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The Role of Tax Policies in Combating Inflation: A Theoretical Comparison of Keynesian and Monetarist Approaches

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Abstract

Inflation is widely recognized as one of the fundamental macroeconomic challenges threatening economic stability. In addressing this issue, fiscal policy, particularly tax policy, plays a role as critical as monetary policy. This study offers a theoretical, comparative analysis of the role of tax policies in fighting inflation within the frameworks of Keynesian and Monetarist thought. While the Keynesian theory regards tax policies as an active tool within the broader strategy of aggregate demand management, the Monetarist approach conceptualizes inflation primarily as a monetary phenomenon and emphasizes the indirect effects of tax policies. The paper discusses the theoretical channels through which tax policy influences inflation, including aggregate demand, production costs, inflation expectations, and fiscal discipline. In the context of Türkiye, the study highlights a complex relationship between tax policies and inflationary pressures, driven by a tax structure heavily reliant on indirect taxation, widespread informality, and institutional weaknesses. The findings underscore the necessity of designing tax policy within a structural framework that is synchronized with monetary policy, grounded in institutional trust, and attentive to income distribution. The study also offers directions for future empirical research, including sectoral analyses, inflation expectation surveys, and comparative country case studies.

Keywords: Inflation, Tax policy, Keynesian theory, Monetarist approach, Fiscal policy

JEL Codes: E31, E62, H21, H60, B22

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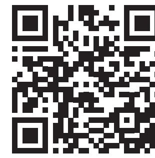

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Introduction

Inflation is commonly defined as a sustained and noticeable increase in the general price level and is widely acknowledged as one of the most critical macroeconomic threats to economic stability. In particular, high and volatile inflation undermines economic growth by distorting income distribution, increasing uncertainty in the investment climate, eroding real wages, and disrupting the structure of aggregate demand (Blanchard & Johnson, 2013). In this context, anti-inflationary policies play a vital role in ensuring economic stability and formulating sustainable growth strategies.

Although monetary policy is typically the first tool that comes to mind in the fight against inflation, fiscal policy particularly public spending and tax regulations also exerts both direct and indirect influences on price stability, especially in developing economies. The relevance of fiscal policy in this struggle emerges through various channels such as controlling public deficits, regulating aggregate demand, and managing inflation expectations (Auerbach & Gorodnichenko, 2012). Within this framework, tax policies can influence consumption and investment decisions, thereby guiding aggregate demand, while also contributing to fiscal discipline through revenue generation, helping to alleviate inflationary pressures.

The impact of tax policies on inflation is shaped not only by their magnitude but also by the structural composition of the tax system. In particular, indirect taxes are frequently emphasized in the literature for their direct influence on price levels and their regressive effects, which can worsen income inequality (Tanzi, 1989; Özden et al., 2023). By contrast, changes in direct taxation may generate more indirect and long-term effects by influencing consumption patterns and shaping inflation expectations.

Accordingly, the question of how tax policies should be designed in the context of inflation control is addressed differently by various schools of economic thought. The Keynesian approach views excess demand as the primary cause of inflation and treats tax policies as active instruments for regulating aggregate demand (Keynes, 1936). Conversely, the Monetarist approach defines inflation as a purely monetary phenomenon and contends that fiscal policy has limited influence in this context (Friedman, 1968). From a Monetarist standpoint, the role of tax policy in inflation control is largely confined to indirect channels, such as the containment of budget deficits.

Despite this, the existing literature has predominantly focused on the role of monetary policy in inflation control, while the impact of tax policy tends to be treated as a secondary concern. While the foundational differences between Keynesian and Monetarist approaches are well established in the macroeconomic literature, their comparative application to the structural tax composition and institutional constraints of developing economies such as Türkiye remains less systematically explored. In developing countries such as Türkiye, where the fiscal structure is heavily dependent on indirect taxation and suffers from structural

weaknesses, the need for theoretical exploration in this area becomes even more pronounced. This study seeks to address this gap and aims to offer a systematic theoretical contribution to the literature by analyzing both approaches in depth.

In line with this aim, the study is organized around two central research questions. First, through which theoretical channels can tax policy affect inflation under Keynesian versus Monetarist frameworks? Second, given Türkiye's reliance on indirect taxation and the presence of institutional constraints, which framework yields more coherent conceptual implications for positioning tax policy within an anti-inflation strategy? By addressing these questions, the paper contributes to the literature in three specific ways. First, it develops a channel-based typology of the tax–inflation nexus by systematically distinguishing demand, cost, expectations, and fiscal-discipline mechanisms across Keynesian and Monetarist frameworks. Second, it proposes a conceptual coordination framework that relates inflation types (demand-pull, cost-push, expectation-driven) to the relative roles and interaction of fiscal and monetary instruments. Third, it advances a tax-structure–inflation sensitivity discussion for Türkiye, showing how reliance on indirect taxation and institutional constraints condition the plausibility of theory-derived policy implications.

To address these questions, the paper compares the perspectives of these two major economic paradigms regarding the role of tax policy in combating inflation. Rather than conducting a primary econometric analysis, the discussion is developed through comparative conceptual reasoning, supported by secondary institutional sources and the broader macroeconomic literature. In addition, recent macroeconomic discussions including the Fiscal Theory of the Price Level (FTPL) (Cochrane, 2023) suggest that fiscal imbalances and expectations regarding future tax liabilities may also influence the price level, indicating that the fiscal dimensions of inflation remain highly relevant in contemporary debates. The study begins by defining inflation and its various forms, followed by an analysis of how tax policies influence inflation. Subsequently, the Keynesian and Monetarist positions on the issue are examined in detail, culminating in policy recommendations for Türkiye, framed within theoretical models. Ultimately, the paper seeks to contribute to the academic literature by offering a comprehensive theoretical perspective on the role of tax policy in inflation control, particularly within the context of developing economies.

