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The Finnish Developmental State and its Growth Regime

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Abstract

This paper reviews Finland's growth strategy in the postwar decades. Finland was able to initiate an impressive mobilization of resources during this period, reflected mostly in a high rate of capital accumulation for manufacturing industries. This was achieved by an unorthodox combination of *dirigiste* means and a basic commitment to upholding the market economy. The state acted as a net saver, and credit was rationed to productive investment outlays. This policy package may have been boosted by the country's precarious international position during the cold war, so that an economic failure would have been very risky indeed. We argue also that incomes policies and welfare reforms were important in sustaining the necessary political compromise that underpinned the Finnish development state.

Keywords: economic growth, incomes policy, income distribution, labour unions, structural transformation, social contacts, developmental state

JEL classification: O43, E64, O15, J5

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1 Introduction

Finland is an example of a late but successful state-led industrialization that was carried out rapidly. The economic policy strategy that achieved this was a judicious mix of heavy governmental intervention and private incentives. Governmental intervention aimed at a fast buildup of industrial capital in order to ensure a solid manufacturing base. This presupposed the mobilization of the nation's resources. Policymakers as well as private actors and corporatist organizations shared the view that market signals and individual incentives would not be sufficient to sustain the desired rapid rate of growth. At the same time, however, it was made clear that the aim of the heavy-handed state intervention was not to establish a planned economy as a permanent solution. Rather, the government and the constitution made it clear that the basic property rights of capitalism would ultimately be respected. It is this characteristic of non-socialist economic planning that has warranted a comparison of the Finnish growth regime with those of the Asian 'tiger countries' (see Vartiainen 1999).

The growth strategy has generally been considered a success since the country was able to undergo a remarkably rapid industrial transformation. Finland was definitely a late industrializing nation. In the 1930s, the economy was predominantly agrarian and, as late as in the 1950s, more than half the population and 40 per cent of output were still in the primary sector. Per capita gross domestic product was only half of that of Sweden. Yet by the late 1970s, Finland had become a mature industrial economy.

Figures 1(b) and 1(c) compare Finland to a few other countries, namely the USA, the UK and Sweden during this period. Figure 1(b) shows the level of GDP per capita, measured in 1990 international PPP dollars for these four countries. Figure 1(c) shows the same series relative to the real GDP per capita of the USA.[1]

Figure 1(b) suggests that the Finnish economy suffered quite large shocks relative to those in other countries (Sweden, geographically close and with a similar climate as in Finland, was Finland's most natural comparator in the nineteenth century). While Finland may have narrowed the gap with other countries in the inter-war period, it was only after the Second World War that growth relative to these other countries really seemed to take off, reaching the GDP per capita level of the UK in the 1980s and that of Sweden in the 1990s, although the depth of the 1990s recession led to a relative decline in Finland's economic position.

Figure 2 shows the economic structure across sectors from 1860 to the present. Figure 2(a) gives the breakdown of the total labourforce employed in agriculture, the manufacturing industries and services. The share employed in agriculture started to decline in the last decade of the nineteenth century. This decline accelerated after the Second World War and again in the early 1960s to slow down somewhat in the late 1970s. The manufacturing sector again increased slowly from the beginning of the series in 1860, increased slightly more rapidly in the inter-war period and rose after the Second World War to around 30 per cent of the labourforce. Since its peak around 1980, manufacturing has declined and is currently lower than at any time since the

1 The cases of Sweden and Finland are discussed in detail by Lindmark and Vikström (2003), who carefully analyse and decompose the growth performance of these two economies to its constituent parts.

1950s. By contrast, services doubled their share of employment from around 30 per cent of the labourforce to about 60 per cent currently.

Figure 1
GDP per capita in selected countries

Figure 1(a)

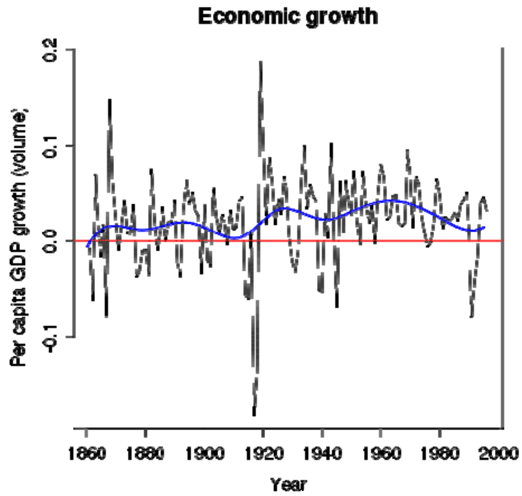


Figure 1(b)

