

# FROM INTERVENTION TO EMPOWERMENT:

A New Approach to Assisting SMEs in Latin  
America

Regulation, Procurement, and Dispute Resolution

prepared for  
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## Executive Summary

The Inter-American Development Bank (IDB) group has a long and important tradition of support to the small and medium enterprise (SME) sector. Since 1990, for example, Multi sectoral Global Credits channeled \$2.5 billion of IDB resources that were leveraged with local capital to reach almost \$4.8 billion in total lending capacity. Over the same period, nonfinancial services loans were approved for a total amount of \$1.3 billion. In a parallel effort, the Inter-American Investment Corporation (IIC) was created in 1989 to attend to the financial needs of SMEs in the region. As of 1997, the IIC had participated in 180 transactions totaling \$450 million in commitments. The Multilateral Investment Fund has also participated in this area creating, for example, eight venture capital funds amounting to \$35 million targeting general and industry-specific small enterprises.

The work presented in this paper is part of the Bank's most recent efforts to develop new approaches and instruments to strengthen its role as a major development partner of this important engine of growth in the Latin American and Caribbean region. It focuses on nonfinancial issues which have seldom been addressed systematically in the debate on the constraints hindering SMEs.

As we review loans presented to the Board, it is clear that many of them deal with themes that potentially affect SMEs. There is consequently the potential to incorporate small business issues in many projects that do not explicitly target this sector. Exploiting these opportunities would allow us to increase our interventions in this area considerably. To explore this idea, we have selected three themes that *a priori* hold promise as candidates to be dealt with in numerous projects in fields such as modernization and reform of the State, decentralization, and labor market reform. These themes are regulations, procurement and dispute resolution. Each of the themes are analyzed in terms of their impact on SME development. At the end of each section, we provide a checklist of issues which operational staff interested in including SME issues in their operation could use as a starting point for project design.

Section I analyzes the effect of regulations on SMEs within a transaction-cost framework considering such issues as taxes, labor, trade, and corruption. It shows that by reforming the regulatory environment business, SMEs can be empowered, thereby spurring economic growth in Latin America. Additionally, it advocates the development of private and independent SME associations in each country. Their participation in regulatory reform efforts is crucial to the development of a framework that takes SME issues into account. Such associations can best monitor bills, law enforcement, and judicial decisions, and advocate on behalf of SMEs in these processes.

The second section considers the possibility of using procurement as an aid to SME development. It determines that the IDB should not use procurement as an instrument of SME promotion but where possible, the Bank should make the processes transparent and remove barriers to SME participation. Although rigid rules for procurement are undesirable, standardized guidelines regarding issues that could encourage SME participation might be beneficial. These issues include prequalification, performance guarantees and information dissemination. Furthermore, there is the potential for coordination between program aimed at assisting SMEs through technical services and training and procurement arising from IDB loans. A pilot or experimental program in this area could reveal important lessons for future promotion of SMEs in the area of procurement.

The final section looks at the effect on SMEs of inadequate dispute resolution procedures. The IDB has already made substantial inroads in this area with many Judicial Reform projects either in execution, preparation, or in the pipeline. However, there are some specific issues that could be considered in future efforts. These include improving the framework and institutions surrounding summary judgement proceedings, introducing competition to notaries in those countries where there appears to be cartelization, and streamlining legal processes in general because the lengthy delays in decision making are an issue for businesses of all sizes.

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## Section I: Introduction

This paper outlines some of the issues that affect small and medium sized enterprises (SMEs) in three areas; regulation, procurement, and dispute resolution. There are obviously many other factors which also influence the ability of entrepreneurs to establish and expand small businesses. Financial sector issues, education, training, information dissemination, property rights, infrastructure, technology and export issues all have an important impact on SMEs. This paper is the first step of a more comprehensive review of how Inter-American Development Bank loans, programs and policies affect small businesses over a broad range of issues.

The paper discusses issues affecting SMEs under each of the three topics. This approach has the advantage of identifying systematically factors that have an impact on small business. There is no attempt to present a detailed review because the minutiae of many of the topics discussed are country specific and need to be examined on a case by case basis. Undoubtedly, one of the most valuable contributions that the Bank could make in this area would be to produce cross-country analyses of the relative importance of different issues, the cost they imply for SMEs and the cost of adjusting those policies.

The paper commences with a brief rationale for focusing on SME issues followed by sections on regulation, procurement and dispute resolution. The conclusion summarizes briefly the main points of the paper and highlights the need for an integrated approach if SMEs are to be helped effectively. Where appropriate, it adopts a transactions costs approach by examining how these issues affect the cost of doing business. A review of recent Bank loans reveals that many involve themes that potentially affect SMEs. As a result, there is the potential to incorporate explicitly small business issues in many projects. Therefore, at the end of each section there is a checklist of topics that could be addressed by those interested in incorporating SME components into Bank loans. Integrating the topics on the checklists into future Bank projects and obtaining more data on SME specific questions will go a long way toward incorporating the needs of SMEs into the Bank's body of work.

### *The Importance of Small and Medium Sized Enterprises*

At the outset, some rationale for focusing explicitly on small and medium sized enterprises is needed. What is the value of studying issues that relate to these particular types of firms? Small and medium sized enterprises are important for several reasons.

◆ First, economies in which large numbers of SMEs are being established are usually dynamic and provide substantial rewards for entrepreneurship. If economies in Latin America encourage and reward dynamism, they are more likely to grow rapidly and provide opportunities for a larger sector of the population than is now the case.

◆ Second, the creation of large numbers of small firms will also create many new jobs. Whether these jobs are permanent is a subject of controversy. However, there is no doubt that those firms that start small and grow into large corporations make a lasting contribution to employment.

◆ Third, examining the problems of SMEs provides insight into larger problems within the economy. It provides a focus for looking at the business environment as a whole. In healthy economies, firms grow from small to medium to large. In economies where the business

environment is deficient, small firms tend not to grow and there are very few small and medium size *formal* firms. Such economies are usually characterized by large informal sectors at one end of the firm size spectrum, and a small number of dominant large firms at the other. There is a “missing middle” of small and medium sized enterprises. In economies such as this, formal firms tend to be “old.” In some countries in Latin America, the average age of small firms exceeds 20 years. This is a startling statistic. In the United States where the small business sector is bursting with dynamism, over 70 percent of new small firms do not last more than five years.

◆ Fourth, people operating in the large informal sectors which characterize many countries in Latin America may possess substantial entrepreneurial ability. Harnessing these skills and energy through the establishment of formal small businesses would reap substantial benefits in the form of poverty reduction, improved income distribution and higher growth rates.

## **Section II: Regulation**

This section examines the extent to which regulations limit or halt SME growth and prosperity. In order to have the greatest impact possible, any regulatory reform policy should be based on careful estimates of the cost to business of complying with regulations. This procedure ensures that the first regulations to be rationalized are those that impose the highest costs on SMEs. In many cases regulatory reform will have the added benefit of reducing the costs of doing business for the private sector as a whole. Nonetheless, because the costs of regulatory compliance and dealing with bureaucratic inertia do not increase in proportion to firm size, regulation at the national, regional, and municipal levels, undoubtedly effects SMEs disproportionately.

Regulatory compliance imposes higher relative costs on SMEs compared to larger firms and, therefore, serves as a barrier to entry for small firms and encourages informality. This section examines these costs and shows that by reforming the regulatory environment for business, SMEs can be empowered to spur economic growth and employment in Latin America. It defines transaction costs, identifies indicators of high transaction costs, and discusses the effect on small business. The section then examines other regulatory costs and suggests ways in which the Bank can help lighten the regulatory burden on SMEs, both through project work and further research.

### *Transaction Costs Defined*

Transaction costs are “the costs of doing business” or “the costs of using the market.” They are not related to factor inputs, goods, or services, but are, rather, the costs of using the mechanisms of production and exchange. In this sense, they can be viewed as the friction in the economic system. Transaction costs are a necessary result of the market process and cannot be entirely eliminated. The best that can be achieved is to reduce transaction costs by rationalizing the most common procedures which include:

- a) Negotiating, drafting, fulfilling and enforcing contracts,
- b) Gathering information,
- c) Managing agents engaged in transacting,
- d) Resolving disputes over transactions, and
- e) Registering to legally use the market, or avoiding detection if using the informal market.

Transaction costs are determined by institutions, that is, by the formal and informal relationships in society, and the rules and technologies which characterize them. For example, when transactions are personal or familial, and characterized by trust and friendship, some transaction

costs will be low. Restricting dealings to those who are personally acquainted, however, comes at the cost of sacrificing efficiency because such patterns of exchange exclude those who may have greater abilities. In addition, it embeds unequal distribution of income.

When transactions are impersonal, risk increases. More time will be spent negotiating, gathering information, and resolving disputes. Thus, institutions such as contracting mechanisms, dispute resolution and enforcement of contracts reduce the risk of impersonal business dealings. In addition, technology which speeds the flow and processing of information, lowers the risks of transacting.

When the costs of transacting are high, the result is significant friction within the economy, limiting development and slowing the growth of private businesses. Furthermore, when the rules in terms of which transactions take place are unclear, information costs increase and firms can become prey to bribe-seeking officials.

In many cases, the costs of transacting are reduced by the public goods supplied by government. These include well-functioning economic and judicial systems and a secure social environment. They encompass such things as:

- ◆ Macroeconomic stability,
- ◆ Clear rules for contracting,
- ◆ Speedy and transparent resolution of disputes,
- ◆ Mechanisms for enforcing judgements,
- ◆ Establishment and protection of property rights, and
- ◆ Well-functioning infrastructure sector.

On the other hand, governments also raise transaction costs within firms, in their business dealings with other companies, and with the private sector's interaction with the public sector. For example, the cost of doing business is increased by:

- ◆ Non-transparent and complicated tax codes,
- ◆ Over regulation of economic activity,
- ◆ Special treatment of specific sectors or activities,
- ◆ Regulatory requirements that are not consistent between levels of government,
- ◆ Unwieldy licensing obligations,
- ◆ Granting of monopoly control within the bureaucracy.

