

# CHAPTER ONE

## INTRODUCTION

### 1.1 General Background

Nepal is small land locked country edged between two economically strong neighboring countries, India and China. Agriculture is the main source of livelihood of the people of Nepal. About 80 percent of the people are engaged in this sector. The contribution of this sector to GDP is estimated to be 38 percent (CBS, 2007:2). Only 42 percent of the agriculture land is irrigated. Nepal is one of the poorest countries in the world with the GNP per capita of \$ 270 in 2006/2007. About 31 percent of the people are estimated to be below absolute poverty line. Only 53.7 percent of the population (six years and above) are literate. In recent years, economic growth rate is confined to 3 to 3.4 percent per annum which exhibits that the economic progress is far below the expectation (Dahal, 2004:15), so to reduce poverty and for economic development, government invest huge amount in the field of transportation, communication, power, road and other basic infrastructure. To invest in all these areas, government needs higher amount of revenue but the source of revenue is very small and limited. Thus, government has to borrow which are fulfilled by internal and external sources.

Majority of the people are deprived of basic needs such as food, clothing, basic education, health care and shelter. So other facilities like education, health, nutrition, pure drinking water, industrialization etc. are beyond the expectation. Although, Nepal is second richest country in the world on water resources after Brazil, a small percentage (just more than 20 percent) of the population have access to electricity. About 90 percent of the population lives in rural areas. There is wide disparity in income distribution (Kharel and Bhandari, 2007:25).

In Nepal, the private sector is not well developed. Lack of modern technology, technical knowledge, skilled and trained manpower, political instability, lack of appropriate government policy and its implementation are the major factors that are discouraging the private sector. Beside these, due to the absence of strong and effective financial markets and modern banking system, and the collection of scattered saving has become very difficult. So to lead the economy, and to the pace of development efforts, the government has to invest a huge amount in the field of socio-economic services like school, roads, bridges, school, drinking

water and health facilities, irrigation, hydropower etc. as well as in the field of direct productive activities, but also in other direct productive economic activities like estate blushing factories and running them so that development process could be accelerated. The government expenditure started to increase, which were not possible to meet only through revenue collection. When the government expenditure exceeds revenue, a deficit arises in the budget of the country. In this context, the most appropriate method is the method of debt finance which is preferred by all for the mobilizing financial resources to bridge fiscal deficits in the government budgetary.

Nepal is facing a growing financial gap on one hand and problem of increasing inflation and population growth on the other. To mitigate and avoid the resource gap and to mobilize the financial resources there is need of public debt and its appropriate management. The sources of finance have to be supplemented by borrowing as a large scale from the banking sources and other financial institutions internally and externally. Therefore the need of public debt for mobilizing additional financial resource is a comparatively modern phenomenon and has come into existence with the development of a democratic form of government.

The government gets its income mainly from two sources, namely, public revenue and public debt (borrowing). Public revenue consists of all income of receipts (tax and non-tax) and public debt carries with it the obligation to pay money back to persons, institutions or countries from whom it has been obtained. "The accumulated amount of what, the government has borrowed to finance past deficit is called public debt" (Samuelson, 1992:628). An Internal debt is owed by a nation to its own citizens and it posses internal burden to a country. An external debt is owned by a nation from foreigners and it is more burdensome.

When we come to talk of the situation of public debt in Nepal, its first experience of foreign economic assistance was heralded by the POINT FOUR program agreement signed on 23 January 1951. It was introduced since 1951 with foreign assistance under the POINT FOUR program accompanying the first budget speech. When Nepal introduced the first five year plan for economic development in the year 1956, since then public expenditure is increasing rapidly. In any country, the duty of government is to fulfill the need of the public like education, health, communication and transportation etc. For these, the country

needs more amount of capital. Tax revenue only is not sufficient thus borrowing is needed. Nepal started planning in 1956. In the first two five years plan, the major goals were to collect the information about the economic variables. From 1970, government started investing directly in productive activities which increased the volume of government expenditure, but at the same time demand for goods and services increased due to increased government expenditure. Revenue could not be increased to fulfill the required expenditure. So government has to rely upon debts because other sources are stagnant.

Form 1964, government started to use deficit financing. The deficit is fulfilled by printing money, borrowing form home and abroad. Many development projects also initiated with the assistance of foreign countries. On the other hand, the internal causes of increased government expenditure and inflation compelled government to accept and take debts. Until 1980s, it was accepted that foreign debt creates political instability, colonization and dependency. So, government didn't use foreign debt for development activities but now-a-days, no one object foreign loan as this is the age of liberalization and globalization. The foreign countries' experiences like South Korea, Singapore got extra lessons for Nepalese government because these countries achieved development with the assistance of foreign countries.

The situation of public debt in Nepal, it is heavily dependent upon external debt. The trend of the public debt is increasing more rapidly than internal debt. So, in the Nepalese context, no doubt, if the trend of external debt goes on like this, Nepal will fall in the 'debt trap'. The importance of the public debt may be appreciated in terms of the strategic role which the government has to play in the initial stage of development. It has always been the task of government to create some minimum pre-conditions of development such as building up of social and economic overheads which don't generally attach private important work, usually require huge amount of resources but don't promise immediate returns. Thus the government has to play a positive and dynamic role in stimulating the rate of capital formation and promoting the rapid development of a country.

The government of a country may borrow because current revenue may not have sufficient to meet its increasing expenditure. In the context of underdeveloped country like Nepal is passing through the critical phase of low-income level equilibrium trap, vicious circle of poverty and huge resource gap.

This problem can be solved not only by the investment form private sector but also by the deliberate actions of the government in the field of transportation, communication, power, road, other basic infrastructure and directly productive activities. For this, the regular sources of government revenue are insufficient to meet the required expenditure. So, government has to make deficit budget, which depend upon borrowing from internal and external sources. External sources include foreign loan and grants from bilateral and multilateral agencies whereas internal sources include individuals, financial institution, non banking financial institution, commercial banks, central bank etc.

In recent years, the subject matter of public debt is concerned with economic and social development of the country. There are several technique financing economic development are put into operation in the process of economic development of underdeveloped countries. Thus, public debt is considered as effective instrument of fiscal as well as monetary policy which helps to increase revenue, saving mobilization and control the inflation. External public debt is more essential for underdeveloped countries as compared to developed countries because of the limited availability of internal resources. At the same time, most of the UDCs face the shortage of foreign exchange, which can be funded by external public debt. Therefore only external borrowing remains the alternative to stimulate economic development in the underdeveloped countries. The external debt may be from bilateral sources or from multilateral sources.

The persistence features of Nepal's public debt both internal and external have been increasing rapidly each year. The trend of external debt is increasing more rapidly in absolute terms than internal debt. Since developing countries like Nepal always need foreign currencies to import many capital goods required for development, these countries have to depend more on external borrowing than internal for favorable balance of payment, maintaining the availability of foreign exchange and controlling of inflation.

## **1.2 Statement of the problem**

In Nepalese economy, the private sector is not well-developed. Due to low per capita income, low private saving rate is consequently the private sector investment is low. Moreover, due to scattered saving and lack of effective

mechanism for mobilizing the scattered savings, it has become very difficult to induce the private sector to save and invest more. This results the deficiency of capital and low rate of capital formation. So to accelerate the pace of development, capital formation from the public sector is essential. But as being the underdeveloped country, such a required capital cannot be obtained from the internal sources only for investment purpose. Hence external borrowing has been the ultimate source to finance the investment works and thus to bridge the gap of capital deficiency in Nepal.

External borrowing is used for meeting the saving-investment gap. The Tenth plan has visualized the need for Rs. 81 billion so it is quite evident that if such borrowing is not forthcoming, the targeted growth rate has to be scaled down. Even if required level of external borrowing is mobilized, there is still a risk of excessive aggregate demand having a potential of inflationary pressure. There is also a potential of distorted foreign exchange rate and increasing current deficits. The other likely impact is to raise the debt burden tremendously due to currency depreciation. Thus, there is need to match the growth rate of external borrowing to that of national income.

In Nepal, Government expenditure is increasing rapidly each year but government revenue is not growing in the same pace. It is very common to know that a rise in the magnitude of public debt must be accompanied by an increase in the debt servicing capacity. Though public borrowing as a means of rising fund is applied in a wide prospective, it is necessary to have a careful look on the increasing magnitude of public debt and proper care must be taken to increase the debt servicing capacity of the country (Economic Survey, 2005/06).

In Nepal, effective management of public finance is a challenging proposition. The miss-match between government revenue and expenditure creates deficit, which is sticky and ever occurring in the Nepalese budgetary system. It has become persistent creating a great tension since the first budget has been balanced by borrowing-internally and externally.

If the borrowed fund to balance the budgetary deficit is utilized properly, it may play vital role for socio-economic transformation, especially if it is used for income earning assets or project(s) of the government or on these heads, which add to productivity of the economy. It results the nation towards the prosperity. Raising the debt for debt servicing and redemption would be a grim and wicked

act to the nation. Moreover, it is harmful to borrow the external debt hugely because it adversely impacts on the balance of payment (BOP) of those countries that can export the goods and services in a very small quantity, like Nepal.

Now-a-days, burden of public debt has been one of the controversial issues in economics of public finance. Academic views regarding it have been changing according to changes in the general economic thinking. The existence of a large debt is neither an evil nor a blessing in itself. It has both adverse as well as favorable effects on the economy. Public debt is an instrument of fiscal policy, but it is one which should be used with care. The problem with which the controversy is concerned are: a) the measurement of the burden b) the cost and the benefits of the public debt, and c) the inter-generation distribution of the burden of public debt. The academic views about these specific aspects have been changing from time to time. In Nepal, both internal and external debt has been increasing rapidly in each fiscal year. The external debt is increasing more rapidly than internal debt. Increasing trend of net public debt is likely to increase further. As a result, debt-servicing obligations are also increasing rapidly. But the pace of capacity of the country to repay debt is not increasing to meet the debt obligation.

The increasing dependency of the country upon the external borrowing is due to poor and inadequate internal resource mobilization. Both, the scarcity of internal resources as well as necessity of external resources have caused for such massive increasing in external borrowing. Ever increasing debt and debt servicing obligations will create a serious problem in the economy like 'debt trap', colonization, internal public instability etc. In short, there may appear macro-economic imbalances which create excessive dependency upon foreign assistance. For this purpose, the study has made an attempt to identify the following problems:

- a) What is the situation of public debt since 1987/88 to 2007/08?
- b) What is the trend of external and internal debt?
- c) What is the condition of resources gap in Nepalese context?
- d) What is the relationship between public debt and GDP in Nepal?

### **1.3 Objectives of the Study**

The main objective of the study is to investigate and analyze the trend and pattern of public debt in Nepal with following specific objectives:

- a) To analyze the trend and pattern of public debt in Nepal.
- b) To examine the resource gap in the financial operations of the government of Nepal.
- c) To analyze the ratio of public debt to GDP of Nepal.

### **1.4 Significance of the Study**

At present, economic planning is taken as the main tool of economic development. Due to low level of taxable capacity of the people, public debt is essential to meet the objectives of development plans in Nepal. Hence public debt has become a reliable and common instrument for resource mobilization and hence to break the vicious circle of poverty in underdeveloped countries like Nepal.s

In the context of underdeveloped countries like Nepal, government has to invest a huge amount in socio-economic sectors as well as in direct productive sectors. For this, there is need of heavy investment due to which the scope and importance of public debt has been increasing day to day. Most of the existing studies are concentrating on the examination of structure, pattern and burden of external debt in Nepal. However, this research provides updated information for the existing study. Unlike the past studies, it explores and analyzes the effect of external debt on the output growth of Nepal. Hence its significance is obvious.

This research provides updated information in regards with public debt. This study explores and analyzes causes of resource gap in the Nepalese context and the trend and structure of public debt which may be helpful for the future economic plans and policies. Hence its significance is obvious. External debt is increasing, so it is more relevant to study. Scholars and academicians are concentrated in this issue. So it is equally important to study issue. This study will focus on the existing scenario of public debt, requirements of borrowing, trend and structure of public debt. So, this study will be beneficial for the readers like students and researchers.

## **1.5 Limitations of the Study**

This study has following limitations:

1. This study covers only the time period between 1987/88 to 2007/08.
2. This research is completely based on secondary data and information.
3. This study has not attempted to examine the effect of public debt on other macro economic variables, except GDP.
4. This study gives emphasis only on the trend and pattern of public debt in Nepal.

## **1.6 Organization of the study**

This thesis has been organized into five major chapters and each chapter contains some sections. The first chapter presents the general background of the study statement of the problem, objectives of the study, significance and limitations of the study.

The second chapter entitle “Literature Review” provides some theories relating to the topic and also discusses some relevant literatures written on public debt. Research methodology has been presented in the third chapter. The third chapter gives information about the sample size and statistical tools, which are used in this study.

The fourth chapter gives data presentation and analysis. This chapter provides a brief discussion of the composition and type of public debt and also it s contribution in financing fiscal deficits and development expenditure. This chapter analyzes the debt burden and debt-servicing problem in Nepal. This chapter also examines the relationship between the total external, internal and total debt and gross domestic product. Finally, chapter five deals the summary, finding, conclusions and recommendation are presented in the fifth chapter.

## 1.7 Working Definition of terminologies

The definitions of some terms which are used in this study are as follows:

- ) **Public Debt:** The public debt is in the form of promises by the treasury to pay to the holders of these promises a principal sum and in most instances interest on that principal.
- ) **Internal Debt:** Internal debt is the borrowing form domestic banking sector and individual.
- ) **External Debt:** External debt is the government's borrowing from international source, agency or autonomous public bodies through bilateral and multilateral sources.
- ) **Gross Domestic Product (GDP):** It is the measure of the total domestic output and factor price.
- ) **Gross National Product (GNP):** It is the measure of the total domestic and foreign output claimed by residents of an economy, less the domestic output claimed by non resident. GNP does not include deduction for depreciation.
- ) **Export of goods and services (XGS):** XGS are the total value of goods and all services (including worker's remittance) sold to the rest of the world.
- ) **Imports of goods and services (MGS):** MGS are the total value of goods and services purchased form the rest of the world.
- ) **Resource Gap:** It is the difference between government's total revenue and total expenditure.

## **CHAPTER TWO**

### **REVIEW OF LITERATURE**

In this chapter, attempts have been made to review the related literatures which have been divided into two parts: theoretical review and research review. In the theoretical review, attempts have been made to review the theoretical aspects of the study especially, Classical, Keynesian, Post Keynesian and recent thinking on government borrowing and in the research review, an attempt has been made to review the relevant research studies being done so far.

#### **2.1 Theoretical Review**

Public debt is a modern invention. It was not heard prior to the eighteenth century. In those days, the living was very simple and there were limited economic activities. The government budgets were very small and there was the policy of Laissez faire in economic system. But after the Great Depression of 1929-33, the public authorities started to take interest in the economic stability and development of their countries. In modern time, the government activities have grown rapidly. The government has to spend a big amount on day to day activities and development functions. In such a situation, any other sources of revenue or taxes are not sufficient to utilize and mobilize the resources and to obtain the macro economic objectives. Hence, it has become an effective instrument of fiscal to stabilize and enhance the economic development of underdeveloped economies (Risal, 1994:95-97).

Generally, the fund or capital taken in the form of loan by the state from various sources is called public borrowing. In other words, public debt refers to loan raised by a government within the country or from outside the country. Every government, like individuals, has to borrow when its expenditure exceeds its revenue. But it is not a source of revenue like taxes.

Public debt is a very common and popular method of solving the problem of deficit financing of any government of developing countries. Generally, governments of developing countries borrow to meet their deficit budget. Sometimes it is also taken to meet the expenditure of war, natural calamities etc. It is a temporary source of government revenue since, it must be paid back with interest and principal after maturity. There are various objectives of public debt which are:

- i) Revenue objectives.
- ii) To fight depression.
- iii) To curb inflation.
- iv) To finance development plans.
- v) To finance public enterprises.
- vi) To finance war expenditure.

There are two sources of public borrowing:

- 1) Internal borrowing
- 2) External borrowing

Internally, the government can borrow from individuals, commercial banks, financial institutions, charitable trusts and the central banks in a country. Externally, the government may borrow from individuals, banks and international financial institutions and foreign governments.

External public borrowing is the acceptance by a government or government agency of real or financial resources from an external source with the obligation or relinquishing such resources in specified future dates. The accumulated liabilities resulting from such external borrowing are external debt.

## **2.1.1 Classical, Keynesian and Post-Keynesian View**

### **2.1.1.1 Classical View**

It consists of the thought as expressed by economists of the 19<sup>th</sup> century and their followers.

Generally, the classical economists were generally against public borrowing and favored the minimum expenditure from the government side. They assumed that individual consumer and business firm employ resources more efficiently. Under a fully employed economy, government can acquire resources by borrowing only at the cost of private sector where they are more fruitfully engaged. In this way, classical economists had negative attitude towards public borrowing and they did not plead for increasing economic role of government. In stead they said “Let money fruiting on the pockets of the people”. According to them, state has to perform its limited activities, maintenance of law and order, justice and social security. Classical economists like J.B. Say, and T.R. Malthus have given their argument that “Debt creates burden in the economy because of its unproductive nature” (Singh, 1982:312-314).

Adam Smith disfavored public debt. He was of the opinion that public debt leads to extravagance, encouraged resort to war and induces generally disadvantageous economic conditions for the nation, which employed it.

