

CHAPTER I

INTRODUCTION

1.1 Background

Public expenditure is basically related to the expenses incurred by the government to meet its own maintenance requirements as well as the society and the economy as a whole. It is the spending by government at any level. Public expenditure consists of spending on real goods and services purchased from outside supplies; spending on employment in state services such as administration, defence and education; spending on transfer payment to pensioners, the unemployed and the disabled; spending on subsidies and grants to industries; and payment of debt interest. The state also spends for overall economic development.

Historical evidence proves the continuous growth of public expenditure every time in almost every country. The increase of public expenditure is in both relative and absolute terms. Classicists believed in the fact that government intervention should be discouraged for the reason that economy runs in full employment. In other words, they do not suggest it very encouraging for the growth of public expenditure.

The Great Depression of 1930s challenged the functioning of the capitalistic economy. Government intervention was a popular need at that period due to the failure of effective monetary policy. Keynesian revolution was a milestone in emphasizing the role of government and its expenditure. Keynes advocated mass government programme to uplift the devastated capitalistic economy from the depression. The detailed study of public expenditure gave birth to the theory of public goods, programme budgeting, cost, benefit analysis etc.

In the modern world, new principles of political institution have been developed. Every country adopts such economic policies which can promote

maximum social welfare. For establishing welfare in the society, government should spend a huge amount.

Public expenditure is the most important instrument of fiscal policy. Public expenditure has to play an increasing role to achieve higher rate of growth, higher level of employment, higher level of per capita income and equitable distribution of income in the society.

Economic development is possible by participant of both private and public sectors. Private sector investors are found to be quite negligible. The small number of investors always tries to invest only in those areas where there is a higher rate of profit in the short term. But private investors of developing countries are not interested in creating infrastructures.

Public expenditure may have direct and indirect impact on development. Directly, public expenditure on industry and commerce may accelerate economic development. Indirectly, it can help in the economic development by its suitable policies and co-operation with private participants by providing the transportation, communication, health, education and other social welfare programmes in the economy. The growing popularity of planning and budgeting, in the developing as well as developed countries, has given importance to public expenditure. It promotes the pace of economic development.

The income disparity between developed and developing countries is continuously increasing. The development gap and the discrepancy between the “haves” and “have not” in every country, is quite severely distinct. For economic development and lessening the income gap, public expenditure is thought to be quite essential.

In Nepal, the planning system was started in 1956. Since then we have completed Tenth plans and now we are in the Eleventh plan. Public sector outlay has increased every five-year plan. The actual growth of expenditure

does not show in the real term because inflation over the same period has increased very quickly. Regular expenditure as well as development expenditure is increasing every year

Thus, the government of developing countries like Nepal by increasing their expenditure on economic development and capital formation, are making valuable contribution towards increasing income and opportunities of employment in the country. Therefore, public expenditure in the developing countries plays a crucial role in raising the level of income and employment.

1.2 Statement of the Problem

The massive poverty, low per capita income, low rate of saving, low rate of investment, low productivity, population pressure, agriculture as the dominant economy, low living standard, illiteracy, malnutrition, higher unemployment, technological backwardness are the characteristics of developing economies. These are the prime characteristics of vicious circle of poverty. This vicious circle of poverty runs in a circular flow, keeping a poor country always in the state of poverty. Nepal is also not far from these characteristics.

There are no simple explanations for the apparent ineffectiveness of public spending in Nepal. A complex web of systemic factors, which cut across virtually all sectors and projects/programs, has consistently contributed to the poor implementation and development results. The study of World Bank (2000) has listed following problem with regard to public expenditure and its management.

- a. Budget preparation is bifurcated, with the Ministry of Finance (MOF) preparing the 'regular budget' and the National Planning Commission (NPC) preparing the 'development budget'. These two budgets are not well integrated; and resources are often allocated on an incremental

basis rather than on resource needs of projects/programs and well-considered priorities.

- b. The budget is heavily well programmed. Because of the political pressures to accommodate new projects, resource estimates have been consistently over optimistic, permitting the size of the budget to be set at levels which are not consistent with the actual availability of resources and institutional capacity.
- c. There is little prioritization of the budget. Although there are ambitious five-year plans, the link between these plans and annual budgets is weak.
- d. Despite several years of technical assistance, institutional mechanisms for project screening and expenditure management are still weak.
- e. The fund release process favors quick spenders rather than priority projects/programs, as funds are released largely on the basis of whether previous releases have been spent and accounted for by implementing agencies.

The budgetary process does not function in an independent or autonomous fashion but is viewed as an integral part of the overall management of the economy. Budget is just an implementation of plan of the country that has specified social objectives both for short run and long run. Problems in Nepal regarding public spending are due to the lack of coordination between policy planning and implementation. Budgets are formulated in an independent fashion with out considering the objectives. Program so mentioned in budget remains largely are out of plan's framework. Many programs and projects are implemented through the budget each year, which are not mentioned on plan. This has given rise to "implementation failure" model in overall resource allocation practices.

1.3 Objectives of the Study

Objectives of the study are as follows:

- a. To examine the trends of public expenditure in Nepal.
- b. To examine the problem of resource mobilization and resource gap in Nepal.
- c. To examine the impact of public expenditure on GDP, Import and Ms.

1.4 Significance of the Study

There are no doubts that Nepalese fiscal systems are no more stable as it was during the 1990s or the early years of millennium. Fiscal discipline and norms have broken the tradition in recent year. So this study has particular significant for its attempt to give sight over current trends in overall public expenditure practice. The extension of this research will certainly benefit the policy makers to correct the errors on practices to public expenditure management.

1.5 Limitations

- a. The study is based on the published secondary data and no attempts are be made in examining the reliability of data.
- b. The study is based basically on the data of 16 years (1990/91 to 2005/06).

1.6 Organization of the Study

The first chapter is introductory chapter, which is followed by literacy review chapter. Where a brief description has been given about the idea of public finance provided by the different school of thought and empirical analysis of the subject matter done in the Nepal has also been included. The third chapter has been given to the research methodology, where the methods of presentation and data analysis tools are mentioned. Chapter four is devoted

to pattern of public expenditure. Chapter five deals with the problem of growing resource gap in Nepal. Chapter six is confined to deal with impact of public expenditure in major economic sectors. The final chapter covers summary, conclusion and some recommendations.

CHAPTER II

REVIEW OF LITERATURE

2.1 Theoretical Literature Review

2.1.1 Classical View on Public Expenditure

About the different schools of public expenditure, Dr. Tyagi in his book 'public finance' writes: "As far as the importance of public expenditure is concerned. We can roughly divide the main schools of thought into two classes. One school restricts the function of government, isn't entirely, to the primary functions of defense, law and order and civil administration. The other school generally sees the importance of public expenditure into a broad spectrum." (Tyagi, 2001)

Classical economists favoured no role of government. They were against the heavy role of government because they believed on the full employment. Classical writings are based on the Say's law of market, which ruled out possibility of disequilibrium in the economy in the long run. According to classicists there always exists full employment in the economy and thus resources are fully employed and when resources are fully employed. There is no need of government intervention. Government intervention creates nothing but disturbance on automatic mechanism of market in the economy. The automatic mechanism what Adam Smith has called 'invisible hands' would lead to the efficient allocation of resources. If any resources are unemployed or over utilized then producers shifts it to another sector by giving higher utility because they are guided by their desire to maximize profits with the possible least cost method of production. Consumers are also wants to maximize their utility subject to their budget by equating marginal rates of substitution with their price ratio. So, in a smoothly going economy automatic mechanism plays vital role for the efficient use of resources. Classical economists ruled out the importance of both fiscal as well as monetary policy. Money for them is only

medium of exchange (Classical ideas about role of money is represented by fisher's equation, $MV = PT$, where change in M causes change in P) and output and employment is determined by real sector. So monetary policy is ineffective to expand output and employment. In classical model, economy is always in full employment, thus there is no need of change in fiscal policy so they favoured minimum government expenditure and emphasized on 'less governance'.

About the role of the government, Adam Smith, in his famous book "Wealth of Nations" wrote: "The Sovereign has only three duties to attend to: first, the duty of protecting the society from violence and invasion of other independent societies. Secondly, the duty of protecting as far as possible, every member of it or the duty of exerting are maintaining exact administration of justice; and thirdly erecting and maintaining certain public work and institution ..." (Smith, 1776).

