

New German government – where to find the money?

The new federal government will significantly increase spending on defense in the coming years, which would widen the already considerable hole in financial planning. As the emerging new coalition of CDU/CSU and SPD will not have a 2/3 majority in the Bundestag, even with the support of the Greens, it would have to rely on the support of the Left Party to set up new special funds or relax the debt brake, although this is likely to come at a high political price. We are discussing various scenarios as to how this problem could be tackled.

Defense spending will have to increase ...

The dispute over the federal budget was the trigger for the break-up of the former coalition. The SPD, Greens and FDP were unable to agree on how the hole in the federal budget, which was estimated at up to 26 billion euros, should ultimately be closed. The new federal government will now have to tackle this problem. This will be made more difficult by the fact that the federal government will probably have to significantly increase defense spending again in the coming years. It may not end up increasing to 5% of GDP, the number US President Trump has called for. But even the 3.5% being discussed in NATO circles and in Germany would represent a significant increase on the 2% achieved last year, especially as the special fund set up after the start of the war in Ukraine is likely to be used up by 2028, meaning that the portion of defense spending previously financed in this way would also have to be provided from another source. Without a new special fund, the “normal” defense budget would have to comprise around 150 billion euros each year, almost 100 billion euros more than at present [1].

... over the coming years

However, this additional expenditure will not be incurred immediately. On the one hand, the expenditure can initially still be partially financed via the special fund. Secondly, new NATO requirements would probably only be implemented in stages. The fact that expensive equipment such as tanks, aircraft and ships can only be delivered with a considerable delay, meaning that corresponding investments could only be realized in a few years' time, speaks for this. This is also shown by the outflows to date from the special fund for the Bundeswehr, which was set up in 2022 and from which only 8½ billion euros (out of a total of 100 billion euros available) were spent in 2023. This means that the additional expenditure from the federal budget this year is likely to be negligible

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and will amount to a low double-digit billion amount at best in the coming year, before increasing significantly from 2028 in particular.

How can this be financed?

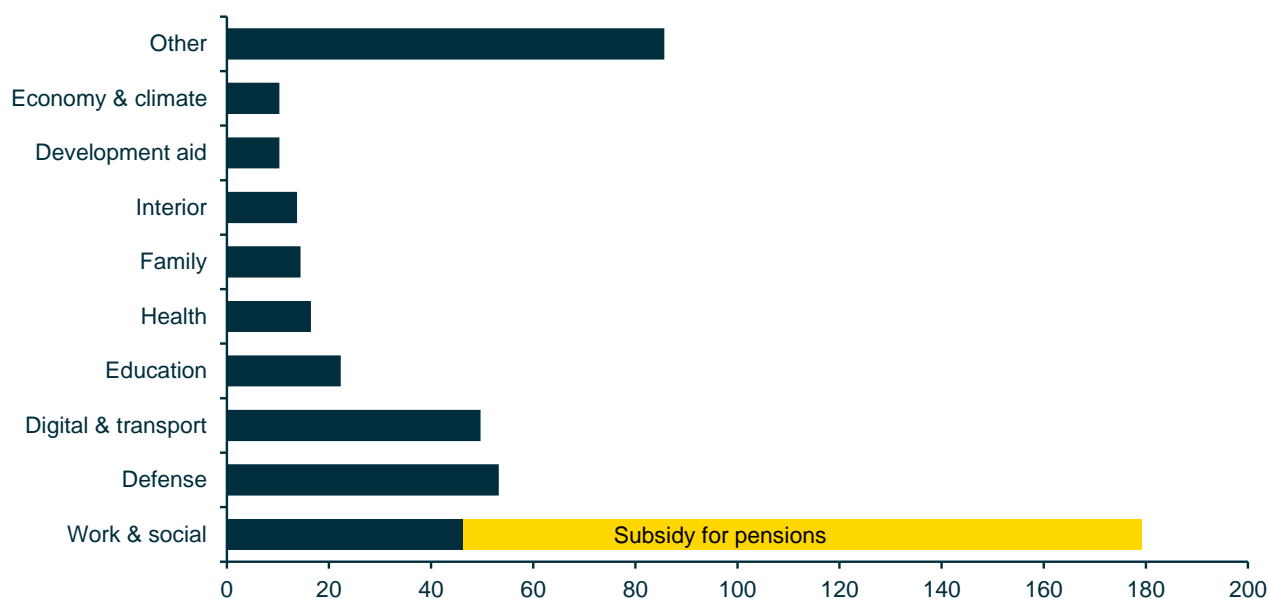
There are various options for financing this expenditure, at least in theory:

(1) Via higher taxes and savings elsewhere

Last week - i.e. shortly before the election - the discussion about an increase in VAT came up when the likely future Chancellor Friedrich Merz did not want to categorically rule it out in a television debate. Some people were reminded of the 2005 federal elections, when the SPD had categorically rejected a 2 percentage point increase in the VAT rate demanded by the CDU/CSU during the election campaign, but the parties agreed on a 3 percentage point increase after the election. A one-point increase in the standard VAT rate (currently 19%) currently generates around EUR 16 billion for the state. Even if only around half of this would go to the federal government, this could at least help to reduce the deficit this year and next. The same applies to reductions in expenditure, with the CDU and CSU targeting expenditure in the social sector in particular, which is one of the largest items in the federal budget even without pension insurance subsidies (Chart 1).

