

ECONOMIC INTEGRATION, POLITICAL INTEGRATION OR BOTH?

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Abstract

We study the effects of economic and political integration by presenting a model in which firms compete with each other in both an economic market – where they produce a good and compete for market share – and in a political (rent seeking) market – where they compete for transfers from the government. Growth is driven by firms' cost-reducing innovation activity and economic and political integration affect firms' incentive to innovate differently. In this setting, economic and political integration can be seen as complementary. Economic integration, when not accompanied by political integration, can lead to less innovation and slower growth as firms respond to increased competition in the economic market by focusing more on rent seeking activity. When economic integration is accompanied by political integration, innovation and growth will be stronger and welfare higher. (JEL: D72, F15, F55, O31)