Does a strong state create a welfare state? - The case of Finland

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Does a strong state create a welfare state? - The case of Finland.1

Introduction

The debate concerning the relationship between the welfare state and economic development has raised a lot of interest both in economics and economic history. Is welfare state a consequence or precondition of economic development? Which factors actually led to the emergence of the welfare state?

In this paper we study the development of the Finnish welfare system from the end of the 19th century until today. Our focus is in the Finnish case, but the questions and results will be put within a broader Nordic and European comparative perspective. The goal is to problematise the current views of the state and the public sector in the development of the welfare state systems, in order to reach a deeper understanding of their role within the Nordic societies.

Nordic countries have commonly been characterized as welfare states. In spite of differences in detail there are a lot of similarities between the Nordic countries. When discussing the Nordic model of welfare and the Nordic model of capitalism, the active role of the state and a large public sector are factors usually seen as characterising the ‘Nordic model’. The state is also regarded as having been fairly strong in these societies, as it has actively promoted the economic and social development by interfering in the economic and social sphere.

The large public sector, the alleged strong and active state, the high level of taxation and extensive welfare system in combination with the successful economic development of the Nordic countries has been seen as something of a paradox. According to some views high taxation connected with a large and inefficient public sector leads to a loss of economic efficiency and are, thus, harmful for economic growth. The Nordic countries have not fitted to this primarily Anglo-Saxon ‘text book’ model as ‘best practices’ for furthering economic development. These countries have been both economically successful and competitive. They have been the ‘bumble bee’, which was not supposed to be able to fly, but in spite of that continues to do so!2 Their experience can rather be

1 We wish to thank participants in the session... at the WEHC Utrecht in August 2009 for comments of an early draft of this paper. A special thanks goes to the commentators Prof. Alice Teichova, Cambridge University, U.K. and Prof. Pauli Kettunen, University of Helsinki, Finland. Moreover, useful comments were also provided by Prof. Christopher Lloyd, University of New England, Australia, Prof. Dr. Eduard Kubu, Charles University, The Check Republic, Dr. L.J. Touwen, Leiden University, The Netherlands, Prof. Price Fishback, University of Arizona, U.S.A. and Prof. Hans Sjögren Linköping University, Sweden. We also wish to thank Antti Moisiota (Government Institute of Economic Research) for carrying out the regressions and Isabella Holm for research assistance.

2 See Anderson et al. 2008.
seen in accordance with the view, that the role of efficient public sector is a necessary precondition for successful economic development.

Frame of analysis and the structure of the paper

We will first present quantitatively the development of the size and expenditure structure of the public sector over time and show how the focus of activities has shifted between various expenditure categories. Next we consider the relationship between the development of the welfare state and economy as a whole. Our interest is to explore in historical perspective the question whether the welfare state precedes and supports economic development or whether it only follows the general development of the economy and enlarges because there are more resources available for the use of public sector purposes. For this purpose we also carry a simple statistical test with historical data.

After this we discuss the main compromises in the development of the public activities in the political context, including the roles of the state, interest groups, such as labour market organisations and of the civil society. We will discuss the changing role of various groups, political parties, interest groups and lobbies – especially the role of labour market organisations – in the development of the welfare state over time. The effects of the needs of the corporate sector, of different interest groups and of civil society in welfare state development have not been systematically explored. One important question here is basically: who has/have been responsible for the development of the welfare state?

Especially we will ask what has actually been the role of the state and if it can be characterised as strong or weak? We claim that the role of the state and the public sector has often been somewhat superficially dealt with within the context of the economic development. There has been a tendency to classify the state and public sector according to simple lines of axes, e.g. of ‘active’ versus ‘passive’ or ‘strong’ versus ‘weak’, or of ‘large’ versus ‘small’. The role and significance of the state and the public sector have been, however, both complex and multifaceted and simple labels such as ‘strong’ and ‘weak’, and ‘active’ and ‘passive’ are not necessarily usable for an in-depth analyzing of the actual policies and actions, and of the transformation in these over time and between various welfare segments. Although the state and the public sector have played a significant part in the Nordic societies and in the development of the “Nordic model”, it is evident that the size, role and activities of the state and the public sector have varied between the individual countries, and also transformed significantly over time. The ‘division of labour’ between central and local government has transformed as well. Neither can the state or the public sector be seen as entities with necessarily common goals and interests, but instead they should be grasped as arenas for various competing interests, for example between strong interest groups and political parties, between civil servants and politicians, within the political decision making and within state bureaucracy and between local and central government.

At the end of the paper we also very briefly consider the future challenges of the Finnish Nordic model in the context of more and more services dominated economic structure in a more and more globalising economic environment of the nation state.
Our frame of analysis can be seen in Picture 1. In the background we see the long term economic growth and development, which has emerged in both in a national and international (now rather global) context. The welfare system has been generated in the framework of this larger national economic system. Different actors or forces have been influencing the development. These forces can be divided into three groups. First there is the structural change in the economy, driven mainly by profit seeking enterprises. We claim that a change from an agrarian society to an industrial (manufacturing) society and then, more recently, towards services dominated economy has been a fundamental factor influencing welfare state development. Other important factors are for example the state itself, with political groups, state bureaucrats and civil servants, and, thirdly, the civil society and various interest and pressure groups, which drive for or are against welfare state reforms. These groups have varying and to some extent conflicting goals with respect to welfare reforms. Moreover, both the roles and goals of different actors in welfare state development can change over time. 

