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**Social policy in a deep economic
recession and after:
The case of Finland**

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SOCIAL POLICY IN A DEEP ECONOMIC RECESSION AND AFTER: THE CASE OF FINLAND

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Abstract

This paper discusses the social policy consequences of the exceptional economic downhill in Finland in the early 1990s and rapid recovery in the latter part of the decade. It looks at income levels, income distribution and poverty. It finds out the Finnish households have suffered economic losses, which are smaller than the decline of the GDP would predict. The findings show that equivalent income distribution and relative poverty levels have not changed during the recession. The income losses of the recession have been spread out relatively evenly, and the redistribution of the welfare state has been important tool. During rapid economic recovery in the second half of the 1990s income inequality and relative poverty have increased, partly because of high income groups have got much property incomes, and partly because of the decline in redistributive effect of the welfare state.

1 Economic crisis and recovery

In most of the Western advanced industrial nations, the welfare state has faced economic and political problems during the 1980s and 1990s. The fiscal crisis of the state has been in the political agenda, although the severity and the timing of the problems have varied from one country to another. In many countries economic and political problems were visible in the 1980s. In Finland, the 1980s was economically very successful, and she was frequently referred to as Europe's Japan. All that changed dramatically in the beginning of the 1990s, when Finland's economy fell into an exceptionally deep downhill which has no parallel in any of the OECD family - former Central and Eastern European socialist countries apart, however. Finland is the only OECD-country in which the recession of the 1980s or 1990s was deeper than the Great Depression in the 1930s.

	Real growth of the GDP, %	Real growth of social expenditure, %	Social expenditure as a % of the GDP	Unemployment rate, %
1989	5.7	2.9	23.8	3.1
1990	0.0	6.9	25.2	3.2
1991	-5.9	8.8	29.9	6.6
1992	-3.2	7.1	33.6	11.7
1993	-0.6	2.0	34.6	16.3
1994	3.7	2.5	33.9	16.6
1995	3.9	0.7	32.0	15.4
1996	4.1	2.6	31.5	14.6
1997	5.6	-0.8	29.4	12.7
1998	5.6	-0.5	27.4	11.4

Gross national product decreased in three years by 10 percent and unemployment grew to 16 percent of the labour force. Of course, negative growth and unemployment were not the only economic problems. Public economy had considerable income losses, while expenditures tended to grow due to increased needs of the population, but also due to a severe banking crisis, which during the recession caused expenditures of 45-50 billion Finnish marks to the state, who subsidised some banks to keep them in business. Consequently, the public debt grew dramatically from 10 percent of the GDP in 1990 up to 50 percent in 1993, and 70 percent in 1995, after which it has started to decline.

Despite social security benefits have been worsened and many cuts have been made, social expenditure grew in real terms in the first years of the recession, mainly because of expenditure due to unemployment and social assistance. Since 1994 economic growth has been among the highest in the OECD-area. However, unemployment has decreased more slowly, and it still is on a very high level. The GDP-proportion of social expenditure has declined rapidly almost the pre-recession level.

2 Social policy

After the general election in March 1991, a centre-right cabinet assumed power. The core of this cabinet was formed by the Centre Party (formerly the Agrarian party) and the National Coalition (conservatives), with the participation of some smaller parties. The cabinet had a firm majority in the parliament. Social democrats experienced losses in the general election, and remained in the opposition.

In 1991 the cabinet could not foresee the deepness of the economic crisis - no one could. Gradually, the consciousness of the crisis increased, and the key elements of the cabinet's economic policies in the crisis were formulated. The cabinet started to see the growth of *public debt and deficit* as the major problem and proposed and made considerable cuts in public expenditure, while the rate of taxation increased considerably. *Tight fiscal policies* were applied and much consideration was devoted to the *international competitiveness* of paper and metal industries, including the deflation of the Finnish mark. Also the growth of *unemployment* was perceived as a major problem, but measures to fight it back were mainly indirect: growth, control of inflation and stability of the currency were seen as keys to decrease unemployment rates.

Social expenditure continued to grow in the first years of recession, although the cabinet started to cut social benefits already in 1991. Cuts of social benefits did not concentrate on any single or few benefit types, but were spread to all schemes. The techniques varied: index promotions of benefits were cancelled, compensation levels of earnings-related unemployment, sickness and maternity benefits were lowered and the eligibility to some benefits was tightened.

