention in the literature. In this paper, we address this research gap and focus on whether emerging market SMEs are sensitive to political risk when choosing a foreign location.

Various factors may influence EMNEs' attitudes to political risk in their location strategies (Buckley et al., 2007; Duanmu, 2012). Mainstream literature has discussed either home-country institutional attributes in preparing large MNEs and SOEs from emerging markets for entering other politically risky environments (Quer et al., 2012), or the ways in which intergovernmental deals are leveraged by these firms to mitigate host-government hostile actions (Duanmu, 2014; Li, Newenham-Kahindi, Shapiro, & Chen, 2013; Shapiro, Vecino, & Li, 2018). However, research has mostly been silent about emerging market SMEs, although these firms may be more susceptible to political challenges encountered abroad. On one hand, SMEs' international expansion tends to fall outside the radar of home-government interest. On the other hand, acceptance or resistance from host-country stakeholders owing to the country-of-origin effect may shape firms' outlook on the host country's political and regulatory impartiality (Bilgili et al., 2023). Recent research does show that EMNEs' country of origin (e.g., the image of their home country or other firms from the same home country) may confer – or not – legitimacy or greater ease of operation in host markets, acting as a boundary condition for the relationship between political risk and location choice (Zhang et al., 2022).

The presence of bounded rationality means that host-country stakeholders resort to drawing upon their mental representation of cognitive categories to evaluate an MNE from a particular home country or industry (Kostova & Zaheer, 1999). Research along these lines has examined how such judgements can be transferred among legitimacy evaluators when looking at MNEs that share similar attributes, which can influence their operation and success (Stevens & Newenham-Kahindi, 2017). However, the roles of the firms themselves, and their responses to host country stakeholders' legitimacy judgements, have been regarded as subordinate. Given that firms and states may interact repeatedly with each other in global investment networks, a host country's judgement of a firm's legitimacy may not only diffuse to influence the view of that firm among evaluators, but may also spill over from incumbents to prospective investing firms to influence their strategic responses (Bilgili et al., 2023). This suggests that scholarly discussion about legitimacy and its effects should not limit itself to the analysis of host countries' concerns about economic and national security, but should also explore to what extent the evaluation of legitimacy of previous investments may shape the strategic choices of prospective investing firms from the same country of origin (Han, Liu, Gao, & Ghauri, 2018). Lack of resources and political access can make emerging market SMEs more sensitive to a host country's judgement of legitimacy about other firms from the same home country. Such judgements can signal willingness to foster mutual trust and acceptance, and, in turn, influence SMEs' assessment of the impact of political risk (such as a host government's discretionary and adverse policy changes) on their FDI. Despite its importance, less scholarly attention has been paid to the question of how the legitimacy of firms from the same country of origin shapes new investors' strategic decisions regarding foreign market entry. Therefore, investigating legitimacy as a moderator in the relationship between political risk and emerging market SMEs' location decisions presents a unique opportunity for theoretical and empirical extension.

This study aims to answer two questions: (1) Does political risk affect Chinese SMEs' location choices? (2) Does legitimacy of firms from the same country of origin moderate the relationship between a host country's political risk and Chinese SMEs' location choices? We focus on

Chinese SMEs due to the growing salience of these firms' outward FDI, but also the political obstacles they face abroad (Qiao, Lv, & Zeng, 2020; Zhu, Sardana, & Tang, 2022). After private firms were allowed to invest overseas in 2003, Chinese SMEs' investment overseas has increased significantly (Qiao et al., 2020), yet these firms remain understudied. With many Chinese firms facing legitimacy challenges in certain foreign countries (Shapiro et al., 2018), we anticipate that Chinese SMEs, being more cautious about FDI due to scarcity of resources, may be more sensitive both to the treatment of other Chinese firms in host countries and to home-host economic ties. To answer our research questions, we build a unique database of 617 investment decisions in 57 countries made by 240 Chinese SMEs between 2006 and 2017. Our results confirm that political risk deters Chinese SMEs from locating in a host country, and we also demonstrate that this effect is strongest for smaller SMEs. We demonstrate that higher levels of political and economic legitimacy mitigate the negative effect of political risk on the probability of entry into a market. Our results also suggest that political legitimacy is more important for firms without experience in a particular host country, while economic legitimacy is more relevant to firms with such experience.

This paper makes several important contributions to the literature on political risk in IB. First, it provides empirical evidence on the relationship between political risk and EMNEs' location choices. We look at SMEs from China and highlight the role of firms' size. Specifically, we show that capabilities for dealing with risky political environments are not homogeneous across Chinese firms, and propose that factors such as resource scarcity and inability to influence home- and host-government policymaking can make emerging market SMEs more vulnerable to host-country political hazards compared to large firms and/or SOEs. Thus, we extend the knowledge by providing a more nuanced account of the role of host-country political risk in EMNEs' decisions about foreign entry, demonstrating that Chinese SMEs behave similarly to advanced market MNEs when locating FDI.

Second, we extend the research examining legitimacy from the host country's perspective in granting or withholding firms' social license to operate (Meouloud, Mudambi, & Hill, 2019; Stevens, Xie, & Peng, 2015) to highlight its economic implications for FDI location choice. Our study suggests additional insights on the role of legitimacy, through analysing host countries' sociopolitical acceptance of firms from particular home countries, and the degree to which such social judgement may spill over to influence prospective investing firms' anticipation of host countries' political risk, in turn encouraging or deterring their FDI decisions. This adds novel understanding of legitimacy as a signal to nurture (or erode) economic and social exchanges, rationalizing firms' strategic responses in the course of foreign market entry. We combine insights from the political institutions approach (PIA) and the legitimacy-based view (LBV) of political risk (Stevens et al., 2015) to understand Chinese SMEs' FDI location choices. We identify the legitimacy of firms from the same country of origin – in particular, political and economic legitimacy – as a boundary condition for the effect of political risk on firms' location choices. With limited resources and access to information, SMEs may use the host country's judgement of legitimacy of other firms with similar attributes, to guide their strategic location choice in the presence of political risk.

Our study informs the consideration of political risk in an increasingly turbulent geopolitical environment. Departing from research about the direct involvement of large MNEs and SOEs with their home country's geopolitical jockeying (e.g. Shi, Hoskisson, & Zhang, 2016; Lubinski & Wadhvani, 2020), we highlight how the effect of home-country legitimacy can be an important mechanism to explain the role of changing geopolitical environments (including, e.g., challenges in the form of sanctions, nationalist sentiments, or populism; Devinney

& Hartwell, 2020; Meyer, Fang, Panibratov, Peng & Gaur, 2023) for Chinese SMEs' FDI location choice. In sum, we extend the political risk literature by demonstrating that different types of legitimacy affect firms' expectations of risk and their strategic decisions.

We organize the rest of the paper as follows. Section 2 provides the theoretical background, followed by the hypothesis development. We then present our research methods, results, and robustness tests. Finally, we discuss the implications of our study for scholarship and practice, limitations, and end with a conclusion.

2. Theoretical background and hypotheses

Today's global economic landscape is characterized by increasing complexity of national and international environments, leading to a diverse and novel range of political risks for cross-border business activities (Kobrin, 2015). In addition to the unpredictability of a host country's political and regulatory institutions, rising geopolitical tensions with the ensuing threats and actual imposition of sanctions, and the recent surge of populism in many countries (often implying skepticism towards "outsider" foreign firms) also represent critical political challenges for firms doing business internationally (Meyer et al., 2023; Panibratov, Herrera, Esquerdo, & Klishevich, 2023). Our paper builds upon Stevens et al.'s (2015) conceptualization of political risk, as well as IB theory on MNEs' location decisions (Cantwell, 2009; Dunning, 1998), adopting the PIA to explore the extent to which host-country political constraints influence EMNEs' locational strategies. Our choice of moderating factors – relating to legitimacy – is motivated by the emergent LBV of political risk.

