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Recommendation for a

COUNCIL RECOMMENDATION

on the 2018 National Reform Programme of Portugal

and delivering a Council opinion on the 2018 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 policies[1], 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 imbalances[2], and in particular Article 6(1) thereof,

Having regard to the recommendation of the European Commission[3],

Having regard to the resolutions of the European Parliament[4],

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 22 November 2017, the Commission adopted the Annual Growth Survey, marking the start of the 2018 European Semester of 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 22 March 2018. On 22 November 2017, 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 day, the Commission also adopted a recommendation for a Council recommendation on the economic policy of the euro area, which was

[1] OJ L 209, 2.8.1997, p. 1.
[2] OJ L 306, 23.11.2011, p. 25.
[3] COM(2018) 421 final.
[4] P8_TA(2018)0077 and P8_TA(2018)0078.

endorsed by the European Council on 22 March 2018. On 14 May 2018, the Council adopted the 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 on the economic policy for the euro area, as reflected in recommendations (1) to (3) below.

(3) The 2018 country report for Portugal[5] was published on 7 March 2018. It assessed Portugal's progress in addressing the country-specific recommendations adopted by the Council on 11 July 2017, 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 7 March 2018[6]. The Commission's analysis leads 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 proportion of non-performing loans constitute vulnerabilities in a context of low productivity growth. A prudent current account position and the maintenance of competitiveness gains are required to ensure the adjustment of net external liabilities. Private debt ratios continue to decline from high levels due to resumed nominal growth and slightly negative credit flows, and the government debt-to-GDP ratio is projected to have entered a downward trend, in a context of persistent deleveraging needs. Financial sector interventions helped to reduce stability risks, although banks remain penalised by low profitability and a large (albeit declining) stock of non-performing loans. Higher productivity growth is key for improved prospects as regards competitiveness, deleveraging and potential growth. Unemployment has been falling fast for several years. Policy gaps remain, notably in terms of implementing planned measures to reduce the number of non-performing loans and improve the business environment. The adoption and implementation of several reform plans, including measures to tackle labour market segmentation and fiscal-structural reforms to improve the sustainability of public finances, will need to be monitored.

(4) On 27 April 2018, Portugal submitted its 2018 National Reform Programme and its 2018 Stability Programme. To take account of their interlinkages, the two programmes have been assessed at the same time. The Stability Programme projects a solid downward path of the public debt-to-GDP ratio. Portugal's National Reform Programme includes commitments both for the short and medium term and covers the challenges identified in the 2018 country report. In particular, it announces measures in the areas of qualifications and innovation, which can boost productivity and increase the value of Portuguese exports. The strategy presented to reduce non-performing loans together with the action to promote firm capitalisation contribute to reduce the indebtedness of the Portuguese economy and clean-up banks' balance sheets. Overall, the effective implementation of the submitted programmes would underpin the correction of imbalances.

(5) Relevant country-specific recommendations have been addressed in the programming of the European Structural and Investment Funds for the 2014-2020 period. As foreseen in Article 23 of Regulation (EU) No 1303/2013 of the European

[5] SWD(2018) 220 final.
[6] COM(2018) 120 final.

Parliament and of the Council[7], 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 make use of that provision in guidelines on the application of the measures linking the effectiveness of the European Structural and Investment Funds to sound economic governance[8].

(6) Portugal is currently in the preventive arm of the Stability and Growth Pact and subject to the transitional debt rule. In its 2018 Stability Programme, Portugal plans to attain a headline deficit of 0.7 % of GDP and 0.2 % of GDP in 2018 and 2019, respectively, and a further improvement to a surplus of 1.4 % of GDP by 2021. Those plans do not include the potential deficit-increasing impact of bank support measures from 2019 onwards. The medium-term budgetary objective — a structural surplus of 0.25 % of GDP — is planned to be achieved by 2020. The 2018 Stability Programme projects the general government debt-to-GDP ratio to reach 122.2 % in 2018 and 118.4 % in 2019, which would then be at 107.3 % in 2021. The macroeconomic scenario underpinning those budgetary projections is plausible for 2018 but favourable for the following years. At the same time, the measures needed to support the planned deficit targets from 2018 onwards have not been sufficiently specified.

