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Institutional Quality and China's Outward Foreign Direct Investment: The Moderating Effect of Foreign Aid

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Abstract: *Driven by economic globalization and the "Belt and Road" Initiative, China's outward foreign direct investment (OFDI) has continued to expand, making China the world's second-largest source of outbound investment. At the same time, China's foreign aid has grown significantly in both scale and form, covering a wide range of areas such as infrastructure development, health and education cooperation, and human resource development. Focusing on the location choice of China's OFDI, this paper uses data on China's foreign aid and OFDI from 2005 to 2021 to empirically examine the effects of host-country institutional quality and foreign aid on China's outward investment. The results show that foreign aid plays a positive moderating role in the relationship between institutional quality and the likelihood of Chinese investment in host countries. In other words, foreign aid can mitigate the adverse impact of poor institutional quality on investment attractiveness, demonstrating a clear "institutional compensation effect."*

Keywords: *Outward Foreign Direct Investment, Institutional Quality, Foreign Aid*

1. Introduction

Driven by deepening globalization and the advancement of the "Belt and Road" Initiative, China's outward foreign direct investment (OFDI) has expanded rapidly, reaching USD 106 billion in 2024. Over the same period, China's foreign aid has grown substantially in both scale and scope, totaling 1.288 trillion RMB in 2024 and covering areas such as infrastructure, health, and human resource development. Institutional quality—reflecting marketization, rule of law, and governance capacity—remains a core determinant of multinational firms' location choices. While strong institutions lower transaction costs and enhance policy stability, weaker environments expose enterprises to higher risks, increasing firms' reliance on government support or aid. Thus, foreign aid may moderate the influence of host-country institutional quality on investment decisions.

In the broader context of global economic restructuring, emerging economies increasingly engage in international resource allocation through OFDI and foreign aid [1]. China's rapid growth in both dimensions over the past two decades underscores the strategic importance of aligning aid with investment [2]. Yet the aid–investment relationship is complex: although aid may improve infrastructure and facilitate market entry, political or inefficient use of aid can weaken its commercial impact [3]. Existing studies highlight institutional quality as a critical factor for foreign capital inflows [4] and China's OFDI location choices [5]. Research also debates whether aid complements or substitutes FDI, offering mechanisms such as infrastructure and leading-firm effects [6][7], while other work stresses aid's buffering role in high-risk environments [8].

To address these gaps, this study examines whether Chinese foreign aid strengthens or weakens the effect of host-country institutional quality on Chinese OFDI, using project-level data from 2005–2021 and a Conditional Logit Model.

2. Literature Review and Research Hypotheses

Before developing the argument that links foreign aid, institutional quality, and their effects on FDI, it is important to review the existing literature. Conducting a comprehensive review of prior studies provides a solid foundation for understanding the complex interactions among foreign aid, institutional quality, and the location choices of Chinese enterprises' outward investment.

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2.1 Institutional Quality and Outward Foreign Direct Investment

Institutional quality is widely recognized as a key factor influencing the inflow of foreign direct investment (FDI). It can be defined as the political, social, and legal rules forming the basis for production, exchange, and distribution. Formal institutions can correct market failures and reduce transaction costs. Existing research generally indicates that FDI tends to flow into countries with higher institutional quality, whereas poor governance may hinder foreign investment. North (1990) argued that institutions shape the incentive structures of economic activities by determining transaction costs and property rights protection[9].

Countries with high institutional quality typically possess strong rule of law, effective government regulation, and low corruption levels, which reduce policy uncertainty and enhance investor confidence [10][11]. Conversely, weak institutions increase political risk and contract enforcement costs, discouraging long-term investment. Interestingly, studies also report an inverted U-shaped relationship between corruption and FDI, suggesting that a moderate level of corruption may attract investment by expediting bureaucratic procedures and providing implicit subsidies [12].

Furthermore, poor institutional quality can dampen local entrepreneurial activity. In such contexts, a country with a weaker entrepreneurial environment may attract more FDI because domestic firms pose less competitive threat to foreign investors [13]. The effect of institutional quality also varies across investment types: market-seeking FDI is more sensitive to institutional quality, while resource-seeking FDI is relatively less affected [14]. Moreover, other factors such as political stability, government effectiveness, and rule of law can moderate the influence of institutional quality on FDI [15].