Political risk can be defined as the unpredictability and instability of legal, political, and regulatory conditions in host countries (Kobrin, 1979). IB literature has argued that a lack of checks and balances of power within a country's political system may allow policymakers to engineer regulations and policies in their favor (Henisz & Delios, 2001). This represents one of the most critical concerns for MNEs' foreign expansion (Delios & Henisz, 2003), with associated threats of reneged contracts, restrictions on profit remittance, discretionary policymaking and changes to policy, and expropriations (Dunning & Lundan, 2008; Henisz & Delios, 2001; Holburn & Zelner, 2010; John & Lawton, 2018). Thus, a key tenet of the PIA is that, all else held equal, a weakly constrained political structure tends to have a detrimental effect on firms' anticipated ability to conduct business in the host country, with implications for their strategic choices (Stevens et al., 2015), including the choice to locate – or not – in the host country.

However, some MNEs still choose to locate in risky political environments. For example, European MNEs have entered African and Latin American countries by leveraging the acceptance of local consumers created in the colonial era (Rangan & Drummond, 2004; Witte, Burger, & Pennings, 2020). Turkish construction MNEs expanded into Libya in the face of a changing political regime by gaining the endorsement of local tribes and communities (Darendeli & Hill, 2016). Some Chinese MNEs accelerated their investments in the Global South in view of intergovernmental deals and trade links (Duanmu, 2014; Shapiro et al., 2018). This growing trend of engagement highlights that MNEs' strategic responses to political risk in the host countries may not be uniform, but depends on the legitimacy of firms with important stakeholders in the host country such as the government and consumers (Cuervo-Cazurra, 2011). Legitimacy refers to "a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs and definitions" (Suchman, 1995: 574). The host country's judgement about the legitimacy of one firm can be extended to other

firms from the same home country, through legitimacy spillover (Stevens & Newenham-Kahindi, 2017). While the role of legitimacy in explaining MNEs' acceptance in foreign markets has been well understood, we suggest that it can also generate economic implications for firms' FDI location choice. A host country's judgement of the legitimacy of previous investments will influence the location choices of prospective investing firms from the same country of origin by shaping their evaluation of the host country's political risk.

Individuals and government in the host country may be receptive (or resistant) to FDI from certain home countries owing to positive (or negative) interactions in the past, and/or perceiving resources brought by FDI from certain home countries as helpful (or harmful) to local development (Cuervo-Cazurra, 2011). On the basis of this, they may therefore grant or withhold investing firms' "social license to operate" (Stevens et al., 2015). For prospective investing firms, such judgements of legitimacy may indicate a sense of welcomeness (or unwelcomeness) that can influence the firms' views about the likelihood of positive or negative actions of politicians in the host country, and may encourage or deter investment decisions. The reason why potential investors pay attention to the legitimacy of firms from the same country of origin is linked to the fact that local stakeholders may grant legitimacy based on the use of stereotypes (e.g., based on firms' country of origin) (Kostova & Zaheer, 1999), and legitimacy is linked to the potential liability of foreignness experienced by MNEs (Zaheer, 1995).

Drawing upon the PIA and LBV of political risk, we look at the varying effects of host countries' political risk on Chinese SMEs' FDI location choices, and argue that their evaluation of the likelihood of discretionary policy changes is subject to host countries' judgements of firms' legitimacy. Previous research has shown that legitimacy can exert substantial influence over firms' expansion in overseas markets (Bucheli & Salvaj, 2013; Sidani & Al Ariss, 2014). In this research, we look at two types of legitimacy. The first is firms' legitimacy with government authority that can determine their very existence (Bitektine, 2011); thus, we define *political legitimacy* as a host government's attitude towards firms from the same (home) country of origin. The second is *economic legitimacy*, conceptualized as the economic links between a firm's home country and host country, which indicates the level of the countries' complementarity in terms of market demands and resources. When prospective investing firms assess the risk of expropriation and adverse regulatory changes for their FDI in a host country, they also consider the political and economic legitimacy of other firms with the same country of origin. Such information tends to be propagated by investment agencies, think-tanks, and their home government to provide a snapshot of a host country's acceptance or resistance (Hu, Natarajan, & Delios, 2021; Luo, Xue, & Han, 2010), which can shape potential investors' inferences about the host country's institutional impartiality and their investment decisions. MNEs can then assess risk based on a range of information, and decide whether to invest or not in potentially risky locations, with legitimacy acting as a moderator in the relationship between political risk and location choice.

2.1. Chinese SMEs, political risk and location choice

Literature on EMNEs has often argued that firms operating under a political and regulatory deficiency in their home country are not deterred from politically risky host countries, as they possess the capabilities to navigate institutional environments similar to their home market (Cuervo-Cazurra & Genc, 2008; Guillén & García-Canal, 2009; Luo & Tung, 2018). However, this may not apply to all EMNEs, as firm capabilities, support from their home government to buffer political risk, and access to resources to shape home- and host-country policy

environments are more likely to accrue to large firms and/or SOEs than to SMEs (Child et al., 2022). In the case of Chinese MNEs, the development of economic statecraft has motivated the Chinese government to provide a protective shield to a selected range of outward-FDI projects that support national strategic priorities (Ramamurti & Hillemann, 2018), while other firms are left to venture in uncharted foreign markets by themselves (Liu, Xiao, & Huang, 2008). These factors help explain why the relationship between location choice and political risk for Chinese MNEs is positive in some studies, while negative or insignificant in others (Buckley et al., 2007; Buckley et al., 2016; Duanmu, 2012, 2014; Quer et al., 2012; Ramasamy, Yeung, & Laforet, 2012).

For Chinese SMEs, we suggest that a high level of political risk in a host country will negatively influence their FDI location choice for two reasons. First, domestic capital market imperfection and selective government intervention can substantially skew resource allocation towards large firms and SOEs in China (Buckley et al., 2007). The lack of a domestic market foothold and resource scarcity can make outward FDI critical to Chinese SMEs' survival, prompting them to seek an environment with less risk of political upheaval and discretionary policy change (Deng & Zhang, 2018). Second, compared to large firms, SMEs tend to be in a less powerful position vis-à-vis the host government to bargain for entry terms and treatment (Child et al., 2022), while the underdeveloped institutional environment in their home country may thwart information flow (Zhang, Ma, Wang, Li, & Huo, 2016), thus limiting SMEs' understanding of the use of commercial arbitration and political risk insurance should disputes arise with the host government. A lack of such knowledge may heighten emerging market SMEs' concerns about outright expropriation and adverse changes in investment terms *ex post*. A limited capacity to address political risk in the host country will prompt SMEs to enter countries with lower levels of political risk. Therefore, we expect political risk to negatively affect Chinese SMEs' location choice.

H1. *Political risk in a host country negatively affects Chinese SMEs' likelihood of investing in the host country.*

2.2. Moderating role of political legitimacy

Before entering a host country, Chinese SMEs' sensitivity to political risk may depend on other Chinese firms' legitimacy in the country, and the attitudes of local stakeholders towards Chinese firms. We propose that a host government's acceptance of previous Chinese MNEs' FDI projects may influence Chinese SMEs' anticipation of the threat posed by political risk.

The LBV suggests that firms face fewer political challenges when their attributes and activities are consistent with the government's long-term goals (Henisz & Zelner, 2005). MNEs may be confronted with concerns about political legitimacy for different reasons, for instance when their business deals are seen to pose a threat to a host country's national security (Stevens et al., 2015), or to entail unfair competition assisted by cheap finance from their home government (Li, Xia, & Lin, 2017), or if they have a record of tense industrial relations or unethical conduct (Han et al., 2018). A host government's previous approval or scrutiny of Chinese MNEs' investments can reflect the government's acceptance of, and attitude toward, Chinese firms. Abrupt and unfavorable policy changes are less likely to happen when firms are deemed legitimate (Stevens et al., 2015), in turn signaling to other firms from the same home country that their investments will be treated in a similar way, which thus influences their trust in the host government (Bilgili et al., 2023).

In a situation of high political risk, positive prior treatment of Chinese MNEs by a host government can foster trust, by raising their expectations of achieving legitimacy and mitigating SMEs' concerns about the threat of opportunistic behaviors by the host government. The expectation of fewer discretionary policy changes targeting legitimate firms implies that political risk can present these firms with business

opportunities, e.g., if political risk leads to fewer competitors in the market (Bilgili et al., 2023). Additionally, SMEs may feel less of an imperative to engage in political bargaining and shape the political environment, which is difficult for them to achieve (Child et al., 2022).

