

# Study on the Impact and Mechanism of the Quality of Host Country Institutions on China's OFDI

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**Abstract:** In recent years, the scale of China's Outward foreign direct investment (OFDI) has grown rapidly, but with the increasingly complex and changeable international environment, China's OFDI is facing great pressure. Taking 159 countries as samples, this paper selects 10 secondary indicators from the three dimensions of politics, economy, and law to construct the evaluation system of host country institutional quality, and measures the host country institutional quality from 2011 to 2021, studies the influence of host country institutional quality on China's OFDI and the intermediary mechanism, and conducts heterogeneity test. The conclusion shows that the improvement of host country's institutional quality significantly promotes the inflow of China's OFDI, and at the same time, the improvement of host country's institutional quality can improve the country's scientific and technological innovation ability and infrastructure construction level, and ultimately promote the increase of China's OFDI. This promoting effect is more obvious in low-middle-income countries and countries that have signed the Belt and Road agreements. Finally, suggestions are put forward based on the conclusions.

**Keywords:** Institutional quality of host country, Foreign direct investment, Mechanism research.

## 1. Introduction and Literature Review

After entering the 21st century, the Chinese government attached great importance to outward foreign direct investment (OFDI). Guided by the "going out" strategy, Chinese enterprises achieved rapid growth in the scale of China's OFDI. In 2021, the flow of China's OFDI was 62.7 times that of 2003, and the stock was 83.9 times that of the end of 2003. The report of the 20th NCCPC pointed out that the world is undergoing unprecedented changes, unilateralism and protectionism are gradually emerging, the international environment is becoming increasingly complex and volatile, and the world is entering a new period of turbulence and transformation. China's OFDI is also facing tremendous development pressure, and the pace of enterprises "going out" is gradually slowing down. The World Investment Report 2022 pointed out that in 2021, global cross-border investment faced tremendous downward pressure. Developed and developing countries showed significant differences in attracting FDI, and the imbalance between the north and the south was further exacerbated. Against the backdrop of the overall contraction of FDI, the growth rate of China's OFDI fell back, further increasing the uncertainty of the future development of China's OFDI.

As China's OFDI involves increasingly diversified industries and gradually diversified investment locations, the host countries have different situations in administrative efficiency, economic system, and the level of the rule of law. Therefore, enterprises are facing a more complex international investment environment. According to the theory of institutional change, institutions cover political, economic, social, and legal dimensions and have a significant impact on various aspects of economic growth. Based on this, this paper takes the institutional quality of the host country as a starting point to explore its impact and impact mechanism on China's OFDI.

At present, there are mainly three viewpoints in relevant

researches, which believe that the institutional quality of host country has a positive impact on OFDI, a negative impact on it and no significant impact on it.

Most scholars have found that the sound institutional system of host countries provides many conveniences for investment countries, which can promote the direct investment of home countries. Some studies have found that the level and efficiency of OFDI are highly affected by the quality of the host country's system, and there is a positive correlation between the two. Transnational enterprises are more inclined to invest in countries with high governance level and complete system [1,2] (Kaufmann et al., 1999; Wei, 2000). When the host country has a more solid and stable governance foundation, it can create a good investment environment and effectively attract capital [3] (Globerman and Shapiro, 2002). After distinguishing three different dimensions of institutional quality, it can be seen that in the formal system, the political and economic system of the host country has a more significant positive attraction effect on OFDI, while in other conditions, the legal system has a more significant positive impact on the quality of OFDI [4,5] (Qi and Zou, 2013; Liu and Deng, 2014). Further analysis of relevant sub-indicators shows that government efficiency, rule of law level, stability and corruption control all have significant positive effects on China's OFDI [6,7] (Buckley et al., 2007; Azmat, 2007), the investment stock increased rapidly among countries with good corruption control [8] (Adiya and Alexander, 2019).

