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## The Economics of Co-ethnic Employment; Incentives, Welfare Effects and Policy Options

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Tinbergen Institute Discussion Paper

# The Economics of Co-ethnic Employment

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# **The economics of co-ethnic employment**

## **Incentives, welfare effects and policy options**

**Frank A.G. den Butter, Enno Masurel and Robert H.J. Mosch \***

### **Abstract**

Co-ethnic employment refers to the stylised fact of many labour markets that there is an over-representation of workers of the same ethnic group within firms. This paper presents empirical proof of the phenomenon and analyses the incentives for employees to work in co-ethnic firms. It argues that strong social networks and related high intra-group trust constitute the major reasons for co-ethnic employment by lowering information and co-ordination costs. In the short run, co-ethnic employment leads to more jobs for employees, easy access to labour for ethnic minority firms, strengthening of the group values and norms, and less unemployment and social security problems for society. In the long run, co-ethnic employment might form an obstacle to the social and economic emancipation of ethnic minority groups. It generates disincentives for individual group members to acquire general skills, hinders the development of ethnic minority firms, fosters the danger of the ethnic trap and stimulates the emergence of an enclave economy.

**Key words:** co-ethnic employment, social capital, trust, networks

**JEL codes:** J61, Z13

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## **1 Introduction**

In many western economies there is a fierce policy debate on the welfare effects of immigration, and more specifically on the (lack of) integration of immigrant groups in the regular labour market. Empirical evidence suggests that the workforce of a considerable number of firms with an ethnic minority owner consists for the larger part of co-ethnic employees. We call this clustering of co-ethnic workers co-ethnic employment. In this paper, we study the questions why so many ethnic minority employees work in co-ethnic firms and how this translates in welfare effects for the employees, the firms, the ethnic minority group and the society. In doing so we seek to explain the rationale behind co-ethnic employment from the perspectives of labour economics and institutional economics

Most of the existing research in this field focuses on ethnic minority entrepreneurs and their ways of doing business. Usually, just small attention is paid to the phenomenon that co-ethnic employees are over-represented in ethnic minority firms, and if this question is raised, the answer is often sought from the perspective of the employer. This paper contributes to the literature by examining the issue of co-ethnic employment from a different angle, namely the perspective of the employees. Instead of studying why employers want to hire co-ethnic employees, we investigate the motivations of ethnic minority employees to work in co-ethnic firms. Our paper argues that strong social networks and related high intra-group trust constitute the major reasons for co-ethnic employment by lowering information and co-ordination costs. Asymmetric information is a well-known phenomenon in the principal-agent relationship between employers and employees. The information asymmetry between bosses and workers is smaller when both have the same ethnic background than when their ethnic backgrounds differ. Therefore search costs, monitoring and bonding costs are lower in co-ethnic employment principal-agent relationships than in the case that the principal belongs to another ethnic group (say a majority group) as the agent (say a minority group). A similar reasoning holds for informational differences and incompleteness of information between workers. Co-ethnic employment seems to lead to immediate positive welfare effects in the short run, but the welfare effects are less prosperous in the longer run, when the dangers loom of ethnic minority group lock-in and inertia.

The set-up of the paper is as follows. Section 2 start with a short overview of the literature on the labour market characteristics of immigrants. Here an operational definition is given and the incidence of co-ethnic employment is illustrated using the results of various surveys. Most of these results relate to our own country, the Netherlands. Given this empirical evidence, section 3 discusses the reasons for co-ethnic employment. Here the focus is on incentives and on the costs of information and co-ordination. Section 4 discusses the welfare effects of co-ethnic employment. Here we consider the positive and negative externalities associated with co-ethnic employment and its consequences for individual welfare and social welfare. This provides a clue for answering the question on policy options to enhance the (positive) welfare effects of co-ethnic employment in section 5, which also summarises the conclusions.

## **2 Ethnic entrepreneurship and co-ethnic employment**

Before we start with a description of the characteristics of co-ethnic employment, we first have to make clear what we mean with this phenomenon. We define a co-ethnic as a firm of which the owner (the employer) has the same ethnic minority background as the majority of his personnel (the employees). Co-ethnic employment refers to the situation that a substantial part of the employees of a specific firm belong to the same ethnic minority group. In this paper, ethnic minorities are considered to be non-western immigrants of the first and second generation. We follow the definition of the Netherlands Central Bureau of Statistics by defining first generation immigrants as persons born in a foreign country with at least one parent born in a foreign country (CBS 2003). Second generation immigrants are persons born in the host country with at least one parent born in a foreign country. In short, immigrants are persons with at least one of their parents born in a foreign country.<sup>1</sup>

The major ethnic minority groups in the Netherlands consist of people from Turkey, Morocco, Suriname, the Netherlands Antilles and Aruba. The people from Turkey and

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<sup>1</sup> We are aware of the discussion that people who were born in a foreign country but migrated to the host countries before their sixth birthday, could be considered as second generation immigrants, because this early migration enabled them to receive their education in the host country (Veenman 1996). As this discussion is somewhat besides the main topic of this paper, we leave this issue by this.

Morocco were invited to work in the Netherlands to fill the labour shortages in the 1960s and 1970s. Suriname, the Netherlands Antilles and Aruba have been colonies of the Netherlands. Suriname became an independent country in 1975. Fear for poverty and the new government in Suriname motivated many Surinams to flee to the Netherlands. The Netherlands Antilles and Aruba are still part of the Kingdom of the Netherlands. This entitles the Antillans and Arubans to study, work and live in the Netherlands.

## **2.1 Labour market characteristics of ethnic minority groups**

Three general observations emerge from the literature on the labour market characteristics of ethnic minority groups: bad labour market performance, high incidence of self-employment and entrepreneurship, and the important role of the own ethnic minority group.