*Picture 1: Factors influencing welfare state development*

International and national development and economic growth

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3 For example, Jussi Vauhkonen shows how the employers made a sudden “U-turn” towards a positive attitude towards the statutory income-related work pension system in the late 1950s. Vauhkonen 2009.
The overall development of the public sector in Finland

To define exactly what is meant by the ‘welfare state’ is not unambiguous. We will adopt a fairly broad definition, where we, apart from including public social transfers and public social and health expenditures, also include public educational expenditures as parts of the welfare state. The size of the welfare state is often measured by these public social expenditures in relation to GDP.\(^4\) There are often other aspects, for example full employment targets, policies promoting equal opportunities and gender equality, which could be included in a broad definition of the welfare state, but due to our approach and also difficulties in the measurement, we will exclude these intangible and more qualitative aspects. Sometimes also measures to create favourable conditions and supporting measures for business are included in the concept of welfare state. However, we see them as part of the welfare state only in case they also include welfare services in a strict sense. Otherwise, they are merely seen as public services. But we are well aware of the fact that many of the welfare reforms also have positive impacts on the business sector. The investment in health and education are the most obvious examples of this.

The present day public activities consist of general administration, maintenance of public order and defence, construction and upkeep of infrastructure, provision of education, health and other social services and paying of transfers and subsidies as well as interests on the public debt. Outlays for these purposes form total public expenditure. To cover the outlays the government collects taxes, fees for services or occasionally incurs debt financing.\(^5\) In Finland the government produces most of the services itself on either a central or a local level.\(^6\)

<table>
<thead>
<tr>
<th>Table 1. The size of the public sector in Finland, 1900-2007.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1900</td>
</tr>
<tr>
<td>Total govt. expenditures, percent of GDP</td>
</tr>
<tr>
<td>Public consumption expenditures, % of GDP</td>
</tr>
<tr>
<td>Central government, percent of GDP</td>
</tr>
<tr>
<td>Local government, percent of GDP</td>
</tr>
<tr>
<td>Value added of the public sector, % of GDP</td>
</tr>
<tr>
<td>The public sector employment, 1000 persons</td>
</tr>
<tr>
<td>The public sector employment, % of total employment</td>
</tr>
</tbody>
</table>

* Includes social security funds, 1,6% of GDP

\(^4\) See e.g. Korpi, 

\(^5\) Long term quantitative descriptions of the public sector are difficult and cannot be made complete as there are not comparable data covering all the public activities. Also international comparisons are difficult because of different budgetary and statistical practices.

\(^6\) It is typical in Nordic countries that government itself produces most of the welfare services. In “non-Nordic” models of welfare state services (health and social) are often financed by transfers from the government budget or from social insurance systems and the producers may be private sector entities.
The size of the public sector does not necessarily tell us much about the welfare state. For that we have to disaggregate the public expenditures. Providing education, health and other social services are the basic activities of a welfare state. Another important and growing part of government welfare activities has been transfers to households. Table 1 shows some basic indicators of the size of the Finnish public sector in relation to the Gross Domestic Product from 1900.

During the 20th century the Finnish public sector has grown faster than the total economy and, accordingly, increased its share in the economy. The relative size of the total public sector, i.e. total government expenditure, has almost quadrupled from 13 to 47 percent of GDP and public consumption has relatively tripled from 7 to 21 percent. Central government consumption was just slightly larger than the local government share until the Second World War. Since then the local government consumption has grown almost twice as fast. This is due to the expansion of the existing local services and creation of new services, but many services previously produced by the central government, have also been transferred to be responsibility of the local government. The public sector is nowadays a significant employer with about a quarter of total employment.

The difference between the total government expenditures and the public consumption expenditures mainly consists of government investments, the share of which has decreased, and a growing share of public transfers. Unfortunately they cannot be shown separately because of lacking comparable statistical data. However, some comments will be given below.

At the end of the 19th century roughly 40 percent of central government public expenditures went to consumption and another ample 40 percent to investments, 10 percent to transfers and subsidies – one third of those to the local government. Interests on public debt required a few percentage points. The largest investments were in railways, but government invested also into administrative buildings and schools. In public consumption general administration and defence were the major expenditures. A quarter was spent on education, health and other social services, education taking by far the largest share and also growing fastest during the last decades of the 19th century. Health and other social services received only a few percentages of the outlays.

Local governments had the main responsibility of poor relief and primary education; education was, however, heavily subsidised by the central government. Moreover, until the law of primary education was passed in 1921 it was in reality mainly the church, which provided primary education in rural areas. The poor financial situation of local governments made the number of schools remain low. In cities and towns the school system developed more rapidly in the late 20th century. Other tasks of the local governments during this period were maintenance and construction of local roads, bridges and harbours as well as local government buildings. Healthcare was modest. Rural


8 Finland under the Russian rule had a small conscript army between 1878 and 1901. See e.g. Pihkala (1977), 95–96.
9 This estimate is based on the distribution of wages and salaries in Pihkala (1977), 62.
10 Rahikainen 2010.
municipalities often had only one doctor and one midwife; in addition towns had small hospitals for infectious diseases. Local governments, town and rural community councils had initially a relatively autonomic position in local administration and more choice on what social services to produce. Local independence has decreased gradually over the last 100 years, as more and more public activities, particularly the welfare services, are today based on national legislation, but produced largely by the local governments. These are and have primarily been funded by means of municipal taxes and by central government transfers to municipalities.\footnote{11}

Approximately the same responsibilities and the same structure of public spending continued in the interwar period although all items in Table 1 grew somewhat and total public consumption considerably. A rough estimate based on the central government accounts of the 1937 shows that about one half of the consumption expenditures went to administration and public order, and about one quarter to defence. This was a time of international military armament and also a time of the construction of the Finnish army. A quarter went into education, health and social services. In the interwar period the emphasis of social policy measures was still in poor relief by the local governments. In an ILO comparison from 1930 Finland was the only member country, where poor relief was larger than state social insurance expenditures. Particularly in rural municipalities social care took the highest share, about a quarter, of all expenditures.\footnote{12} The government, central and local, continued to be basically a “night watch” state and not an active welfare provider.\footnote{13} A welfare state in the modern sense was not yet in sight.

