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Taxes on your income and earnings

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Income tax and national insurance

Income tax: when you think about tax, that's probably the tax you're thinking about. It was introduced by the Prime Minister, William Pitt the Younger, as a temporary measure in 1798 to fund the Napoleonic Wars. Legally, it's still temporary. Every year, Parliament has to vote for income tax to apply for another twelve months. If ever MPs failed to do so, the government would run out of money and have to shut down.

We all know that the basic rate of income tax is 20p in the pound and the higher rate is 40p. These headline figures are the UK's 'marginal rates of tax'. When tax experts talk about the marginal rate of tax, they mean the rate you pay on each extra pound of income that you earn. Just looking at income tax, the first £11,000 you earn is tax free so the marginal rate up to this amount is nil. Then it increases to 20%, the basic rate. When you earn over £43,000 the marginal income tax rate goes up to the higher rate of 40%. So, if you are paid £20,000 a year, your marginal income tax rate is 20% because if your pay increases to £20,001, you have to pay 20p of income tax on the extra pound you earn.

A 20p marginal rate of income tax doesn't sound so bad compared to all the public services we enjoy, like healthcare and education. But you have to factor in employers' and employees' national insurance as well. These add 26p of tax on each extra pound a basic rate taxpayer earns.

On top of that, any welfare benefits received from the government are reduced as we earn more. Handing back your benefit payments acts like yet another form of taxation on each extra pound you earn. For the lower paid, the way that benefits are phased out as people start working means they can face marginal tax rates of up to 90%. We'll talk some more about that later in the chapter. For the middle classes, child benefit is clawed back if anyone in the family earns over £50,000. Having to pay back child benefit has the same effect on take-home pay as an increase in tax. This means income tax and national insurance, together with benefit payments, can combine to produce very high marginal tax rates.

In the Introduction, I showed how you probably need to earn £60 to buy a Lego truck worth £40, once you include income tax, national insurance and VAT. That's £20 in taxes. However, this amount factors in your personal allowance of £11,000 on which you don't have to pay income tax. Now imagine you needed to work some overtime before you could afford to buy the toy. You've already used up your personal allowance so you now have to look at your marginal tax rate to work out how long you need to work. As a basic rate income taxpayer, you would need to earn £70.60 in overtime to buy that £40 truck. Thanks to high marginal rates of tax, over £30 of the £70.60 that your employer pays you to work the overtime goes to the government. That's an overall tax rate of 43%. Add employers' national insurance and it's 50% (see Figure 1.1). If you are a higher rate income taxpayer, your combined tax rate for ordinary purchases is 58%.

The way multiple taxes add up to big bucks is my First Golden Rule of tax: lots of small taxes together combine to make large tax bills. Rather than hit us with a single massive demand that we can't help feeling bad about, the system is organised into lots of smaller levies that accumulate. There are lots of different taxes with lots of different names charged on lots of different things. But, in the end, you and I end up paying them all.

Whether a tax is levied on the companies we work for, or the shops we buy from, it all comes out of our pockets. That's my

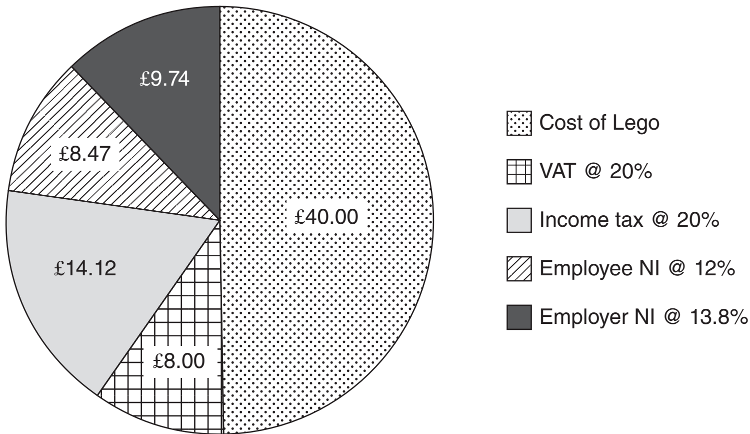

Figure 1.1 The taxes on a £40 Lego set for a basic rate taxpayer showing taxes coming to as much as the toy.

Second Golden Rule of tax: no matter what name is on the bill, all tax is ultimately suffered by human beings. There is no magic pot of money for governments to dip into. Even when the government borrows, it must tax us in the future to pay back the debt. To understand your personal tax burden, you have to add up all taxes, even the ones that you don't pay directly and may not even know about.

