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Attracting Foreign Investment and Its Influence on Outward Investment in Developing Countries: An Empirical Analysis Based on China's Reform and Opening - up Experience

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Abstract

This paper aims to explore whether attracting foreign investment promotes outward foreign investment in developing countries, taking China's experience during its reform and opening-up as a typical case.By leveraging panel data encompassing 31 provinces (municipalities) across China spanning the period from 2007 to 2022, it employs empirical methods to examine FDI's impact on OFDI. The results show that: 1) FDI generally enhances provincial OFDI regardless of control variables and fixed effects; 2) regional heterogeneity exists—FDI inhibits OFDI in eastern and central regions but promotes it in western China; 3) government incentive policies are closely associated with OFDI's formation and growth. The study provides empirical evidence for developing countries to optimize their open development paths.

Keywords: fdi, ofdi, developing countries, china during its reform and opening-up

1. Introduction

Since China launched its reform and opening-up policy in 1978, it has redirected its national priorities toward economic development. By adopting the dual opening-up strategy of "bringing in" and "going out," it has expanded the depth and breadth of its opening to the outside world. As two vital components of China's opening-up strategy, "attracting foreign investment" and "outbound investment" serve different purposes. On the one hand, attracting, and even relying on, foreign investment to participate in or lead domestic economic development is a significant pathway for developing countries seeking open development. On the other hand, outbound investment by a country is viewed as a manifestation of its national competitiveness and a necessary means for effectively utilizing international resources in the globalization era. Therefore, fostering an increase in outbound investment capabilities and developing local multinational enterprises are crucial for nurturing national competitiveness in developing countries. During the process of opening up, is there a specific relationship between these two aspects? In other words, does attracting foreign investment contribute to the cultivation of outbound investment capabilities? Will the formation and sustainability of outbound investment capabilities benefit from a country's policy of attracting foreign investment through opening up? In fact, he theoretical framework for understanding how attracting foreign investment relates to outbound investment finds its origins in the Investment Development Path theory, put forward by John H. Dunning—a British economist and master of international management—in the late 1970s and early 1980s. This theory suggests a systematic correlation between attracting foreign investment and outbound investment. However, at the FDI level, developing countries are significantly higher than developed countries, but at the OFDI level, developing countries are significantly inferior to developed countries. Therefore, what is mainly involved in the theory are the developed countries that are already in the advanced stage of development, among which are the United Kingdom and the United States. So, does the IDP theory hold true for developing countries? This question has attracted widespread attention and discussion in both industry and academia. Scholars from various countries have empirically tested the IDP model using sample data from different periods and countries. In this paper, we take China during its reform and opening-up as an example and reassess the role of attracting foreign investment in promoting the development of China's outbound investment, using panel data encompassing 31 provinces (municipalities) across China spanning the period from 2007 to 2022. We examine whether attracting foreign investment significantly boosts the growth of outbound investment flows and stocks, offering a theoretical foundation for the open development path of developing countries. This is the theoretical value of this study.

