Importance of Ethnic Networks in Business Transactions in India

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Sector(s): Finance

Fieldwork: Ideas42

Location: Chennai, India

Sample: 107 pen and stationery stores

Target group: Small and medium enterprises

Outcome of interest: Profits/revenues

Intervention type: Audits Pricing and fees

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In the presence of weak legal structures, people may use ethnic stereotypes to try to minimize their risk during business transactions. Researchers evaluated whether the ethnicities of wholesale buyers and sellers in Chennai, India, affected the transaction terms. They found that traders offered lower prices to buyers of the same ethnicity, but not necessarily because they trusted them more.

Policy issue

Many low-income and middle-income countries have weak legal structures that are unable to enforce contracts between two parties, such as repayment of a loan or honoring a business transaction. In situations where people must make a risky business deal where one party could easily default, they often rely on personal and family contacts, or characteristics they consider trustworthy to substitute for missing governance and contractual enforcement. For example, in many countries certain subgroups of the population are considered entrepreneurial, such as the Marwari' s in India or the Esfahanis in Iran. Similarly, there is a common perception that individuals that come from like backgrounds can easily establish business relationships or even get access to finance through the their community network. In the presence of weak institutions, people may be using ethnic stereotypes to try to minimize their risk during business transactions. Similarly, when two parties from the same ethnicity interact during a business transaction, a higher level of trust may be established. However, there have been no systematic studies that look at the extent to which ethnic networks play a role in business transactions.

Context of the evaluation

In India, Small and Medium Enterprises (SME) contribute 17 percent of the GDP and provide employment for 400 million people . The city of Chennai is home to a wholesale industry for pens and stationery, comprised of a range of SMEs, whose owners come primarily from three different communities: Tamilians, Marwaris and Andhrites. Marwari' s have provided a remarkable proportion of India' s industrialists, and are known for their shrewd business and entrepreneurial skills.

Indian man pictured with his family and his wares

Photo: Robin Saidman

Details of the intervention

This study used an audit methodology to track the effect of both the buyer and seller's ethnicity on prices and bargaining strategies in business interactions. Researchers hired local entrepreneurs from the Tamil, Marwari and Andhra communities to pose as real customers to negotiate large scale pen transactions. These auditors were randomly matched to the wholesalers in such a manner that each shop would be visited at least once by auditors from each of the three communities.

The purchases were divided into two types: printed/customized purchases, and plain/non-customized purchase. Every auditor was assigned to do half of their respective visits for customized purchases (printed pens) and the rest for non-customized purchases (non-printed pens). The customization of pens (printing a logo on them) increases the risk for the seller because if a printed pen order is rejected or canceled at a later stage by the customer, the seller would suffer a larger loss since the secondhand market for these pens is very low. Because of this risk, the seller asks for part of the payment in advance. The amount of the advance payment that the seller charges for the customization may reflect whether the seller trusts the buyer and if so whether it varies with the buyer' s ethnicity.

The script given to the auditors contained specific bargaining rules which the auditors had to follow during their purchase negotiations. These rules were intended to capture the flexibility in the different dimensions of the business transaction like order size, customization of the pens (printing), per unit rate, advance payment, delivery days and mode of payment and quality.

Results and policy lessons

Price Charged by Seller: There was a large difference in the average price of pens depending on the ethnicity of the seller. On average, wholesalers from Andhra demand about 5 percent higher prices than the average price charged. In contrast, Marwari wholesalers demand prices that are 12 percent lower than the average price. These results validate the idea that wholesaler ethnicity can affect business outcomes. However, they do not offer an explanation about why this is occurring.

Upfront Payment by the Buyer: The ethnicity of the buyers also had an effect on business outcomes. The Andhra buyers paid more for a similar product purchase, while the Marwari buyers paid the least. There was not much difference between the advance payments paid by Marwari and Andhra buyers, but both were asked for a higher upfront payment than Tamilians. Additionally, the different ethnic groups seem to have very different bargaining strategies in terms of the final prices they agree upon and the prices they offer as the starting point of the negotiation.

Ethnicity Match: Buyers received a discounted price when they were randomly matched with a wholesaler from their own ethnic group. However, on average the wholesalers do not seem to ask for smaller upfront payments on a customized product if the buyer is from the same ethnic group. If upfront payments are used to measure how much the seller trusts the buyer, it appears that in this context, ethnic group matches are not useful in affecting the level of trust in business transactions. Instead, sellers seem to show "preference-based" discrimination - where the traders prefer to do business with people from their community and so are inclined to give them better deal terms.

Schoar, Antoinette, Raj Kamal Iyer, and Sandya Kumar. "Importance of Ethnic Networks for Business Transactions of the Small Enterprises." Working Paper, Institute for Financial Management and Research Small Enterprise Finance Centre, November 2008.