(7) Portugal's 2018 Stability Programme indicates that the budgetary impact of the large-scale wildfires that occurred in 2017 was significant and provides adequate evidence of the scope and nature of these additional budgetary costs. In particular, the Stability Programme indicates that the 2018 budget comprises exceptional expenditure amounting to about 0.07 % of GDP in relation to preventive measures to protect the national territory against wildfires. The Stability Programme sets out expenditure related to the emergency management, classified as one-offs, and 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 0.07 % 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. A final assessment, including on eligible amounts, will be made in spring 2019 on the basis of observed data for 2018 as provided by the Portuguese authorities.

(8) On 11 July 2017, the Council recommended Portugal to ensure that the nominal growth rate of net primary government expenditure[9] does not exceed 0.1 % in 2018,

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[7] 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).

[8] COM(2014) 494 final.

[9] Net primary government expenditure comprises total government expenditure excluding interest expenditure, expenditure on Union programmes fully matched by Union funds revenue and non-

corresponding to an annual structural adjustment of at least 0.6 % of GDP. At the same time, it was stated that the assessment of the 2018 Draft Budgetary Plan and subsequent assessment of 2018 budget outcomes will need to take due account of the goal of achieving a fiscal stance that contributes to both strengthening the ongoing recovery and ensuring the sustainability of public finances. Following the Commission's assessment of the strength of the recovery in Portugal while giving due consideration to its sustainability challenges, carried out in the context of its opinion on Portugal's Draft Budgetary Plan, no additional elements in that regard need to be taken into account. Based on the Commission 2018 spring forecast, there is a risk of a significant deviation from that recommended adjustment in 2018 and over 2017 and 2018 taken together.

(9) In 2019, in view of Portugal's general government debt ratio above 60 % of GDP and projected output gap of 1.3 %, the nominal growth rate of net primary government expenditure[9] should not exceed 0.7 %, in line with the structural adjustment of 0.6 % of GDP stemming from the matrix of requirements under the Stability and Growth Pact. Under unchanged policies, there is a risk of a significant deviation from that requirement in 2019 and over 2018 and 2019 taken together. At the same time, Portugal is forecast to comply with the transitional debt rule in 2018 and 2019. Overall, the Council is of the opinion that the necessary measures should be taken as of 2018 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 prudent.

(10) Ensuring public debt sustainability hinges on sustainable fiscal consolidation via a structural improvement in public finances, to be achieved through stronger revenue collection and expenditure controls. To enhance expenditure controls, effective enforcement of the commitment control law, strict and timely implementation of the budget framework law and continued spending review and rationalisation efforts are key. Budgetary planning and implementation continue to be a considerable challenge particularly in the health sector, where late payments (arrears) remain very high, which also points to weaknesses in accounting control and managerial practices. For sustainable fiscal consolidation, high and rising ageing costs should be addressed. In the medium term, higher ageing-related fiscal risks are expected to relate largely to the costs of financing pensions, while health-related costs will increase pressure in the long-term. Steps to improve the medium-term sustainability of the pension system, together with a comprehensive strategy to tackle the health-related costs of ageing, would help to address these risks.

(11) In a similar vein, controlling expenditure, managing debt and improving the overall financial sustainability of state-owned enterprises could contribute significantly to the structural improvement of public finances. Although overall net income continues to be negative, the operational results of state-owned enterprises have generally improved in recent years, except in the health sector, where they have worsened. Total non-consolidated debt of public corporations included in general government also remains high, at around 19.0 % of GDP at the end of 2017. Measures to improve the monitoring of state-owned enterprises are being rolled out, but their impact remains to be seen. An ongoing debt management and

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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.

recapitalisation plan for state-owned enterprises should reduce indebtedness and lower interest costs, but good incentives could be reinforced by ensuring a predictable and transparent framework for limited budgetary transfers.