Empirical studies focusing on China indicate that institutional quality has become increasingly important for OFDI. Buckley et al. (2009) found that international capital tends to flow to regions with abundant natural resources and smaller institutional distance from the home country [16]. However, most Chinese outward-investing firms are state-controlled, and profit maximization is not their sole objective; they also aim to strengthen diplomatic relations and support economic growth in developing countries [17]. As Chinese corporate governance evolves, the emphasis on shareholder value has increased, and risk aversion has grown, especially for market-seeking and resource-seeking FDI. Consequently, institutional quality has become a critical factor in Chinese OFDI location choices.

Hypothesis 1: The higher the institutional quality of a host country, the greater the likelihood that Chinese enterprises will undertake outward FDI there.

2.2 Foreign Aid and Outward Foreign Direct Investment

Foreign aid, as an important tool of international development cooperation, has received considerable attention regarding its impact on the economic development of recipient countries. From the perspective of host countries, aid and FDI can complement domestic savings and stimulate economic growth in low- and middle-income countries [18]. Existing research generally focuses on two dimensions.

The first examines the relationship between foreign aid, OFDI, and economic growth. Younsi et al. (2021) found that foreign aid and OFDI complement domestic investment, enhancing its effectiveness in promoting economic growth [19]. Dong and Fan (2016) similarly argued that China's foreign aid fosters economic development in recipient countries, primarily by improving local infrastructure [20]. While aid has traditionally been viewed as promoting growth, infrastructure, and welfare, some scholars note that its impact is limited due to smaller scale and sectoral dispersion compared with FDI [21].

The second dimension investigates whether foreign aid can facilitate OFDI. Recent studies suggest that aid not only directly affects economic development but also indirectly promotes Chinese OFDI by improving institutional quality and enhancing the host country's image. Aid enhances the investment environment by improving infrastructure, increasing human capital, and reducing information asymmetries and institutional transaction costs [22][23]. Empirical evidence shows that Chinese aid, particularly in infrastructure and economic cooperation projects, has a "pioneering effect," stimulating OFDI [24][25]. For instance, standardized management of China's port and railway aid projects in Africa reduces rent-seeking opportunities and policy uncertainty, facilitating investment. Improvements in governance, social stability, and welfare in recipient countries have also been shown to significantly promote Chinese OFDI [26].

International research on aid and FDI identifies two main mechanisms: the "resource complementarity effect" and the "institutional moderation effect." Productive aid, such as infrastructure

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projects, has been found to positively influence FDI, whereas non-productive aid may have negative effects due to resource crowding or corruption [27][28]. Moreover, excessive aid in poorly governed environments may be captured by elites, leading to inefficiencies and reduced private investment [29][30]. Thus, the net effect of aid on FDI depends on aid type, efficiency, and host-country institutional conditions.

Hypothesis 2: The higher the level of Chinese foreign aid received by a host country, the greater the likelihood that Chinese enterprises will undertake outward FDI there.

2.3 The Moderating Role of Foreign Aid

Regarding the relationship between foreign aid and institutional quality, two main perspectives exist. The first argues that aid can improve the institutional quality of recipient countries by promoting infrastructure development, enhancing public administration, and facilitating institutional modernization [31]. For example, China's infrastructure projects in African countries have improved government service capacity and administrative efficiency, indirectly enhancing governance levels. This "institutional strengthening effect" reflects the positive spillover of aid on governance and policy implementation [32].

The second perspective suggests that, in weakly governed or poorly monitored environments, aid may create an "institutional dependence effect." Excessive aid can reduce the recipient government's incentives for autonomous reform and may even promote rent-seeking and corruption [33]. Dreher and [34] note that while Chinese aid may stimulate short-term economic growth, a lack of institutional constraints and transparency can lead to misuse of aid funds, undermining long-term governance capacity. Therefore, the impact of aid on institutional quality is context-dependent, shaped by the recipient's initial institutional level, governance capacity, and aid type.

