The Shadow Economy and Its Impact on National Competitiveness: The Case of Slovenia

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Abstract:

The paper presents a socioeconomic analysis of the phenomena of informal economic activity. It is argued that the shadow economy has been beneficial for Slovenian society since the 19th century and has significantly contributed to the success of the Slovenian economy under the socialist regime. During Slovenia's transitional phase it has stimulated the formal economy, soothed social tensions and allowed export-oriented enterprises to remain internationally competitive by paying lower wages and obtaining cheaper inputs. However, it hinders innovation, impedes entrepreneurship and maintains the status quo, and thus represents an obstacle for future economic development in Slovenia.

Keywords: shadow economy, Slovenia, competitiveness, socioeconomic analysis

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1. Introduction

The shadow economy is a phenomenon that is to a certain extent present in all world economies. It started to attract scientific interest no earlier than the 1970s (Schneider, Enste; 2002) and has since been looked at from many different angles. It has been often found to be an obstacle to free competition that in the end reduces the potential GDP of a country (Fleming et al, 2000). Although it reduces potential fiscal revenues and thus undermines a state's ability to provide public goods, it can not be treated as entirely unconstructive. For example, the shadow economy provides for basic needs and gives income to the people, especially in poorer countries (Fleming et al., 2000). Other researchers have stressed the view of the shadow economy as a realm of hidden enterprise culture that should be harnessed, rather than deterred, and brought into the formal economic sphere (Williams, Windenbank; 2006). In countries in transition it is viewed as an integral part of this process by relieving social tensions and is assumed to diminish in size as conditions that favor its development (high unemployment, lack of legal framework, heavy tax and social security burdens, bureaucracy) normalize and the country adjusts itself to a market economy.

However, we believe that the shadow economy in Slovenia is not just a transitional phenomenon, because it has not significantly declined by the end of transition. Rather, it is an integral part of the country's institutional environment. We assert that it is deeply embedded in the Slovenian business system and is one of the most important "background institutions" (Whitely, 1992) or "contextual factors" (Jaklič, Zagoršek, 2002) that have patterned the social behavior of Slovenian actors over the last two centuries. It has been beneficial for Slovenian society since the 19th century

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and has significantly contributed to the success of the Slovenian economy under the socialist regime. The upsurge in moonlighting activities at the beginning of transition (1990s) was therefore just a natural extension or adaptation of old, deeply entrenched practices, inherited from the past.

Further, we believe that the shadow economy has become an important obstacle to future economic development in Slovenia, as the country is striving to move from an efficiency- based economy to an innovation-based society (Jaklič, 2002). It hinders innovation and maintains the status quo in terms of economic paradigm, which is not sustainable in the long run.

Public authorities would generally attempt to control the shadow economy by prosecution, punishment and education. Some hope for diminishing the shadow economy would also be put on general economic growth (Schneider, 2004). However, should the action against the shadow economy be effective, one needs to understand its underlying causes. These causes are often and at least superficially similar between different countries, e.g. taxes or regulatory burden. Yet underneath these general issues there are important specific triggers that differ from country to country. In the example of Slovenia, we want to show the importance of understanding a broader institutional context when explaining the shadow economy.

In the first section we define the shadow economy and discuss some of its characteristics, especially within transition countries. In the second section we present the data on the persistence of the shadow economy in Slovenia. We add data on economic categories that are considered to have the most impact on the shadow economy. The third and fourth sections are dedicated to socioeconomic analysis of the historical development of the shadow economy in Slovenia before and during the transition period, showing its historical embedment in Slovenian economy and society. The fifth section discusses the problems and challenges that Slovenia faces on its path to an innovation-driven economy, while the last section analyses the negative impact of the shadow economy on competitiveness and the long-term development of Slovenian economy. The paper concludes with a discussion on research limitations and suggestions for future research.

2. Characteristics of the Shadow Economy

There is extensive disagreement among scholars regarding the name applied to the phenomenon of informal economic activity. Apart from the shadow economy, it is also called the grey, unofficial, parallel, underground, hidden or even black economy. Similarly, there exist a number of different definitions of the shadow economy, each focusing on a particular type of informal activity. Schneider and Enste (2000, 2002) define it as "all economic activities, which should be included in the added value, but such a recording is prevented by evasive strategies of private sector. Smith (1994) defines it as "market based production of goods and services, whether legal or illegal, which escapes detection in the official estimates of GDP." Alternatively, Feige (1990) focuses on whether the economic activity adheres to the established, prevailing formal institutional rules of the game. "Adherence to the established rules constitutes participation in the formal economy … whereas noncompliance or circumvention of the established rules constitutes participation in the informal economy (Feige, 1990). Similarly, Portes et al (1989) state that the informal economy is "unregulated by the [formal] institutions of society, in a legal and social environment in which similar activities are regulated." The European Commission (2004) in its report prefers to use the term "undeclared work" instead of "shadow economy" and defines it as "productive activities that are lawful as regards to their nature, but are not declared to the public authorities, taking into account the differences in the regulatory system between the Member States."

