

Abstract

There are both empirical and theoretical arguments for the thesis that external factors have an impact on domestic institutional quality. Consequently, external factors may have large effects on domestic income via local institutions. This paper investigates the role of external factors by estimating the impact of openness and the institutional environment of proximate countries on local institutions and local income. In a 107-country cross-section, we find that both openness (in trade, and especially FDI) and the institutional indicators of nearby countries have an independent impact on local institutional indicators. The effects on income levels are not symmetric, however. We estimate that trade openness plays a major role as a direct determinant of the income level, and a smaller role in determining local institutions. By contrast, institutions of nearby countries are a prime determinant of local institutions, but carry no direct effects on local income levels.