Accordingly, we contend that the political legitimacy of firms from the same home country acts as a moderator to shape SMEs' level of confidence in investing in a risky political environment. With a high level of political legitimacy, Chinese SMEs may consider political risk as less of a threat, and expect the host government to commit to providing predictable policy despite less political constraints (Slangen, 2013). SMEs may expect that they will be treated in a similar way to previous MNEs from the same country of origin, and adjust their responses to the host country's political risk. Therefore, we propose that Chinese MNEs' political legitimacy alleviates Chinese SMEs' concerns about political hazards in a host country. Our second hypothesis is thus:

H2. *The negative relationship between political risk and Chinese SMEs' likelihood of investing in a host country is positively moderated by Chinese MNEs' political legitimacy.*

2.3. Moderating role of economic legitimacy

Another type of legitimacy for foreign firms in a host country is economic legitimacy. We suggest that economic legitimacy acts as an indication of the level of the countries' complementarity in terms of market demands and resources. This is linked, on one hand, to the ability of foreign firms to sell products and services in the host market, and, on the other hand, to economic ties in terms of trade intensity between the home and host markets. As close economic ties imply a level of mutual trust and understanding (Rangan & Sengul, 2009), prospective investing firms may see it as signaling the host country's willingness to buttress a broader range of economic exchange activities (Bilgili et al., 2023). This can boost SMEs' outlook by supporting the inference that discretionary policy changes are less likely to happen to their investment in the host country.

We identify two mechanisms through which economic legitimacy moderates the relationship between political risk and SMEs' location choices. First, strong economic ties indicate positive attitudes from local stakeholders towards firms, products, and services from the partner trading country. Close economic ties point to existing trade exchanges between home and host country, which promote economic growth (Rangan & Sengul, 2009), and indicate a high degree of complementarity (Huang, Shen, & Zhang, 2020). This means the host government is less likely to engage in abrupt and unfavorable policy changes as such actions would incur opportunity costs (Bilgili et al., 2023).

Second, strong economic ties may indicate that products from a country of origin are accepted by consumers or other legitimating actors in the host market (Kostova & Zaheer, 1999), while frequent business transactions imply greater mutual familiarity with business practices and thus boost bilateral trust (Witte et al., 2020). Therefore, a congruence of economic interests means firms may expect greater legitimacy from local stakeholders, offering them a shield from opportunistic actions by the host government (Bilgili et al., 2023; Darendeli & Hill, 2016). For these reasons, we contend that strong (or weak) economic ties signal potentially greater (or lower) legitimacy conferred by local stakeholders on economic activities of firms from a specific country of origin.

In turn, economic ties between China and a host country will affect Chinese SMEs' location decisions by altering their sensitivity to political risk. One factor is economic connectivity and cooperation; through trade, countries align their economic interests, which increases trust and positive reciprocity between business partners (Huang et al., 2020). For potential investors, economic alignment can act as a positive signal and influence firms' assessment of political risk in the partner country. For SMEs with fewer resources to penetrate the local market, economic legitimacy indicates greater potential to succeed, even in a risky foreign

market. SMEs may also have fewer concerns about unfavorable policy changes. For these reasons, we hypothesize that Chinese firms' economic legitimacy will positively moderate the relationship between political risk and Chinese SMEs' location choice.

H3. *The negative relationship between political risk and Chinese SMEs' likelihood of investing in a host country is positively moderated by Chinese firms' economic legitimacy.*

3. Data and methods

To test our hypotheses, we developed an original database, using information from a variety of sources, and analysing 617 investment decisions in 57 countries made by 240 Chinese SMEs between 2006 and 2017. Details are presented below.

3.1. Data collection and sample description

Our data includes FDIs made by Chinese private SMEs listed on the Shenzhen and Shanghai stock exchanges. In building our database, we adopt the Chinese definition of SMEs, as the classification reflects local incentives and the treatment of firms by the Chinese government both domestically and abroad. The definition uses two criteria: number of employees, and annual income, with some variation depending on the industry (Deng & Zhang, 2018). The data on SMEs' location choices were collected from the China Stock Market and Accounting Research Database (CSMAR), which has also been used by prior studies for this purpose (Li, Meyer, Zhang, & Ding, 2018). Chinese listed firms are required to disclose overseas subsidiaries in their annual reports, on which the data from CSMAR are based. We collected the data manually by identifying the firms pursuing FDI in a given year. Specifically, we selected all listed firms meeting our defined criteria on number of employees and income each year. We then retained SMEs with subsidiaries abroad. Following Lu, Liu, Wright, and Filatotchev (2014), we define a subsidiary as any entity in which a firm has at least a 20% holding. We identified the year of a location choice as the earliest year in which a particular subsidiary was reported. If a subsidiary existed in year t and not in year $t-1$, we recorded this subsidiary as being established in year t , and the year of location choice as t . We adopt the approach used in prior studies to ensure accuracy by checking the annual reports of investing firms and tracking the exact year of establishment (Li et al., 2018; Lu et al., 2014).

We used data for location choice in year t and data for independent variables in $t-1$, matching the data of SMEs' location choices with data from the World Intellectual Property Organisation (n.d.) (WIPO), China Global Investment Tracker (American Enterprise Institute, n.d.) (CGIT), State Statistical Bureau of China (n.d.) (SSBC), and Quality of Government (Teorell et al., 2021) (QoG), with a one-year lag. The time-period for location choice is from 2006 to 2017, and that for independent variables is from 2005 to 2016. In the sample, the initial combined database comprised 78 countries (areas). Eighteen countries (areas)¹ were removed due to missing data at country level. As investments in some locations are predominantly driven by tax considerations, we further dropped Hong Kong, Macau and Singapore (Lu et al., 2014).

Overall, our database consists of a sample of 617 investments (location choice) (i.e., foreign investment, not export or portfolio investment), conducted by 240 SMEs in 57 countries between 2006 and 2017. In terms of size, about one-third of SMEs in the sample have fewer

than 500 employees, and just over half have 500–1000 employees.² Over 90% of SMEs are aged six years or older. Most of our sample firms have located in developed countries, but a wide range of host countries are represented in the data.

3.2. Variable measurements

3.2.1. Dependent variable

The dependent variable is a dichotomous variable that equals 1 if an SME invests in a particular country in a particular year, and otherwise is 0. As our sample SMEs invested in 57 countries between 2006 and 2017, we specify these as the 57 potential location choices, following the approach adopted in prior studies (Holburn & Zelner, 2010; Li et al., 2018). Therefore, for each firm investment year, there are 57 observations, each representing a potential location choice.

3.2.2. Independent variables

3.2.2.1. Political risk in the host country. Our main measure of political risk is the Political Constraint Index (POLCON), created by Henisz (2000) and used widely in other studies (Delios & Henisz, 2003; Henisz & Delios, 2001; Slangen, 2013). We collected the data from the QoG dataset (Teorell et al., 2021). The POLCON index is based on the number of independent branches with veto power over policy change (including the judiciary and sub-federal entities) and the extent of preference heterogeneity within a country's government branches (Henisz & Delios, 2001). It thus measures to what extent policymakers can unilaterally change policy in their favor. The score ranges between 0 and 1. The higher the score, the more difficult it is for policymakers to unilaterally change policy, and the lower the political risk. We reverse the variable so that the higher the score, the higher the political risk.

