

# Offshore Finance, Welfare, Financial Stability and Regulation

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## 1 Sujet de recherche

The offshore financial system can drain trillions of dollars from treasuries, worsen wealth disparities and protect those who commit illegal activities. In this project, I will quantify the global impact of the offshore finance industry on investors and governments' welfare, financial stability, and regulation. More specifically, I will study the mechanisms that make corporate insiders use these offshore services, as well as how to regulate them. I will rely on the structural estimation of a series of dynamic models in which the incentives to use offshore accounts are micro-founded for managers. As I will focus on the impact of the offshore finance industry on investors' welfare, government's welfare, financial stability and regulation, I will solve and estimate partial and general equilibrium variations of a dynamic model. In its simplest form, I micro-found how corporate insiders (managers) could use secret offshore accounts to i) avoid and evade taxes, ii) bribe foreign officials to circumvent regulation, iii) hide empire seeking activities, and iv) expropriate outside shareholders. Moreover, I study the role that the government plays, as it sets the tax rate for corporations, audits the activity of managers, and regulates their compensation. To take these models to the data, I will study how the equity and debt markets react to data leaks exposing managers of firms with connections to offshore vehicles.

## 2 Thème ou rubrique d'appartenance

The offshore financial system can drain trillions of dollars from treasuries, worsen wealth disparities and protect those who commit illegal activities. Despite the importance that understanding this industry has for governments and market regulators, we do not fully understand its impact on welfare, financial stability, or how to regulate it. The two main reasons are lack of data and the empirical challenges that studying a large unobserved industry raises. In fact, there is a disagreement on the size of the offshore finance industry itself, which is estimated to be between \$7 and \$32 trillion USD (Zucman, 2017). While some early work has focused on the role of tax-havens on personal wealth, inequality, private property, and income tax avoidance (Zucman, 2013; Johannesen and Zucman, 2014; Zucman, 2014), not much has been studied from a corporate finance perspective on how managers use these offshore accounts for their private benefit. Our current understanding is that corporate insiders may use secret offshore vehicles to evade taxes (Desai, Dyck, and Zingales, 2007), bribe foreign officials to circumvent regulations (Zeume, 2017; Cheung, Rau, and Stouraitis, 2020), and expropriate resources, as anecdotal evidence suggest (O'Donovan, Wagner, and Zeume, 2019). Regardless of this evidence, we do not know the relative importance of these activities on investors' welfare, as different offshore activities can create or destroy value and only the net effect is observed. Moreover, since standard reduced-form analyses do not allow to study counterfactuals, we do not know how governments should regulate this industry.

To the best of my knowledge, my project is the first to propose quantifying the impact of this industry by structurally estimating a corporate finance model. All other studies that aimed to quantify the impact of the offshore finance industry on shareholder welfare rely on reduced-form approaches (O'Donovan, Wagner, and Zeume, 2019; Li and Ma, 2022), which do not allow for the study of counterfactuals, nor to unravel the mechanism that incentivizes managers from using offshore vehicles. A structural approach on this area of research will allow to i) study the mechanism that makes managers use off-shore accounts, ii) quantify the relative importance of different off-shore activities, and iii) use counterfactual scenarios to guide policy on this topic.

My project will contribute to two strands of the literature. First, I will contribute to a growing literature of structural estimation in corporate finance (see e.g. Strebulaev and Whited 2012 and references therein). In particular, my structural model will rely heavily on

the role of agency frictions on cash-holdings (Nikolov and Whited, 2014), strategic communication (Terry, Whited, and Zakolyukina, 2022), and moral hazard (Nikolov, Schmid, and Steri, 2021). Finally, I will contribute to the literature studying the impact of the offshore finance industry on investor's welfare (O'Donovan, Wagner, and Zeume, 2019; Cheung, Rau, and Stouraitis, 2020; Desai, Dyck, and Zingales, 2007).

### **3 Equipe de recherche ou chercheur**

Main Researchers

- Juan F. Imbet. Ph.D. in Finance from Pompeu Fabra University and the Barcelona School of Economics. Assistant Professor at DRM-Finance Paris Dauphine University - PSL, and a PSL Junior Fellow.
- Marcelo Ortiz. Ph.D. in Finance from Universidad Adolfo Ibáñez, School of Business. Assistant Professor of Financial Accounting in the Department of Economics and Business at Universitat Pompeu Fabra, affiliated at the Barcelona School of Economics and the UPF Barcelona School of Management.

### **4 Sponsors (autres que EIF)**

- PSL via the PSL Junior Fellow

### **5 Calendrier**

The research agenda, which is planned to be composed of three research papers, is expected to last five years since the start of the project until the publication of these studies. The data analysis and theory development is expected to last for three years. Not all research papers will require the same duration, and probably the project that involves the structural estimation of parameters will last more. The project has started as of December 2022, and once the transfer process of the PSL Junior Fellow is completed we will have a permanent Research Assistant supporting the main researchers in the project.

## 6 Publications

Overall, it is estimated that with this project at least three different high quality papers can be produced, focusing on investors' welfare, financial stability, and regulation. The quality of these papers is expected to be high given the resources given to us and it should be worth presenting at top conferences worldwide (AFA, WFA, EEA) as well as to work towards their publication in top peer-reviewed journals in the Finance (JF, JFE, RFS, JFQA, or MS) as well as top Journals in Accounting (JAR, JRS).

## 7 Applications

I plan to host an international workshop on the Offshore Finance Industry aimed at joining together researchers from top universities in Europe to present the latest research trends in the field. This workshop will be financed by the PSL Junior Fellow.

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