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Recommendation for a

COUNCIL RECOMMENDATION

**on the 2019 National Reform Programme of Portugal and delivering a Council opinion
on the 2019 Stability Programme of Portugal**

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THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Articles 121(2) and 148(4) thereof,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies¹, and in particular Article 5(2) thereof,

Having regard to Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances², and in particular Article 6(1) thereof,

Having regard to the recommendation of the European Commission,

Having regard to the resolutions of the European Parliament,

Having regard to the conclusions of the European Council,

Having regard to the opinion of the Employment Committee,

Having regard to the opinion of the Economic and Financial Committee,

Having regard to the opinion of the Social Protection Committee,

Having regard to the opinion of the Economic Policy Committee,

Whereas:

- (1) On 21 November 2018, the Commission adopted the Annual Growth Survey, marking the start of the 2019 European Semester for economic policy coordination. It took due account of the European Pillar of Social Rights, proclaimed by the European Parliament, the Council and the Commission on 17 November 2017. The priorities of the Annual Growth Survey were endorsed by the European Council on 21 March 2019. On 21 November 2018, on the basis of Regulation (EU) No 1176/2011, the Commission also adopted the Alert Mechanism Report, in which it identified Portugal as one of the Member States for which an in-depth review would be carried out. On the same date, the Commission also adopted a recommendation for a Council recommendation on the economic policy of the euro area, which was endorsed by the European Council on 21 March 2019. On 9 April 2019, the Council adopted the

¹ OJ L 209, 2.8.1997, p. 1.

² OJ L 306, 23.11.2011, p. 25.

recommendation on the economic policy of the euro area ('Recommendation for the euro area').

- (2) As a Member State whose currency is the euro and in view of the close interlinkages between the economies in the economic and monetary union, Portugal should ensure the full and timely implementation of the Recommendation for the euro area, as reflected in recommendations (1) to (4) below. In particular, focusing economic policy related to investment in the specified areas and using windfall gains to reduce public debt will help address the second euro area recommendation as regards supporting investment and rebuilding buffers. Measures to reduce labour market segmentation, improve skills and effectiveness of social safety net will help address the third euro area recommendation as regards functioning of the labour market and social protection systems. Measures to reduce regulatory burden will help address the first euro area recommendation as regards business environment and productivity improvements for euro area rebalancing. Increasing the efficiency of insolvency and recovery proceedings will help address the fourth euro area recommendation as regards the reduction of non-performing loans.
- (3) The 2019 country report for Portugal³ was published on 27 February 2019. It assessed Portugal's progress in addressing the country-specific recommendations adopted by the Council on 13 July 2018, the follow-up given to the recommendations adopted in previous years and Portugal's progress towards its national Europe 2020 targets. It also included an in-depth review under Article 5 of Regulation (EU) No 1176/2011, the results of which were also published on 27 February 2019⁴. The Commission's analysis led it to conclude that Portugal is experiencing macroeconomic imbalances. In particular, the large stocks of net external liabilities, private and public debt, and a high share of non-performing loans constitute vulnerabilities in a context of low productivity growth. Policy gaps remain, notably in terms of implementing the measures outlined to reduce non-performing loans and to improve the business environment. The adoption and implementation of several reform plans, including fiscal-structural reforms to strengthen the sustainability of public finances, will need to be monitored.
- (4) On 30 April 2019, Portugal submitted its 2019 National Reform Programme and its 2019 Stability Programme. In order to take account of their interlinkages, the two programmes have been assessed at the same time.
- (5) Relevant country-specific recommendations have been addressed in the programming of the European Structural and Investment Funds ('ESI Funds') for the 2014-2020 period. As provided for in Article 23 of Regulation (EU) No 1303/2013 of the European Parliament and of the Council⁵, where it is necessary to support the implementation of relevant Council recommendations, the Commission may request a Member State to review and propose amendments to its Partnership Agreement and relevant programmes. The Commission has provided further details on how it would

³ SWD(2019) 1021 final.

⁴ COM(2019) 150 final.

⁵ Regulation (EU) No 1303/2013 of the European Parliament and of the Council of 17 December 2013 laying down common provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund, the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund and laying down general provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund and the European Maritime and Fisheries Fund and repealing Council Regulation (EC) No 1083/2006 (OJ L 347, 20.12.2013, p. 320).

make use of that provision in guidelines on the application of the measures linking the effectiveness of the ESI Funds to sound economic governance⁶.

