Rev Austrian Econ (2008) 21:209–218
DOI 10.1007/s11138-007-0035-z

Government intervention and the structure of social capital

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Published online: 5 January 2008

Abstract Over the past decade, policymakers and scholars have devoted increasing attention to the nature and role of social capital in the functioning of society. We examine the implications of government attempts to manipulate the existing structure of social capital to create homogeneity among agents. We find that these attempts can weaken, erode or destroy existing social capital. We conclude with policy implications regarding government efforts to create or manipulate social capital.

Keywords Government intervention · Social capital · Trust

JEL codes B53 · Z13

1 Introduction

Since the sociologist James Coleman (1988) introduced the term "social capital", social science scholars ranging from political science (Putnam 1992, 2000; Putnam and

We thank Peter Boettke for helpful comments and suggestions. An earlier version of this paper was presented at the Southern Economic Association Meetings, Washington, DC, November 19, 2005.

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Feldsteing 2002; Fukuyama 1995, 1999) to economics (Knack and Keefer 1997; Glaeser et al. 2000a; b) have incorporated the concept into their research in various forms.[1] Important recent work by Chamlee-Wright (2008) points out that social capital, which includes the array of relationships, norms and interactions that facilitate interactions, should be viewed as a complex structure of complementary components that are constantly evolving.[2] Just as the entrepreneur is the agent of change in the realm of economic capital, so too can we envision entrepreneurs acting in the realm of social capital. In the economic realm, entrepreneurs must align heterogeneous capital goods that have multi-specific uses. Similarly, entrepreneurs in the social realm act to align and discover new combinations of social capital.[3]

Because of its importance in the functioning of society, over the past decade, policymakers have also devoted increasing attention to the nature and role of social capital. The World Bank, for instance, has incorporated the concept as a key element of its programs aimed at fostering economic development.[4] Along these lines, the Bank has emphasized promoting the creation of social capital in underdeveloped countries as a critical step in changing their economic and social trajectories.

Several authors have considered some of the potential problems with government intervention aimed at manipulating the structure social capital. Elinor Ostrom (2000: 180–1) discusses the knowledge problem associated with government intervention. External agents may not even realize that their actions are destroying existing social capital combinations. She also highlights the possibility of government intervention crowding out private investments in social capital, as well as discussing the public choice issues associated with interventions aimed at affecting its structure (Ostrom 2000: 182). Ikeda (2002, 2004) discusses the dynamics of intervention as it relates to social capital,[5] and points out that these interventions may generate unintended consequences that require further interventions to achieve the desired end.

Missing, however, is a mechanism that explains how these perverse outcomes of intervention occur. For instance, why does government intervention crowd out private investment in social capital? Likewise, why does government intervention generate unintended consequences that may require further intervention? To answer these questions, this paper focuses specifically on one type of government intervention in the structure of social capital—state-directed attempts to create homogeneity within a society.

One example of this type of intervention is Quebec's language laws that govern many aspects of life in the province. These laws not only make French the official language of the province, but also mandate specific guidelines for the preparation of documents and advertising. For instance, the laws state that all legal documents in the province must be in

[1] For a general survey of the current state of the literature on social capital, see Dasgupta and Serageldin (2000); Lin et al. (2001); Portes and Landolt (1996).

[2] For others who model social capital in a similar fashion see, Ikeda (2002, 2004) and Coyne (2005).

[3] We recognize that there is a fundamental difference between entrepreneurial activity in the economic realm and in the social realm. The economic realm is characterized by prices and profit and loss while these mechanisms are either limited or absent in the social realm. While recognizing the importance of this issue it is not our aim in this paper to contribute to this discussion. For a theory of entrepreneurship in the non-profit sector, which addresses these issues, see Boettke and Prychitko (2004).

[4] The World Bank social capital website is: http://www1.worldbank.org/prem/poverty/scapital/home.htm

[5] For more on the nature of the dynamics of intervention see, von Mises (1929), Rothbard (1977) and Ikeda (1997).

French, as well as requiring that all store signs contain twice as much French as English.[6] Other examples of attempts to impose heterogeneity include public education systems and the current efforts in Iraq and Afghanistan to establish centralized political, economic, and social institutions.

