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Importance of Ethnic Networks for Business Transactions of the Small Enterprises

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Abstract

This paper explores the importance of ethnic networks in determining the outcome of business transactions in Small and Medium Enterprises sector. In a situation of hold up¹ the degree of trust between the business parties will affect the willingness to enter into an agreement with each other. If a wholesaler gets a product customized and then the buyer does not come back to collect the delivery; the value of the products becomes less than the market price. In our study, auditors from different ethnicity purchase either a customized or non-customized product for delivery at a later date. Auditors were asked to adhere to a script and a predefined bargaining process. The analysis of the data shows that ethnicity plays a critical role in determining the fate of a business transaction. A match in the ethnicity of both the parties impacts the bargaining process and subsequently affects the contracted price. These results suggest that ethnicity of parties involved in a contract plays an important role in determination of the contractual features.

¹ The **hold-up problem** is a term used in economics to describe a situation where two parties (such as a supplier and a manufacturer) refrain from making relationship specific investments due to concerns that after the investments are made the other party may try to renegotiate the terms of the contract under the threat of withdrawing from the relationship.

Background

Small and Medium Enterprises (SME) make up an important part of the economies of most of the developing countries. In India for example this sector contributes 17% to the GDP and provides employment to 400 million people². Many economists believe that SMEs play a major role in improving the upward mobility in society and allow for more balanced regional development, since SMEs usually are the most flexible in adjusting to changing economic circumstances of a region or country. One of the earliest descriptions of the transformational role that entrepreneurs can play in society goes back to Schumpeter's (1911)³ description of entrepreneurship as a separate class of individuals that are endowed with specific skill such as increased risk tolerance and the ability to create new and more efficient businesses. These new entrants then form a dynamic class of businesses that often supplants existing firms and ensures the constant inflow of innovations and improvements in the economy.

A large literature following Schumpeter has tried to identify and measure these special traits and talents that distinguish entrepreneurs. Many studies have embarked on quest for this "special entrepreneurial gene". A large literature in sociology and anthropology has conjectured that ethnic differences in a society play an important role in explaining who engages in entrepreneurial activities. The influence of culture on entrepreneurship was first emphasized by Weber (1904). Weber argued that Protestantism ethic encouraged a culture that emphasized entrepreneurial vocations.⁴ These studies document that in many countries specific subgroups of the population are considered entrepreneurial, e.g. the Svabians in Germany, Marwari's in India, Esfahanis in Iran⁵. However, there are no systematic studies that have been able to document whether indeed business people from different communities vary in their approach to business or the strategies by which they trade.

Our study wants to close this gap. We test whether indeed there are important differences in trading strategies and business practices across small business owners in India that come from different ethnic backgrounds. The landscape of Indian SMEs is distinguished by cultural diversity and there are many

² Study by The Associated Chambers of Commerce and Industry of India (Assocham) in 2007-08

³ Joseph A. Schumpeter's The Theory of Economic Development (1911)

⁴ Citation from Iyer & Schoar (2008)

⁵ Citation from Iyer & Schoar (2008)

stories within the country that people from different states run enterprises in their own distinct ways. One of the most famous entrepreneurial traditions in India finds its roots in the trading practices within the *Bania* or *Vaishya* families. India's traditional trading castes⁶ in early modern times were predominantly Aggarwals and Guptas in the North, Chettiars in the South, Parsees, Gujarati Jains and Banias, Muslim Khojas and Memons in the West, and Marwaris across the country. To this date the common perception in India is that these business communities are more adept at entrepreneurship and trade than people from other backgrounds. There are many myths and stories about the way children of these communities are taught from early on how to be a business person. Moreover, there is a common perception that the community ties allow individuals that come from these backgrounds to easily establish business relationships with other people in community or even get access to finance through the community network.