Accordingly, C.E. Bastable, “A nation cannot do any more than an individual keep adding continuously to its liabilities without at least coming to the end of its resources”. Hence, public debt was considered hazardous for the economy. It is no longer a cake eating feast but rather need a careful and efficient brain to handle the management of the public debt. (Singh, 1982: 322)

Classical economist considered public debt as dead weight in the sense of wasted opportunity but modern economists consider public borrowing as an important technique of public finance. Public loans in modern times are necessary to met financially unfavorable situations like deficit in budget, flood and famine; warfare has

become so costly that the normal income through taxation falls short of the actual war expenditure. Many economists like J.M. Keynes have advocated increased public expenditure financed through borrowings and not through taxation as means to remove depression and unemployment. Public borrowings are considered very useful for the development of natural resources of developing countries (Tyagi, 1976:21).

In the opinion of Findlay Shirras, “government must remember that borrowing is not a short cut to prosperity and a policy of borrowing must be retreated except for what cash reasonably be regarded as productive expenditure” (Lekhi, 2002:45).

It is not that the classical writers were against any form of debt. They favored minimum public expenditure and between taxation and borrowing, they favored taxation for the following reasons:

- a) Deficit financing means an increase in public debt. Since it is an easy method of obtaining income, gives likely to be extravagant and irresponsible. Consequently, public debt will become a definite burden on the economy.
- b) Payment of interest on public debt and refund of the principal will require additional taxation. It might prove to be difficult since government’s power to tax is not unlimited
- c) Deficit financing might produce currency deterioration and price inflation.

Form the above statements, it can be said that classical economists were not against all types of public debt. They agreed that public debt should be used for productive purposes, that is, for capitals projects since the fruits of such projects could be sold to buyers so debt servicing and refund of principal did not necessitate additional taxation. These are called self-liquidating projects. In the words of R.A. Musgrave, “self-liquidation projects may be defined narrowly as investment in public enterprises that provide a fee or sales income sufficient to service the debt incurred in their financing without requiring an increase in the future level of tax rates” (Singh, 1982:321).

The classical economists Edgeworth viewed the government should not raise the public debt for consumption on activities. Economists R.A. Musgrave and P.B. Musgrave hold, "Tax raised to finance this payment imposes a burden on economy". They further say "This burden does not arise because resources are withdrawn from the economy". In this context they also state that "Debt accumulation during war may be so drastic as to lead to fiscal and debt repudiation in the post war period (Musgrave 1989:689).

### **2.1.1.2 Keynesian View**

In the classical system, all private income is spent on either consumption or investment. Full employment is secured automatically. Price level stability is maintained if the money supply is held stable or increased at the same rate at which real income grow. After the great depression of the 1930's new wave of thinking took place in the writing of J.M. Keynes who advocated for increasing government role in the economic activities by adopting deficit financing so that effective demand is created in the economy ensuring employment opportunities.

Keynes stood against the concept of classical economists and propounded different view in his book "General Theory" in 1936. He did not accept the classical notion of a free enterprise economy, which is self-equilibrating at a full employment level. He advanced the concept the concept of underemployment equilibrium and who effected a truly significant revision in the theory of public debt. Keynes argued that if debts are internally held, there is nothing to worry about their size. Such debt involves merely a series of transfer payments and they cancel out for the economy as a whole. Hence the only concern should be about economic stability at high level of income. Keynes also stressed and challenged the version of classical economists and hold opposite opinion on the subject of burden of public debt. He submits that there is no shift of the basic burden to the future generation because the same posterity that pays the additional taxes will be benefited from the repayment of the debt.

A.P. Lerner, a profounder of the functional finance approach to public debt, maintains that government should borrow only when it wants to make people hold more bonds in place of money. This action will raise the rate of interest by lowering

the value of bonds and will prove to be anti-inflationary. In the event of falling aggregate demand and shortage of funds for productive investments, government should lend to the private sector or increase its own expenditure to arrest the fall in real income and employment. Debt servicing poses no problem since it is always open to the government to borrow from the central bank. Since the function finance maintains a correct level of aggregate demand corresponding to available output, there is no danger of inflation (Singh, 1982:323). Lastly, it can be said that Keynesians carried out views with the support of public debt that if they are normally held, there is nothing to worry about their size.

### **2.1.1.3 Post Keynesian View**

During World War II and the post-war years, the size of public debt increased enormously. The increase in the size of public debt has caused some revision in economists thinking on the subject. The Post-Keynesian economists accept a large part of the modifications of the classical debt theory as brought about by Keynesian economists. It emphasizes, however, the transfer and management aspects as well as the interrelationship between public debt and money supply.

Post-Keynesian economists advanced their idea that government borrowing does not always deprive the private economy of resources as, for instance, in a period of widespread unemployment. It is also not accepted how that borrowing in a period of full employment must be inflationary. It depends on these circumstances if borrowing taps funds otherwise spent on consumption; it is not more inflationary than taxation. A large public debt, if internally held, poses many problems for the economy. It complicates monetary policy and creates difficulties of management. They think that the developing countries have very low income, saving and investment. They further says that without increasing the rate of these three crucial factor, no country could achieve steady growth so the over all aim of borrowing is not to equalize income in different countries but to provide every country with an opportunity to achieve steady growth. On the other side, people of the developed countries are enjoying high prosperity, high standard of living, high educational facilities etc. Population problem is also not so serious on such economies. Post-Keynesian economists Goode views that borrowed money when used to finance

public investment causes no such reductions, all that will happen is the change in the consumption of capital formation. According to his, “the inference is that failure to restrict borrowing to the finance of investment will retard economic growth. A weakness of the argument is that not all outlays classified as investment actually contribute to growth, while some expenditure usually classified as government consumption promotes growth”.

In this way, different economists in different periods have expressed their own views on public debt and they are conscious of the burden as well. The situation of foreign debt and internal debt is different because for foreign debt needs foreign exchange for its debt servicing for which foreign exchange earning sector must be created effectively. The true burden of debt servicing on the debtor country thus depends to a substantial degree on how for the loans can be transferred into productive investment.

The case of shifting the burden to the future generation is one of the burning issues of debate between the economists. Classical economists state that through debt financing, it is the present generation, which suffers a loss of resources. They further say that if the present generation reduces its saving in order to meet the debt finance and leave a smaller amount of capital resources for the future. This will reduce the productive capacity of the coming generations and they will accordingly lose. In this way, burden of public debt may pass on to the future generations but on the other hand; modern economists including J.M. Keynes, Harris, Hansen, Buchanan, Bowen Davis, and Musgrave have challenged the version of classical economists and hold opposite opinion on the subject of burden of public debt. They submit that there is no shift of the basic burden to the future generation because the same posterity that pays the additional taxes will be benefited from the productive use of the debt. Thus, the question of shifting the burden of public debt to the future generation has remained an unsettled problem. However, the burden controversy depends upon the nature of investment, productive or unproductive. If it is productive, there will be no burden because of creation of real asset in the economy, which further generates income of the people thereby increasing national income. If it is unproductive, the situation will be burdensome on the government.

Even though, public debt imposes burden into the economy, Samuelson has suggested for the use of foreign capital in the process of economic development of developing countries. He has said that if there are many difficulties in the way of domestic financed capital formation, why not rely more heavily on foreign sources.

## **2.2 Recent Thinking of Government Borrowing**

Nowadays, government borrowing is connected with development purpose of the underdeveloped countries in wider prospective. It is used for recovering the deficiency of the effective demand. Government borrowing can be used as an instrument of fiscal policy for mobilizing saving for the development purposes and can also be used as tools of monetary policy for combating inflation. Besides, it also acts as a balancing wheel that controls the tempo of the business cycle. In a period of depression, when aggregate demand is not enough to accelerate the level of production and employment, compensatory theories of fiscal policy suggest to increase public expenditure on public works by mobilizing idle saving at the hands of the people through public borrowing to create effective demands and to promote an economic recovery (Barman, 1986:12)

According to Post Keynesians and Second World War economists, public borrowing plays a prominent role in underdeveloped countries. It helps the mobilization of resources for the economic development. In such countries, sources of revenue are inadequate and insufficient for the heavy expenditure that has to be incurred on the development schemes.

Michael Posner points out that growth in the debt ratio causes alarm for two reasons. First, growth in debt ratio might lead to crowding out of private investment, second and more important is the assumption that government spending out of the borrowed funds might be unproductive (Posner, 1992:204).

Raja J. Chelliah points out that the ideal situation is one in which first, revenues will meet subsidies, other transfer, interest payments and the greater part of current expenditure, debt finance will be used for meeting the governments non remunerative capital formation, a propositions of current expenditure designed to increase social capital and productive requirements of financial investments and

second, the total of domestic borrowing will be determined in such a way that it gives the rate of domestic saving, the non-government sector will be to obtain borrow from the central bank that current account seignior age (Chelliah, 1992:20).

In recent years, the objective of the government borrowing in developing countries is that it should be used as an instrument to mobilize saving of people which would otherwise have gone to idle or wastefully consumption. Public debt should be advocated for creating additional capacity and producing capital equipment. Generally, government borrows for the creation of infrastructures in the economy since it requires huge investment initially which cannot be meet only through revenue collection. The aim of the government borrowing policy should be helped in strengthening the money and capital market, which in turn accelerate development and price stability. The government of a developing country tries to mobilize the saving of the community partly through the device of public borrowing in order to meet the financial need of its development program.

A discussion paper was prepared by United Nation conference on trade and development 'Multinational debt of least developed countries'. It has reviewed development in multilateral debt of least developed countries since the debts crises of the early 1980. This paper has discussed on the problem of multilateral debt as sustainability, liquidity and accumulations of large-scale arrears. The discussion paper has also evaluated recent schemes to provide debt relief and suggested possible measures to strengthen and improve existing schemes as well as present other innovative obtains. The analysis focused mainly on the least developed countries. The World Bank and IMF classify 37 of these countries registered multilateral debt arrears in 1993, 29 of them as heavily indebted poor countries. There are 48 countries classified in 1995 by the United Nation as least developed countries. (Sablater, 1995:2-20)

### **2.3 History of Public Borrowing in Nepal**

In the Nepalese economic history, public debt is not that old. In history text books there are discrete reference to Great King Prithivi Narayan Shah, raising revenue and even borrowing from the public for the purpose of unifying the Kingdom

of Nepal. But the information on terms and amount of borrowing is missing in those references. Even, then Rana Prime minister Chandra Samsher, is reported to have borrowed money from Pashupati Nath temple to resettle the emancipated slaves around A.D. 1925.

M.C. Regmi has written in Nepalese economic history that there was no public debt but the government provided some regulation to maintain public finance before 18<sup>th</sup> century. Some instances of public debt in Nepal can be seen existed in the period of Rana Bahadur Shah who borrowed a large amount of fund from Indian merchants. At the same time in 1803 government had taken borrowing for internal finance. (Regmi, 1971:71)

Evolution of budgetary development in Nepal is a factor for to increase in government expenditure, which pushed government borrowing. Until 1975, public expenditure amounted 11 percent of GDP. In 1980s, there was heavy increase in public expenditure from 1990s onwards expenditure had exceeded one fifth of GDP. Revenue remained around 9 percent of GDP till 1993. Another interesting feature of Nepalese budgetary development has increasing magnitude of regular expenditure as compare to that part of development expenditure, particularly in the 1990s.

In Nepal, regular expenditure is growing with the planned development. Recent trend of government expenditure shows that regular expenditure is surpassing the development expenditure. This situation has limited the availability of revenue surplus for development expenditure. As the revenue surplus is not sufficient to meet the development expenditure, foreign grants as well as foreign and internal loans have been mobilized from the previous years to meet such expenditure. Therefore, the amount of foreign loans is rising for the past several years. Similarly, due to the depreciation of Nepalese currency vis-à-vis the convertible foreign currency, the burden of debt services has been increasing year by year. Compared to FY 2000/01 the net outstanding foreign loan increased by 9.8 percent in FY 2001/02 and reached Rs. 220125.6 million.

Foreign aid consists of both grants and loans. Nepal has been receiving foreign aide since 1951. The first donor country was U.S.A. It flows under Point Four

agreements for technical co-operation in January 23, 1951. Then first Indian aid in 1951/52 for the construction of Tribhuvan International Airport. Now a days several countries are providing foreign aid in the form of grants and loans. Basically higher proportion of grants is receiving through the bilateral sources and most part of loans are receiving through the multilateral sources. Inflow of foreign aid in Nepal has significantly increasing over the year, after 1951 due to expansion of Nepal with foreign countries.

Foreign aid has been entirely in grants from up to 1960/61. Then after this the share of grants has been declining but still it continued to account for a large proportion of total aid (more than 50percent up to 1982/83). The share of loan in total aid started to increase since 1983/84. Nowadays, government is receiving foreign aid to meet the regular government expenditure too.

In 1999/00 the share of loan in total aid was eighty percent. In fiscal year 2001/02 Nepal revived Rs. 14384.8 million total foreign aid by bilateral and multilateral sources. In which Rs. 6686.2 million and Rs. 7698.6 million were grants and loans respectively. Till now, the amount of grants is higher but the increasing trend of grants is lower as compare to loans. All these information shows that the burden of public debt of Nepal is increasing due to growing share of foreign loans. So, public debt is increasing at faster rate.

#### **2.4 Research Review in the Nepalese Context**

Some writers and students of Masters' level have tried to express their views on public debt in Nepal. Some of them have focused on its structure and importance where as other emphasized on its burden and impact in inflation, employment and national solvency. These thesis paper and articles have also enriched the importance, role, need and scope of public debt in economy. This section presents review of various research studies, thesis and articles related to the government borrowing in Nepal.

### 2.4.1. Review of Research Articles

Munla (1992) in his article entitled “External Debt Policy” has analyzed the origin of debt problems and explained about it. The debt crisis had its origin in the substantial rise in the external liabilities of the developing countries during the second half of the 1970s and early 1980s, in an environment of large-scale recycling of the oil exporter’s surpluses, rising world inflation and negative real interest rate. At the time many viewed that this recycling of funds as a positive development: creditors were able to identify new investment and debtors could acquire funds needs for development purposes”.

He again explained that an external debt crisis was due to:

- i) A drastic deterioration in external economic environment in the form of higher interest rates, lower commodity price and severe recession in industrialized economies;
- ii) Economic mismanagement and policy errors in debtor countries; and
- iii) Excessive lending by commercial banks to some countries with little regard to country risk limits.

In this article Munla contributed towards principle of debt strategy and pointed out three fundamental principles which are:

- i) Debtor countries need to pursue strong adjustment programs, supported by determined structural reforms, aimed at increasing domestic resource mobilization. Attracting non-debt creating flows, and reducing impediments to growth;
- ii) Creditors and donors need to ensure to provision of adequate external financing in support of such programs on a case-by-case basis; and
- iii) The international economic environment must be conducive to the success of these efforts.

Adhikari (1996) in her article entitled, “Foreign Debt Servicing: A Case Study” analyzed the foreign debt servicing problem in Nepal. She prescribed effective implementation of liberalization policy in all area of investment. This can bring a

great relief to the country by creating capacity for foreign exchange earning which can reduce burden of debt servicing substantially in the years to come.

Gurugharana (1996) in his article entitled “The Role of Foreign Aid in Economic Development and Poverty Alleviation” analyzed the burden of public debt, as debt servicing cost in Nepal and has come to the view that the long term upward trend of increasing debt burden inflict greater burden. He finally said that through the lean component of foreign aid, Nepal is suffered more than other countries like India and China though rate of return is very low and rapidly increase volume of debt slowly brings the Nepalese economy towards crisis of debt trap.

Sharma (1998) in his article entitled, “The growing fiscal imbalance in Nepal, Are we falling into the Debt Trap?” has analyzed that the even increasing debt in Nepal and its servicing has really created a situation which is driving the country towards debt-trap because of the following reasons:

- i) Large amount of loan is allocated for meeting current expenses within the development expenditure.
- ii) A good amount of borrowed money is used for debt servicing.
- iii) Size of borrowed amount exceeds the maximum legal limited of borrowing.

In the context of the Nepalese situation, Nepal is facing a paradoxical situation in that she can neither promote her economy without aid, nor has she been able to avoid the risk of becoming the victim of aid intoxication. Meanwhile, aid for long periods has created a separate social group, namely, the rental class.

Khatiwada (1998) in his article entitled “Public debt management and macro economic stability” basically dealt with monetary implication of public debt. He found that public debt has:

- i) Exerted excess monetary expansion, which has indirectly resulted in high rate of inflation and deterioration of current account situation.  
Crowd out resources available for private sector investment.
- ii) Exerted upward pressure on the market rate of interest.

- iii) Pressurized on debt servicing to the government resulting in higher budgetary deficit which further contributes to monetary expansion having subsequent repercussion on the internal as well as external sector stability.

He has further analyzed the situation more alarming, as foreign loan of the long-term nature is maturing out at faster rate and exchange rate of Nepalese Rupee has been depreciated very fast.

Acharya (1998) in his article entitled “Burden of Public Debt in Nepal” has analyzed the situation in Nepal. He has also pointed out the various factors that cause excessive internal and external debt burden. In which internal factors are:

- i) Inappropriate or excessive fiscal policy
- ii) very low tax effort
- iii) Poor maturity mix of public debt burden
- iv) Over-regulated prices that dampen incentives to export oriented production resulting in falling exports and revenue, and increased import.

External factors to lead excessive debt burden are:

- i) Adverse external conditions such as deterioration in the terms of trade.
- ii) Inadequacies in external debt management such as poor maturity mix and exchange rate misalignment.
- iii) Over leading by creditors of commercial banks.

Acharya also analyzed the situation of widening saving-investment gap, persistently growing share of regular expenditure, GDP and government revenue, per capita debt burden increasing trade gap. These factors clearly indicate the ever-increasing debt burden.