<p>| Table 2. Finland’s total public expenditures in relation to Gross Domestic Product, 1960-2005, percent. |</p>
<table>
<thead>
<tr>
<th>1960</th>
<th>1980</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public consumption</td>
<td>11,9</td>
<td>18,1</td>
</tr>
<tr>
<td>Gross capital formation</td>
<td>4,5</td>
<td>3,8</td>
</tr>
<tr>
<td>Subsidies</td>
<td>2,9</td>
<td>3,2</td>
</tr>
<tr>
<td>Transfers</td>
<td>5,5</td>
<td>8,3</td>
</tr>
<tr>
<td>Other</td>
<td>1,8</td>
<td>3,2</td>
</tr>
<tr>
<td>Total</td>
<td>26,6</td>
<td>36,6</td>
</tr>
</tbody>
</table>


\footnote{11}{Until the 1960s towns had many more public duties compared to the rural municipalities. The local law and order enforcement, lower level courts and police, were the responsibility of town administration, but the state paid for courts and police in the countryside. These responsibilities were only gradually moved to central government between the 1960s and the early 1990s. Accordingly, towns used to hire many more people and had much higher total and administrative costs per capita. Only 15 per cent of the population lived in towns, but towns spent eight times as much as rural communities per person.}

\footnote{12}{Karisto et al. (1985), 278–280; Statistical Yearbooks of Finland.}

\footnote{13}{Statistical Yearbooks of Finland; Taimio (1986), 50–51.}
The post-WWII development has directed the public sector to a very different path (Table 2). From 1960 to 1980 public consumption and transfers were the relatively fastest growing items.\textsuperscript{14} Since 1980 transfers to households have continued to grow swiftly. Gross capital formation has declined relatively – a trend which has been typical for some other countries too. Transfers mainly include pensions for old age and disability, family allowances and unemployment benefits. The growth of this item shows that the tasks of the public sector are almost totally different today; compared to the first half of the 20th century. The years from about 1960 to 1990 can be called the welfare state construction period, with many new welfare programs. The attitudes towards the role of the public sector in the society have experienced a radical change.

**Finland in an international comparison**

In 1900 the Finnish GDP per capita was still less than a half of that of the United Kingdom and the United States, and it was behind the other Nordic countries by 30–40 percent. During the 20\textsuperscript{th} century Finland was clearly catching up her living standard towards that in the most advanced Western European countries. Now the GDP per capita is about the same in Finland, Sweden and in the UK. During the period 1900–2007, the average annual growth of the Finnish Gross Domestic Product was 3.2\% and per capita it was 2.6\%.

According to Table 4 the total public expenditures in a selection of European countries, all of them rich today, have behaved in surprisingly similar ways in the course of the 20th century, with public expenditures about quadrupling to around 45 – 50 percent of GDP. Only two clear exceptions stand out, namely the United States and Japan, which have had much smaller outlays. One may note, however, that in Japan the public expenditures were of the same level as in the western European countries before the Second World War.

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Finland</td>
<td>13</td>
<td>28</td>
<td>22</td>
<td>24</td>
<td>36</td>
<td>48</td>
<td>47</td>
</tr>
<tr>
<td>France</td>
<td>9</td>
<td>12</td>
<td>23</td>
<td>28</td>
<td>39</td>
<td>54</td>
<td>53</td>
</tr>
<tr>
<td>Germany</td>
<td>18</td>
<td>31</td>
<td>42</td>
<td>30</td>
<td>42</td>
<td>47</td>
<td>44</td>
</tr>
<tr>
<td>Holland</td>
<td>8</td>
<td>11</td>
<td>22</td>
<td>27</td>
<td>46</td>
<td>58</td>
<td>45</td>
</tr>
<tr>
<td>U.K.</td>
<td>13</td>
<td>24</td>
<td>29</td>
<td>34</td>
<td>42</td>
<td>45</td>
<td>45</td>
</tr>
<tr>
<td>U.S.A.</td>
<td>8</td>
<td>10</td>
<td>20</td>
<td>21</td>
<td>31</td>
<td>37</td>
<td>37</td>
</tr>
<tr>
<td>Japan</td>
<td>14</td>
<td>19</td>
<td>30</td>
<td>20</td>
<td>23</td>
<td>34</td>
<td>36</td>
</tr>
</tbody>
</table>


\textsuperscript{14} Table 6 below shows the distribution of public consumption expenditures in different categories.
Table 5 shows the final public consumption expenditures and the gross capital formation or public investments in relation to GDP in some countries from the 1950s–1960s to 2007. The structures of public consumption and gross capital formation or investments are again very similar. In all countries the share of the public consumption has showed a rising trend.

### Table 5. Final consumption expenditure and gross capital formation of total government, in relation to GDP, 1952–2007, percent.

<table>
<thead>
<tr>
<th></th>
<th>consumption expenditure</th>
<th>gross capital formation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Finland</td>
<td>11</td>
<td>14</td>
</tr>
<tr>
<td>France</td>
<td>15</td>
<td>13</td>
</tr>
<tr>
<td>Germany</td>
<td>15</td>
<td>16</td>
</tr>
<tr>
<td>Holland</td>
<td>14</td>
<td>16</td>
</tr>
<tr>
<td>Norway</td>
<td>10</td>
<td>14</td>
</tr>
<tr>
<td>Sweden</td>
<td>13</td>
<td>17</td>
</tr>
<tr>
<td>U.K.</td>
<td>19</td>
<td>17</td>
</tr>
<tr>
<td>U.S.A.</td>
<td>16</td>
<td>18</td>
</tr>
<tr>
<td>Japan</td>
<td>11</td>
<td>9</td>
</tr>
</tbody>
</table>


Between 1952 and 2007 all government consumption expenditures doubled in Sweden, Finland and Norway, while they have grown somewhat less in the central European countries and in Japan. In the U.K. and the U.S.A. they have stayed on the 1950’s level. Government investments, on the contrary, have stayed roughly on the same level or even decreased in. The investments figures are overall relatively low. In the post WWII period the fastest growing category in total public expenditures have been income transfers. We have not been able to construct exactly comparable figures, but in principle the difference between total public expenditures and government consumption and investments consists of transfers. This difference has grown in all countries.