The first observation is that immigrants tend to do worse on the labour market than members of the native born population, also when controlled for objective characteristics like education, gender, age, et cetera. This observation stands in shrill contrast with the popular fear that natives lose their job as a result of immigration. In the Netherlands, non-western immigrants and their offspring have a relatively high incidence of unemployment and a relatively low labour participation rate, see Table 1. Studies for the United States (e.g. Chiswick, Cohen and Zach 1999) and for the UK (e.g. Wheatly Price 2001, Blackaby et al. 1997) show the same kind of immigrant labour market problems. This poor labour market performance of first and second generation immigrants in the recent past, and the resulting small or even negative contributions to welfare, contrast with historical accounts of immigration. For example, the German peasants that migrated to the Netherlands at the end of the 19<sup>th</sup> century) contributed considerably to welfare in the Netherlands (see also section 4).

**Table 1. Labour market position of persons of age 15-64 years in the Netherlands, 1996-2002.**

	1996	1997	1998	1999	2000	2001	2002
<b>Labour participation (%)</b>							
Natives	61	63	64	66	67	67	68
Ethnic minorities	40	41	44	46	48	50	50
From:							
Turkey	34	35	37	40	44	48	46
Morocco	31	35	38	39	34	42	46
Suriname	53	52	58	58	63	62	61
NI Antilles and Aruba	46	45	50	53	55	54	57
<b>Unemployment (%)</b>							
Natives	6	5	4	3	3	3	3
Ethnic minorities	22	21	16	14	11	9	10
From:							
Turkey	24	22	16	13	9	8	9
Morocco	28	22	20	16	13	10	10
Suriname	15	13	12	10	9	6	8
NI Antilles and Aruba	21	21	16	14	8	8	10

Source: CBS 2003: 138.

The second labour market characteristic of immigrants is their overrepresentation in self-employment and entrepreneurship figures. Ethnic entrepreneurs are defined as being united by a set of connections and regular patterns of interaction among people sharing common national background or migration experiences (Waldinger, Aldrich and Ward 1990) or simply as business owners who are not of the majority population (U.S. Department of Commerce 1997). Ethnic entrepreneurship comprises a multi-faceted phenomenon that has at least as many sides as there are different ethnic groups. We refer to the studies of Boissevain and Grotenbreg (1986), Aldrich and Waldinger (1990) and Chaganti and Greene (2002) for general evidence and theory on ethnic entrepreneurship.

The motivations for immigrants to start an own firm vary widely. Negative reasons or push factors are high unemployment (Kloosterman, Van der Leun and Rath 1998), discrimination (Deakins 1999, Johnson 2000), socio-economic status and cultural factors (Rafiq 1992), leaving immigrants no alternative but to start for their own. Positive reasons or pull factors are the need for achievement and the wish to be own boss. Especially sectors with low entry barriers (like retailing and hospitality – bars and restaurants) are attractive for these start-ups; they usually set up their businesses in those sectors where informal production (with low government control) can provide a competitive advantage. This is also the case in the Netherlands, see Table 2.



In comparison with the native population, immigrants are over-represented in hospitality and commercial services.

**Table 2. Persons of age 15-64 years with one or more jobs as an employee as percentage of the total ethnic group in the Netherlands, October 2000.**

<b>Industry</b>	<b>Natives</b>	<b>Ethnic minorities</b>
Agriculture and fishing	1.8	2.0
Mining	0.1	0.1
Industry	13.9	14.4
Utility companies	0.5	0.2
Construction	6.5	2.7
Trade	17.1	14.5
Hospitality	3.0	6.5
Transport and communication	6.4	5.5
Financial organisations	4.0	3.1
Commercial services	15.2	30.5
Public administration	7.2	4.8
Education	6.1	3.1
Health	13.4	9.1
Culture and other services	3.6	2.7
Unknown	1.2	0.7

Source: CBS 2003: 146.

The issue of ethnic minority entrepreneurship is discussed in the literature in the context of the incorporation of new immigrants into the labour market. Classical theories of assimilation assume labour supply as a pool in which immigrants start at the bottom and gradually (and occasionally) climb up the socio-economic ladder, while gaining social acceptance. Integration and emancipation are just a matter of time in this view. A second line of theories considers new immigrants as being mainly additions to the secondary labour market linked with small peripheral firms. According to this theory, ethnic minorities experience prolonged problems in entering the regular labour market and thus seek refuge in self-employment. Wilson and Portes (1980) introduce a third possibility: the enclave economy, which consists of immigrant-owned firms that are isolated from the regular economy, thus constituting a dual labour market. In the words of Portes (1998: 13), enclaves are “dense concentrations of immigrant or ethnic firms that employ a significant proportion of their co-ethnic labor force and develop a distinctive physical presence in urban space” (see also Peterson and Roquebert 1993). The separation of the regular and the ethnic minority labour market is permanent in this case and integration has failed completely.

The third typical aspect of ethnic minority labour and, especially, ethnic minority entrepreneurship is the crucial role of the own ethnic group. Almost by definition the entrepreneur has a strong focus on his (or her) own group, especially the first generation who starts for his (her) own. Nijkamp (2003) stresses that, although network participation by creative entrepreneurs does not necessarily need an urban base, informal spatial networks may be favourable for ethnic entrepreneurs.<sup>2</sup> In the fields of clients, finance, information and employment the ties with the own ethnic group strongly dominate (Waldinger et al. 1990, Ram 1994, Greene 1997, Kloosterman, Van der Leun and Rath 1998). Van Delft, Gorter and Nijkamp (2000) argue that ethnic related social networks appear to be multi-faceted and flexible, and offer good possibilities for the efficient recruitment of personnel and capital. In general, ethnic businesses rely heavily on labour from their particular ethnic group or, more specifically, the (extended) family.<sup>3</sup> Also capital can be more easily borrowed informally (Van Delft, Gorter and Nijkamp 2000). In addition, within the network of the ethnic group, individuals are depending on informal ways of doing business and exchanging information, because there is mutual trust within the network. Lee, Cameron, Schaeffer and Schmidt (1997) call this phenomenon the social resources explanation: the success of ethnic minority business can in part be explained by the existence of such social resources as rotating credits, a protected market, and a labour source.

This third typical aspect of co-ethnic employment is elaborated further in the next section from the general perspective of relative small information and co-ordination costs, but we will first consider the question whether we can find empirical evidence on over-representation of ethnic minority employees in co-ethnic firms.