The new parliament was elected in March 1995. The parties in the cabinet lost, especially the centre party, while social democrats - the largest opposition party - made considerable progress. The new cabinet was a broad coalition cabinet formed by the Social Democratic Party, the National Coalition (conservatives), the Leftist League (a party to the left of social democrats), the Swedish People's party, and the Green League. These parties have more

than two thirds of the seats in the Parliament. The centre party, which had the key role in the previous cabinet, became the largest opposition party.

The programme of the cabinet emphasised two targets: the improvement of the employment situation and the decrease of the ratio of the public debt to the national product. The major new element in the economic policy of the cabinet was the emphasis on the fulfilment of EMU-criteria, which European Union has set as a condition to enter the forthcoming European Monetary Union.

When doing the cuts of public expenditures the cabinet emphasised following principles. *Disincentives to work* existing in the subsidy system must be removed. It set out a working party the task of which was to present a total estimate of the co-ordination of social income transfers, charges and taxation and to suggest necessary measures without diminishing the security for those in the most vulnerable position. Most of the suggestions made by the working party were included in the budget for 1997.

In order to balance the employment pension contributions and the pension benefits and to reduce the pressure to increase the pension contributions, employment pension schemes were reformed in 1996. The basic amount that was payable to all above 65 years of age because subject to income testing. Another similar step was taken in the sickness insurance system in which the eligibility of receiving the minimum daily allowance was tightened.

A revision of the unemployment benefits was carried out rapidly in consultation with the labour market parties. The reform includes a reconsideration of the period for which the benefit is paid out and of the bases on which the benefit is granted. At the same time there is an increase in the activating factors - rehabilitation, training - and in the measures of labour policy to improve the employment situation.

In Finland, social and health (as well as educational) services are to a very large extent publicly provided. In practise the responsibility is in the hand of the municipalities, who tax their citizens to provide (these and other) services. They also get a block grant from the state to finance these services, the level and quality of which is monitored by the state. The cabinet cut considerably the block grants to municipalities.

Amongst all cuts and discussions about the curtailment of the welfare state one important improvement of social security has been carried out. This is the extension of the right to day-care for children under school age. Earlier this right was valid only for children under three years of age.

After the election in 1999 the same coalition continued in the cabinet. Its programme included much of the same elements as that of the previous cabinet. Tight budget policy continues: State expenditures are kept at the level of 1999 in real terms. Taxation and social security is developed to encourage employment. The prevention of social exclusion and poverty and securing social welfare and health care services are key social policy goals of the cabinet. No further cuts of social benefits and services were proposed.

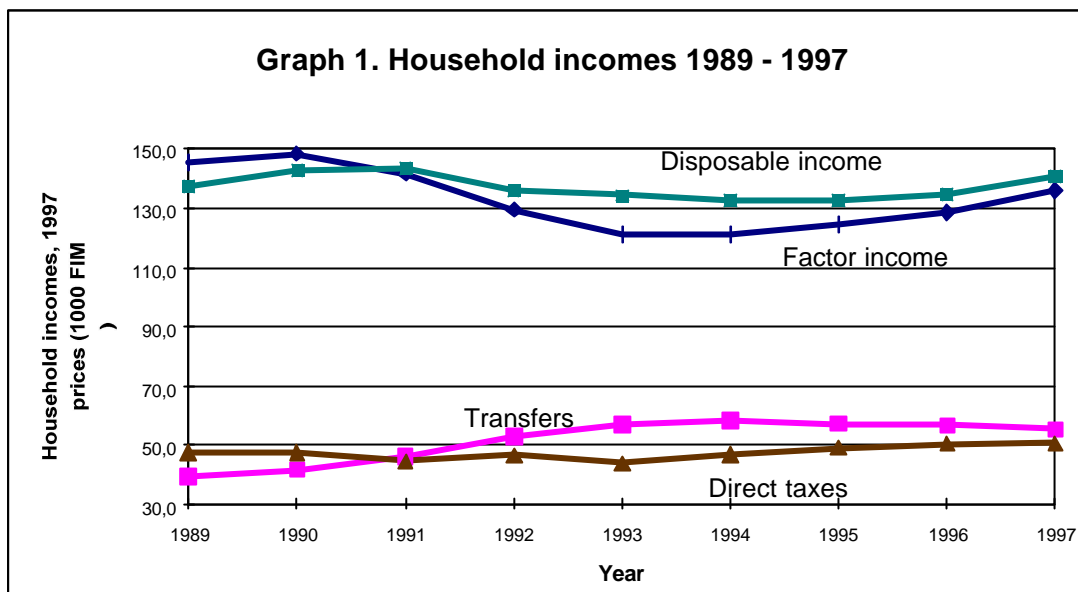
The Ministry of Finance has estimated that the public spending in 1999 is more than 9 billion Euros smaller than it would have been without the cuts. In economic terms, most significant cuts were made to state subsidies to municipalities, to unemployment benefits, housing allowances and other social benefits like future pensions. These cutbacks had an impact on the welfare state. Table 2 gives a very brief summary of these impacts.¹