National insurance contributions

We've seen that, as well as income tax, we also pay national insurance contributions on our salaries. It's time to have a closer look at this most misunderstood of taxes.

When you pay national insurance contributions (usually abbreviated to 'NICs'), what exactly are you contributing to? Many people are vaguely aware of a link between national insurance and their state pension. Indeed, you need to have been paying NICs for

30 years to qualify for the full state pension (if you miss a few years out, you can catch up on them later).

Let's see what that means. Assume you are on average earnings of £26,500 throughout your 35-year working life. That means the combined employees' and employers' national insurance contributions paid on your salary will be about £4,750 a year. Now, suppose you invested that £4,750 a year in a private pension instead of paying it over to the government. With a growth rate of 5% above inflation (the long-run rate of return for shares), your notional pension pot from payments equivalent to your national insurance contributions should be worth over £430,000 when you retire. That would get you an index-linked pension at today's historically low annuity rates of £14,750 a year. A few years ago it would have got you considerably more and, once interest rates return to normal levels with the economic recovery, we can expect pension annuity rates to rise as well. Alternatively, under the new pension freedom rules, you could take that £430,000 as income or reinvest it.

The £14,750 a year pension you would have from saving £4,750 a year in a private pension scheme is a much better deal than the state pension of £8,094 that you really get for making those 35 years of contributions. Worse, if you work for longer (as most of us do) or pay higher NICs because you have higher earnings, you don't get a better state pension. The government does pay our national insurance contributions into a special fund separate from general taxation. But it is not investing the money to pay for your pension when you retire. The national insurance fund only has enough money in it to pay for about two months of benefits for today's claimants. In essence, it is a current account, not a savings account. The government collects money from people currently in work to pay pensions to today's retirees. There is no money set aside to fund pensions in the future. We are entirely reliant on our children being willing to cough up in the same way we have. So, looked at as a contributory pension scheme, national insurance is a very bad deal. However, we should instead regard NICs as another income tax with a different name. It accounts for a fifth of the government's

revenues. Although it funds pensions and some other benefits, a large amount of it is used to pay for the NHS. Now, of course, the NHS needs funding and our taxes are the way to do it. But given national insurance contributions have no real contributory element and are really a tax on earnings, why don't we call them a tax?

The answer is one of low politics rather than high principle. At the most basic level, it's a manifestation of the First Golden Rule of tax: lots of small taxes together combine to make large tax bills. It suits the government that we pay multiple taxes with low rates rather than a single transparent and easily understood levy. The complexity of the tax system means no one ever realises how much he or she is paying. This makes it a whole lot easier to extract more tax from us without causing a revolution. Combining income tax with employees' and employers' national insurance into a single levy would give us a basic rate of income tax of about 45p in the pound. No government wants to admit that tax rates are that high. So they prefer the sleight of hand of having a 20p income tax rate, 12% employees' national insurance contributions and the essentially invisible 13.8% employers' national insurance contributions.

What, you might ask, is the difference between employers' and employees' national insurance? In all honesty: nothing. They are both taxes on your salary, they are both collected in the same way (through PAYE, which we will discuss further below) and your employer sees them both as amounts they have to pay to keep you turning up to work. The main distinction is that earnings are capped at £43,000 when calculating most of an employee's NICs (and the version paid by the self-employed). This recognises that, by earning more, you don't get better benefits or a bigger pension from the system. In fact, it was not until the 1970s that national insurance stopped being charged at a flat rate so that everyone paid the same. Thanks to Gordon Brown, you now also pay 2% NICs on your earnings over the £43,000 threshold.

Employers' NICs are 13.8% of our entire salary above £8,112 without any upper limit. That means employers' national insurance embodies the Golden Rules of tax: following the First Rule, it is

kept separate from income tax, even though it is a tax on income. This disguises just how much we actually pay. It is also in accordance with the Second Golden Rule: no matter what name is on the bill, all tax is ultimately suffered by human beings. Because this element of national insurance is paid by our employers, we don't realise that we are suffering it. But, despite all the subterfuge, ordinary people still end up shelling out.