<table>
<thead>
<tr>
<th></th>
<th>Finland</th>
<th>Sweden</th>
<th>Norway</th>
</tr>
</thead>
<tbody>
<tr>
<td>General administration</td>
<td>3</td>
<td>4,1</td>
<td>3,6</td>
</tr>
<tr>
<td>Defence</td>
<td>1,4</td>
<td>1,4</td>
<td>0,7</td>
</tr>
<tr>
<td>Education</td>
<td>4</td>
<td>5,4</td>
<td>2,7</td>
</tr>
<tr>
<td>Health</td>
<td>2,2</td>
<td>3,9</td>
<td>3,1</td>
</tr>
<tr>
<td>Social security</td>
<td>1,1</td>
<td>2,3</td>
<td>9,3</td>
</tr>
<tr>
<td>Other</td>
<td>0,9</td>
<td>1</td>
<td>2,9</td>
</tr>
<tr>
<td>Total</td>
<td>12,6</td>
<td>18,1</td>
<td>22,2</td>
</tr>
</tbody>
</table>

In Table 6 we compare the structure of the public consumption in three Nordic countries since the 1960s. We can observe some striking similarities as well as a few differences. The overall trend was a rising relation of the public consumption to the GDP from the 1960s to the 1980s. After that the relative growth stagnated in Norway, slowed down in Finland, while a small decrease occurred in Sweden. Sweden has had the largest public consumption between 1960 and 2005. The fastest growing and constantly growing category in all three countries was social security. The shares of education and health expenditures grew between 1960 and 1980, but decreased then by 2005. The shares of education outlays have actually halved.

We can summarise that the overall developments of the welfare state expenditures in Finland seem to have followed the patterns in the other developed countries, particularly those in the Nordic countries. Within the overall small public sector of the late 19th century general administration and construction of infrastructure were in the core of the development. The early 20th century phenomenon in social arena was still poor relief. We see the initial phases of construction of new hospitals, schools and social institutions but still not covering the country very completely. The big expansion of education and health care were carried out mostly in the post-war period, and finally extensive transfer payments have expanded since the 1980s with maturing of the pension system as well as sickness insurance, family allowances and unemployment benefits.

**Slow and late development of the Finnish welfare state**

The early development of the welfare state was a slow, gradual and stepwise process. Initially, at the end of the nineteenth century, the role of the public sector was everywhere small. As Table 7 shows, the first country to develop important welfare reforms was Germany. This has often been credited to Bismarck. We can see that the Nordic countries were by no means the forerunners in the development of the welfare state institutions. Denmark and Norway seem to have been among the first, but not Finland, where the innovations often came much later, the only notable exception being general suffrage (if included in the welfare state institutions) and work casualty insurance. In addition the Finnish labour protection legislation was fairly ‘modern’ already at an early stage.\(^{15}\) However, most of the welfare state institutions in Finland have been established only during the past 40–50 years. On the other hand, in case welfare state reforms follow the economic development, it can even be claimed that the Finnish development did not emerge very late; the Finnish economy clearly lagged behind the forerunners. As Olli Kangas has emphasised, it is not necessarily fruitful to only make comparisons of the size of the welfare state, or of welfare state reforms, at certain points of time. It would give a fuller picture also to look at the reforms in relation to a certain level of economic development. The picture is also dependent on what kind of reforms we look at and how we carry out the comparisons.

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\(^{15}\) Kettunen 2006.
Table 7: Early welfare state innovations in some countries

<table>
<thead>
<tr>
<th>Innovation</th>
<th>First country</th>
<th>Second country</th>
<th>Third country</th>
<th>Finland</th>
<th>Sweden</th>
<th>Norway</th>
<th>Denmark</th>
</tr>
</thead>
<tbody>
<tr>
<td>Work casualty insurance</td>
<td>Germany (1871)</td>
<td>Switzerland (1881)</td>
<td></td>
<td>1895</td>
<td>1901/16</td>
<td>1915</td>
<td>1899</td>
</tr>
<tr>
<td>Sickness insurance</td>
<td>Germany (1883)</td>
<td>Italy (1886)</td>
<td>Austria (1888)</td>
<td>1963</td>
<td>1962</td>
<td>1956</td>
<td>(1893/)1933</td>
</tr>
<tr>
<td>Old age and work disability insurance</td>
<td>Germany (1889)</td>
<td>Denmark (1891)</td>
<td>France (1895)</td>
<td>1937</td>
<td>1913</td>
<td>1936</td>
<td>1891*</td>
</tr>
<tr>
<td>Unemployment insurance</td>
<td>France (1905)</td>
<td>Norway (1906)</td>
<td>Denmark (1907)</td>
<td>1917</td>
<td>1893</td>
<td>1906*</td>
<td>1907*</td>
</tr>
<tr>
<td>Child benefits (allowances)</td>
<td>Austria (1921)</td>
<td>New Zealand (1926)</td>
<td>Belgium (1930)</td>
<td>1948</td>
<td>1947</td>
<td>1946</td>
<td>1957</td>
</tr>
<tr>
<td>General suffrage</td>
<td>New Zealand (1893)</td>
<td>Australia (1902)</td>
<td>Finland (1907)</td>
<td>1907</td>
<td>1921</td>
<td>1913</td>
<td>1915</td>
</tr>
<tr>
<td>General education</td>
<td>Germany (Prussia)</td>
<td>Austria (1774)</td>
<td>Denmark (1814)</td>
<td>1921</td>
<td>1842</td>
<td>1889</td>
<td>1814*</td>
</tr>
</tbody>
</table>


Thus, the developments of the main welfare state institutions in Finland are of quite recent origin. It seems that welfare state came to Finland later than to other Nordic countries. How do we explain this?