Table 2: The Finnish Welfare State After the Recession
<p>The Nordic model of social security has been maintained, but it is less generous:</p> <ul style="list-style-type: none"> • Universality of benefits weakened • Net replacement rates of benefits reduced • The role of means/needs testing strengthened <p>Several concerns in health and social care emerged (care of the elderly, mental health care, care for substance abusers, child welfare services and the heavy workload of care providers).</p>

3 Household incomes

Keeping in mind that during three years the GDP declined by nearly 10 percent and unemployment multiplied, it is interesting to look at the development of household incomes, and ask how much they have declined. This question can be examined with the help of Graph 1, which displays the development of household incomes and makes no adjustments to household size or structure.

¹ Social policy measures carried out during the recession as well as their impact on the economy of households, on income distribution and on poverty are analysed in Heikkilä & Uusitalo 1997. Social policy changes in the Nordic countries are analysed in Heikkilä, Hvinden, Kautto, Marklund & Ploug 1999. The situation of health and social services is analysed in Uusitalo, Parpo & Hakkarainen 2000. The Academy of Finland has launched a research programme to study the causes and consequences of the economic crisis. For its first results see Kiander 2000.



The average disposable income of households was at its highest in 1991. In succeeding years it dropped significantly, and the drop has continued to 1994. After 1994 disposable incomes have increased, but have not reached the level of 1991. The most interesting finding of Graph 1 is the comparison of the development of factor and disposable incomes. The factor incomes (incomes from employment, self-employment and property) of households were at their highest in 1990, and the decline to 1994 has been as high as 18 percent, compared to 7,6 percent of the drop in disposable incomes. This decline is for the most part due to increased unemployment levels. However, the welfare state has through its cash transfers compensated a large part of this decline: income transfers have in real terms increased by almost 40 percent from 1990 to 1994! The growth is caused by unemployment insurance, but also pension expenditure and social assistance expenditure have grown remarkably. This is, of course, what the welfare state is about: to help individuals and households when they meet difficulties.

From the year 1994 the growth of factor incomes has been more rapid than the growth of disposable incomes. Partly this is due to the decline in income transfers received by the households (which is caused by improved employment and cuts of social transfers), but mainly because direct taxes have continued to increase.

4 Income distribution

Many studies comparing income distributions in advanced industrial nations in the 1980s and mid-1990s have shown that Finland is a country where income inequality is among the lowest (Atkinson, Rainwater and Smeeding 1995, Jäntti 1999, Burniaux & al. 1998).

Finland has comparable income distribution data from 1966 up to 1998. The data for the years 1966-85 are based on household budget surveys, carried out at five-year intervals, while data for 1986-984 are based on income distribution statistics, both collected by Statistics Finland. Income distribution statistics is an annual statistics based on a larger sample than household budget surveys. Both operate with very similar income concepts. The data sets are not exactly comparable, but their differences are likely to be within the limits of sampling variation.

From the viewpoint of economic welfare or standard of living, the most crucial income concept is *disposable income*. Wages, salaries, income from self-employment and property income add up to *factor income*. When income transfers such as pensions, sickness insurance benefits, unemployment insurance benefits and others are added, we get *gross income*. Gross income minus direct taxes (including other tax-like payments) is disposable income.