The "aid–policy–growth" hypothesis and subsequent studies emphasize that institutional quality is both a prerequisite for aid effectiveness and a determinant of its sustainability [35][36]. In China's case, aid policies follow principles of "mutual benefit" and "non-interference in internal affairs," suggesting that their impact on institutional quality is not unidirectional but manifests as a dual pathway of "cooperative improvement" and "conditional dependence" [37].

Hypothesis 3: Foreign aid positively moderates the relationship between host-country institutional quality and the location choices of Chinese enterprises' outward FDI. Specifically, aid can mitigate the adverse effects of low institutional quality on investment, reflecting an institutional compensation effect.

3. Research Design

3.1 Model Specification

From the perspective of location choice by outward foreign direct investment (OFDI) firms, this study examines the relationship among foreign aid, host-country institutional quality, and Chinese OFDI, with a particular focus on the interaction between foreign aid and institutional quality.

In terms of methodology, we primarily employ a Conditional Logit Model to achieve the research objectives. The Conditional Logit Model is well-suited for analyzing situations where Chinese enterprises face multiple location options, each with specific attributes. This model emphasizes how the characteristics of the chosen option, as well as differences across options for each firm, affect the final investment decision. In this study, Chinese companies must choose among different countries when making OFDI decisions.

The econometric model is specified as follows:

$$Ofdi_{it} = \beta_0 + \beta_1 instit_{it} + \beta_2 sumlabor_{it} + \beta_3 urban_{it} + \beta_4 hightec_{it} + \beta_5 ore_{it} + \beta_6 pgdp_{it} + \beta_7 inflationrate_{it} + \varepsilon_{it} \quad (1)$$

$$Ofdi_{it} = \beta_0 + \beta_1 lnaid_{it} + \beta_2 sumlabor_{it} + \beta_3 urban_{it} + \beta_4 hightec_{it} + \beta_5 ore_{it} + \beta_6 pgdp_{it} + \beta_7 inflationrate_{it} + \varepsilon_{it} \quad (2)$$

$$Ofdi_{it} = \beta_0 + \beta_1 lnaid_{it} + \beta_2 instit_{it} + \beta_3 (lnaid_{it} \times instit_{it}) + \beta_4 sumlabor_{it} + \beta_5 urban_{it} + \beta_6 hightec_{it} + \beta_7 ore_{it} + \beta_8 pgdp_{it} + \beta_9 inflationrate_{it} + \varepsilon_{it} \quad (3)$$

In the above model, $OFDI_{it}$ indicates whether China invests in country i in year t; $lnAid_{it}$ represents the amount of aid received by country i in year t; and $Instit_{it}$ denotes the institutional quality of country

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i in year t. The variables $SumLabor_{it}$, $Urban_{it}$, $HighTec_{it}$, Ore_{it}, $PGDP_{it}$, and $InflationRate_{it}$ represent, respectively, the labor endowment, urbanization level, technological innovation capability, natural resource endowment, economic growth rate, and inflation rate of country $i$in year t. $\varepsilon_{it}$is the error term.

Model (3) adds the interaction term between foreign aid and institutional quality to examine the moderating effect of aid.

3.2 Variable Selection

3.2.1 Measurement of Chinese Outward Foreign Direct Investment

The measure of Chinese outward foreign direct investment (OFDI) is a dummy variable, taking the value of 1 if an OFDI project occurs, and 0 otherwise. The data are sourced from the China Global Investment Tracker (CGIT). CGIT is the only comprehensive public dataset covering Chinese outbound investment and construction projects, which can be recorded individually or collectively. It includes 4,750 major transactions across sectors such as transportation, real estate, entertainment, and others, as well as over 400 problematic transactions. The dataset provides complete information on transaction amounts, Chinese parent companies, host countries, and industries.

3.2.2 Measurement of Institutional Quality

The institutional quality indicator used in this study, ICRG, is derived from the standardized dataset provided by the Quality of Government Institute. ICRG is one of the most authoritative and widely applied systems for assessing institutional quality and political risk internationally. The ICRG measure used here is the average of the variables "Corruption," "Law and Order," and "Bureaucracy Quality," with values ranging from 0 to 1. Higher values indicate better government quality. In this study, we calculate $1 -$ ICRG average, so that the resulting value represents the degree of government quality deficiency, with higher values indicating poorer government quality.