The demands of public services emerges

A stylized picture of the public sector and welfare state growth could be described as follows: In the traditional pre-capitalist economy the public sector was minimal. During the early industrialisation and commercialisation the few welfare services were in general supplied by the paternalistic entrepreneur /employer. Entrepreneurs gradually started to demand more public services: the law and order (intangible infrastructure) and physical infrastructure (public capital like roads, railways and harbours). These supply factors are all important for economic growth. Gradually as the technological development started to require more skilled workers, the demands for an educated labour force grew.

The emergence of wage labour and the pitfalls of the working conditions contributed to the emergence of labour unions, which apart from aiming to raise the wage-level of their members also started to require labour protection and later on other social security measures.
At least in Finland we can see that the expansion of the public sector has especially since WWII originated primarily from demands for social security, while the role of investment in infrastructure has declined relatively.

Thus needs for public sector growth come from both the supply and the demand side of the economy. In principle welfare and educational products can be either carried through within the private or within the public sphere. But these inputs are public goods in their nature or have important externalities, and, therefore they can in many cases be effectively supplied only by public sector using taxes to finance the provision.

In the Nordic context, welfare services have mainly been developed within the public sphere, although there have for instance in Finland also existed private parallel systems, for example in health care and day care. *This raises the political issue: who is to decide what will be produced and how efficiently these decision will be carried out.* With this question we will study how the other factors in Figure 1 - political parties, state bureaucracy and interest groups - have influenced the development of the welfare state.

**Relationship between public expenditures and GDP**

An interesting question in this context is whether the public sector was somehow leading the economic development or whether it was only following the development, making the necessary adjustments in the system when needed or when they were demands for such services. By looking at the expansion of the welfare state in various countries, it appears that demands for such services appeared hand in hand with economic and industrial development. In case there is a positive causality between investments in welfare services and economic growth, it is evident that a slow welfare state development can in principle retards the economic development.

Before we go to the political side we also briefly deal with a question what is the relationship between the development of the public sector and GDP. Whether the public sector development follows or leads the development of the GDP can be tested by using a statistical causality test. An early study on this has been carried out by Hilkka Taimio (1986) for the period 1900–1962. According to her results one cannot find causality in either way i.e. it seems that both the public sector expansion and economic growth occur simultaneously. There seems to be no clear causality link between these variables.

We have repeated the tests for this paper and explored the statistical causality\textsuperscript{16} between the public consumption and GDP since 1860, both in real and nominal terms. We cannot find any causality between the real variables. Instead in nominal terms in 1975–2000 the GDP seems Granger-cause public expenditures. This is in accordance with the idea, that public expenditures will be expanded if there is a favourable growth in the economy. This causality does not run the other way: the time path of GDP seems to be independent of the time path of the public consumption, both in real and

\textsuperscript{16} Both Taimio and we have used the Granger-causality test between GDP and public consumption for this. Calculations have been done for both real and nominal variables for 1860-2000.
nominal terms.\textsuperscript{17} So is the expansion of the public sector a result only of the fact that incomes have grown?\textsuperscript{18}

In a study by Reino Hjerppe, Pellervo Hämäläinen, Jaakko Kiander and Matti Viren (2007) the contribution of public capital to economic growth was tested by using a time-series cross-country regression over the 1960–2002. The authors developed a concept on enlarged public capital, which included not only the physical capital but also the human capital based on the expenditures of health and education. According to their studies the public capital stock has a positive impact on private sector productivity. The results of the study suggest also that in addition to traditional infrastructure also public health and education expenditures (i.e. intangible public investments in human capita) have contributed positively to private sector productivity in almost all countries included in the study.\textsuperscript{19}

The role of state and politics

In the introduction we entered the question of the weak state and the strong state. It is often in literature put forward that one of the characteristics of the Nordic model has been a strong state and centralised state and that this also has been a prerequisite for the Nordic model to emerge. Was it weak or strong states that made the welfare state expand in the Nordic countries?

Basically, the state creates and maintains the legal foundation of the society; and its behaviour is highly important to the development of the society according to the institutional theory of economic history. Both the state and the political system are thus also significant for the development of the welfare state. For example, in the fragmented political system in the US, the welfare system has primarily been based on state, and not on federal level.\textsuperscript{20} In the small Nordic countries, which have been based on a centralised political system a universal welfare system could more easily emerge. The strong legitimacy for welfare provision and for educational investments in the Nordic countries was, however, also important for this development. It seems also evident that in these small open economies there has also existed a shared conception that the state is important for supporting economic growth, while substantial welfare services and egalitarian policies, equal opportunities to free education, strive to low income differentials and gender equality has not been perceived as per\textsuperscript{17} In a recent paper Durevall and Henrekson (2010) test two “grand” explanations, the Wagner hypothesis and the so called “ratchet” effect in historical perspective and conclude that these are not generally valid. Historical periods differ in this respect. See also Henrekson (1993). Taimio also tested the so called Peacock Wiseman hypothesis. According to this hypothesis public sector enlarges strongly after some crises, like wars. This is because during the crisis there is a need for larger public sector activities and after the crises people are used to this higher level and higher taxes and it is not any more possible to return to the previous lower level. Taimio indeed found that the independence in 1917 and the second World War pushed up the size of the public sector in Finland. For the second World War this was also confirmed by a study by Kopra (1979).
\textsuperscript{18} In political discussions we often hear an argument “we can increase the public sector or the welfare state services only if we have means to do this, not before”. This argument implies a view, that public sector is only consumption good, not a factor of production.
\textsuperscript{19} There were two data sets in this study: World Development Indicators (WDI) by the World Bank for 1960-2002 covering all world countries and OECD data for 1960-2004 covering 22 countries.
\textsuperscript{20} For the US model, see e.g Fishback 2009.
But what is actually meant by the “state”? Is it the parliament or the civil servants and bureaucracy or semi-independent government bodies? This is an important question, as the state and the public sector are not homogenous identities with clearly defined boundaries. People might, thus, talk about different things when they talk about the “state”. Moreover, the state has also changed shape over time. For example, the state system in Finland at the end of the 19th century consisted of estates and a few civil servants. The democratic parliamentary reform in early 20th century replaced the estates with political parties. The state transforms.

