

The Cost of Resolving Small-Business Conflicts

The Case of Peru

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Acknowledgment

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EXECUTIVE SUMMARY

The goal of this study is to analyze the impact of judicial inefficiency on small businesses in Peru. It is based on the hypothesis that chronic problems in the region's judicial systems have negative consequences on the development of micro, small and medium-sized businesses. Our analysis focuses, first, on the relationship between Small and Medium Enterprises (SMEs) and the legal system. Secondly, it investigates the decisions made by SMEs to mitigate the effects of bad court performance. Lastly, it identifies several ways in which judicial inefficiency is transferred to the business sector. The analysis also attempts to quantify the economic impact of judicial inefficiency.

This study is based on an opinion survey of micro, small and medium-sized businesses in Peru, a workshop attended by 30 businesses and various interviews with economists, lawyers, judges, academics, people in charge of bank portfolios, members of SME development associations (Entidades para el Desarrollo de la Pequeña y Micro Empresa – EDPYMES) and government officers.

Findings regarding the relationship between SMEs and the judicial system show that businesses have a negative image of the judiciary and that they avoid using the court system. They view the judiciary as a corrupt, slow, complex and expensive system, partially biased against SMEs. This view of the judicial system leads businesses to attempt solving their conflicts informally, avoiding the courts at all costs.

Other legal aspects which also affect SMEs are analyzed, for example: (i) the use of written contracts; (ii) the use of accounting and legal services; (iii) official and unofficial costs of litigation; (iv) the use of alternative mechanisms of dispute resolution; and (v) the relation between SMEs and the State. Indeed, we found that the costs arising from litigation are proportionately much higher for smaller debts, a fact which discourages smaller enterprises from using the judicial system. Likewise, there are problems regarding SME access to government procurement processes at all levels. This represents a \$4 billion annual market. We also demonstrated that corruption negatively affects various aspects of SME development and, particularly, their capacity to access impartial judicial services.

The problems described above influence the behavior of businesses, often forcing them to mitigate the risks and costs arising from judicial inefficiency. For example, many SMEs avoid contracting with the government or looking for credit support; nor do they invest in their business, contract with large businesses or expand their activities by means of subsidiaries or geographic coverage. Likewise, businesses avoid subcontracting some stages of their production process and generally do not carry out joint purchases or sales.

In order to lessen the risks of noncompliance, especially due to the impossibility of taking conflicts to court, businesses place much importance on reputation and trust. Thus, they avoid changing suppliers, even if this represents higher production costs. They avoid transactions with new customers unless

they investigate the credit and business record of potential new suppliers and the transactions are secured or in cash. These decisions have various negative effects on SMEs' commercial activities, which, in general, take judicial inefficiency to the business sector, reducing the range of possible transactions and creating higher costs.

Based on some pioneer research in Brazil and the Philippines, we developed a model designed to quantify the economic impact of judicial inefficiency. The methodology used allowed us to create alternative scenarios related to the impact that reasonable increases in the added investment rate might have on economic growth.

The methodological sample and the tools used should now be built upon and refined. Our intention is to establish with this report a general theoretical

framework which will serve as the basis for future research and, at the same time, to contribute to the debate on the various approaches to measure economic impact.

Our study makes two important contributions. On the one hand, it identifies the full range of issues pertinent to the relationship between SMEs and the judicial system. In this sense, it presents evidence related to the legal needs of SMEs and provides important details about the obstacles and incentives of accessing judicial services. On the other hand, it analyzes the economic impact of judicial inefficiency – highlighting the various ways in which this affects business performance. Finally, it suggests ways to incorporate these findings into a new model to more accurately measure the economic impact through future investigations.

INTRODUCTION

Attention to the relationship between financial development and legal institutions has increased throughout the last decade. Various investigations on this subject have highlighted the importance of having an efficient, predictable and accessible judicial system to give impetus to growth and investment. The need for an appropriate legal framework that guarantees long-term financial growth and maximizes the potential of financial markets, business growth and private investment has been emphasized as well. The absence of these conditions creates “non-optimal” scenarios, which lead to inefficient results. Within this context, businesses have been forced to modify their behavior in order to adapt to this environment and to mitigate the risks derived from the inefficiency of the judiciary.

Scarce attention has been paid to the legal problems of SMEs. Little is known about their legal needs, including the characteristics of their needs in court or the frequency with which they use the judicial system. It is thus necessary to deepen the analysis and empirical research in a variety of related areas. In this sense, this study analyzes the overall interaction between the judicial system and SMEs in Peru. First, SMEs are studied as users of the judicial system and we try to capture the main characteristics of their relationship with courts (frequency of use, perception of the judicial system by businesses, costs, incidence of corruption, etc.). Second, we try to elucidate the behavior of SMEs as one of the main reasons for an inefficient judicial system. Finally, we analyze the economic impact that results from problems related to an inefficient judicial system.

Given the breadth of issues in this field, the primary goal of this research was to develop a roadmap for further analysis and to lay the foundation for new proposals of research, reform programs and policies. Questions that we attempt to answer include:

- How often do SMEs use the judicial system in Peru?
- How do SMEs resolve their disputes?
- What are the most important socioeconomic and institutional barriers that SMEs have to confront in order to use the Peruvian legal and judicial systems?
- What are the incentives and disincentives to use the judicial system, to contract or, more generally, the institutions of the broader legal system?
- What is the impact of judicial inefficiency on the behavior of businesses?
- What are the main legal obstacles to SME development?
- What kinds of activities would SMEs undertake if the judiciary was more trustworthy in resolving disputes and able to protect their contractual rights fairly, effectively and efficiently?
- What is the economic impact of judicial inefficiency?

This study is based upon the premise that the “ideal” judicial system has the following qualities: (i) *predictability*, that is, given the same circumstances, judicial decisions are similar; (ii) *accessibility*, that is, citizens do not face serious obstacles to use judicial services, the complexity of the processes is reasonable, legal advice is available and the geographic presence of the judiciary is

well spread¹; (iii) *efficiency*, this implies not only the rational use of time and resources but also a correct allotment of litigation costs; and (iv) *effectiveness*, that is, having the ability and resources to enforce decisions.

A judicial system with the above-mentioned characteristics will have various effects on the behavior of citizens. First, the existence of such an institution effectively would impose higher costs on those who do not comply with their contracts. In other words, the cost of contract noncompliance tends to be higher than that of contract performance. As will be discussed, in the present context, the inability of the judiciary to sanction contractual noncompliance is an incentive to engage in inefficient business behavior.

Second, when the judiciary is efficient, citizens have less of a reason to act inefficiently. Knowing that the judicial system can resolve a dispute in a reasonable term and enforce decisions and impose litigation costs properly, citizens have fewer incentives to delay payments or not perform their contractual obligations. Third, the predictability of the judicial system reduces the margin for judicial corruption. It becomes more difficult to influence judicial decisions because deviating from precedent can place the judge and the decision under close scrutiny. The same would apply to reckless legal behaviors, such as the use of the courts to seek a decision X for a case in which all precedents indicate that the decision of the courts should be Y. Finally, an efficient judicial system makes the use of judicial services more

attractive because the costs and benefits of using the system are higher than in an inefficient system.

These qualities also have an indirect effect on the judiciary itself: reduced backlogs. If the appropriate legal framework was in place, the judiciary's limited time and resources could be more targeted, efficiently managed and predictable, which could result in reduced case backlogs. At the same time, a clearer, focused legal framework would provide more incentives to businesses resolve disputes through private negotiation or alternative dispute resolution mechanisms. For example, in some countries, tax laws encourage financial institutions to obtain a judicial decision acknowledging a debt before they can deduct it as a tax loss. Banks therefore go through the motions of securing a judicial decision to enforce debts that are known beforehand to be irrecoverable.

This study analyzes these incentives when the judiciary is not effective, efficient, predictable or accessible. The underlying hypothesis is that businesses modify their business decisions to mitigate the risks of noncompliance, to reduce the number of conflicts and to avoid using the courts. All of this, of course, has an economic impact.

This study is organized in six chapters. The **first** is this introduction. The **second** presents a description of the SME sector in Peru. The **third** summarizes the research and academic literature used as references for our analysis. The **fourth** presents the main results of the field work. The **fifth** analyzes the economic impact of judicial inefficiency. And the **sixth** contains our conclusions and recommendations.

¹ In the particular case of Peru, the multicultural elements of society must be added to the judicial web.

Micro and Small Businesses in Peru

Micro, small and medium enterprises (SMEs) are business organizations that produce goods and/or services in a very limited scale if we view them individually; however, collectively, they represent a significant economic force. As business management units, SMEs are an essential element to characterize the Peruvian economy.

The Small and Micro Enterprise Act No. 27.628 (2000) defines small and micro enterprises as “business units which work under any form of business management devoted to the production, extraction, transformation, and trading of assets and services”. Under this law, a micro enterprise may not employ more than 10 persons and its sales volume may not exceed 100 tax units. A small enterprise may not have more than 40 employees and their sales should be under 200 tax units.

According to the main macroeconomic indicators, 75.9% of economically active workers in Peru are employed by SMEs. SMEs contribute about 43% of Peru’s gross domestic product (GDP). Their prevalence in the national economy is most significant in the service sector – 66% versus 14% of the industrial sector. In the industrial sector, SMEs work in a wide variety of fields, including food products, the clothing industry and tailoring, the wood industry, glass manufacturing, basic industries of non-ferrous minerals, machinery and appliance manufacturing and electrical accessories and supplies.

In spite of the magnitude of these figures, SMEs face a series of obstacles which substantially affect their development, such as obstacles to compete, obstacles to

enter other markets, credit discrimination and the lack of information and technical training.

Table 1 – Employment per Categories in Peru, 1994

	Number of firms	%	Number of employees	%
TOTAL	236,453	100.00	1,033,434	100.00
1 to 10 employees	226,497	95.79	383,609	37.12
11 to 49	7,782	3.29	160,117	15.49
50 to 199	1,689	0.71	156,023	15.10
More than 200	485	0.21	333,683	32.29

Source: Instituto Nacional de Estadística e Informática [National Statistics and Computer Science Institute (Peru)]

For reasons discussed later, SMEs generally prefer to deal with non-banking institutions within the financial system, such as municipal and rural credit unions, local micro finance institutions (also known as EDPYMES – Development Associations for Small and Micro Enterprises) and cooperatives. There are also many nongovernmental micro-credit organizations, which play a significant role in financing the activities of micro businesses.

Perhaps the main access barrier to being able to access credit and the financial system is that a large number of SMEs operate in the informal sector. Consequently, they usually cannot demonstrate their creditworthiness, they do not pay taxes, they do not have accounting records, they cannot support their production capacity, they cannot contract and they lack the legal collateral

necessary to mitigate credit risk. The informal economy is estimated to compose between 34% and 49.2% of the economically active population (De Soto *et al.*, 1986; Carbonetto *et al.*, 1988).

In the last few years, Peru has taken steps to promote SMEs through various measures, including the creation of the Small and Micro Enterprise Promotion

Committee (Comisión de Promoción de la Pequeña y Micro Empresa – PROMPYME), which is an entity created to represent their interests. It has also passed the Small and Micro Enterprise Promotion Act of 2000, which is an *ad hoc* legal framework established to provide SMEs with preferential access to the public procurement process.

Literature Review on Justice and Small Businesses

This study is based on the hypothesis that there are serious problems regarding the relationship between SMEs and the judicial system. Given the bad performance of judicial systems in Latin America, SMEs cannot count on efficient, timely and accessible mechanisms to resolve their commercial disputes. The lack of access to justice, plus the scarcity of legal services, gives rise to a deficit that has an important impact on SME behavior, as shown throughout this investigation.

The relationship between SMEs and the judicial system presents problems from several different perspectives, including that of the law, the economy and business development. However, this phenomenon has not always received sufficient attention as an object of scientific investigation. Indeed, the scarcity of academic research and empirical studies has been a real challenge for this investigation. Below are many of the studies used as references in our study.

There is a significant body of literature, which, though not cited as an immediate source for this work, provides the general theoretical framework under which much of our analysis takes place.² Other research has been directly referenced. For example, the pioneering work of Hernando de Soto and the Instituto

² We refer here to the studies of the following authors: Davis and Trebilcock, (1999); Gan, Fang y Xin Chunying, (1998); Kwan Shik Shin and Seung Wha Chang, (1998); Anant and Mitra, (1998); Stephenson and Bueno de Mesquita, (1999); Barro, (1999); Clague, Keefer, Nack and Olson, (1997); Djankov, La Porta, Lopez de Silanes and Shleifer, (2001); Buscaglia and Ratliff, (2000); Holden, (2000/2001); Half, (2002); Fleysig and de la Peña, (2001).

Libertad y Democracia (Institute for Freedom and Democracy – IDL), was factored into our thinking with regard to reforms geared towards business development and economic growth (De Soto *et al*, 1986). These reforms include the implementation of a variety of mechanisms related to the protection of property rights, the reduction of new business registration costs and the procedures and the processes of legalizing property (the latter with the purpose of giving access to credit to the owners and thereby enabling them to start a business). Numerous works on the problems of the Peruvian judicial system were taken into account and were very important to understanding the legal and institutional context within which relations between SMEs and the judicial system takes place.³

The relationship between SMEs and the judicial machinery, which is the core of this investigation, is an area of vital importance; however, it has only received scant attention. There are virtually no empirical studies regarding the way SMEs interact with the judicial system, the frequency with which they use the system or the nature of the cases within the system (amounts claimed, subject-matter, etc.). Likewise, there are only a few studies on the official and unofficial costs of litigation, the length of judicial procedures and the phenomenon of judicial corruption, as an obstacle to accessing the courts. In cases where businesses do not use the judicial system, there is almost no information regarding

³ Hammergren, (1998). For more details on the legal and judicial problematic in Peru, see: Haro Bustamante, (2001); Landa, (2001); García Sayán, (1991); Ortiz de Cevallos and Pollarollo (2000); Eyzaguirre, Pollarollo and Andrade, (2000).

the mechanisms they use to resolve disputes.