3.2.2.2. Political legitimacy. We use the ratio of the number of successful investments to the total number of investments as a proxy for previous Chinese firms' political legitimacy as signaled by the host government. The total number of investments is the sum of successful investments and troubled transactions blocked or scrutinized by host governments (Han, 2021). We collected data from 2005 to 2016 from the CGIT database, which tracks Chinese investments, construction contracts, and troubled transactions of over \$100 million. The endorsement (or disapproval) of the government authority acts as a signal for potential investors (Bitektine, 2011), and affects their business decisions and activities (Deephouse, 1996; Marquis & Qian, 2014). Therefore, this database has been used to construct measures of legitimacy (and illegitimacy) by prior studies (Han, 2021; Li et al., 2018). We exclude construction projects for the following reasons. First, contractual agreements for construction projects tend to be reached between the Chinese government and other developing host countries. This means that these projects are less relevant for a large portion of the sample consisting of advanced markets, and including them in the measure could lead to a lack of comparability across all host locations. Relatedly, their benefits of political legitimacy may be limited to national champion projects that aim to bolster China's influence with little regard for profit (Scissors, 2022). Knowing the differences between FDI and construction projects, the latter seem less relevant to shaping Chinese SMEs' expectations of their political legitimacy when contemplating FDI that involves considerations such as ownership and profitability in the host country. Second, given the complexity of international construction projects, firms from different countries may engage in joint bidding, and a project may be subcontracted to contractors in the host country and/or third countries (Chan, Tetteh, & Nani, 2022; Jaselskis & Talukhaba,

¹ American Samoa, Bahrain, Barbados, Belarus, Bangladesh, British Virgin Island, Cayman Islands, Iran, Kazakhstan, Marshall Islands, The Democratic Republic of the Congo, Federated State of Micronesia, Republic of the Congo, Samoa, San Marino, Seychelles, and Tanzania.

² Some Chinese SMEs can be identified as large firms by other definitions of SMEs (e.g., the US definition).

Table 1

Results estimated by unconditional logit model.

Variables	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6
Political risk		−1.8523 *** (0.2914)	−1.8663 *** (0.2911)	−4.7955 *** (1.1694)	−2.4454 *** (0.4198)	−4.8993 *** (1.1559)
Political legitimacy			0.3909 (0.2980)	−0.6717 (0.4791)		−0.6058 (0.4922)
Economic legitimacy			3.2672 ** (1.5021)		0.2587 (2.3058)	1.5952 (2.5129)
Political risk * Political legitimacy				3.5303 *** (1.3080)		3.2030 ** (1.3455)
Political risk * Economic legitimacy					12.3421 ** (6.2944)	7.1932 (7.9893)
Host-country experience	0.7434 *** (0.0703)	0.7273 *** (0.0685)	0.7233 *** (0.0681)	0.7241 *** (0.0681)	0.7245 *** (0.0681)	0.7219 *** (0.0678)
GDP per capita	0.2396 *** (0.0186)	0.2618 *** (0.0208)	0.2638 *** (0.0216)	0.2896 *** (0.0233)	0.2637 *** (0.0214)	0.2861 *** (0.0235)
GDP growth	−0.0108 (0.0183)	0.0132 (0.0168)	0.0092 (0.0171)	0.0185 (0.0161)	0.0094 (0.0172)	0.0148 (0.0166)
GDP	0.5962 *** (0.0678)	0.6499 *** (0.0683)	0.7592 *** (0.0838)	0.6687 *** (0.0688)	0.7663 *** (0.0833)	0.7791 *** (0.0828)
Total patent applications	0.1179 *** (0.0379)	0.0302 (0.0406)	−0.0268 (0.0463)	0.0172 (0.0410)	−0.0338 (0.0463)	−0.0416 (0.0461)
Firm size	−0.0179 (0.0528)	−0.0187 (0.0528)	−0.0185 (0.0528)	−0.0186 (0.0528)	−0.0186 (0.0528)	−0.0185 (0.0528)
Firm age	0.1541 (0.6042)	0.1535 (0.6052)	0.1522 (0.6055)	0.1535 (0.6056)	0.1531 (0.6058)	0.1529 (0.6059)
Constant	−22.0571 *** (2.4547)	−22.3623 *** (2.4518)	−25.2960 *** (2.7290)	−22.3714 *** (2.4793)	−24.9273 *** (2.7111)	−24.9078 *** (2.7169)
Observations	35,169	35,169	35,169	35,169	35,169	35,169
Year Fixed	Yes	Yes	Yes	Yes	Yes	Yes
Industry Fixed	Yes	Yes	Yes	Yes	Yes	Yes
Pseudo R-squared	0.204	0.212	0.213	0.213	0.213	0.214
LR chi square	1268	1315	1322	1325	1322	1330
Log Likelihood	−2472	−2449	−2445	−2444	−2445	−2441

Standard errors in parentheses

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

1998).

We then code the missing data for particular countries as 1. The logic is that SMEs should not anticipate legitimacy concerns if no previous Chinese investors have experienced barriers to investment.³ Therefore, the higher the ratio, the higher the expected political legitimacy of Chinese MNEs.

3.2.2.3. Economic legitimacy. Bilateral trade volume between home and host country was used to measure legitimacy in a prior study (Kang & Jiang, 2012). We use the ratio of bilateral trade to host-country GDP to represent economic legitimacy, to account for the relative economic importance of trade. The higher the ratio, the more likely it is that local stakeholders will interact with Chinese firms, or that the host government will view strong home-host economic ties as important for its economy (relative to the size of the economy). Therefore, Chinese SMEs will expect greater economic legitimacy in that country. The data come from the SSBC.

3.2.3. Control variables

We include a set of country-level variables, controlling for FDI motives (Dunning, 1998; Dunning & Lundan, 2008; Kang & Jiang, 2012). To control for market-seeking motivation, we use GDP (natural logarithm) to measure current market size, and GDP growth to measure potential future market size. To control for efficiency-seeking motivation, we use GDP per capita as a measure of labor costs. To control for strategic asset-seeking motivation, we use patent applications in the host country (Buckley et al., 2007). Data for GDP and GDP per capita

³ We have checked the robustness of our results to this assumption. We find that the results hold when dropping the observations for which data are missing.

originate from the World Bank and are collected from the QOG database (Teorell et al., 2021). Data on patent applications are collected from the WIPO database.

Firm-level controls include firms' age and size. Firm size is measured by number of employees. Although all our sample firms are SMEs according to Chinese classifications, their numbers of employees range from a few dozen to a thousand, depending on the Chinese definition for the sector in question. Additionally, we control for SMEs' host-country experience (Delios & Henisz, 2003; Holburn & Zelner, 2010; Li et al., 2018). Following measurements adopted in previous research (Delios & Henisz, 2003; Lu et al., 2014), we use prior entries by focal SMEs into a host country to measure their host-country experience. A table of measurements is attached in the Appendix (Table A.1).

4. Results

Logistic models have been used widely in previous location-choice studies, including the unconditional and conditional (fixed effects) logit models (Duanmu, 2012; Holburn & Zelner, 2010; Lu et al., 2014). A conditional logit model is disadvantageous when independent variables vary by alternative-specific attributes (host country) and case-specific attributes (firm) simultaneously (Holburn & Zelner, 2010). We apply the unconditional logit model because it gives flexibility to include variables varying by both country and firm. We include year and industry dummies. To mitigate potential reverse causality issues, and since investments may take some time for firms to plan after they obtain the relevant information, we use independent variables with a one-year lag.

Descriptive statistics and correlations are presented in the Appendix (Table A.2). Location choice is significantly correlated to most variables, except for political legitimacy, firm size, and firm age. Amongst the independent variables, the total patent applications variable is highly correlated with political risk, GDP growth, and GDP in host countries.

Therefore, we conducted variance inflation factor (VIF) tests to check for potential multicollinearity. All VIF values are below the recommended benchmark of 10 (Neter, Wasserman, & Kutner, 1985), suggesting no multicollinearity issue in our analysis.

4.1. Result for full sample

The estimated coefficients and standard errors of the logit model are presented in Table 1. Model 1 displays the results for control variables only. Model 2 presents the results of our baseline model for location choice that includes *Political risk* and control variables. *Political risk* is negatively and significantly related to SMEs' location choices ($p < 0.01$). Therefore, Hypothesis 1 is supported, suggesting that Chinese SMEs' location choices are deterred by political risk in a host country. Model 3 contains all the independent variables except for the interactive terms. It is notable that the coefficient of *Economic legitimacy* is positive and significant ($p < 0.05$), showing that SMEs tend to locate in countries where there is potential for achieving economic legitimacy.