Fleming et al. (2000) and Schneider and Enste (2002) divide the shadow economy into four broadly comparable components: the criminal, irregular, household and informal sectors. The criminal sector is defined as illegally produced goods and services, such as the production and trade of illicit narcotics. The irregular sector is defined as legally produced goods and services that evade legal reporting requirements, such as tax evasion. The household sector consists of household production. And the informal sector is defined as economic activities that circumvent the costs and are excluded form the benefits of law, such as unregulated microenterprise. In our analysis we concentrate mainly on latter three sectors, disregarding purely criminal activities.

The characteristics and drivers of the shadow economy differ for countries on different developmental levels. The shadow economy in the OECD countries is usually attributed to high taxation and onerous labour regulation. In less developed countries (LDC), the driving forces are usually tax and regulation avoidance, corruption and general distrust of citizens towards the political system (Gerxani, 1999). Although the abovementioned aspects are relevant to transition countries as well, Kaufmann and Kaliberda (1996) identify additional dimensions of the shadow economy specific to them: a coexistence of state and non-state activities and enterprises in the unofficial economy; considerable visibility and size of unofficial activities; unofficial activity is mostly nonviolent and non-criminal; activities exist on a continuum in the official/unofficial spectrum – many activities operate in both; social services and state subsidies are accessible to unofficial activities; and the unofficial economy is shallow or sensitive to economic incentives from governments relative to other regions of the world.

The researchers mentioned above suggest that more than in other countries of the world (OECD or LDC), transition economies need relatively minor changes in some government policies and formal institutions, such as reduction of total tax and social security burdens as well as simplification of bureaucratic procedures, to drive the majority of the shadow economy into the formal sector. While we agree with that, our article goes further to argue that a broad institutional context should also be taken into account when explaining the reasons for the shadow economy and we support this assertion with the case of Slovenia. Our analysis shows that the shadow economy has been historically embedded in Slovenian society, a part of the generally accepted "rules of the game," and that the shadow economy and its surrounding institutional setting mutually support each other. As such, the Slovenian shadow economy makes a strong case for the institutional approach to its study and the following paper shows that in order to reduce the extent of the shadow economy, much more is needed than mere tax policy modifications. The following section supports this view by showing that the persistence of the shadow economy in the case of Slovenia can not be explained only by traditional variables e.g. GDP p.c., GDP growth or tax burden, but must be considered from the institutional setting point of view.

3. Persistence of the Shadow Economy in Slovenia

At the beginning of the transition and during the 1990s, the Slovenian shadow economy was considered to be relatively small in comparison to other transition countries (Schneider, 2000; Lacko, 2000, Eilat, Zines, 2000).

Author	***Slovenia***	***Czech Republic***	***Slovakia***	***Poland***
Schneider, 2000	28,6	28,7	30,6	31,8
Lackó, 2000	31,2	31,8	32,0	31,7

Table 1: Size of shadow economy in Slovenia, Czech Republic, Slovakia and Poland as % of GDP for 1992 (Lackó) and 1993 (Schneider)

Source: Lacko, 2000; Schneider 2000

Yet data after the year 2000 show that this is no longer the case. Schneider (2004) identified the Czech Republic, Poland and Slovakia to have smaller shadow economies than Slovenia. Detailed data can be seen in the following table:

Slovenia	***Czech Republic***	***Slovakia***	***Poland***
29,4	20,1	20,2	28,9

Table 2: Size of shadow economy in Slovenia, Czech Republic, Slovakia and Poland as % of GDP for 2002/2003

Source: Schneider, 2004

Similarly, in the 1999 World Competitiveness Yearbook (IMD, 1999), Slovenia was ranked last out of 45 countries earning 2,19 points out of 10 for the "degree to which parallel economy impairs economic development in the country." Three years latter, in WCY 2002 it was ranked next to last, before Argentina, but after Russia, India and other transition countries (the Czech Republic, Hungary, Estonia, Slovak Republic, Poland). In the 2003-2005 period it kept being placed near the rear, where it was but then that was already behind the Czech Republic, Slovakia and Estonia (IMD, 2004, 2005, 2006).

At the same time it should be noted that among all the compared countries, Slovenia has since 1993 constantly exhibited the least volatile GDP growth, was not hit by any recession and has remained at the forefront of ex-socialist countries concerning GDP p.c. in nominal and PPP terms (Eurostat $_{(GDP)}$, 2007). Inflation has been kept under control at moderate single-digit levels and has been slowly declining (Eurostat $_{(INFL)}$, 2006). The real exchange rate has been relatively stable throughout that time (ZMAR, 2006). Unemployment has decreased since 1995 and has been relatively lower than in other transition countries (Eurostat $_{(UNP)}$, 2006). Overall, the macroeconomic performance of the Slovenian economy was significantly better than that of other ex-socialist counterparts. Taxes on income and wealth as a share of GDP have risen slightly throughout the transition period in Slovenia. However, they have been in line with other transition countries and are far lower than those of EU-15 economies (Eurostat $_{(TAX)}$, 2006).

