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**Institutionalism and the Intergovernmental Allocation  
of Taxes**

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# Institutionalism and the Intergovernmental Allocation of Taxes

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Abstract:

This paper challenges the mainstream public finance principle of benefit taxation, which advocates a rigid intergovernmental division of tax bases. We contend that the principle of benefit taxation is empirically suspect and often serves as an ideological cover for institutional interests, especially those of the central state. We pursue our critique first through a review of political science and public finance approaches to tax politics, and then through a more in-depth discussion of examples of intergovernmental tax regimes. Our conclusion is an argument for the enhancement of the fiscal base of Japan's local authorities, due to the changing roles of the national and local states in the context of an increasingly borderless international economy.

“modern taxation or tax-making...is, first of all, a hard game in which he who trusts wholly to economics, reason, and justice, will in the end retire beaten and disillusioned.”

(T.S. Adams, in Louis Eisenstein, *The Ideologies of Taxation*).

### *Ideology and Fiscal Politics*

The above quote from Eisenstein’s influential work continues, “Class politics is of the essence of taxation.”<sup>1</sup> This comment stemmed from experience with debates over income taxation in the United States, and it is important that it relates normative arguments concerning taxes to actors’ class interests. Certainly the history of the income tax in North America reveals a clear perception of class politics on the part of the actors involved.<sup>2</sup> Moreover, anyone who has spent time following contemporary debates concerning how and on whom taxes ought to be imposed, knows that there is a lot of self-interest being offered as politically neutral principle.

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<sup>1</sup> Louis Eisenstein, *The Ideologies of Taxation*, New York: The Ronald Press, 1961, pp. 4-5. T.S. Adams’ comment can also be found in the *American Economic Review*, March 1928, p. 18.

<sup>2</sup> See, for example, Jerold Waltman on the role of Populism and Progressivism in putting the income tax on the US policymaking agenda and getting it enacted as a constitutional amendment in 1913, “The Origins of the Federal Income Tax,” in *Mid-America: An Historical Review*, Volume 62, No. 3, October, 1980. The politics of the Canadian case are covered in Richard Krever, “The Origin of Federal Income Taxation in Canada,” in

However, the political analysis of tax issues, or fiscal politics, has moved well beyond simple macro-level and behaviourist conceptualizations of ideology. The field has become more diverse -- as indeed modern society and the tax state have -- with attention having turned to the role of state agencies, sectoral interests, "fiscal interest groups,"<sup>3</sup> and other more meso-level actors. Moreover, the kinds of taxes that are studied have come to include consumption, corporate income, and others, partly because of more sophisticated methods and partly because the progressive personal income tax is retreating from its highly politicized role as the pillar of the redistributive fiscal system.<sup>4</sup>

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Canadian Taxation, Volume 3, No. 4, Winter, 1981.

<sup>3</sup> The term is Richard Musgrave's, and refers to the phenomenon of groups organizing across Marxian class lines and instead on the basis of age, taste, and other variables associated with specific kinds of taxes; see "Theories of Fiscal Crisis: An Essay in Fiscal Sociology," in *Public Finance in a Democratic Society*, Volume 2. New York: New York University Press, 1986.

<sup>4</sup> The policy of Japanese fiscal bureaucrats, for example, is to "balance" revenues from the asset, consumption, and income-tax fields, by increasing taxation on the first two while holding steady or making cuts to the latter. Also, Sven Steinmo relates the virtually global retreat from highly progressive income taxation to changes in the international economy; see "Why Tax Reform: Understanding Tax Reform in its Political and Economic Context," a paper presented at the June 24-5, 1995 conference on Tax Regimes in the Asia-Pacific Region, Australian National University, Canberra. Note that in the late 1980s, the focus of tax politics in Canada and Japan turned to consumption taxation.