Model 4 includes the variable of *Political legitimacy* and its interaction with *Political risk*. The interaction effect is positively and significantly related to Chinese SMEs' location choices ($p < 0.01$). This result implies that Chinese SMEs are less sensitive to political risk when there is high political legitimacy, supporting Hypothesis 2. Model 5 includes the variable of *Economic legitimacy* and the interaction of *Political risk* and *Economic legitimacy*. The interaction coefficient is positive and statistically significant ($p < 0.05$), suggesting that economic legitimacy mitigates the effect of political risk, supporting Hypothesis 3. Finally, Model 6 reports the results when including all the variables. *Political risk* generates a negative and significant effect ($p < 0.01$), which upholds Hypothesis 1. The moderating effect of *Political legitimacy* remains positive and statistically significant ($p < 0.05$), buttressing Hypothesis 2. The moderating effect of *Economic legitimacy* is positive but not significant in the full model.

In nonlinear models, the coefficient and p-value of the interaction variable may not stand for the magnitude and statistical significance of the conditional effect (Holburn & Zelner, 2010). We thus further interpret our interaction effects using the simulation-based approach used in prior studies (Holburn & Zelner, 2010; Lu et al., 2014). The graphs produced through this approach visually provide information on how the political risk effect differs for different values of *Political legitimacy* and *Economic legitimacy*. Confidence intervals are also included.

Fig. 1(a) presents the relationship between the probability of locating in a host country and *Political risk*, when *Political legitimacy* is at the level of 1 standard deviation (SD) above the mean (dashed line) and 1 SD below the mean (solid line). We construct 95% confidence intervals in this figure. According to Fig. 1(a), when *Political risk* is above around 0.22, the dashed line is above the solid line, implying that a higher level of *Political legitimacy* makes the effect of *Political risk* on the probability of locating in the host country less negative. For higher values of *Political risk*, the degree of overlap of the confidence intervals is low, providing additional evidence of the statistical significance of the results (Cumming, 2009). When *Political risk* is lower than 0.22, the dashed line is under the solid line, but we observe a large degree of overlap of the confidence intervals. Indeed, the graph provides further support to our theoretical arguments by suggesting that *Political legitimacy* does not have a significantly different effect when *Political risk* is low.

As an alternative way of assessing whether the conditional effect is significant, Fig. 1(b) plots the relationship between the difference in the probability of location and *Political risk*, when *Political legitimacy* changes from a low to a high level. As the figure shows, the 95% confidence interval does not include 0 when *Political risk* is higher than 0.4, suggesting that the positive moderating effect is significant. Therefore, Hypothesis 2 is supported.

Fig. 1(c) shows the relationship between the probability of locating in a host country and *Political risk*, when *Economic legitimacy* is at the level of 1 SD above the mean (dashed line) and 1 SD below the mean

(solid line). According to Fig. 1(c), the dashed line is above the solid line, implying that a higher level of *Economic legitimacy* mitigates the negative effect. There is less overlap of the confidence intervals for most values of *Political risk*, confirming the significant results suggested by the interaction coefficient. Fig. 1(d) presents the relationship between the difference in probability from *Political risk*, when *Economic legitimacy* changes from low to high. The 95% confidence interval does not include 0 for most values of *Political risk*, suggesting that the moderating effect is significant. Hence, Hypothesis 3 is sustained.

Among the control variables, all our models generate similar results. *Host-country experience* has a positive and significant coefficient ($p < 0.01$), suggesting that an SME's prior experience in a host country makes them more confident to invest again in that country. Firm-level variables including *Firm size* and *Firm age* do not significantly affect SMEs' location choices. The coefficient of *GDP per capita* is positive and significant. The effects of *Total patent applications* and *GDP growth* are not statistically significant, suggesting that strategic assets and potential market size do not explain Chinese SMEs' location choices. However, *GDP* is positively and significantly related to location choice ($p < 0.01$), suggesting that among typical motives for FDI, market-seeking motivations drive Chinese SMEs, consistent with the findings of Wu and Deng (2020).

4.2. Comparing smaller and larger SMEs

To provide finer-grained analysis about the impact of political risk on emerging market SMEs' location choices, we test our results for smaller and larger size SMEs. We identify SMEs with fewer than 500 employees (based on the US definition) as smaller SMEs, and the others as larger SMEs (Child et al., 2022). Table 2 presents results for larger SMEs, with the impact of *Political risk* on larger SMEs being negative and significant across all the models. However, the moderating effects of *Political legitimacy* and *Economic legitimacy* are insignificant. The results for smaller SMEs are reported in Table 3. Based on results across Models 2–6 in Table 3, *Political risk* generates significant and negative effects on smaller SMEs. The more negative coefficients than those for larger SMEs suggest that smaller SMEs are more sensitive to political risk when making location choices. More importantly, the moderating effects of *Political legitimacy* and *Economic legitimacy* remain positive and significant in separate and full models. These results suggest that smaller SMEs are more likely than larger SMEs to consider other Chinese firms' legitimacy when assessing their exposure to political risk through location choice.

4.3. Results for firms with and without host-country experience

We further test our results by splitting our sample into firms without and with host-country experience.⁵ The logic of this test is that firms without previous host-country experience may rely more on anticipated legitimacy from previous Chinese investments and trade when deciding on a location. Moreover, firms with experience may have built up firm-level legitimacy in the host country. In this smaller sample, we are unable to control for industry fixed effects due to multicollinearity, and omit these in both subsamples for consistency. For sample firms without host-country experience, the results are very similar to those in the full sample, except for the interaction of *Political risk* and *Economic legitimacy*. The interaction effect remains positive but insignificant, suggesting that economic legitimacy does not mitigate the influence of political risk on SMEs without host-country experience.

For SMEs with host-country experience, the interaction of *Political risk* and *Political legitimacy* does not have significant influence on the probability of location, while the interaction of *Political risk* and

⁵ Supplementary files with result tables for Sections 4.3 and 4.4 are available online.