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<sup>2</sup> According to De Graaff (2002), minimising the costs of adaptation (or migration costs) is the main reason for the spatial clustering of immigrants. This can be translated into various positive spatial externalities, such as the possibilities of obtaining information, housing and even finding future spouses.

<sup>3</sup> This may be a result of labour market discrimination, which is defined by Borjas (1996) as the arise of differences in earnings and employment opportunities among equally skilled workers employed in the same jobs simply because of the workers' race, gender, national origin or sexual orientation and other seemingly irrelevant characteristics. This argument goes back as far as Becker (1957).

## 2.2 Empirical evidence

A number of studies indicates that co-ethnic employees dominate in ethnic minority firms, see Table 3. All of these studies are based on interviews with managers (mostly the owners) of small firms in or around Amsterdam. Most firms operate in the retail sector or in the hospitality sector. Together they form a dataset of 120 ethnic minority firms. Between 50 and 84 percent of these firms only employ co-ethnic personnel. Some firms employ personnel with mixed co-ethnic background and between 16 and 33 percent of the firms only employ non co-ethnic personnel. When we compare these figures with the benchmark of the size of the ethnic minority groups as percentage of total population, this gives a clear idea that co-ethnic employment is a real phenomenon.

**Table 3. Prevalence of co-ethnic personnel in ethnic minority firms in the Netherlands.<sup>a</sup>**

Study	Ethnic background of owner <sup>e</sup>	Number of firms in dataset	Only co-ethnic personnel (% of firms)	No co-ethnic personnel (% of firms)	Personnel with mixed ethnic background
Masurel et al. (2002) <sup>b</sup>	14 Turkey, 15 Pakistan/India, 12 Morocco	41	84.4 %	15.6 %	0.0 %
Baycan Levent, et al. (2003) <sup>c</sup>	Turkey	25	69%	31%	0.0%
Masurel et al. (2004a) <sup>d</sup>	Morocco	14	66.7%	33.3%	0.0%
Masurel and Nijkamp (2004b)	Turkey	40	50.0%	25.0%	25.0%

<sup>a</sup> The empirical evidence does not come from the papers as such, but from the underlying databases. It should be noted, furthermore, that we did not make a sharp difference between active family members and formal personnel.

<sup>b</sup> 2 respondents work alone, 32 work with employees and the remaining 7 do not work alone, but without employees, but with business partners, spouse and or family members. Other ethnic minority personnel accounts for 6.3% of the cases: this is now part of 'no co-ethnic personnel'.

<sup>c</sup> 13 of the 25 firms had employees. Only percentages of total volume were available. 5% of the employees were family members.

<sup>d</sup> 6 work only with Moroccan employees, 5 only with Moroccan family members, 2 with only native employees, and 1 with native employees and Moroccan family members.

<sup>e</sup> People from Turkey, Pakistan/India and Morocco as percentage of total population in 2002, respectively 2.1, 0.1 and 1.8 (CBS 2003: 116).

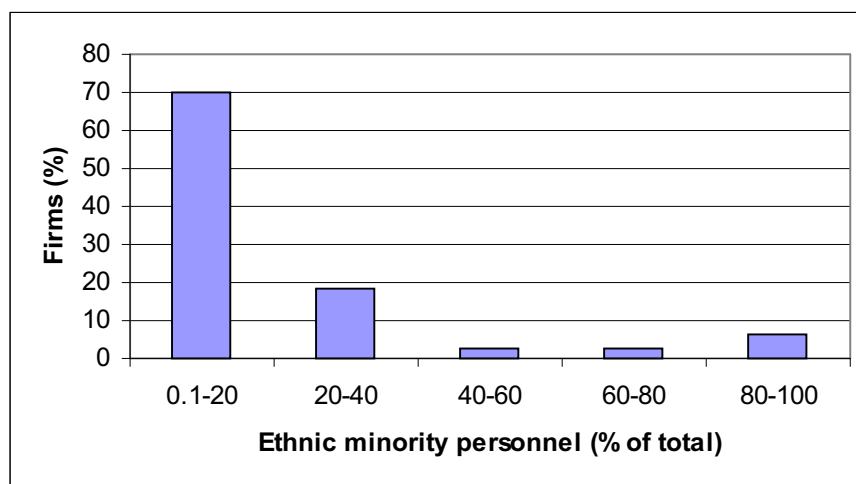
Other evidence for the proposition that co-ethnic employees tend to cluster together in firms comes from a survey conducted by the Netherlands Economic Institute for the Construction Industry (EIB 2003). Their survey was sent to 8883 firms and responded by 3573 firms (40 percent response rate). The definition of an ethnic minority employee in this research is a person of whom at least one parent was born in a non-

western foreign country. A typical aspect of the construction industry is that members of ethnic minority groups are underrepresented in its employment, also see Table 2. Reported causes are the informal way of attracting new employees (which leads to a path dependency), the ‘tough’ culture in this profession, and discrimination and prejudice among employers about the language skills and the productivity of immigrants (EIB 2003: 23). About 90 percent of all firms in the construction sector report to have no ethnic minority personnel.

The prevalence of ethnic minority personnel in the construction industry in firms with at least one ethnic minority employee is shown in Figure 1. The interesting aspect of this figure is the ‘fat tail’ on the right. One would expect that the frequency of firms decreases when the prevalence of ethnic minority personnel rises. This can indeed be seen in the figure until a prevalence of 80 percent. After this, in the 80-100 percent prevalence area, we see an unexpected hump that indicates that there is a substantial number of firms which mainly consist of co-ethnic employees. This confirms the idea that co-ethnic employees tend to flock together. Note however, that we do not know the ethnicity of the entrepreneur in this case.

Although the information from empirical research on co-ethnic employment is scarce, the data that we find all point in the direction that co-ethnic employment is a real and substantial phenomenon. However, there is ample scope for further research on the prevalence and magnitude of co-ethnic employment in different sectors of industry and in different countries.