*Intergovernmental Fiscal Politics*

In line with the above trends, recent work on Japanese tax politics has employed the methods of fiscal sociology and the new institutionalism. These accounts argue that the Japanese fiscal system retains much of the structure it assumed as a result of the 1940 wartime tax reform. This reform maintained Japan's highly deconcentrated supply of services while centralizing the collection of taxes, decisions on tax rates, and the authority to impose new taxes.<sup>5</sup>

The new institutionalist approach -- specifically, historical institutionalism -- has been used to highlight the role of the Ministry of Home Affairs (MOHA) as a decisive influence on Japan's intergovernmental fiscal affairs. Briefly, the argument is that the distribution of taxes between the central and local governments in Japan is not so much a struggle between the two levels of government. Rather, the two strong central bureaucratic agencies, the Ministry of Finance (MOF) and MOHA, compete for jurisdiction on the asset, income, and consumption tax fields. This competition strongly shapes the tax policymaking agenda, as is evident in recent politics concerning the consumption, land, and corporate tax bases. Hence, our use of the expression

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<sup>5</sup>Discussion of these issues can be found in Jinno Naohiko, *Nihongata Zei, Zaisei Shisutemu* [The Japanese Fiscal System], in *Gendai Nihon Keizai Shisutemu no Genryuu* [The Roots of the Contemporary Japanese Economic System], Tokyo: Nihon Keizai Shinbunsha, 1993.

“trench warfare on the tax fields.”<sup>6</sup>

The new institutionalism takes issue with the behaviourist neglect of institutions and asserts that they are important variables impinging on tax and other policymaking outcomes.<sup>7</sup> From this perspective, locating MOF and MOHA’s turf war as a decisive influence on the division of tax resources between Japan’s central and local states is likely quite obvious. But, the increasing sophistication of analyses of fiscal politics notwithstanding, the significance of the turf war went unnoticed by scholars in the fields of public finance and political science.

Political science work on Japan’s intergovernmental relations, for example, has largely been preoccupied with refuting rigid models of “vertical control,” or outright dominance of the local authorities by the central state. The field

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<sup>6</sup> See, for example, Jinno Naohiko and Andrew DeWit, “Trench Warfare on the Tax Fields: Bureaucratic Politics and Fiscal Decentralization in Japan,” in *Japanstudien*, No. 7, 1996. See also Andrew DeWit, “Trench Warfare on the Tax Fields: Bureaucratic Turf and Japan’s Centralized Tax State” (Unpublished PhD Thesis, University of British Columbia, 1996). A nuanced rational choice analysis of the Japanese Ministry of Finance’s goals in pursuing the 1989 Consumption Tax can be found in Kato Junko, *The Problem of Bureaucratic Rationality*. Princeton: Princeton: University Press, 1994.

<sup>7</sup> An excellent discussion of the new institutionalism can be found in Sven Steinmo and Kathleen Thelen, “Historical Institutionalism in Comparative Politics,” in Sven Steinmo, Kathleen Thelen, and Frank Longstreth (eds) *Structuring Politics: Historical Institutionalism in Comparative Analysis*. Cambridge: Cambridge University Press, 1992. For a recent application of the approach to the question of why America’s welfare-state is so residual, see Sven Steinmo “Why is Government So Small in America?” in *Governance*.

thus shifted in the late 1960s to emphasizing a hitherto unrecognized scope for autonomous local policymaking. This was a welcome development in contrast to earlier models that had exaggerated the effectiveness of formal, centralized control in Japan's intergovernmental affairs. But a major shortcoming of this new research programme was its neglect of the politics of Japan's centralized tax state. In particular, it failed to note that Japan is relatively unusual because of the divided authority -- between MOF and MOHA -- over the national and local tax bases and the truly massive flow of resources from the centre to the local authorities.<sup>8</sup>

Public finance has done an even worse job at teasing out the significance of differences among tax states. Premised on the ideas of local autonomy and the local administration as an open system,<sup>9</sup> the conventional public finance debate has focused on constructing principles of local taxation analogous to the border management functions of the central state. The mainstream public finance argument on the division of fiscal resources has, at least in Japan, functioned as a tax ideology for the central state. By acting as a brake on pressures for fiscal decentralization, this ideology has helped shape the

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<sup>8</sup> See, for example, Ronald Aqua, "Politics and Performance in Japanese Municipalities" (Unpublished PhD. dissertation, Cornell University, 1979), Muramatsu Michio, *Chihou Jichi* [Local Autonomy]. Tokyo: Tokyo Daigaku Shuppankai, 1988, Steven R. Reed, *Japanese Prefectures and Policymaking*. Pittsburgh: University of Pittsburgh Press, 1986, Richard Samuels, *The Politics of Regional Policy in Japan: Localities Incorporated?* Princeton: Princeton University Press, 1983.



