Learning Module 3: Fiscal Policy

Q.1517 Which of the following is *least likely* an objective of fiscal policy?

A. Liquidity trap.

B. Controlling inflation.

C. Increasing industrial or agricultural output.

The correct answer is **A.**

A liquidity trap is not an objective of fiscal policy. It is a situation that limits the effectiveness of monetary policy. In a liquidity trap, interest rates are near zero and savings rates are high, making monetary policy ineffective. Consumers choose to hold onto their savings rather than invest in Treasury securities due to the expectation that interest rates will soon rise, which would decrease bond prices. Fiscal policy, which involves government spending and taxation, does not directly aim to address or create a liquidity trap.

B is incorrect. Controlling inflation is indeed an objective of fiscal policy. Fiscal policy can be used to manage inflation levels in an economy. When inflation is high, the government can increase taxes or reduce spending to decrease the demand for goods and services, which can help to control inflation.

C is incorrect. Increasing industrial or agricultural output is also an objective of fiscal policy. Fiscal policy can directly or indirectly influence specific sectors of the economy. For instance, certain policies can directly impact the value of land in the agricultural sector. Additionally, fiscal policy can affect the relative demand and competitiveness of exports for agricultural products. Therefore, fiscal policy can be used to stimulate the output of certain sectors in the economy.

CFA Level I, Economics, Learning Module 3: Fiscal Policy. LOS b: Describe roles and objectives of fiscal policy as well as arguments as to whether the size of a national debt relative to GDP matters.

Q.1518 Bob Jarislowsky bought wine for his birthday party at a price of $200 + $20 VAT. VAT is an example of which of the following fiscal policy tool?

A. Direct taxation: Spending tool

B. Direct taxation: Revenue tool

C. Indirect taxation: Revenue tool

The correct answer is **C.**

VAT (Value Added Tax) is a prime example of an indirect taxation mechanism used as a revenue tool by governments. It is levied on the value added to goods and services at each stage of production or distribution. The essence of VAT is that it is charged on the consumer but collected at every stage of the supply chain, making it an efficient revenue tool for governments. This indirect tax is different from direct taxes, which are levied directly on the income or wealth of individuals or organizations.

A is incorrect. Direct taxation as a spending tool is a misinterpretation of fiscal policy tools. Direct taxes, such as income taxes and corporate taxes, are indeed used as revenue tools, not spending tools. These taxes are levied directly on the income or wealth of individuals and corporations, and the revenue generated is used by governments to fund public services and infrastructure, not as a mechanism for government spending.

B is incorrect. VAT is not a form of direct taxation; rather, it is an indirect tax. Direct taxes are levied on the income or wealth of individuals or entities, such as income tax or property tax. VAT, on the other hand, is levied on the sale of goods and services and is paid by the end consumer, making it an indirect form of taxation.

CFA Level 1, Volume 1, Topic 2 - Economics, Learning Module 3 - Fiscal Policy, LOS 3c: describe tools of fiscal policy, including their advantages and disadvantages.

Q.1520 If the marginal propensity to consume is 60% and tax rate is 30%, the fiscal multiplier is *most likely*:

A. 1.72

B. 1.90

C. 3.33

The correct answer is **A.**

The fiscal multiplier is a crucial concept in macroeconomics, representing the ratio of a change in national income to the change in government spending that causes it. It quantifies the effect of fiscal policy on the economy's overall activity. It is calculated by dividing 1 by 1 minus the marginal propensity to consume (MPC) multiplied by the tax rate.

In this case (with an MPC of 60% (or 0.6) and a tax rate of 30% (or 0.3)), the fiscal multiplier would be calculated as follows:

$$\begin{aligned} \text{Fiscal multiplier} &= \frac{1}{(1 - \text{MPC}(1 - \text{Tax}))} \\ &= \frac{1}{(1 - 0.6(0.7))} \\ &= 1.72 \end{aligned}$$

This calculation shows that for every dollar of government spending, the national income increases by $1.72, assuming the given MPC and tax rate. This multiplier effect is a result of the increased spending leading to more income, which then leads to more consumption and further increases in income, creating a virtuous cycle of economic activity.