The Set Up

In order to understand whether there are indeed systematic differences between business people from different communities we conducted an audit study in the wholesale industry for pens and stationary items. This industry lends itself very nicely for the purpose of our investigation since the industry is composed of a wide range of SMEs from three different main communities, Tamilians, Marwaris and Andhrites. The Marwari community is known for their shrewd business & entrepreneurial skills. Marwari's hail from Marwar region of Rajasthan and can be identified by their specific surname. This community has provided a remarkable proportion of India's industrialists and have established themselves as traders across India as early as the 17th century. But why Marwari's are good entrepreneurs is still debated. Today you can find this community in all kinds of trades especially where capital investment is slightly higher like money lending, gold business, wholesale and distributorship. Local Marwari folklore says that the Marwar region of Rajasthan is extremely dry and survival is extremely difficult, hence since childhood they are taught to live in limited resources. No farming or usual livelihood possibilities exist in the Marwar region, hence people from this area travel across and start enterprise with their own resource. They migrate outside their region to utilize the opportunity but have retained their distinct entrepreneurial skills. They are known as hard and efficient bargainers. This is one community which shows high communal harmony, kinship, and development of their fellow community members is very crucial for their own business growth. Hence they bring

⁶ Origins of the Modern Indian Business Class , D.R. Gadgil,

help from their own village to the place they have established their business. And transfer of business through generations is the most common practice in this community. Marwari's came almost a century back when the Chennai port was one of the main trading routes especially during East India Company. Hence most of the Marwari entrepreneur in Chennai are the first generation entrepreneurs and have established themselves as one of the main business community. When they came to Chennai, they joined as apprentice in the existing enterprises which were usually run by Tamilians and Andhrites. Once they became conversant with the tricks of the trade, they ventured out or bought shop from the wholesaler itself. Once established in their respective business, they explored other business opportunities and slowly expanded. During the course of the study when we were interacting with the entrepreneurs, they said that they become extra cautious when they have to enter into a business transaction with a Marwari.

Chennai was part of Andhra and Tamil Nadu province before the formation of a separate state and hence you will find that the second highest population in Chennai is of Andhrites. It is extremely difficult to distinguish between a Tamilian and an Andhrites unless they speak their mother tongue because most of them have learnt Tamil and also have similar physical features. Andhrites' are mainly known as small and medium traders. In this ethnic group, the caste based trading is the most common feature⁷. And hence there are specific castes which are known as traders or merchants from ancestral times. Castes like *Rao, Naidu, Chettiar* (*Tamilian trading community is also known by the same name*) are mainly known as trading community in Andhra Pradesh. It is a state which has utilized its resources efficiently especially in agriculture and hence traded in agricultural products. Though the scenario is changing nowadays and they can be found in all kinds of enterprises. In Chennai, Andhrites are mainly seen in spices, grocery trading, transportation business etc.

Tamilians the native of Tamil Nadu are better known for their professional and educational qualifications even if the state is mainly referred in agricultural context. The Tamil trading communities are mainly from the castes *Chettiars & Nadars*. From earlier days onwards these communities were known to take up entrepreneurial activities as social structure restricted trading to these castes only and they flourished in trading agricultural products. .Although this trend has reduced from last decade onwards but even now it is common in Tamil Nadu to assume that if an entrepreneur

⁷ Interview with the auditors & anecdotes from field

is doing well in his business he would belong to one of the trading community only. Typical Tamilian traders would be involved in all kinds of enterprises but usually at a local level trading only. Though there have been many exceptionally good business groups from Tamil Nadu who have forayed to national & international business

Methodology of the Study

We used audit methodology⁸ to understand the effect of ethnicity in the business transactions. For that purpose we hire local entrepreneurs who are from the three different communities as the wholesalers and pose as real customers to negotiate large scale pen transaction. The selection process of the auditors was of utmost importance and we made sure to only include auditors who had the required skill set to pose as entrepreneurs. We also made sure not to disclose any of the expected outcomes of the study to avoid auditor's conscious effort to bring about the desired outcome.

Auditors were trained in the same script to maintain consistency in the study. The script contained specific bargaining rule which the auditors should follow during their purchase negotiations. These rules were 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 & quality.

