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Long-Term Economic Growth and Poverty
Reduction in Finland

Jaakko Kiander

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

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UNRISD, Palais des Nations
1211 Geneva 10, Switzerland

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

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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).

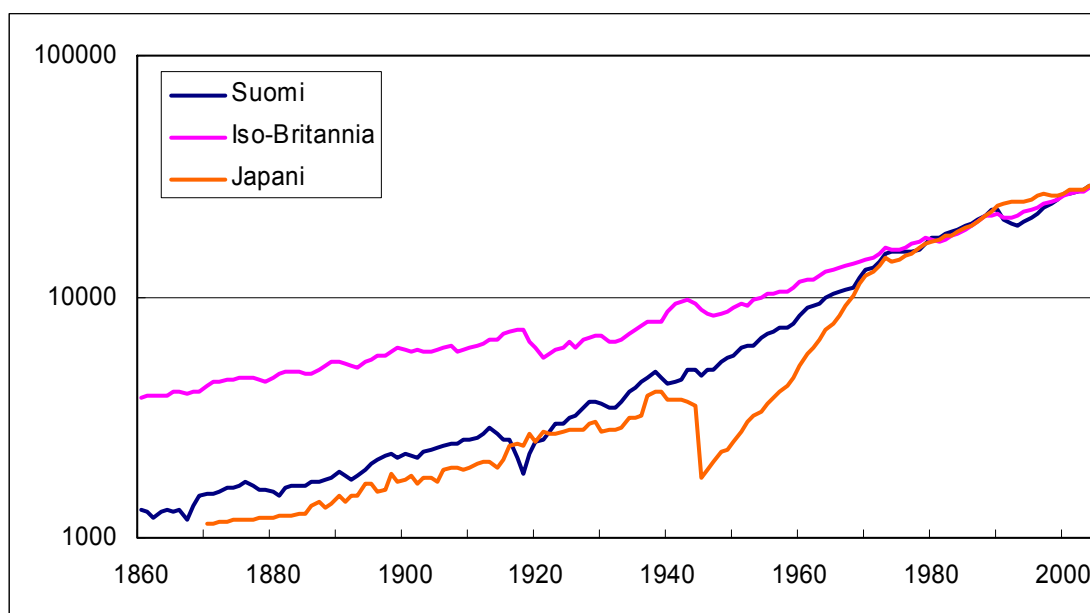
results can be achieved by fostering education and labour market participation as well as by providing basic health care.² This means that primary education and health care are necessary parts of public policy oriented to poverty reduction and equality. The next, and equally important step is to establish 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

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