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Luxembourg's Financial Services Sector as a Product of Nimble Tax and Regulatory Policy

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Introduction

In 2007 Luxembourg had the highest GDP per capita in the world at $80,800 per person. (CIA) The financial services industry, which includes banks, investment services, advisory services, and holding companies, accounts for nearly one quarter of Luxembourg's GDP. The most important factor in the industry's continued growth has been the country's "nimble" tax and regulatory frameworks.[1] Over the last forty years, financial services in Luxembourg have grown from a minor sector to the largest sector of the nation's economy. Following the initial growth in the 1970s, attributable to the decline in the steel industry and the tax and regulatory policies of neighboring states, the nimble tax and regulatory policies of Luxembourg have provided a strong foundation for the sector's growth and international competitiveness.

This article will analyze the financial services industry in Luxembourg in relation to its tax and regulatory policies. The first section examines the ways in which the decline of steel, coupled with Luxembourg's location, languages and stable political environment, led to the growth and prominence of financial services in the economy. The following section assesses the ways in which the tax and regulatory policies are nimble and aid the financial services industry's continued success, and offers three specific examples of Luxembourg's nimble response to challenges in tax and regulatory policies. The final section examines the implications of Luxembourg's tax and regulatory policies for other economies, showing that the policies have the ability to positively impact surrounding nations.

From Steel-Based Economy to Financial Services

The financial services industry in Luxembourg is relatively young, as steel dominated the nation's economic landscape for much of the

[1] Luxembourg's tax and regulatory policies are "nimble" in that they adapt to changing conditions very quickly, capitalizing on opportunities and turning rulings, events, and new financial services products to their favor.

last 100 years. After the Second World War, the steel industry continued to grow due to the need for reconstruction and brought about high growth rates for the Luxembourg economy as a whole. Rapid growth led Luxembourgers to coin the period from 1945–1975 as the “thirty glorious years.” In fact, growth rates for GDP were more than 3.9 percent for each decade in this period. (STATEC) Despite steel’s importance in the history and development of Luxembourg’s economy, however, the industry eventually came under intense pressure due to greater competition from new steel producing centers. Following the first oil crisis in the mid-1970s, the Luxembourg steel industry experienced a crisis of its own; worldwide overcapacity contributed to declining prices and grim prospects for future profitability. By 1981 the last iron mine in Luxembourg closed, and steel production was greatly reduced. (STATEC)

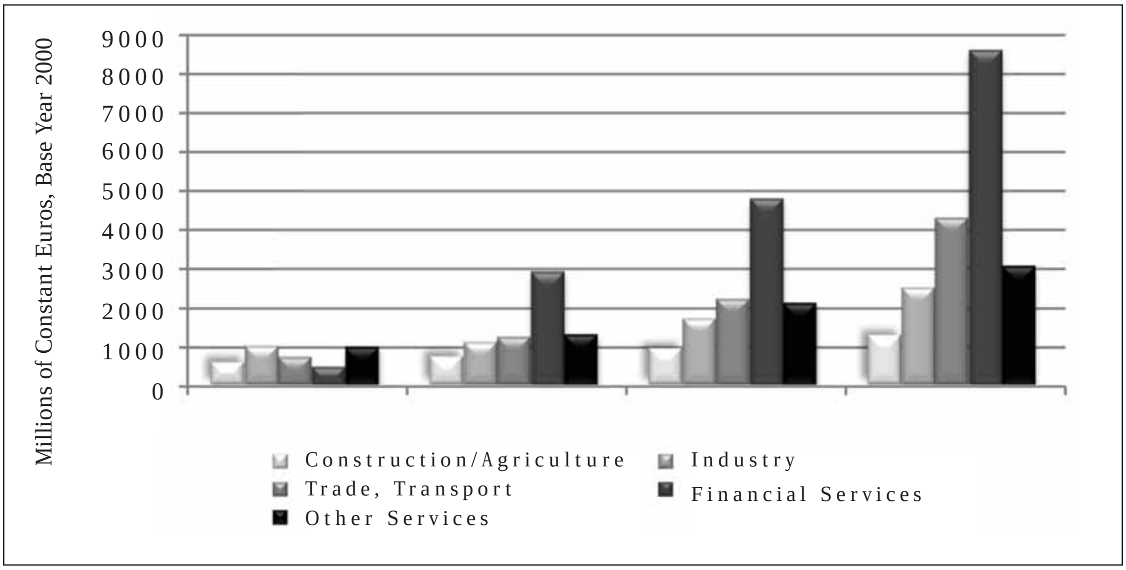
Ironically, the decline of the steel industry provided the perfect opportunity for the emergence of a new dominant industry — financial services. With a gaping hole in its national economy, Luxembourg required new sources of employment and economic activity. Since the 1970s, the composition of the Luxembourg economy has shifted dramatically toward financial service activities, as shown in Figure 1. From 1970 to 2001, the steel industry’s share of the value added to GDP plummeted from 28 percent to 2 percent. At the same time, the financial services’ share of the value added to GDP expanded from 4.6 percent to nearly 25 percent. (STATEC)

