

Republic of San Marino: Selected Issues for the 2010 Article IV Consultation

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REPUBLIC OF SAN MARINO

Selected Issues

Prepared by Phakawa Jeasakul, Edda Zoli (both EUR) and Richard Pratt (consultant)

Approved by the European Department

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I. THE DEVELOPMENT OF A NEW BUSINESS MODEL FOR SAN MARINO'S FINANCIAL SECTOR¹

A. Introduction

1. **As a small country embedded within Italy, San Marino's financial sector focuses primarily on services to its residents and the residents of its large neighbor.** Italy and San Marino are bound together economically: (i) porous borders facilitate trade and factor mobility; (ii) both countries use the euro (although San Marino does so according to a monetary agreement with the EU, dating from 2001, since it is not a member of the Euro Area or the EU); (iii) there is no requirement for customs checks or declarations at the border; and (iv) Italian citizens can visit Sammarinese financial institutions very easily. It is therefore natural that the overwhelmingly large majority of its trading and financial relationships are with Italian individuals and businesses.

2. **The Sammarinese financial sector has experienced a number of shocks in the last two years and appears now to have accepted that it needs to develop a new business model.** The business model developed over time consisted largely of Sammarinese banks taking funds from Italian citizens who were looking for confidentiality, and investing them in securities. While in the past this has been successful, it required the Italian authorities to take no effective action to impede the flow of deposits from Italian residents seeking such confidentiality. The risk that the attraction of such confidentiality might be reduced by changes in the attitude of Italian residents or the authorities should have prompted the Sammarinese financial sector to seek to provide a more diverse range of services, so as to avoid the need to rely primarily on bank secrecy. While the authorities have gone a long way in recent years to play their part in developing the infrastructure for greater diversity, there has been less evidence of corresponding action on the part of the financial sector. There may now be a greater awareness within Sammarinese financial institutions of the need for change but, having delayed for so long, the options are limited and harder to achieve.

3. **This paper examines the development of the business model hitherto and considers the options for the future.** Sammarinese banks and other financial institutions have escaped much of the attention that international institutions have focused on offshore centers and have preserved a bank secrecy regime longer than most. Their ability to resist international pressure may have prompted a reluctance to invest in new skills and now places them at a disadvantage in seeking rapidly to develop new services. Nevertheless, an analysis of the services offered by offshore centers and of the strengths and weaknesses of San Marino does suggest some possible avenues for the future. Much depends on the ability to enhance relations with Italy and this, in turn, requires a mature understanding of the effect of past choices with respect to international standards on the attitude of negotiating partners now.

¹ Prepared by Richard Pratt.

4. **The paper is organized as follows.** Section B examines the development of San Marino's financial system over the past two decades, including the evolution of its regulatory regime. Section C summarizes the effects of international initiatives on bank secrecy and transparency. Section D reviews the strengths and weaknesses of the Sammarinese financial system, including through the prism of offshore financial centers. Section E discusses options for a new business model, and section F concludes.

B. The Development of the Sammarinese Financial Sector Over the Past Two Decades

The 1990s

5. **Sammarinese banks have a long history.** The first bank in San Marino (Cassa di Risparmio della Repubblica di San Marino - CRSM) opened its doors in 1882. It remained the sole Sammarinese bank until 1920 when it was joined by the Banca Agricola Commerciale (BAC) and what is known today as the Banca di San Marino (BSM). A fourth bank, Credit Industriale Sammarinese (CIS), opened in 1980. By the early 1990s, both BAC and CIS were owned by Italian banks, while CRSM and BSM remained domestically owned.

6. **By the mid 1990s, Sammarinese banks were offering substantial services to Italian residents.** During 1993-1997, total liabilities of what were still the original four banks averaged 600 percent of San Marino's GDP. The primary activity was intermediating funds between Italian savers and capital markets. This was a highly profitable activity with commercial bank profits amounting to 14 percent of GDP. The basis of this activity was differences in withholding tax rates and strict bank secrecy.²

7. **The business model was driven by tax haven and bank secrecy motivations.** Nonresident (i.e. Italian) funds were received through direct bank deposits and repurchase agreements. The funds were then used to buy short term lire financial instruments of three to six month maturity. While interest income on these instruments, when held by Sammarinese banks, was subject to Sammarinese withholding tax rate of 13 percent, it was not subject to the Italian withholding tax on interest income of 27 percent. Italian residents who declared their interest income from San Marino to the Italian authorities would have been liable for the difference between the Italian and Sammarinese withholding tax rates. This would have removed much of the advantage of investing through Sammarinese banks.

8. **The strategy of mainly investing in foreign securities was profitable.** The practice of the four Sammarinese banks was to invest the funds they received in foreign securities. The extent of lending to customers remained relatively modest. Notwithstanding the relative stability

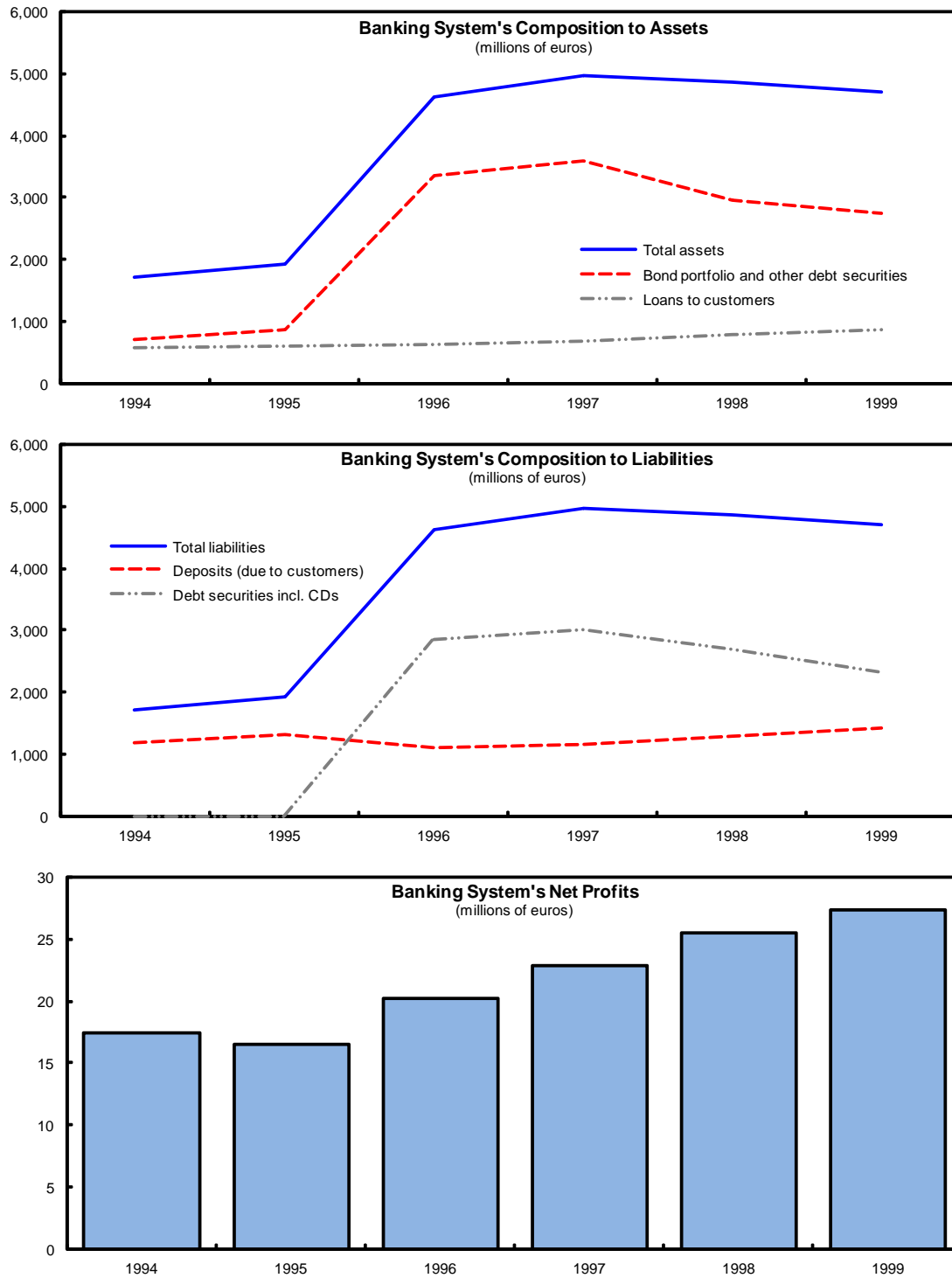
² The bank secrecy provisions in the late 1990s forbade any disclosure of any information by banks except through the judicial authorities. Bank supervisors seeking information would also have to seek information via an official request to the Sammarinese judicial authorities.

of deposits, the profits of Sammarinese banks continued to grow, with net profits of the banking system rising from €17million in 1994, to €27 million by 1999 (see Figure 1).

9. **The financial system was also bolstered by the development of nonbank financial companies.** The first nonbank financial companies offering fiduciary services began operating in 1990. By 1996, there were 17 nonbank financial institutions, rising to 26 by 1998. These firms engaged in both leasing and fiduciary activity. The fiduciary companies would accept funds from customers (primarily Italian) and invest them in their own name. The funds were provided in cash or in the form of multiple endorsed checks. In both cases, the provenance of the funds was difficult to prove, but the fiduciary companies relied upon their own knowledge of the customers and references from professionals in Italy. This service was primarily attractive to those Italian clients who were seeking confidentiality.

10. **The banks were not subject to regulation at international standards.** In the 1990s, financial sector supervision was the joint responsibility of the Office of Bank Supervision (OBS) and the Istituto di Credito Sammarinese (ICS). The OBS took primary responsibility for monitoring the banks and collecting bank information. No formal assessment of compliance with the Basel Core Principles was undertaken. However, as early as 1999, the IMF urged the Sammarinese authorities to make efforts to adopt the Basel Core Principles.

Figure 1. San Marino: Banking System, 1994–1999



Source: CBSM; and IMF staff calculations.

1/ After extraordinary items and taxes, and after provision to "fund for general banking risk."

The Second Development Phase: The Expansion of Institutions

11. **Banks' balance sheets expanded sharply between 2000 and 2008, despite a tax amnesty in 2001, but then contracted as a result of the 2009 tax amnesty.** Perhaps as a result of the strong growth in bank profits during the 1990s, and facilitated by a decision to relax bank licensing policy somewhat, the number of Sammarinese banks increased from the original four in 2000 to ten in 2003 and twelve by 2009. Following an Italian tax amnesty in 2001, which caused a temporary pause in the rise of bank liabilities, the flow of Italian funds into San Marino quickly resumed and total liabilities had reached €7 billion in 2004. They continued to increase, peaking at €11.5 billion in 2008. The 2009 tax amnesty had a substantial effect, with bank liabilities falling by a third (see Figure 2).

12. **Over this period, lending to customers increased, but the level of liquid securities remained significant, which helped unwind the deposit outflow in 2009-10.** As Figure 2 shows, the business model evolved slightly, as much of the increase in deposits received between 2000 and 2008 was lent to customers, while investments in securities remained fairly constant, thus increasing the proportion of customer loans in total assets. Nevertheless, the investment in liquid securities was extremely helpful in 2009-10 as these securities were sold to accommodate the deposit outflow.

13. **Increased competition halted the growth in profits of the original four banks, but profitability resumed its upward trend until 2008.** Notwithstanding the expansion in liabilities, the increased competition appears to have put pressure on bank profits, which held steady at about €30 million between 2000 and 2004 (see Figure 2). Throughout this period, the original four banks accounted for virtually all the profits as the new banks sought to establish themselves. In 2005, total profits were hit by the losses suffered by one bank, but the original four maintained their joint profitability at around €30 million. After 2005, the profits of the original four began to rise, while the more recently established banks also began to show profits. By 2008, total system profitability had grown to €47 million, of which the original four banks accounted for 93 percent. Profitability held up in 2009, but was clearly suffering by 2010 as a result of the tax amnesty and other actions taken by the Italian authorities to crack down on tax haven countries.

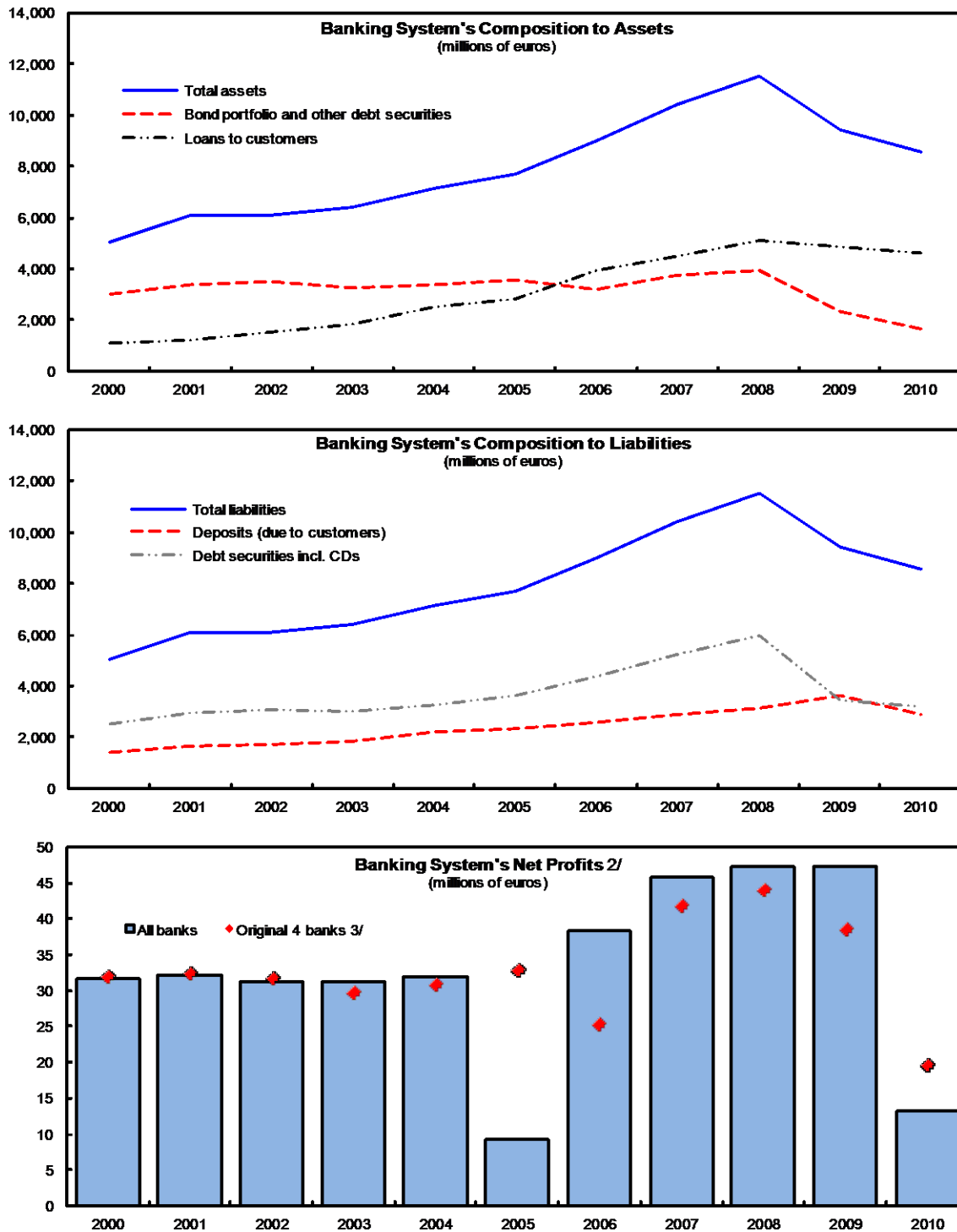
14. **Notwithstanding the strength of Sammarinese balance sheets, there were some problems with respect to lending policies.** It would appear that Sammarinese banks found it difficult to diversify their lending and, when the Central Bank of San Marino (CBSM) imposed loan concentration limits, many Sammarinese banks required a five year transition period to allow them to rebalance their portfolios to meet the new limits. Moreover, the largest bank, CRSM, invested heavily in an Italian financial group – Delta – and found, when the Italian authorities seized the assets and appointed administrators, that the investment would be largely lost and that credits advanced to Delta would also suffer substantial losses.

