BanRep Blog: Financial and Real Impacts of the Wealth Tax on SMEs

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Tax authorities in both advanced and emerging economies have resorted to tax wealth as a tool to increase tax revenues, replace other taxes, promote the use of productive capital, and reduce wealth inequality. A recent research paper published in the series Working Papers on Economic (*Borradores de Economía*) by *Banco de la República* (the Central Bank of Colombia), co-authored by Bank economists Hernán Rincón and Miguel Sarmiento, assesses and analyzes the financial and real effects of the 2010 wealth tax reform in Colombia.

The reform in question incorporated small and medium-sized enterprises (SMEs) as new taxpayers by lowering the tax base threshold from COP 3,000 million to COP 1,000 million. This led to a 223% increase in the number of corporate taxpayers, from 3,441 to 11,119, and raised tax revenue by 0.3 percentage points of GDP. The tax was introduced in response to higher public spending triggered by the severe rainy season that heavily affected several regions of the country that year.

The research used a unique administrative dataset from records of all corporate loans in the financial sector, matched with balance sheets and financial and tax reports from banks and firms. To estimate the impact of this tax, an econometric method was employed based on the comparison of similar SMEs that differ only in wealth, which determines their tax treatment, before and after the introduction of the new tax. Specifically, the treatment group consists of new taxpayer firms, that is, those with wealth equal to COP 1,000 million and up to a certain amount above the threshold. On the other hand, the control group comprised similar firms that remained non-taxpayers, that is, those below the threshold or up to a certain amount below it. The richness of the dataset allows for comparison of firms that are otherwise very similar in all other characteristics, and thus the estimated effect is interpreted as the causal impact of the tax.

The analysis reveals that the tax had substantial, negative real effects on investment, capital accumulation, productivity, and employment among SMEs, along with other outcomes. In other words, firms subject to the tax experienced a decline in real performance following the reform, compared to firms that were not taxed.

Additionally, the analysis shows the effects of the tax on firms through the credit market. As taxed firms became decapitalized, the volume of bank credit extended to them declined by between 2.0% and 6.0% following the reform, interest rates increased by 50 to 100 basis points (bps), and loan maturities shortened by around 30%. This suggests a contraction in credit supply due to banks' higher perception of firm-level risk.

At a more detailed level, the research shows that SMEs subject to the new tax and with higher leverage face more restrictive credit conditions than non-taxed firms. Affected firms increase their reliance on trade credit as a potential substitute for bank credit, but in turn reduce the supply of this type of credit to their counterparts by around 7.3 percentage points. The research also shows a direct impact on banks subject to the tax and an indirect impact on their clients. It was found that highly taxed banks—those with wealth at the highest threshold established by the reform and subject to a 4.8% tax rate (plus a 25% surcharge)—reduce credit and impose higher interest rates on new taxpayer firms, thus confirming the distortions that the tax generates in credit supply.

It is worth noticing that the wealth tax on firms and individuals was applied during this century, between 2002 and 2017, always with a 'temporary' nature. Since 2018, it has been eliminated for domestic firms and

reintroduced for individuals. The reason for this change was likely to avoid negative effects on firms such as those documented in the research. The magnitude of the estimated impacts should serve as a reference in case the wealth tax on firms is considered again in the future.

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