**Figure 1. Prevalence of ethnic minority personnel in the Dutch construction sector in firms with ethnic minority personnel, 2003.**



Source: calculations based on the survey reported in EIB (2003).<sup>4</sup>

### **3 Reasons for co-ethnic employment**

Given this empirical evidence on over-representation (and under-representation) of ethnic groups in specific firms and sectors of the economy, we now try to explain this phenomenon from the theoretical perspective of information and co-ordination costs.

#### **3.1 Social capital, networks and trust**

In general social networks and social capital are seen as major reasons why ethnic firms hire a disproportionate amount of co-ethnic workers and why co-ethnic workers want to work in co-ethnic firms. Social networks are networks based on some shared characteristics of people, e.g. they have the same ethnic, cultural or religious background, live (or have lived) in the same region or neighbourhood, speak the same language, and/or have the same social-economic status. The importance of these networks is that they can create resources for the members of the network, which is known as social capital. In the words of Bourdieu (1986: 248), social capital is “the aggregate of the actual or potential resources which are linked to possession of a durable network of more or less institutionalized relationships of mutual acquaintance

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<sup>4</sup> We acknowledge the help of the EIB for providing us these data from the survey.

and recognition – or in other words, to membership in a group”. These resources range from highly implicit to concrete material benefits.

Immaterial benefits are generated by the social control function of the network. This involves the creation of uniform values and norms, which ease the co-ordination of behaviour. Values and norms make the behaviour of other people more predictable. This lowers information costs as part of transaction costs by reducing uncertainty without needing the help of expensive formal co-ordination systems, like the police and the legal system. Social control and social sanctions uphold these informal rules. Breaking the rules leads to a depreciation of the reputation of the violator of the rules, sometimes with consequences for his whole family. This can go as far as social ostracism, which has serious consequences for the offender’s social, religious and business life. But values and norms also create loyalty of individual members to (other members of) the group. Even when the network is putting pressure on an individual member, he may decide to stay in the network (not to exit), not to raise his voice and protest (not to voice his anger), but to support the network (to be loyal) (Hirschman 1970).

The advantages of the network can also be found in its function as a communication device, through which reliable information, about for example job opportunities, is spread through the community quickly and efficiently (Portes 1998). Networks can also be helpful in starting up businesses by acting as a lending channel. A famous example are the Korean rotating credit associations in the United States (Light and Bonacich 1988).

The main force behind the networks is that the members see themselves as belonging to the same group of people, who are ‘in the same ship’, and have to co-operate to ‘survive’ in the strange and maybe ‘hostile’ environment they have migrated to. This leads to, as Putnam (1993) calls it, general reciprocity. Members of the network help each other. They do not do this to get their favour returned in the same amount, from the same person and as soon as possible, but in the idea they will receive some kind of help from someone in the network somewhere in the future when they need it in their turn. A characteristic of these networks is that there exists mutual trust, i.e. the members of the network expect that the other members will co-operate and will reciprocate in the future the favours received now.

Results of micro-economic game experiments are in line with the above mentioned characteristics of networks. People tend to have more trust in people that are of the same race or nationality than in other people (Glaeser et al. 2000, Buchan et al. 2002). Reciprocity has also been tested in laboratory experiments. The results suggest that both positive and negative reciprocity influence people's behaviour (Fehr and Gächter 2000).

The effects – advantages and disadvantages – of networks are highly dependent on their degree of density. The more closed and dense the network, the better are the members able to uphold the implicit values and norms of reciprocity and trustworthiness, and the better they are able to circulate information. However, this can easily turn into a disadvantage, as a closed network impairs the risk to miss new, potentially beneficial influences from outside the network. A feature of many high-density networks with high mutual trust among its members is that they expose very little trust in people from outside the network. Fukuyama (1995) argues that this could be the reason that countries in which people only have trust in their (extended) family seem to have relatively less large firms than countries in which people have a higher general trust in strangers, i.e. in people from outside their own (extended family) network. For a firm to grow large, it is necessary to attract strangers with certain skills and capabilities that cannot be found in one's own network or family. This hypothesis has been corroborated by the empirical research of La Porta et al. (1997). If the above is true, then it should be the case that firms owned by migrants from 'low trust' countries (like China, Turkey, South-Italy and France) have a larger portion of co-ethnic employees than firms owned by migrants from 'high trust' countries (like Japan, Germany, North-Italy, Netherlands and the United States).<sup>5</sup> When appropriate data were available, this hypothesis could be tested in future research.

### **3.2 Utility of co-ethnic employment**

We now turn to the incentives for a member of an ethnic minority group to find a job in a co-ethnic firm or a regular firm. A regular firm is a firm in which ethnic minorities are not over-represented in the personnel structure as compared with the

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<sup>5</sup> This distinction in high and low trust countries is based on Fukuyama (1995).

prevalence of the ethnic minority group in the total population. A regular job is a job in a regular firm and a co-ethnic job is a job in a co-ethnic firm. We start with the basic assumption that a person wants to maximise her utility function. She can choose between a regular job and a co-ethnic job. The utility she derives from a job depends on the chance of finding the job (and the search costs) and the rewards of the job (corrected for investment costs in education et cetera). She chooses a regular job if the utility of a regular job is higher than the utility of a co-ethnic job. We first look at the incentive structure that is connected to the rewards, after that we continue with the incentives arising from the search process.

### *3.2.1 Rewards – management problems*

The rewards of an employee are largely determined by her productivity. A widely recognised problem considering productivity is that productivity is hard to measure. Asymmetric information with respect to tasks and their fulfilment between managers and personnel leads to the well-known principal-agent problem. The principal (the manager) has other objectives than the agent (the employee), but is not able to monitor the behaviour of the employee completely. Strong formal monitoring on the aspects of the employee's behaviour that can be monitored often leads to perverse consequences. The employee will tend to do her utmost best to perform well on the monitored tasks but will neglect her other duties. The principal-agent problem is aggravated by the inherent incompleteness of contracts. It is very costly to gather information, some information cannot be obtained at all, it is costly to write down an extensive contract and writing down all possible events may even create distrust among the contracting parties. Furthermore, even with a complete and legally binding contract, severe costs are involved with the enforcement of this contract through judicial procedures. They are costly, time consuming and some parts of the contract cannot be verified by third parties like judges. These highly incomplete contracts give contracting parties opportunity and incentives to shirk on the expense of the other party (Williamson, 1985).

