

# SMES: TRUST AND JUDICIAL SYSTEM

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## Abstract

Italian SMEs share capabilities and routines that permit them to reach high level of competition. But in a global system that is affected by structural deficiencies and negative performance of judicial system, it is very hard to maintain high performances. In this work, starting from the resilience capacity of a group of SMEs of surviving to the crisis, we try to analyse the quality of the expectations of a sample of resilient firms. Our study leads to the hypothesis that the economic crisis is in line with a crisis of confidence in the judicial system. This is all the more serious when considering that this distrust is rooted in those firms located in Southern Italy, where the inefficiency of the judicial system is particularly pronounced.

**Keywords:** Entrepreneurship, SME's, Justice

## 1. ITALIAN JUSTICE AND NATIONAL PRODUCTIVE SYSTEM

It is well-known that an efficient judicial system is fundamental to economic growth and to civil society in general. Well-functioning judicial systems in particular sustain economic growth. However, it is also true that the time spent on legal processes reduces legal certainties, seriously affects the confidence of citizens and firms and increases the risks for economic activity. These factors result in more difficult access to banking credit and decrease the level of investment (as shown by the reports of Doing Business and of the World Bank). Furthermore, delays in justice compel firms and the economic system to adopt choices, corporate structures and types of behavior aimed at minimizing the risk of "stumbling" into a legal contention. A number of studies (Sherwood et al, 1994; Jappelli et al, 2005; Di Vita, 2010) have shown how slow and congested judicial systems lead economic systems and firms into making economically inefficient decisions. The choices firms make are mainly aimed at avoiding, where possible, the unknown risks represented by an indefinite legal process. This means that such choices must not only be economically efficient, but they also have to take into account the need to avoid the consequences of a malfunctioning judicial system. This results in a substantial decline in the competitiveness of the economy. The economic effects resulting from the inadequate performance of the civil judicial system weigh principally on firms as they are forced to work in uncertain regulatory conditions. This situation leads to an increase in the variables which negatively influence the total efficiency of productive factors, and is considered the main cause of the lack of national competitiveness. In fact, international comparisons of legal systems and the organization of justice show that Italy presents a significant number of negative records. From an economic point of view, civil justice, with its delays and its malfunctions, can cause:

– inappropriate or dishonest conduct by some firms, with negative consequences for the whole economy and a loss of confidence in them by other firms. Firms that exploit illegal labour in order to take advantage of lower production costs, or firms that are involved in corruption, tax evasion or counterfeiting, damage those that are law abiding and could force them out of the market. In such cases therefore, the ineptitude in enforcing the rules leads to distortion of competition;

– a pervasive uncertainty that decreases both domestic and foreign investments. This is especially serious in today's world where everything changes rapidly, necessitating complex commitments in order to adapt to different contexts.

The World Bank report "Ease of doing business", 2013, explores how the industrial environment supports entrepreneurship. Italy is in 73rd place due to the simplistic methods of company management. This is because of the complicated bureaucratic procedures required to obtain the necessary authorizations when setting up a new business, to the difficulty in accessing energy sources and utilities in general and to the limited capacity and efficiency in enforcing contracts (this aspect is linked to the different practices and times of justice). Furthermore, in the document "Italy 2015" published by Confindustria, the main unknowns and urgent reforms suggested for Italy included:

– the public administration, more specifically its institutional aspects, such as the complexities of the legal framework, the institutional context, the state of public finances, the amount of administrative costs, fiscal policy, and corporate laws;

– the civil judicial system. The document states "The timing of the processes is unreasonably long and this is unacceptable", and "the economic activity is exaggeratedly precarious, and this reduces the predisposition to invest, discourages the growth of the size of the firms, and also impedes the development of financial markets"

– the infrastructures.

