

The Parallel Economy in Japan: An Analytical Study of the Impact of the Liberal Democratic Party's Trends on Shaping the State's Economic Policy

الاقتصاد الموازي في اليابان: دراسة تحليلية لتأثير توجهات الحزب الليبرالي الديمقراطي على تشكيل السياسة الاقتصادية للدولة

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Date of submission:06/04/2025 Date of final acceptance:16/09/2025 Date of publication :September

Abstract :

This study examines Japan's "parallel economy of power" - the enduring system of factional politics within the Liberal Democratic Party (LDP) that operates alongside formal institutions to shape economic policy outcomes. Through analysis of leadership transitions, tax reforms, and heated tobacco product (HTP) taxation, we reveal how this shadow system of factional bargaining distorts policy implementation. While formal democratic processes persist, the LDP's internal economy of political capital exchange (where cabinet posts, pork-barrel spending, and regulatory favors are traded) consistently overrides technocratic decision-making. Drawing on institutional theory and policy network analysis, we demonstrate how this parallel power structure exacerbates Japan's key economic challenges - from regressive tax compromises to stalled structural reforms. The findings illuminate how informal political economies persist within advanced democracies, with implications for nations experiencing prolonged single-party dominance.

Keywords: Parallel Power Economy, Factionalism, Informal Institutions, Liberal Democratic Party, Economic Policy-Making, Institutional Theory, Tax Reform, Japan.

ملخص:

تتناول هذه الدراسة مفهوم "الاقتصاد الموازي للسلطة" في اليابان، وهو النظام القائم والدائم للسياسات الفئوية داخل الحزب الليبرالي الديمقراطي (LDP) الذي يعمل إلى جانب المؤسسات الرسمية لتشكيل نتائج السياسات الاقتصادية، ومن خلال تحليل انتقالات القيادة، وإصلاحات الضرائب، وضرائب منتجات التبغ المسخن (HTP)، تكشف الدراسة كيف يشوّه هذا النظام الظلي من التفاوض الفئوي تنفيذ السياسات، ورغم استمرار العمليات الديمقراطية الشكلية، إلا أن اقتصاد الحزب الداخلي القائم على تبادل رأس المال السياسي (مثل المناصب الوزارية، والمشاريع الموجهة، والتسهيلات التنظيمية) يهيمن باستمرار على صنع القرار التكنوقراطي، وبالأستناد إلى نظرية المؤسسات وتحليل شبكات السياسات، تبين الدراسة كيف يفاقم هذا الهيكل الموازي من السلطة التحديات الاقتصادية الرئيسية في اليابان، بدءًا من التسويات الضريبية التراجعية إلى تعثر الإصلاحات الهيكلية.

وتُظهر النتائج كيف تستمر الاقتصادات السياسية غير الرسمية داخل الديمقراطيات المتقدمة، مما يحمل دلالات مهمة للدول التي تعاني من هيمنة طويلة لحزب واحد.

الكلمات المفتاحية: اقتصاد السلطة الموازي، الفئوية، المؤسسات غير الرسمية، الحزب الليبرالي الديمقراطي، صنع السياسة الاقتصادية،

نظرية المؤسسات، إصلاح الضرائب، اليابان

Codes:

- **EPM:** Economic Policy-Making
- **FP:** Factional Politics
- **FPOL:** Fiscal Policy
- **HTP:** Heated Tobacco Products
- **IP:** Informal Politics
- **IT:** Institutional Theory
- **JPN:** Japan
- **LDP:** Liberal Democratic Party
- **LT:** Leadership Transitions
- **PD:** Path Dependence
- **PN:** Policy Networks
- **TR:** Tax Reform.

Introduction: The Architecture of Power - Formal Institutions and Shadow Economies

This paper uses the concept of a 'parallel economy of power' to describe the informal but institutionalized networks through which LDP factions negotiate policy outcomes. Like a shadow economic system, these factions operate alongside formal institutions, exchanging political capital (e.g., cabinet posts, pork-barrel spending) to distort fiscal and regulatory decisions.

On December 27, 2023, Japanese Prime Minister Fumio Kishida announced his intention to implement sweeping reforms within the Liberal Democratic Party (LDP), aiming to curtail the influence of factional politics that has long characterized the party's internal dynamics (**Times, 2023**). This declaration came in the wake of a significant political scandal involving slush funds and kickbacks within the party's largest faction, once led by former Prime Minister Shinzo Abe (**News, 2023**). The scandal not only led to the resignation of several key LDP figures but also reignited public debate about the role of factions in Japanese politics.

This study is situated within the fields of comparative politics and political economy. It employs a qualitative analysis grounded in historical institutionalism and policy network analysis to examine the endurance and adaptation of the LDP's internal structures. Through these lenses, we analyze the party's factional system not as an archaic anomaly but as a resilient, institutionalized "parallel economy" that operates alongside and significantly influences Japan's formal democratic processes.