Besides this monitoring problem, also the bonding problem comes forth out of the combination of bounded rationality, scarcity of information and contracting problems. The productivity of an employee rises when she works longer in the same firm (learning by doing) and when specific investments are made. Specificity of an



investment means that the value of an investment is directly dependent of the continuation of the relationship. An example is a firm investing in the skills of an employee while these skills are only valuable in this particular firm. The productivity of the employee in this firm rises and, as long as the employee stays within the firm, the investment leads to extra rents (to be divided between firm and employee). The lack of complete contracts hinders mutually advantageous investments in this case, because the ex ante (before the investment) commitments are not credible in the post-investment phase. The incentives for splitting the rents and continuing the relationship have changed by then. Although there are profitable investments to be made, potential investors may refrain from doing so, because they are afraid that their transaction partner will hold them up.

This means that there is no formal way to solve the principal-agent based monitoring and bonding problems. The principal and his agent have to trust each other, i.e. they expect that the other will refrain from opportunistic behaviour and perform according to the letter and spirit of the agreement. The ability to trust is often seen as an important element of social capital, while networks are regarded as an essential framework for the development of trust and social capital (see e.g. the reviews by Nooteboom 2002 and Sobel 2002). Within a certain network, e.g. an ethnic minority group, members can easily transpose and enforce collective values and norms, which creates mutual trust. Acting in accordance with these values and norms leads to the positive reward of social recognition, while 'bad' behaviour results in a loss of reputation and, in the worst case, exclusion from the network. Because it takes some time to create a solid reputation – a valuable asset as it is useful in both business and social matters – while it can be destroyed at once by one unwise malevolent act, the implied trigger mechanism forms an indisputable strong incentive to behave by the rules.

From this perspective, the ethnic network can be seen as a trust creating device, which makes it possible to economise on the transaction costs that accompany management problems. The informal ties are used as a means of managerial discipline that mitigates the monitoring and the bonding problem. Another advantage of this management device is that it is helpful in substituting formal procedures. Especially in the case of ethnic minority firms, the firm owner might have little or no knowledge

of the official labour market and its regulations. Co-ethnic employees are for these reasons more productive in co-ethnic firms than employees with other ethnic backgrounds. The resulting extra rents for the co-ethnic firm may be split among owner and personnel, which forms a monetary incentive for co-ethnic employment.

If the monitoring and bonding problems analysis is correct, we expect that the average tenure of ethnic minority personnel is lower in regular firms than in co-ethnic firms. The trust creating network aspect is missing in regular firms, while it is doing its beneficial work in co-ethnic firms. It is hard to find data on firing decisions or average tenure of ethnic minority group members, but the EIB survey (2003: 36) about ethnic minorities in the Dutch construction industry reports an extraordinarily high volatility in ethnic minority personnel. Both inflow and outflow are about 25 percent of the total number of ethnic minority employees per year. This could be regarded as an indication that firms with a non-co-ethnic owner suffer substantial management problems to keep their ethnic minority labourers inside the firm.

### *3.2.2 Rewards – general and culture specific skills*

A more direct link between rewards and productivity goes through the notion of general skills. General skills originate in formal education and raise the productivity of the employee and thereby her rewards. These skills are extremely important in regular jobs and natives might have a natural lead, for example because they are better speakers of the native language. In ethnic firms, these general skills might be somewhat less important, because the on average small size of these firms requires an on average lower level of skills and also fluency of the majority language may be less of a necessity.

Culture specific investments in knowledge of one's own ethnic minority culture and language are useless for regular jobs, but are valuable for co-ethnic jobs. Knowledge of the specific culture and language gives the employees a comparative advantage to non-co-ethnic people in communicating with the co-ethnic boss, the other employees, the suppliers and the customers. This might also involve 'tacit knowledge' about the product, for example how it should taste or look like. Furthermore, the customers might expect co-ethnic personnel, for example in a restaurant. So, because of their culture specific skills, co-ethnic employees are more productive in co-ethnic firms

than in non-co-ethnic firms, and co-ethnic employees are more productive in co-ethnic firms than employees with a different cultural background. Both reasons form incentives to work in a co-ethnic firm.

### *3.2.3 Rewards – positive and negative discrimination*

Obviously discrimination in regular firms has a negative effect on rewards for members of ethnic minority groups. Discrimination on cultural background leads to both monetary disincentives to work for a regular firm (not making promotion, not receiving bonuses) and non-monetary disincentives (victim of teasing by colleagues, always having to do the dirty jobs). Discrimination may work the other way round in co-ethnic firms. The employer might feel a moral obligation, resulting from the social network, to help and comfort co-ethnic employees. The employer is more benevolent to his co-ethnic personnel than a non-co-ethnic boss. This might even offer the possibility for the workers to have a ‘good time’ and shirk. A job in a co-ethnic firm might also offer better career perspectives, for example to get promoted, to become a partner or to take over the business when the owner retires.

This issue can also be related to trust and networks. Ethnic minority employees only trust co-ethnic employers to be fair to them and to not discriminate against them. They might have less or no trust in (or are unaware of) the official labour market regulations and/or the motivations of non-co-ethnic employers. Their trust in co-ethnic employers is based on the knowledge that they can rely on the social network in case they are mistreated by their co-ethnic boss, while this protection mechanism is not available when a non-co-ethnic employer is involved.

The networks also deliver non-monetary rewards to the employees in the sense of a certain social recognition from other group members, when employees decide to work for a co-ethnic firm. In this way, both employers and employees obey to an informal moral obligation to help each other. The employer helps the members of his co-ethnic group by offering employment. The employees help the co-ethnic employer by offering their labour.

We now turn our attention to the incentives that come forth out of the search process.