Research Methodology

This study employs a qualitative theoretical approach to comparatively examine the role of tax policies in combating inflation within the frameworks of Keynesian and Monetarist theories. As a methodological strategy, the foundational texts of both schools (Keynes, 1936; Friedman, 1968) along with relevant contemporary literature (Blanchard & Johnson, 2013; IMF, 2023) were systematically reviewed. The impact of tax policies on inflation was analyzed across key dimensions such as demand management, fiscal discipline, and inflation expectations. The analysis

of the Turkish context was supported by Central Bank of the Republic of Türkiye (CBRT) reports, OECD assessments, and country-specific case studies drawn from the economic literature. Although the study does not rely on primary econometric modeling, it draws on secondary institutional materials and theoretical literature to adapt the analytical framework to Türkiye's structural challenges, including the predominance of indirect taxation, widespread informality, and institutional coordination problems. This paper is a conceptual-theoretical study; policy implications are derived deductively from the Keynesian and Monetarist paradigms and are not claimed as empirically identified causal effects.

The rationale for adopting this method lies in the need to capture structural and institutional constraints that may not be fully visible through econometric modeling alone, particularly in developing economies such as Türkiye, where informality, tax composition, and policy credibility shape the inflationary impact of fiscal instruments. Accordingly, a comparative conceptual analysis was deemed the most suitable approach for systematically revealing the differences between the two theoretical perspectives. For the literature review, a thematic comparative method was applied, focusing on the structural distinctions between Keynesian and Monetarist approaches along defined conceptual axes. In the analysis related to Türkiye, selected CBRT and OECD reports, as well as national academic studies, were incorporated and linked to the broader theoretical framework.

However, the primary limitation of this study is the absence of empirical testing; therefore, the conclusions should be interpreted as conceptual implications rather than empirically established causal relationships.

Definition, Core Dynamics, and Types of Inflation

Inflation is defined as a sustained and noticeable increase in the general price level and is considered a critical macroeconomic indicator in terms of economic stability. The decline in the purchasing power of a currency not only raises the cost of living for individuals but also directly influences decisions related to production, investment, and savings ultimately creating various imbalances within the economic structure (Blanchard & Johnson, 2013). A precise definition and accurate measurement of inflation are therefore essential for designing effective policy responses.

Among the most widely used indicators for measuring inflation are the Consumer Price Index (CPI), which tracks price changes in a representative basket of goods and services purchased by households, and the Producer Price Index (PPI), which monitors price movements at the producer level. These indicators provide critical insights into the impact of inflation across both consumption and production chains. However, it is important to recognize the limitations of these measures, as their coverage, basket composition, and weighting methodologies may change over time (ILO, IMF, OECD, Eurostat, UNECE & World Bank, 2004).

The causes of inflation are typically categorized into three main groups in

economic literature: demand-pull inflation, cost-push inflation, and expectation-driven inflation. Demand-pull inflation arises when aggregate demand exceeds aggregate supply. This form of inflation is often fueled by expansionary monetary and fiscal policies that stimulate consumption and investment spending beyond productive capacity, thereby exerting upward pressure on prices (Mankiw, 2021). In contrast, cost-push inflation results from increases in input costs such as energy, labor, or imported intermediate goods which are eventually passed on to consumers through higher final prices (Samuelson & Nordhaus, 2010). This type of inflation is typically triggered by supply-side shocks and often presents a trade-off between inflation control and economic growth.

The third category, expectation-driven inflation, occurs when economic agents adjust their pricing behavior based on anticipated future price increases. During periods of high inflation, expectations can become self-fulfilling, contributing to a vicious cycle of accelerating prices. In this regard, inflation targeting frameworks serve as crucial tools for managing expectations and anchoring price stability (Bernanke et al., 1999; Kara & Öğünç, 2008).

The root cause of inflation whether demand-driven, cost-based, or expectation-led has a direct bearing on the effectiveness of tax policy instruments. For instance, tax hikes may help curb consumption in cases of demand-pull inflation, whereas increases in indirect taxes during cost-push inflation may exacerbate price pressures. Therefore, selecting the appropriate fiscal tools in the fight against inflation hinges on accurately diagnosing the underlying source of inflation (Blanchard, 2024).

Given these three fundamental types of inflation, it is evident that tax policies can influence inflation through different channels. Indirect taxes, for example, may intensify cost-push inflation, while direct taxes can suppress demand and help mitigate demand-pull inflation. It is important to distinguish, however, between a one-off price-level effect and a persistent change in the inflation rate, as the pass-through of tax adjustments may differ across these two dimensions. In the case of expectation-driven inflation, the transparency and predictability of the tax system play a key role. Accordingly, the next section will examine the theoretical effects of tax policy on inflation through this multidimensional lens.

Before turning to the general theoretical transmission channels, the paper briefly situates these inflation types within the Turkish context as an illustrative case. This contextualization is intended to motivate the subsequent channel-based analysis rather than to provide empirical testing.