Figure 1. A concise diagram of the core issues in this article

2. Literature Review

Barry et al. (2003)[1] utilized bilateral direct investment data from Ireland and the United States spanning from 1980 to 1999 and similarly found that the development path described by the IDP theory aligns with real-world situations. Chen Taotao (2011)[2], compared the spillover effects of foreign investment in China and India through an empirical study, discovered that the inflow of foreign investment into a country does not automatically prompt the development of the country's outbound investment capabilities over time. For developing countries like China and India, the formation of outbound investment capabilities involves different internal research and exploration mechanisms related to their national development and policies.Based on the panel data covering 30 provinces across China from 2004 to 2017, Zhu Shiwang (2020)[3] also confirmed that there are marked regional differences in how China's inward foreign direct investment positively affects its outward FDI . Specifically, in eastern regions, the positive role that IFDI plays in OFDI is statistically significant at the 1% level, while it is not significant in central and western regions. Moreover, the institutional environment plays an intermediary role in this relationship. Li Fuyou (2020)[4], based on provincial data from 2013 to 2016, empirically tested the spatial spillover and nonlinear effects of foreign investment on regional outbound investment using spatial panel models and nonlinear panel threshold models. He concluded that China's foreign direct investment exhibits significant spatial agglomeration effects, characterized by high-high and low-low spatial distribution features, demonstrating a "Matthew Effect" in spatial distribution. Additionally, over the short term, foreign investment plays a notably positive role in regional outbound direct investment activities. However, in the long term, there exists a nonlinear relationship between FDI and OFDI.It is worth noting that a quantitative analysis of China's policies on attracting foreign-invested R&D institutions from 2012 to 2019 conducted by Cui Hongyi et al. (2020)[5] shows that the selection of policy tools significantly affects the absorption efficiency of FDI spillover effects. Among these tools, environmental tools are used most frequently, followed by supply-side tools, while demand-side tools are insufficient. This policy difference further clarifies the "policy-related internal mechanism" that comes with developing countries forming their foreign investment capabilities. In 2015, Chen Taotao's team employed global panel data to examine the core issue of "the impact and mechanism of attracting foreign investment on outbound investment." The research showed that, in terms of how attracting foreign investment affects outbound investment, although the global-level test indicated a significant impact, empirical results from countries like Japan and South Korea suggested that, for specific nations, the role of attracting foreign investment in outbound investment has a degree of uncertainty. Furthermore, high-end FDI from developed countries can bring about higher spillover effects, thereby having a greater impact on the OFDI capabilities of domestic enterprises.

From the above tests, it is evident that over 95% of international investment originates from developed countries. Therefore, developed countries have a systematic link between attracting foreign investment and outbound investment, which means attracting foreign investment helps grow a country's outbound investment capabilities. For developing countries, the applicability of the IDP theory to net outward investment has received further attention but has not been fully demonstrated, requiring further testing. This deficiency corresponds to the confusion faced by most developing countries today regarding which development strategies and paths they should adopt. Consequently, this paper focuses on China during its reform and opening-up as the target country, conducting a special discussion on China's opening-up process. It aims to complement and improve the development strategies and paths of developing countries while providing practical guidance for their opening-up practices.

3. Discussion on the mechanism through which foreign direct investment influences outward foreign direct investment

3.1 Selection of Target Countries and Data Characteristics

As the largest developing country in the world, China's economic development since the reform and opening-up has been extremely representative. By attracting foreign direct investment , China has achieved rapid economic growth and industrial upgrading, providing a valuable case for studying the impact of FDI on outward foreign direct investment in developing countries. Furthermore, China possesses abundant and detailed statistical data, including inward FDI, OFDI, financial development, regional openness levels, etc., which provides a solid data foundation for empirical analysis. This presents a historical opportunity for scholars in China and other developing countries. Therefore, addressing the aforementioned shortcomings of the Investment Development Path theory model, we select China during its reform and opening-up period, and through in-depth research on our country's experience, explore the underlying logic of China's transition from attracting FDI to engaging in OFDI. This serves as a preliminary empirical test of the question, "Does attracting FDI really promote OFDI in developing countries?"

Analyzing the history and data characteristics of China's inward FDI and OFDI after the reform and opening-up (Figure 2), we find that China's IFDI generally exhibits a trend of rapid growth; OFDI also shows an upward trend overall, especially after the State Council further approved the "Opinions on Encouraging and Regulating the Foreign Investment Cooperation of Chinese Enterprises" in October 2006, and subsequently issued a series of policies and measures including finance, fiscal, foreign exchange, and taxation. In 2007 and 2008, China's OFDI grew rapidly. Even in 2009, when global FDI significantly decreased due to the financial crisis, China's OFDI did not show a noticeable decline. From this, we observe that although China has attracted a large amount of FDI, the formation and growth of OFDI seem to be more closely related to government incentive policies; regarding the net outward investment (NOI), due to the rapid growth of IFDI since 2004, NOI showed a negative growth trend, which gradually tended towards zero after 2008 as the growth rate of OFDI exceeded that of IFDI.