Figure 1 shows that the financial services industry became the dominant contributor to GDP by 1980, quickly dwarfing all other industries. This industry is not only important in terms of the dollars generated by the industry, but also for employment. In 2006 the financial services industry accounted for 40 percent of the Luxembourg workforce, both directly and indirectly. (“Luxembourg”) However the impact on the nation is measured, financial services is clearly the leading sector in Luxembourg’s economy.

How did financial services grow at such a rapid rate? And why did Luxembourg choose financial services to replace its steel industry? Three sets of factors explain Luxembourg’s rise as a financial services center. First, Luxembourg is a multilingual, centrally located, and geographically small nation. Second, changes in the tax and regulatory policies of nearby nations encouraged financial services and cap-

Figure 1

Luxembourg GDP by Industry: 1970–2000



Source: OECD National Accounts: Statistics Portal.

ital from investors to move to Luxembourg. Third, Luxembourg's nimble tax and regulatory systems provide a favorable environment for the financial services economy in response to changes in international financial markets and policy. These systems also enable Luxembourg to corner niche markets in financial services — such as international pension funds and mutual funds. However, this success has not always come without criticism from other entities, such as Germany, the OECD, and the EU. In fact, Luxembourg is often referred to as a "tax haven," and competitors claim that its policies distort the European market or unfairly erode the tax base of other European nations.

Sources of Strength in the Financial Services Sector

National Characteristics

Luxembourg is located in the heart of Western Europe, bordered by France, Germany, and Belgium. Since Luxembourg is a member of the European Union, people within the EU can travel freely through Luxembourg to other member states. In addition, Luxembourg is a short flight from most major European cities. Its location has also been crucial in attracting talent and expertise from neighboring nations, such as Belgium and Germany. Due to Luxembourg's small size, foreign workers often can choose either to relocate to Luxembourg as residents or commute across the border. In fact, foreigners comprise 40 percent of Luxembourg's population and 50 percent of the total Luxembourg workforce today. (Luxembourg for Finance)

Another major factor in Luxembourg's regional and international appeal is its population's strong command of languages. Luxembourg has three officially recognized languages. Luxembourg schools conduct preschool in Luxembourgish, primary school mostly in German, and middle school and high school primarily in French. For those who enter the general secondary track, the normal curriculum for college-bound students, English is a required course of study. (SIP) Thus, Luxembourgers graduating from general secondary schools have a strong command of at least four languages. This means that neighboring nations can generally do business in Luxembourg in their native language, thereby removing a major obstacle in multinational business. Luxembourg also presents a stable political environment, which is reassuring to financial services firms. With a single political party holding the majority of seats in Luxembourg's Parliament over most of the past fifty years, policies and strategies have not changed drastically, and this continuity reduces the risks of doing business in Luxembourg. (U.S. Department of State) At the time of the steel industry's major downturn, Luxembourg's three major advantages of a prime location, a multilingual population, and a stable political environment all contributed to its attractiveness for financial services.

