The Value of Offshore Secrets: Evidence from the Panama Papers

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Main Findings

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

• **Main results**
  » 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
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
Research Question

• 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

• 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

<table>
<thead>
<tr>
<th>Firm is connected to offshore vehicle via</th>
<th>N Firms</th>
<th>N Firms w/exposure</th>
<th>% w/exposure</th>
</tr>
</thead>
<tbody>
<tr>
<td>...a legal entity (shell)</td>
<td>23,540</td>
<td>89</td>
<td>0.38%</td>
</tr>
<tr>
<td>...a person</td>
<td>23,540</td>
<td>296</td>
<td>1.26%</td>
</tr>
<tr>
<td>an intermediary</td>
<td>23,540</td>
<td>86</td>
<td>0.37%</td>
</tr>
<tr>
<td>...any of the three</td>
<td>23,540</td>
<td>397</td>
<td>1.69%</td>
</tr>
</tbody>
</table>
Data

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
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