The Value of Offshore Secrets: Evidence from the Panama Papers

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Main Findings

- **<u>Paper examines</u>**
  - » Stock market reaction to firms that through subsidiaries and/or officers were exposed to the leak of Panama Papers

- **<u>Main results</u>**
  - » Stock market reacts negatively to exposure
    - » Stock prices drop by 0.7% ~ $340 of lost market cap.
    - » Value declines more for firms with exposure to corrupt countries and for tax aggressive firms
    - » Value declines less for weakly governed firms
    - » Key result: Value declines more for firms with ”secret” exposure

Research Question

- Title of the study ["*The Value of Offshore Secrets: Evidence from the Panama Papers*"] hints at a research question focusing on the value of offshore secrets
- According to the authors … "Whether these secret offshore activities are beneficial to shareholders or not is the question we attempt to answer in this paper"
- In contrast, the empirical evidence establishes that when ***exposure*** is revealed it ***has negative consequences for shareholders***, and find evidence of a ***tax*** channel, a ***corruption*** channel, a ***governance*** channel, as well as a ***reputation*** channel
- Does the empirical evidence answer the research question?
  - Value of offshore activities = expected benefit – expected cost
  - Large difference between ex ante and ex post value if probabilities are differentially affected by the exposure of secret activities

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- Simple example:
  - Suppose a firm can reduce corporate taxes by 1 million by using a offshore identity

  - Suppose that with a probability of 10% the firms get caught by the tax authorities. If caught, the tax authorities will impose triple penalty
    - Ex ante value = 1 million – 10%·3·1 million = 700,000

  - Suppose that a leak increases the detection probability to 100%
    - Ex post value = 1 million – 100%·3·1 million = - 2 million

Data

- Mossack Fonseca data:
  - 212,845 offshore firms / subsidiaries
  - 144,791 individuals

- Orbis data:
  - 23,540 publicly held firms
  - 913,819 subsidiaries
  - 1,879,048 officers

Firm is connected to offshore vehicle via	N Firms	N Firms w/exposure	% w/exposure
…a legal entity (shell)	23,540	89	0.38%
…a person	23,540	296	1.26%
…an intermediary	23,540	86	0.37%
…any of the three	23,540	397	1.69%

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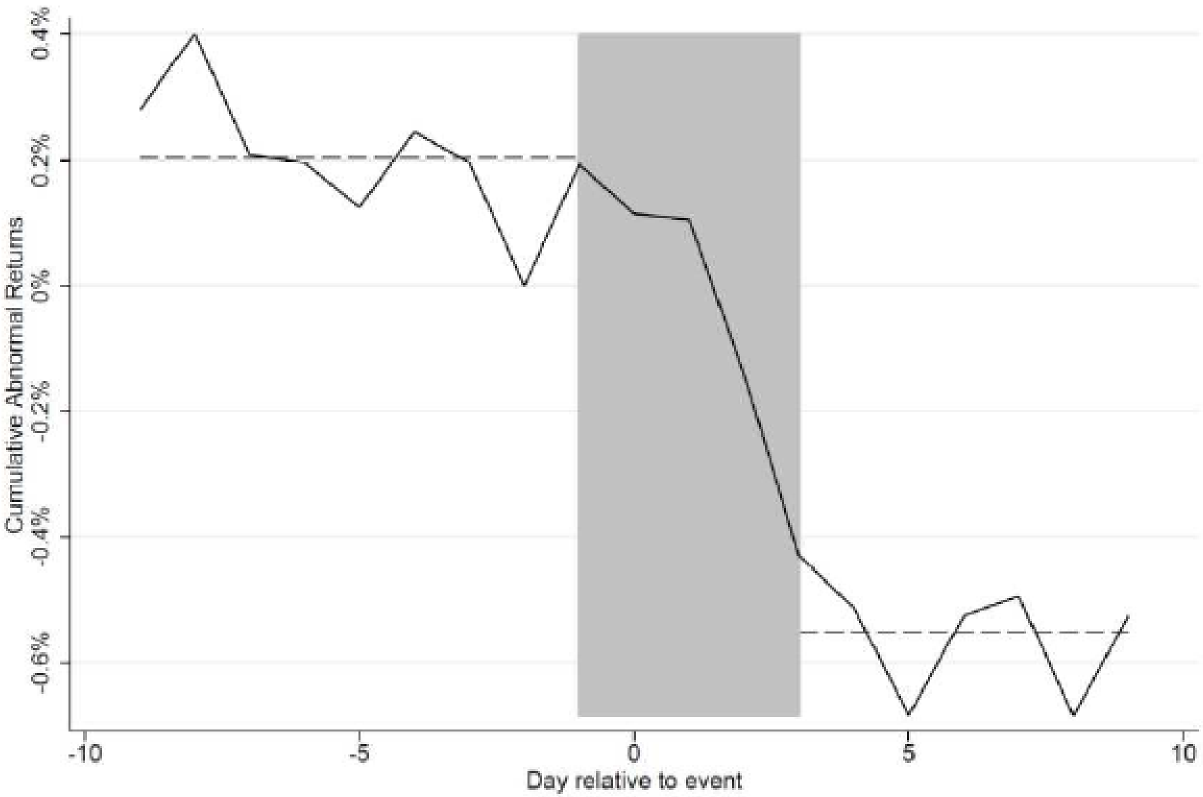
- » What if we look at the data in the other direction?
  - » What fraction of the Mossack Fonseca data can be matched with Orbis?
- » I would to learn more about the geographical mapping for Mossack Fonseca's data
  - » Where are Mossack Fonseca's offices located?
  - » What is the geographical distribution of firms and officers?
  - » Does the distribution match the matched sample?

Market reaction to Panama Paper Exposure

Main Result—Additional Evidence/Robustness



Market reaction to Panama Paper Exposure

- Authors use three event dates
  - April 3 — First press coverage of leak
  - April 26 — Announcement of publication of data on May 9
  - May 9 — Publication of database with leaked documents

- Most of the negative stock market reaction occurs on April 26, before we know which firms and officers are involved
  - Anticipated vs. unanticipated exposure

- Large volume of data which takes time to process, curious to understand why the market on average figures out the value (i.e. market reaction) on April 26

Interpretation

- Stock price reaction might be caused by several channels
  - Tax evasion
  - Litigation risk
  - Corporate governance
  - Reputation

- Additional channel
  - Managerial talent
    - Unexpected exposure to Panama Papers occurs for officers that leave a paper trail
      - Transactions at arms-length will remain unobserved
      - Transactions with multiple layers of secrecy will remain unobserved
    - Panama papers only expose “dumb” officers

Alternative counterfactuals & evidence

- Alternative counterfactuals
  - ✔ Companies with links to tax heavens
  - ✘ Companies with links to Mossack Fonseca
  - ✘ Companies with economic activities in same location as Mossack Fonseca has offices
  - ✘ Companies with links to Mossack Fonseca's competitors

- Strength of exposure not used in current draft
  - Indicator variable for exposure, rather than the strength of the exposure

- Time dimension of exposure not used in current draft
  - Differences in time provide an alternative source of variation of exposure

Conclusion

This study uses exposure to Panama Papers to uncover interesting evidence on exposure to offshore secrets

- Unexpected revelation of exposure solves the main problem of the unobserved nature of offshore secrets
  - Key finding is that secret exposure is driving down stock prices
- Main takeaway from paper is that stock reacts negatively when firms offshore secrets are exposed
  - Consistent with these activities being illegal in nature, carrying a reputational costs, or that officers who get exposed are incompetent
- Hard to say anything about the ex ante attractiveness of offshore secrets