Expert: Basics on why going over fiscal cliff takes America down a dangerous path

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Barring a deficit-reduction deal in Washington, D.C., Americans should be quite concerned about going over the "fiscal cliff," says Charlotte Crane, a tax specialist and professor at Northwestern University School of Law.

Failure to work things out, she says, would likely result not only in an economic stall in 2013 but also in a continuing revolving door of legislative stalemates like the ones that have plagued Congress since the 2008 election.

In short, the fiscal cliff refers to some $600 billion in tax increases and across-the-board spending cuts scheduled to take effect in January unless the White House and Republicans in Congress reach a more nuanced alternative deficit-reduction deal.

"The effects of going off the fiscal cliff might not be felt right away, as some players in the economy may have already adjusted their strategy assuming Congress won't act," Crane says. Others, she says, may just automatically be assuming that Congress will work things out.

The mandatory spending cuts, called "sequestration" in federal budgetary parlance, total more than $100 billion per year and would include both defense and non-defense spending.

As bitter partisan fighting continues, business leaders have descended on Washington to lobby against going over the cliff. Without an agreement to narrow deficits over the long run, the United States could eventually lose investors' trust, triggering a debt crisis.

No one would be immune from the effects of the mandatory tax increases and spending cuts, Crane says.

The fiscal cliff could hardly be more important or relevant for Northwestern students, faculty and staff—and for Americans in general. If the White House and Congress fail to find a compromise, taxes will go up significantly. An average family of four would see taxes rise on annual earnings of $50,000 by nearly $2,000 and on earnings of $100,000 by $5,000.

"The combination of tax increases and spending cuts will reduce the amounts both consumers and the federal government will have available to spend," she says.

The tax increases are built into current law, since a failure to reach a new agreement, means the "Bush tax cuts" would finally be allowed to die, she adds. "Although they have been extended several times since their first expiration date in 2010, these cuts were never made permanent."

Individual income, capital gains and estate tax rates would all be restored to pre-2001 levels. In addition, a 2 percent reduction in Social Security-funding payroll taxes that was enacted in 2010 as part of an economic stimulus package would go away.

"The Brookings/Urban Institute Tax Policy Center estimates that the income and payroll tax rates would increase for the 25 percent of households earning the least by an average of 3.7 percentage points, while the 1 percent with the highest incomes would experience a 7.2 percentage point increase in rates," Crane says.

The deadline for coming to an agreement about tax increases and spending cuts was set back in the summer of 2011 when Congress was having trouble agreeing on a federal budget, Crane says. The idea was for legislators to force themselves to make tough decisions on important tax and budgetary issues, but only after last month's general election.

"The Jan. 1, 2013 deadline that Congress set has particular significance, because it also is the cut-off date for several other important federal fiscal measures," Crane stressed. "Extended unemployment payments will end. Appropriations for the 'doc fix'—which provides for payment to medical providers under Medicare—will also end."

Ben Bernanke, the chairman of the Federal Reserve, coined the metaphor "fiscal cliff" to warn of the dangerous yet avoidable drop-off in the nation's fiscal path if the White House and Republicans do not work out an agreement with tax hikes and program cuts.

While White House and Congressional Republicans are beginning to engage in a genuine give-and-take in the negotiations, reaching a deal by Jan. 1 is far from a done deal.

"Failure to work things out means risking the loss of the confidence not only of the American public, but also the rest of the world," Crane says. "These spending reductions are clearly of an order of magnitude large enough to send the economy back into recession."

Provided by Northwestern University