Macroeconomic Management and Fiscal Decentralization

Edited by
Jayanta Roy

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Macroeconomic Management and Fiscal Decentralization

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Jayanta Roy

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Foreword

This publication consists of a set of papers prepared for a Senior Policy Seminar on Intergovernmental Fiscal Relations in China held in Dalian, China in September 1994. The seminar was organized jointly by the Dongbei University of Economics and Finance (DUFE), the Economic Development Institute (EDI) of the World Bank, and the Ministry of Finance of the People's Republic of China. It was directed by Jayanta Roy of EDI, as part of an ongoing program of activities in Macroeconomic Management and Policy.

Thirty participants from China attended the seminar, including senior representatives from several provincial administrations. They were joined by senior officials from the International Monetary Fund (IMF) and the World Bank, and by distinguished experts from India, the United States, Germany, and Canada.

Comprehensive tax reforms were undertaken in China in January 1994 with a view to broadening the tax base and simplifying the system of tax sharing between central and provincial administrations. The seminar was designed to alert participants from all levels of the Chinese government to the major elements in a strategy for effective intergovernmental fiscal arrangements and to help them build consensus for change.

This book, which is intended to be of use to policymakers and practitioners, reviews the fundamental principles underlying a system of good intergovernmental fiscal relations; examines the development of the Chinese system of fiscal relations up to and including the reforms of January 1994; evaluates intergovernmental fiscal arrangements in a range of countries (including both developed and developing countries) with the purpose of drawing lessons for China; and presents views of Chinese and foreign experts on China's fiscal relations problems. The primary focus of the book is on center-state relationships; it only briefly addresses state-local relationships.

Jayanta Roy edited and prepared the manuscript for publication. The summary proceedings of the seminar, as reported in Chapter 1, were prepared by Allan Roe who acted as seminar rapporteur.

Vinod Thomas, Director
Economic Development Institute
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Intergovernmental Fiscal Relations in China:
Report of a Senior Policy Seminar

Alan Roe

A Senior Policy Seminar on Intergovernmental Fiscal Relations in China was held in Dalian, China, September 12-17, 1994. The context for this seminar was the comprehensive tax reforms recently undertaken in China that will significantly broaden the tax base and simplify the complex system of tax sharing between central and provincial administrations.

These reforms could strain many aspects of the relationships between national, provincial, and local fiscal administrations. For example, the achievement of macroeconomic stability and a more equitable distribution of income between and within provinces necessitates more resources being placed at the disposal of the central government. However, this will need to be achieved at a time when the burdens on the subnational authorities are intensified by having to absorb new expenditures for social welfare as well as other expenditures associated with reform. In that sense, the timing of the seminar, just a few months after the latest fiscal reforms were introduced, was extremely timely. It also complemented the work already undertaken by the International Monetary Fund on the same topic. The seminar broadened both the scope of the issues under discussion (the IMF's current focus is mainly on the establishment of a grants system) as well as the geographical extent of the Chinese participation.1

The seminar was designed to alert participants from the central and provincial levels of the Chinese government to the major elements in a strategy for effective intergovernmental fiscal arrangements and to help them build consensus for change. To this end, the seminar involved in-depth explanations and discussions of experiences with intergovernmental fiscal arrangements in other relevant countries, as well as presentations and workshop sessions focused explicitly on various aspects of the fiscal problem in China itself.

The seminar was organized jointly by the Dongbei University of Economics and Finance (DUFE), the Economic Development Institute of the World Bank (EDI), and the

1. For a synthesis of the earlier IMF-World Bank seminar on a similar theme, see E. Ahmad, Jon Craig, and Zuliu Hu, Conference on Intergovernmental Fiscal Relations: Summary Conference Proceedings, IMF (mimeo), October 25, 1993.
Ministry of Finance of the Government of the People’s Republic of China (MOF). It was directed by Mr. Jayanta Roy of the EDI. There were thirty participants from China, including senior representatives from thirteen provincial administrations—namely Jilin, Hebei, Shanxi, Anhui, Jiangxi, Henan, Hunan, Guangdong, Guizhou, Quhai, Ningxia, Liaoning, and Inner Mongolia.

The proceedings comprised four separate elements, and the report presented here has adhered to this four-way division of material as closely as possible even though this results in some minor contraventions of the chronological order of the seminar itself. The first element was the definition of the basic principles underlying a good system of intergovernmental fiscal relations. This discussion, led by Ved Gandhi of the IMF, is summarized in the first section of this chapter.

