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Staring Into an Abyss? A Closer Look at the "Fiscal Cliff"

Several impending changes to federal tax laws and spending policies could bring the U.S. economy to a "fiscal cliff" in 2013 -- and back into recession.

The term fiscal cliff refers to the potential economic fallout from several federal government budget and tax law changes currently scheduled to take effect at the end of this year and the beginning of 2013.

The U.S. economy is growing, according to the Federal Reserve, and the stock market was up nearly 12% through August.[1] Yet many investors, consumers, and businesses remain anxious about the future, fearful that Congress will allow the economy to fall over a potentially devastating "fiscal cliff" at year-end.

On the Edge?

The term fiscal cliff refers to the potential economic fallout from several federal government budget and tax law changes currently scheduled to take effect at the end of this year and the beginning of 2013. Those plans include the expiration of the Bush-era tax cuts, the payroll tax cut, and other tax-relief programs, as well as the start of automatic U.S. government spending cuts agreed to by Congress in 2011.

If those changes are implemented as scheduled, the combination of less government spending and higher taxes for working Americans could cause the economy to slip back into recession in 2013, according to analysts at the Congressional Budget Office[2] and S&P Capital IQ.[3] If, on the other hand, Congress reverses course and opts to extend tax cuts and forestall spending cuts, the federal deficit would continue to grow. That, in turn, could pose longer-term threats to the economy.

Points to Consider

As you consider how the fiscal cliff could affect your financial strategies during the remainder of 2012 and beyond, keep the following in mind:

- Standard & Poor's Rating Services' "baseline" outlook for the economy through 2013 anticipates -- with a 60% likelihood -- that fiscal cliff dynamics will not jeopardize economic growth. Potential spillover from the debt turmoil in Europe is a bigger concern. However, the fiscal cliff's negative effect on the U.S. economy would probably be substantially larger, should it occur.[3]
- The Federal Reserve could initiate a new round of economic stimulus to cushion the fall from a fiscal cliff, but it may not be enough to stave off recession. Chairman Ben Bernanke made that clear during the summer when he said there is "no chance the Fed could offset the hit to the economy."[3]
- The fiscal cliff -- or its possible resolution -- could potentially affect the performance of investments in your portfolio. For example, analysts at S&P

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Capital IQ note that a repeal of the Bush tax cuts (including those that reduced tax rates on dividend income) could adversely affect higher-yielding sectors, such as Consumer Staples, Telecom Services, and Utilities.[4]

- Tax rules and investment strategies can be complex and always warrant careful planning, regardless of how the economy is performing. Be sure to discuss your personal situation with a professional.

So is the nation careening toward a financial precipice? Not necessarily. Congress could take steps between now and the end of the year to alter the economy's direction, such as extending tax breaks and/or cutting spending less dramatically than planned. In the meantime, though, political gridlock that is currently blocking any potential detour around the fiscal cliff may continue to weigh on consumer, investor, and business confidence.

[1]Source: S&P Capital IQ. U.S. stocks are measured by the S&P 500, an unmanaged index considered representative of the U.S. stock market. You cannot invest directly in an index. Past performance does not guarantee future results.

[2]Source: Congressional Budget Office, "An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022," August 22, 2012.

[3]Source: S&P Capital IQ, "Second Half Investment Outlook," June 25, 2012.

[4]Source: S&P Capital IQ, "Likely Election Beneficiaries," September 4, 2012.