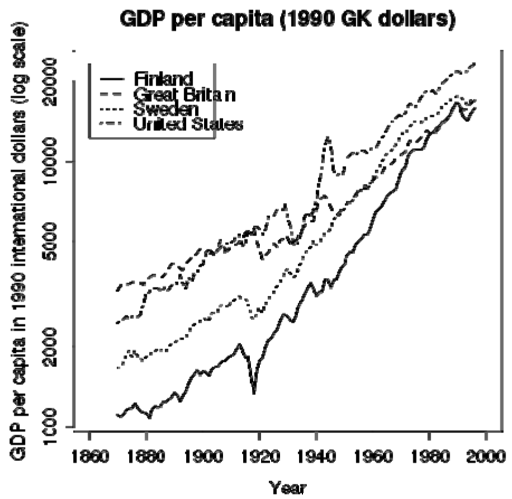
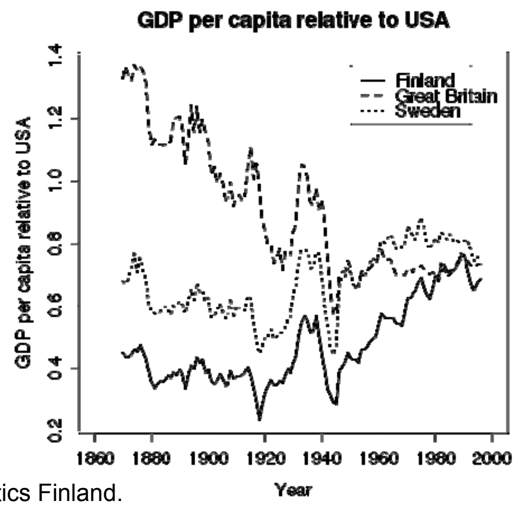


Figure 1(c)



Source: Statistics Finland.

The growth performance was all the more remarkable because of Finland's bruised political past before the Second World War, as well as because of the country's precarious international position during the cold war. As soon as the country had achieved independence in 1918, it succumbed to an extremely bloody civil war that decimated 34,000 people from a population of about three million.

Figure 2
Sectoral distribution of employment

Figure 2(a)

Figure 2(b)

Source: Statistics Finland.

2 Changed political preconditions after the Second World War

The political scene remained acrimonious even in the interwar years. Political contradictions were acute, and the Communist Party was banned. In the 1920s, however, some tentative steps towards national reconciliation were taken.

It was only after the Second World War, however, that economic growth really took off. The most important engine for growth was simply an energetic accumulation of capital, reflected in an unusually high investment rate.

The outcome of Second World War changed the political constellation of the country and paved the way for a long-standing political coalition of the centre-left parties. This political shift reinforced the preconditions for economic interventionism, but the Finnish *dirigiste* growth regime was never imposed on reluctant capitalists. Instead, under this phase of rapid capital accumulation, the state cooperated with banks and business organizations. From the 1950s onwards, as the trade unions had become stronger, the labour movement became a more active partner in this more or less implicit social contract. Thus, in a manner similar to that of Austria, Korea and Taiwan, decisionmaking has been quite corporatist.

Of course, the general mood of economic thinking was quite sympathetic to state intervention after the Second World War. Directly after the war, it was generally accepted in Europe that the state would play an active role in economic policymaking, and 'socialism' as well as economic planning was openly discussed in many countries. Committees for 'nationalization' or 'socialization' were set up in many countries (such as Norway, the UK and France) and many policymakers in the west were probably wondering whether the market system alone would be sufficient to match the massive military-industrial buildup that was occurring in the Soviet Union. Furthermore, the military performance of the Soviet Union during the Second World War had boosted the prestige of economic planning: in the course of two decades, the country had achieved an impressive accumulation of resources for heavy industries, and this high investment rate was widely seen in Europe and the United States as a challenge or an example to be emulated. This emphasis on heavy capital accumulation may seem archaic as of now, but contemporary observers should remember that the crucial role of individual incentives for long-term economic growth came to be appreciated within the economist profession only from the 1970s onwards. Operating a war economy had offered policymakers in many countries practical lessons on how to intervene in the market in order to mobilize the economy's resources.

Finally, development of the national accounts also contributed to policymakers' practical ability—or at least their perceived practical ability—to influence the working of the economy. In the Nordic countries, the main macroeconomic national account, that of income and expenditure, was called from the outset the *provision account*,[2] with a direct connotation to the issue of meeting the needs of the population with adequate supply. Thus, at this stage even the national accounts were largely regarded as planning tools.