According to a study by the CGIA Mestre in 2011 - summing the costs that Italian firms incur for delays in bankruptcy proceedings (1.03 billion euros), the cost of delays in first-degree and second-degree civil judgments (1.09 billion euros) and the bureaucratic costs related solely to bankruptcy processes (532 million euros) - the length of justice amounts to a financial burden of 2.6 billion euros a year for firms, including "costs related to the delays of the first and second degree of judgment, and the costs incurred by the firms in bankruptcy proceedings". Over the years the Research Department of the Bank of Italy has produced many studies and analyses in the area of Justice, claiming that the vulnerability of this "pillar between the institutions of a market economy" has resulted in uncertainty in "property rights, contracts, and promotion of competition". (Palumbo, 2009). Indeed, in its Annual Report in 2011 the Bank of Italy argued that the length of civil processes resulted in the loss of one GDP point for the Italian economy. This inefficient management of the judicial system occurred before the financial crisis. It was calculated that between 2005 and 2008, the costs for firms involved in some kind of process involving the judicial system amounted to 0.8% of their annual revenue. This resulted in a total cost for the company system of about 22.9 million euros, with notable differences in terms of both geographical location of firms and their size (costs for micro firms were about 3.5%, for firms with 10-49 employees it was 1.9% and 0.7% for those with more than 50 employees). In addition, the civil judicial system in Italy shows considerable territorial differences, mainly in relation to the length of proceedings. In fact, a first-degree sentence takes 306 days in the North West of Italy, but 590 days in the South. Consequently, the 480 days cited in a study of Cepej (2008), is the average number of days between these two very different realities. This difference includes the various types of legal process: labour, social security and assistance and ordinary cognition judgments etc. This longer period that prevails in the southern regions favors the widespread perception of illegality and arbitrariness in this territorial area, which is already stifled by a significant presence and penetration of criminal activities. Given these circumstances it is obviously more difficult to start or continue any kind of commercial activity in these areas. This lack of territorial homogeneity in terms of length and costs of justice is also reflected in some asymmetric procedures of the credit market both in terms of territory and in relation to the size of firms. To some extent, therefore, it can be reasonably argued that the levels of evolution/involution of the credit markets may be due to the higher/lower efficiency of the judicial system. As regards Italy, a number of studies on the performance of justice in Italian provinces (Felli et al, 2007), show that in those provinces with many delayed or on-going processes, credit is more rationed. The "collateral effect" of such banking decisions is due to the increase in interest rates applied by the credit system, rates that are influenced in some way by "slow" judicial proceedings. The higher the costs related to legal proceedings needed to enforce commitments and obtain credit repayments, the stricter the conditions applied on loans. In fact, when deciding the

monetary conditions on loans, banks seem to discount the prospective costs which they will incur in the event that the financed client defaults. This general trend produces a "crowding out" of private investments and of the multiplier effects related to them. Therefore, the slow pace of justice emphasizes regional disparities. In the regions where there is a greater number of pending cases, bank interest rates are higher due to the resulting uncertainty leading to greater difficulty in accessing credit. The main victims of such circumstances are the small southern firms. Consequently, in recent years, small southern firms have had to face many problems that have dramatically reduced their competitiveness. According to many studies (Cappellani et al, 2012; Marinangeli et al., 2011), some of these, such as poor infrastructure, the lack of uniform credit and organized crime, have a structural and "environmental" value and are physiologically connected to southern firms. Other problem areas are of an institutional nature and are also linked to the malfunctioning of justice, such as:

- disadvantages of localization (lower level of infrastructure and of social capital);
- difficulties related to small size, which reduce the capability of firms to organize counter-cyclical strategies;
- judicial processes that are "slower" than the national average, which often causes a more difficult and expensive access to credit.

In recent years these problems have been aggravated by the tragedy of the economic crisis which hit the financial and real economy of the country and its productive system. The crisis profoundly affected the competitiveness of domestic firms and their strength on the market. In this scenario, southern firms which had already started at a disadvantage, have seen their chances of survival decrease further. In previous studies (Gurrieri-Lorizio, 2014a) we carried out a partial empirical verification (Gurrieri-Lorizio, 2014b) and noted that in Italy there have been various disincentives in the economic system resulting from the malfunction of justice, including:

- a reduction in start-ups;
- the tendency to "loyalty of partnership" in trade relations, and the consequent difficulty to grasp the opportunities offered by a competitive system;
- the establishment of almost total monopolies - or monopsony - as a result of the value assigned to "other" factors rather than to strictly productive ones;
- the recourse to systems or aggregations of firms - such as family firms or industrial districts - where the contractual commitment is somewhat safeguarded by alternative forms of sanctions. The result is a deficiency in terms of business management;
- the propensity of firms to integrate vertically in order to remove all forms of interaction with other firms that may potentially lead to lengthy and costly legal contentions.