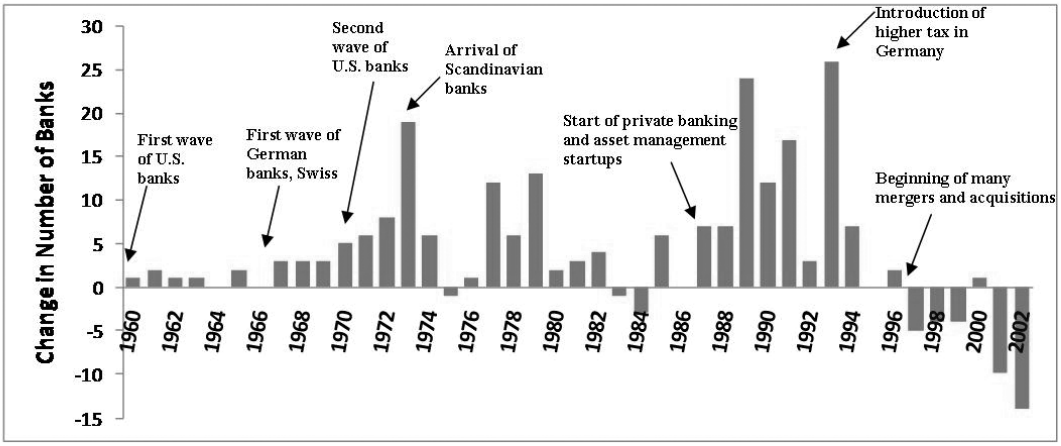
Tax and Regulatory Policies of Other Nations

Today, these three advantages mentioned above continue to be touted prominently in investment brochures for Luxembourg. However, it is still unclear why the financial services industry in particular rose to prominence following the decline of steel, as the above advantages could also have aided a number of other industries serving multinational corporations and foreigners. Luxembourg's growth as a financial center did not accelerate until the 1960s and 1970s, as financial service firms and activities needed an additional impetus to bring them to Luxembourg. As conditions in other nations became less favorable to financial services, bankers, individuals, and businesses turned to Luxembourg as a convenient alternative; and after the decline of steel, certain changes in the tax and regulatory policies of nearby nations also drove this growth.

Banking is a prime example. The number of foreign banks in Luxembourg rose in response to certain policy changes in those nations, creating several "waves" of growth in foreign banks which are discussed below. The growth in the total number of banks, along with the primary nation(s) associated with each wave of growth, are shown in Figure 2. (STATEC) For example, in the 1960s, German banks set up affiliates in Luxembourg, due in part to rising interest rates and reserve rates in Germany. (IMF, 2002) The 1970s saw an influx of banks from the U.S. and Switzerland. Swiss banks

Figure 2

Change in the Number of Banks in Luxembourg: 1960–2002



Source: CSSF (Commission de Surveillance du Secteur Financier).

entered for the liquidity of the euromarket and to establish relations with the German banks in Luxembourg, while American banks came mainly for private banking. Scandinavian banks began to enter at the end of the 1970s in order to gain access to lending in foreign currencies. In the 1980s private banking and asset management grew considerably, helped by Luxembourg's introduction of a more comprehensive banking secrecy law. Finally, in the 1990s large amounts of German capital came into Luxembourg when Germany introduced considerably higher taxes on interest from savings in 1992. Foreign banks continue to comprise a large part of the financial services activity in Luxembourg, with 130 of the total 155 banks registered in Luxembourg as of March 2006 being foreign. (ABBL)

The relationship between financial service sector growth and the tax and regulatory policies of other nations is not restricted to banks. The eurobond and eurodollar markets both emerged in Luxembourg due to restrictive measures in the U.S. In the 1950s and 1960s, Europe and much of the rest of the world had higher interest rates than the U.S., making foreign bonds with higher interest rates attractive to U.S. investors. In response, many foreign bonds were issued in the U.S. during this time period. In an effort to reduce the exodus of U.S. funds to other nations, in 1963 the United States introduced an interest equalization tax of 15 percent on the interest from foreign bonds. The introduction of this tax led to the growth of the eurobond market. Eurobonds are bonds that are denominated in a currency different from the domestic currency in the nation of issue. Since the 1960s, these markets have grown tremendously; in 2005 the Luxembourg Stock Exchange listed 59 percent of the international bonds in Europe. (ABBL) Issuers in Luxembourg include the European Investment Bank, the European Commission, and the World Bank. Thus, the eurobond market in Luxembourg grew as a result of the introduction of a new tax in the United States.