In literature on the state it is generally assumed that the state is not a self-evident material object. However, it does exist and it has a capacity to act autonomously. In theoretical considerations the state is also sometimes taken as an unbiased representative of the median voter. In practice, it acts under the influence of different political forces and views of civil servants. A democratic state forms an arena for various groups and agents, all with their own goals and with the aim to shape the policies. The ideological views and behaviour of bureaucracy, and the relation between the bureaucracy, interest groups, and the parliament is both complex and has been transforming over time.

Neither are the boundaries of the state easy to draw. Research dealing with the state has often been looking on elected governments and/or departments of states. However, as e.g. Flinders show there are also a huge variety of organisations, which could claim to be part of the state. In the Finnish case it is easy to find semi-independent government and expert organisations, especially within the social policy area (e.g. so called sector institutes like STAKES - today the Institute for health and welfare). The boarders of the state are, thus, not so clear, and it has been claimed that it has become increasingly to define these boarders. This is a result of tendency towards increasing public-private networks and projects. For example, the expanding ‘third sector’ often carries out services in close co-operation with the local or state authorities. These agents can receive considerable public or semi-public funding, for instance in Finland from the state gambling monopoly.

However, apart from various concepts of the ‘state’, also the role and capacity of both the state and of the public sector varies over time, according to the size of the public sector, the rate and structure of taxation, the quality of the public expenditures, and the tasks of the government. The ability of the state to influence the development varies also according to its institutional structure and the quality of its civil servants. This is particularly important to be aware of when studying the role of the state in a historical perspective. As the welfare state – and the public sector broadly – have expanded, the power relations between the various groups and actors, i.e. between the interest...

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21 Fellman & Sjögren 2008.
22 See e.g. Kangas 2006, 199.
23 Hay & Lister 2006, 5.
24 Skocpol 1985.
25 Skocpol, 1985.
26 See Flinders 2006
groups, between civil servants and the parliament, and between the local and central government, have changed significantly. Moreover, with the expansion of the welfare state new groups of power have also emerged.\textsuperscript{27} For example the Finnish work pension system has strengthened the position of the labour market parties as their role in the administration and the development of the system is extensive. But also the biggest Finnish work pension funds, which are independent companies, and their administrators have become important investors and players in Finnish economy and also indirectly in developing the framework of the actual pension system.\textsuperscript{28}

The concepts of “a strong” and “an active” state have, moreover, to be kept apart. An active state is not always a strong one, nor is a strong one always active. A big public sector does necessarily mean that the state is strong. For example, growing public expenditures usually mean an active state, but such a development can also be a result of powerful interest and pressure groups. In that case the state is weak (and/or passive) in relation to sector interests. This was the case in the inter-war period in Finland, when the business sector was skilled in advancing their interests. Since the Independence in 1917, the state did become more active, which is well illuminated by the development of the first state companies, while public expenditures on education and health increased. But as the prevailing ideology was non-interference and self-regulation, the state was fairly weak with respect to the business interest. As part of the state, key civil servants and the bureaucracy have in general been important in the creation and formation of the welfare state model. Their professional expertise and the tradition civil servants who are independent of the sitting government made them independent and influential.

In the post-war period especially, in the 1960s and 1970s, the role of interest groups, especially the labour market parties also grew. The first important corporatist welfare reform agreed by the labour market organisations happened in 1962. This was the statutory earnings-related pension scheme which was initially negotiated by the employers’ and employees’ organisations and only later legislated by the parliament as a “negotiated fact”. However, the start to the corporatist, tripartite model is usually dated to the war, especially to the so called January Engagement, when the Confederation of employers and the Confederation of trade unions accepted each other as a negotiating partner in the midst of the Winter War.\textsuperscript{29} This paved the way for collective wage bargaining and bridged the deep distrust between the employers and the unions, which had existed since the civil war in 1918. In the so called corporatist model, the employers’ and employee organisations worked together with the state as central three partite forces and they were important actors in the development of the welfare state systems during this period. The state became in this period essentially a consensus builder. But it was by no means weak, although the interest groups were strong. Within the incomes policy system, the state used social political reforms and/or taxations as trump cards in the negotiations in order to make the employers and employees agree. It would smooth out conflicts on the labour market, and also between the wage earner interests and the agrarian population, in a society marked by more tension than the other Nordic countries. At the same time the aim was to promote growth and prevent the high inflation which was a persistent problem during the decades after the war.

\textsuperscript{27} Kangas 2006, 206.

\textsuperscript{28} For example Kari Puro, the former CEO of one of the two biggest pension funds Ilmarinen, was influential in many committees and working groups developing the Finnish work pension system.

\textsuperscript{29} See Bergholm 2008.
However, consensus was necessarily not reached, but instead the conflicts between the agrarian interests and the working class population was for long a marked feature in the shaping of the Finnish welfare state, where the division line was often between incomes related and flat rate compensations. However, there have also been diverging views about the welfare system for example between various left-wing fractions (e.g. between communists and social democrats). Also tensions between politicians and civil servants, and civil servants and the strong interest groups have existed, where occasionally the strong interest groups ‘stepping on the toes’ of the traditionally strong civil servants in the legislative process.\textsuperscript{30} In many cases the outcome was compromises and a combination between the two principles.

