

The Cost of Resolving Small-Business Conflicts

The Case of Peru

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Foreword

With this report we intend to open a discussion on how problems in the business environment affect the economic performance of the micro, small and medium enterprises in the region. The simple enunciation of these problems is no longer enough and a more specific and deeper analysis should be undertaken. In this case, we have concentrated on the impact that weak conflict resolution mechanisms have on a small business in Peru.

The results of the present report show that the presence of a weak conflicts resolution mechanism has a significant negative economic impact on small businesses. This impact is explained by the lost of business opportunities and high transaction and production costs.

We believe that this analysis will spark a debate on a topic barely covered in specialized literature. We believe attention should be paid to its results, but also to the methodology used in the research. The following steps should be fine-tune this methodology and broaden the study to cover other Latin American and Caribbean countries so as to improve policy design and the exchange of ideas and views on the subject.

We believe that this report will be of interest of the policy makers and researchers concerned with the competitive performance of the micro, small and medium enterprises in Latin America and the Caribbean.

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Executive Summary

This study analyzes the impact of judicial inefficiency on small businesses in Peru. It is based on the hypothesis that chronic problems in the region's judicial systems have negative consequences on the development of micro, small and medium-sized businesses. The analysis focuses, first, on the relationship between small businesses and the legal system. Secondly, it looks at decisions made by small businesses to mitigate the effects of poor performance by the courts. Lastly, it identifies several ways in which judicial inefficiency is transferred to the business sector. The analysis also attempts to quantify the economic impact of judicial inefficiency.

This study is based on an opinion survey of micro, small and medium-sized businesses in Peru, a workshop attended by 30 entrepreneurs and various interviews with economists, lawyers, judges, academics, persons in charge of bank portfolios, members of SME development associations (*entidades para el desarrollo de la pequeña y microempresa* – EDPYMES) and government officials.

The results of this study show that businesses have a negative image of the judiciary and that they avoid using the courts system. They view the judiciary as a corrupt, slow, complex and expensive system that is somewhat biased against small businesses. This view of the judicial system leads businesses to attempt to solve their conflicts informally, avoiding the courts at all costs.

Other legal issues that also affect small businesses are analyzed in this report. Among the topics studied are: (i) the use of written contracts; (ii) the use of accounting and legal services; (iii) official and unofficial costs of litigation; (iv) the use of alternative mechanisms for dispute resolution; and (v) the relationship between small businesses and the state. Indeed, the analysis found that the costs of litigation are proportionately much higher

for smaller debts, a fact that discourages smaller enterprises from using the judicial system. Likewise, there are problems regarding SME access to government procurement processes at all levels, which represents a \$4-billion annual market. The report also demonstrates that corruption has a negative effect on various aspects of SME development and, particularly, on their capacity to gain access to impartial judicial services.

The problems described above influence the behavior of businesses, often forcing them to mitigate the risks and costs arising from judicial inefficiency. For example, many small businesses avoid entering into contracts with the government or searching for credit; nor do they invest in their business, enter into contracts with larger companies or expand their activities by means of subsidiaries or a broader geographic coverage. Likewise, businesses avoid subcontracting some stages of their production process and generally do not carry out joint purchases or sales.

In order to lessen the risks of noncompliance (particularly those that result from their inability to resolve conflicts in the courts) businesses rely on reputation and trust factors. Thus, they avoid changing suppliers, even if this means higher production costs, unless they are able to investigate the credit and business record of potential new suppliers. They also avoid transactions with new customers unless they are secured or in cash. This has several negative effects on small businesses' commercial activities, and multiplies the impact of judicial inefficiency throughout the business sector, reducing business opportunities and increasing costs.

Based on some pioneer research in Brazil and the Philippines, we developed a model designed to quantify the economic impact of judicial inefficiency. The methodology used allowed us to create alternative scenarios to

determine the impact that reasonable increases in investment might have on economic growth.

The aim of this report is to establish a general theoretical framework that will serve as the basis for future research and, at the same time, to contribute to the debate on the various approaches to measuring the economic impact of improvements in judicial efficiency.

This study makes two important contributions to the debate. First, it identifies the full range

of issues that affect the relationship between small businesses and the judicial system. In this sense, it presents evidence related to the legal needs of small businesses and provides important details about the obstacles to and incentives for gaining access to judicial services. Second, it analyzes the economic impact of judicial inefficiency, highlighting the various ways in which this affects business behavior. Finally, it suggests ways to incorporate these findings into a new model to more accurately measure the economic impact.

Introduction

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

Scarce attention has been paid to the legal problems of small businesses (including micro, small and medium enterprises). Little is known about their legal needs, including the characteristics of this court-related needs or the frequency with which they use the judicial system. It is thus necessary to deepen the analysis and empirical research in a variety of related areas. This study analyzes the overall interaction between the judicial system and small businesses in Peru. It first examines small businesses as users of the judicial system and defines the main characteristics of their relationship with the courts (frequency of use, perception of the judicial system by businesses, costs, incidence of corruption, etc.). Secondly, the report analyzes how small businesses behave when the judicial system is inefficient. Finally, we analyze the economic impact of an inefficient judicial system.

Given the breadth of issues, the primary goal of this research was to develop a road map for further analysis and lay the foundation for new research, reform programs and policies. Among the questions that this report attempts to answer are the following:

- How often do small business use the judicial system in Peru?
- How do small business resolve their disputes?
- What are the most important socio-economic and institutional barriers that small business have to confront in order to use the Peruvian legal and judicial systems?
- What are the incentives and disincentives to use the judicial system, to enter into contracts or, more generally, to gain access to the institutions of the broader legal system?
- What is the impact of judicial inefficiency on business behavior?
- What are the main legal obstacles to SME development?
- What kinds of activities would small business undertake if the judiciary’s ability to resolve disputes and protect contractual rights were more reliable, fair, effective and efficient?
- What is the economic impact of judicial inefficiency?

This study is based upon the premise that the “ideal” judicial system has the following qualities: (i) *predictability*, that is, given the same circumstances, judicial decisions are similar; (ii) *accessibility*, that is, citizens do not face serious obstacles to use judicial services, the complexity of the processes is reasonable, legal advice is available and the geographic presence of the judiciary is well spread;¹ (iii) *efficiency*, this implies not only the rational use of time and resources but also a correct allotment of litigation costs; and (iv) *effectiveness*, that is, having the ability and resources to enforce decisions.

¹ In the particular case of Peru, the multicultural characteristics of society must also be included.

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

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

These qualities also have an indirect effect on the judiciary itself: reduced backlogs. If the

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

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

This study is organized in six chapters. The second chapter presents a description of the SME sector in Peru. The third summarizes the research and academic literature. The fourth presents the main results of the fieldwork. The fifth analyzes the economic impact of judicial inefficiency, while the last chapter presents conclusions and recommendations.

Micro and Small Businesses in Peru

Microenterprises and small and medium enterprises are business organizations that produce goods and/or services in a very limited scale if viewed individually; however, collectively, they represent a significant economic force. As business management units, small businesses are essential to the Peruvian economy.

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

According to the main macroeconomic indicators, 75.9 percent of economically active workers in Peru are employed by small businesses, which account for about 43 percent of Peru’s gross domestic product (GDP). Their prevalence in the national economy is most significant in the service sector where 66 percent of businesses are small businesses, compared to only 14 percent in the industrial sector. In the industrial sector, small businesses operate in a wide variety of fields, including food products, the clothing industry and tailoring, the wood industry, glass manufacturing, basic nonferrous mineral industries, machinery and appliance manufacturing and electrical accessories and supplies.

In spite of the magnitude of these figures, small businesses face a series of obstacles that substantially affect their development, such as competitiveness obstacles, obstacles to enter other markets, credit discrimination and the lack of information and technical training.

Table 1. Employment by Categories in Peru, 1994

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

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

Small businesses generally prefer to deal with nonbanking institutions, such as municipal and rural credit unions, local microfinance institutions (also known as EDPYMES – development associations for small and micro enterprises) and cooperatives. There are also many nongovernmental microcredit organizations that play a significant role in financing the activities of microenterprises.

Perhaps the main barrier to gaining access to credit and the financial system is that, in Peru, a large number of small businesses operate in the informal sector. Consequently, they usually cannot demonstrate their creditworthiness, they do not pay taxes, they do not have accounting records, they cannot support their production capacity, they cannot enter into contracts and they lack the legal collateral necessary to mitigate credit risk. The participation of the economically active population in the informal economy ranges from 34 to 49.2 percent (De Soto *et al.*, 1986; Carbonetto *et al.*, 1988).

In the last few years, Peru has taken various steps to promote small businesses, including the creation of the Small and Microenterprise Promotion Committee (*Comisión de Promoción de la Pequeña y Micro Empresa* – PROMPYME) to represent their interests.

The Small and Microenterprise Promotion Act, an *ad hoc* legal framework established to provide small businesses with preferential access to the public procurement process, was enacted in 2000.

Literature Review on Justice and Small Businesses

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

Problems in the relationship between small businesses and the judicial system relate to issues of the law, the economy and business development. However, this has not always received sufficient attention as an object of scientific investigation. Indeed, the scarcity of academic research and empirical studies presented a real challenge for this investigation. Below are descriptions of the studies used as references for this report.

There is a significant body of literature, which, though not cited as an immediate source for this work, provides the general theoretical framework under which much of our analysis takes place.² But other research was used as a direct reference, including the pioneering work of Hernando de Soto and the Instituto Libertad y Democracia (Institute for Freedom and Democracy – IDL) on reforms to foster business development and economic growth (De Soto *et al.*, 1986). These reforms include the implementa-

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

tion of a variety of mechanisms for the protection of property rights, the reduction of registration costs and procedures for registering new enterprises, as well as processes for legalizing property (to serve as collateral and thus enable owners to gain access to credit and start a business). Numerous works on the problems of the Peruvian judicial system were taken into account and were very useful to understanding the legal and institutional context within which interactions between small businesses and the judicial system take place.³

The relationship between small businesses and the judicial system, which is the core of this investigation, is an area of vital importance; however, it has only received scant attention. There are virtually no empirical studies regarding the way small businesses interact with the judicial system, the frequency with which they use the system or the nature of the cases that these enterprises present to the system (amounts, subject matter, etc.). Likewise, there are only a few studies of the official and unofficial costs of litigation, the length of judicial procedures and the phenomenon of judicial corruption as an obstacle to gaining access to the courts. There is almost no information regarding the mechanisms that small businesses use to resolve disputes when they do not resort to the judicial system.