In brief, classical economists' arguments were designed to restrain government interference in the private sector, because public sector was viewed with apprehension and fear, hence were suspected of corruption. The position of classical economists can be epitomized, as "That government is the best, which governs less."

2.1.2 Keynesian view on Public Expenditure

Classicist has great faith on full employment in the economy, so they argued that there should be balanced budget in the economy. According to them deficit budget signifies an increase in the demand for resources in the economy which ultimately leads economy to the inflationary situation.

The classical concept of full employment of capitalist economy was dismantling in 1930s when western world felt an unprecedented depression. At the time of depression balanced budget, the concept of classicists failed to work, so Keynes came with a new concept of expansion of public expenditure

programs to revive the economy from depression. It was John Maynard Keynes who brought the field of public expenditure in the mainstream of economics from the small periphery of classical economists.

Keynes didn't accept the classical notion of free enterprises economy, which is self-equilibrating at the full employment level. He advanced the concept of under employment equilibrium and challenged the classical view that private enterprise economy automatically ensures full employment. Similarly, he said that employment depends upon effective demand and there is no guarantee that there will always be adequate effective demand to generate full employment. Unemployment arises due to deficiency of demand.

If there are unemployed resources, there is no special virtue in keeping the budget small and balanced. When resources are unemployed, it is the duty of state to increase effective demand by increasing its expenditure. In the time of depression, deficit financing helps to rise the level of employment and output. Similarly, during the period of demand deficiency, it is unjustified to tax on consumption, it is essential to raise the level of demand.

During the period of depression, appropriate fiscal policy should be adopted to increase demand. In this time, the government can increase its expenditure and spend more on public works so that additional resources can be employed even if it is not a productive process. In the same way, government can give subsidy to producers of mass consumption in order to increase consumption. Thus, the evil word 'deficit' can to time of depression be only remedy in lifting the economy upwards.

To show the positive effect of public spending, Keynes uses the concept government expenditure. The model is:

$$Y = C + I + G \dots\dots\dots (1)$$

Where, Y = aggregate national income in three sector economy

C = Consumption expenditure

I = Investment Expenditure

G = Government Expenditure

$$C = C_a + bY \dots\dots\dots (2)$$

Where, C_a = autonomous consumption

B = marginal propensity to consume and $0 \leq b \leq 1$.

$$I = \bar{I} \dots\dots\dots (3)$$

$$G = G \dots\dots\dots (4)$$

From equations 1, 2, 3 and 4:

$$Y = C_a + bY + \bar{I} + G$$

$$(1 - b) Y = C_a + \bar{I} + G$$

$$Y = \frac{1}{1-b} [C_a + \bar{I} + G]$$

$$\therefore \Delta Y = \frac{1}{1-b} \Delta G$$

and $\frac{\Delta Y}{\Delta G} = \frac{1}{1-b}$ which is government expenditure multiplier.

Here, value of b lies between 0 and 1, thus, increase in government expenditure results higher increase in income than increase in spending.

For example, suppose $b = 0.75$ and $\Delta G = 10$.

$$\therefore \Delta Y = \frac{1}{1-0.75} \times 10 = 40$$

i.e. $\Delta Y = 40$

When government expenditure is increased by 10 national income increases by 40. Thus, at the time of depression, Keynes favours higher public expenditure through deficit financing, which can increase effective demand.

On the other hand at the time of inflation, demand is high. Hence it is better to reduce public expenditure by the government and also impose heavy tax to cut the level of consumption. Thus, in the period of inflation it is better to have a surplus budget.

2.1.3 Peacock-Wiseman Hypothesis

Peacock and Wiseman, in their book entitled *The Growth of Public Expenditure in the United Kingdom* emphasized the time pattern of public expenditure trends rather than striving for a genuine positive theory of public sector growth. In their analysis, they have taken war and other social crisis as a cause of increasing public expenditure and concluded that during the period of social crisis and war public expenditure is displaced from the old level and never returns to the pre-war level. From an empirical analysis of the data on public expenditure of British economy, they were able to establish that the relative growth of public sector expenditure in that country had occurred on a step like pattern rather than a continuous growth pattern. Their research was carried out during the periods of emergency or during social disturb areas such as war and depression that most of the upward steps in public expenditure has occurred. These emergency situations created a displacement effect by which the previous lower expenditure and Tax levels were displaced by new and higher levels of expenditure. And these new levels of expenditure attained during the period of emergency were not reversed once the emergency had ended. Peacock and Wiseman explained this displacement effect with two separate but like effect inspection effect and contraction effect. The first is the inspection effect, which as they argued, helps to perpetuate the higher levels of public expenditure, forced on the public sector institutions at times of emergency. The inspection effect is the phenomenon whereby as a direct consequence of the social emergency. Public expenditure comes to encompass within with purview economic and social activities, which might have been the province of allocation history. Furthermore, war and other social disturbance frequently force the people and the government to inspect the adequacy of the measures hither to undertakes to meet problems which would have been considered as trivial but which assume importance and urgency owing to the disturbances, and continue to enjoy priority attention even after the period of disturbance. In the secular growth of public expenditure in Great Britain,

Peacock and Wiseman also discovered the influence of another factor, which they term concentration effect. This refers to the evolution of public expenditure undertaken at different levels of government and their tendency to be concentrated in the central government.

Peacock and Wiseman hypothesis indicate that in the absence of major disturbances government outlay would increase only gradually; hence they cannot explain the explosion in the spending that took place in late 1960's. This indicates that these hypotheses are only suggestive (S.K. Singhi 1982).

2.1.4 Productivity Lag Hypothesis

W.J. Baumol, analyzing the time series data of US economy in 1967, propounded 'productivity lag hypothesis'. This hypothesis is based on productivity differentials of private and public sector. To stabilize the economy when economy is not automatically stabilized, expansion in public sector is made. Distinguishing between progressive and non-progressive sectors in economy, Baumol says, to keep same output level in the non-productive public sector labour input has to be increased tremendously. As a result, public sector expansion takes place at the cost of private sector. 'Productivity lag' hypothesis is sometimes called "Baumol's disease", because productivity gains are less inherently greater labor intensity in the public sector compared with private sector.

Baumol has given two causes that create 'productivity lag'.

1. Technical barriers opposing innovation in the public sector are higher.
2. Institutional barriers are greater in public sector in comparison to the private sector.

2.1.5 Critical Limit Hypothesis

Colin Clark sets the ceiling on public expenditure level on the basis of taxable capacity of the people. He argues that when public expenditure reaches 25

percent of total economic activity or the aggregate activity in the country, tax payer's ability to pay more tax is exhausted. Any further increase in public expenditure, therefore, means disincentive to producers and fall in production. Disincentive is due to taxation beyond tolerance level. Since increase in government expenditure constitutes rising demand but output declines due to higher tax level, the result would be necessarily inflationary. In his words:

1. When the government's share of aggregate economic activity reaches the critical limit of 25 percent the community behaviours pattern changes and people produce less since incentives are harmed by the fact that increasing proportions of additional income must be paid in taxes under a progressive tax system.
2. People become less resistance to various inflationary means of financing government expenditure, which in turn reduces the 'aggregate supply'. On the other hand, increased purchasing power tends to expand aggregate effective demand. Inflation results from maladjustment between demand and supply under condition of high employment of resources.

2.1.6 Stanley Please Hypothesis

Stanley Please hypothesis deals the cause and sources of increasing government expenditure in LDCs with its effectiveness and overall impact in economy.

In his study, he found that most of the developed countries fulfill the resource gap created by growing pressure on public sector in developing countries for development works through external assistance. But for him sustainable development of a development country largely based on external assistance is only a mirage. This hypothesis states that for sustainable development of a developing country proportion of domestic resources in public expenditure should be high. Even, lending agencies, including World Bank looks closely at

country's efforts to overcome the internal obstacles in development before they do business with it. In part this stems from moral judgment that only those who help themselves deserve to be helped.

