Amsterdam University Press

Chapter Title: The Evolution of the Finnish Model in the 1990s: From Depression to High-Tech Boom

Chapter Author(s): Jaakko Kiander

Book Title: Employment 'Miracles'

Book Subtitle: A Critical Comparison of the Dutch, Scandinavian, Swiss, Australian and Irish Cases versus Germany and the US

Book Editor(s): Uwe Becker and Herman Schwartz

Published by: Amsterdam University Press

Stable URL: https://www.jstor.org/stable/j.ctt46n1mk.7

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4 The Evolution of the Finnish Model in the 1990s: From Depression to High-Tech Boom

Jaakko Kiander

Introduction

Finland has recently been much admired due to economic success. Finland has been in the news because of high rankings in competitiveness, technology, education and economic growth.[1] The success has largely been embodied in the growth of the Nokia group and ICT sector. Yet the economic boom and the success of the Finnish high tech industries are a relatively new phenomenon, starting from the mid-1990s. In fact, the years of good economic performance were preceded by an exceptionally deep recession in the beginning of the 1990s. At that time, the Finnish GDP shrank by 10 percent in 1991-93, and employment decreased by 20 percent. As a consequence, the unemployment rate rose from 3 to 17 percent between 1990 and 1994.

However, the economic crisis and the rise of unemployment turned out not to be permanent. Instead, the Finnish economy started a strong recovery, and unemployment fell during the latter half of the 1990s by 7 percentage points. Economic growth was fast, too, averaging 4 percent in 1994-2000. In 2001-03 the unemployment rate stabilised at the 9 percent level, mainly due to the recession of the European economy. The employment rate, however, was clearly higher than the European average, and the Finnish GDP per capita exceeded the EU average. It is also worth noticing that although the cyclical downturn increased unemployment throughout Europe in 2002-03, that did not happen in Finland.

This chapter discusses the roots of the crisis of the Finnish economy, and the factors which helped it to recover and to create the technology-driven growth of the last decade. Finland was by no means the only country experiencing a significant drop in unemployment and a revival in employment towards the end of the 1990s. Recent experience shows that numerous countries have been able to reduce their unemployment rates significantly, and more than anyone relying on earlier estimates of high structural unemployment would have predicted. These countries include Sweden, Denmark, Ireland, the Netherlands and Spain. In these countries employment has im-

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proved more than anyone relying on earlier estimates of high structural unemployment would have predicted. It is also noteworthy that this improvement took place without any deep labour market reforms – or at least it is hard to find evidence of such path-breaking institutional changes.[2]

How has that been possible in the case of Finland? The most obvious answer is rapid economic growth. After all, some kind of rebound in growth rates should not have even been surprising given the very deep and deflationary recession of the early 1990s.

Many commentators and analysts have been inclined to see the high unemployment and related underemployment as evidence of structural weaknesses typical to European welfare states – arising from the disincentives inherent in the European social model and overly regulated labour markets. It has been claimed repeatedly by e.g. the OECD and many others that the high unemployment of many European countries is structural by its nature and hence requires a certain set of reforms in order to be cured. Perhaps the most magisterial and exhaustive presentation of this evidence was provided by the 1994 OECD Jobs Study. Since then, the OECD has repeatedly emphasised the importance of incentive-improving structural reforms in its economic analysis as a necessary precondition of sustained improvement in employment. The set of proposed reforms usually includes cuts in taxes and benefits and labour market deregulation. It is commonplace that such proposals include only supply-side measures and exclude all references to the need for aggregate demand stimulus.

In light of the Finnish experience, such a uniform view of sclerotic European economies and rigid labour markets does not entirely fit the facts. The main conclusion of this chapter is that the institutional reforms (or the absence of them) seem to have played only a minor role in the emergence of unemployment and in the subsequent employment revival in Finland in the 1990s. In addition to the breakthrough of ICT technologies, more traditional macroeconomic factors like changes in monetary policy and exchange rate and pro-cyclical fiscal policy may have been of great importance. It is likely, too, that the fact that employment has not fully recovered, notwithstanding the rapid economic growth, can be largely explained by using the same macroeconomic factors. The surge in productivity and the rapid upgrading of the industrial structure which took place in the 1990s were changes that are harder to explain by traditional macroeconomics. They can be viewed as a result of a more complex process where long-term development of the national innovation system, technological breakthroughs and industrial change induced by 'creative destruction' were important components.

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Despite economic shocks and industrial restructuring, Finnish political governance and corporatist institutions remained relatively stable. Like before political decision-making in the beginning of the new century was still largely based on national consensus building. The structures of the welfare state survived the fiscal crisis though the welfare state was forced to go through numerous small and incremental changes, which reduced many entitlements. The central labour market institutions – strong trade unions with high unionisation rate, and centralized incomes policy – remained almost intact.

The background of the Finnish miracle: the economic crisis of the 1990s

Eurosclerosis avoided in the 1980s

In the 1980s Finland was known among experts[3] as a small and relatively rich EFTA country with advanced welfare systems and corporatist labour market institutions. At that time, EFTA was a free-trade association of half-a-dozen small non-EEC European countries.[4] That group seemed to be immune to the rise of unemployment and related economic and social problems experienced elsewhere in Western Europe (or EEC countries) at the same time.

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 – the small countries seemed to be immune to the economic problems of the larger European countries (Katzenstein 1985). In the 1970s and 1980s unemployment rates rose almost continuously in the member countries of the EEC, while unemployment in the Nordic EFTA countries fluctuated between 2 and 6 percent without any serious upward trend. Finland together with the other EFTA countries were able to escape the perils of recession and mass unemployment plaguing most other European countries.[5]

Finally, that situation changed. After a long period of rapid economic growth[6] and almost full employment, the Finnish economy entered an unexpected and exceptionally deep economic recession in the beginning of the 1990s. To some extent, the same happened also in the USA and in the Western European countries, but in Finland the crisis was much more severe than elsewhere. In the case of Finland, one may even talk about a 'depression', because the crisis resembled very much the Great Depression of the 1930s.

