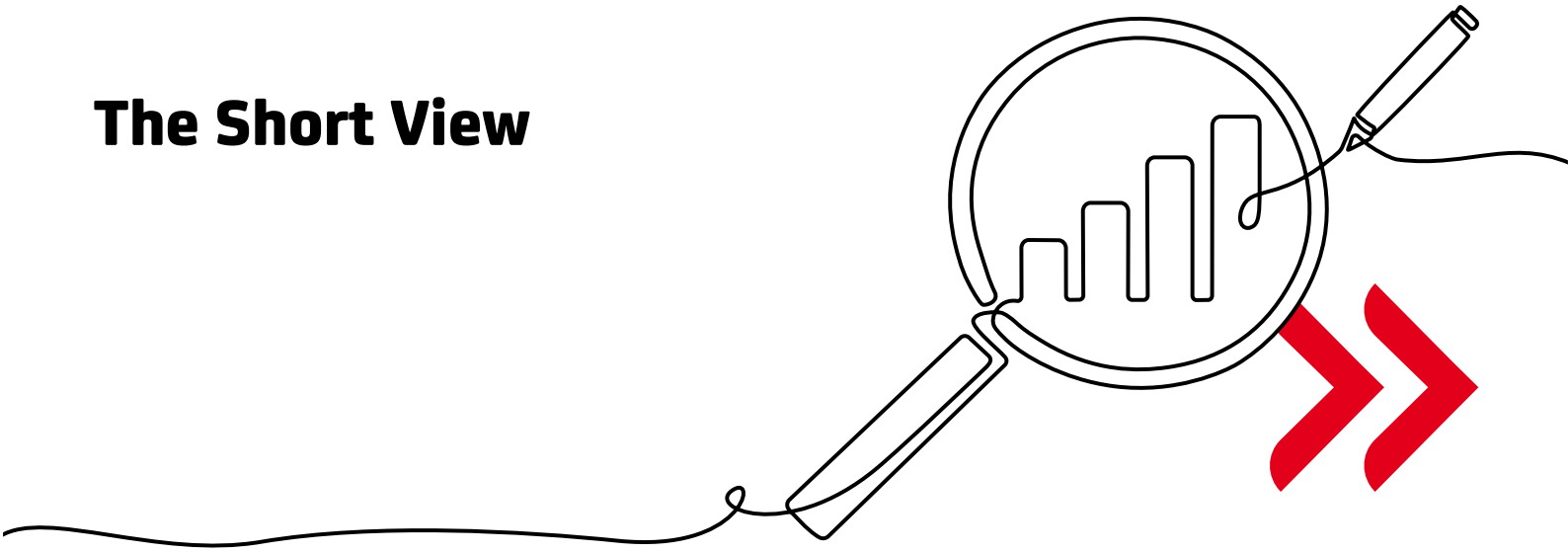
The Investment Institute
by UniCredit

The Short View



The Short View offers insights on key macro and market stories and is designed to promote discussion and debate.

Italy: impact of 2027 budget plan on fiscal outlook

3 November 2026

The 2027 budget combines targeted support for households and investment in defence and energy security with cautious use of the flexibility available under the national escape clause. While this flexibility will temporarily slow fiscal consolidation and interest expenditure is projected to rise, public debt dynamics remain manageable and financing needs are set to improve materially beyond 2027, supporting a constructive medium-term sovereign outlook.

1. Italy enters the 2027 budget cycle from a strengthened institutional and fiscal position, benefiting from a more predictable medium-term fiscal framework and a return to a primary surplus. The budget bill has now been submitted to parliament for examination. The overall size of the 2027 package amounts to about EUR 26bn, with a similarly sized package planned for 2028.
2. The budget-deficit target is 3.4% of GDP in 2027 and 3.2% in 2028, declining to 2.3% in 2029. While defence and energy-security spending enabled by the national escape clause will temporarily slow fiscal consolidation, it does not materially alter the medium-term deficit outlook. Limited fiscal space for further interventions, especially to support those most affected by higher living costs, underscores the importance of careful policy targeting.
3. Higher government bond yields increase debt-servicing costs, but public debt dynamics remain manageable, with a stronger projected primary surplus and the fading impact of past tax incentives supporting a gradual decline in the public debt-to-GDP ratio towards 137%.