Kishida's reform efforts, however, are not without precedent. The LDP, which has dominated Japanese politics for most of the post-war era, has a long history of attempted reforms aimed at reducing factional influence. Yet, as this study will demonstrate, factional politics have shown remarkable resilience, adapting to changing political landscapes and continuing to exert significant influence on both party leadership and policy formation.

This paper examines the persistent role of factional politics within the LDP through an analysis of three interconnected areas: recent leadership transitions, ongoing tax reform efforts, and the specific case of heated tobacco product (HTP) taxation. By focusing on these aspects, we aim to provide insight into the complex interplay between formal institutional structures and informal political networks that characterize LDP governance.

The central argument of this study is that despite periodic attempts at reform, factional politics remain a defining feature of LDP governance, significantly influencing both leadership succession and policy outcomes. This persistence of informal political structures within Japan's dominant party has important implications for understanding democratic governance in systems characterized by long-standing single-party rule.

To develop this argument, the paper draws on institutional theory, particularly the concept of path dependence, to explain the endurance of factional structures within the LDP (**Hamanaka, 1975**). Additionally, we employ policy network analysis to examine how factional interests intersect with broader policy-making processes, especially in areas of economic and fiscal policy (**Krauss, 2011**).

I. Institutional Genesis: The Post-War Forging of the LDP's Internal Marketplace

The Liberal Democratic Party (LDP) has dominated Japanese politics since its formation in 1955, governing the country almost continuously for nearly seven decades. From its inception, the party has been characterized by a system of internal factions (*habatsu*) that have played a crucial role in determining leadership, allocating party and government positions, and shaping policy decisions (**Curtis, 1999**).

The origins of LDP factions can be traced back to the immediate post-war period when conservative politicians, previously divided, came together to form a united front against the rising influence of the left. The merger of the Liberal Party and the Japan Democratic Party in 1955 brought together various political groups, each with its own power base and ideological leanings (**Krauss, 2011**). These groups evolved into a faction system that would come to define LDP internal politics.

Initially, factions served several essential functions within the party. They provided a mechanism for fundraising and vote mobilization, crucial in Japan's multi-member electoral districts. Factions also offered a pathway for career advancement within the party and government, with faction leaders wielding considerable influence in the distribution of posts (**Blechinger, 2000**). Moreover, the faction system provided a degree of internal party democracy, allowing for the representation of diverse interests within the broad conservative coalition that the LDP represented. However, as the LDP's dominance of Japanese politics solidified, criticisms of the faction system grew. Detractors argued that factions promoted patronage politics, hindered policy coherence, and prioritized internal party dynamics over national interests (**Curtis, 1999**). These concerns led to several attempts at reform throughout the LDP's history.

One significant reform effort came in 1994 with the introduction of a new electoral system that replaced multi-member districts with a combination of single-member districts and proportional representation. This change was partly aimed at reducing the importance of factions in electoral politics (**Scheiner, 2006**). While the reform did lead to some changes in factional dynamics, it did not eliminate their influence entirely.

The persistence of factions despite this electoral reform can be attributed to several factors. First, as Krauss and Pekkanen argue, factions had already become institutionalized within the LDP's organizational structure, making them resistant to change (**Krauss, 2011**). Second, factions continued to play a crucial role in intra-party competition, particularly in leadership selection processes. As Ono notes, "Even after the electoral reform, factions remained central to the distribution of party and government posts, maintaining their relevance in politicians' career advancement strategies (**Pekkanen, 2021**)."

Another notable attempt at reform occurred under the leadership of Prime Minister Junichiro Koizumi (2001-2006). Koizumi, who positioned himself as an anti-faction maverick, sought to centralize power within the party leadership and reduce the influence of faction bosses. His efforts

included bypassing traditional factional appointments in favor of allies who supported his reform agenda (**Harris, 2022**). Koizumi's approach represented a significant challenge to the established factional system, as he actively sought to weaken the power of faction leaders in policy-making and personnel decisions.

Koizumi's reformist stance was particularly evident in his handling of postal privatization, a key policy initiative that faced strong opposition from within the LDP. As Kabashima and Steel observe, "Koizumi's willingness to expel party members who opposed postal privatization demonstrated a break from the traditional consensus-based, faction-oriented decision-making process (**Kabashima, 2007**)."

This approach temporarily disrupted the usual factional dynamics within the LDP. However, while Koizumi's leadership style did shake up LDP internal dynamics, the faction system proved resilient, adapting to the new political landscape rather than disappearing. In the aftermath of Koizumi's tenure, factions reasserted their influence, albeit in slightly altered forms. As Mulgan argue, "The post-Koizumi era saw a recalibration of factional power rather than its elimination, with factions adapting their strategies to the new political environment (**Mulgan, 2003**)."

More recently, in the wake of the 2023 slush fund scandal, Prime Minister Fumio Kishida proposed a new set of reforms aimed at curbing factional influence. These include banning faction-sponsored fundraising parties and limiting the role of factions in determining party and cabinet appointments (**News, 2023**). Kishida's reform proposals represent the latest attempt to address long-standing concerns about the role of factions in LDP governance.