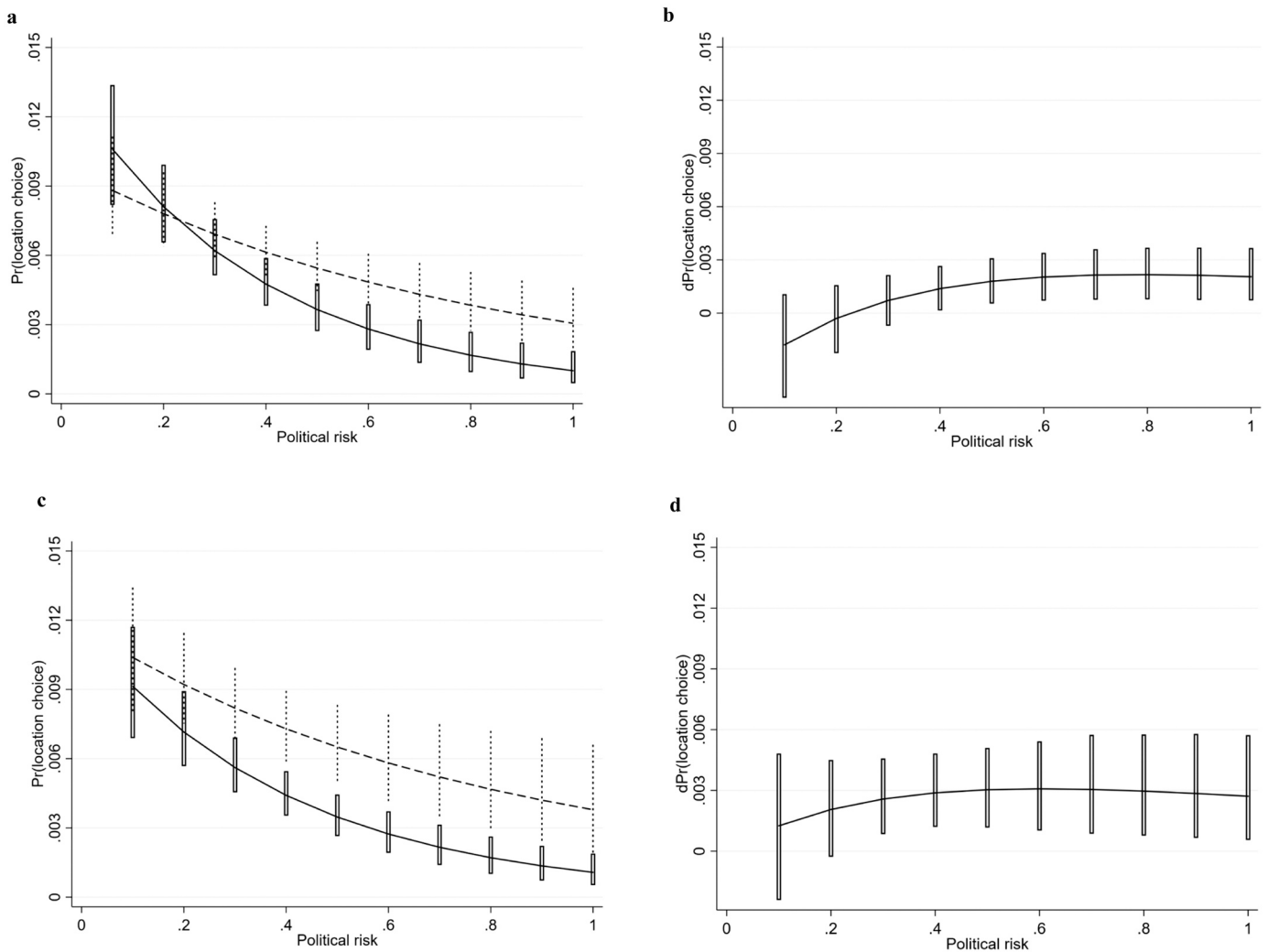


Fig. 1. Graph of interaction effects. Note: (a, b) show the moderating effect of *Political legitimacy*.⁴¹ (c, d) show the moderating effect of *Economic legitimacy*.

Economic legitimacy has a positive and significant effect. This implies that economic legitimacy mitigates the effect of political risk on SMEs with host-country experience.

4.4. Robustness tests

We conduct robustness tests to examine whether our results vary with measurement and sample. In the political risk literature, besides the POLCON index, the International Country Risk Guide (ICRG) and the World Governance Index (WGI) are widely used to measure political risk. First, we use the ICRG from the Political Risk Service group (PRS) as a measurement of political risk, and rerun Models 1–6 in Table 1. The measure contains components of corruption, law and order, and bureaucratic quality (Teorell et al., 2021). We obtain similar results to those in Table 1. *Political risk* remains negatively and significantly ($p < 0.01$) correlated to SMEs' location choices. The interaction of *Political risk* and *Political legitimacy* remains positively and significantly related to SMEs' location choices in separate ($p < 0.05$) and full ($p < 0.01$) models. For Model 5, there is a slight difference. The coefficient of the *Economic legitimacy* interaction variable is not significant. Therefore, only Hypotheses 1 and 2 are confirmed when using the ICRG measurement of political risk.

Second, we use the measurement of political risk by the WGI, which is based on a country's control of corruption, government effectiveness, political stability and absence of violence/terrorism, rule of law,

regulatory quality, and voice and accountability. The results are very similar to our original regression analysis in Section 4.1. The effect of *Political risk* remains negative and statistically significant ($p < 0.01$). The interaction of *Political risk* and *Political legitimacy*, and the interaction of *Political risk* and *Economic legitimacy* are positively and significantly related to SMEs' location choices ($p < 0.05$). In the full model, both interaction effects are positive and significant. Therefore, Hypotheses 1, 2, and 3 are supported when using the WGI measurement.

Third, in our sample, about one-third of outward FDI is located in the US, a low-risk country. To ensure that our results are not driven by this outlier, we drop investments in the US. The results show that *Political risk* still generates negative and significant effects across all the models, while moderating effects are no longer significant. As the results in Section 4.2 suggest that political and economic legitimacy are more important for smaller SMEs, we further test the results only for these firms, to check the robustness of the moderating effects. The results show that the interaction effect of *Political legitimacy* is positive and significant in separate and full models. The impact of *Economic legitimacy* is positive and significant in the separate model but insignificant in the full model. However, the p-value is 0.189. Therefore, even if we remove investment to the US, the effect of political risk holds, and the moderating effect for political legitimacy is robust for smaller SMEs, while the moderating effect for economic legitimacy still has a relatively low significance level.

Fourth, to account for the fact that SMEs that invest abroad are likely

Table 2
Results for larger SMEs.

Variables	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6
Political risk		−1.8705 *** (0.3681)	−1.8684 *** (0.3671)	−3.3695 ** (1.4520)	−1.8860 *** (0.6584)	−3.3416 ** (1.4715)
Political legitimacy			0.3862 (0.3521)	−0.1491 (0.5911)		−0.1867 (0.6048)
Economic legitimacy			0.6736 (1.8634)		0.6406 (3.4334)	1.4799 (3.4927)
Political risk * Political legitimacy				1.8180 (1.6593)		1.9450 (1.7202)
Political risk * Economic legitimacy					0.2668 (12.4160)	−3.0902 (12.6217)
Host-country experience	0.6023 *** (0.0821)	0.5833 *** (0.0806)	0.5811 *** (0.0804)	0.5814 *** (0.0804)	0.5828 *** (0.0805)	0.5807 *** (0.0804)
GDP per capita	0.2412 *** (0.0238)	0.2551 *** (0.0268)	0.2598 *** (0.0275)	0.2696 *** (0.0293)	0.2553 *** (0.0269)	0.2704 *** (0.0294)
GDP growth	−0.0171 (0.0233)	0.0084 (0.0218)	0.0090 (0.0219)	0.0124 (0.0213)	0.0069 (0.0223)	0.0107 (0.0217)
GDP	0.3626 *** (0.0825)	0.4108 *** (0.0839)	0.4357 *** (0.1079)	0.4175 *** (0.0844)	0.4367 *** (0.1085)	0.4441 *** (0.1082)
Total patent applications	0.2327 *** (0.0479)	0.1527 *** (0.0512)	0.1377 ** (0.0630)	0.1474 *** (0.0516)	0.1384 ** (0.0637)	0.1337 ** (0.0635)
Firm size	0.0066 (0.0861)	0.0045 (0.0862)	0.0044 (0.0861)	0.0044 (0.0862)	0.0046 (0.0862)	0.0045 (0.0861)
Firm age	0.6008 (1.8563)	0.5853 (1.8586)	0.5825 (1.8587)	0.5835 (1.8590)	0.5852 (1.8587)	0.5831 (1.8589)
Constant	−14.2718 * (7.9166)	−14.5384 * (7.9298)	−15.4817 * (8.0902)	−14.6542 * (7.9446)	−15.1299 * (8.0851)	−15.2801 * (8.0929)
Observations	23,085	23,085	23,085	23,085	23,085	23,085
Year Fixed	Yes	Yes	Yes	Yes	Yes	Yes
Industry Fixed	Yes	Yes	Yes	Yes	Yes	Yes
Pseudo R-squared	0.182	0.189	0.190	0.190	0.189	0.190
LR chi square	740.5	771.5	772.9	774.1	771.7	774.3
Log Likelihood	−1669	−1653	−1652	−1652	−1653	−1652

Standard errors in parentheses

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

Table 3
Results for smaller SMEs.