Assessing Italy's fiscal outlook

The government's approval of the draft budget law marks the start of the parliamentary budget process, which must conclude with final approval before year-end. Meanwhile, the European Commission (EC) has begun its assessment of Italy's draft budgetary plan (DBP) to verify compliance with the medium-term fiscal adjustment path agreed under the revised European economic governance framework. A key step will be the publication of the EC's Autumn 2026 Economic Forecast on 17 November, which will underpin the Commission's opinions on member states' plans.

This process is attracting even greater scrutiny this year following the sharp rise in euro area government bond yields. At the centre of the debate are two closely related issues: Italy's ability to sustain growth in a challenging international environment and the resilience of its fiscal position against a backdrop of higher financing costs and continued pressure to support domestic demand. In this note, we focus on the latter and assess Italy's fiscal outlook in light of the updated macroeconomic and public finance framework presented by the government, its decision to increase spending on defence and energy security through the activation of the national escape clause (NEC) and the key features of the 2027 DBP.

Italy enters this phase in a stronger institutional position than in previous cycles. The reform of European economic governance has provided a credible medium-term anchor for fiscal adjustment, while a prudent fiscal policy has supported a gradual reduction in the budget deficit and a steady improvement in the primary balance, which has returned to a surplus of around 1% of GDP. More importantly, while attention has increasingly focused on the impact of higher government bond yields, the debate no longer appears to be centred on whether a significant fiscal consolidation is required. Rather, the key question is whether the available fiscal space can be deployed effectively to support investment and address emerging economic policy priorities.

Four key conclusions stand out in our assessment of Italy's fiscal outlook.

Rebalanced spending. Italy has gradually rebalanced public expenditure, containing current spending while preserving capital investment. Although higher inflation exerts upward pressure on current expenditure, this reallocation is expected to continue. Importantly, public investment is projected to remain above 3.5% of GDP until the end of the decade.

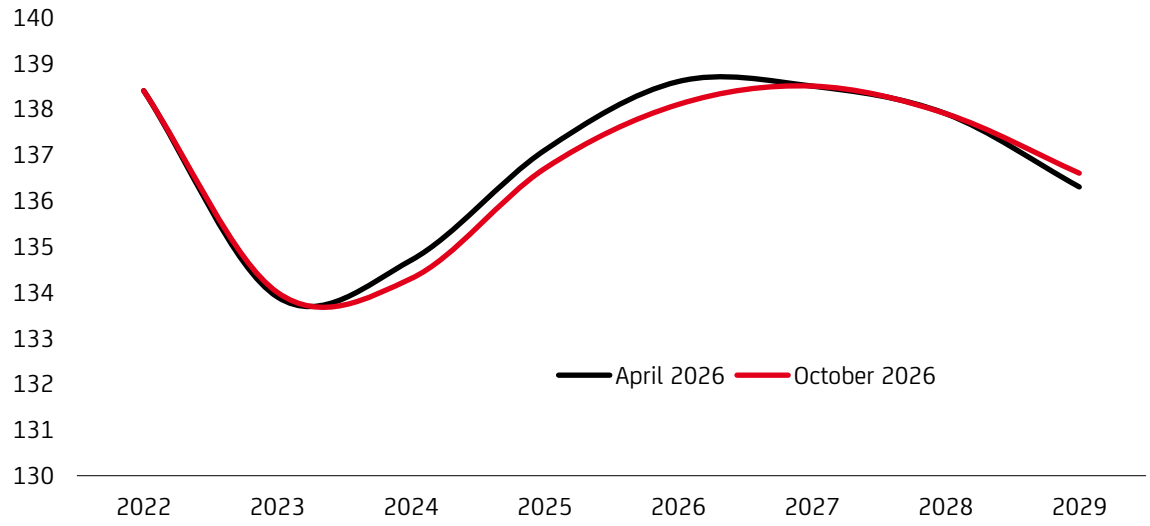
Leveraging flexibility. Under unchanged policies, Italy remains on a path of deficit reduction, with the budget deficit projected to move towards 2% of GDP by 2029. The planned use of fiscal flexibility would temporarily slow this adjustment process but would not fundamentally alter it. The key questions concern the temporary nature of these measures and their effectiveness in supporting investment and growth. We remain broadly constructive on the former. On the effectiveness of fiscal flexibility, a positive but relatively limited impact is expected, reflecting the need to balance multiple objectives, including fiscal prudence and a gradual increase in defence investment.