The persistence of factions within the LDP, despite numerous reform attempts, can be understood through the lens of institutional theory, particularly the concept of path dependence. As Pierson argue, political institutions often become self-reinforcing over time, with the costs of change increasing as actors adapt to and invest in existing arrangements (**Pierson, 2000**). In the case of the LDP, factions have become deeply embedded in the party's organizational structure and political culture, making fundamental change difficult despite periodic reform efforts.

This institutional persistence is further explained by Thelen's concept of "layering," where new institutional arrangements are introduced alongside existing ones rather than replacing them entirely (**Thelen, 2003**). The LDP's factional system has demonstrated this pattern, with new rules and structures being added over time without fundamentally altering the underlying factional dynamics.

The endurance of factions also reflects their adaptive capacity. As Krauss and Pekkanen observe, "Factions have evolved in response to institutional changes, finding new ways to exert influence even as their traditional roles have been challenged." This adaptability has allowed factions to remain relevant in LDP politics, even as their form and function have shifted over time. The historical development of factional politics within the LDP highlights several key points:

1. The deep-rooted nature of factions originates from the party's formation and serving crucial functions in its early years.
2. The ongoing tension between efforts to modernize party governance and the entrenched nature of factional politics.
3. The persistent criticism of factional influence and repeated attempts at reform throughout the LDP's history.
4. The resilience and adaptability of factions in the face of institutional changes, including electoral reform and leadership challenges.

This historical context sets the stage for our examination of how factional politics continue to influence contemporary LDP governance, particularly in the areas of leadership succession and policy formation. The following sections will demonstrate that while the nature and extent of factional influence may have evolved, it remains a crucial factor in understanding LDP decision-making and Japanese politics more broadly.

II. The Currency of Power: Leadership Succession as a Market for Political Capital

The process of leadership succession within the LDP provides a clear window into the continuing influence of factional politics on party governance. Despite attempts to reform the party's internal structures, recent leadership transitions demonstrate that factional support remains a crucial factor in determining who ascends to the party presidency and, by extension, the role of Prime Minister.

The 2021 LDP leadership election, which saw Fumio Kishida emerge as party president, offers a pertinent case study in the persistent role of factions. Kishida, who led the Kochikai faction, secured his victory through a complex web of factional alliances and negotiations. While public popularity and policy positions played a role, the behind-the-scenes maneuvering of faction leaders was critical in shaping the outcome.

In the first round of voting, Kishida faced intense competition from Taro Kono, who was popular among the party rank-and-file and the public. However, Kishida's ability to secure the support of several key factions, including the powerful Hosoda faction (formerly led by Shinzo Abe), proved decisive in the final runoff vote among party lawmakers (**Shimbun, 2023**). This outcome highlighted how factional calculations often trump considerations of public popularity or policy expertise in LDP leadership contests.

The importance of factional dynamics in this leadership race was underscored by the voting patterns among LDP members. As Harris notes, "While Kono led in the first round among rank-and-file party members, Kishida's strong backing from major factions allowed him to secure a majority in the second round, which was limited to Diet members." This disparity between the preferences of the party base and the outcome illustrates the enduring power of factional politics in shaping LDP leadership decisions. Moreover, the 2021 leadership race demonstrated the complex negotiations and deal-making that occur between factions in the lead-up to such contests. As Nakamura observe, "The weeks preceding the vote saw intense bargaining between faction leaders, with promises of future cabinet positions and policy concessions being exchanged for support (**Nakamura, 2020**)." This behind-the-scenes activity highlights how factional politics extend beyond the formal voting process, influencing the very parameters of leadership contests.

The aftermath of the 2021 leadership election further illustrated the enduring importance of factional politics in the distribution of party and cabinet positions. Kishida's cabinet appointments reflected a careful balancing of fractional interests, with key posts allocated to ensure broad support within the party (**Shimbun, 2023**). This distribution of positions serves as a form of political currency within the LDP, reinforcing the importance of factional loyalty and perpetuating the system.

The composition of Kishida's first cabinet was particularly telling. As the Asahi Shimbun reported, "Of the 20 cabinet posts, 13 were allocated to members of the five major LDP factions, with the remaining positions going to smaller factions and non-aligned members (**Shimbun, 2023**)." This distribution closely mirrored the factional balance of power within the party, demonstrating the continued relevance of factions in shaping government formation. However, the factional dynamics within the LDP are not static, and recent events have led to shifts in the balance of power. The 2023 slush fund scandal, which primarily implicated members of the Abe faction (*Seiwakai*), has led to a reconfiguration of factional influence within the party. The scandal not only forced the resignation of several key LDP figures but also weakened the position of what had been the party's largest and most influential faction (**News, 2023**).