3.2.3 Measurement of Chinese Foreign Aid

This study relies on AidData's Global Chinese Development Finance Dataset (Version 3.0), the most detailed source of Chinese foreign aid data, given that China—unlike OECD donors—does not disclose project-level financial records. Using the TUFF 3.0 methodology, AidData systematically and transparently tracks under-reported financial flows from China and other non-Western donors. The dataset documents 20,985 projects across 165 low- and middle-income countries from 2000 to 2021, totaling over USD 1.34 trillion, with aid amounts aggregated based on project-level commitments.

3.2.4 Control Variables

Based on a review of relevant literature, this study includes several control variables to account for host-country characteristics. The total labor force (logarithm) is used to measure the labor endowment, while the urban population ratio captures the level of urbanization. High-technology exports as a percentage of manufactured exports reflect the host country's technological innovation capability and industrial structure, and ore and metal exports as a percentage of total merchandise exports indicate its natural resource endowment. Economic growth is measured by the GDP per capita growth rate, and monetary policy is proxied by the inflation rate. All data are sourced from the World Bank's World Development Indicators (WDI) database. Variables are listed in Table 1.

Table 1: Variable Names, Descriptions, and Data Sources.

Variable Name	Description	Data Source
Chinese Outward FDI	Dummy variable, 0 or 1	China Global Investment Tracker
Institutional Quality Decline	1 minus the average of the ICRG indicators; higher values indicate worse institutional quality	Quality of Government Institute
Foreign Aid	Total aid aggregated from the commitment levels of individual aid projects	AidData Database
Labor Population	Logarithm of the total labor force	World Bank WDI
Urbanization Level	Urban population as a percentage of total population	World Bank WDI

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Technological Innovation Capability	High-technology exports as a percentage of manufactured exports	World Bank WDI
Natural Resource Endowment	Ore and metal exports as a percentage of total merchandise exports	World Bank WDI
Economic Growth Rate	GDP per capita growth rate	World Bank WDI
Inflation Rate	Inflation rate measured by the consumer price index	World Bank WDI

4. Empirical Results and Analysis

4.1 Descriptive Statistics

The descriptive statistics for all variables are presented in Table 2.

Table 2: Descriptive Statistics of Variables.

Variable	Observations	Mean	Std. Dev.	Min	Max
Institutional Quality	239,758	0.450	0.207	0	0.889
Foreign Aid	162,928	18.477	2.845	6.430	24.371
Labor Population (log)	284,105	15.538	1.644	10.842	20.206
Urbanization Level (%)	286,482	59.090	23.074	12.978	100
Technological Innovation (%)	229,404	10.639	11.794	0	68.143
Natural Resource Endowment (%)	246,711	9.564	15.208	0	86.420
Economic Growth Rate (%)	279,835	1.733	4.499	-34.831	62.111
Inflation Rate (%)	268,166	6.400	18.243	-10.067	557.202

4.2 Regression Analysis

Table 3: Results of the Conditional Logit Model.

Variable	Model 1	Model 2	Model 3
Institutional Quality	-2.601***		-16.165***
	(0.155)		(3.339)
Foreign Aid		0.120***	-0.289***
		(0.021)	(0.084)
Labor Population (log)	0.741***	0.585***	0.632***
	(0.018)	(0.032)	(0.036)

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Variable	Model 1	Model 2	Model 3
Urbanization Level (%)	0.017***	0.011***	0.013***
	(0.002)	(0.002)	(0.002)
Technological Innovation (%)	0.026***	0.018***	0.020***
	(0.002)	(0.003)	(0.003)
Natural Resource Endowment (%)	0.026***	0.012***	0.013***
	(0.002)	(0.003)	(0.003)
Economic Growth Rate (%)	0.008	0.040***	0.031*
	(0.011)	(0.015)	(0.017)
Inflation Rate (%)	0.000	-0.028***	-0.025**
	(0.003)	(0.009)	(0.010)
Foreign Aid * Institutional Quality			0.774***
			(0.168)
Observations	172,438	38,898	29,244
Pseudo R^2	0.177	0.142	0.160
Log-likelihood	-6,928.430	-2,184.501	-1,846.557
Chi-squared	2,973.428	720.239	704.187

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

Table 3 reports the estimation results for the effects of institutional quality, foreign aid, and their interaction on the location choices of Chinese firms' outward FDI. Using the Conditional Logit model and controlling for host-country economic and structural characteristics, the models exhibit good overall fit, with pseudo R^2 values ranging from 0.14 to 0.18.