The second element comprised presentations and papers, mainly from Chinese experts, describing the gradual development of the Chinese system of fiscal relations up to and including the reforms of January 1994. This is summarized in the second section.

I then cover the third element of the seminar—a series of presentations by international experts about intergovernmental fiscal relations in other countries, including Australia, Canada, Germany, India, Indonesia, Russia, the United States, and Switzerland.

Finally, the views of Chinese experts on particular aspects of the country’s fiscal relations problems are considered. These views emerged from workshops during the five days of the seminar. Comparable reflections of the foreign experts regarding some of the same issues are also represented.

In his introductory remarks, Mr. Liu Jubin, vice-minister of finance, drew attention to the previous initiatives to adapt the Chinese system of intergovernmental arrangements since the opening up of the economy in the late 1970s. These had included the 1980 system of “revenue-expenditure assignment and contracting,” which was adjusted further in 1985. Then, in 1988, the government introduced a revised system that included “incremental revenue contracts” and “gross revenue sharing.” Mr. Jubin argued that these systems had been reasonably well-adapted for their own times: they certainly provided both central and local governments with incentives to raise more revenue and moderate expenditures and, in this way, contributed to the broader reforms of the country.

Reviews of these systems, however, identified important weaknesses. They criticized the lack of standardization and concluded that the systems were poorly adapted to the next stages of development of China’s socialist market economy. Hence, further reforms were introduced at the beginning of 1994. These were integrated into the broader reforms of the Chinese tax system and sought, among other things, to clarify the functions of the different levels of government, to improve budget management, and to promote the aims of rational resource allocation and sound macroeconomic management. Mr. Jubin noted that the reforms had been well received both nationally and internationally and were already being reflected in faster revenue growth at central and local government levels.

However, he recognized that some established market economies had been operating with systems of fiscal relations for as long as 100 years. Relative to this, China has taken only the first steps. He also noted that the basic framework now in place is still not a fully standardized one and that there are numerous practical problems in developing it further and consistently with the distinctive characteristics of the Chinese economy. In his opinion the search for these solutions should incorporate ongoing study of international practices in the area of intergovernmental fiscal relations. These practices should then be evaluated in relation to the circumstances in China.
He noted that his own Ministry had already collaborated with the World Bank, the IMF, and other international agencies through symposia and seminars on particular aspects of the problem. He fully expected that this latest seminar would provide an excellent opportunity for Chinese officials to learn more about the fiscal arrangements of other countries and to consider their suitability for China. He expressed his thanks to all the organizers for their extensive preparation and for arranging such a strong team of international and domestic experts to lead the discussion.

These sentiments were endorsed by the seminar director, Jayanta Roy, who noted that the importance of an optimal structure of intergovernmental relations in large economies had been recognized in the work program of the Economic Development Institute of the World Bank for several years. That work had culminated in a seminar in New Delhi in 1991 on Intergovernmental Fiscal Relations and Macroeconomic Management in Large Countries; at this seminar China had been represented. A similar seminar that focused on Russia had been held in April 1993.

In reviewing the content of the present seminar, Mr. Roy agreed with Mr. Liu Jubin that foreign experts and the existing literature on the subject can provide important lessons and principles about the design of an efficient multitiered system to meet national objectives. However, the foreign experts and literature cannot set the national objectives and cannot present a fully worked out system designed to meet them. Mr. Roy very much hoped that the Chinese experts present at the seminar would learn from the foreign experts' best practices as well as the pitfalls but would then regroup to continue the work of designing a system specifically suited to Chinese circumstances.

Fiscal Relations and Economic Performance: Some General Principles

In the opening keynote address, Ved Gandhi from the Fiscal Affairs Department of the IMF sought to examine the effects that a system of intergovernmental fiscal relations can have on economic performance both in general terms and in the specific circumstances of China. In particular, he posed the question of whether the exceptional Chinese growth performance of 12 to 13 percent per annum in the previous two or three years might be damaged by a failure to modernize the existing fiscal arrangements.

He began by defining a few basic terms used during the seminar (see Annex at the end of this chapter). He then addressed two specific questions. First, can the lack of an appropriate intergovernmental fiscal structure seriously affect the continuation of rapid economic growth in China? And is it possible to design a “good” intergovernmental fiscal structure that will be conducive to continuing strong economic performance? Second, do countries generally and China in particular have intergovernmental fiscal structures that meet the tests of economic principle against which the design of the “good” system is assessed? Gandhi suggested that this was not the case generally or in China in particular. Partly this is because of the conflicting demands involved in the design of such systems.