tax structure it purports to examine.<sup>10</sup>

### *Fiscal Sociology and Institutions*

The fiscal sociology approach is a bridge between the political science and public finance critiques discussed above. Moreover, fiscal sociology is particularly suited to the task of exploring, from a macro-level perspective, the role of interests and ideologies in intergovernmental fiscal politics. The basic tenet of the approach is Schumpeter's insight that "The public finances are one of the best starting points for an investigation of society, especially though not exclusively of its political life."<sup>11</sup> This assertion is, in itself, profoundly institutionalist since it suggests that fiscal structures both affect

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<sup>9</sup> That is, local governments permit actors to move freely across their areas of jurisdiction.

<sup>10</sup> This function is evident when MOF officials, academics, and other interested parties appeal to the principle to legitimate the maintenance of centralized taxation and a restricted local tax base. The orthodox argument concerning local and national taxes is seen, for instance, in Kato Hiroshi and Yokoyama Akira, *Zeisei to Zeisei* [The Tax System and Tax Politics], Tokyo: Yomiuri Shinbunsha, pp. 230-36. Note that Kato is the longtime chairman of the important *Seifuzeisei Chousakai* [Government Tax Advisory Commission], whose reports are generally regarded to be a reflection of the aims of MOF; indeed, MOF supplies the secretariat and research materials for the commission and writes the final reports.

<sup>11</sup> See Joseph Schumpeter, "The Crisis of the Tax State," in *International Economic Papers*, 1954, p. 7. On fiscal sociology generally, note the survey paper by John L. Campbell, "The State and Fiscal Sociology," in the *Annual Review of Sociology* 19, 1993. An application of fiscal sociology categories to Japan can be found in Jinno Naohiko, "Nihongata Zei, Zaisei Shisutemu" [The Japanese Fiscal System], in *Gendai Nihon Keizai Shisutemu no Genryuu* [The Sources of the Contemporary Japanese Economic System]. Ed. by Okazaki Tetsuji

and are affected by social forces and the other variables of political analysis.

A deepening of this institutionalist perspective can, as Campbell has indicated,<sup>12</sup> be achieved by drawing on historical institutionalism's non-reductionist model of preference formation. Preferences, in this view, are not the exogenous constructs one finds in rational choice work, but rather are shaped by the institutional structure in which actors operate.<sup>13</sup> This nuanced, meso-level approach calls our attention to the interactions among political and fiscal institutions and their effect on what actors perceive to be in their best interests. In this way, we can inquire into the reasoning that underlies the significant empirical variation among intergovernmental fiscal arrangements.

However, it is also crucial to keep in mind the value of fiscal sociology's concern to analyze the overall fiscal system. Though the macro-level approach is a handicap when specific institutions and cross-national comparisons are in order, it is a major strength when the focus is on change in the fiscal regime itself. Schumpeter's classic paper on the crisis of the tax state, for example, sketched the emergence of the state itself as a consequence of the "common exigency" brought about by the increasing cost of war. His

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and Okuno Masahiro. Tokyo: Nihon Keizai Shinbunsha, 1993.

<sup>12</sup> John L. Campbell, "An Institutional Analysis of Fiscal Reform in Postcommunist Europe," in *Theory and Society* 25, 1996, pp. 74-5.

<sup>13</sup> A discussion of this point can be found in Steinmo and Thelen, *op. cit.*

approach emphasized broad social change, of the type that tends to be neglected in meso- and especially micro-level analyses. Schumpeter's aim was, in fact, to highlight how such change causes systemic crisis -- as opposed to transient difficulties -- that forces systemic change.<sup>14</sup>

The importance of this macro-level perspective for the present work is precisely because part of the argument is that the current era is one of fundamental change in the character of the tax state. As we discuss below, the prewar period saw a similar protracted crisis in the tax state, at the intergovernmental level. Local governments, burdened with increasing tasks as societies industrialized, ran into severe fiscal stresses during the Great Depression that were irresolvable under the contemporary tax regimes. Yet efforts to reform the intergovernmental fiscal systems, in countries as diverse as Australia, Canada, and Japan, faced the hostility of powerful actors with a stake in the old system. It was not until the outbreak of world war two that such countries managed to overcome this opposition. The reforms that then became possible generally centred the most lucrative tax bases in the central state and redistributed vast amounts of revenues to local and regional governments.