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Table 4.1 Summary of the cycles of the Finnish economy in 1978-2000

Period	Economic cycle	Labour market	Economic policy
1978-1985	Period of balanced growth with declining inflation rate	High employment	Regulation of financial markets, public sector growth
1986-1989	Period of unbalanced rapid growth	Full employment with wage inflation	Financial market deregulation
1990-1993	Years of economic crisis	Mass unemployment	Collapse of exchange rate regime
1994-2000	Period of export-oriented rapid growth and structural change with stable prices	Rising employment with wage moderation	Fiscal consolidation, tax reforms, EU and EMU membership
2001-2004	Cyclical downturn in export markets, strong domestic economy	Stable employment, slowly decreasing unemployment with continued wage moderation	Fiscal expansion through tax cuts and increased infrastructure investment

Financial market deregulation and the creation of a bubble economy

The Finnish economic crisis of 1990-93 was preceded by a debt-financed boom in the latter half of the 1980s (the different periods of economic growth are summarised in Table 4.1). That, of course, was not exceptional. Most OECD economies boomed in 1987-89, and some of them experienced speculative bubbles with rising asset prices. Well-known examples are the Japanese economic 'miracle' in the 1980s and the house price bubble in the UK, both of which were followed by recessions.[7]

In Finland and Sweden the bubble of the 1980s was caused by a credit expansion initiated by financial market deregulation. Before the liberalisation, the banking sector and credit markets were tightly regulated in Finland, and most households faced liquidity constraints – i.e., they were not allowed to borrow as much they would have liked. When these constraints were lifted in 1986 – as a part of an international wave of deregulation – household debt started to climb up quickly. Loans were used to finance purchases of houses and durable goods. Debt service was not expected to cause problems, because the real after-tax interest rates of households were expected to remain low due to the modest level of nominal interest rates, relatively

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rapid earnings growth and tax deductions. The indebtedness of the corporate sector increased rapidly, too. At that time, corporate taxation 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 (1986-1989). The bubble was good to the real economy. It helped to speed up economic growth, and to achieve full employment. The Finnish employment rate was record high at 74 percent in 1989-90.

The boom ended in 1990 when international interest rates started to increase. Domestic interest rates in Finland were linked to German interest rates through exchange rate targeting. The central banks of all Nordic countries had a policy to maintain their exchange rates almost fixed vis-à-vis other European currencies, which were linked to the Deutschmark.[8] As a consequence, the Nordic interest rates could not be lower than those in Germany. Additionally, any uncertainty about the sustainability of the fixed exchange rate policy would cause an additional rise in interest rates. Such worries started to increase in 1989. Due to inflation, both Finland and Sweden were losing their competitiveness, which reduced export growth. At the same time, a booming domestic economy raised the demand for imports. As a result, the current account deficit widened. In the Finnish case a special problem was caused by the disintegration of the Soviet Union, which reduced Finnish exports to that country.[9]

The recession: exchange rate targeting, interest rate shock and debt deflation

The crisis was closely related to the policy regime of exchange rate targeting. The attempt to maintain fixed parity with the Deutschmark finally turned out to be unsustainable. However, before that, the Bank of Finland (and the Swedish Riksbank) 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 an economy where households and firms had accumulated large debts, this interest rate shock was disastrous. As can be seen from Figure 4.1,[10] the interest rate shock was huge. Within two years the real short-term interest rate went up from 2 to 12 percent

With higher than expected interest rates, the debt-financed boom came to an end. The 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[11], financial and banking crisis and currency crisis.[12] High interest rates in a debt-ridden economy effectively constrained private

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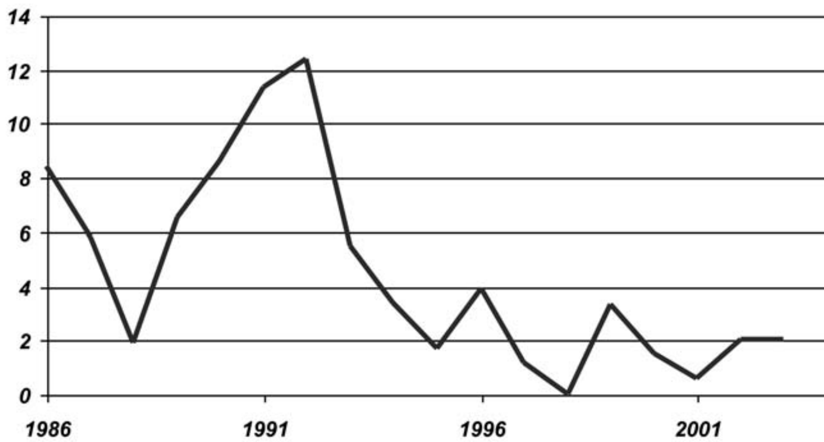

Figure 4.1 Real start-term interest rate

demand. Firms and households which had a few years earlier accumulated lots of debt now faced liquidity constraints and were forced to sell their assets. That fuelled further falls in asset prices. Within four years the Helsinki stock market index fell almost 70 percent, and house prices decreased by half. Falling asset prices caused negative equity and balance-sheet problems to indebted households, firms and their creditors. Solvency problems reduced consumption and investment; consequently, output and employment fell in both Finland and Sweden for three consecutive years (1991-93), and unemployment soared. In Finland the crisis was twice as great as in Sweden whether measured by output losses or unemployment; in Finland GDP shrank by 10 percent, and employment by 20 percent.

It is tempting to argue that the basic factor behind the recession was a monetary shock: a sharp rise of interest rates in 1989-90 bankrupted many debt-ridden firms and forced households to cut their spending, which caused a deflationary spiral and a recession. In that respect, the crises of Finland and Sweden can be seen as unintended consequences of changing economic policy regimes in Western Europe (i.e. financial market deregulation and strong commitment to a fixed exchange rate) and policy-makers' surprising determination to fight inflation, notwithstanding the fact that inflation was not a very serious problem at that time.

The explanation of the Finnish and Swedish recessions seems to be a macroeconomic policy failure, and a necessary pre-condition for the severity of the recessions of Sweden and Finland was the huge build-up of private sector debt after the financial market deregulation (cf. King 1994 for de-

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tails). The monetary and exchange rate policies were not used in the 1990s to stabilise the economy – unlike in earlier crises in the 1970s and 1980s. Instead, things were made worse by the stubborn (but at that time fashionable) policy of exchange rate targeting which prevented the needed currency depreciation and which forced the central banks to maintain high interest rates.[13] The rules-based exchange rate policy doctrine was adopted widely by politicians and central bankers. The idea of the policy was to fight inflation by creating 'an anchor' for the value of the domestic currency. However, the consequences of the deflationary policy were not properly understood at the time, and the resulting recessions were to a large extent surprising to decision-makers and economists.