Mobilization of domestic resources in public finance is necessary but very different task for developing country. Due to higher MPC higher resource mobilization through voluntary savings is impossible. To overcome this many economists have argued that domestic savings for national development can be increased only by government compulsory reducing (by taxes) the personal consumption of citizens. Saving capacity of the people is also restrained by low income of large proportion of population, attempt to attain the level of consumption of people in the highly developed countries, fear of price increase which undermines the real value of savings, political misgivings etc. In this case, Please advocates a development strategy aiming at rising the level of domestic saving through combination of budgetary policy and public expenditure management. That is reducing personal consumption by increasing taxation while ensuring that this increased revenue is not used to increase government consumption or defense, civil service etc. For this Stanley Please suggests some policies in public expenditure management.

1. Government should be more rational and more self-disciplined in determining public expenditure policy.
2. Expenditure on current activities and alternative uses of revenue should be calculated. Spending on education, health which is generally taken as current expenditure are capital expenditure as it provides benefit to the country after a log of many years.
3. Assigning the public fund for financing development expenditure through earmarking can be applied.
4. In case of foreign loan, the productivity that it yields and the ability that the country has to pay later should be calculated and has to use in beneficial projects.

2.2 Empirical Estimates

Analyzing the growth of public expenditure in USA and many other European countries with the help of cross country data over the period 1929 to 1985. Dannis C. Muller found that “government has grown and grown dramatically, can’t be questioned.”

He has used data of US and other OECD economics in his analysis total government expenditure in the US in 1985, as percentage of GNP was 34.4 percent up from 23 percent in 1949 and to percent in 1929.

Table 2.1
Growth of Public Expenditure and Revenue

Countries	Year 1960		Year 1984	
	Expenditure	Revenue	Expenditure	Revenue
Australia	22.1	25.4	36.3	34.2
Japan	18.3	20.7	34.2	30.2
U.K.	32.69	30.3	47.4	43.7
US	27.6	27.3	47.6	32.0
Fed R. Germany	32.5	35.1	49.4	45.3

Source: IMF Staff Paper, vol. 34 No. 1, 1987.

The data reveals accelerating growth of public expenditure. Muller found government expenditure is growing exponentially because the role of government is increasing over time.

He analyzed following roles of government.

1. Government as provider of public goods and eliminator of externalities.
2. Government as re-distributor of income and wealth.
3. Interest groups and the growth of government.
4. Bureaucracy and the growth of government.

Among these four causes the later two played very much important role to increase government share.

More promising as an explanation of the growth of government is the hypothesis of bureaucratic power. Bureaucratic power stems from bureaucratic size. Growth in size is more than function of absolute size, which leads to the precondition that the government grows exponentially. The bureaucratic power hypothesis might also explain the ratchet effect in government growth.

There is a parallel growth between the growth of government and the growth of white colour and managerial employment in the private sector. Both can be seen as response to the greater transition costs from organizing a market economy with increasing specialization. Growing specialization helps to create a host of new interest groups. The demands these groups press to a government are not simply for a redistributing within an increasingly specialized society. Thus due to the emergence of new interest groups. Non defense, non transfer expenditures of government have growth faster than total government has grown since World War II and almost as faster as transfer". (Muller, 1987)

Singh (1977). In his book on the fiscal system of Nepal, analyzed the consistency between fiscal policy of Nepal and targeted growth rate from the time series data over the period of 1954/55 to 1974/75. In the period, he found that the expenditure/GDP ratio was increased substantially. In 1954/55, total government outlay/GDP ratio was only 2.44 percent and increased to 10.57 percent in 1974/75. On the revenue side, Nepal took a giant leap. In 1950s tax revenue to GDP ratio was 1.27 percent of GDP, which stood up 6 percent of GDP in 1974/75.

Nepal had targeted high growth rate. For this large development expenditure was needed huge amount of revenue. But GoN revenue wasn't sufficient to meet even regular expenditure. Thus deficit budget came into existence. Foreign aid hadn't been adequate to wipe out deficit; result is growing account

of dept. amidst such situation, 2.4 percent of annual growth rate was achieved which was less than targeted growth rate.

Koirala (1979), in his unpublished M.A. thesis entitled *Public Expenditure: A Tools for Economic Development of Nepal*, found that public expenditure of Rs. 330 million in the first five-year plan has increased 30 times to Rs. 11404 million in the fifth five year plan. In the study period of 1956/57 to 1979/80, the growth rate of development expenditure was higher than the growth rate of regular expenditure despite the slower growth rate of country's GDP. He found that low per capita income due to the higher growth rate of population had caused to low level of saving and investment. He also noticed the low corporation and personal saving.

Basnet (1983), in his unpublished M.A. thesis entitled *Analysis of Public expenditure and Economic Development in Nepal* figured out that amount of public expenditure had increased 100 times in between the first plan to sixth plan. In the study period of 1970/71 to 1981/82, the percentage of foreign grant decreased from the third plan to sixth plan period, but the percentage of foreign loan increased in relation to the total external assistance. His study of the period of ten years also showed the higher growth rate of development expenditure than the regular one.

Sharma (1986), in her unpublished, M.A. thesis entitled: 'A Study on Deficit Finance in Nepalese Planning', found that the total government expenditure increased greatly during the study period of 1965/66 to 1984/85. He noticed that the total revenue collection and foreign grants have also increased but not with the pace to meet the excess development expenditure. His finding supports the notion of increasing resource gap in the economy. He also found out of growing trend of deficit financing with in the economy. Though the deficit financing provides some stimulant to the developing economies like Nepal. He recommended to use this source of financing up to a proper scale and level.

Integrated Development System (1987), carrying out a study, found that government had grown rapidly in relation to the country's GDP during the period of 1974/75 to 1984/85. In FY 1974/75, the share of government expenditure in GDP was only 9.13 percent, which reached to 20.11 percent on FY 1984/85. Their findings were that the expenditure on economic services in relation to GDP registered the highest each year during the study period. Payment of service category, however, registered a rapid growth during the period under review. Its share on GDP in GY 1974/75 was just 0.2 percent, which reached to 1.21 percent in FY 1984/85. A major noticed fact was that the share of regular expenditure had increased significantly in relation to development expenditure. This study found regular expenditure on FY 1979/80 claimed just 15.41 percent share. On total expenditure, which explosively increased to 59.24 percent by the FY 1984/85. Except the years of fiscal crisis, there was found an upward trend on the regular expenditure.

Upreti (1996), in his unpublished M.A. thesis entitled trend, pattern and impact of Public Expenditure in Nepal, found increasing trend in total expenditure, development expenditure and regular expenditure. He noticed an increase in the total expenditure as a percentage of GDP from 9.1 percent in FY 1974/75 to as much as of 18.2 percent in 1991/92 where as the same for regular and development expenditure were 3.3percent and 5.8percent in the FY 1974/75 which reached to 6.8 percent and 11.4 percent in FY 1991/92. He also pointed out the growing resource gap within the economy. Analyzing the impact of public expenditure on the employment sector, he observed that the expenditure elasticity of the employment on the agriculture sector being -0.3 while the same for transport and communication was 1.41 during the period of 1975-1992.

Basyal (1994). carried a research about growth of development expenditure of Nepal in different plan period and source of financing it. He found that foreign capital was very dominant in Nepal's plan financing. During the fifth (1976-1980), the sixth (1981-1985), and the seventh (1986-1990) plan period. Share of foreign grants and loan to the total development expenditure were 47.3

percent, 48.1 percent and 59.5 percent respectively. He concluded that this situation showed a distinctly upward trend in the reliance on foreign resources and consequently, the downward share of revenue surplus in meeting the development expenditure (Basyal, 1994).

Sharma (1999), in his article entitled problems and prospects of GoN forthcoming Budget published in economic journal of Nepal (1999 June), observed that during the period of about 45 years (1954-1999), there has not been much change in the concepts used to distinguish regular and development budget though both regular and developmental expenditure of the government are increasing every year in absolute term. He concluded, on the one hand the average annual growth rate of development budget is less in percentage term compared to the regular budget during the past two decades, on the other, due to not being clear in the concepts of regular and development expenditure, large amount of money is being spent in regular expenses such construction of project office and quarter for staffs, salary and allowances to the administrative staffs and so on. On his article, he suggested that government should do away altogether with the distinction between a current and a development budget and should as in expenditure.