- (6) Portugal is currently in the preventive arm of the Stability and Growth Pact and subject to the transitional debt rule. In its 2019 Stability Programme, Portugal plans to attain a headline deficit of 0.2% of GDP in 2019, a surplus of 0.3% of GDP in 2020 and a further improvement to a surplus of 0.7% of GDP by 2022. Those plans only partially include the potential deficit-increasing impact of bank support measures from 2020 onwards. Based on the recalculated structural balance, the medium-term budgetary objective – which has been changed from a structural surplus of 0.25% of GDP in 2019 to a balanced budgetary position in structural terms as of 2020 – is planned to be achieved in 2020. The 2019 Stability Programme projects the general government debt-to-GDP ratio to reach 118.6% in 2019 and 115.2% in 2020, which would then be at 103.7% in 2022. The macroeconomic scenario underpinning those budgetary projections is plausible for 2019 and 2020 and favourable for the following years. At the same time, the measures needed to support the planned deficit targets from 2019 onwards have not been sufficiently specified.
- (7) The 2019 Stability Programme does not provide information on the budgetary impact of the exceptional expenditure in relation to preventive measures to protect the national territory against wildfires, following the large-scale wildfires that occurred in 2017. However, in a letter dated 9 May 2019, the Portuguese authorities have provided adequate evidence of the scope and nature of these additional budgetary costs. In particular, the letter indicates that the 2018 budget implementation comprises exceptional expenditure amounting to about 0.04% of GDP in relation to preventive measures to protect the national territory against wildfires. The letter of 9 May 2019 sets out expenditure related to the emergency management, classified as one-off measures, and expenditure related to prevention. Due to the integrated nature of these expenditures and due to the direct link with the large-scale wildfires of 2017, the specific treatment of wildfire-prevention expenditure could be considered in application of the ‘unusual event clause’. According to the Commission, the eligible additional expenditure in 2018 amounts to 0.04% of GDP for preventive measures. The provisions set out in Articles 5(1) and 6(3) of Regulation (EC) No 1466/97 cater for this additional expenditure, in that the unprecedented large-scale wildfires are considered unusual events, their impact on Portugal's public finances is significant and sustainability would not be compromised by allowing for a temporary deviation from the adjustment path towards the medium-term budgetary objective. Therefore, the required adjustment towards the medium-term budgetary objective for 2018 has been reduced to take into account these additional costs.
- (8) On 13 July 2018, the Council recommended Portugal to ensure that the nominal growth rate of net primary government expenditure⁷ does not exceed 0.7% in 2019, corresponding to an annual structural adjustment of 0.6% of GDP. Based on the Commission 2019 spring forecast, there is a risk of a significant deviation from that recommended adjustment in 2019.

⁶ COM(2014) 494 final.

⁷ Net primary government expenditure comprises total government expenditure excluding interest expenditure, expenditure on Union programmes fully matched by Union funds revenue and non-discretionary changes in unemployment benefit expenditure. Nationally financed gross fixed capital formation is smoothed over a 4-year period. Discretionary revenue measures or revenue increases mandated by law are factored in. One-off measures on both the revenue and expenditure sides are netted out.