Furthermore, it is likely that the Finnish recession was made worse by discretionary fiscal tightening. The recession caused a huge budget deficit. The government attempted to cure this by increasing taxes and cutting discretionary spending during the recession, which made the recession even worse by reducing domestic demand.

Political response to the crisis

The economic crisis coincided with a political crisis. The long post-war tradition of coalition governments of the two major parties – the Social Democrats and the Centre Party (formerly called Agrarian Union) – was broken in 1987. The years of economic liberalisation and the economic boom were governed by a new coalition, an 'unholy alliance' of Conservatives and Social Democrats, both of which were in favour of pro-market economic reforms and rules-based monetary policy. In 1991, at the outbreak of the economic crisis, a new coalition was formed after a landslide victory of the Centre Party in the parliamentary elections. The government of Esko Aho, the leader of the Centre Party, was the first centre-right coalition in decades. Rather quickly it proved to be highly controversial. Aho's government tried to maintain the exchange rate target and support that goal by restrictive budgetary policies. The government also attempted to persuade the trade unions to accept a cut in nominal wages. When that attempt failed, the relations between the government and the trade unions soured. The government tried in vain to introduce reforms that would have weakened the bargaining position of the trade unions.

Economic crisis, mass unemployment and tight fiscal policy made the centre-right coalition unpopular, and it was easy for the Social Democrats to regain power after the parliamentary elections in 1995. A new 'Rainbow

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coalition' led by the Social Democratic Party leader Paavo Lipponen consisted not only of the Social Democrats and the Conservatives, but also of the Green Party and even the Left Alliance (i.e. the former Communist Party). The coalition reigned over two terms, until 2003. This coalition was very explicitly oriented to co-operation with labour market parties.

The centre-right coalition of the recession years created a discontinuity of the Finnish tradition of consensus-building and over-the-block co-operation. It ignited conflicts and distrust. It utilized the crisis mood to carry through unpopular reforms like reductions in almost all welfare entitlements and public services. Although many decision makers and analysts viewed these measures as necessary, it is possible that the government's inability to create co-operation made the crisis longer and deeper by eroding the confidence of consumers and investors – or the financial market and wider public.

The exceptional character of the subsequent Rainbow coalition manifested a widely desired return to older modes of political co-operation. The unpopular reforms were continued, although more incrementally and negotiated with the labour market parties. Instead of ad hoc crisis management, government policy became more predictable and dominated by long term goals.

The recovery and the Finnish 'miracle'

Turnaround in economic policy

The deflationary pressures caused by high real and nominal interest rates and currency overvaluation ended when Finland – together with many other European countries, most notably the UK – was forced to abandon the policy of exchange rate targeting in the autumn of 1992 and let the currency float.[14] As a result of floating, the Finnish currency depreciated quickly, by more than 30 percent. However, the depreciation was not all that bad because it improved the competitiveness of Finnish exports. Floating also enabled the central bank to cut short-term interest rates by 10 percentage points within a couple of months. Without any fixed exchange rate target, there was no longer any need to defend the exchange rate by high interest rates, and the rates fell.

If we think that the excessive monetary tightening was the main cause of the recession, then it is not illogical to conclude that the biggest macroeconomic change contributing to the recovery was the easing of the monetary policy together with currency depreciation in the aftermath of the 1992

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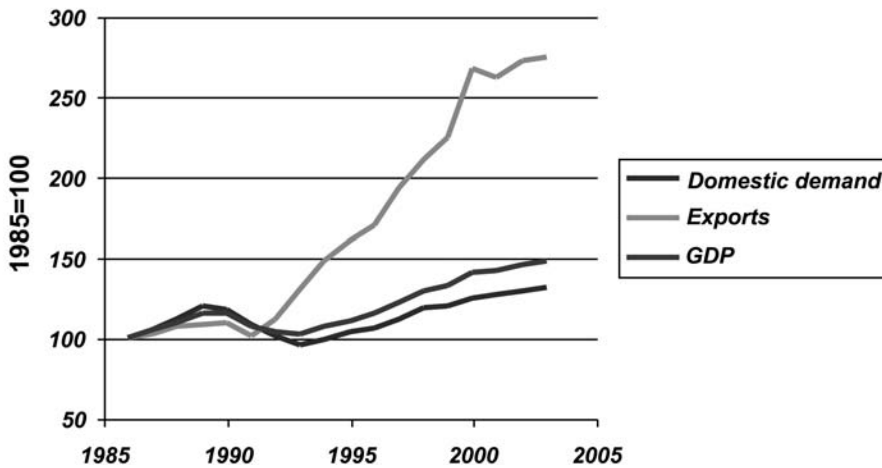

Figure 4.2 GDP, domestic demand and export volumes

EMS crisis. The lower interest rates helped to stabilise and reflate the asset prices, which ended the deflationary process. Private consumption and investment began to grow again in 1994.

The competitiveness problem which constrained Finnish export growth in 1989-91 was solved when the Finnish markka depreciated significantly after it was allowed to float with many other EMS currencies in the autumn of 1992. The currency depreciation in 1992-93 helped Finland to gain a marked and sustained improvement in competitive position. The improved competitiveness led to rapid export growth.

The post-crisis output growth was export-led in Finland, and the rising net exports contributed positively to the growth of GDP in 1994-2000. The export growth was clearly faster than the development of domestic demand, which remained subdued and did not exceed the 1990 level in real terms until 1999. In this respect, Finland differed from all other European countries, in which the growth contributions of external and internal sources have been much more balanced (see Figure 4.2). Rapid export growth together with depressed domestic demand caused an unexpectedly strong improvement in the current account, which went quickly from a deficit of 5 percent of GDP to a surplus of 7 percent of GDP.