World Bank (2002), on a study under the title “Nepal: Public Expenditure Review”, concluded that Nepal is not facing a fiscal collapse; rather the fiscal situation is quite stable. This study however showed inefficiency and mismanagement on public spending. Deficiencies in the budget planning resource allocation and expenditure management process have been found a major factor contributing to low productivity. This study pointed out the institutional weakness for the ineffectiveness of public spending in Nepal. The report concluded that institutional weakness remain probably the most critical set of factors affecting the projective implementation and the effectiveness of public spending across sector in Nepal. It present number of suggestions to improve the effectiveness of public spending among which more realistic resource allocation practice, medium term expenditure projections, good

governance and transparency, decisive action to formulate an anti corruption agenda, greater local ownership of the public expenditure program, build a partnership between local and central, and public and private etc. are major.

Upreti (2002), making a study on the performance of public expenditure in Nepal, found both demand side effects and supply side factors contributing to a rapid growth of public expenditure in Nepal. He argued that the real threaten is due to increasing trend of resource gap causing a large chunk of resources devoted for the principle and interest payment. He suggests number of measure among which the focus of scare resources on core priority areas, more local ownership, resource forecasting, mid year budget review, strong then the capacity for monitoring expenditures on well as physical progress of projects etc in order to ensure the good performance of public expenditure.

Khadka (2002), in his unpublished M.A. thesis entitled public expenditure economic development in Nepal concluded that the public expenditure has increased primarily due to increasing role of government. He found that the share of total expenditure in GDP was 9.1 percent in FY 1975/76, which increased to nearly 21 percent in FY 1994/95. He noticed the pattern that the regular expenditure covers 34.8 percent of the total expenditure and the remaining 65.2 percent in development expenditure on average of study period. On the empirical basis, there was found a strong relationship between total expenditure and country's GDP. In the same way, regular expenditure was quite strong with regard to total revenue while the development expenditure was found to be associated with foreign aid. He strongly suggested to reduce the consumption type of expenditure to increase the amount of investment expenditure.

Pyakural (2004), under the study titled "Nepal's Conflict Economy: Cost, Consequences and Alternatives" asserted that the Nepalese economy has lost its productive capacity to respond to sustained growth following the government expenditure and revenue pattern. He found the ratio of regular

expenditure to GDP in FY 1996/97 was 8.6 but increased to 11.5 percent in 2001/02. The revenue during the same period decreased from 7.3 in 1996/97 to 7.0 in 2001/02. Development expenditure also declined from 9.5 to 7.5 during the same period. Analyzing this pattern, he recommend for contractionary fiscal policy rather the expansionary one during the war period.

CHAPTER III

METHODOLOGY

3.1 Sources of Data

The present study attempts to get various empirical results using only secondary data, which have been calculated by various bulletins, publications and official records. The main sources of data used in this study are Economic Surveys, FY1995/1996 to FY2005/06, MOF, GON; Quarterly Economic Bulletin, July 2002 NRB; Financial Statistical Year Book, IMF. The other bulletins and publications like budget speech of various years, monthly reports and economic reviews of NRB and CBS are also used for providing other important information.

3.2 Period of the Study

The budgetary contents today are not the same as they were in the initial year of 1952. It has changed its heading and sub-headings during different time periods. The changing context has brought more complicated problems in the analysis of public expenditure. The data of gross domestic savings, gross national savings and total investment are not available. Due to the unavailability of some data and changing budgetary classification, the fiscal year 1990/91 will be the starting year of the study. On the other hand, 2005/06 will be taken as the last year of the study mainly on the grounds of the availability of actual data on gross domestic product, expenditures, revenues, gross domestic savings, gross national saving, total investment, foreign aid and so on.

3.3 Specification of the Variables

The purpose of this chapter is to examine the substantive questions: Is there statistical evidence that government expenditure has significant impact on GDP

growth, money supply and imports? Some of the relevant variables are briefly discussed below:

a. Gross domestic products

Real gross domestic product at 1994/95 prices has been used in the study. To make nominal GDP to real GDP, GDP deflators calculated by Central Bureau of Statistics has been used.

b. Public and private investment

One of our objectives is to see the effect of public investment in GDP growth. To find public and private investment, public and private capital formation have taken as proxy. Finding percentage share of public and private capital formation from total capital formation, series of nominal public and private investment has been derived by using same percentage from total investment. To make real, construction deflator and agriculture deflator deflate nominal public and private investments, respectively. Construction deflator has been calculated by using the following formula.

$$\text{Construction deflator} = \frac{\text{current price of construct}}{\text{constant price of construct}}$$

$$\text{And real public investment} = \frac{\text{nominal public investment}}{\text{Construction deflator}} \times 100$$

In the same way, real private investment has been calculated by taking agriculture deflator.

$$\text{Agricultural deflator} = \frac{\text{current price of agriculture}}{\text{constant price of agriculture}}$$

$$\text{And real private investment} = \frac{\text{nominal private investment}}{\text{agriculture deflator}} \times 100$$

The value for the real private and public investment for the FY 1990/91, 1991/92, 1992/93 and 1993/94 are calculated by considering the growth rates of nominal private and public investment respectively because of the impossibility to calculate deflator as agriculture and construction. Deflators are calculated at 1994/95 (i.e. 1994/95 = 100).

c. Imports

The term imports denotes total imports from India and other countries. Due to the lack of imports deflator, Indian wholesale price index has been used as a deflator to change real nominal imports. In view of the largest share of imports being made from India during the study period, the Indian wholesale price index might be considered a better proxy.

d. Money Supply

There are two commonly used monetary aggregates in Nepal i.e. narrow money supply and broad money supply. Here narrow money supply has been used in the analysis.

Under the fractional reserve system, reserve money and money multiplier determine money supply. Reserve money is defined as the sum of currency held by the private sector, currency held by commercial banks, deposits of the private sector and deposits of commercial banks.

e. Public Expenditure

Public expenditure figures (PE) have been taken from the budgetary sources. While preparing the budget public expenditure categories are divided into two broad groups, viz, regular and development expenditure. Actually, these two expenditure categories are non-plan and plan expenditure, respectively. Total PE comprises both regular and development expenditure. To make nominal government expenditure real, the national urban consumer price index (in 1995/96 prices) has been used as a deflator. Although a separate price deflator for

public expenditure is needed in the absence of suitable deflators, CPI has been used.

3.4 Statistical Tools

Quantities methods have been used for the purpose of data analysis and also to reach at conclusion. Different statistical tools have been employed as demanded by the objectives so specified above. In general following models are used for analysis.

3.4.1 Simple Regression Equation

Simple regression equation has been used while carrying out Impact of public expenditure in GDP growth and money supply. Where as log linear regression equation is employed while carrying out Impact of public expenditure on Imports. Regression equations are defined as:

$$(a) Y = a + b_1 PI + b_2 PrI$$

Where,

Y = Real GDP

PI = Real public investment

PrI = Real private investment

A > 0 and constant

Bi = Regression coefficients.

$$(b) \ln(M) = a + b_1 \ln(APrc) + b_2 \ln(PE) + b_3 \ln \frac{PII}{PIN} + b_4 \ln(M_{-1})$$

Where,

M = Real imports

APrc = Real aggregate private consumption

PE = Real public expenditure

PII = Price Index of India

PIN = Price index of Nepal

M-1 = Real lagged imports

$A > 0$ and constant

B_i = Regression coefficients.

$$(c) \text{ RM} = a + b_1 \text{ PE} + b_2 \text{ TR} + b_3 \text{ CPCB} + b_4 \text{ NFA}$$

Where,

PE = Public Expenditure

TR = Nominal total revenue

CPCB = Claims on private sector and commercial bank

NFA = Net foreign assets

$A > 0$ and constant

B_i = Regression coefficients.