2. It should be noted that a later session of the seminar, and especially the presentation by Anwar Shah, provided further definitions of the basic principles underlying a sound system of fiscal federalism. That presentation is not reflected in the write-up here because most of the points raised are covered more fully in his already published paper on this subject. See Anwar Shah, *The Reform of Intergovernmental Fiscal Relations in Developing and Emerging Market Economies*, Policy and Research Series, No. 23, World Bank, Washington, D.C., 1994.
**Fiscal Relations and Economic Growth in General**

Gandhi pointed out that there are four main factors that influence directly the performance of an economy. These are the microeconomic efficiency of resource allocation; the degree of macroeconomic stability that is achieved; the extent to which the fiscal system of an economy is believed to be fair and equitable; and the degree to which the growth potential, conditioned by these first three factors, is actually achieved.

He explained how fiscal interrelations could negatively affect growth through each of these four factors. First, the tax system could encourage a significant migration of the resources of either labor or capital between provinces and localities. This in turn might arise if the fiscal system resulted in wide differentials in the taxable capacities of different locations, as well as in their access to grants, subsidies, and other transfers from higher levels of government. The same problem might also be associated with a situation in which provinces and localities were assigned expenditure responsibilities, the benefits of which spilled over beyond their own geographical jurisdictions to result in expenditure levels considerably in excess of available revenues.

Second, the achievement of macroeconomic stability could be problematic if the central government was not given the responsibility for those categories of public expenditures that could be adjusted reasonably quickly through the course of the business cycle. Similarly, the central government's responsibility for macroeconomic stability might be more difficult to achieve if the provincial and local governments were given the right to borrow on their own account or to run up large arrears. This is not to say that such borrowing should not be permitted—only that the possible consequences and the need for some controls should be well understood.

Third, the equity in the fiscal system could be greatly impaired if redistributive taxes (the personal income tax, wealth and inheritance taxes) and redistributive expenditures (social welfare expenditures) were assigned too heavily to subnational governments rather than to the central government.

As a final example, growth prospects would be impaired if provincial and local governments were assigned the responsibility for taxes on those essential raw materials and natural resources that happened to be located in their geographical locations, and if they also sought to levy excessively high tax rates on such resources. The burden of these rates would then be exported to manufacturing industries in other regions.

Gandhi argued that if the economic principles underpinning these four examples were the only factors conditioning intergovernmental fiscal structures, then such structures would tend to have relatively uniform features across different countries. In practice, differences between countries, in terms of both economic and other characteristics, operate to prevent such uniformity.

**Strong Features of the Chinese System**

The Chinese system as reformed in early 1994 has several important qualities as judged against his general principles. First, most of the public services with benefits widely distributed across the population (for example, national defense, internal security, external trade, other aspects of foreign relations, macroeconomic management) have been assigned to the central government. So, too, have those expenditures where the geographical spill-over effects are likely to be large (for example, higher level education and health, scientific research, technical renovation, new product development, and regional devel-
opment). On the other hand, those expenditures where the benefits accrue essentially to the local populations (for example, lower level education, basic health, and investment in locally owned enterprises) have been made the responsibility of lower level governments.

A second good feature is that the taxes applying to mobile economic bases, including some that can usually generate very large revenues (for example, enterprise profits tax and value-added tax) have been assigned to the central government. By contrast, taxes on immobile factors of production (such as land and property taxes, agricultural and husbandry taxes), have been assigned to subnational governments. So, too, have taxes with a mainly local incidence (such as the slaughter taxes, stamp taxes, city maintenance and construction taxes and taxes on contracts).

Third, arrangements are in hand to ensure that the revenues from relatively buoyant taxes such as the value-added tax, and the securities transaction tax, are shared with provincial and local governments even though they are collected centrally. This is an eminently sensible arrangement and one that is extremely important for the balancing of provincial and local government budgets.

Fourth, the recent separation of the National Tax Service from Local Tax Services, and the withdrawal of the rights of subnational governments to grant tax exemptions and reliefs from central government taxes, is an important step that will considerably enhance the efficiency of tax collection.

Fifth, the central government in China retains the power to legislate the rates and bases of most taxes assigned to subnational governments, and this seems desirable on the grounds of economic efficiency. It should also help to ensure that the burdens of provincial and local taxes, which can be exported beyond their own borders, will remain moderate.

Finally, by restraining the powers of provincial and local governments in China to finance their budget deficits through bank and other borrowing, the authorities seem to have improved greatly the prospects of effective macroeconomic control and inflation control by the central government.