Although the domestic demand and investment remained depressed throughout the 1990s, the growth record of GDP in the post-crisis years was impressive. In 1994-2000, the annual rate of economic growth averaged 4 percent, and employment growth was 2.1 percent. In the ten-year period of

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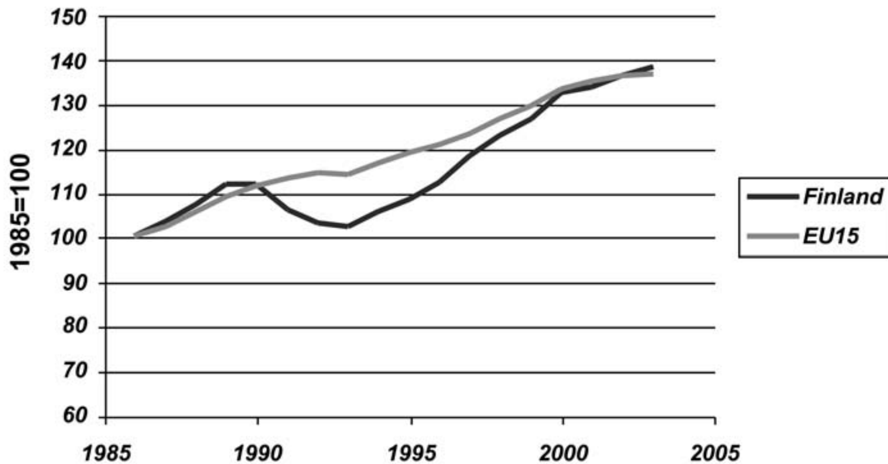

Figure 4.3 The evolution of GDP volume in Finland and EU 15

1994-2003, the Finnish GDP growth surpassed the growth rate of the EU15 in 9 years (see Figure 4.3). Productivity growth was fast, too. As a result, the unemployment rate was reduced from 17 percent in 1994 to 9 percent in 2001. Total employment rose by 15 percent at the same time, and the employment rate increased 8 percentage points.

The employment record was good, but it was not sufficient to enable a return to the earlier full employment. Employment could have increased more quickly if the economic growth had been stronger in labour-intensive sectors like services and construction. However, until the year 2000, the main contributors to the Finnish economic growth were exports and industrial production. That helped to improve average labour productivity faster than elsewhere, but it also made the economic growth less labour-intensive.

Creative destruction and knowledge-based growth

A decisive improvement in competitiveness was first achieved through currency depreciation. However, the depreciation was not permanent. Part of it resulted clearly from financial market overshooting which was not long-lasting, and after that the Finnish currency appreciated again in 1995-96 before it was irreversibly linked to the euro. More durable factors contributing positively to competitiveness were wage moderation and productivity growth, which together helped to reduce unit labour costs almost every year after 1991. Since 1995, wage moderation was achieved through wide agreements between the government and the labour market parties, and they were supported by tax cuts.

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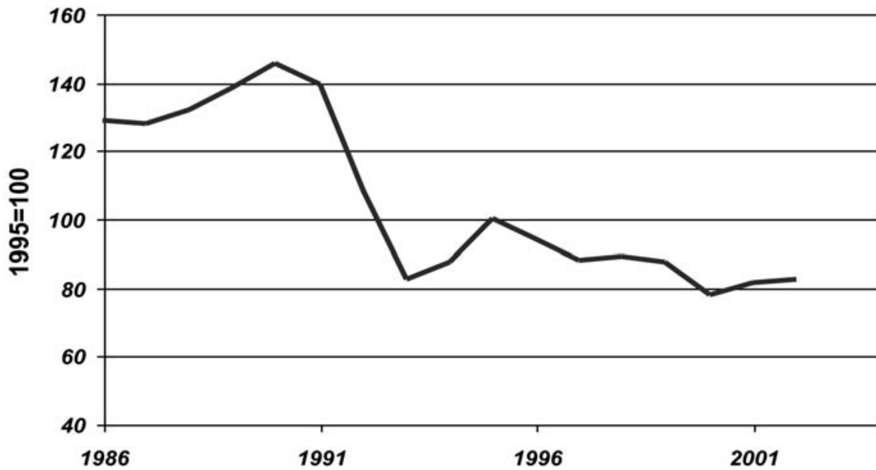

Figure 4.4 The competitive position of Finland in terms of Unit labour costs

The rapid productivity growth of the 1990s was caused by structural change. Finland made a qualitative leap from an economic structure dominated by mostly resource-based heavy industries to one with knowledge-based, mostly ICT industries as a leading sector.[15] That change contributed to a productivity acceleration which also improved the real competitiveness of the Finnish economy. The development of the competitive position of Finland vis-à-vis other industrial countries is depicted in Figure 4.4, which shows the level of real relative unit labour costs. The measure is a combination of relative changes in labour costs, productivity and exchange rates. It is surprising that in spite of the currency appreciation in 1994-96 and improving employment (which should have added to wage pressures), the unit labour costs continued their decrease. At the same time, total factor productivity growth also accelerated.

The accelerated productivity growth which followed the crisis launched a productivity catch-up process. As a result, during the latter half of the 1990s, the average labour productivity in Finland approached the productivity frontier of the USA and EU15 (see Figure 4.5). Recent research has linked that change to something which can be called 'creative destruction' (Maliranta 2001; Jalava and Pohjola 2002). The economic crisis triggered or forced a process of rapid structural change and rationalisation, which first caused a contraction of employment and improvement in productivity. Restructuring of companies at the plant level was the main cause of that; lots of old plants and companies were either closed or bankrupted, and typically they were the least efficient units. The remaining ones were – almost by defi-

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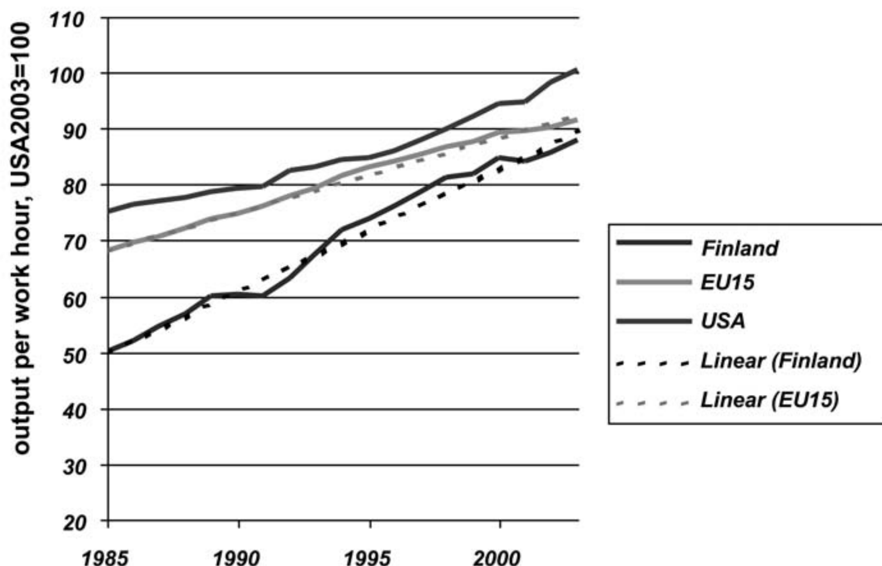

