

Ice, Water, and Steam: Threshold Effects and Getting the Institutions Right

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Abstract

Although there is a widespread scholarly consensus that “getting the institutions right” generates beneficial economic outcomes, much of the literature is unclear about what the right institutions are and how exactly they affect economic growth. In this paper, we improve upon these shortcomings by introducing a threshold model of how institutions affect outcomes. Specifically, we survey laboratory experiments (which are in many ways ideally suited for studying the effects of institutions) that demonstrate that the relationship between institutions and outcomes is characterized by threshold effects. That is, at low levels of institutional quality, improving the institutions has little effect on outcomes. Indeed, it is not until institutional quality crosses a threshold that outcomes will improve. Given the extensive evidence of threshold effects, we argue that scholars must rethink common policy recommendations and develop an understanding of the relationship between institutions and outcomes that accounts for the threshold effects observed in experimental settings.

¹ The author’s would like to thank Mat McCubbins and the Chancellor’s Associate Chair VIII for financial assistance. Contact information for the authors is clboudreau@ucsd.edu and nweller@ucsd.edu.