

**Republic of San Marino: 2001 Article IV Consultation—Staff Report, Public Information Notice on the Executive Board Discussion, and Statement by the Executive Director**

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of a combined discussion of the 2001 Article IV consultation with the Republic of San Marino the following documents have been released and are included in this package:

- the staff report for the 2001 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **September 24, 2001** with the officials of the Republic of San Marino on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on November 20, 2001.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF;
- the Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during the December 5, 2001, Executive Board discussion** of the staff report that concluded the Article IV consultation;
- a statement by the Executive Director for the Republic of San Marino.

The following document will be separately released:

- Selected Issues and Statistical Appendix

The policy of publication of Article IV staff reports and PINS allows for the deletion of market-sensitive information.

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SAN MARINO

**Staff Report for the 2001 Article IV Consultation**

Prepared by the Staff Representatives for the 2001 Consultation with San Marino

Approved by Alessandro Leipold and Mark Allen

November 20, 2001

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## I. BACKGROUND

1. **The Republic of San Marino operates in a customs union with the European Union, it has adopted the euro, and its workforce is very mobile.** San Marino is located near Rimini, between the Italian regions of Emilia-Romagna and Marche, with a population of about 27,000. The economy is diversified and open, with exports and imports totaling some 400 percent of GDP (Figure 1; and Table 1). About 13,000 Sammarinese live abroad and one third of the private sector workforce are Italian commuters.
2. General elections held in June 2001 returned a Christian Democratic/Socialist coalition to power. The next elections must be held within five years.
3. In concluding the last Article IV consultation on March 1, 1999,<sup>1</sup> Directors commended San Marino on its enviable growth performance but noted that reforms of the pension and health care systems were required to maintain the country's sound fiscal position. At the same time, the economy's performance could be enhanced through streamlining the public administration and reforming product and factor markets. These considerations, as well as the agenda of the recently elected government, were at the center of the 2001 consultation discussions, which took place in San Marino during September 13–24, 2001.<sup>2</sup>

### A. Economic Developments and Policies

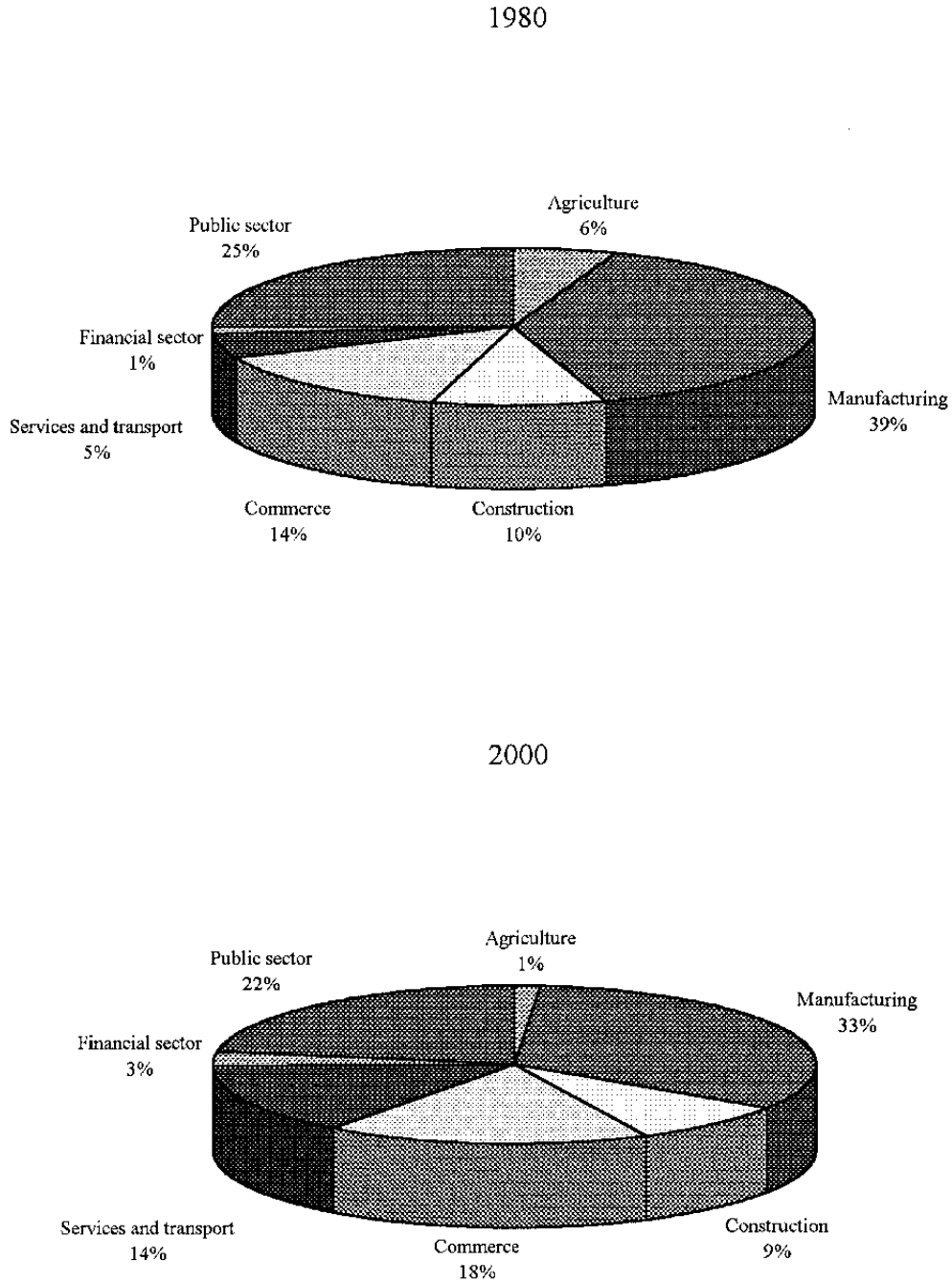
4. **Economic growth remained high and well above that recorded in neighboring regions over the past decade.** Real GDP growth climbed to 9 percent in 1999 (Figure 2), driven by strong investment, while real national income increased by about 7 percent. With continued strong employment growth (Figure 3) and accelerating credit (Figure 4), activity is estimated to have remained buoyant in 2000.

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<sup>1</sup> San Marino is on the 24-month consultation cycle. The Executive Board was notified of a delay in the current consultation cycle due to changes in government and scheduling difficulties (EBD/01/19, 02/15/2001).

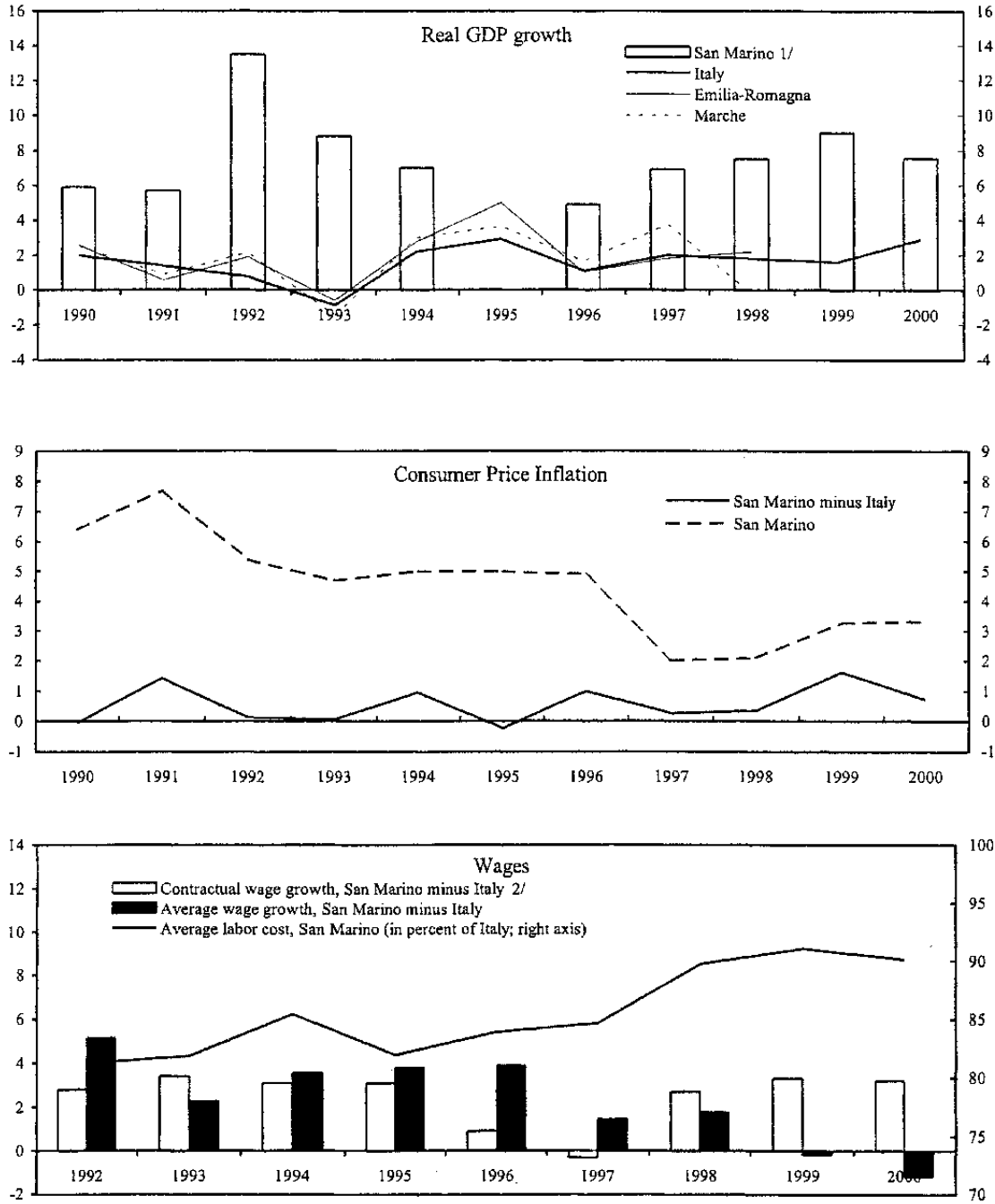
<sup>2</sup> Meetings were held with the Ministers of Foreign Affairs, Internal Affairs, Finance and Budget, Industry and Handicrafts, Labor, Public Health and Social Security, and Tourism and Commerce. The mission also met with representatives of the Central Bank, the Office of Banking Supervision, the Social Security Institute, and the public enterprises as well as with private sector representatives, including labor union officials, employers, and bankers. There was also an audience with the Captains Regent, the co-heads of state. The staff team comprised Mr. Decressin (head, EU1) and Mr. R. Krueger (STA). The Executive Director's Office was represented by Mr. Lombardi. The authorities released the mission's concluding statement and intend to publish this staff report. San Marino's Fund relations are summarized in Appendix I.

Figure 1. San Marino: Employment by Sector



Source: Data provided by Sammarinese authorities.