15. **Nonbank financial institutions also expanded until recently.** The number of financial companies increased from 26 in 1998 to 53 in 2008. However, the 2009 tax amnesty, strengthened regulation and other factors caused the number of nonbank financial firms to fall to under 40 by end-2010. Assets within fiduciary companies were also subject to the same pattern, rising to €3.4 billion by 2008 and falling to €1.5 billion by June 2010.

16. **Rising competition did not alter the business model.** Although the proportion of loans in total assets grew, following the expansion in the number of banks and financial institutions, the essential characteristics of the business model remained the same. Deposits were attracted primarily from Italian citizens who wished to enjoy the protection of bank secrecy. These deposits were invested in securities and, to an increasing extent in lending. Nevertheless, although not apparently recognized by the financial system, the model was becoming increasingly risky. More of the assets were being lent – and it appears that there was increasing exposure to single individuals or institutions or to connected groups. Moreover, there were increasing external threats to the model in the form of strengthening regulation and international pressures for greater transparency.

17. **Since 2000, the Sammarinese authorities began to strengthen regulation (Box 1).** By 2001, the authorities had adopted the first Basel capital accord and committed themselves to moving to full compliance with the Basel Core Principles (BCP). In 2003, the OBS and the ICS merged to form the new central bank. The 2005 financial services law formally created the central bank and gave it full regulatory powers. Prudential regulations for banks were issued in 2007, with enhancements in 2008-09. Some banks were subject to a transitional regime, which allowed them until 2013 to come fully into line with the prudential standards. A BCP assessment undertaken as part of the 2009 FSAP judged the level of compliance to be reasonably good, subject to the completion of the transitional measures. The regulation of the nonbank financial institutions was also strengthened in 2010, in line with IMF recommendations, and the authorities have enacted legislation that enabled the introduction of mutual funds for investment business and insurance. The Sammarinese authorities have accepted that they will need to implement the acquis of EU Financial Services Directives as part of a continuing agreement that the country should use the Euro as its currency, but have stated that it will take them until 2015 to achieve this.

Figure 2. San Marino: Banking System, 200–2010



Source: CBSM; and IMF staff calculations.

1/ As of June 2010.

2/ After extraordinary items and taxes, and after provision to "fund for general banking risk."

3/ Before 2000, the system had four banks:

Box 1. Strengthened Regulation

Over the past decade, the IMF has been urging the adoption of international standards of prudential regulation and the authorities have responded. Indeed, much has been achieved since 2001; however, the regulatory authorities were starting very late and from a low base.

Measures to counter money laundering and terrorist financing have been upgraded. The authorities enacted and strengthened AML laws in the early part of the decade, giving the responsibility of acting as Financial Intelligence Agency to the OBS. Following the evaluation by MONEYVAL in 2008, San Marino reacted quickly to enact new AML/CFT legislation, to create an independent Financial Intelligence Agency (FIA) and otherwise to strengthen defenses. The regime was assessed as part of the 2009 FSAP and reviewed again by MONEYVAL in 2010. A number of FSAP recommendations were addressed quickly. The latest assessment by MONEYVAL is not yet available.

The bank secrecy regime has been substantially amended for the purpose of meeting AML/CFT obligations. The previous ban on any disclosure except through judicial authorities was clearly a barrier to full cross-border transparency. Action taken to enhance exchange of information between financial intelligence units for AML/CFT purposes has enabled the Sammarinese FIA actively to share intelligence with its Italian counterparts (even though there is no bilateral agreement). The FIA is also exchanging information regularly with other foreign counterparts, is a member of the Egmont group, and has signed agreements with a number of its counterparts in other countries. It has no agreement with its Italian counterpart but this has not prevented it from passing intelligence to it.

Action has also been taken to dilute bank secrecy in other areas. The previous bank secrecy regime not only prevented exchange of information held in financial institutions for prudential purposes, but also for tax purposes. It was also argued by some that the regime prevented the proper flow of information from Sammarinese subsidiaries to their foreign parents for normal risk management processes. Amendments to the 2005 Financial Services Law were made to address these matters and have been partially successful in practice. The law allows existing banks (which are subsidiaries of foreign bank parents) to pass information to their parent banks. However, for any new banks, such exchange of information could only take place if there were an agreement in place between supervisors. Moreover, the ability of bank supervisors to exchange confidential information about banks and their customers for prudential reasons is dependent on agreements being signed between the CBSM and any foreign counterpart with whom it wishes to share information. The most important such counterpart is the Bank of Italy, and while an agreement has been drafted, it has not yet been brought into effect. Similarly, the ability of the tax authorities to share information depends on a double tax treaty, which has not yet been brought into force. The Sammarinese authorities state that they wish to implement these agreements, but cannot do so because their Italian counterparts cannot sign without the approval of the Ministry of Economy and Finance.

While the willingness of the authorities to take action to address recommendations of international standard setting bodies is impressive, implementation has been slow. As noted above, the authorities have taken action to impose international standards of regulation. However, in respect of capital adequacy and loan concentration provisions, the banking standards are not yet fully in force because the domestic financial sector has been able to persuade the authorities to allow time to move towards full implementation. As a result, the impact of strengthened regulation has been modest so far.

C. International Pressure on the Financial Sector

18. **Over the past decade, San Marino was able to escape much of the impact of international initiatives against bank secrecy.** Although the IMF has consistently recommended stronger regulation and greater transparency (and the authorities responded with moves to international standards of regulation), San Marino has not been subject to many of the international initiatives that have been taken to encourage more transparency. Those to which it has been subject, such as the OECD harmful tax practices initiative in 1999 and the EU Savings Tax Directive in 2003 have had only modest effect prior to 2009 (see Box 2). Pressure from the Italian authorities, the OECD and MONEYVAL only had a serious impact after 2008. Consequently, the Sammarinese financial sector continued to expand its business based on bank secrecy long after other offshore centers had accepted the need for change and were developing new services and skills.

19. **The most important element of international pressure on San Marino has been the action of the Italian authorities.** Following the 2001-02 tax amnesty, funds appeared to flow back to San Marino relatively quickly. The 2009-10 amnesty, however, was accompanied by other action. In 2009, the Italian authorities ended the previous arrangement whereby Sammarinese banks had been accepted as Italian banks for the purposes of access to the Italian payments system. This created some disruption for Sammarinese banks which were henceforth required to enter into agreements with Italian banks and had to bear an increased burden in the form of additional reporting requirements. Costs and risks increased as a result. In 2010, the Italian decree 78/2010 extended the impact of the previous inclusion (in 1999) of San Marino on a list of tax havens. The effects of this are, as yet, not completely certain but Sammarinese financial institutions report that their customers are concerned that by doing business with San Marino they may attract unwelcome attention from the Italian authorities and may suffer additional tax burdens as a result. Fiduciary companies, in particular, have reported a sharp change in the willingness of customers to do business.

20. **Although San Marino responded by building the infrastructure for a wider range of services, the financial system has not taken advantage of this to any great extent.** The authorities responded to early IMF recommendations for strengthened regulation, and the comprehensive 2005 financial services law set the basis for supervision of banks, insurance and investment business. Moreover, the essential elements of a supervisory regime for mutual funds are also now in place. However, there is little evidence of an expansion in insurance, investment business or mutual fund activity by the private sector. By June 2010, the funds managed by asset management companies were €21 million, compared to €7.5 billion in total bank assets. Insurance companies had liabilities of only €118m (all in life insurance). This suggests that, notwithstanding the pressures from international initiatives and the response from the regulatory authorities, the financial businesses in San Marino did not consider it necessary to amend their approach and move away from the bank-secrecy, simple deposit-taking model.

21. It is striking that, despite rising pressures on offshore centers to increase transparency, the Sammarinese financial sector continued to rely on bank secrecy.

International cooperation for the purposes of prudential supervision, and the fight against money laundering and the financing of terrorism, have been developing seriously since the early 1990s, with the creation of the FATF and the focus by international standard setting bodies for financial supervision on cross-border cooperation. The FATF, OECD, and Financial Stability Forum turned their attention to offshore centers by the late 1990s, and early 2000s. However, it was after this time that the Sammarinese financial sector expanded most quickly. Even as late as 2006, the CBSM regarded bank secrecy as a continuing comparative advantage for San Marino. This was at a time when most other offshore financial centers were realizing that bank secrecy was unsustainable as the basis for a durable business model.

Box 2. Little Impact from Early EU and OECD Initiatives

San Marino has been subject to pressure from the EU, as a result of the EU Savings Directive. But the impact has been limited so far. Along with four other non EU countries, San Marino agreed in 2003 to cooperate with the EU Savings Tax Directive. Under the agreement, San Marino imposed a 15 percent withholding tax (rising to 35 percent by June-2011) as an alternative to agreeing to the automatic exchange of information. The fact that Sammarinese banks considered that their customers would prefer to pay a withholding tax than allow their identity to be made known to their national authorities reinforces the notion that the primary benefit of holding funds within Sammarinese institutions was confidentiality. The effect of the withholding tax has been limited as yet, with the rate of withholding tax being 15 percent from 2005 – 2008 and 20 percent since 2008. Sammarinese institutions sought to develop new services to minimize the impact. Nevertheless, the CBSM has confirmed that both banks and fiduciary companies will be subject to the 35 percent withholding rate later this year. It is expected that the higher rate may have a greater impact on the attractiveness of Sammarinese banks for Italian customers than the lower rates imposed hitherto.

The existence of the OECD initiative on tax competition had a limited impact until 2009. In 2000, San Marino avoided being placed on the OECD list of tax havens because it had made a high level commitment to eliminate harmful tax practices. San Marino does not appear to have been placed under any further pressure by the OECD in respect of the harmful tax initiative until it was substantially strengthened by the endorsement of the G20 in 2009. In its 2009 progress report, the OECD identified San Marino as a country that had agreed to cooperate in 2000 but had not yet implemented the program. Since then, San Marino proceeded to sign tax information agreements with a number of countries to meet the OECD target of twelve. By the time of the OECD 2010 progress report, San Marino had achieved this target; albeit, the double taxation agreement with Italy is not yet signed for reasons explained in Box 1.

In its October 2010 report, the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes stated that San Marino had some way to go to meet international standards. Notwithstanding its commitment in 2000 to meet international standards in respect of tax information exchange, the OECD report in October 2010 noted that San Marino had not taken action to meet its commitments until 2009. At that time, the OECD initiative was given greater emphasis by the G20 and San Marino was identified as a country that had not yet met the OECD standard in terms of tax information agreements. San Marino then moved quickly to make treaties and information exchange agreements. However, according to the OECD (October 2010 report), the tax treaty with Italy – by far the most important – had been signed but not ratified for 8 years and did not contain all the necessary provisions to meet the standards. In other respects as well, the report of the Global Forum in 2010 identified failures by the Sammarinese authorities to meet requirements for tax information exchange. Professional secrecy obligations were deemed to be too broad and undefined.

D. Strengths and Weaknesses of the Sammarinese Financial Sector

22. **In developing a new business model, the Sammarinese authorities will need to consider the strengths and weaknesses of their position as an international financial center.**

Although San Marino has never seen itself as an offshore center, it needs to consider its strengths and weaknesses as a supplier of financial services abroad, including those that would make it more or less competitive with other offshore centers.

23. **The first and most important barrier to diversification in the past was the success of the existing bank secrecy model.** The authorities point out that, although San Marino meets the BIS definition of an offshore centre, neither the businesses nor the authorities saw themselves in that light. Businesses were selling services to domestic residents, to residents in the region nearby and to Italian residents elsewhere. Hardly any banks or financial firms sought substantial business beyond Italy. The authorities did not join the Offshore Group of Banking Supervisors. Apart from the impact of Italian amnesties (which, until 2009, appeared to be only temporary), there was little effective pressure on the financial system prior to 2009. The business model was working up to that time, assets were increasing and profits were healthy. This appeared to be sufficient to dissuade many businesses from taking the initiative to invest in diversification.

24. **Failure to invest in new skills in the past has meant an absence of appropriate skills on which to base new areas of business.** Obstacles in hiring highly-skilled nonresident workers and a fairly centralized hiring system in the labor market hindered the development of a diverse set of human capital skills in the financial sector. Indeed, there appear to be few people in the Sammarinese financial sector with the skills on which new lines of international business could be based. Quite apart from the technical skills, any attempt to develop San Marino into an international financial services center would require language skills. Even today, only one of the four largest banks has a website with a significant English section.

25. **The most effective aspect of international pressure was the action by the Italian authorities and this now represents a serious barrier to the development of new business.** The Sammarinese authorities point out that the difficult relations with Italy have a broad effect in holding back the development of new business. The absence of clear cooperation agreements between Italy and San Marino – such agreements being held up pending the signing of a double tax treaty – mean that the longer term rules of engagement between Sammarinese business and Italian customers are unclear. So long as this is true, it is difficult for businesses to invest in developing new areas of activity. The difficult relations are also holding back authorities' initiatives in other ways. For example, the CBSM is seeking agreements with foreign institutions that would enable it to have lines of credit to provide support for local banks with liquidity problems. The current relations with Italy make such an agreement with the Italian authorities unlikely. Moreover, any attempts to by-pass Italy and seek agreements with institutions in other countries prompts questions about why San Marino is not able to come to a proper accord with its largest and most obvious partner.

26. **The structure of the banking system represents a further possible barrier to the development of new business outside Italy.** Most small offshore centers offering banking services to nonresidents have banks that are branches or subsidiaries of large multinational groups. This is true of the Crown Dependencies, for example, and of most British Overseas Territories. It is also true of other small centers such as the offshore business of Cape Verde and (for the most part) The Bahamas. While some offshore centers, such as The Cayman Islands, may have a domestic bank, such banks tend to offer services primarily to local residents. This is not an inviolable rule but it has considerable advantages. A bank in a small country successfully serving nonresidents may well receive more in deposits than it can safely lend to domestic residents or businesses. Moreover, a bank may well acquire liabilities that are many multiples of the country's GDP and thus grow to a size that the authorities may not be able to support in difficult times. Foreign owned subsidiaries can overcome the first problem by lending surplus funds back to a parent company, whereas domestic owned banks may be tempted either to lend domestically more than is prudent or to lend in foreign markets which they may not know well. In respect of the second problem, the foreign-owned subsidiary would be able to call on the support of its parent, which would, if necessary, have access to a lender of last resort in its home country.

27. **The Sammarinese financial system can, however, look to the significance of its brand in Italy as a particular strength when considering the development of new business.** San Marino has a long and proud history during which time it has maintained its independence from its overwhelmingly larger neighbor and survived many variations in the approach of the Italian authorities. At present, it is experiencing difficulties with Italy and this is dissuading some potential Italian customers from doing business with San Marino. Nevertheless, the Sammarinese authorities and businesses consider that, among potential clients in Italy, respect for the Sammarinese brand and trust in its institutions remains high. To the extent that this proves to be long lasting, it constitutes San Marino's greatest potential strength for business growth in the short and medium-term. Among offshore centers, San Marino has the distinct advantage to Italian customers of being familiar and operating in Italian.