Our core thesis is that interventions by government to manipulate the structure of social capital with the aim of creating homogeneity have undesirable effects on the social and economic order. Our analysis applies Leeson's (2007a, b) theory of social-distance reducing signaling for trade expansion in the context of social capital. Government interventions in the structure of social capital produce a signal extraction problem whereby the signals that naturally evolve between social actors through existing social capital combinations are distorted. As such, the natural rate of interaction and exchange are distorted as well, retarding entrepreneurial discovery of new social capital combinations and eroding existing ones.[7]

2 The structure of social capital

The structure of social capital consists of the various combinations of social norms and relationships that exist at any time. Some of these combinations may be close-knit and exclusive—what social scientists have termed "bonding social capital"—or they may be loose ties that allow for impersonal interaction—what social scientists have termed "bridging social capital."[8] Individuals, acting in an entrepreneurial manner, seek out new combinations of social capital to achieve their goals. Social capital is consequently not a fixed and static stock. Instead, it is more accurately understood as a continual changing and ongoing discovery process (Chamlee-Wright 2008). Over time, new social capital combinations are discovered while others are discarded. As this process unfolds, the structure of social capital evolves in its overall make-up.

Uninhibited, this discovery process leads to a "natural level" of social capital, which in turn facilitates a "natural level" of exchange. Entrepreneurs discover those social capital combinations they find profitable given the institutional environment and constraints they face. For instance, at any time, an individual may have some relationship with close family and friends, another with a church community and another with distant trading partners. The norms governing these relationships will be different in each case and will vary depending on what the individual hopes to achieve through the relationship.

In cultivating these various relationships, individuals and those they interact with invest in and adopt certain signals to convey their credibility and trustworthiness to others (Leeson 2007a). These signals compose important elements of social capital. The signals adopted by

[6] Lawmakers in Quebec are also attempting to extend these laws to the Internet. See, "Quebec firm ensnared in language web," *The Washington Pos*t, June 19, 1997. Available at: http://www.efc.ca/pages/media/washington-post.19jun97.html

[7] Our argument here about government intervention in the structure of social capital closely parallels the Austrian theory of business cycles based on government manipulation of economic capital (see, for instance, von Mises 2005, 1912; Hayek 1935; Garrison 1989, 2001). In both analyses, government attempts to artificially boost exchange and interaction cause signal extraction problems and distortions in the structure of capital. Furthermore, in both arguments, government's actions may temporarily increase exchange. However, since this increase does not reflect the underlying realities of the market, in both cases, the state's intervention ultimately results in less exchange than prevailed before the intervention.

[8] For more on the distinction between bridging and bonding social capital, see Putnam (2000: 22–24) and Putnam and Feldstein (2002: 279–282).

individuals to facilitate new or existing relationships vary but may include things like membership in a group or association, the adoption of a language, or other cultural practices. Investing in certain signals communicates to others information about the investing individual's underlying type. The adoption of some signals may indicate a certain level of credibility, while the failure to adopt others may indicate the opposite.

The resulting natural level of social capital in society reflects the preferences of individuals for investing in and cultivating the array of relationships and social capital combinations. Individuals are willing to invest in adopting signals of credibility and trustworthiness when the expected benefit of doing so outweighs the expected cost. The related costs include whatever steps must be taken to adopt the relevant signal. Learning a new language to develop a relationship with an outsider, for instance, is a costly endeavor. The benefits are the expected gains from potential interaction and exchange in current and future periods.

It is common to see a need for government as an active player in the creation of social capital. As Fukuyama (1995: 16–17) notes, for example, "When there is a deficit in social capital, the shortfall can often be made good by the state, just as the state can rectify a deficit in human capital by building more schools and universities".[9] These interventions are beneficial, it is argued, when social capital is absent or when a society possesses social capital deemed to be undesirable. In this latter case, interventions by government serves as an exogenous shock aimed at shifting the existing structure of social capital.

Government intervention in the structure of social capital can take a number of different forms. Here we focus on government efforts to create homogeneity across individuals with the aim of increasing interaction and exchange between citizens. Some readily apparent examples of this include imposing standards or creating centralized institutions such as courts and political institutions. Interventions aimed at manipulating the structure of social capital are not limited to local and national initiatives. Efforts to manipulate the structure of social capital can also be international in nature, for instance, the World Bank's focus on fostering social capital in developing countries, or military interventions in weak and failed states where foreign governments attempt to establish central liberal democratic and social orders.

Government interventions that manipulate the structure of social capital with the aim of creating homogeneity are not part of the natural process described above. In other words, these interventions are not part of the process whereby entrepreneurs discover new combinations of social capital and individuals voluntarily adopt signals to indicate credibility and trustworthiness to others. Instead, the social capital combinations created by the government are exogenously imposed on members of the society. This has perverse effects on the structure of social capital and also on the level of interaction and exchange.

Specifically, government intervention in the structure of social capital creates a signal extraction problem for individual agents. Before government intervention, individual actors could judge the credibility and trustworthiness of others by the signals they voluntarily adopted. Government-created social capital combinations introduce homogeneity into the system that diminishes the effectiveness of signals that previously indicated underlying agent types. Agents can observe the signals being sent by others but cannot determine if they are credible.