What Are the Remaining Problems?

Notwithstanding the soundness of the basic structure referred to in the introductory remarks by Mr Liu Jubin, Gandhi suggested that a number of problems remain to be resolved.

The first problem he referred to concerns the lack of clarity about the matching up of the expenditure responsibilities of the different levels of government with their corresponding tax assignments plus shared taxes. Serious "vertical imbalances"—chronic deficits for one or more levels of government matched by chronic surpluses elsewhere—could arise from the present system. If this indeed were the case, it would have major implications for the provision of essential services by some provincial and local governments, as well as for the operations and maintenance expenditures on the investment capital needed for economic growth.

Second, "horizontal imbalances"—imbalances between the fiscal positions of different governments at the same level (for example, local or provincial) — were also foreseeable. This being so, it was still unclear what the system of corrective transfers might be and also how the transfers might affect allocative efficiency and economic growth.
Third, it was his understanding that many of the important price subsidies for food grains, cooking oil, meat, and other essential consumer goods continue to be adminis-
tered and controlled by governments at the subnational level. These responsibilities
could give rise to budgetary problems for at least some subnational governments. Nor-
mally, the main responsibility for redistributive policies lies with central governments.

A related concern is that personal income taxation, as well as inheritance and gifts
taxes, have been assigned to subnational governments, which probably have some
authority to grant exemptions. Gandhi suggested that the redistributive effects of such
taxes would be eroded as individuals at the margin changed localities in order to escape
the full brunt of such taxes. In addition, any remaining powers to grant exemptions and
reliefs would be likely to encourage undesirable competition between provinces and lo-
calities to attract a fixed total supply of labor and capital.

A fifth problem related to the treatment of natural resource taxes in China. It was his
understanding that the revenues from these taxes are shared with provinces and locali-
ties partly on the basis of their geographical origin. He wondered whether this was a de-
sirable arrangement. In particular, was it right for the population of a particular region or
locality to benefit disproportionately from such revenues just because of where the re-
sources in question were located?

Finally, he questioned the present system of grants and subsidies in China and asked
whether such a system is adequately transparent and is effective from the point of view
of encouraging subnational tax effort, improved fiscal discipline, and strengthened
budget accountability.

He conceded that he was not aware of the answers to all the problems that he had
posed and was naturally less well informed than the local participants about the par-
ticular historical, political, and cultural factors in China that needed to be factored into
their resolution. However, he presented his ideas as a useful organizing agenda for the
discussion that would follow in the remainder of the seminar.

Discussion from the floor noted that the good and bad features of the Chinese as-
signment of taxes, as noted by Gandhi, had been substantially preserved by the January
1994 reforms. The major change had been that the important new value-added tax (VAT),
which is likely to attract 40 percent or more of total tax revenues, will share those reve-
nues between central and provincial administrations. The share of revenues accruing to
the central government, which until 1992 had been about 39 percent of the total, was ex-
pected to increase. Why then had the provincial authorities accepted the new arrange-
ments? Apparently, the higher tax base and prospective revenues from the VAT will re-
sult in a higher guaranteed revenue base for subnational administrations, as well as a
rising share for them of any revenues over and above that base.

A more serious problem was felt to be the absence of any real scientific basis for as-
sessing the expenditure needs of the local administrations. This assessment is done at
present by incremental adjustment to a base-year allocation, which itself was not scien-
tifically established.

A related issue of concern was that some of the tax revenue sharing arrangements, in-
cluding the new arrangements for VAT sharing, were ad hoc. Some participants argued
that little serious effort has been made to link these sharing arrangements to any assess-
ment of the taxable capacity of different provincial and local governments, or to their ex-
penditure responsibilities.
On the basis of the discussion of Gandhi's paper, participants earmarked three main topics for in-depth consideration by working groups: the manner in which expenditure responsibilities should be assigned between central and provincial government administrations; the manner in which taxation responsibilities might best be assigned between the various tiers of government; and the manner in which an intergovernmental transfer system might be designed to support the needs of vertical and horizontal equalization between and within the provinces. Working groups were set up to consider each of these matters, and their reports back to the main seminar are described later in this chapter.

The Main Features of the Reformed Chinese System

The next important task of the seminar was to define and discuss the present Chinese arrangements in more detail, including the nature of the reforms recently introduced. This task fell to Xu Shanda, Chen Gong, Ding Xianjue, and Liu Minhyuan.

