



UNRISD

UNITED NATIONS RESEARCH INSTITUTE FOR SOCIAL DEVELOPMENT

DRAFT

Country Overview Paper No. 2
Long-Term Economic Growth and Poverty
Reduction in Finland

Jaakko Kiander

Labour Institute for Economic Research, Helsinki
Department of Economics, University of Helsinki

prepared for the UNRISD project on
Poverty Reduction and Policy Regimes

February 2008 ▪ Geneva



UNRISD was established in 1963 as an autonomous space within the UN system for the conduct of policy-relevant, cutting-edge research on social development that is pertinent to the work of the United Nations Secretariat; regional commissions and specialized agencies; and national institutions.

Our mission is to generate knowledge and articulate policy alternatives on contemporary development issues, thereby contributing to the broader goals of the UN system of reducing poverty and inequality, advancing well-being and rights, and creating more democratic and just societies.

UNRISD, Palais des Nations
1211 Geneva 10, Switzerland

Tel: +41 (0)22 9173020
Fax: +41 (0)22 9170650
info@unrisd.org
www.unrisd.org

Copyright © United Nations Research Institute for Social Development

This is not a formal UNRISD publication. The responsibility for opinions expressed in signed studies rests solely with their author(s), and availability on the UNRISD Web site (www.unrisd.org) does not constitute an endorsement by UNRISD of the opinions expressed in them. No publication or distribution of these papers is permitted without the prior authorization of the author(s), except for personal use.

Abstract:

The purpose of this paper is to examine the role of development strategies and social policies pursued in Finland in the 20th century and their role in the development of welfare state and poverty reduction. The paper studies the interconnections of institutions and economic and social policies to explain the economic growth on one hand and the social achievement on the other.

1. Introduction

The purpose of this article is to review the long term social and economic developments in Finland and to examine the role of strategies and policies pursued. Our time span covers the 20th century. We focus on the role of policies in the development of the Finnish variant of the Nordic welfare state, and especially in poverty reduction. The article studies the interconnections of institutions and economic and social policies in order to explain the long term economic growth on one hand and advances in the social welfare and equality on the other.

We start by reviewing the Finnish record of economic growth and the policies and institutions which enabled the growth process as well as advances in social wellbeing in the 20th century. Our focus is on the growth strategies and the role of state. The second part of the article reviews the development of the Finnish welfare state system and the role of politics and social structures behind it.

2. On poverty and economic growth

For most developing countries the central goal of national policy has been poverty reduction. That has also been an important goal for many developed countries: in their past they have been successful in starting up economic growth processes, and they used the fruits of growth to improve the living conditions of their populations.

It is obvious that sustained economic growth is crucial for poverty reduction. Without economic growth it is not possible to achieve income level which would be sufficient to avoid large-scale poverty. Economic growth is thus necessary if we want to reduce poverty in absolute terms. As long as general income level is not high enough to provide a decent minimum living standard for the majority of population, economic growth should be the most important policy goal. Income distribution and reductions in relative poverty grows in importance only after the majority has escaped starvation and absolute poverty. Without economic growth there are seldom sufficient resources for policies which could improve living conditions (health etc) and enable redistributive policies to decrease relative poverty.

That is why the priority in poverty reduction is in most cases given to growth oriented policies, especially those fostering capital accumulation and skill formation. The most successful examples of such policies in today's world are China and India, and the so called Asian tiger economies.

However, although it should, poverty reduction is not always an overriding political priority in poor countries. For many reasons those who possess political power may decide otherwise. That is the case especially when the narrow objectives and interests of powerful groups are in conflict with the wider goals of social good. That can happen if the big landowners or owners of natural resources (like oil) are more interested in defending their privileges and economic rents than fostering the well-being of the poor. Usually a necessary precondition for such a situation to prevail is lack of democracy or widespread corruption.¹

Reducing relative poverty requires different policies, but without economic growth and sufficient income level there are not enough resources for such policies. To achieve ambitious goals of economic equality is not possible without large-scale redistributive policies. However, significant

¹ See e.g. Easterly (2006) and Acemoglu et al. (2006).

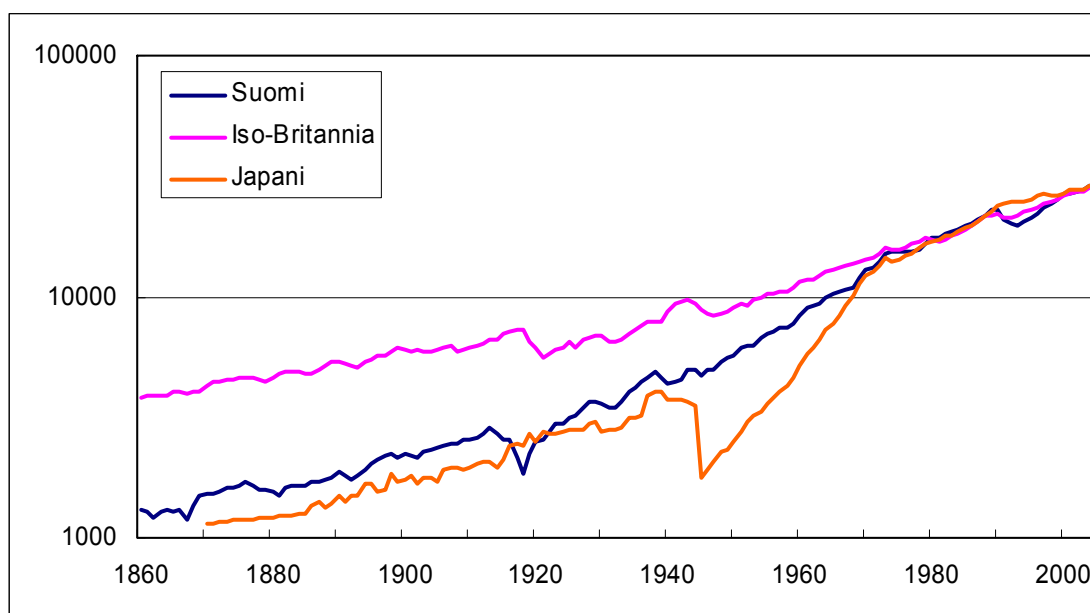
results can be achieved by fostering education and labour market participation as well as by providing basic health care.² This means that primary education and health care are necessary parts of public policy oriented to poverty reduction and equality. The next, and equally important step is to establish at least minimum level collective insurance systems against social risks: injuries and accidents, sickness and disability, unemployment and old-age. In the case of Finland the development towards the Nordic welfare state has gone in this order.

3. Modernisation and economic growth in Finland

In the beginning of the 21st century Finland got much admiration due to economic and technological success. Finland come to news because of high rankings in competitiveness, technology, education and economic growth (see e.g. IMD (2003) and WEF (2003)). In many comparisons Finland's rankings are among the top countries, often together with two other Nordic countries, Sweden and Denmark. The recent success has largely been caused by technological advances, and it has been embodied in the growth of Nokia group and ICT sector. In addition to this economic dynamism, Finland and its Nordic neighbours are also known for their egalitarian welfare states.