One of the few examples is that of Peru, where the Instituto Apoyo undertook a study regarding SMEs and the judicial system (Eyzaguirre and Calderon, 2002). The objective of this research, based primarily on surveys of micro and small businesses from Lima and the suburbs, was to analyze the ways SMEs interacted with the judiciary and the varied ways in which they resolved their disputes. This study, which established valuable baseline topical research, served as an important reference for our investigation. A previous study, also by the Instituto Apoyo, analyzed how judicial inefficiency affects business decisions. Even though the sample used was composed only of large businesses, some of its findings and conclusions can be extrapolated to the problems of SMEs.

Another series of valuable empirical studies, by the World Bank, relates to the overall functioning of the judiciary. More specifically, the World Bank examined, among other things, issues related to the judicial systems in Argentina, Peru, Ecuador, Brazil and Mexico from a “users’ perspective”.⁴ Although SMEs were not the primary focus of those studies, much of the data and findings is very relevant to this field of work. For instance, these reports present estimates on the average time of enforcement proceedings in general and provides useful insights related to actions taken or not taken during different stages of the

⁴ The authors thank Linn Hambergren for facilitating access to some drafts and providing comments on preliminary findings. FORES/World Bank, *Usuarios del Sistema de Justicia en Argentina [Users of the Judicial System in Argentina]* (2000). Unpublished, mimeo in possession of the authors.

“life” of the cases examined (average time between filing the complaint and the plea, delays in notification, etc.). All this information helps us paint a clearer picture of the processes that SMEs are confronted with when they use the judicial system. Another related pioneering study, done by IFES, outlines and examines the myriad barriers to enforcing court judgments in Argentina and Mexico. This study provides, for the first time, a valuable overview and empirical information on the legal and structural obstacles to the effective enforcement of courts judgments.⁵

Finally, one of the most important aspects of the SME-justice relationship is the economic impact of judgments. There has been little research or programming in this key area. Our study took as direct reference two important research projects. The first one is entitled: “Hidden Costs of Judicial Inefficiency: General and Estimated Concepts for Brazil.” This work analyzes the results of a survey of Brazilian businesses in order to determine the extent to which the poor performance of judicial system affects their businesses and the economy of the country (Pinheiro, 1998). This research reveals there is a consensus among businesses that the judiciary is viewed very poorly, that businesses are reluctant to use the judiciary and that the inefficiency of the judiciary has a high negative economic impact on businesses, business decisions and the Brazilian economy as a whole. Using a model which links economic growth to investment levels, the author predicts a 10% added growth in investment if the judicial system were

⁵ IFES. 2003. Barriers to the Enforcement of Court Judgments and the Rule of Law. Produced by IFES for USAID. USAID, Bureau for Democracy, Conflict and Humanitarian Assistance; Office of Democracy. Mimeo.

efficient, which means that the potential growth rate of the GDP would increase by approximately 35%.⁶

The second one, entitled “Justice and the Cost of Doing Business: The Philippines”⁷, analyzes the perception of justice among Philippine businesses and the economic impact of judicial inefficiency. The results of this study show that judicial inefficiency has negative effects on the frequency of transactions and that businesses see the judicial system as an obstacle for their businesses. Applying the same model as Pinheiro, the authors conclude that the bad performance of the Philippine judicial system has an economic impact equivalent to 6% to 11% of the total investment in the economy and less than 0.25% to 0.46% of the annual GDP.

The studies of Brazil and the Philippines represent a significant progress in the field of measuring the economic impact of judicial inefficiency and they are a valuable reference for the development of new measurement instruments and methodologies. Their main contribution is that they begin to empirically quantify the financial cost of inefficient judicial services. However, because they focus primarily on large businesses, studies from the perspective of SMEs also need to be undertaken. Likewise, the methodology used to assess the economic impact is based on the link between investment and economic growth. This

methodology, however, fails to capture many costs unrelated to investment.

In short, although there are studies relevant to some of the objectives of this research, large knowledge and information gaps still remain concerning the relationship between SMEs and the judicial system, as well as dispute resolution processes.

In the following sections, we present the analysis of our SME surveys and workshops. We would like to emphasize that the small sample size we necessarily had to use, for timing and resource reasons, was not optimal from a statistical point of view. Therefore, this sample may not represent, with absolute accuracy, the full dimensions of the issues raised or the entire Peruvian business sector. We believe, however, that the findings and issues reflected in our study are, on the whole, both relevant and consistent with the results of similar prior studies. We hope that future research validates our findings.

⁶ The Tinker Foundation asked the Instituto Apoyo in Peru to undertake an investigation similar to the one performed by Pinheiro. The work was done but, although it analyzed the way in which the problems of the justice sector affect business decisions, it did not quantify the economic impact of judicial inefficiency. Eyzaguirre, Salhuanar and Andrade (1998).

⁷ Sereno, de Dios y Capuno. (2001) (not published, copy in possession of the authors).

Fieldwork Results

SMEs and the Judiciary

Key survey findings regarding the relationship between SMEs and the judicial system are presented in this section. Our analysis also incorporates information collected and discussed during the SME workshop as well as targeted interviews throughout Lima.

Image of the Judiciary

The first issue analyzed was the image of the judiciary among Peruvian businesses. Different past Peruvian public opinion measurements indicated that the perceived credibility of all public institutions was extremely low, the judiciary being among the lowest ranked. These surveys also indicated a systematic rejection of political institutions, which tells us the situation and image of the judiciary is not an isolated phenomenon in Peru. When asked whether there was effective compliance with the law, only 3% of businesses agreed; 62% stated that the law was not complied with and 32% stated there was compliance only in “some cases”. These answers reaffirm the hypothesis that problems in the judicial system are not an isolated phenomenon but are part of a much wider crisis in both the political system and of governance in general.

When businesses were asked about the reasons for the failure to effectively comply with the law, they ranked judicial corruption as the main problem, followed closely by political corruption. If, however, answers from micro businesses are disaggregated from those of small and medium businesses, there are some significant differences. Micro businesses give much more importance to the

socioeconomic situation as a disincentive to comply with the law. This may mean, among other things, that they also feel vulnerable to socioeconomic crises and that they have problems complying with the requirements of the law including contractual obligations. Small and medium businesses, in turn, see political instability as the main reason for noncompliance with the law. Evidently, there is widespread dissatisfaction with the performance of the political system. Likewise, this group gives strong importance to the fact that a culture of noncompliance with the law exists, which by reference relates to socio-legal and cultural factors and to recurrent political crises.

Only 5% of the people surveyed believed the judiciary functioned well or very well. 52% stated that the performance of the judicial system is bad or very bad and 35% considered it average. When looking only at the answers of micro businesses, the negative image observed is even higher (58%).

Access to the Judiciary: Frequency of Use and Obstacles

The negative perception of the performance of the judiciary matches the low level at which businesses use the courts. Out of the total sample, only 15% stated that they had sometimes used the courts to resolve disputes. However, if we limit the response to micro businesses, this percentage falls to 9%. This percentage difference between micro businesses, on one side, and small and medium businesses on the other, leads us to infer that the larger and better established the business the greater its access or perhaps its need to use formal

mechanisms of justice administration. Also, the few businesses that answered they had even used the judicial system noted that they had done so very infrequently (hardly ever or for less than 50% of their disputes).

Although businesses are reluctant to use the courts to resolve their disputes, this does not mean that they do not have disputes. Rather, they tend to minimize the risk of controversies and, when a dispute arises, they use other mechanisms to resolve them. This subject was the subject of lively discussion during the SME workshop, where most participants stated that they avoided using the courts at all costs.

When asked the reasons that dissuade them from using the judicial system, businesses stated the first obstacle was judicial corruption. They said the main disincentive for using the courts was the feeling that judges and court personnel can be manipulated through handouts and bribes. The corruption phenomenon has worrisome dimensions and, even though it is a problem openly acknowledged by the various actors of the judicial system, this is not reflected in concrete programs and actions designed to reform and improve this phenomenon. Through the interview process, it became clear there was a clear consensus among lawyers, judges, academics and civil servants regarding the gravity of this problem. For example, members of the judiciary and lawyers noted that it is common knowledge that one can “choose” the court where the case will be heard⁸, if

⁸ The phenomenon of paying a amount of money to choose the court where the case will be heard is a well known fact for all the users of the judicial system, even judges are aware of this situation (this does not imply that they receive part of the money, it just means that they know about the

payment of a certain amount of money is made when a case is filed before the Civil and Commercial Courts of Lima, Likewise, unofficial payments to speed up the proceedings of the case are not unusual, and that sometimes it was even possible to influence the final decision of a judge through unofficial payments or bribes.

Businesses pointed to slowness or excessive delays as the second most important obstacle to using the courts. Excessive delays in resolving even the simplest cases (for example, the collection of an overdue check) discourage the use of the judicial system. During the workshop, businesses noted that the maximum “ideal” time to resolve a dispute is around six months. After that time, the debt or claim is considered lost. This means that businesses expect to resolve their disputes either through the judicial system or through other unofficial mechanisms in a period of no more than six months.

The third most important obstacle cited related to the complexity and length of judicial proceedings. There is a belief that judicial proceedings are in and of themselves long and complex. Businesses usually have financial conflicts of relatively small amounts, making lengthy proceedings unprofitable and unjustified. Likewise, the availability of complex solutions to relatively simple problems deters potential users from utilizing the judicial system. Moreover, there is a marked reluctance to use the legal services of lawyers (this subject will be dealt with in further detail later).

demand of undue payments). Indeed, several people interviewed pointed out that there is a fixed amount (US \$500) to choose a court.

The fourth obstacle cited relates to the problem of litigation costs. This subject surfaced repeatedly, not only in the survey, but also in the SME workshop and in interviews of various professionals and agents of the judicial system. For purposes of our study, “cost” is defined to include all formal payments required by the judiciary, as well as professional fees, “unofficial” payments and lost opportunity costs. Even though the survey primarily related to questions concerning official costs, unofficial costs were raised and openly discussed in the workshop.

Finally, businesses stated that another important disincentive to using the judicial system related to the low likelihood that court judgments would be effectively enforced. This perception of businesses, even when they did not use the courts frequently, is consistent with other studies. A study performed by the World Bank and the Pontificia Universidad Católica of Lima (in press) notes that about 80% of civil court decisions are not enforced.⁹ That is, judgments rendered by judicial authorities in civil cases are hardly ever enforced. The problems involved in the enforcement of court judgments are complex and deserve deeper analysis; yet, they have been largely ignored in spite of their importance.¹⁰

If the answers by micro businesses and small and medium businesses are disaggregated, it is evident that the former

considers litigation costs a higher deterrent. This gives rise to two interpretations which are not necessarily contradictory. On the one hand, the cost of resolving a conflict in court might be proportionally higher for smaller claims than for higher ones.¹¹ On the other hand, perhaps micro businesses just have less financial ability to incur litigation costs, such as judicial fees or professional fees.

The comparison also shows that small and medium businesses give more importance to the issue of the slow pace of justice to resolve their disputes. Whether in the surveys or in the SME workshop, it became clear that the average time for the judicial system to resolve disputes did not meet the needs or expectations of the business sector. The slowness of the system imposes severe costs on businesses, either in direct costs (professional fees, justice rates, etc.) or costs associated with the impact of judicial delays on their business activity. A businessman, summarizing the ideas of his peers, said: “... I’d rather take a debt as a loss than go to court”.

There are two different court venues, depending on the amount of the claim and the geographic location of the business: (i) small claims courts and (ii) civil courts. Businesses show no clear preference for either venue (we should keep in mind here that businesses lack direct contact with the judicial system). However, a study carried out by the World Bank and the Pontificia Universidad Católica (González Mantilla et al., 2002) points out that small claims courts are much more efficient than civil courts in debt collection proceedings.

⁹ La República Newspaper, January 13, 2003.

¹⁰ IFES recently released a report on the enforcement of court judgments which discusses many of the key obstacles to the fair and effective enforcement of civil and commercial judgments and judgments against the State around the world and especially in Argentina, Mexico and Peru. IFES. 2003. Barriers to the Enforcement of Court Judgments and the Rule of Law.

¹¹ The costs are effectively proportionally higher for smaller debts. See, a detailed analysis on this subject in the section on litigation costs.

Even though we could take the position that businesses, due to their lack of contact with the judicial system, ignore the fact that small claims courts are more efficient, this does not appear to be necessarily true. Indeed, findings from the empirical study by González Mantilla *et al* have been surprising, even for those who have frequent contact with courts, such as lawyers and academics.

How Do SMEs Resolve their Disputes?

The evidence shown so far indicates that SMEs hardly ever use the judicial system. Only 15% of businesses stated that they had used the judiciary. However, this number is even less than it appears, if we take into account the fact that the businesses interviewed had been in the market for an average of ten years.¹²

SMEs, like all the other economic actors, have disputes, but they avoid resorting to the judicial system to resolve them. One of the aims of the survey was to identify the behavior of businesses when a dispute arises. As shown in Chart 1, the first step would be to contact the other party in the dispute and reach an agreement. If this fails, the next step would be to attempt arbitration or conciliation to resolve the dispute. If this fails, the next step is to look for a lawyer and, finally, to use the judicial system.

Even though this appears to be a logical sequence, we need to analyze each sequential step in more detail.