Illustrative Contextualization: Structural Characteristics of Inflation in Türkiye

The following discussion is not intended as an empirical analysis, but rather as an illustrative contextualization that links the theoretical transmission channels outlined above to the structural features of the Turkish economy. The inflationary

trajectory observed in the Turkish economy in recent years presents a complex and multifaceted structure that cannot be explained solely by cyclical factors. Particularly in recent years, the upward trend in inflation can be interpreted in light of a combination of elements, including exchange rate volatility and pass-through effects (Kara & Öğünç, 2008), global supply-side shocks (Blanchard, 2024), and the macroeconomic consequences of expansionary policy frameworks (Friedman, 1968; Sargent & Wallace, 1981).

Given the prominence of consumption taxes—particularly value-added tax (VAT) and the special consumption tax (SCT)—in Türkiye's tax system, changes in these indirect taxes are typically transmitted to consumer prices through standard tax pass-through mechanisms (OECD, 2025; Mammadov, 2024). This structure reveals a dual mechanism in which indirect taxes may reinforce cost-push inflationary pressures, while public spending can intensify demand-side dynamics.

Indirect taxes account for more than 65% of total tax revenues in Türkiye (OECD, 2022), which is consistent with a stronger cost-transmission channel within the price formation process. Increases in VAT and SCT, by construction, alter firms' cost structures and may be transmitted to consumer prices depending on the degree of tax pass-through and market conditions (OECD, 2025). Moreover, the frequent changes in tax regulations heighten economic uncertainty and reinforce the institutional drivers of inflation (Alesina & Perotti, 1996).

In addition, challenges related to fiscal discipline and the use of expansionary policies to finance public spending contribute to a monetary expansion that fuels inflation. The lack of effective coordination between fiscal and monetary policies can weaken inflation expectations and complicate the anchoring of price expectations, a dynamic repeatedly noted in recent IMF and CBRT assessments of the Turkish economy (IMF, 2023; CBRT, 2022). Indeed, recent assessments by the Central Bank of the Republic of Türkiye (CBRT) and international institutions have increasingly emphasized that Türkiye's price dynamics are shaped not only by supply and demand conditions but also by institutional and structural factors (IMF, 2023; CBRT, 2022).

In developing economies, as exemplified by the case of Türkiye, inflation is shaped not only by supply–demand imbalances but also by structural factors such as institutional fragilities, the inequitable composition of the tax system, and political uncertainty (Hausmann et al., 2008). The repercussions of these structural constraints are rendered more visible through their reflections in the labor market, particularly in the historical trajectory and sectoral distribution of female employment, which are closely associated with broader patterns of economic vulnerability (Özçiftçi & İncekara, 2023). Accordingly, a growing strand of the literature argues that anti-inflationary strategies are not confined to monetary instruments alone, but also encompass structural and institutional reforms.

Inflation in Türkiye does not stem from a single source but rather from a combination of demand, cost, and expectations-based dynamics. For example,

exchange rate shocks can fuel cost-push inflation through exchange rate pass-through mechanisms, while expansionary fiscal and monetary measures may stimulate demand-side pressures, complicating the anchoring of inflation expectations and potentially deepening inflationary dynamics (IMF, 2023; CBRT, 2022; Kara & Öğünç, 2008). Within this complex framework, tax policies can simultaneously play a cost-increasing role (via indirect taxes) and a demand-suppressing role (through income taxation).

These structural dynamics require that tax policies be examined not only through an economic lens but also in terms of their institutional and governance dimensions. Therefore, the inflationary effects of taxation should be assessed not only from a technical standpoint but also in relation to institutional credibility and political stability. The analysis now turns to the general theoretical transmission channels through which tax policy can affect inflation, which then provides the basis for the Keynesian and Monetarist discussions in the subsequent sections.

Theoretical Transmission Channels of Tax Policy on Inflation

It is widely acknowledged, especially in the context of developing economies, that fiscal policy plays a role as vital as monetary policy in addressing inflation. Within this scope, tax policy is not merely a tool for increasing government revenues but also a strategic policy component for ensuring macroeconomic stability. The structure and implementation of the tax system can influence the general price level both directly and indirectly through various channels, such as aggregate demand, production costs, inflation expectations, and fiscal balance. This section examines these effects under four main channels, followed by a general assessment within the framework of policy synchronization.

Real Economic Effects: Demand and Cost Channels

The direct impact of tax policy on inflation primarily operates through the real economy. In this regard, direct taxes reduce household disposable income and thereby constrain aggregate demand, while indirect taxes increase production and consumption costs, exerting upward pressure on the general price level.

Within the Keynesian framework, increases in direct taxes during periods dominated by demand-pull inflation reduce disposable income, curtail consumption and investment, and consequently help stabilize prices by dampening aggregate demand (Musgrave & Musgrave, 1989). However, the effectiveness of this mechanism depends heavily on structural factors such as the prevalence of the informal economy and voluntary tax compliance rates (Schneider & Enste, 2000). In Türkiye's case, the high level of informality significantly weakens the ability of direct taxes to influence aggregate demand. From a Keynesian perspective, this can be interpreted as an attenuation of the automatic stabilizer mechanism. Automatic stabilizers rely on a broad and effectively administered tax base to generate countercyclical income adjustments. When informality is widespread and administrative capacity is limited, the transmission from tax changes to disposable

income and aggregate demand becomes weaker, thereby reducing the stabilizing capacity of fiscal policy. In such contexts, discretionary fiscal interventions may be required to compensate for the structural weakness of automatic stabilizers.

On the other hand, indirect taxes especially Value-Added Tax (VAT) and Special Consumption Tax (SCT) form a direct transmission mechanism between production costs and final consumer prices, making them one of the key drivers of cost-push inflation (Tanzi, 1989).