B is incorrect. It suggests a fiscal multiplier of 1.9, which does not align with the given MPC and tax rate. The calculation of 1.9 likely results from a different set of assumptions or errors in the calculation process.

C is incorrect. It proposes a fiscal multiplier of 3.33, which significantly overestimates the impact of government spending on national income given the specified MPC and tax rate. A multiplier of 3.33 would imply an extremely high sensitivity of national income to government spending, which is not supported by the given parameters.

CFA Level I, Economics, Learning Module 3: Fiscal Policy. LOS c: Describe tools of fiscal policy, including their advantages and disadvantages.

Q.1521 The time governments take to discuss, vote and enact fiscal policies is *most likely* called:

A. Action lag.

B. Impact lag.

C. Recognition lag.

The correct answer is **A.**

The time governments take to discuss, vote, and enact fiscal policies is referred to as the action lag. This term describes the period between the identification of an economic issue and the implementation of policies to address it. It reflects the time-consuming nature of the legislative process, which includes debating, voting, and enacting fiscal policies. The action lag accurately describes the time taken by governments to discuss, vote, and enact fiscal policies.

B is incorrect. The impact lag refers to the time it takes for corrective monetary and fiscal policies, designed to smooth out the economic cycle or respond to an adverse economic event, to affect the economy once they have been implemented. This lag occurs after the action lag and reflects the time needed for the implemented policies to produce their intended effects on the economy.

C is incorrect. The recognition lag is the delay between when an economic shock occurs and when it is recognized by economists, central bankers, and the government. This lag occurs before the action lag and reflects the time needed to identify and acknowledge an economic issue before any corrective actions can be taken.

CFA Level 1, Volume 1, Topic 2 - Economics, Learning Module 3 - Fiscal Policy, LOS 3d: Explain the implementation of fiscal policy and difficulties of implementation as well as whether a fiscal policy is expansionary or contractionary.

Q.1522 A country in which the government is enacting an expansionary fiscal policy which will reduce private investments and the aggregate demand simultaneously may result in:

A. Crowding out.

B. A liquidity trap.

C. A supply shortage.

The correct answer is **A.**

When the government enacts expansionary fiscal policies, it may crowd out private investments and reduce the aggregate demand. Crowding out occurs when government borrowing diverts private-sector investment from happening, leading to higher interest rates and lower private-sector investing.

B is incorrect. A liquidity trap is when interest rates are close to zero and savings rates are high, rendering monetary policy ineffective.

C is incorrect. In economic terms, a shortage is a condition where the quantity demanded is greater than the quantity supplied at the market price.

CFA Level I, Economics, Learning Module 3: Fiscal Policy. LOS c: Explain the implementation of fiscal policy and the difficulties of implementation as well as whether a fiscal policy is expansionary or contractionary.

Q.2475 An expansionary fiscal policy may *most likely* include:

A. Reductions in government expenditures and reductions in taxes.

B. Increases in government expenditures and increases in tax credits.

C. Reductions in interest rates and Increases in government expenditures.

The correct answer is **B.**

An expansionary fiscal policy is typically characterized by measures that increase aggregate demand in the economy. This can be achieved through increases in government expenditures and tax credits. Higher government expenditures directly boost aggregate demand by increasing the total spending in the economy. Tax credits, on the other hand, increase the disposable income of households, encouraging consumer spending and indirectly increasing aggregate demand.

A is incorrect. Reductions in government expenditures and taxes is a contractionary fiscal policy, not an expansionary one. A contractionary fiscal policy is used to slow down economic growth, usually in an attempt to combat inflation. It involves reducing government spending and/or increasing taxes, which decreases aggregate demand in the economy. This is the opposite of what an expansionary fiscal policy aims to achieve.