First, the level of effort to resolve disputes within each sequential step is uneven. The attempt to reach an

¹² The average for micro businesses is 11 years, while for small and medium businesses it is 9 years.

agreement with the other party (the first step of the sequence) takes longer than the others. Businesses stated that in order to get a satisfactory solution, they have to contact the other party numerous times. This implies many phone calls and visits to the shop or head office of the other party. Only after all efforts have been made, which could take several months, would the next step be taken. But the premise remains the same “*look for the debtor and negotiate, trying to lose the least possible.*”

The second step is to use alternative dispute resolution mechanisms, such as conciliation or arbitration, which are widely used practices in Peru. For example, 50% of the workshop participants stated that they were familiar with or had heard of conciliation. In the survey questions, many businesses described faithfully the steps that they most often follow. Others discussed the steps that they would follow without knowing the detailed characteristics of arbitration or conciliation. In other words, they would try to use all possible legal means to avoid using the judicial system.¹³

The third sequential step is to seek a lawyer, although businesses showed a certain amount of overall reluctance to hire professional legal services for business advice. Charts 2 and 3 illustrate the differences according to the size of the business. Notably, small and medium businesses present a more frequent, regular use of lawyers and accountants (39%), and that micro businesses use them much less (23%). This may be explained by the fact that larger

¹³ During the workshop with owners of micro, small and medium businesses, 17 out of 30 said that they had had contact with conciliation and arbitration.

businesses have higher transactional levels and more legal and accounting

requirements, as well as a higher degree of formalism.

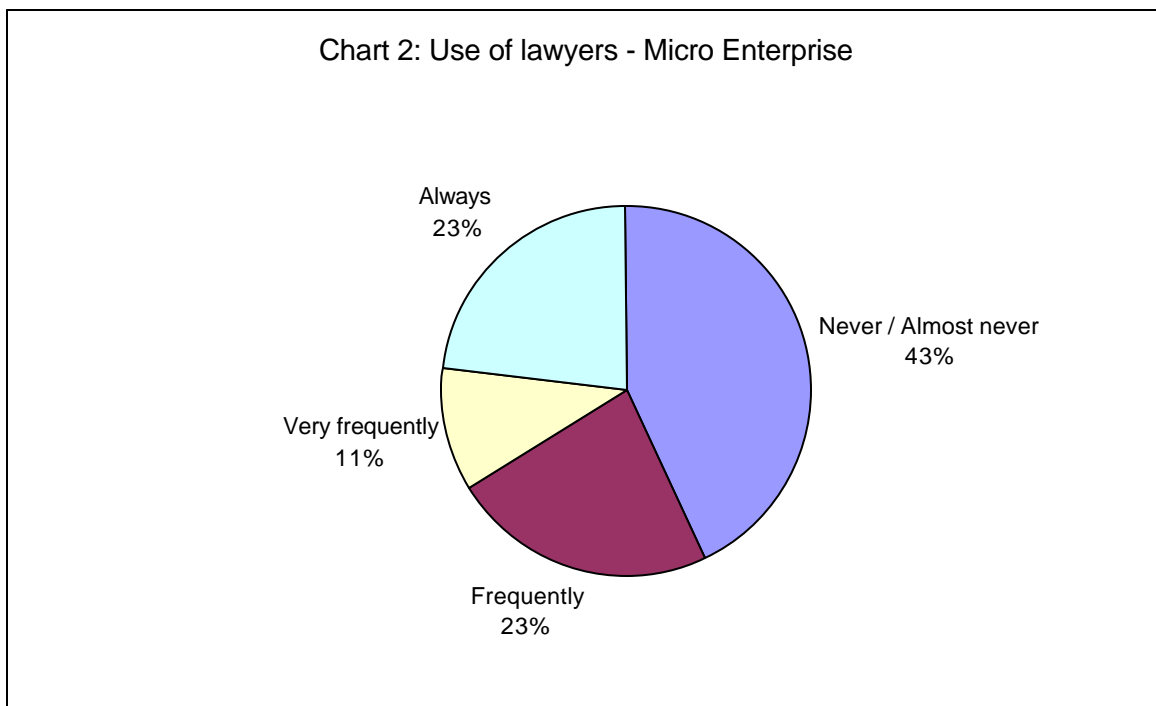
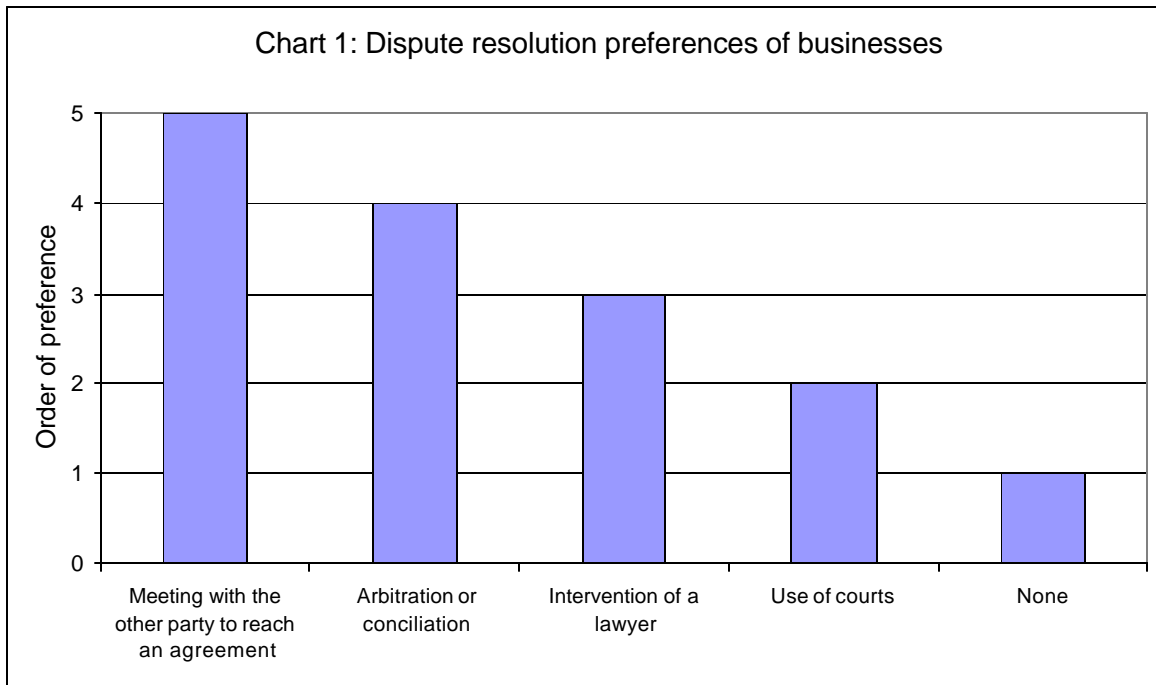
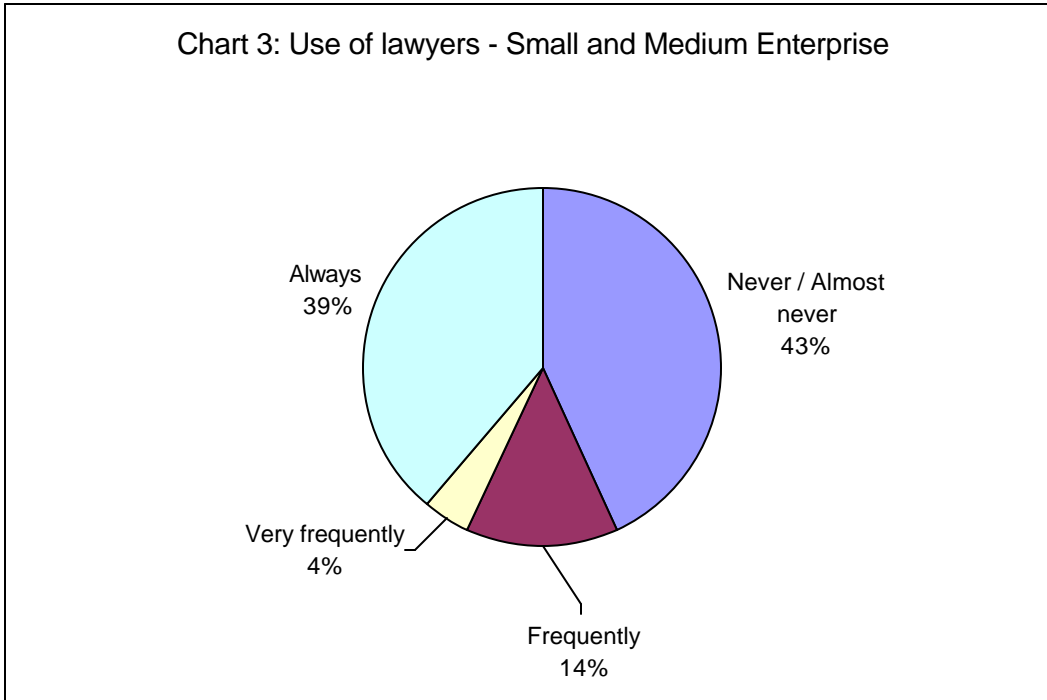


Chart 3: Use of lawyers - Small and Medium Enterprise



As a way to elaborate and further explain the survey results, the issue of whether lawyers and accountants should be used was discussed during the SME workshop. Businesses noted that they use accounting services much more frequently and, that, in many cases, they sought accountants, rather than lawyers, for legal advice.¹⁴ When asked to explain their choice, they answered that they used lawyers less frequently because their fees were higher than those of accountants. Some participants also stated that they do not trust lawyers, either because of their connection with the judicial system or because they used complicated language.

Litigation Costs

According to businesses, one of the main reasons they tried to avoid the judicial system was because it was too costly. They noted these costs not only included

official litigation fees and professional fees, but also “unofficial” costs (corruption) and their time invested in the process. The various kinds of costs will now be analyzed in order to try to determine the total cost of litigating in a judicial setting.

To identify the official costs of using the judicial system, two debt collection hypotheses were analyzed. In the first hypothesis, we quantified the costs of collecting a debt using the judicial system through the attachment of a bank account of the debtor. (Table 2) In the second hypothesis, which is shown in Table 3, we analyzed the costs of collecting a debt using the judicial system through the attachment and sale of a vehicle. In both cases it is assumed that the debtor raised no objections. Likewise, two amounts for the debt were introduced for each hypothesis in order to determine if the relation between the amount of the debt and the litigation cost is variable or constant.

¹⁴ While 13 people said that they use accounting services constantly, only 8 workshop participants stated that they use legal services frequently.

Table 2: The judgment is enforced by attachment of a bank account and the debtor raises no objections (in US\$)

Costs	Case 1	Case 2
Amount of the debt	\$2,000	\$10,000
Request of conservatory measure	\$80	\$170
Attachment act	\$10	\$10
Notice to the debtor	\$1	\$1
Proportional fee owed by the debtor	\$2	\$10
Proportional fee owed by the creditor	\$8	\$30
Lawyer's Fee	\$200	\$2000
Total Cost	\$301	\$2221
Total cost in percentage of the debt	15.05%	22.21%
Fixed administrative cost	\$101	\$221
Fixed administrative cost in percentage of the debt	5.05%	2.21%

In a debt collection case through the attachment of a bank account there are great cost differences depending on the total amount claimed. For example, in a \$2,000 debt, the total litigation cost is \$301, while for a \$10,000 debt the amount of litigation is \$2,221.¹⁵ These figures represent 15% and 22%, respectively, of the total amount claimed. Although the relation between both costs seems to be proportional to the amount of each debt, this changes if we simply calculate the fixed administrative cost of the judicial service rendered. In the case of a \$2,000 debt, the fixed cost represents 5.05% of the debt, while for \$10,000 the debt represents only 2.21% of the debt.

Litigation costs increase significantly if the collection is performed through the attachment of a vehicle. For a \$2,000 debt, the total cost amounts to \$1,118 (equivalent to 55% of the debt), while for

¹⁵ "Total litigation cost" means the payment of taxes and judicial fees plus lawyer's fees. "Fixed administrative cost" means the payment of taxes and judicial fees –lawyer's fees are not included.

a \$10,000 debt, the cost amounts to \$3,028 (30% of the amount claimed). Once again, the analysis of fixed administrative costs presents a significant difference with respect to smaller debts. For the \$2,000 debt, the administrative cost represents 45% of the amount claimed, while for the \$10,000 debt, it represents only 10%.

Table 3: The judgment is enforced by the attachment and sale of a vehicle and the debtor raises no objections (in US\$)

Costs	Case 1	Case 2
Amount of the debt	\$2,000	\$10,000
Complaint/request of conservatory measure	\$100	\$200
Seizure of the vehicle		
Police	\$25	\$25
Storage	\$50	\$50
Writ of attachment in Registry	\$2	\$2
Publications	\$250	\$250
Valuation of property	\$250	\$250
Auction	\$200	\$200
Judicial Fees	\$30	\$50
Lawyer's Fee	\$200	\$2000
Total cost	\$825	\$2975
Total cost in percentage of the debt	41.25%	29.75%
Fixed administrative cost	\$908	\$1,028
Fixed administrative cost as percentage of the debt	45.40%	10.28%

As shown in the tables, the cost of collecting a debt varies considerably according to the amount of the debt. Smaller debts have costs proportionally higher than larger debts. This deserves further analysis because there appears to be strong incentives to avoid using the judicial system to collect small debts, although it remains unclear whether this is deliberate or fortuitous. In other words, the information available has not shown whether the demand of higher costs for small debts was an objective

intentionally-fixed by judicial policy-makers.

Conciliation and Arbitration

Conciliation and arbitration are the main dispute resolution alternatives to using the judicial system. Peru is one of the countries in the region where alternative dispute resolution mechanisms (ADR) are most widely used.¹⁶ From the mid 1990s, the use of ADR began to spread dramatically both in Lima and throughout the country. According to 2002 data from the Peruvian Ministry of Justice, there are 500 private conciliation centers currently working throughout the country and 11,857 people certified to work as conciliators. The Ministry of Justice, in turn, has 31 conciliation centers of its own. It is important to note that conciliation is a mandatory pre-court procedural step in Peru. This means the parties are legally compelled to go through the conciliation process as a prerequisite to the filing of a court claim.

At present, the volume of cases dealt with in conciliation centers is the highest in the region. In the period 1999-2002, 31,203 conciliation cases were registered at a national level, out of which 27,195 had satisfactory results. The Arbitration Center of the Chamber of Commerce of Lima had two cases in 1993; the average in 2002 was 182 cases. In response, the American Chamber of Commerce recently created a new arbitration center for commercial disputes.