Another group of scholars found that host countries with higher institutional quality were less likely to attract direct investment from transnational corporations. The good institutional environment of the host country not only does not attract capital inflow, but even inhibits China's capital inflow [9] (Li and Yu, 2011), and the three sub-indicators of legal level, corruption control and stability all have an inhibitory effect on China's OFDI [10] (Li and Li, 2017). From the perspective of further distinguishing the sub-dimensions of institutional quality, the political stability of the

host country has a significantly positive effect on promoting OFDI, but corruption control, rule of law and government work efficiency will all reduce the driving effect on Chinese investment [11] (Wang, 2023).

In addition, a small number of scholars believe that the institutional quality of the host country is not significantly correlated with OFDI of the home country. Through empirical test, it can be found that better institutional quality in host country has no significant promoting effect on OFDI inflow in China [12,13] (Yang et al., 2016; Cheung et al., 2009). Host country system has different impacts on China's OFDI in different industries, and there is no significant impact on investment manufacturing [14] (Amighini et al., 2011).

Most literatures focus on the direction and significance of the influence of the institutional quality of the host country on OFDI, and there are few researches on the influence mechanism. Therefore, the main purpose of this paper is to explore the mechanism of the influence of the institutional quality of host country on China's OFDI. Firstly, the evaluation system of institutional quality index of host country is constructed to comprehensively evaluate the institutional quality of various countries and empirically test the impact of institutional quality of host country on China's OFDI. Then, the intermediary effect model is added to the empirical study to explore the mechanism of the influence of host country's institutional quality on China's OFDI. Finally, it provides a reference for promoting the sustainable development of China's OFDI.

## 2. Theoretical Analysis and Research Hypotheses

The eclectic theory of international production and the theory of institutional change both explain the important role of institutional factors in economic activities. As a series of rules and regulations to maintain and consolidate the complex relations of various societies, the system has the characteristics of standardization and predictability. The higher the quality of institutions, it means that the host country has a more sound and perfect legal system, more transparent and open market rules, more stable social order, etc. On the one hand, it can regulate people's behavior, prevent chaos and malicious activities that harm the interests of others, and enhance the trust between people. On the other hand, by stipulating in advance, all kinds of unforeseeable behaviors and opportunistic behaviors are prohibited or restricted, so that the production process and trading activities are more orderly. Good institutional quality will provide a favorable environment for foreign capital to make direct investment in the country, reduce the risk of transnational corporations investing in the host country, reduce transaction costs, improve the efficiency of factor allocation, facilitate their integration into the local market, and promote the direct investment of the home country to the host country. At the same time, if the quality of the system is poor, it may mean that the host country is in social unrest, lack of open and transparent market, and the legitimate rights and interests of transnational corporations cannot be guaranteed. Therefore, the uncertainty in the transaction process will increase greatly, and the transaction cost will rise accordingly, and the OFDI activities of transnational corporations will not be sustainable. Based on this, hypothesis 1 is put forward: the improvement of the host country's institutional quality will promote the development of China's OFDI.

On the one hand, host countries with better institutional quality have a sound legal system and more detailed requirements for the full disclosure of relevant information, which can reduce the adverse impact of information asymmetry. On the other hand, it also have more transparent market rules, which can optimize the efficiency of resource allocation, speed up the flow of capital, and give full play to the advantages of market competition mechanism. Starting from the transaction cost theory, it can be found that the host countries with high institutional quality have more developed product and factor markets, more active and free market economic environment and less government intervention, and usually have a strong awareness of property rights protection and higher administrative efficiency, which can give full play to the role of the market and optimize the allocation of innovation resources. Relying on the real and sensitive price signals released by the factors themselves and the effective transmission of new product information to reflect the relationship between supply and demand in a timely manner, at the same time, the illegal cost is high, and the opportunity to obtain excess returns by relying on "free riding" is few, so as to guide enterprises to absorb high-tech talents for scientific and technological research and development, improve innovation performance and enhance innovation ability. The motivation of OFDI includes seeking strategic assets, aiming to obtain the strategic assets of the host country including advanced technology. It can be seen that enterprises prefer the host country with high level of scientific and technological innovation when making direct investment. Therefore, the host country has strong scientific and technological innovation ability to attract more OFDI of China. Based on this, hypothesis 2 is put forward: The improvement of the institutional quality of the host country can promote China's OFDI development of the country by improving its scientific and technological innovation capability.