- (9) In 2020, Portugal should achieve its medium-term budgetary objective, taking into account the allowance linked to unusual events for which a temporary deviation is granted. Based on the Commission 2019 spring forecast, this is consistent with a maximum nominal growth rate of net primary government expenditure of 1.5%, corresponding to an annual structural adjustment of 0.5% of GDP. Based on the Commission 2019 spring forecast under unchanged policies, there is a risk of a significant deviation from that requirement in 2020. At the same time, Portugal is forecast to comply with the transitional debt rule in 2019, as a result of the allowed annual deviation of 0.25%, but is *prima facie* not projected to comply with the debt rule in 2020. Overall, the Council is of the opinion that the necessary measures should be taken as of 2019 to comply with the provisions of the Stability and Growth Pact. The use of any windfall gains to further reduce the general government debt ratio would be important.
- (10) Strengthening Portugal's fiscal sustainability hinges on continued growth-friendly fiscal consolidation, there is, however, scope to improve the quality of public finances and to make expenditure more growth-friendly by supporting investment (see below). Despite having increased in 2018, public investment has remained very low compared with EU standards and consistently below the government's own targets. Enforcing the commitment control law, implementing the budget framework law in a strict and timely manner and continuing rationalisation efforts remain crucial to improving expenditure control and making spending more efficient. Recent stand-alone bottom-up expenditure reviews in specific sectors have led to overall limited efficiency savings. To achieve higher efficiency gains, expenditure reviews should instead become a regular feature of Portugal's budget framework. Moreover, deeper reforms to increase efficiency and a clear top-down focus on containing overall expenditure, are still needed. This should largely build on a strategy for public administration reform aimed at better aligning public employment levels with the need to deliver effective services, which includes supporting staff reallocation and retraining, and promoting individual performance and the attractiveness of the public service for highly skilled staff.
- (11) Portugal's public finances are under continuous pressure from adverse demographic trends, notably the ageing population, with negative consequences, especially for the sustainability of the pension and health systems. While the past reforms improved the long-term sustainability of the pension system, ongoing special pension increases and early retirement reforms have entailed further discretionary increases in pension spending on top of the underlying upward trend driven by ageing. The overall sustainability of the pension system may be at risk if there are no adequate compensatory measures. In the health sector, cost-effectiveness continued to be promoted in 2018, including through an increased reliance on centralised purchasing and a greater use of generics and biosimilars. At the same time, persistently high hospital arrears result from inadequate budgetary planning and implementation and weaknesses in accounting control and managerial practices. Temporary decreases in hospital arrears in 2018 have essentially resulted from sizeable extraordinary clearance measures. A new programme for 2019 aims to structurally address hospital arrears by introducing a new governance model for public hospitals, in combination with a substantial increase in their annual budgets. This programme's ability to slow down the accumulation of hospital arrears in the short term and thereby lead to a structural reduction of their overall stock crucially hinges on its timely and effective implementation.

- (12) Increasing the net incomes of state-owned enterprises and reducing their debt would help to make Portuguese public finances more sustainable. The authorities are planning the net incomes of state-owned enterprises as a whole to approach a level close to balance in 2019, which means a delay compared with earlier announcements aiming at a similar outcome already in 2018. Moreover, measures to ensure adherence to initial activity plans and efforts to ensure more timely, transparent and comprehensive monitoring were delayed and have been slow in translating into corrective action where needed. In particular, a sufficient level of ex-ante transparency regarding the financing of state-owned enterprises through recapitalisations and loans has not been ensured.
- (13) Despite the ongoing implementation of some measures to decrease labour market segmentation, such as the reinforcement of the labour inspectorate and the launch of an integration programme for precarious workers in the public service, the proportion of temporary workers in Portugal still exceeds the EU average. More specific measures agreed between the government, employers and employees representatives aimed at further reducing labour market segmentation and precariousness and promoting collective bargaining are still to be approved by Parliament and materialise into concrete legislation.
- (14) Improved labour market conditions have resulted in fewer people at risk of poverty or social exclusion. Despite this improvement, income inequality remains high and the impact of social transfers on poverty reduction is limited. While income inequality in Portugal is decreasing, it still remains significantly higher than the EU average. The adequacy of the minimum income scheme is among the lowest in the EU providing incomes of only 40% of the national poverty threshold. Unless reviewed, the low effectiveness of social transfers could be severely tested in case of a future economic slowdown with the vulnerable people particularly affected.
- (15) The low qualification level of workers is an obstacle to investment and productivity growth. About 50% of the population aged 25-64 has low educational attainment levels, well above the Union average of 22% in 2018. The low availability of skilled staff is an important obstacle to investment that companies report. For adult learning in particular, there is scope to further engage the low qualified (whose participation in learning is below the Union average) and to extend targeted public incentives to small and medium-sized enterprises to train their staff. Digital skills are a particular challenge, with 50% of the Portuguese population lacking basic digital skills compared to a Union average of 43%. Investment in education and training, including infrastructure, is key to improving employability and social mobility.
- (16) Measures to increase enrolment in higher education, such as a significant increase in scholarships, are ongoing as part of efforts to increase the number of higher education graduates. Among 30-34 year olds in Portugal, 33.5% have completed higher education, which is still below the EU average of 40.7%. The persistency of these low shares, in particular for graduates in information and communication technologies, the natural sciences, mathematics and statistics may have negative consequences for Portugal's productivity growth and capacity to innovate. While the government is trying to address the issue by increasing the number of study places in these fields and implementing a review of the higher education system, more efforts are needed.
- (17) The ratio of non-performing loans in the financial system remains relatively high at 11.3%. Nevertheless, most banks made substantial progress in meeting the targets to reduce non-performing loans. The secondary market for distressed assets gained