One of the few examples is that of Peru, where the Instituto Apoyo undertook a study of micro, small and medium entrepreneurs and the judicial system (Eyzaguirre and Calderon, 2002). The research was primarily based on surveys of micro and small entrepreneurs from Lima and the suburbs, and it analyzed the ways in which they interacted with the judiciary and how they re-

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

solved disputes. This study, which established a valuable baseline, served as an important reference for our investigation. A previous study, also by the Instituto Apoyo, analyzed how judicial inefficiency affects business decisions. Even though the sample used consisted only of large businesses, some of its findings and conclusions can be extrapolated to the problems of micro, small and medium enterprises.

The World Bank undertook another series of valuable empirical studies that relate to the overall functioning of the judiciary. The World Bank carried out research on users of the judicial systems in Argentina, Peru, Ecuador, Brazil and Mexico.⁴ Although small businesses were not the primary focus of those studies, much of the data and findings are very relevant to this field of work. For instance, these reports present estimates on the average time of enforcement proceedings in general and provide insights into the different stages of such processes (average time between filing the complaint and the plea, delays in notification, etc.). All this information gives a clearer picture of the processes facing small businesses when they use the judicial system. Another pioneering study by IFES outlines and examines the barriers to enforcing court judgments in Argentina and Mexico. This empirical study provides a valuable overview of the legal and structural obstacles to the effective enforcement of court decisions.⁵

Finally, one of the most important aspects of the relationship between small businesses and the justice system is the economic impact of judicial decisions, an area in which there has been little research and few programs. This study takes two important research projects as direct reference. The first one, entitled *Hidden Costs of Judicial Inefficiency: General and Estimated Concepts*

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

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

for Brazil, analyzes the results of a survey of Brazilian entrepreneurs to determine the extent to which the poor performance of the judicial system affects their businesses and the overall economy (Pinheiro, 1998). The research shows that businesses view the judiciary very poorly, that they are reluctant to use the judiciary and that judicial inefficiency has a high negative impact on businesses, business decisions and the Brazilian economy as a whole. Using a model that links economic growth to investment levels, the author predicts an efficient judicial system would increase investment by 10 percent, leading to a potential increase in GDP of approximately 35 percent.⁶

The second study, entitled *Justice and the Cost of Doing Business: The Philippines*⁷, analyzes the perception of justice among Philippine entrepreneurs and the economic impact of judicial inefficiency. This study shows that judicial inefficiency has negative effects on the frequency of transactions and that businesses see the judicial system as an obstacle. Applying the same model as Pinheiro, the authors conclude that the poor performance of the Philippine judicial system has an economic impact equivalent to 6 to 11 percent of total investment and 0.25 to 0.46 percent of the annual GDP.

These two mark a significant improvement in the analysis of the economic impact of judicial inefficiency and are a valuable reference for the development of new measurement instruments and methodologies. Their main contribution is that they provide an empirical measure of the financial cost of inefficient judicial services. However, because they focus primarily on large businesses, studies that look at this issues from the perspective of small businesses area also needed. In addition, the methodology used to assess the economic impact fails to capture costs unrelated to investment.

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

⁷ Sereno, de Dios y Capuno, 2001. Unpublished.

In short, although there are studies relevant to some of the objectives of this research, large knowledge and information gaps still remain concerning the relationship between small businesses and the judicial system, as well as the way small enterprises resolve disputes. Also, it is of utmost importance to clearly define the theoretical framework and instruments to be used so that judicial inefficiency can be measured according to its impact on small enterprises.

In the following sections, we present an analysis of our SME surveys and workshops. It should be pointed out that the small sample size was not optimal from a statistical point of view. Therefore, this sample may not represent, with absolute accuracy, the full dimensions of the entire Peruvian business sector. We believe, however, that the findings and issues reflected here are, on the whole, both relevant and consistent with the results of similar prior studies. We hope that future research validates our findings.

Fieldwork Results

Small Businesses and the Judiciary

This section presents key survey findings regarding the relationship between small businesses and the judicial system. Our analysis also incorporates information collected and discussed during the small businesses workshop as well as targeted interviews in Lima.

Perceived Image of the Judiciary

The first issue analyzed was the image of the judiciary among micro, small and medium enterprises in Peru. Prior public opinion surveys indicated that the perceived credibility of all public institutions was extremely low, and that the judiciary was among the lowest ranked. These surveys also indicated a systematic rejection of political institutions, which tells us the situation and image of the judiciary is not an isolated phenomenon in Peru. When asked whether there was effective compliance with the law, only 3 percent of businesses responded positively; 62 percent stated that there was no compliance with the law and 32 percent said that there was compliance only in “some cases.” These answers reaffirm the hypothesis that problems in the judicial system are not an isolated phenomenon but are part of a much wider crisis in the political system and of governance.

When businesses were asked about the reasons for the failure to effectively comply with the law, they ranked judicial corruption as the main problem, followed closely by political corruption. If, however, answers from micro-entrepreneurs are disaggregated from those of small and medium businesses, there are some significant differences. Microentrepreneurs consider the socioeconomic situation to be a more serious obstacle to compliance with the law. This may mean, among other things, that they also feel vulnerable to socioeconomic crises and that they have problems complying

with legal requirements, including contractual obligations. Small and medium entrepreneurs, in turn, see political instability as the main reason for noncompliance with the law. Evidently, there is widespread dissatisfaction with the performance of the political system. Likewise, this group gives strong importance to the culture of noncompliance with the law, which makes reference to socio-legal and cultural factors tied to recurrent political crises.

Only 5 percent of the people surveyed believed the judiciary functioned well or very well. Fifty-two percent stated that the performance of the judicial system is poor or very poor and 35 percent considered it average. When the sample is restricted to micro-enterprises, the perceived negative image is even higher (58 percent).

Access to the Judiciary: Frequency of Use and Obstacles

The negative perception of the judiciary’s performance matches the low level at which businesses use the courts. Out of the total sample, only 15 percent stated that they had sometimes used the courts to resolve disputes. However, if we limit the response to microentrepreneurs, this percentage falls to 9 percent. This difference between microenterprises and small and medium enterprises leads us to infer that the larger and better established the business the greater its access or perhaps its need to use formal mechanisms of justice administration. Also, the few businesses that answered stating that they had even used the judicial system noted that they had done so very infrequently (hardly ever or for less than 50 percent of disputes).

Although entrepreneurs are reluctant to use the courts to resolve disputes, this does not mean that disputes do not arise. Rather, businesses tend to minimize the risk that prob-

lems will arise and, when they do, small businesses rely on other mechanisms to resolve them. This was the subject of a lively discussion during the SME workshop, where most participants stated that they avoided using the courts at all costs.

When asked the reasons that dissuade them from using the judicial system, entrepreneurs stated that the main obstacle was judicial corruption and that the main disincentive for using the courts was the feeling that judges and court personnel can be manipulated through handouts and bribes. The corruption phenomenon has worrisome dimensions and, even though the problem is openly acknowledged, there are no concrete programs and actions designed to reform and improve it. During the interview process, there was consensus among lawyers, judges, academics and civil servants regarding the gravity of this problem. For example, members of the judiciary and lawyers noted that it is common knowledge that one can “choose” the court where a case will be heard⁸ if bribes are paid when a case is filed before the Civil and Commercial Courts of Lima. Likewise, under-the-table payments to speed up proceedings are not unusual, and it is sometimes possible to influence the final decision of a judge through handouts or bribes.

Businesses pointed to slowness or delays as the second most important obstacle to using the courts. Excessive delays in resolving even the simplest cases (for example, the collection of an overdue check) discourage the use of the judicial system. Workshop participants noted that the maximum “ideal” time to resolve a dispute is around six months. After six months the debt or claim is considered lost. This means that businesses expect to

⁸ The phenomenon of paying an amount of money to choose the court where the case will be heard is a well known fact for all the users of the judicial system, even judges are aware of this situation (this does not imply that they receive part of the money, it just means that they know about the demand for undue payments). Indeed, several people interviewed pointed out that there is a fixed amount (US\$500) to choose a court.

resolve their disputes either through the judicial system or through other unofficial mechanisms in a period of no more than six months.

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

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

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

⁹ La República Newspaper, January 13, 2003.

been largely ignored in spite of their importance.¹⁰

If answers by micro and small and medium enterprises are disaggregated, it is evident that microenterprises consider litigation costs a higher deterrent. This gives rise to two interpretations that are not necessarily contradictory. On the one hand, the cost of resolving a conflict in court might be proportionally higher for smaller claims than for higher ones.¹¹ On the other hand, perhaps microenterprises just have less financial ability to incur litigation costs, such as judicial fees or professional fees.

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

There are two different court venues, depending on the amount of the claim and the geographic location of the business: (i) small claims courts, and (ii) civil courts. Entrepreneurs show no clear preference for either venue (we should keep in mind here that they lack direct contact with the judicial system). However, a study carried out by the World Bank and the Pontificia Universidad Católica

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

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

(González Mantilla et al., 2002) points out that small claims courts are much more efficient than civil courts in debt collection proceedings. Even though we could take the position that businesses, due to their lack of contact with the judicial system, ignore the fact that small claims courts are more efficient, this does not appear to be necessarily true. Indeed, even for those who have frequent contact with courts, such as lawyers and academics, were surprised at the findings of the study.

How Do Small Businesses Resolve Disputes?