Figure 2. San Marino: Real GDP Growth, Inflation and Wage Growth, 1990-2000  
(In percent)

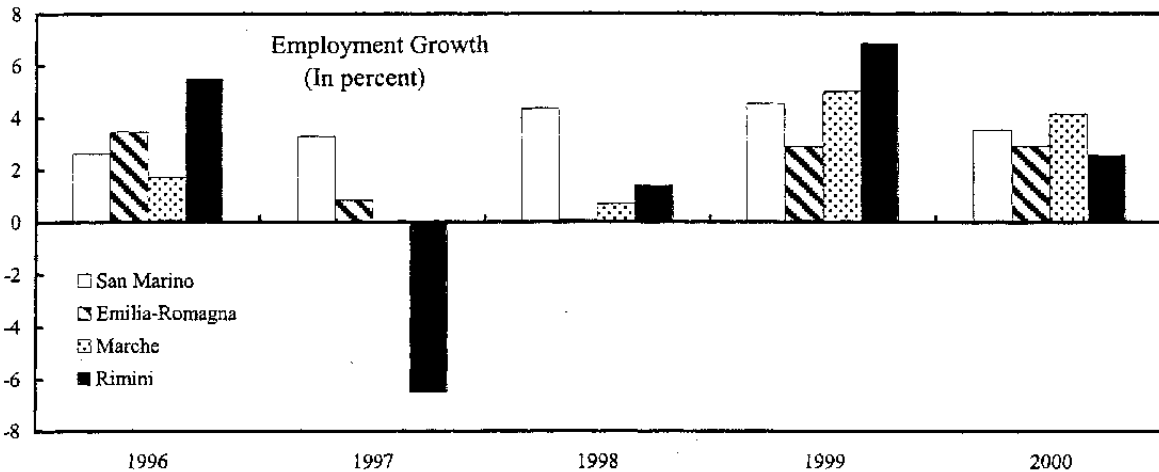
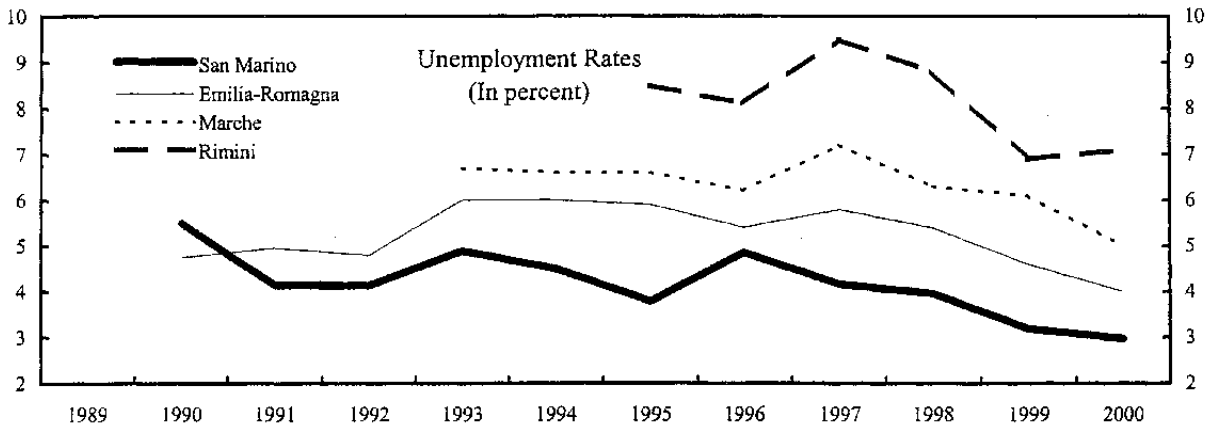
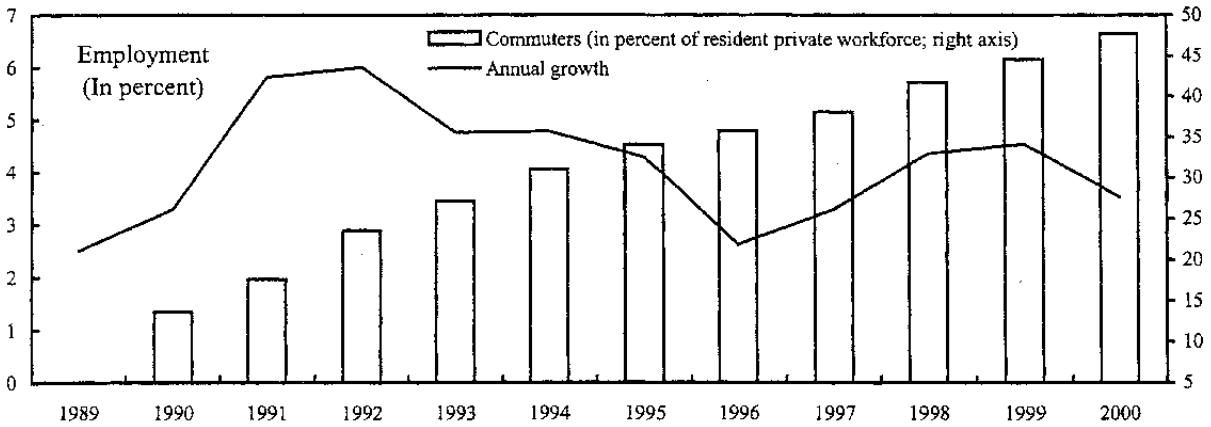


Sources: Sammarinese authorities; SVIMEZ; and ISTAT. For San Marino and the Italian regions data are ESA79 until 1995 and ESA95 thereafter. For San Marino, old and new data do not overlap.

1/ Data for 2000 are Fund staff estimates.

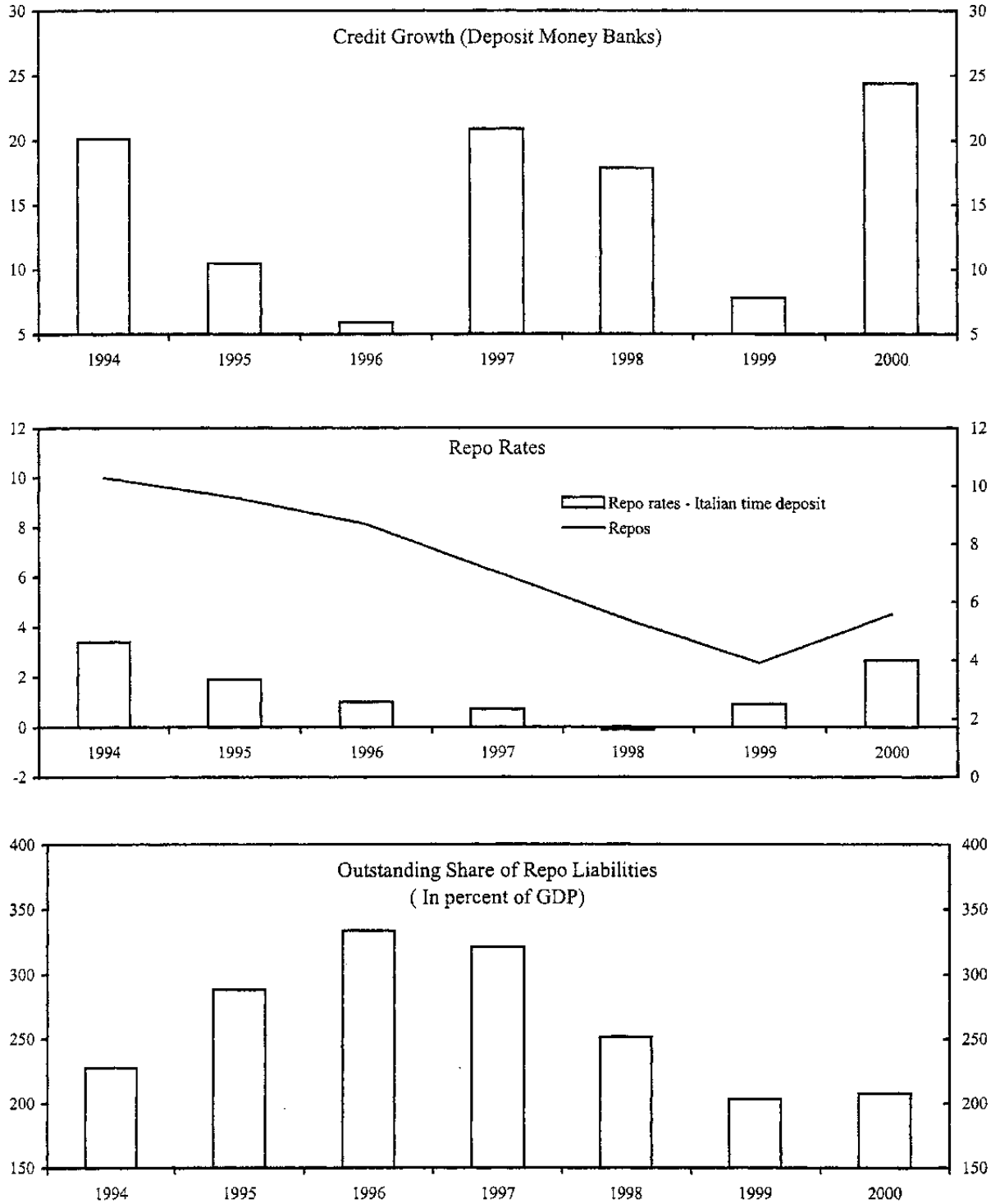
2/ The data on the contractual wage increases in Italy comprise only the national, sectoral element of the wage increases, not the firm-specific element, unlike the data for San Marino.

Figure 3. San Marino: Employment and Unemployment, 1989-2000



Sources: Sammarinese authorities; SVIMEZ; and ISTAT.

Figure 4. San Marino: Credit, Interest Rates, and Repo Transactions, 1994-2000



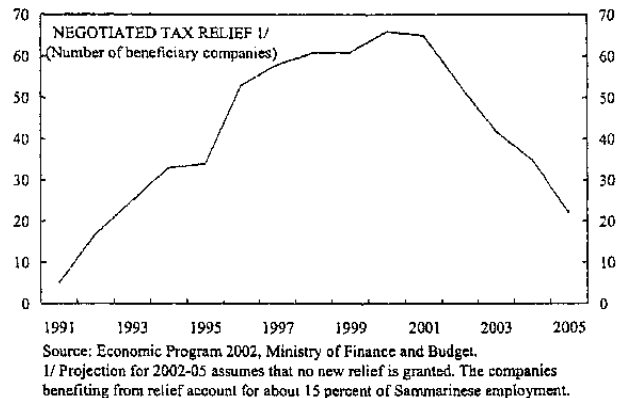
Sources: Sammarinese authorities; and Bank of Italy.



5. **Underlying price pressures moderated in the course of 2000 but rising oil prices kept headline inflation above 3 percent.** Inflation developments are coupled with those of Italy but changes in administratively set prices led to a temporary widening of the inflation differential in 1999. Due also to converging wage growth, the differential diminished again in the course of 2000. Data for 2001 are not yet available, pending changes in data collection.<sup>3</sup>

6. **The central government budget deficit widened to around 2¾ percent of GDP in 1999–2000** (Figure 5).<sup>4</sup> Consolidated accounts for the public sector are not available. To assess fiscal developments at the level of the central government, it is necessary to reclassify the published accounts, as the definition of the *avanzo d'esercizio* (the fiscal balance aggregate monitored under Sammarinese laws) includes various “below-the-line” items, notably large changes in the asset and liability float.<sup>5</sup> Such a reclassification reveals that, despite a rapid expansion of the tax base, the central government balance fluctuated around a deficit of about 1 percent of GDP for most of the 1990s (Table 2). Generous entitlement programs that did not benefit the commuters who have boosted activity and the tax base raised primary spending by 8 percent annually since 1993.

7. **The recent deterioration in the fiscal performance reflects a poor revenue performance and continued high growth of spending; no significant change is expected for 2001.** Tax payments by employees grew considerably but receipts from the self-employed and businesses declined, despite strong economic activity and profits. Tax administration difficulties related to excessive loopholes and negotiated tax relief—the number of relief beneficiaries reached a new peak in 2000—are partly responsible. Also, receipts from taxes on interest income dropped, as investors increasingly accessed untaxed financial instruments.

