Over the Cliff?
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It may not feel like we're in a bull market, but stocks are in the midst of an extended rally that has taken the S&P 500 index from below 1280 in early June to the low 1400s currently. Yet whenever you read about America's economic recovery, there is inevitably a mention of the looming fiscal cliff, a scary future event that could decimate the economy and drive share prices back down.

What is this fiscal cliff? I referred to this issue in the most recent *Navigator,* our quarterly newsletter, in the article on Ben Bernanke's recent testimony to the Senate Banking Committee.

Why are economists so frightened of it? The term refers to a sudden change in a lot of different tax policies that is scheduled to take place automatically at midnight on December 31. As soon as the clock strikes twelve, the Bush-era tax cuts will expire, eliminating the 10% tax bracket altogether, and moving the current 25%, 28%, 33% and 35% brackets up to 28%, 31%, 36% and 39.6% respectively. At the same time, for those in the lowest two tax brackets, the 0% capital gains tax rate would bump up to 10%, and the tax rate on dividends would rise to 15% or 28%. Those in higher brackets will see capital gains increase to 20% and dividends up to as high as 39.6%.

Also expiring: a provision that eases the so-called "marriage penalty," some deductions for college tuition, child tax credits, dependent care credits and a particularly harsh phase-out would eliminate up to 80% of some taxpayers' itemized deductions for mortgage interest, state and local taxes, and charitable donations.

Making the cliff a bit steeper, the Budget Control Act of 2011--what most of us remember as the tense compromise that ended last year's budget standoff--calls for automatic government spending cuts of $1.2 trillion from the federal budget over the next 10 years.

The cliff becomes a bit steeper still as the Obama-era payroll tax cuts (reducing taxes by about 2% for workers) expire at the same moment in time.

All of this would boost government revenues and lower government spending--the opposite of a government stimulus--and suck some of the spending power out of consumer balance sheets. How much? The Congressional Budget Office estimates that if we go over the cliff--that is, if Congress doesn't act between now and the end of the year--a total of $560 billion would exit the economy to pay down the government deficit. That's the good news. The bad news is that the CBO estimates that this would reduce America's total economic activity in 2013 by four percentage points. To put that in perspective, last year our economy grew at a 1.7% rate.

So is a recession inevitable? What are the odds that Congress will take bold, decisive action during a Presidential election year? Some pundits believe that the magnitude of the economic consequences has gotten the attention of Congress, and that no matter who gets elected, something will be done. The most likely possibility, alas, is yet another stop-gap measure which might extend some of the tax cuts but repeal some of the automatic spending cuts, pushing the cliff out so that future lawmakers will have to deal with it--which is basically how we got in this mess in the first place. In other words, will they continue to “kick the can” down the road and let the 113th Congress deal with it?

Meanwhile, as the U.S. economy continues to march straight toward the edge, a growing nervousness may be part of the reason why the economy as been so slow to recover. Businesses are reluctant to hire or invest in the future when there are serious questions about what that future will look like. The slow, steady rise in the stock market this summer suggests that many investors have not yet looked up and noticed that the economy is on a collision course with a recession-causing event. The big question that none of us knows the answer to is: what will they do when they look up and see the cliff?

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