Germany's coalition government collapsed in November due to budget disagreements. The February 2025 elections reshaped the Bundestag, making future constitutional amendments difficult. Before the transition, the outgoing Bundestag is pushing a €1 trillion defense and infrastructure package, exempt from the national debt brake. However, concerns over higher interest rates and weakened incentives for structural reforms persist, with final approval still pending.

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When Germany's coalition government of Social Democrats, the Greens and the Free Democrats collapsed in November last year, the primary cause was deep disagreements over the budget. The positions of the three parties were too far apart, making the necessary prioritization impossible.

At the start, the coalition tried to reconcile the financing needs of the green transition and the growing burden on the social security system with the promise not to raise taxes, all while adhering to the national debt brake. To achieve this, they reallocated 60 billion euros in unused Covid-19 funds to a special fund for energy transition and climate protection. This maneuver alleviated budgetary pressure and allowed the three parties to balance their political interests without painful compromises—all while maintaining compliance with the national debt brake enshrined in the German Constitution. However, in November 2023, the Constitutional Court ruled this shift of funds to be void. One year later, the resulting financial strain proved too great for the government to withstand.

Germany's political crisis coincided almost to the day with Donald Trump's victory in the U.S. presidential election. The widespread expectation that this would mark a rupture in the long-standing geopolitical certainties proved to be more than right. The angry spat between Donald Trump and Volodymyr Zelenskyy in the Oval Office made it clear to all that the geopolitical realities of the past decades would no longer be the same. More specifically, Europe was now forced to accept a much greater responsibility for its own security, while Ukraine's fate became even more dependent on European commitment, including a strong and determined German role.

For the last three decades, Germany placed little focus on defense. Beginning in the early 1990s, military spending was reduced to below 2% of GDP. This allowed Germany to reap benefits of the "peace dividend" and redirect funds toward other priorities—most notably, expanding the welfare state. Even Russia's annexation of Crimea in 2014 did not change this. However, the Russian attack of Ukraine in 2022 finally served as a wake-up call. In response, the government, together with the Conservatives – the largest opposition party at the time - agreed to amend the Constitution. This paved the way for a 100 billion special fund, exempt from the debt brake's credit ceiling, to be spent on strengthening the German armed forces. In 2024, for the first time since the early 1990s, German defense spending exceeded the NATO's 2% of GDP requirement, even if only slightly. However, it has become quickly clear that the special fund will not be enough – especially as it is set to be exhausted by 2027, if not sooner.

The parliamentary elections in February 2025 reshaped the Bundestag. The Conservatives emerged as winner, while the former coalition partners suffered heavy losses. The Free Democrats were hit the hardest and failed to be part of the new Bundestag. Meanwhile, the hard-right Alterative for Germany finished in second place, and together with the Left Party, now controls more than one-third of the seats. As a result, constitutional amendments, which require a two-thirds majority, will be far more difficult to pass in the future. This poses a particular challenge for establishing additional special funds for defense spending, as both the Alternative for Germany and the Left are firmly opposed.

However, the newly elected Bundestag has yet to convene; meaning the outgoing Bundestag - with its previous distribution of seats - is still in place. Seizing this opportunity, the likely future governing partners, the Conservatives and the Social Democrats, have decided to push through propose a huge defense and infrastructure package before the transition takes place. The proposal consists of several ley components:

1) Exempting defense spendings above 1% of GDP from the national debt brake: This provision theoretically allows unlimited borrowing for external security, ensuring that any potential increase in NATO's spending requirement would also be covered.
2) A 500-billion-euro special Infrastructure fund, also exempted from the debt brake: Of the total amount, 20% are allocated to the federal states, while another 20% go into the Climate and Transformation Fund, which finances projects such as the expansion of the energy infrastructure, including transmission grids. To prevent a mere reallocation of existing infrastructure spending from the core budget, the special fund can only be used for additional investments.

This is complemented by a loosening of the borrowing rules for Germany's sixteen Länder. The Länder, which previously had to maintain a structurally balanced budget, will now be allowed to borrow up to 0.35% of GDP. The details will be determined by the Länder. It is fair to say that this part of the package, in addition to removing an imbalance between the borrowing capacity of the federal government and the Länder, is also designed to secure the approval of the Bundesrat, Germany's upper house, which represents the Länder.

The Greens, whose support is essential for securing the required two-third majority in the Bundestag, strongly pushed for greater consideration of green issues. Additionally, an expert commission will be established to propose long-term reforms to Germany's debt regulations.

Overall, the agreement paves the way for up to 1.7 trillion euro in defense and infrastructure spending over the next decade – a sum that some argue is justified given the scale of the challenges ahead. In the best-case scenario, the funds will lead to more growth with spill-overs on its European neighbors and create synergies at the European level in terms of deeper military integration. However, the plan is not without controversy, particularly the additional funds allocated for infrastructure investments.

A higher debt level will quite likely lead to higher interest rates, not just for Germany but also for other European countries, particularly highly indebted ones such as Italy and France. This has already been witnessed immediately after the plans were announced. Rising interest payments will consume a growing share of Germany's future budgets. Also, Germany's role as a stability anchor within the European Union may be weakened.

Moreover, the increased debt burden risks very likely violating the recently reformed European fiscal framework undermining the credibility of the new framework from the outset. Attempts to reopen the debate on fiscal rules, including the Maastricht criteria, may be a short-term reflex, but a stable Europe requires sustainable fiscal policies in the member states, and this is difficult to achieve without rules – however they are designed - to limit unsustainable spending.

It also represents a major financial burden for future generations, who will already face significant demographic challenges. While it can be argued that a huge effort is now needed to restore the Armed Forces to an effective and deterrent power and that this requires extra money from debt financing, this should not divert attention from the adjustments to the core budgets that will be needed in the medium term. Core responsibilities, such as defense and most infrastructure, should be financed within the core budget and thus for a large part by present generations rather than through debt-financed special funds. This is all the more true as the present generation has reduced defense spending, enjoying the peace dividend, and has also neglected infrastructure investment for the last decades.

The biggest concern is that the availability of higher debt financing could reduce pressure for essential structural reforms, such as cutting red tape, scaling back the welfare state, and implementing necessary economic adjustments. Investing in the economy, in growth-enhancing projects and in R&D activities, best in a joint European effort, requires above all an institutional stetting that does not burden new ideas with rules and regulations, but provides an attractive framework, such as a well-functioning capital market and an innovation-inducive tax system.

Time is running out. The new Bundestag will convene on March 25, and despite numerous concessions, the outcome remains uncertain. Although the package has been passed by the Bundestag, it still needs a two-thirds majority in the Bundesrat. There is noticeable opposition coming from some Länder. The days ahead could still bring surprises.