In Models (1) and (3), the coefficients of institutional quality are negative and highly significant, indicating that poorer institutional environments—reflected by higher institutional quality values—significantly reduce the likelihood of Chinese firms investing in a country. This aligns with institutional economics theory, suggesting that sound institutions, including strong legal systems, secure property rights, and transparent policies, lower uncertainty and transaction costs, thereby encouraging investment.

Model (2) introduces foreign aid, which shows a positive and significant coefficient, implying that aid promotes Chinese firms' investment in recipient countries. Aid likely improves local infrastructure, strengthens political and economic ties, and reduces information asymmetry, thus fostering a more favorable environment for investment.

When the interaction between aid and institutional quality is included in Model (3), the main effect of aid turns negative, while the interaction term becomes positive and highly significant. This indicates that the impact of aid on investment depends on the institutional context. Specifically, in countries with weaker institutions, foreign aid mitigates the adverse effects of poor institutional quality and enhances firms' willingness to invest. In this sense, foreign aid serves as a "risk-buffering" or "institutional compensation" mechanism, reducing entry barriers in high-risk environments and generating a synergistic relationship between aid and investment.

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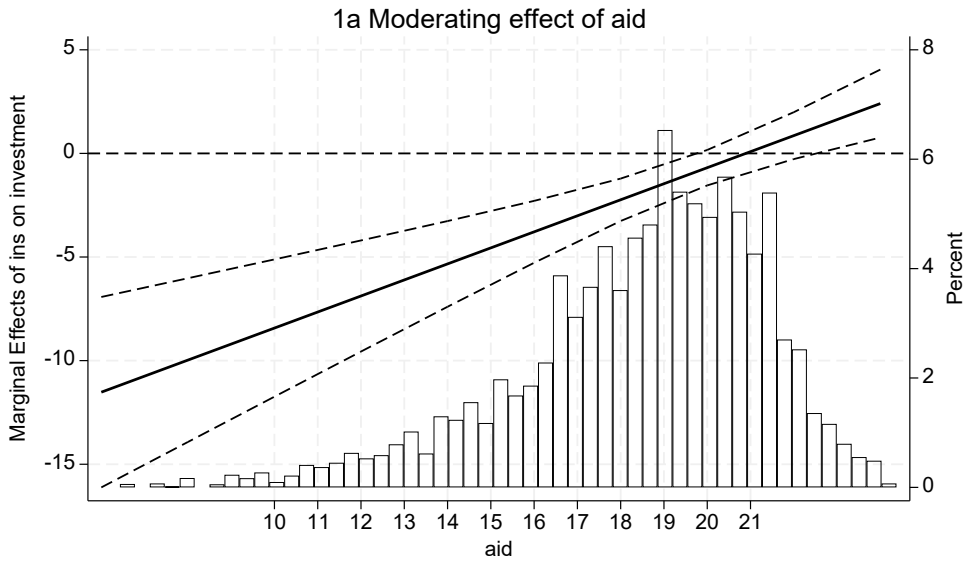

Figure 1: The Moderating Effect of Foreign Aid on the Relationship between Institutional Quality and Investment.

Figure 1 illustrates the moderating effect of foreign aid on the relationship between institutional quality and Chinese outward foreign direct investment (OFDI). The horizontal axis represents the level of foreign aid, the left vertical axis shows the marginal effect of institutional quality on investment, and the right vertical axis displays the frequency distribution of observations across different aid levels.

As shown in the figure, within the low-aid range (for example, aid = 10 to 14), the marginal effect of institutional quality on investment is strongly negative. Since institutional quality in this study is reverse coded, where higher values indicate poorer institutional environments, this suggests that a deterioration in institutional quality significantly discourages Chinese OFDI when aid levels are low. In other words, in host countries characterized by weak institutions and limited Chinese aid, institutional deficiencies constitute a substantial barrier to investment, markedly reducing firms' willingness to enter these markets.