Because of the pervasiveness and complexity of government regulations in most countries in Latin America, dealing with the public sector involves significant costs. Lawyers, politicians, lobbyists, bureaucrats, managers, and accountants all devote significant portions of their time to issues involving transaction costs. It is the purpose of this section to discuss the implications of such regulation for small and medium sized enterprises in the region.

### *Regulations, Transaction Costs, and SMEs*

The time and money spent complying with government regulations impose significant transaction costs on SMEs. In addition, the direct cost of payments, such as licensing fees, also represent a significant cost of doing business. Conversely, payments made to avoid detection of non-compliance, or payoffs to government officials are the costs of operating in the informal sector. The regulations imposed on SMEs fall into several categories. Some regulations governing

business start-up raise the costs of entering the formal sector. Other regulations govern ongoing business activity. Some are dictated by the central authority, others by regional or municipal governments. Furthermore, SMEs face government imposed costs in the areas of labor practices, payroll charges, health and safety standards, taxation, and foreign trade.

### *Business Start-Up Costs*

Entrepreneurs in the informal sector in Brazil, Ecuador, Peru, and Uruguay identified the high cost of formalizing their businesses as one of the most important factors in their decision to stay outside the formal sector [Holden and Rajapatirana 1995]. In particular, they cited costly licensing and paperwork requirements at the municipal level. Such entry barriers explain why relatively few small companies in Latin America are registered formally. Additional barriers to formal start-up are the expected costs of compliance with regulations regarding future business dealings, including taxes, labor regulations, and payroll charges.

Regulations which govern the establishment of an enterprise involve registration and licensing requirements. While specific regulations vary from country to country, and from municipality to municipality, they usually include most of the following:

- ◆ Incorporation of the business as a legal entity;
- ◆ Inclusion in a business registry at the national, regional, or municipal level;
- ◆ Registration with the national tax authority;
- ◆ Registration of employees in pension, health, and other national social security schemes;
- ◆ Acquisition of building permits, at the municipal level;
- ◆ Acquisition of operating and other licenses, at the municipal level;
- ◆ Approval of health officials upon inspection (especially for sales of food), at the national and/or municipal levels;
- ◆ Safety approval from local fire officials.

Each of these steps can involve multiple sub-steps, and the completion of one is often linked to the fulfillment of others. Often it is not the financial cost itself that creates the largest transaction cost obstacle to setting up a small business, but rather the time and energy required to navigate the bureaucratic maze, along with the opportunity costs involved. A well known example was provided by Hernando de Soto when he measured the cost of establishing a small garment manufacturing enterprise in Lima, Peru. He found that it required many different steps over an extended period of time to set up a small formal manufacturing company [de Soto 1989]. Although Peru has substantially reformed and simplified the process of setting up a small business, de Soto's overall conclusions remain as valid for many other Latin American countries today as they did in Peru in the late 1980s. This is why entrepreneurs frequently resort to bribes or professional "fixers" in order to expedite the registration and licensing process. Fixers' fees range from US\$600 to US\$800 to establish a company in most Latin American countries. These fees rise quite sharply as the size of the firm increases.

Table 1 demonstrates two points. Firstly, it shows the direct costs and time costs for establishing small garment businesses in three Latin American countries in 1994. Compared with the average salary in Latin America, these costs are substantial and they make entrepreneurship particularly challenging for the poorer sectors of the population. These numbers go a long way toward explaining informality.

**Table 1 - Costs of Starting a Business**

<b>Country</b>	<b>Total Direct Cost (US\$)</b>	<b>Total Time (months)</b>
Brazil	640	1.6
Chile	739	2.0
Peru	800	4.4

Sources: World Bank survey data

A formal investigation of the costs of starting a business in all the countries in the region should unearth useful information for future Bank reform efforts. For example, in Peru, the changes implemented under the Fujimori government appear to have greatly eased the difficulty of business start-ups. Following the establishment of a single unified business registry in October 1990 and subsequent simplification of registration procedures, the number of new enterprises has skyrocketed. Instituto de Libertad y Democracia, which pioneered the single-registry concept, estimates it has resulted in the creation of more than 350,000 new, formally registered enterprises.

Although informality reduces the transaction costs of complying with many of the regulations considered in this paper, informality imposes transaction costs of its own. These costs stem from the low profile that many informal businesses must maintain in order to avoid enforcement of regulations by the authorities. For one, entrepreneurs often have to pay bribes to police and other officials. Such payments may be viewed as costs of accessing illegal transactions. In addition, information becomes more costly to obtain when businesses are relatively clandestine, both for the firms themselves and for their customers and suppliers.

It is also important to note that many of the regulations discussed in this section not only discourage formal business start-up, but also discourage firm growth. Were an enterprise to grow, it would become more difficult to hide its activities from authorities. Therefore, many informal businesses choose to maximize profits by remaining small.

### ***Labor and Related Costs***

Labor regulations that affect SMEs may be divided into three categories: mandatory non-wage benefits, job security guarantees, and minimum wage legislation.

#### **Mandatory Non-wage Compensation**

This can include mandated vacation bonuses, housing bonuses, transportation bonuses, food vouchers, family wage allowances, extended paid maternity leave, employer insurance contributions, compulsory end-of-year bonuses, savings plans, sick leave, and other forms of compensation. Strictly speaking, the direct costs of such payments are not transaction costs, but rather additional labor costs. Besides the financial burden, however, they also represent an additional accounting and administrative burden for formal businesses. For this reason, many SMEs prefer to remain informal. If they do formalize, larger SMEs often hire temporary labor or subcontract. SMEs thus incur additional transaction costs in searching for and hiring employees more often. Temporary or new employees also increase transaction costs by requiring more attention from management. In addition, SMEs have less incentive to invest in training such workers, thus hindering workforce productivity.

#### **Job Security Guarantees**



These generally take the form of severance pay requirements and making dismissal difficult and costly. Severance payments are direct costs, but can also be seen as a special case of transaction costs, since they are associated with exiting the market. For example, they place an extra burden on businesses adjusting during economic downturns. They also serve as a disincentive to hiring workers. Thus, they encourage either informality or temporary hires, and make SMEs incur the transaction costs associated with these choices.

In many countries in Latin America workers dismissed without cause are entitled to full severance payments. Just cause is usually limited to such criteria as absenteeism, theft, sabotage, and insubordination. Poor performance is seldom included, and even where it is, it can be especially difficult to prove in court. Such strict criteria for dismissal often have the effect of fostering labor disputes, which increase transaction costs to business. They, like severance pay, constrain businesses from hiring workers permanently and formally, and from adjusting to adverse economic conditions. By increasing the costs of exit, job security guarantees raise the costs of doing business for SMEs.

### Minimum Wages

Since SMEs are commonly believed to have lower capital-labor ratios than larger firms, it is clear that the wage component of their cost will be accordingly more significant. If high minimum wages keep them from hiring the number of workers they need to expand, and there is substantial unemployment in the country, an inefficiency has been introduced into the economy. Moreover, a minimum wage can indirectly increase transaction costs for SMEs if it encourages informality or temporary hiring, both of which are associated with raising transaction costs. A minimum wage can also be the subject of disputes between business owners, workers and government departments dealing with labor issues thus increasing transaction costs to all employers and in particular to SMEs. Unlike in OECD countries, however, minimum wages do not appear to be a binding constraint on employers in Latin America. In most cases, the wage is well below what unskilled laborers earn and it is the *non-wage* labor costs that make hiring additional workers prohibitively expensive.

### Taxes

The costs of compliance with tax regulations often make them the principle regulatory problem of SMEs in Latin America. In private sector surveys, they were rated as the chief obstacle to business growth in Brazil, Mexico, Peru, and Uruguay [Holden and Rajapatirana 1995]. There are three ways that taxation affects the transaction costs of SMEs.

*Complexity.* The more complex the tax system, the more resources businesses must expend on calculation and compliance. Complexity generally involves four factors: the number of taxes, the timing of tax reporting and payment, the base for calculation, and exemptions. More complex tax systems have a large number of direct, income, and payroll taxes. Companies in Brazil, for example, face some fifty different taxes and levies. Many of these fall due at different times, and many use different bases for calculation. Combined with the myriad exemptions applied to corporate income tax, these factors force many SMEs to hire expensive external accountants to prepare their taxes, which often must be submitted on a monthly basis.

*Stability.* If the rules of taxation are continually changing, then SMEs incur transaction costs in learning and complying with new systems. If the rules are fixed but their application is

discretionary, this can increase transaction costs by placing extra costs on long-term planning, making both coordination and information collection more costly.

*Enforcement.* If enforcement is strong, then the transaction costs imposed by the tax system's complexity and instability will be unavoidable. If enforcement is weak, then these costs may be avoided. However, tax avoidance has its own set of transaction costs. Firms often maintain two or more sets of books, pay off tax inspectors, and hold more cash. High rates, complex rules and weak enforcement all lead to significant tax avoidance, as well as encouraging informality.

### *Social Security*

Social security and other payroll charges often constitute another obstacle for SMEs in the region. They are not only a large direct financial cost to an enterprise (typically 25-50% of wages), but also constitute a major source of transaction costs, because of the large amount of paperwork necessary to comply with them. Often SMEs must register with several different agencies (pension, health, unemployment, etc.), each with its own reporting requirements and payment systems. Efficiency at the agencies is often low, and delays in processing are common. When these taxes are high and complex, SMEs have an incentive to avoid them and hire temporary workers or subcontract.

### *Health and Safety Regulations*

Even the most ardent supporters of deregulation acknowledge that health and safety are two areas in which regulation cannot be removed, because the consequences of ineffective regulations in these areas—either for workers or consumers—are so extreme. Moreover, the cost of this type of regulation is not as clear since some studies have shown that an increase in workplace safety brings an increase in worker productivity [Egorov 1997]. However, since the damage caused by an unhealthy work environment or an unsafe product can be approximated by the injuries inflicted on specific individuals. For that reason in some areas it is feasible to allow market forces to determine the level of “safety” where the same is not necessarily true of health.

Workplace health and safety standards are governed by three different influences: market forces, direct regulation, and the incentives that workers' compensation create to increase overall safety. In each case, firms will be better off financially if they invest in methods and devices that make the workplace safer and protect consumers against faulty products. Improved safety leads to reduced wage premiums for risk (market incentives), lower penalties for noncompliance (regulatory incentives), and reduced payments for workers or consumers injured through inadequate safety precautions (workers' compensation and damage suits) as well as the additional benefit of higher productivity.