It is important, however, to distinguish between a one-off price-level effect and a persistent increase in the inflation rate. An increase in indirect taxes typically generates an immediate upward adjustment in the price level through cost pass-through mechanisms. Yet, unless accompanied by accommodative monetary policy or sustained expectation shifts, such tax-induced shocks do not necessarily translate into continuous inflation. Therefore, the inflationary impact of indirect taxation depends on whether the initial level effect becomes embedded in expectations and wage-setting behavior.

According to OECD (2022) data, indirect taxes account for more than 65% of total tax revenues in Türkiye. This structure may contribute to price volatility and is often associated with regressive distributional effects, as consumption taxes tend to place a relatively higher burden on lower-income households (OECD, 2022; Tanzi & Zee, 2000). Therefore, the structural composition of the tax system is a critical determinant in fighting inflation through supply-side channels.

Expectations and Fiscal Discipline: Institutional and Financial Dynamics of Inflation

Tax policy affects inflation not only through real economic channels but also via more indirect yet equally important mechanisms, such as expectations, institutional credibility, and fiscal discipline.

Given that inflation arises not only from current supply-demand imbalances but also from agents' expectations about the future, the predictability and consistency of the tax system become especially important. More broadly, recent literature suggests that central banks increasingly discuss price stability within a broader macro-financial risk framework, incorporating systemic risk considerations into their supervisory and policy agendas, thereby reinforcing the importance of credible and predictable fiscal (including tax) policy in anchoring expectations (Özçiftçi, 2025). Frequent, temporary, or unpredictable tax changes generate uncertainty in the markets and may adversely affect inflation expectations (Alesina & Perotti, 1996). According to the rational expectations hypothesis developed by Lucas (1976), economic agents form their price-setting behavior based on past policy patterns, which are directly reflected in inflation dynamics. In Türkiye, fiscal policy unpredictability is seen as a factor that undermines the credibility of monetary policy (Akçay & Alper, 2006).

Moreover, when tax revenues are insufficient to finance public spending, budget deficits are often covered through borrowing or monetary expansion, which in turn becomes a major source of inflationary pressure (Sargent & Wallace, 1981). Modern extensions of this line of reasoning, particularly the Fiscal Theory of the Price Level (Cochrane, 2023), suggest that expectations of unsustainable future deficits and insufficient fiscal backing may affect current price dynamics even in the absence of immediate monetary expansion. This argument is closely related to the concept of fiscal dominance, where monetary policy becomes subordinated to fiscal financing needs. Under fiscal dominance, even a formally independent central bank may be constrained to accommodate public deficits, thereby weakening its capacity to anchor inflation expectations. In such settings, inflation dynamics cannot be understood solely through monetary aggregates, but must also be analyzed in relation to fiscal sustainability and the intertemporal government budget constraint. From the Monetarist perspective, the impact of tax policy on inflation is not direct but rather indirect operating through its role in maintaining fiscal discipline (Friedman, 1968). In Türkiye, persistent structural deficits in public finance often place pressure on monetary policy and negatively affect inflation expectations (Uygur, 2001). Therefore, expanding the tax base, improving the quality of tax revenues, and financing budget deficits through sustainable means are key policy priorities for ensuring price stability.

Having outlined the real-economy channel (demand and cost) as well as the expectations and fiscal-discipline mechanisms, the analysis now turns to the coordination problem between fiscal and monetary authorities. This synchronization dimension matters because the inflationary impact of tax policy depends not only on its design but also on how it interacts with monetary policy and expectation management.

Policy Synchronization and Theoretical Evaluation

As discussed in earlier sections, the inflationary effects of tax policy extend beyond its influence on demand, costs, expectations, and fiscal discipline; they are also contingent upon the level of coordination with monetary policy. The conventional approach in economic policy prioritizes synchronized and complementary implementation of fiscal and monetary tools to achieve price stability. In this framework, monetary policy directly targets inflation via short-term interest rates, liquidity management, and expectation anchoring, while fiscal policy contributes indirectly by influencing aggregate demand, public finance, and expectations through spending and taxation instruments (Blanchard & Johnson, 2013).

Blanchard and Galí (2010) emphasize that these two policy components must function in harmony rather than in opposition to ensure macroeconomic stability. Particularly during crises, striking a balance between the flexibility of fiscal policy and the rule-based nature of monetary policy is crucial. In this context, tax policy should be seen not merely as a technical budgetary instrument but as a strategic

component of macroeconomic governance.

The following subsections provide an applied dimension to the theoretical framework by detailing how policy synchronization strategies vary depending on the type of inflation and how institutional conditions shape their effectiveness.

Synchronization Strategies Based on Types of Inflation

The origin of inflation whether demand-pull, cost-push, or expectation-driven determines the relative effectiveness and focus of fiscal and monetary policies. Hence, policy synchronization should not follow a one-size-fits-all model but rather be adapted to the underlying drivers of inflation.

In the case of demand-pull inflation, where aggregate demand exceeds productive capacity, fiscal policy measures particularly tax-based tools aimed at curbing demand play a frontline role. Increasing direct taxes or temporarily raising consumption taxes can reduce domestic demand and ease inflationary pressures (Musgrave & Musgrave, 1989).

Cost-push inflation, on the other hand, is caused by rising input costs. In such cases, monetary policy becomes less effective, and raising indirect taxes (such as VAT and SCT) may further amplify inflation by increasing costs. Therefore, combating cost-push inflation may require tax reductions, tax incentives, or relief in the tax burden on production.