If you are in work, it's a good rule of thumb to treat NICs and income tax as the same thing, although there are, inevitably, various wrinkles and complications in the rules. For example, savers and pensioners pay income tax but not national insurance. When you factor in employers' NICs, this means there is twice as much tax on wages from work than on money you get from savings or your pension. This might make sense economically, since we do want to encourage saving. And maybe it is fair that pensioners, after being taxed all their lives, don't have to keep paying national insurance after they've retired. But that doesn't explain why wealthy pensioners are taxed a great deal less than low-paid workers.

In most respects, however, NICs and income tax are drawing ever closer together. For example, until 1991, there was no national insurance on many perks such as company cars. Even in the 1990s, it was still possible to exploit gaps between the rules on income tax and NICs. Some city firms were paying bonuses in gold or diamonds to avoid national insurance (which was payable on cash wages only).

More recently, both Labour and Conservative governments have been ironing out the smaller wrinkles to make national insurance and income tax as similar as possible. Nowadays, many benefits in kind, including company cars, are subject to both income tax and employers' national insurance. They go on a special form called a P11D and you pay tax on the monetary value of a benefit as if it were cash. As it happens, one of the most tax-efficient perks available today is not turning up to work. If you take extra holiday as a benefit (and many firms allow their employees a few extra days a year in exchange for sacrificing some of their salary), the cost to you is only the pay you would have received after tax.

Although income tax and NICs are now administratively almost identical, no politician is going to amalgamate them into a single transparent rate of tax. After all, under the First Golden Rule, there is no sense in emphasising how high the combined rates of tax that we pay really are. Tory MP Ben Gummer did suggest in 2014 that NICs should be renamed ‘earnings tax’. That would, at least, be a candid name.

Paying tax

Most people with jobs don’t have to worry about paying their taxes as it is all done for them automatically. Payslips show the tax paid, but many of us never really look at any figure except the bottom line, which is our take-home pay. We pay most of our taxes through PAYE, which was invented at the end of the Second World War as a way to improve the efficiency of tax collection. From the point of view of the government, it has three major advantages. The first is the official one. The administration of the tax system for employees was handed to the people they work for. It was no longer necessary for individual workers to figure out how much tax to pay. Instead, our employers calculate the tax we owe and deduct it from our salary. We only ever receive our net wages. The tax component is paid straight over to HMRC. In effect, this privatised a large chunk of tax collection. The primary responsibility for gathering tax was transferred from the tax authority to employers. They bear the cost and suffer the penalty if things go wrong. It is much easier for HMRC to audit employers’ tax collection systems than it is to check the tax returns of all the individual employees.

The second advantage of PAYE for the government is that it accelerates when the money arrives in the Treasury’s coffers. With PAYE, the government gets paid monthly, just like we do. I receive my net salary and the Exchequer receives both the income tax and national insurance. Given that, between them, NICs and income tax collected through PAYE account for over half the government’s

total tax-take, the cash flow benefits of regular payment are extremely significant.

The third advantage of PAYE is the subtlest, but perhaps the most important: we never see the tax we are paying. Out of sight, it is kept out of mind. Employers' NICs are also concealed in plain sight. Most of us never think about them or realise that they are a tax on our salary just as much as income tax. Even though employees' national insurance and income tax are supposedly taxes that we pay ourselves, the system requires businesses to pay these taxes on our behalf using the same PAYE machinery with which they account for employers' national insurance. So we never possess our money before the government gets its paws on it.

Ensuring that we hardly ever have to pay any tax directly is a major pillar of the UK's revenue system. In fact, it is a principle that deserves to be enshrined in the Third Golden Rule of tax: taxes are kept as invisible as possible. The government wants to avoid people paying their taxes directly so they are less likely to notice them. I can explain why this is so important from personal experience.

As I noted in the Introduction, I've worked as an accountant for many years. But I'm also occasionally paid for my journalism. This means I have to fill out a tax return each January. Completing the return is a pain, but nothing like as painful as what happens next. Once I've calculated my tax bill for the year, I have to write a cheque for what I owe. This is not usually very large, a few hundred pounds in most years, occasionally a couple of thousand. But I resent writing that cheque far more than I do paying the tax on my regular salary, even though the latter is a much greater amount. I also have to make sure I've saved up enough to cover the bill. Seeing the money leave my bank account and sail off into the grateful arms of the Chancellor of the Exchequer seems far more onerous than the cumulatively much bigger deductions my employer makes from my monthly wages.