C is incorrect. While reductions in interest rates can stimulate economic activity by making borrowing cheaper and encouraging investment, this is a tool of monetary policy, not fiscal policy. Fiscal policy involves the use of government spending and taxation to influence the economy. Therefore, while reductions in interest rates and increases in government expenditures could both stimulate economic activity, they do not both represent measures of fiscal policy.

CFA Level 1, Volume 1, Topic 2 - Economics, Learning Module 3 - Fiscal Policy, LOS 3d: Explain the implementation of fiscal policy and difficulties of implementation as well as whether a fiscal policy is expansionary or contractionary.

Q.2477 Primary objectives of fiscal policy are *most likely* to:

A. Control inflation and unemployment.

B. Ensure stable prices and low-interest rates.

C. Manage the economy through the government's ability to influence GDP.

The correct answer is **C.**

The primary objectives of fiscal policy involve managing the economy through the government's ability to influence Gross Domestic Product (GDP). Fiscal policy, which includes government spending and taxation, directly impacts aggregate demand and, consequently, the overall economic activity. By adjusting its spending and tax policies, the government can stimulate economic growth during a downturn or cool down an overheated economy. This ability to influence GDP makes fiscal policy a crucial tool for managing economic cycles and ensuring long-term economic stability.

A is incorrect. While controlling inflation and unemployment are critical objectives for any economy, they are traditionally seen as the primary goals of monetary policy, which is conducted by central banks through mechanisms such as interest rates adjustments and open market operations. Fiscal policy can indirectly influence inflation and unemployment by affecting economic growth and demand, but these are not its direct primary objectives. The direct manipulation of inflation and unemployment rates is more closely associated with the actions of central banks rather than fiscal policy measures.

B is incorrect. Ensuring stable prices and low-interest rates are typically the goals of monetary policy rather than fiscal policy. Monetary authorities, such as central banks, use various tools, including setting the benchmark interest rates and controlling the money supply, to maintain price stability and influence interest rates. While fiscal policy can have an impact on these areas through its effects on the economy, its primary focus is on influencing GDP through government spending and taxation. The direct management of price levels and interest rates falls under the purview of monetary policy, which aims to achieve these goals through different mechanisms than those used in fiscal policy.

CFA Level 1, Volume 1, Topic 2 - Economics, Learning Module 3 - Fiscal Policy, LOS 3b: describe roles and objectives of fiscal policy as well as arguments as to whether the size of a national debt relative to GDP matters.

Q.3212 Fiscal policy is *best* described as:

A. Government activities centered on alleviating the unequal distribution of wealth.

B. Government targeting interest rates and extensions of credit to affect the economy.

C. Government actions through the adjustment of expenditures and taxes to influence the economy.

The correct answer is **C.**

Fiscal policy is best described as the government's use of its budgetary tools, specifically through adjustments in government spending and taxation, to influence economic conditions. This approach allows the government to target various economic issues, such as controlling inflation, stimulating economic growth, and reducing unemployment. By increasing or decreasing government expenditures, or by adjusting tax rates, the government can directly impact the level of aggregate demand in the economy, which in turn influences overall economic activity. For example, during a recession, the government might increase spending or reduce taxes to stimulate demand and pull the economy out of the downturn. Conversely, to cool down an overheated economy and control inflation, the government could reduce its spending or increase taxes, thereby reducing aggregate demand.

A is incorrect. While alleviating the unequal distribution of wealth may be a goal of some fiscal policies, it is not the primary or sole purpose of fiscal policy. Fiscal policy is a broader tool used by governments to manage the economy's overall health, including influencing the level of economic activity, managing inflation, and influencing employment levels. Redistribution of wealth can be an outcome or objective within the broader scope of fiscal policy, especially through progressive taxation and targeted spending, but it does not encompass the full range of fiscal policy actions.

