The study looks at the competition for foreign direct investment (FDI) through country size, taxation with trade cost, and subsidy games. It addresses the following questions. How countries in the same geographical and economic region use investment policies such as subsidies to compete and attract potential FDI? Investment allocations are meant to be either divisible or indivisible. In line with Krugman’s new trade theory (Krugman 1980) and Haufler/Wooton’s account of competition for foreign direct investment (Haufler/Wooton 1998), I focus on household utility optimisation and a monopolistic firm’s profit maximisation problems for two countries of unequal size. I also show in line with Haaparanta (1996), how governments offer positive subsidies to influence the location decision of a MNF.

The study demonstrates that with trade cost (transportation cost) and indivisible amount of physical capital, the firm can charge a higher producer price in the larger country than in the smaller country. Consequently, in the presence of tax competition with symmetric trade cost, the larger country with larger market size can set a positive profit tax on the firm’s profit. The firm then extracts positive profit from both countries, irrespective of where it locates, but gains higher profit from the larger country. Therefore to limit the amount of trade cost, and to take advantage of both markets, it is always better for the firm to locate in the larger country.

Moreover, with divisible amount of capital, the study identifies that at the equilibrium, the smaller country has to pay more subsidies in order to win more investment. The larger country offers higher subsidy in line with a higher wage rate, it may still lose FDI.