In Finland, the *étatist-dirigiste* view was certainly espoused by President Urho Kekkonen, whose influential pamphlet 'Do we have the patience to prosper?' (in Finnish *Onko maallamme malttia vaurastua?*) advocated a state-sponsored programme of massive investment in productive equipment (Kekkonen 1952). Kekkonen was no socialist and probably was not interested in ideological controversies about the relative role of the state and private investors. By contrast, he was keen to generate economic growth via investment by any means possible, be it through direct discussions with industrialists or more sophisticated policy schemes. This pragmatic but *dirigiste* attitude was typical even

2 *Huoltotase* in Finnish, *försörjningsbalans* in Swedish.

for many other protagonists of the Finnish growth model. Finnish capitalists and industrialists regarded the state as a vital partner in advancing industrial investment.

3 The Finnish industrial growth regime

The main economic and institutional elements of Finland's high-growth policy regime were the following:

- A high rate of capital accumulation in particular sustained by a high public saving rate. The public sector has been an important net saver in the economy;
- A high rate of investment in key areas of manufacturing, the paper and pulp and metalworking industries in particular;
- Low and rigid interest rates and administrative rationing of credit to some areas of business investment, at the expense of depositors and households. With administratively-set interest rates, bouts of high inflation have resulted in transfers from creditor households to debtor businesses; and
- A high average growth rate but a very volatile growth path: during a period that is often characterized as a 'golden age' of Keynesianism, Finnish business cycles were particularly severe.

We next describe some of these aspects of the growth model in more detail.

3.1 The state as a net saver

As in other war-affected countries, the Second World War required a mobilization and reorientation of the nation's resources. This implied a sharp rise in the tax rate and an acceptance of a far more active role for the state in the allocation of resources: price regulations, selection of investment targets together with industrialists, rationing of credit, social contracts with trade unions and business organizations, and outright economic planning. The tax rate also went up sharply, as one might expect. Once the two world wars were over, a strategic decision was made not to return to pre-war levels of taxation, but to use instead the public surplus to finance a programme of public and private productive investment. In the aftermath of the war, this was partly a necessity, since war indemnity to the victorious Soviet Union forced a rapid buildup of industrial capacity in the metal and engineering sectors, in particular. The continuation of a state-sponsored programme of capital investments became a conscious policy choice. As shown by Katri Kosonen (1992), this was, to some extent, typical for all the Nordic countries. In Finland, the state adopted an even more direct, interventionist role in industrial policy than what was the case in Sweden, for example.

In the period until the first oil crisis, public saving was in Finland higher than in most comparable countries: its share of GDP hovered around 8 per cent in the 1960s and 1970s (Kosonen 1992), and it was even higher in the 1950s. The structural budget surplus did not fade until the 1980s, and public savings accounted for as much as 30 per cent of aggregate savings during the 1950s and 1960s. This surplus was channelled partly to support private investments in capital equipment throughout the country, and partly to start public companies in some key sectors of the economy. State companies were established in the basic metal and chemical-fertilizer industries as well as the energy sector.[3] As late as in the 1980s, state-owned companies contributed about 18 per cent of the total industry value-added in Finland (Kosonen 1992). It is noteworthy that this interventionist attitude to selective and *ad hoc* industrial policies was accompanied by a conservative stance to fiscal management in general. Fiscal deficits were abhorred and the public sector had a structural economic surplus throughout the 1950s and 1960s (Pekkarinen and Vartiainen 1995).

3.2 Credit rationing

Another instrument for capital accumulation was the administrative rationing of credit. This took the form of interest rate controls as well as a policy of selective loan approvals for capital equipment investment. In many ways, this area of policy predates from even the 1950s. In the 1920s, when banks were faced with bankruptcies among the farmer debtors, and market interest rates were on the rise, the central bank initiated a collusive interest rate agreement among the main banks to limit the competition for depositors, since competition among banks was perceived to be the force driving interest rates up. By the same token, the banks were to offer more advantageous credit to their business customers, the overwhelming majority of whom at that time were farmers. Formally, the contract was a voluntary cartel on deposit interest rates, which proved to be remarkably long-lived, since it persisted in one form or another until the mid-1980s. At the same time, the policy rhetoric of the central bank was quite conservative and wary of other forms of economic interventionism.