28. **Sammarinese institutions also have a comparative advantage in that they are readily accessible to nearby residents.** Many small offshore centers are islands and can only be reached by aircraft. For Sammarinese financial institutions, there are a substantial number of clients in the region who can easily drive to San Marino for a meeting. For them, San Marino's financial institutions may not be offshore business at all, as it is usually understood, but local business which happens to be undertaken in the historic Republic of San Marino. For such clients, San Marino will not be perceived as having the disadvantages of offshore investment, but rather provides a convenient place to do business with a little extra cachet. For example, according to one major bank in San Marino, this was where most of its nonresident business arose.

29. **Still, when considering the future direction of business, San Marino can consider the experience of offshore financial centers (OFCs).** Although the authorities and businesses of

San Marino do not consider themselves as OFCs, the experience of OFCs in developing international business may be of relevance. A summary of the business of selected OFCs is shown in Box 3.

Box 3. Main Lines of Businesses of Selected Offshore Centers

Country	Businesses
San Marino	Collecting Italian deposits and placing them in Italian financial companies and securities
Andorra	Bank deposits, asset management
Anguilla	Company incorporation for nonresidents
The Bahamas	Banking services to nonresidents, fund administration, investment management
Bermuda	Captive insurance and reinsurance
British Virgin Islands	Company incorporation for nonresidents, fund administration
Cayman Islands	Hedge fund incorporation, registration, management, and advisory services, corporate banking services to nonresidents, captive insurance and reinsurance
Cape Verde	Bank deposits for Portuguese residents
Gibraltar	Bank deposits for nonresidents, insurance services, company and trust formation
Guernsey	Captive insurance, fund registration and administration, wealth management, bank deposits for nonresidents
Isle of Man	Company and trust administration, bank deposits for nonresidents
Jersey	Bank deposits for nonresidents, wealth and fund management services, company and trust administration and management
Liechtenstein	Wealth management
Monaco	Private banking and asset management mainly to nonresidents
Samoa	Company incorporation and administration for nonresidents
Vanuatu	Company and trust formation and administration for nonresidents, largely Australians

Source: IMF Reports, UK National Audit Office report on overseas territories

30. **Services offered by successful offshore centers, fall into five broad categories, the first of which is banking deposits.** As can be seen from Box 3, many offshore centers, like San Marino, offer bank deposits to nonresidents. However, in many cases, bank deposits are either negligible, or offered as part of a wider range of asset management services. A few centers, such as Cape Verde, focus primarily on the provision of bank deposits and in that case, the services are offered almost exclusively to foreign residents speaking the same language as the residents of the OFC.

31. **A second key area is the specialization in providing company incorporation for nonresidents.** The market leader in this business, the British Virgin Islands, with over 600,000 companies, provides rapid incorporation and registration of companies. The foreign customer must employ a local agent who will provide a registered office address. Other OFCs, such as Samoa and Anguilla offer these services on a smaller scale and many other countries offer these services but only as part of a wider tax and wealth management service. The key attribute for such OFCs is the ability to allow companies to be incorporated in a matter of hours, preferably through on-line application, and this usually requires investment in specialist legislation and equipment, together with appropriate AML/CFT legislation to ensure that there is sufficient information held about the companies that are incorporated.

32. **The third major area is captive insurance and reinsurance.** For such business, Bermuda is the world leader, with Guernsey and the Cayman islands also offering substantial services of this kind. Gibraltar offers a particular kind of insurance management service that provides for tax efficiency. Captive insurance involves the creation of an insurance company offering insurance solely to its own parent company. This structure can be efficient for large companies capable of self insuring against key risks, and the location of the captive insurer in low tax jurisdictions reduces costs. Reinsurance, when combined with certain tax advantages, can also be successfully offered by OFCs and this is the area where Bermuda is dominant. OFCs that are successful in this area have also developed specialist legislation such as the development of protected cell companies.

33. **The fourth principle area of offshore business is fund management.** In this case, there are essentially two sub divisions, with some OFCs offering themselves as the location for the registration and incorporation of the fund (or in many cases, securitization) vehicle. There are few taxes or charges on the fund itself and little active management of the fund. The prime revenue generating services offered by the OFC in this case are the associated legal, accountancy and other professional services designed to ensure that the fund structure is efficient and robust. The Cayman Islands is the world leader in this business, although some other OFCs such as Jersey and The Bahamas offer these services as well. The second subdivision consists of the OFCs that provide fund administration services. In this case, businesses undertake the administration of such matters as subscriptions and redemption by investors, asset valuation and other administration services. The Bahamas and the Isle of Man provide such services. In neither case is the investment portfolio management element of fund management usually undertaken in

the OFCs. Typically it is outsourced to major centers such as New York or London. Fund custodian or prime bank functions are also conducted by custodian banks located in major financial centers.

34. **The fifth category of OFC service is wealth management.** Wealth management will include private banking, investment advice, tax planning advice and the use of companies' trusts and foundations as vehicles for holding assets. Although not included in Box 3, Switzerland is a prime example of such services. Of the smaller OFCs, Jersey, Liechtenstein, and Monaco are well known for offering such business. Other centers, including the Isle of Man and Guernsey also offer business of this kind. The key attribute in these cases is the existence of trusts and/or foundations, accompanied by a body of law and legal precedent that governs their use. A substantial body of legal professionals, investment advisers and trust experts is also important.

35. **It would not be easy for San Marino to become a major provider of services in any one of the five broad categories.** San Marino already provides bank deposits and is discovering that such services, on their own, are not sustainable if predicated largely on bank secrecy. In the other broad categories of insurance, company incorporation, fund management and wealth management, there are real difficulties in breaking into a market where there is an established market leader, unless there is a clear competitive advantage. Indeed, San Marino suffers from a number of disadvantages arising from its late start into many of the business areas and the consequent lack of familiarity with its services and legal structure on the part of foreign investors. Moreover, at present, San Marino does not have the capacity to offer rapid company incorporations.

36. **However, San Marino is a small country and does not need to become a market leader.** The Sammarinese authorities have pointed out that they do not need to capture very much business in order to generate sufficient activity to sustain the financial center. It is not necessary for them to become a market leader in any of the service areas, and they could be successful if only a small part of the international business were to come their way.

E. Options for a New Business Model

37. **Future business to be pursued by San Marino must have certain characteristics.** The analysis of the history of the Sammarinese financial sector, its strengths and weaknesses as a financial center, and the options available to OFCs suggest that any future international businesses in San Marino should have the following characteristics:

- They should exploit the strength of the San Marino brand among Italian customers;
- They should seek to provide fee based services, so as to avoid creating bank balance sheet liabilities that are many times San Marino's GDP;
- Insofar as they provide banking services, they should do so through foreign-owned banks that can draw on the strength of the parent;

- They should not rely on bank secrecy;
- They should provide services that genuinely add value to international clients in a way that does not attract the approbation of foreign governments or international institutions;
- They should not require a substantial body of law and legal precedent in key areas of financial law;
- They should not require a substantial body of professional skills.

38. **One possibility is to focus on providing traditional banking services to the region surrounding San Marino.** One bank has already indicated its intention of pursuing this strategy. Indeed, a Sammarinese bank is easily reached by nearby Italian residents and may be regarded as local for such purposes. Such a strategy would build on the existing skills of Sammarinese banks in offering traditional banking services, the use of Italian would be an advantage and there would be no need to seek to develop unfamiliar lines of business. Moreover, it would not be difficult to ensure that the bank understood the local market sufficiently to pursue a prudent lending policy. There remains the risk that a bank's balance sheet will be too large for the economy to support in times of trouble. In the longer term, the Sammarinese authorities could seek to encourage foreign ownership, or discourage domestic banks from allowing their balance sheets to grow to a risky size.

39. **There is some scope for developing a fund management capability.** Of the five areas of OFC business, the most likely area for Sammarinese diversification would appear to be fund management. This does not require a long established specialist legal infrastructure (such as trusts, or protected cell companies). It does require particular kinds of administrative skills, but such skills are certainly not beyond the ability of Sammarinese businesses to acquire, provided that they are able to look abroad as well as domestically. Such fund management activity would, initially, probably have to be undertaken in conjunction with partners in other countries – particularly Italy. It would be possible (subject to the improved relations with Italy) to find such partners and some Sammarinese businesses indicated that such partnerships may already exist.

40. **San Marino may also seek to provide a wider range of offshore services to Italian customers.** Not all offshore services depend on bank secrecy to be successful. San Marino can adjust its level of regulation, consistent with international standards, to enable its financial institutions to sell certain kinds of products that may not be otherwise available to Italian customers. Perhaps by focusing on high net worth individuals, Sammarinese financial institutions could provide services and sell products that would not be appropriate for the retail customer. One bank has indicated that it proposed to sell insurance products not otherwise available in Italy. Another bank proposed to sell alternative investment funds, with the options to buy mutual funds specializing in works of art. Again, such a strategy would meet the criteria outlined above (provided that the products were not unsuitable for the customers at whom they were aimed and did not rely on illegal tax practices). While it is difficult to see that there is an

unsatisfied demand for such products and services internationally, given the range of activities in existing OFCs, most of those providers would be operating in English and San Marino could have an advantage in the Italian market.

41. **Moving beyond the Italian market would be a much more difficult task and should be pursued with care.** With over 50 OFCs, and established world leaders in various niche businesses, it would be difficult for San Marino to make much headway. While such a policy would be useful in diversifying the risks associated with a focus on the Italian market, it would not be playing to the existing strengths. If the authorities wish to create the conditions required to enable such a course to be successful, it would be necessary to (i) increase labor market flexibility to allow businesses to recruit foreign workers without substantial hurdles, where it is necessary to acquire new skills quickly; (ii) encourage foreign ownership of banks so as to reduce the risks of systemic threats from individual banks being greater than the economy can bear; (iii) seek to conclude lines of credit to enable the CBSM to provide some support for the remaining domestically owned banks; (iv) develop more international products, particularly the use of trusts; and (v) be prepared to adjust regulation, within international standards, to enable Sammarinese businesses to exploit new opportunities globally.

F. Conclusion

42. **The Sammarinese authorities are aware of the acute problems they face.** The existing business model is unsustainable. Developing new models takes time and requires better relations with Italy. It is also likely to take time to convince the Italian authorities that the moves to international standards of regulation and transparency are permanent and will be fully implemented. However, the financial system is hurting now as a result of the time it has taken businesses to realize (i) that their previous practices are unsustainable and (ii) the lack of investment in new skills, services and products. The fact that the present problem is a consequence of choices made by the authorities and businesses in the past does not make the search for a solution any easier for those who have recognized the need for change.

43. **The way forward is likely to involve some contraction of the business while the financial institutions consolidate their position and acquire new skills.** It is unlikely to be possible for Sammarinese businesses to find new markets quickly. The number of nonbank institutions is falling rapidly and the number of banks may also decline, perhaps through mergers and takeovers. Indeed, San Marino may have to retreat to its domestic and regional customer base until it has demonstrated that the commitment to change is sufficient to encourage the Italian authorities to sign the cooperation agreements and thereby improve relations. Such improved relations are the sine qua non for a new business model to be successful.

44. **The importance of strong relationship with Italy may also require San Marino to take more initiatives to amend its position on transparency.** While it is undoubtedly the case that other jurisdictions have some provisions that are comparable to those in the San Marino law

– such as the requirement for an agreement between prudential authorities before there can be information exchange – it may be necessary for San Marino to demonstrate its permanent commitment to change by moving voluntarily into the mainstream of jurisdictions’ practice with respect to transparency. One example of the action that could be taken would be to decouple the demand for the tax treaty with Italy from the other cooperation agreements (even if Italy itself maintains that no treaties can be signed until they are all agreed). Another choice would be to follow many other jurisdictions in allowing information exchange between central banks without a formal bilateral agreement at the national level.

45. **The Sammarinese authorities cannot ignore the legacy of previous choices and will need to take it into account when charting the course forward.** San Marino has a long and proud history of developing relations with its larger neighbor in a way that preserves its sovereignty and dignity. It is natural and right that the Sammarinese authorities should wish to ensure that in negotiating new agreements, they receive benefits in return for concessions. In making judgments about the way forward, it is important that the authorities accept that a move to international standards does not represent a concession for which they should be rewarded in international agreements. Rather, it is important to appreciate that the failure to meet international standards in the past is bound to have an effect on the attitude of counterparts today. The response to that problem should include taking bold moves to enhance cooperation and transparency beyond the minimum necessary to meet international standards, so as to demonstrate a clear desire to break from the legacy of the past.

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II. ASSESSING SAN MARINO'S COMPETITIVENESS ³

A. Introduction

46. **Following a long recession, San Marino's economy needs to adjust in order to boost competitiveness and revitalize growth.** The successful economic development of the past, based on bank secrecy and a favorable tax system, is unlikely to remain sustainable for much longer. Indeed, under pressure from larger economies in the aftermath of the global financial crisis, tax havens around the world have been forced to embrace greater economic and financial transparency. On the other hand, the scope for further development of the Sammarinese industrial sector may be jeopardized by the ongoing globalization process, which intensifies international competition, especially from countries where labor costs are very low. Therefore, to restore vigorous economic expansion, San Marino must achieve durable competitiveness. Against this background, the paper assesses San Marino's competitiveness by examining both conventional measures and other factors affecting the business environment.

47. **The paper is organized as follows.** Section B reviews San Marino's economic performance in recent years in order to understand the factors underpinning economic growth. Section C assesses San Marino's competitiveness on the basis of real exchange rates, productivity, and labor costs. Section D examines structural issues affecting the business environment, including flexibility of product and labor markets, quality of education, and efficiency of the public sector. Section E concludes and draws policy implications.

B. Economic Performance in Recent Years

48. **San Marino's economic performance was very strong over the past two decades, but the economy has been hit by a severe recession since 2008.** Real GDP grew at an average rate of 5.8 percent between 1990 and 2007, recording one of the top performances among international financial centers. However, the economy contracted by 1.1 and 13.0 percent in 2008 and 2009, respectively. Furthermore, growth is estimated to have been negative also in 2010, as recovery was deterred by the inclusion of San Marino in Italy's blacklist of tax haven countries, which has discouraged Italian firms from trading with Sammarinese companies.⁴ In the two decades up to the onset of the recession, San Marino's economic expansion and employment growth tended to be higher than Italy's, while its unemployment rate remained lower (Figure 3). The productivity of the Sammarinese economy also increased steadily during 1991-2007, although its level has been lower than that of Italy and other advanced European countries. Moreover, the output collapse led to a sharp decline in productivity in the past few years.

³ Prepared by Phakawa Jeasakul and Edda Zoli.

⁴ Since July 2010, Italian firms doing business with Sammarinese companies are subject to enhanced scrutiny from the Italian authorities and are more likely to be inspected. Reportedly, some Sammarinese companies have since moved their operations to Italy.

49. **Fixed investment has been the underlying factor for economic growth.** The past robust output expansion and the recent deep economic recession have been mirrored by large fluctuations in fixed investment (Figure 4). Manufacturing activity has been on a declining trend after the slowdown in investment, despite the implementation of investment enhancing measures (for example, the new business-friendly corporate law passed in 2006 and the introduction of tax benefits on reinvested profits in 2007). Furthermore, San Marino appears to serve as an integral part of Italy's production chain, and its close economic linkages with Italy primarily work through investment activity. In particular, Sammarinese capital formation is correlated with Italy's domestic demand more than Sammarinese exports. Such relationships might well be expected because Sammarinese exports account for a tiny share of Italy's absorption, while the decision to undertake investment is likely to be largely influenced by perceived prospects for the Italian economy.