Furthermore, from 1995 onwards Slovenia has been heavily engaged in the implementation of *Acquis Communautaire* and it could be rightly argued that it has improved its public governance and regulatory restrictions during the process of accession to the EU, which was concluded in 2004. Corruption had never been a large problem in Slovenia and decreased throughout the studied period (Open Society Institute, 2002).

However, despite these favourable, or at worst neutral developments, the shadow economy in Slovenia has not declined significantly and continues to persist on a relatively high level. While economic development has helped to reduce the shadow economy in some other ex-socialist countries, this has not happened in Slovenia.

This speaks in favour of our hypothesis that the shadow economy is a deeply embedded institution and that it is influenced by numerous factors that go beyond the neoclassic explanation of economic activity.

Further empirical support for the thesis that informal institutions have a significant impact on the extent of the shadow economy is provided by Schneider (2000), who observes that Anglo-Saxon countries (US, Australia and United Kingdom) all have relatively small shadow economies (8,8%; 13,1% and 8,3% of GDP respectively) although the amount of total tax and social security burdens (formal institutions) varies considerably (41,4%; 54,9% and 70,4% of GDP respectively).

In the case of the shadow economy in Slovenia, the combined influence of (economic) history, values and a culture of local mutualism obviously continues to prevail over the influence of economic growth and global market pressures. While further simplification of the complex tax code and reduction of high marginal tax rates would be beneficial with regard to diminishing the shadow economy, it would not be enough. The next sections are dedicated to an explanation of the evolution of the shadow economy in Slovenia.

4. Slovenia's Shadow History: from Village Mutualism to Socialist Market Economy

In the 19th century "moonlighting" was essential for the survival of Slovenian peasants and their communities. After the abolishment of feudalism in 1848, Slovenian farmers were stuck with small farms, which they had to buy from previous landowners. In order to do so, they had to take loans in newly created saving and mortgage banks. They were heavily taxed by the Austro-Hungarian Empire due to military needs for the protection of borders. In addition, the hereditary rule stated that the heir had to pay a fair share of the inheritance to his brothers and sisters in money, or the farm was divided in equal parts. Because of that, and because of the rough farming conditions of the mountainous terrain, small farmers were prevented from accumulating wealth and discouraged from embarking on any entrepreneurial activity that would enable them to improve their farming conditions (Kristensen, Jaklic, 1998). Even today, after one and half centuries, Slovenian farms are extremely small compared to other European countries[1].

From 1868-1890, peasants all over Slovenia were constantly living in a state of crisis, struggling to produce enough to be able to pay rent, taxes and inheritance claims. Few farmers would embark on entrepreneurial activities to improve agricultural productivity and thus restructure farming communities. Rather, they began to cooperate and help each other within their local communities. They started producing wooden crafts or textiles and offering various services on the local "gray" market. United in the face of a "foreign occupier," they gradually institutionalized a system of reciprocity of services and help among neighbors. If this system prevented farmers from engaging in a capitalist process of modernization, it simultaneously prevented the farming communities from destroying their traditional village mutualism and co-operation. Rather than participate in an economy built on principles of market exchange, they developed a system that could be kept secret and untaxed from the Empire authorities and which for these very same reasons had a high degree of legitimacy among the population.

The problem was that this unofficial, "hidden" economic system could not by itself generate the incomes necessary for it to be self-sufficient. Therefore, in order for them to continue with subsistence farming, farmers were forced to generate supplementary wage-incomes from sources outside the system (Cepic et al, 1979). The solutions to insufficient monetary incomes from farming differed substantially from one valley to the next, and even between villages in the same valley. Villages with nearby mines provided easy access to wage incomes. However, as such establishments were owned by foreigners, primarily Germans and Austrians, who managed their property in much the same way as a feudal estate, and because wages were extremely low, it is easy to see that subsistence farming was simultaneously a subsidy to the mine owner in a way that enabled him to reduce the wage bill. Thus the two systems cohabited in a mutually reinforcing way, also reproducing their mutual enmity.

In other villages, one of the basic incomes for smallholders stemmed from working in forests owned by the Catholic Church or in saw mills, which were established primarily by non-Slovenes in the 19th century in continuation of the tradition established in the 14th century, when Slovenians provided merchants from Venice with lumber for ship building. Especially in areas where the saw mills were not owned by the forest owners, smallholders had access to several rather than a single employer and could thus induce various owners to compete in making jobs and pay a bit more attractive. Thus various forms of benevolent paternalistic enterprises have evolved in some valleys, making it possible to enlarge the system of mutualism to the monetary sector and vice versa.