The infrastructure level of the host country is closely related to the institutional quality of the host country. The host country with higher institutional quality can provide a fair and open market, an efficient and clean government and a complete legal system, which can provide a good external environment for infrastructure construction, thus reducing transaction costs, making full use of various resources, and improving the input and output rate. Host countries with poor institutional quality will set up more barriers on infrastructure construction projects and interfere with the operation of market economy through complicated approval procedures, resulting in infrastructure construction enterprises having difficulty in making profits through normal market behaviors, so they will turn to obtaining qualification and approval through fraud, etc. No matter the host country's domestic enterprises or multinational companies face such unfavorable environment, in order to make profits, They have to use part of their resources for fraud, which increases the transaction costs and risk defense costs of foreign-funded enterprises in disguise, such as the cost of entering the host country market and the cost in the execution of investment contracts. A good infrastructure can greatly facilitate the entry and subsequent operation of foreign capital. Perfect infrastructure reduces the possibility of losses and additional costs caused by conditions such as transportation difficulties, information asymmetry and insufficient energy supply in the investment process of transnational corporations. It enables transnational corporations to control and adjust the operation process of

investment projects in a timely manner, which is conducive to improving profitability and maximizing profits. If the lack of perfect infrastructure to ensure the orderly production and life of transnational corporations, it will disrupt the connectivity of the market, it is difficult for transnational corporations to obtain good economic benefits, resulting in the obstruction of foreign investment inflow. Based on this, hypothesis 3 is put forward: The improvement of system quality in host country can promote the development of China's OFDI in that country by improving the level of domestic infrastructure construction.

### 3. Study Design

#### 3.1. Model construction

Firstly, in order to test the impact of the host country's institutional quality on China's OFDI, a benchmark regression model is established, as shown in equation (1) :

$$\text{Lnofdi}_{i,t} = \alpha_0 + \beta_0 \text{Insq}_{i,t} + \gamma_0 X_{i,t} + \mu_t + \delta_i + \varepsilon_{i,t} \quad (1)$$

In equation(1), Lnofdi represents China's OFDI stock scale, Insq represents the institutional quality level of country, X represents the set of all control variables,  $\mu_t$  is the time effect,  $\delta_i$  is the country individual effect, and  $\varepsilon$  is the random disturbance term.

Secondly, in order to further explore the mechanism by which the institutional quality of the host country affects China's OFDI, this paper constructs the following intermediary effect model on the basis of the benchmark regression model, as shown in equation (2) and (3) :

$$\text{Inter}_{i,t} = \alpha_1 + \beta_1 \text{Insq}_{i,t} + \gamma_1 X_{i,t} + \mu_t + \delta_i + \varepsilon_{i,t} \quad (2)$$

$$\text{Lnofdi}_{i,t} = \alpha_2 + \beta_2 \text{Insq}_{i,t} + \pi \text{Inter}_{i,t} + \gamma_2 X_{i,t} + \mu_t + \delta_i + \varepsilon_{i,t} \quad (3)$$

### 3.2. Variable descriptions and Data sources

#### 3.2.1. Explained variable

In this paper, panel data of China's OFDI composed of 159 countries or regions in the world (excluding tax havens such as Cayman Islands and countries with poor data quality) from 2011 to 2021 are used to analyze the data, which comes from the Statistical Bulletin of China's OFDI released annually by the Ministry of Commerce of China. Since the flow data is prone to large fluctuations due to short-term uncertainties, China's OFDI stock to host countries is used as the proxy variable of explained variable (Lnofdi), which is added to the model after logarithm.

#### 3.2.2. Explanatory variables

Host country Institutional Quality (Insq). In this paper, 10 sub-indicators from three dimensions of political system, economic system and legal system are selected to establish an INSQ evaluation system. The specific indicators are shown in Table 1. The principal component analysis method is used to extract three principal components and calculate the institutional quality index of the host country. The data are derived from the World Governance Index (WGI) released by the World Bank, the Index of World Economic Freedom (IEF) released by the Wall Street Journal and the Heritage Foundation, and the Global Corruption Perceptions Index established by the NGO Transparency International.