When inflation is driven by expectations, the consistency and predictability of both fiscal and monetary policies become critical. Frequent changes in tax legislation can distort agents' pricing behavior and worsen inflation expectations. In such scenarios, a transparent, stable, and simplified tax system aligned with monetary policy may serve as an effective tool for anchoring expectations (Lucas, 1976).

This analysis illustrates that neither fiscal nor monetary policy alone is sufficient to combat inflation; rather, strategic combinations tailored to the specific type of inflation are essential for effective intervention.

Institutional Preconditions for Policy Synchronization

The coordination of fiscal and monetary policies depends not only on technical alignment but also on institutional capacity and governance quality. In developing economies, factors such as institutional independence, transparency, and fiscal discipline are fundamental to successful synchronization.

In countries like Türkiye, limited central bank independence weakens the effectiveness of monetary policy and undermines inflation targeting frameworks (Akçay & Alper, 2006). Under such circumstances, fiscal policy must be designed in a more proactive and responsible manner to preserve price stability.

In addition, frequent and unpredictable changes in tax policy create uncertainty for market actors and negatively influence both pricing behavior and investment decisions. Therefore, designing tax policies in accordance with the principle of institutional predictability enhances the credibility of both fiscal and monetary policy (Alesina & Perotti, 1996).

Ensuring fiscal discipline also plays a crucial role in reducing monetary pressures and preserving the autonomy of the central bank. As argued in the Monetarist tradition, when fiscal discipline is compromised, indirect financing pressures on the central bank may lead to monetary expansion and, consequently, inflation (Sargent & Wallace, 1981).

In conclusion, the success of policy synchronization depends not only on technical coherence but also on the quality of institutional capacity, the degree of coordination among policymakers, and the overall climate of societal trust. In contexts like Türkiye, where institutional independence and fiscal discipline are under strain, the effectiveness of synchronized policy responses can only be ensured through a comprehensive reform agenda.

The Role of Tax Policy in Combating Inflation from a Keynesian Perspective

Building on the channels discussed in the previous section namely, aggregate demand, cost structures, expectations, and fiscal discipline this section analyzes the impact of tax policy on inflation through the lens of Keynesian macroeconomic theory. Developed in response to the Great Depression of the 1930s, Keynesian economics attributes macroeconomic fluctuations primarily to insufficient aggregate demand. According to this approach, market mechanisms alone are not flexible enough to ensure full employment in the short run, thereby necessitating active government intervention. This intervention is carried out primarily through fiscal policy instruments, including public expenditures and tax policies (Keynes, 1936). Within the Keynesian framework, tax policy is not merely a means of generating public revenue but also a powerful tool for influencing aggregate demand and maintaining price stability. In periods characterized by demand-pull inflation, tax policy can curb domestic demand and help contain inflationary pressures (Mankiw, 2021).

Aggregate Demand Management and Countercyclical Adjustments

In the Keynesian model, fiscal policy plays a decisive role in managing economic fluctuations. Increases in public spending or tax cuts stimulate aggregate demand, whereas reductions in public expenditures or tax hikes contract demand and ease inflationary pressure (Musgrave & Musgrave, 1989). In particular, increased direct tax burdens on low- and middle-income groups reduce disposable income and limit consumption, thereby facilitating the control of demand-side inflation. In this context, a progressive tax system functions as an automatic stabilizer, helping

to smooth out economic cycles (Blinder, 2006).

The Keynesian view holds that tax policies should be responsive to the business cycle. Raising tax rates during inflationary periods and lowering them during recessions can stabilize aggregate demand and limit price volatility (Elmendorf & Furman, 2008). Temporary tax increases can contribute to suppressing inflationary pressure while also helping to reduce budget deficits. However, the effectiveness of such adjustments depends on factors like timing, the consideration of social impacts, and the sustainability of implementation. In developing countries, the effects of these fiscal adjustments on consumption are generally more pronounced and should therefore be supported by targeted social transfers to protect lower-income groups (Tanzi & Zee, 2000).

The Role of Tax Policy in Macroeconomic Models

In Keynesian analysis, the impact of tax policy on aggregate demand is typically explored using the IS-LM and AD-AS models. The IS-LM model analyzes the simultaneous equilibrium in goods and money markets and suggests that tax increases reduce disposable income, thereby shifting the IS curve leftward. This results in lower output levels and reduced inflationary pressure (Blanchard & Johnson, 2013). Similarly, in the AD-AS model, an increase in taxes shifts the aggregate demand (AD) curve leftward, leading to lower price levels. However, the magnitude of this effect depends on how close the economy is to full employment. In economies operating below potential output, tax hikes may suppress economic growth more significantly (Romer, 2006). Therefore, macroeconomic indicators such as the output gap, capacity utilization, and aggregate demand trends should be considered in the design of tax policies.

Contemporary discussions of these models have moved beyond classical frameworks to incorporate dynamic analyses that account for behavioral responses, time lags, and expectations. In developing countries, where economic volatility tends to be higher, the predictive power of classical models is often limited, making contextual interpretation of model outcomes essential in policy design (Blanchard, 2024).

Effectiveness of Tax Policy under Price and Wage Stickiness

One of the core assumptions of Keynesian economics is the short-term rigidity of prices and wages. This rigidity delays the self-correcting mechanisms of the market and necessitates government intervention. Tax policies, without directly intervening in price-setting, can play an effective role in stabilizing prices through the demand channel. However, the degree of this effectiveness depends on several structural factors, including the design of the tax system, the size of the informal economy, income inequality, and the composition of public spending.

