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Correction 1

CONTAINS CONFIDENTIAL
INFORMATION

July 13, 1994

To: Members of the Executive Board

From: The Acting Secretary

Subject: San Marino - Staff Report for the 1994 Article IV Consultation

The following corrections have been made in SM/94/144 (6/8/94):

Page 1, para. 3, line 2: for "June 1993" read "May 31, 1993"

Page 7, line 2: for "beginning of 1993" read "beginning of 1994"

Corrected pages are attached.

Att: (2)

Other Distribution:
Department Heads

SM/94/144
Corrected: 7/13/94

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INTERNATIONAL MONETARY FUND

SAN MARINO

# Staff Report for the 1994 Article IV Consultation

Prepared by the Staff Representatives
for the 1994 Consultation with San Marino

Approved by Michael Deppler and Mark Allen

June 6, 1994

## I. Introduction

A staff team 1/ visited San Marino during April 6 to 15, 1994 to conduct the 1994 Article IV Consultation discussions. The mission met the Secretary of State for Finance and Budget, the Secretary of State for Foreign Affairs, the Ministers of Industry and Handicrafts, Labor, and Commerce, the Director of the Sammarinese Credit Institute (the recently-established central bank), the Directors of the Social Security Institute and the Office of Bank Supervision, and other government officials, as well as representatives of manufacturing and other economic sectors, commercial banks, and trade unions. There was also an audience with the Captains Regent, the joint heads of state. Mr. Lanciotti, the Executive Director for San Marino, held discussions with the authorities prior to the mission. San Marino has accepted the obligations of Article VIII, Sections 2, 3, and 4.

These were San Marino's first Article IV Consultation discussions since accession to membership in the Fund in September 1992. Since then, there have been two short staff visits, in December 1992 and December 1993.

In the most recent elections for the Great and General Council (the Sammarinese parliament), held on May 31, 1993, the ruling coalition of Christian Democratic and Socialist parties returned to power. Under this government, San Marino continued its policy of widening its international involvement. Previous steps along this path included membership in 1992 in the Fund, the United Nations, and the Council for Security and Cooperation in Europe; the Cooperation Agreement with the European Union (1991); and the Exchange and Financial Agreement with Italy (signed in 1991 and now moving towards implementation).

San Marino maintains a system free of restrictions on the making of payments and transfers for current international transactions.

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1/ T. Lane (head), A. Hamann, A. Prati (all EU1), T. Mathisse (STA), with G. Jeffers (EU1) as staff assistant.

## II. Background to the Discussions

Economic conditions in San Marino are shaped by the country's particular circumstances, as a tiny mountain enclave in north-central Italy, covering an area of 62 square kilometers, with a population of some 24,000. Geography, together with the absence of border controls with Italy and the use of the Italian lira as the domestic currency, have helped integrate San Marino into the economy of the surrounding regions of Emilia-Romagna and Marche. At the same time, San Marino has maintained a distinct set of political and economic institutions.

Several sectors of the Sammarinese economy have been important in its development; their shares of total employment are shown in Chart 1. There is a diversified industrial sector consisting of a large number of firms, which average fewer than 10 employees per firm. The country receives some 3 million visitors annually, but these consist mainly of tourists staying at the popular Adriatic beaches who come to San Marino for a few hours, and thus do not generate a commensurate tourist service industry. There is, however, a substantial volume of commercial activity oriented towards these day visitors, also benefiting from lower tax rates than in Italy. The banking system is relatively large, with total liabilities in 1993 estimated at nearly 800 percent of GDP; it attracts substantial nonresident deposits due to lower rates of withholding tax and greater bank secrecy than in Italy. The public sector plays an important role in the Sammarinese economy, and accounts for one-quarter of total employment. Agriculture, once a key area of economic activity, is now of negligible importance except as a means of preserving the environment.

The Sammarinese economy appears to have weathered the European recession rather well so far. Some industries, such as textiles and tourism, were affected adversely by the recession, but others, such as ceramics and banking, experienced favorable conditions. No measures of aggregate economic activity are available, but labor market data suggest continued, although likely decelerating, growth. 1/ Unemployment remained relatively low at 4.9 percent in December 1993 compared with 7.4 percent in Emilia-Romagna and 11.3 percent in Italy as a whole. This marked only a small rise in relation to 1992, and was still below the 1988-92 average (see Chart 2). Total employment continued to grow as labor was drawn into San Marino from Italy and elsewhere; by 1993, nonresident workers (*frontalieri*) accounted for roughly one-quarter of private sector employment. 2/

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1/ In particular, San Marino's national accounts are only experimental and the most recent data available are for 1992, when they show an estimated growth rate of GDP of 9.6 percent. No data are collected on industrial production, retail sales, or other indicators of aggregate economic activity.