Under PAYE, most people don't have to fill out a tax return, let alone write a cheque to HMRC. We never receive the tax we pay on our salaries. This means we never feel its loss. In fact, although we all seem to know what our monthly take-home pay is, few can

recall our monthly gross salaries. Surprisingly, many people aren't even sure exactly what their annual gross salary is. The pain of the tax being deducted at source is much less than if we received our salaries gross and then had to pay the tax ourselves.

In recent years, many businesses have done away with paper payslips, so employees have to go online to see them. Since we rarely do that, we've become even more remote from the taxes on our salaries. However, this is only the start of the digitisation process. HMRC has launched a grand project called Making Tax Digital that will require employers to use the PAYE machinery to deduct the tax we owe on our savings and other income, as well as on our salary. This is supposed to mean the annual tax return, still filled in by ten million of us, can be abolished by 2020. Without this one occasion each year when we have to face up to the amount we have paid, the distance between taxpayers and the tax collection machinery will grow to a chasm.

The distorting effect of PAYE is that we pay more tax than we feel like we do. This means we are less demanding than we should be about value for money from public spending. We are also less aware that increases in public spending are something that we all pay for. PAYE helps the government convince us the money it spends is somehow different from the money in our wallets and bank accounts. For example, we call the NHS and state education 'free' when they are really nothing of the sort.

Not that I think we should abolish PAYE. If we did, the country would go bust within weeks. But I do think it is important that taxpayers know how much they pay. The cumulative effect of the three Golden Rules of tax is that we put up with failures in the public sector that we would not tolerate in our own affairs. Surely we should expect the same value for our taxes as we do from the money we spend at our local supermarket. We also accept much higher levels of taxation than those that have caused revolutions in centuries past. Next time a pressure group demands that we spend more public funds on its particular hobbyhorse, remember that it is talking about your money.

Taxes on high earners

A common suggestion to meet the government's need to raise more money is to tax the rich. Sadly, things are a bit more complicated than that. The issue of whether well-off people pay their fair share is difficult and important. It is also one of the most controversial questions in politics today. Can we just tax the rich until their pips squeak? Or would that mean that we all end up worse off than we started? To find out the answer, it is essential we understand more about how tax works and who pays what.

Income tax and national insurance between them (and we've seen they are pretty much the same thing) account for just over half the government's revenue. But who pays all this? The answer, if you have a job or a pension, is that you do. There are 30 million income tax payers in the UK, which equates to roughly half the population. Non-taxpayers include the poor (who we'll come to below), non-working dependents (such as homemakers and students) and 14 million children. As we've seen, retired people pay income tax on their pensions and other income, but not national insurance.

If you are well paid, you pay a lot more tax than the average, as you'd expect. Politicians go on about fairness a lot, but what they are most concerned about is maximising tax revenues while upsetting the fewest number of people. After all, they want us to vote for them. That means all decisions on taxation are a mix of the economic and political.

Do the rich pay their fair share? That depends on what we mean by 'fair'. Let's start with the so-called '1%'. What proportion of the total amount of income tax do you think the top-earning 1% of British taxpayers, that is, the top 0.5% of the British population, currently pay: 10%, 20%? More or less? Bear in mind that these people enjoy over 10% of all taxable income (so they are very well paid).

Having decided that, what figure do you think would be fair?

In fact, the top 0.5% of the British population pay over a quarter of all income tax. That is 10% or so of the government's total tax

take. The top 10% of earners pay over half the income tax, which is about £100 billion a year. Just 5% of the population pay more in income tax than the rest of the population put together.

Is that fair? Most people would say yes. After all, they reckon, 5% of the population are rich, aren't they? As it happens, anyone who earns more than £50,000 a year falls into this category. I have yet to meet anyone earning that amount who considers themselves to be rich, although they are reasonably well-off. But look at this from the other side. As far as the government is concerned, the 5% pay for the entire NHS budget (even though many will have private health insurance), or all basic pensions (although they probably have private pensions too). Without them, the country would be bankrupt. Put bluntly, the 5% pay for the public services that they don't really need but that the rest of the population do.

Luckily, the 5% seem reasonably content to carry the load for everyone else. Part of the reason for this is that tax rates are not seen as confiscatory (even if they are, as we have seen, a lot higher than people realise). Any democratic government, whether left or right wing, tries to pile as much of the tax burden as it can onto a small number of rich people. That's just sensible politics. The rich only have one vote each, just like the rest of us. In fact, universal suffrage leads to both higher taxes in general (people are more willing to pay taxes to representative governments that they have helped to elect) and higher taxes on the rich. Nonetheless, you might think it makes sense for governments to tax high earners far more than they do. Higher taxes on the wealthiest mean less tax on the rest of us. We would then reward the government that reduced our taxes by out-voting the rich.