50. **The economy is well diversified for its size, with manufacturing and financial services having the dominant shares.** Manufacturing (almost 40 percent of GDP and private sector employment) continues to be the most important activity by size. However, while contributing to about half of overall growth during 2002-2005, manufacturing has been on a declining trend since 2006. By contrast, financial services, which constitute the second largest sector (about 20 percent of GDP), served as the driving force for economic activity during 2002-2007 (Figure 5). Specifically, one third of output growth over that period was supported by the rapid expansion of the financial system. The remaining important sectors consist of public services, commercial activities, including tourism, and non-financial services, each accounting for about 12-14 percent of GDP.

51. **The favorable tax system, which supported manufacturing in the past, may not be able to ensure further development in the future.** Low average labor costs and low profit taxation provided a powerful incentive for firms to set up factories in San Marino rather than in Italy. San Marino's payroll taxes effectively amount to 23 percent of gross pay, compared to 40 percent in Italy, while the profit tax rate is only 17 percent, compared to 27.5 percent in Italy. However, San Marino's ability to compete against emerging markets where labor is cheaper seems limited. This dilemma is exacerbated by the fact that Sammarinese manufacturing does not rely on advanced technologies and highly skilled workers. Indeed, industrial activity already began to contract in 2006, before the global recession started.

52. **The financial sector's contribution to economic growth is likely to be very limited in the near future, as the system seeks a new business model.** The financial sector's productivity has been falling since 2001, suggesting that the expansion in recent years was mainly driven by bank secrecy and tax haven activities rather than by high value added services. In the new environment of increased economic and financial transparency the existing business model is unsustainable. Furthermore, following the Italian tax amnesty, bank balance sheets have shrunk,

and profitability has concomitantly fallen. To adopt a new business model and revamp profitability, Sammarinese financial institutions will have to undertake significant adjustments.⁵ As this process is likely to take time, the financial sector is unlikely to grow significantly in the near future.

53. Among commercial and non-financial services, tourism has the greatest potential for development. While San Marino attracts about 2 million visitors each year, it remains primarily a day-trip destination from nearby locales. Tourism's contribution to GDP was only 2.3 percent in 2009.⁶ There would appear to be scope for the tourist industry to develop much further. Several initiatives have been undertaken to promote tourism, but a strategic plan to transform San Marino into a primary tourist destination is still lacking. Other commercial activities and non-financial services do not seem to have significant growth prospects in the near future, as they are currently mainly oriented toward the small local economy.

C. Indicators of Competitiveness

54. To assess San Marino's competitiveness, several conventional measures are considered, namely, real exchange rates, productivity, and labor costs. Particular attention is paid to relative productivity and relative unit labor costs (ULC) with respect to Italy, the main economic partner, accounting for more than 90 percent San Marino's exports.

55. Real exchange rate movement vis-à-vis Italy suggests that San Marino has been steadily losing competitiveness since 2005. Between 2005 and 2009, the CPI-based "real exchange rate" appreciated, albeit by only 3 percent.⁷ More significantly, the ULC-based real exchange rate, a more relevant indicator for gauging competitiveness, appreciated by 13 percent for the overall economy and 15 percent for manufacturing over the same period (Figure 6).

56. Distortions in San Marino's product markets may have contributed to the movement in relative prices vis-à-vis Italy. Price divergences between Italy and San Marino are likely to reflect mostly differences in the price of nontradables products or nontraded components of tradable goods, as price equalization for tradable goods and services should be expected between the two countries (putting aside taxation issues). Indeed, the largest relative price movements between the two countries have been for communication, health, housing and utilities (Figure 7). A much smaller decline in prices of communications in San Marino

⁵ See Chapter I of this Selected Issues Paper.

⁶ This official number is likely to underestimate the contribution of tourism to GDP, as it only reflects activities related to hotels and restaurants in the historical center. Nevertheless, tourism's contribution to GDP is probably much lower than the total share of commercial activities in GDP (14 percent).

⁷ The term "real exchange rate" is used for convenience and to be consistent with conventional measures of competitiveness. However, given that San Marino and Italy use the same currency, fluctuations in the real exchange rate only reflect movements in relative prices or labor costs.

compared to Italy suggests that domestic competition in this sector may have been hindered by restrictions on foreign ownership and barriers to entry. The smaller increase in utility prices in San Marino compared to Italy may reflect the fact that utility services in San Marino are subsidized.

57. Unit labor costs in San Marino have been increasing rapidly. ULC-based real exchange rates reflect relative production costs across countries, with an appreciation implying higher costs in the domestic economy. The loss in labor cost competitiveness could have significant implications, especially because San Marino is an integral part of Italy's production chain. The steady surge in San Marino's ULC is evident for the overall economy, non-public services (the overall economy excluding public services), the industrial sector, and the financial sector (Figure 8 and 10–12).

58. The recent increase in San Marino's ULC for the overall economy is mainly driven by the decline in relative productivity with respect to Italy. San Marino's productivity has been lower than Italy's since the early 1990s, although a more rapid increase in productivity in the years preceding the global financial crisis did help narrow the productivity gap. The output collapse in 2009 translated into a sharp deterioration in productivity and a significant increase in ULC, as average wages and average labor costs remained roughly unchanged (Figure 8). A similar conclusion can be drawn by looking at relative productivity and ULC for non-public services (Figure 10). It is noteworthy that while average wages have tended to be higher in San Marino than in Italy; average labor costs are typically lower due to smaller employers' social security contributions. However, the latter will need to rise in the future, given the unsustainability of the current pension system, thus further eroding San Marino's labor cost advantage.

59. Sammarinese industrial and financial sectors are more productive than their Italian counterparts, but have become less competitive since 2005. The higher productivity level in the industrial and financial sectors has contributed to lower ULC compared to Italy (Figure 11-12). However, in the industrial sector, San Marino's productivity vis-à-vis Italy's has been declining since 2003, possibly as a result of low capital formation. San Marino's productivity in financial services has been on a similar declining trend over the past decade, even in the midst of the rapid expansion of the financial sector.

60. Moderate expansion in commercial and non-financial services, supported by rising relative productivity, suggests these sectors have maintained their competitiveness position. Productivity in commercial and non-financial activities has been rising since 2002, thus moderating the surge in ULC, in spite of the rapid increase in average wages and average labor costs (Figure 13). These two sectors have also contributed significantly to the expansion of private sector employment over the past decade, and their further growth prospects seem promising.

D. The Business Environment

61. **A country's competitiveness and productivity will depend on a range of structural factors.** The flexibility of product and labor markets, the quality of labor force and the efficiency of the public sector are all important elements in determining the ability of the Sammarinese economy to remain competitive and restore sustained output expansion. Growth theory and empirical evidence also suggest that technological progress, the quality of institutions, and physical and human capital are key drivers of economic growth.⁸ Against this background, this section assesses the education level of the Sammarinese labor force, the flexibility of product and labor markets, and the efficiency of its public sector.

Education levels of the workforce

62. **The education level of the labor force in San Marino appears to be low in comparison with other high-income countries.** The economy is employing a significant share of unskilled workers, as 44 percent of employees have not received upper secondary education—a higher portion than in most other European countries (Figure 14). Moreover, in San Marino only 12 percent of employees hold a university degree. While the current economic structure, largely comprised of manufacturing, may be consistent with this labor force composition, the shortage in highly skilled workers may jeopardize San Marino's ability to produce high value-added goods and services, including in the financial sector.

63. **Most cross-border workers from Italy also possess low education levels.** The share of cross-border workers in total employment has been rising steadily, from 10 percent in the early 1990s to 30 percent in recent years. However, these cross-border workers include mostly workers with low education levels. In fact, the share of low-skilled workers in total employees within the group of Italian commuters (55 percent) is higher than within the group of Sammarinese resident workers (39 percent). Also, the portion of cross-border workers with a university degree is lower (Figure 14).

Labor market rigidities

64. **The labor market is plagued by severe rigidities,** mainly resulting from a centralized employment system, extensive impediments on hiring nonresident workers, and several distortionary regulations.

⁸ Solow (1956) illustrated the role of physical capital accumulation in economic growth, and pointed out that sustained growth in the long run requires technological improvement. Romer (1990) showed that growth is driven by technological progress resulting from research and development. Lucas (1988) emphasized the importance of human capital for growth. Acemoglu, Johnson, and Robinson (2001), among others, provided empirical evidence on the impact of institutions on economic development.

65. **The hiring system is fairly centralized, as hiring requires an involvement from the Labor Office, a body within the Ministry of Labor.** In order to hire a worker, firms are obliged to interview all candidates shortlisted by the Labor Office before an open search can be conducted.⁹ In practice, since an approval is necessary for hiring a worker not on the list provided by the Labor Office, the hiring process can be lengthy, especially if the Labor Office insists that its selected candidates are qualified for such job openings.

66. **Obstacles in hiring nonresident workers include lengthy bureaucratic processes as well as potential political interference.** In addition to the cumbersome hiring procedure described above, potential candidates must demonstrate that they have never been convicted for criminal acts, and pass a medical examination by public practitioners. Furthermore, hiring a nonresident worker also requires an approval from the Labor Commission, which consists of the Minister of Labor along with representatives from trade unions, employers' associations, and the Labor Office. These additional hurdles tend to increase the time to complete a hiring procedure by 2-3 weeks, which firms consider excessive.

67. **Moreover, unfavorable treatments on nonresident workers undermine the ability of firms to recruit highly skilled workers.** In particular, nonresident workers can be offered an open-ended contract only after being employed for at least 7 years during which certain benefits pertaining to workers with an open-ended contract are precluded.¹⁰ Furthermore, the budget law approved last December curtailed tax benefits for cross-border workers. Finally, since San Marino is not part of the European Union, non-Italian foreign workers are supposed to obtain a residence permit in order to be able to stay and work in San Marino,¹¹ even though recently the process of obtaining a residence permit from the Ministry of Foreign Affairs has been expedited.

68. **Several labor market regulations make doing business in San Marino less attractive than in other countries (Table 1).** Many labor market practices are largely based on a 1961 law, which provides an outdated regulatory framework. Key constraints involve the rigidity of working hours, the limited scope for using fixed-term contracts, and the complicated dismissal procedures. Furthermore, the presence of powerful trade unions creates rigidities, ranging from

⁹ The Labor Office maintains the lists of people who are interested in getting a new job, with information on educational attainment, work experience, specific skills, such as language knowledge and other expertise, and individual preferences, such as availability to work and desirable jobs. There are 5 lists: (1) mobility list for workers who got dismissed with entitlement to mobility benefits; (2) unemployment list for other resident workers who want a job; (3) cross-border list for other cross-border workers who got dismissed; (4) transfer list for workers who want to change their jobs; and (5) disabilities list for people with disabilities.

¹⁰ For Sammarinese workers, an open-ended contract must be offered after the maximum length of fixed-term contracts (9-24 months, depending on job types) is reached.

¹¹ According to the 1939 convention, Sammarinese and Italian people are free to work in their neighboring country.

wage bargaining to negotiations related to outsourcing and overtime work. Finally, existing policies may also jeopardize labor market efficiency. In particular, the wage supplementation system, while helping maintain low unemployment, induces firms to retain workers rather than let them go when adjustment (downsizing) or reorganization is needed.¹² The social safety net system, which was largely redesigned and strengthened in 2010, may also provide incentives for dismissed workers to remain unemployed rather than searching for new jobs, including outside San Marino.¹³

Product markets

69. In spite of liberalization measures in product markets, certain restrictions on foreign ownership and barriers to entry remain. For example, operators in wholesale businesses must be residents or legal entities majority-owned by residents. For retail activities, the same restriction applies, even though the government can grant a waiver (if proposed business plan would benefit San Marino's economic development). Foreign ownership of properties in San Marino's territory has to be authorized by the Council of Twelve.¹⁴ Furthermore, substantial barriers to entry result from complicated regulatory frameworks in selected sectors, which could deter potential foreign investors.¹⁵ While the licensing process for new business has been simplified and expedited, a government approval is still required for licenses in regulated activities.¹⁶

Quality of the public sector

70. Inefficiencies in the public sector further exacerbate the economy's competitiveness due to its interfering role in the labor market. First, jobs in the public sector are better paid.

¹² The wage supplementation system, a contribution-based system managed by the Social Security Institute, pays a fraction of workers' salary when firms face business difficulties (e.g. temporary bad market conditions and corporate restructuring). Therefore, workers can remain employed at a much lower cost.

¹³ The social safety net system foresees two types of unemployment benefits. One, known as mobility benefits, is for workers being employed with an open-ended contract and being dismissed as a result of redundancy. Another is for workers who got dismissed for other reasons. Firms can hire individuals receiving mobility benefits at a subsidized salary for up to one year, with the social safety net fund paying 82 percent of salary. Also, the 2010 law on social safety nets has introduced unemployment benefits for individuals searching for the first time and those that have been out of the job market for long time and looking for a job (long-term unemployed, women that have been out of the labor market for family reasons, people over 50). Beneficiaries of unemployment benefits are supposed to enroll in training/retraining programs.

¹⁴ The Council of Twelve consists of the two Captain Regents and other parliamentarian members.

¹⁵ Regulated activities include: (1) telecommunication services and sales of devices; (2) real estate; (3) construction; (4) car rental; (5) wholesale trade and manufacturing related to energy, telecommunication (e.g. mobile phones), transportation (e.g. automobiles, boats, and planes), and weaponry; (6) certain commercial activity yielding commission fees; (7) garbage disposal; and (8) production of stamps.

¹⁶ Based on a new 2010 law, the standard timeframe to obtain a business license has been significantly reduced to 10 days. However, the process may take additional 2 weeks if a government approval is required.

The average wage of public administration employees is about 30 percent higher than that of private sector employees, although compensation for workers in public enterprises is in line with the private sector (Figure 15). Moreover, working hours in the public administration are lower than in the private sector.¹⁷ Second, the public sector absorbs a disproportionately large share of well-educated workers. As of June 2010, as much as 42 percent of workers with a university degree were employed in the public administration. Consequently, the private sector is left with too few well-educated workers (Figure 14). Thirdly, the public sector continues to play the role of the employer of last resort, absorbing about one fifth of the labor force.

71. **The public administration appears oversized and inefficient.** By international standards, the size of the Sammarinese public administration is exceedingly large, accounting for 14 percent of GDP and 15 percent of total employment (Figure 16). Moreover, though comparable to that of high-income European countries, its productivity level is lower than that of the Sammarinese private sector as well as compared to more efficient public administrative systems such as that of Switzerland. Lastly, the level of absence from work, a common efficiency measure, is markedly higher in the public administration than in the private sector. This differential is one of the largest among high-income European countries. Such excessive bureaucracy in the public administration may be detrimental to the business environment.

E. Conclusions and Policy Implications

72. **San Marino is at a critical juncture where adjustments in the economy will be essential to boost competitiveness and revitalize growth.** While San Marino's economic performance was very strong in the two decades prior to the global downturn, the economy has been mired in a severe recession since 2008. At the same time the successful economic development of the past, based on bank secrecy and a favorable tax system, is unlikely to remain sustainable for much longer.

73. **Standard indicators suggest that San Marino has been losing competitiveness.** Since 2005, ULC relative to Italy has been rising, mainly due to a decline in relative productivity. Over the same period, investment in San Marino slowed significantly, while manufacturing activity contracted.

74. **Structural weaknesses jeopardize the ability of the economy to regain competitiveness and restore sustained growth.** These include low education levels of the labor force; severe rigidities in the labor market; barriers to competition in product markets; and an inefficient public administration that is excessively bureaucratic and create further distortions in the labor market. Immediate policy actions are needed to address these weaknesses and to promote competitiveness.

¹⁷ Regular weekly working hours are 37.5 in the private sector and 36 in the public administration.

75. **Restrictions on hiring highly skilled nonresident workers should be relaxed.** A successful repositioning of the economy will depend critically upon the ability of firms to acquire the expertise needed for business restructuring. This is particularly important for the financial sector at the moment, but also for the manufacturing sector in the medium term. Given the limited population size, and the relatively low education level of the resident work force, it is essential for San Marino to open up its labor market to highly skilled nonresident workers.

