Analysis: Perry plan cuts top tax rate to 1916 level

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(Reuters) - Republican presidential candidate Rick Perry's plan for a 20 percent top individual income tax rate would be the lowest U.S. levy on the rich since 1916.

While analysis of the Perry plan is still emerging, early reviews from liberals say it is a gift to the rich that will worsen the budget deficit, while conservatives say it will benefit business, investment and spur economic growth.

Low- to middle-income households would either see no change in their tax bill or a tax cut, as they would have the option of using the 20 percent flat-tax calculator or filing under regular tax rates while taking certain deductions.

For corporations, the current 35 percent tax rate would be slashed to the lowest level since 1939, putting U.S. companies on a par with some of their top international global competitors.

In sum, tax experts say the Texas governor's plan would reward investment and savings over wage income, while avoiding many of the flat tax flaws that have doomed previous, one-size-fits-all tax plans. His idea is to stimulate business and individual investment to boost economic growth.

Opinions on its benefits vary widely, largely influenced by the political perspective of the commentator on the appropriate role of tax policy to forward economic and social goals. Tax think tanks are crunching the numbers over the next few days to evaluate its impact on income groups and tax revenues.

But one thing is clear: the upper income groups who rely more heavily on capital gains and investment income for their wealth would benefit.

"It would be fabulous for businesses, investment and for economic growth," said Chris Edwards, director of tax policy at the Cato Institute, a libertarian think tank.

"It would make us competitive in the global marketplace."

Roberton Williams, a fellow at the centrist Tax Policy Center, however, views it as a major bonus for the rich.

"These are the people who have capital gains and dividend income, and they would be exempted from taxes. They rely far less on wage income," he said.

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For those choosing the flat tax, Perry's plan would more than double the standard deduction for individuals, to $12,500 from $5,950 for tax year 2012, retaining up to three individual deductions. Mortgage interest deductions, a sacred cow for homeowners, charitable contributions and state and local taxes deductions would be preserved.

The deductions would be phased out for those earning over

$500,000.

Taxes would be eliminated on Social Security income, long-term capital gains and qualified dividends.

For a family of four earning up to $50,000 and opting for the flat-tax plan, their tax bill would be zero. Lower-income individuals in the bottom two brackets who earned $34,500 or less in 2011 could continue to pay their current 10 percent or 15 percent rate.

The flat tax would mark a significant shift in tax policy for the United States. The federal income tax, first established in 1913, started with a top rate of 7 percent. It has always had a progressive scale, edging higher for wealthier Americans.

In the years following World War II, the top tax bracket was above 90 percent.

Previous flat tax schemes have been criticized for significantly reducing taxes for wealthy taxpayers, while locking low-income earners into an unfair rate. Republican candidate Herman Cain has faced this charge over his plan.

Perry circumvented that problem by making the flat tax optional, adding a new wrinkle to the tax code that may add complexity while failing to generate substantial federal revenues, critics say.

"To do the kind of tax cuts he's talking about implies massive cuts in government spending," said Howard Gleckman, a fellow at the Tax Policy Center, a nonpartisan think tank. "I don't quite see how he could possibly balance the budget."

Len Burman, an economics and public policy professor at Syracuse University, is concerned that by making the system voluntary, it risks exploding the federal budget deficit by making the system voluntary.

"It sounds to me like a way to move toward bankruptcy," said Burman, a former Congressional Budget Office senior adviser.

But the Cato Institute's Edwards said previous flat-tax proposals, from magazine magnate Steve Forbes and former House Leader Dick Armey, were revenue neutral at a 17-19 percent rate. Therefore, a 20 percent optional scheme should work.

Perry also proposes to lower federal spending by capping it at 18 percent of gross domestic product, a level it has not been below since 1966, according to Office of Management and Budget data. In 2010, federal spending was 23.8 percent of GDP, and it only got close to 18 percent of GDP in 2000 and 2001, when the United States ran a budget surplus.

Reducing spending to an 18 percent level would require about $900 billion in annual spending cuts, estimated Peter Morici, a professor at the University of Maryland. That level could be achieved by increasing the retirement age to 70, while slashing Medicare, Medicaid and defense spending.

"I just don't think that's possible, given how old the fleet is," Morici said. "I think we're going to end up spending more, not less, on defense," he said.

(Reporting by Stella Dawson and Patrick Temple-West; Editing by William Schomberg and Dan Grebler)