The recent success is not an entirely new thing in Finland. Starting from poverty, Finland was successful in catching up the more advanced European countries in the post-war years and finally – in the 1970s – achieved the EU15 average GDP per capita level. As such, Finland belongs to a group of late industrialisers which has gone through rapid process of high structural transformation. This catching up process is illustrated in Figure 1.

FIGURE 1: GDP: catching up



Translation

Suomi – Finland

Iso-Britannia – Great Britain

Japani – Japan

² Cf. Barro (1997).

Historical background

In history, Finland has traditionally been a poor and underdeveloped country in Northern periphery. Being a small and remote country with unfriendly climate, Finland was still in the beginning of the 20th century mostly poor and underdeveloped, with subsistence farming as the main ways of living. Because of the harsh climate agriculture was an unreliable source of living, and food shortages and even famines were not uncommon in past. As a result, poverty was still widespread in the 19th century – even the local nobility was poor if compared to their peers in neighbouring countries. It was endemic that Finland was the country which suffered from the last great European famine in the 1860s.

There were periods of growth and social development even before the industrial revolution and rapid economic growth started in Finland in the 1870s. For instance, a couple of iron mills and a national university were established in the 17th century. However, wars and other disasters stopped these developments too often, and mercantilist regulations prevented private economic initiative to flourish. It was only after economic and political liberalisation – a series of reforms carried out in the 1860s – when the sustained economic growth began.

Finland was a part of Sweden from the twelfth century to 1809. Being a part of a great Scandinavian kingdom was crucial for the development of Finnish culture and institutions, like religion, education and rule of law. However, as an eastern province of Sweden, Finland suffered from almost continuous warfare, and heavy taxes needed to finance war. Finland's status improved, when the country was annexed to Russia – as an autonomous Grand Duchy – after the last war between Russia and Sweden in 1809. Finland remained part of the imperial Russia until the October revolution in 1917.

Being an autonomous part (practically a state without foreign policy) of Russia was not bad for the economic development of Finland. The foundations of resource-based manufacturing industries as well as national economic policies with central bank and own currency were laid down during that period. The Finnish economy benefited greatly from easy access to the large and rapidly growing Russian markets.

Origins of growth-promoting institutions and their importance

Many studies of economic development emphasize the importance of private ownership and well-functioning institutions as necessary prerequisites for sustained economic growth to start.³ Although Finland had many disadvantages due to its location and harsh climate, economic and social development of the country benefited from the ancient Nordic traditions of freedom and ownership, and early adoption of rule of law. Reformation in the 16th century induced the church to promote literacy, and the continuous warfare forced the central government to organize taxation, efficient bureaucracy and population records. In mercantilist spirit the government was also eager to foster mining and manufacturing. The first university of Finland was established in 1640.

Annexation to Russia in the beginning of the 19th century meant increased autonomy in domestic affairs and more important role for national government (which did not exist before), but it also meant a freezing all political reforms for half a century. A wave of reforms became only possible when the liberal-minded Russian emperor Alexander II allowed the Finnish national parliament to

³ See North (1990) and Temple (1999).

convene in 1863. Before that the economic development mainly relied on the initiative of the small and cautious bureaucratic elite which governed the country.

A stream of reforms followed. Old mercantilist restrictions were abolished and trade and industry were liberated. Business law was reformed. Finland got a central bank and independent monetary policy, and the banking sector started to develop. Government began the building of national railway network. These changes led investments in manufacturing, and the growth of sawmills, pulp and paper industries. These growing export industries increased the demand for wood, which raised the value of forests and incomes in countryside.⁴

An important part of development was language question. During the many centuries of Swedish rule, it was the Swedish language which became the official one used in higher education, administration and business – in spite of the fact that more than 90 percent of population was Finnish speaking. As a consequence, the majority of the population was in a disadvantaged position. This situation started to improve in the mid-19th century, when the Finnish language gained a status of official language. This change opened new opportunities through education to the Finnish-speaking majority of the country. Human capital was also increased through international exchange. Finland was open to foreign entrepreneurs, who imported capital and new technologies. Government also supported talented young people who were interested in acquiring skills and knowledge by studying abroad.

TABLE 1. <i>Factors crucial for the take-off of the economic growth in Finland in the 19th century</i>
Political reform 1863 Liberalization of domestic trade and industry 1863- Corporate law reform (limited liability) Increase in world market price of wood products 1870- Free access to Russian market with protective tariffs against imports Currency reform and development of banking sector Transport investments: inland waterways and railways

The social and political development in Finland was affected by that of Russia. The 1905 revolution in Russia led also to democratic reforms in Finland. The momentum was used to develop a new democratic constitution with a modern parliament and universal suffrage in 1906. However, many of the reform proposals set forth by the new Finnish parliament were vetoed by the Russian emperor. The situation changed radically, when Finland was able to gain full independence in 1917 after the Russian revolution.

Economic growth and structural change had gone hand in hand in Finland. The primary reason for that has been the fact that in the beginning of the modernisation process (in 1860s), the population was dominated by small-scale farmers, even with subsistence farming in many cases, and lots of rural poverty. Urbanization had not taken place. Agriculture remained the livelihood of the majority of people up to the 1950s – much later than in Western European countries.

⁴ See Puntila (1975).

The processes of industrialisation and urbanisation started in the 1860s and 1870s, but the structural change was first relatively slow. Increasing incomes from wood exports started to slowly transform the subsistence farming toward a monetary economy and division of labour. Yet large-scale structural change started only in the 1950s and 1960s, with rapid urbanisation and industrialisation. The main reasons for the late urbanization were two land reforms. The first one was done shortly after the national independence, in 1921. The purpose of the reform was to solve the problem of widespread rural poverty. Land was given to former tenants.

Another land reform was done after the WW II. As a result of war, Finland lost about 10 percent of her territory to the Soviet Union, and the inhabitants of the lost areas became refugees in their own land. A solution was found in a new land reform, where land was given to the refugees. Thus, in the beginning of the 1950s, Finland was a country with large share of population living in countryside, and most of them relatively poor small holders.

Economic growth and catching up

Sustained economic growth started in the 1860s and rapid growth was achieved in the *belle époque* years (1890-1913) before the first World War. Early adoption of new innovations like electricity and telephones contributed to the development.

Although industrial capacity increased steadily and the new plants were in many cases technologically advanced, the average productivity level of the whole economy remained low, because the majority of labour force remained in inefficient primary sector (agriculture and forestry). Gradually urbanization and structural change decreased this low-productivity sector and increased labour force in manufacturing, where productivity was much higher. As a result, the Finnish economy was able to maintain relatively rapid productivity growth during the 20th century. It took also decades before the productivity growth was reflected in real wages. For manufacturing industries, there was up to the 1960s an abundant supply of labour coming from countryside, where the small farms were not able to provide livelihood to increasing population. Excess supply of labour kept the real wages in control.