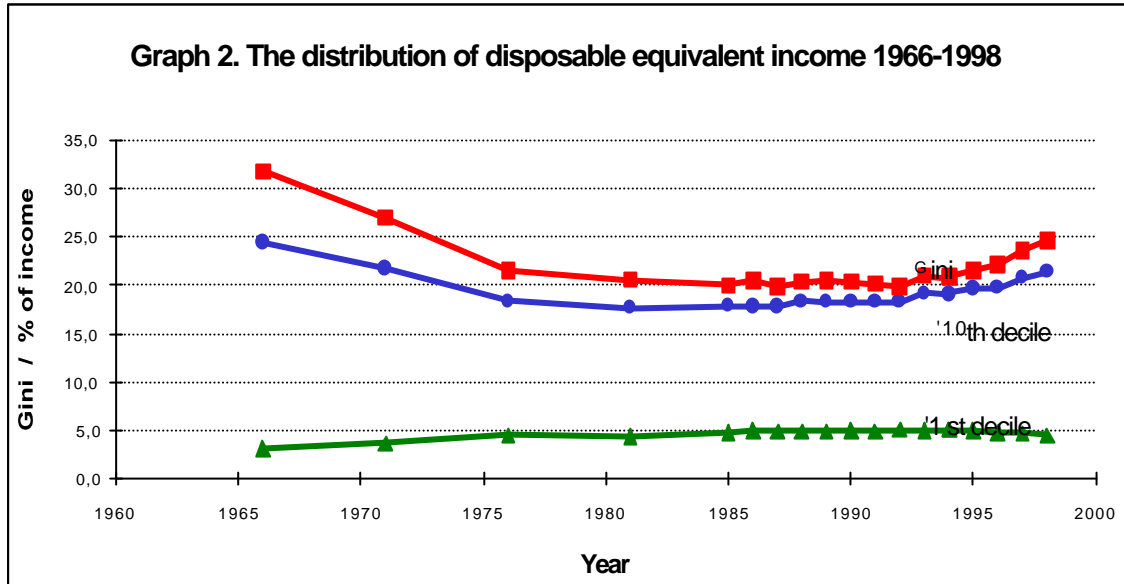
In order to compare the income levels of households having varying number of members and varying structures, an adjustment must be made. Equivalence scales do this. There is no one scale, which can be regarded as the right one, but there are many alternatives. The equivalence scale used by the OECD is applied here. The first adult gets the weight of 1.0, the second 0.7 and children 0.5. This means that a two-parent family with two children needs 2.7 times the income of a single adult in order to get the same standard of living.

Finally, we do not compare the distribution of income between households, but the distribution of household equivalent income between persons. For further information on methods and specifications see Uusitalo (1989: 20-31).

By comparing the distributions of factor and gross income we can find out the redistributive effect of social transfers. The comparison of gross and disposable income is due to direct taxes. Finally the comparison of factor and disposable income gives the combined effect of transfers and taxes.

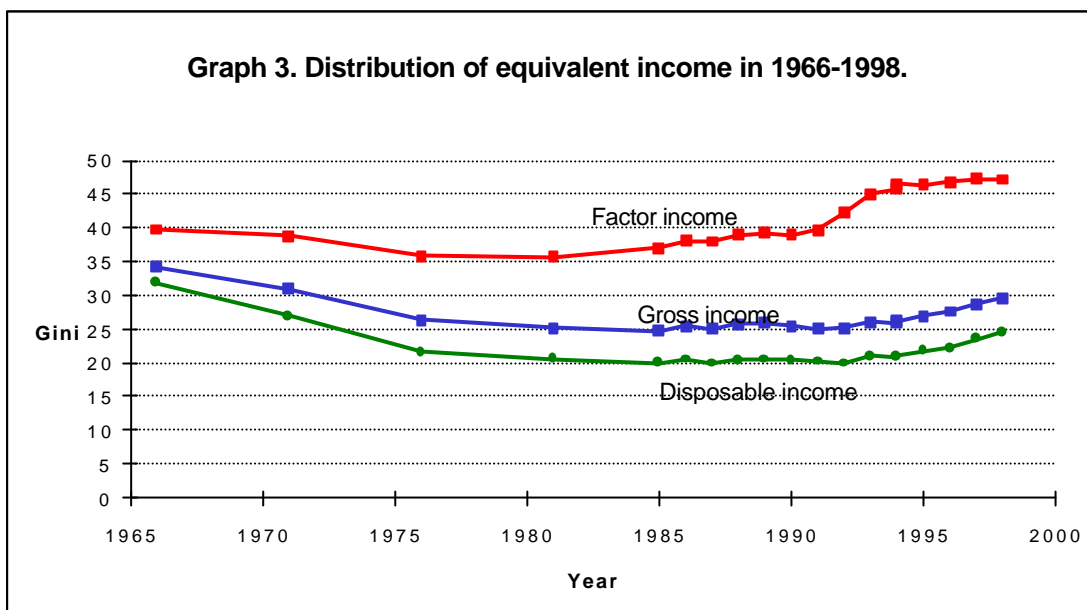
As a measure of income inequality we use Gini-coefficients and the respective income shares of deciles of persons. The higher the value of the Gini-coefficient, the greater the