A third force comes from the society and especially civil society associations. The Nordic countries have been marked by a strong civil society and for example in Finland it has become customary to say that Finland is “a country of associations”. Civil society can be seen as extremely important for economic development from different aspects. First, civil associations spread useful information amongst their members. This information is often consistent with the creation of the human capital which is needed for economic development. Secondly, civil associations can also enhance the solidarity amongst their members and promote trust amongst the members. Interest groups or civil associations can of course work as hindrances for economic development if their role is mainly to distribute benefits and not to contribute to the production or aim for exclusion of “outsiders” from e.g. welfare services. Overall it is believed that the quite varied and deep civil society has predominantly been a positive force in the economic and societal development of Finland. The level of trust in society is generally seen as high in the Nordic model. There seems to be also relatively little corruption in the public sector in the Nordic countries. Non-corrupt civil servants have contributed to the development of high level of social capital in Nordic countries.\textsuperscript{31} Moreover, also the universal welfare system in itself appears to have increased the legitimacy of the Finnish and Nordic welfare system, and thus the trust in the system and as such promoted the formation of social capital.\textsuperscript{32}

The relationship between the public sector and the civil society is also very important in this context. The strong state-strong civil society has formed something of a puzzle, but recent discussions have stressed that the Nordic societies have been characterised by a public-private mix, rather than a split.\textsuperscript{33} Arenas for various groups to meet have existed. In the area of social policy for example, the Social Policy Association - a common forum for academics and reform oriented civil servants – established in 1908 in Finland, was a forum for discussion of social policy reforms, and even prepared proposals for reform laws to parliament.\textsuperscript{34} The state committee work has been suggested as another important arena for such a meeting between the civil society and the state in Finland and Sweden.\textsuperscript{35} The committee institution has been of crucial importance in the legislative work concerning welfare state reforms, although today in Finland the political administration have

\textsuperscript{30} This, for example, was the case in the process preceding the formation of the statutory work pension system. See Vauhkonen 2008.

\textsuperscript{31} See e.g. Rothstein, 1998.

\textsuperscript{32} Kangas 2006, 272.

\textsuperscript{33} Kettunen2001; Hernes 1988.

\textsuperscript{34} Hellisten, 2009.

\textsuperscript{35} Rainio-Niemi 2009.
abandoned the committee work, and moved towards a system with “one-man” committees. This has been part of the demands for more efficient public governance, and adapting to global environment, but also as a result of the weakening of the consensus society. Being in principle important arenas for various interest groups to meet, the committees were, however, also sometimes ways of postponing decision making and transferring political power from parliament to the various interest and pressure groups.

However, in spite of strong interest groups, strong bureaucracy and powerful civil servants, one should not rule out the role of the elected parliament in welfare reforms. Olli Kangas show that also the parliament has been important as an arena for both political debate and for decision making. In the Nordic countries there is a long history for legally based social order, which has enjoyed a high legitimacy by its citizens. Only Finland experienced a civil war in 1917, and then the legitimacy of the prevailing system was challenged. This has also affected the interplay between the actors in the welfare state reforms in the interwar period, but less in the post-war period: the “Finnish model” became gradually more and more Nordic since the 1960s onwards.

So was the state strong or weak in the development of the Finnish welfare system? It depends on how we define the state, obviously. Furthermore, it depends on which segment of the welfare system we are looking at and at which historical phase. In some cases the parliament, the government and the political parties have been important for the outcome of the reforms, while other segments especially the work pension system and unemployment insurance have been a result a corporatist model, where the government influence has been limited and met with strong resistance. On the other hand, the government was also from time to time involved as a third party, and actively interfered, in such areas which over time have come to be seen as belonging to the ‘table’ of the labour market parties. However, this interference from politics did not always occur without conflict. For example when the future of the Finnish pension system was recently debated, both the prime minister of Finland and the civil servants within the Ministry of Health and Social Affairs met with strong resistance from the labour market parties when presenting plans for reforming the system. This was not the first time. It appears to have been much easier to complete reforms in the work pension system in Sweden than in Finland during the last decades as the system is there governed within the political process.

Overall, the history of the Finnish welfare state shows that the development of the welfare system has occurred along fairly diverse paths, and that the power balance and the sources of conflict also have transformed. Some welfare reforms seem to have been fairly easy to accept by most parties, some have been much more difficult for certain political parties and interest groups to accept. Some has caused conflicts – or been a result of compromises arising from such conflicts - while others have been less influenced by these tensions. In some cases the civil servants have been particularly prominent for sketching the reforms and the ‘models’, while in other cases the political process have steered the direction.

36 See Kangas 2006, 199ff, for a discussion of this.
38 For an interesting analysis, see Kangas 2006.
We see that there has been a considerable change in the dominating ideologies with respect to the role of state. We have moved from liberal ideologies of the 19th century to progressive Beveridgian-Keynesian view of the role of public sector after the Second World War. After a long period of deepening involvement of the state into economic matters, the tide has somewhat changed during the past couple of decades towards more neoliberal directions. This is a phenomenon also observed in many other European countries and is a reflection of prevailing ideologies. On the other hand, there has also been an opposite tendency, where especially emerging market economies seems to move towards what could be called social democratic welfare systems.\(^{39}\)

It has often been assumed the state has become weaker during the ‘neo-liberal’ regime of the last decades, which has meant the de- or re-regulation, increasing competition and an ideology of non-interference from the state in the economic sphere. Although a rapid liberalisation, an opening up of the economy, and an active promotion of the working of the market forces has occurred also in Finland since the 1980s, it does not necessarily mean that the state has become ‘weak’. It can still be seen strong, although fairly withdrawn (‘at arm’s length’). It for example monitors and actively promotes the functioning of the market mechanism. The state, instead of regulating and interfering directly in the economy, plays in the new environment the role of controlling actors, enforcing the ‘rules of the game’ in the economy. That cannot be seen \emph{a priori} as a sign of a weak state, but can on the contrary indicate a strong state.

