

Credibility Mountain

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Let's imagine that the waste of unemployment in Canada was visible, rather than invisible. Let's imagine that Canada had in place a system of "workfare" so that rather than sitting around at home feeling useless, the unemployed were put to work doing something useless in return for the unemployment insurance or social assistance payments they get. Let's imagine, for example, that Canada's unemployed were put to work building "Credibility Mountain".

Let's think of Credibility Mountain as an enormous construction project, aimed at building (just outside Ottawa) a mountain of sand to symbolize our national commitment to zero inflation. We would not use in this construction project any of the resources that aren't normally unemployed in a market economy, due (for example) to the time that it usually takes to find a new job when entering the labour market for the first time, or changing jobs -- we would only use unemployed labour and capital in excess of the rate of unemployment which prevailed in 1989 (7.5%). Since the construction of Credibility Mountain only uses unemployed resources, it would not (unlike most actual workfare projects) compete with private sector output, so the income of all other Canadians would remain exactly as it actually would have been. However, since the cumulative amount of output foregone due to excess unemployment over the 1989-1995 period was approximately 260 billion¹, by now Credibility Mountain would be rather large, and continually growing.

Built as it is of sand, Credibility Mountain is continually subject to erosion, and therefore requires a continual expenditure of resources for its maintenance. Since it is huge and impressive, its designers are proud (though a little sensitive about cost overruns) and

¹ Over the 5 years 1990 to 1994 inclusive, the cumulative amount of unemployment in excess of 7.5% was 13.9%. If the Okun's law approximation holds of 2.5% of GDP forgone for each percentage point of excess unemployment, given that GDP at current market prices was \$767.08 Billion in the fourth quarter of 1994, total output foregone was approximately \$266.56 billion (= 767.08 x .139 x 2.5).

resent any criticism. However, imagine how different the debate on deficits and debt in Canada would be if the cost of excess unemployment were visibly accumulated in a single place, rather than invisibly dispersed around the nation.

The size of Credibility Mountain would certainly be a highly visible indicator to the international financial community of the seriousness with which the Government of Canada approaches the crusade for zero inflation. However, the visibility of Credibility Mountain would also lead many Canadians to question whether there is a connection between the fact that we have build a huge mountain of sand at the same time as we have accumulated a huge mountain of debt.

At a minimum, the building of Credibility Mountain would attract the attention of journalists, parliamentary committees and investigative agencies such as the Office of the Auditor General, all of whom would want to know what evidence there was to support the decision to engage in its construction. It would be natural to ask:

- (a) was a careful study of the costs and benefits of this decision done beforehand?
- (b) how reliable was the evidence on which this study was based?
- (c) were there cost overruns during construction?
- (d) what have the benefits of building Credibility Mountain actually been?

People ask these sorts of questions of public officials in a democracy because they are interested in governance and competence. In a democracy, the expectation is that major expenditures of public resources require public consent -- either specifically through a referendum or indirectly, through the election of a government pledged to a particular course of action. If decision-making is delegated to civil servants, the democratic expectation is that they should be responsible to elected officials, and competent in the exercise of their duties.

The issues of competence and governance are also crucial to the debate about

Canada's "debt mountain", because the two mountains are connected. As the Fortin and Kneebone chapters in this volume document, one can divide the building of the debt mountain into three distinct phases -- 1975-1980, 1981-1988 and 1989-1995. Over the period 1975-1980, the debt to GDP ratio rose because governments ran a series of deficits, as the result of a succession of tax policy changes which decreased the tax share of total GDP. Although the 1981-1989 period saw a rapid rise of the debt to GDP ratio due to the collapse of output and the rise in interest rates of the recession of the early 1980's, it can be argued that in the early 1980s, Canada really followed the United States in a high interest rate policy, in order to get inflation under control. By the latter part of the 1980s, Canadian governments had raised taxes considerably, and were, despite high real interest rates, by 1989 running sufficiently large surplus on their primary balances to begin to reduce the debt to GDP ratio.