¹⁶ The important development of ADR in Peru is largely due to the funding received from international donors. Through the IDB, the Multilateral Investment Fund funded an operation of great importance which laid the groundwork for the development of ADR and was later continued with funding from bilateral cooperation agencies.

One of the advantages of ADR is that it is generally speedier than the conventional judicial process. The average duration of cases resolved under arbitration is five months and twenty days, much shorter than the average of three years and ten months for cases handled by the judiciary. Another advantage of ADR relates to the privacy factor. The parties resolve their disputes in a private and confidential environment, thereby avoiding publicity concerning the details of the dispute or the eventual agreement. This may be particularly important when disputes revolve around confidential business issues which generally prefer to avoid this kind of publicity.

Unfortunately, there are no statistics regarding the frequency with which SMEs resort to arbitration or conciliation. This information, however, could be collected through a study of the cases handled by the conciliation centers. There may be a number of advantages to resolving disputes through conciliation, such as the fact that it is less formal, that non-legalistic language and terminology is used and that it provides an opportunity for SMEs to play a more active role in the process.

An alternative dispute mechanism that might be attractive in some cases would be to create conciliation centers specifically designed for SMEs. Towards this end, the adaptation of experiences and lessons learned in the current centers, but from the needs perspective of SMEs, would appear to be a useful first step. Also, simplified conciliation procedures, rather than current complex, elongated arbitration procedures, would also lower the costs of dispute resolution for SMEs.

However, in the current legal and business environment, a number of

problems and challenges must be overcome in order to make the conciliation process more efficient and attractive to Peruvian SMEs. Our analysis indicates that many of these problems may be attributed to the explosive growth of conciliation centers without appropriate oversight by the State. This situation has opened the door for abuse quite widely and, in some cases, it appears to have resulted in low quality service. These factors should be taken into account at the time of designing or reforming any system adapted to the needs of SMEs.

Contracting Mechanisms

The utilization of written business contracts to memorialize agreements is both revealing and problematic in several respects. The frequency in which contracts are used sheds some light on the levels of formality of business transactions the degree to which businesses believe these legal instruments increase business certainty. The use of contracts also facilitates access to credit since transactional volume can be easily documented.

However, the business survey tells us that the use of contracts is infrequent at best. Only 27% of businesses use contracts in 100 % of their transactions and 15% stated that they use them in 75% of the time. These figures are considerably higher than those presented in another study carried out in 2002, which indicated that 73.7% of businesses did not use contracts to sell their products to customers (Eyzaguirre and Calderón 2002).

If we disaggregate answers according to business size, we find that the use of contracts is much more frequent in small and medium businesses. As Chart 4

shows, larger businesses comprise 50% or more in the first half of the chart (71% versus 56%). This large percentage differential also existed in similar prior studies, which found an almost 20-percentage-point gap between micro and small businesses (Eyzaguirre and Calderón 2002). One possible explanation is that micro businesses manage their businesses with higher levels of informality.

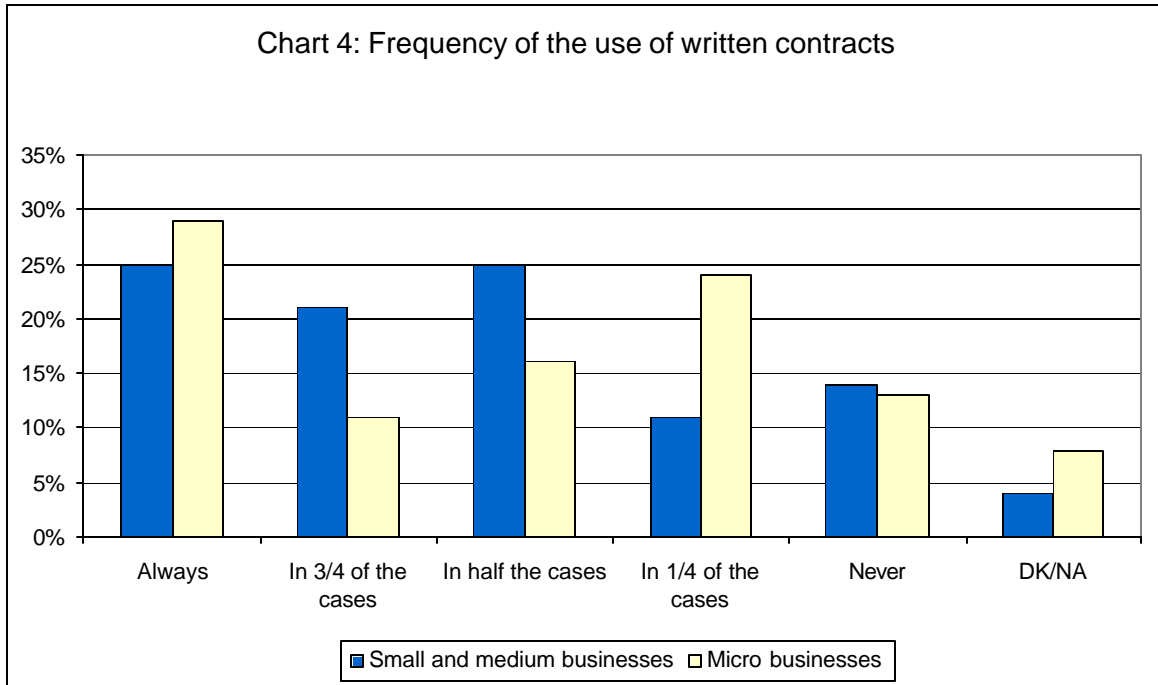
This data raises questions as to how businesses guarantee or formalize credit or long-term transactions. A possible alternative is the use of negotiable instruments (promissory notes, cross-reference guides, warrants, bills of exchange, etc) as substitutes or complements of written contracts. However, the use of these instruments is infrequent.¹⁷ We should note that, even though 38% of small businesses stated that they use negotiable instruments, the number for micro businesses drops to 15.5% (Eyzaguirre and Calderón 2002).

The use of written contracts was discussed thoroughly during the SME workshop. Businesses gave varied answers regarding their reasons for using these instruments. Some stated that the use of a written contract is “... *a psychological pressure for the parties that helps in the fulfillment of the contract*”. Others stated that written contracts give more formality to business transactions, which prevents inaccuracy

¹⁷ Regarding the use of negotiable instruments, the distortion of checks as payment instruments was mentioned several times. Indeed, the check has become a guarantee for transactions. In other words, instead of using checks as quasi-money, they are used as guarantee for compliance with the obligations. Concerning bills of exchange, workshop participants stated that it may take between a year and a year and a half to collect them.

or confusion regarding the actual terms of the business agreement. Interestingly enough none cited using contracts as an

enforcement mechanism in the event of a legal action for noncompliance.



Nor did any business say it used contracts to certify the volume of its business transactions when applying for credit. The tendency to avoid using written contracts was confirmed in interviews with institutions that specialize in the provision of SME credit lines. Nonetheless, credit portfolio managers stated that in most cases they are required to ask petitioners to formalize transactions with customers and suppliers through written contracts.

Businesses, however, do not always act with the knowledge or specialized advice necessary to write contracts. This situation is exacerbated by the absence of institutions that provide legal advice on this subject.¹⁸ Although there are business

¹⁸ This statement is based on information obtained through the survey and discussions from the SME workshop. Although there are some business advice centers, none of the businesses interviewed had used them or knew about them.

associations which have legal aid departments for SMEs, they are either geographically located some distance away or SMEs are not aware of their existence.

The infrequent use of written contracts is also one of the underlying problems of accessing justice. The informality of transactions dissuades many SMEs from using the courts because they do not have the evidentiary documents required to protect their claim through formal judicial channels.

The infrequent use of written contracts also increases the risk of noncompliance with regard to long-term transactions or transactions with multiple services over time. Businesses lower this risk by relying almost exclusively on cash transactions. In some cases, an advance

payment or deposit is required. Restrictions on the means of payment undoubtedly decreases the variety and number of business opportunities pursued, which has a concrete negative economic impact on the economy.

SMEs and the State

Given the economic significance of SMEs and of the Peruvian government, the relationship between SMEs and the Peruvian State is extremely important. SMEs represent 99.6% of the Peruvian business community, employ 75.9% of the people and are responsible for 42% of the GDP. At the same time, the State is the main contractor of the country with 850,000 contracts, totaling \$4 billion, per year.

However, the relationship between SMEs and the State is far from ideal. Many problems negatively affect SMEs and discourage them from even trying to engage in business with the public sector.¹⁹ At first glance, it may appear logical to assume that State contracts are too large and that SMEs would therefore not have the capacity to participate in them. However, official data shows that

¹⁹ Under the Small and Micro Enterprise Act No. 27628, SMEs enjoy certain benefits in the government procurement processes. For example, in the selection process, in case of a tie in the grade score with another business, the SME will be favored. Indeed, paragraph a) of the Implementing Regulations of the Government Contracting and Procurement Act establishes that in the event of a tie between two or more proposals, preference will be given to the winning SME. Likewise, another benefit in favor of SMEs is the obligation of State entities to send a copy of their Contracting and Procurement Annual Plan to the Small and Micro Enterprise Promotion Committee (Comisión de Promoción de la Pequeña y la Microempresa – PROMPYME), in accordance with section 7 of the Implementing Regulations of the Government Contracting Act.

70% of the 850,000 State contracts per year range between \$3,000 and \$5,000; therefore, there would appear to be no capacity obstacle, in principle, to more active SME participation with the State.²⁰

Unfortunately, there appears to be no monitoring process focused on the level of SME participation in the State contracting process. Specialists, however, speculate that such participation is low, even though there are State agencies with the specific task of ensuring that SMEs have adequate contracting opportunities.²¹ The exact number of SMEs that win State contracts also appears to be unknown, as well as the various obstacles they face in the government procurement process and the impact of corruption. A specific study of the government procurement system would allow one to investigate the true ramifications and dimensions of this phenomenon.

The survey reveals that most SMEs are reluctant to contract with the State because the latter fails to honor its agreements and does not make the payments in the periods stipulated. When businesses are asked who they would request a written contract from as a necessary condition to enter into business, curiously enough the State appears at the top of their list (see Chart 5).

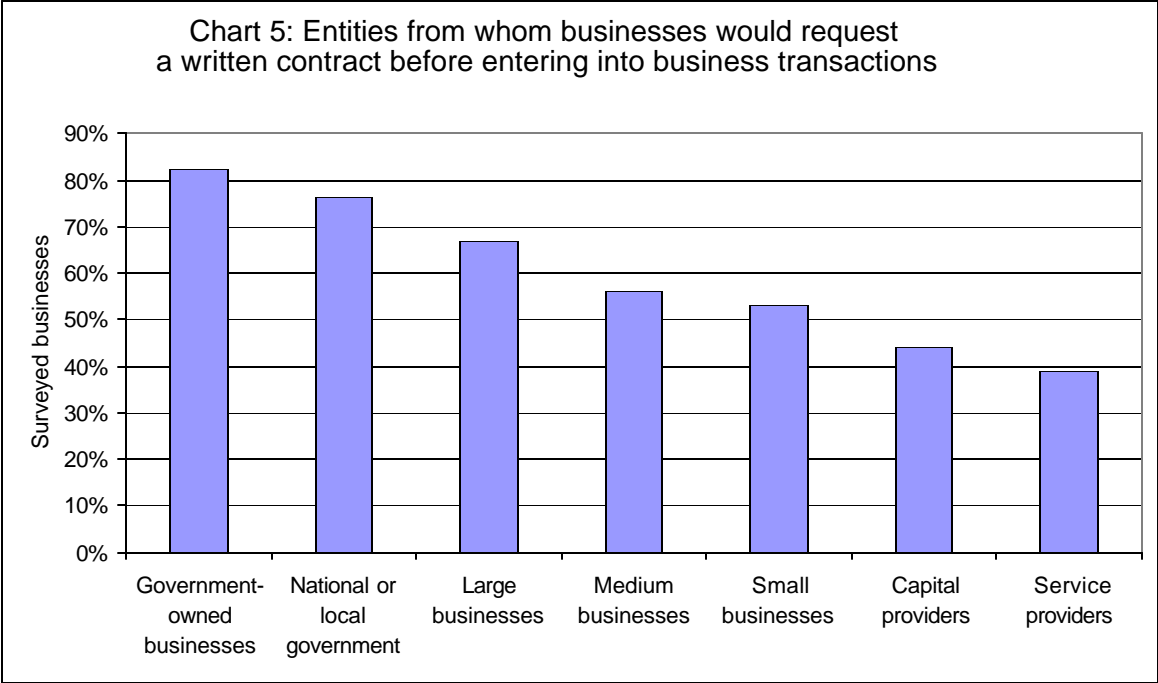
There is also a significant level of distrust in everything in which the State apparatus is involved. This issue was likewise discussed during the workshop, where

²⁰ Data supplied by CONSUCODE.

²¹ Some experts point to corruption as one of the main obstacles to SME participation in the government procurement process. Apparently, a small group of large businesses would win the great majority of the contracts. In other words, some economic groups have a stranglehold on the government procurement mechanism.

overall dissatisfaction with the State’s general behavior was expressed over and over again. Many stated that they have had experiences with both the national and local governments. In every case they described these experiences as negative and almost all of the criticism was leveled at payment problems. They stated that in

order to obtain a payment from the State they had to press multiple government officials on numerous occasions. The following words expressed during the workshop summarize their feelings: ‘we find it hard to obtain payment’, ‘they always have no budget’, ‘they waste my time’.