momentum while banks also accelerated write-offs and non-performing credits cures. The breakdown of non-performing loans continues to show a steady high proportion (65%) of corporate non-performing loans. Over the past few years, the authorities have implemented a number of legal and institutional reforms for insolvency and debt enforcement. However, the average length of insolvency proceedings remains persistently high as does the number of pending court cases. The legal and judicial frameworks are heavily affecting the recovery process and the prospects for efficient repossession of collateral. The long average duration of recovery proceedings weighs on the prices applied by the market to non-performing assets.

- (18) Reforms aimed at administrative simplification have been largely absent, as efforts in this area are mostly limited to across-the-board implementation of dematerialisation of procedures and the once-only principle. Priority should be given in particular to limiting the number of documents that have to be submitted and either replacing authorisation schemes with simple declarations of compliance with applicable conditions or, for the more sensitive sectors, simplifying authorisations by reducing decision times and adopting tacit approval. The streamlining of procedures for specific sectors is still lacking. Excessive administrative charges remain in place, notably in the construction sector. Additionally, shortcomings in planning and monitoring public procurement hinder competition. The performance of public procurement could be improved by introducing structured and quantified planning and ensuring closer supervision of the execution phase of contracts. Despite a significant reduction in direct awards between 2017 and 2018, their use remains high.
- (19) In the context of the financial assistance programme, Portugal has made an effort to reduce the regulatory burden for highly regulated professions, notably with the introduction of the 2013 framework law. In some cases, however, this progress was halted or even reversed with the adoption of bylaws for the individual professions and the introduction of a ban on corporate groups. Regulatory and administrative restrictions on business and professional services prevail, raising concerns about competition, price levels, innovation and the quality of services. So far, no reform plans have been announced in response to the Commission's recommendations on regulation of professional services⁸, or in response to the 2018 OECD Competition Assessment Review on Portugal's self-regulated professions (in cooperation with the Portuguese Competition Authority).
- (20) The conditions for firms to access finance have been improving over the last few years and the proportion of firms reporting access to finance as main constraint to investment is now in line with the EU average. The Portuguese authorities launched and strengthened several initiatives in this area, such as the Capitalizar programme and other programmes targeting specific types of companies or sectors. However, Portuguese firms still heavily rely on their own resources to finance investment, and a significant amount of bank loans ends up in firms with very low productivity. The low level of capital invested per worker represents a major obstacle to upgrade the productive structure of the Portuguese economy. In this context, it is important that productive investment increases while being gradually rechannelled towards firms with growth potential and in sectors with high productivity profiles. Although other sources of financing, such as venture and equity capital, have been increasing over the last few years, they remain markedly lower than the EU average.

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SWD(2016) 436 final.