B is incorrect. Targeting interest rates and managing the extension of credit are primarily functions of monetary policy, not fiscal policy. Monetary policy is conducted by a country's central bank (such as the Federal Reserve in the United States) and involves managing the money supply and influencing interest rates to achieve economic objectives. While both fiscal and monetary policies aim to influence the economy, they do so through different mechanisms. Fiscal policy focuses on government spending and taxation, whereas monetary policy focuses on controlling the money supply and interest rates to influence the level of economic activity.

CFA Level 1, Volume 1, Topic 2 - Economics, Learning Module 3 - Fiscal Policy, LOS 3a: Compare monetary and fiscal policy.

Q.3237 Expansionary fiscal policy measures may include:

A. Reducing personal income taxes and buying new aircraft for the military.

B. Easing interest rates and buying treasury bonds to encourage economic activity.

C. Reducing the regulatory burden by reducing or eliminating environmental regulations.

The correct answer is **A.**

Fiscal policy involves government spending and taxation decisions made to influence economic conditions, particularly aggregate demand, employment, and inflation. It is primarily executed by the government or treasury department. When the government reduces personal income taxes, it leaves households with more disposable income. This increase in disposable income boosts consumer spending, which directly increases aggregate demand. Higher aggregate demand can lead to higher production, employment, and potentially economic growth. This is a classic example of expansionary fiscal policy, aimed at stimulating the economy. Government spending, whether on goods and services or capital expenditure, directly increases aggregate demand. Military spending is a part of government purchases, one of the components of GDP. By purchasing new aircraft for the military, the government is directly injecting money into the economy, which can stimulate production, increase employment in relevant sectors, and promote overall economic growth.

B is incorrect. Easing interest rates and buying treasury bonds are tools used to implement monetary policy. Monetary policy involves managing the money supply and interest rates and is typically executed by a country's central bank. Lowering interest rates is a monetary policy tool used by central banks to stimulate economic activity. Lower interest rates reduce the cost of borrowing, encouraging businesses and consumers to take out loans for investment and consumption, thereby increasing aggregate demand. However, this is not a fiscal policy measure. When a central bank buys treasury bonds, it is conducting open market operations, a key monetary policy tool. This action increases the money supply by injecting liquidity into the banking system, encouraging lending and lowering interest rates.

C is incorrect. Reducing the regulatory burden is not a fiscal policy measure. Regulatory measures involve changing the rules by which the economy operates, including labor laws, environmental regulations, and financial oversight. While reducing or eliminating environmental regulations can influence economic activity by potentially lowering the cost of production and encouraging investment, this is not typically classified under fiscal policy. Regulatory changes are part of regulatory policy, affecting the economy through different mechanisms than fiscal spending or taxation adjustments.

CFA Level 1, Volume 1, Topic 2 - Economics, Learning Module 3 - Fiscal Policy, LOS 3d: Explain the implementation of fiscal policy and difficulties of implementation as well as whether a fiscal policy is expansionary or contractionary.

Q.3238 Which of the following is most likely a reasonable argument to support using a fiscal deficit as a tool to stimulate an expansion?

A. If unemployment is high, then the crowding out effect is of less concern.

B. Additional taxes to offset the deficit at future points could be distortionary.

C. Fiscal policy is set by the government and may be manipulated solely for political gain.

The correct answer is **A.**

Using a fiscal deficit as a tool to stimulate an expansion can be justified, especially when unemployment is high. In such scenarios, the concern about the crowding out effect, which refers to the situation where increased government spending leads to a reduction in private sector investment due to rising interest rates, is significantly lessened. This is because, with high levels of unemployment, there is underutilized capacity in the economy. Government spending can help absorb this excess capacity, leading to an increase in economic activity without necessarily causing a significant increase in interest rates. Moreover, by stimulating demand through fiscal spending, the government can help reduce unemployment, which is a critical goal during economic downturns. This approach aligns with Keynesian economic principles, which advocate for increased government expenditures and lower taxes to stimulate demand and pull the economy out of a recession.