Until the end of the first World War, most Slovenian industrial enterprises were owned by Germans or Austrians, and they seem to have been rather uncontested by an emerging small scale industrialisation that could have grown out of cottage- or craft-production. Perhaps this explains why there was no bourgeois movement to change the situation radically. People who had to leave their farms would have to live as workers on a wage that only allowed them to survive if this could be supplemented with cultivating a small plot of land. Even though the position as a smallholder in Slovenia was not favourable, it was the only possible form of existence. Others would have to exit and voices could not be heard in Vienna. The structure was certainly not very supportive for a modern labour movement. Because of this, a strange combination of village mutualism based on extremely small family farms together with a foreign owned monetary sector combined and secured each other's existence.

There were valley communities that could have broken away from this Slovenian steady state. In Dolenjska, several valley communities were manufacturing iron and metals, often into goods of

[1] 60% of farms have less than 3 hectares and the average size is 3.3 as compared to 14 hectares in the EU (Kovacic, 1996).

high quality to be delivered all over the empire (smoothing irons, candlesticks, stoves, fences, fountains, elements for machines,...) or luxuries for the Vienna Court. However, it is interesting to note that such communities collapsed because they could not take independent action when events in the larger empire changed their conditions (changes in transport routes, collapses of the Vienna bourse). Such events only help underline that within the monarchy the abovementioned combination of valley communities and foreign enterprises was a lasting strategy for survival.

However, this implied that Slovenia did not create a self-reinforcing indigenous mode of developing and organising industrial enterprises that could challenge foreigners' (non-Slovenes) way of organising work and production. Industrial discipline and capitalist employment contracts were associated with relations to foreigners, and these relations seemed to contrast hightly with the peer-relations the Slovenes had developed among themselves so as to mutually help each other survive on small lots. From this perspective, it is no wonder that Slovenians would often consider the capitalist sector as instrumental to village mutualism, thereby probably paving the way for the importance of the "moonlight economy".

Thus the hidden "valley"[2] system of reciprocity and mutuality was in a way subsidizing the formal capitalist system, which was in the hands of foreigners. In effect, both systems cohabited in a mutually reinforcing way. Since none of them permanently succeeded in dominating the other, they were able to coexist up to the end of the Second World War, when the formal economic system was changed radically.

After WWII, the partisans (communists) knew that the easiest way to gain local support, create legitimacy in a rural society and simultaneously establish authority, was to simply allow people to live on their small lots and to create enterprises that would offer "workers" additional, though not necessarily very high wages (Kristensen, Jaklic, 1998). Thus factories that had been established at the end of WWII could simply be seen as collective associations for the provision of money in terms of wages. The workers could still conceive of themselves as farmers and orient their life and careers toward this form of life with the necessary additional income being provided for as a collective good organized and managed by the socialistic state. Those without land, e.g. craftsmen and technicians, would also find their challenges in the surrounding community, where their skills were welcomed among the house building friends and neighbours and not in a formal economy where they kept working on undemanding and unchallenging jobs. The decisive sign of community integration was the "house and garden", because this could only be achieved through active participation in moonlighting, which meant learning how to play the secret game of local mutualism.

Even managers of socialist enterprises were actively participating in informal activities. Since the effectiveness of Slovenian firms was assessed by their ability to fulfil the needs of the local population, they became increasingly involved in informal transactions of goods and services. Middle managers beside their official duties also took care of a number of covert exchanges that would benefit the mutualism of the village community rather than the books of the firm. They were large consumers of shadow economy products and services, building lavish houses and maintaining expensive lifestyles. As Slovenian companies penetrated the west, they also became providers of foreign currency and western products for the local shadow markets.

The shadow economy introduced elements of a market system into socialist society. It fostered the entrepreneurship and creativity of local people. At the same time it was hidden and thus uncontrolled by the central authorities in Belgrade, which gave it even greater legitimacy. It contributed to the relatively high standard of living in Slovenia compared to other socialist countries or Yugoslav republics. Though there

[2] Instead of the word "locality", we use "valley community" despite the fact that many localities in Slovenia are not situated in a valley. However, the reason is that we think that internal social cohesion and mutual rivalry as a pattern are rooted in a distant past, because Slovenia's continuos geo-political situation has been structured by the Alps. In such societies, locality is more than an administrative abstraction, as it gives social space a physical place. And as Eric Hobsbawm has expressed it, such placed consisted of land, distrust towards cities, towards strangers (especially Jews) and governments (Hobsbawm, 1997).

are huge problems in comparing statistics across the former divide between capitalist and socialist economies, comparisons of the social product by the internal purchasing power show that by 1985 Slovenia's amounted to 85% of Austria's per capita social product (GSP) and was higher than in Portugal, Spain, Greece and Ireland (Potocnik et al, 1996, p.13). Another estimate of GSP p.c. in current prices shows that in 1987 Slovenia achieved 6.202 $ p.c., while Austria stood at 14.870 $ p.c. of GDP (Statistics Office of Austria, Statistics Office of Slovenia, 2006). As GDP is defined more broadly than GSP, it can be argued that Slovenia in 1987 stood at some 50% of Austrian GDP p.c. in current prices. In terms of PPP that ratio would be significantly higher.