Chart 1 - German federal budget

Preliminary federal budget for 2025 (without debt service), outlays in billion euros



Source: BMF, Commerzbank Research

Even if these measures could be passed in the Bundestag with the normal government majority, they would still face a number of obstacles. For example, the SPD would not only oppose savings in the social sector, but also higher VAT, as the latter is considered a tax that disproportionately burdens lower incomes. There would probably also be resistance from the CDU and CSU, as they had promised in the election campaign not to raise taxes. Last but not least, the Bundesrat would have to agree, where the higher VAT could be blocked by the Greens, the Left Party and the BSW.

(2) A renewed suspension of the debt brake

The specific reason for the break-up of the traffic light coalition was the refusal of the then Finance Minister Lindner to suspend the debt brake again after the Bundestag had already decided to do so for previous years. The coalition could now make up for this. Various reasons could be given for this: either - as planned by Chancellor Scholz at the time - the expenditure to support Ukraine, which he put at around 15 billion euros for the whole of 2024, or the demands from the US for additional defense spending.

The advantage of this option for the government would be that it could decide on this with the absolute majority of MPs in the Bundestag, which the new coalition would at least nominally have. However, this would only help it in the long term if it were to



suspend the debt brake for several years, in which case it would run the risk of violating the spirit of the regulation and thus calling the Federal Constitutional Court into action.

(3) A new special fund for the Bundeswehr

Another option could be the expansion of the existing special fund for the Bundeswehr or the establishment of a new special fund for which additional debt could be taken on without this being counted towards the debt brake. The advantage for the new government would be that the additional defense spending could be financed without cuts elsewhere and without tax increases, and the debt brake would not be touched, at least nominally. The latter would be a plus point for the CDU/CSU, as they promised in their election manifesto to “stick to” the debt brake. Until the election, we had therefore considered this option to be the most likely. However, a new special fund whose debt is not to be counted towards the debt brake can only be established through an amendment to the Basic Law, which would require a $\frac{2}{3}$ majority in the Bundestag and thus the approval of the Greens as well as votes from the Left Party. However, the leader of the Left Party already declared on the evening of the election that his party would not agree to additional funding for the Bundeswehr.

(4) A loosening/abolition of the debt brake

The Left Party is likely to be more open to a general relaxation of the debt brake or even its complete abolition. Various options are conceivable here: From an increase in the structural deficit, which currently amounts to 0.35% of gross domestic product and is limited to the federal government, to the exclusion of (net) investments by the state, to the complete abolition of the debt brake. Excluding investments would also increase the scope for defense spending, as expenditure on weapons systems is also counted as an investment in the national accounts.

One advantage of this variant from the new government’s perspective would be that the regulations for the federal states could also be relaxed – currently, they have to present a structurally balanced budget – and the approval of the Bundesrat could therefore be secured. However, it is questionable whether the Left Party would be satisfied with a certain relaxation of the debt brake or whether it would demand its complete abolition. The latter is likely to meet with resistance from the CDU and CSU in particular, meaning that no agreement could be reached here.

(5) Outgoing Bundestag decides on new special funds or relaxation of the debt brake

During the election campaign, the Greens’ candidate for chancellor, Robert Habeck, had already called for the outgoing Bundestag to pass a reform of the debt brake or a new special fund so that this could not be blocked by the approval of parties on the left and right of the political spectrum. The Greens have renewed this demand today, and Friedrich Merz at least did not rule it out at his press conference today.

In fact, the old Bundestag will remain in office until the new parliament is constituted, which must take place no later than 30 days after the election, i.e. on March 25. Until then, it can still make all decisions. However, this option has so far only been used for issues such as the extension of Bundeswehr deployments abroad, which would probably have received a majority in the new Bundestag. This would be different this time. Perhaps this is why both the current Minister of Finance, Jörg Kukies, and CDU politicians such as parliamentary group leader Frei have expressed skepticism about such an ad hoc measure.

Is the new government playing for time?

From today’s perspective, it is difficult to predict which of these options – or which combination of them – the new government will choose. If it does not want to have the old Bundestag decide on changes, it could initially play for time. For example, it could try



to use a combination of savings and a suspension of the debt brake for Ukraine aid to finance the rather limited additional defense spending this year and next and to close the existing hole in the federal budget.

[1] In addition, there are other additional expenditures demanded by the future coalition partners in their election programs, such as greater investment in infrastructure. However, these wishes will probably have to take a back seat to the goal of strengthening the Bundeswehr and fulfilling the new NATO requirements. ([back to text](#))



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