### 3.2.4 *Search – signalling*

As we saw above, principal-agent problems arise because of information asymmetries between employers and employees. The equivalent of this management problem for the search process emerges from the differences in asymmetric information about the qualities of applicants. Applicants know more about their own skills and motivations than the potential employer does and tend to present an overoptimistic view of their qualities. There are three reasons why ethnic minority applicants could make a better impression on a co-ethnic employer than a on non-co-ethnic employer.

First is the problem that certain foreign diplomas are not recognised by native employers, but are recognised by co-ethnic employers. The magnitude of this problem increases when it is combined with communication problems between the employer and the applicant, for instance when the candidate has trouble in expressing herself in the majority language of the host country. This makes it more difficult for the applicant to communicate her skills and motivations to the native employer, while she has no problem discussing this subject in her native language with a co-ethnic employer.

Second is the problem of discrimination. This can be outright discrimination, but also statistical discrimination (Loury 1977). When a certain ethnic minority group gets a stigma attached for being ‘lazy’, ‘unproductive’ or ‘fraudulent’, this diminishes the chance of all members of this stigmatised group to get employed in a regular firm. Bad employees will drive out good employees. Since the rate of rejection is so high, it is not worthwhile anymore for ‘good’, unrightfully stigmatised employees to invest in applications for such jobs. Only the ‘bad’ applicants keep on applying, because for them the rewards of success are much higher, as it enables them to shirk at the expense of the hiring firm. This confirms the stigma and increases the prejudice against members of this ethnic minority group. Even more good employees stop applying for jobs in the regular sector, and so on and so forth.

A third issue is that applicants are backed by members of their own network. The credentials of native applicants are thus for the greater part backed by other natives who might be higher valued by native employers than the ethnic minority references of ethnic minority applicants. This holds vice versa for applicants at ethnic firms.

These are three objective reasons why it might happen that ethnic minority employees end up in co-ethnic firms, even if they themselves have no preference for the one above the other.

### *3.2.5 Search – search channels*

Social networks are often used as a channel for information about vacancies and job opportunities. Nan Lin has written extensively on this subject (e.g. Lin, Ensel and Vaughn 1981). Especially the ‘weak links’ of one’s network can be very helpful in finding a job (also see Granovetter 1974). Given that the network of an ethnic minority group member consists for the larger part of other members of this group, information about vacancies will mainly consider job openings in ethnic firms. This information function of the network also works the other way round. Co-ethnic employers can more easily find a suitable co-ethnic employee than a non-co-ethnic one. The transaction costs involved in the search process are lower when using the social network than the official canals.

Using panel data for the United Kingdom Frijters et al. (2003) report on how the job search methods of unemployed immigrants vary from those of the native born. Striking result of this research is that all immigrant groups and especially South Asian immigrants rely more on their social networks for job search than the UK born. The researchers conclude however that the relative failure of immigrants to find a job “cannot generally be explained by differences in the choice of main job search method or in observable characteristics” (Frijters et al. 2003: 1). This confirms the idea that immigrants make a relatively strong use of social networks to find a job. It also confirms that this is a rational thing to do, because it does not influence (read: it does not worsen) the probability of immigrants to find a job. The result of the extensive use of this search channel however is that ethnic minorities end up to be over-represented in co-ethnic firms.

### *3.2.6 Conclusion*

We conclude from our economic analysis of the labour market incentives of ethnic minority group members, that there is much economic rationality for ethnic minorities to find a job in a co-ethnic firm instead of in a regular firm. Their ethnic background makes them more productive in co-ethnic firms, because it enables firms to economise on management control and bonding costs. A second source of their higher

productivity lies in the specific cultural capital they have accumulated and that is valuable in certain ethnic business niches. Discrimination and problems with the verification of their qualities form clear disincentives to work in regular firms. Finally, the social network allows ethnic minorities to lower their search costs when looking for a job.

The fact that the behaviour of immigrants to find a co-ethnic job is rational, does not automatically imply that this behaviour is beneficial for them in the longer term or beneficial for their employers, their ethnic community or for the society as a whole. We explore the positive and negative externalities of co-ethnic employment in the next section.

#### **4 Welfare effects of co-ethnic employment**

The emphasis of this section lies on the welfare effects of co-ethnic employment. We first present a broad historical perspective of the welfare effects of immigrants, we continue with a somewhat smaller scope about the welfare effects of ethnic entrepreneurship and end with an analysis of the welfare effects of co-ethnic employment in the short and long run.

##### **4.1 Welfare effects of immigrants**

In the Dutch history the freedom of the Protestant religion, the high tolerance to other religions and the economic prosperity of the region attracted several waves of immigrants, particularly in the 16th to the 19th century. Among them were the Huguenots, who fled France after the revocation of the edict of Nantes in 1685 that was directed against Protestantism, and among them were many (Portuguese) Jews who saw their lives threatened for religious reasons in other parts of Europe. These influxes of highly skilled and wealthy immigrants are generally seen as important contributions to the rise of the Low Countries as an economic superpower in the 17th century (De Vries and Van de Woude 1995). For the immigrants themselves, their migration benefited them at least in the sense that it provided them a way to survive the religious feuds in Europe. But even at the end of the 19<sup>th</sup> century immigration was substantial, especially from the poor regions of Germany. This wave of immigration benefited the Dutch economy in the sense that it provided a source of cheap labour. At the same time, it was beneficial for the immigrants, because they earned a better salary than at home.

This picture has changed dramatically. Evaluations by the CPB Netherlands Bureau for Economic Policy Analysis (Roodenburg et al. 2003) and the Netherlands Scientific Council for Government Policy (WRR 2001) are not optimistic about the contributions of recent immigrant inflows to the Dutch economy. Non-western immigrants have a relatively low labour participation, have a relatively high unemployment rate and make a relatively high use of social security. Remarkably, these differences between the native population and immigrants are much larger in the Netherlands than in other countries, like Italy, Spain, Canada and Australia (WRR 2001: 121). The welfare effects of new immigrants whose social-economic characteristics correspond to those of the average non-western resident are likely to be small and maybe even negative on residents' incomes and are a burden for the public budget (Roodenburg et al. 2003: 7-8). This can be partly blamed on the lagging performance of immigrants on the labour market, but is "also the reflection of the generous system of Dutch collective arrangements" (Roodenburg et al. 2003: 8).

