Do Agglomeration Economies Reduce the Sensitivity of Firm Location to Tax Differentials?

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Abstract

Low corporate taxes can help attract new firms. This is the main mechanism underpinning the standard 'race-to-the-bottom' view of tax competition. A recent theoretical literature has qualified this view by formalizing the argument that agglomeration forces can reduce firms' sensitivity to tax differentials. We test this proposition using data on firm startups across Swiss municipalities. We find that high corporate income taxes do deter new firms, but less so in more spatially concentrated sectors. Firms in sectors with an agglomeration intensity at the twentieth percentile of the sample distribution are up to 50 percent more responsive to a given difference in corporate tax burdens than firms in sectors with an agglomeration intensity at the eightieth percentile. Hence, agglomeration economies do appear to dampen the impact of tax differentials on firms' location choices.