The Fiscal Cliff

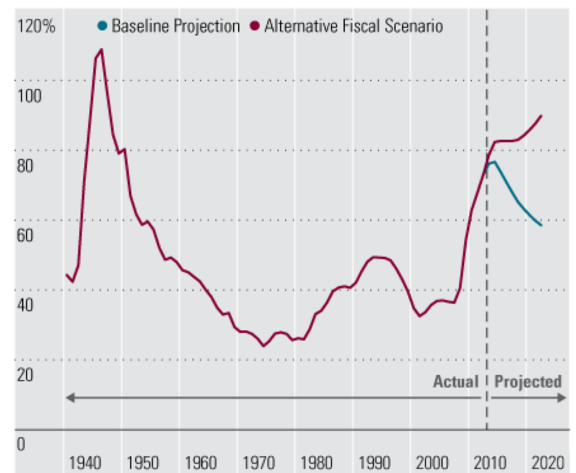
The term "fiscal cliff" has dominated headlines but besides adding another phrase to your political vocabulary, what does it really mean to you? The "fiscal cliff" is the U.S. fiscal situation that could dramatically change the economic landscape in this country, defined by a bundle of momentous tax hikes and spending cuts that are due to take effect at the end of 2012 and early 2013. The intended goal of these tax hikes and spending cuts is to reduce the national deficit. A reduction of national deficit appears to be a good thing on the surface but such dramatic belt-tightening so quick has raised concerns about the possibility of growth deceleration and a potential recession. Before digging deeper, it is important to distinguish between baseline and alternative fiscal scenarios. Under the baseline scenario, existing policies would expire, allowing for the implementation of tax hikes and spending cuts whereas the alternative scenario calls for an extension of existing tax provisions.

According to the Congressional Budget Office (CBO), the 2012 federal debt held by the public will reach 73% of GDP; the highest level since 1950. Under the current baseline scenario*, the federal budget deficit will shrink to an estimated $641 billion in 2013 from $1.1 trillion in 2012. Given the current fragile economic conditions, the CBO anticipates that the U.S. economy may fall into a recession if GDP declines and unemployment increases. To be precise, the CBO expects the 2013 (year-over year) fourth quarter real GDP to decline by 0.5% and the unemployment rate to rise to about 9% in the second half of 2013. Under the alternative scenario*, the 2013 federal budget deficit could total $1 trillion, with the 2013 (year-over-year) fourth quarter real GDP growing by 1.7% and unemployment staying in 8% range.

If Congress fails to extend tax breaks, here is what we can expect. The Bush tax cuts will expire and income taxes, estate taxes, capital gains taxes, and tax rates on dividend income will increase. The Social Security tax cut will expire, raising the rate from 4.2% to 6.2%. The alternative minimum tax (AMT) will affect significantly more Americans. High-income earners will be taxed as part of the Affordable Care Act (Obamacare). Spending cuts legislated by the Budget Control Act of 2011 will affect the national defense budget and other programs across the board. The emergency unemployment compensation will expire at the end of the year. The Medicare payment rate at which Medicare pays physicians will decrease by about 27%.

While inaction by Congress may have dire consequences, Morningstar economists expect Congress will take action after the 2012 election season to keep tax rates from rising too drastically and delay the spending cuts. Until then, revisit your retirement portfolio to ensure it is well positioned to weather a fiscal cliff worst-case scenario.

Federal Debt (as % of GDP) Held by the Public



*The baseline project assumes that current laws remain in place and are set to expire as planned. The alternative fiscal scenario incorporates the assumptions that all expiring tax provisions (other than the payroll tax reduction), including those that expired at the end of December 2011, are instead extended; that the alternative minimum tax is indexed for inflation after 2011 (started at the 2011 exemption amount); that Medicare's payment rates for physicians' services are held constant at their current level; and that the automatic enforcement procedures specified by the Budget Control Act of 2011 do not take effect. The budgetary effects under the alternative fiscal scenario also include the incremental interest costs associated with projected additional borrowing.