Figure 4.5 Labour productivity in business sector

nition – more productive. It is likely that capacity underutilisation and the existence of slack resources caused by the crisis facilitated organisational restructuring (e.g. through mergers and acquisitions) and reallocation of resources.

That was not the end of the process. In the next phase the improved competitiveness made it possible for the remaining firms to increase their exports rapidly. The growth of industrial production in 1992-2000 was record high, on average 7 percent per annum. The annual rate of labour productivity growth in manufacturing was 6 percent. Due to the accelerated productivity growth, the Finnish manufacturing sector jumped into the group of countries with the highest productivity.

Especially the rise of wireless communication technology (or the so-called Nokia cluster – the leading firms in that field were in the 1990s the Finnish Nokia and the Swedish Ericsson) manifested that change.[16] The spectacular ICT sector growth contributed significantly both to the Finnish GDP and exports growth and to the productivity growth. The share of business sector value-added produced by the ICT sector increased by almost 10 percentage points in the 1990s. Moreover, the rapid growth of the electronics and electrotechnics industry was largely based on productivity gains and increased use of intangible inputs. The national technology policy played an impor-

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tant if not decisive role behind that phenomenon. Innovation policy and a long-term approach in building a national innovation system were already active in the 1980s. Industrial R&D spending grew throughout the 1980s and 1990s faster than in any other OECD country. Today, the Finnish R&D spending is more than 3 percent of GDP, which is among the highest figures in the world. These investments have also been supported by public sector support to higher education, and especially increases in high-level technical education. For studies on the Finnish ict cluster: see Jalava (2003), Koski et al (2001), and Paija (2000).

Still in 1990 Finnish industrial production and exports were dominated by paper, pulp, metal products and machinery. By 2000 the electronics industry had become the biggest export industry, mainly due to the growth of mobile communications revolution. In 2000 the Finnish Nokia Group was the world's biggest manufacturer of mobile phones. The Finnish production of telecoms equipment had a global market share of 7 percent. The growth of the electronics industry in the post-recession years was truly spectacular. The output of that industry was multiplied more than six-fold and its relative share grew from 8 percent to over 27 percent of total industrial production – at the time when the total production also almost doubled. In 1992 the electronics sector was smaller than the metal, paper and pulp, food and chemical industries. In 2000 it was the largest sector of them all.

The growth of the Finnish ICT cluster made a crucial contribution to the productivity gains achieved in the 1990s. The direct impact of the growth of Nokia had a large macroeconomic impact on the Finnish economic growth. Finnish producers benefited also from worldwide trends in prices: decreasing prices of semiconductors and machinery improved the profitability (and value-added) of many Finnish ICT firms (not only Nokia), which contributed positively to the measured total factor productivity.

Table 4.2 shows the difference made by the 'new economy' or the Nokia sector to the Finnish manufacturing productivity. Total factor productivity, labour productivity and the productivity of fixed capital all increased by double-digit rates in the 1990s.

Role of policy reforms

It would be intriguing to argue that such good growth, productivity and employment performance as experienced in post-recession Finland would have been caused by a wave of institutional reforms. However, there is not much evidence of any radical changes (cf. Blanchard and Portugal 2001, Blanchard and Wolfers 2000). There are only a few signs of any kind of supply-

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Table 4.2 Productivity in Finnish manufacturing industry in the 1990s; annual average growth rates

	Total manufacturing	Electronics (the 'new economy sectors')
Labour productivity		
1991-1995	6.9	10.9
1996-2000	6.4	20.3
Capital productivity		
1991-1995	2.2	10.6
1996-2000	7.4	14.9
Total factor productivity		
1991-1995	5.3	11.2
1996-2000	6.6	16.7

Source: Junka (2003)

side changes or institutional reforms – in addition to the aforementioned public support to R&D and higher education – which could have improved the productive potential and work incentives.

It is evident that all European countries went through many minor reforms and adjustments during the 1990s. Still, in the end, most of them remain examples of the so-called European social model with regulated labour markets even after the 1990s. The same applies to Finland, too. Perhaps the biggest change which took place in the 1990s in Finland was the adoption and wide acceptance of a policy of long-term wage moderation. However, that was a quite natural response to high unemployment even in unionised labour markets, and for the unions it was a positive alternative compared with their marginalisation or exclusion from decision-making. A shift in political power launched some attempts for an institutional reform. The usually dominant Social Democrats were in opposition after an electoral defeat during the recession years (1991-95). The centre-right government which was in power in 1991-95 expressed intentions to diminish the role of trade unions and to get rid of the old corporatist wage bargaining system dominated by central organisations of trade unions and employers. These initiatives were successfully opposed by the trade unions, which threatened twice to arrange a general strike. The center-right government lost the general elections in 1995 and the Social Democrats were able to retake their position as the biggest party and to hold the position of prime minister in two coalition governments in 1995-2003. These governments[17]

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were careful to maintain the corporatist model and the strong position of trade unions in the Finnish economic and social policy.

There were some changes in taxation and welfare benefit system in 1990s which probably supported the economic recovery and improved public finances. The boldest change took place when the corporate and capital income taxation was reformed in 1993. A new system was introduced where profits, capital income and capital gains were taxed by a proportional 25 percent rate. At the same time the tax base was widened by abolishing several deductions. The reform improved the after-tax profits of firms and the incentives of entrepreneurs. Another part of policy was a gradual reduction of labour taxes in the latter half of the 1990s – after increases in taxation in the first half the same decade. To a large extent that meant only a return to pre-recession tax rates.

