Negotiating A Path Away From the Edge
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The S&P 500 surged 3.6% in a holiday-shortened week, after politicians seemed to emit happier sounds about their plans to avoid the "fiscal cliff". We're hearing a lot about this fiscal cliff in this post-election time period, and surprisingly, considering the angry partisanship of the campaign, some of the news is encouraging. The White House and Congressional leaders, elected officials from both sides of the aisle, are saying that they believe they can reach agreement before the end of the year.

In the last few years, investors have looked to Fed Chairman Ben Bernanke to rescue the markets with his innovative plans to refuel money supply, but it looks like the Fed's took kit is spent. The Fed Chairman has now symbolically passed the fiscal torch to Congress. Specifically, his speech before the New York Economic Club last Tuesday made it very clear that the country's debt solution rests with Congress.

What is this fiscal cliff? The term refers to a lot of different tax and budget provisions that are all scheduled to take place automatically at midnight on December 31. These include:

Higher tax rates. When 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, the 0% capital gains tax rate for lower-bracket Americans would bump up to 10%, and the tax rate on dividends would rise to 15% or 28%, depending on the recipient's income tax bracket.

The loss of deductions--including 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 that would eliminate up to 80% of some taxpayers' itemized deductions for mortgage interest, state and local taxes, and charitable donations.

Random across-the-board budget cuts that nobody intended to see enacted. 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 cuts apply to just about every discretionary (non-Social Security, Medicare, Medicaid) program in Washington, although most of what you're hearing about are reductions in the defense and education budgets.

The expiration of stimulus measures: The Obama-era payroll tax cuts will go away, raising taxes by about two percentage points for workers.

Why do we call this a "cliff?" Because everything on that list would take money out of the hands of taxpayers and, at the same time, lower government spending—essentially providing the U.S. economy with the opposite of a government stimulus, what some have called a hard punch in the gut. The Congressional Budget Office estimates that if we go over the cliff--that is, if Congress and the President don't act between now and the end of the year--a total of $560 billion would exit the economy. The CBO estimates that this would reduce America's total economic activity in 2013 by four percentage points. Hello recession!

So what are the odds that Washington will get its act together and choose a course that doesn't take us over the cliff? As it happens, there is reason to hope. Leaders on both ends of the partisan divide agree on many things in this negotiation: that the tax cuts are too painful and random to allow in their present form, and that tax rates on American taxpayers with less than $250,000 in income should continue as they are today. The sticking points are if or how much tax rates should rise for Americans in the higher tax brackets, and where to apply the budget knife.

This rare moment of meaningful negotiation offers Washington policymakers a chance to expand the discussion and come up with a long-term solution to the nation's debt problem—which is, after all, the topic of debate which led Congress to create this fiscal cliff in the first place. If you're optimistic, then cross your fingers that the leaders in the room will want to do something more with this conversation than just address the immediate problem.

As you follow the debate, pay attention to whether our elected officials are actually tackling the issues or just kicking the can down the road yet again. If you hear discussion about permanent laws, such as a balanced budget amendment, or a framework that forces Congress to offset any expenditures with cuts elsewhere, or a change in tax rates, or some kind of entitlement reform (Means testing? Raising eligibility ages?), that will be a sign that Washington is getting serious about addressing real issues.

If, on the other hand, you hear about caps on future appropriation bills, or frameworks for deficit cutting, or solutions which sunset in 12 or 24 months, that means that we'll be going through a version of this debate for the foreseeable future, and the can could be kicked, once again, far enough down the road to become a 2016 Presidential election issue and a headache for the next President to deal with.

We should also pay attention to the timing. The longer the U.S. economy continues to march straight toward the edge, the longer businesses will be reluctant to hire or invest in the future. But for now, this moment may be something to enjoy. How often do we see Democratic and Republican leaders in the same room together, promising to get something done? Maybe it will become a habit.

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