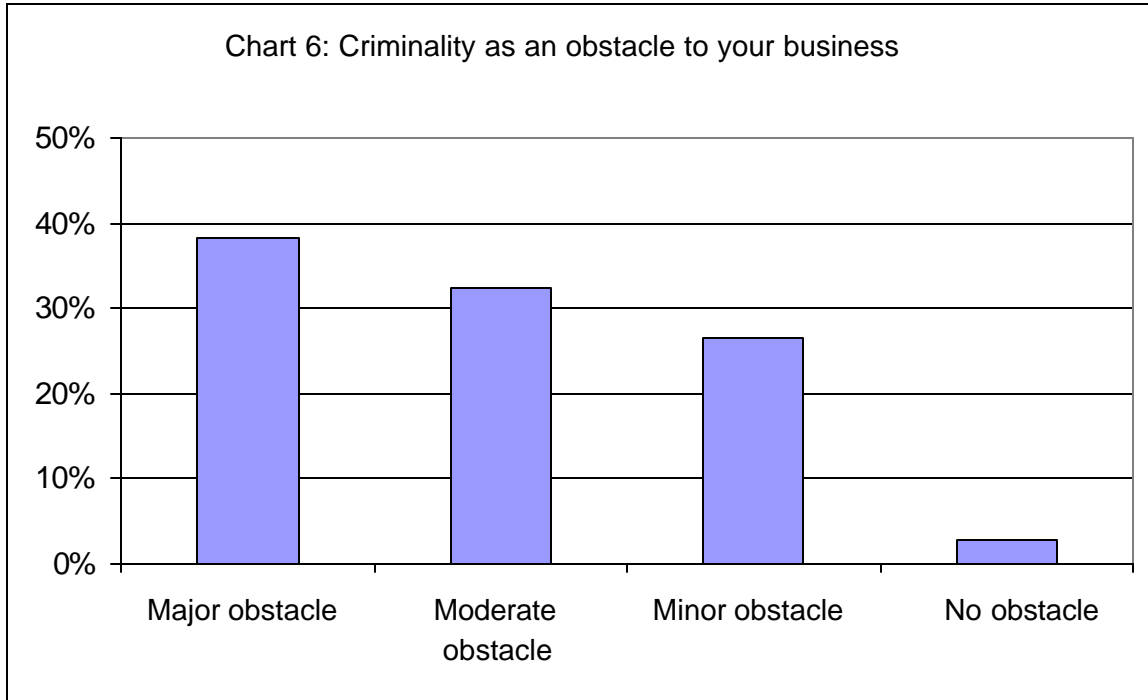


An interesting aspect of the government procurement system is that in the event of a dispute the parties have an obligation to resolve it through arbitration. The body in charge of monitoring compliance with this requirement is the Superior Council of State Contracting and Procurement (Consejo Superior de Compras del Estado – CONSUCODE). By most accounts, this organization appears to have made progress with regard to managing the government procurement process. One of its most important roles is that of monitoring and ensuring the transparency of the process and providing both citizens

and government officials with information.²²

According to official figures, most SMEs do not generally resort to the mandatory arbitration services required by law. This may be because either they do not have access to the government procurement process at all, or, if they do, they resolve their disputes through alternative or informal means – deviating from what the law provides. The first explanation seems the most likely, but this phenomenon needs to be examined in greater depth.

²² The data supplied by CONSUCODE show that 90% of the disputes arise in relation to the terms and conditions of tenders.



Crime and Insecurity

The relationship between criminality and economic growth has not been well understood or the subject of very much research to date. However, we do know that although the judiciary *per se* is not directly responsible for the formulation of either criminal policies or crime prevention plans, its inefficiency considerably affects the fight against crime, since undue delays in the investigations and trials of criminals are rampant.²³ In the case of Peru, criminality generates significant costs for businesses (see Chart 6), which was one of the issues discussed in detail during the workshop. When asked whether insecurity had any impact on their businesses, 75% answered

“yes”. Many, approximately half, said that they usually take measures to avoid being victims of robberies, thefts and other criminal forms. This included hiring security staff or guards, installing alarm systems and even having watch-dogs. When asked to identify the most common crimes, they answered robbery, including stolen payments or consignments of goods.

Survey respondents also described some of the indirect consequences of crime that are often overlooked. For example, because of the high level of insecurity, tourists generally do not frequent their stores. They also stated that during work stoppages and strikes their stores are usually the subject of attacks and robberies.

Measures to prevent crime undoubtedly impose a significant economic cost that needs to be analyzed in greater detail (Rubio, 1998; CISALVA, 1998). Businesses also incur direct costs, such as hiring security staff and installing alarm

²³ In the great majority of Latin American countries the formulation of the public policy on public safety is within the sphere of the justice department or ministry. In some cases there is a specific ministry devoted to the prevention and treatment crime, whereas in others it is within the sphere of the department of the interior or the body responsible for the police force and penitentiary system.

systems. In addition, they also suffer indirect losses derived from the increase in public insecurity, such as the reduction in the number of people frequenting commercial areas. Criminality and insecurity reduce the levels of foreign investment.

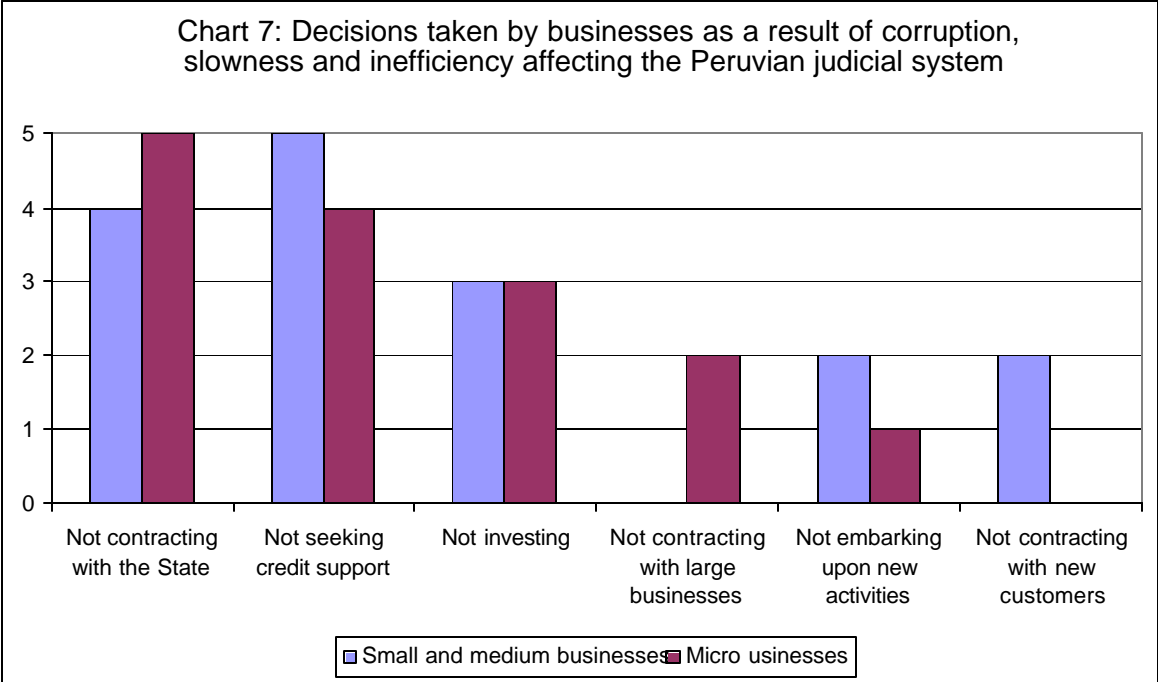
Judicial Inefficiency and Business Decisions

In this section we will analyze the impact of judicial inefficiency on business decisions.

Judicial Inefficiency and Business Opportunities

One of the hypotheses of this study is that judicial inefficiency has repercussions on SME development. More specifically, the problems of slowness, low effectiveness and corruption of the judiciary generate scenarios where there is no optimization of resources. This forces SMEs into making certain business decisions that affect their economic efficiency.

As shown in Chart 7, when faced with judicial inefficiency, businesses make decisions such as refraining from contracting with the State, reducing the search for credit and limiting the scope of their investments and the establishment of new enterprises. This has a significant economic impact and affects business opportunities in a number of ways.



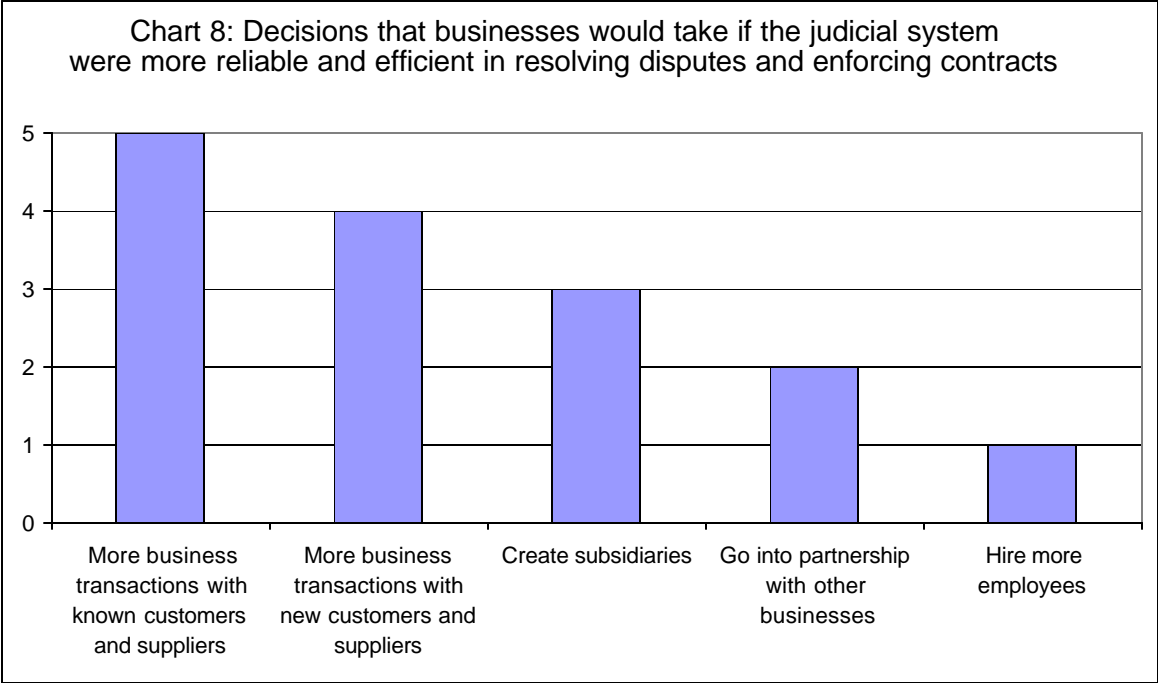
Even when the answers are disaggregated according to business size, one can see that business of all sized make similar business decisions. However, it is worth noting that micro businesses generally refrain from contracting with large businesses. During the workshop, micro businesses stated they made this decision

for two reasons. The first is that they feel they are not on equal terms. This is reflected by the perception that large businesses impose detrimental conditions in their contracts with SMEs. They said that if there is a disagreement and the SME does not meet its contractual commitments, the large business may

simply stop buying from it regardless of who is right.

The second perceived reason is that when faced with a possible dispute, large businesses ‘*always obtain the result they want*’. Micro businesses perceive, for example, that the judicial system always rules in favor of the most powerful and that it is useless to litigate against large businesses. Even though SMEs see business opportunities with large businesses to engage in more business transactions and thereby grow, the general feeling is that large businesses tend to abuse their position of power.

Likewise, businesses were asked about the actions they would be willing to perform if the judicial system were efficient and able to enforce contracts (Chart 8). Here, the answers have profound economic consequences. First, businesses would increase the number of business transactions, not only with known customers and suppliers, but also with new ones. Second, they would expand territorially and create new subsidiaries and sales outlets. Third, they would enter into more business partnerships. Finally, they would hire more employees.



The possibility of businesses creating new subsidiaries is noteworthy. This activity most likely entails their desire not only to increase the levels of investment but also to expand geographically. To refrain from opening subsidiaries and sales outlets reduces the territorial coverage of the business activity, thereby missing the possibility of winning new markets.

Most respondents noted that entering into business partnerships was an uncommon practice. Among workshop participants, only one business stated that it went into partnership with its peers in order to buy supplies at wholesale prices. Another participant, a member of a native Peruvian community, noted that in his community there was a group of 40 families that formed a cooperative to market their products. However, others

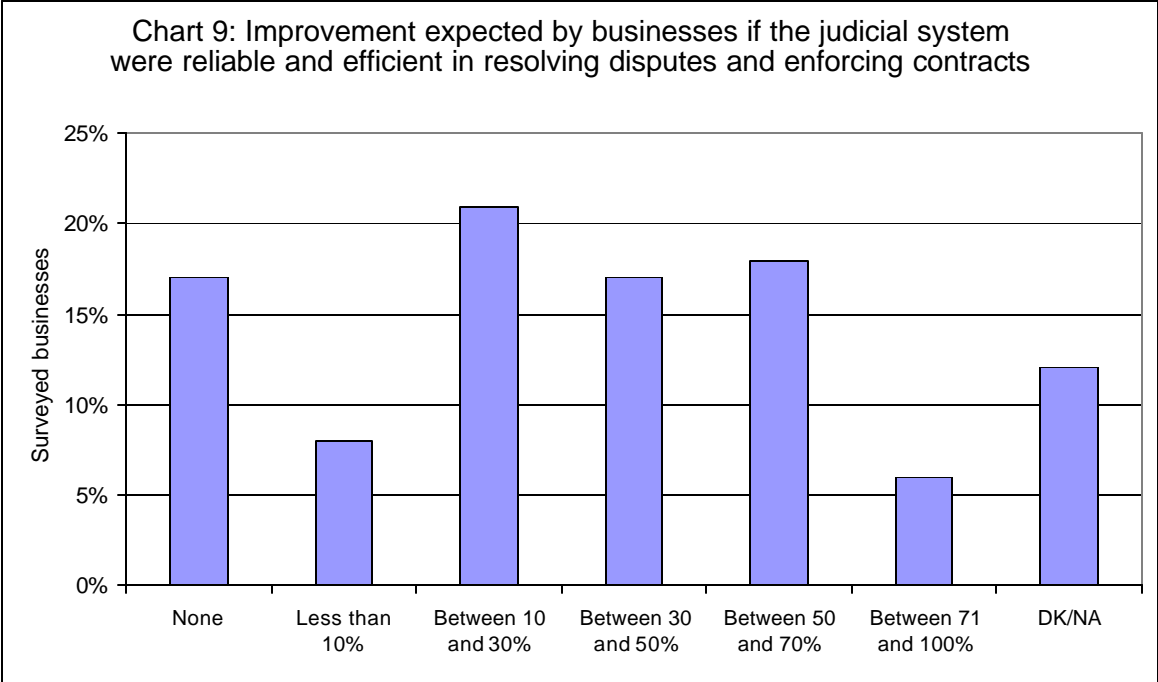
present stated that they had no experience in this type of practice. These results are consistent with a survey aimed at micro businesses, which shows that only 1.8% of the businesses make purchases in conjunction with other businesses and that 16.8% have had experience in joint sales (Eyzaguirre and Calderón, 2002). With regard to subcontracting, figures show that only 13.8% of the businesses usually subcontract for a specific activity of the production process.

