Title: Internationalization of Italian SMEs and the role of judicial barriers

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Abstract

This work investigates the role of local institutions in the internationalization process of SMEs, considering the Italian manufacturing industry and SMEs' import trade flows between 2015 and 2019. In detail, we test the hypothesis of whether courts' ability to enforce contracts can amplify uncertainty on the GVC, discouraging foreign suppliers from performing international transactions. We interpret these expectations in terms of financial constraints, imagining that the quality of a legal system limits firms' access to local financial resources, which are essential to guarantee such operations. The proposed hypothesis is assessed considering alternative explanations that might characterize importers: absence of ex-ante business networks on the GVC (i), expected bankruptcy risks (ii) and asymmetric information (iii). Results are consistent to several robustness tests and, according to the collected evidence, we cannot reject the hypothesis that judicial quality might represent an institutional barrier to local SMEs, preventing their internationalization process.

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Extended abstract

Internationalization is one of the most relevant corporate strategies, representing an opportunity to improve their performance and to increase their competitiveness on the market, as well as an opportunity to grow for the territories where these firms are located (Minetti *et al*., 2019). Literature has focused on the barriers that might prevent this business strategy, emphasizing the role of financial institutions and firms' access to their resources (Chaney, 2016; Greenaway *et al*., 2007; Forte and Salomé Moreira, 2018), international institutions and the related agreements to promote such transactions (Rose, 2005; Belloc, 2006; Mansfield and Reinhardt, 2008), as well as the quality of local institutions (Levchenko 2007; Álvarez *et al*., 2018). Literature has also investigated the public interventions to mitigate the trade risks associated with the uncertainty of these international transactions (Egger and Url, 2006; Moser *et al*., 2008), as well as the private solutions introduced by the capital market (Van der Veer, 2015; Ahn, 2011; Crozet *et al*., 2022). Considering the former (i.e., export credit agencies), this instrument is commonly justified by governments to mitigate political risks for exporting firms in well identified and specific contexts (Heiland and Yalcin, 2021). Considering the latter (i.e., letter of credit), this type of intervention transfers the uncertainty from the exporter to the financial institution that issues a guarantee on importers' payment, implying that restrictions to the capital market could also represent a barrier to their internationalization process. Current literature corroborates this expectation suggesting that firms under financial constraints have a lower probability of being importers and, if they have such opportunity, they tend to import less amount of goods (Muûls, 2015; Aristei and Franco, 2014; Bas and Berthou, 2012; Fauceglia, 2015). On the other hand, literature also emphasizes that a poor legal environment might represent a barrier to the capital market, increasing firms' difficulties in collecting external financial resources to fund their strategies (Shvets, 2013; Ponticelli and Alencar, 2016; Falavigna and Ippoliti, 2023).

Considering these strands of literature, we expect that judicial inefficiency prevents firms' access to financial resources that might guarantee international trade flows and, in this way, it represents a barrier to the internationalization process. Disentangling these two dynamics, we provide a contribution to the current debate on whether institutions are a source of comparative advantage (or disadvantage) in international trades (Belloc and Bowles, 2017 Nunn and Trefler, 2014; Tag, 2021). Even if literature is widespread and rich of case studies, at the best of our knowledge, there are no works that explore the relation between quality of local institutions and internationalization of SMEs, focusing on the key role of financial constraints. We expect to fill this specific gap, verifying whether a relation between the unenforceability of contracts and the import trade flows exists, and explaining our evidence in terms of clients' difficulties in obtaining guarantees by local banks on such trades.

Our study proposes three steps. First, we discuss an agency game between importer and exporter, and a sub-game with the commitment of a local bank. According to the expected solutions, we hypothesize that the unenforceability of a contract can amplify the uncertainty in case of insolvency, preventing the internationalization process of SMEs. Second, to verify these expectations, we investigate empirically the relation between import trade flows by local clients and the delay in enforcing insolvency procedures by the competent local courts. More precisely, focusing on the Italian manufacturing industry, we investigate the internationalization process of private limited SMEs between 2013 and 2019 (more than 600,000 observations), and their import trade flows. On the one hand, we explore the relation between a set of representative proxies of the internationalization process (i.e., propensity, diversity, and intensity of import trade flows) and judicial delay in enforcing credit rights within the districts where these SMEs are located, testing our main hypotheses. On the other hand, we verify the robustness of our evidence to alternative hypotheses, i.e., absence of ex-ante business networks on the GVC (i), expected bankruptcy risks (ii) and asymmetric information (iii). Third, to emphasize the conclusions of our investigation, we extend the analysis to the relation between the outcome of the internationalization strategies and SMEs' productivity, verifying whether a higher access to the GVC can contribute to an improvement of their productivity.

According to results, increasing by one unit the bankruptcy delay within the district where SMEs are located, we observe lower odds of importing raw materials and semi-finished products by 0.6-0.7 (*p-value* < 0.01), as well as lower incidence rate ratios of having an additional foreign market by 0.8-0.9 (*p-value* < 0.01). Finally, results suggest that increasing the delay in enforcing bankruptcy cases by 1%, we expect to decrease the intensity of import trade flows by 0.6-0.9% (*p-value* < 0.01). Afterwards, considering the extension analysis, we observe a statistically significant positive relation between Total Factor Productivity (TFP) and the internationalization process of these firms.

The results are consistent to several robustness tests. We adopt a System GMM regression model (i.e., Arellano–Bover/Blundell–Bond), so that we can verify whether our results are robust to suspected endogeneity due to reverse causality between institutional change and international trade (Levchenko, 2013; Puga and Trefler, 2014). We also verify whether the collected results are affected by the market under investigation (i.e., the presence of tariffs and international agreements), and whether the observed evidence relies on the specific judicial procedure used as explanatory variable (i.e., mortgage foreclosure instead of bankruptcy).

The manuscript is organized as follows. Second section proposes an overview of current knowledge and our contribution, presenting an agency game with our key players (i.e., importer, exporter, and local bank), and then our hypotheses. Third section illustrates the data and method, highlighting the case study under investigation and the empirical strategy. Fourth section shows the collected results, and it discusses the main evidence. Finally, the fifth section presents practical implications for research and policy.