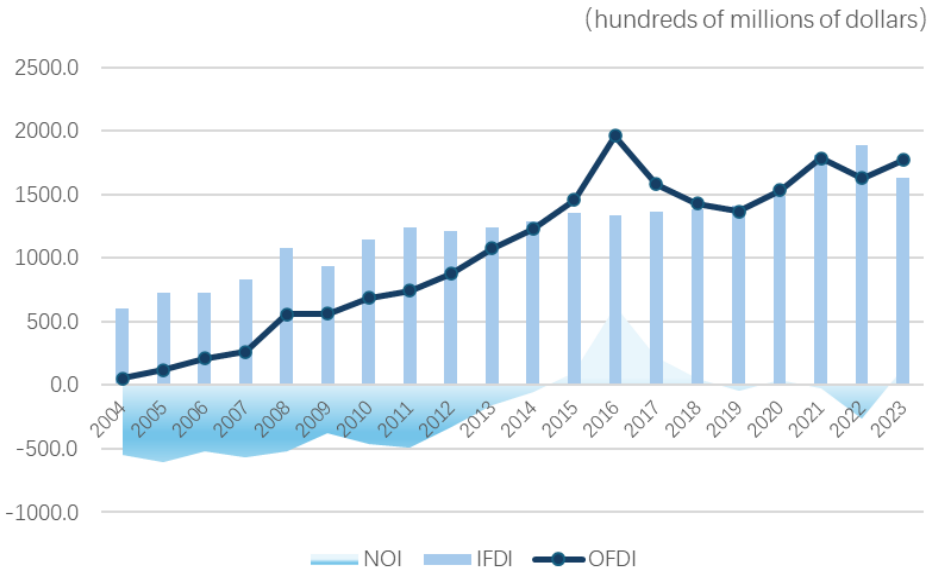

Figure 2. The situation of China's foreign capital inflows, outward investment flows and net outward investment from 2004 to 2023

Data source: Statistics on foreign investment of the Ministry of Commerce.and China's Statistical Bulletin of Outward Foreign Direct Investment over the years.

3.2 Selection of Specific Environmental Data of Target Countries

The impact of a country's attraction of foreign direct investment on its outbound foreign direct investment is a multidimensional and intricate dynamic process. Among various factors, the country's industrial structure, labor force size, and regional openness constitute key variables influencing OFDI activities.

The optimization and upgrading of industrial structure play a crucial role in attracting FDI and promoting OFDI. By adjusting industrial structure and cultivating emerging industries, developing countries can not only enhance the competitiveness of domestic industries but also provide broader investment space for foreign capital. Meanwhile, the optimization of industrial structure creates opportunities for local enterprises to "go global." Through OFDI, they can export mature industrial technologies and management experiences to international markets, achieving the extension and expansion of industrial chains. The increase in the size and quality of the labor force is also a critical factor influencing developing countries' attraction of FDI and OFDI. The vast labor resources provide abundant production factors, while the improvement in labor quality further enhances their attractiveness to foreign capital. With the upgrading of labor quality, developing countries can better undertake international industrial transfers and attract foreign capital into high-end manufacturing and service industries. At the same time, the mobility of high-quality labor also promotes OFDI, providing strong support for local enterprises to expand in overseas markets. The enhancement of regional openness creates more favorable conditions for attracting FDI and promoting OFDI. By intensifying regional development, improving infrastructure, and optimizing the business environment, developing countries not only enhance the attractiveness of domestic markets but also provide solid support for enterprises' OFDI. The increased regional openness facilitates the interconnection between domestic and foreign markets, offering more opportunities for local enterprises to expand into international markets. Meanwhile, an open market environment creates freer and more convenient conditions for foreign capital entry, further advancing the process of opening up in developing countries.

In summary, factors such as industrial structure, labor force size, and regional openness play significant roles in attracting FDI and promoting OFDI. These factors interact and jointly shape the investment capacity and dynamics of developing countries in the globalization process.