76. **The centralized employment system, which hinders market-driven private sector employment, should be liberalized.** The efficiency gains from liberalizing the hiring system and modernizing regulatory frameworks appear substantial. Currently, labor market rigidities prevent firms from undertaking the necessary adjustments to improve their operational efficiency. Furthermore, these rigidities do not encourage foreign business investment.

77. **Complicated regulatory frameworks governing business licensing and operations should be streamlined.** One major obstacle for foreign enterprises interested in starting a new business in San Marino is the difficulty in understanding the relevant regulations. The regulatory framework should be simplified and made more accessible and transparent to foreign investors.

78. **Public sector reforms must be accelerated.** The government in 2009 introduced a number of laws aimed at addressing the large and bureaucratic structure of the public administration. Among other objectives, the laws envisaged greater labor mobility within the public sector, enhanced autonomy and accountability for managers, and increased transparency in the hiring process. However, implementation has been slow, especially with respect to efforts to downsize and streamline the operations of public administration. Measures should also be introduced to reduce the disparity in the pay and conditions of public and private sector employees. Several advanced economies have undertaken comprehensive public administration reforms that represent useful examples for San Marino's policymakers (OECD 2005, 2010).

79. **A strategic plan to transform San Marino into a prime tourism destination should be considered.** While various recent initiatives undertaken by the authorities have helped boost tourism activities, the sector's contribution to growth remains limited. New initiatives should be undertaken in this area.

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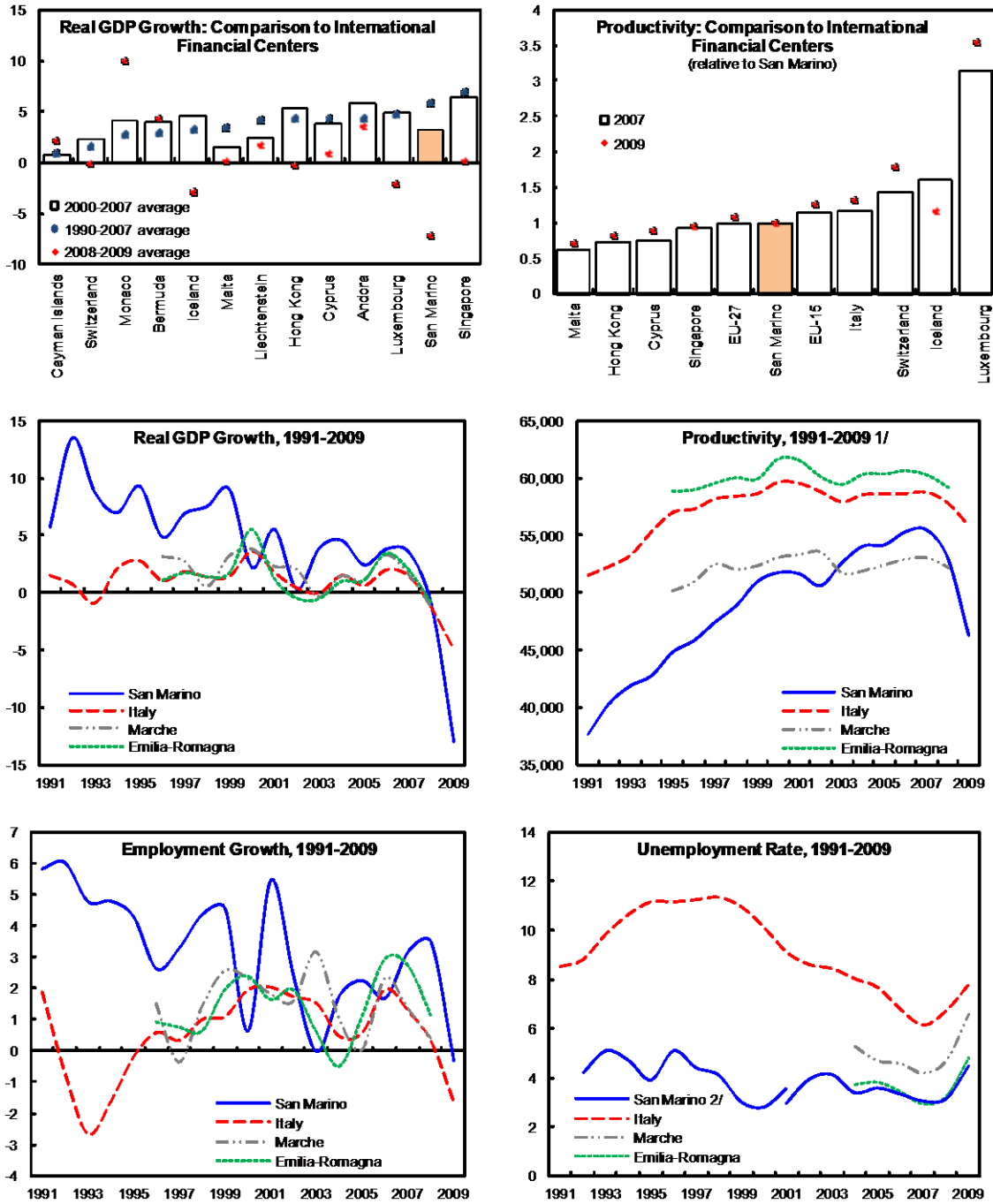
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Figure 3. San Marino: Performance on Employment, Output and Productivity



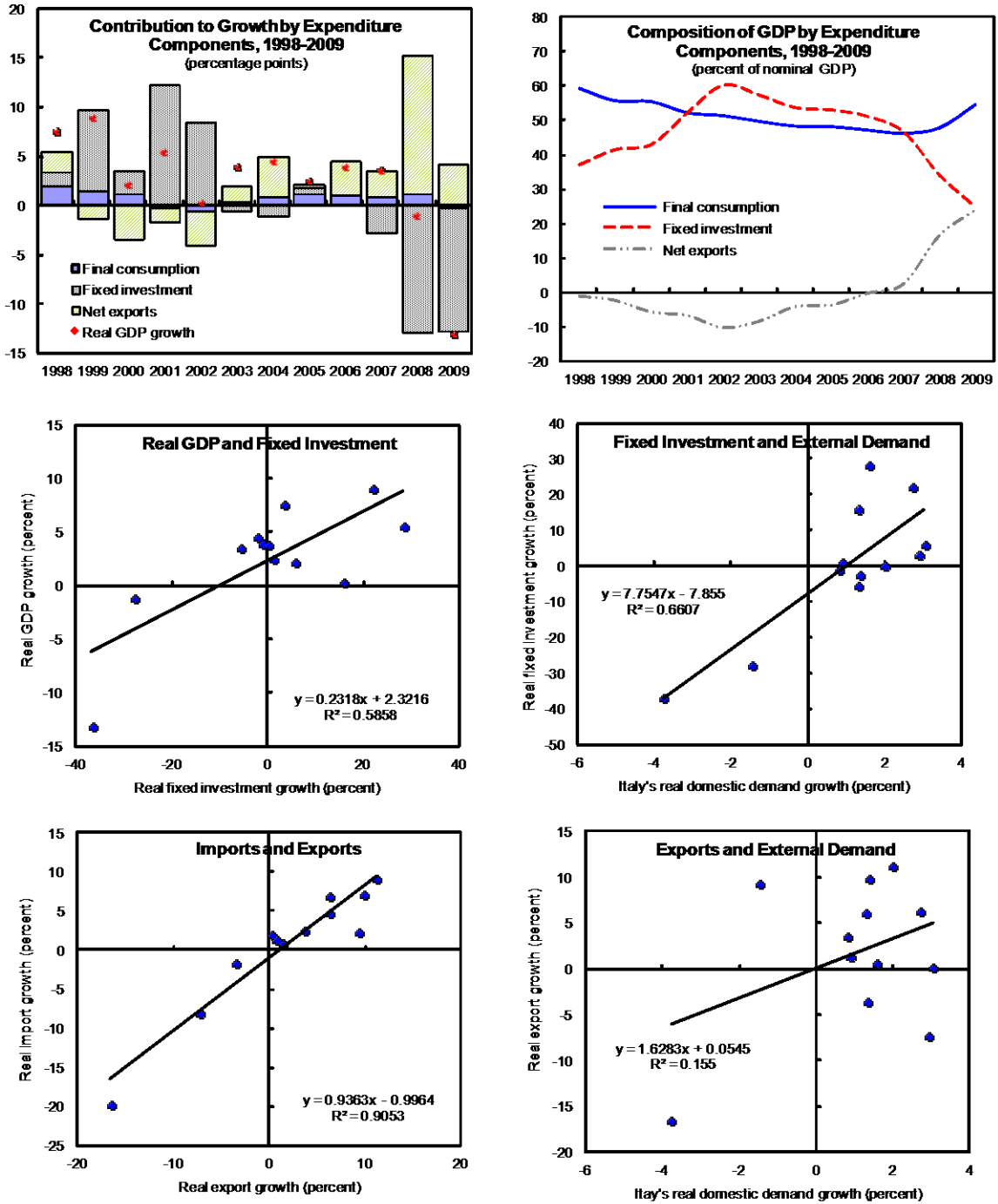
Sources: IMF, World Economic Outlook; ISTAT; Sammarinese authorities; UPECEDS; United Nation; and IMF staff calculations.

Note: Lines are smoothed between actual data points.

1/Productivity is real GDP (1995 price) per employment.

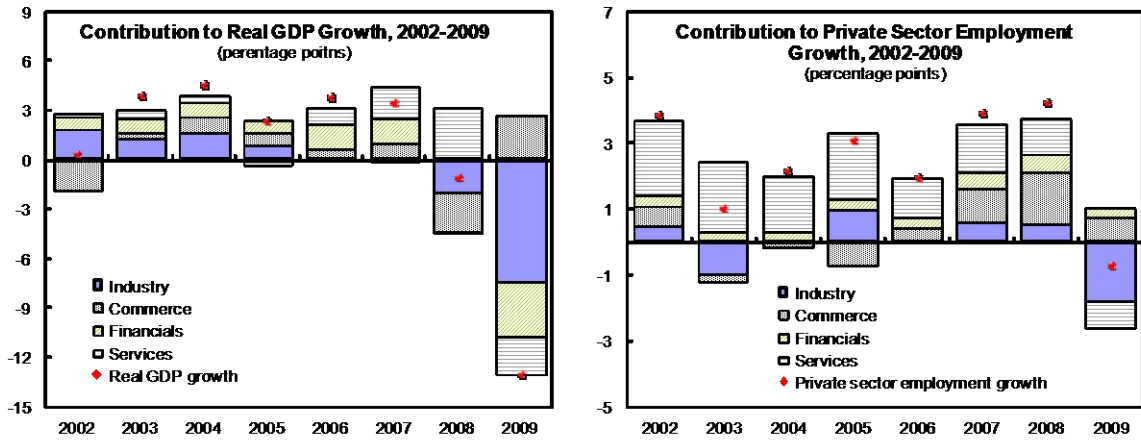
2/The unemployment rate is end-of-year for 1992-2001 and average for 2001-2009.

Figure 4. San Marino: Sources of Growth—Demand side

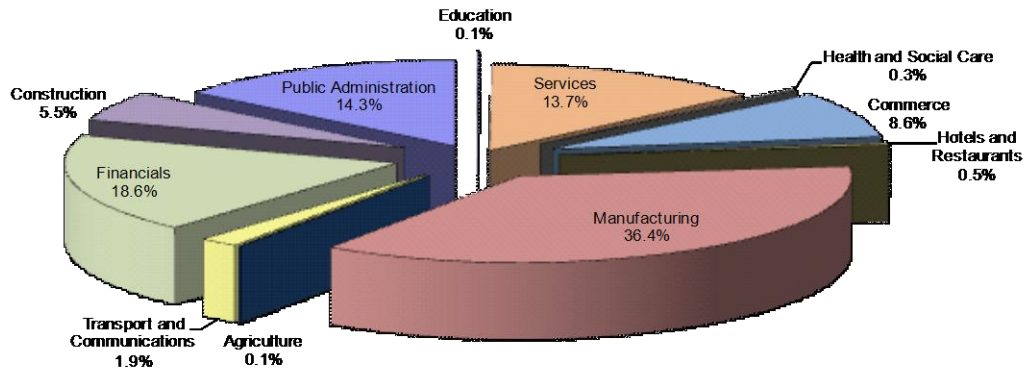


Sources: IMF, World Economic Outlook; UPECEDS; and IMF staff calculations and estimates.
 Note: Lines are smoothed between actual data points.

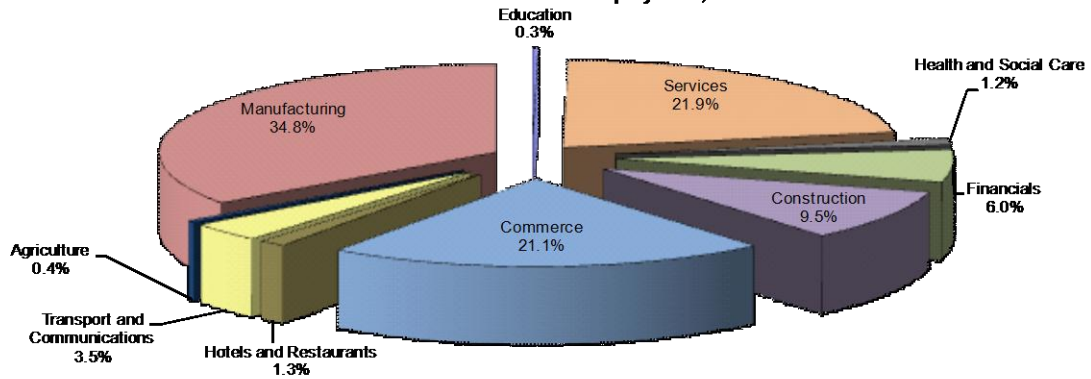
Figure 5. San Marino: Sources of Growth—Supply Side



Breakdown of Gross Domestic Product, 2008



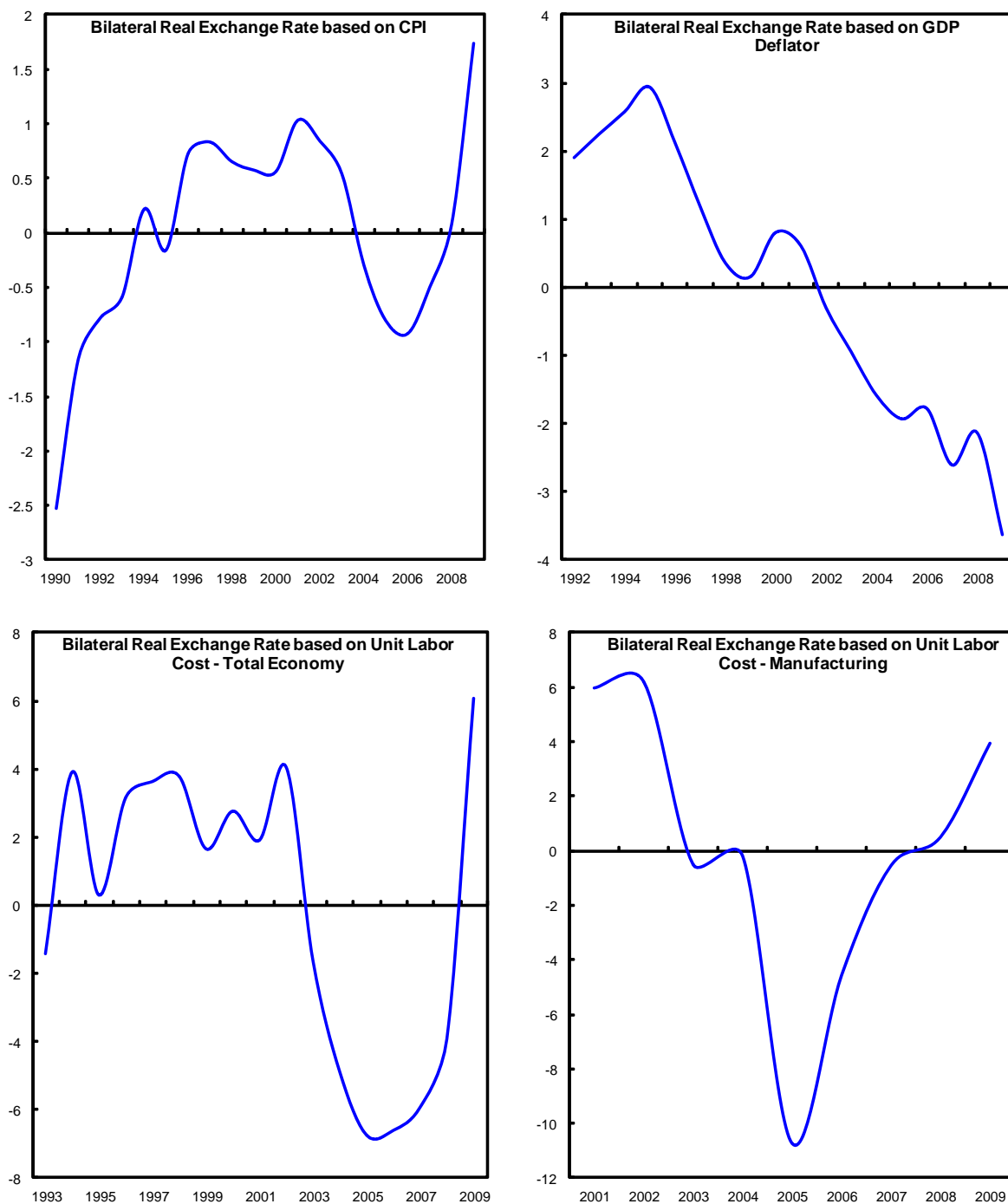
Breakdown of Private Sector Employment, 2009



Source: UPECEDS; and IMF staff calculations.