By 1988, the Canadian inflation rate had stabilized at approximately 4%, but it was in 1988 that the Bank of Canada embarked on a new policy of aiming at the complete elimination of inflation. Since this policy choice was not imitated by other countries, it produced a "Made in Canada" recession. By raising interest rates and thereby engineering a 21% increase in the exchange value of the Canadian dollar², monetary policy precipitated a collapse in aggregate output. Excessively tight monetary policy very much worsened the severity of the 1989-1992 recession -- and also destroyed the debt stabilization plans of Canadian governments. The debt to GDP ratio soared to new heights, and by 1995 all Canadian governments perceived no alternative but to engage in major cuts in program expenditure.

² From an average of \$.72 (U.S.) in 1986, the dollar went to \$.754 in 1988 and a peak of \$.867 in 3rd quarter 1990.

Among the contributors to this volume, there is substantial disagreement (e.g. between Kneebone and Rosenbluth) about whether Canadian governments should have begun earlier to take action to control their aggregate expenditures. There is also disagreement as to whether or not, and to what extent, further increases in taxation are desirable or feasible. However, there is no disagreement about the implications for the national debt, in the actual situation of 1988, of the decision to use monetary policy to attempt to achieve a zero inflation rate. As the debt stability equation implies, when the debt to GDP ratio is at the level it was in 1988, any increase in interest rates has a huge impact on the national debt, much larger than the impact of social programmes.³

Since the increase in interest rates was large, and the consequent recession was severe, a substantial increase in the national debt and the debt to GDP ratio was the result -- McCracken estimates the impact on the federal debt at \$696 Billion, or an increase of nine percentage points in the debt/GDP ratio (over and above the implications of the international recession of the early 1990s). All this occurred despite the fact that during the 1980's elected

In 1988/89, the federal debt/GDP ratio was .539. Between March 1988 and March 1990, the Bank of Canada raised the Bank Rate from 8.7% to 14.05%, (an increase of 5.27 percentage points) and other short term interest rates followed in rough parallel. This increase cannot be explained by international trends. The comparable U.S. interest rate (the Federal Reserve Bank discount rate) was 6.0% in March 1988 and 7.0% in March 1990 - i.e. the U.S./Canada interest rate differential widened to an unprecedented level. Nor can it be explained by trends in core inflation (4.7% in the second quarter of 1988, 4.4% in the second quarter of 1990) - i.e. real short-term interest rates were raised to dramatic levels.

The impact of such a rise in interest rates on the deficit depends in part on the term structure of the federal debt and the percentage of the federal debt that has to be refinanced during the period interest rates are kept high (quite a while, in this case). The importance of a 5% hike in interest rates can be partly gauged from the fact that, if applied to the entire debt, when the debt/GDP ratio is .539, it would amount to an increase in the deficit equal to 2.84% of GDP, or over \$13.9 Billion, (in 1988). This increase in interest costs can be usefully compared to the total expenditure of the federal government on social assistance under the Canada Assistance Plan (\$5.108 Billion in 1988/89).

Canadian governments had adjusted their taxation and expenditure decisions so as to generate, by 1989, a surplus on their primary balances.

However, the policy initiative of an unelected agency has produced such a large increase in the debt to GDP ratio that deficit reduction has now become the overriding objective of all Canadian governments. Deficit reduction is forcing a substantial retreat of the federal government from areas (such as health care and social policy) that it has influenced since the second World War. Deficit reduction is forcing substantial change in the services which both provincial and federal governments can provide to their citizens. Deficit reduction is, in short, forcing a substantial reorganization of federal and provincial roles within the Canadian federation and a substantial change in the social role of government. Surely there are no bigger issues in politics than the structure and role of government, but now these changes are being driven by an economic policy choice -- the decision to use monetary policy to achieve zero inflation.

There are two logical possibilities. At the time, in 1988, that the decision was taken to begin raising interest rates in order to eliminate inflation, it was either (a) foreseen or (b) not foreseen that such decisions would have a major impact on the national debt.