Koirala (2001), in his article entitled, “Effective Public debt Management in Nepalese Perspective” analyzed the impact of public debt on socio-economic development in Nepal. In this article, he concluded that debt crises is not only an economic issue but also political. Therefore, it should be handled politically with an economic perspective.

#### **2.4.2 Review of Thesis**

Joshi (1982) has submitted thesis entitled "Structure of public debt situation in Nepal" in 1982. The major findings of his study are as follows,

- i) The concept of public debt is not new in the literature of economics but it has not a very long history in Nepal. The chapter of public debt began only after the late 60s in Nepal.
- ii) The proportion of soft loan is increasing very fast and the development expenditure of budget of Nepal.
- iii) The rate of interest charged varies on the public debt provided by different sources.
- iv) The system of public debt in one of the best ways of financing development expenditure of the government which helps to control inflation in the country.
- v) The system of public debt also has helped to mobilize the internal financial resources in the productive sector of the country's economy.

Upadhaya (1985) has submitted thesis entitled "External Debt and debt servicing in Nepal" in 1985. The major findings of his study are as follows,

He analyzed indebtedness of the country with increasing external borrowing and the determinants of external borrowing in Nepal. He has pictured the poor economic performance of the nation, due to which nation's natural topography and human behavioral limitations. He concluded that internal borrowing is most essential to develop the money and capital market in the nation and external borrowing is mainly for the rapid economic development. He describes the external debt as supplementary tool for the resource gap in the countries' budgetary expenditure.

Sharma (1988), has submitted the thesis entitled "Public Debt in Nepal" in 1988. The major findings are as follows,

He has dealt with the positive role of government borrowing for the sound economic growth and prosperity on the one hand and on the other hand he has alarmed the state not to disburse the debt unproductively. He has focused on the increasing public debt because only richer section of the society gets double benefits from the public debt. According to him one benefit is in the form of the interest in the debt and other benefit from the development itself. But if there is any increase in small saving, ownership of debt is defused and the problem of inequality in the distribution of wealth and income is minimized. He further maintains, "The expansionary impact of the ownership pattern of government securities has contributed to the inflationary spiral in the country. And hence it has caused a severe real burden of the public debt."

Wagle (1999), has submitted the thesis entitled, "An Analysis of public debt situation in Nepal" in 1999. The major findings are as follows,

He found that the share of interest payments to total debt servicing was greater than principal payments till 1997/97. But then, the share of principle amount to total debt servicing is greater than interest payment till 1999. The servicing amount of interest and principal payments indicates that large portion of regular expenditure has gone to creditor countries, which has hampered regular expenditure as well as development expenditure. In 1998/1999, 15 percent of regular expenditure has gone to service of principal payments and interest payments; this indicates the seriousness situation about debt servicing and burden of public debt in Nepal. He concluded that macro economic imbalance such as widening trade deficit that the debt servicing capacity of Nepal is very poor which is also responsible for increasing debt obligation and financial resource gap.

Sharma (2003), in his M.A. thesis entitled, "Trend and structure of public debt situation in Nepal" analyzed the trend and structure of public debt in descriptive nature. The major findings are as follows,

He found that Nepalese economy is characterized as three kind of macroeconomic imbalances viz. - saving-investment gap, export-import gap, and revenue-expenditure gap. These fundamental gaps represent the foreign dominance in Nepalese economy while saving-investment and revenue-expenditure gap is mainly the consequence of excess government activities in economic matters. To fulfill these gaps public debt in the form of either internal or external is inevitable. The volume of external debt is excessively rising in the recent years under the liberalization policy. As globalization concept is wide spreading all over the world, aid is gradually decreasing and emphasis goes on loans, technology transfers and trade which have created high degree of indebtedness and, consequently, debt servicing obligations are increasing. In the meanwhile, the loan is not self-liquidating i.e., the debt repayment capacity is not increasing in the same pace. During the study period, average annual growth rate of GDP, revenue and merchandise export earnings are out stepped by annual growth rate of debt and debt servicing obligations. He concluded that external debt in Nepal over

the period 1998/1999 to 2004/2005 is some extent productive. Therefore, it is necessary to have a careful look on the debt servicing capacity of the country.

Ultimately these conditions are compelling the researchers to ask a question that "is Nepal really falling in the debt-trap?"

After the study he had concluded that Nepal has not really fallen into debt-trap but if the process continues for years there will be no other results.

Loan component through internal and external sources are both under the ceiling but debt servicing amount is increasing annually and its growth rate is higher than GDP growth rate and revenue growth rate.

### **2.4.3 Concluding Remarks**

It can be concluded that governments of underdeveloped countries have to borrow due to low saving. This in turn is resulted from the low level of investment. Hence the poverty sequences more like inadequate capital, low productivity, low real income and low purchasing power, inadequate capital gain. This justify that capital deficiency in the underdeveloped countries are facing the deficiency of capital in relation to their population and natural resources.

From the above literature, it can be concluded that economists were not against all types of public debt. They agreed that public debt should be used for productive purposes, i.e., for capital projects since the fruits of such projects could be sold to buyers so debt servicing and refund of principal did not necessitate additional taxation. Previous researchers analyzed the trend of public debt by using secondary source of information in terms of internal and external borrowing. But actually speaking, debt can be determined by various factors among them countries' environment and fiscal policy in terms debt servicing and refund of principal may be the strong determinant for debt management in the country. In present context, these are the heart issue in Nepalese economy. Present study tries to define trend and structure of public debt in Nepal by applying those various facts in the context of Nepalese economy. It can be very fruitful to those interested persons, parties, scholars, professors, students, businessman and government for academic as well as policy perspective. Hope this study will help to others in future in the related field.

## **CHAPTER THREE**

### **RESEARCH METHODOLOGY**

A systematic Research study needs to follow a proper methodology to achieve the pre-determined objectives. Research methodology is a sequential procedure and methods to be adopted in a systematic study.

#### **3.1 Research Design**

This study is based on secondary data of the public debt and the approach is historical, analytical as well as descriptive. In fact, the research design is the conceptual structure within which the research is conducted. This study analyzes the trend and pattern of public debt of Nepal. For this purpose, we have estimated some models. Variables used in the models have been explained analytically. The statistical models have been estimated by using Ordinary Least Square method.

#### **3.2 Source of data**

Data and information have been collected from various sources such as Government's budget speeches (1989/90-2007/08), and various Economic surveys publications of Ministry of Finance (MOF), various Quarterly Economic Bulletins publications of Nepal Rastra Bank (NRB), various Statistical Pocket Books publications of Central Bureau of Statistics (CBS), and various publications of National Planning Commission, etc.

#### **3.3 Time Frame Considered**

In order to show the trend and structure of public debt, 21 years data (1987/88-2007/08) have been taken into account, this is because researcher is interested to examine the relationship between public debt and Gross Domestic Product (GDP) of Nepal of such period when Nepal has just adopted the policy of liberalization in 1985 and after the restoration of democracy 1990. Researcher has chosen this time period because in 1987 although Nepal has adopted the liberalization policy its benefit was

minute. So this work can be taken as showing the effect of liberalization policy in the public sector mainly after the restoration of democracy.

### **3.4 Tools and Technique**

In order to support the study, different statistical and mathematical tools such as percentage, ratio, arithmetic mean, and hypothesis testing have been used. It is, therefore, evident that the subjective patterns of analysis guided by theoretical tools and statistical as well as mathematical tools have been collectively exercised to explain the different component of the study raised basically through the major issues related to external debt in Nepal.

### **3.5 Statistical Methodology**

It attempts to establish the nature of relationship between dependent and independent variables. It also provides a mechanism for prediction or forecasting. The regression of Y (=GDP) on X (=public debt) is used to estimate the value of the dependent variable and Y for any given value of independent variable X and vice versa.

The regression equation of GDP on Total public debt has been estimated form of the equation given by:

$$Y = a + bX$$

Where

Y= Gross Domestic Product

X= Total public debt

a= Autonomous element which does not vary with public debt

b= Induced element which vary directly with public debt

Regression equation of Y on INT<sub>debt</sub>

$$Y = a + b \text{INT}_{\text{debt}}$$

Where

Y = Gross Domestic Product

INT<sub>debt</sub> = internal debt

Regression equation of Y on EXT<sub>debt</sub>

$$Y = a + b \text{EXT}_{\text{debt}}$$

Where

Y = Gross Domestic Product

EXT<sub>debt</sub> = External debt

### **3.6 Statistical Test of Significance**

Standard error of estimate SEE, like standard deviation, measures the reliability of the estimating equation and estimating coefficients. The larger SEE, the greater happens to be the dispersion of scattering of given observation around the regression line (or coefficient) and no better the estimate. On the other hand, the smaller value of SEE, the better will be the regression line (or coefficient) and the better estimation based on the equation for this line. With the help of SEE, it is possible to ascertain how good and representative the estimated regression line (or coefficient) are as a description of the average relationship between two series. For this study, the SEE, for regression coefficients have been calculated by using a computer.

#### **3.6.1 Test of the Goodness of Fit ( $R^2$ )**

After estimating the regression parameters,  $R^2$  is used for judging the explanatory power, which measures the dispersion of observation around the

regression line. It is essential, because the closer the observation to the line, the better the goodness of fit, that is the better explanation of the variations of Y by the change in the explanatory variables. R<sup>2</sup> shows the percentage of the total variation of the dependent variable that can be explained by the independent variables of the multiple determinations and is the square of the correlation coefficient. The formula to derived R<sup>2</sup> is mentioned below:

$$R^2 = \frac{SSR}{SST}$$

$$SSR = \sum_{i=1}^n (x_i y - \hat{y}_i)^2$$

$$SST = \sum_{i=1}^n y^2$$

Where

$$\bar{y} = \frac{\sum Y}{n}$$

$$\bar{x} = \frac{\sum X}{n}$$

### 3.6.2 Test of Significance of the Parameter Estimates

It is applied for judging the statistical reliability of the estimates of regression coefficient. The following tests have been performed to test the hypothesis of the study.

#### t-test

This test will be performed in order to identify the statistical significance of an observed sample regression coefficient and the formula for calculating the value is:

$$t = \frac{\hat{a}}{SE(\hat{a})}$$

Where,  $\hat{a}$  X estimated value of  $a$

$SE(\hat{a})$  X Standard error of  $a$

$$SE(\hat{a}) = \sqrt{\text{Var } \hat{a}}$$

The calculated t-values have been compared with tabulated t-values at a certain level of significance, for a given degree of freedom. If the calculated t-value exceeds the

tabulated value it is inferred that estimated coefficient is significantly different from zero.

### F-test

F-test is used to examine the overall significance of the model

The formula for calculation is 
$$F = \frac{R^2 / K}{(1 - R^2) / (N - K)}$$

Where,

$R^2$  = Co-efficient of determination

K = Number of explanatory variable

N = Number of observation in the sample

The calculated F-variance ratio is compared with the tabulated value at a specific level of significance with (K-1) and (N-K) degree of freedom.

If  $F_{cal} < F_{tab}$ , we accept null hypothesis.

If  $F_{cal} > F_{tab}$ , we reject null hypothesis.

### D-W test

D-W test can be performed to see whether the variables are auto-correlated or not. This test can be performed using the following formula

$$d = \frac{\sum_{i=1}^n (u_i - Z u_{i-1})^2}{\sum_{i=1}^n u_i^2}$$

## CHAPTER FOUR

### DATA PRESENTATION AND ANALYSIS

#### 4.1 Introduction

Public debt is a modern invention and was not heard prior to 17<sup>th</sup> century. Concepts and needs of public debt arose simultaneously with the need of community development. After the Second World War, it became the vital source of development expenditure. The government may borrow because current revenue may not be enough to meet its expenditure. It is obvious the government borrows when its annual expenditure exceeds its revenue and the general objectives of government borrowing are: a) revenue objective, b) to fight depression, c) to curb inflation, d) to finance development plans e) to finance public enterprises and f) to finance war expenditure. Objective of public debt in Nepal are: a) to control depression b) to control inflation c) to finance immediate problems like natural calamities, d) to reduce poverty, e) to finance development plans and f) to finance the deficit budget. It also borrows because of some sudden and unforeseen expenditure, when tax revenue cannot be increased to the same extent. It may also borrow to finance capital expenditure, as current revenue is usually insufficient for the purpose. Wars and growth of defense expenditure have also led to increase in public expenditure. In fact, increased public expenditure has been responsible for vast increase in public debt everywhere.

In modern time, public borrowing is considered as an effective tool of fiscal operation of the government. Thus as a fiscal weapon, it has to play the role of revenue generation and also to mobilize savings for development purpose. Similarly as a fiscal measure it helps to control inflation/deflation and ensure growth with stability. As Bhargava observes, “the government borrowing is also useful to combat inflation because in this situation effective demand is more than the available supply of goods and services and by way of internal borrowing the government transfers extra purchasing power from the hands of people to government treasury. In order to fight

against depression, the government can borrow from the external sources and it can spend the borrowed fund in public works which generate opportunities of employment and increase for the unemployed people. Similarly, internal borrowing can be used to check boom. Thus a sensible debt policy can be used to check depression or a boom". (Bhargava, 1956:191).

Nepal has accepted foreign loan since the first five-year plan (1956/57-1959-60) but it has systematically started to raise the debt since the fiscal year 1961/62 through the means of Treasury bill that amounted Rs. 7 million and carried one percent of interest rate. After this, the government firstly floated the development bond of Rs. 131 million in FY 1963/64. In the same year, the government issued the public debt regulation and practice was still managed with this regulation.

Public debt is interrelated with the basic government fiscal flows of taxation and expenditure. If the volume of government expenditure exceeds the volume of tax revenue and other non-tax revenue then a deficit budget exist. Such deficit budget provides the fundamental precondition for debt creation. Having once been created debt requires interest payments to maintain the debt and refinancing operations of the debt is to beyond the maturities of existing securities.

The government of Nepal has been borrowing new fresh loan mainly to balance its deficit budget however, other causes may exists with it. It is applied for the maintenance of the balance between the expenditure and revenue. It is also applied for financing economic development since under developed countries always face the problems of adequate funds, which is reflected in a large extent as ever increasing financial resource gap in the government budgetary operations.

There are mainly four reasons for raising the government borrowing:

- i. To recover the deficit budget.
- ii. To tackle the emergency period of crisis.
- iii. To maintain the economic and monetary stability.
- iv. To accelerate the pace of economic development.

Government borrowing in Nepal is rapidly increasing since the FY 1984/85 the government started to raise borrowing with new long term security named 'national saving certificate'. Therefore the amount of public debt has been fluctuated in its size but in aggregate, it has been increased tremendously under the review period 1987/88 to 2007/08, but it amounted to Rs. 13236.8 million in FY 2003/04.

#### **4.2 Resource Gap in Nepal**

Resource gap is the gap between total expenditure and total revenue of the government. Resource gap in Nepalese economy has always been a common phenomenon since the start of the systematic budgetary system. Nepal is experiencing a serious and growing resource gap because the annual growth rate of total expenditure and that of its revenue are not increasing in the same pace. In the past few years (i.e. 1951/52 to 1961/62), the government used to finance such gap with foreign grants. However, since the fiscal year 1964/65, the government started to borrow from domestic as well as foreign sources to fill up the gap. The extent of financial resource gap is shown in Table 4.1.

**Table -4.1**  
**Different Scenario of Resource Gap (1987/88 to 2007/08)**

(Rs. In Million)

Fiscal Year	Government Revenue	Government Expenditure	Revenue Deficit	Foreign Grants	Fiscal deficit	EXT. Loans	domestic Resource deficit
1987/88	7350.40	14105.00	6754.6	2067.80	4686.80	3815.80	871.00
1988/89	7776.90	18005.00	10228.1	1680.60	8547.50	5666.40	2881.10
1989/90	9287.50	19669.30	10381.8	1975.40	8406.40	5959.60	2446.80
1990/91	10729.90	23549.80	12819.9	2164.80	10655.10	6256.90	4398.20
1991/92	13512.70	26418.20	12905.5	1643.80	11261.70	6816.90	4444.80
1992/93	15148.40	30897.70	15749.3	3793.30	11956.00	6920.90	5035.10
1993/94	19580.80	33597.40	14016.6	2393.60	11623.00	9163.60	2459.40
1994/95	24575.20	39060.00	14484.8	3937.10	10547.70	7312.30	3235.40
1995/96	27893.10	46542.40	18649.3	4825.10	13824.20	9463.90	4360.30
1996/97	30373.50	50723.70	20350.2	5988.30	14361.90	9043.60	5318.30
1997/98	32937.90	56118.30	23180.4	5402.60	17777.80	11054.50	6723.30
1998/99	37251.00	59579.00	22328	4336.60	17991.40	11852.40	6139.00
1999/00	42893.80	66272.50	23378.7	5711.70	17667.00	11812.20	5854.80
2000/01	48893.60	79835.10	30941.5	6753.40	24188.10	12044.00	12144.10
2001/02	50445.50	80072.20	29626.7	6686.10	22940.60	7698.70	15241.90
2002/03	56229.80	84006.10	27776.3	11339.10	16437.20	4546.40	11890.80
2003/04	62331.00	89442.60	27111.6	11283.40	15828.20	7629.00	8199.20
2004/05	70122.70	102560.40	32437.7	14391.20	18046.50	9266.10	8780.40
2005/06	72282.10	110889.20	38607.1	13827.50	24779.60	8214.30	16565.30
2006/07	87712.10	133604.60	45892.5	15800.80	30091.70	10053.50	20038.20
2007/08	107622.50	161349.90	53727.4	20320.70	33406.70	8979.90	24426.80
Average Annual Growth Rate	13.89	12.53	11.35	16.40	11.85	7.14	27.55

*Source: Nepal Government, MOF, Various Economic Surveys 2001/02 and 2008/09.*

In the table 4.1, three scenarios, revenue deficit, fiscal deficit and domestic resources gap are shown. This table shows that the revenue deficit is increased by the average annual growth rate of 11.35 percent. Similarly the average annual growth rate of fiscal deficit is

11.85 percent and the average annual growth rate of domestic resource gap is 27.55 percent. The three scenarios are explained below:

### **Scenario 'I'**

First scenario exhibits the revenue deficit. Revenue deficit is the gap between total expenditure and total revenue that shows an excess of total expenditure over total revenue. This gap is shown in column 4 of table 4.1. In this table, we can see the increasing tendency of revenue deficit. It is due to the increase in volume of total expenditure. The amount of total expenditure was Rs. 14105.00 million in the FY 1987/88 which has gone up to Rs. 161349.90 million in the FY 2007/08, whereas total revenue has increased from Rs. 7350.40 million in FY 1987/88 to Rs. 107622.50 million in FY 2007/08 during the same period of time. This shows that the revenue gap has widened tremendously.