Regulatory changes in other nations also spawned much of the demand for financial services in Luxembourg. However, many neighboring nations felt pressure to maintain attractive business practices after seeing their talent, business, and potential tax revenue relocate to Luxembourg. Thus Luxembourg could not rely solely on the restrictive regulations of other nations to sustain the growth and success of its financial services industry. Other nations can see the effects of their policies and respond accordingly.

A Nimble Luxembourg Government

Instead of waiting to capitalize on policies of other nations that are unfavorable for financial services, Luxembourg's government has become proactive in fueling the growth and prominence of financial services through its own tax and regulatory policies. Today, this is perhaps the most important competitive advantage for financial services. With the financial services industry comprising a large proportion of GDP, contributing greatly to the national budget through the tax revenues it produces, as well as serving as an important source of employment within Luxembourg, there is great incentive for the government to cater to the needs of the industry. Luxembourg's policies have been extremely responsive to the interests of the financial services industry, responding to both opportunities and threats in ways that provide advantages to the industry.

For example, Luxembourg has established niche financial services markets that are highly competitive and very profitable. Over the years, entities such as the OECD, the European Commission, and foreign nations have pressured Luxembourg to make changes to its tax and regulatory policies, as the examples below will illustrate. Luxembourg has responded to these pressures by fighting to maintain its "pillars" of business, such as banking secrecy, and modifying its policies to accept new regulations, such as SPFs.[2] In addition to protecting the current strengths of the financial service industry, Luxembourg has proven itself to be an early adopter of new opportunities in the industry. For instance, in 1985 the European Economic Committee established a regulatory framework for undertakings in collective investment in transferable securities (UCITS), otherwise known as open-end investment funds, which allowed funds to be registered in a single nation and subsequently brought to other member states without having to re-register. (Patnaik) In 1988 Luxembourg became the first member state to turn this framework into national law, thereby becoming a top location for investment and mutual funds. Incidentally, in 1995 Luxembourg hosted 23.2 percent of the European UCITS, ahead of France and Germany. Furthermore, the net assets of Luxembourg's UCITS in 2005 amounted to more than 1.5 trillion euros. (ABBL) This is just one of many examples of Luxembourg's work to provide favorable tax and regulatory policies for its financial services industry.

[2]As will be discussed later, SPFs are a specific type of holding company which Luxembourg introduced in 1997.

Luxembourg's Response to Threats to the Financial Services Industry

Banking Secrecy

Banking secrecy became an important feature of financial services in many European nations following the Second World War. Many nations consider banking secrecy to be a necessary extension of the protection of an individual's right to privacy. (Giovannini et al.) In Luxembourg, banking secrecy has been a tradition for some time, but was first written into law in 1981, following the first waves of foreign banks coming to Luxembourg. Luxembourg's laws on banking secrecy prohibit banks from disclosing information about their customers to a third party. Luxembourg's laws regarding banking secrecy are among the most protective in the world. For example, in Luxembourg (as well as in Switzerland) a breach of banking confidentiality is a criminal offense punishable by jail time, whereas in most other nations the offense is a civil offense subject only to fines. (Giovannini et al.)

Although Luxembourg provides much protection for depositors, the protection does not extend to criminal acts. Banking secrecy cannot be claimed in order to protect a customer in a criminal matter. Therefore, in the case of a criminal or judicial investigation, banks can be ordered to cooperate fully with the investigation if the offense is considered a crime in Luxembourg as well as in the foreign nation. While this policy is highly effective and has been praised for its use in such crimes as money laundering, there is a large legal grey area regarding tax evasion. Indeed, both Luxembourg and Switzerland make a distinction between tax evasion and tax fraud, and only the latter is considered a criminal offense. As a result, it is difficult for foreign governments to prove suspected tax fraud, and not simply evasion, in order to gain access to account information in Luxembourg.