If it was foreseen in 1988 that a substantial rise in interest rates would destabilize the national debt and eventually force all governments into a substantial realignment of their roles, governance is the issue. Since the experience of the 1981-1982 recession clearly showed that a run up in interest rates would produce a substantial increase in the debt to GDP ratio and since the “debt stability equation” was already well known, it can be argued that it should have been easy to foresee in 1988 the consequences of such tight monetary policy. However, if the full political and economic consequences of the zero inflation policy adventure were in fact foreseen, this implies that a secret agenda for substantial political

change has been successfully imposed on Canadian society.

Some people applaud the trend to a much reduced role of government in general, and the federal government in particular. Some people oppose the trend to provincialism and a more market dominated society. However, whatever one's opinions about whether "less government" is "good" or "bad", a fundamental principle of our legal system is the rule of law - that elected officials can only instruct appointed officials to perform actions which are within their legislatively authorized terms of reference. Moreover, a fundamental democratic value is that decisions of this order of importance should be publicly debated and receive public consent. Since officials at the Bank of Canada are not elected it would not be appropriate for such officials, on their own initiative, to embark on a policy which produces a fundamental redesign of the Canadian political system. Since the legal mandate of the Bank of Canada does not include any mandate to implement political and economic change of this magnitude, the approval of the Finance Minister of the day is not enough -- either the mandate of the Bank of Canada should have been amended, or the specific policy should have been approved, by an explicit act of the elected legislature. Hence, the possibility that the full consequences of the Bank of Canada's monetary policies were foreseen, and implemented anyway, raises important issues of governance in a democracy.

The alternative possibility is that the consequences were not foreseen. This hypothesis gains some support from Kneebone's review of the published discussions of the period, but it raises important issues of competence. In the literature on monetary policy, there is frequent reference to the importance of Central Bank credibility in the pursuit of anti-inflation objectives. However, although Canada has invested a huge amount of resources in the construction of "Credibility Mountain" anyone who probes into the issue will rapidly

discover that there is far less documentation⁴ to support assertions about the benefits of its construction than we routinely demand of other major expenditures of public resources. Furthermore the vast majority of studies that did exist at the time (1988) when the decision was made were entirely theoretical in nature and were contradicted by other available studies -- i.e. this was a policy choice advocated by a segment of the theoretical economics profession.⁵

Our preference is for the “not foreseen” hypothesis -- but that raises the issue of how to avoid such forecasting errors in future.

Since we prefer the "not foreseen" hypothesis, we are not impugning the motives of officials at the Bank of Canada, or suggesting that they did not inform officials at the Finance Department of their analysis. What we are questioning is the narrowness of economic perspective that informed that analysis and the failure to foresee a very important implication

⁴ See the references in Selody (1993) for evidence on the empirical content and date of publication of support for the zero inflation argument. The only then existing empirical study of the productivity benefits to Canada of zero inflation (Cozier and Selody, 1982) was widely referred to by advocates of the zero inflation initiative at the time (e.g. Howitt 1990) but has since been largely discredited. (See MacLean and Setterfield, 1993). It is crucial to emphasize that one can agree that high and variable inflation rates have substantial social costs, yet disagree with the 1988 decision to try to go from a low and stable inflation rate to zero. There is little evidence possible on the benefits of zero inflation for the simple reason that no country has managed to come close to zero inflation for long enough for the policy to pay off (see Cozier and Selody, 1992, footnote 7). However, by 1993, Bank of Canada researchers preferred to ignore the issue of the productivity benefits of zero inflation on the grounds that estimates are "fragile" -- see Johnson (1995). More disinterested observers are less ambiguous in their conclusions. Levine and Zervos (1993:428) conclude "inflation is not significantly negatively correlated with long-run growth. More impressively, we could not find a combination of variables that produced a significant negative association between growth and average inflation over the 1960 to 1989 period".

⁵ By way of comparison, one can reasonably ask whether it would have been considered reasonable (for example) to embark on the construction of a \$50 billion cold fusion reactor, based on the theoretical writings of several university professors and the empirical results of a single research project.

of monetary policy choice.