Interest expenditure on the rise. The most significant deterioration concerns interest expenditure, which is now expected to rise to a relatively high level by historical standards. As a result, further strengthening the primary surplus and supporting economic growth will become even more important over the coming years, given Italy's large stock of public debt. Nevertheless, we remain constructive on debt dynamics, as deviations from the debt trajectory projected in April remain limited and, at worst, the public debt-to-GDP ratio would broadly stabilise around current levels until the end of the decade.

Declining borrowing needs. A constructive message also emerges from net issuance dynamics. While Italy will still need to attract substantial investor demand in a highly competitive environment in 2027, borrowing conditions are set to improve significantly thereafter. Net issuance is expected to decline materially, suggesting that the most demanding phase of the refinancing cycle is gradually coming to an end. In our view, this reduction in funding needs remains one of the strongest arguments in support of a constructive medium-term assessment of Italy's sovereign outlook.

PUBLIC DEBT DYNAMICS LARGELY UNCHANGED DESPITE NEC AND HIGHER RATES

PUBLIC DEBT-TO-GDP RATIO: GOVERNMENT PROJECTIONS (%)



Source: Italy's Ministry of Economy and Finance, The Investment Institute by UniCredit

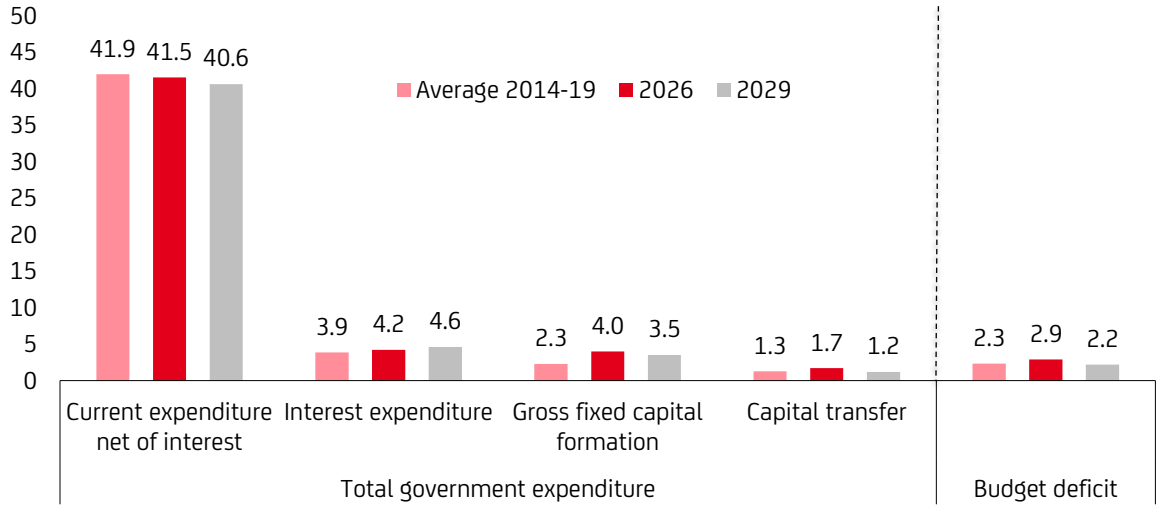
Deficit reduction interrupted, not reversed

Under unchanged policies, Italy's budget deficit would remain below 3% of GDP throughout the projection horizon and continue to decline gradually, moving closer to 2% of GDP by 2029. The most significant change relative to the April assessment concerns interest expenditure. Higher government bond yields and the impact of higher inflation on inflation-linked securities are projected to increase interest expenditure and, in turn, widen the budget deficit by around 0.1pp of GDP per year at least until 2029. As a result, interest expenditure is now forecast to rise towards 4.6% of GDP, from slightly above 4.0% currently (see chart).