As the level of aid increases (for example, aid = 16 to 21), the marginal effect of institutional quality on investment gradually rises, approaching zero and in some cases even becoming positive. This pattern clearly demonstrates that higher levels of aid effectively mitigate the adverse impact of weak institutional environments on Chinese OFDI. When aid is sufficiently high, its positive externalities such as improved infrastructure, enhanced policy coordination, and stronger bilateral relations can offset or even reverse the negative influence of institutional deficiencies. Consequently, Chinese firms remain willing to invest even in countries with suboptimal institutional conditions, reflecting the risk buffering and institutional compensation effects of foreign aid.

4.3 Robustness Test

In the previous analysis, institutional quality was measured using ICRG (International Country Risk Guide) data. For robustness, this study now adopts the Worldwide Governance Indicators (WGI) published by the World Bank as the primary measure of host-country institutional quality. Updated continuously since 1996, WGI covers more than 200 countries and regions worldwide and is one of the most widely used institutional quality measures in international academic research.

WGI measures governance across six dimensions, including political participation and stability, government effectiveness, regulatory capacity, rule-of-law performance, and corruption control, capturing the overall quality of institutional functioning in host countries.

All six sub-indicators are standardized, ranging from -2.5 to +2.5, with higher values indicating better governance quality. To comprehensively capture the host country's institutional environment, this study averages these six indicators to construct a composite institutional quality index, reflecting governance characteristics across political, legal, and administrative dimensions.

For ease of interpretation in regression analysis, the index is reversed by subtracting the original value from the sample maximum, so that higher values indicate worse institutional quality.

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Table 4: Robustness Test Results.

Variable	Model 1	Model 2	Model 3
Institutioal Quality	-0.684***	-0.318***	-2.503***
	(0.040)	(0.119)	(0.794)
Foreign Aid		0.130***	-0.120
		(0.021)	(0.091)
Labor Population (log)	0.721***	0.572***	0.579***
	(0.017)	(0.032)	(0.032)
Urbanization Level (%)	0.009***	0.008***	0.008***
	(0.002)	(0.002)	(0.002)
Technological Innovation (%)	0.024***	0.016***	0.017***
	(0.002)	(0.003)	(0.003)
Natural Resource Endowment (%)	0.022***	0.009***	0.010***
	(0.002)	(0.003)	(0.003)
Economic Growth Rate (%)	0.021**	0.036**	0.035**
	(0.010)	(0.015)	(0.015)
Inflation Rate (%)	0.002	-0.021**	-0.022**
	(0.003)	(0.009)	(0.009)
Foreign Aid * Institutional Quality			0.111***
			(0.040)
Observations	201873	38442	38442
Pseudo R^2	0.175	0.143	0.145
Log-likelihood	-7366.921	-2159.906	-2156.232
Chi-squared	3132.806	723.742	731.090

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

Table 4 presents robustness test results. Based on the regression results of Model (1), the direction and significance of the core variables are consistent with theoretical expectations, and the model demonstrates a good overall fit. The coefficient of institutional quality is -0.684, significant at the 1% level. Since higher values indicate worse institutional conditions, this finding shows that weaker institutional quality significantly reduces Chinese outward foreign direct investment (OFDI). Conversely, sound institutions lower investment risks and improve resource allocation efficiency, thereby encouraging OFDI. This result supports both the “institutional avoidance” and “institutional promotion” hypotheses, confirming institutional quality as a key determinant of firms’ outward investment decisions.

Regarding economic factors, labor force size, urbanization rate, technological innovation capability, natural resource endowment, and economic growth rate are all positive and significant at the 5% level or above. A large labor force and higher urbanization reflect human capital availability and market maturity, jointly supporting OFDI. Technological capability strengthens competitiveness and helps firms overcome

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technological barriers, while abundant resources attract resource-seeking investments. Meanwhile, stronger economic growth enhances financial capacity and risk tolerance, enabling firms to expand abroad.