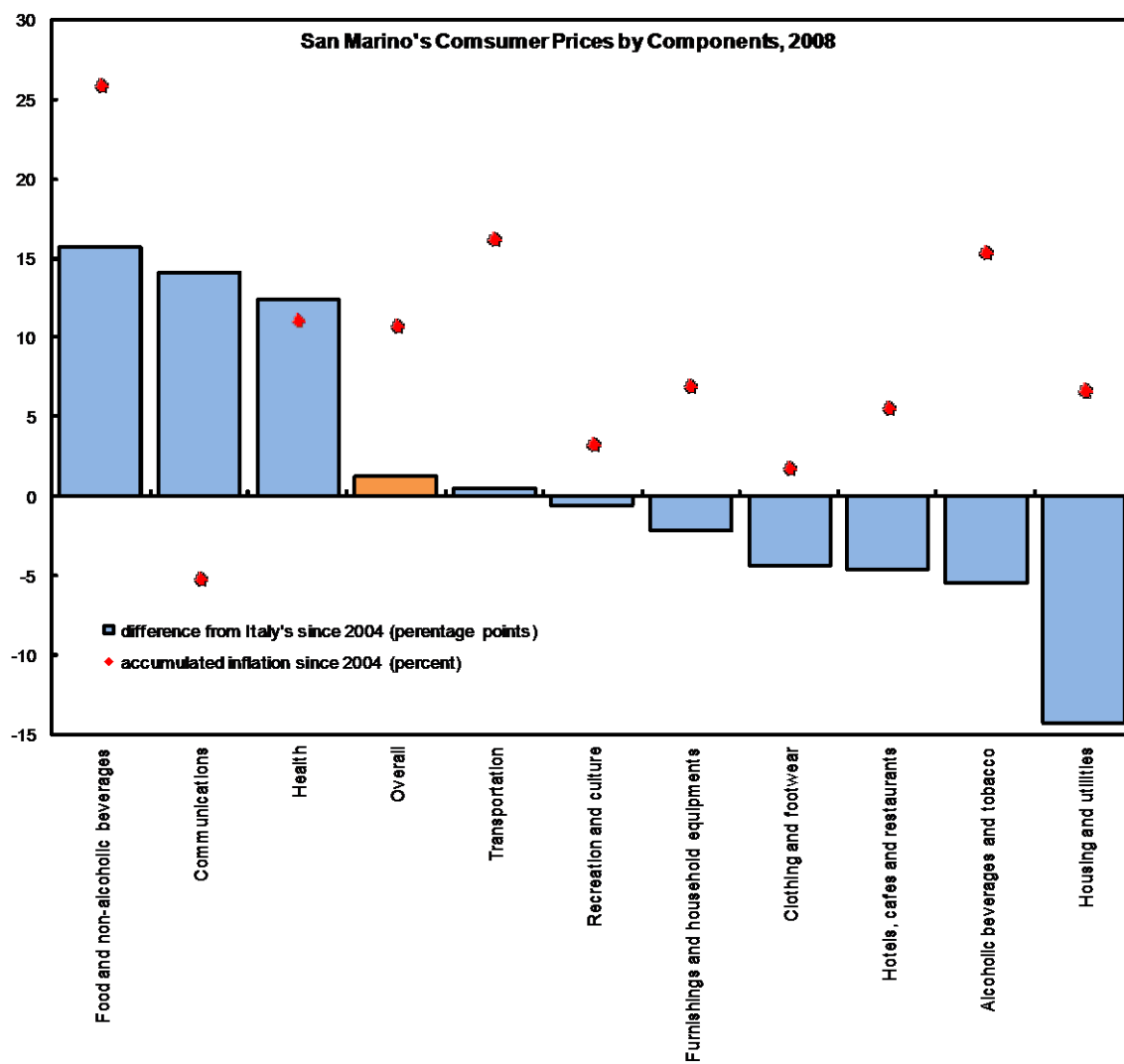
Figure 6. San Marino: Bilateral Real Exchange Rate relative to Italy

(deviation from historical average; percentage points)



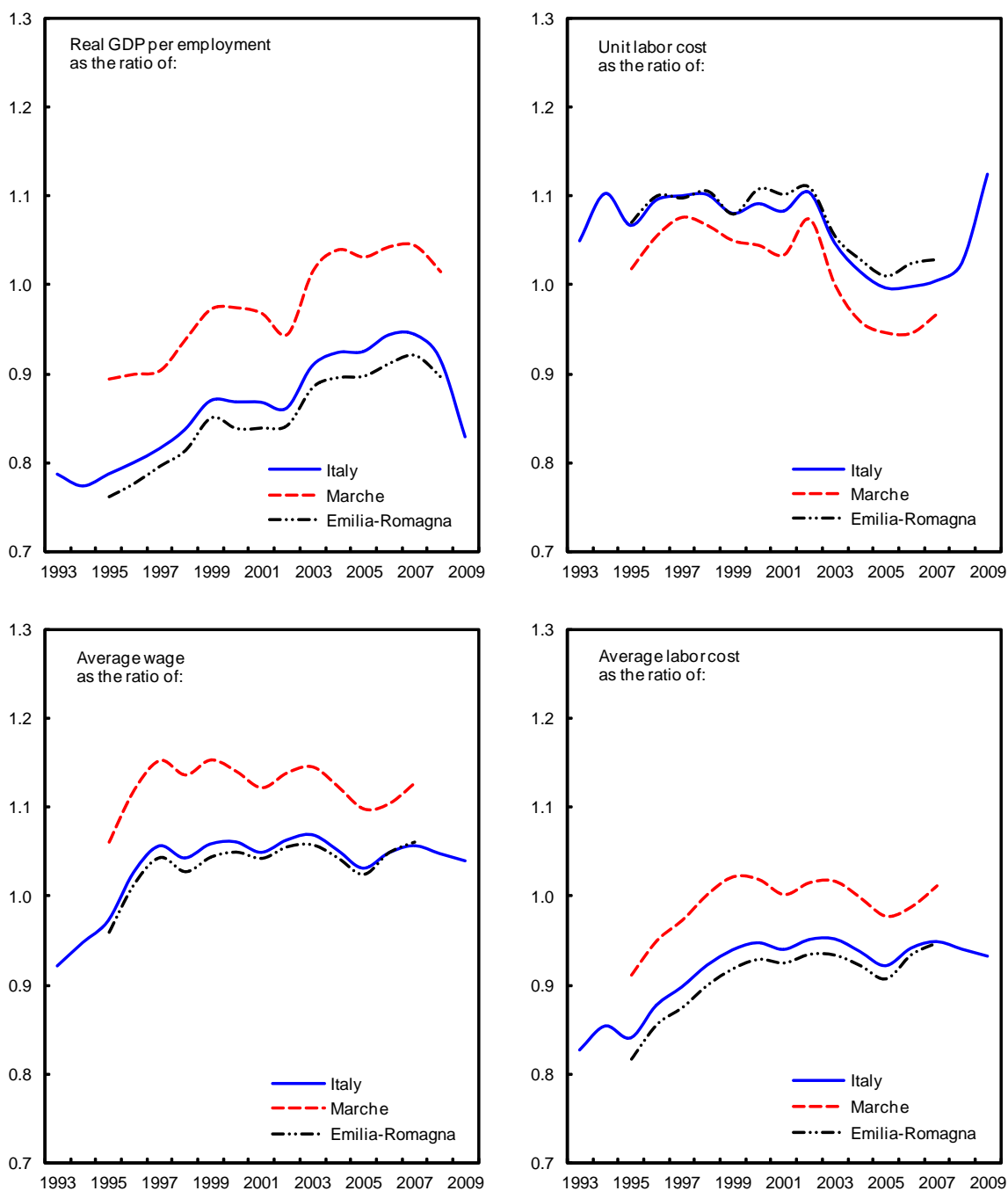
Sources: ISTAT; UPECEDS; and IMF staff calculations.

Figure 7. San Marino: Consumer Prices



Source: ISTAT; UPECEDES; and IMF staff calculations.

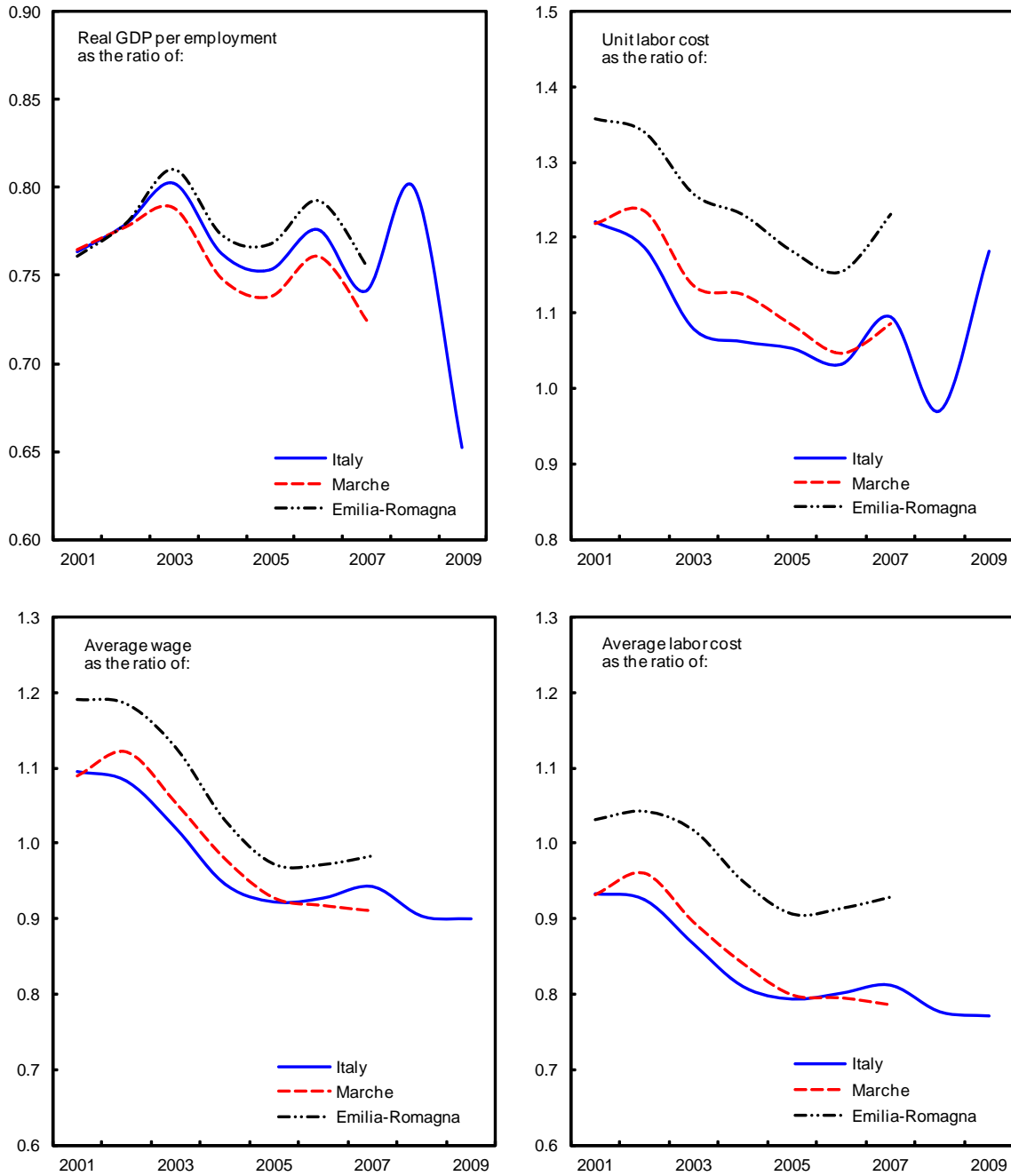
Figure 8. San Marino: Competitiveness Indicators—Overall Economy
 Figure 6. san Marino: Competitiveness Indicators—qedfw



Sources: ISTAT; Sammarinese authorities; UPECEDS; and IMF staff calculations.