At the same time, Italy continues to rebalance public expenditure by containing current spending while preserving capital spending. Although higher inflation exerts upward pressure on intermediate consumption and social benefits, the moderation in current spending is expected to continue over the remainder of the decade, with the primary current spending-to-GDP ratio moving below 41%. The reduction in capital transfers is largely driven by the phasing-out of tax incentives, including those related to the Superbonus programme, which had the largest impact between 2021 and 2023. A positive development is the commitment to maintaining public investment above 3.5% of GDP despite the expiry of the NGEU programme. In our view, preserving this reallocation of government spending remains crucial, also to foster potential growth in the longer term. Nevertheless, creating additional fiscal space will increasingly require further improvements in spending efficiency, particularly in light of growing pressures on social expenditure.

THE CHANGING COMPOSITION OF ITALY'S PUBLIC SPENDING

UNCHANGED-POLICY SCENARIO (WITHOUT NEC): GOVERNMENT EXPENDITURE, SELECTED ITEMS (% GDP)



Source: Istat, Italy's Ministry of Economy and Finance, The Investment Institute by UniCredit

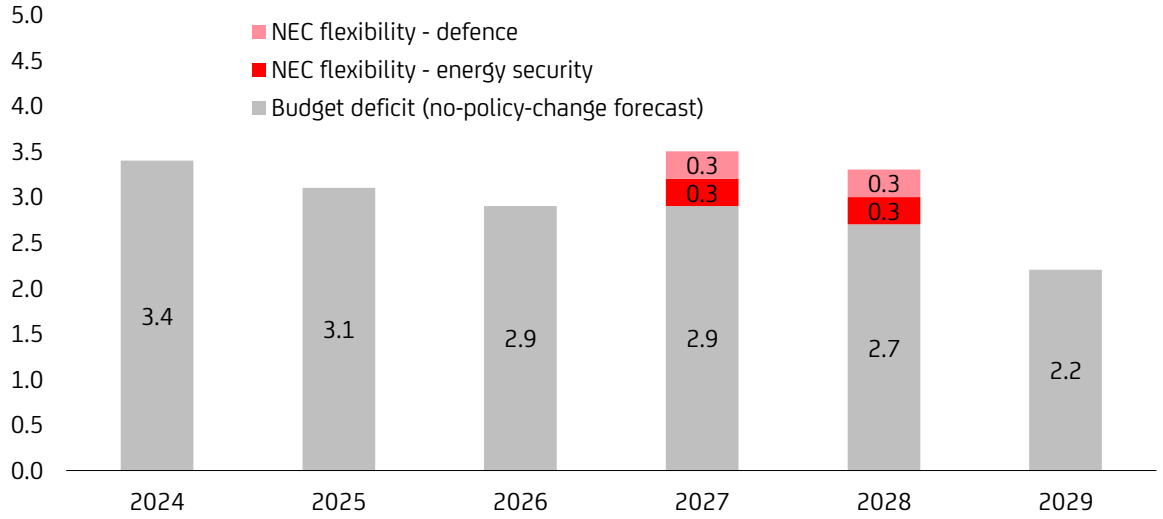
Under the government's policy scenario, the budget deficit target for 2026 has been confirmed at 2.9% of GDP, although uncertainty remains elevated given persistent geopolitical tensions and continued volatility in energy markets. For next year, the government has decided to seek activation of the NEC and make use of the flexibility available for defence expenditure and eligible energy security investment. Importantly, the amount of flexibility ultimately requested is smaller than envisaged during the summer. The government now plans to use flexibility of up to 0.3% of GDP, per year, for each policy objective in both 2027 and 2028 (see chart), compared with the possibility discussed earlier of using the full allowance of up to 1.5% of GDP to increase defence spending, particularly in 2028. The final plan reflects a more cautious approach, with the use of fiscal flexibility evenly distributed across 2027 and 2028 rather than concentrated in the latter year.