Funnily enough, this has already been tried. Back in the 1970s, the top marginal rate of income tax was an eye-watering 98%. It was 83% on earnings. When taxes get that high, they rapidly become counterproductive. Instead of raising more money, penal rates of tax lead to less cash being collected and damage the economy in the process.

Part of the problem was that, back in the 1970s, high earners felt no moral obligation to pay all the tax the law stipulated. Avoidance and outright evasion were rife. But that was only part of the problem. Many of the most talented individuals just left the country. This was the era of the tax exile. And it wasn't just pop stars living in Monte Carlo. Exiles were far more likely to be entrepreneurs moving to America or Australia. When the tax burden is heavy, it drives them out of the country so that the economy as a whole suffers. As a result, the government's revenue falls.

Think about it this way: I need a job done and I ask you to do it for me. I'm willing to give you £100 for an hour of hard work, but you have to pay tax on what you receive. If you were subject to 1970s rates of tax, you might only get £17 of the £100 with the rest going in income tax at 83%. You probably wouldn't think it was worth your while. However, if you were subject to today's top income tax rate of 45%, you would be able to keep £55 and be more willing to do the job. The work hasn't changed and the amount I'm willing to pay hasn't changed either. But tax makes a very significant difference to the amount you receive and thus the chance of the job getting done at all.

This is why economists are concerned about marginal tax rates: these tell us what incentive we have to work a little bit harder. Why work over the weekend for some overtime if the government keeps too much of the extra money? Sir James Mirrlees, who has a Nobel Prize in economics to his name, showed that, from an economic point of view, it is best to keep marginal tax rates low. This is because we tend to decide how hard to work based on how much extra tax we'd have to pay on increases to our salary, rather than the total amount of tax we pay on all of it. If you are a higher rate taxpayer and the basic rate of income tax increases, you'll pay more tax, but only on the income you are already earning. That won't make it less worthwhile for you to do some overtime. Your incentive to work harder or advance your career is unaffected. Nonetheless, high marginal rates of tax on the well paid are popular, even if they are economically perverse.

Both Labour and Conservative governments kept the top rate of income tax unchanged at 40% from 1988 to 2009. Of course, you may recall the increase from 40% to 50% imposed by Labour's Alistair Darling in his 2009 budget. This rate applied to incomes over £150,000 and was controversially cut to 45% in 2012 by the Conservative George Osborne. But, at the same time, Darling also increased the tax rate for people earning between £100,000 and £112,950 to 60%. He did this by abolishing the tax-free personal allowance for incomes over £100,000 per annum. Effectively, because they are losing their personal allowance, the people affected are being taxed at both ends. It means that the marginal rate for someone paid £105,000 a year, when you include employees' and employers' NICs, is over 70%. This hidden tax rise, which even many of the people who pay it seem to be completely unaware of, raises far more money than the 45p rate. That explains why, even though people earning £105,000 pay a higher marginal rate than those earning over £150,000, the government has been in no hurry to give high earners their personal allowances back. Besides, there's been almost no political pressure for it to do so.

The Laffer curve

As we've seen, economists have long realised that when people get to keep less of the money they earn, they work less hard. They stop striving for promotion or a pay rise. They work shorter hours and take longer holidays. In short, high taxes shrink the economy and reduce the tax take. This isn't a question of avoidance or evasion: it's about taking away the incentive to work.

The apparent paradox, that lower tax rates can increase tax revenue, was brought to the public's attention by a US economist called Arthur Laffer in the 1970s. Laffer was having lunch with a couple of US President Gerald Ford's staff at a restaurant in Washington DC. To explain his theory, Laffer drew a curve on a napkin. The idea is simple. If tax rates are zero, the government obviously won't

raise any revenue. And if they are 100%, no one gets to keep any of the money they earn, so they won't bother to work. Again, revenue will be nil. This means somewhere between a tax rate of zero and 100%, there is a level that maximises the amount of money that the government can bring in.

Everyone agrees with the theory behind the Laffer curve but, unfortunately, there is no data that tells us exactly what the curve looks like. Economists have tried to construct models using information from various countries, but as the Laffer curve depends on all sorts of variables, the results have not been very illuminating.