#### **4.2 Welfare effects of ethnic entrepreneurship**

In 1998 the Netherlands Social Economic Council (SER) wrote an advice to the government on ethnic entrepreneurship as a reaction on the perceived labour market problems of immigrants (SER 1998). The SER concludes that entrepreneurship of ethnic minorities is part of the solution of the problem and should therefore be stimulated by the government. The government has underwritten this advice in its official reaction. According to the SER, weak points of the present ethnic minority firms are the lack of entrepreneurial skills, the relative weak basis of much firms, the lacking presence in business networks and the insufficient accessibility of services for ethnic entrepreneurs.

We agree that ethnic entrepreneurship is, in principle, a positive phenomenon that contributes to the integration and economic emancipation of ethnic minority groups. However, we have more doubts about the co-ethnic employment that is often involved with the creation of ethnic firms. We sum the pros and cons later, but first look at some actual developments.

The number of ethnic enterprises in the Netherlands has sharply risen over the last 10 years (Van den Tillaart 2001). The type of firms is also changing. Originally, most ethnic firms were in the hospitality and retail sector. Newly founded firms, mostly by second generation migrants, are more and more in commercial services. In this new sector, second generation ethnic entrepreneurs often choose more sophisticated branches like advice and consultancy, research and public-relations offices and travel agencies instead of car driving schools and cleaning services (Van den Tillaart 2001). Does this mean that the differences between ethnic and native entrepreneurs are disappearing? Yes and no. On the one hand we see that the distribution of firms over the different sectors of second generation ethnic entrepreneurs has become more similar to that of the native entrepreneurs than it has ever been with regard to the first generation immigrants. This is in line with the thought that the second generation of immigrants has less strong ties within the migrants' community. The rules and resources of the social ethnic network are less applicable to 'newer' generations. Although these figures only give an indication about the sectors of activity and not about employment policies, the broader picture that arises from it is that the phenomenon of co-ethnic employees and employers is less pregnant for newer generations, because they 'break out' of the old structures. On the other hand however, one can notice that a part of the second generation ethnic entrepreneurs is explicitly focusing their activities on their own ethnic group. They develop ethnic niches to exploit, for example in culture, recreation and sports (Van den Tillaart 2001). This makes the Scientific Council for Government Policy conclude that it is very troublesome that the immigrants –especially those coming from Turkey and Morocco – mainly use their own ethnic network to find a job, because of the restricted and internal focus of these networks (WRR 2001: 119).

### **4.3 Welfare effects of co-ethnic employment**

In this subsection we discuss the welfare effects of co-ethnic employment for employees, co-ethnic firms, the ethnic minority group and the society as a whole. Most of the positive welfare effects seem to lie in the short run. Structural problems that lead to negative welfare effects come to the fore when we analyse the long-term effects of co-ethnic employment. We pay extra attention to externalities: the external effects (positive and negative) that arise for society as (unintentional) consequences of individual behaviour.



#### *4.3.1 Positive welfare effects and externalities*

The immediate effects of co-ethnic employment are positive at every level of analysis. The major reason why co-ethnic employment is associated with positive externalities is that it creates jobs for ethnic groups. This increases the labour participation and work experience for the individual employees. Although some of these jobs may be 'network subsidised' jobs, such a job in a co-ethnic firm is better than no job at all. A second positive welfare effect for individual employees exists when their rewards are higher in co-ethnic firms than in regular firms. The monetary rewards may be higher, because their culture specific skills enhances their productivity in co-ethnic firms (especially when active in ethnic niches) and lowers management and search costs for firms. The non-monetary rewards may be higher, because co-ethnic employment leads to moral appraisal and recognition from the ethnic group.

The co-ethnic firm benefits from co-ethnic employment for the same reasons. The productivity of co-ethnic personnel may be higher than the productivity of other personnel, and because of reductions in management and search costs.

The welfare benefits for the ethnic group lie in the fact that all value created by the ethnic firms stays inside the ethnic group. The rents are split among the co-ethnic suppliers of capital, management and labour. It also makes the group less dependent on outsiders. A feeling of autonomy can be regarded as valuable. Above all, the ethnic network stays intact and dense. This makes it easier to uphold the (traditional) values and norms.

The welfare effects for society are the less recourse to social security combined with higher income taxes. Moreover, poverty reduction among ethnic minorities is a positive good in itself. When one believes in the existence of poverty related crime, one can argue that this poverty reduction may have positive external welfare effects for the society, because it translates in a reduction of the crime rate among ethnic minority groups.

#### *4.3.2 Negative welfare effects and externalities*

There is also a number of negative externalities associated with co-ethnic employment. To start with, it may prevent the development of general skills among the co-ethnic employees. It reduces the necessity of (fluently) speaking the majority language and co-ethnic employees are not confronted with the native 'work ethics'. Regardless of the fact whether this work ethic is better or worse, not being familiar with it does not improve your chances on the regular labour market. When for some reason immigrants lose their job at the co-ethnic firm, the pool of potential new employers is restricted for them to the part of co-ethnic firms, while the possession of general skills would allow them to seek a job across all firms in the economy.

A second negative welfare effect for employees may result from the fact that they keep very closely attached to their social ethnic network when they work in a co-ethnic firm. This makes it relatively easy for the other network members to enforce network rules, values and norms upon them. Social control co-ordinates the behaviour of group members and thus prevents sub-optimal outcomes in social dilemma situations. However, it also restricts individual freedoms. It impedes individual welfare, when social control and sanctions are used to enforce unwanted solidarity with other group members. In the worst case, this results in the exploitation of co-ethnic employees, who are obliged to work in ethnic firms under bad working conditions (hard work, low salary). Social pressure exercised by the network then sacrifices the welfare of the individual for the good of the group.

