Examining the deterrence effect of whistleblowing

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Whistleblowers are not only helping to disclose immoral or criminal acts but also to deter offenders. Niels Johannesen, an economics professor from the University of Copenhagen and Tim Stolper, a former research associate at the Max Planck Institute for Tax Law and Public Finance found clear evidence for this deterrence effect, using the example of data leaks surrounding banking services in tax havens. The economists discovered that following the appearance of the first data leak, which originated from LGT Bank in Liechtenstein, also Swiss banks engaged in cross-border tax evasion suffered significant drops in their share prices. At the same time, bank deposits in tax havens fell by more than ten percent compared to deposits in non-haven countries.

Whistleblowers steal confidential information in order to lay bare criminal actions such as tax evasion. For this, they are sometimes considered to be "heroes of our time", to paraphrase Alfred de Zayas, former UN Special Rapporteur for the promotion of a democratic and equitable international order. This positive view of informants assumes that whistleblowing not only acts as the catalyst for prosecuting individual criminals but also promotes honest behavior by lifting the lid on undesirable conduct. The empirical results by Niels Johannesen, an economics professor from the University of Copenhagen and Tim Stolper, a former research associate at the Max Planck Institute for Tax Law and Public Finance, support this hypothesis.

For their analysis, Johannesen and Stolper examined developments in Switzerland, the world's largest financial center for cross-border wealth management. The economists observed how the share prices of Swiss banks implicated in offshore tax evasion, reacted to a total of 13 data leaks that became public. Their main insights derive from analyses of the so-called Liechtenstein tax affair, the first data leak from a bank involved in tax haven activities to come to the public's attention. An employee of LGT Bank in Liechtenstein had copied customer information and later sold it to the German Federal Intelligence Service. The Liechtenstein tax CD triggered the scandal surrounding the former head of Deutsche Post Klaus Zumwinkel in 2008, and in the following weeks, around 800 further suspects were caught in the authorities' spotlight.

Leak of data lowered expectations of profit

The examination conducted by Johannesen and Stolper revealed that the share prices of Swiss "tax evasion banks" behaved inconspicuously in the ten trading days leading up to the LGT leak. However, in the first two days after the revelations, their prices fell by a market-adjusted amount of 1.1 percent, and in the four subsequent days by a total of 2.2 percent which is statistically significant. Banks that helped to conceal money from the financial authorities clearly suffered a significant drop in their profit expectations as a result of the data leak from LGT Bank.

According to the theory of efficient financial markets as developed by economics Nobel prize winner Eugene Fama, share prices always follow the information available and reflect the net present value of expected future profits. They rise when there is new, positive information on future profits and fall if new negative information comes to light. Applying this theory to the results of Johannesen and Stolper, a decline in the share prices at precisely the time of the data leak can be interpreted as that the financial markets were expecting to see a fall in the future profits from criminal offshore activities.

As the Liechtenstein tax affair was the first data leak that became public, tax evaders and their accomplices—as per the researchers' interpretation ran—had hitherto not taken into account the risk emanating from data leaks, or had not done so sufficiently. The first perception of the risk of a data leak, or at least the perception of a heightened risk, therefore affected the supply and demand for offshore banking services and reduced the expected profits of offshore service providers.

This insight is supported by the results of further analyses by Johannesen and Stolper. For example, Swiss banks with no connection to offshore tax fraud suffered no drop in their share price. It can also be assumed that the US authorities initially investigated those banks where they suspected the greatest involvement in offshore tax evasion or where they had the clearest signs of such activity, and that investors in the stock markets harbored similar suspicions. This chimes with the finding that the share prices of banks which were later subject of criminal investigations by the US authorities fell more appreciably (6.1 percent in four days after the data leak) than those of banks which subsequently offered voluntary disclosures (1.2 percent in four days). The two economists also established that banks that had to pay above-average penalties also suffered higher falls in their share prices (3.2 percent in four days) than banks whose penalties were below the median (1.4 percent in four days).

Bank deposits in tax havens dropped around the world

Johannesen and Stolper also discovered that later uncovering of offshore banking activities, for example the Swiss Leaks in 2009 or the Panama Papers in 2016, had no more significant effects on the banks' share prices. This result also supports the scientists' main hypothesis: after the first data leak became known, owners of illegal bank accounts and offshore companies as well as their accomplices on the side of the banks adjusted their expectations, or in other words factored in the risk that their criminal schemes might be uncovered. The share prices fell because new negative information affected the price. The data leaks that subsequently came to light, contained no additional news in terms of the risk of discovery.

Finally, Johannesen and Stolper underpinned their theory of the deterrent effect of whistleblowing with statistics from the Bank for International Settlements. After the data leak, international bank deposits in tax havens around the world fell by more than ten percent by comparison with deposits in countries not acting as a tax haven. This implies that the effects of whistleblowing identified by the economists constitute more than a mere financial market phenomenon. Rather, the revelations actually had real consequences, namely the effect of frightening off tax fraudsters and their accomplices.

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