Though the average rate of growth was good, the development was not steady. The economic growth was first interrupted by a short but violent civil war in 1918. The second serious crisis was Great Depression in 1929-1932, which was followed by the second World War, in which Finland finally lost land and industrial capacity to the Soviet Union.⁵ A longer period of sustained economic growth was hence experienced only in the post-war years. The 45-year period from 1945 to 1990 was one with the fastest economic growth in Finnish history, and towards its end Finland finally achieved and even surpassed the average income levels of Western European countries.⁶

⁵ After the war Finland was a neutral country which had close ties with the Soviet Union. After the collapse of the Soviet Union Finland joined the European Union in 1995 and the EMU 1998. In spite of the special relationship with the Soviet Union Finland was able to maintain its democratic political system as well as the market economy.

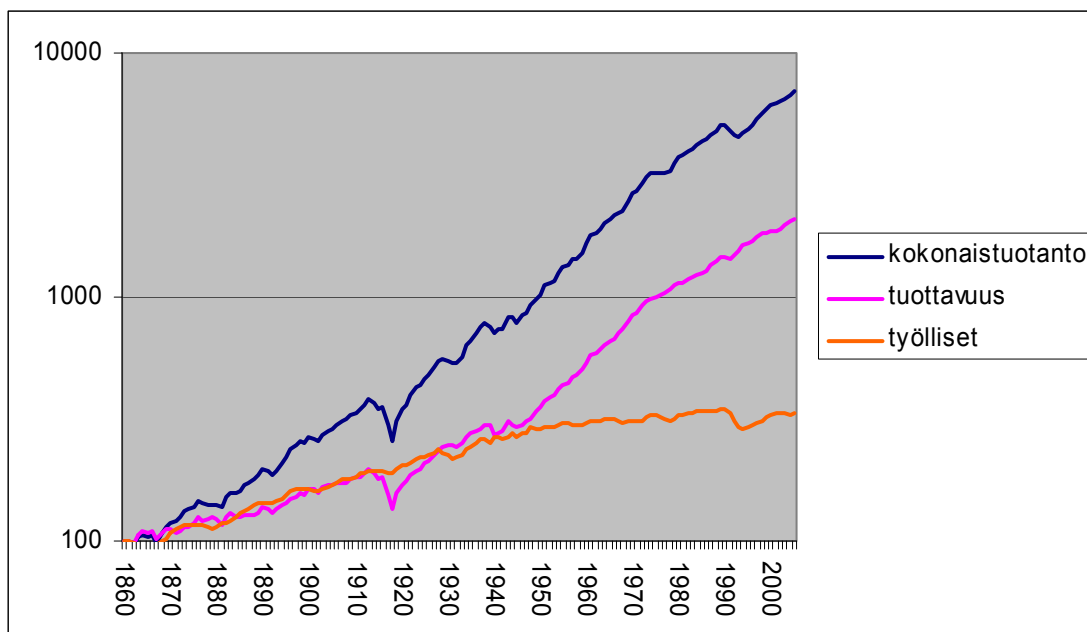
⁶ See Hjerpe (1989).

TABLE 2. <i>Periods of growth and recession in the Finnish economic history</i>	
Growth periods	Crisis periods
1890-1916 1919-1928 1933-1938 1945-1975 1979-1989 1994-	1917-18: Russian revolution and Finnish civil war 1929-32: The Great Depression 1939-44: The Second World War 1976-78: Oil crisis and stagflation 1990-93: The recession of the 1990s

As can be seen from Figure 2, the rate of productivity growth increased in the 1950s. The main reason for that was capital deepening. Capital accumulation became faster due to higher investment rate. In addition to physical capital, also intangible capital increased a lot through skill formation and human capital accumulation. The economy benefited greatly from structural change and better division of labour.

The average rate of economic growth in the 20th century was about 3 percent per annum. However, during the periods of growth the rate was actually higher, 4-5 percent. Rapid rate of growth was achieved already in the 1920s and in the 1930s after the Great Depression.

FIGURE 2: GDP, labour productivity and employment



Translation

Kokonaistuotanto – GDP

Tuottavuus – Labour productivity

Työlliset – employment

In addition to wars and major depressions, the Finnish economic history includes occasional bursts of financial instability with inflation (1915-1920, 1940-1950, 1970s) and currency depreciations (there were major devaluations in 1931, 1957, 1967, 1977, 1982, 1991-92).

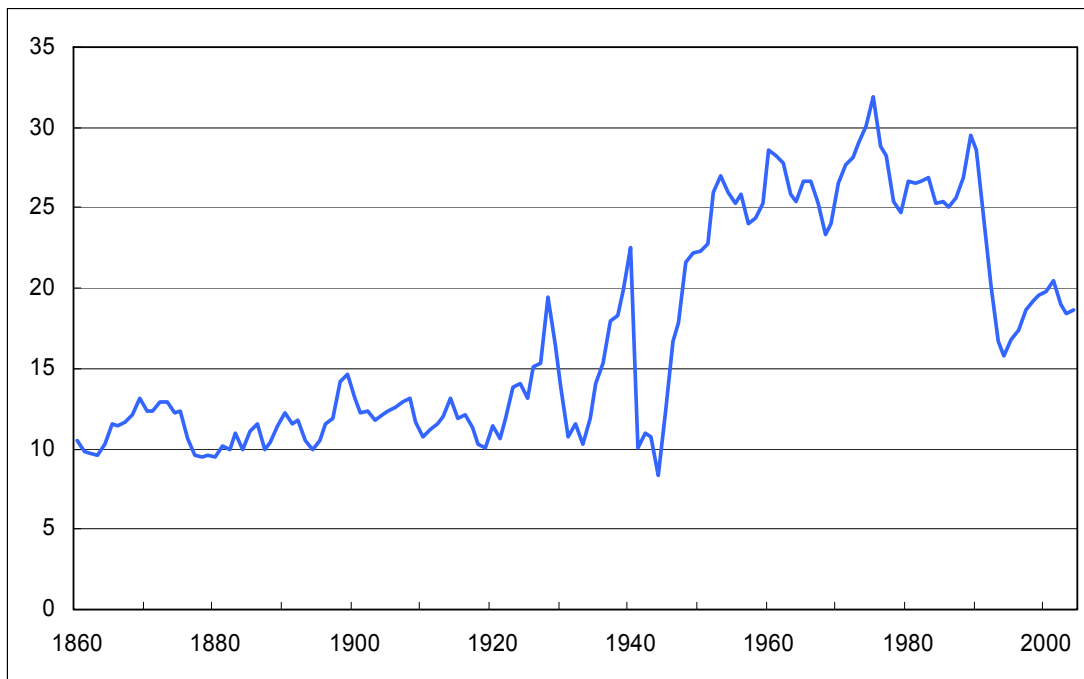
Economic policy and the role of state

The Finnish economic history is not a story of endogenous growth process and workings of invisible hand. Economic growth did not start spontaneously. It required deliberate policies. Government activism started in an early phase, and it increased after the Finland achieved full independence in 1917. Government had been eager to support infrastructure investments and industrialisation since the mid-1800s; an example of that is the construction of the railways. In addition to government, there was also lots of voluntary citizen activism like co-operative movement, which helped to develop banking, insurance, retail and telephone sectors.