The work incentives were improved by a new earned-income tax deduction and by reductions in the levels of welfare benefits. Most entitlements programs 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 making full adjustments to inflation. As a result, the replacement ratio 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 although the number of pensioners had increased (Kiander 2001).

Figure 4.6 shows how the volume of public consumption (i.e. the public services) was reduced in the midst of the recession. At the same other expenditures increased. That was mostly due to increased social spending caused by higher than expected unemployment. Later on, when unemployment declined, also transfer spending started to decrease.

Motivation for the budgetary cuts was twofold: first the cuts were justified as necessary savings, but later also as a way to improve work incentives of the unemployed. The cuts were not popular. However, the majority of voters accepted them reluctantly as the only way to save the basic structures of the Finnish welfare state.

In the 1990s fiscal policy was more or less pro-cyclical in most European countries, and Finland does not make an exception. In the first half of 1990s fiscal policy was tightened with discretionary tax increases and spending cuts. These policies aimed to fiscal consolidation and to fulfilment of the EMU convergence criteria. There was a relatively deep fiscal deficit (7 per-

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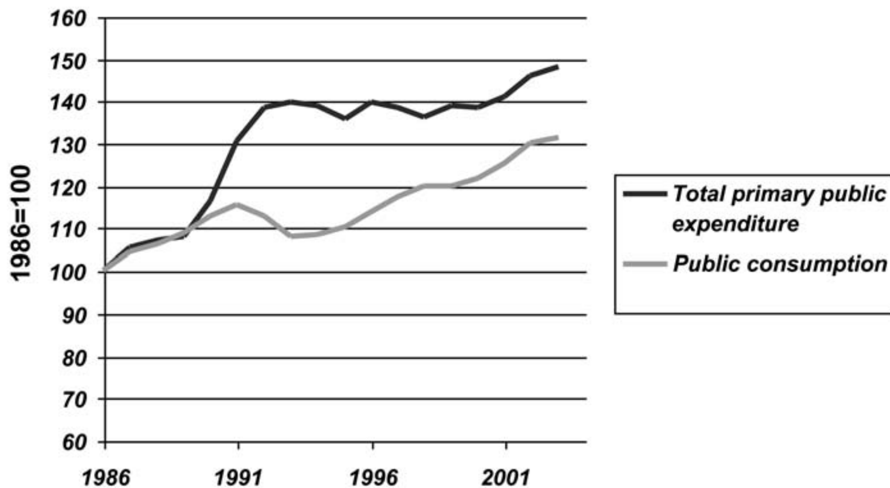

Figure 4.6 Total public sector primary expenditure and consumption expenditure

cent of GDP) in 1992-94 when the rate of unemployment was highest. The deficit was not much cured by the spending cuts made in the same years; higher taxes and reduced public spending increased unemployment, which lead to higher than expected social spending and lower than expected tax revenue.

In the latter half of the 1990s the opposite took place; lower interest rates and earlier budgetary savings created new leeway for policy-makers, who used the higher than expected tax revenues to finance tax cuts and some increased public spending. In the environment of decreasing real interest rates, improved competitiveness and growing employment expansionary fiscal policy did not threaten fiscal stability. Instead, fiscal balances were improving. Thus the improvement in fiscal balance achieved in 1995-2000 was not caused by higher taxes but instead by strong growth, lower interest payments and declining unemployment-related expenditures. After six years of rapid growth and falling unemployment, Finland had a record high (7 percent of GDP) fiscal surplus in 2000. The huge improvement in fiscal balance was achieved at the same time with steadily increasing public consumption and reduced taxes. That fiscal miracle (which resembled very much the famous Laffer curve) was made possible by rapidly increasing tax bases (due to output and employment growth) and by decreasing transfer payments (caused by lower unemployment-related and interest expenditures, and by erosion of the relative value of some transfer programs).

It can be argued that pro-cyclical discretionary fiscal policy had a positive

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impact on employment growth after the recession of the early 1990s. The growth contribution of fiscal policy may not necessarily have been very important but still it was clearly supportive for growth.

Structural issues: welfare state and labour market institutions

The recession and the subsequent output and employment losses helped to make the case that the crisis and slow growth were not results of a mere macroeconomic co-ordination failure but instead a deeper systemic malfunction ultimately caused by the structures of the welfare state. In the midst of the recession, it was argued that the Nordic welfare state is generally bad for growth because it creates bad incentives.[18] According to such views, overly generous benefits, labour market rigidities and high taxes will finally discourage investment, job creation and labour supply. Many critics used the dismal growth record of the first half of the 1990s as evidence supporting the negative diagnosis for both Sweden and Finland. During the crisis it was widely thought that the large budget deficits would be incurable without abolishing the welfare state. It was easy to find expressions of an 'orthodox' view which emphasises the dismal economic consequences of redistributive welfare ('tax and spend') policies.[19] The analytical background to such a view is provided by mainstream economic theory on the one hand and by the seemingly permanent economic problems of many EU countries since the 1970s on the other.

Since both countries recovered from the crises within a couple of years, they cannot be used any more as ultimate evidence of the failure of the Nordic model. It is now more widely admitted that the recessions were mostly related to financial factors and policy failures, not to serious systemic malfunctions. Both in Sweden and Finland, the sudden rise of unemployment turned out to be largely a temporary shock. The unemployment in the Nordic countries was much less persistent than that in the large EU countries. In Finland, the sudden rise of unemployment in 1991 was not a result of a long-term deterioration of employment but a consequence of a drastic destruction of jobs within a period of three years. After the crisis, employment recovered quickly, supporting the view that the Finnish labour market was relatively flexible, after all. The relation between employment and output did not change much after the surge in productivity in the mid-1990s.

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The Nordic welfare state: Good to economic growth?

The relation between advanced welfare state and competitive economy is a complex one, at least in theory. There is a classical trade-off between equity and efficiency in economic thinking. It is also easy to find expressions of such an 'orthodox' view which emphasises the dismal economic consequences of redistributive welfare ('tax and spend') policies. During the Nordic crisis in the 1990s it was widely thought that the large budget deficits of 1992-95 would be incurable without abolishing the welfare state. The analytical background to such a view was (and still is) provided by mainstream economic theory on one hand and by the seemingly permanent economic problems of many EU countries since the 1970s on the other.