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

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

Even though this appears to be a logical sequence, a few points need further clarification. First, the level of effort in each sequential step is uneven. The attempt to reach an agreement with the other party (the first step of the sequence) takes longer than the others. Entrepreneurs stated that in order to get a satisfactory solution, they have to contact the other party numerous times. This implies

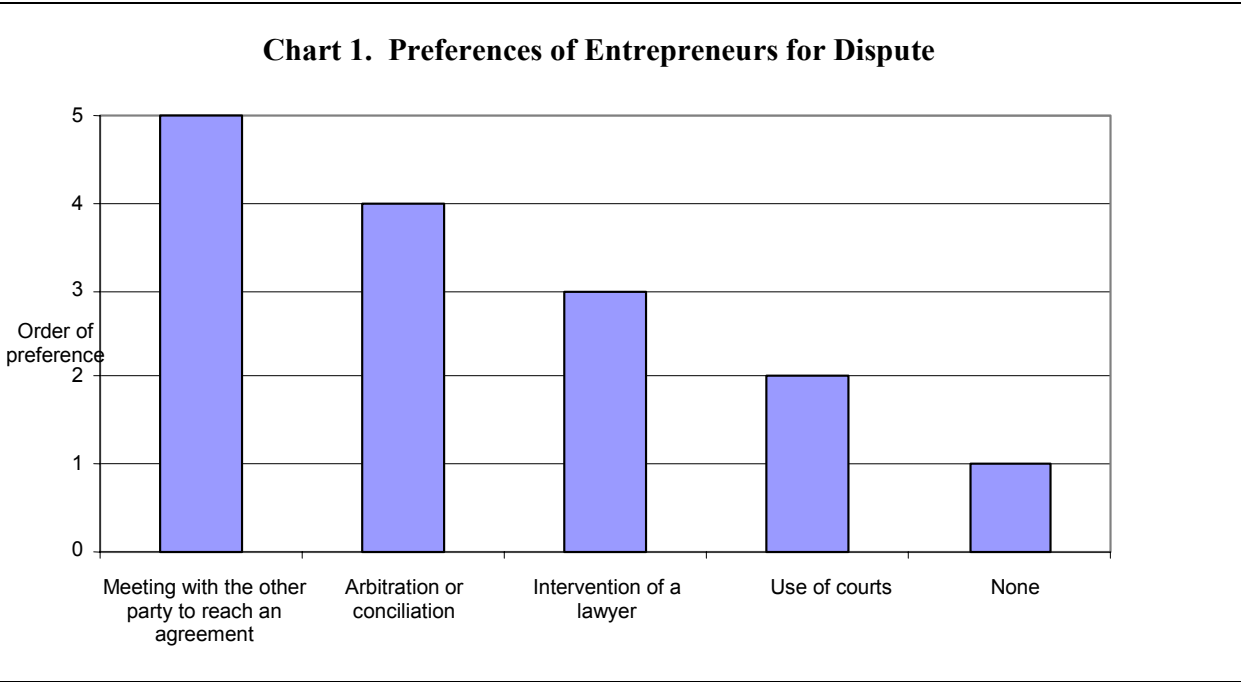
¹² The average for microenterprises is 11 years, while for small and medium enterprises it is 9 years.

many phone calls and visits to the shop or head office of the other party. Only after all efforts have been made, which could take several months, would the next step be taken. But the premise remains the same: *look for the debtor and negotiate, in an attempt to lose the least possible.*

The second step is to use alternative dispute resolution mechanisms, such as conciliation or arbitration, which are widely used practices in Peru. For example, 50 percent of the workshop participants stated that they were familiar with or had heard of conciliation. In the survey questions, many entrepreneurs described faithfully the steps that they most often follow. Others discussed the steps that they would follow without knowing the detailed characteristics of arbitration or con

ciliation. In other words, they would try to use all possible legal means to avoid using the judicial system.¹³

The third sequential step is to seek a lawyer, although businesses showed a certain amount of overall reluctance to hire professional legal services for business advice. Charts 2 and 3 illustrate the differences according to the size of the business. Notably, small and medium enterprises present a more frequent, regular use of lawyers and accountants (39 percent), and microenterprises use them much less (23 percent). This may be explained by the fact that larger businesses have higher transactional levels and more legal and accounting requirements, and that a greater number of them operate within the formal economy.



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

Chart 2. Use of lawyers - Microenterprise

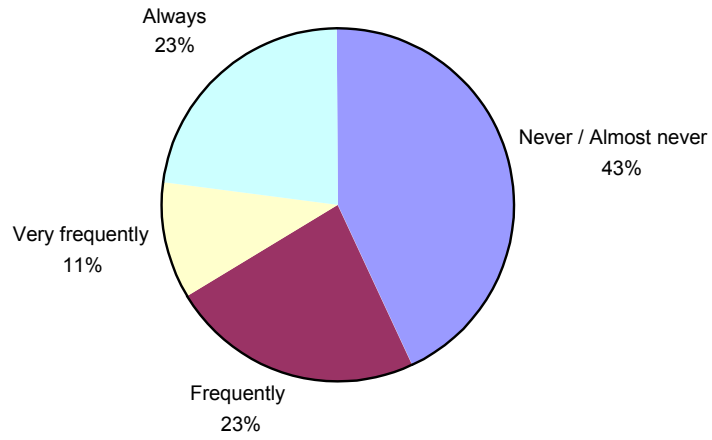
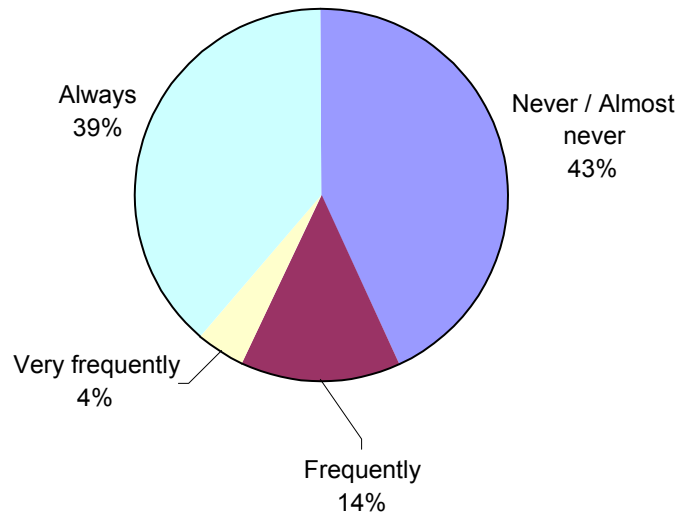


Chart 3. Use of lawyers - Small and Medium Enterprise



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

Litigation Costs

According to the entrepreneurs surveyed, one of the main reasons they tried to avoid the judicial system was because it was too costly. They noted that these costs not only included official litigation fees and professional fees, but also “unofficial” costs (corruption) and the time they invested in the process. The various kinds of costs are analyzed next in order to try to determine the total cost of litigating in a judicial setting.

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

Table 2. The Judgment Is Enforced by Attachment of a Bank Account and the Debtor Raises No Objections (in US\$)

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

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

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

¹⁵ “Total litigation cost” means the payment of taxes and judicial fees plus lawyer’s fees. “Fixed administrative cost” means the payment of taxes and judicial fees—lawyer’s fees are not included.

Litigation costs increase significantly if the collection is performed through the attachment of a vehicle. For a \$2,000 debt, the total cost amounts to \$1,118 (equivalent to 55 percent of the debt), while for a \$10,000 debt, the cost amounts to \$3,028 (30 percent of the amount claimed). Once again, the analysis of fixed administrative costs presents a significant difference with respect to smaller debts. For the \$2,000 debt, the administrative cost represents 45 percent of the amount claimed, while for the \$10,000 debt, it represents only 10 percent.

Table 3. The Judgment Is Enforced by the Attachment and Sale of a Vehicle and the Debtor Raises No Objections (in US\$)

Costs	Case 1	Case 2
Amount of the debt	\$2,000	\$10,000
Complaint/request of conservatory measure	\$100	\$200
Seizure of the vehicle		
Police	\$25	\$25
Storage	\$50	\$50
Writ of attachment in Registry	\$2	\$2
Publications	\$250	\$250
Valuation of property	\$250	\$250
Auction	\$200	\$200
Judicial Fees	\$30	\$50
Lawyer's Fee	\$200	\$2,000
Total cost	\$825	\$2,975
Total cost as a percentage of the debt	41.25%	29.75%
Fixed administrative cost	\$908	\$1,028
Fixed administrative cost as a percentage of the debt	45.40%	10.28%

As shown, the cost of collecting a debt varies considerably according to the amount of the debt. The cost of collecting smaller debts is proportionally higher than that of collecting larger debts. This deserves further analysis because there appear to be strong incentives to avoid using the judicial system to collect small debts, although it remains unclear whether this is deliberate or fortuitous. In other words, the information available has not

shown whether the demand of higher costs for small debts was an intentionally result of judicial policy.

Conciliation and Arbitration

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

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

One of the advantages of ADR is that it is generally speedier than the conventional judicial process. The average duration of cases resolved under arbitration is five months and twenty days, much shorter than the average of three years and ten months for cases handled

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

by the judiciary. Another advantage of ADR relates to the privacy factor. The parties resolve their disputes in a private and confidential environment, thereby avoiding publicity concerning the details of the dispute or the eventual agreement. This may be particularly important when disputes revolve around confidential issues whose details enterprises generally prefer not to make public.

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

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

However, a number of problems and challenges must be overcome in order to consolidate the use of the conciliation process in Peru. The explosive growth of conciliation without appropriate oversight by the state generated cases of abuse and, in some cases, a low quality of services. These factors should be taken into account at the time of designing a system adapted to the needs of small businesses.

Contracting Mechanisms

The use of written business contracts is both revealing and problematic in several respects. The frequency with which contracts are used sheds some light on the levels of formality of business transactions. A frequent use of contracts also shows a higher degree of knowledge on the part of entrepreneurs regarding available legal instruments to increase business certainty. The frequent use of contracts also facilitates access to credit since transactional volume can be easily documented.

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

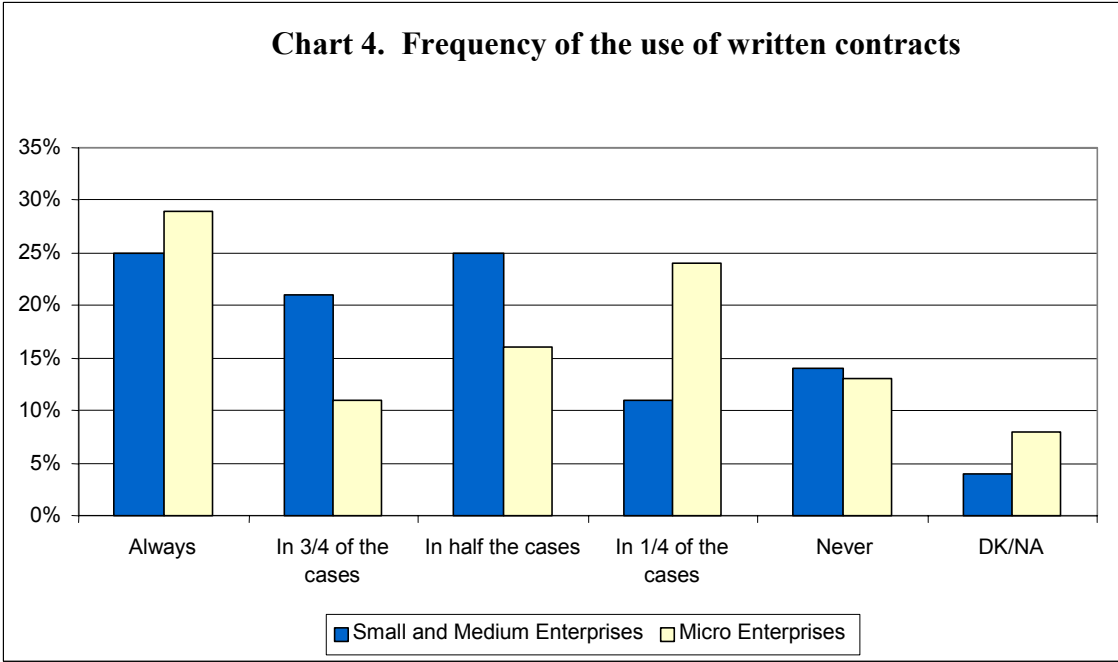
If we disaggregate answers according to business size, we find that the use of contracts is much more frequent in small and medium businesses. As chart 4 shows, larger businesses comprise 50 percent or more in the first half of the chart (71 percent versus 56 percent). This large percentage differential also existed in similar prior studies, which found an almost 20-percentage-point gap between micro and small enterprises (Eyzaguirre and Calderón, 2002). One possible explanation is that microenterprises manage their businesses with higher levels of informality.