The government activity and interventionism increased after independence. Although the overall policy stance was at that time mostly conservative and followed liberal principles in economic policy in the inter-war period (at least in theory), that did not prevent government activism and the use of state-owned enterprises in fostering industry and investment. In the 1920s government purchased companies which had been formerly in foreign ownership, and established new state-owned companies in energy and mining industries. The idea of this activism was to speed up economic development and to keep strategic assets in national control. It was thought that private initiative and capital would not have produced results fast enough. The policy was effective: the investment ratio increased both in the 1920s and again after the Depression in the 1930s (see Figure 3).

The role of state grew significantly because of the Second World War, and it remained strong for many decades. An obvious reason for that was the regulated war economy. However, in the end of the war the need for regulation continued. Political balance shifted leftwards, and it was thought that regulation and government activism could be also used to speed up industrialization and capital accumulation. The result of this policy stance was a wide spread regulation of capital movements, banking, investments and price setting which continued till the 1980s. Regulation was prone to create inefficiencies and inflationary pressures on one hand, but on the other hand it was successful in speeding up investment and economic growth. The investment ratio more than doubled from the pre-war average to more than 25 percent of GDP, and remained that high till the end of the 1980s.

FIGURE 3: The investment rate



The post-war economic growth was thus statist by nature: government was a central economic decision maker. Government had a central role in the economy through numerous and powerful state-owned enterprises (in heavy industries and energy production), and it used them together with various investment subsidies to pursue aggressively growth oriented industrial and regional policy.

TABLE 3. *Economic policy in the post-war period of regulation 1945-1985*

Regulated capital movements
 Restricted foreign ownership
 State-owned companies as vehicles of industrial policy
 Credit rationing and investment subsidies
 Protectionism and lack of competition in domestic markets
 Incomes policy and price controls

The post-war economic policy was very much against the principles of the Washington consensus of the 1990s. However, the statist and interventionist policy of Finland resembles the growth policies of Japan, Korea and China.⁷

A central part of the economic policy was the regulation of markets, ownership, capital flows, and investment decisions. The overwhelming objectives of were to maintain (1) high investment rate – especially in export industries – on one hand and (2) the social consensus on the other. Incomes

⁷ See Rodrik (2006).

policy and price controls were needed to keep different social groups like wage earners in different sectors and farmers to satisfied so that the growth policies were acceptable for the majority.

Macroeconomic policy was targeted to maintain competitiveness of export industries and to support investment; it used credit rationing and discreetly flexible exchange rates and incomes policy as instruments. The policy created so called devaluation cycle. Every once and a while the competitiveness and profitability of export industries had to be restored by major currency devaluations, since the regulated and fast-growing economy created inflationary pressures and balance-of-payments problems. An orthodox way to solve these problems would have been to let the economy slow down, but the social and political costs of recessions were thought to be too high.⁸

Tax policies and corporate governance supported also growth targets, not profitability. Corporate finance was based on debt-finance, which was favoured in taxation, like investments. Shareholders' position was weak, and profits and dividends were heavily taxed. As a result the managers and banks were the ones who set the objectives in corporate decision-making, and they favoured growth and investment, not profitability.

Credit rationing was used to subsidise corporate investment. Household credit was rationed while firms were able to get low-interest loans to their investments.

In addition to various policies to foster tangible investment, public sector also supported skill formation and human capital accumulation by systematic investments in education and training.

In the beginning of the 1980s it was obvious, that the post-war regime of regulation was not compatible with free markets and free factor movements, which were the new policy targets of Western nations. Investment subsidies and credit rationing were criticized, because they led to overinvestment and forced savings. Overinvestment caused inefficient use of capital, and forced savings constrained private consumption. Liberalization of capital movements and banking sector in the 1980s gradually ended the post-war period of investment-led growth.

4. Development of an egalitarian welfare state

The Finnish version of the Nordic welfare state

Finland and the other Nordic countries are welfare states – i.e., egalitarian societies with extensive public sectors and income redistribution. They are also rich economies with high living standards and excellent quality of life. Although the Nordic countries and their welfare models are not identical, there are so many similarities between them and so many differences between them and the other European countries that it is legitimate to speak about 'Nordic model'.

The public expenditures of the Nordic countries are largely used to finance the production of public welfare services and large-scale income transfers. The social expenditure in the Nordic countries includes public provision of children's day-care and many social services to the old, free education

⁸ There were major devaluations in 1957, 1967, 1977, 1978 and 1982 during the years of the post-war regulated economy. These were also years when supply of labour was growing quickly and the political left (including the Communist party) had wide support. In those circumstances it was feared that rise in unemployment would cause political instability. The last currency depreciation in 1992-93 followed a major depression, which was partly caused by a stubborn attempt to avoid devaluations by deflationary macroeconomic policies. In 1999 Finland joined the European Monetary Union and abandoned devaluations together with national currency.

(from elementary school to university level), free or heavily subsidized health care, public pension systems, and active labour market policy measures. Incomes are redistributed through taxes and transfers. There are transfers and subsidies to almost everybody: public old-age and disability pensions, child benefits, housing benefits, student benefits, unemployment benefits and maternity (or parental) benefits. The idea of the system is to provide assistance when it is needed (as young and old, for instance), and thus minimise poverty risks. The Nordic systems redistribute income within life-cycles, from middle-aged to young and old.

High spending to disability and unemployment helps to prevent poverty and social exclusion within these groups. Similarly, generous support to families and housing subsidise child-bearing and helps to smooth the life-cycle income of families. As a result, the child poverty is very low in the Nordic countries. Equality is produced by not only by extensive and universal public service provision and but also by progressive taxation.

The Nordic welfare states have produced egalitarian societies with relatively equal income distributions and low poverty rates and Finland is not an exception. If measured by gini-coefficients, the inequality of factor incomes is in Finland almost as high as in other comparable countries. However, after including the income transfers received by the households and the taxes paid by them the resulting distribution of disposable family income is relatively evenly distributed.

