

# The Simplification of Debt Collection in Italy

TRAIN2EN4CE Project and Future Challenges

# La semplificazione del recupero crediti in Italia

Il Progetto TRAIN2EN4CE e le sfide future

*a cura di* Sara Tonolo



**Giappichelli**

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LUCIANO MAURO

EUROPEAN SMALL CLAIMS PROCEDURES,  
TRUST AND TRADE

TABLE OF CONTENTS: 1. Introduction. – 2. A simple scheme to rationalize the economic effects of ESCP. – 3. Formal and Informal Institutions to limit market failures.

*“Virtually every commercial transaction has within itself an element of trust, certainly any transaction conducted over a period of time. It can be plausibly argued that much of the economic backwardness in the world can be explained by the lack of mutual confidence”<sup>1</sup>.*

## 1. *Introduction*

In 2007 an optional procedure to solve claims under 2,000 euro was introduced by Regulation 861/2007 and successively this amount was increased to 5,000<sup>2</sup>. The new European Small Claims Procedure (ESCP from now on) eases the access to justice and

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<sup>1</sup> ARROW, *Gifts and Exchanges*, in “Philosophy & Public Affairs”, Vol. 1(4), pp. 343-362.

<sup>2</sup> Commission Delegated Regulation of 19 June 2017 replacing Annexes I, II, III and IV to Regulation (EC) n. 861/2007 of the European Parliament and of the Council establishing a European Small Claims Procedure, in *OJEU* of 13 July 2017, L 182, p. 1.

lowers the costs of claims. The first of the two objectives is reached through the use of standard forms across EU and e-mail based communications, the second objective by rendering optional the presence of lawyers, limiting the costs in case of unsuccessful verdict and by direct enforceability in case of successful claim without the need for a declaration of enforceability (*exequatur*). The regulation was introduced as a mean to increase consumer and business confidence also recognizing that the integration of the markets is not only a matter of large corporations that can afford the high legal costs of international litigations but also of regular citizens and small or micro firms. This is evident if one thinks of sectors such as tourism and e-commerce. As they thrive, involving common customers and small firms no more confined to their home country, so naturally increase the number of small claims. In what follows we try to rationalize in a simple scheme limiting technicalities and formalization, the economic mechanisms underneath the effect of institutions on market functioning. After a brief introduction of the effect of uncertainty upon welfare in chapter 2, in chapter 3 we discuss the possible effect of formal and informal institutions on trade and conclude.

## 2. *A simple scheme to rationalize the economic effects of ESCP*

A simple demand and supply scheme can shed some light on the mechanisms at work. In a perfect world without uncertainty and with symmetrical information among buyers and sellers, the price,  $P$ , is set such as to equalize the marginal cost of production of the good,  $Q$ , to the utility that the last unit of the good purchased gives to consumers<sup>3</sup>:

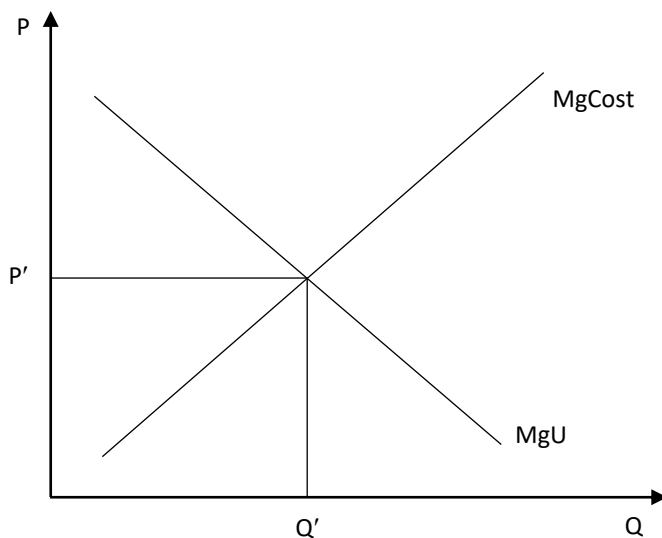
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<sup>3</sup> This occurs in the case of quasi-linear preferences. In facts at the optimum

$$P = Mg.Costs(Q) = Mg.Utility(Q)$$

The condition above leads to the familiar graph of supply and demand:

**Figure 1**



When we introduce uncertainty things can change and sometimes degenerate up to the total collapse of the market. Let's assume, for the sake of simplicity, that uncertainty concerns only the possibility of the buyers being insolvent and that firms are risk neutral. As for the supply, firms will still equate the price to

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consumers considering the choice of bundle made by two goods,  $x$  and  $y$  set the marginal rate of substitutions equal to the price: the price ratio  $p_x/p_y$  equals MRS at the optimal bundle, which in turn is equal to  $MU_x/MU_y$ . So, setting  $y$  as a numeraire good, so  $p_y=1$ , we will have  $p_x=MgU_x/MgU_y$ . Clearly  $p_x=MgU_x$  can only occur if  $MgU_y$  is always 1, that is the case when one assumes utility to be linear in  $y$ .

marginal costs but it will be now an expected price since there is a risk of credit default. Assuming a probability  $q$  that a client does not pay the due price, the expected earnings of the firm is  $(1-q) \times P$  and the condition for the firm becomes:

$$\text{Price} = Mg. \text{ Costs}(Q) / (1-q)$$

It is evident, as it is shown in Figure 2, that in this case, the entire supply curve moves up to the left lowering the quantity supply for any price. This negative effect can be exacerbated whenever we abandon the assumption of risk neutral firms. Risk neutrality is reasonable for medium and large enterprises but less so in the case of small firms. In fact, large corporations with large capitalization and run by managers are likely to behave as risk neutral agents but small firms, possibly family owned, or artisans and independent workers in general are likely to be risk averse since their assets are expected to be not much diversified. In that case, as Baron<sup>4</sup> in 1970 shows, the firm's supply decreases as the uncertainty increases and risk averse firms will demand higher price in exchange, shrinking the market size even further.

On the other hand, also the demand is affected by uncertainty, typically about the quality of goods supplied. The problem of asymmetry of information about the quality between the sellers and the buyers is at the core of the field of contract theory since the breakthrough contribution of Akerlof<sup>5</sup> in 1970. Under uncertainty about the quality buyer will demand less for every given price the more so the greater is the risk aversion of the buyer. Let's say, again for the sake of simplicity, that there is a probability  $v$  that the good is not working at all yielding zero utility, then for the buyers the following condition holds:

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<sup>4</sup>D. BARON, *Price Uncertainty, Utility, and Industry Equilibrium in Pure Competition*, in "International Economic Review", 11, (3), 1970, pp. 463-80.

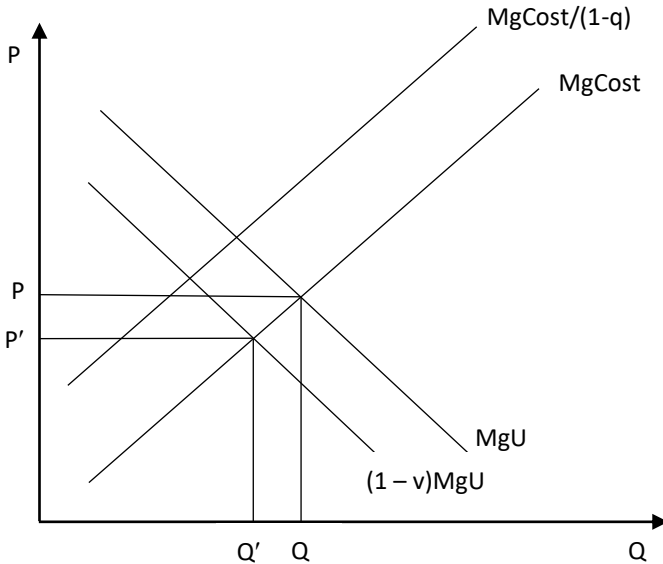
<sup>5</sup>AKERLOF, *The Market for 'Lemons': Quality Uncertainty and the Market Mechanism*, in "Quarterly Journal of Economics", 1970 (3), pp. 488-500.

$$Price = (1-v) Mg.Utility(Q)$$

As it's apparent the demand shifts to the left-downward as consumers demand a lower price for every unit since now the expected marginal utility is less than the marginal utility in the certain case.