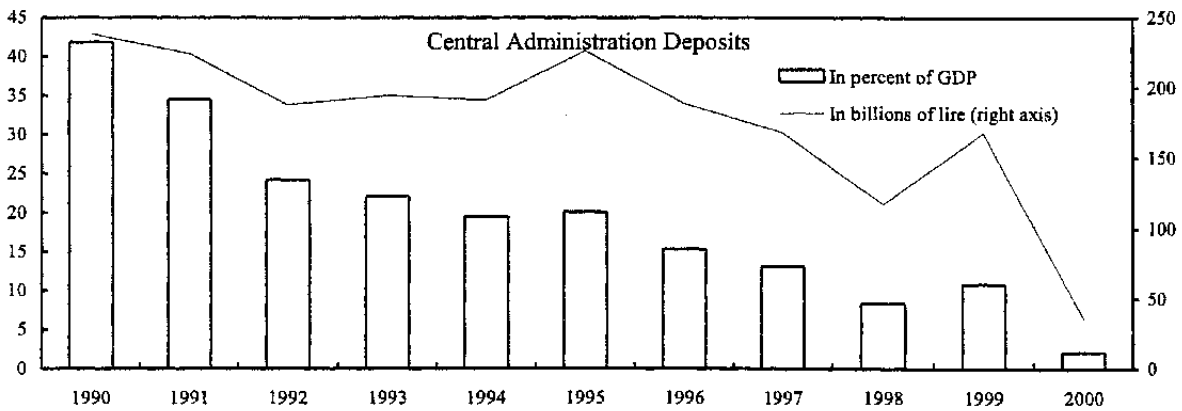
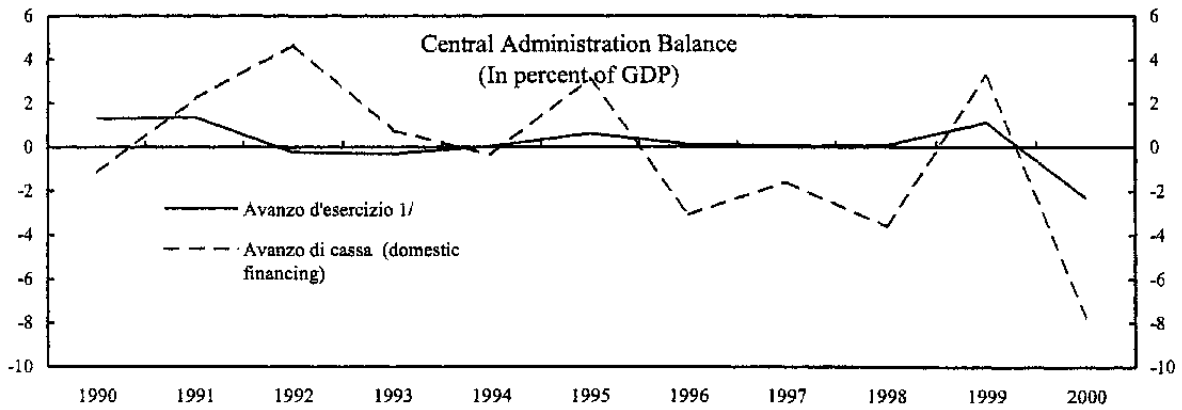
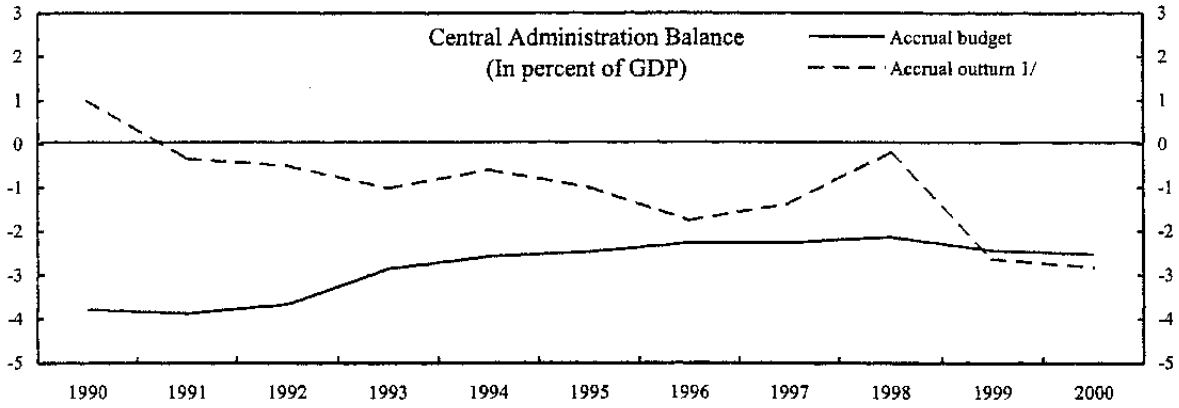


<sup>3</sup> Data on consumer prices are obtained from voluntary replies to questionnaires and thus are not considered very accurate. As of 2002, data will be collected at the source and be made available monthly with a short delay.

<sup>4</sup> The Social Security Institute—the other major component of the general government—recorded deficits of about ¼ percent of GDP in 1999–2000.

<sup>5</sup> The *avanzo d'esercizio*, which does not conform to a standard definition of the government budgetary deficit, shows a cumulative deficit of some Lit 15 billion over 1993–2000 (about 1 percent of 1999 GDP). The cumulative deficit computed in line with standard definitions was about ten times larger (Lit 156 billion), according to staff estimates.

Figure 5. San Marino: Central Administration Balance, 1990-2000 1/



Source: Sammarinese authorities.

1/ The avanzo d'esercizio and avanzo di cassa include "below-the-line" items, unlike the accrual budget outturn calculated by the staff by reclassifying the authorities' numbers.

Revenue data through the summer suggest no significant change in fiscal performance, while spending also accelerated in the run-up to elections.

8. **Nevertheless, the financial position of the public sector is still sound, albeit much weaker than at the beginning of the decade.** Government deposits dropped considerably in 2000, largely because of increased transfers to the Social Security Institute (ISS) on account of health care expenditure accrued previously.<sup>6</sup> As of mid-2001, gross assets (including the pension fund) again stood at over 20 percent of GDP and gross debt is estimated at about 10 percent of GDP.

## B. Outlook

9. **Reflecting the global slowdown in activity, San Marino's near-term outlook has weakened, but remains comparatively positive.** Few data are available on current economic conditions but continued strong output growth is expected. The likely effect of the global slowdown is difficult to predict, as economic activity in San Marino does not appear closely correlated with activity in Italy or the euro area. During the sharp 1992–93 slowdown in Italy and the euro area, real GDP growth in San Marino was well above its average for the 1990s. The resilience to shocks of factor markets and the specialization of activity could explain such a performance (Box 1). Overall, activity is likely to slow but is expected to remain relatively buoyant compared with surrounding areas, considering also that (i) monetary conditions are becoming increasingly accommodating for San Marino (Figure 7); (ii) oil prices are moderating; and (iii) additional labor supply is available in nearby Rimini.

10. **San Marino's medium- and long-term growth outlook is more uncertain.** The challenge at hand is to maintain high growth in an increasingly competitive international environment. Important ingredients in San Marino's success during the 1990s were a lower labor cost and a higher take-home wage (thanks to lower payroll taxes) than in surrounding regions that promoted job creation and attracted Italian commuters from areas with high unemployment. However, the setting for growth will turn less favorable over the medium term for several reasons: (i) San Marino's labor cost advantage over surrounding areas has narrowed considerably; (ii) Italy has recently lowered the tax burden on capital and labor and it plans further, sizable tax cuts during the current legislature; and (iii) the Italian Parliament

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<sup>6</sup> The ISS manages both the pension and health care systems but the government has to reimburse the ISS for health care expenditure.

### Box 1. Growth, Migration, and Fiscal Sustainability

Real GDP growth averaged almost 7½ percent during the 1990s, more than three times the rate recorded in neighboring regions and Italy, but comparable to the growth performances of Ireland and Luxembourg. Economic activity in San Marino and Italy has not been closely correlated: a linear regression of real GDP growth in San Marino on growth in Italy over 1990–99 reveals an insignificant slope coefficient of  $-1$  and an adjusted  $R^2=0$ .

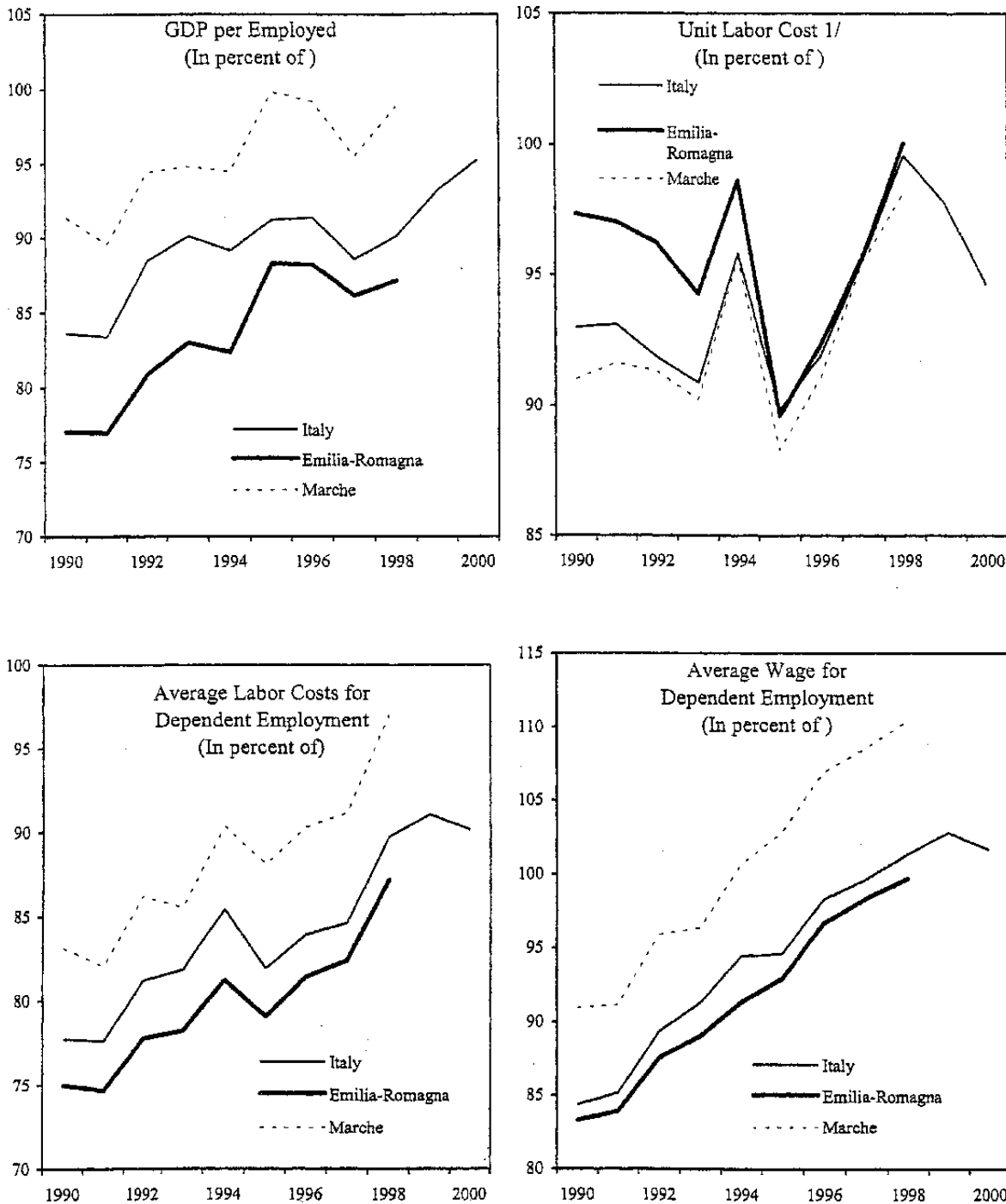
The Sammarinese economy remains well diversified considering its size, which makes it difficult to identify whether specific product demand shocks have been driving growth. While no data are available on the composition of San Marino's output, sectoral data on employment (Figure 1) do not suggest that growth was driven by a single sector. In particular, employment in financial services accounted for only 5 percent of total employment growth during the 1990s and its share in the economy stands at about 3 percent, compared with about 10 percent in Luxembourg.

High real GDP growth was sustained by large increases in employment, at annual rates averaging nearly 4½ percent during the 1990s. Such employment growth rates are comparable to those achieved in Ireland, as well as in Luxembourg (including commuters from Luxembourg's neighbors). They were supported by a comparatively low labor cost that promoted job creation. At the same time, high unemployment in surrounding regions boosted the supply of labor to San Marino through commuting. It is noteworthy that labor costs remained lower in San Marino than in surrounding regions (Figure 6), in spite of lower unemployment (Figure 3). As a result, the number of commuters (*frontalieri*) working in San Marino rose from the equivalent of 14 percent in 1990 to 48 percent in 2000 of the resident private sector workforce. However, with wage growth slowing in Italy and continued strong demand for labor in San Marino, average wages (labor costs excluding employer-paid social security contributions) have recently surpassed Italian levels and the labor cost advantage relative to Italy now stands under 10 percent. Throughout the 1990s, the level of output per employed in San Marino has been below the levels recorded in Italy and the neighboring regions of Emilia-Romagna and Marche, and thus the unit labor cost advantage was lower than the average labor cost advantage. However, this lower productivity is likely to reflect the structure of activity in San Marino, including the low number of workers per firm (3.2 versus 4.2 in Italy), not worker-specific characteristics or external diseconomies of scale. Accordingly, for job creation in San Marino, labor costs may be more relevant than unit labor costs.

Lower taxation has helped in maintaining a labor cost advantage, thereby attracting business and fostering job creation. For a typical worker in manufacturing, payroll taxes in San Marino amount to about 22 percent of gross pay, relative to almost 40 percent of gross pay in Italy. Income tax rates in San Marino are lower by 5–10 percentage points than in Italy at all levels of income up to US\$85,000. Marginal taxes on corporate income are lower but may now be comparable, following the introduction of the Tremonti law in Italy, which exempts half of re-invested earnings from corporate taxes.

