

Sanctions, Substitution, and the Informal Margin: Geoeconomic Spillovers in Eastern Europe

Ceyhun Elgin

“This paper develops a two-sector general-equilibrium model to analyze structural spillovers of geoeconomic fragmentation on Eastern European economies. Focusing on trade-restricting sanctions that raise import prices, we identify a mechanism of informal leakage: firms substitute sanctioned formal inputs with unregulated domestic alternatives. When the elasticity of substitution exceeds unity, sanctions expand the shadow economy, depressing productivity and eroding fiscal capacity. Calibrating to Baltic states versus the Balkans, we find high Russian input exposure creates disproportionate fiscal erosion in frontier economies. Our theoretical analysis suggests sanction regimes may require compensatory transfers to preserve allied states' institutional integrity.”