With regard to the above equations following measures are carried out to check the reliability of the analysis.

i. Coefficient of determination (R^2): The R -squared (R^2) statistic measures the success of the regression in predicting the values of the dependent variable within the sample. R^2 is the fraction of the variance of the dependent variable explained by the independent variable. The statistic will equal one if the regression fits perfectly, and zero if it fits no better than the simple mean of the dependent variable. It can be negative if the regression does not have an intercept of constant, or if the estimation method is two stage least squares.

$$R^2 = 1 - \frac{\sum e_1^2}{\sum y_1^2}$$

ii. Adjusted Coefficient of determination (\bar{R}^2): This measure will also be employed to get additional information about the goodness of fit. One problem with using R^2 as a measure of goodness of fit is that the R^2 will never decrease as more regressors are added. In the extreme case, we can always obtain an R^2 of one if you include as many independent regressors as there are sample observations.

The adjusted R^2 , commonly denoted as \bar{R}^2 , penalizes the R^2 for the addition of regressors, which do not contribute to the explanatory power of the model.

$$\bar{R}^2 = 1 - \frac{\sum e_1^2 / (n - k)}{\sum y_1^2 / (n - k)}$$

iii. t- test: the t-test is based on the student's T distribution. It is used to test the hypothesis about any individual partial regression coefficient. To compute the t- statistic, the standard errors for each input are computed separately. The t-ratio is the significant test of the regression coefficient of the hypothesis. Broadly speaking, a test of significance is a procedure by which sample results are used to verify the truth or falsity of null hypothesis. The decision to accept or reject null hypothesis is made on the value of the test statistic obtained from the data at hand. The t- statistic, which is computed as the ratio of an estimated coefficient to its standard error, is used to test the hypothesis that a coefficient is equal to zero. To interpret the t- statistic, we should examine the probability of observing the t- statistic given that the coefficient is equal to zero.

iv. F- Test: for the purpose of analysis of variance, this test is employed. The F- statistic tests the hypothesis that all of the slope coefficients (excluding the constant, of intercept) in a regression are zero. For ordinary least squares models, F- statistic is computed as

$$F = \frac{R^2 / (k - 1)}{1 - R^2 / (N - k)}$$

If $F > F_{(k-1, N-K)}$ reject H_0 : otherwise we accept it, where $F_{(k-1, N-K)}$ is the critical F value at the level of significance and (k-1) numerator df and (N-K) denominator.

3.4.2 Relationship between R² and F

Manipulation of F in terms of R is

$$F = \frac{R^2 / (k - 1)}{1 - R^2 / (N - k)}$$

This shows that these two statistics vary directly. The larger the R², the greater the F value. In limit if R² = 1, F is infinite. Thus the F-test, which is a measure of the overall significance of the estimated regression, is also a test of significance of R².

3.4.3 Hypothesis of the Study

Depending upon the model developed in conceptual framework part, the following hypotheses have been tested here were H₀ stands for null and H₁ stands for alternative hypothesis.

1. H₀: Public investment makes positive impact on GDP growth. (i.e. b₁>0)
H₁: Public investment doesn't make positive impact on GDP growth. (i.e. b₁>0)
2. H₀: There is positive association between government expenditure and imports (i.e. b₂>0)
H₁: There is not positive association between government expenditure and imports (i.e. b₂<0)
3. H₀: There is positive association between government expenditure and money supply (i.e. b₁>0)
4. H₁: There is not positive association between government expenditure and money supply (i.e. b₁>0)

3.5 Procedure of Data Analysis

- a. Linear regressions have been estimated as specified in the conceptual framework part. The estimation uses statistical computer programme SPSS. With the same programme the value for the statistical tests such as T value, F value, R^2 , \bar{R}^2 and standard errors have been calculated.
- b. Hypothesis have been tested by comparing calculated and tabulated values at 5 percent and 10 percent level of significance
- c. This empirical analysis is made covering the period of 16 years from 1990/91 to 2005/06. It is primarily decided by the availability of the data.

CHAPTER IV

TRENDS OF PUBLIC EXPENDITURE

The history of national budget announcement isn't very old in Nepal. "the necessity of national budget in Nepal was realized after the establishment of democracy in the country in 1951 and first annual budget was introduced in 1952. But the budget presented by the Minister of Finance of the first elected government in 1958/59 is considered as the first scientific budget of Nepal. (Sharma, 1999).

In that situation of growing political consciousness after the over thrown of Rana Regime in 1951, the government was compelled to undertake development activities to fulfill the aspiration of the people (Rana, 1986). But the situation wasn't conducive for economic development due to the existence of many hurdles like small revenue base, lack of infrastructure and socio-overhead capital, topographical constraints etc. This situation produced two-pronged effect in the growth of public expenditure. In one hand, public expenditure was needed to increase for development activities. On the other hand, growth of public expenditure was accelerated to make institutions for development activities.

Due to the increasing pressure for the development first development plan was launched in 1956. To carry out development works annually in a planned way budget was divided in two parts-regular and development budget in 1957. The regular budget was meant for meeting the administrative expenditure and development budget was meant for covering annual development activities of the government. Sharma (1999) writes "After that at the end of each fiscal year government presents its plans and programs and strategies through budget for the coming year, with the division of budget into two parts such as regular and development budgets. During the period of 15 years long history of budget in Nepal, there hasn't been much change in the concepts used to distinguish regular and development budget though both the regular and development

expenditure of the government are increasing every year in absolute term.”
(Ibid)

After the restoration of Democracy on early nineties, new regimes came up with new economic programs targeted to meet the popular expectations and aspiration of the people. The whole world also witnesses a substantial change in the field of economic liberalization. The development plans formulated subsequently the Eight Plan (1992/93-1996/97) and Ninth plan (1997/98-2001/02) overriding objective being poverty alleviation. Significant progresses were made in the liberalization of the economy, maintenance of macro economic stability, expansion of health and education facilities, and in the augmentation of electricity supplies, telecom services and road networks during the period (NPC: 2003). However the economy continues to remain at low-level equilibrium trap (Dahal: 1999). The overall economic growth, including that of agriculture, remained below expectation and the incidence of poverty and unemployment is still high. The core reasons for the less-than-expected outcomes, especially in the poverty front, are unsatisfactory implementation

Successive government formed after referendum followed an expansionary fiscal policy (Acharya: 1999). Followed by large fiscal deficits on the FY from 1982/83 to 1984/85, the governments introduced the reforms package on suggested by multi-lateral donor agencies. Fiscal reforms were carried out which in turn were largely centered on reducing fiscal deficits by increasing the revenue and rationalizing the government expenditure.

The democratic governments then set up made their attempt to reduce the regular expenditure and increase the development one. Different report and task force (PERC, 2000, Dahal, 1999) suggested to rationalize the government expenditure especially on the field of general administration, defence etc. However, these attempt lies well below the expectation. In the recent years several measure have been taken to rationalize expenditure and strengthen Public Expectation Review Commission (PERC) was set up in 2000/01; and its

key recommendation have been subsequently implemented (NPC: 2003). The notable action is the formulation of Medium Term Expenditure Framework, which was subsequently adopted as the basis of 2002/03 budget. The MTEF introduced important reforms, including a more realistic budget framework a serious prioritization involving a major reduction in the number of projects/programs, greater focus on implementation and monitoring of expenditures, and linking fund releases to performance (NPC: 2003).

4.1 Reforms in Public Expenditure

The reforms in Fiscal front were started from mid 1980. Nepal incurred large fiscal deficits following the 1980 referendum, the verdict of which went in favour of party less Panchayat system against multi-party system (Acharya: 1999). Successive governments formed after the referendum followed an expansionary fiscal policy. The widened deficits were financed largely from domestic resources. Among others, those large fiscal deficits put pressure on the balance of payments, leading it to deficit for three consecutive years-fiscal year 1982/83 to 1984/85 (Ibid: 1999). This crisis on the external front forced the government to initiate economic reforms. The types and contents of economic reforms were largely the result of negotiations conducted with the IMF and World Bank for financial assistance (Ibid: 1990).

Reforms in Public expenditure front as such were launched during late 90s when the government was preparing a comprehensive poverty reduction strategy paper (PRSP) - the tenth plan. These reforms excessively include the public expenditure management as an important agenda. Critical actions in this area include prioritizing all development expenditures (through MTEF) on the basis of PRSP priorities; and providing adequate funding for high priority activities. For this purpose, a realistic medium terms expenditure framework was adopted, projects/programs were ranked into these categories (P₁, P₂ and P₃) and 190 projects/activities, which were considered low priority, were dropped (NPC: 2000).