A study done in the late 1980s estimated that 43% of all employees were involved in the shadow economy and that additional incomes from those activities equalled 38% of their regular-job incomes. That trend was estimated to even increase in the following years as the economic crisis in Yugoslavia deepened. Most involved in the shadow economy were people with specific technical knowledge, e.g. plumbers, carpenters, whose day jobs had fixed schedules and their wages were relatively low. Thus they had knowledge, time and motivation to engage in the afternoon shadow economy. Other profiles, e.g. clerical workers or top managers, were less engaged in moonlighting. On one hand they lacked specific skills or time and on the other hand their salaries were higher. Shadow economy thus contributed to a lowering in social disparities (Glas, 1991). Altogether, a combination of safe day jobs and a developed shadow economy offered most of the population the opportunity to maintain their standard of living and find a social place by combining modernization and tradition.

Overall, the inefficient formal economics of the socialist period further cemented the shadow economy as an integral and necessary part of the everyday pursuit of better living standards in all sectors of the economy and across all levels of society.

5. The Shadow Economy in Transition

Although transition has brought a number of changes, most people did not suffer a loss in their living standards. Few have become very rich very fast, in contrast to what has happened in certain former socialist societies. The majority of companies have survived the transition without radical restructuring. Workers were able to maintain their social security through working in the company and earning as much money as possible in the untaxed shadow economy sector. As long as they were able to continue with the patterns of the past they resisted any changes that would endanger their "afternoon" activities. For example, when Renault-owned car producer Revoz tried to change working hours so that shifts would start one hour later than before, it faced fierce opposition from workers and unions. Finally, French managers realized that they were facing potential labour unrest because of something that they believed was a minor issue and gave in, deciding to leave existing working hours unchanged.

On the other hand, legitimate companies have also benefited from the shadow economy. It allowed them to pay low wages that would not be possible if workers were not working a "second shift" in the informal economy, and obtain cheaper inputs, produced by small shadow microenterprises. Therefore, they were able to remain competitive in the world markets despite operating with relatively obsolete and less advanced technology.

Estimates of the hidden economy during the economic transition in Slovenia in the 90's range from around 20% to 34% of the GDP: the Ministry of Economic affairs estimated the shadow economy at 22% of the GDP in 1996, Lacko (2000) estimated it at 24% in 1995, while Eilat and Zinnes (2000) assessed it to be 35% of the GDP in 1995. According to Kukar (1995), around 26% of the active population or 239,000 persons actively participated in hidden or unreported activities in 1994. In terms of working hours that was equal to some 80.000 jobs. Rosser, Rosser, Ahmed (2003) in their substantive study, stated the size of shadow economy in Slovenia at 25% of the official GDP. Schneider and Enste (2002) estimated that in 1998, when the transition was coming to its end, 31% of the Slovenian labour force was engaged in the shadow economy, with a product equalling 22,4% of the official GNP.

The shadow economy in Slovenia was acting as a kind of a social buffer, soothing the transition and making social peace possible in spite the fact that in the year 1993, for example, some 130,000 people, or 14,4 percent of the active population, were officially unemployed. In addition to the unemployed, there were also tens of thousands of workers who were retired early rather than made redundant. Equipped with skills and creative energy, they were well able to enter the shadow sector and offer their services.

In the delicate early transition period the shadow economy had a stimulating effect on the official economy, since a large part of the income earned in the shadow economy is immediately spent in the official economy. Schneider and Enste (2002) estimated this portion to be around 70% in the case of Austria, meaning that 70% of the value added produced in the shadow economy would not be produced in the official economy if the shadow economy did not exist (Schneider & Enste 2002).

The shadow economy has provided strong competition to some legitimate businesses that were operating in a protected, domestic market (e.g. services), forcing them to become more efficient and expand their operations. Legitimate, foreign oriented companies have only benefited from shadow activities, in the form of cheaper labour and input costs. Therefore, the shadow economy has contributed to the better satisfaction of the needs of the society and raised the standard of living. At the end of transition, in 2000, Slovenian GDP per capita measured in terms of purchasing power parity amounted to $17,127 per capita, equal to 64% of the EU-15 average at that time and thus being on par with Greece (Schwab et al, 2002; Eurostat $_{(GDP)}$, 2006; respectively). However, there is no room for complacency where economic development is concerned. The next section shows that the end of one transition brings the start of another and that future success is by no means assured by past achievements.

6. Present Challenges: Advancing Through the Stages f Economic Development

After successfully navigating through the transition period, Slovenia today finds itself before the next decisive step: moving from investment-driven economic development to the innovation-driven stage of economic development (Jaklič, 2002).