This data raises questions as to how entrepreneurs guarantee or formalize credit or long-term transactions. A possible alternative is the use of negotiable instruments (promissory notes, cross-reference guides, warrants, bills of exchange, etc.) as substitutes or complements of written contracts. However, the use

of these instruments is infrequent.¹⁷ We should note that, even though 38 percent of small entrepreneurs stated that they use negotiable instruments, the number for microentrepreneurs who do so is only 15.5 percent (Eyzaguirre and Calderón, 2002).

The use of written contracts was discussed thoroughly during the SME workshop. Businesses gave varied answers regarding their reasons for using these instruments. Some entrepreneurs stated that the use of a written

contract exerts “...psychological pressure on the parties that helps in the fulfillment of the contract.” Others stated that written contracts give more formality to business transactions, which prevents inaccuracy or confusion regarding the actual terms of the business agreement. Interestingly enough, nobody cited using contracts as an enforcement mechanism in the event of a legal action for noncompliance.



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

Nor did any entrepreneur say he used contracts as a way of certifying the volume of business transactions when applying for credit. The tendency toward not using written contracts was confirmed in interviews with institutions that specialize in the provision of SME credit lines. Nonetheless, credit portfolio managers stated that in most cases they are required to ask petitioners to formalize transactions with customers and suppliers through written contracts.

Entrepreneurs, however, do not always act with the knowledge or specialized advice necessary to write contracts. This situation is exacerbated by the absence of institutions that provide legal advice on this subject.¹⁸ Although there are business associations with legal aid departments for small businesses, they are either geographically located some distance away or small businesses are not aware of their existence.

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

The infrequent use of written contracts also increases the risk of noncompliance with regard to long-term transactions or transactions with multiple services over time. Entrepreneurs lower this risk by relying almost exclusively on cash transactions. In some cases, an advance payment or deposit is required. Restrictions on the means of payment undoubtedly decrease the variety and number of business opportunities pursued, which has a concrete negative economic impact on the economy.

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

Small Businesses and the State

The relationship between small businesses and the Peruvian government is extremely important, given the economic importance of both actors. Small businesses represent 99.6 percent of the Peruvian business community, employ 75.9 percent of workers and are account for 42 percent of the nation's GDP. At the same time, the government is Peru's main contractor with 850,000 contracts, totaling \$4 billion per year.

However, the relationship between small businesses and the government is far from ideal. Many problems have a negative impact on small businesses and discourage them from even trying to engage in business with the public sector.¹⁹ At first glance, it may appear logical to assume that government contracts are too large and that small businesses would therefore not have the capacity to participate in them. However, official data shows that 70 percent of the 850,000 government contracts per year range between \$3,000 and \$5,000; therefore, there would appear to be no capacity obstacle, in principle, to more active SME participation.²⁰

Unfortunately, there appears to be no monitoring process focused on the level of SME participation in the government contracting process. Specialists, however, speculate that

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

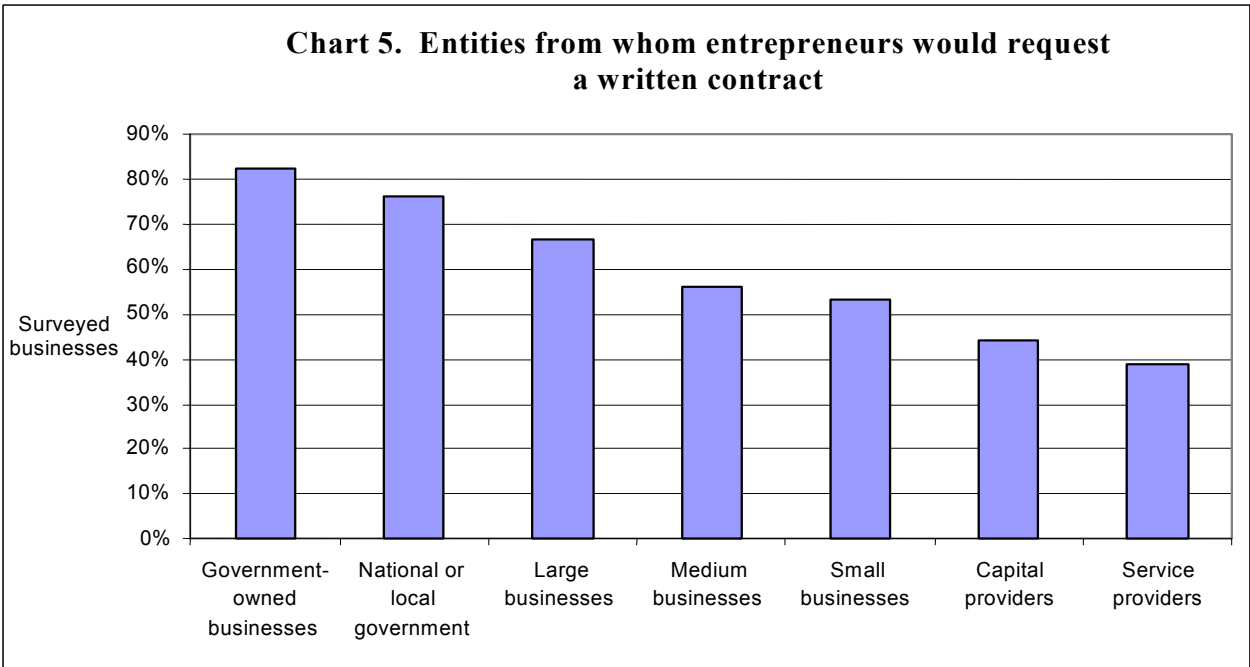
²⁰ Data supplied by CONSUCODE.

such participation is low, even though there are government agencies whose specific task is to ensure that small businesses have adequate contracting opportunities.²¹ The exact number of small businesses that win government contracts also appears to be unknown, as well as the various obstacles they face in the government procurement process and the impact of corruption. A specific study of the government procurement system would permit investigating the true ramifications and dimensions of this phenomenon.

The survey reveals that most small businesses are reluctant to enter into contracts with the government because it fails to honor its agreements and does not make payments within the time periods stipulated. When businesses are asked who they would request a written contract from as a necessary condition to enter into business, curiously enough

the government appears at the top of their list (see chart 5).

There is also a significant level of distrust in everything that involves the government. This issue was likewise discussed during the workshop, where overall dissatisfaction with the general behavior of the government was expressed over and over again. Many participants stated that they have had experiences with both the national and local governments. In every case they described these experiences as negative and almost all of the criticism was leveled at payment problems. They stated that in order to obtain a payment from the government they had to press multiple government officials on numerous occasions. The following words expressed during the workshop summarize their feelings: “we find it hard to obtain payment,” “they always say that they have budget problems,” “they waste my time.”



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

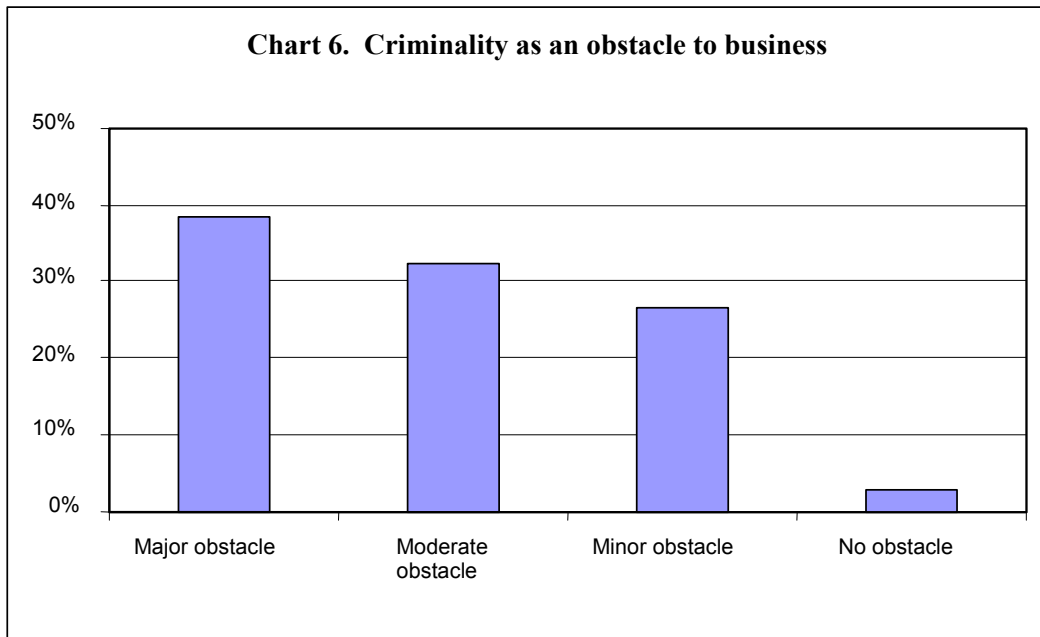
An interesting aspect of the government procurement system is that in the event of a dispute the parties have an obligation to resolve it through arbitration. The Superior Council of State Contracting and Procurement (Consejo Superior de Compras del Estado – CONSUCODE) is vested with enforcing compliance with this requirement. By most accounts, this entity appears to have made progress with regard to managing the government procurement process. One of its most important roles is that of monitoring and ensuring the transparency of the process and providing citizens and government officials with information.²²

According to official figures, most small businesses do not generally resort to the mandatory arbitration services required by law. This may be because either they do not have access to the

government procurement process at all or, if they do, they resolve their disputes through alternative or informal means—deviating from what the law provides. The first explanation seems the most likely, but this phenomenon needs to be examined in greater depth.