B is incorrect. This option incorrectly suggests that additional taxes to offset the deficit in the future could be distortionary. While it is true that taxes can have distortionary effects, this statement does not directly support the use of a fiscal deficit as a tool for economic expansion. The primary concern with using fiscal deficits for economic stimulus is not the distortionary effects of future taxes but rather the immediate impact on economic activity and employment. The argument against using fiscal deficits often revolves around concerns of long-term debt sustainability and potential inflationary pressures, not necessarily the distortionary effects of taxes.

C is incorrect. The concern that fiscal policy may be manipulated for political gain does not provide a reasonable argument in support of using a fiscal deficit to stimulate an expansion. While it is a valid concern that fiscal policy can be subject to political influences, this point does not address the economic rationale behind using fiscal deficits as a tool for economic stimulus. The effectiveness of fiscal policy in stimulating economic expansion is based on its ability to increase aggregate demand, reduce unemployment, and utilize idle capacity in the economy, rather than on the motivations behind its implementation.

CFA Level 1, Volume 1, Topic 2 - Economics, Learning Module 3 - Fiscal Policy, LOS 3b: Describe roles and objectives of fiscal policy as well as arguments as to whether the size of a national debt relative to GDP matters.

Q.3239 Which of the following statements about the size of the national debt relative to GDP is *most likely* a reasonable and truthful statement?

A. In the end, the central bank can print more money to pay the debt.

B. Over the long run, the crowding-out effect may have a significant negative effect on capital accumulation.

C. For countries such as Canada and South Korea, most of the debt is held by foreigners, so the burden of the debt carrying costs is more severe than for countries such as the USA.

The correct answer is **B.**

The crowding-out effect occurs when increased government borrowing leads to higher interest rates, which in turn discourages private investment. Over time, this can lead to a decrease in capital accumulation, as private sector investment is a critical driver of economic growth and innovation. When the government borrows heavily, it competes with the private sector for available funds in the financial markets, potentially raising the cost of borrowing for everyone. This can result in less investment in productive assets like factories, technology, and infrastructure, which are essential for long-term economic growth and development.

A is incorrect. It oversimplifies the complex issue of managing national debt. While it is technically true that a central bank can print more money to pay off the government's debt, doing so can lead to inflation or hyperinflation, severely damaging the economy. The example of Zimbabwe, where excessive money printing led to hyperinflation, illustrates the potential consequences of relying on this approach to debt management. Printing money to pay off debt undermines the value of the currency, erodes purchasing power, and can lead to a loss of confidence in the financial system. It is not a sustainable or responsible method for managing national debt.

C is incorrect. It misrepresents the ownership structure of national debt in countries like Canada and South Korea. In reality, a significant portion of the national debt in these countries is held domestically, not by foreigners. While foreign ownership of national debt can pose certain risks, such as currency risk and sudden capital outflows, the statement inaccurately characterizes the situation in Canada and South Korea. Moreover, the United States also has a substantial portion of its debt held by foreign entities, yet it manages its debt-carrying costs without severe consequences, partly due to the dollar's status as a global reserve currency.

CFA Level 1, Volume 1, Topic 2 - Economics, Learning Module 3 - Fiscal Policy, LOS 3b: Describe roles and objectives of fiscal policy as well as arguments as to whether the size of a national debt relative to GDP matters.

Q.3241 Which of the following is *least likely* a true statement about using fiscal policy tools to regulate the business cycle?

A. It may take considerable time to recognize that the economy is slowing. Consequently, any fiscal policy actions may be too late.

B. Once a need for an expansionary action is recognized, it may take considerable time to put a plan, such as a capital expenditure program, into action.

C. Increases in government spending will move the economy smoothly to the full employment level without the inflationary risks presented by monetary adjustments.