Model (2) adds the foreign aid variable, whose coefficient (0.130) is positive and significant at the 1% level. This suggests that aid effectively promotes Chinese OFDI by improving host-country infrastructure, providing policy support, and fostering intergovernmental cooperation, which reduces entry costs and increases firms' confidence in the host market.

Model (3) incorporates the interaction term between aid and institutional quality. Results show that aid's positive effect strengthens as institutional quality improves, but weakens or may be offset when institutions are poor. This indicates that aid moderates the relationship between institutional quality and investment, mitigating institutional risks and enhancing investment feasibility in less developed institutional environments.

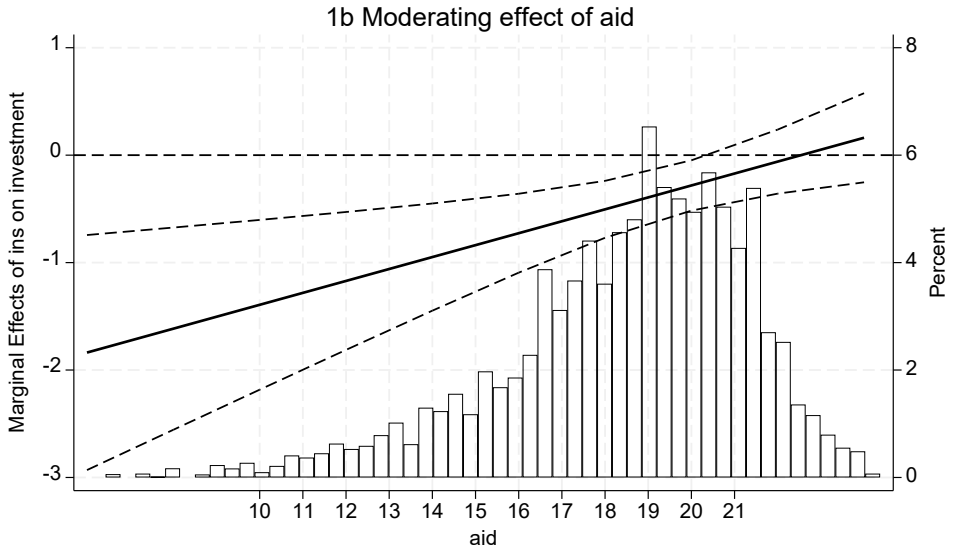

Figure 2: The Moderating Effect of Foreign Aid on the Relationship between Institutional Quality and Investment.

Figure 2 provides a more intuitive illustration of the moderating role of foreign aid in the relationship between institutional quality and Chinese outward foreign direct investment. As the level of aid increases, the negative impact of institutional "deterioration" on investment weakens. In other words, aid mitigates the adverse effect of declining institutional quality (under the reverse-coded indicator) on investment, meaning that high levels of aid can reduce the detrimental impact of poor institutional quality on investment, which is consistent with the previous results.

5. Conclusion

Driven by economic globalization and the "Belt and Road" Initiative, China's outward foreign direct investment (OFDI) and foreign aid have expanded markedly, with their functions in China's "Going Global" strategy becoming increasingly interconnected. Using data from 2005 to 2021, this study examines how host-country institutional quality and Chinese foreign aid shape the location choices of Chinese enterprises, and further assesses the moderating effect of aid on the institutional–investment nexus.

The empirical findings indicate that higher institutional quality significantly increases the probability of Chinese firms investing in a host country. Sound institutional environments—characterized by effective rule of law, transparent policymaking, and well-functioning market mechanisms—reduce investment risks and transaction costs, thereby attracting greater OFDI. This aligns with the "institutional promotion effect" emphasized in institutional economics.

Moreover, Chinese foreign aid plays a facilitative role by improving infrastructure, enhancing economic conditions, and strengthening policy coordination in recipient countries. Aid deepens political

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trust, reduces uncertainty, and lowers policy barriers. The positive and significant interaction between aid and institutional quality suggests that aid amplifies the favorable impact of institutional improvements on OFDI. Particularly in countries with weaker institutional environments, aid exhibits an "institutional compensation effect" by bolstering governance capacity and institutional implementation, thereby enhancing both the feasibility and sustainability of Chinese investment.

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