Crime and Insecurity

Not much attention has been paid to the relationship between criminality and economic growth. Even when the judiciary *per se* is not directly responsible for the formulation of either criminal policies or crime prevention plans, its inefficiency considerably affects the fight against crime, since undue delays in investigations and trials of criminals are rampant.²³ In the case of Peru, criminality generates significant costs for businesses (see chart 6), which was one of the



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

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

issues discussed in detail during the workshop. When asked whether insecurity had any impact on their businesses, 75 percent of participants answered “yes.” Many, approximately half, said that they usually take measures to avoid becoming victims of robberies, break-ins and other criminal activity. This included hiring security staff or guards, installing alarm systems and even having watchdogs. When asked to identify the most common crimes, they answered robbery, including the theft of goods on consignment or thefts resulting from lack of payments that are due.

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

Measures to prevent crime undoubtedly impose a significant economic cost that needs to be analyzed in greater detail (Rubio, 1998; CISALVA, 1998). Businesses incur direct costs, such as hiring security staff and installing alarm systems. In addition, they also suffer indirect losses derived from the increase in public insecurity, such as the reduction in the number of people

frequenting commercial areas. Criminality and insecurity reduce foreign investment.

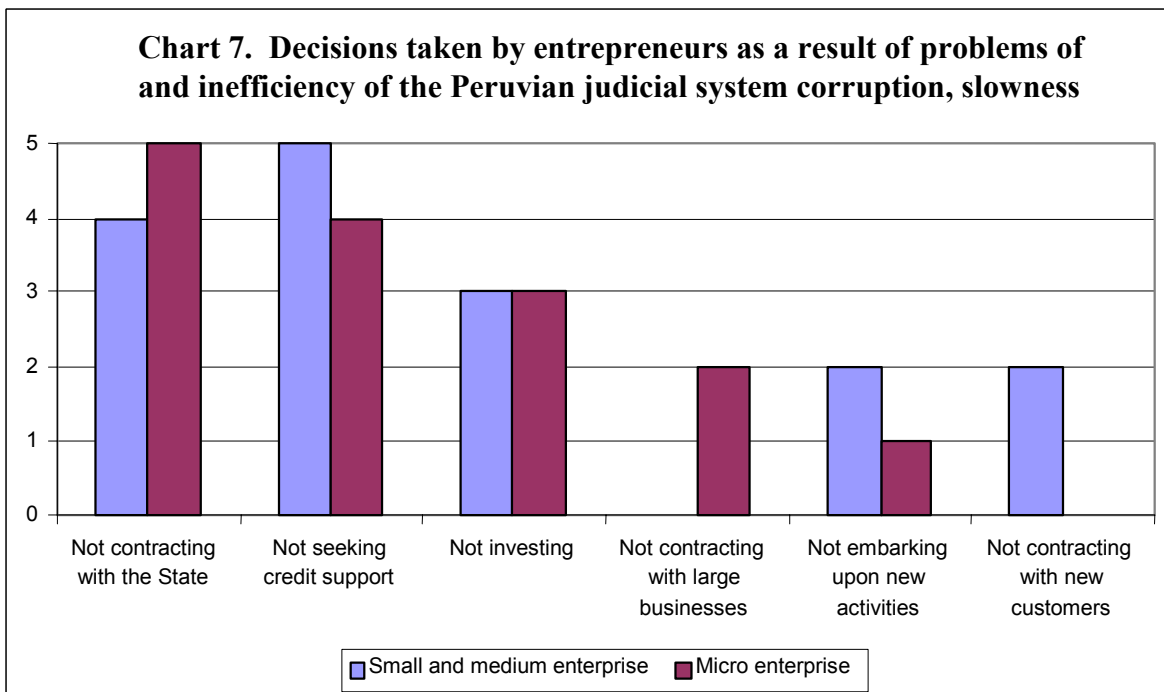
Judicial Inefficiency and Business Decisions

This section analyzes the impact of judicial inefficiency on business decisions.

Judicial Inefficiency and Business Opportunities

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

As shown in chart 7, when faced with judicial inefficiency, entrepreneurs make decisions such as refraining from entering into contracts with the government, reducing the search for credit and limiting investments and new entrepreneurial activities. This has a significant economic impact and affects business opportunities in a number of ways.



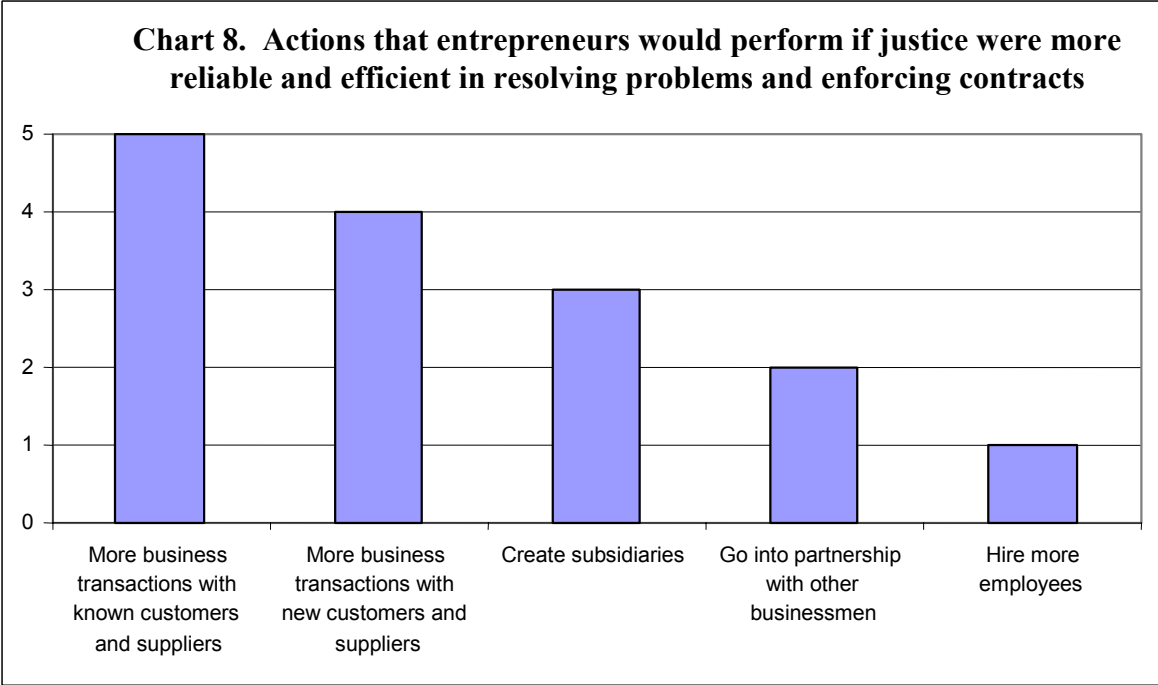
Even when the answers are disaggregated according to business size, it is apparent that businesses of all sizes make similar business decisions. However, it is worth noting that microenterprises generally refrain from entering into contracts with large businesses. During the workshop, microentrepreneurs stated that there are two reasons for this. The first is that they feel they are not on equal terms. Large businesses are perceived to impose detrimental contractual conditions on small businesses. They further state that if there is a disagreement and the microenterprise or SME does not meet its contractual commitments, the larger businesses may stop buying from them regardless of who is right.

The second perceived reason is that when faced with a possible dispute, large businesses “always obtain the result they want.” Microenterprises perceive, for example, that the judicial system always rules in favor of the most powerful and that it is useless to sue large businesses. Even though small businesses regard large firms as an opportunity to increase their business and grow, the general

feeling is that large businesses tend to abuse their position of power.

Likewise, entrepreneurs were asked about the actions they would be willing to take if the judicial system were efficient and able to enforce contracts (chart 8). The answers to this query have profound economic consequences. First, entrepreneurs would increase the number of business transactions, not only with known customers and suppliers, but also with new ones. Second, they would expand into other geographic areas and establish new subsidiaries and sales outlets. Third, they would enter into more business partnerships. Finally, they would hire more employees.

The interest in establishing new subsidiaries is noteworthy given that it reflects an interest in increasing investment as well as expanding geographically. Refraining from opening subsidiaries and sales outlets reduces the territorial coverage of the business activity and restricts the ability of entering new markets



Most respondents noted that entering into business partnerships was an uncommon practice. Only one workshop participant stated that he had entered into a partnership in order to buy supplies at wholesale prices. Another participant noted that 40 families in his native Peruvian community had formed a cooperative to market their products. Other workshop participants had no experience in this type of practice. These results are consistent with a survey of microentrepreneurs, which shows that only 1.8 percent engage in joint purchases of inputs and that 16.8 percent have experience in joint sales (Eyzaguirre and Calderón, 2002). With regard to subcontracting, figures show that only 13.8 percent of the businesses usually subcontract a specific part of the production process.

Business partnerships, such as subcontracting joint purchases or joint sales, are also affected by judicial inefficiency. The reluctance of businesses to use these methods prevents them from obtaining lower cost supplies and selling their products under better conditions.

Businesses believe that an eventual improvement in judicial services would have a direct impact on their business. When asked if they believe that their businesses would improve if the judicial system were able to reliably and efficiently resolve disputes and enforce contracts, 64 percent of the respondents gave positive answers. As shown in chart 9, answers ranged from an estimated improvement of 10 percent to as much as 71 percent to 100 percent.