inequality. Redistribution due to transfers and taxes are estimated by the changes in the values of Gini-coefficients due to them.



Graph 2 displays the development of equivalent income inequality in Finland 1966-1994. Inequality declined dramatically between 1966-1976. The main causes of this decline are to be found in the growth of social transfers and direct taxes, but also in incomes policy introduced in Finland in the late 1960s, which considerably compressed the distribution of earnings (see Uusitalo 1989). During the next ten years one can also observe a decline, but a much weaker one. From 1985 to 1994 inequality has remained roughly at the same level. It is of particular interest to note that the recession years have not witnessed any growth of income inequality. For instance, the income share of the lowest decile has remained astonishingly stable during the recession.

From 1995 onwards income inequality has increased. The most prosperous 10 percent of the Finns has increased its share of disposable incomes. More detailed statistics show that this is due to increased property incomes, which concentrate strongly to the highest income decile. The share of the lowest decile of Finns has decreased slightly, as has the share of all whose income is below the median. However, this decline is modest when compared with the growth in the income share of the highest decile.

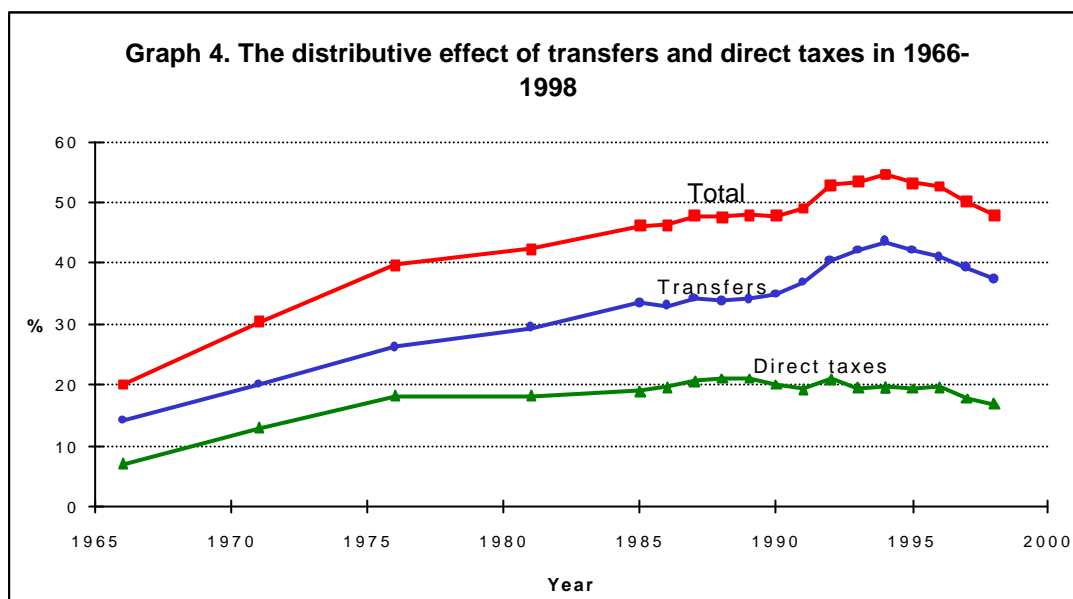


As seen in Graph 3, the distribution of *factor income* became more equal between 1966 and 1976, but in contrast with the distribution of disposable income it has become more unequal since 1981. The main reason for this is likely to be the increased proportion of elderly and non-working population. During the recession, the unequalizing tendency has accelerated. The increased unemployment has worked for the widening factor income parities. After the recession, the distribution of factor income has not changed much, due to the decrease of unemployment. The development of *gross income* distribution is broadly similar to that of disposable income, indicating that the impact of direct taxes has not changed dramatically.