During the 1939-44 war economy, selective rationing of credit to military production purposes was made easier, since the main banks and the central bank were accustomed to talking to each other and the government. Lending interest rates were established through direct regulation, and the ministry of finance was authorized to approve larger credit decisions suggested by the banks. Similarly, trade in foreign currencies became subject to the central bank's approval, and the bank had the right to freely deliberate whether a currency trade was justified in the name of national interests. Once the war was over, this administrative steering of interest rates was continued and was flexibly adopted for industrial policy purposes. Of course, at that time, Finland was hardly alone in its endeavours to regulate the credit market. In the 1950s in particular, monetary policy was seen in many countries as a poor demand management instrument. Instead, it was often believed that interest rates were to be structurally and permanently low, so that the economy would have room to expand, and the growth rate in turn was to be steered by fiscal demand management.[4]

This perspective eventually gave way to a more balanced view of the roles of monetary and fiscal policy. In Finland, however, the emphasis was again clearly on structural growth issues. The aim of credit rationing was to generate advantageous loans for businesses. Borrowing by households in general was not possible, with the exception of housing mortgages. Mortgages, in turn, usually required a lengthy period of ex ante savings at low interest rates, and until the 1980s households had no access to any form

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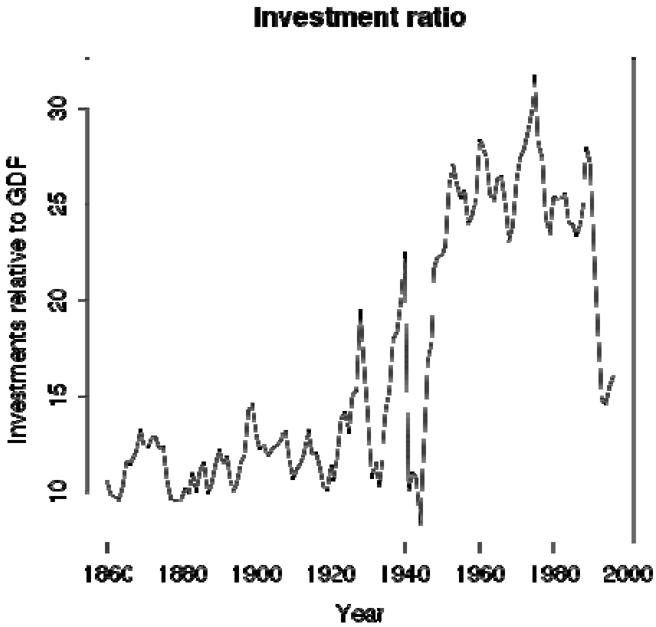
3 An important example is Neste, which established a monopoly on oil refining and then continued into different lines of petrochemicals and plastics.

4 These policy strategies are described by Thygesen (1982) in general and, for Sweden and the UK, by Lindbeck (1975) and Dow (1964), respectively.

of market rent-bearing investment assets. Thus, a form of forced savings from depositors to debtors was sustained.

This setup, together with the state's role in savings, helped to sustain the economy's high investment rate. In the period 1960-84, gross fixed capital formation was 26.3 per cent of GDP, a figure exceeded in the OECD area only by Norway (Kosonen 1992). Figure 3 depicts the dramatic rise in the investment-GDP ratio over the period from the Second World War through the 1980s. Thus, inasmuch as sustaining a high investment rate was the main aim of Finland's policy model, it certainly achieved its objectives.

Figure 3
The ratio of investments to GDP in Finland



Source: Statistics Finland.

4 The role of international linkages

It is also clear that the Finnish policymakers always pushed for greater international exposure. Since the starting point was a small economy with a resource base linked to forestry and mining, it was apparent from the outset that the desired accumulation of wealth could succeed only if the Finnish firms were able to sell on the international market. This international orientation is duly reflected in the growth of exports, as shown in Figure 4.

Consequently, throughout the postwar period Finland was keen to enter free trade agreements. With the exception of the agriculture sector, protectionism never had strong political support.

The fragile international position of Finland during the cold war (see below) may have enhanced this trend. In many countries, powerful lobbies of domestic industries or domestic unions have tried to obstruct foreign firms from penetrating the domestic market. Instead, in the case of Finland, the main political parties and main societal actors like business organizations and unions were concerned with the need to open up the economy in all directions as a condition for the country's *political* survival. Closer economic cooperation with the Soviet Union was a political necessity after the Second World War, as well as economically attractive for many sectors. Yet the authorities were also well aware of the political need to maintain many economic options and not to become over-dependent on the Soviet Union. Thus, political opposition was minimal to the strategy of openness: expanding international trade with the Soviet-Eastern-European bloc while ascertaining at the same time that Finland would be a part of the Nordic, European and global trade agreements.

Figure 4
The ratio of exports to GDP in Finland

Source: Statistics Finland.