In developing countries like Türkiye, the heavy reliance on indirect taxation, sensitivity of consumption patterns, and prevailing income disparities make the

implementation of effective tax policy more complex. Consequently, the Keynesian approach emphasizes the importance of carefully targeted tax policies that align with the prevailing economic cycle and are supported by complementary mechanisms that uphold social justice.

The next section will present the Monetarist perspective a contrasting school of thought that conceptualizes inflation primarily as a monetary phenomenon and explore its interpretation of the role of tax policy in inflation control.

The Indirect Effects of Tax Policy on Inflation from a Monetarist Perspective

This section evaluates the influence of tax policy on inflation within the framework of Monetarist economic theory, which conceptualizes inflation fundamentally as a monetary phenomenon. Emerging prominently in the wake of the stagflation crisis of the 1970s, the Monetarist approach asserts that controlling the money supply is essential for achieving price stability. Milton Friedman's well-known assertion that "inflation is always and everywhere a monetary phenomenon" (Friedman, 1968) encapsulates the core of this school of thought. In this framework, tax policy is not regarded as a primary instrument for inflation control, but rather as a secondary mechanism with indirect effects through fiscal balance and monetary expansion dynamics.

Inflation as a Monetary Phenomenon and a Cautious Stance Toward Fiscal Policy

According to the Monetarist view, persistent increases in the general price level are a result of excessive growth in the money supply that outpaces the production of goods and services. When money supply expands faster than the economy's productive capacity, aggregate spending rises, placing upward pressure on prices (Mishkin, 2016). Consequently, controlling money supply is viewed as the central tool in combating inflation. In contrast, fiscal policy is perceived as having limited and indirect effects due to implementation lags, political susceptibility, and uncertainty in execution (Barro, 1978).

Lucas (1976) emphasizes the politically driven nature of fiscal policies and argues that such influences can hinder economic stability. Hence, the Monetarist school adopts a cautious stance toward fiscal instruments, advocating for price stability to be maintained through central bank independence and rule-based monetary frameworks (Sargent & Wallace, 1981).

Indirect Transmission Mechanism: Tax Policy, Budget Deficits, and Monetary Expansion

Within the Monetarist framework, the influence of tax policy on inflation is realized indirectly through its role in maintaining fiscal discipline and managing public deficits. When tax revenues fall short, governments may resort to borrowing or central bank financing, both of which can expand the money supply and

intensify inflationary pressures (Feldstein, 1982). A robust tax base, therefore, not only ensures fiscal sustainability but also supports the autonomy of monetary policy by reducing the need for monetary financing.

In developing countries like Türkiye, where fiscal deficits are frequently monetized and the tax system relies heavily on indirect taxation, this indirect relationship becomes even more pronounced. Effective implementation of tax policy not only helps maintain fiscal balance but also contributes indirectly to achieving price stability.

Interest Rates, Public Borrowing, and the Crowding-Out Effect

According to the conventional macroeconomic view, when public deficits are financed through borrowing rather than taxation, the increased demand for loanable funds may place upward pressure on interest rates and reduce private investment. This mechanism is commonly described as the crowding-out effect. In this sense, the impact of tax policy on investment and inflation is not direct, but works through the government's financing requirements and their interaction with monetary conditions. However, this interpretation is not uncontested. From the Ricardian equivalence perspective associated with Barro (1974), forward-looking households may internalize future tax liabilities, thereby weakening the aggregate-demand effects of debt-financed fiscal actions.

This structural relationship reinforces the secondary role of fiscal policy in the money supply–interest rate balance and highlights the necessity for tax and expenditure decisions to align with the objectives of monetary policy in the fight against inflation.

The Neutrality of Money and the Long-Term Limitations of Fiscal Policy

A central assumption in Monetarist theory is the neutrality of money, which posits that changes in the money supply affect only the price level in the long run, with no lasting impact on real macroeconomic variables such as output, employment, or investment (Friedman, 1968). Based on this principle, the long-term effectiveness of fiscal policy is also considered limited, and fiscal tools are not seen as primary instruments in controlling inflation.

Taylor (1993) emphasizes that maintaining price stability requires central banks to act according to predictable, rule-based policies free from political interference. In this framework, tax policy is viewed more as a tool for ensuring fiscal discipline than as a direct mechanism for influencing inflation. Accordingly, the Monetarist approach attributes meaningful inflation control to the prevention of monetary expansion and the promotion of fiscal sustainability rather than to activist fiscal measures.

The Monetarist approach largely considers the effects of tax policy on inflation to be indirect and secondary. Core determinants of price stability include control of

the money supply, central bank independence, and adherence to fiscal discipline. In contrast to the Keynesian emphasis on proactive fiscal policy, the Monetarist school maintains a cautious distance and places monetary management at the center of macroeconomic stabilization.

The next section will offer a comparative analysis of Keynesian and Monetarist perspectives, providing a multidimensional assessment of the role of tax policy in inflation control.

Theoretical Comparison and Discussion

This section presents a comparative evaluation of the Keynesian and Monetarist approaches, previously discussed in Sections 4 and 6, within the context of their theoretical assumptions regarding the causes of inflation and the role of tax policy. In addition, it explores emerging hybrid policy strategies, evolving flexibility trends in contemporary literature, and the practical applicability of these approaches across different country typologies. The goal is to provide a comprehensive assessment of the place of tax policy in combating inflation.

Theoretical Divergence and Interpretations of Tax Policy

Keynesian theory generally defines inflation as a macroeconomic imbalance that arises when aggregate demand exceeds aggregate supply (Keynes, 1936). Therefore, this school of thought prioritizes active fiscal policy, particularly the use of tax instruments to regulate domestic demand (Blinder, 2006; Musgrave & Musgrave, 1989). During periods of economic expansion, tax increases are expected to curb demand and reduce inflationary pressure, while the automatic stabilizer function of progressive taxation is considered a key feature enhancing the effectiveness of fiscal policy.