We are also not questioning the wisdom of the legal mandate of the Bank of Canada. The law now requires the Bank of Canada "to regulate credit and currency in the best interest of the economic life of the nation, to control and protect the external value of the national monetary unit and to mitigate by its influence fluctuations in the general level of production, trade, prices and employment, so far as may be possible in the scope of monetary action, and generally to promote the economic and financial welfare of Canada."

In our view, a capitalist market economy needs some assurance of stability in macroeconomic context if it is to function effectively. Unless individuals and firms have some reasonable grounds to believe that there will not be large fluctuations in the general level of production, trade, prices and employment, they will try to insure themselves against the risk of losses due to such fluctuations, in ways that are often socially costly. What we are questioning is the wisdom of the Bank of Canada decision to narrow its chosen policy mandate to that of price stability alone, at the cost of greater instability in production, trade and employment.

We recognize that not everyone agrees with us -- on issues of this importance, it is clear that there is now a vigorous debate among economists, based on differences of analysis and emphasis. However, we think that it is crucial that such a debate should occur, and all relevant evidence be considered, before major policy decisions are made. We also think that it is desirable that such a debate be open, both because open, informed debate is politically essential in a democracy and because errors are spotted in an open debate that are often missed in comfortable gatherings of the like-minded.

Our preference is for structural reform to the administration of the Bank of Canada, in order to increase the likelihood that alternative interpretations of the economic evidence

are seriously considered. We feel confident that if the evidence on the potential output capacity of the Canadian economy is rigorously assessed and if the economic costs of unnecessarily low growth and high unemployment are dispassionately considered, the unavoidable conclusion will be that the Bank of Canada should use its control over short-term interest rates to encourage economic growth. We think that unemployment in Canada could be safely brought down below 7%, without fear of producing a resurgence of inflation. As Fortin (1994) has argued in some detail, macroeconomic policy⁶ which eliminated the output gap gradually, over three years, would, in combination with a freeze on total programme expenditures, substantially reduce the deficit and would, over time, bring the debt to GDP ratio down

We therefore emphasize the importance of monetary policy in solving Canada's debt problem. We do not advocate substantial cuts to programme expenditure because the impact of such cuts is now relatively small, compared to the impact of variations in the interest rate, and because we think the debate on "big government" has become rather misleading

In thinking about the costs and benefits of "big" or "small" government, Ruggieri and Hermanutz (1995) argue that it is crucial to distinguish between the resources which government uses (e.g. in building schools or roads) and the resources which governments transfer between households (e.g. by making payments to bond-holders or Canada Pension

Some readers may have been taught the "Lucas Critique" -- that macro economic policy is ineffective because optimizing agents will incorporate anticipated policy responses into their decision making. Ericsson and Irons (1995) have convincingly demolished this perspective by examining all the published economics articles (513) which made reference to Lucas (1976) over the 1976 to 1990 period, and categorizing them by whether or not they were purely theoretical, assumed the truth of the Lucas critique or tested the Lucas hypothesis or tested some other, unrelated hypothesis. Their conclusion is unambiguous -- "Virtually no evidence exists that empirically substantiates the Lucas critique. Numerous studies refute the Lucas critique for various empirical macroeconomic relations".

Plan or UI recipients). They note that the resources used by Canadian governments have increased very little over the last 22 years, if measured as a percentage of GDP or relative to total employment or total consumption in the private sector.⁷ What has increased is the share of GDP going to transfers to individuals and to business, as well as the taxes needed to pay (partially) for such transfers. They note that transfers to persons and businesses grew at similar rates, over the 1961 to 1993 period but with different patterns. As Rosenbluth points out in this volume, high unemployment has played a crucial role in increasing the need for social transfers to individuals, and that high interest rates have also increased transfers to bond-holders. Since there has been no increase in the percentage of resources used by government, while there has been an increase in the resources transferred by government, Ruggieri and Hermanutz argue that the current debate on “big government” and how to bring the deficit under control is really a debate on income distribution.