[9] To be fair, Fukuyama does recognize the potential problems with government intervention, "Government often has to step in to promote community when there is a deficit of spontaneous sociability. But state intervention poses distinct risks, since it can also too easily undermine the spontaneous communities established in social society (1996: 27).

For instance, the government may introduce a set of mandatory standards that decree that a certain activity is either required or illegal. Because all individuals must adopt the standards by government decree, the adoption of the standards no longer serves to signal the underlying type of the individual to others. Stated differently, actors will not be able to judge whether the signal, and hence the individual, is credible or not. Both those individuals who are credible, as well as those who are not, are required to adopt the same set of standards. Consequently, the signal no longer serves as an effective indicator of agent type. Leeson (2007a), for instance, shows how government prohibitions that outlawed certain religious practices perversely impacted individuals' abilities to successfully extract signals following legal changes introduced by European powers in colonial Africa.

There are two possible effects of this government-created signal extraction problem. The first effect is that individuals increase interaction and exchange with others. They interpret the government-created social capital combination as viable and interact with others adopting that same signal. The level of interaction and exchange temporarily rises above its natural level. The magnitude of this effect depends on several factors including the nature and extent of the government intervention. For instance, the mandate of a standard that is implemented over time or applies only to some agents may lead to a short-term increase in interaction and trade only among the affected portion of the population. Furthermore, individuals must learn that the signal is no longer effective. Only when agents realize that the mandated signal is not actually a viable indicator of credibility will the second effect, discussed below, come in to play. In contrast, if the specifics of the mandate—the implementation, who is required to adopt the standard, etc.—are known by all, the intervention may have no impact. In this case, the intervention does not generate increased interaction or exchange.

The second effect is that government-created social capital combinations cause individuals to significantly decrease their level of interaction and exchange. In this instance, individuals cannot utilize the social capital combination as a clear signal of credibility or the lack thereof. As such, they remove themselves from interactions and exchanges that they otherwise would have engaged in. In this case, individual agents limit their interactions to relationships that can be effectively governed by bilateral punishment. In such relationships the individual can punish cheaters by refusing to enter into future transactions. When this occurs, the government intervention, which is initially aimed at increasing interaction and exchange, has the reverse effect.

These two effects are not mutually exclusive and may both occur following a government intervention. For instance, the government-created social capital combination may initially increase interaction and exchange as individuals engage with others who have been forced to adopt the same signal. However, this is an artificial "boom" over the natural rate of interaction and exchange that is not sustainable.

Individuals will come to realize that they cannot distinguish agent type based on the signal and will subsequently tend to reduce their overall level of interaction and exchange. As previously mentioned, the resulting reduction in interaction and exchange may fall below the natural rate. In such a situation, as long as government maintains the artificially created social capital combination, the structure of social capital will not return to its natural path.

The process described above provides a means of illuminating the mechanism through which government intervention in the structure of social capital generates perverse outcomes. Government interventions may crowd out private social capital combinations on a number of margins. One possibility is that the government may outlaw the adoption of certain types of signals, as it did in colonial Africa. Similarly, if government mandates the adoption of a certain signal it may, over time, make previously effective signals ineffective. Finally, if the second effect of government intervention comes to fruition and individuals reduce their level of interaction and exchange, this will distort the structure of social capital in future periods. Individuals will not be willing to seek out and invest in new social capital combinations with other individuals. Instead they will retreat to their small, close-knit groups where the underlying types of others are well known.

Along similar lines, the signal extraction story helps to explain the knowledge problem and the dynamics of interventionism as they apply to government intervention in the structure of social capital. Government agents initially intervene with the aim of increasing interaction and exchange. However, they lack the full knowledge of existing social capital combinations and the signals used by various individuals and groups to judge the credibility and trustworthiness of others. While this intervention may increase the level of interaction and exchange in the short run, it is unsustainable over the long run. When individuals reduce their level of interaction and exchange, government agents have two choices: they can rescind the original intervention, or they can intervene again with the aim of increasing interaction and exchange.

3 Case study in the effects of government-imposed homogeneity

An example serves to illustrate the process described above. Kranton and Swamy (1999) provide an analysis of the impact of introduction of civil courts in Colonial India by the British and its impact on agricultural credit markets in the Bombay Deccan. Their study shows that before the introduction of the courts, a functional informal credit market existed. This market was based on relationships between borrowers and lenders over time, which partially composed society's structure of social capital. These relationships were in turn grounded in signaling long-term credibility and trustworthiness between parties. The introduction of civil courts, which homogenized contractual enforcement procedures, shifted the incentives of borrowers and lenders such that previously effective signals became ineffective. Initially, exchange increased, but ultimately the courts generated distrust and social unrest.