In contrast, the Monetarist school conceptualizes inflation primarily as a monetary phenomenon, caused by unchecked growth in the money supply (Friedman, 1968). Within this framework, tax policy is seen as having limited and indirect effects on inflation. It does not directly influence prices but can contribute indirectly through ensuring fiscal discipline, preventing the monetization of deficits, and preserving central bank independence (Sargent & Wallace, 1981; Barro, 1978).

This theoretical divergence extends beyond academic debate to shape practical policy preferences. While the Keynesian approach allows for flexible, short-term interventions, the Monetarist model emphasizes long-term price stability through rule-based, predictable monetary policy (Romer, 2006).

Flexibility in the Literature and Hybrid Approaches

Recent economic literature indicates a softening of the sharp theoretical divide between Keynesian and Monetarist views, with a growing shift toward context-sensitive, flexible policy strategies. Particularly in the post-COVID-19 era, the

coordinated application of expansionary fiscal and monetary policies has enabled many countries to implement short-term inflation control measures (Blanchard, 2024).

Nevertheless, in extraordinary periods such as stagflation characterized by high inflation coupled with economic stagnation traditional policies often prove inadequate. Keynesian expansion may fuel demand-side pressures, while Monetarist tightening can deepen economic contraction (Bruno & Sachs, 1985). In such dilemmas, supply-side reforms, tax base broadening, cost-reduction strategies, and synchronization between fiscal and monetary policy become essential (Calmfors & Driffill, 1988).

Modern approaches recommend not only technical coordination between fiscal and monetary policies but also institutional coherence. Blanchard and Galí (2010) highlight the need for balancing the flexibility of fiscal policy with the rule-based discipline of monetary policy not only to ensure price stability but also to reinforce institutional credibility (Mishkin, 2016; Woodford, 2003).

Implementation Capacity in the Context of Country Typologies

The practical implications of these theoretical approaches vary according to countries' macroeconomic structures, fiscal capacities, and institutional quality. Thus, the role of tax policy in managing inflation depends not only on theoretical validity but also on implementation capacity. Key determinants include the structure of the tax system, informality rates, public borrowing needs, central bank independence, and the quality of governance.

Diverging Dynamics in Advanced and Developing Economies

Advanced economies typically benefit from strong institutional frameworks, broad-based direct taxation, and relatively low public borrowing needs. In these countries, price stability is largely maintained through independent and rule-based monetary policy, while fiscal policy acts primarily as an automatic stabilizer. Within this context, tax policy functions as a tool for maintaining fiscal sustainability without disturbing macroeconomic balance (Clarida et al., 2000).

Conversely, in developing economies, high levels of informality, narrow tax bases, volatile capital flows, and external fiscal dependence necessitate more active fiscal policy. Limited central bank independence and reliance on indirect taxation often contribute directly to price instability and cost-push inflation. As such, the flexible, demand-side tools offered by the Keynesian framework may be more applicable in developing contexts (Tanzi & Zee, 2000; Hausmann et al., 2008).

Fiscal Structures and Inflation Sensitivity

There is a strong correlation between a country's tax structure especially the share of indirect taxation and the degree of inflation pass-through. In economies where indirect taxes (e.g., VAT, SCT) constitute a significant portion of total tax

revenues, changes in tax policy tend to have immediate and pronounced effects on prices. As a result, tax hikes may intensify inflationary pressures, while tax cuts though potentially necessary may jeopardize fiscal discipline.

By contrast, systems based on direct taxation exhibit more delayed and indirect effects on price levels. In such contexts, monetary and fiscal policies can be more easily harmonized. In countries like Türkiye, where indirect tax reliance and high informality coexist, tax policy impacts inflation through both cost and expectation channels, creating a dual transmission mechanism.

Institutional Capacity and Policy Effectiveness

The effectiveness of tax policy is shaped not only by economic structure but also by the institutional environment. Frequent changes in tax regulation, unpredictable fiscal measures, and politically exposed public finance systems can erode trust and undermine inflation control efforts. In systems with limited central bank independence, fiscal policy assumes a more prominent role in inflation management. However, without proper coordination, short-term solutions risk exacerbating long-term imbalances (Alesina & Perotti, 1996; Akçay & Alper, 2006).

Accordingly, countries with strong institutional capacity may adopt the Monetarist preference for predictable, limited fiscal intervention. In contrast, developing countries with weaker institutions may benefit more from active and targeted tax policies that influence both demand and expectations.

Example Typologies Based on Implementation Capacity

To enhance the applicability of theoretical frameworks, countries can be classified into typologies based on structural characteristics. Below are three proposed example typologies:

Country Type	Tax Structure	Monetary Policy	Inflation Dynamic	Recommended Approach
Type A	Predominantly direct taxation, strong tax base	Independent central bank	Expectation-driven inflation	Monetarist approach
Type B	High indirect tax rates, widespread informal economy	Limited monetary policy independence	Cost-push and demand-pull inflation	Hybrid anti-inflation strategy with fiscal discipline and structural tax reform
Type C	Mixed structure, moderate level of fiscal discipline	Limited institutional coordination	Mixed inflation structure	Hybrid policy synchronization

These typologies illustrate how tax policies should be positioned across different national contexts and provide an analytical foundation for identifying the conditions under which specific policy recommendations may be valid.