Given that these regulations do have a place in the economy, the best way to incorporate the interests of SMEs is to ensure that the burden does not penalize small businesses more than necessary. Certain types of regulations may fall more heavily on small business without providing the same benefit in terms of health or safety. For example, a certain number of exits and fire extinguishers may be required per square meter in order to conform with fire regulations. Yet, firms with few employees do not need to have fire drills to practice how to vacate their location nor should they be required to install sophisticated sprinkler systems when a hose would serve the same purpose.

Finally, any contradictions between regulations at different levels of government adds an unnecessary cost to businesses of any size. Regulations in this area should be uniform through all levels of government.

### *Trade Regulations*

Another significant source of regulatory transaction costs to SMEs are import and export procedures. Paperwork, long delays, and bribes often absorb the resources of SMEs dependent on international trade, either for importing raw materials or capital goods, or exporting their products. Younger and smaller firms often export indirectly, subcontracting to provide their product to a large exporter. In such cases, transaction costs to the small firm are greatly reduced. However, regulations impede medium-sized exporters and small firms that wish to grow through exporting. While regional integration has brought down many barriers to trade, customs and port procedures remain cumbersome by international standards. Because values are smaller, the fixed costs of dealing with importing and exporting procedures fall more heavily on SMEs.

### *Enforcement and Corruption, Transparency and Predictability*

A crucial aspect that determines the cost and effectiveness of the regulatory framework is the manner in which regulations are enforced. An obvious way to improve enforcement is to remove corrupt elements from the system. Corruption affects all businesses and the overall well-being of the economy, as well as undermining trust in government institutions. Corruption is the violation of the arms' length relationships in transacting between any pair or group of agents. The most damaging form of corruption, especially for SMEs, is the sale for personal gain by government officials of government property in the most general sense. This includes licenses, permits, contracts, documents such as passports and visas, tax incentives or dispensations, and so on. Because SMEs cannot compete with larger firms in terms of resources, they are likely to be always last in line when "favors" are handed out by officials.

Corruption flourishes when regulation is endemic and nontransparent. A reduction in the role of government through deregulation, privatization, lowering tax rates, eliminating selective policies, freeing trade, and making local regulations consistent with the national ones also reduces the potential for corruption. Copies of commercial rules and regulations should be readily and cheaply available so that businesses can keep current. In addition, the probability of corrupt practices being identified and punished needs to increase along with the penalties for corruption.

### *Indicators of Transaction Costs.*

What then can be done to determine the extent to which regulations are increasing the costs of doing business? If the Bank is to act forcefully to improve the business environment, and in particular to assist in the growth and development of the SME sector, some measure of these costs must be found. The paucity of data on the total dollar value of transaction costs indicates that such a step, though essential, may be some way off. How then can the Bank begin to make these estimates?

Informal indicators of regulatory transaction costs in an economy are readily observable. Widespread cellular phone use, for example, is often an indication that the costs of acquiring wired telephones lines involves significant bureaucracy and regulation. Queues for services, such as notaries or in banks, is another visible sign of the effect of transaction costs. A large informal sector is also an indication that taxation and regulation have increased the costs of operating in

the formal sector. Environments in which the indicators listed below are highly visible are those that merit closer regulatory glances.

*Contracting.* The greater the costs associated with contracting, the more likely it is that firms will vertically integrate to internalize these costs. Thus, economies in which transaction costs are high tend to be dominated by large firms in the formal sector and a sizable informal sector. There is frequently a “missing middle” of small- and medium-sized firms.

*Entry and exit.* In economies where transaction costs are high, firms tend to be “old.” There are not large numbers of formal start-up firms. Bankruptcies, the means by which resources that are being used inefficiently are reallocated to more productive uses, occur infrequently and the process is lengthy. Typically the cost of registering new firms is relatively high and numerous permits are required.

*The presence of “fixers.”* Pervasive state regulation frequently leads to the creation of a profession of “fixers” (known variously as *despachantes* or *tramitadores*) who, for a fee, deal with regulations and red tape within the bureaucracy. In some countries, such as Brazil, the profession is formalized to the extent that it has its own association which sets examinations for prospective new members.

*Payments for using the formal or informal market (bribes).* Any payment made to access the market is an indicator of misapplication of the regulatory system. The greater the number of these payments that change hands, the more costly is the regulatory system. The extent to which firms must pay bribes to facilitate legal transactions or to avoid prosecution for transacting informally indicates the high costs of transacting.

### ***The Role of the Bank***

Although the Bank has not yet focused specifically on the issue of small business regulation, it has given some priority to overall regulatory reform. Recently, for example, there have been customs administration projects in Guatemala and Peru as well as the Comprehensive Labor Market Program initiated in 1996 in Mexico. These efforts obviously benefit small business, however, effective SME assistance suggests a closer focus on the specifics of regulation in the small business sector.

The task of evaluating the regulations of each country in the region, in each of the relevant areas at each level of government, and of insuring that such regulations do not burden SMEs with unwarranted transaction costs, is too large for any one report. Yet the Bank can make significant contributions in this area by looking for indicators of high regulatory costs and encouraging specific studies in those countries of the costs of regulation on small business.

Whether the Bank should perform these studies itself is unclear. The country- and sector-specific knowledge required to perform these exercises quickly and inexpensively is most likely to be found locally. For this reason, the development of private and independent SME associations in each country, and their participation in regulatory reform efforts, is crucial to the development of a framework friendly toward SMEs. Such associations can best identify and monitor new laws and decrees on behalf of their members and can help the Bank estimate the costs of regulation.

Since the region’s sweeping economic reforms, business associations have increasingly entered the national policy arena. However, associations in which the state requires membership of all businesses are largely controlled by entrenched economic interests beholden to the state. They

often resist rather than promote reforms to protect themselves from competition. Nonetheless, where voluntary business associations are able to organize, they can have a significant impact in liberalizing policy.

A 1995 survey of 27 of the region's major business associations, revealed that two-thirds were working to eliminate onerous regulatory and tax policies which impede the formation and growth of small businesses. These organizations realize that promoting entrepreneurship broadens their membership and strengthens them, both financially and in their advocacy efforts. The fact that so many regulatory obstacles remain demonstrates the need to strengthen advocacy efforts.

Whether the Bank would be able to support these associations directly, given its mandate to provide assistance to public rather than private sector initiatives, remains to be seen. The Bank might accomplish this goal by working with the Multilateral Investment Fund (MIF) or the Inter-American Investment Corporation. Another option would be to provide technical assistance components to train and hire lawyers for these associations who would then monitor legal decisions and advocate on behalf of SMEs. The training would include skills such as advocacy techniques, lobbying, and policy analysis. With the guidance of the studies to determine the relative costs of different regulations to businesses, the associations could increase their effectiveness by focusing their efforts on the most harmful regulations.

In conclusion, although reducing the cost of regulation requires detailed country-specific work, there are measures that the Bank can undertake to initiate the process.

- ◆ Compile a cross-country comparison of business start-up costs.
- ◆ Compile a registry of national small business associations.
- ◆ Request that these associations identify the most onerous regulations in their country or region. These can be used in conjunction with issues already identified by the associations as targets for reform.
- ◆ Initiate a country-by-country evaluation of the effects of regulation on small business.

### *Checklist of Issues*

To address SME interests and issues, projects and sector work related to regulatory reform, SME assistance, the reform of the State, and tax issues should include, where applicable, an analysis of the following:

- Does the operation consider the effect of regulations on SMEs?
- Will the operation result in more, or more complex, requirements for businesses, especially SMEs?
- Will it apply regulations in a manner appropriate to the size of SMEs?
- How will it contribute to the coordination and simplification of regulations within and between different levels of government?
- If the operation's objective is to strengthen SMEs, does it emphasize empowerment via strengthening the legal framework for business?
- If the operation concerns the labor market, what labor regulations would the operation place on businesses, or which ones may be loosened through the implementation of the project, i.e., nonwage compensation, security guarantees, minimum wage, social security contributions?
- If the operation concerns tax reform, how may business taxation be reduced and simplified in the number of taxes, their timing, and exemptions?

- If the operation concerns technological development, has it addressed the intellectual property rights framework, its enforcement, and the role of SMEs?
- Have existing SME associations been consulted?
- How might an operation strengthen the independent advocacy role of SME associations in the policy, enforcement, and judicial processes?

### **Section III: Procurement**

This section examines whether procurement has any role in Bank programs to encourage SME development. It looks at procurement in OECD countries, programs designed to funnel contracts to SMEs, and potential policy options for governments interested in increasing the percentage of government contracts for SMEs. Finally, it reviews Bank and other operations that could further this goal.

Since goods and services that are purchased by the State from the private sector account for a significant portion of GDP, policymakers interested in assisting SMEs have long viewed access to government procurement as a potentially powerful instrument of small business policy. However, even in the industrial countries, using procurement to help SMEs has proved to be much more difficult than anticipated and in no country can procurement policy be judged an efficient means of helping the SME sector. Reasons for this arise partly from the information and transaction costs associated with government purchases of goods and services, partly the nature of the way the public and private sectors interact, and partly bureaucratic inertia.

According to calculations by the OAS and the Bank, the equivalent of 20 percent of Latin America's GDP is spent by governments on procurement. They estimate that within NAFTA, total central government procurement is close to US\$ 1 trillion [OAS 1995]. The central government's component of all government procurement amounts to about 35 percent in the United States, 30 percent in Canada, and 74 percent in Mexico [McKenna & Cuneo 1993].

Determining the extent of procurement in most Latin American countries from SMEs is virtually impossible because governments do not keep accurate statistics on overall procurement, let alone the amounts from SMEs. This is not a matter of pure neglect. Government procurement is decentralized in most countries between many ministries and increasingly between states and municipalities, which makes judging the role played by SMEs more difficult. Within the Bank itself, the ability to track procurement dollars is similarly complicated because Headquarters is responsible for initiating the contracts while the local offices supervise the operations. Nevertheless, given the sheer dollar amounts spent on procurement, an examination of the issues related to the role of SMEs, combined with hard data on the distribution of contracts, is very timely.