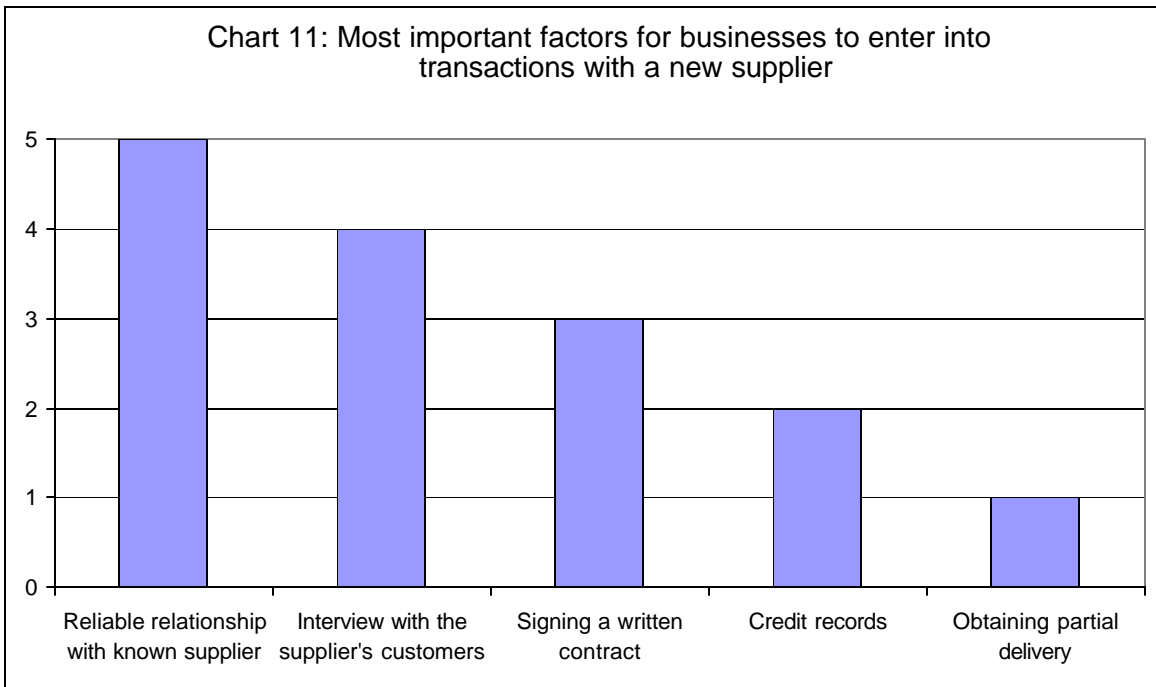
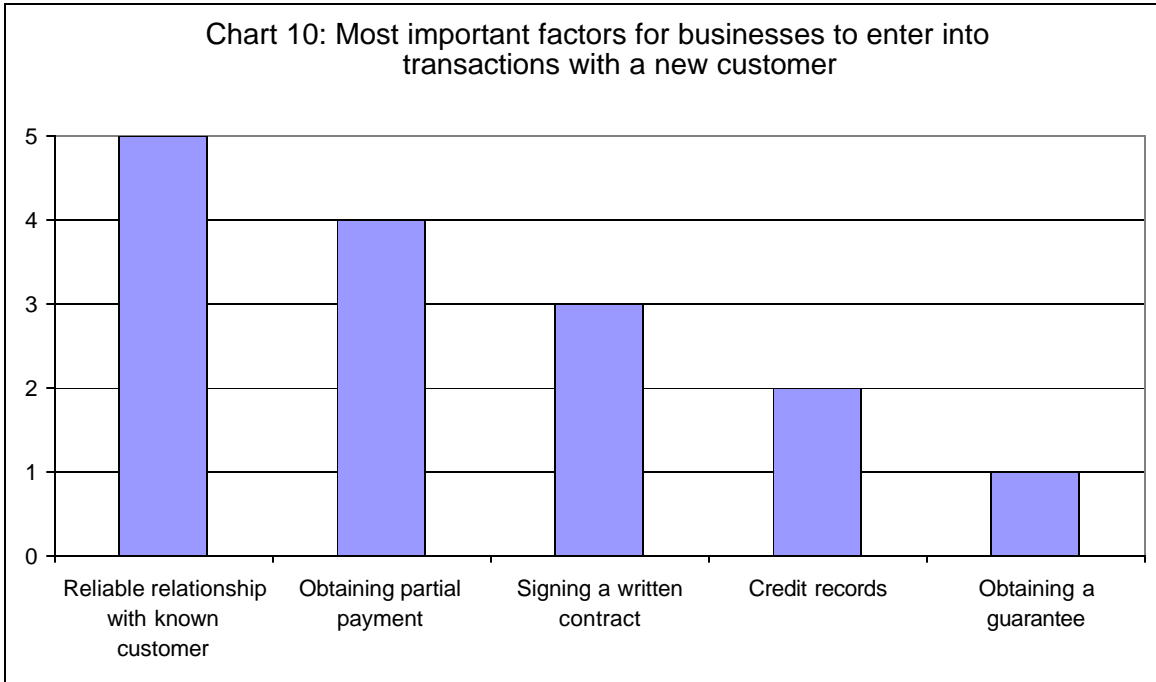
The various forms of business partnerships, such as subcontracting, joint purchases or joint sales, are also affected by judicial inefficiency. The reluctance of businesses to use these methods has an economic impact since it prevents them

from, among other things, reducing the cost of supplies and obtaining better conditions to sell their products.

On the other hand, businesses believe that an eventual improvement in judicial services would have a direct impact on their business. When asked if they believe that their businesses would improve if justice were reliable and efficient in resolving disputes and enforcing contracts, 64% of the respondents gave positive answers.

As shown in Chart 9, answers range from an estimated improvement of 10% to one between 71% and 100%.





Mechanisms to Mitigate Risk in View of New Business Opportunities

As shown in the previous section, judicial inefficiency encourages businesses to engage in a number of behaviors. These are risk adverse behaviors that largely

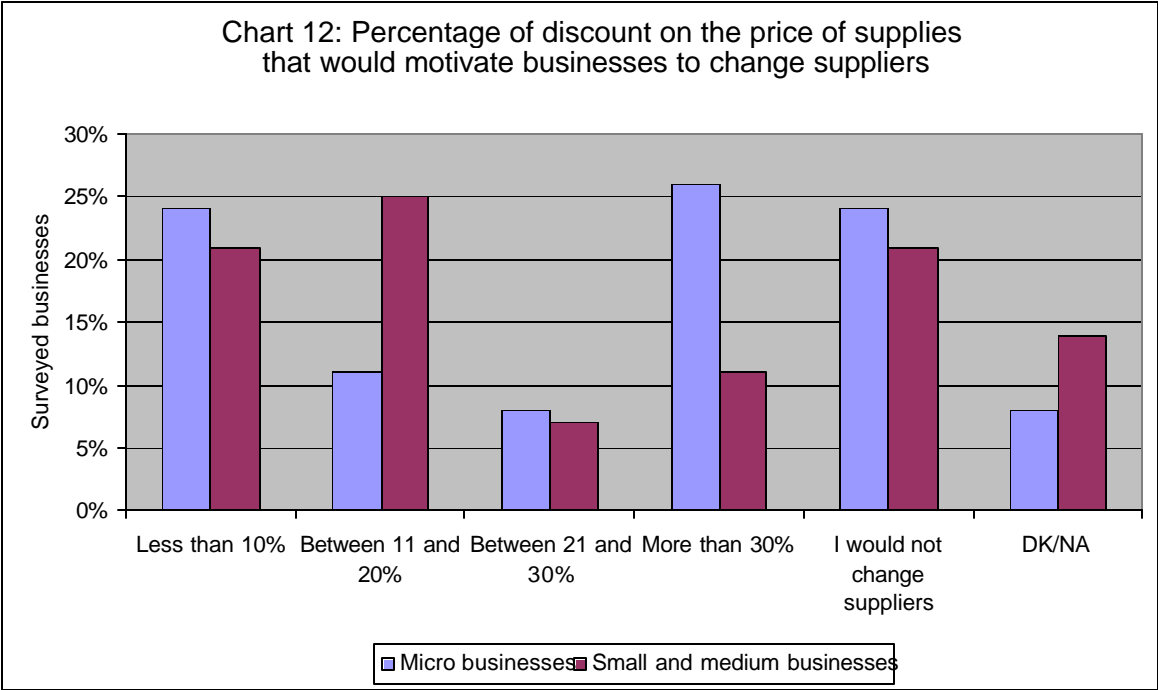
stem from their unwillingness to contract with certain agents – such as the State or large businesses – or to embark upon new activities. We next try to analyze the mechanisms adopted by businesses to mitigate the potential risks of entering

into business with new customers and suppliers.

When businesses are asked about the most important factors that would determine whether to initiate business relations with a new customer or supplier, they immediately raise the important issue of trust (see Charts 10 and 11). This is a decisive factor for engaging in new business transactions. The importance of this issue was corroborated in the SME workshop, where participants stated personal trust and familiarity with their business counterparts were important factors that encouraged them to embark upon new business opportunities. Another important factor noted was the execution

of a written contract. However, a contract seemed to be of more interest when undertaking new business ventures. As previously noted, businesses do not always formalize their agreements by means of a contract.

In addition to trust, another factor that leads to the establishment of new business relations with suppliers is reputation. Businesses generally ask the customers of a potential new supplier such questions as whether the latter delivered the goods in the time agreed upon, whether he respected the stipulated quality for the supplies and whether he honored the sale conditions.



One other factor frequently noted was the need to verify the credit history of the new customer or supplier. We were told that the use of credit center services has grown considerably in the past few years, and a number of Peruvian businesses now often utilize this service in order to verify the business credentials of the potential customer or supplier. However, since the

use of this service is not inexpensive, many businesses appear to necessarily utilize this service with moderation.²⁴

²⁴ Besides the cost of credit center database consulting services, businesses pointed out that 5% of the amount due should be paid in order to register a debt in those records.

While trust within the context of business relations creates greater business and contractual certainty, it also fosters behaviors that are economically inefficient. For example, when businesses were asked whether they would choose a supplier that offered better prices, a significant percentage said they preferred to continue with their “reliable” supplier, even though this may mean higher production costs (Chart 12). Indeed, nearly 25% of businesses state they would not change their regular supplier under any circumstances, even the supplier offered a discount of more than 30%. Another 15% stated they would only change their supplier if they received a discount of more than 30%. Overall, then, over 40% of the businesses would be unlikely to change their supplier even at significantly lower costs.

The aversion to changing suppliers is even more pronounced among micro businesses. Their overwhelming response clearly illustrates that micro businesses are even more reluctant to make changes; consequently, they forego opportunities to reduce their production costs. When this issue was discussed in the workshop, most micro businesses stated that they always preferred to work with known customers and suppliers. They also stated that in many circumstances they preferred to actually lose some business rather than to have a deal with a customer or supplier about whom they do not have much information, or, if they do not know “*whether he is a good payer.*”

As noted above, when in doubt, businesses demand payment in cash, and rule out any possibility of a credit transaction. Yet another issue raised during the workshop was the size of their business suppliers. Most noted that large businesses are more reliable as suppliers

because there is greater certainty that the supplies will be delivered in the time and form agreed upon. Many observed that micro businesses, on the other hand, were more informal and did not always satisfactorily meet their obligations.

As noted above, in an environment in which judicial services are inefficient, businesses respond by taking a number of risk mitigation measures. These measures undoubtedly have a negative economic impact on their bottom line because they increase the cost of business and inhibit business transactions with new businesses. Undertaking more impact-oriented research to determine how effective these strategies and mechanisms are in mitigating these kinds of risks would be worthwhile. If the research shows businesses were using these risk mitigation strategies and mechanisms effectively, one might assume that they would have a relatively small number of disputes with their customers and suppliers.

Indeed, the survey results indicate that the average number of disputes per year is relatively low. 25% of the businesses answered they had had no contractual or payment disputes; 22% answered they had between two and three and 17% answered they had four or more. Similarly, during the workshop, 75% of the participants stated they only had between one and two disputes per year. In principle, this data indicates the measures taken by businesses to reduce the risks of noncompliance are fairly effective. Although there are no comparative data or model standards on this subject, the annual number of disputes would appear to be quite low or, at least, within acceptable limits. If the results are disaggregated according to business size, no significant variations are observed.

The Economic Impact of Judicial Inefficiency

Issues to Be Taken Into Account in Measuring the Impact of Judicial Inefficiency

As shown throughout this study, Peruvian businesses operate in an environment where economic conditions are not optimal. Thus, they are forced to make business decisions aimed at mitigating the risks that flow from the absence of a predictable and efficient judicial system. Judicial inefficiency encourages businesses to engage in smaller, risk free transactions because it increases business costs and reduces the number and spectrum of possible transactions. The low likelihood that the judicial system will impose sanctions for non-compliance also discourages contract compliance because it lessens the economic cost of noncompliance.