## 2. SMEs, FINANCIAL CRISIS AND JUSTICE

Some studies (Gurrieri-Lorizio, 2014a, Sherwood et al, 1994) have shown that the course of justice

considerably affects the choices made by firms, especially SMEs, which often make inefficient choices. It is, therefore, plausible that these effects were amplified during the financial crisis. The recession that affected the world economy in recent years has been deep and widespread. It has led to a decrease in the gross domestic product of the major economies and, consequently, a reduction in international trade. The Italian economy is among those that have suffered the consequences of the global recession to a greater extent. The crisis caused a serious fall in Italian exports, significantly greater than that which occurred in international trade. The strength of the Italian credit market partially stemmed the effects of the financial crisis. Despite the relative strength of the domestic banking system, however, the crisis was long and intense as a result of the increased cost of credit and of the reduction in loans to the firms sector, especially for smaller firms. Small and medium-sized domestic firms, on the one hand, provided considerable flexibility for the Italian production system while, on the other, they have also historically shown a number of structural weaknesses. In fact, the reduced size of the firms over time has not encouraged national SMEs to innovate products and production processes, to adopt new technologies or to increase their efficiency (Pagano e Schivardi, 2003). Instead, the small size of firms has made small and medium domestic firms more exposed to changes in the international context and to competition from emerging economies. The ability of SMEs to deal with the most vital markets has been weakened. As a result of the crisis, some firms have forced out of the market while others, in some respects, have shown an unexpected resilience and ability to reorganize. The theme of resilience emerges more often in studies on firm strategies (Gunasekaran et al., 2011) mainly as a result of the dangers for SMEs deriving from the international financial crisis and the globalization of competitive conditions. One aspect common to the "resilient" national firms consisted mainly in the adoption of specific forms of innovation - from the traditional to the most original - which permitted their "endurance" on the market. Many firms chose strategies of diversification of markets and customers, and improved the quality of their products (Bugamelli et al. 2010; Alberti, 2008 e 2012); others have mainly invested in R & D, thereby enhancing their performance (D'Aurizio and Marinucci, 2013). The link between innovation and a firm's performance is also confirmed by empirical analysis based on the estimation of a production function which includes the investment in research and development (R & D) among the inputs. In particular, these studies show a positive relationship between product innovation indicators (R & D) on the one hand, and productivity on the other (Klette and Kortum, 2004). As for Italy, Parisi, Schiantarelli and Sembenelli (2006) and Hall, Lotti and Mairesse (2009) found that investments in R & D expand the possibilities of developing a new product. But the innovation in question does not consist only in the creation of new products and more efficient production processes. Hall, Lotti and Mairesse (2012) also show that organizational innovation has positive consequences on the productivity of firms, which goes beyond production efficiency. In fact, the

capacity to innovate is also linked to a greater tendency towards internationalization, both commercially (through exports), and productively (through foreign direct investment). The upgrading of production, especially of the organizational process, has allowed a group of small sized Italian firms to obtain positive results even in areas that are relatively traditional and are the target of competition from emerging countries. In fact, some national enterprises have implemented strategies that reinforce their international market position through commercial and productive re-organization. Resilient firms also have more capital, equipment, modern machinery and cheap labour. They invest time both in customizing the after-sales services as well as in the use of information on sellers. The most interesting aspect of this is that some of these "resilient and innovative" firms are located in the South of Italy. The interesting characteristics of these Southern "resilient" firms are (1) their innovative productive strategies, (2) the entrepreneurial vocation of the owners and (3) a constructive relationship with the institutions. The functioning of the judicial system interacts with all these variables which are the basis of resilient firms.