The average annual growth rate of total expenditure over the review period is 12.53 percent per annum whereas the annual growth rate of total revenue is 13.89 percent. It shows the growth rate of revenue is greater than expenditure but in absolute terms the table shows the horrible increment of revenue deficit that was increased from Rs. 6754.6 million (in 1987/88) to Rs. 53727.4 million (in 2007/08) and the average annual growth rate of this gap is 11.35 percent over the revenue period.

### **Scenario 'II'**

The second scenario exhibits the fiscal deficit. Fiscal deficit is the gap between total revenue (revenue plus grant) and total expenditure in column 6. The result in this case is not encouraging. It is also called fiscal budgetary deficit. Grant is a potential source of foreign currency, which is used in importing capital goods from abroad and paying the interest and principle of external debt. Foreign grants are not increasing as desired. It increased from Rs. 2067.80 million in 1987/88 to Rs. 20320.70 million in 2007/08. The condition of foreign grants was good in two years (i.e. FY 2004/05 and 2006/07). Due to these types of condition, fiscal deficit was 4686.80 million in 1987/88 and Rs. 33406.70 million in 2007/08. Where we can see the average annual growth rate of fiscal deficit is 11.85 percent. It is due to the fluctuations in the foreign grants.

Over the review period, amount of bilateral and multilateral loans has increased tremendously which created some sort of constraints in the performance of the economy as a whole. In FY 1987/88, the external loan was Rs.3815.8 million and it has gone up to Rs. 8979.9 million in the FY 2007/08. But in the last four fiscal years i.e. 2000/01 to 2004/05 the amount of external loan has decreased. Due to this, the average annual growth rate of external debt is 7.14 percent. The causes of the decreases external loan may be due to the increment in foreign grants and reduction in the development activities

### **Scenario 'III'**

The third scenario shows that the domestic resource gap. Domestic resource gap is the difference between total expenditure and total revenue (revenue + grant + external loan) or fiscal deficit and external loan which is shown in column 8 of table 4.2. The third type of resource gap is also increasing which was Rs.871.00 million in FY 1987/88 and has gone up to Rs. 20320.70 million in 1997/98. It was largest in the FY 2007/08 i.e., 24426.8 million.

**Table -4.2**  
**Resource Gap as Percentage of GDP (1987/88 to 2007/08)**

(Rs. In Million)

Fiscal Year	GDP at producer's price	Revenue Deficit	Revenue Deficit as percent of GDP	Fiscal Deficit	Fiscal Deficit as percent of GDP
1987/88	76906	6754.6	8.78	4686.80	6.09
1988/89	89270	10228.1	11.46	8547.50	9.57
1989/90	103416	10381.8	10.04	8406.40	8.13
1990/91	120370	12819.9	10.65	10655.10	8.85
1991/92	149487	12905.5	8.63	11261.70	7.53
1992/93	171492	15749.3	9.18	11956.00	6.97
1993/94	199272	14016.6	7.03	11623.00	5.83
1994/95	219175	14484.8	6.61	10547.70	4.81
1995/96	248913	18649.3	7.49	13824.20	5.55
1996/97	280513	20350.2	7.25	14361.90	5.12
1997/98	300845	23180.4	7.71	17777.80	5.91
1998/99	342036	22328	6.53	17991.40	5.26
1999/00	379488	23378.7	6.16	17667.00	4.66
2000/01	441519	30941.5	7.01	24188.10	5.48
2001/02	459443	29626.7	6.45	22940.60	4.99
2002/03	492231	27776.3	5.64	16437.20	3.34
2003/04	536749	27111.6	5.05	15828.20	2.95
2004/05	589412	32437.7	5.50	18046.50	3.06
2005/06	654084	38607.1	5.90	24779.60	3.79
2006/07	728178	45892.5	6.30	30091.70	4.13
2007/08	818401	53727.4	6.56	33406.70	4.08
Average Annual Growth Rate	12.03	11.35	-0.16	11.85	-0.25

*Source: Nepal Government, MOF, Various Economic Surveys 2001/02 and 2008/09.*

Table 4.2 reveals that the revenue deficit as percent of GDP and fiscal deficit as percent of GDP. To analyze the revenue deficit as percent of GDP is more important as the GDP is the main indicator of the performance of the economy, which includes different components of the economy and shows their performance. In this context, revenue deficit as percent of GDP has decreased from 8.78 percent in 1987/88 to 5.05 percent in 2003/04 and average annual growth rate is -0.16 percent.

The fiscal deficit as percent of GDP also decreased from 6.09 percent in 1987/88 to 2.95 percent in 2003/04. The inclusion of grants in government's revenue may not be appropriate because the amount of grants depends upon political considerations of donor countries and agencies and the expected amount of grant may differ from actual amount which may differ from year to year, because it is determined by various factors.

#### **4.3 Composition and Trend of Public Debt in Nepal**

Public debt has been the main source for financing fiscal deficit in Nepal. Although for financing the fiscal deficit both internal and external sources of borrowing have been used in any under developed economy. The total public debt has been increasing rapidly since the restoration of multiparty system in Nepal for meeting the requirement of fiscal deficit.

**Table-4.3****Internal and External Debt as Percentage of Fiscal Deficit (1987/88 to 2007/08)**

(Rs. In Million)

Fiscal Year	Fiscal Deficit	Total Debt	Total debt as percent of Fiscal Deficit	Internal Debt	INT as percent of total debt	External Debt	EXT as percent of total debt	Loan as a percent of fiscal deficit	
								INT loan	EXT loan
1987/88	4686.80	4945.80	105.53	1130.00	22.85	3815.80	77.15	22.85	81.42
1988/89	8547.50	6996.40	81.85	1330.00	19.01	5666.40	80.99	19.01	66.29
1989/90	8406.40	8109.60	96.47	2150.00	26.51	5959.60	73.49	26.51	70.89
1990/91	10655.10	10809.40	101.45	4552.70	42.12	6256.70	57.88	42.12	58.72
1991/92	11261.70	8894.40	78.98	2078.00	23.36	6816.40	76.64	23.36	60.53
1992/93	11956.00	8540.90	71.44	1620.00	18.97	6920.90	81.03	18.97	57.89
1993/94	11623.00	10983.60	94.50	1820.00	16.57	9163.60	83.43	16.57	78.84
1994/95	10547.70	9212.30	87.34	1900.00	20.62	7312.30	79.38	20.62	69.33
1995/96	13824.20	11663.98	84.37	2200.00	18.86	9463.98	81.14	18.86	68.46
1996/97	14361.90	12043.60	83.86	3000.00	24.91	9043.60	75.09	24.91	62.97
1997/98	17777.80	14454.50	81.31	3400.00	23.52	11054.50	76.48	23.52	62.18
1998/99	17991.40	16562.40	92.06	4710.00	28.44	11852.40	71.56	28.44	65.88
1999/00	17667.00	17312.20	97.99	5500.00	31.77	11812.20	68.23	31.77	66.86
2000/01	24188.10	19044.00	78.73	7000.00	36.76	12044.00	63.24	36.76	49.79
2001/02	22940.60	15698.70	68.43	8000.00	50.96	7698.70	49.04	50.96	33.56
2002/03	16437.20	13426.40	81.68	8880.00	66.14	4546.40	33.86	66.14	27.66
2003/04	15828.20	13236.80	83.63	5607.80	42.37	7629.00	57.63	42.37	48.20
2004/05	18046.50	18204.20	100.87	8938.10	49.10	9266.10	50.90	49.10	51.35
2005/06	24779.60	20048.50	80.91	11834.20	59.03	8214.30	40.97	59.03	33.15
2006/07	30091.70	27945.80	92.87	17892.30	64.03	10053.50	35.97	64.03	33.41
2007/08	33406.70	29476.30	88.23	20496.40	69.54	8979.90	30.46	69.54	26.88
Average Annual Growth Rate	11.85	10.45	0.28	20.26	8.66	7.14	-2.52	8.66	-2.77

Source: Nepal Government, MOF, Various Economic Surveys 2001/02 and 2008/09.

The table 4.3 indicates the increasing trend of public debt from both internal and external sources. The total debt was Rs. 4945.80 million in FY 1987/88 and has increased to Rs. 29476.30 million in the FY2007/08. Its average annual rate of growth

over the review period is 10.45 percent. The table shows the increasing trend of public debt in which the increasing trend of external debt is so rapidly then internal debt.

Internal debt was only Rs1130.00 million in the FY 1987/88 and has gone up to Rs. 8880.0 million in 2002/03, but in 2003/04 it has decreased up to 5607.8 million again it has gone up to Rs. 20496.40 in 2007/08. Whereas external debt was Rs. 3815.80.7 million and increased tremendously up to Rs. 12044.0 million in 2000/01 and since then it has decreased to 7629.0 in 2003/04 and again it has increased up to 10053.5 million in 2006/07 and again decreased to 8979.90 in 2007/08.

This table shows the percentage share of internal and external debt to fiscal deficit, in which the contribution of both internal and external debt to their fiscal deficit has been fluctuating. The contribution of internal debt to fiscal deficit was 22.85 percent in the FY 1987/88 whereas external debt was 77.15 percent. But the share of internal debt is 69.54 percent in the FY 2007/08 which shows the increasing contribution and external is 30.46 percent in the same fiscal year, which shows the decreasing contribution to the fiscal deficit.

The absolute terms of the above table show our growing reliance on external loan for meeting the ever-increasing fiscal deficit. This absolute term also shows that (during the last 21 years) our economic performance has not been conducive enough to reduce growing reliance on external loan. This situation has led us to think seriously about this alarming situation.

#### **4.4 Growth Trend of Public Debt**

After the restoration of multiparty system, the financial operations of the government of Nepal have been increased and accordingly the volume of government expenditure is increasing. The reliance on taxation is not possible in view of the large amount of financial resources required for the government expenditure. Therefore, Nepal is facing large and growing financial resource gap in the government budgetary system. In this context, the government borrows from both external and internal sources to bridge the resource gap. The government has borrowed large amount of loans to bridge meet the fiscal deficit. The growth trend of public debt is shown in table 4.4 below:\

**Table -4.4**  
**Trend of Public Debt and Its Annual Growth Rate (1987/88 to 2007/08)**

(Rs. In million)

Fiscal Year	Total Debt	EXT Debt	INT debt	Annual Growth Rate of Total Debt as percent	Annual Growth Rate of Ext Debt as percent	Annual Growth Rate of INT Debt as percent	percent Share of EXT Debt in Total debt	percent Share of INT Debt in Total debt
1987/88	4945.80	3815.80	1130.00	41.46	48.50	17.70	77.15	22.85
1988/89	6996.40	5666.40	1330.00	15.91	5.17	61.65	80.99	19.01
1989/90	8109.60	5959.60	2150.00	33.29	4.99	111.75	73.49	26.51
1990/91	10809.40	6256.70	4552.70	-17.72	8.95	-54.36	57.88	42.12
1991/92	8894.40	6816.40	2078.00	-3.97	1.53	-22.04	76.64	23.36
1992/93	8540.90	6920.90	1620.00	28.60	32.40	12.35	81.03	18.97
1993/94	10983.60	9163.60	1820.00	-16.13	-20.20	4.40	83.43	16.57
1994/95	9212.30	7312.30	1900.00	26.61	29.43	15.79	79.38	20.62
1995/96	11663.98	9463.98	2200.00	3.25	-4.44	36.36	81.14	18.86
1996/97	12043.60	9043.60	3000.00	20.02	22.24	13.33	75.09	24.91
1997/98	14454.50	11054.50	3400.00	14.58	7.22	38.53	76.48	23.52
1998/99	16562.40	11852.40	4710.00	4.53	-0.34	16.77	71.56	28.44
1999/00	17312.20	11812.20	5500.00	10.00	1.96	27.27	68.23	31.77
2000/01	19044.00	12044.00	7000.00	-17.57	-36.08	14.29	63.24	36.76
2001/02	15698.70	7698.70	8000.00	-14.47	-40.95	11.00	49.04	50.96
2002/03	13426.40	4546.40	8880.00	-1.41	67.80	-36.85	33.86	66.14
2003/04	13236.80	7629.00	5607.80	37.53	21.46	59.39	57.63	42.37
2004/05	18204.20	9266.10	8938.10	10.13	-11.35	32.40	50.90	49.10
2005/06	20048.50	8214.30	11834.20	39.39	22.39	51.19	40.97	59.03
2006/07	27945.80	10053.50	17892.30	5.48	-10.68	14.55	35.97	64.03
2007/08	29476.30	8979.90	20496.40	-	-	-	30.46	69.54
Average Annual Growth Rate	10.45	7.14	20.26	10.45	7.14	20.26	64.03	8.66

*Source: Nepal Government, MOF, Various Economic Surveys 2001/02 and 2008/09.*

Table 4.4 shows the government borrowing (internal and external) and their annual growth rate, between the period 1987/88 and 2007/08. The table shows the over the review period total government borrowing has increased with an average annual growth rate of 10.45 percent from Rs 4945.80 million to Rs. 29476.30 million, which is about 5.96 folds. Similarly external borrowing also increases with an average

annual growth rate of 7.14 percent from Rs. 3815.80 million to Rs. 8979.90 million during the period of study. It was at the peak in FY 2000/01, (i.e. 12044.00 million) which was about 3.16 fold. But in FY 2003/04, it became Rs. 7629.0 million, which is about 1.9 times from the beginning. And the average annual growth rate of internal debt is 20.26 percent and in increasing trend from Rs. 1130.00 million to Rs. 20496.40 million.

Table 4.4 also indicates that the external debt increased more than the internal debt in absolute term during the period of review. Although the trend clearly shows that the government borrowing is increasing in both absolute and relative terms. The percentage shares of external and internal debt in total debt are 30.46 and 69.54 percent respectively in 2007/08. It indicates that external loan is in decreasing rate and internal loan is in increasing rate.

#### **4.5 Outstanding Public Debt in Nepal**

The government of Nepal has to borrow large amount of public debt to meet ever increasing financial resource gap. Usually public debt is used as a means of meeting government budgetary deficit, but in case of Nepal, it has become main and reliable source of meeting the government's budget deficit over the last years. So the volume of outstanding public debt is continuously increasing. In Nepal, public debt is used as a means of financing the government expenditure. There was a target of 20.79 percent of total expenditure to be financed through public debt in 2004/05 but about 24 percent of total expenditure was financed by public debt in FY 2000/01. And about 15 percent of total expenditure was fulfilled by public debt in 2003/04. It shows that slightly decreasing direction but increasing trend in practice (Gorkhapatra, July 17, 2005).

Table 4.5 shows that the net outstanding debt in Nepal over the review period. The table shows that total outstanding public debt of the government of Nepal has increased from Rs. 29823.40 million in 1987/88 to Rs. 366004.90 in 2007/08 with the average annual growth rate of 12.31 percent. The table also shows that the outstanding external debt has increased from Rs. 20826.00 million in 1987/88 to Rs.249965.40 million in 2007/08. Its share in total outstanding debt was 69.83 percent in 1987/88 that has gone up to 81.52 percent in 1998/99 and 68.29 percent in 2007/08.

On the other hand internal outstanding debt has increased from Rs. 8997.40 million in 1987/88 to Rs. 116039.51 million in 2007/08, where its percentage share in total outstanding debt was 30.17 in 1987/88 and 31.70 in 2007/08. The average annual growth rate of external outstanding debt is 14.28 percent and the average annual growth rate of internal outstanding debt is 13.42 percent. Table 4.5 shows that during the review period the average percentage share of external debt to the total outstanding debt was above -0.03 and that of the internal debt was below 1.08 percent in each year. One of the factors responsible for rapid increase in the external debt is depreciation of Nepalese currency. Some other attributing factors are growing needs of foreign currencies, to bridge the current account deficits and capital deficiency in the economy. The average annual share of internal outstanding debt and external to total outstanding debt is 1.08 percent and -0.03 percent respectively over the period of study. This table also indicates that the share of external debt to total outstanding public debt is lower than that of internal. So, in reality we have been indebted to internal debt to a considerable extent. The government of Nepal should, therefore make a rigorous attempt to reduce the increasing debt burden.

