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Interaction effect of tax evasion and legal system inefficiency on firms' financial constraints

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Abstract

This paper analyzes the joint effect of tax evasion and the legal system's inefficiency on firms' financial constraints. Our theory highlights that each factor exerts ambiguous effects on the difficulties encountered by firms that seek financing. However, under mild assumptions, our model leads to the conclusion that higher degrees of tax evasion and judicial inefficiencies both increase firms' financial constraints. Moreover, tax evasion and legal system inefficiency exert a joint impact as they mitigate each other's negative effect on credit constraints. We test our results by using firm-level data based on the World Business Environment Survey. The empirical findings confirm our theoretical hypotheses.

Keywords: financial constraints, tax evasion, legal system efficiency.

JEL: D2, G3, H26, K4.

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