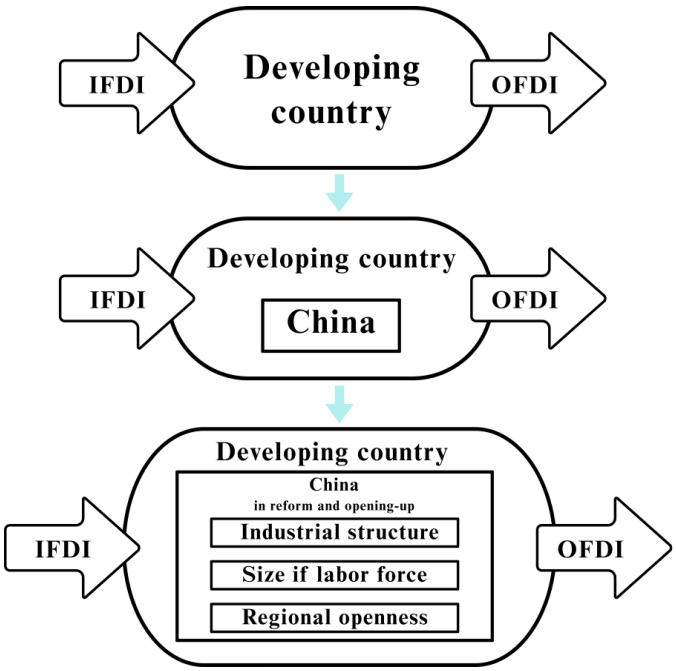

Figure 3. Mechanism analysis diagram of the impact of IFDI on OFDI

3.3 Building the Analytical Framework and Path for Mechanism Research

Figure 3 reflects the basic situation of the analytical framework for mechanism research that we have built. To clearly demonstrate the internal logical structure of the framework, this mechanism is decomposed into three progressively deeper levels: developing countries, target countries, and specific environments of target countries. Based on China's provincial panel data, this study fully considers the reality that China has a vast territory with significant differences in regional resource endowments, market sizes, technological stocks, and human capital. Firstly, the framework clarifies the core proposition of the study, which is to explore whether attracting FDI in developing countries promotes their OFDI capabilities. Secondly, the framework analyzes this comprehensive influence mechanism into the internal mechanism of target countries and the logical connection mechanism between IFDI and OFDI, emphasizing the importance of specific environments as the core analysis level. On this

basis, the framework further analyzes the impact mechanism of IFDI on the specific industrial environment of target countries and how this impact is transmitted to the OFDI side. The mechanism research analysis framework we have constructed provides a comprehensive and systematic analysis framework to take a deep look at how attracting FDI drives developing countries' ability to invest abroad.

4. Model Construction and Data Processing

To examine the impact of foreign direct investment on regional outward foreign direct investment(OFDI), this paper employs panel data from 31 provinces(municipalities) in China between 2007 and 2022 to study how FDI influences OFDI. Some missing data were completed using interpolation methods. Following the research of Chen Taotao (2017)[3] and Chen Hao (2018)[4], the basic model is set as follows:

$$\mathrm{OFDI}_{it} = \alpha_0 + \alpha_1 \mathrm{FDI}_{it} + \varepsilon_{it} \quad (1)$$

When studying the impact of a country's inward FDI on its OFDI, we may have overlooked three key factors: industrial structure, labor force size, and regional openness. When industrial structures optimization and upgrading, they can offer businesses more growth opportunities and competitive edges, acting as a key driver for their OFDI. The size and quality of the labor force directly affect enterprises' productivity and innovation capabilities, which are crucial supports for successful OFDI. Regional openness is an important indicator measuring the integration of a region's economy with the international market, reflecting the openness of the policy environment, the convenience of market access, and the reduction of international trade and investment barriers.

Therefore, it is necessary to further revise the regression equation , using the basic model as a foundation, to incorporate the three variables of industrial structure (Is), labor force size (Lfs), and regional openness (Open). Such a revision will make our model more comprehensive and accurate, enabling it to capture and explain various factors influencing OFDI more precisely. The revised regression equation may be as follows:

$$\mathrm{OFDI}_{it} = \alpha_0 + \alpha_1 \mathrm{FDI}_{it} + \alpha_2 \mathrm{Is}_{it} + \alpha_3 \mathrm{Lfs}_{it} + \alpha_4 \mathrm{Open}_{it} + \lambda_i + \delta_i + \varepsilon_{it} \quad (2)$$