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<sup>14</sup> See Schumpeter, *op. cit.*

*The Debate on Tax Allocation as an Ideology*

Though many countries centralized their tax systems and implemented large-scale intergovernmental redistribution during the war, there were and remain important differences in their fiscal structures. The mainstream debate on tax allocation is in this sense too abstract and insensitive to empirical work that would seek to appreciate differences for what they are rather than as departures from an assumed ideal. Differences in intergovernmental tax regimes are, in other words, potentially effective responses to political or administrative problems in a given nation's fiscal history. But though various principles of local taxation are adduced in public finance discussions, generally speaking they have not yet gone beyond J. V. Miquel's prescription that national taxes are taxes on people, whereas local taxes are properly levied on things. Another way of putting this is the argument that national taxes ought to be based on the principle of ability to pay whereas local taxes should respect the benefit principle.<sup>15</sup>

But benefit taxation is a principle, of course, not a law of science like gravity or other consistently observable phenomena. Indeed, benefit taxation is

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<sup>15</sup> Benefit taxation, as we note further below, derives from the era of the nightwatchman state, and calls for taxation commensurate with the individual's benefit from publicly supplied services. A short description of the principle can be found in Richard Musgrave and Peggy Musgrave, "Tax Equity with Multiple Jurisdictions," in *Taxation in a Sub-National Jurisdiction*. Ed. by Allan M. Maslove. Toronto: Fair Tax Commission, 1993, pp. 5-7.

more properly defined as an ideology born of historical and institutional influences. Moreover, because it is an ideology and not hard science, we can quite easily raise questions about its persuasiveness.

In fact, the ideology clearly lacked legitimacy from the very start of its reign. This was seen when commodity taxation, rather than direct taxes, came to be viewed as an appropriate national tax base for France in the wake of the 1789 revolution. The roots of this trend can be found in the French citizenry's detestation of the tax exemptions that had been a right of aristocratic status.<sup>16</sup> The French aversion to direct taxes, especially the income tax, became further institutionalized in the modern era through opposition from the politically powerful classes of small business and farmers. Of particular note in this respect is the fact that France was the first country to enact a Value Added Tax, in 1948, at a time when most other developed societies were generally emphasizing the income tax as the centerpiece of the national fiscal system. France thus poses a fascinating case of divergent fiscal history and politics, one where fiscal institutions shaped two centuries ago continue to exert an influence on the tax structure and intergovernmental allocation

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<sup>16</sup> According to Roy Taylor, "Concerning the practice of adding the 'de' or 'van' to one's name in order to achieve noble status (and thus achieve exemption from direct taxation in France), Maximilien de Robespierre began his legal career by researching and notarizing pedigrees which granted the important enclitic." The comment is logged at the internet WWW site, <http://www.urz.uni-heidelberg.de/subject/hd/fak7/hist/e3/gen/mediev1/log.started941101/mail-4.html>, from <rtay102@emoryu1.cc.emory.edu>. See also Carl S. Shoup, "Taxation in France," in the *National Tax Journal*, Vol. 8, No. 4, December

of tax bases.

### *Taxation and the Laissez-Faire State*

In the era of the laissez-faire, or nightwatchman, state, public services were overwhelmingly aimed at preserving the market. Thus, one can argue that it was legitimate to impose property, indirect consumption taxes, and the like according to the principle of benefit. But fiscal evolution saw a decline in the focus on simple protective services, and a shift to higher military expenditures and selective social services for the poor. The principle of benefit taxation lost its legitimacy to that of equity and the ability to pay, which calls for the imposition of progressive taxes, especially on income.