Variables	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6
Political risk		−1.9458 *** (0.5096)	−1.9218 *** (0.5088)	−7.9345 *** (1.9894)	−3.8761 *** (0.7742)	−7.7329 *** (1.9829)
Political legitimacy			0.4540 (0.5673)	−1.7787 ** (0.8441)		−1.3751 (0.8993)
Economic legitimacy			7.3656 *** (2.6024)		−1.9900 (3.8409)	0.9314 (4.4234)
Political risk * Political legitimacy				7.0546 *** (2.1616)		5.1950 ** (2.3500)
Political risk * Economic legitimacy					38.4831 *** (10.3379)	26.0350 * (14.5101)
Host-country experience	1.1461 *** (0.1531)	1.1388 *** (0.1509)	1.1338 *** (0.1504)	1.1320 *** (0.1503)	1.1339 *** (0.1496)	1.1298 *** (0.1493)
GDP per capita	0.2377 *** (0.0304)	0.2725 *** (0.0343)	0.2697 *** (0.0360)	0.3377 *** (0.0402)	0.2864 *** (0.0370)	0.3212 *** (0.0410)
GDP growth	−0.0143 (0.0310)	0.0100 (0.0283)	0.0044 (0.0295)	0.0213 (0.0259)	0.0122 (0.0286)	0.0210 (0.0272)
GDP	1.0454 *** (0.1160)	1.0808 *** (0.1121)	1.2701 *** (0.1268)	1.1325 *** (0.1106)	1.3023 *** (0.1252)	1.3114 *** (0.1230)
Total patent applications	−0.0851 (0.0588)	−0.1735 *** (0.0617)	−0.2542 *** (0.0622)	−0.2082 *** (0.0608)	−0.2874 *** (0.0624)	−0.2947 *** (0.0619)
Firm size	0.2339 (0.4470)	0.2146 (0.4471)	0.2158 (0.4488)	0.2095 (0.4488)	0.2065 (0.4503)	0.2074 (0.4510)
Firm age	0.1680 (0.3971)	0.1616 (0.3978)	0.1622 (0.3989)	0.1601 (0.3991)	0.1585 (0.4000)	0.1593 (0.4003)
Constant	−33.4993 *** (3.3295)	−33.2937 *** (3.2325)	−38.4586 *** (3.6550)	−33.4602 *** (3.2624)	−38.2192 *** (3.5753)	−37.6963 *** (3.5680)
Observations	12,084	12,084	12,084	12,084	12,084	12,084
Year Fixed	Yes	Yes	Yes	Yes	Yes	Yes
Industry Fixed	Yes	Yes	Yes	Yes	Yes	Yes
Pseudo R-squared	0.267	0.275	0.279	0.281	0.282	0.285
LR chi square	569.9	586.5	594.9	598.9	602.7	608.6
Log Likelihood	−782.3	−774	−769.8	−767.8	−765.9	−763

Standard errors in parentheses

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

to represent a selected sample based on factors such as their capabilities, we estimate Heckman selection models. We randomly select a control sample of SMEs that did not conduct FDI using the same SME criteria as in Section 3.1. In the first stage, we use probit regression to estimate the probability of making outward FDI, and generate the Inverse Mills Ratio (IMR) based on firms' characteristics. The IMR is then included in the second stage to estimate our models to control for sample selection bias. Since the Heckman test is based on a normal distribution, we also use a probit model in the second stage. The statistical insignificance of the IMR suggests that our results are not affected by sample selection bias. Implementing the full Heckman procedure using the *heckprob* command in Stata produces virtually identical results.

Finally, we run a conditional logit model, as in the work of Holburn and Zelman (2010), and Duanmu (2012). The results are again close to those of our original regression analysis. In addition, the results for smaller SMEs are even more robust. Therefore, our Hypotheses 1, 2, and 3 remain supported across the robustness tests.

5. Discussion

While recent decades have witnessed a surge of outward FDI conducted by EMNEs, the rapidly changing international political environment exposes their expansion to an increasingly complex array of political risks. In addition to conventional political hazards in host countries, rising geopolitical tensions between major powers (e.g., US–China) for economic and technological dominance has subjected these firms to growing sociopolitical backlash. The ongoing geopolitical contest has triggered a series of political challenges in the form of sanctions, nationalist sentiment, and rising populism with its clear demarcation between “us,” or “insiders,” versus “them,” or “outsiders” (Devinney & Hartwell, 2020; Meyer, Fang, Panibratov, Peng, & Gaur, 2023; Blake, Markus, & Martinez-Suarez, 2022). These aspects suggest an important departure from the traditional IB assumptions about global economic integration and interdependence, and point to a new reality of growing international political conflict for firms contemplating expansion abroad (Panibratov et al., 2023). All these factors may substantially shape cross-border investment activities, highlighting the need to examine the role of political risk in EMNEs' foreign market selection. Moreover, different types of emerging market firms may be affected differently. In this paper, we have addressed the questions: (1) Does political risk affect Chinese SMEs' location choices? (2) Does legitimacy of firms from the same country of origin moderate the relationship between a host country's political risk and Chinese SMEs' location choices? Drawing on the PIA and LBV of political risk (Stevens et al., 2015), we hypothesized that host countries' political risk negatively influences Chinese SMEs' location choices, but that this negative relationship is mitigated by political legitimacy and economic legitimacy. Using an original dataset on 240 Chinese private SMEs, we found support for our hypotheses.

Our findings contribute to the political risk literature in IB in the following ways. First, we consider the influence of political risk on foreign entry decisions of emerging market SMEs, a subject which has received little attention within the EMNE literature and the literature on SMEs' internationalization (Child et al., 2022). Our results indicate that, in contrast to some previous findings for large emerging market MNEs and SOEs, Chinese SMEs' location choices show an aversion to political risk in host countries. Against a background of inconclusive findings regarding responses to political risk (e.g. Duanmu, 2012; Quer et al., 2012, 2018), our results provide empirical evidence of a negative relationship for SMEs. Furthermore, by differentiating between smaller and larger SMEs, we show that smaller firms are more sensitive to the impact of host-country political risk when making decisions about FDI location.

By doing so, we provide a more nuanced account of the heterogeneity of SMEs. This informs existing debate on EMNEs' evaluation of political risk, and illustrates the need to consider EMNEs' heterogeneity when investigating their expansion in hazardous political environments (Gammeltoft & Panibratov, 2021).

Second, we contribute to research applying the LBV of political risk by looking at the extent to which legitimacy as a social judgement rationalizes firms' strategic response of FDI location choice. Scholarly literature has taken a state-centric view to examining the sociopolitical implications of legitimacy by discussing (1) host countries' concerns about firms from particular home countries or industries; (2) the ways that stakeholders in host countries form, use, and diffuse judgements about legitimacy; and (3) strategies taken by firms to gain legitimacy in the eyes of stakeholders in host countries, or alleviate their concerns (see Suddaby, Bitektine, & Haack, 2017 for review). We extend the analysis to understand how the legitimacy of firms from the same country of origin in a host country influences the relationship between political risks and the FDI location choices of prospective investing firms. We focus on firms' strategic decision-making, and suggest that a host country's judgement about the legitimacy of previous investments may be viewed as a friendly (or unfriendly) signal of fostering (or damaging) mutual acceptance, which may attenuate (or aggravate) the concerns of prospective investing firms from the same home country about opportunistic behaviors by host governments. As firms and state may follow different logics about how FDI should be governed (Newenham-Kahindi & Stevens, 2018), these differences in perspective influence the legitimation dynamics and how they are examined or overlooked (Suchman, 1995). We highlight the strategic responses of potential investors to the legitimacy of firms from the same country of origin in a host country, and show how they shape the relationship between political risks and firms' location choices. Therefore, we add novel insight to the extant literature by showing the relevance of legitimacy effects in an environment where the responses of the host country and firms both matter.

In addition, we contribute to the political risk literature by demonstrating that different types of legitimacy represent a boundary condition for the relationship between a host country's political risk and firms' location choices. Combining the PIA and LBV of political risk helps to provide a holistic understanding of why some SMEs enter risky political environments. As firms and their home countries are embedded in the wider international political and economic context, this suggests the economic decisions about cross-border investment may co-evolve with sociopolitical influences. We demonstrate that the experience of previous firms' investments and business activities act as signals for the political and economic legitimacy of firms from the same country of origin, thus influencing SMEs' confidence in the political institutions of host countries, and their location choices. Our results also show that political legitimacy and economic legitimacy exert greater influence over smaller SMEs' strategic decisions. We argue that this is because smaller firms face a particular scarcity of resources, and exercise caution when assessing the extent to which their activities may be affected by political risks in host countries. Thus, the legitimacy of firms from the same country of origin is more important to assess for firms that suffer to a greater extent from resource constraints. Unlike large firms and SOEs that are deemed part of state economic diplomacy with other countries (Duanmu, 2014; Shi et al., 2016), SME decisions about FDI locations may be influenced by the rapidly changing geopolitical environment via the signal effect of the legitimacy of firms from their home country.