In parallel, changes in budget/fund release procedures were undertaken by the MOF to ensure that priority activities (identified by the MTEF's ranking process) were provided adequate funding. Fund releases were linked directly to the preparation of the work programs, submissions of trimesterly process report and certification of satisfactory performance by appropriate authorities in the line ministries and agencies. MTEF has tried to ensure these procedural changes in district and local levels, with the local bodies made responsible for release of funds on the basis of expenditure reports and certification analysis.

National planning commission and ministry of finance are optimistic that these initiatives will completely transform the traditional planning and budgeting, fund allocation and release process. Unlike in the past when hundreds of questionable projects found their way into the development budget, procedures for inclusion of projects in the budget and for funding them are now more transparent and explicit (MOF: 2004).

Though the reforms in public expenditure offers hope for efficient and pro-poor based resource allocation practices, the apparent scene yet to be noticed. However, the concern is not the intention and application of standard rules; it is the questions has the recommended policies made any impact in ensuring better living condition of Nepalese population by narrowing down income inequality over past two years (Pyakuryal: 2004).

4.1.1 Medium Term Expenditure Framework (MTEF)

As a consequence in the reforms in public expenditure in Nepal, Government of Nepal (GON) has implemented Medium Term expenditure Framework. To improve the public resource management is an important objective of this agenda. Due to the recommendation of the public expenditure reform commission (PERC), MTEF is included in the Tenth Plan. The need for on MTEF has also been reinforced by a number of other considerations. Most important consideration is the poverty reduction strategy paper, the Tenth plan.

The Tenth Plan has its focus on key policies, programs and activities that will help to reduce poverty; to base on more realistic macroeconomic framework; to be more result-oriented and to be more cognizant of the Government's implementation and capacity constraints. The MTEF is an important element of the Government's response to the present crisis. It is not just an attempt to manage public resource more efficiently and effectively by prioritizing expenditure, but also guaranteeing good governance and accountability to revive and strengthen public faith and confidence in the government. In this context, the MTEF is an essential complement to the Tenth Plan, designed to help implement the latter by giving priority in resource allocation the latter by giving priority in resource allocation and implementation by implementation of activities identified as the most important. The medium term expenditure framework is based on the recommendation put forward by the public expenditure reform commission (PERC) 2000/01.

The MTEF introduced important reforms, including a more realistic budget framework, a serious prioritization involving a major reduction in the number of projects and programs, greater focus on implementation and monitoring of expenditures, and linking fund releases to performance. The MTEF is expected to be a regular part of the budgeting and planning process, and now provided an extremely useful mechanism for adjusting the tenth plan and the budget to the changing resource situation. (NPC: 2003).

MTEF document (2000/01) dealt exclusively about the approach and process involved while preparing MTEF. Initially, MTEFs were prepared by the following five core line ministries, which roughly account for 57.5 percent of the development budget. These sectors includes: Agriculture sector- Ministry of Agriculture and co-operatives; Education sector- Ministry of Education and Sports; Health Sector- Ministry of Health; Water Resource Sector- Ministry of Water resources; and Roads, Drinking water and Urban Development- Ministry of Physical Planning and Works. Besides these, MTEF has also considered the macro economic projection and framework to make the MTEF more realistic.

This is because the actual resource availability has always fallen below the estimated resource collection for financing current as well as capital expenses. Thus macro economic framework that comprises. Thus macro economic framework that comprises projection of GDP growth rate both aggregate and sector wise, fiscal deficits, domestic borrowing as well as revenue collection has been seen as an integral to overall resource allocation practices. This macro economic projection has again been framed for two situations keeping the insurgency problem at sight. There are two sceneries- first consider the normal situation that is the cease fire case, while second consider the war period.

The MOF and NPC are quite optimistic about the good performance of this reform. But some economists are still skeptic about the successful implementation of the MTEF.

4.2 Trends in Public Expenditure

In Nepal, Budget is formulated under the tradition budgetary approach when total expenditure is divided under the two headings viz. regular expenditure, which is also termed as recurrent expenditure, and development expenditure which is termed as capital expenditure. The former does not increases the stock of capital but the later is considered to add to the stock of capital.

The table 4.1 gives the idea about regular and development expenditure under two heads. Table 4.1 shows that both kinds of expenditure are increases in each year. Moreover the regular expenditure has suppressed the development expenditure which is against the fiscal norms. In FY 1990/91, total expenditure was 23549.8 million, which reached to 110889.2 million in the FY 2005/06. Regular expenditure has also increased from Rs. 7570.3 million in the FY 1990/91 to 67017.8 million in the FY 2005/06. The development expenditure does not consistently increased in the student period. Its volume decreased by Rs. 1393.3 million in the FY 1994/95 and by Rs. 412.6 million in FY 1998/99 then the previous years. But the overall development expenditure is increased from Rs. 15979.5 million to Rs. 43871.4 million in the study period.

The percentage distribution in table 4.1 gives more precise idea about the structure of public expenditure. Table 4.1 shows that the overall trends of regular expenditure is increasing during the study period. This is the clear indication that more resources have been allocated towards recurrent type of expenditure then development expenditure i.e. budgetary classification is not supporting for accumulation of capital.

Table 4.1
Trends of Regular and Development Expenditure and Percentage
Distribution

Rs. in million

Fiscal Year	Nominal Distribution			Percentage Distribution (RE and DE as % of TE)		
	Total Exp (TE)	Reg. Exp (RE)	Dev. Exp (DE)	RE	DE	Total
1990/91	23549.8	7570.3	15979.5	32.15	67.85	100
1991/92	26418.2	9905.4	16512.8	37.49	62.51	100
1992/93	30897.7	11484.1	19413.6	37.17	62.83	100
1993/94	33597.4	12409.2	21188.2	36.94	63.06	100
1994/95	39060.0	19265.1	19794.9	49.32	50.68	100
1995/96	46542.4	21561.9	24980.5	46.33	53.67	100
1996/97	50723.7	24181.1	26542.6	47.67	52.83	100
1997/98	56118.3	27174.4	28943.9	48.42	51.58	100
1998/99	59579.0	31047.7	28531.3	52.11	47.89	100
1999/00	66272.5	34523.3	31749.2	52.09	47.91	100
2000/01	79835.1	42769.2	37065.9	53.57	46.43	100
2001/02	80072.2	48863.9	31208.3	60.68	39.32	100
2002/03	84006.1	52090.5	31915.6	65.44	34.56	100
2003/04	89442.6	55552.1	33890.5	62.11	37.89	100
2004/05	102560.4	61686.4	40884.0	60.15	39.81	100
2005/06	110889.2	67017.8	43871.4	60.44	39.56	100

Source: Economic Survey, MOF, 1990/91-2004/05.

In FY 1990/91 regular expenditure was 32.15 percent which is reached to 65.44 percent the highest percentage in the study period in FY 2002/03 and reduced to 60.44 percent in the FY 2005/06 the last FY of the study period. Where as the development expenditure is decreased from 67.85 percent in FY1990/91 to 34.56 percent, the lowest percentage distribution in FY 2002/03 and reached 39.56 percent in FY 2005/06. Regular expenditure has overlapped development expenditure in FY1998/99.

Table 4.1 leads to several important aspects of Nepalese public expenditure structure. First that government's goal to meet major social objectives poverty alleviation are overshadowed by the increasing share of regular expenditure. The bulky resources have been devoted to unproductive recurrent expenditure with very little scope of contribution for acceleration of economic growth. No doubt, government expenditure should contribute to economic growth of the country when private sector is at infant. However the government has failed to maintain this ascertain. Accordingly, government's willingness to fulfill the major societal objective specified by periodic plan; and parallely the government's commitment to maintain fiscal discipline is questionable against the background of the current public expenditure pattern. These trends have some importance consequences of institutional weakness and the political commitment. The urgency is felt for the political commitment of reforms in public expenditure management as well as on resource allocation practices.