The rising number of commuters to San Marino increased the tax base but posed virtually no demand on public resources. Once the commuters retire, their social security contributions will be transferred to Italy or, if they have worked in San Marino for more than 20 years, they will receive pension payments from the Social Security Institute. However, the rapid growth of commuting is a fairly recent phenomenon and the commuters do not benefit much from other expenditure. The expanding tax base allowed primary expenditure to grow by about 8 percent annually during 1993–2000—about double the rate of growth in Italy—without seriously imperiling the government's financial position.

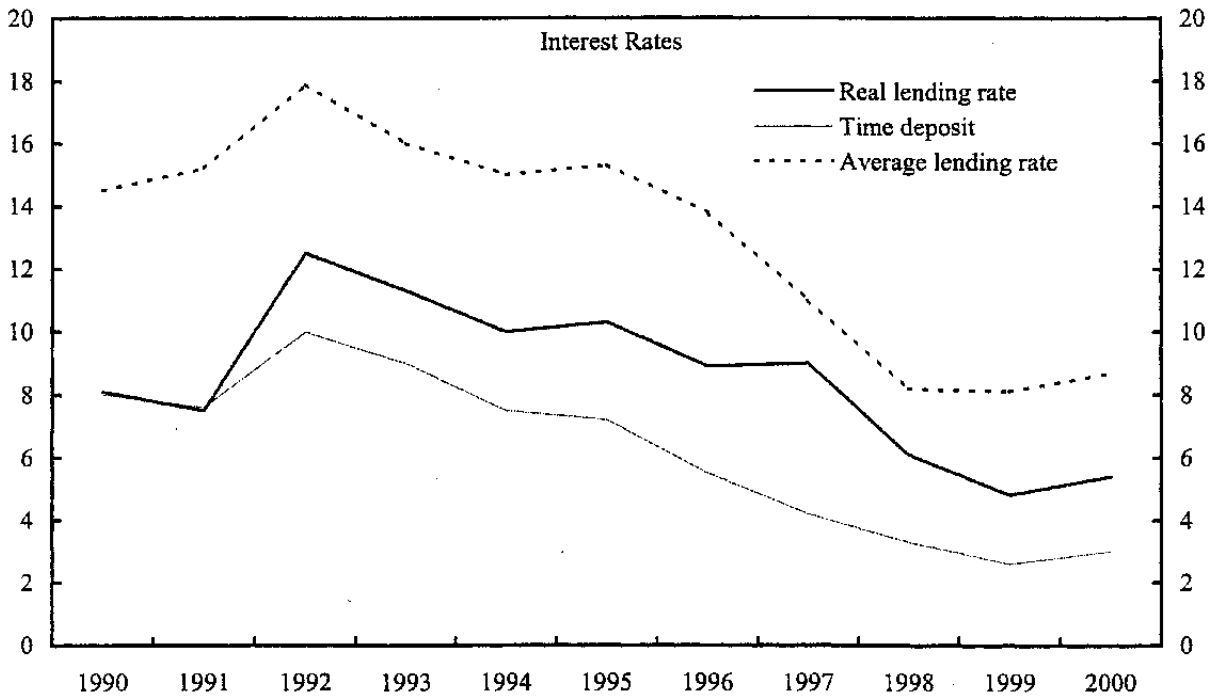
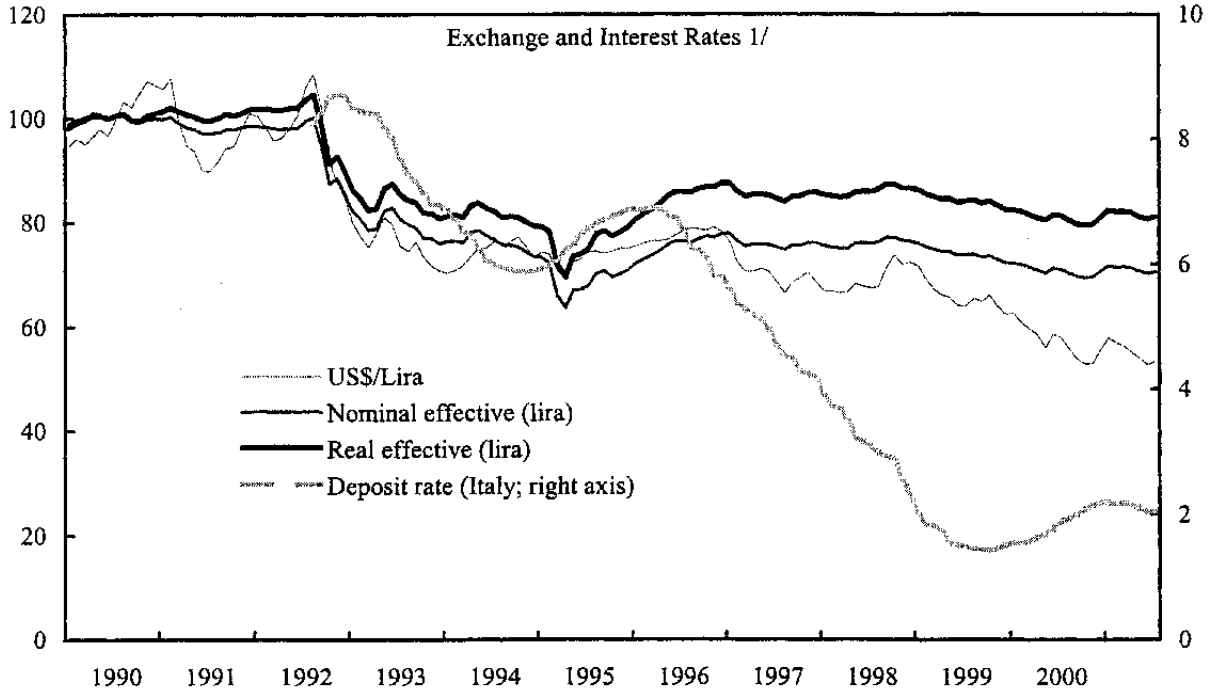
Figure 6. San Marino: Productivity and Labor Costs Compared, 1990-2000  
(In percent of Italy, Emilia-Romagna, or Marche)



Sources: Sammarinese authorities; SVIMEZ; and ISTAT. Data before 1995 are on an ESA 79 basis; afterwards they are on an ESA 95 basis. For San Marino, data for 2000 are available only for wages and employment. Nominal GDP growth is estimated to have grown at 10 percent, as in 1998-99, and labor costs are assumed to have grown at the same rate as wages, because there were no changes in payroll taxes.

1/ Labor cost per employee divided by output per employed.

Figure 7. San Marino: Exchange Rates and Interest Rates, 1990-2000



Sources: Sammarinese authorities; Bank of Italy; IMF, *Information Notice System*.

1/ No data on the geographic composition of San Marino's trade are available.

has passed a law that would require commuters working in San Marino to pay income taxes in Italy; its applicability has been suspended until January 1, 2002, pending the conclusion of a double taxation agreement.<sup>7</sup>

## II. POLICY DISCUSSIONS

11. The consultation discussions focused on the policy changes that are necessary to maintain the virtuous circle of high economic growth and comparatively low fiscal pressure into the medium term. Key issues included (i) the reasons for San Marino's outstanding economic growth performance; (ii) the measures needed in the near term to improve the fiscal performance; (iii) structural fiscal issues, specifically reforms to entitlement programs; and (iv) policies for factor and product markets, anti-money laundering efforts, and statistical issues.

### A. Growth, Fiscal Policy, and the Budget in a Highly Open Economy

12. **The authorities attributed San Marino's strong growth performance to several factors and argued that the near-term outlook for economic activity remained favorable.** In their view, the outstanding performance relative to surrounding regions was driven by (i) lower labor costs (wages and, especially, payroll taxes); (ii) a lower tax burden; (iii) a more efficient and business-friendly public administration; and (iv) a more stable political environment. As the above factors remained in place, activity was projected to stay buoyant in the near term. They also stressed that no special advantages had been offered to specifically attract foreign direct investment.

13. **The staff argued that the recent growth performance would be challenging to sustain over the medium run, a view to which the authorities were sympathetic.** However, they also underscored some mitigating factors that could help maintain solid growth, particularly a lower corporate tax burden. Regarding the taxation of Italian commuters, they expected no major revenue losses or changes to labor costs and thought that an agreement could even unlock Italian investment for San Marino. While the financial sector could suffer over the long run if EU-wide efforts succeeded in harmonizing withholding of interest income taxes, the authorities thought that financial activities mainly offered opportunities for growth and a number of measures to promote their development were under discussion (see para. 29).

14. **The authorities and the staff concurred that because of the high mobility of San Marino's factors of production, a sound fiscal policy—as exemplified by a budget in**

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<sup>7</sup> San Marino made a commitment to contribute to the fight against harmful tax competition and was not listed among the tax havens in the OECD's 2000 report on the matter. The country participated in the July 2001 meeting of the Global Forum working group on the effective exchange of information.

**balance or in surplus, a low debt level, and a low tax burden—was crucial for growth.** There was agreement that, because of its mobile tax base, San Marino could ill afford large increases in tax rates or an accumulation of public debt over the medium term. Indeed, once the new government in Italy proceeds with its intention to reduce taxes, San Marino might even have to lower taxes to avoid falling into a vicious circle of a declining workforce and rising taxes. Moreover, the usefulness of automatic stabilizers or countercyclical policy measures is limited as (i) the economy is very small and highly open and thus it is difficult to stabilize output; and (ii) it is difficult to decompose output (and thus fiscal revenue) developments into trend and cycle components because of the combination of highly mobile factors of production and region-specific and macroeconomic shocks. Small changes in product demand, wages, or production costs relative to surrounding regions could have large effects over the medium term on employment and growth.

15. **The staff thus encouraged the authorities to make a political commitment (i) to begin submitting central government budgets to parliament that are balanced or in surplus and, if necessary, to explain—in a formal report to parliament—any ex post deficits, including plans for remedial measures; and (ii) to maintain or improve the central government’s net liability position.**<sup>8</sup> Such a commitment would help in sustaining the inflow of the mobile factors of production by providing a measure of certainty on the evolution of fiscal policy over the medium term. It should apply to a fiscal balance aggregate in line with standard definitions. As proposed, the commitment would allow temporary fiscal deficits on an ex post basis. Moreover, since the commitment does not carry the weight of a law, it represents a relatively limited obstacle to submitting to parliament a budget in deficit, as might be warranted by exceptional circumstances. However, both ex ante and ex post deficits would have to be justified to parliament.<sup>9</sup>

16. **To foster fiscal transparency, policy intentions should be explained clearly in the central government budgets.** The authorities and the staff agreed that this required spelling out the underlying macroeconomic frameworks; presenting realistic borrowing requirements

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<sup>8</sup> Under the staff’s proposal, the budget would target the fiscal balance of the central government, as consolidated government accounts have not yet been produced; the finances of the Social Security Institute would be dealt with separately in the context of the reform of the pension system.

<sup>9</sup> From the point of view of the structure of the economy, San Marino resembles more a city or a state within a country than a typical industrial country. In 37 states of the United States, the legislature actually **must** enact a balanced budget (ex ante balance) and in 24 of these 37 states, deficits may not be carried forward (ex post balance). The last, more stringent rule is more common in the small states than in large ones (see Poterba, James M., 1996, “Budget Institutions and Fiscal Policy in U.S. States,” *American Economic Review*, vol. 86(2), pp. 395-400).



in the budgets; and monitoring a fiscal balance aggregate on an accruals basis. The authorities explained that, as had been customary, they did not intend to have recourse to the full amount of borrowing programmed for 2001–03 in the medium-term budget prepared in 2000. This borrowing partly constituted a contingency reserve that allowed recourse to financing without parliamentary approval. A fiscal balance aggregate in line with ESA95 requirements would be published soon, in addition to the *avanzo d'esercizio* required by Sammarinese laws. The staff recommended that the authorities begin realistically projecting revenue—with the help of a fully specified macroeconomic framework—and prudently budgeting expenditure, by allocating part of revenue to a contingency reserve. Also, any remaining financing requirement should be clearly specified.

### B. Near-Term Fiscal Policy Issues

17. **The authorities and the staff concurred that balance on an accruals basis should be achieved in 2003 and that considerable progress could be made in 2002.** At the time of the discussions, the preparation of the 2002 budget was at an initial stage. The authorities explained that measures to lower spending growth permanently would be ready in 2003, while several temporary revenue measures with little impact on economic activity and competitiveness were envisaged for 2002.