## *Procurement in the Industrial Countries*

Even in the industrial countries, programs to facilitate SME involvement vary widely. Most countries concentrate on lowering barriers to SME participation primarily by trying to lower participation costs through information dissemination and on-line bidding. Only the US and Japan use procurement policy systematically and programmatically to target the SME sector.<sup>1</sup>

The US has the most advanced and *activist* programs for targeting SME procurement. Goals for SME participation in federal procurement are set by statute. In 1994, contracts with SMEs accounted for about 2.7 percent of all government procurement and 5,833 firms participated. The Small Business Administration (SBA) negotiates compliance targets for federal agencies and departments and aggressively monitors their performance. The SBA also enters into prime contracts with federal departments and agencies, and then subcontracts to small businesses. The federal government also uses set-asides to target procurement toward non-minority SMEs.

ELPRO, the European electronic public procurement system will build and demonstrate on a number of sites (including a "virtual procurement region") regional procurement information partnership and business information networks. They are targeted at SMEs. They include a range of free and paid-for Telematics services, from fax-on-demand services, electronic data interchange and Internet services to demonstrate ways of establishing SME support networks on any Telematics environment in Europe. This will enable procuring entities to generate Telematics, support services for local SMEs at the same time as capturing the efficiency benefits of electronic procurement for themselves.

The US government has invested extensively in on-line information dissemination. All contracting information is available electronically and some bidding documents may be filed online. The government is in the process of moving to an exclusively electronic procurement system. By providing information this way, the government has significantly lowered the cost of participation for SMEs. The SBA also keeps electronic registries of qualified SMEs interested in bidding for government contracts.

Set-asides for SMEs do not exist in the EU, but most countries provide targeted assistance to SMEs. This includes assistance in completing bid documents, obtaining financing, and technical assistance in complex technological bids. Some countries also provide assistance in helping SMEs coordinate bidding for contracts. The push toward electronic procurement is, however, the focus of EU activities. The most important of these initiatives is ELPRO, the Electronic Public Procurement System for Europe, developed in response to an EU white paper on problems facing SMEs in government procurement. [European Union 1993] The EU is also taking steps to correct other problems identified in the white paper including speeding payment to firms.

### *The Advantages and Disadvantages of Set-Asides*

Set-asides, which reserve a certain percentage of government procurement contracts or total spending for a limited pool of applicants, are one tool that could be used to increase SME participation in government contracts. On first consideration, the attraction of this option is that it produces the quickest, most visible gains. On the other hand it risks compromising quality, price,

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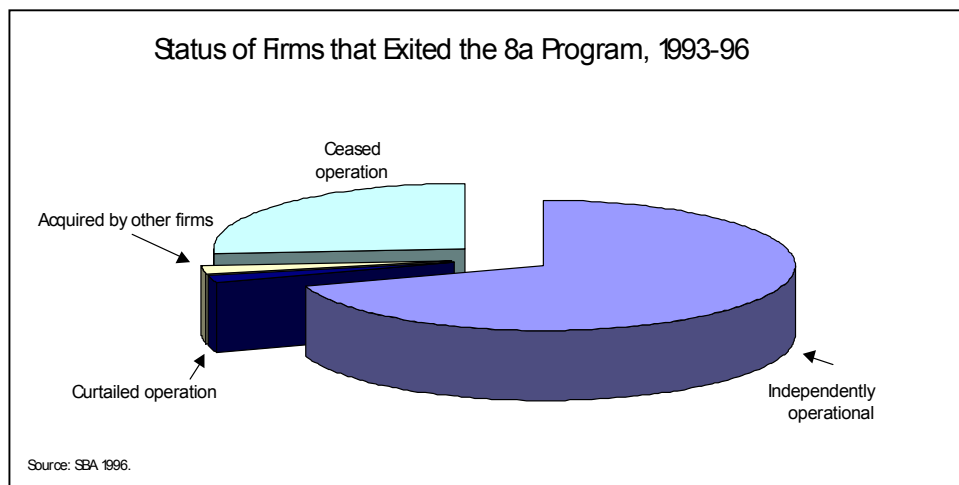
<sup>1</sup> In the US, procurement policy is used to assist *only small enterprises*, defined according to the SIC code for each sector of the economy. There is no program for medium sized enterprises.

and delivery targets because the suppliers may be less efficient than larger companies. There is no evidence that set-asides produce efficiency gains and at best ambivalent evidence that they promote equity goals. The inherent danger in creating programs mandating a level of involvement is that political pressures make them almost impossible to monitor effectively let alone discontinue. The economic danger is that they foster rent seeking as opposed to efficiency maximizing behavior.

Only the US, and to a lesser extent Japan, has extensive experience in using set-asides. In the US, set-asides for SMEs, and particularly for socially disadvantaged or minority SMEs, have been in existence for over three decades. They arose from a perceived need to correct problems preventing minority participation in government procurement caused by discrimination. The set-aside program is designed to increase the proportion of federal procurement going to minority firms and to give these firms work experience. This is a prerequisite that most lack because, it is argued, of past and current discrimination. Given the opportunity, these firms will gain the experience necessary to compete on an equal basis with firms that have not suffered from discrimination.

Minority participation in central government procurement has increased during the period that the set-aside program has been operational. This corresponds with findings in other studies of an apparent relationship between affirmative action programs and increased levels of minority participation in local government procurement. [Enchautegui et al 1997] Further, it appears from anecdotal evidence that the SBA set-aside program has been responsible for much of the increase in central government procurement. Thus, the program is widely recognized, even by its critics, for achieving part of its policy objective. Therefore, in a *political* analysis, the set-aside program may be judged successful. Whether it promoted equity is another matter.

One indication of the relative level of success may be gathered by examining firms that “graduated” from the set-aside program. Firms must leave the program after either nine years or reaching a certain size or volume of business depending upon the firm’s industrial classification. In its most recent audit of the set-aside program, the SBA surveyed a sample of firms that graduated from the set-aside program between 1993 and 1996. The results are shown in the figure below, which indicates that about one-third of those leaving the program either went out of business, substantially curbed their operations or were acquired by other companies.





No further quantitative data is available from the SBA upon which to judge the relation between the set-aside program and the status of firms leaving the program. Thus, it is impossible to know if those firms now “independently operational” owe this status to having participated in the set-aside program. The large number of firms still operational is at least an indication that most firms were not simply created to take part in the program and then dissolved once their eligibility expired. On the other hand, the SBA audit revealed that income from set-aside contracts accounted for over one-third of participating firm’s profits [SBA 1996].

Defenders of the program also claim economic benefits accrue from set-asides. According to the SBA:

“The most direct measure of benefits to the economy and to the Federal Government is through the market value of goods and services produced and the number and quality of jobs provided. The ... areas in which 8(a) certified businesses are contributing to the gross domestic product, the Nation’s tax base, employment, and the individual wealth and well-being of all Americans. [SBA 1996]

This claim has to be treated with some skepticism. These benefits would also have accrued without the set-aside program. Non-minority firms would have paid taxes, hired employees, and contributed to GDP. They would have done so without the cost of administering the set-aside program—over US\$4 million for 1996. Therefore, even according to the SBA’s own analysis, the program does not appear to have produced significant efficiency gains for the US government. Instead, for US\$4 million in 1996, the government steered roughly US\$5 billion in 27,000 contracts to 6,500 firms. In addition, other sources claim that the number of firms that benefited significantly were small and many did not qualify in terms of the formal criteria of the SBA program. If this is correct, from an economic standpoint, the program may be described as a failure

Furthermore, since the minority set-aside program in the United States is designed to meet political ends, it has become highly politicized. The debate surrounding the program, including how to reform it, is centered on political, not economic, issues. The set-aside program has become a genie that once released has grown beyond the control of its creators. This is a powerful lesson for governments that are considering creating set-aside programs.

### *The SME Share of Procurement*

Without specific set-asides for SMEs, the evidence indicates that larger companies obtain the lion’s share of contracts. This is primarily because transaction costs for both sellers and public procurement officers are often lower when the companies supplying the governments with goods and services are large. Since many of the costs are fixed regardless of firm size, SMEs start at a disadvantage in public sector procurement.

From the perspective of the SME the costs, which do not include those associated with the actual production of the goods or services are:

- ◆ Registering and qualifying as a supplier to the government. Some of these conditions can be onerous and automatically exclude smaller businesses.
- ◆ Obtaining information on the goods or services being sought by the State.
- ◆ The cost of preparing a bid.
- ◆ The costs of supplying a performance bond or guarantee.
- ◆ The costs of complying with inspections at various stages of the process.

- ◆ The costs of financing goods and services supplied since many governments are notoriously slow payers.

For government procurement officers the cost of dealing with SMEs include:

- ◆ The cost of evaluating a small bidder
- ◆ The cost of monitoring many small suppliers rather than one large one.
- ◆ The costs of monitoring quality control from many small suppliers.
- ◆ The risks of a small company defaulting and the associated costs of dealing with default.

As a result, transaction costs on both sides of the buyer–seller relationship are high and SME participation is therefore low. The following discussion explores these issues in more detail.

### *Government and SME Procurement*

The rising devolution of political power and control of procurement presents both opportunities and problems for the greater involvement of SMEs in government procurement. Municipalities and states often buy in quantities that are more manageable by smaller businesses. Where procurement is decentralized to local government, lower transportation costs often allow local SMEs selling to local governments to compete more effectively with larger firms. Local government officials may also better know the capabilities of local producers. In turn, there is a greater chance that SME owners know government officials—a case of familiarity breeding facility.

However, the problem with purchasing by local governments is that they often lack qualified staff. While central governments in Latin America have increasingly decentralized authority and money, so far this has not been matched by stronger capability at the local level. Besides economic considerations, there is a greater political incentive for local governments to buy locally, and this could mean greater involvement of SMEs. Local governments should have a clear incentive to favor the local producers. However, the attendant problem, especially for agencies with unqualified or inexperienced staff, is that decentralized, local procurement is harder to monitor, so that transaction costs rise.