Before the legal reforms that introduced civil courts, the informal market was based on relationships between lenders and borrowers (farmers). Both parties invested resources in cultivating their relationship through actions that signaled trustworthiness and credibility. Individuals, acting as social entrepreneurs, invested resources in discovering social capital combinations that allowed them to lend or borrow funds.

Borrowers had access to only a few lenders, and lenders had to ensure that borrowers were indeed trustworthy. If in fact the borrower defaulted, the lender would need to utilize his private resources to attempt to recover the outstanding loan. As such, there was a large benefit to the lender of ensuring *ex ante* that the borrower was in fact credible. By incurring the cost of investment in reputation, borrowers would signal to lenders that they were credible thereby reducing the potential for default. Since lenders had to expend personal resources to recover defaulted debts, a signal of trustworthiness was a valuable commodity that reduced transaction costs.

To understand the functioning of the informal credit market, it is important to realize that it was not just borrowers that signaled credibility. A key aspect of the lender-borrower relationship was the widespread willingness of lenders to assist borrowers in times of crises and economic downturns. This was critical to the livelihood of the farmers because it allowed them to continue operations even during economic downswings. The logic behind lenders' willingness to extend further credit during downturns is straightforward. These lenders had a direct interest in the productivity and success of farmers. Because they had invested in signaling credibility, lenders knew that current clients would return to them in future periods for further credit. Because they would interact and exchange in future periods, lenders had a direct interest in ensuring that borrowing farmers maintained their assets so that they would demand more complementary goods and hence credit in the future. As such, both borrowers and lenders had an interest in signaling credibility. Borrowers invested in signals that indicated they were a wise long-term investment for lenders. Likewise, lenders signaled that they would not seek to collect defaulted debts during economic downturns.

The British took control of the Bombay Deccan in 1818. Soon thereafter they introduced legal reform and civil courts, which allowed lenders to recover debts from borrowers through court order. The logic behind the introduction of the courts was as follows. In markets that are segmented, transaction costs are high. Economic interaction and exchange can be increased if those transaction costs can be reduced. An effective centralized legal system, which homogenizes through mandate the procedure for enforcing contracts and settling commercial disputes, is thought to be one means of accomplishing this goal. And initially, it seems as if it did.

With the introduction of the civil courts, the number of lenders increased and the market became increasingly competitive. The formal credit market quickly grew. Interest rates fell and borrowers had access to numerous lenders.[10] While the legal reforms at first appeared to achieve the desired goal, in actuality they produced significant unintended consequences. Because lenders could now recover unpaid debts using the courts, the incentive to invest in cultivating relationships through signaling a long-term commitment with borrowers was greatly weakened.

Relationships that existed before the legal reforms were eroded as borrowers had a greater number of lenders to choose from. Most importantly, lenders no longer had a direct incentive in ensuring the long-term success of borrowing farmers. There was no longer a long-term relationship between borrowers and lenders and there was no guarantee that borrowers would return to lenders in future periods. As a result, when economic downturns occurred, lenders would use the full power of the courts to recover funds owed to them. This stands in stark contrast to the period preceding the legal reforms when lenders would provide extensions and additional credit to clients affected by economic downturns. In sum, before the formal courts, both parties in the borrower–lender relationship had an incentive to invest in signals of credibility and trustworthiness. After the introduction of the courts, this incentive was removed.

The initial "boom" of interaction and economic activity generated by an increase in lenders and a fall in interest rates was not sustainable. Indeed, as Kranton and Swamy (1999) indicate, the erosion of relationships between lenders and borrower led to increasing social tension. This led to a number of riots and violent attacks on moneylenders. As a result, the British appointed a Deccan Riots Commission to investigate this turn of events. A passage from the Commission's report nicely illuminates the impact of government intervention in the structure of social capital that existed before legal reforms:

> ... for all practical purposes, the relations between the debtor and the creditor were determined... without reference to any legal... means of enforcing payment of debts...

[10] Kranton and Swamy (1999) provide specific data on the increase in interaction and exchange in the credit market after formal legal institutions were introduced.

> the relations between lenders and... debtors were those of mutual interest and confidence... Under our... British system this happy and mutually advantageous state of affairs has... been completely overturned... Mutual confidence and goodwill have been replaced by mutual distrust and Dislike. (quoted in Kranton and Swamy 1999: 6)

This "mutual confidence and goodwill" that existed before the formal legal institutions manifested itself in signals of credibility and trustworthiness that parties invested in before the implementation of legal institutions.