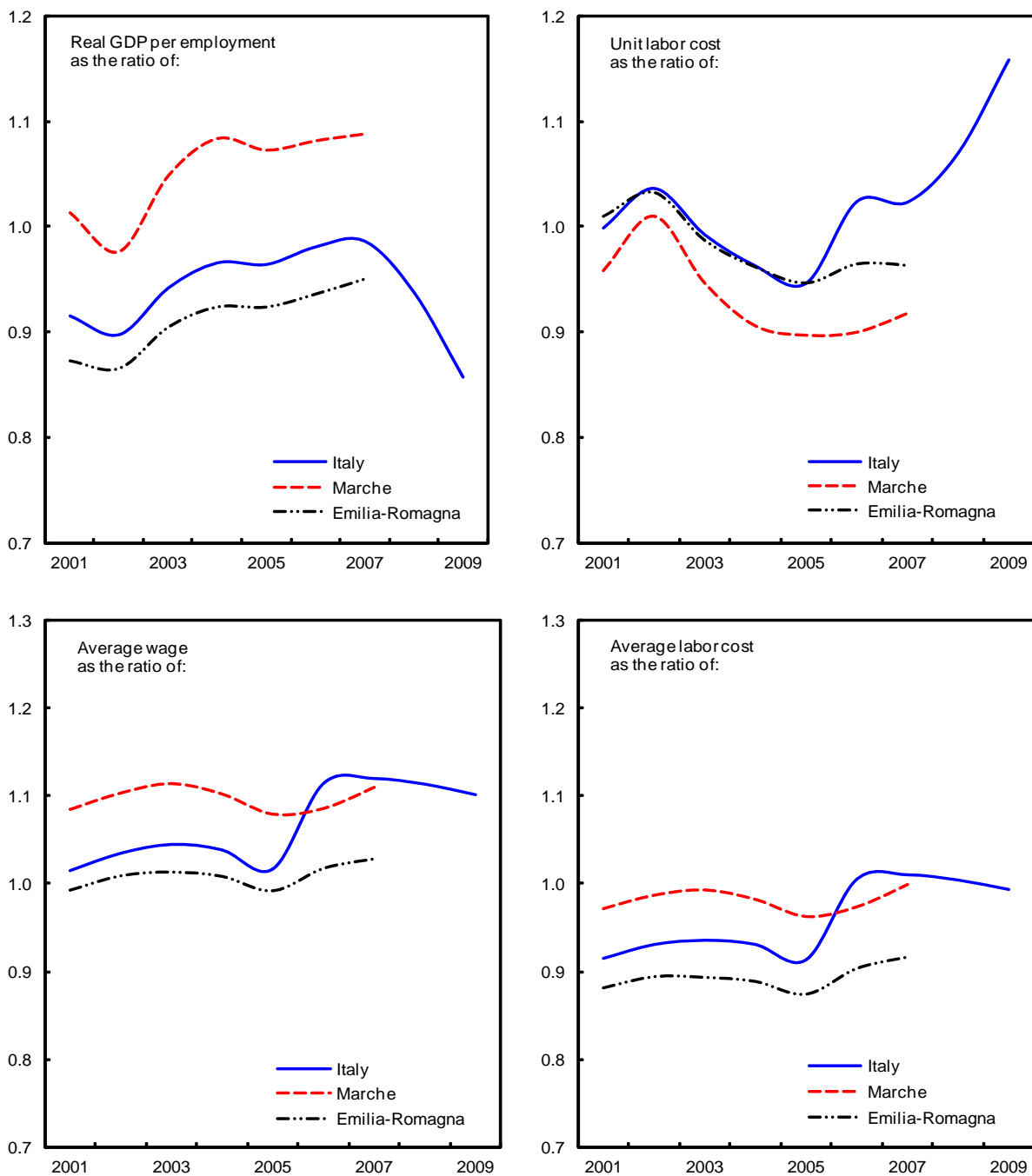
Note: Lines are smoothed between actual data points.

Figure 9. San Marino: Competitiveness Indicators—Public Services



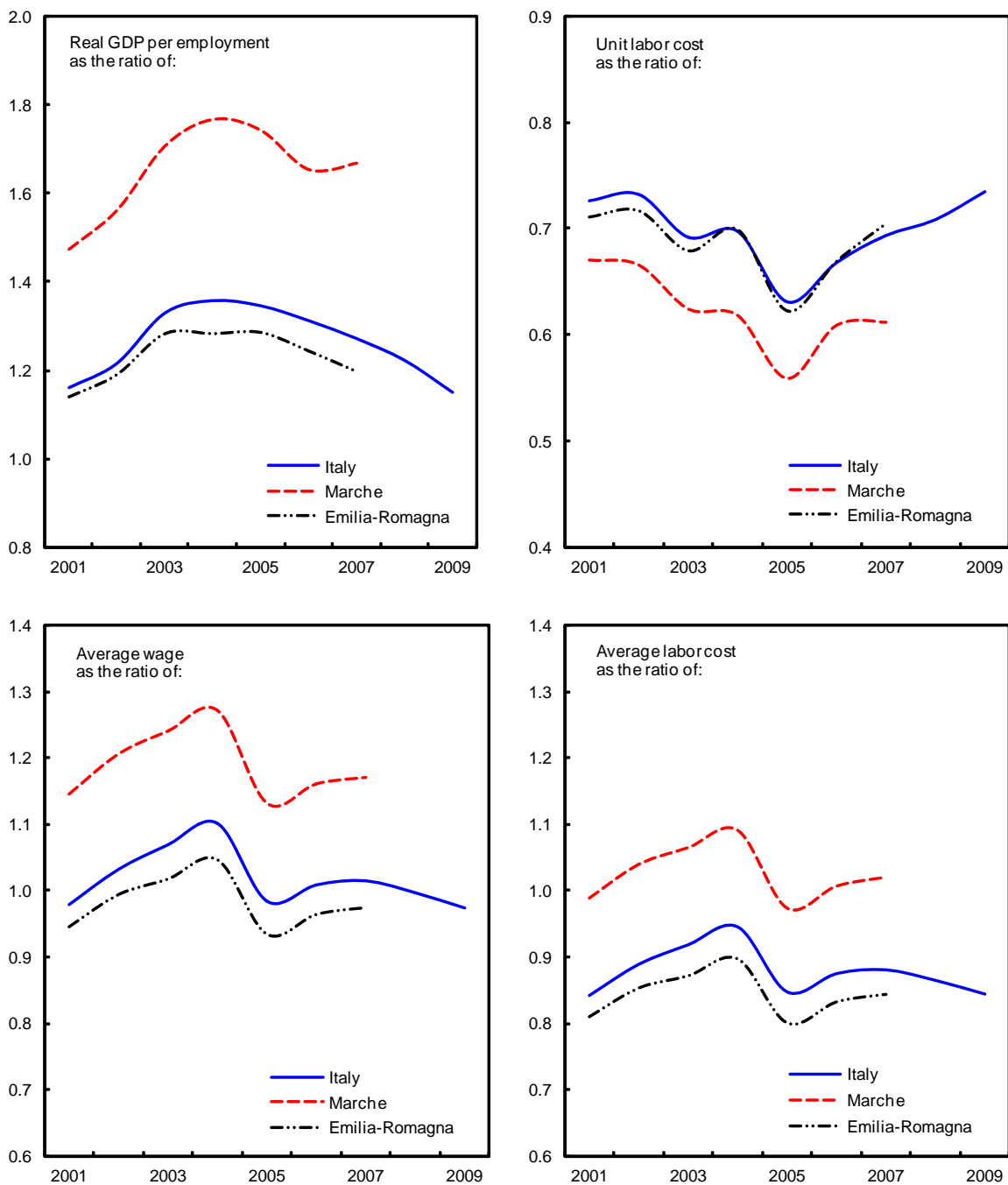
Sources: ISTAT; UPECEDS; and IMF staff calculations.
 Note: Lines are smoothed between actual data points.

Figure 10. San Marino: Competitiveness Indicators—Non-public Services



Sources: ISTAT; UPECEDS; and IMF staff calculations.
 Note: Lines are smoothed between actual data points.

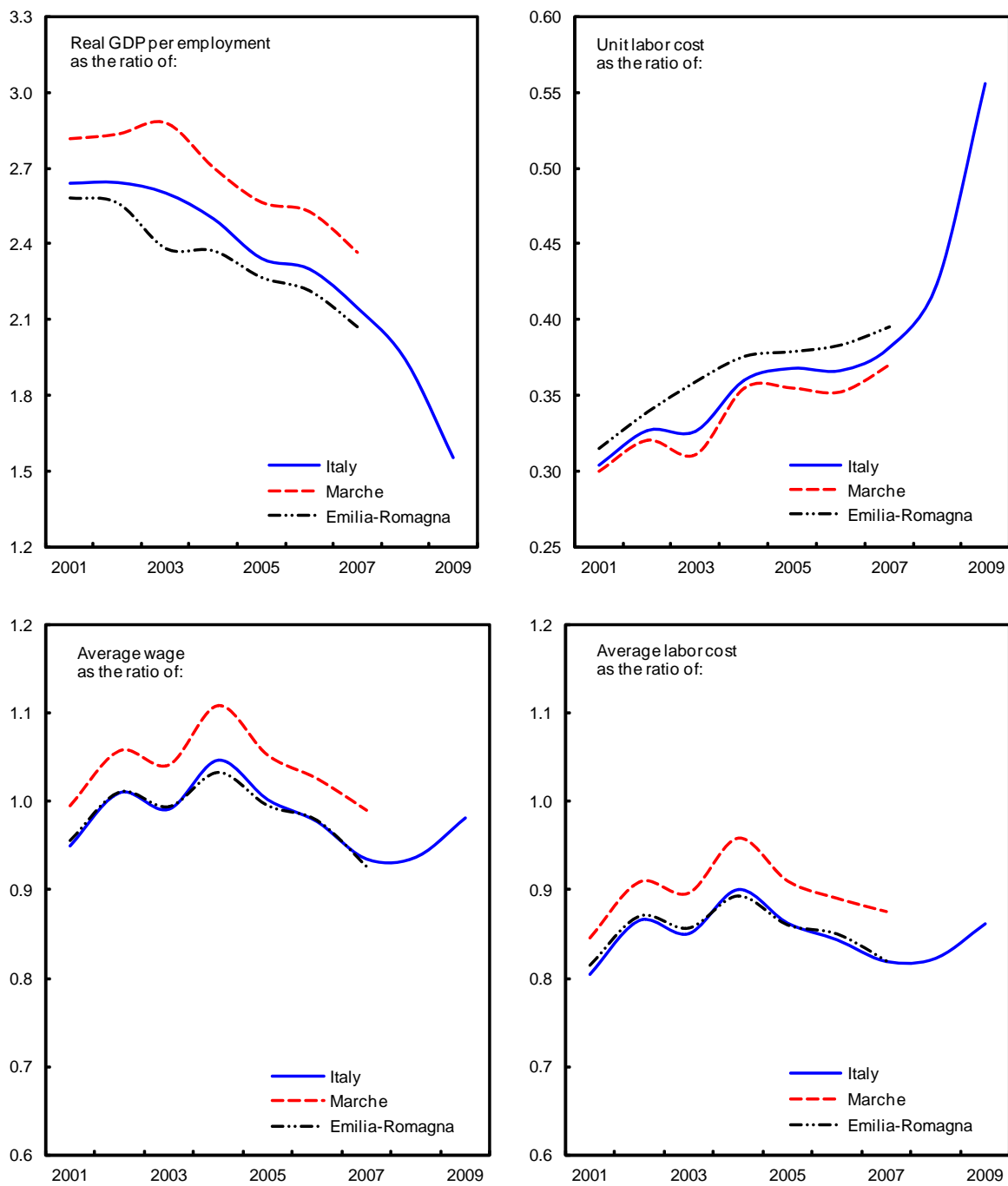
Figure 11. San Marino: Competitiveness Indicators—IndustryFigure



Source: ISTAT; UPECEDS; and IMF staff calculations and estimates.

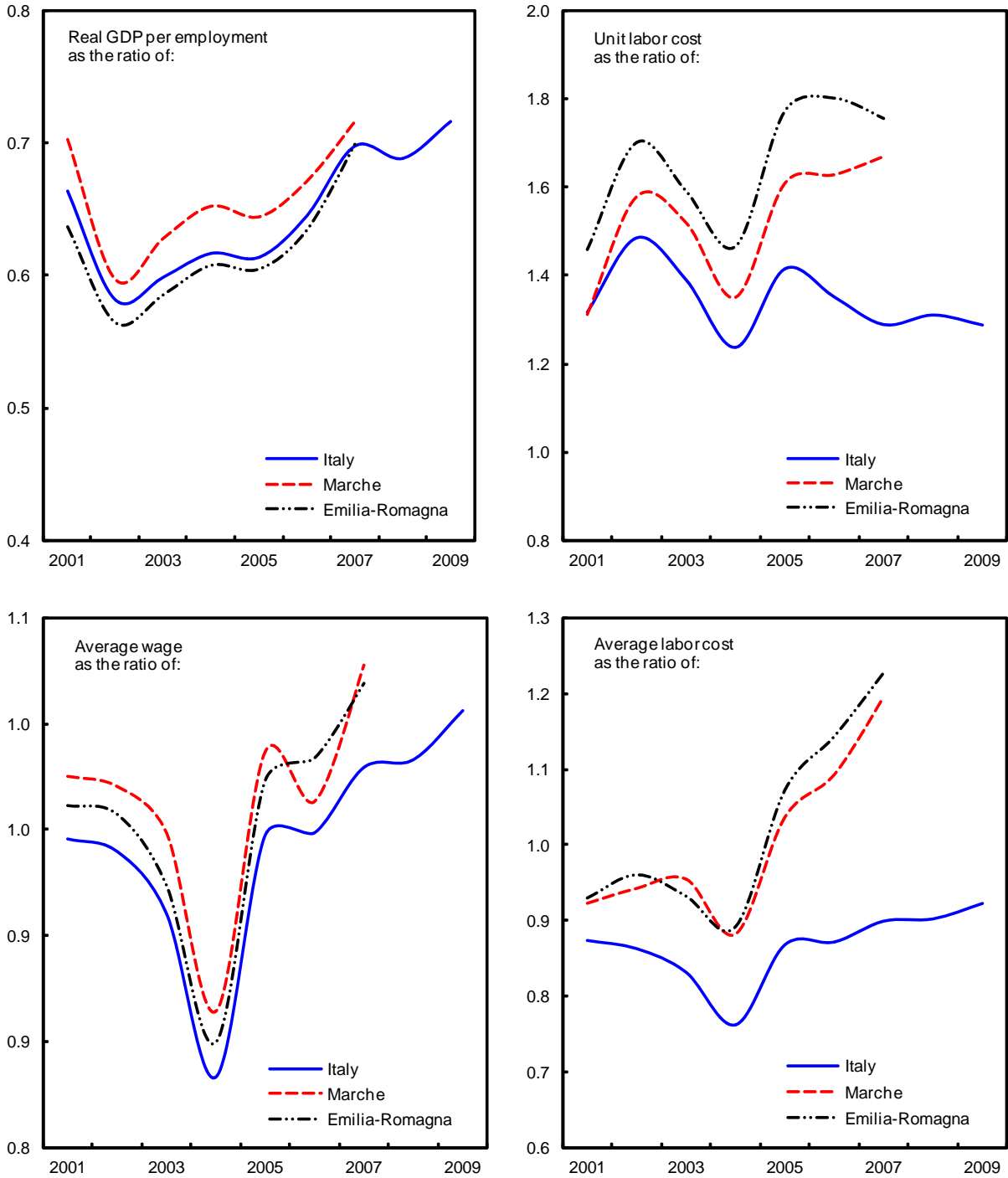
Note: Lines are smoothed between actual data points.