Successful economic development is a process of successive and co-evolving progress in which enterprises and their supporting environment are able to engage in increasingly sophisticated forms of international competition (Jaklič, 2002). As nations develop, they progress through a number of stages in terms of their characteristic competitive advantages and modes of competing.

In the factor-driven stage, basic factor conditions such as low-cost labour and access to natural resources are the dominant sources of competitive advantage and international products. In the investment-driven stage, efficiency in producing standard products and services becomes the dominant source of competitive advantage. In the innovation-driven stage, the ability to produce innovative products and services at the global technology frontier using the most advanced methods becomes the dominant source of competitive advantage (Porter, 2002).

In 2003, Slovene labour reached 45 per cent of the EU-15 average labour costs (Eurostat $_{(LC)}$, 2006). This meant that it was 92 per cent more expensive than that of the Czech Republic or even 157 per cent more expensive than the 4.11 €/hour average of other ex-socialist EU members. At the same time, Slovene labour achieved 62 per cent of an average EU-15 hourly labor productivity (Eurostat $_{(PROD)}$, 2006). However, the gap between Slovenia and other ex-socialist EU members has been closing, as productivity in other transition countries grew at a faster pace. Calculations show that in the 2000-2003 period Slovene labour productivity grew 3 per cent more than the EU-15 average. On the other hand, labour productivity in the rest of ex-socialist EU members[3] grew on average 11.6 per cent more than the EU-15 average (Eurostat $_{(PROD)}$, 2006).

[3] Lithuania was not included in the calculation as data were not available (Eurostat $_{(PROD)}$, 2006).

Over the same period the relative cost of labour in Slovenia grew 10 per cent faster than the EU-15 average, making Slovenia lose some of its relative competitiveness as cost growth significantly outpaced the growth in productivity. On the other hand, Poland, for example, improved its labour competitiveness (index of 1.15) as relative labour costs grew at the same pace as in the case of the EU-15 average (i.e. remained at 20 per cent of EU-15 average) while its relative productivity grew 15 per cent faster than in the case of the EU-15 average.

Rebernik et al. (2005) have found very unfavourable figures concerning the comparison of value added per employee between Slovenian and EU-15 companies. While in EU-15 the level of value added per employee is positively correlated with the firm's size, in Slovenia this is true only in absolute terms. In relative terms, Slovenian micro companies with up to 9 employees achieve 50% of their EU-15 counterparts' average, while large firms fall 1:4 behind their EU-15 counterparts (Rebernik et. al., 2005). In the case of EU-15 countries, 16% of their exports were classified as hi-tech in 2004. In the case of Slovenia, the figure was a meagre 6% (Eurostat $_{(THE)}$, 2006), while the IMD 2006 Competitiveness Yearbook made an even lower gauge of 5.6% for 2005 (IMD, 2006, p.263).

Porter et al. (WEF, 2006) emphasize that economic development requires continuous evolution of the whole economic environment. Lack of improvement in any important area can lead to stagnation and stalled economic growth. The shift from the second to the third developmental level is highly demanding, as there is no ready-to-use recipe for doing it; on the contrary, each country has to innovate its own way into the club. In the case of Slovenia, the presented figures clearly indicate a slow movement towards an innovation-driven economy and show an uninspiring trend that could lead to slow long-term growth.

Without significant improvement in the level of productivity, and thus value-added, and abandoning a low-cost production strategy, Slovenia will soon not be able to compete with other transition or developing countries that have access to similar technologies but have a much cheaper labour force. The following section describes mechanisms by which a persistent shadow economy prolongs the status quo in terms of productivity and value-added and exerts a negative influence on economic development on the Slovenian economy as a whole.

7. The Shadow Economy as an Obstacle to Competitiveness

As Slovenia is trying to attain the third developmental level, where growth and development depends on the innovative capacity of the society or the enterprises within that society (Schwab et al, 2002; Jaklič 2002), we believe that the shadow economy is becoming an obstacle to its development. It is not the mere extent of the hidden economy, but its impact on national competitiveness that is problematic. Although the size of the shadow economy, which is above 20% of the GDP in the case in Slovenia, cannot qualify as rampant, it still far exceeds the levels from highly developed economies, which Slovenia is eager to join. The following table shows some estimates made by Schneider (2004) for the period of 2002/2003:

Slovenia	***Germany***	***Austria***	***Sweden***	***France***	***UK***
29,4	16,8	10,9	18,3	14,5	12,2

Table 3: Size of shadow economy as % of GDP for 2002/2003

Source: Schneider, 2004

We believe the problem with the shadow economy in Slovenia is threefold: first, it is itself oriented towards low value-added production; second, it impedes the development of entrepreneurship; and third, it inhibits innovation. All this impedes the development of an economy towards higher levels of value-added. While the Slovenian (formal) economy has had to transform according to global competitive pressures, the shadow sector has continued its low-value added and labour-intensive profile as the only way to keep under the radar of authorities.