Clearly the simultaneous shifts of both demand and supply could lead to a sensible shrink of the market (PxQ) with large welfare loss. When one considers all the welfare losses in all markets, the potential GDP loss in the aggregate can turn out to be substantial.

**Figure 2**



In his paper “The Market for ‘Lemons’: Quality Uncertainty and the Market Mechanism”, Akerlof shows how whenever the asymmetry concerns the quality of the goods it can induce a vicious dynamics leading to a collapse of the entire market. The

idea is that when the probability  $v$  is not constant but changes in response of the transitory equilibrium, as the number of high quality goods decreases so does  $(1-v)$ , then the market shrinks period after period till the market for high quality goods disappears. In the less severe scenario where the initial uncertainty does not induce further crowding out of trade we still have potential substantial welfare gains if suitable institutions are established to lower uncertainty<sup>6</sup>.

### 3. *Formal and Informal Institutions to limit market failures*

Institutions have been developed to limit and/or overcome the market failures we described above, and in the end we can rationalize their intervention as lowering  $v$  or  $p$  or both.

North<sup>7</sup> would distinguish between formal institutions (rules, laws, constitutions) and informal ones (norms of behaviour, convention, and self-imposed codes of conduct). Both types contribute to define the de facto rule of law and the actual functioning of public and private institutions.

Obviously, a natural answer to limit the market failure in trade is the building of judicial institutions<sup>8</sup>. Courts, arbitral tribunals and quasi-judicial institutions that guarantee the rule of law, and in our context, the respect of the terms of contracts (together with security institutions) they all represent the formal institutional

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<sup>6</sup> A set of institutions like third party certifications, certification of origins, quality marks, are all means to lower the asymmetry of information we discuss above. In the end they bring an *ex ante* signal able to distinguish high quality goods from the low quality ones lowering the value of  $v$ . Nevertheless they cannot totally eliminate uncertainty and they suffer by free rider effects.

<sup>7</sup> NORTH *Institutions, Institutional Change and Economic Performance*, Cambridge-New York, 1990.

<sup>8</sup> See DAM, *The Judiciary and Economic Development*, in "Chicago Law & Economics", Olin Working Paper n. 287, 2006.

answer to tackle the market failures<sup>9</sup>. An efficient judicial system able to solve the inevitable controversies that trade implies is fundamental in particular to foster cross-borders trade both for its *ex post* effect as well as its *ex ante* effects of deterrence<sup>10</sup>. Indeed, without the possibility to settle future possible controversies by an independent judge, no party would easily engage in exchange at all. What is also evident is that the trust in judicial system is important. A high trust in the judicial system can also deter parties from defaulting the agreed terms of contract.

The importance of the trustworthiness and the efficiency of the judicial system is therefore crucial for the deterrence effect and virtuous dynamics can take place as the more it is trusted the lower is the expected number of claims<sup>11</sup>. In this respect any regulation that succeed in lowering the costs of judicial system both in term of direct costs as well as opportunity costs (e.g. time) as it is the case of the ESCP, could represent an important additional instrument to lower the risk in transactions. Measuring the success of ESCP could be less trivial however. The deterrence effect could bias downward the number of claims questioning it as a good measure of the ESCP's success.

Indeed, the possibility of suing the defaulting party of the contract is also the pre-condition for the existence of other institutions which are able to alleviate the market failures we discussed: the financial institutions. In facts, risk neutral financial institutions, private and public ones, are able to bear the costs of collecting the information about the solvability of the two contracting parties

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<sup>9</sup> See TODD, ZYWICKI, *The Law and Economics of Consumer Debt Collection and its Regulation*, in 28 "Loy. Consumer L. Rev.", 167, 2016, pp. 167-236.

<sup>10</sup> See on this: RIZOS, KAPOPOULOS, *Judicial Efficiency and Economic Growth: Evidence based on EU*, data MIMEO, University of Piraeus May, 2021, pp. 1-54.