As a result, in the policy scenario, the budget-deficit target is now 3.4% of GDP in 2027 and 3.2% in 2028, declining to 2.3% in 2029. This implies a temporary deviation from the post-pandemic deficit-reduction path. Still, there is a plausible scenario under which Italy could exit the excessive deficit procedure (EDP) despite making use of fiscal flexibility. Should the 2026 deficit ultimately be reported below 3% of GDP next spring and the budget deficit remain below that threshold in 2027 and 2028 once flexibility measures are excluded, Italy would probably be able to exit the EDP next year and continue to make progress towards full compliance with the European fiscal framework. In this respect, growth in the net expenditure indicator, excluding the impact of flexibility, remains aligned with the limits recommended by the EU and set out in the medium-term fiscal structural plan. There is an ongoing discussion in Brussels on whether Italy can exit the EDP, and further clarification is likely in the EC's next assessment by the end of November.

The precise allocation of the additional fiscal flexibility will become clearer over time. Based on currently available information, some of the resources will finance new investment, while the rest is likely to take the form of capital transfers, especially energy-related incentives for businesses, and selected current expenditure items, particularly for defence spending. This helps explain the relatively modest growth impact. According to government estimates, the measures financed through fiscal flexibility should support GDP growth by about 0.2pp in 2027 and 0.1pp in 2028. These estimates also appear broadly consistent with conservative fiscal multipliers and in line with prudent macroeconomic assumptions.

BUDGET-DEFICIT TARGETS TO TEMPORARILY MOVE ABOVE 3% OF GDP

BUDGET DEFICIT WITH AND WITHOUT NEC FISCAL FLEXIBILITY (% GDP)



Source: Istat, Italy's Ministry of Economy and Finance, The Investment Institute by UniCredit
Note: Any discrepancies are due to rounding.

The implications for the fiscal-adjustment path are nevertheless important. Both the structural balance and the structural primary balance are estimated to continue to improve over the medium term, although the estimate for 2027 now incorporates a temporary easing of around 0.3pp of GDP in the structural balance, compared with a fiscal consolidation of the same amount envisaged in the April projections. Because the activation of the NEC does not increase further in 2028, fiscal consolidation is expected to resume in that year and strengthen further in 2029, when the temporary increase in expenditure begins to unwind. The key conclusion is that the medium-term fiscal adjustment path remains largely intact. Italy continues to move towards a structural deficit closer to 2.5% of GDP by the end of the decade without the need to implement sizeable fiscal tightening. Put differently, if markets were eventually to demand a faster pace of consolidation, Italy's first line of defence would simply be to relinquish part or all of the flexibility available under the NEC and return to the adjustment path already embedded in current legislation. In our view, this remains a key consideration when assessing Italy's sovereign risk in the current environment of higher yields.

Indeed, while stronger fiscal adjustment would improve fiscal metrics, it would also weigh on domestic demand, investment and ultimately economic growth. Striking the right balance remains essential. Finally, it is worth recalling that the revised EU economic governance framework includes a deficit-resilience safeguard requiring member states with headline budget deficits below 3% of GDP to continue adjusting until a structural deficit of no more than 1.5% of GDP is achieved. Italy is gradually moving in that direction, suggesting that its medium-term fiscal objectives are likely to remain broadly consistent with the requirements of the EU economic governance framework.

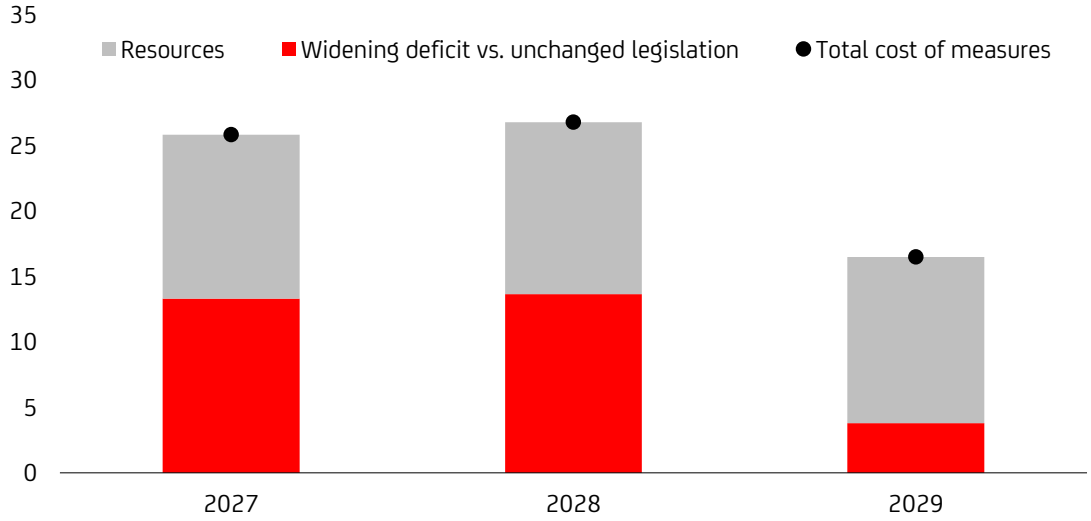
2027 budget policy: limited fiscal space, targeted priorities