Most government agencies at the central as well as at state and municipal levels require that potential bidders on contracts be pre-qualified. This policy ensures that companies can successfully complete the procurement contracts upon which they bid. However, the qualification criteria and the process that must be completed are often so onerous and time consuming that most SMEs are discouraged from even entering the bidding for procurement contracts. In order to discourage SMEs less, it might be useful to have different pre-qualification processes at different levels of government or for different values of contracts. It seems clear that larger, more complex projects should require a more extensive qualification process than smaller, local projects. Conversely, having the same pre-qualification requirements for all sizes of contracts imposes unnecessarily high transaction costs on all parties. It is quite conceivable that smaller companies could supply low value contracts more efficiently than large ones.<sup>2</sup> However, for low value

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<sup>2</sup> Many scandals in the US Government over procurement costs, including toilet seats supplied to the Defense Department, result from large companies mechanically applying overhead accounting costs to low value items. Since larger companies' overheads are higher, items that have low value incur large "add-ons." This would not happen if smaller firms were used in procurement of such items. The example is illuminating because

contracts, fewer companies will be willing to bid if the qualification process is time-consuming or costly. That is, the higher the cost of entering the process as a percentage of the potential profit, the riskier that process becomes. The Bank and some governments recognize these issues in that there are different requirements for contracts of different sizes. However, there is little standardization across Latin America and not much transparency in procedures.

One solution could be to give banks and insurance companies that guarantee government contracts a bigger role in determining appropriate qualifications for bidders on larger contracts. Not only would this remove the responsibility from governments, but it would likely make for greater uniformity and transparency in all government contracts. For smaller contracts, the question of whether pre-qualification is necessary at all must be addressed. In the private sector, small suppliers of large firms do not have to go through pre-qualification; rather experience reveals the ability and reliability of smaller suppliers. Furthermore, in some industrial countries, larger firms assist small suppliers to ensure that their quality and delivery standards are met. This approach holds much promise for involving SMEs in government procurement. The guarantee issue has ramifications beyond the SME sector. No matter the type of contract, whether it be for goods or services, governments almost always insure themselves against non-performance of the contractor. Before bidding on a project, contractors must obtain a guarantee from a bank, insurance firm, or other financial institution, providing insurance against the value of the contract.

There are two main types of guarantees, those based on *performance* and those based on *demand*. Under *performance guarantees*, a financial institution warrants that all the terms of the contract between the government and the contractor will be successfully completed. The guarantee, which in the United States normally costs about 1 percent of the amount guaranteed, contains the criteria as well as the adjudicating conditions that determine success. Non-compliance must be confirmed by a third-party or by the guarantor. If the contractor is found to have failed to have completed the contract as specified, then the guarantor has the option to either pay the government the amount guaranteed or to find and pay another contractor to complete the project. The amount guaranteed varies from 100 percent in the United States to 30 percent or less in Europe, where other forms of guarantees are included to reach the total value of the contract. Because of statutory issues, this type of guarantee is not widely used in Latin America.

*Demand guarantees* typically cover a smaller portion of the contract. They require a payment to the government ranging from 5 to 15 percent in the event of non-performance. Demand guarantees are exactly that. They are payable upon demand and thus can be called without identifying the specific conditions that the contractor violated. Thus, the government can declare that the conditions of the contract have not been met and demand payment from the guarantor. The only recourse for either the contractor or the guarantor is to take legal action.

For SMEs, performance guarantees have several advantages. Most importantly, the insurers are more concerned with the contractor's ability to complete the project than with its ability to repay the insurer if the guarantee is called. In the United States, performance guarantees are based wholly on the contractor's perceived competence and not on collateral. This type of reduction in collateral requirements would benefit greatly qualified SMEs. It also would assist the government since the pre-qualification is performed by the guarantor, thereby reducing transaction costs. An added bonus for SMEs in the United States is that payment of sub-contractors also is guaranteed by the insurer. Since most sub-contractors are SMEs, this is a substantial benefit.

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the Defense Department has particularly rigorous pre-qualification requirements that might well discourage SMEs bidding on contracts.

## *Reducing Transaction Costs*

A disadvantage for government agencies in contracting with SMEs is their small size and the high associated transaction costs. Rather than contracting with one large firm, contracting agencies must duplicate their efforts with several smaller ones. What, then, are some methods that can be used to reduce these transaction costs and bring more SMEs into the procurement arena? One possibility is fostering SME cooperatives and business organizations. These associations can counter this disadvantage and increase SME involvement in government procurement by significantly lowering the high cost of contracting with many small producers that usually discourages government from considering smaller firms.

The most notable example of this innovation is in the State of Ceará in Brazil [Tendler 1997]. It represents an interesting example of “demand driven” procurement in which the state buys from SMEs while at the same time providing technical assistance to all phases of the businesses involved in procurement. In Ceará, the procurement of furniture for schools was organized in a manner which reduced some of the transaction costs associated with state agencies dealing with small firms. The state did not purchase from individual SMEs but through associations of small manufacturers. Technical assistance was provided to the firms by Brazil’s small business assistance service (SEBRAE) which was paid a commission on the value of the contracts by the state. As a result, local manufactures were able to produce better quality furniture more cheaply than the state’s traditional supplier, a large manufacturing firm in another state. Purchasing through the association of small firms also enhanced quality control because it created peer pressure; if one producer produced inferior goods it imperiled the entire group’s status. Organizing the furniture producers also produced ripple benefits. The organization contained within itself a structure for disseminating money, enforcing obligations, gathering information, organizing training, and dispensing aid. Some of the administrative burden of providing assistance to the sector was thus transferred from the state to the sector while at the same time enhancing productivity and the ability of the small firms in the program to compete in other markets. The producer associations saw themselves as competitive entities able to compete on price and quality. Since the state was not obliged to accept the association’s output, there were strong incentives for self-policing of quality and delivery.

This is not to say that the associations formed in Ceará were not political. A crucial and conscious strategy of the state agency and the governor responsible for creating the association was to create a political counterweight to the larger firms, to generate political support for SME development, and to end traditional clientelist practices inherent in local procurement. Since the larger firms had been selling lesser quality goods at higher prices, the strategy was obviously successful. However, the danger in this is clear. The associations could mobilize to demand a “fair share” of government contracts and this could turn into another form of patronage. Unfortunately, attempts to replicate the experiment in other parts of the region were unsuccessful. There is also evidence that local mayors have wrested some control in procurement decisions away from the state. A follow-up study to determine the current fate of the SMEs, their business association, and other similar experiments in the area could turn this case into one that provides valuable lessons. The Ceará case shows that targeting assistance toward helping SMEs deal with all aspects of procurement can pay dividends, although the costs of doing so may be high if the incentive structures are poorly designed. Targeted assistance that involves training often has an added benefit of *transferring* skills to the SME sector, on a demand driven basis, which makes improvements in the SME sector sustainable.

Targeted assistance appears to be the best compromise between achieving efficiency goals and creating distortions. This approach minimizes distortions because it does not create new and

unique advantages for SMEs. Rather, it helps level the playing field between large firms and SMEs. Finally, the effectiveness of these programs is easily identified—an increase in SMEs winning competitive open bidding.

Changes in the procurement practices of the city of Buenos Aires provide an illustrative example of the way that procurement practices can be reformed. In early 1996 Buenos Aires, which has a procurement budget of around US\$1 billion, (30 percent of the total city budget) undertook an overhaul of its procurement procedures and practices. It had evidence that prices on many municipal contracts were as much as 30 percent higher than those on the open market.

First, officials set out to eliminate “closed procurements,” where only a limited number of companies were allowed to bid for a contract, and greatly expanded commercial advertising of upcoming contract opportunities. Predictably, the number of companies submitting bids increased. Second, officials began using a database of “reference prices.” Before awarding a contract, officials check the latest market prices for any product or service and compare it with bid prices. When the city requested new proposals for an expiring contract to provide food services to 29 metropolitan hospitals, 34 companies offered competitive bids. The new contract was awarded for just under US\$32 million, or 47 percent less than the US\$59 million paid to the previous contractor for the same services.

Comparable savings materialized as the city awarded contracts in other sectors. Buenos Aires saved 37 percent on food services for public schools, 45 percent on garbage collection and public lighting maintenance, and 60 percent on contracts to run communal kitchens. Overall, the city saved US\$200 million in the first full year following the procurement reforms. The city also improved its relationship with suppliers by overhauling its payment system so that contractors were paid on time. Deficiencies in the previous system, in which payments were decentralized and issued by the unit that had purchased a service, led to chronic payment delays that contractors ultimately used to justify their higher prices. The city has now centralized the payment system through the creation of a single account managed by the general treasury office. This example, which is based on an article from the May 1998 issue of the Inter-American Development Bank’s publication *America*, provides some guidance for local governments hoping to reduce contract costs and demonstrates that if contracts are awarded without competition, with little publicity and inconsistent rules for bidders, prices will be inflated.

Governments can also reduce the transaction costs associated with gathering information. Even when detailed bid information is published in newspapers and trade journals, it is often not readily accessible to SMEs. It is beyond the capacity of many SMEs to undertake the time-consuming and expensive examination of various sources of information. Electronic dissemination, either through the Internet or by fax, is far more efficient.

The ELPRO example from the EU, while perhaps the most ambitious attempt to lower information costs, is not unique. Every industrialized nation has a program similar in design if not in scope. Moving to greater use of digital and electronic dissemination of information is an essential reform in the way government does business. It allows the government to reach more businesses with more information at less cost to both businesses and the government. It also makes the government more open and accessible to all business, not just those with staff dedicated to government relations.

The costs of increasing or introducing digital and electronic dissemination for the government are not high. They are usually more a diversion or reapportionment of current expenditure for dissemination while investment in technology and hardware are ancillary to general

modernization and capital investment. Further, models in the industrialized world based on open systems and off-the-shelf technologies are readily available.

A good example of how this could work in Latin America is provided in Mexico, where the government recently initiated an Internet based procurement system, named *Compranet*. This system also includes limited access to state procurement. The move toward electronic and digital dissemination, bidding, and registration also has a secondary benefit for the SME sector in that it increases the use of technology. In the longer term this has the potential to make SMEs more competitive locally and internationally.