Many challenges to banking secrecy have emerged over the years. In 1998 the OECD issued the Harmful Tax Competition report, which outlined general tax practices that were believed to distort the natural flow of trade and investment as well as erode national tax bases. The OECD identified the lack of "exchange of information" as a major contributor to harmful tax practices. (OECD. "Harmful Tax Competition") While the initial efforts of the Harmful Tax Competition report were to establish a framework to identify and combat harmful tax practices in non-OECD nations, it has since also taken a closer look at potentially harmful practices within the OECD.

Recently, the EU proposed a directive which included a provision requiring all member states to participate in the exchange of information on savings held by non-residents beginning July 1, 2005. This directive would have required Luxembourg to give foreign governments access to the names of non-residents and the corresponding amounts of investments in Luxembourg. ("Taxation: Commission Welcomes . . .") Luxembourg, along with Belgium, and Austria, fought against the exchange of information mandated by the proposed EU Directive. These three nations argued that as soon as the proposed directive would go into effect, there would be an exodus of funds to nearby non-EU nations, specifically several principalities of other EU nations, such as the Isle of Man and Jersey, as well as other nations such as Switzerland. Luxembourg argued that it was disingenuous for EU states to enforce directives on other member states while tolerating the banned practices in their own dependent principalities. Furthermore, as funds can easily be relocated from EU to non-EU nations, eliminating banking secrecy within the EU might harm Luxembourg and other EU nations while not achieving any great reductions in tax evasion or higher tax revenues for EU nations.

In the end, Luxembourg, Belgium, and Austria were successful in placing a special clause in the directive stating that the three nations would not be required to exchange information until other neighboring countries and countries associated with member states also removed banking secrecy laws. These neighboring and associated countries include Monaco, Switzerland, Andorra, Jersey, and the Isle of Man. ("Taxation: Commission Welcomes . . .") Because these named nations show no current intentions of eliminating their banking secrecy laws, banking secrecy therefore appears to be secure in Luxembourg for the near future.

Withholding Taxes on Savings and Dividends

Luxembourg's success in maintaining banking secrecy opened the door for another long-running area of contention among EU nations — withholding taxes. To provide some background, Luxembourg historically has left the responsibility to pay taxes with its bank depositors. However, some other European countries assist foreign tax collection by withholding a certain amount of non-residents' interest income and dividends and then transferring this amount to the non-residents' home nations for tax collection.

For years some nations such as Germany have insisted that Luxembourg impose withholding taxes on such unearned income. For example, Germany's increase in its tax on resident unearned income and tighter enforcement of the same tax in 1993 led German depositors to flee to Luxembourg and other nearby nations. According to Nathaniel Nash, the Frankfurt bureau chief of *The New York Times*, it is estimated that Germans deposited $150 billion in Luxembourg bank accounts, with large amounts coming from both middle and lower class German workers. (Nash) Stories emerged of Germans packing the highways into Luxembourg, with suitcases of money in the trunks. As Nash continues, "During the last two years [1992–1993], German government officials estimate that they have lost $15 billion in tax revenues." This flight of capital and loss of potential tax revenue from Germany caused Germany to place pressure on Luxembourg to impose a withholding tax. Luxembourg opposed the introduction of a withholding tax, claiming that there were other nations such as the U.K. that did not impose such withholding taxes and that these nations would be the next target for German depositors. Also, Luxembourg claimed that it had depositors from many other nations besides Germany. In the end, no such tax was introduced in Luxembourg, and Germany subsequently reduced its own tax on unearned income.

Later, the EU, the OECD, and the European Commission all sought to introduce broad withholding taxes in all member states, citing the strong incentive for tax evasion in their absence. In exchange for maintaining banking secrecy in the proposed EU directive discussed earlier, Luxembourg, Belgium, and Austria agreed to impose withholding taxes on non-resident savings, taxes that would rise from 15 percent in 2005 to 35 percent in 2009. Three-quarters of the withholding taxes collected would be transferred to the home countries of non-resident depositors, while the remaining 25 percent of the money withheld would stay in Luxembourg. However, the names or amounts of depositors would not be transferred back to the home countries of non-residents with the withholding revenue. ("Taxation: Commission Welcomes . . .") Thus, it appeared that Luxembourg would have to sacrifice some but not all of its advantages in providing financial services.