<sup>11</sup> RIZOS, KAPOPOULOS, *Judicial Efficiency and Economic Growth: Evidence based on EU*, cit., pp. 1-54.



and by diversification eliminate the risk of transactions. They create financial instruments as “credit letters” for example, that anticipate credits between parties at a discount and in so doing they ease transactions<sup>12</sup>. Fisman and Love<sup>13</sup> in 2001, show the importance of trade credit for trade and development. Nevertheless such insurance instruments are not for free and small transactions are basically excluded.

Indeed some type of insurance contract used to be embodied in the activity of traders since the mists of time. Whenever payment is postponed there is an implicit financing service and an act of trust from the seller that drives down the uncertainty for the buyer. Nowadays, the development of e-commerce has led to the creation of cross borders platforms (Amazon, E-bay, Google etc.) that together with the logistic services they offer insurance to customers across all Europe<sup>14</sup>. They do it in two ways. On one hand they collect and share information about the reputation of the sellers as well as about the quality of goods and service supplied. The information is constantly updated by costumers’ feedbacks and this help to build up trust among parties<sup>15</sup>. On the other hand, these large e-commerce enterprises guarantee the refunds bearing the costs of possible claims. All this, however, is not for free. Clearly, even if it is hidden in the final price of goods, the cost of this type of “insurance” is not marginal for both the sellers and the buyers. Moreover,

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<sup>12</sup> FREEMAN, *The Economics of Trade Credit: Risk and Power*, 2020, SSRN: <http://dx.doi.org/10.2139/ssrn.3235838>.

<sup>13</sup> FISMAN, LOVE, *Trade Credit, Financial Intermediary Development, and Industry Growth. Policy Research Working Paper*, n. 2695, Washington DC, 2001.

<sup>14</sup> On this point see: FALK, HAGSTEN, *E-Commerce Trends and Impacts Across Europe*, UNCTAD Discussion Papers paper n. 220, March 2015, as well as DIACON, DONICI, *E-commerce across European Countries*, CES Working Papers, 2011, 3(3), (3), pp. 390-397.

<sup>15</sup> See MELNIK, ALM, *Does a Seller’s Ecommerce Reputation Matter? Evidence from eBay Auctions*, in “The Journal of Industrial Economics”, 2002, Vol. 50, n. 3, pp. 337-349.

the high entry cost and the economies of scale, characterizing the e-commerce sector, generate monopoly power which in turn implies high mark-up over costs and possible unfair practices. As a matter of fact, unfair practices by some leading e-commerce platforms have recently been subject of investigation by the European Commission.

Another type of institutions affecting transactions are those of the informal type. A set of unwritten norms determine auto imposed behaviours or moral restrains from misbehaviours. They typically rise when the interactions among parties are repeated processes as suggested by game theory. In fact, the main message of game theory is that cooperation among parties is the most probable outcome when games are repeated whereas non-cooperation prevails when they are not. As Arrow<sup>16</sup> stated, trade involves some type of trust to induce cooperative behaviour since both parties, as in the prisoner's dilemma, decide not to cheat for they trust the other party will not. In the long run, trust can emerge when repeated interactions among parties create a set of common shared believes on each party's behaviour or when past history or common cultural traits create an environment of trust (or less distrust) embodied in a set values affecting moral costs. The network of Maghribi traders of the eleventh-century Mediterranean, is a very much quoted example of network of traders without formal legal institutions (see Greif<sup>17</sup>). More recent examples are New York diamond traders belonging to Jewish orthodox community who do not use contracts. These networks of culturally homogeneous traders are bonded by social norms. Deviations from the

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<sup>16</sup> ARROW, *Gifts and Exchanges*, cit., pp. 343-362.

<sup>17</sup> GREIF, *Cultural Beliefs and the Organization of Society: A Historical and Theoretical Reflection on Collectivist and Individualist Societies*, in "Journal of Political Economy", 1994, 102 (5), pp. 912-50. For a critical alternative view see the contribution of EDWARDS, OGILVIE, *Contract Enforcement, Institutions and Social Capital: the Maghribi Traders Reappraised*, in "Cambridge Working Papers in Economics", 0928, 2009.

community's code of conduct imply severe social costs<sup>18</sup>.

