

Abstract

This paper studies external factors that influence quality of governance inside a country. The main finding is the importance of relative geographical location: good governance in the neighboring countries has a positive impact on quality of governance inside a particular country. Spatial links work mostly through long-term determinants of governance that include culture, legal system, and colonial history. At the same time, the closest neighbors have the strongest impact on quality of governance, while cultural and colonial "neighbors" that are not close geographically, have very little impact on the local institutional development. According to our results, cross-country regressions that do not take into account spatial interdependence of countries can produce biased estimation of the coefficients and incorrect inference of variance-covariance matrix. Spatial lags of exogenous variables are used as instruments for the quality of governance and Generalized Method of Moments (GMM) is applied to estimate the model. Another important finding of the paper is that spatial lags of exogenous variables are very good instruments for governance indicators and can be used in the models that investigate the impact of good institutions on economic growth.