First steps of welfare state

Towards the end of the 19th century general willingness to develop social insurance increased in all European countries, and Finland was no exception. There were at least three reasons for that: (1) the German example set by the social insurance system introduced by Bismarck in the 1880s; (2) the rise of socialist ideas and labour movement (the Finnish Social Democratic party was established in 1899 following the German and Austrian models); and (3) the growing acknowledgement of social problems like rural poverty.

First steps towards public services and social insurance were increased public spending to primary and higher education from the 1860s, and the introduction of work injury insurance in 1895. Democratic reforms and the universal suffrage in 1907 gave a powerful voice to reformist ideas. The Social Democratic Party became the biggest party in the first elections in 1907 and maintained that position in most of the next 100 years. That political power helped to keep the reformist ideas permanently on political agenda, although sufficient political power to the support of the agenda was formed only after the Second World War.

Most of the planned reforms came politically possible only after Finland gained independence in 1917. Although the country was mostly governed by center-right parties in the interwar period, gradual development of welfare state's institutions began. Important reforms were the introduction of unemployment insurance in 1917 and the 8-hour working day in 1918. These were followed by compulsory and free primary education (first as 4-grade school), and first annual vacations.

It was only in 1937 when the Social Democratic Party became an almost permanent governing party together with the centrist Agrarian Union. Together these parties started new reforms (basic pensions and disability pensions in 1937 and a two-week summer vacation), but the outbreak of the Second World War interrupted this process.

*Reforms of the post-war period*⁹

In the years which followed the Second World War the Finnish politics was characterized by instability, reconstruction and attempts to find new homes to the Karelian refugees. In these circumstances government policy focused on new land reform and urban housing policy. There was not much room for welfare states building, although child benefits were introduced in 1948 – a time which coincided with the post-war baby boom. Child benefits were an important step in reducing child poverty (and poverty amongst young families with lot of children, especially in rural areas where money incomes were low).

Another major reform was the system of occupational pensions, a new earnings-related and compulsory semi-public pension insurance which was established in 1957. The system started as a gradually improving pay-as-you-go system, which later on became a partly funded but still defined-benefit system. The pension reform was preceded by a major political dispute over the choice of future pension system – whether it should be an earnings-related insurance system or a universal flat rate pension (a model supported by the Agrarian Union party). It was the Social Democrats and the trade unions who supported the insurance model, and their objective prevailed. However, the result was a compromise, since a smaller flat-rate basic pension for all over 65 year became a part of the reform. In the 1960s and 1970s it was the basic pension which was the more important, because the occupational pensions only grew with time: a full pension required a 40 year work history, and the starting year for new pensions was 1962. The pension reform was a very effective tool in poverty reduction: before the reform it was the old people without pensions who were a major group suffering from poverty.

The evolution of the welfare state in Finland was not as smooth and rapid as in Sweden and Denmark. There were obvious reasons for that: Finland was much poorer, and had suffered from wars (in 1918 and again in 1939-45) unlike the Nordic neighbours. An additional reason was a different political landscape. In other Nordic countries the Social Democratic parties (which were the major supporters of welfare state) held a very powerful position throughout the 1950s and 1960s. Instead in Finland reforms were slowed by continuous political conflicts between the Social Democrats and the Agrarian Union on one hand, and between the Social Democrats and the Communists on the other. This conflict reflected the different social structure of Finland, with large rural population (which formed the basis for the strong support of the Agrarian Union) and the open wounds of civil war (which help to explain the support of the Communist Party). It was only in the 1960s when domestic policy became more stable and the political left was able to start fruitful co-operation. A major landmark was the electoral victory of leftist parties in 1966. It started a new era of coalition governments, which included the Social Democrats and the Centre Party (former Agrarian Union) as major partners, and reform-minded Communists as junior partners.¹⁰

A wave of reforms quickly followed the change in political balance. The main focus was now in the extension of public service provision, following the Swedish model. The old primary schools were substituted by a comprehensive school with 9 grades in 1967. The volume of higher education was increased hugely by a system of new regional universities. These reforms multiplied the numbers of students and started a continuous improvement in the average education levels.

Public health care was also reformed and extended. A new Public Health Act legislated the establishment of hundreds of municipal health centres, which substituted the old system of over-

⁹ See Pesonen and Riihinen (2004) for a more detailed account.

¹⁰ This change also effectively divided the Finnish Communist Party, because the revolutionary minority of the party refused to support evolutionary reform policy.

worked municipal doctors. The number of doctors and other personnel in the public health care started to increase (a process which is seemingly endless). Better availability of medical care led quickly to increases in longevity.

In the 1970s public sector improved old-age care and extended gradually the daycare for children. However, it was only in the 1980s, when all children aged 2-6 got a universal right to daycare or preschool. These services improved the women's possibilities to work. The new services also created lots of new jobs, typically for women.

Maternity benefits were also improved step by step. Paid maternity leaves were extended gradually up to 12 months, and in the 1980s they were still improved by a provision of a two year additional extension with lower income support (the so called domestic child care subsidy).

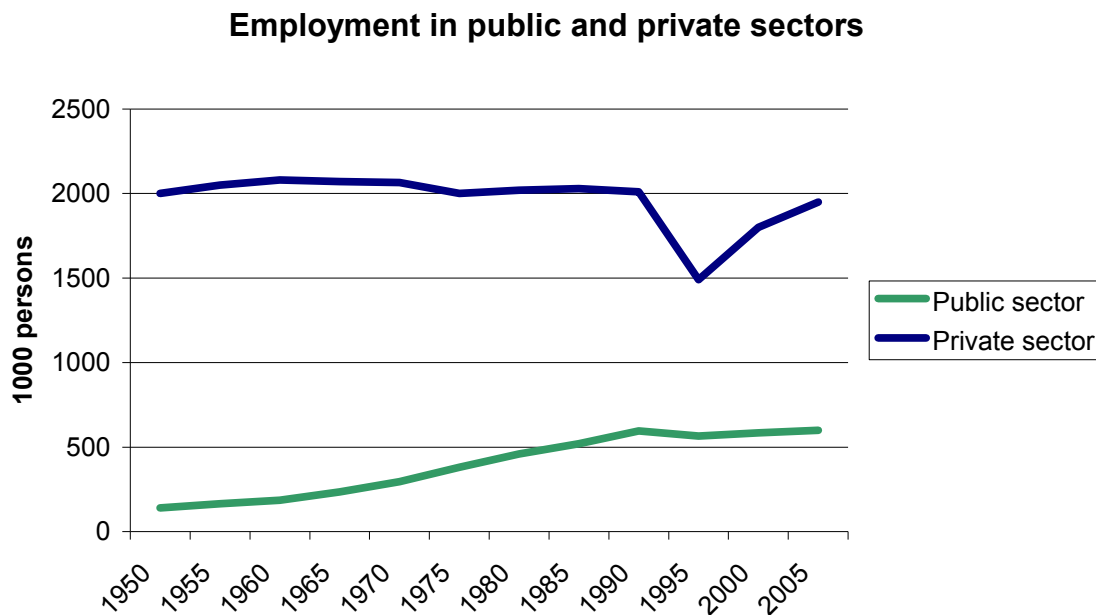
Other forms of social benefits introduced in the 1970s included early retirement schemes, housing subsidies to low income families, student benefits and loans, and improved unemployment insurance system (the last reform was made in 1986).