Taken together, the fiscal flexibility available under the NEC effectively defines the fiscal space available for the 2027 DBP. Any additional policy initiatives therefore require offsetting measures elsewhere in the budget. This is a particularly relevant point in an election year. Political incentives would naturally favour measures aimed at strengthening electoral support and delivering on coalition commitments, but the combination of a challenging geopolitical environment, elevated government bond yields and limited fiscal space significantly constrain the ability to pursue a more expansionary policy agenda.

The overall size of the 2027 budget package amounts to about EUR 26bn, or 1.0% of GDP. Around EUR 13bn (about 0.6% of GDP) will be financed through the higher deficit allowed by activation of the NEC, resulting in a budget deficit of 3.4% of GDP compared with 2.9% under an unchanged-policy scenario. The remaining EUR 13bn must be financed through offsetting measures. A similarly sized package is currently planned for 2028.

THE OVERALL COST OF MEASURES FOR 2027 IS EUR 26BN

2027 DBP: COSTS AND RESOURCES (EUR BN)



Source: Italy's Ministry of Economy and Finance, The Investment Institute by UniCredit
Note: Any discrepancies are due to rounding.

The largest allocation is intended to protect household purchasing power and support broader social policy measures, particularly among lower-income households, young people and more vulnerable groups. Defence expenditure and measures aimed at supporting firms represent the other two major spending categories. Energy-security investment is expected to focus on the upgrading of public infrastructure, including schools, hospitals, universities and hydroelectric assets, as well as the railway network and the national road network. Measures supporting business competitiveness are expected to combine energy-cost relief with incentives aimed at strengthening energy security and accelerating the green transition. Therefore, support to the corporate sector is also likely to take the form of capital transfers and investment incentives. As such, the associated fiscal multiplier is likely to be lower than that of new investment programmes, helping to explain why the overall macroeconomic impact of the package remains relatively moderate despite its size. The budget also includes a limited number of tax-reduction measures, likely to be targeted at lower-income households and young people, as well as additional resources for health care spending, particularly to support older people.

On the financing side, more than 70% of the resources are expected to come from revenue-raising initiatives. The largest contribution is expected to come from the financial sector, primarily banks and insurance companies, with additional revenue stemming from measures targeting the gaming and energy sectors. The remaining resources will be generated through a spending review that will also affect government ministries.

The final composition of the package is likely to be shaped through the parliamentary process. However, experience over recent years suggests that this process has generally respected the overall fiscal targets outlined in the DBP. Given today's environment of elevated yields and heightened investor scrutiny, there are strong reasons to preserve this approach.