We identified 107 pen and stationary shops in the city of Chennai that were part of our study. We then hired 47 auditors that come in almost equal proportions from the three communities described above. These auditors were randomly matched to the wholesalers in such a manner that each shop gets visited at least once by auditors from each of the three communities. And also each wholesaler gets matched with respective community auditor (Marwari wholesaler with Marwari auditor; Tamil wholesaler with Tamil auditor and Andhrites with Andhrites). We also made sure that each buyer conducts at least ten different visits so that we can compare negotiation outcomes across wholesalers that were conducted by the same auditor. The order size of the bulk purchase was randomly assigned to the buyer within a

⁸Audit Methodology is an examining or investigative study to understand the issue in-depth using mystery shoppers/auditors. Auditors act or does the shopping legitimately the shops in return for some combination of cash, store credit, purchase discounts or the goods or services purchased

fixed range of 500-750 to create variation in the deals. Auditors were provided with business cards with name of the firm they operate along with company information in order to build an initial trust with the wholesaler that the deal is a legitimate business transaction. The type of company the auditors represented were from four common categories in this market (event management, advertising agency, conference organizer and marketing company).

The purchases were divided into 2 types i.e Printed/Customised purchase & Plain/Non Customised purchase. Every auditor was assigned to do half of their respective visits for customized purchase (Printed pens) and the rest for non customized purchase (Non Printed pens). The customization of pens (via printing a logo on them) allows us to vary the hold-up risk for the seller as from the pen traders perspective if a printed pen order is rejected or cancelled at a later stage by the customer, the wholesaler would suffer a larger loss since the second hand market for these pens is very low. This customization aspect helps us to understand the trust of the wholesaler on the auditor and if so whether it varies with the ethnicity.

The flow of the script was such that the auditor were to introduce themselves with their respective native place which signals the ethnicity of the auditor and also enquire about the wholesalers ethnicity before they start their bargain for the bulk order. This was to ensure that the wholesaler is informed about the ethnicity before the negotiation begins.

To confirm the auditors are adhering to the script correctly and to check their performance we had continuous monitoring in the field. During the training of the auditors the first visit of the auditor was to a simulated wholesaler⁹ and on the basis of the feedback on the performance at the mock business transaction the auditor was selected to be a part of this study. The field monitors were not introduced to the auditors so that a performance bias does not occur during the business transaction. The monitors were present in the same shop enquiring for some items while listening to the auditor's bargaining process with the wholesaler. The field monitors were not introduced to the auditors so that a performance bias does not occur during the business transaction.

⁹ A wholesale shop was established at the IFMR campus for the purpose of gauging the skills of the auditors

Major Findings of the study

In analysis of the data captured we primarily focused on the two most important dimensions of the study which are price per pen and the amount of upfront payment. The findings¹⁰ were mapped and investigated across ethnicity of the wholesaler and the auditor (henceforth referred as “buyers”). Also it was cross examined for the consistency across the different visits.

1. Price and Advance payment offered by the wholesalers from different communities

We first investigate how the contract terms vary for buyers and wholesalers from different ethnic groups. We find large and significant differences in the average price of pens depending on the ethnicity of the wholesaler. If the average pen price is 4.50 INR; shops run by wholesalers from Andhra on average demanded higher prices than the Tamil wholesalers approximately 5% difference from the average price. In contrast, Marwari wholesalers on average demand significantly lower price (*Table 1 below*). These results show that Marwari wholesalers on average charge clients a lower price than all other wholesalers, while wholesalers from Andhra offer the highest prices. *The result validate the hypothesis that wholesalers ethnicity does affect the business outcome.*

Table 1

Type of trader	Average price per type of trader (Rs.)
Tamilian	4.50
Andhrite	4.72
Marwari	3.96

Now the interesting aspect to probe is why Marwari wholesalers are offering lower prices? The explanation could be that Marwari wholesalers might be looking for a future business prospect or expecting an increase in the volume of business through “word of mouth” publicity for his low prices. It might also be possible that the Marwari wholesaler would be getting the products at lower price from the distributor because of his effective bargaining skills.

Similarly, in the case of upfront payment for the customized pens the risk of hold up is similar across the wholesaler of different ethnicity. Results confirm that Andhra wholesalers ask for a 10% higher

¹⁰ Refer Iyer & Schoar (2008) for detailed analysis result

upfront payment whereas the Marwari wholesalers ask for 5% lower upfront payments on average compared to Tamil wholesalers. Thus on the dimension of upfront payments & price there are differences in bargaining outcomes across ethnic groups. *This contradicts the local stereotype that Marwari wholesalers will always ask for higher upfront payment because of their shrewd business skills.* The explanation for such a behavior might either be a sign that the Marwari's are most generous and trusting or alternatively it could signal that they are willing to take more risk in their relationship with customers.