5 The corporatist nature of the growth model

Finland is an example of a developmental state, but the relationship between the state and other societal actors was not one-sided. The very notion of a strict separation between 'state' agents and 'private' agents, so central to modern economics, becomes anachronistic when applied to Finland's policy experiences. In this respect, the country's growth strategy bears surprising similarities with those of the Asian tiger economies.[5] In Korea and Taiwan as well as in Finland, a pragmatic cooperation between organized private agents (bankers and business leaders), on the one hand, and government officials and civil servants, on the other, has played a key role in enhancing economic growth. As is typical in such corporatist regimes, many key decisions have been taken in a kind of twilight zone between private and public functions. Much of this policy set is hard to describe with well-established categories such as fiscal policy, monetary policy or industrial policy. Is it industrial policy, monetary policy, fiscal policy or incomes policy when civil servants and industrialists agree that bank loans be channelled to some particular new plant projects? Or when trade unions, business organizations and the government agree that the price of milk will be subsidized but that in return workers will refrain from excessive wage claims and thereby boost the competitiveness of the open sector? These examples are amusing, but the economic

5 This resemblance has been more systematically described and analysed in Vartiainen (1999).

logic of this policy regime can in many ways also be regarded as quite sophisticated: it was an attempt to exploit growth externalities and put the economy on a high growth path through direct intervention, but without infringing on private property rights or formally reverting to economic planning, which would have been interpreted as a challenge to the capitalist order.

6 Understanding the model's political preconditions: nationally and internationally

To sum up, we see a curious combination of conservatism and supply-side interventionism. Without wishing to question the market economy's legitimacy *per se* or fundamental private property rights, the Finnish business elites colluded to distort the markets in a way that sustained a high investment rate. This is reminiscent of the conservative interventionism of the Asian tiger states. It also illustrates the point that economic planning can be quite effective to some extent if presented as a means of accelerating certain stated economic policy goals, rather than a challenge to market economy *per se*.

With hindsight, such conservative *dirigisme* can be legitimized with thoroughly modern economic ideas. If authorities adopt interventionist policies, it is all the more important to be clear on the ultimate values of capitalism. With these means, private investors and entrepreneurs can be made much more tolerant of activist interventionism. This point is nicely borne out by many of the success cases of late industrialization. The accounts by Wade (1991) and Amsden (1989) show that Taiwan and Korea were not much behind the German Democratic Republic in overall *dirigisme*. Katzenstein's work shows that at times there was more effective planning in the Austrian economy than in some of its nominally (formerly) socialist neighbours (Katzenstein 1985, 1987). Yet, whatever their dirigisme, all of these economies were committed to becoming successful capitalist economies. A contrasting failure is evident in Peru during the years of Alan Garcia's presidentship (1985-88). Even Garcia wanted to mobilize investors for a broad programme of industrial restructuring, but his leftist political orientation and his anti-IMF rhetoric aroused the suspicion of the national business elites, and his economic policy resulted in failure, even though its overall degree of interventionism was less ambitious than those of the Asian tiger economies.

Another modern economic idea concerns growth externalities. It is one thing for the government to force the rate of growth for purely geopolitical considerations, but if there are important externalities between the various channels of economic growth, such an intervention might even be Pareto improving. This assumption is the backbone of modern concepts of endogenous growth. Models of endogenous growth can often have multiple equilibria. In such models, economic policies *can* make the economy 'jump' from one equilibrium growth path to another. The 'exploitation of economic externalities' probably would have seemed to be an intelligent characterization of the policymakers' action at the time. According to such a view, many production processes are interdependent in such a way that investments of individual firms and workers in machinery and human capital could appear profitable only if complementary investments were undertaken by other firms.[6] In the Finnish context, this was obvious after the Second World War, since the country's two economic pillars, the forest industry and the metal industry, were obviously interdependent. For a long time, the forest industry, with its paper and pulp sectors, was the main motor for export income, and the metal industry grew in a symbiotic relationship to that sector. It was typical in the 1950s and 1960s that the ten largest export firms generated almost half of the country's export income.

Some other historical contingencies probably contributed to the favourable outcome. There was a nationalistic and meritocratic civil service in place, and the prestige and strength of this bureaucracy was largely due to the country's period of autonomy under Russian rule. At that time, its legalistic tradition provided a protective shield against the imperialistic aspirations of Russian politics. This provided a meritocratic self-esteem within the bureaucracy, so that it regarded itself as the bearer of national success, something that probably weakened any aspirations for individual optimization through corruption.

Finally, as was emphasized in the introduction, there was the remarkable external challenge in the form of the Soviet Union that sharpened the will and minds of all concerned. For investors and capital owners, this implied that any strategy for growth would also have to cater to the workers, lest the appeal of communism increased to a dangerous extent, while for policymakers, it was clear that the country could not afford economic failure. In game theory terms, it might have changed the payoffs in a way that made today's sacrifices for tomorrow's high prosperity a preferred alternative.

We illustrate this with a game theory argument that captures the effect of this external challenge.[7] Suppose there are two industries in the economy and suppose that both can either invest a lot or just seek short-term rents by influencing policymakers. If there are productive externalities in investment, the payoff table might look like those depicted in Table 1.