For developing countries that are mainly copying technologies and are competing on price, the shadow economy is not problematic. It can even be beneficial, as in the case of Turkey, where shadow operations have been quite large, well organized, flexible and capable of doing business on a large scale, making the unofficial economy even more dynamic than the formal economy (EIU, 1997).

The Slovenian shadow economy, on the other hand, is fragmented, consisting mainly of many microenterprises and unorganized individuals, unable to respond to global challenges or act internationally. The growth of these businesses is in any case restrained by their limited time in the afternoons and limited access to credit markets (Schneider, Enste, 2002). They must also not grow over a certain, rather low, threshold in order to avoid detection from tax authorities, which are strong enough that any undeclared large-scale economic activity would not go unnoticed. Furthermore, the shadow economy in Slovenia is not about undeclared manufacturing of advanced products, but about providing traditional, low value-added products and services. Consequently, any shadow entrepreneur can only cover a geographically limited local market, which reduces competition and seriously impedes learning. Such a shadow economy can only exist since shadow entrepreneurs do not pursue the goal of business growth but merely of modest additional income that allows them to "buy the latest car and build a house and a garden". It is clear that the role of the shadow economy as an institution in Slovenia has not changed since its very beginnings.

The second problem that the shadow economy causes is the impediment of entrepreneurship, which it does in two ways. The first and most important way is through the coexistence of the shadow economy and efficiency-focused large enterprises. Working in a large company offers lower business risk and stress than an individual would have to face in pursuing an entrepreneurial path and it at least superficially guarantees greater social security. In a rather risk-averse Slovenian society (Hofstede, 2006), a promise of a "safe" job in a respected company has usually prevailed over prospects of entrepreneurial success (Groff Ferjančič, 2000). The relatively low wage a worker would receive is then topped up by income from moonlighting and the sum is enough for living a modest life. Second, SMEs, as primary "products" of declared entrepreneurial activity, are subdued to unfair competition from shadow entrepreneurs who do not have to include taxes and salary benefits in their prices. Consequently, instead of fuelling entrepreneurial growth in ambitious SMEs, the Slovenian workforce toils in relatively undemanding and low-paid day-jobs that offer basic social security and earn some additional income by working another few low-value-added-hours in the afternoon.

Small and medium enterprises (SMEs) are an important part of a dynamic economy. Research has shown their importance in the aspects of innovation and economic growth. Acs and Audretsch (1988) found empirical evidence of decreasing return from R&D expenditure in relation to the innovation output. In their further research they found that small firms in the United States produced up to 2.4 times more innovation per employee than larger firms (Acs, Audretsch; 1990, 1991). SMEs can thus be considered highly important in the context of achieving the innovation-driven stage of economic development.

Yet in the field of SMEs, Slovenia faces a double problem. First, it, like other ex-communist countries, exited the socialist era with a great lack of SMEs. Second, among EU candidate countries, Slovenia has had by far the lowest level of new enterprises founded (Bučar, 2002). We also have to add the fact that at the beginning of transition large companies started to cut R&D expenses to survive the transition (Dmitrović, Zupan; 2001; Žnidaršič, 2003). Thus, during transition, the push in innovativeness could have only come from newly founded SMEs, but as there were few SMEs born, little innovativeness was born as well. The combination of a lack of dynamic SMEs and cost-cutting large companies positioned the Slovenian economy as firmly focused on efficiency and low-cost production, i.e. a concept pertaining to Porter's second developmental level.

Understanding the orientation of the shadow economy toward low value-added and its impact on entrepreneurship, it is not difficult to envisage its negative effect on innovation. We believe the major problem lies in the cohabitation of low value-added jobs and low value-added moonlighting, with low value-added jobs being an indirect consequence of the shadow economic activity. Namely, earning additional shadow income, workers are ready to accept lower salaries in return for the at least provisional social security of a "safe job". This in turn lowers the price of labour, which lowers the pressure on value-added. Less pressure on value-added means less need for innovativeness in all fields. Companies consequently keep lagging behind the best Western performers due to the lack of innovativeness and the vicious cycle is closed. Wages remain low and the shadow economy continues being a necessity.

There are also other reasons why the shadow economy inhibits innovativeness or at least cannot act as an innovation catalyst.

First, due to its focus on small-scale, low value-added production, the shadow economy cannot be seen as a springboard toward innovation that would be significant and valuable in the context of global technological trends. Second, shadow entrepreneurs cannot undertake large and complex projects but have to stick to simpler ones. As they need their business to stay small in order to hide from tax authorities, moonlighters can hardly form interdisciplinary teams that are needed to deal with complex orders. Finally, it could be argued that it actually deters innovativeness since its own innovative potential has been largely exhausted. The production technology of traditional and low value-added products is well known and has not changed much for decades. And even in the case of services and products based on modern technology, e.g. web-design, buyers of shadow economy products and services are cost-focused rather than quality-focused.