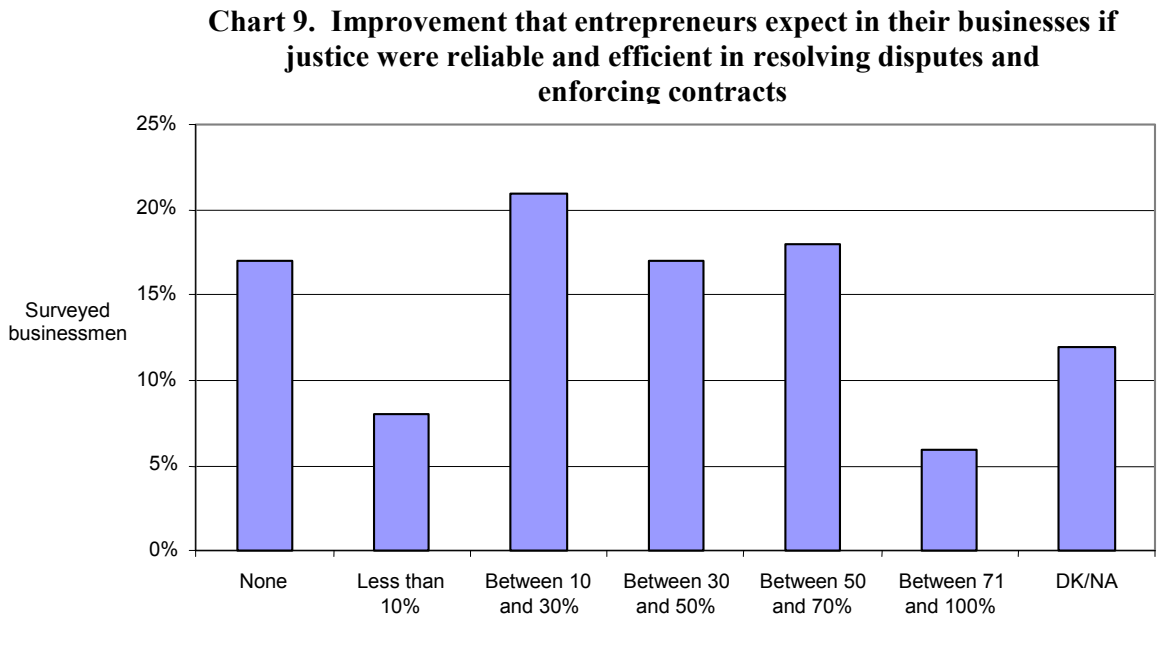


Chart 10. Most important factors for entrepreneurs to initiate business relations with a new customer

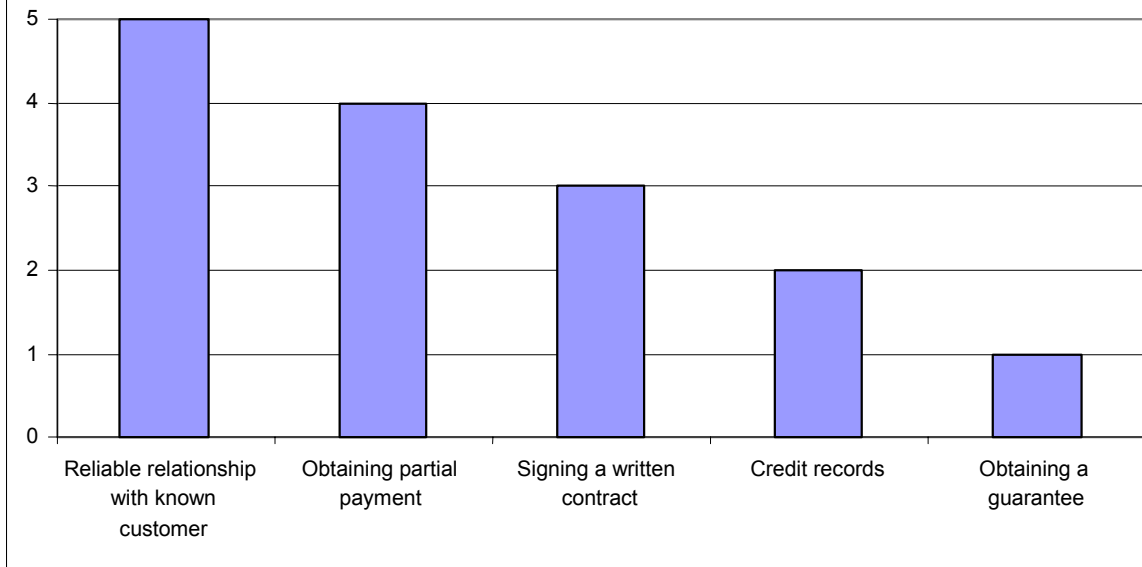
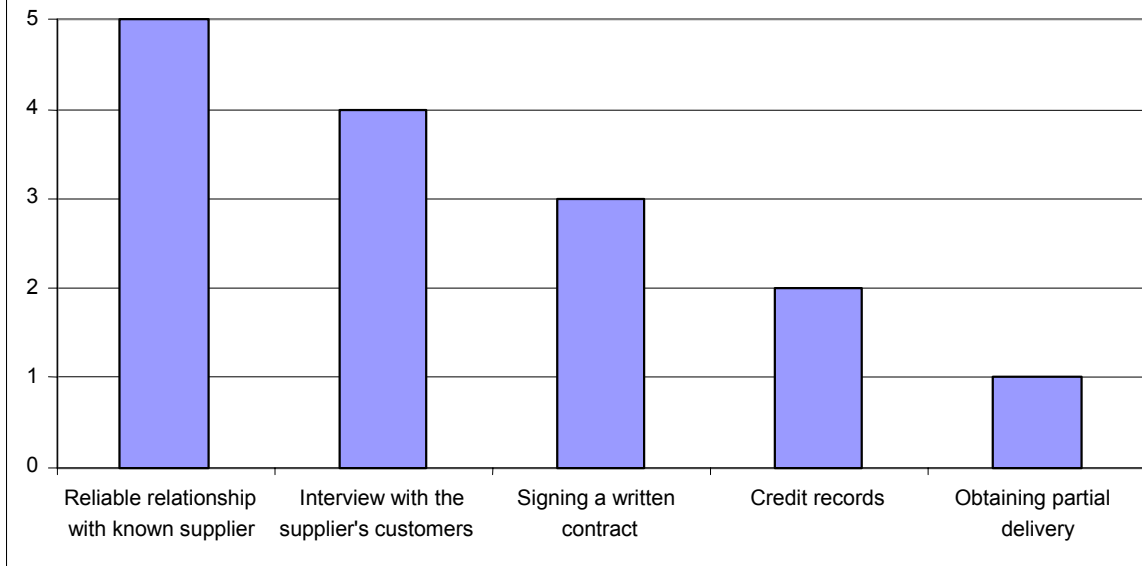


Chart 11. Most important factors for entrepreneurs to initiate business relations with a new supplier



Mechanisms to Mitigate the Risks of Entering into New Business Opportunities

As shown, judicial inefficiency encourages entrepreneurs to engage in a number of risk adverse behaviors that largely stem from their unwillingness to enter into contracts with the government or large businesses, or to embark upon new activities. This section analyzes the mechanisms adopted by entrepreneurs to mitigate the potential risks of entering into business with new customers and suppliers.

When entrepreneurs are asked about the most important factors that would determine whether or not they would be willing to enter into business with a new customer or supplier, the most important issue raised is that of trust (see charts 10 and 11). This is a decisive factor for engaging in new business transactions. The importance of this issue was corroborated in the SME workshop, where participants stated that personal trust and familiarity with their business counterparts were important factors that encouraged them to embark on new business opportunities. Another important factor noted was the execution of a written contract. However, a contract seemed to be of more interest when undertaking new business ventures. As previously noted, entrepreneurs do not always formalize their agreements by means of a contract.

In addition to trust, another factor that leads to the establishment of new business relations with suppliers is their reputation. Entrepreneurs generally seek references from a potential new supplier, asking their customers questions about the timeliness of the potential supplier's deliveries, the quality of the goods provided and whether or not sale conditions were honored.

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

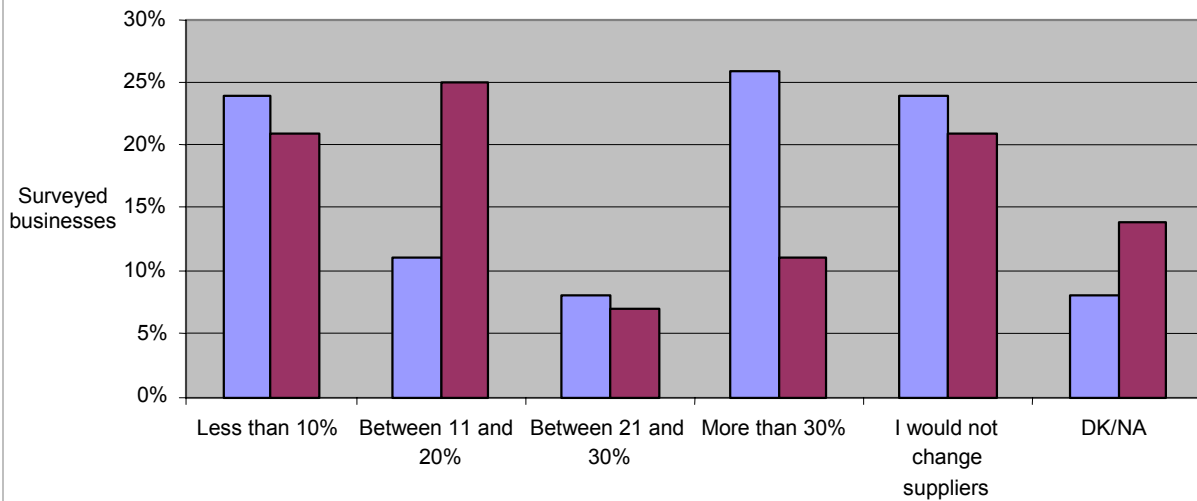
However, since the use of this service is costly, many entrepreneurs appear to use this service with moderation.²⁴

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

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

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

Chart 12. Percentage of discount on the price of supplies that would motivate entrepreneurs to change suppliers



As noted above, when in doubt, entrepreneurs demand payment in cash, and rule out any possibility of a credit transaction. Yet another issue raised during the workshop was the size of their business suppliers. Most noted that large businesses are more reliable as suppliers because there is greater certainty that the supplies will be delivered in the time and form agreed upon. Many observed that microenterprises, on the other hand, were more informal and did not always satisfactorily meet their obligations.

As noted above, in an environment in which judicial services are inefficient, entrepreneurs respond by taking a number of risk mitigation measures. These measures undoubtedly have a negative economic impact because they increase the cost of business and inhibit other possible business transactions. It is unclear how effective these strategies and mechanisms are in mitigating these kinds of risks. If these risk mitigation strategies and mecha-

nisms were effective, one might assume that they would have a relatively small number of disputes with their customers and suppliers.

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

The Economic Impact of Judicial Inefficiency

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

As shown throughout this study, Peruvian entrepreneurs operate in an environment where economic conditions are not optimal. Thus, they are forced to make business decisions aimed at mitigating the risks resulting from the absence of a predictable and efficient judicial system. Judicial inefficiency increases business costs and reduces the number and variety of possible transactions, thus limiting entrepreneurs to low risk transactions. The low likelihood that the judicial system will impose sanctions for noncompliance reduces the cost of noncompliance and discourages contract compliance because.