Since careful analysis of the winners and losers from the disinflationary process shows that, not surprisingly, the unemployed tend to be poor while the beneficiaries of high real interest rates tend to be rich (see Erksy, 1994), the anti-inflation crusade has already redistributed a great deal of income from poor to rich. We think it would be unfair, as well as inefficient, to both continue with a high unemployment policy and make major cuts in the programmes that have partially mitigated the burden of unemployment up to now.

We therefore advocate instead a policy of eliminating the output gap and growing at

⁷ Ruggieri and Hermanutz add federal, provincial and local government employees, teachers and professors, the armed services and institutions (but exclude medical doctors) and calculate public sector employment as a percentage of total employment to average 22.01% between 1961 and 1970, 24.24% from 1971 to 1980 and 22.58% from 1981 to 1992. (1995:46) Total purchases by all levels of government of goods and services rose between 1961 and 1971 from 24.14% of net national income to 31.13% (as Medicare was phased in) but fell to 30.05% of net national income in 1981 and 30.31% in 1991. (Table 2-2).

the potential of the Canadian economy -- but why is this not happening now? In our view, the answer is a combination of vested interests in the wisdom of past policy decisions, flawed methodology in the estimation of potential output and a blinkered vision of the costs and benefits of zero inflation in the long term. The builders of Credibility Mountain have an understandably human desire to minimize their perception of its costs and overstate the importance of Credibility Mountain to the international financial community. Since the Bank of Canada has always followed a policy of promotion from within, and since control over monetary policy essentially rests in the hands of the Governor of the bank alone, each new Governor comes to office as a party to previous major policy decisions.

If one looks at the incentives which participants in the monetary policy debate have to accept or reject evidence on the costs and benefits of the zero inflation strategy, it must be recognized that since both of us have argued against the policy of zero inflation in the past, we face the potential barrier of ego -- the difficulty that everyone has in admitting that they were possibly wrong. This barrier may cloud our judgements in assessing the strengths of new arguments and new evidence on the issue. On the other hand, as Professors of Economics, we are expected to examine the evidence dispassionately. If we were to convert to monetarism, we would gain new friends (and lose old ones), but could expect to receive increased status within the Economics profession as people who are scientifically objective in their consideration of the evidence. However, whatever happens we have tenure. Our current job would remain, and nothing very important in our personal lives would change.

The incentives to deny new evidence, and to persist in the pursuit of previously announced policy, are entirely different for senior officials of the Bank of Canada. After inducing the most severe recession in 50 years in the pursuit of a policy of zero inflation, after destabilizing the national debt and forcing major political and social changes on the

country at large, they could not conceivably appear before the Commons Committee on Finance and say "Oops ... - we got it wrong." All incentives -- personal, professional and financial -- point to refusing to admit error.

On a personal level, it would be inconsistent with a person's own sense of their fundamental decency to admit that one has been responsible for a policy which has caused enormous pain to many thousands of people, to no good purpose. To the ordinary barriers of ego, one must add the sense of personal responsibility which goes with the power of the Bank of Canada. Since it is inconceivable that senior officials of the Bank could admit error on such a fundamental policy and expect to retain their jobs, income, prestige and power are on the line, over and above any personal psychological impediments to admitting error. It is probably just about impossible for the senior staff of the Bank of Canada to admit the error of such a major policy -- and it is always possible to reinterpret the evidence in order to see the benefits which are "just around the corner" if only Canada stays the course, for just a little bit longer.⁸

As things now stand, therefore, each new Governor comes to office having been a part of the policy team which produced past decisions, but then becomes a personal embodiment of the Bank's policy, with enormous power and responsibility. When the Chretien government was, in the fall of 1993, considering whether or not to reappoint Governor

⁸An example of the potential for data re-interpretation is the Bank's method of calculating potential output (see Monetary Policy Report, Bank of Canada, May 1995, Page 8) which relies heavily on the "Hodrick-Prescott filter", to estimate the trend in potential output. Since this is really a type of weighted average of past output levels the calculation has two implications: (1) by estimating output potential as a weighted average of past actual output, past performance becomes defined as potential performance and the Bank and other macro policy makers are absolved of responsibility for bad macro-economic performance (2) in order to keep inflation from ever increasing, the economy can never be allowed to exceed this estimate of potential output, which tends to guarantee, since current unemployment is always kept above a moving average of past unemployment, that unemployment will trend up.