18. **While the outlook for global activity has worsened since the discussions, the objective of budgetary balance in 2003 remains appropriate, in the staff's view.** San Marino's near-term growth prospects remain relatively strong and many of the proposed revenue measures (see para. 19) have a limited effect on economic activity, and contribute rather to eliminating distortions. Moreover, the authorities consider the political setting for action on expenditure auspicious, following several years of political difficulties that have stalled the reform process. The term of the government—which has a two-thirds majority in parliament—has just begun, and a consensus has emerged among social partners on the need to reform the entitlement programs.

19. **The authorities were studying and, in some cases, had already proposed to parliament various revenue measures for the 2002 budget,** including: (i) a favorable, temporary tax on asset revaluation gains; (ii) the sale of public land; (iii) the suspension of the tax expenditure program available to business, with the intent to replace it with a more restricted program (also, curtailing subsidized credit was being considered);<sup>10</sup> and (iv) a small tax on saving, which had been discussed but rejected in previous years. These measures had been designed partly to facilitate tax administration, and business and labor representatives foresaw no adverse consequences, given the tax regime in surrounding regions. But

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<sup>10</sup> On staff estimates, the tax exemptions alone cost over 3 percent of GDP in 1996 and thus their phase out could boost revenue considerably over the medium run (IMF Staff Country Report No. 99/26, 5/5/1999).

administrative measures would also be taken to improve the monitoring of tax compliance. Since the yield of the proposed measures would be highly uncertain, the staff advocated prudent estimates for the temporary measures.

20. **The staff stressed that to durably balance the budget, action should focus first and foremost on containing current expenditure.** The authorities planned to reduce the growth rate of public sector wages—which have outpaced wages in the private sector—to slow current spending but also to allow the private sector to compete better. Some reforms to entitlement programs were also envisaged for 2002 but a comprehensive reform would, in all likelihood, be ready only for the 2003 budget. In the meantime, however, the practice of underfunding the ISS for health care expenditure accrued during the year and paying the difference in the subsequent year would be ended, requiring higher spending in 2002.

### C. Structural Fiscal Policy Issues

21. All agreed that the key policy challenge over the medium term was to achieve a durably balanced budget by reforming the civil service and the pensions and health care systems. The staff argued for stronger measures to contain health care spending.

22. **The authorities plan to reduce the size of civil service, which accounts for about 17 percent of total employment, through natural attrition.** They argued that the hiring freeze had already been successful and explained that reforms were underway to facilitate the mobility of civil servants and thus the reallocation of manpower to areas in greatest need. In addition, red tape would be reduced and the reform of bureaucratic procedures accelerated, including the adoption of new technologies. Moreover, a key objective was the alignment of public sector and private sector wages over the medium term.

23. **All social partners agreed on the need for measures to put the pension system on a sound financial footing.** The Social Security Institute (ISS) is running deficits, despite sizable state transfers and a ratio of workers to retirees of about 4:1 (against 1:1 in Italy; Box 2). The authorities have already proposed to increase the retirement age for new workforce entrants to 65 years as of 2002, up from 60 years at present. In addition, the management of the pension fund is to be separated from that of health care under the ISS and the fund is to pursue higher returns on its investments. However, further measures to strengthen the link between benefits and lifetime contributions, including the introduction of a fully funded pillar alongside the present defined-benefit system, would be necessary and were under discussion among the social partners. The authorities were confident that a full-fledged reform would be ready for implementation in 2003.

24. **Health expenditure would be slowed through tighter budget constraints on the ISS, according to the authorities.** Health care is essentially provided free of charge in San Marino and expenditure rose by almost 30 percent during 1997–99. The health care system appears to function relatively well and was ranked third best in the world by the World Health Organization. While all social partners agreed that the health care system was

## Box 2. The Pension System

The current pension system is entirely a pay-as-you-go-system, mandatory for all workers. It provides retirement benefits to local residents and *frontalieri* (commuters). The system also provides for disability pensions and survival benefits but these represent only 1 percent of total pension outlays. A minimum pension is guaranteed for all residents who are at least 65 years old with no other source of income.

San Marino's pension system—which is analyzed in a background paper—provides benefits that are among the most generous of the EU systems, in terms of a low average retirement age, high statutory and average replacement rates, and a short required contribution period. Weaknesses stemming from this generosity were addressed in a reform proposal drafted by the government in 1995, but no action was taken. The minimum retirement age for old-age pensions is typically 60. The minimum contribution period for old age pensions is 15 years. The pension is equal to the simple average of the individual's income (adjusted for inflation) over the last 5 years for dependent workers (10 years for self-employed) multiplied by a coefficient that is obtained by adding 3 percentage points for each of the first 15 years and 2 percentage points for each additional year of work subject to a pre-determined ceiling. Each year of active labor after the entitlement age adds 5 percentage points to the weighting coefficient. The *frontalieri* are entitled to receive either a pension from San Marino or from Italy, provided they have at least 20 years of active contributions; otherwise, they receive a yearly rent based on the capitalized contributions.

Payroll taxes are low in San Marino, at about 22 percent of income for a typical worker, against 40 percent in Italy. Extraordinarily strong growth in employment has helped to fund a significant rise in pension outlays without imperiling the public finances. Nevertheless, the generosity of the current system is putting the financial position of the pension funds under strain. This trend is expected to continue over the medium term, with yearly expenditure growth averaging 8–9 percent. By contrast, contributions would grow, at best, at 7½ percent per annum, assuming that the current very high rates of employment growth and inflows of *frontalieri* would be sustained over the medium term. In addition, many workers in the active labor force have not claimed their entitled pension rights: if all acquired rights were claimed, the social security deficit would widen considerably.

To put the pension system on a sound financial footing over the medium term, the link between benefits and contributions needs to be strengthened. This could be achieved by changing the parameters in the existing system or by introducing fully funded private pension funds. A fully funded component of the pension system is particularly attractive for San Marino because of the mobile tax and contributions base.

San Marino: Pension Statistics  
(In billions of lire, unless otherwise noted)

	1996	1999	Change 96/99
Total pension expenditure 1/	64	86	34.4
Number of retirees 1/	3,806	4,448	16.9
Average pension per retiree (in millions of lire)	16	19	16.2
Number of workers	15,985	18,010	12.7
Of which: <i>frontalieri</i> (in percent)	20	24	
Workers-to-retirees ratio	4.2	4.1	
Contributions 2/ 3/	65	80	23.1
Balance (in percent of GDP)	0.1	-0.5	-0.6

Sources: Sanmarinese authorities; and Fund staff estimates.

1/ Old-age pensions only.

2/ Staff estimates.

3/ Including mandatory state contributions.

providing services and products well beyond the required “essential” level, no direct measures were foreseen to curtail the supply of some “nonessential” services or products. The authorities thought that considerable progress could be achieved with the envisaged separation of health care management in the ISS and a hardening of budget constraints.

25. **The staff argued that preserving free access to essential health care over the medium term would require further action on supply and demand.** In particular, (i) the list of health care services and products that are provided free of charge should be reviewed and be limited to essential items; (ii) the introduction of co-payments on selected services and pharmaceutical products should be considered, possibly combining them with some transfers to limit the adverse consequences for the poorest segments of society; and (iii) pharmacies should dispense generic products whenever available.

#### **D. Factor and Product Market Issues**

26. **Product markets in San Marino appear to be working well.** The staff welcomed the authorities’ plans to considerably reduce and refocus subsidies, which are estimated at almost four times the EU average (as a share of GDP) and encompass cash grants, tax exemptions, and subsidized credit. Following the liberalization of the licensing system (May 1999) and the adoption of a less-restrictive commerce law (July 2000), the authorities have proposed to parliament the transformation of the major public services company (AASS) into a publicly-owned joint stock company.

27. **High employment growth and a low unemployment rate were supported by wage moderation, low payroll taxation, and a successful social partnership.** While labor market regulation is very restrictive, flexibility exists at the margin, as employers are free to hire Italian commuters under temporary contracts. With a weak job market in surrounding areas, commuters could be attracted by Sammarinese employers even with lower average wages than in Italy. Recently, however, average wages have surpassed Italian levels but labor costs remain lower, thanks to lower payroll tax rates. The staff thus argued that wages in the private sector needed to be set bearing in mind wage developments in surrounding regions. The authorities explained that the rapid decline of San Marino’s labor cost advantage relative to Italy over the last decade was partly due to generous public sector wage increases. They planned to improve education and training and to contribute to wage moderation through the intended reduction in public employment as well as through slowing public sector wages.

28. **Available data point to a banking system that is well capitalized and provisioned and the authorities are further strengthening the regulatory environment** (Box 3). The staff strongly supported the formal implementation of Basel principles and capital adequacy requirements—envisaged for the first half of 2002—as the framework for supervision of the banking system. It recommended that the Office of Banking Supervision (OBS) adopt a more stringent definition of nonperforming loans: at this stage, the classification is left to banks and thus such loans appear as nonperforming only after action has been taken to recover them. Furthermore, the staff recommended a reconsideration of the high limits on large

### Box 3. The Banking System

The banking sector is of strategic importance for San Marino given its size and contribution to fiscal revenue. A background paper analyzes developments and emerging challenges. The Sammarinese banking system comprises four large banks—two of which are Italian owned—and four small banks that have begun operating in 2000–01. However, the entire financial sector employs only 3 percent of the economy’s workforce, compared with 10 percent in Luxembourg.

**Performance and activities:** The data suggest that the banking system is profitable, well capitalized, and well provisioned. Profits rose in 2000, owing to higher interest rate margins, a continued expansion of asset management, and more lending to firms. The bulk of activity is concentrated in buying euro-denominated certificates of deposits at longer maturities and reselling them to nonresident depositors at Sammarinese banks through three-month repurchase agreements, a low-risk activity the importance of which partly explains the high capital adequacy ratios. However, asset management is becoming increasingly important. For example, Sammarinese banks have teamed up with Italian banks to offer mutual funds managed in Luxembourg. As a result, fees and commissions quadrupled during 1997–2000, to reach 23 percent of operating income, similar to the share in the Italian banking system. About one-fifth of the banking system’s assets are traditional loans, of which some 10 percent are granted at preferential rates under a government-subsidized credit scheme.

**Comparative advantage:** Sammarinese banks can offer more attractive interest rates than their Italian counterparts because they enjoy lower operating costs and have a better loan portfolio. Assets managed per employee are almost 2½ times the level recorded at Italian banks, and administrative costs, in percent of operating income, are only 40 percent. The loan portfolios of Sammarinese banks are stronger, helped by a more efficient judiciary system: in 2000, the ratio of nonperforming to total loans stood at about one-sixth of the ratio in Italy. In addition, the Sammarinese banks pay lower taxes. With respect to depositors, taxes withheld on interest income are 13 percent, versus 27.5 percent or 12.5 percent (on public debt) in Italy. Furthermore, bank confidentiality is high but with the Financial and Exchange Agreement concluded with Italy—which allows Sammarinese banks to operate directly in international markets—San Marino agreed to provide information to the Italian judiciary for investigations into tax evasion.

Banking System Indicators

	1999	2000
Assets (in percent of GDP)	586	574
Foreign deposits (in percent of total deposits)	...	54
Loans (in percent of GDP)	109	125
Nonperforming (in percent of total credit)	1.6	1.2
Preferential (in percent of total credit)	10	10
Provisions (in percent of credit)	...	5.1
Deposits (in percent of credit)	177	130
Capital (in percent of assets)	12.1	12.9
Capital adequacy ratio		...
Highest	48.5	57.6
Lowest	14.0	12.6
Administrative costs (in percent of operating income)	24	23
Profits (in percent of assets)	0.6	0.7
Profits (in percent of capital)	5.1	5.2

Sources: Sammarinese authorities; annual reports of banks; and Fund staff estimates and calculations.

**Supervision and the regulatory environment:** Aside from supervising the financial sector, the Office of Banking Supervision (OBS)—with eight employees as of mid-2001—advises on legal changes for the financial sector; drafts and implements regulatory changes; collects and disseminates data; and investigates money laundering activities. Banks do not need to meet a specific capital-to-asset ratio but the supervisor monitors developments in their BIS ratio. Banks can provision up to 5 percent of outstanding credit (tax-free) for general credit risk, but there are no specific provisioning requirements; loans must be classified as nonperforming only once the bank has taken action against a delinquent debtor. Medium- and long-term loans cannot exceed the highest of one-third of deposits or one-half of total loans. Exposures exceeding 20 percent of bank capital are considered large, and they require prior approval if they exceed 40 percent. In practice, banks submit proposals of loans exceeding 20 percent of capital to the OBS before proceeding.

exposures. On nonperforming loans, the authorities were in agreement but stressed that San Marino's legal system was working well. On large exposures, they explained that the banks submit all proposals for loans exceeding 20 percent of capital to the OBS for an evaluation.