As has come to be expected of Luxembourg, though, government officials began to work immediately to put new favorable tax policies into place. One way to avoid the high withholding tax rates is Luxembourg's network of double-tax treaties with trading partner nations. Following the directive, Luxembourg began to work on this network of treaties, updating older treaties with nations such as the U.S. as well as forming new treaties with such nations as Malta and Estonia. Many of these treaties follow the OECD model and have 5–15 percent tax rates on dividends, 10 percent on interest, and 5–10 percent on royalties. The above rates in the treaties are much lower than those specified in the directive (15 to 35 percent), and thus greatly reduce the taxes on foreign depositors in Luxembourg. By negotiating double-tax treaties, Luxembourg can match low withholding tax rates of many nations competing for financial services clients; and current banking customers thus have little incentive to flee Luxembourg. Luxembourg also continues to aggressively expand its double-tax treaty network. As of June 2007, Luxembourg had double-tax treaties with 51 countries, with 13 more under discussion. ("Luxembourg Tax Treaty . . .") Thus, while Luxembourg has had to make concessions in order to maintain banking secrecy, it has still been able to preserve low withholding tax rates in order to keep its financial services industry competitive with other nations.

Holding Companies

Luxembourg has a large number of foreign businesses that have established their headquarters in Luxembourg through the use of holding companies. There are many different acts regulating holding companies, and firms may choose among these when deciding to incorporate in Luxembourg. An important 1929 law allowing holding companies in Luxembourg, called the Holdings 1929 legislation, was enacted to allow special investment vehicles which attracted multinational corporations, mostly financial companies, to establish their headquarters in Luxembourg. ("State Aid: Commission Opens Formal . . .") By 1933 the number of companies under the legislation had grown to 360, while their number in 2006 was estimated to be more than 10,000. (Pesch) For a time, companies achieving this status enjoyed substantial tax benefits, as qualifying companies were exempt from Luxembourg taxes on earnings, dividends, and royalties.

The Holdings 1929 legislation created some resentment among neighboring nations, as more and more companies looked to Luxembourg for its favorable tax environment. By 1997 the European Commission had begun working on a package of several measures to eliminate "harmful tax competition." ("Taxation . . .") In 1999 the Code of Conduct group of the European Commission issued a report outlining 66 harmful tax practices within the EU and neighboring states, one of which was the Holdings 1929 legislation. ("Code of Conduct . . .") The report claimed that many holding companies are established entirely or in part due to tax planning purposes, and therefore have little real business activity or purpose other than to hold earnings or transfer and distribute them among related businesses. ("Code of Conduct . . . ," p. 16)

In 2006 the European Commission (EC) first ruled the 1929 legislation constituted illegal state aid and demanded its repeal. Luxembourg had been aware of the threats to its Holdings 1929 legislation for some time, as the legislation was singled out in the 1999 Code of Conduct report. In fact, Luxembourg attempted to modify the legislation in order to avoid repealing the law in June 2005, limiting the scope of the 1929 legislation to corporations that were taxed on an effective basis of at least 11 percent through the taxes imposed on the dividends of non-resident companies associated with the holding company. (Fort and Lesage) Despite the modifications to appease the European Commission, Luxembourg's law was still found to be in violation of the Code of Conduct. The EC reasoned that the legislation provided unjustified tax advantages and encouraged companies to create structures in Luxembourg to avoid taxes in their home nation. ("State Aid: Commission Demands . . .") According to a *vade mecum*[3] issued by the EU regarding state aid, state aid is illegal when all of the following criteria are met: (1) there is a transfer of state resources (2) to create an economic advantage (3) which is selective and (4) which has a potential effect on trade and competition within the EU. ("State Aid," 2007) The legislation cannot exclude or specifically include certain sectors of the economy to receive the benefits and bypass the selectivity criteria for state aid. The 1929 Holdings legislation targeted financial services firms and was found to constitute state aid because it offered tax advantages only to this sector.