Figure 12: San Marino: Competitiveness Indicators—Financial Services



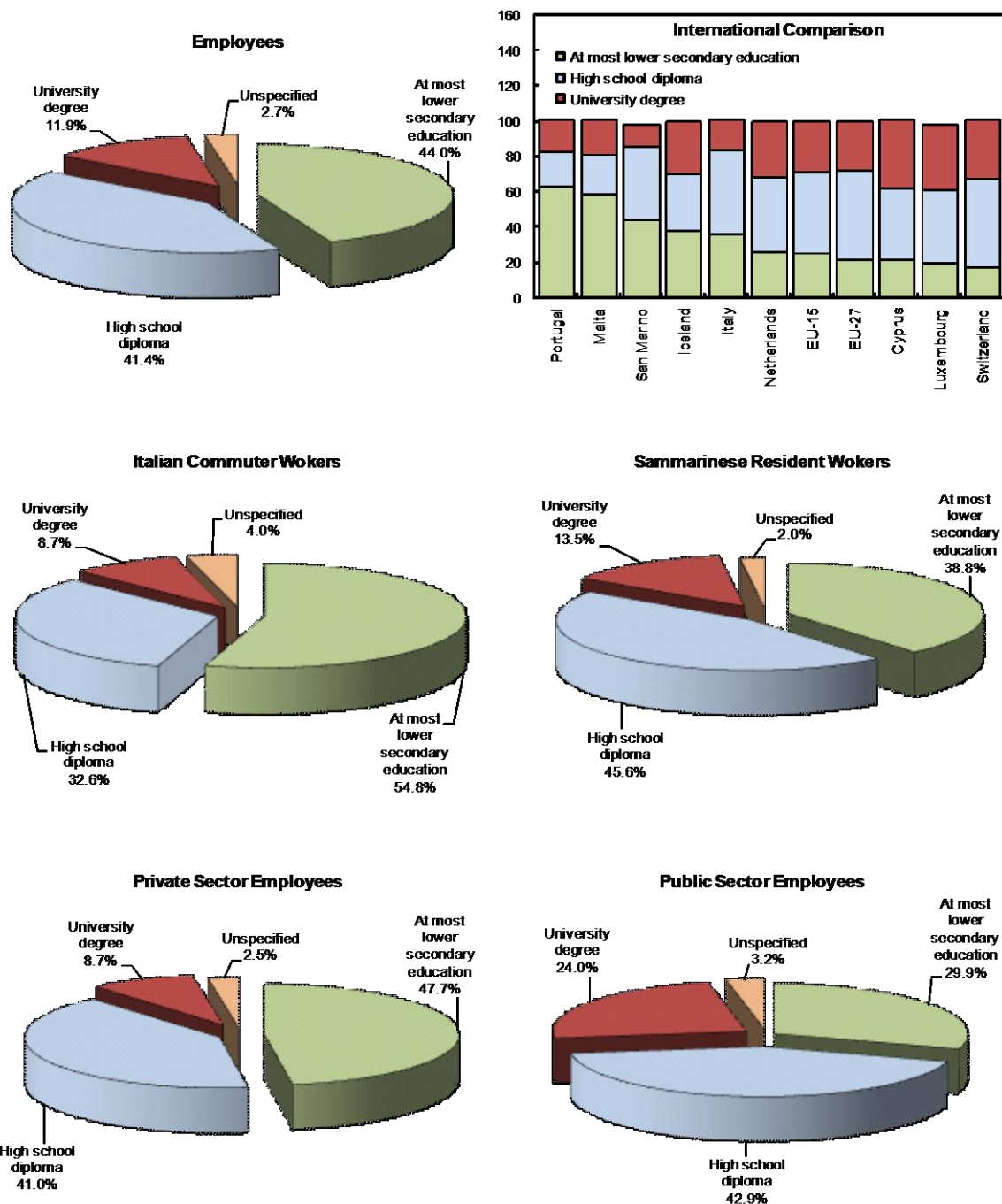
Sources: ISTAT; UPECEDS; and IMF staff calculations.
 Note: Lines are smoothed between actual data points.

Figure 13. San Marino: Competitiveness Indicators—Commerce and Non-financial Services



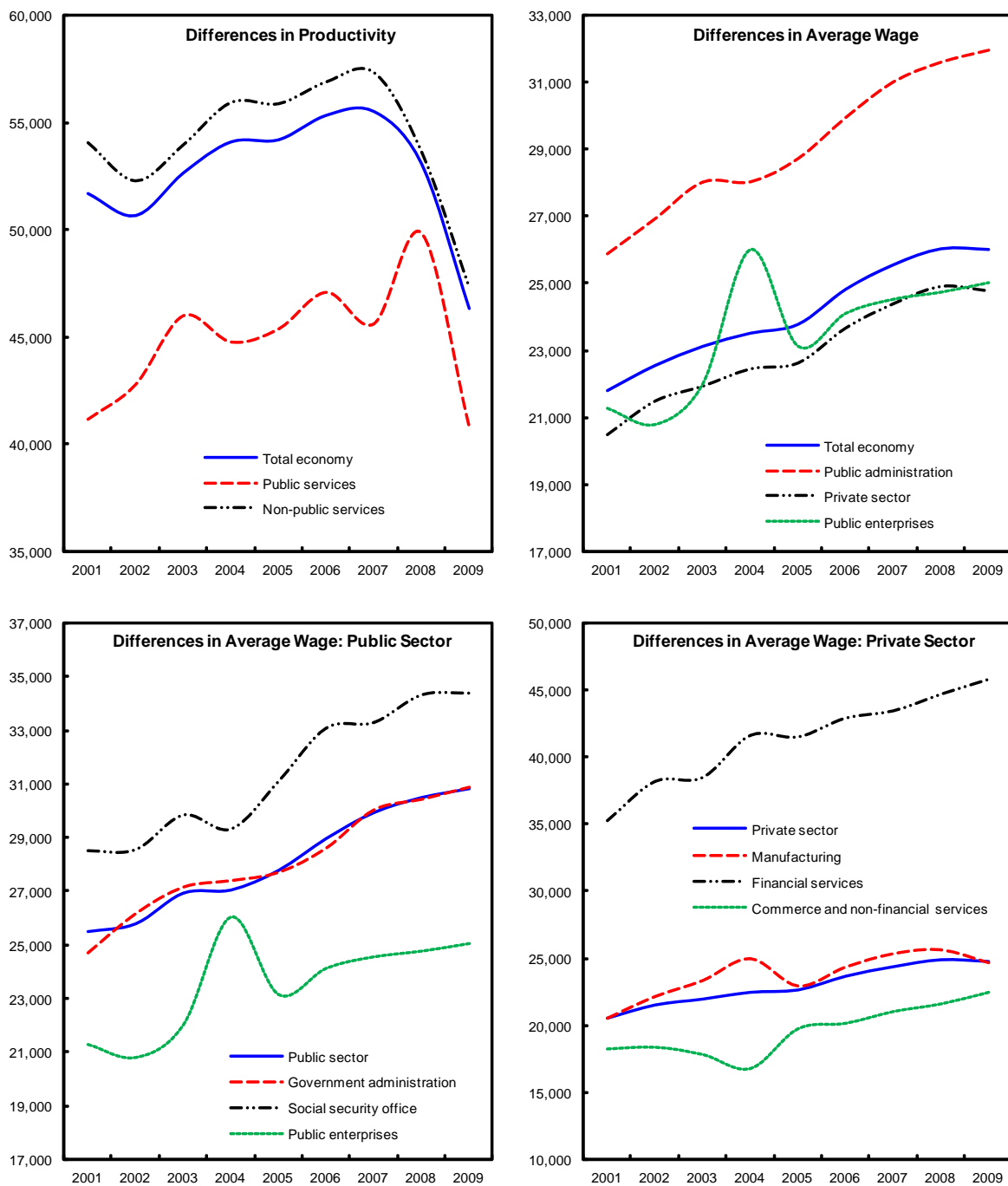
Source: ISTAT; UPECEDS; and IMF staff calculations.

Figure 14. San Marino: Education of Labor Force 1/



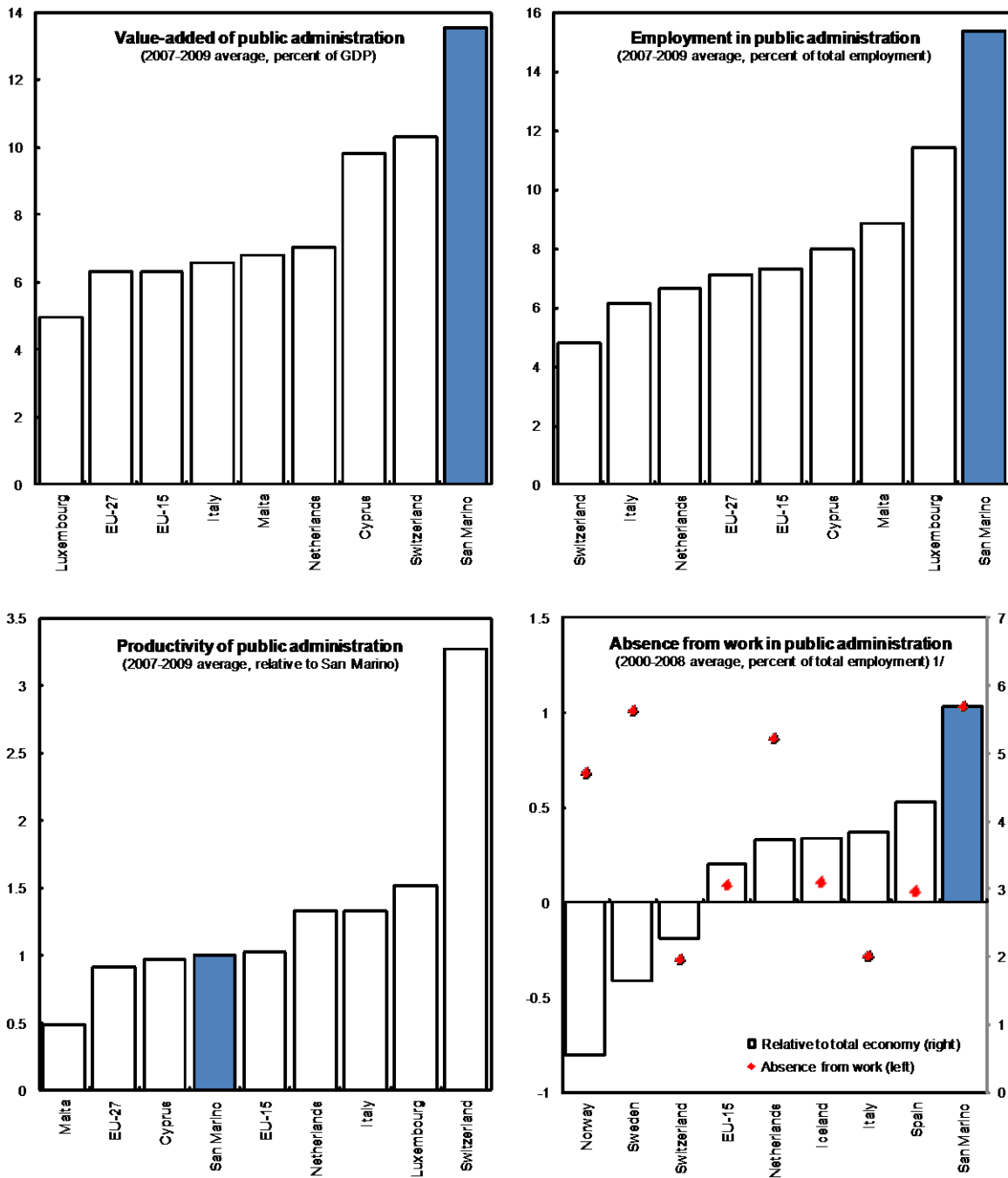
Source: Eurostat, UPECEDS; and IMF staff calculations.
 1/ For San Marino, as of June 2010; for other countries, as for 2009.

Figure 15. San Marino: Differences in Productivity and Wage across Sectors



Sources: UPECEDS; and IMF staff calculations.
 Note: Lines are smoothed between actual data points.

Figure 16. San Marino: Public Administration Efficiency: International Comparison



Source: Bonato and Lusinyan (2010); Eurostat; UPECEDS; and IMF staff calculations and estimates.
 1/ For San Marino, numbers are based on 2002-2009 data.

Table 1. Difficulty of Employing Workers

	San Marino	Italy	Singapore	Hong Kong	Luxembourg	Switzerland
Difficulty of hiring						
Fixed-term contracts prohibited for permanent tasks?	Yes	Yes	No	No	Yes	No
Maximum length of a single fixed-term contract (months) 1/	12	No limit	No limit	No limit	24	120
Maximum length of single fixed-term contracts, including renewals (months) 1/	12	No limit	No limit	No limit	24	120
Minimum wage for a 19-year old worker or an apprentice (US dollar per month) 2/	0	1,583	0	0	2,407	0
Ratio of minimum wage to average value added per worker 2/	0	0.36	0	0	0.26	0
Rigidity of hours						
Standard workday in manufacturing (hours)	7.5	8	8	8	8	8
Minimum daily rest by law (hours)	None	11	12	None	11	11
Maximum overtime limit in normal circumstances (hours)	2D	2D; 8W; 200Y	None	None	None	2D; 170Y
Maximum overtime limit in exceptional circumstances (hours)	2D	None	72M	None	2D; 8W	2D; 170Y
Premium for overtime work (percent of hourly pay)	25	30	50	0	40	25
50-hour workweek allowed for 2 months a year in case of increase in production? 3/	Yes	Yes	Yes	Yes	No	Yes
Maximum working days per week	6	6	6	6	5.5	6
Premium for night work (percent of hourly pay)	50	30	0	0	15	0
Premium for work on weekly rest days (percent of hourly pay) 4/	35	50	100	0	70	0
Major restrictions on night work in case of continuous operations?	No	Yes	No	No	No	No
Major restrictions on weekly holiday in case of continuous operations?	No	No	No	No	Yes	No
Paid annual leave for a worker with 1 year of tenure (in working days)	26	20	7	10	25	20
Paid annual leave for a worker with 5 years of tenure (in working days)	26	20	11	10	25	20
Paid annual leave for a worker with 10 years of tenure (in working days)	26	21	14	14	25	20
Difficulty of redundancy 5/						
Dismissal due to redundancy allowed by law?	Yes	Yes	Yes	Yes	Yes	Yes
Notification of a third party required if 1 worker is dismissed?	Yes	No	No	No	Yes	No
Approval of a third party required if 1 worker is dismissed? 6/	Yes	No	No	No	No	No
Notification of a third party required if 9 worker is dismissed?	Yes	Yes	No	No	Yes	No
Approval of a third party required if 9 worker is dismissed? 6/	Yes	No	No	No	No	No
Retraining or reassignment obligation before redundancy?	No	Yes	No	No	No	No
Priority rules for redundancies?	Yes	Yes	No	No	No	No
Priority rules for reemployment? 7/	Yes	Yes	No	No	Yes	No
Redundancy costs (in salary weeks)						
Notice period for redundancy dismissal for a worker with 1 year of tenure	1.0	6.5	1.0	4.3	8.7	8.7
Notice period for redundancy dismissal for a worker with 5 years of tenure	2.0	8.7	4.0	4.3	17.3	8.7
Notice period for redundancy dismissal for a worker with 10 years of tenure	4.0	10.8	4.0	4.3	26.0	13.0
Severance pay for redundancy dismissal for a worker with 1 year of tenure 8/	0	0	0	0.3	0	0
Severance pay for redundancy dismissal for a worker with 5 years of tenure 8/	0	0	0	1.4	4.3	0
Severance pay for redundancy dismissal for a worker with 10 years of tenure 8/	0	0	0	2.9	8.7	0

Sources: Sammarinese authorities; World Bank, Employing Workers Survey.

Note2 on San Marino:

1/ Only applicable to resident workers, the maximum length of a single fixed-term contract, including renewals, varies across different job types: commerce (9 months), manufacturing (12 months), handicraft (18 months), and banking (24 months). For nonresident workers, firms can offer an open-ended contract only after workers have been employed for at least 7 years.

2/ No laws impose a minimum wage in San Marino. However, wage bargaining, which negotiated among trade unions, employers' associations, and the Ministry of Labor, determines a minimum wage for each job grading.

3/ This is possible, but an agreement with trade unions must be made.

4/ Based on the premium for work on Saturday (workers are typically entitled to rest on Sunday). The premium for work on public holidays is 200 percent.

5/ Based on workers with open-ended contracts.

6/ The employer must reach a mobility agreement with the trade union, the employers' association, and the Minister of Labor. The cabinet must also endorse the mobility agreement.

7/ If a similar job is reinstated within one year, the dismissed worker is entitled with priority of being re-employed.

8/ Based on operational staff. For intermediate-ranked staff, the notice period is 4.3, 6.5 and 13 for a worker with 1, 5 and 10 years of tenure. The notice period is further doubled for management-level staff. However, employees are required to inform their employers when they would like to voluntarily terminate employment. In this case, the notice period is one half of the applicable notice period for redundancy dismissal.