2/ In calculating the unemployment rate, non-resident workers are excluded from the denominator.

took place, providing an incentive for Italian residents to purchase cars in San Marino. Since the beginning of 1994 it is collected by the country in which a car is registered, regardless of the country in which it was purchased. This is expected to depress auto sales by Sammarinese dealers, and therefore reduce revenues from the import tax.

Expenditure in several areas is projected to decline from 1993 levels, but this is attributed mainly to nonrecurring spending items in 1993, rather than to any deliberate policy adjustment. 1/

## III. Policy Discussions

In presenting their policy agenda, the authorities emphasized their intention to increase San Marino's involvement in the world economy and its institutions. In this regard, they stressed the potential role of international surveillance, which they viewed as useful in providing external scrutiny for Sammarinese economic policies and institutions. They also welcomed advice on improving the quality of the statistical base.

The authorities recognized that this process of integration would require a greater degree of harmonization of taxation and regulations with neighboring countries. In particular, the Cooperation Agreement with the EU will require the introduction of a value added tax on domestic production at the same rate as the current single-stage import tax by 1996; and the Exchange and Financial Agreement with Italy will likely require some exchange of information relevant to the Italian authorities' investigation of possible tax evasion and money laundering. The authorities said they would have to achieve a compromise between their desire to participate more widely in the world economy and their desire to preserve Sammarinese sovereignty and institutions. The staff noted that while the transition would likely entail difficulties for some sectors, and might for some time lead to a significant decline in government revenues, harmonization could also have some potentially beneficial consequences for San Marino. In particular, it could reduce San Marino's vulnerability to wide swings in national income and government revenues, associated with changes in the political, tax, and regulatory situation in Italy--as illustrated by the variations in tax revenues associated with variations in nonresident deposits and nonresident automobile sales.

While San Marino's fiscal situation has, on the whole, been a major strength, there have lately been some signs of weakening, in which public sector wage increases have played a critical part. The staff discussed the issue of public sector salaries with government officials, representatives of industry and other sectors of the economy, and organized labor. There seemed to be quite general agreement, even by the trade unions, that these

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1/ The nonrecurring items include land purchases, the payout of money previously accumulated in a severance pay fund, and some subsidized loans.

salaries were inappropriately high relative to those in the private sector. Not only the fiscal, but also the structural aspects were emphasized: high salaries, accompanied by the shorter working hours and greater job security of public sector employment, had created an incentive for many Sammarinese workers to wait for a job in the public sector rather than accepting available private-sector openings. This labor market distortion may have ancillary fiscal consequences, as preferential credit and tax exemptions are given to provide employment to those who become unemployed as a result. The 1991-93 contract for public sector workers stipulated that new entrants earn 20 percent less than the standard salary for their first two years, but this was seen as insufficient to rectify the imbalance. A further adjustment could be incorporated in the 1994-96 public sector wage contract, to be concluded later this year.

The authorities discussed their projections for the pension plans, according to which the funds will collectively be solvent over the next five years. The ISS has begun to accumulate reserves for these funds to cover possible shortfalls in the future. The staff expressed concern that some potential problems, including those associated with a possible slowdown of labor force growth, might only surface over the longer term, with the retirement of the present cohort of workers. 1/

Another issue discussed was the remuneration of public sector deposits, which include the reserves accumulated by the pension funds. At the end of 1993, these deposits amounted to Lit 257 billion, an estimated 31 percent of GDP. Currently, these funds are deposited with the Sammarinese Credit Institute (ICS); the latter has, in turn, deposited over one-third of these funds in the Sammarinese commercial banks, where they are remunerated at a rate fixed at a spread of 2 percentage points below Italian interbank rates. The staff queried the reasons for such a wide spread, given the commercial banks' ease of on-lending the funds in the Italian interbank market. The authorities said that holding large deposits in the Sammarinese banking system at below-market rates would only be a transitional arrangement.

On the monetary side, one issue is the emerging role of the ICS as an embryonic central bank. The staff asked what remained for a central bank to do, given that most traditional central banking functions are not relevant in the context of the currency union. The authorities appeared to have few plans for how it might go beyond its current treasury management function.

A key structural area is the labor market. Here, in addition to the issue of public sector wages, the discussions focused on the continued

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1/ These issues are discussed further in the background document.