So called incomes policy started also in the 1960s. That became to mean a continuous collaboration and bargaining between the confederations of the trade unions and employers, and with government as the third party. Social partners and governments decided together on many reforms, especially in labour law and earnings-related social insurance schemes. One part of these changes was a gradual reduction in annual working time. The process started by the introduction of a 5-day and 40-hours working week in the end of the 1960s, continued till the end of the 1980s when a 6 week paid annual vacations were achieved.

The rapid upbuilding of many social benefits and public services increased the public expenditures and the size of public sector by all measures. The financing of the higher expenditures required increasing tax burden. However, the financing of the reforms was made easier by the improving age structure of population (ie improving dependency ratios between 1965-1995). Higher taxes also meant increased redistribution of income, which contributed together with improved benefits favourably to income distribution. In the mid-1960s income differentials were still large and there lots of poverty in Finland. Twenty years later, in the mid-1980s, Finland had achieved a high degree of equality and poverty was largely abolished.

The central elements of social insurance systems and public services were built in the 1960s and 1970s. The extension of public services meant also a significant increase in public sector employment. In the beginning it was the public sector – and usually the local government sector – which was the sole producer of the public social, health and education services. As can be seen from Figure 4, the number of public sector employees increased from 150,000 to 600,000 in 30 years. At the same time the total private sector employment remained more or less unchanged. However, private non-farm sector employment increased by 300,000 persons due to rapid decline in primary sector's employment.

FIGURE 4

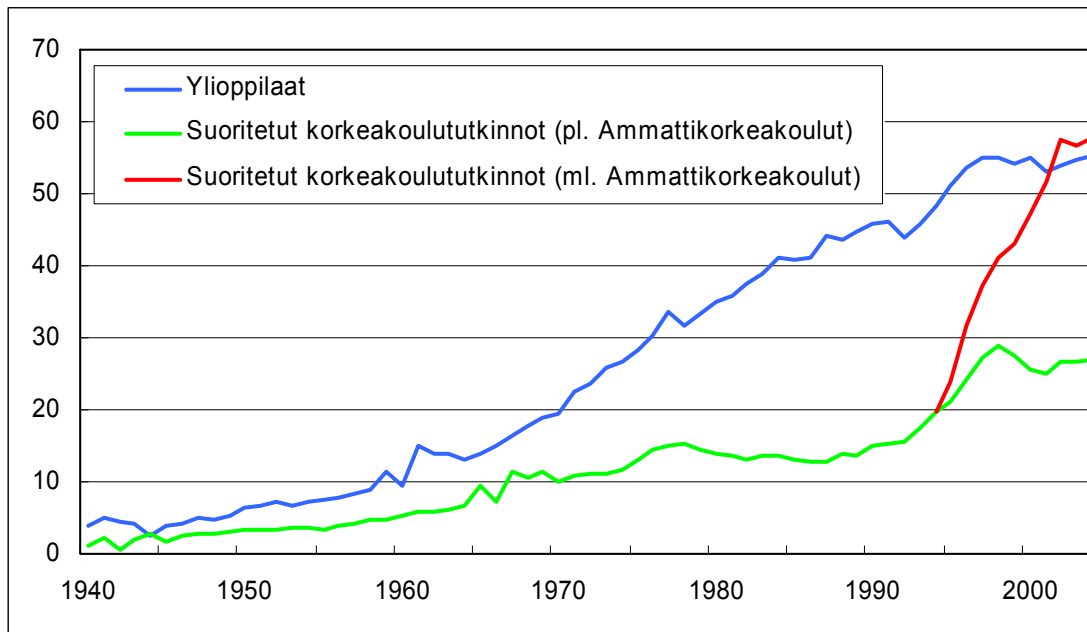


This development has had its impacts also on the relative size of the public sector as well as on the composition of public expenditures. It is typical to Finland and other Nordic welfare states that the overall level of public spending is higher than in other industrial countries, and that the difference is mainly caused by social expenditures. As can be seen from Table 4 Finland is in these respects on higher level than the other EU and EMU countries on average, and clearly higher than the USA, but lower than Denmark and Sweden. The current level of public expenditure is about 50 percent of GDP in Finland. That is slightly more than the EU15 average. The difference is caused by spending on social protection, and partly by public education expenditures. It is noteworthy that other public expenditures including the so called nightwatch functions are on the same level as in other comparable countries.

TABLE 4.	Sweden	Denmark	Finland	EU15	USA
total expenditure	56,4	53,1	50,5	47,2	34,2
nightwatch state	10,7	9,3	9,9	10,0	10,8
welfare state, total	38,1	37,4	34,1	30,8	20,7
- health	7,0	6,9	6,8	6,6	7,8
- education	7,3	7,9	6,1	5,2	5,3
- social protection	23,8	22,6	21,2	19,0	7,6
other	7,6	6,4	6,5	6,4	2,7

From the perspective of economic growth the development of the welfare state has had a positive role. The extension of public services has naturally increased public expenditures and tax burden, but it has also been an investment into human capital. Social services like universal daycare for children has enabled broad female labour supply. Development of health care has improved overall health of the population and increased longevity.

FIGURE 5. EDUCATION



Translation

Ylioppilaat – High school graduates

Suoritetut korkeakoulututkinnot (pl. Ammattikorkeakoulut) – University degrees obtained (excluding polytechnic degrees)

Suoritetut korkeakoulututkinnot (ml. Ammattikorkeakoulut) – University degrees obtained (including polytechnic degrees)

Perhaps the most important in economic terms has been the public provision of free education, even on graduate level. Increasing level of education has steadily increased the stock of human capital and very likely contributed positively to labour productivity. Figure 5 shows the development of shares of high school (gymnasium), college (or polytechnics) and university graduates. Especially in the 1990s the share of age cohorts graduating from tertiary education increased and exceeded 50 percent.

The economic cost of high public expenditures is the need for high taxation. Finland with the other Nordic countries has had one of the highest gross tax rates in the world. However, the Finnish tax rate has been clearly lower than those of Denmark and Sweden. Currently the total tax revenues are about 43 percent of GDP. The main sources of tax revenues are progressive income taxes levied by central and local governments, compulsory social insurance contributions collected mainly from employers, and consumption taxes consisting of value-added tax and excise taxes.