- (21) The justice system is becoming more efficient but continues to face critical challenges with lengthy proceedings and a high backlog of cases, in particular in the administrative and tax courts. While efforts to crack down on corruption continue, preventing corruption remains an issue due to the lack of a coordinated strategy and fragmented responsibilities.
- (22) Investment in research and development has recently picked up again but remains insufficient to upgrade the Portuguese national research and innovation system. After years of decline, the share of spending on research and development in relation to GDP increased recently and in 2017, business research and development intensity slightly surpassed the public research and development intensity. Little progress has been made to upgrade Portugal's economic structure to higher shares of value-added in high-tech manufacturing and in knowledge-intensive services. Promoting investment in intangible assets, including research and development but also managerial skills, financial literacy and digital skills to enable firms to grow, increase their innovation capacity and enter export markets offers Portugal significant potential to boost investment and productivity growth.
- (23) Insufficient maritime and railway connections make it difficult for export-oriented businesses to fully benefit from the potential of the single market. Due to its geographical location, Portugal is a natural maritime entry point, especially for the transatlantic routes. Timely investments in the new container terminals in Sines and in Barreiro (Terminal Vasco da Gama) and finalisation of the ongoing investment projects in the other main Portuguese ports (Viana do Castelo, Leixoes, Aveiro, Figueira da Foz, Setubal) would increase the container handling capacity of these ports. Railways are still widely underused in the connections to Spain (both East-West and North-South corridors). Developing a comprehensive Iberian plan, which includes identifying the intermediate steps, terminals, interconnections needed to benefit from the Spanish network upgrade and developing the International Union of Railways gauge, would help boost Portugal's international rail performance.
- (24) Investments in resource efficiency and climate adaptation would help to achieve long-term sustainable growth. Anticipating the adverse effects of climate change, such as floods and forest fires, remains a challenge in Portugal. Challenges remain to achieve the 2020 energy efficiency target, and the latest data for 2017 show that energy consumption is increasing. There is still a wide margin to improve energy efficiency in buildings and reduce energy consumption in business. Better energy connectivity of the Iberian Peninsula could enable more competition and facilitate the deployment of renewable energy.
- (25) The programming of EU funds for the period 2021-2027 could help address some of the gaps identified in the recommendations, in particular in the areas covered by Annex D to the country report⁹. This would allow Portugal to make the best use of those funds in respect of the identified sectors, taking into account regional disparities and the special situation of the outermost regions. Strengthening the country's administrative capacity for the management of these funds is an important factor for the success of this investment.
- (26) In the context of the 2019 European Semester, the Commission has carried out a comprehensive analysis of Portugal's economic policy and published it in the 2019 country report. It has also assessed the 2019 Stability Programme and the 2019 National Reform Programme and the follow-up given to the recommendations

⁹ SWD(2019) 1021 final.

addressed to Portugal in previous years. It has taken into account not only their relevance for sustainable fiscal and socioeconomic policy in Portugal, but also their compliance with Union rules and guidance, given the need to strengthen the Union's overall economic governance by providing Union-level input into future national decisions.

- (27) In the light of this assessment, the Council has examined the 2019 Stability Programme and its opinion¹⁰ is reflected in particular in recommendation (1) below.
- (28) In the light of the Commission's in-depth review and this assessment, the Council has examined the 2019 National Reform Programme and the 2019 Stability Programme. Its recommendations under Article 6 of Regulation (EU) No 1176/2011 are reflected in recommendations (1) to (4) below. Those recommendations also contribute to the implementation of the Recommendation for the euro area, in particular the first, second and fourth euro area recommendations. Fiscal policies referred to in recommendation (1) contribute inter-alia to address imbalances linked to high government debt.

HEREBY RECOMMENDS that Portugal take action in 2019 and 2020 to:

- 1. Achieve the medium-term budgetary objective in 2020, taking into account the allowance linked to unusual events for which a temporary deviation is granted. Use windfall gains to accelerate the reduction of the general government debt ratio. Improve the quality of public finances by prioritising growth-enhancing spending while strengthening overall expenditure control, cost efficiency and adequate budgeting, with a focus in particular on a durable reduction of arrears in hospitals. Improve the financial sustainability of state-owned enterprises, while ensuring more timely, transparent and comprehensive monitoring.
- 2. Adopt measures to address labour market segmentation. Improve the skills level of the population, in particular their digital literacy, including by making adult learning more relevant to the needs of the labour market. Increase the number of higher education graduates, particularly in science and information technology. Improve the effectiveness and adequacy of the social safety net.
- 3. Focus investment-related economic policy on research and innovation, railway transport and port infrastructure, low carbon and energy transition and extending energy interconnections, taking into account regional disparities.
- 4. Allow for a swifter recovery of the collateral tied to non-performing loans by increasing the efficiency of insolvency and recovery proceedings. Reduce the administrative and regulatory burden on businesses, mainly by reducing sector-specific barriers to licensing. Develop a roadmap to reduce restrictions in highly regulated professions. Increase the efficiency of administrative and tax courts, in particular by decreasing the length of proceedings.

Done at Brussels,

*For the Council
The President*

¹⁰ Under Article 5(2) of Council Regulation (EC) No 1466/97.