29. **The authorities plan to develop a legal and regulatory framework for insurance and mutual fund activity. The staff pressed for adequate staffing of the OBS and recommended more disclosure of financial sector information.** The authorities stressed that various measures to increase the staffing at the OBS, which had only eight employees at the time of the discussions and supervises all financial sector companies, were being examined. In the spirit of the increased disclosure envisaged under the new Basel capital accord, the staff recommended that the OBS publish its periodic reports on the aggregate banking system, move toward frequent and timely reporting of financial soundness indicators, and require similar action by individual financial institutions. The authorities indicated that they intended to take steps in this direction. Regarding the central bank, staff recommended that it divest its majority equity stake in a company that manages a mutual fund in which the central bank invests and which it markets to the public in San Marino.

30. **Major progress has been made in the fight against money laundering** through the adoption of a law on money laundering.<sup>11</sup> A recent evaluation by the Select Committee of Experts on the Evaluation of Anti-Money Laundering Measures of the Council of Europe concluded that San Marino's anti-money laundering system had a solid legislative basis and that the main challenges now lay in the operational domain.<sup>12</sup> The OBS, the designated financial intelligence unit, has already referred several cases of suspected money laundering activities to the judicial authorities. The staff nonetheless argued that, given its many responsibilities, the OBS's ability to conduct investigations would benefit from additional staffing. Measures to restrict the recourse to anonymous nonfinancial company ownership through bearer shares and nominee shareholders—a weak point in San Marino's anti-money laundering system, as the transfer and ownership of shares in these companies is not monitored by financial sector supervisors, nor is it accounted for in a public register—are under consideration. The staff stressed the need to better identify remaining owners, a position with which the authorities agreed. Since the discussions, the authorities have strengthened their international collaboration to monitor financial flows related to terrorist

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<sup>11</sup> San Marino has also ratified the *1990 Council of Europe Convention on Laundering, Search, Seizure and Confiscation of Proceeds from Crime* (the Strasbourg Convention) and signed the *European Convention on Mutual Assistance in Criminal Matters* and the *European Convention on Extradition*. San Marino is a member of the Council of Europe Select Committee of Experts on the Evaluation of Anti-Money Laundering Measures, which has observer status with the Financial Action Task Force on Money Laundering.

<sup>12</sup> A summary of the findings is reported in the Financial Action Task Force Annual Report 2000–2001.

activities and have instructed banks and other financial institutions to freeze the assets of persons or organizations listed as suspects of international terrorist activities.

#### E. Statistical Issues

31. **The statistical base has improved considerably but important weaknesses remain** (Appendix II). The authorities agreed with the staff that more work was needed to build a database that would inform ongoing policymaking. In particular, they concurred on the need to: (i) produce quantitative and qualitative indicators of current and expected economic conditions; (ii) compile a full set of public sector accounts on an ESA95 basis; (iii) publish more comprehensive data on the financial sector; and (iv) improve the quality of existing data. The staff stressed that this would require a considerable increase in resources devoted to statistics, including expert technical assistance, and should allow the preparation of an *International Financial Statistics* data page.

### III. STAFF APPRAISAL

32. **San Marino has enjoyed an extended period of remarkably strong economic performance**, posting real GDP growth well above the rates recorded in neighboring regions or in the euro area and low unemployment. Product and factor markets generally work well. The challenge at hand is to sustain this performance in an increasingly competitive international environment.

33. **Despite the positive economic developments, the central government budgetary balance has moved into a substantial deficit on an accruals basis**, because of tax collection difficulties and rapidly rising outlays on generous entitlement programs. This fiscal performance compares unfavorably against that of euro-area countries, particularly the rapidly growing economies. If left unchecked, it could break the virtuous circle of high growth and a low tax burden.

34. **While the near-term economic outlook remains comparatively positive, the medium-term challenge is that of maintaining strong growth in a more competitive international environment.** In the immediate future, the factors that have driven the high growth relative to surrounding regions—notably a lower tax burden and a stable and efficient public administration—remain in place and augur well for near-term performance. However, San Marino's labor cost advantage over neighboring regions has gradually narrowed and further pressure could emerge if surrounding regions reduce the tax burden or reform factor markets.

35. **Against this background, fiscal policy must play a key role in maintaining San Marino's attractiveness as a place to conduct business.** San Marino's tax base is potentially highly mobile, ruling out sizable tax increases to finance generous expenditure policies. Similarly, contracting public debt—even to fund public investment—carries risks, as the returns on such investment crucially hinge on the presence of mobile factors of

production. By contrast, an explicit commitment by the government to a sound fiscal policy—as exemplified by a central government budget in balance or in surplus, a low debt level, and a low tax burden—would provide an important assurance to investors and workers on the evolution of fiscal policy over the medium term. Because of the mobile tax base, the case for maintaining balance or a surplus—a target to which euro-area countries are already committed—is particularly compelling in the case of San Marino.

36. **The budget should present clearly the intended fiscal policy.** Revenue should be realistically projected, with the help of a fully specified macroeconomic framework, and if a contingency reserve is needed, it should be shown explicitly under programmed expenditure. Thus, the programmed borrowing requirement should reflect only the intended gap between expenditure and revenue, with the sources of financing clearly spelled out.

37. **In line with a commitment to a sound fiscal policy, the central government budget should be returned to balance in 2003.** The government's new economic program recognizes that public policies need adjustment to maintain the virtuous circle of high economic growth and low taxation. While it might have been preferable to focus on measures to cut spending, the revenue measures for 2002 are generally well targeted—notably the suspension of the tax expenditure program, which should be made permanent—as they would not affect growth and competitiveness and would facilitate tax administration. However, further action is needed to durably balance the budget in 2003, as a large proportion of the receipts flowing from the revenue measures will be temporary. Such action will need to focus on slowing current expenditure growth.

38. **Reducing public expenditure pressures requires reforms to the public administration and the entitlement programs.** The authorities' plans to gradually align public sector wages with those in the private sector, to reduce the size of the civil service through attrition, and to reallocate staffing to areas of greatest need are well placed. Their implementation should begin in the context of the wage contract that is presently under negotiation. Similarly, the steps under consideration for the reform of the pension and health care systems—improvements to management and stronger incentives for cost savings—go in the right direction.

39. **Putting the pension system on a sound medium-term financial footing requires a broader reform.** Building on the consensus among social partners on the need for action, measures should, in the first instance, strengthen the link between contributions and benefits, including a lengthening of both the period over which the qualifying wage is calculated and the required minimum contribution period to qualify for a worker pension. Furthermore, the establishment of a fully funded pillar, which is presently under discussion, should be pursued: such a pillar is particularly attractive because of the high mobility of San Marino's tax and contributions base.

40. **The health care system generally performs well but, under the pressure of population aging, expenditures have rapidly accelerated and measures will be needed to**



**ensure free access to essential products and services to future generations.** The steps to improve management and reduce waste are welcome but further reforms are necessary, including dispensing, whenever possible, only generic products free of charge and limiting health care services and products that are provided free of charge only to essential items.

41. **The labor market has operated smoothly but wage setting needs to take into account labor cost developments in surrounding regions.** San Marino's labor cost advantage over surrounding regions has rapidly diminished because of tight labor market conditions. The authorities' plan to reduce public sector wage increases and employment is welcome, as it would help free up resources for the private sector. Despite a locally tight labor market, wage moderation in the private sector is called for. By sustaining the inflow of business and commuters, such a policy can help in the transition to entitlement programs that are consistent with a budget in balance or surplus over the medium term.

42. **San Marino's financial sector appears profitable and strong but faces a number of challenges that call for changes in the regulatory framework and in supervision.** The increasingly competitive environment in the financial sector and the planned introduction of a legal and regulatory framework permitting insurance and mutual fund activities in San Marino require changes in supervisory policies and practices that need to be supported with an increase in the staffing at the Office of Banking Supervision (OBS). The planned adoption of the Basel capital adequacy framework is an important step in strengthening banking supervision. Following its adoption, the OBS should consider a self-assessment against the Basel Core Principles of Supervision. Additionally, to leverage the effect of the strengthening of policies, the OBS should publish its periodic reports on the financial sector and move toward frequent and timely reporting of financial soundness indicators. Similar action should be required of individual financial institutions. Considering the products and services offered by private financial sector operators, the monetary authorities should not remain involved in financial sector activity for commercial purposes.

43. **The fight against money laundering has been stepped-up** through the adoption of a solid legal framework. Other than the need to better identify the anonymous owners of some forms of incorporated businesses, the main challenges lie in the operational sphere and here the authorities should stand ready to meet requests by the OBS for additional resources to investigate money laundering.

44. **There are important shortcomings in many parts of San Marino's statistical database.** In particular, the lack of data on current economic conditions undermines informed policymaking and hampers effective Fund surveillance. In the fiscal area, drawing up and publishing a full set of public sector accounts in line with ESA95 standards would help policymaking and facilitate the public's understanding of fiscal policies and developments. The authorities' determination to continually improve statistics and accounting is welcome but it is crucial that the resources devoted to the collection and compilation of data be increased expeditiously to soon remedy the remaining important deficiencies.

45. The staff urges to authorities to raise the level of **official development assistance**—which stood under 0.3 percent of GNP in 1999 but has since fallen—to the UN-recommended target of 0.7 percent of GNP.

46. It is recommended that the next consultation take place on the 24-month cycle

Table 1. San Marino: Basic Data

Total area (sq. km.):	61.2						
Population (December 2000):	26,941						
GNP per capita (current US\$, 1999):	23,390						
Life expectancy (2000):	77 (male)						
	84 (female)						
Infant mortality (1995/1999 average):	7.9 per thousand						
	1996	1997	1998	1999	2000	2001	2002
<b>Output and Prices</b>							
Real GDP 1/	4.9	6.9	7.5	9.0	7.5	7.5	6.0
Real National Income	...	...	6.1	7.1	...	...	...
Employment	2.6	3.3	4.3	4.5	3.5	3.5	3.0
Unemployment rate (end of year)	4.9	4.2	4.0	3.2	3.0	2.6	2.5
Inflation rate (annual average)	4.9	2.0	2.1	3.3	3.3	3.3	2.0
Wages	9.3	5.0	4.2	3.9	1.9	...	...
<b>External Accounts</b>							
Trade balance (in millions of US\$)	22.6	...	...	...	...	...	...
Exports 2/	218.7	233.8	201.6	196.7	...	...	...
Imports 2/	215.8	238.3	203.8	200.0	...	...	...
Current account balance (in millions of US\$)	10.7	...	...	...	...	...	...
(In percent of GDP)	1.3	...	...	...	...	...	...
Number of tourists (in millions)	3.3	3.3	3.3	3.1	3.1	...	...
(Percent change)	-0.7	-1.1	-1.3	-3.6	-2.5	...	...
Average length of visit (in days)	1.3	2.1	1.5	1.5	1.4	...	...
Lira US\$ exchange rate (end of period)	1,531	1,759	1,936	1,945	1,802	...	...
Nominal effective exchange rate index (Italy) 3/	75.6	75.8	76.0	74.1	70.7	71.1	...
Real effective exchange rate index (Italy) 3/	84.9	85.4	86.0	84.3	80.9	81.6	...
<b>Fiscal variables 2/ 4/</b>							
Central government revenue	55.1	59.7	57.2	57.5	47.5	44.1	44.6 5/
Net of tax reimbursements	30.1	31.2	31.8	28.1	26.9	25.6	26.7 5/
Central government expenditure	56.9	61.1	57.4	60.2	50.3	46.6	45.6
Net of tax reimbursements	31.9	32.6	32.0	30.7	29.7	28.1	27.7
Central government balance	-1.8	-1.4	-0.2	-2.6	-2.8	-2.5	-1.0 5/
Central government deposits 6/	15.3	13.1	8.4	10.8	2.1	8.5	...
Gross public debt 7/	12.8	14.5	14.3	14.0	13.3	...	...
<b>Interest rates 8/</b>							
Loans	13.8	11.0	8.2	8.1	8.7	9.0	...
Repurchase agreements	8.1	6.2	4.3	2.6	4.5	4.3	...
Time deposits	5.5	4.2	3.3	2.6	3.0	2.9	...
Italian deposits	6.6	5.0	3.3	1.8	1.8	2.0	...
<b>Net foreign assets 2/ 8/</b>							
Deposit money banks	81.6	84.5	66.7	73.9	55.0	47.0	...
Central bank 9/	26.8	25.2	20.1	17.9	16.5	15.9	...
Fitch IBCA country rating 10/	AA						

Sources: Sammarinese authorities and Fund staff estimates. Data for 2001-02 are Fund staff estimates and projections.