5. Political support of the welfare state

In search for the origins of the modern Nordic welfare models – including the Finnish one – one cannot neglect the decisive impact of long-time political dominance of Social Democratic parties and their political ideas as one of the most important factors explaining the birth of extended egalitarian welfare state model in the Nordic countries. That influence began seriously in the 1920s and 1930s, when the social democratic parties first time formed governments in the Nordic countries. Since that the Social Democratic parties have been the major governing parties in all Nordic countries most of the time. Together with strong trade union movement that has meant a significant position of power for many decades. This position of power or even political hegemony

enabled the gradual evolution of the increasingly complex systems of taxes and social programs in the post-war years – a system which even today forms the essential part of the Nordic welfare model.

In Finland the Social Democrats became a permanent partner in coalition governments in 1937. However, it was not before the 1960s when the political left was united enough to pursue effective reform policy in Finland. That was done together with the Centre Party (former Agrarian Union). The fact that the Social Democrats had to co-operate with the centrist parties and with the Communists made the Finnish situation different from the other Nordic countries. A strong emphasis on regional policy and protectionist agricultural policy was one consequence of that.

The development of the welfare state – public services and social insurance schemes – was a popular policy from its beginnings. Increasing tax burden has widely been accepted as a necessary price of the welfare state, and serious tax revolts (or political campaign to cut taxes) have not taken place. One can assume that the main reason for that is the universality of transfer and service provision on one hand, and the way taxes are collected on the other. The universality of the welfare state's provision means that all social groups benefit from them. Even those with highest incomes find free university education and earnings-related occupational pensions¹¹ very useful, and also less expensive than any alternatives.

On revenue side, the tax burden is not fully transparent. Most of public sector's tax revenues are collected through payroll taxes paid by the employers and indirect consumption taxes. Hence they are not visible in every-day life. For the great majority of people, income taxes are modest; it is only a small group of highly paid wage earners who face the highest income tax rates. The very rich have also had reason to be happy in recent years: since 1993 capital income has been subject to 25-28 percent flat tax.

6. The regime shift in the 1990s

In the 1980s the unemployment rates in Finland and in other EFTA countries were among the lowest in the OECD and the employment rates were the highest. Finland together with the other EFTA countries was able to escape the perils of recession and mass unemployment plaguing most other European countries. Finally that situation changed. After a long period of rapid economic growth and almost full employment, the Finnish economy entered an unexpected and exceptionally deep economic recession in the beginning of the 1990s – one may even talk about a 'depression', because the crisis resembled very much the Great Depression of the 1930s.

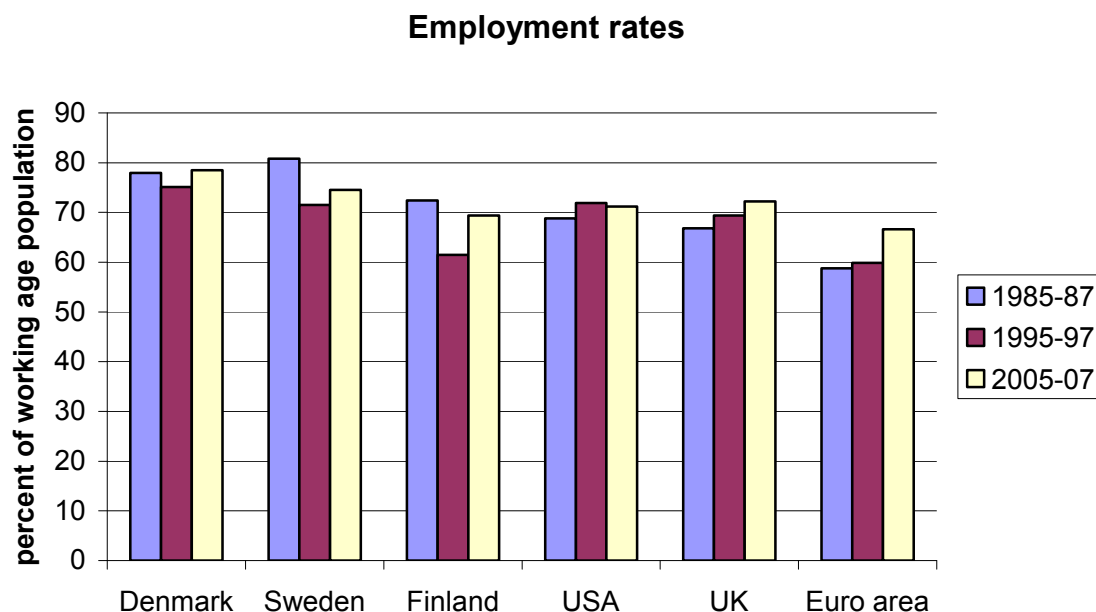
The Finnish economic crisis of 1990-93 was preceded by a debt-financed boom in the latter half of the 1980s. The bubble of the 1980s was caused by a credit expansion initiated by financial market deregulation (or a regime shift away from the post-war regulation). When credit constraints were lifted in 1986 – as a part of an international wave of deregulation – household debt started to climb up quickly. The indebtedness of corporate sector increased rapidly, too. Corporate taxation still favoured debt finance, and firms – especially in construction and service sectors – were eager to invest. As a result, private sector debt and asset prices doubled within a short period, in 1986-1989. In short run, the bubble was good to real economy. It helped to speed up economic growth, and to achieve full employment.

¹¹ There is no upper ceiling for pensions in the public pension system, which has effectively limited the need for private pension insurance.

The debt-financed boom did not last. Investors started to worry about the competitiveness of the economy, and exchange rate became under pressure. Because of the policy of exchange rate targeting, the Nordic central banks tried to defend the exchange rate by raising the domestic interest rates. This led to a three-year period (1989-92) of very high real interest rates. In a economy where households and firms had accumulated large debts this interest rate shock was disastrous. Economic growth stopped in 1990, and in 1991 the economies of Finland and Sweden begun to shrink. The boom was followed by a bust – a three-year period of high interest rates, falling output and collapsing asset prices, debt-deflation, mass unemployment, and subsequently financial and banking crisis and currency crisis.

The recession helped to make the case that the crisis and slowdown of economic growth were not results of some minor macroeconomic co-ordination failure but instead a deeper systemic malfunction ultimately caused by the structures of welfare state. In the midst of the recession it was widely argued that the Nordic welfare state is generally bad for growth because it creates bad incentives. Many observers (e.g. OECD) were ready to conclude that the rising unemployment in Sweden and Finland was evidence of the malfunction of the Nordic welfare state. It is hence not surprising that the large fiscal deficits caused by the recession induced cutbacks. As a consequence, the Finnish welfare state was forced to cut expenditures. Most entitlements were subject to savings measures throughout the 1990s. A usual way to erode the value of entitlements was to reduce their relative and real value by not doing full adjustments to inflation. As a result, the replacement ratios of unemployment benefits and old-age pensions declined. More drastic cuts were made to child benefits and other family support programmes. Health care subsidies were also reduced and the user fees increased. In the end of the 1990s the relative level overall level of social spending (excluding the unemployment-related expenditures) was about 10 percent lower than in the beginning of the decade.