The good standing of the Nordic countries – Sweden, Denmark and Finland – in the various measurements of growth, employment, high tech indicators and R&D (OECD 2003d, Koski et al 2001) 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 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 (Castells and Himanen 2002).

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 (see Rosen 1996, Stemrod 1998, Freeman 1995a). The Nordic welfare states are systems which create incentives and possibilities to increase the labour supply, and particularly that of women. Taxation based on individual (instead of family) incomes together with many incomes-related benefits (most importantly pensions, but also maternity and sickness benefits) favour a family model where both parents work. Publicly provided and heavily subsidised day-care for children makes that an easy option even for the mothers of small children and for those with low incomes. Furthermore, the large-scale public provision of social services offers lots of employment opportunities, especially to women. As a result, the Nordic countries have labour markets where men typically work in the business sector and women in public sector jobs.

The large public sectors of the Nordic countries seemingly do not crowd out much private sector employment. The number of business sector employees as a share of the population in Finland is roughly the same as in other European countries. The impact of the large public sector is that it has

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created new jobs in public services and shifted a part of unpaid household work (mostly done by women) to the market (Kiander 2005).

The Nordic welfare states have traditionally been good in improving the well-being of their citizens and equality between them. The Nordic social policies are by their nature egalitarian and universal in order to create inclusive systems. They aim to promote equality not only in regard of income distribution but also between genders.[20] Some of the benefits are universal and independent of family income like basic pensions, child and student benefits, while some benefits decrease with income, like housing benefits, and some are earnings-related, like unemployment insurance and occupational pensions.

The low overall poverty rates and especially the very low child poverty rates of the Nordic countries are due to deliberate social policies which help to maintain the disposable incomes of families notwithstanding their labour market position. The egalitarian outcome is helped a lot by subsidised social services like day-care provided by the public sector. The effect of these policies is most visible when one compares the poverty rates of families with single mothers. In most countries the poverty risk of such families is very high, but not in the Nordic countries.[21]

Denmark and Sweden have the most generous welfare state systems with regard to the provision of public services and income transfers, while the Finnish system is more modest and less ambitious. Due to the fiscal belt-tightening in the 1990s the differences between Finland and the more generous Swedish and Danish welfare systems have increased.

Labour market institutions and corporatism

Finnish society can be described as a parliamentary democracy with a Nordic welfare state system and highly corporatist labour market institutions. The unionisation rate in Finland is one of the highest in the world (more than 80 percent) and the coverage of collective agreements is almost 100 percent. Wide union membership is supported not only by political tradition but also by deductible membership fees and unemployment insurance system run by the unions. Employers are also highly organized.

The strong voice of the unions and employers is partly due to their co-operation and continuous dialogue. An unexpected and probably unintended consequence of the economic transformations of the 1990s was the strengthening of the corporatist system (cf. Kettunen 2003). All post-recession governments have been eager to emphasize the importance of the co-

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operation of the labour market parties. A positive result from that consensus has been continued wage moderation and improved competitiveness. Union members have benefited from low inflation, lower taxes and improved employment. Wage moderation has resulted from biannual centralized bargaining between the confederations of trade unions and employers.

There seems to be a strong continuity in the Finnish corporatist institutions. The recession of the early 1990s was a tough test for that system, and it was challenged by the centre-right government. However, that attempt failed to ignite a systemic shift. Since 1995 the governments have (like in the 1980s) co-operated with the labour market parties and relied on their support in big decisions, like ones on reforming pension system and joining the EMU.

The decision to join the EMU was seen risky on the ground that in past Finland had experienced many asymmetric shocks which were cured by using exchange rate flexibility (indeed, that was the main argument why Sweden decided to not join the EMU). Trade unions were ready to accept Finnish membership only after the government and the employers agreed to establish so called buffer funds (i.e. surplus funds in the social insurance system) to be used to stabilise labour costs in a case of asymmetric shock in future. The buffer funds decision effectively gave part of the control a fiscal policy into the hands of the labour market parties, and further strengthened the institutional basis of the corporatist system.

On the prospects of the Finnish model

Starting from poverty, Finland has in the 20th century succeeded first in catching up with other (more advanced) European countries and finally in surpassing the EU average GDP per capita level. The 'new economy' phase of the 1990s enabled the Finnish manufacturing sector even to achieve the global productivity frontier. In light of such a performance, the Finnish economy can be viewed as dynamic. The trends of output and productivity growth are still stronger than those of other EU countries and the USA. If they can be maintained, then Finland will surpass most other European countries in GDP per capita and productivity, and approach the American productivity and output frontier.

Thus, the economic prospects of Finland are bright; together with Sweden, Finland is the only EU country fulfilling the Lisbon targets of high level of R&D spending. As a consequence of the deep financial crisis of 1990-93, the Finnish unemployment rate is still relatively high. Yet the employment rate is 67 percent,[22] higher than in most other EU countries and reasonably

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close to the Lisbon target of 70 percent. The Finnish welfare state model and even the corporatist labour market institutions are supportive of wide labour markets participation and full-time work. That is why we can expect the employment rate to continue its growth and to finally achieve the level of almost 75 percent which prevailed in the 1980s.

In the longer term, the biggest challenge for the Finnish economy will be caused by demographic changes. The Finnish labour force is ageing rapidly, and it is expected that the labour supply will start to shrink after 2010. If strong economic growth is to be continued, Finland is going to need immigration and a higher average retirement age (i.e. longer careers). The greying will increase public pension and health care expenditure in the future. However, Finland is prepared for that change better than most other countries; the public finances have a surplus, and the government sector has more financial assets than debts.

Conclusion

In recent years Finland has received much attention as an economic star performer. That view has not been based on traditional economic indicators like income level but on other indicators measuring wider competitiveness and the development of a so-called new economy. Much of that success is very closely related to the Nokia phenomenon. The emergence of the world's biggest producer of mobile ICT in a small country has clearly made a difference. In macroeconomic terms, the biggest change has been a productivity revolution – sustained and exceptionally rapid productivity growth in manufacturing industries in the 1990s.