There is no surprise that the major problem of the Slovenian economy is a lack of new ideas that would enhance and improve existing capabilities and build international competitive advantage, at least in some niche markets (Jaklič, 2002). Slovenia seems to have already crossed the point where the existing economic structure no longer supports the healthy long-term development of the economy. IMD Competitiveness Yearbooks show that in the 2003-2005 period private final consumption growth was consistently higher than the overall GDP growth (IMD, 2004, p. 564; IMD, 2005, p. 445; IMD, 2006, p. 321), showing a trend which cannot be maintained in the long run.

It is clear that the shadow economy in Slovenia may have been a valuable way for raising living standards throughout the second developmental stage, but it lacks the fundamentals for propelling economic development into the innovation-driven stage as it did not transform accordingly. Porter et al. (WEF, 2006) stress that the competitiveness of an innovation-driven economy depends on its ability for social learning and on the ability of people to rapidly embrace new technologies. The shadow economy in Slovenia obviously does not facilitate this, as it has been largely built on the paradigm of hard physical/manual work, a paradigm that pertains to the second developmental level and has little to do with high value-added, clusters, networks and innovativeness.

8. Conclusion

The aim of this paper has been twofold. First, we wanted to show that the institutional approach to explaining shadow economy is necessary if we want to fully understand it when its behaviour defies our expectations. Second, we wanted to prove our hypothesis that the shadow economy in Slovenia has turned into an obstacle to economic development and growth.

As far as our first aim is concerned, the paper has presented a case of the shadow economy persisting on a relatively high level despite economic circumstances that should lead to its diminishment. By shedding light on historical and social institutions that have been closely related to the development and functioning of the shadow economy, we have sought to explain its persistence. Thus we have made a strong case for an institutional approach to explaining shadow economies.

Next, we have found the impact of shadow economy to be threefold. The shadow economy's orientation toward low value-added, its unfair competition with full-scale entrepreneurship, and its distraction of energy and focus from serious innovation have had an adverse impact on economic development in Slovenia during the last decade. Data regarding productivity and the number of new SMEs support our hypothesis that a vicious cycle of low value-added cohabitation between regular employment and afternoon moonlighting has taken root in the Slovenian economy.

The implications are at least twofold. With regard to the role of the shadow economy, we have shown that it can act as an important obstacle to economic development in the period when an economy is moving from investment-based growth to innovation-based growth. The key problem that we have identified is the fact that the shadow economy has little or nothing to do with valuable innovations. This serves as a reminder to other countries that have been following Slovenia on her way to economic development. Even though not wide-spread, a persistent shadow economy can slow down economic development.

Second, the case we have made with the institutional approach to explaining the shadow economy stands as an upgrade of the usual practice of explaining the shadow economy by categories such as tax and regulatory burden, corruption, level of GDP p.c. and GDP growth. While these variables are by no doubt important, they are not the only decisive factors. In times when stable growth of GDP p.c., decreasing unemployment, constant improvement in public governance, decreasing inflation and modest tax rates should lead to a decrease in shadow economic activity, as it has happened in other ex-socialist countries, the shadow economy in Slovenia has persisted almost unchanged.

We recognize there are several limitations with regard to our assertions and findings. First, the presented paper has been based on an extensive literature review, and this fact has been at the same time its key strength and its greatest limitation. While the presented data are credible, we believe that the hypothesis they support, i.e. the negative impact of the shadow economy on the competitiveness of Slovenian economy, would best be re-confirmed by further empirical testing. This also is the basis of our first suggestion for further research.

At the same time, we recognize that our assertion that the shadow economy persists unchanged in Slovenia rests on a single research study carried out by Schneider (2004). We would like to support that assertion from a greater number of different sources, but although there has been other research on the shadow economy in East and Central Europe, they have either not included Slovenia, or the comparison between countries is not possible due to different methodologies employed in assessing the extent of the shadow economy in each country. Thus our second suggestion for future research would be to further follow the size and structural nature of the shadow economy in Slovenia per se and in comparison to other post-socialist countries and highly developed economies.

Third, it would be valuable to have an assessment of the shadow economy's stimulating effect on the Slovenian formal economy. So far the exact stimulating effect of the shadow economy in Slovenia on the formal sector has remained unknown, and its closest estimate continues to be Schneider and Enste's (2002) estimate for Austria.

Finally, the shadow economy represents an obstacle to the long-term development of Slovenia because it diverts human resources from long-term entrepreneurial growth to pursuing short-term goals on a small, local scale. Therefore, one of the major challenges for managers and politicians at this time should be to find a way to mobilize the hidden power, creative energy and entrepreneurship of the informal economy and to incorporate it into a formal one, which as a result should become more internationally competitive. Besides favourable taxes and administrative processes in regulating small business, thus stimulating the shadow economy to become part of the formal one, they should creatively take into account the history of valley-mutualism in Slovenia.

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