General Assessment

This section has presented a comparative analysis of Keynesian and Monetarist theories based on their divergent perspectives on the causes of inflation and the role of tax policy in that process. The evaluation reveals that both approaches retain relevance under particular economic conditions; however, relying solely on a single theoretical framework may be insufficient to explain complex macroeconomic dynamics.

In the context of developing countries in particular, it becomes evident that flexible and context-sensitive policy frameworks designed through effective synchronization between fiscal and monetary instruments are essential. When considered as part of such a coherent policy mix, tax policy emerges not only as a tool for maintaining price stability but also as a multidimensional instrument capable of supporting fiscal discipline, fostering investment confidence, and promoting social stability.

The final section will present short- and long-term policy recommendations for the Turkish case and offer a detailed discussion of how theoretical insights may translate into practical policy implementation.

Policy Recommendations for Türkiye and Conclusion

Within the scope of this study, the effects of tax policy on inflation were analyzed theoretically in light of Keynesian and Monetarist approaches. Based on this framework, and taking into account the structural characteristics of the Turkish economy, applicable policy recommendations have been formulated. These recommendations should be read as theory-based implications that are consistent with the two paradigms, rather than as empirically tested prescriptions. This section first provides a critical assessment of the current tax system and then outlines short- and long-term recommendations.

Structural Issues in Türkiye's Tax System

Türkiye's current tax structure is heavily reliant on indirect taxes. High rates of consumption-based taxes such as Value-Added Tax (VAT) and Special Consumption Tax (SCT) exert cost-side pressure on prices and fuel inflationary trends. Moreover, because these taxes are applied uniformly without regard to income levels, they impose a disproportionate burden on low-income groups and exacerbate income inequality (OECD, 2022).

Additionally, reductions in corporate tax rates have not produced the desired stimulus for capital investment. Legal uncertainties, high financing costs, and macroeconomic volatility can limit the effectiveness of corporate tax incentives when implemented in isolation (Feldstein, 1982). Therefore, rather than focusing solely on tax rate reductions, a comprehensive improvement in the investment climate appears to be more consistent with the broader structural dynamics identified in this study.

Short- and Long-Term Policy Recommendations

In periods dominated by demand-pull inflation, tax-based measures may in principle be used to restrain domestic demand. However, in Türkiye, generalized increases in consumption taxes such as VAT and SCT may simultaneously intensify cost-push inflation due to high tax pass-through and the already heavy reliance on indirect taxation. Therefore, under Türkiye's structural conditions, anti-inflationary tax design should prioritize selective taxation of luxury consumption, the broadening of direct tax bases, and revenue-neutral tax restructuring rather than generalized increases in indirect taxes. However, such measures may be more effective when accompanied by targeted social transfer mechanisms aimed at protecting low-income households (Blanchard & Perotti, 2002).

In the long term, a structural transformation of the tax system emerges as a priority within the theoretical framework developed in this study. A gradual reduction in the share of indirect taxes in total revenue, in favor of more progressive direct taxation, would be consistent with the theoretical implications discussed above. Broadening the tax base, combating informality, expanding digital tax collection systems, and enhancing the transparency of tax incentives would strengthen fiscal sustainability and reinforce the effectiveness of monetary policy (Tanzi, 1989; Feldstein, 1982).

Tax policy may be more appropriately understood not merely as a revenue-generation tool, but as a structural lever that can contribute to macroeconomic stability. Accordingly, fiscal policies are likely to be more effective when designed in coherence with inflation targeting frameworks and when coordinated with monetary policy in a manner that preserves central bank independence (Blanchard, 2024).

Conclusion and Future Research Directions

The core findings of this study suggest that the inflationary impact of tax policy operates through multiple channels. While the classical Monetarist perspective tends to treat this impact as largely indirect through fiscal discipline and monetary accommodation, modern approaches also indicate that fiscal imbalances, tax structure, and expectations regarding future liabilities may shape price dynamics more directly. In the context of Türkiye, restructuring the tax system, strengthening direct taxation, and improving the effectiveness of tax incentives appear to be closely aligned with the objective of enhancing price stability, social justice, and economic sustainability.

Future research could reinforce these theoretical evaluations through empirical testing and thereby clarify the causal mechanisms underlying the policy implications discussed in this study. In this regard, the following topics are particularly important:

Sectoral Impact Analyses: The effects of tax increases on production costs,

pricing strategies, and investment decisions across different sectors can be examined in detail to reveal the sectoral sensitivity of tax policy.

Impact of Tax Reforms on Investment Behavior: Structural reforms in direct taxation may be assessed through panel data analysis to evaluate their influence on firms' investment tendencies, capacity utilization, and employment levels.

Expectation Surveys and Modeling Approaches: The relationship between inflation expectations and tax policies can be measured using household and firm surveys, and analyzed through dynamic models to understand how expectations translate into pricing behavior.

Institutional Trust and Policy Predictability in the Tax System: The impact of frequently changing tax legislation on economic actors' perception of trust can be investigated through qualitative methods and experimental studies.

Comparative Analysis with Developing Countries: Türkiye's tax policy impact on inflation can be examined in comparison with other developing economies that share similar macroeconomic characteristics, helping to generate broader insights into policy effectiveness.

Empirical testing of the dual transmission mechanism: Future studies may examine how indirect taxation in developing economies such as Türkiye simultaneously affects inflation through both cost pass-through and expectation channels.

Such multidimensional research would provide a strong foundation for both testing the empirical validity of the theoretical framework and designing applicable, goal-oriented tax policies in developing countries such as Türkiye.

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