**Table -4.5**  
**Outstanding Public Debt (1987/88 to 2007/08)**

(Rs. In Million)

Fiscal Year	Total outstanding debt (I)	External outstanding debt(II)	(II) as a percent of (I) (III)	Internal outstanding debt(IV)	(IV)as percent of (I)
1987/88	29823.40	20826.00	69.83	8997.40	30.17
1988/89	40852.90	29216.90	71.52	11636.00	28.48
1989/90	49688.80	36800.90	74.06	12887.90	25.94
1990/91	74178.40	59505.30	80.22	14673.10	19.78
1991/92	91779.80	70923.90	77.28	20855.90	22.72
1992/93	110655.70	87420.80	79.00	23234.90	21.00
1993/94	127422.90	101966.80	80.02	25456.10	19.98
1994/95	143632.10	113000.90	78.67	30631.20	21.33
1995/96	158302.20	128044.40	80.89	30257.80	19.11
1996/97	166328.70	132086.80	79.41	34241.90	20.59
1997/98	137698.90	101808.00	73.94	35890.90	26.06
1998/99	207872.60	169465.90	81.52	38406.70	18.48
1999/00	240360.80	190691.20	79.34	49669.60	20.66
2000/01	260448.10	200404.40	76.95	60043.70	23.05
2001/02	293746.30	220125.60	74.94	73620.70	25.06
2002/03	308078.50	223433.20	72.52	84645.30	27.48
2003/04	318913.00	232779.30	72.99	86133.70	27.01
2004/05	307206.10	219641.90	71.50	87564.20	28.50
2005/06	328679.40	233968.60	71.18	94710.80	28.82
2006/07	320404.94	216628.90	67.61	103776.04	32.39
2007/08	366004.91	249965.40	68.30	116039.51	31.70
Average Annual Growth Rate	12.31	14.28	-0.03	13.42	1.08

*Source: Nepal Government, MOF, Various Economic Surveys 2001/02 and 2008/09.*

#### **4.6 Sources of Internal Debt**

The government can borrow internal debt from banking and non-banking sources. Borrowing from banking sources is the borrowing from the central bank and other banks. This type of borrowing may be inflationary because it assists to increase the demand of goods. Borrowing from non-banking source is the borrowing from general

public of the country like citizen saving bond, national saving bond etc. This type of borrowing assists to reduce the disposable income of the general people and hence it may not be inflationary. Hence the efforts should be made toward internal debt mobilization through non-banking system. The volume of internal debt from banking and non-banking source has been shown in the table 4.6.

**Table – 4.6**  
**Sources of internal Debt (1987/88 to 2007/08)**

(Rs. In Million)

Fiscal Year	Banking source(1)	Non banking source(2)	Total debt(3)	(1) as percent of (3)	(2) as percent of (3)
1987/88	NA	NA	NA	NA	NA
1988/89	1320.00	10.00	1330.00	99.25	0.75
1989/90	1450.00	700.00	2150.00	67.44	32.56
1990/91	3713.20	839.50	4552.70	81.56	18.44
1991/92	1178.80	900.00	2078.80	56.71	43.29
1992/93	920.00	700.00	1620.00	56.79	43.21
1993/94	1000.00	820.00	1820.00	54.95	45.05
1994/95	1300.00	600.00	1900.00	68.42	31.58
1995/96	750.00	1450.00	2200.00	34.09	65.91
1996/97	1500.00	1500.00	3000.00	50.00	50.00
1997/98	1600.00	1800.00	3400.00	47.06	52.94
1998/99	2850.00	1860.00	4710.00	60.51	39.49
1999/00	3300.00	2200.00	5500.00	60.00	40.00
2000/01	NA	NA	NA	NA	NA
2001/02	NA	NA	NA	NA	NA
2002/03	NA	NA	NA	NA	NA
2003/04	NA	NA	NA	NA	NA
2004/05	63897.20	21567.80	85465.00	74.76	25.24
2005/06	70570.10	20455.80	91025.90	77.53	22.47
2006/07	78343.60	17837.80	96181.40	81.45	18.55
2007/08	78096.80	20213.10	98309.90	79.44	20.56
Average Annual Growth Rate	19.59	471.82	16.59	0.29	290.38

*Source: Nepal Government, MOF, Various Economic Surveys 2001/02 and 2008/09.*

Share of banking sources to total internal borrowing has increased from Rs. 1320.00 million in 1988/89 to Rs. 63897.20 million in 2004/05 and 78096.80 million in 2007/08. On the other hand, Share of non- banking sources to total internal borrowing has increased from Rs. 10.00 million in 1988/89 to Rs. 21567.80 million in 2004/05 and 20213.10 million in 2007/08 percentage share of non-banking source has increased from 0.75 percent to 20.56 percent over the study period. This indicates that the contributions of non-banking financial sources have been increasing.

#### **4.7 Pattern of Internal Net Outstanding Debt**

Internal borrowing program carried since 1961 in Nepal. Nepal has been borrowing internally under the different plans to bridge the resource gap on the budgetary system and mobilizing financial resource for development.

Now the government receives the internal borrowing by issuing mainly treasury bills, development bonds, National Saving Certificate, Public Saving Card and special bonds, where Citizens saving certificates is new concept and has issued since 2001/02. The pattern of internal debt is shown in table 4.7.

**Table – 4.7****Structure of Internal Net Outstanding Debt (1987/88 to 2007/08)**

(Rs. In Million)

Fiscal Year	Treasury bills	Development bonds	National saving certificate	Citizens saving certificates	Special bonds	Total internal outstanding debt
1987/88	3440.00	2990.00	1940.00	NA	627.40	8997.40
1988/89	4090.00	4651.70	2196.50	NA	697.80	11636.00
1989/90	1171.00	5088.60	2196.50	NA	4431.80	12887.90
1990/91	1821.00	5388.60	2896.50	NA	4567.00	14673.10
1991/92	2351.00	5482.30	3646.50	NA	9376.10	20855.90
1992/93	3483.20	5132.20	4546.30	NA	10073.20	23234.90
1993/94	4403.20	5132.20	4901.50	NA	11019.20	25456.10
1994/95	5216.30	4732.20	5691.50	NA	14991.20	30631.20
1995/96	6392.50	4122.20	6076.40	NA	15466.70	32057.80
1996/97	7142.50	3672.20	7376.50	NA	16050.70	34241.90
1997/98	8092.50	3042.20	8736.50	NA	16019.70	35890.90
1998/99	9182.50	3302.20	9886.40	NA	16035.60	38406.70
1999/00	17586.90	3872.20	10426.40	NA	17784.10	49669.60
2000/01	27610.80	5962.20	12476.40	NA	13994.30	60043.70
2001/02	41106.50	11090.70	11536.10	628.10	9259.30	73620.70
2002/03	48860.70	16059.20	9629.80	931.10	9164.50	84645.30
2003/04	49429.60	17549.20	9029.80	1178.90	8946.20	86133.70
2004/05	51383.10	19999.20	6576.70	1428.90	8176.30	87564.20
2005/06	62970.30	17959.20	3876.80	1678.90	8225.60	94710.80
2006/07	74445.34	19177.10	1516.92	1391.00	7245.69	103776.05
2007/08	85033.03	21735.43	1116.92	3014.36	5139.77	116039.51
Average Annual Growth Rate	22.03	12.44	0.89	10.15	29.42	13.40

Source: Nepal Government, MOF, Various Economic Surveys 2001/02 and 2008/09.

Table 4.7 shows the structure of internal net outstanding debt in which the government mainly receives the internal resources by five sources. Among them Citizens Saving Card was started from 2001/02. Before this, there were only four

sources, which contributed much more in the field of internal net outstanding debt, where the contribution of Treasury Bills is larger because its percentage share to total internal outstanding debt is increasing trend over the study period.

After the enforcement of public debt Act 1960, internal debt for the first time was issued by Nepal in 1962 through Treasury Bills amounting Rs. 7.0 million. The next instrument of internal debt as development bonds was first issued in FY 1963/64, amounting Rs. 250.0 million.

Table -4.8

**Structure of Internal Net outstanding Debt in Percentage (1987/88 to 2007/08)**

(Rs. In million)

Fiscal Year	Total Internal Outstanding Debt(1)	percent Share of Treasury Bills to (1)	percent Share of Development Bonds to (1)	percent Share of National saving Certificate to (1)	percent Share of Citizens saving Certificate to (1)	percent Share of Special Bonds to (1)
1987/88	8997.40	38.23	33.23	21.56	NA	6.97
1988/89	11636.00	35.15	39.98	18.88	NA	6.00
1989/90	12887.90	9.09	39.48	17.04	NA	34.39
1990/91	14673.10	12.41	36.72	19.74	NA	31.12
1991/92	20855.90	11.27	26.29	17.48	NA	44.96
1992/93	23234.90	14.99	22.09	19.57	NA	43.35
1993/94	25456.10	17.30	20.16	19.25	NA	43.29
1994/95	30631.20	17.03	15.45	18.58	NA	48.94
1995/96	32057.80	19.94	12.86	18.95	NA	48.25
1996/97	34241.90	20.86	10.72	21.54	NA	46.87
1997/98	35890.90	22.55	8.48	24.34	NA	44.63
1998/99	38406.70	23.91	8.60	25.74	NA	41.75
1999/00	49669.60	35.41	7.80	20.99	NA	35.80
2000/01	60043.70	45.98	9.93	20.78	NA	23.31
2001/02	73620.70	55.84	15.06	15.67	0.85	12.58
2002/03	84645.30	57.72	18.97	11.38	1.10	10.83
2003/04	86133.70	57.39	20.37	10.48	1.37	10.39
2004/05	87564.20	58.68	22.84	7.51	1.63	9.34
2005/06	94710.80	66.49	18.96	4.09	1.77	8.68
2006/07	103776.05	71.74	18.48	1.46	1.34	6.98
2007/08	116039.51	73.28	18.73	0.96	2.60	4.43
Average Annual Growth Rate	13.40	7.41	-0.97	-10.87	21.62	14.36

*Source: Nepal Government, MOF, Various Economic Surveys 2001/02 and 2008/09.*

Table 4.8 shows the share of Treasury Bills, Development Bonds, National Saving Certificate and Special Bonds to total net internal outstanding debt which are 38.23

percent, 33.23 percent, 21.56 percent and 6.97 percent respectively in 1987/88, which has increased over the review period in case of treasury bills and there is fluctuating trend in case of Saving Certificate, Citizens Saving Card, and Special Bonds over the review period.

The percentage share of Treasury Bills is 73.28 and of Development Bonds, National Saving Certificate, Citizens Saving Card and Special Saving Bonds are 18.73 percent, 0.96 percent, 2.60 percent and 4.43 percent respectively in FY 2007/08. This shows that more than half of internal net outstanding debt has mobilize through Treasury Bills.

We can reach in the conclusion by above table but volume of internal borrowing is increasing without increasing in tax revenue collection proportion to the growth in the government expenditure. This action also will create the inflationary situation, which may leads us into debt crisis in future.

#### **4.8 Sources of External Borrowing**

Nepal has borrowed the external loan through bilateral and multilateral sources.

Bilateral loans are the, loans from foreign individual government and their agencies, loans from autonomous bodies and direct loans from official expert credit agencies.

Multilateral loans are the loans form multilateral agencies such as World Bank, IMF, Regional Development Banks and other multilateral and intergovernmental agencies (WB, 1996).

**Table -4.9**

**Structure of External Loan in Terms of Disbursement by Major Sources  
(1987/88 to 2007/08)**

(Rs. In Million)

Fiscal Year	Total External Loan(1)	Bilateral Loan(2)	Multilateral Loan(3)	(2) as percent of (1)	(3) as percent of (1)
1987/88	3094.30	462.50	2631.80	14.95	85.05
1988/89	4188.70	507.80	3680.90	12.12	87.88
1989/90	4628.30	1000.60	3627.70	21.62	78.38
1990/91	4360.00	1602.80	2757.20	36.76	63.24
1991/92	6269.40	2389.80	3879.60	38.12	61.88
1992/93	5961.70	1307.60	4654.10	21.93	78.07
1993/94	9163.60	582.90	8580.70	6.36	93.64
1994/95	7312.30	717.30	6595.00	9.81	90.19
1995/96	9463.90	460.00	9003.90	4.86	95.14
1996/97	9043.60	850.70	8192.90	9.41	90.59
1997/98	11054.50	1314.50	9740.00	11.89	88.11
1998/99	11852.40	584.00	11268.40	4.93	95.07
1999/00	11812.20	757.90	11054.30	6.42	93.58
2000/01	12044.00	586.70	11457.30	4.87	95.13
2001/02	7698.60	87.00	7611.60	1.13	98.87
2002/03	4546.40	657.20	3889.20	14.46	85.54
2003/04	7629.00	66.00	7563.00	0.87	99.13
2004/05	9266.10	126.50	9139.60	1.37	98.63
2005/06	8214.30	40.60	8173.70	0.49	99.51
2006/07	10053.52	9004.59	1048.93	89.57	10.43
2007/08	8979.88	632.11	8347.77	7.04	92.96
Average Annual Growth Rate	8.62	1080.17	39.58	905.84	34.65

*Source: Nepal Government, MOF, Various Economic Surveys 2001/02 and 2008/09.*

Table 4.9 clearly shows the decreasing trend of bilateral loans and increasing trend of multilateral loans over the review period.

In the beginning of the review period the share of bilateral loans to total external loan is Rs. 462.50 million (14.95percent) and multilateral is Rs. 3094.30 million (85.05

percent) and the end of the year of the study the bilateral loan decreased to Rs. 632.11 million (7.04 percent) and multilateral loan increased to Rs. 8979.88 million (92.96 percent). But it was high in the FY 2005/06 with Rs. 8214.30 million (99.51 percent). The average annual growth rate of bilateral and multilateral loan is 1080.17 percent and 39.58 percent respectively over the study period.

Table 4.9 shows the multilateral debt was dominated the bilateral debt in the structure of external debt of Nepal, where annual growth rate of multilateral loan average is 39.58 percent and bilateral loan is 1080.17 percent. Over the period of review, the amount of grants did not sufficiently increase; where it is Rs. 2067.80 million in 1987/88 to Rs. 20320.70 million in 2007/08, which has not enough to cover the budgetary deficit. During this period, the amount of bilateral and multilateral loan has increased tremendously which has created some sort of constraint in the performance of economy as a whole.

Due to the delay in timely implementation of the projects, donors are reluctant to disburse the committed amount of foreign aid. The main cause of the delay in the disbursement is the time lag because aid for the many project are committed in one year and the committed aid is being disbursed in the subsequent years. When the returns from the investment in the economy were not obtained on time, the foreign assistance could not be fully utilized government of Nepal ever since it began to receive aid. It becomes clear that if one goes to the gap between the commitment and disbursement of aid during the study period. Another main feature of foreign aid is during the study period. Another main feature of foreign aid in Nepal is the constant shortfall of disbursement against commitment.

#### **4.9 Burden of Public Debt in Nepal**

The debt burden refers to the extra tax imposed by government on the citizens to repay public debt including interest. Every government is bound to repay the public borrowing whether internally or externally with interest, this burden of public debt may be direct, indirect, monetary or real and it may tend to fall on the person or sometimes on the future generation.

The total burden of public debt can be divided into two parts: 1) burden of internal public debt, 2) burden of external public debt. The internal means the total part of the debt which is held internally. Dalton (1949) takes internal public debt burden as not much significant as the payment of principle amount and its interest involves taxation. It is an early transfer of purchasing power from one person to another or money market. Similarly, Lerner (1955) points out that the internal debt may not have any direct monetary burden on a community as a whole, since the payment of interest and increased taxation to meet the burden of debt involved simply transfer of the purchasing power from one group of people to another extent that creditors and tax payer are the same; there may not be any net burden to all the community. But to the extent of creditors and tax payers belong to different income groups, the changes in the distribution of income among different section of the community may take place.

In case of external debt burden it is however, completely different. External debt imposes real burden on the economy because it reduces national welfare. External debt is paid not in monetary terms but in real terms, in terms of goods and services. Which are exporters to the creditor country for the settlement of debt? The process will have to continue during the whole period of loan because the borrower country has to pay interest charges, but if external loans are used for increasing the productive capacity of the economy, the debt repayment may not be a serious burden. The debtor country may pay off the debt and interest without any difficulty because of increased capacity of export oriented industries. If debtor country does not sufficiently increase the production and export, it will have to face the balance of payments problem.

Therefore any borrower country has to spend the borrowed fund on creation of new productive capacity, which further generates income and increases the rate of capital formation then it is quite possible that the debt would not be burden to the society. If the borrowed fund is spent otherwise and the government would have to borrow again to meet the requirements of development funds and for meeting the charge of debt servicing, it is quite possible that this process leads to bankruptcy of the government or debt crisis in the future.

Regarding the shift of the debt burden to the future generation, there is debate among the economists. A group of economists argues that if the present generation reduces

current saving in order to repay the debt and leaves a smaller amount of capital resources for future, it will not create sufficient capacity for the coming generation. In this way, burden of public debt may pass on to the future generation. But on the other hand, another group of economists has challenged the above version and expressed opposite opinion on the subject of burden of public debt. They argue that there is no shift of the basic burden to the future generation because the stage posterity, which pays the additional taxes, will be benefited from the repayment of the debt with interest. In my opinion, if additional taxes are imposed on present generation to repay the debt, it is paid partly by reducing current consumption and partly by reducing current saving. The former lowers the standard of living of the present generation. This is the real burden of debt on present generation. Reduction on current saving means reduction in future consumption which will become small burden on future generation. Thus the part of current saving used in paying tax reduces saving and future consumption and to that extent the debt burden is shifted to future generation.

On the basis of the above discussion, we can say that it is difficult to conclude a specific opinion in the issue. Thus, the question of shifting the burden of public debt to the future generation has remained an unsettled riddle so far.