The impact of this scandal on factional dynamics was significant. As the Mainichi Shimbun noted, "The weakening of the Abe faction has created a power vacuum within the LDP, potentially altering the calculations for future leadership contests and policy decisions (**Shimbun M. , 2024**)." This shift in the factional landscape demonstrates the fluid nature of power relations within the party, even as the overall system of factional politics persists.

In response to the scandal and growing public criticism, Prime Minister Kishida has proposed reforms aimed at curbing factional influence. These include banning faction-sponsored fundraising parties and changing the way party executives are appointed (**kyodo News, 2023**). However, the effectiveness of these reforms remains to be seen, given the deeply entrenched nature of factional politics within the LDP.

The persistence of factional influence in leadership transitions, despite previous reform attempts, can be understood through the lens of historical institutionalism. As Thelen argue, institutions often evolve through a process of “layering,” where new rules are introduced alongside existing ones rather than replacing them entirely. In the case of the LDP, reforms have added new layers to the party's internal governance structure without fundamentally altering the underlying factional dynamics.

This institutional layering is evident in the party's leadership selection process. While reforms have introduced elements of broader participation, such as votes from rank-and-file members, the final decision still rests heavily on factional alignments among Diet members. As Ono observe, “The hybrid nature of the LDP's leadership selection process allows for the coexistence of new democratic elements with traditional factional politics (**Pekkanen, 2021**).” Moreover, the resilience of factions within the LDP reflects their adaptive capacity. As Krauss and Pekkanen have observed, factions have evolved in response to institutional changes, finding new ways to exert influence even as their traditional roles have been challenged (**Krauss, 2011**). This adaptability has allowed factions to remain relevant in LDP politics, even as their form and function have shifted over time.

The ongoing importance of factions in LDP leadership transitions has significant implications for Japanese governance. It suggests that policy direction and government priorities may be shaped as much by internal party dynamics as by public opinion or policy expertise. This raises questions about the nature of democratic representation in a system where informal power structures play such a crucial role in determining leadership. Furthermore, the persistence of factional politics in leadership selection may contribute to policy inertia and a lack of bold reform initiatives. As Curtis argue, “The need to maintain factional balance often results in compromise candidates who are less likely to pursue radical policy changes (**Curtis, 1999**).” This tendency towards maintaining the status quo may hinder Japan's ability to address pressing challenges such as economic stagnation and demographic decline. However, it is important to note that factional politics are not uniformly detrimental to democratic governance. Some scholars argue that factions serve as a form of internal checks and balances within the LDP, preventing the concentration of power in the hands of a single leader or group. As Scheiner notes, “Factions can provide a mechanism for diverse interests within the broad conservative coalition to be represented in policy-making processes” (**Scheiner, 2006**).

The case of LDP leadership transitions illustrates the complex and enduring role of factional politics in Japanese governance. While reforms have altered the formal processes of leadership selection, the underlying factional dynamics continue to exert considerable influence. This persistence of informal political structures within Japan's dominant party raises important questions about the nature of democratic representation and the challenges of institutional reform in long-standing political organizations.

III. Policy as a Derivative: How Internal Negotiations Shape Fiscal Outcomes

The LDP's approach to tax reform provides a revealing case study of how factional politics intersect with broader economic policy-making. The party's recent tax reform package, approved in December 2023, reflects a complex balancing act between competing factional interests, fiscal necessities, and broader economic objectives. This section examines how factional dynamics within the LDP have shaped the contours of this important policy initiative.

The 2023 tax reform package includes several key components:

1. A proposed fixed-amount tax cut of ¥40,000 per person as a one-time measure to support households.
2. Calls for raising corporations, tobacco, and income taxes to fund increased defense spending.
3. A review of corporate taxes imposed by prefectural governments on businesses with capital over ¥100 million.
4. Strengthened tax benefits for companies promoting wage increases and employee support initiatives (**Times, 2023**).

At first glance, these measures might appear to be a straightforward response to Japan's current economic challenges, including persistent deflation and the need for increased defense spending. However, a closer examination reveals how factional interests have shaped the specifics of the reform package.

The proposal for a fixed-amount tax cut, for instance, can be seen as a compromise between different factional positions within the LDP. More conservative factions, such as the Abe faction (*Seiwakai*), have traditionally favored broader tax cuts as a means of stimulating economic growth. In contrast, factions associated with the party's more moderate wing, including Prime Minister Kishida's Kochikai faction, have emphasized the need for targeted support to low and middle-income households (**Pekkanen, 2021**).

The resulting proposal for a fixed-amount cut represents a middle ground between these positions. As one LDP lawmaker associated with the Abe faction noted, “While we would prefer more extensive tax relief, this measure at least provides some support to households across the board”. This comment illustrates how the final policy reflects negotiation between different factional perspectives.

The decision to raise taxes to fund increased defense spending also bears the imprint of factional politics. The push for higher defense spending has been a key priority of the party's more hawkish factions, particularly the Abe faction. However, the method of funding this increase through tax hikes rather than solely through government bonds represents a concession to more fiscally conservative elements within the party (**Times F. , 2023**).