Crowe, dire predictions were made of financial instability in international capital markets if Crowe was not reappointed. In the event, these predictions proved false -- but such predictions do raise the point that it is not reasonable to concentrate so much importance on a single personality (who could, after all, get run over by a bus at any given time).

We would, therefore advocate a new model of governance for the Bank of Canada. Rather than a single full-time Governor, with executive decision-making powers reporting to a part.-time, nominal Board of Directors, we would advocate that the day-to-day operation of monetary policy should be under the control of the committee of full-time Governors, operating by a majority vote, with a rotating chairmanship. If a seven member operational committee were appointed with overlapping seven-year terms of office, there would be substantial continuity in membership -- hence financial markets would have the assurances they need that monetary policy would not change radically in the short term. On the other hand, the gradual replacement of the membership of the operational committee would also ensure that new perspectives have a chance to appear and be considered in decision-making, and that board members would be able to examine dispassionately the lessons of past policy decisions.

We would argue that the members of such an operational committee should be appointed from outside the permanent staff of the Bank of Canada and that they be full-time appointments, each supported by their own research staff of economists. It would make sense, in a regionally diverse country such as Canada, to ensure regional representation in membership -- for example, two members from Ontario, two from Quebec, two from Western Canada and one from Atlantic Canada. We would argue that the members of the operational committee should remain normally resident in their region of appointment, and that their research staff should likewise be regionally based.

With electronic mail and telephone conferencing, it should be easy for a geographically dispersed committee to consult daily, if not more frequently, on monetary policy issues -- perhaps supplemented by a weekly face-to-face meeting in Ottawa with the Minister of Finance. However, we would insist on the importance of geographically separate research staffs, reporting to their own member of the operational committee, both in order that monetary policy researchers should see, in their day-to-day lives, the world outside Ottawa and in order to decrease the chances of conformity of approach and analysis.

As many readers will be aware, this structure of decentralized governance and majority decision-making is very similar to the decision-making structure now in place in the United States Federal Reserve Board system. Although we would not argue that the U.S. Federal Reserve Board cannot be criticized, we would argue that the U.S. system has generated a more reasonable mix of policy choices over the last few decades than the Bank of Canada has in recent years.

In our parliamentary system, responsibility for fiscal policy rests with the Minister of Finance and it is crucial that fiscal and monetary policy be co-ordinated. Furthermore, it is desirable for the stance of macro-economic policy to be clearly and credibly announced to all. Hence we would urge that on a quarterly basis the Minister of Finance and the Bank of Canada should issue a joint policy statement on fiscal and monetary policy and the macro-economic outlook for the coming year, including medium term forecasts of expected outcomes.

When a major national institution, such as the Bank of Canada, produces a systematic series of decisions which substantially decrease the economic well-being of Canadian society, one can expect to hear calls for radical change. Marc van Audenrode's article in this volume is an example, because he essentially gives up on the possibility of reform of the

Bank of Canada, and advocates that Canadians import the better monetary policy decisions of the U.S. Federal Reserve Board system, by tying the Canadian dollar to the U.S. dollar, and forswearing independent monetary policy of any kind.

To us, this goes too far, since although we have seen in the 1990s the costs of an ill-advised independent monetary policy adventure, there are still some potential benefits to the capacity for independent monetary policy choices (even if such benefits are not now being realized). As Goodhart (1994) has argued, central banks have their influence on the real economy via their almost total control over the level of short-term interest rates. This policy lever has a strong direct impact on economic activity through its effects on business investment, consumer durables purchases and (as higher interest rates impinge on mortgages coming up for renewal) on general consumption expenditure. Acting indirectly through the exchange rate, short-term interest rates influence exports and imports (for a summary diagram see Rosenbluth's article in this volume). These tools could be used to generate more rapid economic growth and a more rapid reduction in the deficits and debts of Canadian governments. However, unless monetary policy changes, both Credibility Mountain and the Debt Mountain will continue to grow.

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