2. Price and Advance payment paid by the buyers from different communities

The above mentioned results proves that the ethnicity of wholesaler have a major impact on the terms of contract in a business transaction. Now we try to analyze if the ethnicity of auditors (buyers) have an effect on the business outcome. The result shows that there are large differences in the prices paid by buyers from different ethnic groups. The Andhra auditors paid more than Marwari & Tamil auditors for a similar product purchase whereas the Marwari buyers have paid the least. The reason for such a behavior could be the difference in the bargaining skill or the difference in the treatment of the wholesalers to buyers. Average final price paid by each type of buyer is given below

Table 2

Buyer Ethnicity	Average price per type of buyer (Rs.)
Tamilian	4.50
Andhrite	4.59
Marwari	4.42

On analysis of the upfront payment asked, there is not much of a significant difference between the advance payments paid by the Marwari & Andhra buyers but both Marwari and Andhra buyers on average were asked for a higher upfront payment than Tamilians. *This is in agreement with local stereotype that Tamilians are more honest and would be asked for lower advance payment.*

Also we found that in the bargaining process the wholesalers from Andhra Pradesh make higher initial offers and Marwari wholesalers make lower initial offers than the comparison group Tamil wholesalers. However, the findings indicate that the different ethnic groups seem to have a very different bargaining strategy in terms of the final prices they agree upon and price they offer as the starting point of the negotiation.

3. Importance of a “Match” between the Ethnicity of Buyer and Wholesaler

During the background study on entrepreneurship one thing that comes across starkly is that each and every community has an affiliation towards the development of individuals of their own community. And thus there should be a preferential treatment towards the buyers from the same community.

The investigation in the change of terms of contract, when there is a match in the ethnicity of the buyer and the wholesaler shows that buyers receive a discounted price if they are randomly matched with a wholesaler from their own ethnic group. Wholesalers not only offer buyers from their own ethnic group a better deal upfront but even the initial price offer of the wholesaler is more generous. This suggests that wholesalers might engage in differential treatment between buyers of different ethnic groups. If the wholesaler likes someone they seem to give the person a better deal but they do not necessarily trust them more.

To further test the hypothesis, we look at the upfront payments charged by the wholesalers and compare them between matched and non-matched. If community affiliation serves as a trust indicator we would expect to see lower upfront payments asked when business parties of the same ethnic community are matched. The results suggest that on average the wholesalers do not seem to ask for a different (smaller) upfront payment if the buyer is from the same ethnic group: This result is in contrast to the earlier findings. It appears that in this context ethnic group matches are not useful in affecting the level of trust in the business transaction but seem to show preference based “discrimination”, since the wholesalers are willing to give the buyer a better deal on the purchase.

One possible explanation could be that differences in treatment between ethnic groups are primarily driven by “preference-based” discrimination. If a trader prefers to do business with people from their own community they might feel more inclined to offer them better deal terms. The idea behind preference-based discrimination could be that traders enjoy dealing with people from their own community or feel greater ease of interacting and thus are willing to forgo a bigger fraction of their profits. A variation on the preference based explanation is that social norms or expectations dictate how to behave to people from your own community, e.g. wholesalers might feel compelled to offer fairer deals. An alternative view is that traders expect that people from their own community are more likely to come back and provide future business if they get a good deal the first time around. Here the

“trust” is that wholesalers might expect buyers from their own community to reciprocate more strongly to a fair deal by giving more future business to that wholesaler.

Conclusion:

This paper tries to understand the effect of ethnicity across business transactions. We have used an “Audit study methodology” to collect field data and “Randomization technique” to have an unbiased allocation of shops to the auditors. The auditors entered into contracts with the wholesaler with a predetermined script and the observations helped us to investigate the nature of the business transactions and variation in contract terms because of ethnicity. It also gave us an insight into the entrepreneurial instinct of a specific community. Also it was revealed that a match in the ethnicity of wholesaler and auditor does not help alleviate the hold-up problem. However, we found that when traders of the same ethnicity meet they offer lower prices. The study suggest that all business transactions in the SME sector have a combination of formal and informal contracting and the ethnicity of the parties plays an important role in determining the features of the contract.

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