4.2.1 Growth Rates of Total, Regular and Development Expenditure

The growth rates of Total, Regular and Development Expenditure during the study period are presented in the following table 4.2:

Table 4.2**Growth Rate of Total, Regular and Development Expenditure**

Year	Total government expenditure	Regular Expenditure	Development Expenditure
1990/91	19.73	13.47	22.94
1991/92	12.18	30.85	3.34
1992/93	16.96	15.04	17.57
1993/94	8.74	8.06	9.14
1994/95	16.26	55.25	(6.58)
1995/96	19.15	11.92	26.20
1996/97	8.99	12.15	6.25
1997/98	10.64	12.38	9.05
1998/99	6.17	14.25	(1.43)
1999/00	11.21	11.19	11.28
2000/01	20.46	23.89	16.75
2001/02	0.30	13.61	(15.80)
2002/03	4.91	13.13	2.27
2003/04	6.47	1.05	6.19
2004/05	14.67	11.04	20.63
2005/06	8.12	8.64	7.31
Average	11.56	15.99	8.44

Source: Economic Survey, MOF, 1990/91-2004/05.

Figures in bracket are negative value.

Table 4.2 suggests that there is no specific pattern of the growth rates of total, regular and development expenditure, rather they consist of random attributes. It depicts that there are significant up swings and downswings in all categories in some fiscal years. For instance, total expenditure has achieved 20.46 percent of growth rate on the FY 2000/01 where as there is just 0.30 percent growth rate in the following FY year. Similarly, regular expenditure achieved ever-highest growth rate in FY 1994/95 of 55.25 percent, which is substantially

higher than the study period's average of 15.93 percent. Distinguishing feature of both total and regular expenditure from that of development expenditure is that they never achieved negative growth rate during the study period. But there are negatives growth rate in the development expenditure in FY 1994/95, 1998/99 and in 2001/02. In FY 1995/96, a year later the negative growth rate experienced, 26.20 percent of growth rate in development expenditure was occurred, which is the highest growth rate achieved during the period of analysis. Similarly, there was a growth rate of 16.75 percent in the FY 2000/01, which drastically come down to negative growth of 15.80 percent in the following FY.. As compared to previous FY, regular expenditure dramatically reduced to 1.05 percent in 2003/04. A decrease in the growth rate of regular expenditure and increase in DE in ending FYs of analysis highlights the government interest towards accumulation of capital.

Thus it can be seen that there are random fluctuations in the all categories discussed so far (irrespective of GDP growth rate, foreign aid, revenue collection etc). These fluctuations are of great importance in knowing the major determinants of the government expenditure in Nepal for the period specified. The trend, as we saw, falls beyond the established norms of public expenditure management.

4.2.2 Total, Regular and Development Expenditure as Percentage of GDP

In order to attain a meaningful picture regarding the trends and patterns of total, regular and development expenditure and attempt is made to compare these with respect to GDP in the following table 4.3

Table 4.3
Total, Regular and Development Expenditure as Percentage of GDP (at current price)

Year	GDP million	Total expenditure	Regular Expenditure	Development Expenditure
1990/91	116128	20.28	6.52	13.76
1991/92	144931	18.23	6.83	11.39
1992/93	65262	18.69	6.95	11.74
1993/94	191540	17.54	6.48	11.06
1994/95	209974	18.60	9.17	9.43
1995/96	239388	19.44	9.01	10.44
1996/97	269570	18.82	8.97	9.85
1997/98	289798	19.36	9.38	9.99
1998/99	330018	18.05	9.41	8.65
1999/00	366251	18.09	9.43	8.67
2000/01	393566	20.29	10.87	9.42
2001/02	405632	19.80	12.05	7.69
2002/03	435531	19.29	11.96	7.33
2003/04	472424	18.93	11.76	7.17
2004/05	530391	19.34	11.63	7.71
2005/06	584261	18.97	11.47	7.51

Source: Economic Survey, MOF, 1990/91-2004/05.

Table 4.3 shows that total expenditure has not changed in relation to GDP from the early 1990s to early millennium. It has remained consistent instead around the average of 18.98 during the period under review. Still there is a negative change from the first year to last year of period 1990/91-2005/06. In FY 1990/91 the share was 20.28percent while it went down to 18.97 percent in FY 2005/06. In FY 2000/01 as an exception the share is reached to 20.29percent breaking the trend of past years. However, remarkable changes are in case of regular expenditure and development expenditure. In FY 1990/91, regular

expenditure as percent of GDP was just 6.52 percent, which reached to 11.47 percent, nearly two fold higher, in the FY 2005/06. The case of development expenditure is just opposite. Development expenditure as percent of GDP was as higher as of 13.76 percent ever highest share, in the FY 1990/91 which came down to the figure of 7.51 percent nearly two fold less, in FY 2005/06.

Thus table 4.3 again justifies that fact of increasing regular expenditure and decreasing development expenditure. Decrease in the total expenditure, as a ratio of GDP may be justifiable under the context of liberalization and privatization. The expansion of private sector and limiting the government activities from the production of commercial goods will certainly reduce the share of public expenditure GDP simply because contribution of public enterprises who are supposed to add to GDP decline. However, the increasing share of regular expenditure and decreasing that of development expenditure is really alarming sign for developing economies like Nepal. Against the background of low growth rate of the revenue than government expenditure, this is leading to widening resources gap. Accordingly, the increasing share of foreign aid, especially foreign loan, in development expenditure for bridging resource gap affects the economy adversely in the long run by forcing repayments of large amounts as principal and interest payment. Government, thus, needs to restructure its expenditure pattern and need to revise its policy regarding government expenditure. Development expenditure must be raised immediately in order to meet the goal set by periodic plan. Only then rationale of government expenditure will be justified with welfare prospective.

4.2.3 Regular Expenditure

The main functional components of RE are general administration, social service, economic service, defense, loan principal payment and interest payment etc. Under the heading of miscellaneous, other (not mentioned above) small component are included.

Table 4.4
Regular Expenditure

Rs. in billion

FY	Constitutional Organ	General Adm.	Rev. Adm	Economic Adm. & Planning	Judicial Adm.	Foreign Services	Defense	Social Services	Economic Services	Loan & Investment	Loan Repayment & Interest	Misc.
1990/91	0.19	1.18	0.12	0.048	0.08	0.18	1.15	0.74	0.37	0.01	2.41	1.08
1991/92	0.28	1.53	0.17	0.06	0.11	0.23	1.49	1.00	0.55	0.00	3.80	0.68
1992/93	0.17	1.82	0.19	0.07	0.15	0.31	1.72	1.27	0.59	0.02	4.56	0.62
1993/94	0.20	1.90	0.19	0.08	0.15	0.33	1.88	1.35	0.61	0.02	4.86	0.85
1994/95	0.21	2.12	0.22	0.09	0.16	0.38	2.00	4.44	1.35	0.01	6.08	2.20
1995/96	0.23	2.51	0.25	0.10	0.19	0.39	2.13	5.38	1.53	0.02	6.72	2.12
1996/97	0.47	2.84	0.26	0.10	0.22	0.44	2.36	5.91	1.74	0.03	7.53	2.28
1997/98	0.35	3.16	0.29	0.11	0.25	0.48	2.58	6.99	1.89	0.02	7.68	3.36
1998/99	0.38	3.62	0.31	0.12	0.28	0.61	2.99	7.38	2.17	0.02	8.72	4.45
1999/00	0.43	4.07	0.34	0.13	0.28	0.67	3.48	8.33	2.22	0.04	10.03	4.50
2000/01	0.44	6.26	0.38	0.19	0.32	0.60	3.81	10.88	1.63	0.01	10.39	7.86
2001/02	0.57	7.73	0.48	0.20	0.44	0.67	5.86	13.35	1.91	0.01	12.21	5.17
2002/03	0.82	7.82	0.47	0.21	0.44	0.72	7.38	13.75	2.05	0.002	16.8	5.13
2003/04	0.74	7.33	0.50	0.27	0.45	0.71	6.63	20.81	5.51	0.06	16.86	6.87
2004/05	0.82	8.23	0.54	0.33	0.50	0.79	8.58	23.4	7.17	0.00	18.84	5.30
2005/06	1.02	9.27	0.61	0.33	0.56	0.83	9.81	25.38	7.53	1.5	19.90	5.64

Source: Economic Survey, MOF, 1990/91-2004/05.

