

## Peering over the Fiscal Cliff

One of the first rules of journalism is to start with a catch line – something that is going to grab people’s attention and inspire them to stay tuned or follow the link to your website to read more. In a world of perpetual news cycles and sensational headlines it can be difficult to draw attention to anything as “boring” as the economy or fiscal policy so perhaps the term Fiscal Cliff is a bit of an exaggeration. But, then again, maybe it’s a fairly accurate description.

The Fiscal Cliff refers to multiple issues which are set to come to a head around year end. These include the expiration of the Bush-era tax cuts, the expiration of the payroll tax cut, new health care reform taxes and governmental spending cuts related to the Budget Control Act.

None of them taken alone would constitute a cliff but put them all together and they represent what could be a serious economic and political problem.

The Bush-era tax cuts were originally passed with an expiration date so that political leaders would have to revisit the tax code by a certain time. That date arrived at the end of 2010 amid an economic environment so weak that the cuts ended up being extended instead. They are now set to expire again and this time it appears that there will be a much more lively debate regarding what to do about it.

Letting the Bush-era tax cuts expire at year end would raise taxes to levels that last prevailed in the early 2000s. Those in favor of letting them expire point to the \$300 billion plus of projected increased tax revenue doing so would lead to – those opposed focus on the potential negative impact to the economy of reducing the amount taxpayers would have to spend.

Also set to expire at year end is the temporary cut to the employee social security tax rate which reduced the rate from 6.2% to 4.2%. Similar to the Bush-era tax cuts, the expiration of the payroll tax cut is projected to increase tax revenue (thereby reducing the annual operating deficit) but would also remove money from the spending economy.

At the same time as the two above tax cuts are about to expire, a round of new tax increases that came with healthcare reform are set to kick in. Families with incomes over \$250,000 will pay a new 3.8% additional tax on investment income. This is projected to raise about \$18 billion in new tax revenue but may impact the amount of capital being put to work through investment, thereby impacting business growth and job creation.

Arguably the largest effect will come from the spending cuts mandated by the sequestration rules built into the Budget Control Act. The cuts amount to more than \$2 trillion over 10 years and include significant cuts to both defense and non-defense programs.

In addition to these major issues, several other significant fiscal events appear to be on the near term horizon including the pending expiration of emergency unemployment benefits, revisions to Medicare payment rates to medical facilities and – not to be forgotten – that pesky debt ceiling which we are on track to hit again sooner than projected.

So what does all of this mean for the economy? Some point to the potential positive impact these changes could have on our deficit long term. Others focus on the short term shock that the full implementation of all of these changes at once could have on an already fragile economy.

The US economy's Gross Domestic Product (GDP) has recently been estimated as growing at an anemic 2%. The impact of the combined issues that make up the Fiscal Cliff have been estimated to have an immediate negative impact on GDP growth of between 3.5% and 6%. If you start at 2 and subtract at least 3.5... well, you do the math. Negative GDP growth over two quarters is the definition of recession so it's pretty easy to see where this could be headed.

While the Fiscal Cliff is going to occur, there is still time for our political leaders to act to modify some of the programs and soften the immediate impact. There seems to be some political will to do so on both sides but with an election cycle fast approaching and campaigning taking precedence it seems very possible that it will be the newly elected leaders – be they the existing individuals or different – that will be faced with trying to tackle many of these issues as the end of 2012 rapidly approaches.

Good luck to them, whomever they will be.

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