1/ Fund staff estimate for 2000.

2/ In percent of GDP.

3/ Annual average. Data for 2001 are for end-July.

4/ Accrual basis.

5/ Assumes that direct tax revenues increase by 3 percent in the absence of measures and that the tax revenue measures yield the budgeted amounts (of about 1.5 percent of GDP). For nontax revenue, capital revenue is assumed in line with the budget. The amount of capital revenue that can be raised through asset sales is capped at the equivalent of about 1.5 percent of GDP.

6/ Data for 2001 are as of August 8.

7/ Data for 2000 are for end-September.

8/ End of period. Data for 2001 are for end-June.

9/ The central bank (ICS) has no foreign liabilities.

10/ Long-term, foreign currency rating. Italy's Fitch IBCA rating is AA-.

Table 2. San Marino : Central Administration Operations  
(In percent of GDP)

	1996	1997	1998	1999	2000	2001	2001	2002
						Est.	Budget	Budget
Total revenue	55.1	59.7	57.2	57.5	47.5	44.1	47.6	47.0
Total revenue net of reimbursements on tax advances and other revenue n.e.c.	30.1	31.2	31.8	28.1	26.9	25.6	26.5	26.3
Current revenue	54.1	59.4	56.3	56.4	46.6	43.3	44.2	43.0
Tax Revenue	46.7	52.1	49.9	50.7	41.2	38.2	39.1	38.3
Direct taxes	9.6	10.8	11.3	10.4	9.2	9.0	9.9	10.3
Indirect taxes	1.9	1.9	1.8	1.9	1.8	1.8	1.8	1.9
Monofase	35.2	39.4	36.8	38.4	30.2	27.4	27.4	26.1
Nontax revenue	7.4	7.2	6.4	5.7	5.4	5.1	5.1	4.7
Capital revenue	1.0	0.3	1.0	1.2	0.9	0.8	0.8	1.7
Other revenue n.e.c. 1/	...	...	...	...	...	...	2.6	2.2
Total expenditure	56.9	61.1	57.4	60.2	50.3	46.6	47.4	46.7
Total expenditure net of reimbursements on tax advances	31.9	32.6	32.0	30.7	29.7	28.1	28.9	28.3
Current expenditure	52.0	56.7	52.9	57.2	47.1	43.3	44.1	43.9
<i>Of which:</i>								
Wages and salaries	10.2	10.8	10.9	10.5	10.3	10.0	9.6	9.7
Goods and services	...	...	3.2	3.1	3.2	2.9	...	2.4
Transfers to private sector	...	...	1.2	1.0	1.0	0.9	...	0.9
Interest	...	...	0.5	0.3	0.3	0.2	0.2	0.3
Reimbursements on tax advances	25.0	28.5	25.4	29.5	20.5	18.5	...	18.4
Transfers to rest of the public sector	...	...	11.3	12.3	11.4	10.5	...	11.4
Other current expenditure	...	...	0.4	0.4	0.3	0.3	...	0.9
<i>Of which: contingency reserve</i>	...	...	...	...	...	...	0.1	0.6
Capital expenditure and net lending	4.8	4.4	4.5	3.0	3.2	3.3	3.3	2.8
Balance	-1.8	-1.4	-0.2	-2.6	-2.8	-2.5	0.2	0.2
Financing	1.8	1.4	0.2	2.6	2.8	2.5	-0.2	-0.2
New Float (- asset) 2/	2.1	2.7	-1.0	5.2	-1.8	0.0	0.0	0.0
Domestic financing	3.1	1.6	3.6	-3.3	7.8	2.8	0.0	0.0
Foreign Financing	0.0	0.0	-0.1	-0.2	0.1	-0.2	-0.2	-0.2
Loans	0.0	0.0	0.0	0.0	0.3	0.0	0.0	0.0
Amortization	0.0	0.0	-0.1	-0.2	-0.2	-0.2	-0.2	-0.2
Payments (-)/ accumulation of arrears 3/	-3.4	-2.9	-2.4	0.9	-3.2	0.0	0.0	0.0
Memo:								
Total transfer to the rest of the public sector	14.2	14.6	13.9	14.0	14.0	...	13.2	...
Net presumed inflow from monofase	10.2	10.9	11.4	8.9	9.7	8.9	8.9	7.7

Sources: Sammarinese authorities and Fund staff calculations.

1/ "Mutuo a pareggio di bilancio" (programmed borrowing requirement): in the authorities' presentation—and for budgeting purposes only—de facto represents an actual unallocated source of fiscal revenue or financing and not necessarily a loan.

2/ The system of reimbursement on tax advances generates large volumes of float to be carried over to the next year. For 2001, no float is assumed to arise.

3/ These are carried over items that were cashed in the fiscal year. No carryover is assumed for 2001.

**San Marino: Fund Relations**

(As of October 31, 2001)

I. **Membership Status:** San Marino became a member of the Fund on September 23, 1992. San Marino accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Fund Agreement as of September 23, 1992.

II. <b>General Resources Account:</b>	<b>SDR Million</b>	<b>Percent Quota</b>
Quota	17.00	100.0
Fund holdings of currency	12.90	75.9
Reserve position in Fund	4.10	24.1

III. <b>SDR Department:</b>	<b>SDR Million</b>	<b>Percent Allocation</b>
Holdings	0.31	n.a.

IV. **Outstanding Purchases and Loans:** None

V. **Latest Financial Arrangements:** None

VI. **Projected Obligations to Fund:** None  
Under the Repurchase Expectations Assumptions

VII. **Exchange Rate Arrangements:** Prior to 1999 the currency of San Marino was the Italian lira. On January 1, 1999 San Marino adopted the euro. The central monetary institution is the Istituto di Credito Sammarinese. Foreign exchange transactions are conducted through commercial banks without restriction at rates quoted in Italian markets. There are no taxes or subsidies on purchases or sales of foreign exchange.

VIII. **Article IV Consultation:** San Marino is on a 24-month consultation cycle; the last consultation discussions with San Marino were held in November 1998 and concluded on 2/11/99 (EBM/99/37).

IX. **Technical Assistance**

<b>Year</b>	<b>Dept.</b>	<b>Purpose</b>	<b>Date</b>
1997	STA	Multisector assistance	3/97

X. **Resident Representative:** None

### San Marino: Statistical Issues

There are important shortcomings in many parts of San Marino's statistical database. The authorities recognize these deficiencies, and requested and received a multi-sector technical assistance mission from STA in 1997 to assist them in addressing the most acute problems. Progress has been made, despite lack of basic data (e.g., due to the absence of border controls) and a limited number of adequately trained personnel.

Since 1992 the authorities have produced an experimental set of **national accounts**. Data for 1995–99 have been calculated in accordance with ESA95. There are still weaknesses in the source data used to construct the accounts and information on a sectoral breakdown of output is not available. **High frequency data on output** in key sectors of the economy are not available. **Consumer price data** are collected through responses to surveys and thus are not considered very accurate; also, they are published with long lags. As of 2002, the data will be collected at source and published monthly with a short delay. **Qualitative data on consumer and business confidence** are not collected.

For **government finance statistics**, the relevant cash and accrual data are collected. However, the balance sheet for the central government is not presented according to standard IMF classifications. The central government **budget** is written so as to close at par, which implies that standard financing items, such as amortization, are included as an expenditure while new loan financing is included among the revenues. Typically, the authorities underestimate revenue to create room for a "borrowing requirement" that would be approved by parliament during the budget discussions. In the event, however, revenue shortfalls have been financed by (i) drawing down deposits at the central bank; (ii) changes in volumes of payables/receivables. The **deficit/surplus** concept monitored by the authorities (the *avanzo/disavanzo d'esercizio*) is the difference between the end of year result and the budget. This concept is different from a standard central government balance on an accruals basis, as it includes unpaid liabilities and revenues receivable among expenditure and the revenue. It is expected that **the new system of budgetary accounting** to be implemented in 2002 will improve the fiscal database, including through the availability of consolidated government accounts. The GFS database includes annual data for 1995 for the consolidated central government, compiled by the 1997 Multisector Statistics mission. It is expected that San Marino will soon provide updates.

For **monetary statistics**, the authorities have, since May 1997, provided balance sheet data on the commercial banks and the monetary authorities to STAs EIS database. These data are provided on a quarterly basis, with approximately a six-week reporting lag. A weakness of the data is that the breakdown of deposits (and other assets and liabilities) between residents and nonresidents is based on working assumptions. However, new data have been prepared and will be submitted soon. More importantly, a breakdown of short-term credit data into public and private sector components is not available. To remedy this, the authorities plan to change the reporting requirements for banks.

San Marino does not compile comprehensive **balance of payments accounts**. It has not committed the required resources, as the currency union with Italy (now superseded by the use of the euro) has made the balance of payments relatively unimportant as a policy consideration.

San Marino: Core Statistical Indicators  
as of October 22, 2001

	Exchange Rates	International Reserves	Reserve/ Base Money	Central Bank Balance Sheet	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/GNP
Date of Latest Observation	1/ 8/2/01	5/ June 2001	2/	June 2001	2/	June 2001	December 2000	4/ 1999	3/	2000	1999 3/
Date Received	8/2/01	August 27, 2001		August 27, 2001		August 27, 2001	September 2001	September 2001		September 2001	September 2001
Frequency of Data	Daily	Quarterly		Quarterly		Quarterly	Monthly	Annual		Annual	Annual
Frequency of Reporting	Daily	Quarterly		Quarterly		Quarterly	Quarterly	Annual		Annual	Annual
Source of Data	Reuters	ICS		ICS		ICS	Statistical Office	Statistical Office		Budget Document	Statistical Office
Mode of Reporting	Electronic	Fax		Fax		Fax	Publication	Publication		Publication	Publication 1/
Confidentiality	None	Internal		Internal		None	None	None		None	None

1/ San Marino officially adopted the euro as its currency since January 1, 1999, but the Italian lira remains the circulating currency. Exchange rate data for the euro are available on a continuous basis through Reuters/Bloomberg services.

2/ The Istituto di Credito Sammarinese (ICS), which began operating in 1992, is the central bank. However, it does not engage in the full range of central bank functions because of the use of the Italian lira (and soon the euro) as legal tender.

3/ San Marino does not produce official estimates of the balance of payments. National accounts data for 1994 and earlier are based on staff estimates and data provided by the authorities.

4/ National accounts data.

5/ San Marino reports data on monetary authorities' current accounts and time deposits at nonresident banks in euros and foreign currencies. However, these assets do not serve the same policy purposes of international reserves in other countries because San Marino does not have an independent monetary or exchange rate policy.



INTERNATIONAL MONETARY FUND

*Public Information Notice*

EXTERNAL  
RELATIONS  
DEPARTMENT

Public Information Notice (PIN) No. 01/128  
FOR IMMEDIATE RELEASE  
December 21, 2001

International Monetary Fund  
700 19<sup>th</sup> Street, NW  
Washington, D. C. 20431 USA

## **IMF Concludes 2001 Article IV Consultation with San Marino**

On December 5, 2001, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with San Marino.<sup>1</sup>

### **Background**

San Marino's economic growth performance has remained impressive. Real GDP growth averaged more than 8 percent during 1998–99, driven by strong investment. With employment growth at about 3½ percent in 2000, accelerating credit, and a rebound in GDP growth elsewhere, activity is estimated to have remained buoyant in 2000.

Underlying price pressures moderated in the course of 2000 but rising oil prices kept headline inflation above 3 percent. Inflation developments are coupled with those of Italy but changes in administratively set prices led to a temporary widening of the inflation differential in 1999. Due also to converging wage growth, the differential diminished again in the course of 2000.