- A defining characteristic of these firms is their investment in activities in the early and late stages of the production process. This is achieved through particular forms of organization/collaboration that are unidentifiable in the recognized models. This increase in "shared" upstream and downstream investment includes all activities that are made before, during and after the production process. These activities, in many ways comparable to services, include not only technology, but also marketing, design, product sales and after-sales services. In particular, these firms are very dynamic in the sector of custom-oriented production. In this way the goods sold have an added value that comes not only from their production in the strictest sense, but increasingly from "other" activities. This organizational structure is based on atypical forms of outsourcing and on interdependence of production, which result from the spread of the knowledge economy and innovation as well as from changes in the design and production. It is therefore different from the district model that characterized the Italian production sector for so long, and that in recent times has shown some signs of fragility. In fact, globalization and technological innovation have been critical for the district areas. The benefits from agglomeration, however, have not vanished completely, but have acquired even greater importance in relation to some aspects, in a context which promotes the sharing of innovation, research and human capital as strategic elements of competitiveness (Ricciardi, 2013). The competitiveness of firms is improved by the sharing of know-how and services. This implies that the supply chains are extended over the territory and become transversal to facilitate the crossing over of abilities and different practices. In particular, the peculiarity that has led to the resilience of some small and medium-sized domestic firms, also recently adopted by larger firms, is that of a localized and personalized production more closely linked to the "sense of place". In this sense, the firms and territories established a policy of "identity branding." The firms that were studied, and

that have acted as incubators in this case, have also fostered the creation from below of firms that have maintained and consolidated a profound attachment to their origins. Their production is "tailored" to their customers, from the design to the finished product, and focuses on customer interaction. In this way these firms occupy a market position which enables them to positively compete with emerging countries with low labour costs. We investigated these unusual types of relation among firms in 2006-7. In particular, we analysed a sample of Apulian textile SMES that generated some spontaneous forms of interaction, with positive results in terms of productivity and competitiveness. These small firms had good technical and problem solving abilities. They were also able to define and satisfy market innovation needs. This was due to the ability of both entrepreneurs and employees. These characteristics are still present today. Moreover, the economic crisis highlights the validity of this organizational model, based on sharing some strategic variables specific to each small unit (Sullivan-Taylor, Branicki, 2011). We believe that in negative periods this model acts by activating a capacity for resilience in small firms. At the basis of these sharing processes lies a relational trust between these firms and in the future of the economic system and its ability to defend economic actors. Thus, trust performances influence the organizational choices of firms.

- Justice also affects entrepreneurship. According to the model of the size of a firm proposed by Lucas (1978) and Himmelberg, Hubbard and Love's (2001) reflection on the circulation of entrepreneurial aptitude, the legal system concerns the growth prospects of firms. Where courts are more efficient, capital is reallocated from entrepreneurs with less entrepreneurial capability to those with more entrepreneurial aptitude. Entrepreneurship is contemplated as a social element that begins with a social perception, includes all the social institutions and cultural factors of the society in which it starts, and then becomes real. The view that education in general affects knowledge does not agree with entrepreneurship education, which is regarded as a personal predisposition for business (do Paco et al. 2013). Entrepreneurial development exhibits psychological and cultural components that strongly influence entrepreneurial behaviour in many spheres. Entrepreneurs structure their relations on friendliness links and opportunistic behaviour. Shaver (2003), and then Omorede et al. (2014) distinguished five characteristics of entrepreneurship behaviour. What are significant for a social entrepreneur's figure are personality and attitude. Moreover, on a personal level the intuition that helps to discern an entrepreneur from a non-entrepreneur is important. Another relevant element of these firms is their investment in training/education, necessary for the generational turnover. These, together with internal competencies, the progression of an entrepreneurial culture and a continuous modernization of the organization, are a critical passage for SMEs, in which the more resilient firms have already successfully engaged.

- In the light of recent related reform projects we would like to confirm the links between these

resilient firms and justice as an institution. We have tried to ascertain whether the course of justice affects the level of confidence of firms and if trust has undergone relevant changes as a result of the recent financial crisis. This level of trust is both an important element in the social capital of a country and a relevant input of a bigger production function.