The absence of a predictable and efficient judicial system affects SMEs on two different, concrete levels. At the “individual” level, businesses must factor in costs related to the use of judicial services. In some cases, these costs are very high or disproportionate compared to the quality of the services received. Such high costs discourage businesses from using the courts. Overall, excessive delays, the incidence of corruption and, in some cases, high costs, make the courts an unattractive option for purposes of resolving business disputes.

At the macro level, it is clear that judicial inefficiency has a negative economic impact on business decisions. In the absence of an institution that efficiently performs the task of enforcing contracts and punishing those who do not comply with their obligations, businesses take

mitigate the risk of noncompliance through various measures.

In essence, businesses face two types of costs: (i) costs directly related to using the formal judicial process; and (ii) costs that flow from operating in a deficient institutional enabling environment.

As previously noted, the *cost of using the judicial system* consists of the following elements: (i) official litigation costs (judicial taxes or fees); (ii) professional legal advice fees (lawyers) and (iii) corruption and facilitation payments to “speed up” judicial processes. According our survey and workshop research, the first two elements can range from 14 to 55% of the total amount of the debt; whereas payments to facilitate processes can range from 10 to 20% of the total debt.²⁵ Cumulatively, official and unofficial costs can range from approximately 25 to 60% of the total debt. It should also be noted that the net cost of using the judicial system is proportionately higher to collect smaller debts, since accessing and using the judicial system has certain fixed official, administrative and overhead costs, regardless of the size of the transaction.

The *economic cost of judicial inefficiency* is rooted in business decisions that have to be adapted to non-optimal business conditions. In order to mitigate the risks of noncompliance, SMEs clearly often take measures that have serious negative

²⁵ The amount of the payments for corruption is an estimate based on the answers of the businesses that took part in the workshop and on the consultations with lawyers and judicial experts throughout the field research in Lima.

consequences. In some cases, they may completely forego or *reduce the number of their business transactions*. In others, they undoubtedly will take measures that *generate higher transactional costs*.

In general, businesses engage in fewer of transactions because:

- They generally only engage in business with known customers and suppliers. Trust is a key element in the *modus operandi* of SMEs. This fact leads them to mitigate the risks of noncompliance by working only with those who have a good reputation and/or with whom they have a reliable working relationship.
- They generally do not expand the geographic coverage of their market. Businesses refrain from operating in villages or cities in which they do not know the customers and suppliers.
- They generally restrict any forms of credit to the maximum extent possible and work almost exclusively on a cash basis. This is the best way to ensure the payment of debts (full or partial payment in cash). Cash transactions are widespread and are a common practice within the business community.
- They generally do not invest in business growth, since this would expand their business activities. This includes not hiring new employees, not going into partnerships with other businesses and not diversifying the production.
- They generally engage in transactions only with businesses that are similar in size, mainly because SMEs believe

they are not on equal terms with large businesses – especially if they have to resolve a dispute through judicial channels. In general, SMEs feel that they do not have the means to defend themselves against large businesses.

- They generally refrain from engaging in business with the public sector. According to SMEs, the State is an unpredictable or poor business partner. They noted that the State often does not comply with the terms agreed upon and that it takes an inordinate amount of time to receive payment. (It is interesting and telling to note that even though State contracts total \$4 billion a year, SMEs are reluctant to take part in these tenders.)

Similarly, businesses make the decision to incur increased production costs based on a number of factors such as:

- Not to change customers and suppliers. While this might imply that businesses obtain supplies at a low cost, businesses told us that they would prefer to pay a higher cost to suppliers if they know the contract will be honored. Indeed, a high percentage of businesses said that they would not change suppliers under any circumstances, or that they would only do so if they received a 30% discount against the price they usually pay.
- Not to subcontract manufacturing or service tasks. In many cases, businesses are reluctant to subcontract because they are afraid that deadlines will not be met or that the quality agreed upon will not be attained. In other cases, they may not subcontract

because of the mere risk of having to outsource an activity.

- Not to make joint purchases (which could reduce the cost of supplies and/or improve their quality).
- Not to make joint sales.
- Not to investigate the credit history of customers' and suppliers'. This is a time-consuming, costly activity, as is the registration of bad debts with credit centers (it may equal as much as 5% of the debt).

Other costs that do not neatly fit into the preceding categories, but nevertheless are related to the judicial system or legal framework, should also be taken into account, including:

- The economic impact of criminality or "lack of public safety" on business activity. For example, the lack of security inhibits tourists and customers in general, which leads businesses to take additional costly measures, such as employing additional security staff and installing expensive security systems.
- The cost of accessing credit. Because many businesses generally do not know contract law, or how to enforce them or court judgments, and they do not know how to legally qualify for credit or access legal counsel, the cost of obtaining credit is often prohibitive.
- The economic impact of informal business sector activity and the precarious value of property titles. In some cases, the lack of a legal title or deed and the informal status of the business (or the informal nature of

some of its business activities) make it difficult to qualify for credit and access credit facilities.

Quantification of the Economic Impact

In this section, we have tried to quantitatively analyze the economic impact of judicial inefficiency based upon a multi-faceted methodology, including strategic surveys. However, we would be the first to say that the methodology employed in our impact analysis can now be refined and tested even further. We all recognize that being able to empirically quantify the economic impact of judicial efficiency is a novel and complex task, and one that requires a certain amount of experimentation. However, we believe the new insights learned from our research and experience in Peru will at least serve as a solid strategic framework and base-line hypothesis for future research and project design exercises. Hopefully, it will also highlight key business and legal issues related to SMEs and the need to make the judiciary more efficient and accessible.

Impact on Sale and Production Levels

The information obtained from the survey enables us to calculate the approximate impact of improving judicial predictability and efficiency on the sales volume of SMEs. Table 4 shows the weighted average percentage increase in sales, classified by business size (which can be inferred from survey answers). Because the respondents were asked to choose a range, average percentages are calculated using the midpoint and the lower and upper limits of each interval. A detailed description of the calculation methodology is given in Annex A.

Table 4: Weighted average percentages of the projected increase in sales, as a result of an improvement in justice (%)

	Lower limit	<i>Midpoint</i>	Upper limit
Micro businesses	24.85	31.67	38.48
Small and medium businesses	28.85	35.38	41.92
Total	26.61	33.31	40.00

As the table shows, if justice were improved, survey respondents for both micro businesses and small and medium businesses believed that average sale increases for each would be similar. And both believed the sales increase would be significant – between 25% and 40% of the sales total, or average increase of 33%.

If we assume that the surveyed sample is representative of the Peruvian SME population, the economic impact that an improved judicial system would have on the overall economy would be significant. SME participation in the Peruvian gross domestic product, or GDP, is 42.1%.²⁶ If the relationship between gross sales and added value remains constant – which would appear to be a reasonable assumption – an average increase of 33% in SME sales would imply an increase of 14% in Peruvian GDP.

However, we might also assume that SMEs would not respond substantially differently than other Peruvian private enterprises to an improved judiciary. In this case, if the lower limit of the estimated sale increase (25%) is used as an indicator of the potential increase in

²⁶ Figures obtained from the materials of PROMPYME and *Observatorio PYMES* (Inter-American Development Bank).

the added value of the private sector, the corresponding growth in the total GDP as a result of the improved efficiency of the judicial system would still be approximately 20%.²⁷

Impact on Investment and Growth

The preceding analysis is static in that it focuses on the percentage increase in the sales and production *level* that surveyed businesses anticipate as a result of an improvement of the judicial system.

However, a total increase of one third in SME sales, which would result in an increase of one fifth in the Peruvian GDP, would require a proportional increase in the production capacity of the country (assuming a steady linear relation between capital and output). In turn, this would require a substantial increase in the gross fixed capital formation as a percentage of the GDP. A calculation of the incremental capital-output ratio (ICOR) in Peru for the 1993-2002 decade yields an estimated value of 6.25 (see methodology in Annex B for details on the calculation procedure).²⁸ This implies that in order to achieve a total expansion

²⁷ For 2001, the weight of the central government (the sum of public investment and consumption) on the GDP was 12.84% (CEPAL). This data can be used as an approximate indicator of the added value of goods and services produced by the government. There are no precise details of the participation of the public sector as a whole – i.e., including local governments, decentralized public institutions and state enterprises – in the GDP. Assuming that it is around 20%, the remaining 80% would correspond to the private sector.

²⁸ The estimated ICOR is based on total gross fixed capital formation data, including public and private investment. But it is reasonable to assume that the ICOR for private investment is similar (private investment represents 79% of the total investment, as shown in the following footnote), and maybe slightly lower (private investment is likely to be more efficient than the public one).

of 20% in GDP (a result of a more efficient, predictable judicial system) a total investment of around 125% of GDP – net of depreciation – would be required. In view of the fact that there are important lags in the capital stock adjustment process before reaching this level level, an improvement of the judicial system would result in a prolonged, though *temporary*, increase in the capital formation private rate (which average between 1993 and 2002 amounted to 17% of the GDP.)²⁹

A fundamental question is whether, apart from the anticipated output volume adjustment, an improvement of the judicial system would stimulate a *permanent* increase in growth and investment rates. The survey shows that judicial deficiencies have a negative impact on SME decisions to invest and undertake new business. It also shows that, if the judicial system were more efficient, businesses would be willing to expand their business volume and production capacity. It is therefore not illogical to conclude that an improvement of the judicial system would have a permanent effect on the investment rate. Unfortunately, the available data does not allow a direct quantification of the sustained impact that a more efficient and predictable justice system would have on annual investment. However, in a previous study undertaken in Peru, which surveyed 712 out of the 1,000 largest businesses of the country in terms of sales volume, it concluded that an

improvement in judicial efficiency would result in a 9.5% increase in the annual investment (Eyzaguirre *et al.*, 1998). It is not improbable to believe that the impact on SME annual investment would be of a similar order of magnitude.

One can calculate the impact that reasonable increases in the investment rate would have on economic growth by using alternative values of ICOR (which is an investment efficiency inverse measure). Table 5 shows a number of possible scenarios.

Table 5: Potential changes in the GDP growth rate (expressed as a % of the GDP) in view of different scenarios of increase in the investment efficiency and fixed private investment rate

ICOR	Absolute increase in the investment rate			
	0.01	0.025	0.05	0.1
8.50	0.12	0.29	0.59	1.18
6.25	0.16	0.40	0.80	1.60
4.43	0.23	0.56	1.13	2.26
4.10	0.24	0.61	1.22	2.44
2.61	0.38	0.96	1.92	3.83

As the table shows, an improvement in justice will result in slight but sustained increases in the investment rate. This will in turn result in significant increases in the annual growth of GDP (based upon reasonable and acceptable assumptions of the level of capital productivity).

²⁹ The average rate of total gross fixed capital formation/GDP was 21.5% from 1993 to 2002 (Central Reserve Bank of Peru – Banco Central de la Reserva de Perú). On the other hand, the participation of the private sector in the gross fixed capital formation was 79% on average for the 1991-2000 period (Carranza *et al.*, 2003).

Conclusions

This study was designed to achieve two important objectives. The first was to study the relationship between SMEs and the judiciary and to determine the main barriers that prevent SMEs from accessing the judicial system. Toward this end, we tried to identify a number of variables, including the kinds of businesses that resolve their disputes in courts and how frequently they do so, as well as the key reasons why businesses use or do not use the judicial system.

The second objective was to determine whether the problems of the judiciary have an impact on the economy and on the overall development of SMEs. Variables analyzed included the identification and cost of the various problems related to judicial inefficiency, such as slowness and corruption, and how those variables affected business decisions.

With regard to the first objective, the evidence analyzed throughout this study indicates that SMEs do not use the judiciary because judicial processes are lengthy, complex, costly and generally inefficient. Most therefore avoid using the judicial system at virtually any cost (in some cases, they may even go to extremes and forego the debt in order just to avoid using the courts). This does not mean that SMEs do not have contractual disputes – of course they do. However, when they do they use alternative dispute resolution mechanisms or strategies, such as negotiation or conciliation.

Through our multi-tiered methodology, including surveys, focus groups, workshops and strategic interviews, we believe we were able to create a relatively comprehensive picture of the legal needs

of SMEs. Their perspective on dispute resolution, legal counsel, contractual formalities, access to credit and the State's procurement process, helped give us insights into their perception and experience with the judiciary. This kind of information was then used to determine what we call the *unsatisfied legal needs* (ULN) of SMEs. It was then considered within a broader analytical framework so that the various shortcomings of the system could be diagnosed and reform programs could be designed for SMEs.

We believe that the findings of our research in this field are valuable because they clearly identify the range of issues and features pertinent to understanding the relationship between SMEs and the judicial and legal systems. We present evidence regarding the legal needs of SMEs and we provide important insights concerning the obstacles and incentives of accessing the judicial system.

However, we believe the data in this study, as well as our findings, needs to be seen through the eyes of the informality phenomenon. Many believe businesses that operate formally, that is, those that are duly registered and operate within the law, means they have access to justice or the courts. At the same time, many believe businesses that operate informally, that is, those that are not duly registered or operating within the legal system, means they do not have access to justice or the courts. In other words, it is often assumed that when SMEs are not formally registered they are automatically precluded from accessing the judicial system, and that if they are formally registered they automatically have access to this system. Our findings do not

support this hypothesis. On the contrary, the businesses that comprised our sample stated that they had serious access problems – despite the fact that most of them were formally registered. Another complicating factor relates to the reality that many businesses are registered before administrative or tax authorities and operate both formally and informally. Thus, distinguishing between formal and informal businesses from an access to justice point of view is often very problematic.

