The Cost of Being Associated with Tax Havens

By James O'Donovan , INSEAD PhD candidate, Hannes Wagner , Associate Professor at Bocconi University and Stefan Zeume , Assistant Professor at Ross School of Business

Firms with shell companies in four tax havens linked to the "Panama Papers" leak lost more than US$220 billion in market capitalisation following the revelations. Firms with activities in corrupt countries suffered even greater losses.

With the recent leak of millions of confidential documents, the **Panama Papers** illuminate the way that companies and individuals shield their assets from reporting with offshore shell companies. The leak has rocked companies and government leaders, even toppling a head of government. Global investors lost confidence in firms with offshore shell companies in the days after the leak.

Mossack Fonseca, the Panama-based law and corporate services firm at the centre of the Panama Papers, has managed more than 214,000 shell companies since the early 1970s. Shell companies, created for business transactions only, were long used to evade taxes and to shelter companies from full reporting. Because so much of their activity was hidden, it was hard for researchers and government agencies to study shell companies and inform investors. The Panama Papers leak allows a whole new look at how shell subsidiaries may or may not add value to firms.

The leak is significant in its contents, including one document which noted that 95 percent of Mossack Fonseca's work consisted of "selling [corporate] vehicles to avoid taxes". Companies create offshore subsidiaries in tax havens for many reasons. Some are legal but others not so and may, for example, be hiding money to finance bribes or to circumvent sanctions.

We found that firms with links to tax havens mentioned in the Panama Papers lost more than US$220 billion in market capitalisation in the days after the leak. These are firms whose tax havens were mentioned in the leak but which are not necessarily behaving illegally. Firms which had operations in countries perceived by investors to be corrupt found themselves in an even worse position.

Immediate impact of the leak

Our paper, **"The Value of Offshore Secrets – Evidence from the Panama Papers"**, takes an initial look at the contents of the leak, and studies how the use of shell companies affects corporate valuation. Using a sample of 26,655 publicly traded firms from 73 countries, we assess the impact of the leak on their value.

We found that more than 1,100 firms in our sample had at least one subsidiary in Panama, the British Virgin Islands, the Bahamas or the Seychelles. These four countries were used by Mossack Fonseca for 90 percent of their offshore subsidiaries. If a company in our sample had a subsidiary in one of these countries, it had more negative returns around the time of the leak. The firms in our sample were large firms, with valuation over US$1 million; the amount of market capitalisation lost per company was between 0.5-0.6 percent on average.

Our paper highlights a potential conflict of interest between companies which are not transparent in their reporting and shareholders. Previous research suggests that tax havens save money for shareholders. On the other hand, some research shows that shell companies are used to hide funds from shareholders.

The corruption exposure

Interestingly, investors saw companies associated with tax havens in the leak in an even worse light if they were associated with one of ten "perceivably corrupt" countries.

We found that these firms had 0.65 percent lower returns than similar companies in early April 2016. The "perceivably corrupt" countries had at least one major government official who was implicated by the Panama Papers – Argentina, Georgia, Iceland, Iraq, Jordan, Qatar, Saudi Arabia, Sudan, United Arab Emirates, and Ukraine.

For instance, Iceland's Prime Minster, Sigmundur Davíð, resigned from office on 5 April 2016, days after the leak was published, as he hadn't disclosed all his interest in a shell company in the British Virgin Islands. We found firms linked to any of the four tax havens and operating in Iceland – a perceivably corrupt country – experienced a negative return of 1.4 percent.

The end of opaqueness

Investor reaction to the Panama Papers leak demonstrates how quickly the market can tar everyone with the same brush. Regardless of whether or not a firm had an offshore company created by Mossack Fonseca, firms with subsidiaries in certain parts of the world – those associated with the leak – lost value right after the leak.

The evidence from the Panama Papers could lead to greater transparency for shareholders; all of this could be the end of opaqueness. Or perhaps firms will continue to behave as though shareholders do not know what is best for them, and look for other loopholes. We intend to update our paper as much of the data pertaining to the Panama Papers leak are not yet available. Future revelations and responses by law enforcement and government agencies will help us shed more light on the impact offshore secrets can have for companies. But for now, our initial analysis suggests big costs, not only for those involved, but any organisation associated with certain tax havens.

James O'Donovan is a PhD candidate at INSEAD.

Hannes Wagner is an Associate Professor at Bocconi University.

Stefan Zeume is an Assistant Professor at Ross School of Business.

Follow INSEAD Knowledge on ***Twitter*** *and* ***Facebook***

Find article at

https://knowledge.insead.edu/economics-finance/cost-being-associated-tax-havens

About the author(s)

James O'Donovan James O'Donovan is a PhD candidate in Finance at INSEAD.

Hannes Wagner Hannes Wagner is an Associate Professor of Finance at Bocconi University.

Stefan Zeume Stefan Zeume is an Assistant Professor of Finance at the Ross School of Business, University of Michigan.