Table 1. System of Quality of Host Country Institution

Target layer	Dimension layer	Indicator layer
Host country Institutional quality	Political system	Political stability and absence of violence/terrorism in WGI
		Government efficiency in WGI
		Quality of regulation in WGI
	Legal system	Rule of law in WGI
		Property rights protection in IEF
		the Global Corruption Perceptions Index
Economic system	Trade freedom in IEF	
	Financial freedom in IEF	
	Investment freedom in IEF	
	Business freedom in IEF	

#### 3.2.3. Intermediary variables

Host country infrastructure construction level (Infr). The data comes from the Global Competitiveness Report and the Global Quality Infrastructure Index released by the World Economic Forum, and the score range is adjusted to 1 to 100 points.

Host country's science and technology innovation capacity (Lnsta). In this paper, the number of scientific and technological journal articles published in the host country each year is used to represent the technological innovation capability of the host country. The data comes from the World Development Indicator Database (WDI) released by the World Bank and is added to the model after logarithm.

#### 3.2.4. Control variables

Bilateral political relationship (Grea). In this paper, the ideal point estimation result of the UN General Assembly vote is used for difference and the absolute value is taken,

indicating the closeness of the bilateral political relationship between the host country and China. The data is from the UN General Assembly vote database.

Bilateral Investment Treaty (Bit). By searching the information disclosure on the website of the Department of Treaty and Law of the Ministry of Commerce of China, the year when the host country signed a BIT with China and the subsequent years when the BIT came into force was recorded as 1, and other cases were recorded as 0.

Geographical distance (Dis). In this paper, the geographical distance between Beijing and the capital of the host country is used to represent the geographical distance between the two countries, and the data are from the CEPII database.

Cultural Distance (Conl). If more than 5% of the population of the host country speaks Chinese (including Mandarin, Cantonese, etc.), it is recorded as 1, and in other cases, it is recorded as 0. The data is from the CEPII database.

The economic development level (Gdpp) of the host country. In this paper, per capita GDP of the host country is used to measure the level of economic development, and the data are obtained from the World Development Indicators Database (WDI).

The future development potential of the host country (Gdpg). In this paper, the annual GDP growth rate of the host country is selected to represent its economic development potential, and the data are obtained from the World Development Indicators Database (WDI) released by the World Bank.

Trade openness of host country (Mgdp). In this paper, trade openness of host country is measured by the proportion of total imports and exports to GDP of host country, and the data

are obtained from the World Development Indicators Database(WDI).

Border adjacency (Conb). Adjacency of the border between the host country and China is denoted as 1, and non-adjacency is denoted as 0. The data are from CEPII database.

### 3.3. Descriptive statistics

As can be seen from Table 2, the size of China's OFDI stock varies greatly among host countries. The maximum value is 15.91, the minimum value is 0, and the standard deviation is 2.59. China's OFDI shows obvious differentiation. At the same time, there are great differences among the institutional quality of host countries, with the minimum value being 0.38, the maximum 11.29 and the standard deviation 2.36.

**Table 2.** The Results of Descriptive Statistics

Variable	Number	Mean	St.d	Min	Max
Lnofdi	1718	10.08	2.59	0	15.91
Insq	1725	6	2.36	0.38	11.29
Infr	1558	60.60	17.95	16	99.58
Lnsta	1569	6.53	2.85	-3.00	13.03
Grea	1748	0.71	0.65	0	3.49
Bit	1749	0.63	0.48	0	1
Dis	1749	9.12	3.83	0.96	19.30
Conl	1749	0.01	0.11	0	1
Gdpp	1748	0.15	0.20	0.002	1.36
Gdpg	1719	2.85	4.67	-36.39	43.48
Mgdp	1748	0.66	0.37	0.08	2.78
Conb	1749	0.07	0.25	0	1

## 4. Empirical Analysis and Testing

### 4.1. Benchmark regression

According to the LM test and Hausman test results, this

paper selects the fixed effect model for benchmark regression, column (1) in Table 3 is the regression result without controlled variables, column (2) is the regression result of adding control variables.