Where FDI_{it} represents the foreign direct investment in province i in year t; OFDI_{it} represents the level of OFDI in that province in the same year; Is_{it}, Lfs_{it}, and Open_{it} represent a series of control variables that may affect OFDI; α_0 represents the intercept term of the model; α_1 represents the effect of FDI on the level of OFDI in the province; α_2, α_3, and α_4 represent the influence coefficients of the control variables; λ_i represents the time fixed effect; δ_i represents the province fixed effect; and ε_{it} represents the random disturbance term. The data sources include the China Statistical Yearbook, the EPS Data Platform, the China Outward Foreign Direct Investment Bulletin, and the statistical yearbooks of various provinces in China. To eliminate dimensionality, some variables in this paper have been log-transformed.

5. Empirical Analysis

5.1 Descriptive Statistical Analysis

Table 1 presents the descriptive statistics of the variables. The mean value of outward foreign direct investment (OFDI) is 12.467, with a standard deviation of 2.118, indicating a certain degree of volatility. The value range, from 4.605 to 16.941, suggests significant differences in OFDI among different regions in China. The mean value of foreign direct investment (FDI) is 11.327, with a relatively smaller standard deviation of 1.901, indicating lower volatility. The range of FDI is between 6.232 and 17.136. The mean value of industrial structure (Is) is 1.282, with a standard deviation of 0.707, showing a relatively concentrated distribution, ranging from 0.527 to 5.283. The mean value of labor force size (Lfs) is 5.938, with a standard deviation of 0.886, indicating moderate volatility. The minimum and maximum values are 2.996 and 7.655, respectively. The mean value of regional openness (Open) is the highest, at 16.607, with a standard deviation of 1.911, indicating some volatility within the sample. The range, from 9.903 to 20.166, indicates significant differences in foreign trade among different regions.

Table 1. Descriptive statistical results

Variable Name	Variable Symbol	Observations	Mean	Standard Deviation	Minimum	Maximum
Outward Foreign Direct Investment	OFDI	496	12.467	2.118	4.605	16.941
Foreign Direct Investment	FDI	496	11.327	1.901	6.232	17.136
Industrial Structure	Is	496	1.282	0.707	0.527	5.283
Labor Force Scale	Lfs	496	5.938	0.886	2.996	7.655
Regional Openness Degree	Open	496	16.607	1.911	9.903	20.166

5.2 Baseline Regression

To examine the effect of foreign direct investment on a province's outward foreign direct investment , we conducted a baseline regression using the Ordinary Least Squares (OLS) method, and the results are shown in Table 2 . Column (1) shows the model without control variables and fixed effects, whereas Column (2) has control variables, along with time and province fixed effects. The findings show that FDI boosts a province's OFDI level, no matter if control variables are added. Taking Column (2) as an example, we find that in the model with control variables, the coefficient of the impact of FDI on a province's OFDI level is 0.194, significant at the 5% level. The coefficient of the impact of industrial structure on OFDI is -0.606, significant at the 1% level. The coefficient of the impact of labor force size on OFDI is 1.942, also significant at the 1% level. The coefficient of the impact of regional openness on OFDI is -0.175, significant at the 10% level. In summary, it is initially verified that FDI can increase a province's OFDI level.

Table 2. Benchmark regression results

Variable	(1) OFDI	(3) OFDI
FDI	0.688***	0.194**
	(0.080)	(0.090)
Is		-0.606***
		(0.189)
Lfs		1.942***
		(0.254)
Open		-0.175*
		(0.090)
_cons	4.669***	2.425
	(0.880)	(1.970)
Time fixed effects	No	Yes
Province fixed effects	No	Yes
N	496	496
r2	0.382	0.944

Note: The robust standard errors are in parentheses below the coefficients; ***, **, and * indicate significance at the 1%, 5%, and 10% levels, respectively. The same applies hereinafter.

5.3 Robustness Checks

5.3.1 Lagged Explanatory Variables

To check if the model and results are robust, we delayed the province's OFDI by one time period. The results are shown in Table 3, Column (1). It can be seen that after lagging the explained variable by one period, the coefficient of the impact of FDI on a province's OFDI level is 0.241, significant at the 1% level, indicating that lagging the explained variable does not alter the finding that FDI promotes a province's OFDI.