The welfare or development of firms is faced by two dangers resulting from co-ethnic employment. The first relates to the fact that easy access of ethnic minority group members to employment in the firm automatically implies that applicants with other ethnic backgrounds are barred from access. This has two consequences. First, it may lead to a very narrow focus of the ethnic firm regarding suppliers and customers, because there are no natural links (established through the networks of employees) with suppliers and customers from outside the own group. Second, it may be problematic to find suitable employees within the own group, especially for certain specialised functions (Fukuyama 1995). Both restrictions might seriously hinder the small family firm to develop into a larger scale enterprise.

The second danger for the development of the firm also results from the situation that the firm becomes too enclosed in the social ethnic network. In some cultures, strong

norms of mutual assistance and solidarity lead to high free-riding problems, because successful firms are overloaded with requests for loans and jobs from fellow kinsmen (Geertz 1963, Portes 1998). The social norms that allow for these excess claims on more successful group members severely impede the accumulation of wealth (and thus the incentives to gather wealth) that is needed for entrepreneurial success and development.

Negative externalities of co-ethnic employment for the ethnic group also arise from the fact that co-ethnic employment leads to less interaction between different ethnic groups and networks. This implies that the separate networks stay relatively closed, small and isolated. One misses the positive external effects that would result from a single 'combined' large network. A concrete example of a negative externality of co-ethnic employment is that information about job opportunities and applicants' skills is not public for all networks. As a result, members of ethnic minority groups may fall in the 'ethnic trap'. They must find a job in the co-ethnic network, because they miss contacts in other networks. As a result, they also do not become a member of other networks, which reduces the chance of other ethnic minority group members to find a job outside the social ethnic network. This problem of path dependency is worsened by the phenomenon of co-ethnic employment.

A more extreme situation occurs when "group solidarity is cemented by a common experience of adversity and opposition to mainstream society" (Portes 1998: 17). Co-ethnic employment can be seen as a form of group solidarity. A prolonged period of discrimination by mainstream society may lead to downward levelling norms in the group. The group members do not believe anymore that they can be successful in society. This implies that there is no use in going to school or in making other long term investments. Pride in the own group for its own sake is the only thing that stays. Ambitious group members who do manage to be successful in the 'hostile' outside world, however, are perceived as traitors, because they undermine the group cohesion that is built on the alleged impossibility of such events. In this situation, the social norms of the group work out as a public bad, because they form fatalism based disincentives for the social and economic emancipation of the group.

The negative externalities for society originate in the missed network opportunities that result when ethnic groups keep a distance from the rest of society, for example by

a high prevalence of co-ethnic employment. A major example is that the emergence of common values and norms in the society is hindered. Common values and norms streamline the co-ordination of human behaviour in (economic) activities, because they form informal guidelines for behaviour. In this way, they reduce the transaction costs involved with co-ordination problems. Another example is that the economy is not running on its possible optimum, because best matches between vacancies and applicants are missed. This hinders the personal development of the employees, the emergence of strong firms and the growth of the national economy.

More in general we may conclude that co-ethnic employment enhances segregation instead of integration. The worst case situation would be the emergence of an ethnic minority enclave economy without ties to the rest of society. This would imply an isolated sub-society in a society and the complete failure of integration policies.

#### *4.3.3 Conclusion*

The immediate effects of co-ethnic employment seem to be positive on balance. In the short run, co-ethnic employment leads to more jobs for employees, easy access to labour for ethnic minority firms, strengthening of the group values and norms, and less unemployment and social security problems for society. This bright picture is obscured when we take a long-term perspective. Co-ethnic employment might form an obstacle to the social and economic emancipation of ethnic minority groups, because it generates disincentives for individual group members to acquire general skills, hinders the development of ethnic minority firms, fosters the danger of the ethnic trap and may stimulate the emergence of an enclave economy. An enclave economy does not seem to be a realistic threat for the Dutch society, but the other dangers certainly are. We therefore look at the possible policy options in the next section.

## **5 Concluding remarks and policy options**

Survey data from various sources in the Netherlands confirm anecdotal evidence of over-representation of co-ethnic employees in ethnic minority firms. This major characteristic of ethnic minority employment can be explained by the relatively low information and co-ordination costs in labour relationships in co-ethnic firms. When people belong to the same ethnic group, or network, they are bound to the same

cultural values and norms, and this will enhance trust, e.g. within a group of immigrants from the same country or background. It implies that within a group of workers from the same ethnic origin information is less asymmetric and less incomplete than between workers of different ethnic origins. In a hierarchical relationship between a supervisor and subordinates the monitoring and bonding costs may be lower in the case that all belong to the same ethnic groups than when they have different ethnic backgrounds. A similar argument holds for search costs when employing workers.

These economics of co-ethnic employment suggest that there are both positive and negative externalities associated with this phenomenon. A positive externality is that it enhances labour participation and therefore reduces demand for social security provisions. However, a negative externality is that it hinders integration of minority groups in the society which will eventually cause these members of minority groups to be less productive. These positive and negative externalities can be considered as market failures. The economics of the public sector teach us that government policy should try to repair such market failures as much as possible. Hence the general rule for government intervention in the case of co-ethnic employment is to design policy options which will minimise the negative externalities and which will exploit the positive externalities.

The biggest structural problem seems to be that the business networks of native and ethnic minority entrepreneurs are separated from each other. In the most extreme case, this would mean the complete isolation of an ethnic minority part of the regular economy: the enclave economy. To prevent the emergence of enclave economies in the Netherlands and to reap the positive external benefits of extended (business) networks, the government has a role to foster the integration of native and co-ethnic business networks. With respect to the phenomenon that co-ethnic firms are used as a 'last resort' for unskilled ethnic minority members, additional schooling programs for co-ethnic employees are necessary to give them a chance on the regular labour market. Concerning the diploma comparison problem in the search process, one could think of government support in the form of a databank for diploma comparison.

Furthermore, positive externalities should be exploited by promoting businesses of ethnic minorities, e.g. by providing assistance in setting up a business (through chambers of commerce), and guarantees for loans, and by not too much strict regulation. The chambers of commerce could play an important role in this process. They have information about the ethnic background of firm owners and play a natural role in stimulating entrepreneurship.

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