Table 1
Payoffs of two industries, no external threat

	Industry 2	
Industry 1	Seek rents	Invest a lot
Seek rents	Poor, poor	Excellent, miserable
Invest a lot	Miserable, excellent	Good, good

Table 2
Payoffs of two industries, with external threat

	Industry 2	
Industry 1	Seek rents	Invest a lot
Seek rents	Miserable, miserable	Miserable, miserable
Invest a lot	Miserable, miserable	Good, good

6 The successful South Korean and Taiwanese experiences are analysed precisely from this perspective by Rodrik, Grossman and Norman (1995).

7 This argument is based on Vartiainen (1999).

We assume that the outcomes are ranked by both parties in the same way: ‘excellent’ is the best, ‘miserable’ is the worst and ‘good’ is in between. The Nash equilibrium of such a game is ‘seek rents’—‘seek rents’, which does not yield a Pareto efficient outcome. However, suppose now that there is an external threat that might lead to a loss of national sovereignty unless economic growth is high. Suppose, also, that sufficiently high growth can only be achieved if all industries invest a lot. The payoff matrix of the transformed game might then look like the one shown in Table 2 (assuming that the loss of sovereignty is as bad as the ‘miserable’ alternative). Since the somewhat worse outcome now became miserable for all parties, the Pareto-efficient outcome is now a Nash equilibrium.[8]

Thus, one equilibrium of this transformed game is ‘invest a lot’—‘invest a lot’. This example might seem naïve, but it captures the idea of how an external threat can improve the economic outcome by establishing a sense of national urgency. It is, of course, a factor that could not and should not be used as a basis of regular policy recommendations. In general, one would not like to live in a world so unsecure that economic outcomes would have to be legitimated by external security threats.

7 The social contract between state, capital and labour

We emphasized above the corporatist nature of the Finnish growth regime as well the challenge posed by the international tension of the cold war. Thus, the state and industrialists worked together and were certainly motivated to do so. Yet it is also clear that the political growth regime had to forge a compromise between capital owners and the working class. The outcome of the Second World War implied a political boost for the leftist parties in Finland. Astute politicians understood the need to integrate the working class, represented by the leftist parties and the trade unions, within the corporatist decisionmaking process. The programme of rapid capital accumulation also presupposed wage moderation and the acceptance of higher taxes. Upholding competitiveness and profitability thus acquired high priority on the economic-political agenda. The crude instruments to accomplish these were comprehensive incomes policy settlements as well as repeated devaluations.

Thus, in Finland, Keynesian interventionism took the form of repeated devaluations and income policies. Devaluations typically occurred at ten-year intervals (1949, 1957, 1967, 1977-80), and were usually accompanied by ‘incomes policy’ settlements which restricted wage growth for at least 2-3 years, so that the profitability-enhancing effect of the devaluation would not evaporate immediately. With such a control mechanism for nominal wage costs in place, accommodating exchange rate changes became one instrument for upholding competitiveness.

That instrument required the acquiescence of the worker part of the labour market, of course. Inclusion of the trade union organizations and encouragement of unionization served other purposes as well, at least in the eyes of key political players. Foremost among these was President Urho Kekkonen, who sought to build a national consensus

8 So is the pair ‘seek rents—seek rents’ as well, of course.

on economic and social policy, so that no political contradictions on the domestic scene would undermine the country's geopolitically limited elbow room.

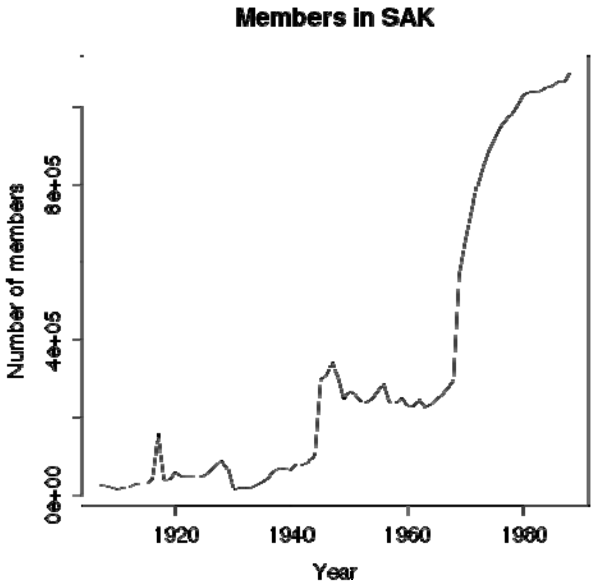
Thus, a political demand for *social corporatism*—social partnership between business, trade unions and the state—arose quite naturally from the country's external and internal challenges. Similarly to other policy areas, even here social corporatism got a practical boost from the war economy. Immediately after the war, the nation was confronted with rampant inflation as well as stringent war indemnity claims from the Soviet Union. Soon, export growth was rapid, in particular during the boom of the Korea war in 1950-51. In these circumstances, the government, the unions and the business representatives established a kind of improvised incomes policy. Comprehensive agreements on wages and prices were concluded during 1950-51. The aim of these programmes was to get inflation in control as well as to avoid industrial conflicts that could have disrupted the promising growth of export income.