When we enlarge the perspective from groups to the society and across societies of different nations, some measure of trust is needed. The World Value Survey and the European Value Survey collect surveys upon several sociological dimensions and in particular data about how much people trust other people of the same country or other country's people, or how much they trust institutions like their government, Judicial System or Police. From these data set it emerges a complex picture characterized by large cross-country variability of trust levels both among people within the same country or regions, but also a large variability of trust across people of different nationality.

Guiso, Sapienza and Zingales in 2009 and Yu, Beugelsdijk S. and de Haan<sup>19</sup> in 2015 report matrices showing cross trust on people belonging to different countries. In general Nordic countries are very much trusted by all others and Nordic people have more trust in people of other countries on average. People of the Mediterranean countries show instead the lowest values. When the authors analyze the effect of trust on trade they find a important effect. Trust appears to ease trade as expected. Den Butter and Mosch<sup>20</sup> in 2003, in their analysis of trade and trust, control also for the cross-country similarity of the judicial system. They find that countries with similar judicial system trade from 46% to 80% more than countries which differ. This is definitely an evidence in favor of the standardization of judicial procedures and thus a point in favor of ESCP. However they also report that differences

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<sup>18</sup> GUISO, SAPIENZA, ZINGALES, *Cultural Biases in Economic Exchange*, in "Quarterly Journal of Economics", 2009, 124 (3): pp. 1095-1131.

<sup>19</sup> YU, BEUGELSDIJK & DE HAAN, *Trade, trust and the rule of law*, in "European Journal of Political Economy", 2015, 37, pp. 102-115, <https://doi.org/10.1016/j.ejpoleco.2014.11.003>.

<sup>20</sup> DEN BUTTER, MOSCH, *Trade, Trust and Transaction Costs*, Tinbergen Institute Working Paper n. 2003-082/3, 2003, Available at <http://dx.doi.org/10.2139/ssrn.459501>.

in trust are responsible for the missing trade among countries. As an example, they find that, without the (lack of) trust effect, Germany and Greece would double their trade. Yu, Beugelsdijk S. and de Haan<sup>21</sup> model carefully the interlink between formal and informal institutions and in turn their link with trade. They find that when the quality of judicial system is high the trust dimension is statistically less important, confirming what explained above that is that informal institutions and formal institutions are somehow substitutes. In line with Guiso, Sapienza and Zingales<sup>22</sup>, Yu, Beugelsdijk S. and de Haan<sup>23</sup> find that trust is more important when the quality of goods is difficult to assess. This is in line with what discussed above: when quality is uncertain, reputation and long run trust among parties is crucial since complete state-dependent contracts are difficult to write and claims of misconduct difficult to prove. They also report that quality of institution is instead more important for homogeneous goods and for exporters in general since the main risk is the default of importer.

The main lesson stemming from this literature is that both the quality, efficiency and homogeneity of judicial system are very important elements to foster trade but it also arises that mutual trust is important. Trust however takes much more time, sometime centuries, to be built compared to the time that formal institutions require. In other words, informal institution have large temporal inertia and a country could end to be trapped into a low welfare equilibrium when these informal institutions are not trade enhancing. Clearly, the policy recommendation for these countries is to invest more in the efficiency and efficacy of formal

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<sup>21</sup> YU, BEUGELSDIJK & DE HAAN, *Trade, trust and the rule of law*, in “European Journal of Political Economy”, 2015, 37, pp. 102-115. <https://doi.org/10.1016/j.ejpoleco.2014.11.003>.

<sup>22</sup> GUIZO, SAPIENZA, ZINGALES, *Cultural Biases in Economic Exchange*, cit., pp. 1095-1131.

<sup>23</sup> YU, BEUGELSDIJK, DE HAAN, *Trade, trust and the rule of law*, cit., pp. 102-115.

institutions<sup>24</sup>.

The case of ECPM is perfectly in line with this policies recommendation. ECPM fosters efficiency and increase homogeneity of legal procedures among countries, it also enlarges the judicial protection to common citizens. Finally, in so doing, ECPM increases interconnections and favor the building of trust among Europeans as a by-product and in this respect the positive welfare as well as political impact of ECPM could be greatly underestimated.

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<sup>24</sup> YU, BEUGELSDIJK, DE HAAN, *Trade, trust and the rule of law*, cit., pp. 102-115.