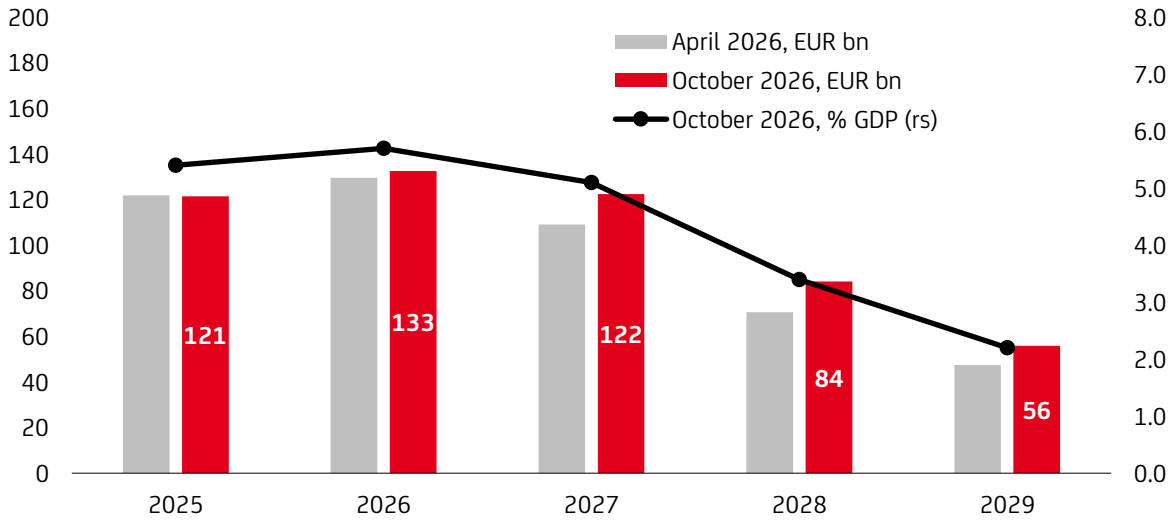
Public debt: level rather than trajectory remains the key challenge

Alongside any risk of a widening in the budget deficit during the parliamentary process, investors remain focused on the implications of the budget for net issuance and the public debt outlook. The public-sector cash deficit is now projected to reach 5.7% of GDP in 2026, equivalent to approximately EUR 133bn – around 0.1pp of GDP higher than estimated in April. This target appears broadly consistent with the evolution of the state-sector borrowing requirement so far this year and with the government's estimate of a budget deficit of 2.9% of GDP on an accrual basis. The upward revision to budget deficits in 2027 and 2028, reflecting both activation of the NEC and a less favourable outlook for inflation and interest rates, will increase borrowing requirements over the next two years, as shown in the chart below.

While this will require Italy to continue to attract substantial investor demand, the broader trend remains favourable. Starting in 2028, the delayed impact of Superbonus-related tax credits on borrowing needs is expected to fade materially. This factor has been one of the main drivers of the unusually large divergence between cash and accrual deficits observed in recent years. As a result, Italy's net issuance profile is expected to become significantly less demanding than it has been since 2023. This is an important consideration in an environment of increasingly intense competition for capital from both sovereign and private borrowers. More specifically, the cash deficit should converge towards the accrual budget deficit, which is projected to decline, leading to a meaningful reduction in financing needs over the coming years.

ITALY'S BORROWING NEEDS TO DECLINE, BUT EXCEED APRIL PROJECTIONS

PUBLIC-SECTOR CASH DEFICIT, APRIL AND OCTOBER PROJECTIONS



Source: Italy's Ministry of Economy and Finance, The Investment Institute by UniCredit

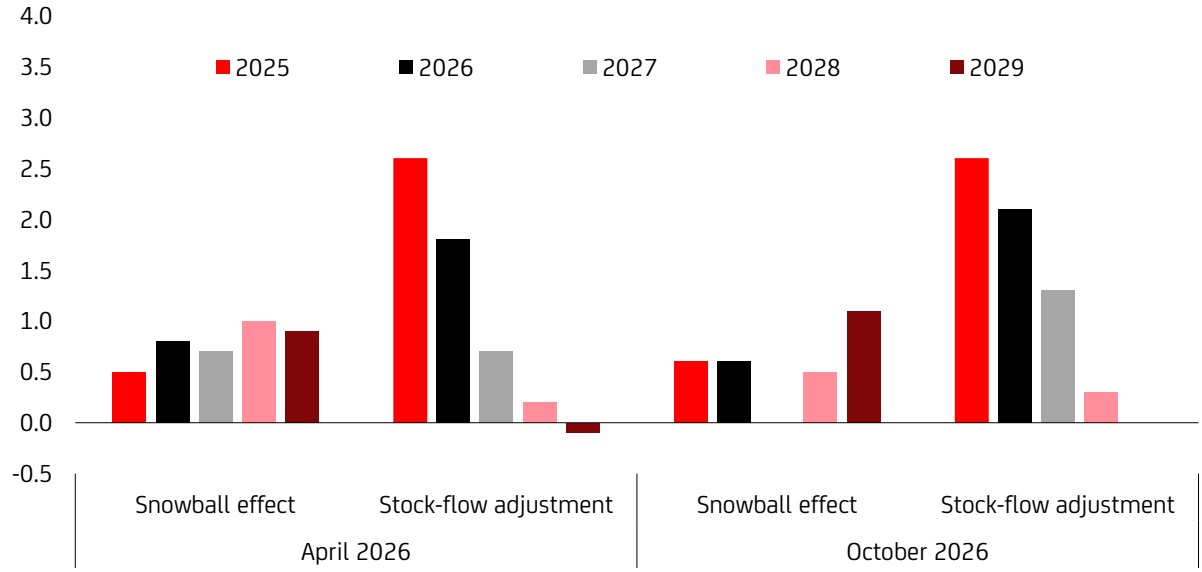
In terms of public debt, as already shown, despite higher interest rates and the activation of fiscal flexibility, changes to the projected debt path relative to the April assessment remain limited. A stronger starting position plays an important role. Following revisions to nominal GDP, particularly for 2024 and 2025, the public debt-to-GDP ratio for 2025 was lowered from 137.1% to 136.7%. The public debt ratio is now projected to reach 138.1% of GDP this year, an increase of around 1.5pp, broadly in line with the April projections, although the level remains below the 138.6% envisaged previously.