As part of this historic change in the role of the state, the provision of protective services was delegated to the local authorities. In consequence, property, indirect consumption, and other taxes based on the benefit principle were deemed appropriate sources of revenue for local governments. This process was, in other words, the genesis of the tax ideology that set taxes on persons at the national level and taxation of things at the local level. Such, in a nutshell, is the origin of the principles of ability to pay and benefit taxation and their application to intergovernmental fiscal relations.

*The Comparative Intergovernmental Allocation of Taxes*

Table 1.1: Tax Structures at National and Local Levels, 1993<sup>17</sup>

(Units: Percent of Gross Domestic Product)

<u>Country</u>		<u>Income Taxes</u>		<u>Property Taxes</u>		<u>Consumption Taxes</u>	
		<u>National</u>	<u>Local</u>	<u>National</u>	<u>Local</u>	<u>National</u>	<u>Local</u>
<u>Federal</u>	Germany	4.9	7.4	0.0	1.1	7.6	3.2
	U.S.	10.6	2.5	0.2	3.3	1.1	4.2
<u>Unitary</u>	France	7.1	0.6	0.8	1.5	10.8	0.5
	Japan	7.6	4.1	1.2	2.0	3.2	0.9
	Sweden	3.3	17.3	1.6	0.0	13.6	0.1
	U.K.	12.4	0.0	2.7	1.1	12.1	0.0

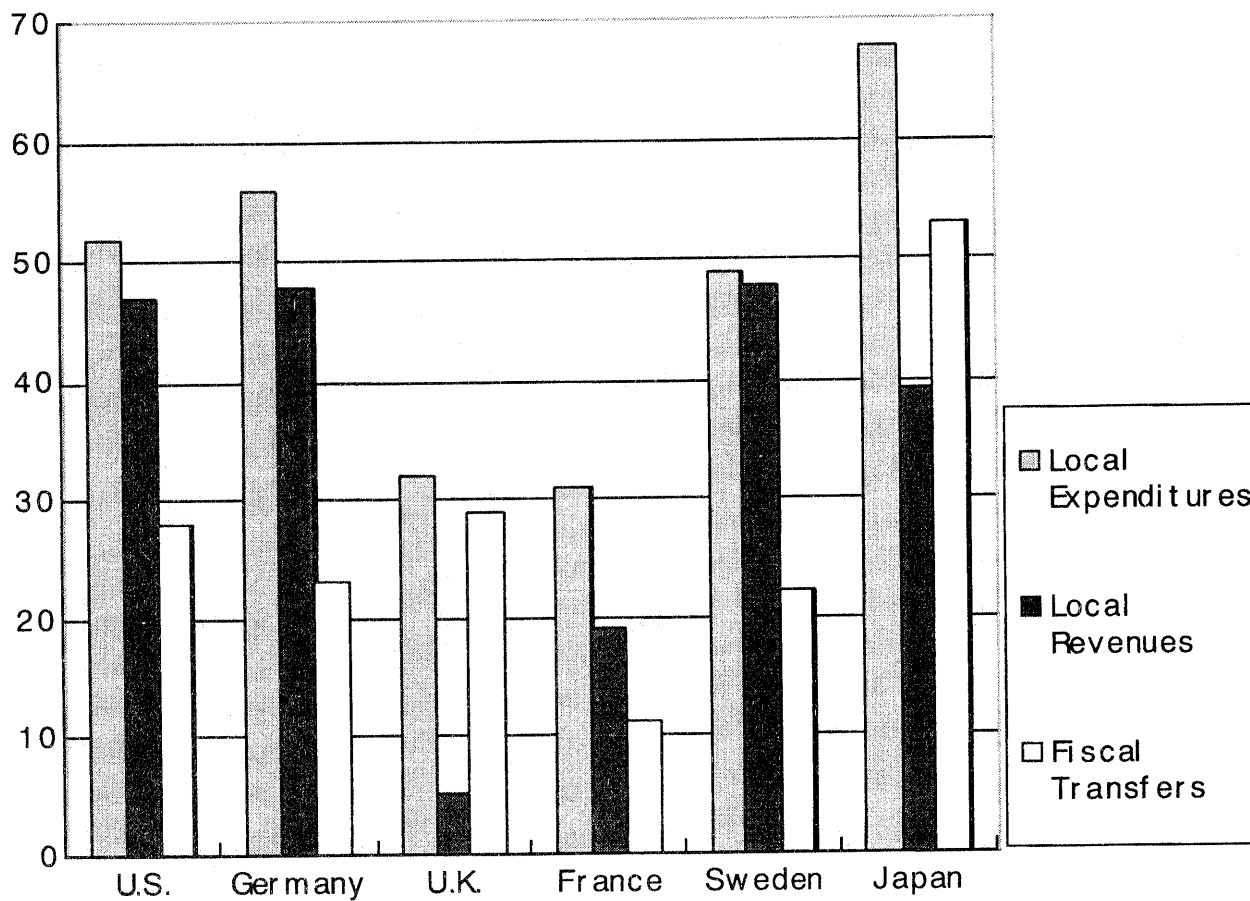
French fiscal history, as we noted above, comfortably violates the main tenets of the public finance orthodoxy. This is also true of the cases in Table 1.1 and Figure 1.1, which present the scale of local revenues and expenditures as well as the structures of local and national taxation.