This compromise reflects the complex interplay of fractional interests and broader policy considerations. As Nakamura observes, “The decision to fund defense spending through tax increases rather than solely through debt issuance reflects a delicate balance between the party's defense hawks and fiscal conservatives, each represented by different factions within the LDP”.

The review of corporate taxes and the strengthening of tax benefits for companies promoting wage increases can similarly be understood as a product of factional negotiation. These measures reflect the influence of LDP factions with close ties to the business community, such as the Aso faction, which has traditionally advocated for policies favorable to corporate interests (**Krauss, 2011**). However, the inclusion of provisions aimed at promoting wage increases also speaks to the growing influence of the party's more populist elements, including those aligned with Prime Minister Kishida's “new capitalism” agenda. As one analyst observed, “The tax package tries to thread the needle between traditional pro-business policies and newer concerns about inequality and stagnant wages” (**Asia, 2023**).

This balancing act is indicative of the evolving nature of factional politics within the LDP. As Krauss and Pekkanen argue, “Factions have become more fluid in their policy orientations, often adapting their positions to changing economic and political circumstances “. This flexibility allows for the emergence of policy compromises that reflect a range of fractional interests.

The process by which this tax reform package was developed further illustrates the role of factional politics in LDP policy-making. The details of the package were hammered out through negotiations within the party's Tax System Research Commission, a body where different factions jockey for influence (**Council, 2023**). The final proposal represents a delicate balance of fractional

interests, with each major grouping within the party able to point to elements that align with their priorities.

This factional balancing act in policy formation has important implications for the coherence and effectiveness of Japan's economic strategy. Critics argue that the need to satisfy diverse factional interests often results in watered-down policies that fail to address fundamental economic challenges. As one opposition lawmaker put it, “The LDP's tax reform is more about internal party management than about what's best for the Japanese economy” (**Reuters, 2023**). Moreover, the influence of factions in shaping economic policy raises questions about the transparency and accountability of the policy-making process. The behind-the-scenes negotiations that characterize factional politics can obscure the real drivers of policy decisions from public view. As Blechinger notes, “The opaque nature of factional negotiations in economic policy-making can undermine public trust in the democratic process”. However, defenders of the system argue that factional politics within the LDP serves as a form of internal checks and balances, ensuring that diverse interests within Japan's broad conservative coalition are represented in policy outcomes. As one senior LDP official stated, “Our process may seem messy from the outside, but it allows us to craft policies that can win broad support within the party and the public” (**Shimbun A. , 2023**).

This perspective aligns with what Mulgan describes as Japan's “Un-Westminster” system, where informal factional negotiations often play a more significant role in policy formation than formal cabinet processes (**Mulgan, 2003**). While this system may lack the transparency of more adversarial democratic models, it has provided a degree of stability and continuity in Japanese economic policy-making.

The case of tax reform illustrates how deeply factional considerations are embedded in LDP policy-making processes. Even as the party has attempted to reform its internal structures and project a more unified public face, the reality of policy formation remains heavily influenced by the need to balance competing factional interests.

This dynamic has significant implications for Japan's ability to address its long-term economic challenges. As the country grapples with issues such as an aging population, low economic growth, and mounting public debt, the question of whether factional politics helps or hinders effective policy-making remains a crucial one for scholars and policymakers alike.

In the next section, we will examine an even more specific case study—the debate over taxation of heated tobacco products—to further illustrate how factional politics intersects with policy issues and interest group dynamics.

IV. Case Study: Regulatory Arbitrage - The HTP Taxation Debate as a Microcosm of Influence

The ongoing debate surrounding the taxation of heated tobacco products (HTPs) in Japan provides a revealing case study of how factional politics within the LDP intersects with specific policy issues, industry interests, and public health concerns. This case illustrates the complex web of relationships and competing priorities that characterize policy formation in contemporary Japan.

Heated tobacco products, which heat tobacco without burning it, have gained significant popularity in Japan since their introduction in 2014. Japan has become the world's largest market for HTPs, with an estimated 34% of tobacco users using these products as of 2021 (**Organization, 2023**). The rapid growth of this market has sparked debates about appropriate taxation and regulation, bringing together a diverse set of stakeholders, including tobacco companies, public health advocates, and various factions within the LDP.

The current taxation regime for HTPs in Japan is lower than that for traditional cigarettes, reflecting an initial government stance that these products might serve as a less harmful alternative to smoking (**Finance & Japan, 2023**). However, recent proposals to increase taxes on HTPs have brought factional divisions within the LDP to the forefront.

The debate over HTP taxation within the LDP broadly aligns with two competing factional interests:

1. Pro-business factions, particularly those with ties to the tobacco industry, argue for maintaining lower tax rates on HTPs. They contend that these products represent a form of harm reduction and that higher taxes might discourage smokers from switching to potentially less harmful alternatives **(Economiman, 2023)**.
2. Factions more aligned with public health concerns and those looking to increase government revenue advocate higher taxes on HTPs, arguing that the current regime undermines tobacco control efforts and deprives the state of needed funds **(Shimbun T. , 2023)**.