The odds of such growth were very low in the beginning of the 1990s. As a result of a financial crisis, Finland suffered a serious shortfall in growth and employment in 1990-93. However, that crisis turned out to be only temporary. In spite of the macroeconomic turbulence, the long-term growth record of Finland (even in the 1990s) has not been bad. On the contrary, Finland has been able to catch up with the most advanced economies. The economic crisis forced the Finnish economy to go through a period of painful adjustment and restructuring. The crisis launched a period of 'creative destruction'. The rationalisation processes together with the unexpected rise of mobile ICT technologies created the productivity miracle of the 1990s. It was based not only on technological advances but also on open sector growth and a huge improvement in competitiveness induced by currency depreciation in 1992. In the rapid rise up the quality ladders – from re-

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source-based to knowledge-based production – the role of intangibles and the knowledge base has been indispensable. Finland has clearly benefited from the long-term policy of investing in national innovation system development and supporting R&D.

In spite of rapid growth, the most burning social problem in the 1990s was mass unemployment. Although the rate of job creation in the post-crisis period (i.e. since 1993) has been rapid and the unemployment rate was reduced by 8 percentage points between 1994 and 2001, there is still underemployment. Employment has not returned to the level achieved in the 1980s. However, due to high labour force participation, the Finnish employment rate has always exceeded the average level of the EU (even in 1993-94 when the unemployment rate was more than 16 percent), and it is likely to continue its growth.

The Finnish economic development – from boom to bust, and from creative destruction to technology-driven prosperity – makes one wonder about the roles of social corporatism and welfare state in that process: were the institutional characteristics of the Finnish society an advantage or a hindrance? In the 1980s Finland was clearly one of the small European welfare states with large public sectors and corporatist labour market institutions. As usual, such institutions tend to be resilient and slow to change. They survived the crisis period more or less unchanged, although the replacement rates of most welfare programs were cut in the 1990s. By accepting wage moderation, the trade unions were able to maintain their traditionally strong position, and the corporatist system survived.

In spite of mass unemployment and fiscal problems in the mid-1990s, the Finnish political governance and corporatist institutions remained relatively stable. There were short-lived attempts by the centre-right government in the first half of the 1990s to introduce more radical institutional reforms, which would challenge the corporatist system. Without sufficient electoral support they did not succeed. Rather quickly the political decision making returned to its old mode of consensus building and incremental reforms. Although the structures of the Finnish welfare state survived the crisis of the 1990s, they were subjected to many small incremental changes, which reduced many entitlements and widened the difference between the Finnish and Swedish variants of the Nordic welfare state.

The prospects of the Finnish economy are relatively good. Given the strong technological base and abundance of skilled labour, Finland still has a potential to grow faster than other Western European countries. The main challenge is the ageing population. Demographic change is expected to reduce the labour supply and put public finances under stress between 2010

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and 2020. However, the Finnish public finances are in good shape to face that change.

Notes

1 See e.g. IMD (2003) and WEF (2003) and the many indicators in EU (2003). In most comparisons Finland ranks among the top three, whether it comes to competitiveness or indicators of technology and knowledge-based growth.
2 This point has recently been emphasised e.g. by Fitoussi et al. (2000) and Ball (1999).
3 To the wider international public, Finland was not known at all.
4 At that time EFTA member countries were: Austria, Finland, Iceland, Norway, Sweden and Switzerland.
5 It is most likely that the differences in unemployment developments between countries reflect corresponding differences in macroeconomic policies; cf. Blanchard and Summers (1986) and Ball (1999), who emphasize the role of macroeconomic shocks.
6 Unlike most other industrial countries, Finland did not suffer from a recession in the beginning of the 1980s.
7 However, it is interesting to note that some other countries which enjoyed an employment miracle in the 1990s did not suffer from asset price bubbles in the 1980s.
8 That was a bit curious choice since Denmark was the only Nordic country which was a member of the EU. Finland and Sweden joined the Union in 1995.
9 In the mid-1980s the Soviet Union absorbed more than 20 percent of Finnish exports. In 1989-91 that market was lost almost totally due to the internal problems of the Soviet Union.
10 All figures, if not indicated otherwise, are based on diverse editions of the OECD's *Economic Outlook*
11 The concept of debt deflation was originally introduced by Irving Fisher (1930) who tried to explain the Great Depression. In debt deflation, declining asset prices increase the real value of debts, which puts the debtors under financial stress by decreasing their net worth.
12 For literature on the Finnish crisis, see e.g. Kiander and Vartia (1996), Honkapohja and Koskela (1999), Bordes et al. (1993), Jonung et al. (1996), and Kalela et al. (2001).
13 Under fixed exchange rates, high interest rates are needed to defend the exchange rate if investors think it is overvalued, which was the case in most European countries in 1990-92.

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14 The European countries were forced to change their exchange rate regime because the market pressure against the fixed parities grew too great. Abandonment of the restrictive monetary policy was not actively sought.

15 In 1990 Finnish exports were dominated by paper, pulp, metal products and machinery. By 2000 the electronics industry had became the biggest export industry.

16 The role of 'new economy' in the Finnish productivity miracle has been studied by Daveri and Silva (2004). For reviews of the growth of the Finnish wireless technology sector and Nokia corporation, see Ali-Yrkkö (2001), Rouvinen and Ylä-Anttila (2003) and Paija and Rouvinen (2003).

17 The Social Democrats were in opposition during the recession (1991-95). After that, they held the position of prime minister in two coalition governments in 1995-2003.

18 An eloquent piece of such criticism and an assessment of the 'Swedish experiment' are provided by Lindbeck (1997).

19 It is easy to find examples of such opinions by reading e.g. *The Economist*, or the country reports of the IMF and the OECD. A good example of a theoretically sound argument showing how excessive social protection can lead to persistent unemployment is presented by Ljungqvist and Sargent (1998).

20 Tanzi and Schuknecht (2000) argue that increasing the size of public expenditure above 30 percent does not yield any economic gains. Such a view seems to neglect the equity-improving impact of welfare states, of which the Nordic countries offer ample evidence. It can also be said that there is no compelling empirical evidence that large public sectors as such would be harmful to growth.

21 Kangas and Palme (2000) show that differences in social policy explain the low family-related poverty rates in the Nordic countries. The same pattern is reflected by the results of Haataja (1999), according to which poverty in the Nordic countries is not connected with unemployment. Forssen (1998) has analysed the Nordic family policies and their distributional impacts.

22 That was the average level of years 2001-2003.

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