The public debt ratio is expected to peak at around 138.5% in 2027. Rather than stabilising as previously expected, it is now projected to increase by a further 0.4pp of GDP. One of the main reasons remains the stock-flow adjustment, largely reflecting the continued legacy effects of tax credits associated with housing-renovation schemes. This component alone is expected to increase the ratio by 1.3pp of GDP in 2027, compared with 0.7pp estimated in April (see chart). A second important factor is the less supportive primary balance. The primary surplus is now projected to decline to around 0.9% of GDP as a consequence of the temporary fiscal easing associated with the NEC.

However, these factors are partly offset by a more favourable relationship between growth and interest rates. While higher yields contribute to a gradual increase in interest expenditure, stronger real GDP growth and, above all, higher GDP deflator growth improve the snowball effect in 2027 and 2028. The snowball effect becomes slightly less favourable in 2029 as the cumulative impact of higher borrowing costs progressively feeds through to interest expenditure. Even so, this deterioration remains relatively modest.

ITALY'S PUBLIC DEBT DYNAMIC: OFFSETTING EFFECTS OF KEY DRIVERS

CONTRIBUTION TO CHANGES IN THE PUBLIC DEBT-TO-GDP RATIO (PP OF GDP)



Source: Italy's Ministry of Economy and Finance, The Investment Institute by UniCredit
Note: The snowball effect captures the contribution of the interest rate-growth differential to debt dynamics, reflecting the combined impact of interest expenditure, real GDP and the GDP deflator. The stock-flow adjustment captures changes in the government's balance sheet that affect gross government debt but not the budget balance.

The medium-term public debt outlook remains constructive. The stock-flow adjustment is estimated to fade to around zero by 2029. Together with a substantial improvement in the primary surplus, which is projected to move towards 2.5% of GDP, this should place the public debt ratio back on a declining path. By the end of the forecast horizon, it is projected to be 2pp below its expected peak.

In our view, a primary surplus of around 2.5% of GDP should increasingly be regarded as the new benchmark required to ensure a sustained decline in Italy's public debt ratio. In the past, Italy was generally able to broadly stabilise its public debt with a primary surplus closer to 1.5% of GDP. Today, however, a higher debt stock, increasing interest expenditure and rising age-related spending imply more demanding fiscal requirements. This remains the key medium-term challenge for fiscal policy.

In conclusion, current projections do not materially alter the debt outlook envisaged earlier this year. Nevertheless, the country will need to maintain fiscal discipline over the medium term and continue delivering primary surpluses consistent with a gradual reduction in the public debt ratio. This objective is also embedded in the new EU economic governance framework. Under the debt-sustainability safeguard, member states with debt levels above 90% of GDP are expected to ensure an average annual reduction in the public debt-to-GDP ratio of at least 1pp over the selected adjustment period. In this respect, the gradual return of the public debt ratio to a declining trajectory remains not only desirable but ultimately necessary.

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