With regard to the second objective, that is, assessing the economic impact of not having access to the justice system, we believe the data and conclusions are both important and revealing. Our study unveils considerable evidence that judicial inefficiency leads businesses to adopt specific business practices in order to mitigate the risk of disputes. Thus, they are reluctant to change suppliers even if it is possible for them to obtain supplies at a lower cost. Instead, businesses limit their transactions to safe-payment modes (cash) and they avoid investing, business expansion and business partnerships. These business decisions clearly illustrate how judicial inefficiency affects the business sector.

In quantitative terms, we believe the data and the results are also illuminating. The methodology we created and employed to quantify economic impact enabled us to develop alternative scenarios regarding the impact that reasonable increases in the aggregated investment rate would have on economic growth. These findings build upon and are consistent with the findings in previous related studies (Pinheiro, 1998; Sereno, et al., 2001) and they should serve as the methodological framework for designing future studies. Undoubtedly, the methodological model

used to measure economic impact can now be further refined. This would enable us to reanalyze the survey data and economic impact calculations, making it possible, for example to measure the full impact that costs related to judicial delays and bribes have on the each business' cost base – according to the size of the business' debts.

We believe that one of this study's main contributions is that it clearly identifies the various ways in which judicial inefficiency negatively impacts the business sector. It also points towards the need for more empirical research, so that all relevant information can be integrated into a more comprehensive and accurate methodology designed to measure judicial inefficiency's full economic impact.

Apart from the study's stated objectives, it also provides important, new evidence regarding a series of inter-related problems concerning the manner in which the judicial system and the legal framework affect SME development. These include the lack of affordable legal advice services for businesses, difficulties in accessing credit, the costs and negative consequences of doing business informally and the precarious condition of property rights.

Two specific areas deserve special attention: (i) problems related to engaging in business with the State – at all levels (national, departmental and municipal) and (ii) corruption.

The data collected in this study appears to indicate serious problems regarding SME ability to participate in the Peruvian government procurement process. On the surface there appears to be no significant legal or economic obstacles to active

SME participation in this process; however, the experts consulted during this study indicate that the actual participation of SMEs is very low. Because there appear to be no monitoring and reporting mechanisms related to procurement, there are no accessible official statistics to review or analyze. Generally, most surveyed businesses said they were reluctant to engage in business with the State since the latter often does always comply with the obligations agreed upon. Because SMEs are such a large and important sector of the Peruvian economy and because the State is such a large procurer of goods and services (\$4 billion annually), these issues obviously deserve much more attention. Additional research could focus on a number of key issues, such as the extent to which SMEs currently participate in the procurement system, the identification of the barriers to their participation and the economic,

legal and political reforms needed to expand their participation.

The corruption issue raised its ugly head throughout all of the research we undertook in Peru. SMEs repeatedly noted how corruption pervaded myriad aspects of their business activities, including their relationship with the judiciary and the government procurement process (national and local), their relationship with the tax and regulatory entities and even their relationship with other businesses. In short, the corruption phenomenon has a significant affect on SMEs that impose costs that either they or consumers ultimately pay for. Clearly, these costs act as a disincentive for businesses to use the judicial system or contract with the State, although the latter costs are difficult to quantify.

Box 1: Business decisions that result from judicial inefficiency

Reduction of Transactions	<ul style="list-style-type: none"> Transactions with known customers and suppliers Restricted geographic coverage Restriction in payment modes Avoid business expansion Transactions with companies of the same size Avoid doing business with the public sector
Major Costs	<ul style="list-style-type: none"> Not looking for better prices in supplies Not subcontracting Not performing joint purchases or sales Investigating credit records of customers and suppliers
Other Costs	<ul style="list-style-type: none"> Criminality / public insecurity Costs of obtaining credit Informality and precariousness of ownership rights

The Way Forward

As noted in the first chapter, the main objective and methodological approach of this study was geared towards analyzing the dynamics between SMEs and legal

institutions. More specifically, we set-out to quantify the economic impact of judicial inefficiency on business development. We believe the study’s findings and lessons on these key issues should serve as a solid foundation upon

which to undertake future research and design and implement reforms. Towards this end, we think it may be useful to share some of the lessons learned and to raise specific research ideas for future consideration.

One of the lessons is that even though the analysis and findings presented in the preceding chapters sheds considerably more light on the legal needs of SMEs, we believe it is now necessary to examine some of the high priority needs identified more closely. This is particularly true with respect to the manner in which businesses utilize various alternative mechanisms and strategies to resolve disputes. In future research it would also be advisable to broaden the size and composition of the sample size. This would serve to validate or challenge, statistically, the data, analysis, findings and trends presented here.³⁰ It would also be useful to undertake more comparative research, since problems and priorities may vary across country borders and sectors.

Additional research related to the mechanisms by which SMEs resolve disputes, the nature of their legal practices, how frequently they have disputes, the degree to which they currently have access to legal assistance, the cost of their accessing legal assistance, and other related issues identified in the study, would provide policy makers with the kind of information necessary to fully analyze the underlying problems so that concrete solutions could be formulated. Future projects in this field also should be built upon the mechanisms and models used

³⁰ Regarding the findings on the relationship between SMEs and the judicial system, they are consistent with the conclusions of previous studies performed by the Instituto Apoyo.

ordinarily by businesses, instead of upon completely untested models unknown to businesses and legal professionals.

Second, additional studies would allow us to refine our methodology and better adapt it to the specific characteristics of SMEs. Measuring the economic impact of judicial inefficiency presents significant challenges. While our study built upon and referenced the research methodology utilized in previous studies (in Brazil and the Philippines), our methodology could still be refined, tested and improved even further. For example, the survey questionnaires could now be complemented with case studies and monitoring programs that are strategically focused on targeted SMEs. Likewise, since some of the information required to accurately quantify economic impact cannot be obtained from informal interviews alone, a more complex method of collecting and analyzing business and economic data should now be undertaken.

Third, perhaps the greatest challenge is to perfect the methodological framework needed to empirically quantify the economic impact of judicial inefficiency. This study allowed us to make notable strides in this direction. This learning process has now given us the necessary tools to undertake future methodological studies tailored to some of the distinguishing characteristics of the SME sector.

We are keenly aware that quantifying the potential economic impact of hypothetical improvements to the Peruvian judicial system has a number of problems and limitations. Some of them are methodological in nature. In particular, the assumption that there is a linear and steady relationship between capital and output, or between their variation rates, is

too rigid in practice. The approach based on the fixed-coefficients production function ignores the endogenous quality of investment and the market conditions that determine the optimal ratios of inputs and factors.³¹ Although the neoclassical approach incorporates relative prices and equilibrium conditions into the markets, it assumes, like the Leontief-Harrod-Domar approach, that the level of productivity in the use of factors is exogenous or steady. Even so, considering the limited information available, the assumption of linearity is practical and useful analytical approach to examining these issues.

The study's narrow scope, particularly with regard to the number and type of information collected and analyzed from the surveys, is another overall weakness of the analysis and findings presented here. The methodological model focuses on the impact of the production level of SMEs and, then, through extrapolation, the economic growth and physical investment aggregated rates. However, it is clear that an improvement in the quality of the judicial system can have a positive economic impact through other mechanisms. On the one hand, an efficient judiciary may have an effect on the technological progress rate³² or increase the efficiency with which the existing factors of production are

combined³³. Additionally, it may have a positive impact on the rate of accumulation of other factors of production and, in particular, of natural resources (especially mineral ones) and human capital. Finally, even if attention were focused on the increase in sales and physical investment, important dimensions of this issue are ignored by the quantification exercise. For example, it does not take into account the potential impact of how improving the judicial system affects the efficiency of the financial system, the volume of available credit or the credit access issues related to producers or investments. It also does not take into account the potential impact that increased sales levels may have on economic efficiency and technological progress.³⁴

Most of these issues and approaches have already discussed in this study in some detail. In any event, the research and survey evidence here all supports the thesis that an improvement of the judicial system would have a positively impact on the economy. However, in order to be able to quantify some elements of this impact, the questionnaire should be expanded and refined to include specific questions on a number of issues, including:

³¹ For a critique of the short-term empirical validity of the ICOR factor based on the Leontief-Harrod-Domar approach, see Easterly (1999). Another problem with the calculation of ICOR on the basis of the investment to growth rate ratio is that the rate of depreciation is not taken into account (i.e., the assumption is that fixed gross investment, which is the one on which statistics exist, equals net investment).

³² For example, the proper protection of intellectual property rights and of property rights in general may increase the investment in research and development and improve the possibilities of attracting foreign direct investment.

³³ A key case is that of the potential reduction of transaction costs (for example, in the search for information on customers and suppliers, in the renegotiation of contracts or in the resolution of conflicts, either through judicial channels or alternative ones).

³⁴ For example, through the exploitation of economies of scale or the increase in the number of suppliers and competitors, and how they might stimulate innovation. For a thorough and detailed analysis of the different mechanisms through which the judicial system influences production and a summary of the theory and existing empirical evidence, see the excellent essay by Pinheiro (1996).

- Expected increments in the *annual rate* of investment.
- Expected increments in employment.
- Projected expansion of the customer and/or supplier base.
- Expected impact on geographic diversification of sales and/or production (potential impact on the level of exports or the possibility of exporting).
- Expected impact on outsourcing.
- Expected impact on research and development or innovation activities.
- Expected impact on corporate structure and capital ventures.

Future research might also shed more light on the cost that judicial inefficiency and unpredictability imposes on the financial system -- particularly the impact of an inefficient credit collateral system and credit diffusion, volume and cost. Obtaining this kind of information would entail expanding the scope of the research and interviews to include the managers of banks and financial institutions. The net

value of analyzing this kind of information would appear to more than justify the cost of obtaining it.

As previously noted, quantifying the added impact that many of these elements would have on the economy's total production level or its overall growth rate is complex. Taking existing studies into account is an obvious starting point of any analysis. However, the empirical analysis in these studies tends to focus on country cross-sections, rather than on time series for a particular country or business cross-sections within that country. Even so, the estimated parameters and coefficients for other countries might be used as a benchmark for future research.

Fourth, in the course of this study we identified a number of legal issues of particular relevance to SMEs. Future research that targets this set of issues would also be very useful. For example, analyzing issues related to small claim courts, SME legal advice centers and business registration programs, through pilot case studies, would help complete the mosaic in which in which SMEs find themselves operating in Peru.

ANNEX A

Research Methodology

This study was conducted between September and December 2002. Three kinds of activities were performed during the project: (i) research, (ii) design of the survey instrument, and (iii) a field study.

In an effort to capture regional and global lessons learned, the research consisted of a review and analysis of all known existing academic and applied studies, as well as other relevant literature. We analyzed a variety of studies undertaken by international organizations, international cooperation agencies, research centers and nongovernmental organizations from both Latin America and other regions such as Asia. Key findings and comparative experiences of these studies are referenced throughout the study.

The survey instrument was designed by a multidisciplinary team composed of legal professionals, political scientists and economists. The questionnaire is composed of two sections. The first section contains 9 questions geared towards profiling the types of businesses surveyed. The second and main section includes 29 questions designed to assess how businesses perceive the judicial system, the level of formality and frequency of use of contracts, the mechanisms of dispute resolution and the general impact of judicial inefficiency on business decisions.

The field work was undertaken in Lima, Peru, between December 8 and 14, 2002. During this timeframe, IFES worked with MARC PERU, a Peruvian NGO well-known for its work on alternative dispute resolution mechanisms and legal education and dissemination programs. A

number of concrete activities were implemented in this phase of the study. First, we met with several experts and interviewed lawyers, judges, researchers, nongovernmental organizations, bankers and government officials. These meetings provided a valuable opportunity to collect information regarding the Peruvian judicial system, the legal framework for SME development, Peruvian public procurement processes and SME financing.

Second, the IFES questionnaire was used to survey Peruvian businesses to assess their opinion of the Peruvian legal and judicial system and whether its inefficiencies interfered with the economic behavior of SMEs.

A first set of surveys was carried out in the Industrial Park of the District of Villa El Salvador, south of Lima, where SMEs representing many key sectors of the Peruvian economy are located. The six-person surveyor team interviewed individual business executives for periods that typically ranged from 35 to 40 minutes.

A second set of surveys took place during a national SME convention held at the Riviera Hotel from December 9th through the 13th.

Third, a workshop was held on December 11, with thirty SMEs representing different SME sectors and regions of the country. The workshop lasted for approximately two and one-half hours and focused on key issues raised in the survey and additional topics raised by the participants. The workshop also served as

a mechanism to check and debate the survey findings.

The survey sample consisted of 30 micro, 22 small and 14 medium sized businesses. The criterion for the classification of businesses into these categories was related to the number of their employees³⁵:

- Micro business: up to 10 employees.
- Small business: between 11 and 20 employees.
- Medium business: between 21 and 200 employees.

Concerning the characteristics of those surveyed, the business representatives surveyed in Villa El Salvador were between 25 and 50 years old. We also tried to strike a balance between men and women as well, although this was not scientifically done. The majority of those surveyed came from districts surrounding Peru. Most had lived in Lima for a long time. The youngest participants were born in Lima but they were “second generation” immigrants. Approximately 10% of the participants refused to fill out the questionnaire because they said they were afraid that the surveyors were in fact labor or tax agents. Others said they did not because of a lack of time.

The survey sample obtained during the referenced SME convention was composed of a younger age group, generally ranging from 25 to 40 years old. The sample also included businesses that represented elements of the indigenous population. Some of the businesses

surveyed also had some experience as exporters and some of those who answered the questionnaire also participated in the workshop.

Both samples contained many “family businesses” in which individual members of the family played important roles. Finally, it should be noted that even though the majority of the interviewees said they were duly legally registered as a formal business, some of them stated they conducted part of their activities in the informal sector.

³⁵ We did not make a classification based on annual income because businesses were reluctant to provide such information.

ANNEX B

Methodology

** The methodology used for the quantification of the economic impact of judicial inefficiency on SMEs is currently only available in the Spanish version of this report, El Costo de la Resolución de Conflictos en la Pequeña Empresa: El Caso de Perú. The methodology can be obtained from the authors.*

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