When they were advising Alistair Darling in 2009 on how much money he could make raising the UK's top rate of income tax from 40% to 50%, the boffins at HMRC tried to develop a Laffer curve to tell them. However, the result was guesswork and they exaggerated how much tax a 50% rate would raise. Admittedly, Mr Darling was quite happy to be told he'd get more money as this justified the tax rise. When the new Conservative Chancellor George Osborne asked them to review their work in 2012, the boffins revised their Laffer curve to show that cutting the rate to 45% would have a negligible effect on revenues. Luckily, this was what Osborne wanted to hear too. All this fiddling with the rate of income tax should provide more impartial researchers in the future with plenty of data to decide what the Laffer curve really looks like. For the moment, the only way to discover the optimum tax rate is through trial and error.

Governments tend to be pragmatic by nature and will try to tax the rich to raise the most money while doing the least damage to the economy. Nowadays, nobody thinks high tax rates are good for economic growth. It would be an irresponsible politician who seriously argued that he or she should increase tax rates but decrease the amount of money raised just to make things more equitable. So the question is simply: what rate of tax raises the most cash in the long term? Without an accurate Laffer curve, this isn't easy to

answer. For a start, it takes several years for all the effects of a tax change to become apparent. It's not so much that people suddenly stop working or move abroad. Gradual effects are more important. People go to the trouble to arrange their affairs in a tax efficient way, whereas before they might not have bothered. The country becomes less attractive to foreign investment and high-earning immigrants who might have considered moving here. And the incentive to better ourselves by working hard to earn promotion and a bigger salary is blunted, to the detriment of the economy as a whole.

Over the last couple of decades, most Western countries have settled on a top rate of income tax of between 35% and 45%. Recent work by the accountancy firm PwC calculated the real marginal rates for someone earning $400,000 for many different countries. For the UK, this came to 43%. In Germany and for an American living in New York it was 40%. So, it's no accident that the Labour government, in office from 1997, maintained the 40% top rate introduced by Conservative Chancellor Nigel Lawson in 1988. It looks like the most sensible number, albeit one subject to an inexact calculation.

Of course, fairness is all-important if any tax system is to enjoy popular consent. If it was just a question of money, we could raise tax rates on ordinary people since there is little that they can do to avoid them. They are already hard pressed, so they have no choice but to work, whatever their marginal tax rate. Fairness is why we have a system where 5% of the population pay half of all income tax. What the Laffer curve tells us is the rate of tax that will bring in the most money. Increase rates beyond that level and revenues fall. But that doesn't mean you have to raise tax rates to the highest possible level for all taxpayers. It is only the better off from whom you want to extract as much as you practically can. Nonetheless, as we've seen, there are limits to how much you can tax them without causing more harm than good.

Sports, prizes and betting

Sometimes you just have to accept that, with tax, fairness takes second place. For example, in the 2012 budget, George Osborne gave some of the world's best-paid professionals a stunning tax break. I'm not talking about the 'tax cut for millionaires' when he reduced the top rate of income tax. True, reducing the 50p rate grabbed all the headlines. But it wasn't just bankers who had reason to be grateful to George. He exempted another group of highly remunerated individuals from UK tax and no one batted an eyelid. That's because the beneficiaries of this generosity were footballers.

Not British footballers like Wayne Rooney and John Terry, but instead Arjen Robben, Thomas Müller and their teammates. They were two of the biggest stars of Bayern Munich who, you may recall, played against Borussia Dortmund in the 2013 Champions League final at Wembley.

Normally, when you work in the UK – even if you actually live abroad – you have to pay tax on the money that you make here. That applies to sports stars as well as visiting business executives. When Tiger Woods or Serena Williams win golf's Open Championships or the tennis at Wimbledon, they have to pay UK tax on their winnings. No one has a problem with that, in part because the tax they pay at home is likely to be reduced by the tax they've had to pay in the UK and other countries where they have competed. But for the biggest stars, the real money is not in the prizes. It is from commercial endorsements and advertising opportunities that result from their high profiles. Serena Williams flashing an Audemars Piguet watch and Tiger Woods wearing his Nike kit are far better remunerated activities than swinging a racket or golf club. Normally, the taxman tries to get his hands on some of this money. This is unpopular with the sportsmen and women, but they are hardly going to forgo the opportunity to take part in premier events like the Open and Wimbledon.