**Table 3.** The Results of Benchmark Regression

Variable	(1) Lnofdi	(2) Lnofdi
Insq	0.155** (0.063)	0.140** (0.065)
Grea		-0.154 (0.099)
Bit		-0.136 (0.352)
Dis		1.811*** (0.154)
Conl		12.297*** (0.856)
Gdpp		2.207*** (0.666)
Gdpg		0.005 (0.005)
Mgdp		0.002 (0.171)
Conb		16.318*** (1.039)
Constant	4.267*** (0.467)	-9.302*** (1.715)
Observed	1695	1667
Adjusted R <sup>2</sup>	0.921	0.921
Time	Fixed	Fixed
Individual	Fixed	Fixed

Note: Symbols \*, \*\*, and \*\*\* indicate statistical significance at 10%, 5% and 1% levels, respectively. Standard errors are in parentheses. The same is below.

Regardless of whether control variables are added or not, the estimated coefficients of the institutional quality of the host country are all positive and significant at 5%, indicating that the improvement of the institutional quality of the host country can promote the expansion of China's OFDI scale. Countries with better institutional quality can provide an orderly market and a complete legal system, which can reduce transaction costs and risk costs such as institutional friction costs and project time costs, thus improving investment returns. Investment in countries with poor institutional quality will exacerbate the uncertainty of business activities, leading to an increase in transaction risks and investment costs faced by Chinese enterprises. Therefore, hypothesis 1 is established. Moreover, the closer the cultural distance between the host country and China and the higher the level of economic development of the host country, the greater the scale of China's OFDI to the host country.

#### 4.2. Robustness test

In Column (1) of Table 4, the one-period-lagged explanatory variables are added to the model, because while the institutional quality of the host country attracts the inflow

of China's OFDI, China's direct investment in the host country may in turn improve the institutional quality of the host country, that is, there may be a problem of reverse causality. The lag term of explanatory variables in column (1) remains positive at the significance level of 10%, indicating that the institutional quality of the host country still significantly promotes the inflow of China's OFDI after dealing with the endogenous problem.

Columns (2) - (4) in Table 4 refer to replacing the core explanatory variables with three sub-indicators of economic system, political system and legal system respectively for regression. It can be seen that the improvement of the quality of the host country's economic system and political system can independently expand the scale of China's direct investment, indicating that the results of this study are robust. However, as an explanatory variable, the legal system is not significant, which may be because the overall level of the legal system is lower than that of the political system and the economic system, so it does not show obvious promoting effect.

**Table 4.** The Results of Robust Test

Variable	(1) Lnofdi	(2) Lnofdi	(3) Lnofdi	(4) Lnofdi
L.Insq	0.119* (0.070)			
Gover		0.015* (0.008)		
Law			0.000 (0.006)	
Econo				0.013* (0.008)
Control variable	Control	Control	Control	Control
Observed	1517	1687	1671	1683
Adjusted R <sup>2</sup>	0.923	0.919	0.920	0.920
Time	Fixed	Fixed	Fixed	Fixed
Individual	Fixed	Fixed	Fixed	Fixed

#### 4.3. Mediating effect test

As can be seen from column (1) (2) of Table 5, the improvement of institutional quality in host countries is not only conducive to the establishment of intellectual property protection system, but also conducive to increasing illegal costs, reducing free-riding behavior, thus improving the enthusiasm of researchers in scientific and technological innovation and R&D, and improving the scientific and technological innovation capacity of the country. And the improvement of domestic scientific and technological innovation ability can satisfy the multinational investment motivation of companies seeking efficiency and strategic assets, and enhance the investment attraction of Chinese multinational enterprises. Hypothesis 2 is established.

As can be seen from column (3) (4) of Table 5, the improvement of the institutional quality of the host country will reduce the government's market intervention, reduce transaction costs, reduce non-monetary transaction barriers,

encourage more private capital to enter the field of infrastructure construction, improve efficiency, and rapidly improve the level of infrastructure construction in the host country, while the improvement of infrastructure construction level can satisfy the investment motivation of efficiency seeking, and increase the scale of China's OFDI, hypothesis 3 is valid.