Finally, governments can remove specific barriers to SME participation, for example in insurance pooling. Where the cost of obtaining insurance may be prohibitively expensive for SMEs, often precluding their bidding on government contracts, the government can help pool all bids or bidders, thus spreading the risk and lowering rates for SMEs without raising the rates for other participants. This puts SMEs on an equal footing with larger enterprises that have lower insurance costs.

### *The Role of the Bank*

The goal of Bank procurement should remain efficiency, not promotion of a particular policy. However, identifying whether there might be any built-in biases that make procurement by SMEs more difficult is useful. In some cases this could be achieved by clarifying the rules that govern procurement and guarantees. In other specific and narrowly defined cases, components of the program could be targeted toward SMEs. In other cases, a more proactive role in promoting information dissemination could bring SMEs into bidding for Bank projects.

In terms of built-in biases, the issue is more one of subcontracting than of procurement. There is a high degree of vertical integration and limited specialization among larger enterprises in Latin America and hence, an underdeveloped subcontracting system [Berry 1997]. Firms that could experiment with subcontracting appear to be resorting to imports rather than domestically subcontracting inputs. Though government intervention is often cited as an important catalyst in encouraging subcontracting by large firms with SMEs in East Asia, it does not appear that procurement was ever used as a policy instrument. East Asian nations were successful in improving technical capability and quality among SMEs, but to the degree it involved subcontracting, it was initiated by the large firms themselves. There is, however, an experimental program in Brazil in which the state's SME organization, SEBRAE, has initiated a program to upgrade the capabilities of small suppliers to meet the demands of large producers. It includes training for both contractor and suppliers on the technical and the behavioral changes necessary to create successful linkages.

A good example of how targeting could occur without compromising efficiency is provided by the National Highway Program Loan to Trinidad and Tobago (32/OC-TT). The loan includes a component for the routine maintenance—landscaping and small repairs—of the entire national road network. Due to the nature of the work most of it will be performed by local SME contractors and microenterprises. The loan description states that it will include works that “will be contracted out to district contractors, microenterprises and roadmen.”

There are further possibilities for the Bank involvement to promote SMEs in contracts of this type. For example, the Bank could make the government and executing agency aware of its SME and micro finance support programs in advance and attempt to incorporate these as part of the

contract. Payment for these services should be demand driven and be linked to successful SME participation.

More generally, it is clear that while the Bank should not use procurement as an instrument of SME promotion, it is nevertheless incumbent upon the Bank to make the processes as transparent as possible and to remove barriers to SME participation. Although rigid rules for procurement are undesirable, guidelines for procurement officers regarding issues that could discourage SME participation might be desirable. Some identified in previous sections include size-appropriate prequalification, performance guarantees and information dissemination. Furthermore, there is the potential for coordination between programs aimed at assisting SMEs through technical services and training and procurement arising from Bank loans. A pilot or experimental program in this area could reveal important lessons for future promotion of SMEs in the area of procurement.

Currently, the Bank has little information on the full-range of effects of its procurement and the procurement carried out by projects it funds. This hampers the evaluation of procurement procedures generally and, in particular, makes assisting SMEs in this area much more difficult. Therefore, the Bank should sponsor the collection of information on procurement and SME involvement. This information could help design better support programs and remove barriers to SMEs participation in procurement.

#### Checklist of Issues

1. Does the loan have SME components?
  - If no, is this because the project is inappropriate for SME participation? If so, no further consideration is required.
  - If no, is this because of artificial constraints, for example project bundling? If so, the appropriateness of the constraints need to be explicitly defended on efficiency grounds.
2. If the loan is open to participation from SMEs, is there coordination with Bank and local SME assistance programs?
  - Is there demand among SMEs for assistance? How is this demand evident?
  - If so, is there provision for technical assistance by the Bank, local support organizations, or businesses?
3. Have SME support or business groups been consulted in project, loan, and bidding preparations?
  - Is there a role for these organizations in the dissemination of information?
  - Is there a role for these organizations in identifying and prequalifying participants?
  - Is there a role for these organizations in organizing procurement?
4. Has the bidding process been rationalized for SME involvement?
  - Simplified paperwork
  - Elimination or restructuring of guarantees
  - Lowered cost of involvement including government fees
  - Initiatives to reduce costs of participation
  - Review of antitrust or other legislation that may prevent joint participation
5. The Bank accepts either demand or performance guarantees. Has this been widely publicized?
6. Are the thresholds below which guarantees are not needed widely known?
7. Is the standard dissemination procedure for information on contracts appropriate and sufficient to encourage SME participation?
  - Language
  - Regional news sources

- Radio or other sources
- 8. Has the use of technology to provide information on the contract been addressed?
  - Appropriateness
  - Technological assistance or advice to government in conjunction with other Bank loans
  - Technological assistance or advice to SME sector in conjunction with other Bank loans
- 9. Have financing issues been addressed?
  - Have steps been taken to ensure timely payment for contracts?
- 10. Are there Bank programs for SME assistance that could be involved in procurement?
- 11. Have the anti-corruption and dispute procedures been widely publicized?



## Section IV: SMEs and Dispute Resolution Mechanisms

For SMEs to grow and become a significant part of a prosperous economy, institutions must be in place to allow them to grow from micro-enterprises to small businesses, and then to medium, and to large-scale enterprises. Among the most important of these institutions are those that facilitate “arm’s-length” transactions. As businesses grow, they move beyond the circle of family, friends, or neighborhood acquaintances in which they initially operated. Where it may not have been necessary to write contracts for agreements between family members or friends, business agreements between firms that do not rest on personal relationships often require formalization to ensure the compliance of both parties.

Recognition of the importance of contracting and its effect on business behavior is not new. To a large extent, institutional economics is the study of exactly these issues. Douglass North [1990] asserts that the absence of a low-cost means of enforcing contracts is “the most important source of both historical stagnation and contemporary underdevelopment in the Third World.” Williamson [1994], observed that a high-performance economy is characterized by a significant number of long-term contracts. However, in the absence of a well-functioning judicial system, it is virtually impossible to engender the trust or security necessary to enter long-term relationships with confidence that contractual commitments will be honored.

When the judiciary is unable to enforce contract obligations, a disproportionately large number of transactions take place in the spot or short-term markets, where the opportunities for contract breach are much lower. Alternately, firms circumvent the judicial system altogether by vertical and conglomerate integration, turning arm’s-length transactions into intra-firm ones. Purchasing goods or services that are to be delivered and paid for today ensures that the transaction will be completed to the satisfaction of both parties. A contract that requires some future delivery of goods or services is more difficult to enforce and is correspondingly less common in countries where the judicial system does not function effectively.

This section focuses on three issues. The first issue includes the use of reputation rather than information to determine creditworthiness and the resulting lack of trade credit available from suppliers. The second issue examines the various mechanisms available to SMEs to resolve disputes and their relative efficiency. The third issue involves the reform of dispute resolution mechanisms. The section concludes with areas that should play a significant role in future Bank operations.

### *What are the Issues for SMEs Entering into Contractual Arrangements?*

There are two key questions that must be answered by firms, regardless of size, before entering into a contract: is this contract enforceable and how expensive will it be to obtain restitution in the event of noncompliance? The more important answer may be the remedies available to contracting SMEs in the event of nonperformance. These remedies are: (i) non-judicial or private ones and (ii) judicial or public ones. They encompass:

- ◆ The ability to use non-judicial methods such as arbitration, mediation or conciliation to enforce contracts.
- ◆ Self-help, including the right to take property back by peaceful means if it is not paid for or to evict tenants that refuse to pay their rent.
- ◆ If the parties must resort to the judiciary, then the courts should have the power to award not only damages but also specific performance.

- ◆ Damages, including interest, must be adequate to cover the costs businesses incur as a result of the breach.

### *How do the Legal System and Judicial Process Affect the Ways in which SMEs Operate?*

Well-functioning legal systems and judicial processes play an important role in SME growth by reducing the transaction and information costs associated with contracting. If it costs little in time and effort to go to court to enforce a contract, firms will do so. If the costs are high (perhaps even including bribing a judge), the types of contracts used will change. They will take the form of spot exchange, “hostage taking” where both parties have to rely totally on each other, or even vertical integration to avoid the need to contract at all. Williamson [1985] was the first to analyze contracting issues in this way. His work stimulated further research, particularly of the manner in which contracting systems evolved in the industrial countries. An important finding, based on the way traders in the Middle Ages enforced contracts before the rise of the nation-states, was that as the number of trades and the number of traders increase, centralized, state-run courts enjoy significant cost advantages over reputation-based mechanisms. As economies develop, contract enforcement becomes an increasingly important public good.

If the legal system is defective, firms have to devise high-cost ways of circumventing institutional shortcomings. They may even be discouraged from transacting altogether. De Soto [1989] shows how Peru’s legal system stifles transactions. A more recent survey of businesses in Peru confirmed these findings [World Bank 1994]. It found that firms were reluctant to change suppliers even when offered significant price discounts because if the new supplier reneged they would have no legal recourse. Such an impediment to transacting can prove particularly daunting to SMEs that must move beyond their immediate circle if they are to grow.

However, even in well-functioning legal systems, using the law is not costless. That is why businesses in countries with modern legal systems still use exchange agreements, credit bureaus, and other mechanisms that allow firms to avoid the courts, except as a last resort. When members of a close knit community transact, they may be able to function effectively with a legal system that would pose significant obstacles to development in more heterogeneous societies. A close knit community need not be equated with a traditional society. The New York Stock exchange is an example of an industry where most contracts are based on reputation and trust.

Finally, there is another way in which a well-functioning legal system and efficient judicial process can reduce the transaction costs of entering into contracts. Well-developed contract law promotes standardized forms of addressing common contracting issues and problems. It economizes in reaching agreement and builds confidence by providing predictable incidents of bargains where the parties failed to spell out the details. In developed economies the end result of this commonality has been the growth of contracts with “boilerplate” language that can be applied with only minor deviations reflecting differences between the concerned parties. This outcome saves time in writing, agreeing to, interpreting, and adjudicating all contracts.

### *Information Systems and the Importance of Reputation*

Once firms choose to contract outside their “community” they must rely on information from other sources regarding the reliability of companies with which they wish to transact. One method is simply word-of-mouth. There is less inherent risk in engaging in business with companies that have a reputation for reliability and integrity. Unfortunately for the promotion of small business,

it is more likely that larger companies will have more established reputations—in general, the larger the firm, the more information there is available. There is, therefore, a built-in bias against newcomers, particularly SMEs.

