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The 5 Things You Must Know to Understand the Fiscal Cliff

With so much focus on the Presidential election in the past few weeks, only financial journalists were paying attention to what's been going on in Congress — or, to be more accurate, what has not been happening in Congress.

However, the news focus shifted toward the next obstacle Congress will face before the year ends — the fiscal cliff. You might have heard several pundits talking about it Tuesday and Wednesday, but the average American doesn't know a whole lot about what the fiscal cliff is and how it could affect them. So here's your primer on what you need to know about the waters below that cliff.

How Was the Fiscal Cliff Created?
Matthew Tuttle, a CFP and author of *How Harvard & Yale Beat the Market*, says the fiscal cliff was created as a part of the agreement in Congress to lift the debt ceiling back in 2011.

"It was designed as a draconian measure that would make it almost certain that Congress would come to terms to avoid it," Tuttle says. "Unfortunately, it isn't working out that way. Liberal Democrats refuse to budge on tax cuts for higher earners and Tea Party Republicans have signed pledges not to increase taxes."
The "cliff" is a set of $500 billion or more in automatic tax hikes and spending cuts that was created as a means of giving the two parties a deadline to figure out the national debt problems. Currently, the national deficit for 2012 is projected to be around $1.1 trillion, according to reports from the Congressional Budget Office. The national debt is currently over $16 trillion.

What's the Deadline for the Fiscal Cliff?
Congress has a ticking clock that is counting down until Dec. 31 of this year. Many investors and economists are worried that if an agreement isn't reached by this time, the tax hikes and spending cuts would send the U.S. into another recession, since the decline of government spending would cripple the U.S. economy.

What Is This "Simpson-Bowles" Everyone Keeps Talking About?
You might have heard the words "Simpson-Bowles" tossed around by pundits the past few days. This term pre-dates the major debt ceiling deal passed by Congress last year.

Back in February 2010, President Obama made an Executive Order forming the Simpson-Bowles commission, also known as the National Commission on Fiscal Responsibility and Reform. This bipartisan commission, headed by Democrat Erskine Bowles and former Sen. Alan K. Simpson (R-Wyo.), was charged with proposing a set of actions that Congress and the President could use to balance the budget by 2015.

The commission's final report was submitted on Dec. 1, 2010. In broad strokes, the commission recommended that combined discretionary spending cuts, comprehensive tax reform, health care cost containment, mandatory savings, Social Security reform and a permanent change to how the budget is balanced year to year.
However, the commission's recommendations have seen little to no action.

What Will Happen If We "Jump Off" The Fiscal Cliff?
There are a few predictions for what will happen if a debt deal isn't reached by Dec. 31. The obvious are that spending cuts and tax hikes will pull billions out of the fragile U.S. economy, Tuttle says.

Eleanor Blayney, CFP and Consumer Advocate for the CFP Board of Standards, Inc., says Americans can do a few things now to prepare for the jump off the fiscal cliff in 2013. First, since tax rates will rise, Blayney recommends workers with a 401(k) start contributing more to their retirement plan. This will have a two-fold effect since the money you contribute won't be taxed at the higher rate and it will help you save more for the future.

Blayney also suggested that workers add to (or start) putting money into an emergency fund. One of the warned repercussions of the fiscal cliff is that companies who rely on government funding will be forced to lay off employees to make up for lost revenue. Get ready for a possible job loss by making sure you have six months' worth of income stockpiled.

Also, credit rating agencies like Fitch and Moody's have already threatened a downgrade of the country's credit rating.

Would a Downgrade of the U.S. Credit Rating Affect You?
The experts we spoke to were mixed on how exactly the average American would be affected if the government's credit is downgraded for a second time.

"A credit downgrade on U.S. government debt can lead to higher cost of borrowing (risk premium) for the federal government, which in turn can cascade to all other interest rates (e.g. car loans, mortgages, student loans, credit cards) as treasuries serve as a benchmark for all other yields; thus affecting the general public, says Luis San Vicente Portes, Associate Professor of Economics at Montclair State University.

So, what's the best situation to stop our dive off the fiscal cliff? Portes says the key is not limiting the progress the economy has made so far.

"The ideal scenario would be for Congress to come to an agreement on growth promoting simpler fiscal regime; that is deferred enough for the economy to return to its long-term trend and achieve the desired deficit reduction for a sustainable government balance by the end of its implementation."

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