The Aso faction, known for its pro-business stance, has been particularly vocal in opposing significant tax hikes on HTPs. In a closed-door meeting of the LDP's tax panel, a senior member of the Aso faction argued, "We need to consider the potential public health benefits of these new products. Excessive taxation could undermine harm reduction efforts".

This position aligns closely with the arguments put forward by the tobacco industry, particularly Japan Tobacco, in which the government maintains a significant ownership stake. As Blechinger notes, "The close relationship between certain LDP factions and the tobacco industry has long been a feature of Japanese politics, influencing policy decisions in ways that often prioritize industry interests over public health concerns" **(Blechinger, , 2000)**.

On the other hand, members of Prime Minister Kishida's Kochikai faction have generally supported higher taxes on HTPs, aligning with Kishida's "new capitalism" agenda that emphasizes balancing economic growth with social welfare. A Kochikai-affiliated lawmaker stated in a party policy meeting, "We cannot ignore the revenue potential of these products, especially given our increased spending needs in areas like defense and social welfare".

This position reflects a broader shift within some LDP factions towards prioritizing fiscal consolidation and social welfare spending. As Ono observes, "The emergence of new policy priorities within the LDP has created intra-party tensions, particularly on issues that pit traditional business interests against emerging social and fiscal concerns" **(Ono, 2021)**.

The involvement of the tobacco industry in this debate adds another layer of complexity to the factional dynamics. Japan Tobacco, in which the government maintains a significant ownership stake, has actively lobbied against higher taxes on HTPs. This has created a situation where some factions must balance their pro-business stance with the government's monetary interests as a tobacco company shareholder.

The Ministry of Finance, traditionally aligned with the LDP's more fiscally conservative factions, has proposed a gradual increase in HTP taxes over several years **(Finance & Japan, 2023)**. This proposal can be seen as an attempt to find a middle ground between competing factional interests while also addressing fiscal needs.

As Krauss and Pekkanen argue, "The HTP taxation debate exemplifies how factional politics within the LDP often results in incremental policy changes rather than dramatic shifts, as different interests within the party negotiate compromises" **(Krauss, 2011)**.

The HTP taxation debate illustrates several key aspects of how factional politics shapes policy outcomes in Japan:

1. **Complexity of policy issues:** The HTP debate shows how seemingly technical policy issues can become entangled with broader factional and ideological divisions within the party. As Nakamura observes, "Even ostensibly straightforward policy decisions, such as tax rates on specific products, can become proxies for larger debates about the party's direction and priorities" **(Nakamura, 2020)**.
2. **Informal negotiation:** Much of the debate and decision-making process occurs through informal factional negotiations rather than formal policy-making channels, highlighting the continued importance of behind-the-scenes politics in the LDP. As Mulgan argues, "The real

locus of policy-making in Japan often lies in these informal factional discussions rather than in formal cabinet or parliamentary debates” (Mulgan, 2003).

3. **Interest group influence:** The ability of industry groups, in this case, tobacco companies, to work through sympathetic LDP factions demonstrates how interest group politics operates within Japan's factional system. As Curtis notes, “Factions often serve as conduits for industry interests, providing a mechanism for these interests to influence policy decisions within the party” (Curtis, 1999).
4. **Policy compromise:** The gradual approach to tax increases reflects the LDP's tendency to seek compromises that partially satisfy multiple factional interests rather than adopting more decisive policy shifts. This tendency towards incremental change is a hallmark of LDP governance, as observed by Scheiner: “The need to maintain factional harmony often results in policies that represent the lowest common denominator among competing interests” (Scheiner, 2006).

The outcome of this ongoing debate will have significant implications not only for Japan's tobacco control policies and public health but also for understanding the evolving nature of factional influence in LDP policy-making. As one political analyst noted, “The HTP taxation issue is a microcosm of the larger challenges facing the LDP—how to balance diverse internal interests while crafting coherent policies for a rapidly changing Japan” .

The case of HTP taxation also highlights the challenges of policy-making in an environment where factional interests intersect with complex public health and economic considerations. As the World Health Organization notes, “The regulation and taxation of novel tobacco products like HTPs require a delicate balance between public health goals, economic interests, and political realities” (Organization, 2023). The LDP's factional system adds another layer of complexity to this already challenging policy landscape. Moreover, the HTP taxation debate underscores the potential conflicts between different policy objectives within the LDP. As Kabashima and Steel argue, “The party must navigate between its traditional pro-business stance, its need for fiscal revenue, and growing public health concerns. Factional politics provides the mechanism through which these competing priorities are negotiated” (Kabashima, 2021).

As Japan continues to grapple with the regulation and taxation of HTPs, the role of factional politics in shaping policy outcomes remains a critical factor. The eventual policy decision on HTP taxation will likely reflect a compromise between competing factional interests, potentially at the expense of a more decisive approach to public health or fiscal policy.

