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Can Russia's Militarized Economy Ever Return to a Civilian Model?

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People walk past an electronic screen showing an image of Russian soldiers in downtown Moscow. **Yuri Kochetkov / EPA / TASS**

Russia's full-scale war against Ukraine has lasted almost as long as the Soviet involvement in World War II and seems endless. But it must end sooner or later. Then Russia will face the task of putting its entirely militarized economy back onto a civilian footing and redistributing demand from military to civilian industries. At least, that is what the government's economic bloc and the Central Bank would like to see, having warned repeatedly of accumulating risks and the threat of stagnation.

President Vladimir Putin, however, seems determined to keep waging war until he is victorious, regardless of sanctions, high inflation, a decline in living standards and structural imbalances. The conversion of the defense industry back to the production of civilian goods is not a priority, even if the war in Ukraine were to end in the foreseeable future. On the contrary: the Kremlin plans to rearm the military and replenish its depots, which will

maintain demand for military-industrial complex products for at least the next three years.

There are certainly solid reasons for such a choice. Even if Putin wanted to return to a peacetime economy, the Kremlin has staked everything on the military sector and the mobilization model over the past three years, resulting in Russia becoming caught in a stagnation trap with low growth rates and chronic internal imbalances. Any attempt to rapidly cut spending will result in collapse. But nor can the military machine be fed indefinitely. Sooner or later, Russia will have to travel the difficult path back to civilian life through a synchronized restructuring on all fronts.

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Over the past three years, Russia has developed a two-speed economy. War-related sectors are not just growing, but positively flourishing thanks to having priority access to limited resources: raw materials, finance, and technology. Meanwhile, the private sector, small and medium-sized businesses, and consumer industries are facing an artificial squeeze on opportunities due to sanctions, rising taxes, and limited access to capital.

This redistribution of resources from lower-priority sectors to strategically important ones creates structural imbalances. A clear example can be seen in metalware production statistics: output of weapons and ammunition has been growing at double-digit rates since the beginning of the war, while that of nonmilitary products has been declining.

Excessive militarization and protectionism dictated by the Kremlin are the main drivers of demand in the economy. Consumer demand is limited by inflation, while private investment demand is being squeezed by budget spending. The economy has already become entrenched in a model where military rent essentially performs the same function for some businesses and categories of people as oil and gas superprofits did in the 2000s.

The difference is that in the 2000s, superprofits from raw materials entered the economy from the outside and were redistributed largely through the state budget, simultaneously creating consumer and investment demand. Now the state is financing its war from the same raw material rent, only that rent is noticeably reduced, and is being spent on replacing tanks, drones, and shells destroyed in Ukraine, as well as on compensation for wounded military personnel and families of soldiers killed in action.

There may still be a foreign trade surplus, but oil and gas are being sold at a significant discount and, under the Western embargo, the geography of sales has moved to Asia and the Global South, giving new buyers powerful negotiating leverage. Imports are limited by sanctions, which increase business costs. The capital account is closed: there are limitations on capital outflow and on the sale of foreign-currency export revenues (in 2023, exporters were supposed to sell 90 percent of their foreign-currency revenue; now that requirement has been dropped, but the mechanism for further restrictions remains in place).

Formally, the trade balance is stable, but only due to robust administrative support, rather than to the flexibility of the economy.

Investments are concentrated in the military-industrial complex and often in low-tech import substitution projects. Private investment in export-oriented sectors is declining due to tax pressure and uncertainty. This squeezing effect is causing industries with potential for integration into global chains (such as the automotive industry, aircraft manufacturing, pharmaceuticals, and IT) to lose ground and actually decline.

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Russia's defense industry devours nearly 8% of GDP. Weaning the country off its military dependence without incurring economic collapse will only be possible if five strict conditions are all met at the same time.

The first is that perceived external threats must truly have disappeared, with security guarantees that satisfy Putin. Second, contract soldiers will have to be demobilized en masse and forced to retrain and integrate into the civilian economy. Third, sanctions will have to be at least partially lifted to give Russia access to critical technologies and components.

The fourth condition is a revolution in defense procurement. Instead of a meaningless race to spend all allocated budget funds, strict key performance indicators must be introduced, including the real cost of military effectiveness and conversion potential.

The fifth is a focus on a "people's military-industrial complex" — an ecosystem of small and medium-sized businesses capable of dramatically reducing production costs through modularity and mass production.

Putin's luck has often been remarked upon, but it would be very difficult to achieve such a combination of factors through luck alone. Yet unless all of these conditions are met, any attempt to cut military spending will result in economic shocks.

The current budget framework is crying out for spending cuts. Oil and gas revenues are falling due to discounted prices, the cost of logistics involving numerous intermediaries, the risk of export restrictions and new price caps, and fluctuations in the ruble exchange rate. Treasury revenues for the first half of 2025 fell by 16.9% to 4.74 trillion rubles ($56.5 billion) due to lower revenues from the sale of energy commodities.

Every $10 per barrel drop in the base oil price reduces government revenue by about 0.8% of GDP. Non-oil and gas revenues are growing, but not as quickly as oil and gas revenues are falling due to the economic slowdown. The Finance Ministry will not increase direct taxes to compensate for that lost revenue: it already did that in 2024, hiking the personal income tax and corporate profit tax rates. The only remaining options are strict spending prioritization and "revenue mobilization" — increasing indirect taxes, fees, excise duties and so on.