The correct answer is **C.**

Option C is the least likely true statement about using fiscal policy tools to regulate the business cycle because it oversimplifies the impact of increases in government spending. Fiscal policy, which involves government spending and taxation, is a powerful tool for managing the economy. However, the assertion that increases in government spending will move the economy smoothly to the full employment level without the inflationary risks presented by monetary adjustments is overly optimistic and neglects several complexities. Firstly, fiscal policy, particularly government spending, can indeed stimulate economic activity by increasing demand. However, if the economy is close to or at full capacity, such increases in demand can lead to inflationary pressures rather than smooth adjustment to full employment. This is because, in a near-full employment scenario, additional demand can push wages and prices up, leading to inflation rather than increased output. Furthermore, the statement underestimates the potential for fiscal policy to contribute to inflation directly, independent of monetary policy actions. Increased government spending can lead to higher demand for goods and services, which, if not matched by an increase in supply, can cause prices to rise.

A is incorrect. It accurately reflects one of the challenges of using fiscal policy to regulate the business cycle. Recognizing that the economy is slowing down and deciding on the appropriate fiscal response can indeed take considerable time. This delay, known as recognition lag, is a well-documented challenge in fiscal policy implementation. By the time a slowdown is recognized and fiscal measures are designed and implemented, the economy's situation may have changed, making the measures less effective or even counterproductive.

B is incorrect. It also correctly identifies a significant challenge in the use of fiscal policy. Once the need for expansionary fiscal action is recognized, implementing such plans, especially those involving capital expenditure programs, can be time-consuming. This implementation lag can delay the intended stimulative effects of fiscal policy, reducing its effectiveness in counteracting economic slowdowns. The process of planning, approving, and executing government spending projects can extend over months or even years, meaning that the fiscal stimulus may arrive too late to counteract a downturn effectively.

CFA Level 1, Volume 1, Topic 2 - Economics, Learning Module 3 - Fiscal Policy, LOS 3c: Describe tools of fiscal policy, including their advantages and disadvantages.

Q.3242 Which of the following is *most likely* an example of an expansionary fiscal policy action available to the government?

A. The introduction of higher taxes on alcohol and tobacco.

B. Lowering the official interest rate through the repurchase agreements market.

C. Making available federal money for “shovel ready” capital improvement projects.

The correct answer is **C.**

Option C, making available federal money for "shovel ready" capital improvement projects, is an example of an expansionary fiscal policy action. Expansionary fiscal policy involves government actions aimed at stimulating economic activity, primarily through increased government spending and/or reductions in taxes. By funding capital improvement projects that are "shovel ready," the government injects money directly into the economy, creating jobs, and stimulating demand for materials and services related to construction. This increase in government spending contributes to economic growth by boosting aggregate demand, which is the total demand for goods and services within an economy. The term "shovel ready" indicates that these projects are ready to begin immediately, ensuring that the impact on the economy is timely and effective in stimulating economic activity during periods of slow growth or recession.

A is incorrect. Introducing higher taxes on alcohol and tobacco represents a contractionary fiscal policy action, not an expansionary one. Contractionary fiscal policy aims to reduce inflation and cool down an overheating economy by decreasing government spending or increasing taxes. Higher taxes on alcohol and tobacco would likely reduce consumption of these goods, leading to a decrease in aggregate demand.

B is incorrect. Lowering the official interest rate through the repurchase agreements market is an example of monetary policy, not fiscal policy. Monetary policy involves the management of the money supply and interest rates by central banks to influence economic activity. Lowering interest rates can stimulate economic growth by making borrowing cheaper, encouraging businesses to invest and consumers to spend. However, this action is undertaken by central banks, such as the Federal Reserve in the United States, rather than by the government through fiscal measures. Fiscal policy, on the other hand, involves government spending and taxation decisions. Therefore, adjusting interest rates is not a fiscal policy action.

CFA Level 1, Volume 1, Topic 2 - Economics, Learning Module 3 - Fiscal Policy, LOS 3d: Explain the implementation of fiscal policy and difficulties of implementation as well as whether a fiscal policy is expansionary or contractionary.