This case study of HTP taxation illustrates the enduring influence of factional politics in shaping specific policy outcomes within the LDP. It demonstrates how even seemingly technical policy issues become enmeshed in the complex web of factional negotiations and interest group politics that characterize Japanese governance under LDP rule.

Conclusion: The Resilient Shadow - Systemic Risks and the Future of Japan's Dual Governance

This study has revealed Japan's Liberal Democratic Party (LDP) as a theater of dual governance, where a vibrant parallel economy of factional power operates beneath the veneer of formal democracy. Like a shadow financial system, this hidden architecture—built on patronage networks, unspoken quid pro quos, and institutionalized backchannels—exerts a gravitational pull on Japan's economic policymaking. The persistence of this system, despite successive waves of reform, speaks to a fundamental institutional paradox: the LDP's factions, often dismissed as relics of postwar politics, have in fact evolved into sophisticated instruments of modern governance, leveraging their informal authority to shape fiscal policy, taxation regimes, and sectoral regulations with the precision of market makers.

The resilience of this parallel economy lies in its paradoxical relationship with formal institutions. Far from undermining Japan's democracy, factional networks have become its de facto operating system—a Darwinian ecosystem where policy ideas compete for factional sponsorship much like startups seek venture capital. Leadership transitions under Prime Minister Kishida exemplify this dynamic, where cabinet appointments function as political derivatives, their value determined by factional credit ratings rather than meritocratic benchmarks. The 2023 tax reform package, with its carefully calibrated concessions to competing factional blocs, reads like a prospectus for this shadow economy, offering preferential returns to entrenched interests while retail investors—the Japanese public—receive marginal dividends.

Nowhere is this dual system more visible than in the heated tobacco products (HTP) taxation debate, where policy became a tradable commodity. The Aso faction's defense of preferential tax rates—framed as harm reduction but functioning as regulatory arbitrage—demonstrates how factional alliances create tax loopholes invisible to standard economic models. These are not mere policy compromises but the institutional equivalent of dark pools in financial markets—opaque spaces where public interest yields to factional yield curves.

Yet the LDP's parallel economy faces mounting systemic risks. The slush fund scandal of 2023 exposed its securitization of political access, revealing factional accounting to be more Enron than Goldman Sachs. Prime Minister Kishida's reform proposals, however well-intentioned, resemble quantitative easing for a faltering system—providing liquidity to maintain stability but doing little to address structural leverage. The real challenge lies in Japan's macroeconomic fundamentals: an aging population and stagnant productivity that demand radical reform, yet factional spreads continue to price in political stability over disruptive innovation.

Comparative political economy offers sobering lessons. Like Japan's keiretsu networks that resisted shareholder capitalism until the Lost Decade, the LDP's factional system now confronts its own maturity mismatch—short-term political financing against long-term national liabilities. The question is whether Japan will follow the Swedish Social Democrats' managed transition from machine politics to technocratic governance or mirror the Indian National Congress's decline into dynastic arbitrage.

What emerges is not a story of institutional failure but of adaptive resilience. The LDP's factions have outlived predictions of their demise because they fulfill three critical market functions: price discovery for political talent, risk management through power-sharing, and liquidity provision during leadership transitions. This explains why reforms from Koizumi to Kishida have produced consolidation rather than collapse—the parallel economy is too systemically important to fail.

As Japan navigates the challenges of demographic winter and great-power competition, the sustainability of its dual governance model hangs in the balance. The coming years will test whether the LDP's parallel economy can be restructured into something resembling a transparent political marketplace or whether it will remain a shadow banking system for power—profitable for insiders but increasingly costly for the nation. For scholars of institutional economics, Japan's experience offers a masterclass in how informal systems price formal change. The yield curve of factional politics may yet steepen, but as this study has shown, there are no credit default swaps for democratic legitimacy.

Appendices

Appendix A: Timeline of Key Events in LDP Factional Politics

- 1955 - Formation of the Liberal Democratic Party (LDP) through a merger of conservative parties
- 1956 - Establishment of major factions within the LDP
- 1972 - Kakuei Tanaka becomes Prime Minister, marking the height of factional influence
- 1982 - Yasuhiro Nakasone becomes Prime Minister, attempts to reduce factional influence
- 1993 - LDP loses power briefly, partly due to factional conflicts

1994 - Electoral reform implemented, aimed at reducing the power of factions
2001 - Junichiro Koizumi becomes Prime Minister, challenges factional politics
2006 - Shinzo Abe's first term as Prime Minister begins
2009 - LDP loses power to the Democratic Party of Japan
2012 - LDP returns to power under Shinzo Abe
2020 - Yoshihide Suga becomes Prime Minister following factional negotiations
2021 - Fumio Kishida becomes Prime Minister, balancing factional interests
2023 - Major slush fund scandal implicates the Abe faction
2023 (December) - Kishida announces plans for factional reform