The situation was different when football's Champions League final was played at Wembley in 2013. This is a one-off match where the winner takes all (it's decided on penalties if necessary). Unlike Wimbledon, which always takes place in southwest London, the Champions League final can be played anywhere in Europe. There is no reason for it to be in the UK. One of the conditions that UEFA imposes on the host nation is that it only taxes prize money directly attributable to the game, not any sponsorship and endorsements that the players might have. So, the British government had a choice. Either give all the players tax immunity, or they would take their ball and play somewhere else. When a big one-off sporting event happens in the UK, it is usually because we've promised to relinquish the tax revenue.

Exactly the same exemption from tax was required as a condition for London hosting the Olympics in 2012. In 2013, the Anniversary Games at Crystal Palace took place a year on from the Olympics. Again, the participating athletes had their own special rule in the Finance Act 2013 exempting them from tax, as they did for Glasgow's Commonwealth Games. In the case of athletics, the exemption is designed to persuade just one man to compete in the UK: Usain Bolt. If other countries are willing to give tax incentives to host the big sporting showpieces, we have to match those. It is an example of tax competition, where countries lower their taxes to attract business. Admittedly, there was no special provision for the Rugby World Cup of 2015. Presumably, rugby players don't earn enough to make it worth the lobbying effort.

Sporting stars have often had an easy ride when it comes to taxes. In 1966, England won the football World Cup at Wembley, beating West Germany. The squad, led by Bobby Moore, received a cash bonus for their success. It was the princely sum of £1,000 each. Unsurprisingly, the Inland Revenue took the view that this bonus was part of the players' wages and wanted to subject it to tax. After all, they had earned the money playing football, which was their job. Moore and his players claimed that the bonus was more akin

to a prize, which meant that it was not taxable as income. He decided to fight the matter in court. The grateful nation, personified by Judge John Brightman, ruled in Moore's favour so the England team kept their bonuses untaxed.

Nowadays, it's not so simple. If British athletes win a prize or award in the course of their work, HMRC expects them to pay tax on that. A change introduced in 2016 also caps the tax-free proceeds from testimonial matches for retiring professional sportsmen and women. And we'll see in Chapter 5 how HMRC has been fighting a protracted battle with big football clubs over the tax on their players' wages.

These rules also apply to other kinds of award. For example, Hilary Mantel, who is a professional writer, would expect to pay income tax on both of her Booker Prizes, reducing the value of each award from £50,000 to less than £30,000 once it reached her pocket. The rest of us don't have to pay tax on prizes as long as we win them as part of a hobby, whether it is writing or something else. The £5 award for best marmalade at the village show is safe from the taxman as long as the winner isn't a professional producer of citric preserves. However, if he is also selling the preserved fruits of his labours to friends and neighbours, he should pay tax on any profits.

With betting, the tax inspector always wins

Until 2001, betting duty was charged when you put money down at the bookies. In that year, it was abolished by Gordon Brown. You might think this was intended to be a tax cut. It wasn't. The iron law of gambling is that the house always wins. So, instead of taxing the punters directly, the government now charges a levy on the gross profits of the bookies. Of course, the punters still end up paying the tax because the bookies offer less good odds. It is an example of the Second and Third Golden Rules: 'No matter what name is on the bill, all taxes are ultimately suffered by human beings' and 'Taxes are kept as invisible as possible'.

The government also siphons off almost a third of the money from the National Lottery. There is an explicit lottery duty on the revenue from tickets and roughly 40% of the cash for good causes also gets diverted to government projects thanks to some more sleight of hand by Gordon Brown back in 2004. So, not only are the odds of winning the Lottery particularly poor, it is also the most heavily taxed form of gambling.

Other kinds of bet are more tax efficient. You've probably seen the advertisements for spread-betting firms. They claim to provide a tax-free way to speculate on shares on the stock exchange or other financial markets (they also offer more traditional betting markets such as sport and politics). If you invest your savings in shares, you'll have to pay tax on your gains (we'll come to the mechanics of capital gains tax in Chapter 3). So why are spread-betting winnings, which are economically exactly the same as profits from holding shares directly, free from tax?

I once asked this question of the head of tax at one of the City's elite law firms. He admitted that there is no law that states spread-betting gains should be tax free, but nonetheless, as a matter of practice, HMRC doesn't try to tax them. The question was even raised in Parliament in 2013 by a certain Lord Eatwell and the Archbishop of Canterbury. They wanted to know how this tax break could be justified. They thought it was a kind of avoidance and demanded that it cease. The government said the matter was under review and we heard no more.