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

At the macro level, it is clear that judicial inefficiency has a negative economic impact on business decisions. In the absence of an institution that efficiently performs the task of enforcing contracts and punishing those who do not comply with their obligations, entrepreneurs are forced to take measure in order to mitigate the risk of noncompliance.

In essence, businesses face two types of costs: costs directly related to using the formal judicial process; and costs resulting from

operating in a deficient institutional environment.

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

The *economic cost of judicial inefficiency* is the result of decisions taken by entrepreneurs so as to be able to adapt to nonoptimal business conditions. In order to mitigate the risks of noncompliance, small businesses often take measures that have serious negative consequences. In some cases, these decisions *reduce the number of business transactions*. In others, they may *generate higher transaction costs*.

Businesses engage in fewer of transactions because:

- They generally only engage in business with known customers and suppliers. Trust is a key element in the *modus operandi* of small businesses. This fact leads

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

them to mitigate the risks of noncompliance by working only with those who have a good reputation and/or with whom they have a reliable working relationship.

- They generally do not expand the geographic coverage of their market. Entrepreneurs refrain from operating in villages or cities in which they do not know the customers and suppliers.
- They generally restrict any forms of credit to the maximum extent possible and work almost exclusively on a cash basis. This is the best way to ensure the payment of debts (full or partial payment in cash). Cash transactions are widespread and are a common practice within the business community.
- They generally do not invest in business growth, since this would expand their business activities. This includes not hiring new employees, not going into partnerships with other businesses and not diversifying the production.
- They generally engage in transactions only with businesses that are similar in size, mainly because small businesses believe they are not on equal terms with large businesses—especially if they have to resolve a dispute through judicial channels. In general, small businesses feel that they do not have the means to defend themselves against large businesses.
- They generally refrain from engaging in business with the public sector. According to entrepreneurs, the government is an unpredictable or poor business partner. They noted that it often does not comply with the terms agreed upon and that it takes an inordinate amount of time to pay its debts. (It is interesting and telling to note that even though government contracts total \$4 billion a year, small businesses are reluctant to take part in these tenders.)

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

- Not changing customers and suppliers even when this might imply obtaining supplies at a lower cost. Businesses told us that they would prefer to pay a higher cost to suppliers if they know the contract will be honored. Indeed, a high percentage of businesses said that they would not change suppliers under any circumstances, or that they would only do so if they received a 30 percent discount against the price they usually pay.
- Not to subcontract manufacturing or service tasks. In many cases, businesses are reluctant to subcontract because they are afraid that deadlines will not be met or that quality will suffer. In other cases, they may not subcontract because of the risk involved.
- Not to make joint purchases (which could reduce the cost of supplies and/or improve their quality).
- Not to make joint sales.
- Not to investigate the credit history of customers and suppliers. This is a time-consuming, costly activity, as is the registration of bad debts with credit centers (it may equal as much as 5 percent of the debt).

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

- The economic impact of criminality or “lack of public safety” on business activities. For example, the lack of security inhibits tourists and customers in general, which leads businesses to take additional costly measures, such as employing additional security staff and installing expensive security systems.

- The cost of accessing credit, particularly because entrepreneurs do not have information or legal advice on how to make use of contracts. When trying to obtain credit, it is difficult for entrepreneurs to prove the actual volume of their business activities.
- The economic impact of informality in business activities and the precariousness of property titles. In some cases, the lack of a legal title or deed and the informal status of the business (or the informal nature of some of its business activities) make it difficult to qualify for credit and access credit facilities.

Quantification of the Economic Impact²⁶

In this section, we analyze the economic impact of judicial inefficiency based upon results from our surveys. However, it should be noted that the methodology employed in our impact analysis can be refined and tested further. We hope that our analysis will serve as a starting point for future research. Hopefully, it will also highlight key business and legal issues related to small businesses and the need to make the judiciary more efficient and accessible.

Impact on Sale and Production Levels

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

²⁶ The section of the paper was authored by Rodrigo Cubero Brealey.

Table 4. Weighted Average Percentages of the Projected Increase in Sales Resulting from an Improvement in Justice (%)

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

As the table shows, if justice were improved, survey respondents for microenterprises and small and medium enterprises believed that average sales increases for each would be similar. And both believed the sales increase would be significant: between 25 percent and 40 percent of total sales, or an average increase of 33 percent for the sample as a whole.

If we assume that the surveyed sample is representative of the Peruvian SME population, the economic impact that an improved judicial system would have on the overall economy would be significant. Small businesses account for 42.1 percent of Peru's gross domestic product.²⁷ If the relationship between gross sales and value added remains constant (which would appear to be a reasonable assumption) an average increase of 33 percent in SME sales would imply an increase of 14 percent in Peru's GDP.

However, we might also assume that small businesses would not respond substantially differently than other Peruvian private enterprises to an improved judiciary. In this case, if the lower limit of the estimated sale increase (25 percent) is used as an indicator of the potential increase in the value added of the private sector, the corresponding increase in total GDP as a result of the improved effi-

²⁷ Figures obtained from PROMPYME material and *Observatorio PYMES* (Inter-American Development Bank).

ciency of the judicial system would still be approximately 20 percent.²⁸

Impact on Investment and Growth

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

However, a one-third increase in SME sales resulting in a one-fifth increase in Peru's GDP, would require a proportional increase in the production capacity of the country (assuming a steady linear relation between capital and output). In turn, this would require a substantial increase in gross fixed capital formation as a percentage of GDP. A calculation of the incremental capital-output ratio (ICOR) in Peru for the 1993-2002 decade yields an estimated value of 6.25 (see methodology in Annex B for details on the calculation procedure).²⁹ This implies that a 20 percent increase in GDP (resulting from a more efficient and predictable judicial system) would require total investment (net of depreciation) of around 125 percent of GDP. In view of the fact that there are important lags in the capital stock adjustment process, improvements in the judicial system would result in a prolonged, though *temporary*, in-

crease in the rate of private capital formation (which averaged 17 percent of the GDP between 1993 and 2002).³⁰

A fundamental question is whether, apart from the anticipated changes in output, an improvement in the judicial system would stimulate a *permanent* increase in growth and investment rates. The survey shows that judicial deficiencies have a negative impact on SME decisions to invest and undertake new business. It also shows that, if the judicial system were more efficient, entrepreneurs would be willing to expand their business volume and production capacity. It is therefore not illogical to conclude that an improvement in the judicial system would have a permanent effect on the rate of growth in investment. Unfortunately, the available data does not allow a direct quantification of the sustained impact that a more efficient and predictable justice system would have on annual investment. However, a previous study undertaken in Peru, which surveyed 712 out of the country's 1,000 largest businesses in terms of sales volume, concluded that an improvement in judicial efficiency would result in a 9.5 percent increase in annual investment (Eyzaguirre *et al.*, 1998). According to this, we could infer that the impact on SME annual investment would be of a similar magnitude.

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

²⁸ For 2001, the central government (the sum of public investment and consumption) accounted for 12.84 percent of GDP (ECLAC). This data can be used as an approximate indicator of the value added of goods and services produced by the government. There are no precise details of the participation of the public sector as a whole (i.e., including local governments, decentralized public institutions and state enterprises) in the GDP. Assuming that it is around 20 percent implies that the private sector accounts for 80 percent of GDP.

²⁹ The estimated ICOR is based on total gross fixed capital formation data, including public and private investment. But it is reasonable to assume that the ICOR for private investment is similar (private investment represents 79 percent of total investment, as shown in the following footnote), and maybe slightly lower (private investment is likely to be more efficient than public investment).

³⁰ Average total gross fixed capital formation as a percent of GDP reached 21.5 percent between 1993 and 2002 (Central Reserve Bank of Peru). On the other hand, private sector participation in gross fixed capital formation was 79 percent on average for the 1991-2000 period (Carranza *et al.*, 2003).

Table 5. Potential Changes in the GDP Growth Rate (expressed as a % of the GDP) Resulting from Different Increase in Investment Efficiency and Fixed Private Investment Rate

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

As the table shows, an improvement in justice will result in slight but sustained increases in the investment rate. This will in turn result in significant increases in annual GDP growth

(based upon reasonable and acceptable assumptions of the level of capital productivity).

Conclusions

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

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

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

Results of our surveys, focus groups, workshops and strategic interviews lead us to believe that we were able to create a relatively comprehensive picture of the legal needs of small businesses in terms of dispute resolution, legal counsel, contractual formalities, and access to credit and the government procurement process. This kind of information was then used to determine what we call the

unsatisfied legal needs (ULN) of small businesses, which can be used as an index to identify the various shortcomings of the system and design legal assistance programs for small businesses.

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

However, we believe that the phenomenon of informality should be taken into account when reviewing data resulting from this study. Many believe that “formality” equals access to justice, and that “informality” means lack of access. In other words, it is often assumed that when small businesses are not formally registered they are automatically precluded from accessing the judicial system, and that if they are formally registered they automatically have access to this system. Our findings do not support this hypothesis. On the contrary, the businesses that comprised our sample stated that they had serious access problems, despite the fact that most of them were formally registered. Another complication is that many businesses are registered before administrative or tax authorities and operate both formally and informally. Thus, distinguishing between formal and informal businesses from an access to justice point of view is often very problematic.

With regard to the second objective, that is, assessing the economic impact of not having access to the justice system, we believe that the findings are important and revealing. Our study unveils considerable evidence that judicial inefficiency leads businesses to adopt

practices to mitigate the risk of disputes. Thus, they are reluctant to change suppliers even if by doing so they could purchase supplies at a lower cost. Instead, businesses limit their transactions to safe-payment modes (cash) and they avoid investing, business expansion and business partnerships. These business decisions clearly illustrate how judicial inefficiency affects the productive sector.

In quantitative terms, we believe the data and the results are also illuminating. The methodology employed to quantify economic impacts enabled us to develop alternative scenarios regarding the effects of increases in the aggregated investment rate would have on economic growth. These findings build upon and are consistent with the findings of previous studies (Pinheiro, 1998; Sereno, et al., 2001) and they should serve as the methodological framework for designing future studies. Undoubtedly, the methodological model used to measure economic impacts can now be further refined. This would enable us to reanalyze the survey data and economic impact calculations, making it possible, for example, to measure the full impact that costs related to judicial delays and bribes have on the each business' cost base according to the size of the business' debts.

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

This study also provides important, new evidence regarding a series of inter-related problems concerning the manner in which the judicial system and the legal framework affect the development of small enterprises. These include the lack of affordable legal advice services for businesses, difficulties in accessing credit, the costs and negative con-

sequences of doing business informally and the precarious condition of property rights.