#### 4.4. Heterogeneity test

Due to the large differences in the institutional quality of different host countries, in order to further explore whether the institutional quality of host countries affects the heterogeneity of China's OFDI, the samples were divided into upper-middle-income countries and lower-middle-income countries according to the per capita income level, and divided into two groups according to whether the Belt and Road agreements were signed, and a grouping regression analysis was conducted on the samples.

**Table 5.** The Results of Mechanism Verification

Variable	(1) Lnsta	(2) Lnofdi	(3) Infr	(4) Lnofdi
Insq	0.194*** (0.027)	0.128* (0.069)	3.288*** (0.781)	0.105 (0.072)
Lnsta		0.273*** (0.073)		
Infr				0.005** (0.002)
Control variable	Control	Control	Control	Control
Observed	1527	1498	1536	1511
Adjusted R <sup>2</sup>	0.990	0.927	0.797	0.921
Time	Fixed	Fixed	Fixed	Fixed
Individual	Fixed	Fixed	Fixed	Fixed

**Table 6.** The Results of Heterogeneity Test

Variable	(1) lower-middle-income	(2) upper-middle-income	(3) B&R	(4) Non-B&R
Insq	0.323*** (0.065)	-0.006 (0.106)	0.170** (0.070)	-0.020 (0.191)
Control variable	Control	Control	Control	Control
Observed	686	981	1323	344
Adjusted R <sup>2</sup>	0.958	0.904	0.921	0.912
Time	Fixed	Fixed	Fixed	Fixed
Individual	Fixed	Fixed	Fixed	Fixed

As can be seen from column (1) (2) of Table 6, the regression coefficient in low-middle-income countries is significantly positive, while that in high-middle-income countries is not. This may be due to low-middle-income countries' weak economic strength, low level of legal construction and improvement at the present stage, and poor social stability. Therefore, low-middle-income countries have more room for improving the institutional quality. It contains great potential and strong market demand, which instead promotes Chinese enterprises to make direct investment in host countries, but in developed countries, the promotion effect is not significant due to the diminishing marginal effect.

As can be seen from column (3) (4) of Table 6, only in countries that have signed the Belt and Road agreement, the regression coefficient of the host country's institutional quality is significantly positive, while in non-Belt and Road countries, the host country's institutional quality has no significant promoting effect on China's OFDI, and has a negative impact. Since the Belt and Road Initiative was put forward in 2013, China has signed more than 200 cooperation documents on Belt and Road cooperation with 152 countries and 32 international organizations, covering 83% of the countries with which China has diplomatic relations. The results have proved that the Belt and Road cooperation has made remarkable achievements, and the level of Chinese investment in Belt and Road countries has continued to rise.

## 5. Conclusions and suggestions

It is found that the improvement of institutional quality in host countries significantly promotes the inflow of China's OFDI. Moreover, the improvement of institutional quality in host country can promote the increase of China's direct investment in the country by improving the country's scientific and technological innovation ability and infrastructure construction level. At the same time, the promotion effect is more significant in low - and middle-

income countries and countries that have signed the Belt and Road Initiative.

In order to give full play to the host country's institutional quality to improve China's OFDI, some suggestions are put forward. First, to establish a complete and transparent information platform, the government should accurately analyze the system quality, scientific and technological innovation level and infrastructure construction level of each country, and publish it in a timely manner to break the information asymmetry and provide support for Chinese multinational enterprises' outbound investment. Second, the government should encourage enterprises to explore new investment destinations and find the most suitable ones according to their own needs, rather than just limiting their eyes to developed countries. Third, the government should strengthen exchanges and communication on foreign direct investment and other business exchanges at the government level, especially in countries that have signed the Belt and Road agreement. The government should create special policies favorable to the countries or regions that have signed the Belt and Road agreement, so that the Belt and Road Initiative can better promote the outbound investment among the contracting parties, and thus accelerate the speed of Chinese capital "going to sea". And contribute to the high-quality economic development of each contracting state.

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