Having access to information on firms reduces the risk of contracting, especially with smaller companies, and provides an incentive to honor contract requirements. In the United States, companies such as Dunn and Bradstreet provide information on millions of firms, from the largest to the smallest. Credit cards are successful, to a large degree, because users understand that their payment records will be made available to all other credit companies as well as many other financial institutions. Where such information is available in Latin America, there are very similar outcomes to those in the industrial countries. For example, in Peru, loans to small businesses increased dramatically once a single credit company—Orión—began keeping records on small land holders. Other financial institutions used the information that Orión provided to increase their lending to small business.

### *Trade Credit*

In the industrial countries, trade credit is an important source of working capital for SMEs. It reduces the need for cash on hand and allows the asset side of the balance sheet to increase through the build up of inventory. The willingness of suppliers to extend credit to small businesses depends on the confidence they have that they will be repaid or, in the event of default, the legal recourse they have to the assets of the business. This in turn depends both upon credit information available and upon the efficiency of the legal system in allowing the recovery of debt. Decisions on whether to extend credit are facilitated by the availability of credit information from companies which specialize in such services. Yet, even with adequate information, firms will still hesitate to extend this credit if it is difficult for them to recover unpaid debt. The lack of functioning dispute resolution mechanisms limits the amount of credit firms are willing to grant.

Trade credit amounts to about one-third of the liabilities in the average small US firm's balance sheet. It is particularly necessary for small firms because they generally do not have the financial resources necessary to operate solely on a cash basis. Research in the US shows that the larger the amount of unsecured credit a firm has, the longer that firm has been in business. The length of time in business is thought to be a proxy for creditworthiness. In Latin America, the history of government support and subsidies for certain industries has muddied the picture. The length of time in business may not be a proxy for business efficiency at all, and the amount of unsecured credit may reflect personal relationships with banks or suppliers.

A World Bank study on garment firms in Brazil, Chile and Peru [Stone, Levy, and Paredes 1992] found that the garment trade would grind to a halt if trade credit were unavailable. They also found evidence that this is more so in Brazil and Chile than in Peru. About 70 percent of Peruvian garment firms sold on credit compared to 85 percent of Brazilian firms. Moreover, trade credit in Peru was dominated by consignment-based credit in which the supplier retained ownership of the merchandise until it was sold. The goods could be repossessed at any time, and payment was due upon sale. Without this system, there would have been no trade credit in Peru. However, consignment selling has major drawbacks and is an inefficient method of conducting business. Only 37 percent of Peruvian garment firms give even consignment credit to new customers, compared to 87 percent for Brazilian firms. In Brazil and Chile, there is readily obtainable information on the payment history of potential customers. In both countries, bad debts are reported to a public office and become a matter of public record. Private firms in turn acquire this information and sell credit-verification services to the public. Only about one in 400 Brazilian

garment sales orders remains unpaid and only about one in 1000 goes to court. Only about one in 500 Chilean garment sales remains unpaid and only about one in 2,600 goes to court.

More recently, as a result of the reforms, a credit reporting system has grown rapidly in Peru—there are now three credit information agencies. Partly as a result of this development, both domestic credit generally and credit to consumers and to small businesses has risen sharply over the past four years from 10 percent of GDP in 1993 to about 25 percent of GDP in 1997. In addition, financial institutions are beginning to specialize, with some targeting the small business sector.

### *Recourse in the Event of Disputes: Summary Judgement, Small Claims, and Alternative Dispute Resolution (ADR)*

No matter how well-designed an agreement is or how well-acquainted the contracting parties may be, there is always the possibility that a dispute between the firms will arise. Occasionally it will be possible to iron out these disagreements directly. However, there must be an impartial process to which firms can resort should direct negotiations fail. Impartial recourse also reassures potential contractors that the rule of law exists to protect the sanctity of contracts. Even if the institutions of the legal system work adequately for SMEs, problems of access and the cost of these mechanisms remain. Certain options used in conjunction with or instead of more formal proceedings may help relieve these burdens.

#### Summary Judgement Procedures

Summary judgment is a decision made on the basis of statements and evidence presented for the record without a trial. It is used when there is no dispute as to the facts of the case, and one party is entitled to judgement as a matter of law. Summary judgment is properly granted when the evidence establishes that there is no issue of material fact to be tried. The court is required to consider all the evidence set forth, except where objections are properly sustained, and all inferences reasonably deducible from such evidence. Any doubts as to the propriety of granting the motion must be resolved in favor of the party opposing the motion.

Summary judgement procedures provide business (or individuals) with a speedy and inexpensive method to obtain legal permission to recover debts through the seizure of property or assets from their debtors. Although it has no effect on legal cases in which the evidence is equivocal and does not lower the transaction cost of pursuing this type of dispute through the judicial system, it does provide an immediate transfer of assets from debtor to creditor. Without summary judgement, therefore, lending becomes more costly as the lender must include risk of non recovery and the time that it will take to collect assets in the event of default into the total cost calculation. Summary judgement is a necessity if governments hope to reduce the risks associated with arm's-length transacting, particularly for SMEs that cannot afford to have their assets tied up waiting for court decisions about their disposal.

There are summary judgement procedures included in the legal system of most Latin American countries but Brazil is the only country that currently uses an effective summary proceeding [Rosenn 1998]. The system guarantees that creditors can collect debts quickly and without undue expense. The debts eligible for summary treatment under the law include:

- ◆ Negotiable instruments,
- ◆ Any obligation to pay a given sum or deliver fungible goods, if either notarized or witnessed by two individuals,

- ◆ Mortgages,
- ◆ Pledges or sums due under insurance policies,
- ◆ Unpaid rents,
- ◆ Judicial awards of costs and fees,
- ◆ Tax debts.

The plaintiff files a demand and the defendant must submit to attachment of his funds or property within 24 hours. Few defenses are available, and cases are usually resolved within a few months. This is not the case in the rest of Latin America, although most countries do have a summary judgement procedure written into their legal code. However, their judicial codes make more defenses available and the proceedings can be dragged out much longer, thus defeating the purpose of summary judgement and effectively removing it as a resolution option for most SMEs.<sup>3</sup>

Based on an investigation of about 400 debt collection cases, it appears that it takes about two years to repossess and sell movable property in Argentina [de la Peña, 1995]. The delay results from procedural rules that require frequent and lengthy court involvement in both the seizure and the sale of collateral rather than being able to resort to a summary judgement procedure. The law treats debt collection cases as any other judicially litigated case. The length and frequency of these interventions raise their cost.

In many countries in the region—Bolivia, Chile, and Uruguay in particular—payment frequently takes the form of post dated checks which, if not honored, result in jail time for the delinquent debtors. While it is not desirable to criminalize a transaction covered by civil law, the relatively high level of trade credit and the low level of default illustrates the benefits of using the legal system to support commercial transactions.

### Small Claims Courts—Do They Have a Role?

The Small Claims Court has been described as a neighborhood forum where disputes between citizens can be decided according to law without too many technicalities or formalities. Small Claims Court is made more accessible than other court systems by using simple procedures and forms. There is a fee for each step in a Court proceeding and frequently the loser is required to pay the fees of the winner. Most claims filed in Small Claims Court are heard within several months, providing a timely resolution. Appeals are possible in some countries, although the fee may be structured to discourage spurious continuances.

Country	US\$
Zimbabwe	450
S. Africa	700
Tasmania	1600
Israel	2500
Canada	3500
Japan	4000
England	4500

Although small claims courts have an important role to play in the judicial system in general and in the area of dispute resolution in particular, they may not have a significant effect on SME contracting. As with summary judgement procedures and the alternative dispute mechanisms discussed in the following section, the goal of small claims courts is largely to reduce the number of cases that can clog up the court system and to allow those with limited resources to obtain judgements. In the past the amounts of money involved were usually too small to be helpful to most growing businesses. In the United States, for example, the maximum amounts ranged from US\$1,500 to US\$5,000. There is, however, a recent trend to increase the limits for small claims in some US states and, as a result, there has been a sharp rise in the use of small claims courts by SMEs to collect debt. The results

have been that disputes have been settled at much lower cost than hitherto and that small claims courts have begun to provide a genuine service for small businesses [Warner 1998]. In other countries (see table) limits are still too small to be useful to the majority of SMEs.

A possible use of small claims courts might be in the informal sector where there is a marked lack of dispute resolution mechanisms. A particular feature of informal firms is that, by definition, they are denied access to formal institutions. Use of small claims courts in this sector could have the double benefit of encouraging contracting between informals and demonstrating some of the advantages of formality.

Most countries in the region have a court intended for less serious criminal and civil cases, sometimes known as *Juzgados de Paz* or *Corte de Primer Instancia*, but the proceedings are formal and require legal representation. SMEs generally do not use these systems. Mistrust of the court system's ability to resolve disputes fairly or speedily have greatly limited SME interest in expanding the region's legal system.

### Alternative Dispute Resolution (ADR):

Alternative Dispute Resolution is any process that resolves a conflict or dispute using processes other than litigation. The forms that ADR takes include arbitration, mediation, and conciliation.

*Arbitration* is a process similar to the court system but it is generally quicker, less formal and conducted in private. A neutral third party—the arbitrator—is hired by the parties and is empowered to resolve a dispute by making an award. The rules of evidence are relaxed and there is little pre-hearing discovery. The arbitrator will hear evidence and submissions on behalf of each party and then decide on the appropriate outcome. Arbitrated awards are normally binding unless the parties have elected a form of advisory arbitration. The ruling can often only be appealed on a narrow range of grounds—such as fraud or the refusal to hear evidence material to the dispute. Awards are enforced by the Courts.

*Mediation* was designed as an alternative to arbitration or litigation. A neutral third party—the mediator—helps the disputants to negotiate their own resolution to the situation. There are different approaches to mediation taken by different mediators but the process in essence is one in which the neutral helps the parties negotiate. The mediator does not have the power to impose a settlement to which either party objects. This is a process in which the parties retain control over the shape of an acceptable outcome. It is an especially appropriate process where those involved in a dispute need to relate to each other or conduct business in the future.