(12) The recovery of the Portuguese labour market continues, in line with strengthened economic performance. The economy added about 150,000 jobs in 2017 and the employment rate (20-64 year olds) increased up to 73.4. % in 2017, back to pre-crisis levels. The unemployment rate dropped considerably and is now below the euro area average. The long-term unemployment rate has also fallen rapidly, although it remains relatively high. Besides ongoing active labour market policies, exemptions on social security and a public employment service model of personalised support for job seekers, Portugal is also planning to implement one-stop shops for employment in 2018. This could play a major role in ensuring wider coverage of activation measures. Poverty and inequality indicators have also improved further. The 'at-risk-of-poverty or social exclusion' rate is coming closer to the EU average and the income share of the poorest 20 % has increased since 2015. However, the level of income inequality is still high. Moreover, the effectiveness of social transfers (excluding pensions) in lifting people out of poverty is low, the adequacy of the minimum income scheme (though improved) remains limited and housing affordability is an increasing challenge for low-income households.

(13) Despite a significant increase in the number of permanent jobs in 2017, the proportion of temporary employees remained stable at 22 %, still one of the highest levels in the EU. In 2017, around 82 % of temporary employees were in this situation involuntarily. While more people are moving from temporary to permanent jobs, temporary contracts remain the norm for unemployed people finding a job. Moreover, the (already wide) wage gap between temporary and permanent employees grew during the crisis. Measures to promote the creation of permanent jobs (e.g. *Contrato-Emprego*) and exemptions from social contributions in return for recruiting people belonging to vulnerable groups proved effective but had limited coverage. Some aspects of employment protection legislation and cumbersome court procedures may still discourage recruitment on open-ended contracts. However, no action is currently planned to review the legal framework for dismissals. The government is planning measures to address labour market segmentation through tripartite discussion with social partners.

(14) The overall skills level of the adult population remains among the lowest in Europe, hampering the country's innovation potential and competitiveness. This includes digital skills: in 2017, only 50 % of citizens aged 16-74 possessed basic or above basic digital skills (against an EU average of 57 %). Programmes are being rolled out in this regard (notably *Qualifica* and the national digital competences initiative *Incode 2030*), but their effectiveness in upgrading workers' basic (numeracy, literacy and digital) skills and ultimately raising productivity will depend on the coverage and quality of the training offered, going beyond the mere recognition of skills. While evidence suggests that recent minimum wage increases (amounting to a cumulative rise of 18.3 % since 2014) have not harmed the employment rate among low-skilled workers, the substantial rise in the number of employees covered, up to 20.4 % in the third quarter of 2017, resulted in increasing wage compression. This threatens to reduce the skills wage premium, in particular between low- and medium-skilled workers, thus lowering incentives for the low skilled to invest in education and training. The government is closely monitoring minimum wage developments together with social partners.

(15) Early school leaving remains higher than the EU average, but it is on a long-term downward trend, partly thanks to measures being implemented to encourage educational success and reduce drop-out rates. Educational outcomes continue to improve, but there are equity concerns as proportions of low achievers differ significantly between the bottom and the top socioeconomic quartiles. Attainment in tertiary education (age 30-34) decreased from 34.6 % in 2016 to 33.9 % in 2017, far below the national target of 40 % by 2020. Despite the high employability of science, engineering, technology, and mathematics graduates, there is low student uptake in these fields.

(16) Despite the positive developments in the Portuguese Research & Innovation system in the last years, notably in terms of quantity and quality of human resources and scientific production, overall significant bottlenecks remain in creating a culture and the enabling conditions for stronger academia-business cooperation. These include barriers to knowledge and technology transfer, commercialisation of research outputs as well as research career tracks that do not sufficiently incentivise researchers to explore the avenues of “entrepreneurial research" and the opportunities for collaboration with industry. Further raising the awareness and clarity of intellectual property in the relation between academia and business could contribute to reduce the time of execution of contractual objectives, the economic monetization of scientific knowledge as well as their economic potential.

(17) A comprehensive strategy for a faster reduction of non-performing assets is being implemented. This helped to reduce the ratio of non-performing loans from 17.2 % of gross loans at the end of 2016 to 14.6 % in the third quarter of 2017. Corporate non-performing loans are a particular concern, as they account for about two-thirds of the total stock of non-performing loans; the ratio of corporate non-performing loans remains high, at 26.6 % of gross loans. Resolving bad assets is key to freeing up credit supply for new investments and sustainable growth. However, procedures for insolvent firms and thin secondary markets for bad assets remain significant impediments to reducing the ratio of non-performing loans. Although capital increases, together with the ongoing efforts to reduce costs, are improving financial sector prospects, profitability remains low, exposure to sovereign debt high and capital buffers weak.