The common element in the table and figure is variability in the local tax structure. Countries differ greatly on the scale of local spending, the weight of fiscal transfers, and the intergovernmental allocation in their overall tax regimes. Fiscal sociology and historical institutionalist methods suggests that this variability stems in large part from the nature of relevant political institutions and the state.

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<sup>17</sup> See OECD, *National Accounts*, 1994.

Figure 1.1 Local Expenditures, Revenues, and Fiscal Transfers, 1992.



$$\text{Local Expenditures} = \frac{\text{Local Expenditures}}{\text{Central Expenditures} + \text{Local Expenditures}}$$

$$\text{Local Revenues} = \frac{\text{Local Revenues}}{\text{Central Revenues} + \text{Local Revenues}}$$

$$\text{Fiscal Transfers} = \frac{\text{Central Transfers to Subnational Governments}}{\text{Central Operating Expenditure}}$$

Source: OECD National Accounts, 1994



## *Japan*

Among the characteristic features of Japan's intergovernmental tax distribution is the comparatively high levels of local taxation and transfers from the central state, as we can see from Figure 1.1. Both of these features are clearly related to Japan's inordinately massive weight of local spending as a proportion of total government expenditures. What is also unusual, given the ideology of taxes on persons properly being national taxes, is the local income tax, known as the Inhabitants Tax (*Juuminzei*). Table 1.1 shows that this tax accounts for over a third of total income-tax revenues in 1993. One could also point to the relatively high burden on corporate income as another anomaly for the orthodox view; but even if one accepts the fiction that the local Enterprise Tax (*Jigyousei*) is a form of commodity taxation, from the perspective of corporate taxation, the Inhabitants Tax remains notable. This local income tax exists in Japan's intergovernmental tax distribution because the former Interior Ministry (*Naimusho*) fought tooth-and-nail to retain the predecessor Household Tax (*Kosuuwari*) when the 1940 tax reform instituted the taxation of persons at the national level and the taxation of goods at the local level. The outcome of this trench warfare was the maintenance of a margin of direct taxation at the local level. Here, then, is another major exception to the ideology of benefit taxation, one that derives from interministerial competition.

### *America*

Figure 1.1 makes it clear that the weight of local taxation is also high in the American case; however, in a sharp contrast with Japan, control over local taxes is greatly decentralized. Commodity taxes such as the property tax are of great fiscal and political significance at the local level, but large shares of local taxation are also occupied by taxes on personal and corporate income as well as general consumption taxes. If we think of this unusual condition from the perspective of policymaking, the important point is the remarkable decentralization and fragmentation of the American decisionmaking system. Because of America's institutional fragmentation, which is one of the main tenets of historical institutionalist work, the policymaking structure is highly porous when it comes to the influence of interest groups. At the level of local politics, the major interests visible in policymaking arenas are the class of mid-sized property holders, whereas interest groups acting on behalf of the low-income class are seldom evident. In consequence, fiscal politics at the local level in the U.S. is marked by opposition to the property tax but acceptance of a high share for regressive general sales taxes.