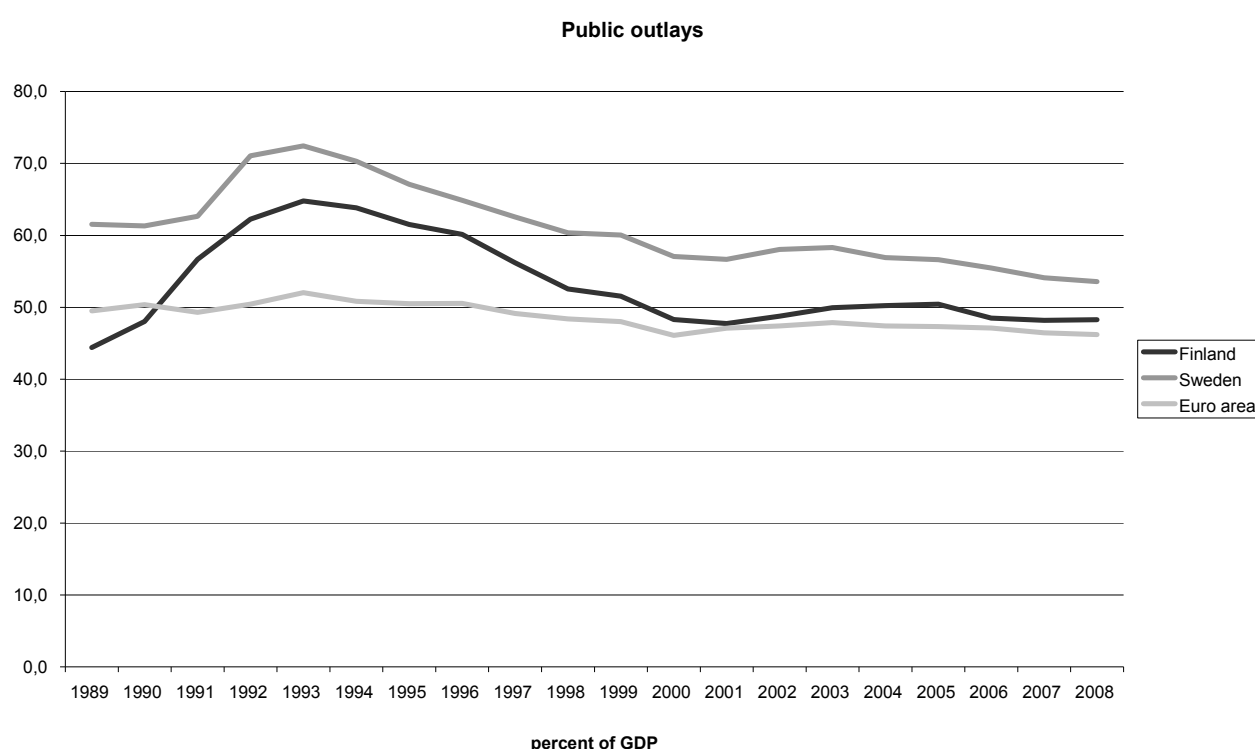
FIGURE 6: Employment rates



The view that the recession was caused by structural factors or excessive welfare provisions turned quickly to be wrong. The competitiveness problem which constrained Finnish export growth in 1989-91 was solved easily when the Finnish currency was allowed to float with many EMS-

currencies in the autumn of 1992. The following currency depreciation in 1992-93 helped Finland to gain a marked and sustained improvement in competitive position and the improved competitiveness led to rapid export growth. Rising exports and lower interest rates turned the economy to robust and sustained growth. The average rate of growth in 1994-2007 was 4 percent, and unemployment rate decreased from 17 to 7 percent. In spite of strong recovery, the welfare state stayed in crisis mood longer. Long-lasting effects of the recession seem to be increased poverty rate, larger income differentials, lower replacement ratios of many social benefits, and lack of resources in many public services. For the welfare state the most important consequence of the economic crisis was the end of growth. After the crisis years of the 1990s the relative share of public expenditure has been stable, and it has returned to the same level as in the end of the 1980s (Figure 7).

FIGURE 7: Public outlays



7. Concluding remarks

Starting from poverty, Finland has in the 20th century succeeded first in catching up other (more advanced) European countries and finally in surpassing the EU15 average GDP per capita level. Hence the Finnish growth policies can be viewed successful. In this article we have tried to emphasize, that this good record has been partly achieved by using unorthodox economic policies: the role of state has been strong, domestic producers have enjoyed protection, and markets have been regulated. At the same time, the institutions of the Finnish variant of the Nordic welfare state were gradually built up. The most decisive period of welfare state development was in the 1960s and 1970s, mainly from internal political reasons.

The new economy phase which started after a deep economic crisis in the 1990s enabled Finnish manufacturing sector even to achieve the global productivity frontier. In a light of such

performance the Finnish economy can be viewed dynamic and highly competitive. The good standing of the Nordic countries – Sweden, Denmark and Finland – in the various measurements of growth, employment, high tech indicators and R&D have even given rise to a new positive evaluation of the economic impact of the Nordic welfare state. The rapid growth and especially the strong performance in new technologies have improved the image of Finland as a dynamic, innovative and modern economy.

It has even been argued that the Nordic welfare state model may actually have been good for such knowledge-intensive growth because it supports research and education and enables individual risk-taking. The high taxes of welfare states may be harmful to private sector employment but the high level of public sector employment more than compensates that. The Nordic welfare states are systems, which create incentives and possibilities to increase labour supply, and particularly labour supply of women. The large scale public provision of social services offers lots of employment opportunities, especially to women.

References

Acemoglu, D. – Johnson, S. – Robinson, J.A. (2004): Institutions as the fundamental cause of long-run growth, in Aghion, P. & Durlauf, S. (eds.): *Handbook of Economic Growth*. North-Holland.

Barro, R. (1997): *The determinants of economic growth: a cross-country empirical study*. Cambridge, MIT Press.

Easterly, W. (2006): National policies and economic growth: a reappraisal, in Aghion, P. & Durlauf, S. (eds.): *Handbook of Economic Growth*. North-Holland.

Hjerpe, Riitta. (1989): *The Finnish economy 1860-1985: Growth and structural change*, Bank of Finland Publications.

North, D.C. (1990): *Institutions, institutional change, and economic performance*. New York, Cambridge University Press.

Pesonen, Pertti & Riihinen, Olavi (2004): *The political system and the welfare state*. Studia Fennica Historica 3.

Puntila, L.A. (1975): *The political history of Finland 1809-1966*. Helsinki 1975.

Rodrik, D. (2006): Growth strategies, in Aghion, P. & Durlauf, S. (eds.): *Handbook of Economic Growth*. North-Holland.

Temple, J. (1999): The new growth evidence. *Journal of Economic Literature*, 37(1).