In case of Nepal, public debt is increasing rapidly each year, which was 57.57 percent of GDP in 2004/05. Large scale public debt have been incurred in the past for financing development programs, but debt servicing capacity is not increasing in the same pace, that may cause undue strain in the balance of payment owing to outflow of funds through debt services. Nepal has been borrowing fresh loan to repay old loans. This also has alarmed the situation of 'debt trap' in the future.

#### **4.10 National Outstanding Debt and Its Share in GDP**

The ratio of public debt to GDP is an important indicator of the manageability of public debt in an economy. The relative shares of the public debt in the GDP should be taken into consideration for assessing the burden of growing public indebtedness. Nepal has to borrow huge amount of external as well as internal loans for meeting the budget deficit. And on the other hand, the tax revenue and non-tax revenue are not increasing as it is predicted and improper utilization of public debt and corruption, debt servicing capacity is not increasing as a result burden of outstanding debt is

increasing. Table 4.10 shows the burden of debt through the method of measure of burden of debt as the ratio of public debt to GDP.

**Table -4.10**

**Outstanding Debt and its Share in GDP (1987/88 to 2007/08)**

(Rs. In Million)

Fiscal Year	External Outstanding Debt	Internal Outstanding debt	Total Public Debt	GDP at Producer's Price	percent Share debt in GDP		
					External debt	Internal debt	Total debt
1987/88	20826.00	8997.40	29823.40	76906.00	27.08	11.70	38.78
1988/89	29216.90	11636.00	40852.90	89270.00	32.73	13.03	45.76
1989/90	36800.90	12887.90	49688.80	103416.00	35.59	12.46	48.05
1990/91	59505.30	14673.10	74178.40	120370.00	49.44	12.19	61.63
1991/92	70923.90	20855.90	91779.80	149487.00	47.44	13.95	61.40
1992/93	87420.80	23234.90	110655.70	171492.00	50.98	13.55	64.53
1993/94	101966.80	25456.10	127422.90	199272.00	51.17	12.77	63.94
1994/95	113000.90	30631.20	143632.10	219175.00	51.56	13.98	65.53
1995/96	128044.40	30257.80	158302.20	248913.00	51.44	12.16	63.60
1996/97	132086.80	34241.90	166328.70	280513.00	47.09	12.21	59.29
1997/98	101808.00	35890.90	137698.90	300845.00	33.84	11.93	45.77
1998/99	169465.90	38406.70	207872.60	342036.00	49.55	11.23	60.78
1999/00	190691.20	49669.60	240360.80	379488.00	50.25	13.09	63.34
2000/01	200404.40	60043.70	260448.10	441519.00	45.39	13.60	58.99
2001/02	220125.60	73620.70	293746.30	459443.00	47.91	16.02	63.94
2002/03	223433.20	84645.30	308078.50	492231.00	45.39	17.20	62.59
2003/04	232779.30	86133.70	318913.00	536749.00	43.37	16.05	59.42
2004/05	219641.90	87564.20	307206.10	589412.00	37.26	14.86	52.12
2005/06	233968.60	94710.80	328679.40	654084.00	35.77	14.48	50.25
2006/07	216628.90	103776.04	320404.94	728178.00	29.75	14.25	44.00
2007/08	249965.40	116039.51	366004.91	818401.00	30.54	14.18	44.72
Average Annual Growth Rate	14.28	13.42	12.31	12.03	2.80	1.25	1.42

Source: Nepal Government, MOF, Various Economic Surveys 2001/02 and 2008/09.

Observing table 4.10, it shows the magnitude of outstanding debt, GDP and their ratio, which also assesses the burden of public debt. This table shows the ratio of internal and external debt to GDP in the year between 1987/88 to 2007/08. The share of external debt in GDP was 27.08 percent in 1987/88, which has increased to 30.54 percent in the year 2007/08, showing fluctuating trend. Similarly, this table also shows the share of internal debt in GDP. It has also increased from 11.70 percent in 1987/88 to 14.18 percent in 2007/08. It means burden of public debt is increasing and total outstanding public debt has increased from Rs. 29823.40 million in 1987/88 to Rs. 366004.90 million in 2007/08 and share of it in GDP has increased from 38.78 percent to 44.72 percent.

This indicates an alarming situation of burden of debt in Nepal. Table also shows that the burden of external outstanding debt is greater than that of internal debt which may be danger for the future generation. This magnitude of the burden of public debt may increase to alarming situation of productive capacity is no created in the economy for increasing production. Here, comparing the table 4.9, we can see that growth rate of GDP is less than the growth rate of outstanding debt and the part of GDP used in repaying debt is continuously increasing. It may lead to a situation of bankruptcy.

#### **4.11 Debt Servicing Issues in Nepal**

The payment of interest and principle of public debt is known as debt servicing. In Nepal, the share of foreign loan is in increasing trend that ultimately increases financial and real burden on future generation.

Table 4.11 shows the ratio of internal and external debt servicing and their average annual growth rate and percentage share of external and internal debt servicing to total debt servicing.

**Table – 4.11****Share of External and Internal Debt Servicing in Total Debt Servicing (1987/88 to 2007/08)**

(Rs. In Million)

Fiscal Year	Total debt servicing(1)	External debt servicing(2)	Internal debt servicing(3)	(2)as percent of (1)	(3) as percent of (1)
1987/88	NA	591.00	NA	NA	NA
1988/89	1720.70	701.30	1019.40	40.76	59.24
1989/90	2279.20	1123.60	1155.60	49.30	50.70
1990/91	2407.40	1086.50	1320.90	45.13	54.87
1991/92	3797.10	1664.90	2132.20	43.85	56.15
1992/93	4560.50	2131.90	2428.60	46.75	53.25
1993/94	4855.10	2488.70	2366.40	51.26	48.74
1994/95	6083.30	2984.70	3098.60	49.06	50.94
1995/96	6715.50	3304.30	3411.20	49.20	50.80
1996/97	7527.20	3349.40	4177.80	44.50	55.50
1997/98	7682.80	4201.20	3481.60	54.68	45.32
1998/99	8723.00	4745.50	3977.50	54.40	45.60
1999/00	10032.80	5321.40	4711.40	53.04	46.96
2000/01	10388.40	6201.40	4187.00	59.70	40.30
2001/02	12205.20	6567.50	5637.70	53.81	46.19
2002/03	16181.30	7519.20	8662.10	46.47	53.53
2003/04	17338.80	7908.90	9429.90	45.61	54.39
2004/05	19751.30	8101.30	11650.00	41.02	58.98
2005/06	20423.50	9151.40	11272.10	44.81	55.19
2006/07	16916.30	9594.30	7322.00	56.72	43.28
2007/08	22760.60	10014.70	12745.90	44.00	56.00
Average Annual Growth Rate	14.81	15.37	16.27	1.14	0.45

Source: Nepal Government, MOF, Various Economic Surveys 2001/02 and 2008/09.

On observing Table 4.11 the amount of total debt servicing was Rs. 1720.70 million in 1988/89 and has increased to Rs. 22760.60 million in 2007/08 with average annual growth rate of 14.81 percent. This shows as an increasing trend of total debt servicing. The volume of external debt servicing was Rs. 591.00 million in 1987/88 and has

increased to Rs. 10014.70 million in 2007/08 and the internal debt service was Rs. 1019.40 million in 1988/89 and has gone up to Rs. 12745.90 million in 2007/08. The average annual growth rate of total and internal debt servicing is higher than external debt servicing and that of internal debt servicing are 15.37 percent and 16.27 percent respectively. The annual growth rate of external debt servicing is lower than that of internal, internal debt servicing is increasing at higher rate than external debt servicing to total debt servicing was 44.00 percent and 56.0 percent respectively. At the end of the year, government is doing well because it has increased its internal source to the debt servicing. It shows a happy signal of improvement in Nepal's debt servicing situation.

**Table – 4.12**  
**Share of Interest and Principal Payments in Total Debt Servicing (1987/88 to**  
**2007/08)**

(Rs. In Million)

Fiscal Year	Total debt servicing (1)	Principle payments (2)	Interest payments (3)	(2) as percent of (1)	(3) as percent of (1)
1987/88	-	-	-	-	-
1988/89	1720.70	534.10	1186.60	31.04	68.96
1989/90	2279.20	802.30	1476.90	35.20	64.80
1990/91	2407.40	739.00	1668.40	30.70	69.30
1991/92	3797.10	1207.00	2590.10	31.79	68.21
1992/93	4560.50	1597.90	2962.60	35.04	64.96
1993/94	4855.10	1898.20	2956.90	39.10	60.90
1994/95	6083.30	2653.20	3430.10	43.61	56.39
1995/96	6715.50	2847.50	3868.00	42.40	57.60
1996/97	7527.20	3453.30	4073.90	45.88	54.12
1997/98	7682.80	3931.20	3751.60	51.17	48.83
1998/99	8723.00	4642.70	4080.30	53.22	46.78
1999/00	10032.80	5212.70	4820.10	51.96	48.04
2000/01	10388.40	5690.60	4697.80	54.78	45.22
2001/02	12205.20	6435.00	5770.20	52.72	47.28
2002/03	16181.30	9559.50	6621.80	59.08	40.92
2003/04	17338.80	10794.90	6543.90	62.26	37.74
2004/05	19751.30	13533.30	6218.00	68.52	31.48
2005/06	20423.50	14264.80	6158.70	69.85	30.15
2006/07	16916.30	16752.34	163.96	99.03	0.97
2007/08	22760.60	16386.93	6373.67	72.00	28.00
Average Annual Growth Rate	14.81	19.96	193.89	5.09	48.53

*Source: Nepal Government, MOF, Various Economic Surveys 2001/02 and 2008/09.*

Similarly table 4.12 shows the servicing amount of interest payments and principal payments in total debt servicing amount. While observing table 4.12 shows the 14.81 percent of average annual growth rate of total debt servicing over the study period, where share of interest amount was Rs. 1186.60 million in FY 1988/89 and has gone up to Rs. 6373.67 million in FY 2007/08. Similarly share of principal amount was Rs.

534.10 million in FY 1988/89 and has gone up to Rs. 16386.93 million in FY 2007/08 over the review period. The table shows that increasing trend of principal payments is higher than interest payments. The servicing amount of interest and principal payments indicates that large proportion of regular expenditure has gone to creditor countries, which has hampered regular expenditure as well as development expenditure. In 2004/05, 18.89percent of regular expenditure has gone to service of principle payments and interest payments; this indicates the serious situation of debt servicing and burden of public debt of Nepal i.e. the burden of debt servicing is increasing that may adversely affect the growth process.

#### **4.12 Ownership Pattern of Internal Debt Servicing Situation**

The burden of public debt is measured by the ratio between the debt servicing and aggregate tax revenue and non-tax revenue or total revenue and the ratio between servicing cost and national income (GDP). This has been shown in table 4.13

**Table -4.13**  
**Share of Internal Debt Servicing in Total Revenue, Regular Expenditure, and**  
**GDP (1987/88 to 2007/08)**

(Rs. In Million)

Fiscal Year	Regular Expenditure (1)	Total Revenue (2)	GDP (3)	Internal Debt Servicing (4)	Debt servicing as percent of (1)	Debt servicing as percent of (2)	Debt servicing as percent of (3)
1987/88	4677.00	7350.40	76906.00	NA	NA	NA	NA
1988/89	5676.20	7776.90	89270.00	1019.40	17.96	13.11	1.14
1989/90	6671.80	9287.50	103416.00	1155.60	17.32	12.44	1.12
1990/91	7570.30	10729.90	120370.00	1320.90	17.45	12.31	1.10
1991/92	9905.40	13512.70	149487.00	2132.20	21.53	15.78	1.43
1992/93	11484.10	15148.40	171492.00	2428.60	21.15	16.03	1.42
1993/94	12409.20	19580.80	199272.00	2366.40	19.07	12.09	1.19
1994/95	19265.10	24575.20	219175.00	3098.60	16.08	12.61	1.41
1995/96	21561.90	27893.10	248913.00	3411.20	15.82	12.23	1.37
1996/97	24181.10	30373.50	280513.00	4177.80	17.28	13.75	1.49
1997/98	27174.40	32937.90	300845.00	3481.60	12.81	10.57	1.16
1998/99	31047.70	37251.00	342036.00	3977.50	12.81	10.68	1.16
1999/00	34523.30	42893.80	379488.00	4711.40	13.65	10.98	1.24
2000/01	42769.20	48893.60	441519.00	4187.00	9.79	8.56	0.95
2001/02	48590.00	50445.50	459443.00	5637.70	11.60	11.18	1.23
2002/03	54973.10	56229.80	492231.00	8662.10	15.76	15.40	1.76
2003/04	55552.10	62331.00	536749.00	9429.90	16.97	15.13	1.76
2004/05	61686.40	70122.70	589412.00	11650.00	18.89	16.61	1.98
2005/06	67017.80	72282.10	654084.00	11272.10	16.82	15.59	1.72
2006/07	77122.40	87712.10	728178.00	7322.00	9.49	8.35	1.01
2007/08	91446.90	107622.50	818401.00	12745.90	13.94	11.84	1.56
Average Annual Growth Rate	15.68	13.89	12.03	16.27	0.95	1.86	4.04

*Source: Nepal Government, MOF, Various Economic Surveys 2001/02 and 2008/09.*

The expenditure heads till FY 2002/03 were classified as regular and development. During FY 2003/04 and 2004/05, such expenditure has been classified as recurrent expenditure amounted to Rs. 55552.10 million and Rs. 61686.4 million, capital

expenditure amounted to Rs. 23095.60 million and Rs. 27340.70 million and principal repayment expenditure amounted to Rs. 10794.90 million and to Rs. 13533.30 million in FY 2003/04 and 2004/05. That's why here researcher did not submit the regular and development expenditure in FY 2003/04 and 2004/05. So comparison is done between 1987/88 to 2002/03 in the regular and development expenditure.

Table 4.13 shows the average annual growth rate and volume of regular expenditure, Total Revenue, GDP and internal debt servicing. It also shows the share of TR, RE and GDP as percentage of internal debt servicing. Under the period of the study, the magnitude of regular expenditure, total revenue, and GDP was Rs. 4677.00 million. Rs. 7350.40 million, Rs. 76906 million in 1987/88 and has increased up to Rs. 54973.10 million (in FY 2003/04), Rs. 62331.00 million, Rs.536749 million and Rs. 61686.40 million (recurrent expenditure), Rs. 70122.70 million ,Rs. 589412 million in 2003/04 and 2004/05 respectively. But due the classification of the expenditure head into regular and development expenditure its actual data could not find in FY 2003/04 and 2004/05.

The trend of debt servicing as percentage of regular expenditure, total revenue and GDP has been decreasing and fluctuating. Debt servicing as a percentage of regular expenditure was 17.96 percent in 1988/89 and decreased to 13.94 percent (till FY 2007/08), and total revenue was 13.12 percent and decreased to 11.84 percent over the period of the study. Likewise, share of debt servicing to GDP is 1.14 percent and increased to 1.55 percent in FY 2007/08.

**Table -4.14**  
**Outstanding Public Debt, Development Expenditure, and Debt Servicing**  
**(1987/88 to 2007/08)**

(Rs. In Million)

Fiscal Year	Total outstanding debt (1)	Development expenditure (2)	Total debt servicing (3)	(1) as percent of (2)	(3) as percent of (2)
1987/88	29823.40	9428.00	NA	316.33	-
1988/89	40852.90	12328.70	1720.70	331.36	13.96
1989/90	49688.80	12997.50	2279.20	382.30	17.54
1990/91	74178.40	15979.50	2407.40	464.21	15.07
1991/92	91779.80	16512.80	3797.10	555.81	22.99
1992/93	110655.70	19413.60	4560.50	569.99	23.49
1993/94	127422.90	21188.20	4855.10	601.39	22.91
1994/95	143632.10	19794.90	6083.30	725.60	30.73
1995/96	158302.20	24980.50	6715.50	633.70	26.88
1996/97	166328.70	26524.60	7527.20	627.07	28.38
1997/98	137698.90	28943.90	7682.80	475.74	26.54
1998/99	207872.60	28531.30	8723.00	728.58	30.57
1999/00	240360.80	31749.20	10032.80	757.06	31.60
2000/01	260448.10	37065.90	10388.40	702.66	28.03
2001/02	293746.30	31482.10	12205.20	933.06	38.77
2002/03	308078.50	29033.00	16181.30	1061.13	55.73
2003/04	318913.00	23095.60	17338.80	1380.84	75.07
2004/05	307206.10	27340.70	19751.30	1123.62	72.24
2005/06	328679.40	29606.60	20423.50	1110.16	68.98
2006/07	320404.90	39729.90	16916.30	806.46	42.58
2007/08	366004.90	53516.10	22760.60	683.92	42.53
Average Annual Growth Rate	13.78	9.67	14.81	5.54	8.10

*Source: Nepal Government, MOF, Various Economic Surveys 2001/02 and 2008/09.*

The expenditure head till FY 2002/03 were classified as regular and development. During FY 2003/04 to 2007/08, such expenditure has been classified into recurrent expenditure and capital expenditure amounted Rs. 55552.1 million and Rs. 91446.90 million, capital expenditure amounted to Rs. 23095.60 million and Rs. 53516.10 million and principal repayment expenditure amounted to Rs. 10794.90 million and

Rs.16386.93 million in FY 203/04 and 2007/08 respectively. That's why; here, researcher has taken into account the regular and capital expenditure of FY 2003/04 and 2007/08. So comparison between regular expenditure and development expenditure is being made between 1987/88 to 2002/03 in the regular and development expenditure.

