Lobbying and Tax Competition in an Agglomeration Economy *

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Abstract

This paper analyzes tax competition between politically-motivated governments in an economy with agglomeration forces. The economy includes trade costs, internationally mobile firms, and two countries of asymmetric size. Each national government sets its tax rate strategically to maximize the weighted sum of residents' welfare and political contributions by owners of firms as special interest groups. It is shown that, if the governments in both countries or the government in the smaller country care about contributions heavily, the smaller country attracts a more than proportionate share of firms by setting a lower tax rate. The result implies that the well-known home market effect, which means that countries with large market size are attractive for firms, may be reversed as a result of tax competition played by politically-interested governments.

Keywords: Tax competition; Lobbying; Market size; Home market effect; Economic geography;

JEL classification: F15; F22; H20; H30

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