In a previous analysis (Gurrieri-Lorizio, 2014) it emerged how the conditions of justice indirectly affect the relationship of trust "between" firms, especially in Italy. This is the result of the choice firms make to remain small, considered a defensive stance, rather than risking the probability of having to resort to legal safeguards by going to trial. In this way, an inefficient judicial system eventually also impacts on relations of mutual trust between firms. Pragmatic indications on the factors of firm size in Italy are limited, but in a recent study Cingano and Pinotti (2011) observed that more elevated degrees of relational trust are connected across Italian regions with greater firm size. Therefore, small dimension as a choice also entails, as a collateral result, a reduced confidence, both in the judicial system and in relations with other firms. In this paper we will analyze mainly the effects that the function of justice produces on the expectations of firms and their confidence in the system.

### 3. THE EMPIRICAL ANALYSIS

Having ascertained the effects of inefficient justice on firms in our other studies, our current aim is to identify whether the crisis has worsened the confidence of firms, and their perception of the effectiveness of the national judicial system. We have concentrated on small firms located in the Apulia region operating in the textile sector which we previously analyzed (Gurrieri-Lorizio, 2008). These firms were still active in the period 2008-2012, in the midst of the crisis. Those who survived the crisis, approximately 450 of an original sample of 700 firms, are resilient, contrary to the trend in the sector and the economy in general. The distinctive characteristic of these firms is the evolution of a unique and informal internal organization of labour, which we previously recognized. We therefore wanted to investigate whether the state of confidence of these resilient firms is somehow influenced by justice. In 2014 we distributed a semi-structured questionnaire with both qualitative and quantitative questions. The first part contains information identifying data of the firm and the entrepreneur; a second part is related to the type and length of the relationship between the firms in the sample; a third part concerns investment and technological innovation; a fourth part investigates the relationships between firms and institutions (public, credit and judicial). The response rate was 78% of the sample. For many firms the breadth and intensity of corruption is mentioned as one of the main causes that undermine their confidence in justice. At the same time, this phenomenon is an indicator of poor efficiency and operation of the national judicial system and its inability to affect economic relations. Corruption has a *grabbing hand* on firms, represented by the cost of bribes for firms. Moreover, the existence of this phenomenon

increases the degree of uncertainty on investment, because hidden agreements obviously can not be asserted in court. However corruption also implies a *helping hand*, because it makes economic activity easier, facilitating initiatives which otherwise would not be feasible, or in any case would be possible only over a very long period of time, and thereby raise the amount of costs and wages produced in the system. In relation to the small size of the firms, in addition to expenses that could be called improper, the spread of corruption also determines a waste of resources and energy, both economic and moral, such as loss of time and concentration and digression of ethical cornerstones essential to governing small production units, in which *intuitu personae* is fundamental. In literature, the effects of corruption on the production environment and distortion of competition between firms have been extensively studied primarily at a theoretical level (Murphy et al, 1993; Mauro, 1998; Bardhan, 1997). However, most of the empirical studies on the topic (Mauro, 1995; Pellegrini, 2011), suggest that the net effect of corruption on FDI is negative (or at least not significant). In fact, an increase of 1% in the level of corruption (as measured by the Index of Corruption of the International Country Risk Guide) determines a decrease of 11% FDI. From the questionnaire it emerges that the *grabbing hand* prevails over the *helping hand*, because it severely affects the confidence that domestic firms have in the ability of justice to bring down this hidden cost. From the considerations of the qualitative analysis, we believe that the confidence of firms - a dependent variable - will depend on a number of variables, some linked to the entrepreneur, (age, gender) and others to institutional factors (average days credit recovery, interest rate on loans, failure-bankruptcies, contacts with the judicial system). We performed a regression model (see tab.1) relating the selected variables to the trust-index elaborated by Istat. The R<sup>2</sup> value is 34.45.

**Table 1.** Regression results

<i>Dependent Variables</i>	<i>Prob.</i>	<i>Coeff.</i>	<i>T-Stat</i>
Constant	0.0000	0.185611	5.984140
Age	0.2184	0.158903	1.279186
Gender	0.2483	0.024554*	1.195404
Average days credit recovery	0.2763	-0.584298	-1.124724
Loans rate	0.7699	0.066687	0.297224
Failures	0.3238	-0.013705	-1.016224
Judicial Contacts	0.0783	-0.291939	-1.873718

