Fiscal cliffhanger

Will the U.S. go over the "fiscal cliff"? Don't expect an answer before the election.

By now, you've likely heard a fair amount about the "fiscal cliff," an unprecedented pileup of spending cuts and tax hikes that will take effect in 2013—unless Congress takes action. Among its building blocks: the expiration of the 2001 and 2003 tax cuts (often referred to as the Bush-era tax cuts) which include lower tax rates on income, capital gains, dividends, and estates; the end of certain fiscal stimulus programs; a new Medicare tax on investment income for higher earners; and the implementation of the budget sequester (i.e., automatic spending cuts), agreed to as a result of the debt-ceiling debate last year.

The stakes are high. Go over the fiscal cliff, and a recession is likely that could hammer corporate profits. Defer action too much for too long, and deficits could balloon further, undermining investor confidence in the United States. And if interest rates rise as a result, deficit reduction could become even more daunting.

So what's ahead? No one knows for sure. But at this point, a few things seem relatively clear:

- The debate over extending or modifying looming tax hikes and spending cuts is not likely to be resolved before the election. Instead, the issues are likely be debated after the election in a "lame duck" session of Congress.

- It's possible that Congress gridlocks in the lame duck and cannot reach agreement on how to address the fiscal cliff until early next year. But some agreement could be reached in November or December—even if only a temporary fix that would push the need for resolution into next year.

- Ultimately, since the elections are unlikely to produce a decisive majority for either party in Congress, some level of compromise will be necessary to avoid the full brunt of the fiscal cliff.

In the meantime, investors should brace for some market volatility.

How high is the cliff?

The nonpartisan Congressional Budget Office (CBO) estimates that falling off the fiscal cliff would reduce the federal budget deficit by $606 billion, or 4% of gross domestic product (GDP) in 2013 alone. That may be good for reducing deficits and debt. However, economists, and the CBO generally agree that allowing the full fiscal cliff to hit at one time could have a substantially negative impact on the economy and "would lead to what will probably be deemed a recession." Indeed, Dirk Hofschirle, Fidelity senior vice president of asset allocation research, has estimated the full impact could cut corporate profits by 20–30% next year.

Of course, these estimates assume that we go over the full fiscal cliff and Congress does not act to reduce the impact for all of 2013. What is currently less clear is the impact to the economy and markets if those spending cuts and tax hikes were to take effect for just a few days or weeks. Regardless of the extent of the impact, the resulting uncertainty could cause market volatility.

It is also important to recognize that certain components of the fiscal cliff may have a bigger economic impact than others. The chart above, based on the CBO's data, stacks the components of the fiscal cliff from smallest to largest. As you can see, the expiring Bush-era tax cuts are by far the biggest component, totaling $221 billion. By comparison, the sequester would save $65 billion.

And don't underestimate the impact this would have on taxpayers of all income levels. "Approximately-two thirds of the cost of extending the 2001 and 2003 tax cuts is attributable to those in the bottom four tax brackets," says Shahira Knight, vice president, Fidelity government relations. "Therefore, the fiscal cliff would have significant implications for people across the income spectrum."

Is another debt-ceiling crisis ahead?

In addition to addressing the fiscal cliff, Congress and the president must also deal with the debt ceiling. U.S. Treasury Secretary Timothy Geithner has publicly stated that we are likely to run up against the debt ceiling toward the end of this year, but there are enough "extraordinary measures" that the Treasury can take to create room under the debt limit until early next year. The debate over the fiscal cliff and the debt limit are likely to be intertwined.
What’s likely from Congress?

Broadly speaking, Fidelity’s government relations and public policy team sees three potential scenarios:

A grand deal is reached. There are some within Congress who view the fiscal cliff as a unique opportunity to do something big by comprehensively addressing tax reform and the long-term deficit situation. A bipartisan group of lawmakers is working to put together a broad package and build support for it. However, a grand deal is likely too ambitious to get done with so little time left in 2012. Instead, the lame duck Congress may just set the parameters for a 2013 debate on long-term budget and tax reform.

Congress does not pass legislation before year-end. The potential of “falling off the cliff” temporarily is possible if Congress and the administration gridlock. However, if that were to occur, we would expect the situation to be short-lived. The team would anticipate that the new Congress would work to address the situation in the first quarter of 2013.

Some compromise is reached during the lame duck. This may be a deal to push the deadline out a few months, or an agreement on several, but not all, the components of the fiscal cliff. It could also include an agreement to increase the debt ceiling or outline an expedited process for long-term tax reform. What any compromise could look like depends on post-election dynamics and the state of the economy at the end of the year.

While the elections will impact the shape of any deal reached, the majorities in both the House and Senate are likely to be very slim. Therefore, regardless of the outcome of the elections, some bipartisan compromise will be necessary to forestall hitting the fiscal cliff.

Current proposals highlight key philosophical differences between parties. A Republican proposal would extend Bush-era tax cuts through 2013 and enact a process for considering tax reform on an expedited basis before the end of next year. The Democrats’ proposal would maintain the Bush-era tax cuts only for income of less than $200,000 for individuals and less than $250,000 for married couples.

Is a long-term solution possible?

Looking past the fiscal cliff, we believe there is potential for longer-term tax and budget reform. Determining what an eventual reform proposal would look like is difficult. With respect to deficit reduction, budget savings have been identified in previous bipartisan deficit reduction efforts, such as the Biden debt-limit negotiations, the Super Committee negotiations, and the Gang of Six proposals. These budget savings might form the basis of a deficit-reduction package. However, addressing the long-term budget situation will require more significant budget savings. Past efforts have been unsuccessful due to disagreements between Republicans and Democrats about the extent to which tax increases and entitlement reforms should be included. While both sides have shown some willingness to compromise, they have disagreed about the relative mix of budgetary savings from revenue and spending.

Similarly, Republicans and Democrats have both signaled interest in comprehensive tax reform. However, significant disagreements remain. For example, most Republicans believe tax reform should not increase the deficit while most Democrats have said tax reform should raise revenue to help reduce the deficit. Another disagreement involves the scope of tax reform. Republicans generally want to reform both the individual and corporate tax codes, while the president has indicated support for reforming business, not individual, taxes.

Getting to a long-term solution won’t be easy. Much will depend on the outcome of the elections, as well as the state of the economy and the markets. Until agreement is reached, however, it would be prudent to brace for some market volatility.

Learn more

Read more about the fiscal cliff and other risks to the market in the Viewpoints special report: Navigating uncertain times.

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