The redistributive impacts of social transfers and direct taxes are more explicitly displayed in Graph 4. They are measured as percentage change of the Gini-coefficients.¹ As a long-term trend, the redistributive effect of *income transfers* has been increasing from 1966 onwards. In the late 1980s, the effect seemed to be stabilising, but during the recession it has grown again. The increase of social expenditure both in real terms and in relation to the GDP is the key explanation for this development.

However, during the latter part of 1990s, the redistribution through transfers has weakened. This is due to the decrease of social expenditure.

¹The redistributive impact of social transfers = $100 * (\text{factor income gini} - \text{gross income gini}) / \text{factor income gini}$; the redistributive impact of direct taxes = $100 * (\text{gross income gini} - \text{disposable income gini}) / \text{gross income gini}$; the redistributive impact of both = $100 * (\text{factor income gini} - \text{disposable income gini}) / \text{factor income gini}$.



The redistributive effect of *direct taxes* increased in the same pace as the effect of social transfers between 1966 and 1976, after which the increase has been much more modest up to 1989. Since 1989 their effect has been declining, slowly but steadily.

The total redistributive impact of transfers and direct taxes follows the changes in the impact of transfers.

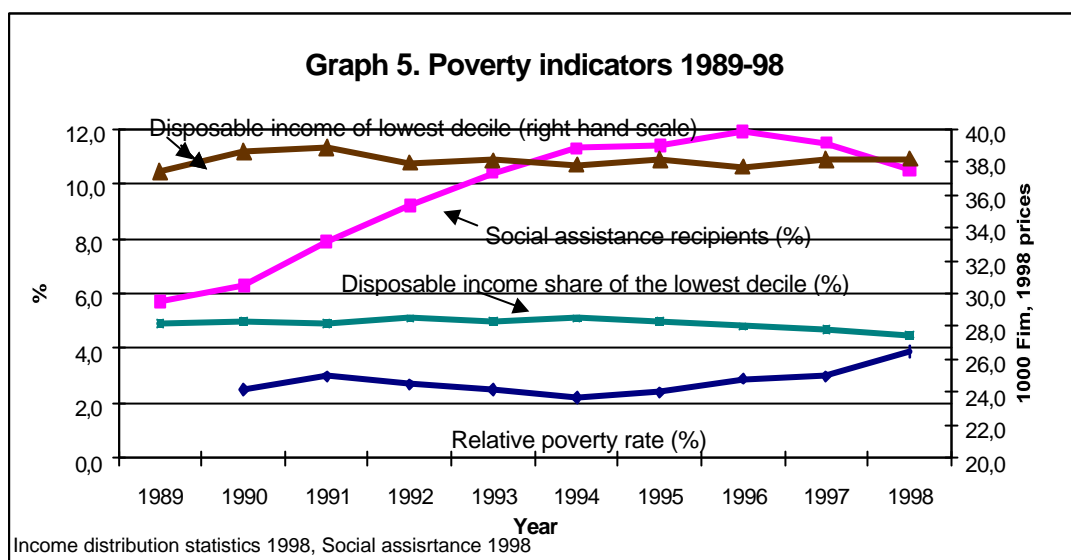
To summarise the developments during the recession in the 1990s: income distribution remained remarkably stable during the recession years. Increased factor income inequality, which probably can be attributed to extremely high level of unemployment, was compensated by the increased impact of social transfers, so that equivalent disposable income distribution has not changed. After the recession income inequality has increased, due to decreased redistribution through transfers and taxes.