Observing table 4.14, we can see the volume of outstanding debt which was Rs. 29823.40 million in 1987/88 and has increased to Rs. 366004.90 million in 2007/08 with the 13.78 percent of average annual growth rate. These show the real burden of debt in Nepal, where total outstanding public debt as percentage of development expenditure was 316.33 percent in 1987/88 gone up to 1380.84 in FY 2003/04. This shows Nepal is going year by year into the depth of the debt burden.

Development expenditure has also gone up to Rs. 29033.0 million in FY 2002/03, which in the beginning of the study period was Rs. 9428.00 million. Table also shows that development expenditure is in decreasing trend at the end of the study period. It may be due to the Maoist insurgency. Till FY 2000/01, its annual average growth rate was 10.0 percent, but it has decreased down to 5.0 percent in FY 2002/03. It clearly shows us that our development process is not increasing at rowing path. In the FY 2003/04 our total expenditure is classified into three heads where capital expenditure is Rs. 23095.3 million, it is less than the recurrent expenditure i.e. Rs. 5552.1 million. This shows the increasing trend of development expenditure is less than outstanding public debt.

Likewise, total debt servicing was Rs. 1720.70 million in 1988/89 and has gone up to Rs. 22760.60 million in 2007/08 with 14.81 percentage of average annual growth rate. It is greater than outstanding public debt. But till FY 2000/01 annual growth rate of outstanding public debt was greater than the growth rate of debt servicing. But at the end of the year, it is improving. If the same situation continues for long run, Nepal would be free from dependency. Total debt servicing as percentage of development expenditure has increased from 13.95 to 42.53 percent during the period of study. While discussing about the burden of internal debt, the analysis of internal debt and annual internal borrowing are important aspect. The table 4.15 has shown the proportional relationship between annual internal debt servicing and internal annual borrowing.

**Table -4.15****Annual Internal Debt Servicing as Percentage of Annual Internal Debt (1987/88 to 2007/08)**

(Rs, in Million)

Fiscal Year	Internal debt(1)	Internal Debt servicing (2)	percent of (2) as (1)
1987/88	1130.00	-	-
1988/89	1330.00	1019.40	76.65
1989/90	2150.00	1155.60	53.75
1990/91	4552.70	1320.90	29.01
1991/92	2078.00	2132.20	102.61
1992/93	1620.00	2428.60	149.91
1993/94	1820.00	2366.40	130.02
1994/95	1900.00	3098.60	163.08
1995/96	2200.00	3411.20	155.05
1996/97	3000.00	4177.80	139.26
1997/98	3400.00	3481.60	102.40
1998/99	4710.00	3977.50	84.45
1999/00	5500.00	4711.40	85.66
2000/01	7000.00	4187.00	59.81
2001/02	8000.00	5637.70	70.47
2002/03	8880.00	8662.10	97.55
2003/04	5607.80	9429.90	168.16
2004/05	8938.10	11650.00	130.34
2005/06	11834.20	11272.10	95.25
2006/07	17892.30	7322.00	40.92
2007/08	20496.40	12745.90	62.19
Average Annual Growth Rate	20.26	16.27	13.97

Source: Nepal Government, MOF, Various Economic Surveys 2001/02 and 2008/09.

Observing the above table, we can find out the volume of internal debt which was Rs. 1130.00 million in 1987/88 and has gone up to Rs. 20496.4 million in 2007/08 with 20.26 percent of average annual growth rate over the period of study. Likewise, internal debt servicing has also gone up from Rs. 1019.40 million (1988/89) to Rs. 12745.9 million with average annual growth rate of 16.27 percent.

The volume of internal debt is larger than that of internal debt servicing in 1987/88, but after 1987/88 the magnitude of internal debt servicing exceeds the amount of

internal debt till FY 1997/98. But at the end of the study period, volume of internal debt service is greater than the volume of internal debt. Till FY 2002/03, this situation indicates that the internal borrowing is being spent on debt servicing and also shows that the government's ability to borrow from internal sources is not conducive to raise enough funds for development requirement and this also shows that the increasing proportion of internal debt servicing is the manifestation of unproductive use of borrowed fund. But at the end of the study period, it became hopeful to develop capital formation by borrowing funds. Even, the proportion of internal debt servicing to the internal debt is fluctuating from the year 1994/95 to 2006/07. Which declined from 163.08 percent to 40.92 percent and again 62.19 percent in 2007/08 which shows it is going up.

**Table -4.16****Annual External Debt Servicing as Percentage of Annual External Debt (1987/88 to 2007/08)**

(Rs, in Million)

Fiscal Year	External debt(1)	External debt servicing(2)	(2) as percent of (1)
1987/88	3815.80	591.00	15.49
1988/89	5666.40	701.30	12.38
1989/90	5959.60	1123.60	18.85
1990/91	6256.70	1086.50	17.37
1991/92	6816.40	1664.90	24.42
1992/93	6920.90	2131.90	30.80
1993/94	9163.60	2488.70	27.16
1994/95	7312.30	2984.70	40.82
1995/96	9463.98	3304.30	34.91
1996/97	9043.60	3349.40	37.04
1997/98	11054.50	4201.20	38.00
1998/99	11852.40	4745.50	40.04
1999/00	11812.20	5321.40	45.05
2000/01	12044.00	6201.40	51.49
2001/02	7698.70	6567.50	85.31
2002/03	4546.40	7519.20	165.39
2003/04	7629.00	7908.90	103.67
2004/05	9266.10	8101.30	87.43
2005/06	8214.30	9151.40	111.41
2006/07	10053.50	9594.30	95.43
2007/08	8979.90	10014.70	111.52
Average Annual Growth Rate	7.14	15.37	13.93

Source: Nepal Government, MOF, Various Economic Surveys 2001/02 and 2008/09.

However, this is good at the end of the year but in the past year, it was not good. Thus, the high reliance on internal borrowing for financing budgetary deficit may have some causes.

- i) Huge amount of development fund was diverted to meet debt-servicing charges, which comes under regular expenditure.

- ii) NRB in the form of over draft will have effect on expansionary money supply and that may create inflationary pressure.
- iii) Likewise, borrowing from commercial banks may crowd out the private investment.

Table 4.16 shows the ratio of external debt servicing was 15.49 percent in 1987/88, it increases to 165.39 percent in 2002/03 and decreases to 111.52 in 2007/08. But due to high increasing rate, external debt was high in 2000/01 with Rs. 12044.0 million and was greater than external debt servicing but at the end of the year external debt became less than external debt servicing and the percentage share of external debt has increased from 15.49 percent to 165.39 percent.

#### **4.13 Issues of Foreign Loans**

Underdeveloped countries like Nepal are facing a serious problem of scarcity of domestic capital formation which is more essential for development process. And these countries are also facing the shortage of foreign exchanges. So, these countries have to borrow public debts from within the country as well as from the external sources like foreign countries and foreign agencies to breakout the vicious circle of insufficient capital formation and development bottlenecks. The scope of domestic borrowing in these countries is very limited, because internal resources are scarce. So, only external borrowing remains the alternative to be undertaken by these countries.

Nepal is facing various problems like poverty, unemployment and Nepal's macroeconomic indicators show declining economic performance. In FY 2005, Nepal's Human Development Indicator and Human Empowerment Indicator were below 0.5, it proved the poverty of Nepal. During the study period, Nepal has to invest a huge amount of expenditure for security, which is not productive. Every year's budget is more than preceding year's budget but revenue is not increasing in the same pace. Due to this reason, Nepal has to depend upon foreign assistance and external loans. Owing to heavy reliance on external assistance in the form of borrowing in public accounts, Nepal's external public indebtedness has increased in geometric progression. A rise in external indebtedness should be accompanied by an increasing debts servicing capacity. An ever increasing debt servicing without similar increase in debt servicing creates undue strain in the BOP, because an increasing

external debt servicing implies outflow of capital which may lead the country to the heavy burden of debt and debt crisis in the future.

Although foreign loans are main pillars for development process and to break out vicious circle of insufficient domestic capital formation, it has adverse effect on national economy when it's servicing, means that the scarce foreign exchange resources have to be transferred to creditors' countries.

When an external debt service has obvious impact on domestic capital formation and reduces the domestic standard of living, unless the loans are used for financing profitable investment, the whole yield is enough to satisfy creditor's claims for debt servicing, therefore, the true burden of debt service depends on profitable investment. In which the borrowed fund from external sources can be transformed into productive investment. If the foreign loans are used for financing unproductive investment projects that provide present consumption with more goods than foreign debt servicing is impossible.

For the purpose of foreign debt servicing, foreign currency has to be earned through increasing volume of exportable goods and services. If this is not done then the purpose of external loan is not fulfilled and it really becomes burden on next generation. Therefore, it is very essential that the real income of the national economy should grow faster than the transfer of resources through its external debt servicing. This requires ever-growing flow of export trade and proper utilization of foreign loans.

Samuelson (1964) has suggested for use of foreign capital in the process of development of developing countries. He argues, "If there are many difficulties in the way of domestic capital formation, why not rely more heavily on foreign sources". He further said, "Economic theory tells that a rich country has used up all its own high investment projects can benefit itself and at the same time benefit a poor country abroad. If it has shifted investment to the high internal project, it will be benefited to the investor or indebted country.

#### **4.14 Foreign Outstanding Debt and GDP**

While discussing on the burden of external debt, it is important to pay attention on the trends of external debt and GDP to make a comparison between the two. This

comparison gives the position of external debt in the country's GDP. This comparison is being made in the following table 4.17.

**Table -4.17**  
**Annual Growth of External Outstanding Debt and GDP (1987/88 to 2007/08)**

(Rs. in Million)

Fiscal Year	Total external debt(1)	Annual growth rate in percent	GDP(2)	Annual growth rate in percent	(1) as percent of (2)
1987/88	20826.00	40.29	76906.00	16.08	27.08
1988/89	29216.90	25.96	89270.00	15.85	32.73
1989/90	36800.90	61.70	103416.00	16.39	35.59
1990/91	59505.30	19.19	120370.00	24.19	49.44
1991/92	70923.90	23.26	149487.00	14.72	47.44
1992/93	87420.80	16.64	171492.00	16.20	50.98
1993/94	101966.80	10.82	199272.00	9.99	51.17
1994/95	113000.90	13.31	219175.00	13.57	51.56
1995/96	128044.40	3.16	248913.00	12.70	51.44
1996/97	132086.80	-22.92	280513.00	7.25	47.09
1997/98	101808.00	66.46	300845.00	13.69	33.84
1998/99	169465.90	12.52	342036.00	10.95	49.55
1999/00	190691.20	5.09	379488.00	16.35	50.25
2000/01	200404.40	9.84	441519.00	4.06	45.39
2001/02	220125.60	1.50	459443.00	7.14	47.91
2002/03	223433.20	4.18	492231.00	9.04	45.39
2003/04	232779.30	-5.64	536749.00	9.81	43.37
2004/05	219641.90	6.52	589412.00	10.97	37.26
2005/06	233968.60	-7.41	654084.00	11.33	35.77
2006/07	216628.90	15.39	728178.00	12.39	29.75
2007/08	249965.40		818401.00		30.54
Average Annual Growth Rate	14.28	-104.94	12.03	12.03	1.81

*Source: Nepal Government, MOF, Various Economic Surveys 2001/02 and 2008/09.*

Observing table 4.17, there is increasing trend of growth rate of outstanding external debt and GDP. The amount of outstanding debt was Rs. 219641.90 million in 2004/05 with 114.28percent of average annual growth rate. Its annual growth rate was 40.29percent in 1987/88 but thereafter it is declining to 1.50percent in FY 2001/02 and slowly increasing to 4.18percent in 2002/03 and was negative by 7.4percent in

2006/07 and again it has been increased to 15.39 by 2007/08. But the rate of increase in GDP is diminishing though GDP is increasing. Increasing trend of average annual growth rate of GDP shows diminishing and it also shows unsatisfactory economic performance because GDP is pillar of National economy. Where, GDP has increased from Rs.76906 million in FY 1987/88 to Rs. 818401 million with 12.03 percent of average annual growth rate over the review period, which is smaller than growth rate of external outstanding debt. After the restoration of multiparty system, the annual growth rate of GDP is not satisfactory and became 2.8percent in 2001/02 and again it rose to 8.5percent in 2003/04 in the market price.

While comparing the increasing trend of external indebtedness with increase in GDP or external debt to GDP was 27.08percent in 1987/88 and has gone up to 51.56percent in 1994/95 with 1.81percent of average annual rate. This show clearly about the burden of external debt was quite heavy. Table 4.17 also shows the average annual percentage share of external outstanding debt is 1.81percent of GDP, which may lead to country to external debt crisis in future. So, external loans have to use for productive sector or think about proper utilization.

#### **4.15 External Debt Flow and Its Annual Servicing**

One of the main features of budgetary system in Nepal is deficit budget in which large proportion of it is fulfilled by external loan. This is also proved by the increasing trend of average annual growth rate of external debt by 5.0percent over the period of the study. Here the ratio of external outstanding debt to GDP has grown up creating adverse situation in the economy, which requires effective measures of control.

**Table -4.18****External Debt Flow and Its Annual Servicing (1987/88 to 2007/08)**

(Rs. in Million)

Fiscal Year	External debt(1)	External debt servicing(2)	(2) as percent of (1)
1987/88	3815.80	591.00	15.49
1988/89	5666.40	701.30	12.38
1989/90	5959.60	1123.60	18.85
1990/91	6256.70	1086.50	17.37
1991/92	6816.40	1664.90	24.42
1992/93	6920.90	2131.90	30.80
1993/94	9163.60	2488.70	27.16
1994/95	7312.30	2984.70	40.82
1995/96	9463.98	3304.30	34.91
1996/97	9043.60	3349.40	37.04
1997/98	11054.50	4201.20	38.00
1998/99	11852.40	4745.50	40.04
1999/00	11812.20	5321.40	45.05
2000/01	12044.00	6201.40	51.49
2001/02	7698.70	6567.50	85.31
2002/03	4546.40	7519.20	165.39
2003/04	7629.00	7908.90	103.67
2004/05	9266.10	8101.30	87.43
2005/06	8214.30	9151.40	111.41
2006/07	10053.50	9594.30	95.43
2007/08	8979.90	10014.70	111.52
Average Annual Growth Rate	7.14	15.37	13.93

Source: Nepal Government, MOF, Various Economic Surveys 2001/02 and 2008/09.

Table 4.18 shows the comparison between the annual flow of external debt and annual external debt servicing obligations. Here, the new borrowing external debt was Rs. 3815.80 million in 1987/88 and has gone up to Rs. 12044.0 million in 2000/01 and

again increased to 8979.90million in 2007/08. This is the great improvement in Nepalese history. We must accept it up to 7.14 percent of average annual growth rate and once we must salute this type of misshaped. The amount of external debt servicing has increased from Rs. 591.00 million in 1987/88 to Rs. 8101.30 million in 2004/05 with 15.37 percent of average annual growth rate during the period of the study. These indicators have threatened its increasing burden because it is going not only large proportion of exchange earning but also rather large proportion of new borrowing. Or till 2000/01, more than half of new annual external borrowing or 51.49 percent of new borrowing transferred to the creditor countries to service the external debt per annum. But in FY 2004/05 more than 100 percent of external debt servicing is transferred to external debt. But there always remains a question as to how it is possible? Is it magic? Then how it became possible? It proved that if we use foreign loan in the productive sector then it is possible to repayment and remittance has played a vital role to develop our economy in the current year. Due to need for internal security maintenance, the external debt in the last three years has been increasing at a very high rate.

#### **4.16 Effect of Debt on Output (Gross Domestic Product)**

To examine the effect of external debt, internal debt and total debt are the major objectives of this study. There is no unanimous agreement among the economists about the productivity of debt, so this section explores the empirical relationship between external debt and aggregate GDP. It also examines the relationship between internal debt and GDP, and total debt and GDP.

If external debt can be shown to have had a tremendous effect on the economic growth and the overall welfare of the country, then the increasing level of external debt can be argued to be necessary for further growth of the economy. The basic starting point is the examination of direct relationship between the GDP and the amount of the external debt, internal and total debt. In all statistical analyses, number in parenthesis, below the coefficients for variables, indicate their respective t-values.

##### **4.16.1 Relationship between External Debt and GDP**

The flow of External Debt is growing over the time whether this growing flow of external debt is contributing for output growth or not? This situation explores the answer of this question. Let us consider the following estimated relationship between change in external debt and change in GDP. This equation is estimate by Ordinary Least Square Method.

The model is

$$y_t = \alpha + \beta \text{EXT}_{\text{debt}}$$

Where,  $y_t = Y$  = Change in Gross Domestic Product

$\text{EXT}_{\text{debt}} = \text{EXT}$  = Change in Total external debt

The fitted equation of the regression model is

$$y_t = -42119.77 + 0.1605 \text{EXT}_{\text{debt}} \dots\dots\dots (1)$$

(-1.73)            (1.44)

$R^2 = 0.10$        $F = 2.07$        $D-W = 1.9550$        $N = 21$

As the t statistics indicates that estimated regression coefficients are statistically insignificant at 5 percent or better level. It indicates that external debt has no any significant influence over the GDP. Very low value of  $R^2$  further support this argument. D-W statistics indicates that estimated relation is free from autocorrelation.

#### **4.16.2 Relationship between Internal Debt and GDP**

The Internal Debt is growing over the time whether this growing of internal debt is contributing for output growth or not? This situation explores the answer of this question. Let us consider the following estimated relationship between change in internal debt and change in GDP. This equation is estimated by Ordinary Least Square Method.