The state’s role in the growth project and in economic development in general has perhaps been particularly elaborate in the Finnish case, but it has been so also in the other Nordic countries, perhaps best exemplified by Norway, where the state has played a prominent role as an active promoter of growth, as owner of the largest companies in the energy sector, and with extensive regional policies and regional transfers.\(^{40}\) The particularly active involvement of the state in Norway and Finland in these countries originated probably partly in the economic backwardness, in combination with nationalistic overtones in the young nations. But it is evident that in all Nordic countries many welfare reforms have had economic motivations: these small, late-coming open economies have mobilised and made efficient use of their scarce resources in order to enhance growth.\(^{41}\)

The view of the role of the state for enhancing growth has also changed, according to economic doctrines and theoretical thinking. While the emphasis was mainly on infrastructural investments in the late 19th century and early 20th century, and human capital and fixed investments during the decades after WWII, today the role of support for R&D and innovations are seen as crucial for future development.

\section*{Conclusions}

Together with the other Nordic countries Finland has been able to combine a good long-term economic performance with a large welfare state. In this paper we have focused on the emergence

\(^{39}\) See e.g. Lloyd, 2009.

\(^{40}\) Thue, 2008.

\(^{41}\) Fellman & Sjögren 2008.
of the welfare state and the roles of state and economic development as explanations for this process.

At the beginning of the 20th century public sector was not exceptionally large in the Nordic countries compared to other European countries. Germany was one of the first countries to develop the public welfare measures in the economy. The welfare state institutions and structures in Finland expanded rapidly only after WWII, somewhat later than in other Nordic countries.

We also observed that the development of the public and the private sectors are closely connected. Public sector programmes and activities have developed more or less simultaneously with the industrial development. Industrialisation puts new pressures for the development of the supply factors like education and infrastructure, while individuals demand for security in an uncertain world. This leads also for the demands for social security.

A well-functioning and well-organised state is needed for the development of the welfare state. But the strength and significance of the state has actually varied in different reforms. Behind each reform one can also see strong private economic interests. During the liberalisation ideology in the nineteenth century the role of state weakened compared to the earlier mercantilist era. In Finland we can see elements of a strong state in preserving the legal order and creating the basic infrastructures. According to the liberalist ideologies the early emphasis on social policy was on the relief of poverty and acts to develop work protection, conditions of work and working hours.

In 1920s and 1930s political disagreements stalled major welfare state reforms. The state, therefore, remained relatively weak with respect to the welfare state developments. Discussions of more general social insurance reforms did not lead to legislative reforms. Although the plan for a national pensions system was accepted in 1938, it became reality only in the post-war period. Tensions between the wage-earner groups and agrarian population also became to the fore, affecting policies, up until today.

After the Second World War major welfare state reforms were introduced. During this period the state also played an important role in participating in the industrial development via state ownership of some important industries. State interference in the economy was extensive, in order to enhance growth and a high investment rate, while the public expenditures and the welfare state expanded. This was the period when the state was at its strongest in the economy, due to its role of actively promoting growth by regulating and interfering in the economy. The labour market organisations became at the same time crucial in the creation of the welfare system, especially the income related benefits and the employment related pension system.

This period from 1960s onwards, has been characterised as a three-partite consensus between the state and employer’s and employees’ organisations. Since then labour market organisations have played an important role in shaping the systems of the welfare state. The parliament accepted the negotiated contract by the labour market agreement. Sometimes the parliament has raised the voice that its role has been only to accept the negotiated reforms by the labour market parties. Although the Finnish state-led economic policy model was particularly elaborate, and the interest groups and

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42 For a discussion see e.g. Fellman (2008).
the state was both strong and active in the post-war decades, it has to be noted that it was so in many other countries as well.

Globalisation is seen to have started a new phase, which puts the welfare state in its present form, and also the power structure of various interest groups, into question. Some people think this development also has led to weaker state. But although the common new liberal view today is that the state should not interfere in the market mechanism, it still is seen to have a significant role in providing a favourable environment. When state in the late 19th century was to provide infrastructural investment it is today to support innovativeness, R&D and skill-formation, by steering resources into these activities.

The Finnish welfare state model can first and foremost be seen as one variation of the Nordic model, although with its own features. Finland has followed the Nordic countries, although somewhat later. The formal and informal contacts to Sweden both among politicians, in civil service, among interest groups and associations, have been strong and long lasting in spreading of the ideas amongst the Nordic countries. There was e.g. active searching for models and for cooperation on the Nordic level between Nordic Social Meetings on social affairs, where both ministers for social affairs and civil servants met regularly to cooperate on Nordic social policy legislation and programs since 1919.43

Coming a little after, Finland has also perhaps avoided some of the pitfalls of social and welfare state reforms. But perhaps one could argue that the very strong state involvement for promoting investments in fixed, human and social capital has been particularly prominent in Finland in the Nordic perspective.

So what does the future look like? The Nordic countries have generally favoured open trading system and benefitted from this. Globalisation puts, however, a strong pressure on structural changes in small countries. Tax competition would seem to require low taxes. On the other hand competitive ability may still benefit from efficient public expenditures on health, education, research and development and public infrastructures. Welfare state also enjoys a strong popular legitimacy in contemporary Finland.

The tendency towards more private-public partnerships has made the limits of the state and the public sector more blurred. This is, however, a phenomenon of the whole western world.44 This makes the question raised here even more intriguing in the future.

43 Petersen, 2006.
44 Flinders 2006.
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