Like firms, governments compete with each other. They can adapt their policies to attract firms or highly skilled workers, or to raise more tax revenues. Since government competition could lead to large wastes of public money, it is important to understand how that competition works exactly. This thesis shows that the spatial characteristics of economies strongly affect the interactions between their governments. The forces that result in clustering of firms, and that govern commuting flows and housing markets, also influence the obstacles that policymakers face in developing their policies. As a result, even if governments have the best intentions, the overall effects of their policies may be far from socially optimal. Central governments can try to steer lower governments towards the welfare-maximizing policies. This thesis shows, however, that the ideal instruments and policies for central governments vary strongly with the trade flows, the commuting flows, and the residential and firm location choices that shape the spatial economy.