The model is

$$y_t = \alpha + \beta INT_{debt,t}$$

Where,  $y_t = \Delta Y$  = Change in Gross Domestic Product

$INT_{debt,t} = \Delta INT$  = Change in Total internal debt

The fitted equation of the regression model is

$$y_t = 40117.8 + 6.341 INT_{debt,t} \dots\dots\dots (2)$$

(1.43)

(15.24)

$R^2 = 0.8908$

$F = 115.02$

$D-W = 1.276$

$N = 21$

The estimated coefficients of equation (2) have expected sign. Both the coefficients are statistically significant at 5 percent level.  $R^2$  is high, which indicates that 89.08 percent variations in dependent variable is explained by the independent variable. Value of DW indicates that errors are positively auto-correlated. Total internal debt is significantly affecting the GDP and relationship between these variables is positive.

#### 4.16.3 Relationship between Total Debt and GDP

The Total Debt (TD) is growing over the time whether this growing of debt is contributing for output growth or not? This situation explores the answer of this question. Let us consider the following estimated relationship between change in total debt and change in GDP. This equation is estimated by Ordinary Least Square Method. To answer this empirical question, following empirical equation is estimated.

The model is

$$y_t = \alpha + \beta TD_t$$

Where,  $y_t = \Delta Y$  = Change in Gross Domestic Product

$TD_t = T = \text{Change in Total debt}$

The fitted equation of the regression model is:

$$y_t = 217775.6 + 1.0877 TD_t \dots\dots\dots (3)$$

(1.19)            (3.71)

$R^2 = 0.896$              $F = 0.00$              $D-W = 0.961$              $N = 21$

Slope coefficients of equation is statistically significant and have positive sign as expected.  $R^2$  Indicate that 89.6 percent of the variation in dependent variable can be explained by the independent variable. DW statistics indicates the evidence of positive autocorrelation. This estimated equation indicates that there exist the significant positive relationship between total debt and output.

The analysis of this chapter reveals that there exist significant positive relationship between Internal Debt and Total Debt with Gross Domestic Product (GDP). Higher external debt is associated with higher Domestic output and vice versa.

## CHAPTER FIVE

### SUMMARY, CONCLUSION, FINDING, AND RECOMMENDATION

#### 5.1 Summary

Public debt is taken with the obligation of future repayment including with certain rate of interest. When government requires funds for development program and security, it is taken by selling- borrowing instruments. So, it is the result of mismatch between revenue and expenditure. It is widely accepted measure for financing deficit. In the context of developing countries, it is playing vital role for socio-economic development because they have limited size of funds which is not sufficient for development financing. So, in case of Nepal, it is playing crucial role for development and fulfill the gap between income and expenditure. The study shows that government borrowing is growing year by year along with the rise in public expenses.

Nepal has started to take borrowing after the restoration of democracy in 1950. it is increased with initiation of economic planning in Nepal. Similarly, after the budgetary development in Nepal, importance and needs of borrowing is increasing year to year.

Basically, the study shows that there is lack of adequate fund for development financing. We have limited resource, small size of GDP, lower per capita income, lack of infrastructure, saving investment gap, export import gap, revenue expenditure gap etc. all these factors are major causes to increase external dependency.

Our government is taking loan from two sources - internal and external. Internal sources consists of, development bonds, treasury bills, national saving certificates, and citizens saving certificates. In it financial /banking sector dominates non-banking sectors. Similarly, in external sources Nepal is receiving debt by two sources – bilateral and multilateral. In the initial study period the share of bilateral is higher than multilateral. But in recent year multilateral sources like WB, ADB, UNDP, IUCN, IMF, WHO etc are dominating the bilateral sources.

Due to poor and insufficient domestic resource mobilization to meet the growing needs of financial resources for financing development expenditure, dependency on foreign assistance has been increasing. Foreign aid has contributed to more than 50percent of development expenditure and the share of external borrowing in total deficit found to be about 61percent in 2003/04. External assistance is necessary to

bridge the growing fiscal deficit. And developing economy like Nepal needs foreign currency in order to improve most essential capital goods for development projects.

Burden of public debt and debt servicing has been increasing continuously which, in fact, is the accumulation of net borrowing of different years. Now, Nepal is indebted by external and internal loans but further more by external outstanding debt. Consequently, external debt servicing has become a current issue. In the context of Nepalese economy, question may arise, whether our country's revenue and foreign exchange availability can sustain or not that increasing external debt servicing payment. If our country's sources cannot meet external debt service payment, there will be need to borrow again external loan for debt servicing in "Debt for debt servicing Trap."

Resource gap in Nepalese finance has been always a common phenomenon since the systematic budgeting system in Nepal, which is only due to mismatch between the annual growth rate of government expenditure and that of its revenue. The widening resource gap in recent years has been cumulative effect if the deficiencies in the investment areas and continues absence of government's fiscal norms. Internal public debt has played a significant role in the financial resources for development expenditure as well as in the in the growth of money and capital market, and it facilitates the effective implementation of monetary policy. The domestic resources are not sufficient to promote the rapid development of the Nepalese economy. Therefore, external assistance (loan and grants) plays all obvious functions in the development force for financial resources. Concerning foreign assistance, grants have big role to play in solving the resource gap for the country's budgetary expenditure.

## **5.2 Findings**

Through this research about the effect of public debt in Nepalese economy especially to the output the major findings can be discussed in following manner.

There is excessively increase in government expenditure which leads to increase in fiscal deficit. In fiscal year 2007/08 fiscal deficit is Rs. 33406.70 million which was Rs. 4686.80 in 1987/88.

Major source of financing deficit are loans and grants. In loan share of external borrowing is higher than internal borrowing. In fiscal year 1987/88 the share of external loan was Rs. 3815.80 million whereas the share of internal borrowing was Rs. 1130.00 million. In 2007/08 the amount of external debt is Rs. 8979.00 million

and the amount of internal debt was 20496.40. It shows that both sources of borrowing are increasing.

In the period of review total outstanding debt increased from Rs. 29823.40 million in fiscal year 1987/88 to Rs. 366004.91 in 2007/08 with average annual growth rate of 12.31 percent.

In internal borrowing contribution of banking sector is large where as external borrowing, multilateral sources dominates the bilateral sources. Over all average annual growth of public debt is 10.45 percent in the review year where as annual growth rate of internal and external loan are 20.26 and 7.1 percent respectively.

Burden of public debt is also growing year by year due to accessibly increase in borrowing amount. The total debt servicing amount was Rs. 1720.70 in 1987/88 which has gone up to Rs. 22760.60 in 2007/08. The average annual growth rate of total debt servicing is 14.81 percent. Internal debt servicing is growing by 16.29 percent annually whereas external debt servicing is growing 15.37 percent annually. In the total debt servicing, share of interest servicing is large as compared to principle payment which is of Rs. 1186.60 and 534.10 million for total debt servicing simultaneously in the fiscal year 1988/89. In 2007/08 the amount of interest and principle servicing was Rs. 6373.67 million and Rs. 16386.93 million respectively.

In the period of review, annual growth rate of external debt to GDP is increased by 2.80 percent whereas average annual growth rate of GDP is 12.03 percent. Annual growth rate of external debt is 14.28 percent. It shows that GDP growth rate is smaller than external debt growth rate.

In the review period, annual growth rate of internal debt to GDP is increased by 1.25 percent whereas average annual growth rate of GDP is 12.03 percent. Annual growth rate of internal debt is 13.42 percent in the same period of review.

Annual growth rate of total debt servicing to GDP is 1.42 percent in the review period whereas annual growth rate of total debt servicing is 14.81 percent and the average annual growth rate of government revenue is 13.89 percent in the review period. It means larger proportion of government revenue is spending for debt servicing.

Most remarkably, from this study relationship between external debt and GDP, internal debt and GDP and total debt and GDP has been established.

According to the study, relationship between external debt and GDP shows that, unit percent change in external debt resulted into 0.1605 percent change in GDP. Hence, external debt is positively affecting the GDP of the economy.

According to the study, relationship between internal debt and GDP shows that, unit percent change in internal debt resulted into 6.341 percent change in GDP. Hence, internal debt is also positively affecting the GDP of the economy but greater than external debt.

According to the study, relationship between total debt and GDP shows that, unit percent change in total debt resulted into 1.0877 percent change in GDP. Hence, total debt is also positively affecting the GDP of the economy.

From this study it can be said that, debt is itself not bad as conceptualize by Classicist but it is good if the use of debt is for productive purposes.

### **5.3 Conclusions**

Nepalese economy is characterized as three kinds of macroeconomic imbalances viz. –saving-investment gap, export-import gap, and revenue-expenditure gap. These fundamental gaps represent the foreign dominance in Nepalese economy, while saving-investment and revenue-expenditure gaps are mainly consequence of excess activities in economic matters. To fill-up these gaps public debt in the form of either internal or external is inevitable. The volume of external debt is excessively rising in the recent years under the liberalized policy. As globalization concept is wide spreading all over the world, aid is gradually decreasing and emphasis goes on loans, technology transfer and trade which have created high degree of indebtedness and, consequently, debt servicing obligations are increasing. In the meanwhile, the loan is not self-liquidating i.e., the debt repayment capacity is not increasing in the same pace. During the study period, average annual growth rate of GDP, revenue and merchandise export earnings are out stepped by annual growth rate of debt and debt servicing obligations.

The ultimate effect of lower capacity to debt servicing falls on capital formation and development process. Mismanagement of fund resulted on lack of self-liquidating projects. These conditions are compelling the researcher to ask a question that “Is Nepal really falling into Debt Trap?” After the study, it can be concluded that Nepal has not really fallen into debt trap but if the process continues for years, there will be no other result. Loan component through internal and external sources both rate are

under the ceiling but servicing amount is increasing annually and its growth rate is higher than GDP growth rate and revenue growth rate. Such condition suggests to better utilization of fund.

The analysis of this study reveals that there exists significant positive relationship between external debt, internal debt and total debt with Gross Domestic Product (GDP). Higher external debt is associated with higher domestic output and vice-versa. The analysis of the effect of external debt on output reveals that there exists significant positive relationship between external debt and GDP. It is concluded that external debt in Nepal over the period 1987/88 to 2007/08 is some extent productive. Therefore, it is necessary to have a careful look on the increasing magnitude of external debt and proper care must be taken to increase the debt servicing capacity of the country.

#### **5.4 Recommendations**

The following are the proposed recommendations on the basis of above study:

- ) Government must use public debt on such projects which are highly productive in nature and can produce exportable items and these projects are to be kept under regular supervision and monitoring process. Government should move towards fiscal balance and strong fiscal discipline through control of unproductive expenditure and maximizing revenue mobilization. Governments' efforts should be directed towards mobilization of internal resources and thus to reduce dependency on loans for financing development expenditure.
- ) The size of overall budgetary deficit excluding grants has remained high mainly due to low revenue and very high expenditure. This has lead to heavy borrowing from internal and external sources. So, for reducing the volume of borrowing, revenue collection must be increased substantially in order to attain self-sufficiency in the long run. Improving effective tax policy and tax administration can do this. This also includes simplification of tax rates, rationalization of tax structure and expansion of tax base.
- ) Loan assistance should be utilized selectively, after careful scrutiny of the purpose, content and benefits of such projects and programs in order to reduce burden of external debt while contributing to accelerate growth and to meet the socio-economic objectives. Therefore, borrowed fund from both internal

and external sources is to be spent on those projects, which are capable of producing exportable commodities within the shortest gestation period. Otherwise, the large volume of loan obtained from external sources has remained unutilized creating additional burden of debt servicing.

- ) Large proportion of internal borrowing comes from banking sectors especially from central bank, which is expansionary in nature and enhance non-banking sectors which stimulate domestic saving and investment. Internal borrowing from central bank has been kept within limitation of 5percent of previous year revenue collection. But limitation rule is not being followed by government. Therefore, in order to reduce the inflationary pressures in the economy, this aspect of internal borrowing rule must be followed.
- ) Government should try to collect foreign assistance through the grants as far as possible by applying effective foreign aid policy. The government should try to get the grants amount more and more as far as possible; there is more domination of bilateral grants. The government also should maintain such external policy so that more of grants should be received than the loans.
- ) Viewing increasing indebtedness of public debt, mainly external outstanding debt, and government should increase its debt servicing capacity by increasing GDP growth, revenue growth (increasing its share on GDP) and export earning. Here growth rate of national outstanding debt, debt servicing obligations, GDP, revenue and export earning must go together in a sustainable path so that country will not be trapped by debt servicing problem.
- ) The policy to discourage capital flight should be developed and conducive environment need to be made for foreign direct investment to accelerate national development and at last, proper attention should be given by NRB to the macroeconomic stability of the country while accepting external loans.
- ) To reduce the foreign dependency various measures must be applied such as export promotion, tourist attraction and import substitution policy.
- ) Proper attention should be given to maintain macro economical stability of the country while borrowing.

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Annex -1

**Relationship between external debt and GDP**

Source	SS	df	MS	Number of obs = 21
-----+-----				F( 1, 19) = 124.96
Model	8.4539e+11	1	8.4539e+11	Prob > F = 0.0000
Residual	1.2854e+11	19	6.7653e+09	R-squared = 0.8680
-----+-----				Adj R-squared = 0.8611
Total	9.7393e+11	20	4.8697e+10	Root MSE = 82251

GDP	Coef.	Std. Err.	t	P> t	[95% Conf. Interval]
-----+-----					
Ext. debt	2.691153	.240742	11.18	0.000	2.187274 3.195032
_cons	-36972.43	39187.53	-0.94	0.357	-118992.9 45048.01
-----+-----					

Durbin-Watson d-statistic( 2, 21) = .4702829

**Prais-Winsten AR(1) regression -- iterated estimates of external debt and GDP**

Source	SS	df	MS	Number of obs = 20
-----+-----				F( 1, 18) = 2.07
Model	246569571	1	246569571	Prob > F = 0.1670
Residual	2.1400e+09	18	118889559	R-squared = 0.1033
-----+-----				Adj R-squared = 0.0535
Total	2.3866e+09	19	125609560	Root MSE = 10904

GDP	Coef.	Std. Err.	t	P> t	[95% Conf. Interval]
-----+-----					
Ext. debt	.1604659	.1114255	1.44	0.167	-.0736305 .3945622
_cons	-42119.77	24313.82	-1.73	0.100	-93201.22 8961.685
-----+-----					
rho	1.100997				
-----+-----					

Durbin-Watson statistic (original) 0.470283  
 Durbin-Watson statistic (transformed) 1.955037

Annex -2

**Relationship between internal debt and GDP**

Source	SS	df	MS	Number of obs =	21
-----+-----				F( 1, 19) =	771.42
Model	9.5052e+11	1	9.5052e+11	Prob > F	= 0.0000
Residual	2.3411e+10	19	1.2322e+09	R-squared	= 0.9760
-----+-----				Adj R-squared =	0.9747
Total	9.7393e+11	20	4.8697e+10	Root MSE	= 35102

GDP	Coef.	Std. Err.	t	P> t	[95% Conf. Interval]
-----+-----					
Int. debt	6.412022	.2308606	27.77	0.000	5.928825 6.895219
_cons	33860.34	13792.75	2.45	0.024	4991.794 62728.89

Durbin-Watson d-statistic( 2, 21) = .5852161

**Prais-Winsten AR(1) regression -- iterated estimates of internal debt and GDP**

Source	SS	df	MS	Number of obs =	21
-----+-----				F( 1, 19) =	155.02
Model	9.8245e+10	1	9.8245e+10	Prob > F	= 0.0000
Residual	1.2042e+10	19	633773982	R-squared	= 0.8908
-----+-----				Adj R-squared =	0.8851
Total	1.1029e+11	20	5.5143e+09	Root MSE	= 25175

GDP	Coef.	Std. Err.	t	P> t	[95% Conf. Interval]
-----+-----					
Int. debt	6.341418	.416171	15.24	0.000	5.470362 7.212474
_cons	40117.8	28052.3	1.43	0.169	-18596.34 98831.95
-----+-----					
rho	.7226536				

Durbin-Watson statistic (original) 0.585216  
 Durbin-Watson statistic (transformed) 1.276506

Annex -3

**Relationship between total debt and GDP**

Source	SS	df	MS	Number of obs =	21
				F( 1, 19) =	238.49
Model	9.0207e+11	1	9.0207e+11	Prob > F	= 0.0000
Residual	7.1866e+10	19	3.7824e+09	R-squared	= 0.9262
				Adj R-squared =	0.9223
Total	9.7393e+11	20	4.8697e+10	Root MSE	= 61502

GDP	Coef.	Std. Err.	t	P> t	[95% Conf. Interval]
Total debt	1.950928	.1263304	15.44	0.000	1.686515 2.21534
_cons	-26792.38	27984.77	-0.96	0.350	-85365.18 31780.42

Durbin-Watson d-statistic( 2, 21) = .4871997

**Prais-Winsten AR(1) regression -- iterated estimates of total debt and GDP**

Source	SS	df	MS	Number of obs =	21
				F( 1, 19) =	0.00
Model	0	1	0	Prob > F	= 1.0000
Residual	2.3724e+10	19	1.2486e+09	R-squared	= 0.8962
				Adj R-squared =	0.8744
Total	1.2348e+10	20	617375854	Root MSE	= 35336

GDP	Coef.	Std. Err.	t	P> t	[95% Conf. Interval]
Total debt	1.087701	.2935553	3.71	0.002	.4732824 1.702119
_cons	217775.6	182649.4	1.19	0.248	-164514 600065.3

rho | .9822022

Durbin-Watson statistic (original) 0.487200  
 Durbin-Watson statistic (transformed) 0.961632