Trade union and leftist representatives were willing to cap the growth of nominal wages as long as the government promised to regulate key prices such as that of milk and of other necessities. In October 1946, an economic council had been established to provide one formal arena for this tripartite consultation. Although the council's formal agenda was to discuss extensive economic planning, a pragmatic consensus soon emerged, which limited its role to the crafting of wage and price agreements. Thus, tripartite social contracts, or what has later become known as 'incomes policy', dates back already to the early 1950s. At that time, however, the trade unions were still rather weak. The very term 'incomes policy' was coined later, in the 1960s, both in Finland and the rest of Europe.

The early stages of this incomes policy were anything but harmonious. It was typical in the 1950s and 1960s to freeze or to limit wage increases to a couple of years only. Then, as inflation accelerated, possibly fuelled by devaluation, the unions would start claiming higher wages. The 1956 general strike became a large political event signalling substantial disagreement over the proper functional distribution of income. Different trade unions were often in disagreement, and many unions were internally divided between the two main parties of the left: the communists and the social democrats. The government had to act as a broker between many conflicting objectives—not only those of labour and business, but also those of the farmers who had an obvious interest in the prices of necessary foodstuffs and of timber. During this early phase, incomes policies eventually often ended in wage-price inflation and a new devaluation.

Unionization received a big boost in 1965-75, partly because it was actively encouraged by the government. For some state actors, such as President Kekkonen, the forging of such a broad consensus on economic matters played a positive role for the country's external security. The 1970s were a period of intense cold war, and President Kekkonen probably thought that the broadest possible acceptance of economic policy was one safeguard against expansionary intentions by the Soviet Union. This was particularly true because a substantial minority of the workers' organizations were inclined to follow communist politics. Thus, it was better to include the radical aspirations of these workers into a consensual model of economic policy rather than to alienate them altogether. Figure 5 depicts the growth in the membership of the main central trade union federation (in Finnish: *Suomen Ammattiliittojen Keskusjärjestö, SAK*) and its predecessors.

Figure 5
Membership in the main central trade union (SAK)



Source: Statistics Finland.

At the same time, purely economic factors made it attractive to establish a calmer industrial relations climate. As mentioned in section 4, this was the time when the economy of Finland was being gradually integrated with a series of trade agreements into the world economy. These agreements brought large potential benefits but also required that the country's competitiveness be preserved with economic policy. Import regulation was gradually dismantled, and sound current account balance became the prominent policy objective in the 1970s (Vartiainen and Vredin 1994). This necessitated a proper functional income distribution. Employers soon realized that dealing with a large trade union federation resulted in more wage moderation than a multitude of collective bargains with rival unions. Finally, the intellectual underpinning of 'incomes policy' was being elaborated upon in the economic literature. The now infamous Phillips curve had become the accepted wisdom (Lipsey 1960), and direct control of nominal wage costs was being promoted by British policy advisors (such as Nicholas Kaldor) of Harold Wilson's Labour government in the UK.

Thus, incomes policy became one main arena of economic policy, in which the government as well as business and labour organizations were active. Yet the outcome was seldom smooth. Wage drift usually accelerated a few years after devaluation, and a new devaluation eventually became necessary. Of course, this pattern was not unique to Finland. This inflationary cycle was not broken until a proper inflation target was set in the 1990s.

8 The long-term promise of the welfare state

The implicit *social contract* was not limited to upholding industrial competitiveness. Social welfare reforms were gradually introduced at the same time, which can also be interpreted as an attempt to buy wage moderation with the promise of welfare services. There was a happy congruence of interest for such reforms at least in the 1950s and

1960s. Many of these obviously boosted labour supply, in particular that of women (primarily due, of course, to childcare and a proper pension system). The reforms also made market economy more palatable at the microeconomic level, thus enhancing the political legitimacy of the economic policy model in the eyes of the politically powerful working class. Finally, they also alleviated the suspicions of the working class with regard to rapid structural transformation. If the government is trusted to provide social insurance to those who lose in structural transformation, it is probably easier to overcome the political opposition towards the growth-enhancing policies that create both losers and winners.