When the EC ruling against the 1929 Holdings legislation was announced in July 2006, Luxembourg decided against appealing the decision. Therefore, after 2010 former 1929 Holdings companies will cease to enjoy the tax benefits of the status. This generously long transition period was a major factor in Luxembourg's decision not to appeal the decision. In Luxembourg, there are already many other attractive alternatives for holding companies and investment vehicles. In fact, according to Keith O'Donnell, a tax advisor, the 1929 Holdings legislation had already lost much of its appeal for potential holding companies in light of other alternatives in Luxembourg. (O'Donnell)

As the 1929 legislation had been singled out by the OECD and the EC for more than a decade prior to the negative ruling, Luxembourg had already been working to provide an alternative vehicle for new holding companies. In 1997 Luxembourg introduced the Family Private Assets Group Management legislation, which allows the formation of Family Private Assets Management Companies, which are more commonly referred to as SPFs (Sociétés de Gestion du Patrimoine Familial). According to O'Donnell, this legislation primarily targets private wealth management, with SPFs having as their functions "the acquisition, holding, management and disposal of financial assets excluding any type of commercial activity." (O'Donnell) By specifically excluding commercial activity, the new legislation cannot be found to constitute state aid, which applies to aiding entities involved in economic activity. The tax benefits of SPFs include exemption from the corporate income tax, the net-worth tax, and the municipal business tax. Distributions from SPFs to their investors will be subject to individual taxes, while non-residents will be exempt from taxes on gains on the investments. (O'Donnell) Thus, new holding companies can be established under this framework, and existing 1929 Holdings companies can re-establish themselves as SPFs by the end of the 2010 grace period. Luxembourg was able to find an alternative means to the same end as the Holdings 1929 legislation that was within the terms of the EU's Code of Conduct.

Implications of Luxembourg's Tax and Regulatory Policies

Luxembourg's responsive regulatory system has allowed its financial services industry to thrive despite challenges and has opened the industry to pioneering new niche activities such as mutual funds and open-end investment funds. The larger looming question is the effect of the financial service industry's success on the greater international economy. Luxembourg's nimble tax and regulatory policies have helped the financial services industry account for approximately 25 percent of its GDP, provide jobs to a large portion of the population, inflate the demand for complementary industries such as hospitality, and contribute to the world's highest GDP per capita. Also, because of Luxembourg's small size, even the low tax rates on financial services provide large contributions to the national budget and allow Luxembourg to provide a high level of public services to its residents.

[3] Manual or handbook.

However, this happy state of affairs is not popular with Luxembourg's neighbors, the EU, or the OECD. They often accuse Luxembourg of distorting the capital market of the EU and eroding the tax revenues of other nations. In the case of financial services, a victory for Luxembourg often entails a loss for other nations, literally. As mentioned earlier, the German government estimated its loss of potential tax revenues at $15 billion following the increase in savings taxes in 1992–93. (Nash) In this case, the flight of capital to Luxembourg was due to public sentiment that the high taxes on savings were unfair and unjustified. (Nash) As *The Economist* notes, "If an individual feels his tax burden is unfair, he can vote for tax-cutting politicians or go to live in a less heavily taxed country — or, if he does not mind breaking the law, he can hide his money abroad." ("All Together Now") While the third option is illegal, the fact that so many German citizens pursued this route can also send a clear message to German lawmakers. Consequently, tax competition may be able to discipline governments when domestic politics fail to do so.

Tax competition is not inherently bad, and small nations providing low tax rates and engaging in tax competition are not necessarily stealing tax revenues and public services from other nations. Frits Bolkestein, a member of the European Commission responsible for Internal Market, Taxation and Customs Union issues, noted in an address to the European American Business Council that tax competition can, in fact, be healthy and can induce governments to offer high quality public services more efficiently (i.e. at a lower cost to taxpayers) by encouraging lower tax rates among competing nations. Indeed, tax competition may be one of the more effective forms of controlling wasteful government spending. (Bolkestein) Tax competition only becomes harmful when it precludes nations from providing the basic public services to its residents, not simply when a nation can quantify a loss of tax revenues. Thus, Luxembourg can play a positive role in improving the efficiency of the EU economy while enjoying success in its own financial services.