The drastically changing international political environment over the last decade has catalyzed the discussion about legitimacy, especially political legitimacy, in IB scholarship (Slangen, 2013). We contribute to this line of research by looking at how SMEs' location choices are influenced by host-country stakeholders' legitimacy judgements. It should be noted that firms' possession or lack of political legitimacy may be due to a multitude of factors. For instance, the deteriorating relations between major powers (e.g., the US and allies vs China), characterized by distrust, competing economic interests, and ideological contest may

⁴ As the value of 1 SD above the mean exceeds the maximum total level of 1, we take the value of 1 as the high level of *Political legitimacy*.

prompt tougher restrictions and the resurgence of populism against cross-border business activities (Meyer et al., 2023). These can have important implications for firms' political legitimacy. Given the variety and diversity of political legitimacy, we provide a detailed discussion below (Section 5.2) about how future research endeavors may advance this topical area in IB research.

IB literature has long demonstrated that host-country experience matters for MNEs, as the liability of foreignness is expected to decrease over time due to accumulated knowledge about the economic and political environment in a host country (Delios & Henisz, 2003; Lu et al., 2014). Our results extend this argument by demonstrating that the moderating effects of political legitimacy and economic legitimacy on the relationship between political risk and location choice differ depending on whether SMEs possess host-country experience or not. In doing so, we contribute to the LBV of political risk, which identifies the relevance of different types of legitimacy but does not consider the role of firms' heterogeneity in their risk assessments and strategic actions (Stevens et al., 2015). One explanation for our result is that political legitimacy alleviates concerns about strict scrutiny in the entry period, and thus matters more for SMEs new to the location. In contrast, SMEs with host-country experience can evaluate the host government's attitude more accurately (Kostova & Zaheer, 1999) and pay greater attention to economic legitimacy than political legitimacy when making a location choice.

5.1. Implications

This study offers implications for practitioners and policymakers. We suggest that SMEs should be clear about how political risk might threaten their foreign investments. SME managers need to consider the experience and actions of prior peers and the host government's attitude towards investors from the same country of origin when assessing political risk in foreign countries. For policymakers, host governments should be aware that political risk discourages foreign investments, but not in a uniform way. The experience of investors from the same country of origin, and host-home economic relations influence strategic decisions and the assessment of risk by potential investors. Economic ties are important if governments want to attract investors from specific home countries, and so are their current relationships with established investors from these countries.

5.2. Limitations and future research directions

Our study has some limitations, which present opportunities for future research. First, the sample firms we used are private SMEs listed on the Shenzhen and Shanghai stock exchanges. Although they meet the criteria of the Chinese definition of SMEs, it has been suggested that Chinese listed firms are usually bigger firms that do not suffer equally from resource shortages (Wu & Deng, 2020). Therefore, future research could generalize our findings and look at smaller non-listed SMEs, for which we would expect the results to be even clearer based on our arguments. Moreover, although we have been able to compare relatively larger and smaller SMEs, an explicit comparison with large and more resourceful firms which have ties with the home government would be valuable in future research. Additionally, it is important to investigate whether our findings apply to SMEs from other emerging markets.

Second, we used the ratio of the number of successful transactions to the total number of investments to represent the political legitimacy of Chinese MNEs with host governments, which can generate an encouraging (or deterring) effect on Chinese SMEs' location choices. Future research may systematically conceptualize political legitimacy for a better understanding about its influence on firms' strategic decisions around foreign entry and expansion. For example, transactions may be

unsuccessful and blocked by host governments for different reasons. The consideration of national security, public sentiment, and gaining voting support from key stakeholders can complicate the issue of political legitimacy. As state governments can prioritize political interests over commercial objectives (Jacobson, Lenway, & Ring, 1993; Meyer et al., 2023), a promising avenue for future research is to analyze how legitimacy concerns arising from a variety of sources – such as competing political ideologies and populism – may independently or jointly influence cross-border investment activities, at the extreme through imposition of sanctions (Devinney & Hartwell, 2020; Jacobson et al., 1993; Meyer et al., 2023; Panibratov et al., 2023). Populism can lead both to weakening of institutions, less political constraints, and institutional volatility, and to lower legitimacy for firms perceived as outsiders, notably foreign firms (Blake et al., 2022). Future research may also utilize textual analysis and examine the rhetoric used in government press reports to understand firms' political legitimacy. Moreover, research may look into MNEs that have already operated in the host country and the frequency at which they experience intervention from the host government.

Finally, while trade links may indicate acceptance by consumers and other stakeholders in host countries of Chinese products, an overlap between political legitimacy and economic legitimacy may exist as close economic ties could be forged by trade agreements between the Chinese and host governments. While our paper uses distinct measures for both concepts, we acknowledge they are not fully separable, and that the political and economic aspects of legitimacy may influence each other reciprocally. Therefore, future research may consider introducing additional measurements to better distinguish these concepts and explore different facets of economic legitimacy in shaping firms' views about the likelihood of discretionary policy change against their investment.

6. Conclusion

The relationship between political risk and MNEs' location choices is a key topic in IB, with some recent studies considering EMNEs. However, the extant literature has paid less attention to the effect of political risk on emerging market SMEs' location choices. In this study, we explore the relationship between political risk and Chinese SMEs' location choices and the boundary conditions of political legitimacy and economic legitimacy. Our findings suggest that the impact of political risk in host countries on Chinese SMEs' FDI location choices may vary depending on the legitimacy of firms from the same country of origin.

Declarations of Competing Interest

None.

Data Availability

The study is based on a proprietary data set.

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Appendix A

Table A.1
Measurement of variables.

Variables	Measurement	Data source (s)
Dependent variable		
Location choice	The choice of country = 1, 0 otherwise	CSMAR
Independent variable		
Political risk	Political constraints index	QOG
Moderators		
Political legitimacy	Ratio of successful transactions to total transactions	CGIT
Economic legitimacy	Ratio of bilateral trade to host-country GDP	SSBC
Control variables		
GDP	GDP (World Development Indicators (WDI))	QOG
GDP growth	GDP growth (WDI)	QOG
Total patent applications	Host-country patent applications	WIPO
GDP per capita	GDP per capita (WDI)	QOG
Firm age	Age from year established to year of location choice	CSMAR
Firm size	Number of employees	CSMAR
Host-country experience	Prior entries by focal SMEs into host country	CSMAR

Table A.2
Descriptive statistics and correlation matrix.

	Mean	Standard deviation	1	2	3	4	5	6	7	8	9	10	11
1 Location choice	0.02	0.13	1.00										
2 Political risk	0.40	0.26	-0.08 ***	1.00									
3 Political legitimacy	0.83	0.24	0.00	-0.00	1.00								
4 Economic legitimacy	0.05	0.05	-0.02 ***	-0.09 ***	0.02 ***	1.00							
5 GDP per capita	3.04	2.36	0.08 ***	-0.09 ***	-0.08 ***	-0.10 ***	1.00						
6 GDP growth	3.41	3.39	-0.04 ***	0.23 ***	-0.05 ***	0.19 ***	-0.15 ***	1.00					
7 GDP	26.56	1.76	0.15 ***	-0.30 ***	-0.11 ***	-0.28 ***	0.15 ***	-0.21 ***	1.00				
8 Total patent applications	6.88	3.22	0.14 ***	-0.43 ***	-0.09 ***	-0.07 ***	0.13 ***	-0.30 ***	0.86 ***	1.00			
9 Host-country experience	0.02	0.27	0.19 ***	-0.06 ***	0.00	-0.02 ***	0.05 ***	-0.03 ***	0.10 ***	0.09 ***	1.00		
10 Firm size	6.56	3.77	0.00	0.00	0.00	-0.02 **	-0.00	-0.00	-0.00	-0.00	0.01 *	1.00	
11 Firm age	13.45	6.30	0.00	-0.00	-0.01	-0.01 *	0.02 ***	-0.04 ***	0.03 ***	0.03 ***	-0.00	-0.13 ***	1.00

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

The unit of GDP per capita is 10,000 international dollars, and the unit of number of employees is 100 people.

Appendix B. Supporting information

Supplementary data associated with this article can be found in the online version at [doi:10.1016/j.ibusrev.2023.102199](https://doi.org/10.1016/j.ibusrev.2023.102199).

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