### *The UK*

By contrast, the level of local taxation in the U.K. is quite miniscule, even when one takes into account the relatively small scale of local expenditures. Moreover, local taxation centres on the rates, and the Thatcherite

introduction of the Community Charge created a politically costly backlash. But whether the rates or the Community Charge (in its revised form), the local tax system in the U.K. clearly remains an archetype of the benefit principle in action. This characteristic of British intergovernmental tax allocation is regulated by the country's highly centralized process of decisionmaking. The conflict between class interests is embodied in the largely 2-party system and penetrates both the central state and the local administrations. But perhaps more important, the history of British intergovernmental fiscal relations reveals a "particularly ruthless" strategy by the central state to marginalize local government, with Thatcherism of the 1980s being only the most recent example. Though differences in rural and urban fiscal capacities became a serious problem in the late 1800s, "[l]ike every Prime Minister since his time, Gladstone refused to give localities a more flexible tax even though a local income tax was recommended by his able financial advisor, Goschen."<sup>18</sup>

### *Sweden*

Figure 1.1 also shows that Sweden represents, in contrast to the UK, a centralized state where the scale of local taxation approaches that of the national level. In addition, the focus of local taxation is the local income tax, which draws over five times the revenues of the national income tax. Of

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<sup>18</sup> On this, see Douglas E. Ashford, *The Emergence of the Welfare States*. Oxford: Basil

course, one can argue that the practice of taxing assessed property income means the property tax is contained in the Swedish local income tax. Another point that is useful to keep in mind is that Swedish public services are by and large supplied as universal community services. This fact can be viewed against the backdrop of Sweden's centralized process of decisionmaking, wherein political parties, bureaucrats, and interest groups have forged a corporatist framework of fiscal policymaking. This structure, especially in its heyday during the 1950s and 1960s, has given bureaucrats ample room to make policy choices that reflect a broader range of interests than the much narrower class demands characteristic of the UK, or the extremely fragmented tax lobbying found in America.<sup>19</sup>

The above comparative points call our attention to Japan's politically centralized and bureaucratic structure of decisionmaking on the intergovernmental allocation of taxes. Japan's relatively high level of local taxation in a centralized state gives rise to a clientistic relationship between MOHA and the local authorities as well as MOHA's defence of the local tax base through trench warfare with MOF. The local income tax, as was noted above, exists because of interministerial politics during the 1940 tax reform.

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Blackwell, 1988, pp. 121-32.

<sup>19</sup> A developed account of political institutions and tax politics in the UK, the US, and Sweden is found in Sven Steinmo, *Taxation and Democracy*. Yale University Press, 1993.

*A Polanyian Perspective*

Important on Japan's agenda of reform to the tax allocation is the increasing demand on local authorities for universal community services. From a Polanyian perspective,<sup>20</sup> which fits well within the ambit of fiscal sociology, this is the emergence of calls for a new form of safety net in an era when an expanding global economy is eroding national borders and social change is reducing the capacity to shift the burden of welfarism onto women in the home. These public services would, in effect, substitute for cooperative labour in the community and ought therefore to be funded by local taxation that is proportionate to income. Such taxation would satisfy concerns for equity.

Moreover, another point to emphasize in the debate on tax allocation is the importance of a spatial approach. From this perspective, the three fields of producing, distributing, and spending income are spatially distributed among the local authorities. For this reason it is important that the taxation of income distribution be proportional to membership and be complemented by proportional taxation of income in the areas of production and expenditure.

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<sup>20</sup> This refers to Karl Polanyi's analysis of the rise of the market economy and its effect on society, in *The Great Transformation: The Political and Economic Origins of Our Time*, Boston: The Beacon Press, 1957.

We noted above that in the Swedish case, there was a notably larger scope than in the UK for bureaucrats to make rational choices on behalf of the broad mass of taxpayers. Thus the heavy weight of local income taxation to fund the generous delivery of universal services by subnational government. But in the institutional milieu of Japanese tax politics, decentralizing fiscal control would generally represent a diminution of MOF's powers. Hence, one can say that the source of the current trench warfare is MOF. Only for that reason are current trench wars so hard-fought and the trenches themselves deep; and thus comprehensive reform of Japan's intergovernmental allocation of taxes, though necessary, will be a very hard slog indeed.