5.3.2 Winsorization

To address outliers in the data, we removed and replaced them with reasonable values. To check if the results are robust, we winsorized all variables at the 1% level. You can find these results in Table 3, Column (2). The coefficient of the impact of FDI on a province's OFDI level is 0.202, significant at the 5% level. This suggests that after removing outliers, the results remain robust, and FDI has a significant positive effect on a province's OFDI.

5.3.3 Exclusion of special events

Extreme market events such as financial crises and stock market crashes can significantly impact economic or financial data analysis in the short term. These events, due to their suddenness and infrequency, may cause analytical results to deviate from normal conditions, affecting the accurate interpretation of long-term trends and cyclical factors. To check if the results are robust, we excluded the special events of the 2008 financial crisis and the 2015 stock market crash. We present the results in Table 3, Columns (3) and (4). When we leave out the 2008 financial crisis and the 2015 stock market crash, the numbers showing how FDI affects a province's OFDI level are 0.202 and 0.191. Both of these are significant at the 5% level. Based on the above analysis, it is concluded that FDI promotes a province's OFDI, and the results are relatively robust.

Table 3. Robustness test results

Variable	(1) l.OFDI	(2) OFDI	(3) OFDI	(4) OFDI
FDI	0.241***	0.178**	0.202**	0.191**
	(0.092)	(0.090)	(0.085)	(0.092)
Control variables	Yes	Yes	Yes	Yes
Time fixed effects	Yes	Yes	Yes	Yes
Province fixed effects	Yes	Yes	Yes	Yes
N	465	496	465	465
r2	0.946	0.944	0.943	0.944

5.4 Heterogeneity Test

Based on geographical heterogeneity analysis, China's urban areas can be divided into eastern, central, and western regions due to significant differences in social and economic development, cultural backgrounds, and policy environments. These differences may affect the impact of FDI. The results are shown in Table 4. Columns (1), (2), and (3) represent the impact of FDI on a province's OFDI level in different regions. In the eastern region, the figure representing how FDI influences a province's OFDI level is -0.242, and it's significant at the 1% level. In the central region, this figure is -0.201, with significance at the 10% level. In the western region, the number is 0.659, and it's significant at the 1% level. The possible reasons are that in the eastern region, due to its high level of economic development, policies may focus more on guiding FDI towards high-value-added industries, resulting in a relatively smaller promotional effect on OFDI. In the central and western regions, differences in policy orientation and regional development strategies may lead to different levels of demand and dependence on FDI, causing variations in the coefficients of the impact of FDI on OFDI levels. In summary, in the eastern and central regions, FDI inhibits a province's OFDI level, while in the western region, FDI promotes a province's OFDI level.

Table 4. Heterogeneity test results

Variable	(1) Eastern region	(2) Eastern region	(2) Western region
FDI	-0.242***	-0.201*	0.659***
	(0.081)	(0.116)	(0.133)
Control variables	Yes	Yes	Yes
Time fixed effects	Yes	Yes	Yes
Province fixed effects	Yes	Yes	Yes
N	176	128	192
r2	0.967	0.947	0.953

6. Conclusion

6.1 Research Findings

In the new era, it is necessary to adhere to the development direction of "giving equal importance to bringing in and going out," fully utilizing domestic and international resources and markets. Especially against the backdrop of the "Belt and Road" initiative, clarifying the connection between drawing in foreign investment and investing overseas and promoting their coordinated development is a common issue faced by both academia and policymakers. Therefore, this paper combines Dunning et al.'s (1981)[1] Investment Development Path theory and uses panel data from 31 provinces (municipalities) in China from 2007 to 2022 to analyze the impact of attracting foreign investment on outbound investment through theoretical mechanisms and empirical testing, yielding the following conclusions:

(1) Regardless of whether control variables, time, and province fixed effects are included in the model, FDI enhances a province's OFDI.

(2) The impact of FDI on a province's OFDI level differs across regions. In the eastern and central regions, FDI inhibits a province's OFDI level, while in the western region, FDI promotes a province's OFDI level.