5 Poverty

Comparisons of relative poverty levels have shown that Finland has one of the lowest poverty rates (Ritakallio, 1994; Atkinson, Rainwater and Smeeding, 1995).

Graph 5 describes the development of some poverty indicators over time in Finland. Relative poverty rate is a measure usually applied in international comparisons. It describes the proportion of individuals who live in households whose equivalent disposable income is less than the median in the nation. The development during the recession was remarkable indeed: the relative poverty rate declined slightly. This is due to two factors. First, because of the median income of the Finns declined, also poverty limit became lower. This means

that some people who before the recession were poor moved to non-poor even if their real income did not increase. Second, despite unemployment and other economic problems people met in the recession, social security lifted many of them above the poverty level.



'Social assistance' measures the percentage of individuals who have during a year got the last resort needs-tested social benefit. This number doubled during the recession. The major causes of this growth are increased unemployment, decreased real income levels, and difficulties to pay back debts taken before the recession.

This poverty measure thus conflicts with the relative poverty rate. However, this is not too difficult to explain. As also shown in Graph 5, the real income level of the lowest income decile (10 percent of people having the lowest equivalent disposable income) has decreased during the recession - as is the income of all other deciles. So they, like people in other deciles as well, have faced economic difficulties to manage their households. These difficulties have led more and more people to social assistance, and absolute poverty increased. The conclusion is then, that economic recession with decreased income levels and increased unemployment has caused economic problems for Finnish households, but because of the welfare state, not more so to low income people than to others. Hence, the stability of relative income shares and relative poverty.

After the recession the relative poverty rate has increased, while real incomes of the lowest decile starts to show improvements and the decline of social assistance recipients is also observed. This is, in a way, the mirror of what was observed during the recession: real incomes of the poor are slightly increasing and their economic problems are decreasing

slowly, but the poor have not had an equal share of increased prosperity, but lack behind others in relative terms.

6 Conclusion

The distinction of the recession years and the years of recovery are worth emphasising. During the recession, the distribution of income between the Finns did not change. Recession caused losses of income, but they met income groups in a fairly similar fashion. Poor and low-income people met serious economic problems, because the room of economic manoeuvre, which even before the recession was small, became even smaller or disappeared completely.

The distribution of income did not change despite huge growth in unemployment. This is social security to thank: even if inequality of factor incomes increased considerably, the increased redistributive impact of social transfers compensated this change. Social security prevented the growth of income inequality and poverty, although in real terms poverty increased.

After the recession the situation is different. From 1995 income inequality has grown. Especially the highest decile of the Finns has increased their income share, due to rapidly increased property incomes. Also the relative poverty rate has increased. This is due to decreased redistributive impact of social transfers. Our time series end 1998, but it is likely that this development has continued at least until 2000.

7 Discussion

So far, the Scandinavian welfare state has been maintained in Finland. It is worth emphasising that given the deepness of the recession, the welfare state has worked surprisingly well in alleviating its harmful consequences to the welfare of the citizens. It has proved to work as it is supposed to work in situations when people are not capable to acquire their living by their own means. However, it is equally true that the Finnish welfare state is not as generous, it is not as universal and it leans more on means-tested benefits than just before recession. It is also true – at least so far - that there are no signs that the welfare state will be restored to pre-recession position.

One could argue that the case of Finland lends support to the thesis according to which the welfare state is irreversible, i.e. once established, it cannot be turned off. Economic growth is regarded as a prerequisite of the growth of the welfare state, even though the relationship is not a linear one and even though the impact of increased prosperity on the welfare state is mediated by other factors. In our case, the dramatic economic decline did not cause the

dismantlement of the welfare state. It could also be argued that the case of Finland supports Pierson's (1994) view according to which the process of retrenchment differs from the process of growth. In the former process existing structures and institutions created by the welfare state play a significant role. They have created their own constituencies and interests, which, during such exceptional conditions as those in Finland in 1990s, work for the stability and against dramatic retrenchments. Not that these structures and institutions stubbornly keep up with on the old; on the contrary, they often adapt flexible strategies in order to survive in changing conditions and show considerable capabilities of political learning. In the case of Finland, these structures and institutions have been strong enough to survive in hostile economic and difficult political conditions, and could do so also in the future.

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