Reducing external threats will, in theory, make it possible to return defense spending to levels that are safe for the economy. But that will have to be done gradually: for example, at an annual rate of 0.5–1% of GDP from the current level of almost 8% of GDP to the target level of 5%. A sudden collapse in demand amounting to hundreds of billions of rubles would be a shock to military enterprises. In any case, however, a reduction in military spending looks unlikely: the end of the hot phase of the war with Ukraine will be followed by a large-scale

rearmament program.

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Any redistribution of demand must be accompanied by active measures to stimulate the labor market. According to official estimates, from the beginning of 2023 to mid-2024, an additional 600,000–700,000 people began working at military-industrial complex enterprises. Total employment in the military-industrial complex now stands at approximately 3.8 million people.

This figure is nonlinear, and defense employment is concentrated in certain regions and even single-industry towns. This means that any change in state defense procurement automatically affects employment in certain regions. Personnel shortages in one region can be filled with workers from elsewhere, but the Russian labor force is traditionally not very mobile, and labor shortages are commonplace.

Unemployment is currently at a record low of 2.2%, meaning there is quite literally no one left to work. In theory, the government has a labor reserve of about 400,000 contract soldiers who will need jobs after the war. But releasing that many people onto a workforce of about 75 million all at once would cause unemployment to grow by 0.5 percentage points. Not only would that be a major shock to the labor market, but it would not solve the shortage of skilled specialists. To avoid this, the government will most likely resort to gradual demobilization.

The Kremlin has other compelling reasons to delay the return of combat-hardened veterans to the civilian labor market. There is little demand for their specific skill set in the civilian economy. These men may be classed as returning war heroes, but civilian enterprises will only be able to offer them high salaries and retrain them either at a cost to their own profitability or with the help of state subsidies, which are currently being cut due to falling budget revenues. In any case, even after the war ends, the threat risk will not immediately go back to what it was before. The reconfigured border will require additional personnel to guard it.

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Sanctions will continue to hinder Russian economic growth, reducing the competitiveness of both civilian and military products. Export controls and tightened compliance among intermediaries are changing the economics of supplying electronics, optical systems, batteries and other components to both the military and civilian sectors. Russia may be managing to avoid shortages, but transactions are more costly.

Meanwhile, supply chains are becoming increasingly volatile, and the proportion of defective goods is on the rise. In response, manufacturers are simplifying designs and switching to products with less demanding technical specifications and cheaper, more readily available components. This reduces the technological complexity of Russian goods and their export potential, since the additional costs incurred as a result of sanctions have to be factored into the product price. And all the while, China is right next door with even cheaper alternatives and unburdened by the kind of sanctions borne by Russia.

Hopes for the conversion of military developments and a boom in defense industry exports may not materialize. The current defense procurement system, built on the principle of spending all allocated budget funds on producing hardware, has transformed the industry into a gigantic machine for melting down public funds into metal products of dubious combat value. The dominance of defense monopolies does indeed simplify state control, but it also causes production costs to soar and stifles innovation.

The paradox of this war is that the scaling up of production of drones and critical components was made possible by the hundreds of small and medium-sized enterprises operating faster and more cost-effectively than giant state enterprises. But this successful experiment is doomed to end in peacetime. Preserving the ecosystem of small defense businesses would mean radically restructuring the entire industry's management — and management revolutions do not happen at a time of shrinking budgets. It's far easier to return to the tried-and-tested model of big factories, big contracts and big kickbacks.

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Before 2022, the Russian economy combined the export of natural resources with relatively stable civilian industries. The Russian auto industry, for example, produced over 1.7 million vehicles per year, including through partnerships with global car manufacturers, while Russian IT and pharmaceuticals were integrated into international supply chains.

Military spending did not exceed 3–4% of GDP, leaving room for investment in infrastructure. The manufacturing base, though largely dependent on imported technology and components, retained the capacity for reasonable modernization. Enterprises were in the process of resuming normal production following the pandemic and were making global plans.

After 2022, the structure of the Russian economy changed dramatically. The budget became the main source of demand. Military spending rose to 6–8% of GDP and began to account for up to 40 percent of the budget, creating a war rent effect. That in turn fueled inflation, as military demand collided with limited production capacity and a shortage of imports.

To curb price growth, the central bank has now kept the interest rate in double digits for over a year. To compensate for lost revenues, in addition to the income tax hikes for individuals and businesses imposed in 2024, quasi-taxes are actively being used, such as export duties, windfall taxes, and growing fines and penalties. Another option being considered by the government is raising the VAT rate.

In this configuration, a painless return to the civilian model is impossible: no amount of fortune can override the unchanging laws of economics. Demobilization and the end of the war will require a large-scale restructuring of demand, the release of resources from the defense sector, the redistribution of a labor force depleted by losses and emigration, and the search for new sources of hard currency. Such a reversal will inevitably lead to a decrease in GDP, given that the entire structure of the economy revolves around military orders. In other words, it will lead to yet another economic crisis — the fifth in the quarter-century of Putin's reign.

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