Fiscal policy has recently deteriorated. The central government budget deficit widened to around 2¾ percent of GDP during 1999–2000. During most of the 1990s, the central government balance fluctuated around a deficit of about 1 percent of GDP despite a rapid expansion of the tax base, owing largely to overly generous entitlement programs that have

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<sup>1</sup> Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the December 5, 2001 Executive Board discussion based on the staff report.



boosted primary spending at annual rates near 8 percent since 1993. More recently, the fiscal balance worsened also because of tax administration difficulties related to excessive exemptions and loopholes. Developments through the summer of 2001 suggest no change in the fiscal performance. Nevertheless, reflecting San Marino's prudent fiscal policy in the past, the financial position of the public sector is still sound, albeit much weaker than at the beginning of the decade. Gross public debt is estimated at about 10 percent of GDP and gross assets (including the pension fund) at over 20 percent of GDP.

Important ingredients in San Marino's success during the 1990s were a lower labor cost and a higher take-home wage (thanks to lower payroll taxes) than in surrounding regions that promoted job creation and attracted cross-border commuters. In addition, a diversified production structure and supportive business environment protected San Marino from shocks and fostered growth. With the tax base expanding rapidly, San Marino has been able to sustain very high growth in primary spending, spending that, by and large, does not benefit the commuters who have boosted the tax base.

The government's economic program for 2002 recognizes that public policies need adjustment to maintain the virtuous circle of high economic growth and low taxation. Several fiscal revenue measures with limited effects on economic activity and competitiveness are envisaged together with improvements in tax administration. Some of the measures are temporary, pending the adoption of durable expenditure reforms. Spending is to be slowed through reforms to the public administration, including a hiring freeze and lower growth of public sector wages; and through reforms to the pension and health care systems, notably improvements to management and stronger incentives for cost savings.

In the face of the global slowdown in activity, San Marino's near-term outlook has weakened, but remains comparatively positive. The likely effect of the global slowdown is difficult to predict, as economic activity in San Marino does not appear closely correlated with activity elsewhere in Europe. However, many of the factors that have driven San Marino's growth performance over the past few years are likely to continue to play a role in the near term. Maintaining the high economic growth of recent years over the medium term will be challenging, as San Marino's labor cost advantage over surrounding areas has narrowed considerably and its tax burden has become relatively less favorable.

### **Executive Board Assessment**

Directors observed that San Marino has enjoyed an extended period of remarkably strong economic performance, posting real GDP and employment growth well above the rates recorded in the euro area. Product and labor markets generally work efficiently.

Directors considered that in the immediate future, the factors that have driven the high growth— notably a low tax burden and a favorable business environment—will remain in place and augur well for near-term performance, even if the outlook is uncertain due to the global slowdown. However, the central government budget has moved into a larger deficit, due to weak tax

collection and rapidly rising entitlement outlays, and Directors underscored that if left unchecked, this unfavorable fiscal performance could break the virtuous circle of a low tax burden and high growth. This risk has been heightened by the gradual narrowing of San Marino's labor cost advantage over neighboring regions, and further pressure on performance could emerge if surrounding countries reduce their tax burden or reform factor markets.

Against this background, Directors considered that fiscal policy is key to maintaining San Marino's attractiveness as a place to conduct business. They therefore welcomed the authorities' objective to return the central government budget to balance over the next two years. The revenue measures for 2002 are generally well targeted, notably the suspension of the tax expenditure program, which, Directors considered, should be made permanent. They emphasized that further action, focused on containing expenditure growth, will be needed to durably balance the budget in 2003. In this connection, Directors welcomed the authorities' intention to reform the public administration and the entitlement programs, and looked forward to implementation of their plans to gradually align public sector wages with those in the private sector, reduce the size of the civil service through attrition, and reallocate staffing to areas of greatest need.

Looking ahead, Directors encouraged the authorities to pursue a sound fiscal policy over the medium term, by committing to a central government budget in balance or in surplus, a low debt level, and a low tax burden. This would provide an important assurance to economic agents. In view of San Marino's mobile tax base, maintaining budgetary balance or a surplus—a target to which neighboring countries are already committed—would greatly contribute to supporting the long-term growth prospects. Directors also emphasized that the budget should present the intended fiscal policy clearly and be built on a fully specified macroeconomic framework.

Directors welcomed the steps under consideration for reforming the over-generous pension and health care systems. They agreed, however, that placing the pension system on a sound medium-term financial footing will require more ambitious and well-sequenced reforms, including strengthening the link between contributions and benefits, and introduction, over time, of a fully funded pillar. Directors commended the plans to improve management and reduce waste in the health care system, but saw a need for additional measures if the authorities intend to preserve free access to essential health care to future generations.

Directors noted that San Marino's financial sector appears profitable and strong, and they welcomed the authorities' plans to strengthen banking supervision. The adoption of the Basel capital adequacy framework will be an important step in this respect. Directors also encouraged the Office of Banking Supervision (OBS) to publish its periodic reports on the financial sector and move toward frequent and timely reporting of financial soundness indicators. The increasingly competitive environment, and the planned introduction of a legal and regulatory framework permitting insurance and mutual fund activities, will require changes in supervisory policies and practices that need to be supported with an increase in the staffing at the OBS. Directors commended the authorities on adopting a solid legal framework to fight money laundering, and their cooperation in international efforts against the financing of terrorism.

Directors encouraged the authorities to continue their efforts in the area of statistics by increasing resources to remedy remaining deficiencies and, in particular, by producing data on current economic conditions and a full set of public sector accounts in line with Eurostat's ESA95 standards.

**Public Information Notices (PINs)** are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2001 Article IV Consultation with San Marino is also available.

**San Marino: Selected Economic Indicators**

	1996	1997	1998	1999	2000	2001 1/
<b>Real economy (change in percent)</b>						
Real GDP 2/	4.9	6.9	7.5	9.0	7.5	7.5
Real National Income	...	...	6.1	7.1	...	...
Employment	2.6	3.3	4.3	4.5	3.5	3.5
Unemployment rate (in percent)	4.9	4.2	4.0	3.2	3.0	2.6
Consumer prices (percent change, period average)	4.9	2.0	2.1	3.3	3.3	3.3
Wages	9.3	5.0	4.2	3.9	1.9	...
<b>Public finance (in percent of GDP) 3/</b>						
Central government balance	-1.8	-1.4	-0.2	-2.6	-2.8	-2.5
Central government deposits 4/	15.3	13.1	8.4	10.8	2.1	8.5
Gross public debt 5/	12.8	14.5	14.3	14.0	13.3	...
<b>Interest rates (end of period) 6/</b>						
Loans	13.8	11.0	8.2	8.1	8.7	9.0
Time deposits	5.5	4.2	3.3	2.6	3.0	2.9
<b>Balance of payments</b>						
Trade balance (in millions of US\$)	22.6	...	...	...	...	...
Current account (in millions of US\$)	10.7	...	...	...	...	...
Exports (in percent of GDP)	218.7	233.8	201.6	196.7	...	...
Imports (in percent of GDP)	215.8	238.3	203.8	200.0		
<b>Exchange rate regime</b>						
				Uses Italian lira/euro		
Present exchange rate (November 16, 2001)				1.13 euro per US\$		
Nominal effective (lira, 1990=100) 7/	75.6	75.8	76.0	74.1	70.7	71.1
Real effective (lira, 1990=100) 7/	84.9	85.4	86.0	84.3	80.9	81.6

Sources: Sammarinese authorities; IMF staff estimates and projections; and International Financial Statistics database.

1/ IMF staff estimates, unless otherwise noted.

2/ Data for 2000 are Fund staff estimates.

3/ Data are on an accruals basis.

4/ Data for 2001 are for August.

5/ Data for 2000 are for end-September.

6/ Data for 2001 are for end-June.

7/ Data for 2001 are average through end-July.

**Statement by Pier Carlo Padoan, Executive Director for the Republic of San Marino  
December 5, 2001**

At the outset, I wish to convey my authorities' appreciation for the excellent set of papers prepared by the Fund's mission team. Since San Marino joined the Fund in 1992, it has enjoyed an extremely fruitful relationship with the Staff.

**Background**

San Marino is a small but highly dynamic economy that has achieved substantial growth in recent years, about 8 percent, well above that in neighboring Italian regions. With inflation subdued, the economy has been able to experience a steady employment growth of 4.1 percent in 2000 against an EU average of 2 percent, while unemployment has decreased to 2.8 percent compared with 8.1 percent recorded within the EU last year. San Marino has been very effective in creating a favorable business environment conducive to growth and development, attracting substantial flows of workforce and capital from abroad. Despite its dimension, the economy is highly diversified and the manufacturing, the services and the financial sectors all share a substantial role in promoting the growth of the San Marino economy. In June, a new government was elected with a mandate to implement appropriate policies designed to sustain the competitiveness and the development of San Marino in the years ahead.

**Fiscal Policies**

The authorities share the Staff's view that a budget deficit may be detrimental to the competitiveness of an economy with high mobile factors of production, by signaling possible future fiscal adjustment. In this regard and consistent with the aim of strengthening the competitiveness of our economy, some measures have been devised for 2002 since the new government has come into power, while more structural actions will be implemented starting from 2003. It is also expected that the budget will revert back to balance by 2003.

Immediate action has already been taken in the suspending of all new applications for tax relief by companies. Tax relief has been growing significantly over the last decade and is partly responsible for the deterioration of the fiscal stance, as the Staff Report correctly points out. Furthermore, a revision of the tax regime on financial instruments is under way, aimed at smoothing the fiscal pressure across the whole range of instruments held by investors in their portfolios, not only on bank deposits as the current framework envisages.

These measures will be coupled with other structural actions on current expenditures. A hiring freeze has already been put in place in the civil service, the size of which will also be streamlined. In addition, greater attention will be devoted to determining how to make the civil service more effective. In this regard, reforms are being implemented with the aim of encouraging mobility within the administration and streamlining procedures and red tape. In the same spirit, it is envisaged that, after the above-mentioned reforms have been

implemented, public sector wages should be set in line with – and not above – market benchmarks.

Another important area of intervention is the pension system, which needs to provide entitlements more closely related to lifetime contributions. While a thorough reform will be presented later next year, the authorities have already increased the age limit for the retirement of new employees (currently 60 years of age) to 65 years of age. In addition, the management of pension contributions will be separated from that of the healthcare system. The move towards greater transparency is an important factor in fostering a pervasive market-oriented management of pension contributions.

### **Financial Sector Development and Anti-Money Laundering Surveillance**

As the Selected Issues paper points out, San Marino's banking sector compares very favorably with those of the Italian and the Luxembourg economies in terms of profitability and efficiency. The challenge ahead consists of implementing policies to maintain its traditional strength. In this regard, a more diversified ownership structure has been encouraged, allowing the establishment of two new banks with a more internationally-oriented shareholders base. Some domestic banks are already owned by major Italian players and have been integrated into their wide and diversified financial groups. Looking ahead, the development of a payment system for the San Marino banks would allow for a gain in efficiency.

Preserving the competitiveness of the banking sector requires changes in the legal framework. As of today, insurance companies and mutual funds may not be established in San Marino. In the near future, the authorities plan to change the legal framework to enable the banking system to gain substantial economies of scale and scope, while strengthening its customers base, by entering these profitable areas of business.

The growth of the financial sector has been accompanied so far by the development of an effective anti-money laundering framework. San Marino has signed all the relevant international agreements such as the 1990 Strasbourg Convention, the European Convention on Mutual Assistance on Criminal Matters and the European Convention on Extradition. San Marino is also a member of the Council of Europe Select Committee of Experts on the Evaluation of Anti-Money Laundering Measures. The authorities are firmly committed to continue supporting, in cooperation with other governments, major international initiatives aimed at improving and making more effective the fight against money laundering. The authorities stand ready to provide relevant support to the Office of Banking Supervision to improve further its effectiveness in carrying out these important tasks in an evolving financial system.

### **Statistical Issues**

Given the restricted physical dimension of San Marino and the absence of formal borders, the compilation of statistics is obviously challenging. Nonetheless, since San Marino

joined the Fund in 1992, the production of statistics has greatly improved, thanks also to Fund technical support in the form of several surveillance missions and a multi-sector assistance mission from the Statistics Department. The authorities share the Staff view that the statistical database needs to be improved further. In this respect, starting in 2002, consumer price data will be collected directly at the source and the results will then be published on a monthly basis. Improvements in the production of monetary statistics are currently under way and they will be made available on a monthly basis soon.

Importantly, San Marino authorities envisage substantial improvements in the production of government finance statistics with reference to the central government budget. Starting in 2002, the budget will be produced on an accrual basis and according to the EUROSTAT methodology. The authorities see the improvement in the production of their statistics as a pre-requirement for compiling the items prescribed by the International Financial Statistics guidelines.