(18) Access to finance and capital remains a major challenge for the Portuguese economy. Obtaining stable access to finance, and in particular to equity capital, is considered to be one of the major challenges for Portuguese enterprises, further exacerbated by the deleveraging pressures. In relative terms, alternative sources of finances remain of little relevance. In recent years, new programmes and credit lines have been launched, along with further simplifications in the business environment, but there is still room for improvement. At the same time, though decreasing, non-performing loans and corporate debt remain high and improvements in the allocation of capital towards more productive firms would be beneficial for the investment environment.

(19) Despite progress in introducing administrative simplification for cross-cutting matters impacting the daily lives of citizens and businesses, sector-specific regulatory and administrative barriers still impede investment and an efficient allocation of resources. A revamp of procedural workflows by shortening deadlines for decision-making, derogating from the tacit approval principle in very limited cases only and replacing authorisation schemes requiring the submission of multiple documents by 'responsible declarations' are much needed sector-specific reforms in this regard. Administrative charges in the construction sector should be brought into

proportion with actual costs. Competition in public procurement remains limited. The revised public procurement code aims to promote transparency, competition and better management of public contracts. The implementation of the new rules should be monitored, including the impact of the stricter rules on the use of direct awards. Even though the Portuguese justice system continues to improve its efficiency, the length of proceedings in administrative courts remains a challenge. Moreover, corruption and lack of transparency are still perceived by businesses as areas of concern. While progress has continued as regards prosecuting corruption, efforts to improve the culture of integrity in public institutions have not so far shown sufficient results.

(20) Regulatory reforms have been scarce since the financial assistance programme, halting or at times even reversing reforms agreed in that context. Corporate groups are banned from providing several professional services. By-laws regulating certain professional business services, notably legal services, are less ambitious than the framework law in decisive respects, such as legal form, shareholding, management, advertising and multidisciplinary practices. A reform of the authorisation and registration of construction service providers has been scarcely complemented by an easing of controls for installation services and building controls.

(21) In the context of the 2018 European Semester, the Commission has carried out a comprehensive analysis of Portugal's economic policy and published it in the 2018 country report. It has also assessed the 2018 Stability Programme and the 2018 National Reform Programme and the follow-up given to the recommendations addressed to Portugal in previous years. The Commission has taken into account not only their relevance for sustainable fiscal and socioeconomic policy in Portugal but also the extent to which they comply with Union rules and guidance, given the need to strengthen the Union's overall economic governance by providing Union-level input for future national decisions.

(22) In the light of this assessment, the Council has examined the 2018 Stability Programme and its opinion[10] is reflected in particular in recommendation 1 below.

(23) In the light of the Commission's in-depth review and this assessment, the Council has examined the National Reform Programme and the Stability Programme. Its recommendations under Article 6 of Regulation (EU) No 1176/2011 are reflected in recommendations 1 to 3 below,

HEREBY RECOMMENDS that Portugal take action in 2018 and 2019 to:

1. Ensure that the nominal growth rate of net primary government expenditure does not exceed 0.7 % in 2019, corresponding to an annual structural adjustment of 0.6 % of GDP. Use windfall gains to accelerate the reduction of the general government debt ratio. Strengthen expenditure control, cost effectiveness and adequate budgeting, in particular in the health sector with a focus on the reduction of arrears in hospitals. Improve the financial sustainability of state-owned enterprises, in particular by increasing their overall net income and by reducing debt.

2. Promote an environment conducive to hiring on open-ended contracts, including by reviewing the legal framework in consultation with social partners. Increase the skills level of the adult population, including digital literacy, by strengthening and broadening the coverage of the training component in adult qualification

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

programmes. Improve higher education uptake, namely in science and technology fields.

3. Increase the efficiency of insolvency and recovery proceedings and reduce impediments to the secondary market for non-performing loans. Improve access to finance for businesses. Reduce the administrative burden by shortening procedural deadlines, using more tacit approval and reducing document submission requirements. Remove persistent regulatory restrictions by ensuring a proper implementation of the framework law for highly regulated professions. Increase the efficiency of administrative courts, *inter alia* by decreasing the length of proceedings.

Done at Brussels,

For the Council
The President