Two specific areas deserve special attention: problems related to entering into business relationships with the government at all levels (national, departmental and municipal), and corruption.

The data collected in this study appears to indicate serious problems regarding small businesses' ability to participate in the government procurement process in Peru. On the surface, there appears to be no significant legal or economic obstacles to active small businesses participation in this process; however, the experts consulted during this study indicated that the actual participation of small businesses is very low. Because there appear to be no monitoring and reporting mechanisms related to procurement, there are no accessible official statistics to review or analyze. Generally, most of those surveyed said that they were reluctant to engage in business with the government because it does not always comply with the obligations it enters into. Because small businesses are such a large and important sector of the Peruvian economy, and because the government is such a large procurer of goods and services, these issues obviously deserve much more attention. Additional research could focus on a number of key issues, such as the extent to which small businesses currently participate in the procurement system, the identification of the barriers to their participation and possible solutions.

The corruption issue came up repeatedly during the research. Small businesses noted how corruption pervaded myriad aspects of their business activities, including their relationship with the judiciary and the government procurement process (national and local), their relationship with the tax and regulatory entities and even their relationship with other businesses. In short, the corruption phenomenon has a significant effect on small businesses, imposing costs that either they or consumers ultimately pay for. Clearly, these costs act as a disincentive for businesses to

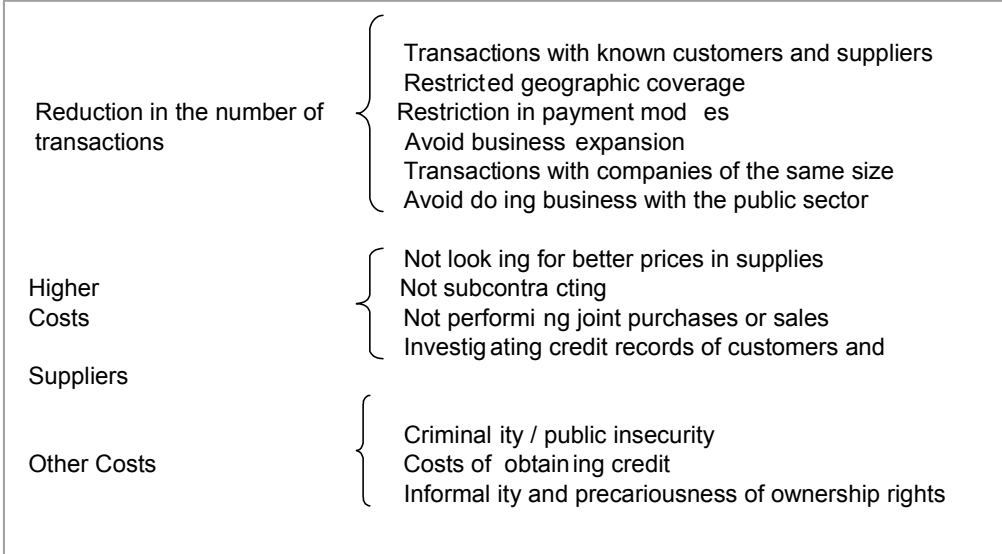
use the judicial system or enter into government contracts, although the latter costs are difficult to quantify.

The Way Forward

As noted in the first chapter, the main objective of this study was to analyze the dynamics between small businesses and legal institutions. More specifically, we set out to quantify the economic impact of judicial inefficiency on business development. We believe the study’s findings and lessons on these key issues should serve as a solid foundation upon which to undertake future research and design and implement reforms. Toward this end, we think it may be useful to share some of the lessons learned and present some final conclusions.

One of the lessons is that even though the analysis and findings presented in the preceding chapters shed considerably more light on the legal needs of small businesses, we believe it is now necessary to closely examine some of the high priority needs identified. This is particularly true with respect to the manner in which businesses utilize various alternative mechanisms and strategies to resolve disputes. In future research it would also be advisable to broaden the size and composition of the sample size in order to validate the trends presented here.³¹ It would also be useful to undertake more comparative research, since problems and priorities may vary across countries and sectors.

Box 1. Business Decisions that Result from Judicial Inefficiency



³¹ Regarding the findings on the relationship between SMEs and the judicial system, they are consistent with the conclusions of previous studies performed by the Instituto Apoyo.

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

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

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

We are keenly aware that quantifying the potential economic impact of hypothetical improvements to the Peruvian judicial system

has a number of problems and limitations. Some of them are methodological in nature. In particular, the assumption that there is a linear and steady relationship between capital and output, or between their rates of change, is too rigid in practice. The approach based on the fixed-coefficients production function ignores the endogenous quality of investment and market conditions that determine optimal input and factor ratios.³² Although the neo-classical approach incorporates relative prices and equilibrium conditions into the markets, it assumes, like the Leontief-Harrod-Domar approach, that the level of productivity in the use of factors is exogenous or steady. Even so, considering the limited information available, the assumption of linearity is practical and useful analytical approach to examining these issues.

The study's narrow scope, particularly with regard to the amount and type of information collected and analyzed from the surveys, is another overall weakness. The methodological model focuses on the impact on SME output and from there extrapolates the impact on overall investment and economic growth. However, it is clear that an improvement in the quality of the judicial system can have a positive economic impact through other mechanisms. On the one hand, an efficient judiciary may have an effect on the rate of technological progress³³ or increase the efficiency of existing factors of production.³⁴

³² For a critique of the short-term empirical validity of the ICOR factor based on the Leontief-Harrod-Domar approach, see Easterly (1999). Another problem with the ICOR calculation on the basis of the investment to growth rate ratio is that it does not take depreciation into account (i.e., the assumption is that gross fixed investment, for which there is data, equals net investment).

³³ For example, adequate protection of intellectual property rights (and of property rights in general) may increase investment in research and development and improve the likelihood of attracting foreign direct investment.

³⁴ A key case is that of the potential reduction of transaction costs (for example, in the search for information on customers and suppliers, in the renegotiation of contracts or in the resolution of

Additionally, it may have a positive impact on the rate of accumulation of other factors of production and, in particular, on natural resources (especially minerals) and human capital. Finally, even if attention were focused on the increase in sales and investment, this exercise ignores important dimensions of this issue. For example, it does not take into account the potential impact of improvements in the judicial system on the efficiency of the financial system, the volume of available credit or the access to credit. It also does not take into account the potential impact that increased sales may have on economic efficiency and technological progress.³⁵

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

- Expected increments in the annual rate of investment.
- Expected increments in employment.
- Projected expansion of the customer and/or supplier base.
- Expected impact on geographic diversification of sales and/or production (potential impact on the level of exports or the possibility of exporting).

conflicts, either through judicial channels or alternative ones).

³⁵ For example, through the exploitation of economies of scale or the increase in the number of suppliers and competitors, and how they might stimulate innovation. For a thorough and detailed analysis of the different mechanisms through which the judicial system influences production and a summary of the theory and existing empirical evidence, see the excellent essay by Pinheiro (1996).

- Expected impact on outsourcing.
- Expected impact on research and development or innovation activities.
- Expected impact on corporate structure and capital ventures.

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

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

Fourth, in the course of this study we identified a number of legal issues of particular relevance to SME, which would be very useful for future research or projects on the subject. For example, an assessment could be undertaken of results obtained from pilot projects dealing with small claim courts, SME legal advice centers and business registration programs.

Annex A.

Research Methodology

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

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

The survey instrument was designed by a multidisciplinary team made up of legal professionals, political scientists and economists. The questionnaire is comprised of two sections. The first section contains nine questions geared toward profiling the types of businesses surveyed. The second and main section includes 29 questions designed to assess how businesses perceive the judicial system, the level of formality and the frequency in the use of contracts, the mechanisms for resolving disputes, and the general impact of judicial inefficiency on business decisions.

The fieldwork was undertaken in Lima, Peru, between December 8 and 14, 2002. During this timeframe, IFES worked with MARC PERU, a Peruvian NGO well known for its work on alternative dispute resolution mechanisms and legal education and dissemination programs. A number of concrete activities were implemented in this phase of the study. First, we met with several experts and interviewed lawyers, judges, researchers, nongovernmental organizations, bankers and

government officials. These meetings provided a valuable opportunity to collect information regarding the Peruvian judicial system, the legal framework for SME development, public procurement processes in Peru and SME financing.

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

A first set of surveys was carried out in the Industrial Park of the District of Villa El Salvador, south of Lima, where small businesses representing many key sectors of the Peruvian economy are located. The six-person surveying team interviewed business owners or managers. Interviews typically lasted between 35 to 40 minutes each.

A second set of surveys took place during a national SME convention held at the Riviera Hotel from December 9 through 13, 2002.

A workshop was held on December 11, with thirty microenterprise and SME representatives from different sectors and regions of the country. The workshop lasted for approximately two and a half hours and focused on key issues raised in the survey as well as additional topics raised by participants. The workshop also served as a mechanism to validate and discuss the survey findings.

The survey sample consisted of 30 micro, 22 small and 14 medium sized enterprises. The criteria for classifying businesses into these

categories was based on the number of employees:³⁶

- Microenterprises: up to 10 employees.
- Small enterprises: between 11 and 20 employees.
- Medium enterprises: between 21 and 200 employees.

The business representatives surveyed in Villa El Salvador were between 25 and 50 years old. We also tried to strike a balance between men and women as well, although this was not done scientifically. The majority of those surveyed came from districts surrounding Peru. Most had lived in Lima for a long time. The youngest participants were born in Lima but they were second-generation immigrants. Approximately 10 percent of the participants refused to fill out the questionnaire because they said they were

afraid that the surveyors were, in fact, labor or tax agents. Others did complete the questionnaire because of time constraints.

The survey sample obtained during the SME convention was comprised of younger entrepreneurs, generally ranging from 25 to 40 years old. The sample also included businesses owned or operated by indigenous persons. Some of the businesses surveyed also had some exporting experience. Finally, some of those who answered the questionnaire also participated in the workshop.

Both samples contained many family businesses. It should be noted that even though the majority of the interviewees reported being legally registered as a formal enterprise, some of them stated that they conducted part of their activities in the informal sector.

³⁶ Classification was not based on annual income because businesses were reluctant to provide such information.

Annex B. Methodology

The methodology used for the quantification of the economic impact of judicial inefficiency on SMEs is currently only available in the Spanish version of this report, *El costo de la resolución de conflictos en la pequeña Empresa: el caso de Perú*. The methodology can be obtained from the authors.

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