(3) Despite China attracting substantial foreign investment, the formation and growth of outbound investment seem to be more closely related to government incentive policies. In particular, after the State Council issued a series of opinions in 2006 to encourage and regulate enterprises' outbound investment cooperation, China's outbound investment showed rapid growth.

6.2 Comparison with Existing Studies

Compared with existing studies, this paper has both similarities and improvements. Similar to Zhu Shiwang (2020)[4] and Chen Hao (2018)[7], this study confirms the regional heterogeneity of FDI's impact on OFDI in China, which aligns with the consensus that "development context shapes investment effects" in academic circles. However, it differs from Li Fuyou (2020)[5], who only emphasized the spatial agglomeration of FDI—this paper further incorporates industrial structure, labor force size, and regional openness as control variables, and verifies the moderating role of government policies, making the impact mechanism analysis more comprehensive. In terms of development, unlike Chen Taotao's team (2017)[6] which focused on global or cross-country comparisons, this paper uses longer-time-span provincial panel data (2007-2022) and adds robustness checks such as lagged variables and exclusion of special events, improving the reliability of empirical results.

6.3 Unresolved Issues in the Study

This study still has limitations and unresolved problems. First, the research scope is limited to China's provincial level, and it fails to further analyze the micro-mechanism at the enterprise level , resulting in a lack of depth in mechanism discussion. Second, when measuring "government incentive policies," this paper only uses policy events as a qualitative reference, without constructing a quantitative policy index, which may lead to insufficient accuracy in assessing policy impacts. Third, it does not consider the heterogeneous effects of different sources of FDI on OFDI, which may ignore the differences in spillover effects of FDI with different attributes.

6.4 Policy Suggestions

Over the past 40 years of reform and opening-up, China's economic development has undergone an extraordinary journey. With the progress of China's economic restructuring and opening-up level, China has leaped from a populous and backward country to the largest developing country with the most vitality and influence in the world. China's remarkable achievements could not have been achieved without close economic exchanges with the world and win-win cooperation with other countries. With this in mind, we put forward the following suggestions:

(1) The role of the government is indispensable for developing countries to develop under open conditions. The government should clearly recognize that policy priorities differ at different stages of economic development, strengthen international cooperation and exchanges, learn from the successful experiences of other countries, grasp the logic of the staged development of bringing in foreign investment and investing abroad, and formulate timely opening-up policies. In addition, under the constraint of the overall global strategic objectives, foreign-invested enterprises often do not actively promote the willingness of the host country's industrial development. Therefore, in the process of utilizing foreign investment, the government needs to continuously guide foreign investment through corresponding policies, improve the quality of "bringing in" and the intensity of "going out," so that "bringing in" can better promote "going out."

(2) Developing countries should actively seek industrial structure transformation and improve the international competitiveness of local enterprises. Given the complexity of foreign capital characteristics, developing countries can upgrade and innovate their industries to boost the international competitiveness of local enterprises, thereby promoting the development of outbound investment and striving to ascend to the high end of the industrial chain. In this process, local governments should focus on guiding high-quality foreign capital inflows that are market-oriented and market-related during the process of attracting investment, promoting the positive spillover effects of high-quality foreign capital, and avoiding the influx of low-skilled foreign capital oriented towards cost.

(3) The size of the labor force and human resources play a positive moderating role in attracting foreign investment to promote outbound investment. The country and government need to attach importance to human capital development, enhance independent innovation capabilities, and recognize the importance of absorptive capacity for enterprises to learn advanced technology and management experience from foreign multinational enterprises. We should pay particular attention to nurturing talent and the employment of staff in foreign - funded enterprises.

6.5 Future Research Prospects

Future research can be expanded in the following directions: First, use enterprise-level micro data to explore the micro-path of FDI affecting OFDI, so as to supplement the mechanism analysis at the macro-provincial level.

Second, construct a multi-dimensional quantitative index of government policies to more accurately evaluate how policies function in the connection between FDI and OFDI. Third, classify FDI by source country or industry, and further examine whether FDI with different attributes has heterogeneous impacts on OFDI, which can provide more targeted policy implications for developing countries to attract foreign investment.

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