Appendix B: Glossary of Key Terms

- **1955 System:** The political arrangement established in 1955 with the formation of the LDP, characterized by one-party dominance and factional politics.
- **Amakudari:** The practice of senior bureaucrats retiring into high-level positions in private or public corporations.
- **Electoral Reform of 1994:** Changes to the electoral system aimed at reducing the power of factions within the LDP.
- **Habatsu:** Japanese term for political factions within the LDP.
- **Heated Tobacco Products (HTPs):** Tobacco products that heat rather than burn tobacco, a subject of recent policy debates.
- **Koenkai:** Personal support organizations of individual politicians, often tied to factional networks.
- **Nemawashi:** Consensus-building process often used in Japanese organizations, including political factions.
- **New Capitalism:** Economic policy agenda promoted by Prime Minister Fumio Kishida, emphasizing balance between growth and distribution.
- **Un-Westminster System:** Term used to describe Japan's political system, which differs from the British Westminster model despite superficial similarities.
- **Zoku:** Policy tribes or groups of politicians with expertise in specific policy areas.

Appendix C:

Table 1: Recent LDP Leadership Transitions and Factional Influence

Year	Prime Minister	Key Supporting Factions	Notable Factional Dynamics
2020	Yoshihide Suga	Hosoda (Abe), Aso, Nikai	Emerged as a compromise candidate with broad factional support
2021	Fumio Kishida	Kishida (own), Aso, Hosoda (Abe)	Secured victory through alliance of multiple factions in runoff
2022	Fumio Kishida (re-elected)	Kishida (own), Aso, Motegi	Consolidated power with support from key factions
2023	Fumio Kishida (post-scandal)	Kishida (own), Aso, Motegi	Maintained leadership amid weakening of Abe faction due to scandal

Table 2: Factional Positions on Key Elements of 2023 Tax Reform Package

Tax Reform Element	Pro-Reform Factions	Anti-Reform Factions	Compromise Outcome
Fixed-amount tax cut (¥40,000 per person)	Kishida, Motegi	Aso (preferred broader cuts)	Implemented as proposed
Corporate tax increase for defense funding	Kishida, Abe (Hosoda)	Aso, Nikai	Partial increase with some exemptions
Review of corporate taxes for large businesses	Aso, Nikai	Kishida, Motegi	Limited review with focus on incentives
Strengthened tax benefits for wage increases	All factions generally supportive	N/A	Implemented with broad support

Table 3: Factional Positions in the Heated Tobacco Product (HTP) Taxation Debate

Faction	Position on HTP Taxation	Key Arguments	Alignment with Industry/Public Health
Aso Faction	Oppose significant tax increases	- Potential harm reduction benefits- Economic considerations	Aligned with tobacco industry interests
Kishida Faction	Support moderate tax increases	- Revenue generation- Balanced approach to public health	Partial alignment with public health advocates
Abe Faction (pre-scandal)	Mixed/Neutral	- National economic interests- International competitiveness	Balanced between industry and public health
Motegi Faction	Support gradual tax increases	- Fiscal responsibility- Incremental policy change	Aligned with Ministry of Finance proposal
Nikai Faction	Oppose rapid tax increases	- Regional economic concerns- Gradual policy shifts	Partially aligned with industry interests

Table 4: Major Attempts to Reform LDP Factional Politics

Year	Reformer	Key Reform Proposals	Outcome	Long-term Impact
1994	Electoral Reform Commission	- Introduction of single-member districts- Proportional representation element	Implemented	Reduced importance of koenkai, but factions adapted
2001-2006	Junichiro Koizumi	- Centralization of power in party leadership- Bypass traditional factional appointments	Partially successful during tenure	Temporary weakening of factions, but they rebounded post-Koizumi
2012-2020	Shinzo Abe	- Strengthened cabinet and party executive control- Emphasis on policy expertise over factional ties	Mixed results	Concentration of power in largest factions
2023	Fumio Kishida	- Ban on faction-sponsored fundraising parties- Changes to executive appointment process	Ongoing	Too early to determine

Table 5: Major LDP Factions and Their Characteristics

Faction Name	Current Leader	Approximate Size	Ideological Tendency	Key Policy Positions
<i>Seiwakai</i> (Abe Faction)	Ryu Shionoya	90 members	Conservative	Strong national defense, economic growth
<i>Kochikai</i> (Kishida Faction)	Fumio Kishida	40 members	Moderate	Balanced economic and social policies
<i>Shikokai</i> (Aso Faction)	Taro Aso	50 members	Conservative	Pro-business, fiscal conservatism
<i>Heisei Kenkyukai</i> (Motegi Faction)	Toshimitsu Motegi	50 members	Centrist	Administrative reform, economic growth
<i>Kinmirai Seiji Kenkyukai</i> (Nikai Faction)	Toshihiro Nikai	30 members	Pragmatic	Regional development, party unity

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