The OECD and the European Commission have chosen to introduce broad measures to reduce harmful tax practices to eliminate distortions in the capital market of the EU. The result of their efforts have been several reports and directives already mentioned, including the OECD's Harmful Tax Competition report and the EU's directive on the taxation of savings. These measures have met with some success. The OECD found 47 tax practices within OECD nations to be harmful in a report from 2000. In a follow-up report in 2004, nearly 40 percent of these practices had been abolished, 30 percent had been amended, and another 30 percent had been re-evaluated and deemed not to be harmful. However, despite the appearance of success suggested by figures such as the ones above, oftentimes the reports and directives become watered down, as in the case of banking secrecy and Luxembourg, Belgium, and Austria. In fact, even the OECD's progress report shows evidence of this, as nearly 30 percent of the practices that are no longer listed as harmful have not been changed or amended, but were instead "re-evaluated" and found not be harmful after discussion with the nations. In another example, in the directive imposing withholding taxes, the U.K. was able to narrow the definition of "savings" to shield eurobonds from the tax, aiding its own eurobond market and Luxembourg's as well. Examples such as these indicate that some of the successes of the OECD and the EU have been somewhat limited.

In looking at the greater effect of these reform measures on the global economy, many recognize that the EU has consistently had higher taxes than many other regions of the world, affecting its ability to compete in today's globalized market. Some initiatives proposed by the EU would improve the internal financial market of the EU, but might, in the end, contribute to the EU simply losing business and tax revenues to other regions of the world (as in the case of banking secrecy). In this instance, Luxembourg's actions to protect its own interests may benefit the ability of the whole EU to compete.

While the OECD has been critical of some of Luxembourg's tax and regulatory policies, the OECD has been criticized for catering to the interests of high-tax nations, and is sometimes facetiously referred to as a rich nation's club. (Mitchell) However, the International Monetary Fund (IMF) often takes a slightly different approach to identifying harmful practices in financial services in offshore financial centers[4] (OFCs) such as Luxembourg, by focusing on the risks that OFC pose to the stability of financial markets. The results of IMF studies reveal that, on average, high-wealth offshore financial center nations have more and better regulations in place than those of non-OFC developed nations. The IMF studies also show that it is the low-wealth OFCs, such as Tunisia, which generate the most concern over criminal activity. (IMF, 2003) Luxembourg was reviewed by the IMF in 2001, and was found to need only minor improvements in the regulation and oversight of its financial service activities, many of which have since been corrected. (IMF, 2004) Therefore, when Luxembourg's tax and regulatory policies are evaluated by the risks that they pose to the international economy rather than by the immediate monetary losses to neighboring nations that they may cause, Luxembourg's policies do not appear to pose a major threat to the stability of economies.

[4]While there is not a singular agreed-upon definition for an "offshore financial center," the requirements are not related to the proximity of a nation to water. Instead, OFCs are characterized by financial institutions with a majority of business conducted with non-residents, or a large amount of non-resident assets and liabilities, and those nations with low tax rates and banking secrecy.

Conclusion

While Luxembourg is often referred to as a "tax haven" with its negative connotations, many overlook Luxembourg's important role in the regional and international economy, a role that has developed over a relatively short period of time. Luxembourg has now established expertise in specialized financial services, while its nimble tax and regulatory framework ensures that Luxembourg continues to reap the benefits of its past successes in financial services.

With its considerable competitive advantages, Luxembourg should continue to offer creative products which provide desired services for financial services clients. However, Luxembourg must also continue to improve its methods of tax competition, ensuring that its success is derived from legitimate business activity and from honest depositors. This must be done even if it means slowly curbing the more questionable options available, such as Luxembourg's somewhat contrived distinction between tax evasion and tax fraud mentioned earlier which contributes to a possible abuse of banking secrecy. These measures will allow Luxembourg to reaffirm that it is among the most secure, reputable places in the world to conduct financial business, and will provide for the success of its financial services in the decades to follow.

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