The case of the Bombay Deccan provides an example of the mechanism we described above. Government attempts to manipulate the structure of social capital to increase homogeneity generates perverse social and economic effects. While the impact of these interventions may increase interaction and exchange in the short-term, this artificially induced boom is unsustainable. This is due to the fact that government-created social capital combinations do not align with the underlying preferences of the actors in the social setting. Signals that were previous effective in indicating agent type are distorted or destroyed and interaction and exchange suffer.

4 Implications for policy

The analysis put forth here has several implications for policy. The overarching implication is that government's focus should not be on directly intervening to manipulate the structure of social capital with the aim of increasing homogeneity. Instead, emphasis should be placed on creating an environment whereby social entrepreneurs can discover new combinations of social capital. As discussed above, the entrepreneur plays a key role in the development of social capital. The entrepreneur is continually engaged in a process of discovering new capital combinations. If the aim of policy is to achieve sustainable social capital combinations, it is imperative that social entrepreneurs have the freedom to discover and cultivate these combinations. This realization highlights the importance of the institutional environment for the creation and maintenance of the structure of social capital (see Sobel 2002: 146–149).

Boettke and Coyne (2003) consider the direction of causation regarding entrepreneurship and economic development. In other words, does entrepreneurship "cause" economic development or is it a consequence of development? They conclude that it is in fact the former. Given that entrepreneurs are present in all settings, it is the institutional environment of a society that generates positive-sum, zero-sum or negative-sum activities. Only in the context of the appropriate institutions will entrepreneurs engage in positive-sum activities that are the essence of economic progress. A similar line of reasoning applies to social entrepreneurs and the discovery of social capital combinations. If the institutional environment precludes or greatly hampers interaction between individuals outside of close-knit groups, we should not expect the structure of social capital necessary to support liberal orders to exist.

Our analysis also has implications for government involvement in institutional reform. As the example of the Bombay Deccan illustrated, government intervention in the structure of social capital can have real effects on the social and economic order. This indicates that imposing formal institutions may often be ineffective, and in the extreme can generate more harm than good. This insight is especially important since nation building and reconstruction efforts are currently a central policy issue facing the international community. In many of these countries, there are various groups of differing religions, ethnicities, etc. Attempts to create homogeneity via imposed institutions may generate perverse effects. This same insight also applies to the development community working in underdeveloped and transitioning countries.

Over the past decade, "civil society" has become a buzzword in the development community. International aid organizations have drastically increased the number of projects aimed at fostering civil society. For instance, within the United States Agency for International Development (USAID), spending on civil society initiatives have increased from $56.1 million in 1991 to $118.1 million in 1993 and to $181.7 million in 1998 (Carothers 1999: 50). Although he did not use the specific term, the importance of civil society can be traced back to the work of the nineteenth-century French author, Alexis de Tocqueville. In *Democracy in America*, Tocqueville noted the way that Americans interacted with one another, or as he called it, the "art of association."[11] It was Tocqueville's contention that Americans had a unique talent for engaging in this art.

The art of association referred to the robust civil society, consisting of an array of associations and social networks, which Tocqueville observed during his travels throughout the country. These associations and networks that comprise civil society were not the result of government design, legislation or intervention. Instead, civil society evolved through the individual ingenuity of self-reliant, entrepreneurial actors.

While those in the development community rightly recognize the importance of civil society, they too often focus on the importance of associations while neglecting the "art" involved in such interactions. Tocqueville emphasized that the art of association was the result of "habit" and "faculty," which requires individuals to possess a certain skill and disposition (1969: 513–517). In short, it is not a matter of simply creating voluntary associations. While the creation of voluntary organizations may strengthen existing social capital combinations, it also presupposes the existence of a certain type of social capital that allows civil society to emerge in the first place. As such, one should not expect government-created associations to generate a robust civil society in the Tocquevillian sense. Indeed, as our analysis indicates, such interventions can generate perverse outcomes that run counter to the initial intention.

Finally, although not the focus of this paper, it is important to keep in mind that there is also a "dark side" to social capital (Levi 1996 and Portes and Landolt 1996). Social capital can be exclusive in nature and social capital combinations that foster crime, violence, and unsocial behavior may form and evolve. The social capital combinations that exist within terrorist organizations are one readily apparent example of this. Government interventions can clearly disturb or destroy these social capital combinations. However, our analysis indicates that policymakers must also be aware of the potential for negative consequences of such interventions.

[11] For de Tocqueville's discussion of the role of associations in American life, see de Tocqueville (1969: 513–528).

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