The Chinese System

Liu Minhyuan began by providing a broad perspective on the Chinese arrangements. From the earliest days of the People's Republic, the major taxes were levied on a nationwide basis including some that would have been better regarded as subnational taxes. Only a few minor taxes (for example, the slaughter tax and the tax on the licensing of ships) were assigned specifically to provincial and other subnational authorities. This was because the imperatives of a highly planned economy saw no obvious role for any real autonomy in subnational taxation. During the period 1953 to 1980, tax revenues in total amounted to only 50 percent of total fiscal revenues and, within this, subnational taxes amounted to only a few percentage points.

Both Liu Minhyuan and Chen Gong explained that with the general economic reforms of the 1980s, matters began to change. Beginning in 1983, a comprehensive reform of industrial and commercial taxation was carried out. This had the effect of raising the overall tax share in total fiscal revenues quite considerably. The reform also included the introduction of the fiscal rationing system. Until 1988, revenues from some taxes were shared between different jurisdictions according to a predetermined formula. In essence, the system provided that the revenues from specific taxes would be shared between central and provincial governments according to tax sharing contracts that varied across regions and also over time. The idea was that the subnational governments should have just enough revenue to provide a reasonable basic level of service in their areas, with the balance of revenues being surrendered to the center. In 1988 the system was put on a more negotiated basis whereby different provinces were able to establish different marginal retention rates for the tax revenues concerned.

This system, however, had many problems, not the least of which was the declining share of central government revenues, especially after the 1988 reforms (51.6 percent of total revenues went to the center in 1981 but only 38.6 percent by 1992). Another problem was the regional imbalances that the system tended to promote: the more prosperous regions kept and invested all revenues above a certain base, while the poorer regions failed to reach that base and needed special subventions. In addition, the incentives within the system encouraged too many quick payoff investments in terms of revenue (for example, tobacco industries yielding high excises) rather than more basic industries.
Finally, the system lacked uniformity across regions as well as certainty in the revenues generated.

Xu Shanda and other Chinese participants explained that the focal point of the 1994 reforms is the designation of three important taxes—the VAT, the new securities trading tax, and the resources tax—as shared taxes. All other taxes are now assigned explicitly to either the central government or the subnational governments. The other major innovation has been the establishment of separate national and local tax services, effective since July 1994.

As regards the shared taxes, it was explained that 25 percent of the 1994 VAT revenues will be apportioned to the provincial governments with the rest to the center. Although the main securities market activity is in Shanghai and Schenzhen, the tax resources that are generated from this activity come from many different parts of the country and hence a 50:50 sharing of the securities tax revenue between the center and local governments has been agreed. As regards natural resources, only the tax take from off-shore oil will be regarded as national, while all other resource-based taxes will be shared. As regards the main assigned (nonshared) taxes, the central government has been assigned customs duties and the new excise taxes as well as almost all other indirect taxes. The local governments have been assigned a number of minor taxes as well as the revenues from the enterprise income tax for those enterprises that are owned locally.

The new system is regarded as something of a compromise but one that should leave no province worse off than in 1993. This is because parity with the 1993 outcome will be achieved by a central government transfer to any province that, on the basis of the new system, achieves less revenue than it retained after tax sharing in 1993. At the same time, the new tax sharing system, especially for the VAT, preserves some incentives for the faster growing provinces. If a province's actual VAT and excise duty collections under the new system exceed its actual 1993 transfers to the center, the center will transfer back an amount equal to 30 percent of the VAT plus excise duty increase compared to 1993. Presumably, this means that the local share of the VAT revenues in some provinces will gradually rise above the 25 percent level.

In addition to eliminating some of the inefficiencies of the previous system, the new system is expected to lead to a significant increase in centralization: the share of central taxes in the total is expected to rise from 27 percent to about 80 percent by the end of the decade. However, the part transferred back to the subnational level would also rise from a presently negative amount to more than 30 percent over the same period. This would mean a rise in the retained or accrued revenue at the center from less than 40 percent of the total tax-take to well over 50 percent by the year 2000.

A corresponding explanation of expenditure assignments was provided in the paper by Ding Xianjue. He noted that there were some broad listings of the expenditure responsibilities assumed by central and local governments respectively. In the postreform period these assignments had been amended to give the local governments a great deal more power in areas such as enterprise promotion and local economic development more generally. However, the system was characterized by considerable ambiguity at the margin and by several manifest weaknesses that needed to be resolved. It was quite common, in relation to functions such as disaster relief, environmental welfare, and new settle-