*Conciliation* is a process whereby conflicts between parties are resolved without formal dispute resolution processes. The neutral party gathers information regarding the issues in dispute and makes it available to both sides. The mediator also deals with any procedural matters. If a case cannot be resolved via conciliation, the mediator explores what remains to be done prior to any other form of alternative dispute resolution.

Most of the countries in the region allow for some form of alternative dispute resolution but it is used infrequently due to a variety of factors. First, ADR judgements can be overturned by a higher court ruling even if both parties agree beforehand that they will accept the outcome as binding. This removes much of the incentive to use the ADR process. Second, in many countries the legal system is unable to enforce ADR judgements, which renders them meaningless. There is

also a general lack of understanding of how ADR functions, not only on the part of those who might resort to it, but even from the mediating officials.

Much of the work that the Bank is doing in the area of ADR emphasizes training and information dissemination. It supports existing ADR centers, trains officials so that they provide this service as efficiently as possible, educates the public—and the business sector in particular—on the advantages of ADR and how to best use the system. The primary goal of these efforts is to provide the private sector with a less costly and less time-consuming way to resolve disputes and to loosen the bottleneck clogging the official judicial system.

The most optimistic outlook is that encouraging the proliferation of ADR centers will relieve some of the pressure on the formal judicial system as well as encourage SMEs to resolve their disputes through more formal means than they had in the past. The more accessible resolution mechanisms are, the less expensive it becomes to contract and to conduct arms-length transactions. These improvements would greatly help SMEs as they grow and develop beyond family-type businesses. A more pessimistic outlook is that the problems that plague the official judicial system will also affect the ADR system. Corruption, lack of enforcement, and lengthy delays, may overflow the existing judicial systems to infect any parallel systems that are created.

In much of Latin America, as ADR becomes more widely recognized, people who already are comfortable with the process will continue to use it. Any improvements in the system would obviously benefit them. Those who had not chosen to use it previously but were on the margin might decide to try an ADR center rather than the formal judicial system if the costs in terms of time and money were lower than using the court system *and* the outcome were equally enforceable. ADRs are less expensive but the lack of enforceability renders that point moot. Given that many SMEs currently prefer to negotiate rather than to use the court system, they are likely to be among those who benefit most should ADR decisions become truly enforceable. On the other hand, there is no substitute for a well-functioning, efficient judicial system and ADR cannot be viewed as anything more than a side component. As SMEs grow they enter into more and more complicated agreements and, at some point, these contracts will require the intervention of a judge rather than a mediator.

One of the most useful things that an ADR system could accomplish would be to publish a list of those companies that had failed to comply with the arbitrators' rulings. Given that SMEs rely heavily on reputation and need ways in which to publicize both good and bad ones, an official and public record of those companies that had failed to adhere to negotiated settlements or judgements made against them, would be extremely helpful.

### *The Role of the Bank*

Almost all of the Bank's client countries have benefited from a judicial reform program. Recent ones include loans to Argentina, El Salvador and Honduras for general judicial reforms. There are specific dispute resolution projects in Costa Rica, Colombia, Ecuador Nicaragua, Panama, Peru, and Uruguay. However, the Bank has recognized the need for further assistance, in particular with respect to dispute resolution, and has worked to fill that gap.

This second group of projects aims to create or strengthen existing procedures to resolve disputes *outside* the judicial system. Although many of the countries have a legal framework in place that should allow for alternative dispute resolution, the procedures remain relatively unused and untested. Even in Argentina, which appears to have one of the more advanced systems in the

region, 48 percent of the disputes that were submitted for mediation in 1996 still had to move through the judicial system because no agreement was reached. Of the remaining cases, agreement was reached in 31 percent while 21 percent were simply dropped [IDB 1997].

Dispute resolution may be a small part of reform in terms of the judicial system as a whole but it could prove to be a crucial issue for SMEs that need to find a secure and affordable method of resolving commercial disputes. The projects reviewed did not have explicit SME components—although they mention the benefits of lower cost options as helping both the poor and the private sector—and tended to focus on whether the alternative dispute mechanism had alleviated crowding in the judicial system.

Overall, the Bank has already made substantial inroads in this area with many Judicial Reform projects either in execution, preparation, or in the pipeline. However there have been some specific issues left out of the projects to date that should be considered in future efforts. These include improving the framework and institutions surrounding summary judgement proceedings, streamlining the general judicial system, which is the most common complaint of business owners throughout the region, and introducing competition to the notaries in those countries where there appears to be cartelization. In Latin America, as in other civil code countries, notaries play a central role in the preparation of documents and contracts. When all documents must be notarized, and there are very few notaries public, the transaction costs skyrocket. In most countries, notaries charge a fee which is a fixed percentage of the value of the transaction, making formal contracts very costly. It also increases barriers to formality and adds to SME costs in the early stages of their existence.

Future projects in the Judicial Reform area could include: (i) an analysis of summary judgement proceedings in practice—in which countries is it most common, who uses it, how long does it take for a decision to be rendered, and how long after that before the assets change hands; (ii) a similar exercise for ADRs; and (iii) a comparison of notary costs in different countries, cartelization of the notary sector, and number of notarized documents that SMEs must present in the registration process. In addition, the introduction of small claims courts with meaningful limits could help speed up debt collection as well as encourage informal businesses to enter the formal economy.

### *Checklist of Issues*

#### *General*

- Do firms attempt to circumvent the legal system because of the high costs? Will this limit the value of the project?
- How common are contract disputes? How are they resolved and how long does this procedure take?
- Does the project rely on fully-operational dispute resolution procedures?
- Does the project allow for alternative dispute mechanisms or must all disputes go through the Court system?
- Is trade credit readily accepted and given in the country?
- Are there information services that provide credit histories to stimulate credit giving?
- Does the project consider the benefits or costs that will accrue to SMEs in the face of changing legislation?

#### *Notaries*

- Are notaries cartelized?
- What are the costs associated with notarizing documents?
- How common is it that documents must be notarized?



### *Summary Judgement*

- ❑ Do Summary Judgement procedures function as intended?
- ❑ What are the requirements for cases to be placed under Summary Judgement? Are the conditions too stringent or too lenient?
- ❑ Does the judicial code provide for conditions under which summary judgements may be appealed?
- ❑ How long does it take to obtain a judgement? How long does it take to obtain the assets after the judgement has been granted?
- ❑ Have firms adapted other methods to circumvent non-performing summary judgement procedures?

### *Alternative Dispute Resolution*

- ❑ How common are alternative dispute resolution mechanisms?
- ❑ Do firms use ADR through the formal judicial system or independently?
- ❑ What are the requirements for using ADR and for appealing ADR judgements?
- ❑ What percentage of ADR decisions are appealed through the judicial system?
- ❑ Do those who use ADR mechanisms do so in preference to private solutions or to litigation?
- ❑ Does any agency publish a list of companies that have failed to comply with a judgement?

## Conclusion:

From the discussion, it is evident that SME issues are present in virtually all aspects of these topics. However, explicitly dealing with how to make SME policy more effective is not simple. Nevertheless, some conclusions can be drawn.

- ◆ First, treating SME policy in isolation is clearly a mistake and reduces the effectiveness of small business initiatives. There is a great deal of scope for cooperation between those attempting to explicitly implement SME related projects and the more general work of the Bank in a way which would assist small businesses and would make the projects more effective at a broader level.
- ◆ Second, the most general conclusion is that while the overall direction is clear, to translate most of the issues into country specific recommendations or projects requires detailed work at the federal, state and municipal level in each country.
- ◆ Third, the paper makes it clear that large areas remain in which there is a great deal of uncertainty regarding how to assist SMEs. Therefore experimentation with innovative pilot projects which try out alternative approaches should yield a great deal of useful information which could provide indications of what works and what does not. Furthermore, widespread dissemination of the results would greatly extend the effort to assist small businesses.
- ◆ Fourth, it is not clear that there is a large leading role for the Bank to play in procurement. The procedures for contract procurement under Bank projects, as they stand, are even-handed and provide as level a playing field as possible for firms. Nevertheless, there is room for experimentation even here. Better dissemination of information, trying out different thresholds to encourage SME participation, and working directly with those trying to help small businesses could have positive effects. Beyond that, the best contribution that the Bank could make may be to serve as advisors and trainers. As the decentralization process progresses, the increased number of government agencies overseeing procurement will require many more people qualified in procurement.
- ◆ Fifth, the Bank has already made substantial inroads in the area of Dispute Resolution with many Judicial Reform projects either in execution, preparation, or in the pipeline. However there have been some specific issues left out of the projects to date that should be considered in future efforts. These include improving the framework and institutions surrounding summary judgement proceedings, introducing competition to the notaries in those countries where there appears to be cartelization, and generally streamlining the process because the lengthy delays in decision-making are a complaint throughout the region.

Another striking point which emerges from the review of Bank projects is that there appears to be a clear division between projects that are aimed directly at SME assistance on the one hand and more general projects on the other. The latter rarely, if ever, take SME issues into account while the former tend to be concentrated on assisting SMEs to overcome deficiencies in the business environment in which they operate. Both approaches make SME assistance less effective. Issues that affect SMEs arise in most aspects of regulation, procurement and dispute resolution

examined in this paper. This is not to say that every project should automatically take SMEs into account. However, for those interested in helping small businesses, the checklists that follow each of the three sections form a good starting point for incorporating small business issues in Bank projects more generally.

This is by no means a comprehensive review of all the non-financial issues affecting small and medium sized enterprises in Latin America. There are other important areas which affect the productivity of SMEs and their ability to operate effectively. These include; property rights over fixed, movable and intellectual property; the education and training of workers and how to most effectively deliver training services; the impact and uses of technology on small businesses; infrastructure issues; labor market issues; small business cooperation programs and industrial districts; the advocacy role of small business associations; and informality and SMEs. Furthermore, this report is an outline of the issues in the areas of regulation, procurement and dispute resolution. Much more work detailed work is needed on a country by country basis to operationalize these concepts. It is only a first step towards broadening SME policy away from the more common financial focus, towards a systemic approach which sees small business issues as part of a broader approach to economic development and poverty alleviation.

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