The government has been wise to kick the matter into the long grass since it knows that spread-betting isn't really tax free. Remember the iron law of gambling: the house always wins. Spread-betting relies on bringing together punters with different views who are willing to wager money on their opinions. A spread-betting firm, like IG Index, acts as the middleman between parties who want to buy and parties who want to sell. IG Index doesn't want to take any risk itself, if it can possibly help it. It makes its money from the spread between the buying and selling prices. As long as IG Index, or at least its computer software, has done its sums right, the winnings of

the punters who bet one way will always be less than the losses of the punters who bet the other. The difference is pocketed by the firm.

Well, not all of it. HMRC won't bother to tax the winners because it knows that their winnings will be outweighed by the losses of the losers. In short, the iron law of gambling applies: the house always wins. There isn't much point in taxing anyone apart from the spread-betting firm because it is the only one guaranteed to make money. Effectively, IG Index pays the tax on behalf of all the punters. From an administrative point of view, this is much simpler. And, it keeps betters happy because they imagine that they are hiding their winnings from the tax inspector. In a way, it is a bit like the PAYE system. People betting don't realise that they are being taxed because the spread-betting firm pays it for them.

The poverty trap

Although the better-off pay the lion's share of income taxes, once you factor in the effect of social security benefits, the poor can be hit by very high tax rates. Tax on the low paid is almost as complicated as tax on the rich. It was one of the obsessions of ex-Chancellor and Prime Minister Gordon Brown. He wanted to help the poor, but in the process made the system so convoluted that many people became trapped by it.

Perhaps the most tax-efficient job is being a student working the tables or serving behind the bar. The money you earn, up to £11,000 a year, is tax free because of your personal allowance (although you may be required to pay a bit of national insurance). There is also no tax due on any grant or scholarship that students are lucky enough to win, including gifts from Mum and Dad.

Things are not so rosy for people on benefits, especially lone parents and those in low-paid jobs. They find that tax and benefits interact in a way that exposes them to effective marginal rates of taxation even higher than those with very high earnings. The problem is, when people on welfare benefits move into paid work, their

benefits are withdrawn. As they earn a bit more, they find the tax system biting chunks out of their take-home pay as well.

A simple example might explain what the problem is. Imagine that Jane is a lone parent who works part time while her son is at school. It so happens that she now has the opportunity to earn an extra £100 a week by working 10 more hours. For Jane, the effect of an additional £100 a week should be life-changing and perhaps a step out of welfare dependency. However, once all her taxes and benefits are adjusted to take account of her increased income, she finds that she is only £10 a week better off. That means that her effective tax rate is 90%, higher than for someone earning a £100,000 a year. Doing the extra hours is simply not worth her while.

That's the poverty trap: the benefit and tax regimes conspire to deprive the poor of much of the extra money they earn. You'd think it wasn't beyond the wit of man to devise a system that works. Sadly, that's easier said than done. Throughout his tenure as Chancellor, Gordon Brown tinkered with the system to try to make it fairer. But each additional tweak had unexpected consequences that required later adjustments to correct. For example, he wanted to encourage people into work so he provided that the system didn't penalise casual jobs of up to 16 hours a week. Sadly, this just made the transition from casual work to a proper career all the more difficult. Today we have a system of awesome intricacy. The interaction of circumstances, pay, benefits and the number of hours worked is very hard to predict on a large scale. The Tory government has committed to replacing the minefield of interlocking benefits and credits with a single universal credit. The idea is to ensure that no one is exposed to an effective marginal rate of over 63% so they can always take home about a third of what they are paid. That is still too little, and implementing the universal credit itself represents a massive logistical challenge.

There are two ways to deal with the poverty trap. The first is to cut benefits so that the incentives to find a job are much higher. There are obvious problems with this approach, not least that it

removes the safety net from those who most need it. Even targeting benefits more carefully takes substantial political will. An alternative approach to the poverty trap would be to pay the same benefits to everyone. Universal benefits, which are not subject to means testing, used to be popular with the political left, but now everyone realises that they are unaffordable. Even child benefit, once paid to all parents, is now denied to families with higher rate taxpayers.

High effective marginal tax rates for the poor, where the government takes back with one hand what it gives with the other, have no moral or economic justification. But this is a problem with no easy answers. Implementing the universal credit and ironing out all its teething problems will take time. Even then, it is still only a partial solution. The poverty trap is still with us.