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# Understanding the "Fiscal Cliff"

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Now that the election is over, all you hear about is the impending financial crisis known as the fiscal cliff. More important, what does it mean for the economy and your investments?

The term "fiscal cliff" refers to a set of tax increases and spending cuts that will automatically take effect in January if Congress does not take action. On the tax side, the Bush-era cuts of 2001 and 2003, and their renewal in 2010, are scheduled to expire at the end of the year.

On the other hand, there are a number of other tax issues to deal with, including the expiration of a temporary payroll tax holiday and the question of whether lawmakers will restore an elevated exemption level in the Alternative Minimum Tax.

The expiration of the Bush-era cuts would increase rates on a broad measure of tax classes, including ordinary income, capital gains and dividends. Going over the fiscal cliff would increase federal tax collections by more than 20% next year, or more than $500 billion, according to the Tax Policy Center, a non-partisan think tank. That would drive up taxes on nearly 90% of households by an average of $3,500.

The spending cuts stem from the 2011 Budget Control Act, the deal lawmakers reached to raise the borrowing limit for the federal government, which included a provision for cuts to lower the deficit by $2.1 trillion.

With the failure of a bipartisan joint select committee to reach a deal on deficit reduction, $1.2 trillion in cuts would begin to take effect on January 1, 2013, a prospect both parties are eager to avoid.

The Office of Management and Budget wrote in a report outlining the impact of the cuts, "The specter of harmful across-the-board cuts to defense and non-defense programs was intended to drive both sides to compromise. The sequestration itself was never intended to be implemented." The report continued: "The administration strongly believes that sequestration is bad policy and that Congress can and should take action to avoid it by passing a comprehensive and balanced deficit reduction package." In plain English, it appears to be a threat that was never intended to be implemented.

Anxiety over the fiscal cliff has been fueled by dismal projections from economists who forecast a return to recession if Congress and the White House can't reach a deal to avert the across-the-board tax increases and spending cuts.

The non-partisan Congressional Budget Office (CBO) has projected that if all of that fiscal tightening actually occurs, GDP will drop 0.5% in 2013, weighed down by a sluggish first half of the year, before economic activity begins to revive in the third and fourth quarter.

They predicted that unemployment would remain a lagging indicator and that a contraction of the economy would cause the unemployment rate to rise to 9.1% in the fourth quarter of 2013.

It is important to remember that economists at the CBO and elsewhere are working with the worse case assumption that lawmakers and the president will fail to reach a deal.

There is a very high awareness on Capitol Hill of concerns of a double-dip recession which is one of the main reasons I feel cautiously optimistic that Congress and the President will strike a deal before the holidays or at the eleventh hour to avert the fiscal cliff.

There will be a lot of news-based volatility until a deal is set in stone. It's easy for you to let “the crisis of the day” rule your emotions and cloud your thinking. However, successful investors take a broader view and realize that crises happen, crises get resolved, and while they can sometimes be scary, they should not lead you to panic mode.

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