Note: P\* < 0.05; P\*\* < 0.01

The value of the coefficients linked to some of the variables used is quite surprising. In fact, the age variable is not significant. This contrasts with what we assumed, as we expected young entrepreneurs to have more faith in the judicial system. However, it is not so disconcerting when considering the average age of entrepreneurs is approximately 40 years, and therefore they are all relatively young. The loans rate variable is not significant either and this may be obvious at a time when lending rates are moderate in an attempt to re-start the economy at a global level. On the contrary, *Average days credit recovery*, *Failures and Judicial Contacts* variables highlight a negative effect on the dependent variable. In relation to variables specifically linked to the judicial system

(*Failures and Judicial Contacts*), it is evident that the increased number of bankruptcies and more frequent contact between firms and the judicial court system can take on a negative value in an already uncertain context. The *Average days credit recovery* variable has the highest negative value, thus unfavourably affecting the dependent variable. The average number of days for credit recovery has increased in the last few years as expected and is in fact an unfavorable element for a healthy economic recovery. Although the resilient firms that were interviewed are active, this does not mean that they do not have debts to be repaid. For a firm that has to deal with many financial commitments, it is possible that the acquired debts are not considered one of the top priorities. The most surprising and positive note is the *gender* variable which shows how the number of female entrepreneurs is increasing and that they have more constructive expectations. This being the only positive aspect, the overall analysis depicts a scenario of pessimism and skepticism as regards the judicial system, even by those firms which have been able to deal effectively with the crisis and whose expectations for the future are bleak. It is therefore necessary to avoid the uncertainty generated by this situation which may lead to a stagnation of investment thus determining the paralysis of the economic system.

#### 4. CONCLUSIONS

SMEs build their internal and external relationships on ethical and professional trust. This trust is the prerequisite for sharing choices, whether productive or not, for the dynamism of the market and for expansion into other markets. A legal, social and fiscal system that does not promote the sharing and dissemination of ethical values also hinders growth, especially for small businesses, forcing them into short-term tactical compromises. Italian firms and families have been affected by the recent economic crisis to a different extent throughout the national territory. The small and medium-sized firms located in the South of Italy and that have already been penalized by lower productivity and poor competitiveness, are particularly disadvantaged. When added to these structural deficiencies, the negative performance of a national judicial system, which even in a stable economic context compromises the solidity of firms, has an even greater effect in a financial crisis. These negative effects of the malfunctioning judicial system affected the whole national system of firms, but have further aggravated the situation of relative weakness of southern firms. Despite these gaps, a significant part of Southern SMEs survived the crisis, showing remarkable resilience, due to their distinctive organizational and management characteristics. Based on these considerations, in particular with regard to the relationship between firms and the judicial system, we have tried in this paper to analyse the quality of the expectations of a sample of resilient firms. We assumed that the confidence of these firms, which is indicative of their expectations, is connected to a series of variables, some related to the entrepreneur, and others to institutional factors. The results have proved quite interesting. Our study leads to the

hypothesis that the economic crisis is in line with a crisis of confidence in the judicial system, according to the information collected from the entrepreneurs interviewed. This is all the more serious when considering that this distrust is rooted in those firms located in Southern Italy that have been able to deal with and overcome the crisis in an area where the inefficiency of the judicial system, at least in terms of time wasted, is particularly pronounced. The failure of the judicial system and the distrust that it generates in citizens and especially in firms, is firstly an ethical problem for the whole country-system. Moreover, it results in a substantial social cost that is negative for growth. The problems of the judicial system and their effects on the competitiveness of the productive system together with secure and transparent links between justice and competitiveness are both important aspects on which quick and appropriate action should be taken in order to promote sustainable development. In Italy it is essential to create and spread a sense of social belonging and social and civic responsibility (as demonstrated by Putnam) between political representatives, firms and citizens. The institutions with solid foundations, characterized by clear-cut rules, rewards and sanctions play a strategic role in this process. Firms should be encouraged to implement cooperative strategies in a context in which competitiveness is not seen only as a prerogative of a single firm, but of the whole system. To this end it is imperative to ensure a well-functioning judicial system, education and training and resistance to both obvious and hidden systems of organized crime or the coalition and patronage of interests that undermine the competitiveness of the underlying economic and social growth of a nation. Measures should be taken therefore in order to boost a global recovery not only in economic but also in social and, above all, moral terms.

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