This insight is emphasized in a recent book on the Nordic economic model by Andersen et al. (2007), but it has been nicely formalized in a paper by Fernandez and Rodrik (1991). In their model, the reform in question is trade liberalization. Yet, the intuitive idea is applicable more generally and can be simplified as following: suppose that there are two sectors in the economy, one of which (the 'modern' sector) stands to benefit from modernization (like trade liberalization or comprehensive industrialization) while the other (the 'traditional' sector) is going to lose. At the initial state, the majority of the economy's manpower is located in the traditional sector. Moreover, income is originally the same in both sectors (and same across individuals), whereas the modernizing reform would increase income in the 'winner' sector and shrink it in the 'loser' sector. The crucial but plausible assumption, however, is that the modernizing reform will also lead to a transfer of people from the traditional sector to the modern sector. Let the economic data of this example be summarized in the Table 3.

Thus, the modern-sector people gain from modernization, since their income grows from 90 to 120. The reverse is true for the traditional-sector individuals, as their income decreases from 100 to 90. Furthermore, ten people shift from the traditional sector to the modern sector. It is impossible to know ex ante who these individuals will be.

How will the people within this economy vote in a referendum on trade liberalization? Suppose that all agents are fully rational and completely aware of the data of Table 3. A traditional-sector person understands that there is an one-sixth probability of increasing his or her income from 100 to 120. However, with a five-sixths probability income will shrink by ten units. The expected gain is $(1/6) \times (20) + (5/6) \times (-10) = -5 < 0$. Thus, the traditional people will vote against the reform. Since they form ex ante the majority of the voters, the reform will not gather the majority of votes (the modern-sector people will obviously vote for the reform, since their expected income change is positive). This is the outcome of the democratic process even if reform increases average income, and even if it increases the income of the majority.

Table 3
The argument of Fernandez and Rodrik

	Before		After	
	Traditional sector	Modern sector	Traditional sector	Modern sector
Size of labour force	60	40	50	50
Income per capita	100	100	90	120
Average income	100		105	

A salient feature of this model is that if the reform is eventually passed, it will gain popular support afterwards, and only a minority of voters would want to return to the original state of affairs. Even in this case, there is an obvious, constructive role for public redistribution of income. If the state can put up an income redistribution scheme that does not waste too much resources, it can introduce ex ante legislation that will ensure that the losers will be a minority (or even that there are no losers).

9 Is the growth strategy still viable, and can other countries learn from it?

We have reviewed the characteristics of the developmental growth regime of Finland. The regime was interventionist without challenging basic property rights. It was preconditioned by the peculiar circumstances of Finland: the need to sustain a good economic outcome in a geopolitically hostile cold war environment. In conclusion, it is natural to ask the following questions:

i) Is the developmental model still applicable?

ii) Could other, less developed countries emulate Finland's specific growth policy model?

iii) Are there more general and indirect lessons for policymakers and scholars of other countries?

In our view, we would answer 'no' to the first two questions. The specific policy package described in this paper is hardly applicable today. We know now that the crude accumulation of physical capital is not the key to rapid economic growth. It has been argued even in the case of Finland that this original wave of investment generated a poor or negative rate of return (see Pohjola 1996).

Instead, today's leading doctrines of economic development and development assistance emphasize property rights, good infrastructure as well as education, particularly that of women. Using public funds to boost expensive physical investment projects is clearly no longer a relevant policy goal. Nor would such a programme be feasible since the regulation tools of the 1950s—credit rationing, soft monetary policy, public ownership of key industries—have become obsolete.

Furthermore, Finland's success story may have been due to rather favourable but transitory circumstances. The crucial phase of state-led economic growth and the buildup of welfare services coincided with favourable demographics, so that reforms created more winners than losers. Once the demographic structure becomes less advantageous, it is less certain that there will be such a happy congruence between the demands of the market economy and the political aspirations of voters. For example, an increasing share of welfare expenditure in the future will be directed to pensions and health care for the elderly, and the implied higher tax rate may not be as easily accommodated with a need to uphold incentives for labour market participation and a high supply of working hours.

However, with respect to the third question (whether there are indirect lessons for policymakers of other countries), the answer is positive. Finland's example offers a general message of hope for many countries affected by conflicts and poverty. Consider Finland's history up to the Second World War: a small, backward country colonized by more powerful neighbours, torn by a violent civil war just as independence was within reach, and subsequently limited in its political manoeuvring room by the geopolitically challenging cold war environment. Yet, it was possible for the Finnish decisionmakers—the government as well as various corporatist organizations—to forge a political compromise that was deemed politically legitimate and exploited the global economy to undertake a rapid economic transformation. This could be the positive message for any aspiring, less developed country in which initial conditions seem uninspiring.

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