Table 4.4 exhibits the composition of regular expenditure under different heads. These categories have again been divided into different sub categories, which is not mentioned here in the table. Table 4.4 shows loan repayment and interest payment claims a higher among than other categories. This has registered the highest amount with in the all FY compared to other. This alone claims at an annual average of 31.47 percent, nearly one third, of total regular expenditure incurred within the period. Next category with substantial amount is the expenditure on social services. Except some initial years, it has stood as one of the major category that claims a large share of total regular expenditure. This has, in an average, a share of nearly 20 percent of total regular expenditure. Defense expenditure, which itself has remained as the center of gravity among the fiscalist, also claims a large share in the total regular expenditure. In the initial years, its share on total regular expenditure was around 15 percent, which decreased in the middle years and registered an average of 10 percent. But Data reveals that this is in increasing trend in defense expenditure in the latter years of the analysis.

Data reveals that expenditure for administration (constitutional organs, general, judicial, revenue etc.) all assert nearly one fourth of the total expenditure, of which expenditure on Foreign Service is substantial except than general administration. The expenditure on revenue administration and the economic planning contains very nominal share of total expenditure. For example, the expenditure on the foreign service was Rs. 0.18 billion on FY 1990/91 while the expenditure on the same FY on revenue administration and the economic planning was just Rs. 0.12 and Rs. 0.048 billion. Though the expenditure on revenue administration and economic planning administration increased in absolute terms of the subsequent years but still has little share over total regular expenditure. For example, the share of these on total regular expenditure on FY 2005/06 is 0.61 and 0.33 billion respectively while the share of constitutional organs, foreign service and defense on the same year is 1.02, 0.83 and 9.81 billions respectively all being higher than those two. Allocation on economic service is quite low in the initial FY than other categories. Expenditure under miscellaneous heading on the other hand has remarkable bearing on the total expenditure.

This table thus shed light over some important aspects. The highest share of loan repayment and interest payment shows that bulk of resources is devoted for the maintenance of public enterprises. Ironically these public institutions have been suffering heavy loses every year adding extra burden to government. This category also consists of the loan and interest payment of foreign aid. Under the background of low productivity of foreign aid, the opportunity cost of loan and interest payment may be higher indeed. Another important aspect is that a substantial amount is allocated for the salaries, wage categories (e.g. general administration, foreign services, constitutional organs, judicial organs etc.) which have left a little amount for other categories like social service expenditure, economic service expenditure and mainly for the organization and management. In effect, allocations for operations and maintenance activities in the regular budget have been highly inadequate.

4.2.4 Development Expenditure

Development is basically a capital expenditure. Thus this category is of particular importance for the developing economies like Nepal. Development expenditure, like regular expenditure, is made of different components. The main constitutes are constitutional organs, general administration, economic service, social service etc.

Table 4.5 shows the development expenditure pattern under different major component of development expenditure. Likewise Table 4.4, these components have been again divided into subcomponent, which are not the mentioned here. Table 4.5 exhibits that the expenditure made under the head economic service is substantial; it's because this category comprises subcomponents which hold a substantial share of total development expenditure. Next category is the social service, which also commands a noticeable share in the development expenditure.

In FY 1990/91, the expenditure under economic service was Rs. 11893.3 million, which reached Rs. 16982.7 in FY 1995/96. The highest amount spent under this head is in FY 2000/01 amounted Rs. 21114.3 million. But in the following year this amount has dramatically decreased to Rs. 17452.0 million.

Social service expenditure shows some ups and downs in different FY. In FY 1990/91 the expenditure made under this heading was Rs. 3569.3 million nearly three fold less than the expenditure on economic service on the same FY. This amount reached to Rs. 6224.8 million in FY 1994/95 lower than the economic service expenditure by Rs. 6627.9 million during the same FY. The highest amount spent on Social service is Rs. 11530.3 million in FY 2000/01; this amount however decreased to Rs. 12.19 billion in the following FY. Expenditure incurred under miscellaneous heading is also significant. Except the FY 1992/93, the amount allocated under this head is significantly higher than other categories like constitutional organs, general administration and economic administration and planning.

Table 4.5
Development Expenditure under Different Heads

Rs. in million

FY	Consti. organs	General Adm.	Eco. Adm & planning	Social Service	Economic service	Misc.	Total
1990/91		11.3	83.3	3569.3	11893.3	422.2	15979
1991/92		13.8	39.3	5040.3	11063.3	356.1	16513
1992/93		29	18.7	7245.5	12111.5	8.9	19414
1993/94		31.3	19.5	7104.1	13841.4	191.9	21188
1994/95		33.5	31.6	6224.8	12852.7	652.3	19795
1995/96		41.6	33.2	7612.7	16982.7	310.3	24981
1996/97		34.5	17.3	9281.3	17054.7	154.8	26543
1997/98	3.6	46.4	19.3	10323.4	17900.2	650.9	28944
1998/99	28.5	79.2	20.5	10265.4	17324.4	813.3	28531
1999/00	26.6	108.1	28.6	12406.2	18648.6	531.1	31749
2000/01	12.7	127.2	196.2	12872.7	21114.3	2742.8	37066
2001/02	13.4	250.1	94.1	11530.3	17452.0	2142.3	31482
2002/03	16.8	581.3	33.3	12190.0	12561.0	875.6	26258
2003/04	36.9	578.1	89.4	7135.2	13129.0	172.0	21141
2004/05	38.0	883.6	242.1	7940.7	15394.9	435.0	24934
2005/06	100.0	1181.7	203.0	10151.8	14797.1	8.8	26442

Source: Economic Survey, 2004/04, MOF.

Table 4.5 exhibits some special characteristics. It is seen that social service expenditure and economic service expenditure hold a large share on total development expenditure. The expenditure on the administrative reforms side such as spending on constitutional organ, general administration and economic administrative and planning also command some amount on development expenditure signifying the reforms process on the administrative side. These will contribute in realizing the efficient as well as good governance with in the country. But at the same time the spending under the miscellaneous head leave an open debate about the productivity of such spending. The expenditure must be clearly stated under specific head rather than miscellaneous.

Table 4.6
Development Expenditure under Social and Economic Services

Rs. in million

FY	Social Services			Economics Services					
	Edu.	Health	Drink	Agri.*	Forestry	Indus.	Comm.	Trans.	Electri.
1990/91	1716.0	366.8	538.5	2693.9	460.1	1751.5	56.7	1979.5	1363.1
1991/92	2395.2	507.2	1334.4	3519.5	884.3	2427.2	116.0	2381.0	1414.4
1992/93	3465.0	600.2	1821.4	4100.4	928.8	1085.6	474.7	2844.0	2229.1
1993/94	3822.1	560.5	1073.6	5536.6	966.5	648.0	437.6	3363.2	2312.2
1994/95	1453.6	858.5	1102.2	5191.6	408.4	27.2	1517.8	3010.6	1764.9
1995/96	1791.0	915.5	1206.4	5138.4	378.7	306.0	1151.7	5968.5	3210.2
1996/97	2356.2	1621.2	1327.1	4641.3	463.5	263.5	1095.9	5305.2	4447.3
1997/98	2037.1	2076.1	1670.0	4633.4	410.4	477.1	1188.4	5619.9	4704.7
1998/99	1641.3	1677.2	1866.8	4928.3	480.5	289.4	466.0	5111.3	4811.3
1999/00	2573.7	2126.7	2423.0	5197.7	519.0	833.9	282.5	4695.4	5537.9
2000/01	2783.9	1972.4	2407.2	6372.6	478.9	366.8	244.0	5354.9	6813.7
2001/02	2755.1	1876.7	1747.3	5807.5	630.9	582.5	271.3	4518.0	4395.3
2002/03	940.7	159.3	1669.9	2041.9	373.7	425.1	1680.1	3664.9	3881.6
2003/04	1003.4	142.2	2065.8	2249.0	459.8	40.5	356.5	3958.0	4746.2
2004/05	1260.4	409.3	1440.0	2204.2	410.7	23.5	536.8	4149.6	7219.1
2005/06	1609.6	948.2	1949.8	2800.1	148.0	31.0	283.6	4178.1	6256.4

Source: Economic Survey 2003/04, MOF.

* Includes Agriculture, irrigation and land reform

Table 4.6 consider only important sub component of social service and economic service. Others, which hold only nominal expenditure, are not taken for the analysis. Table 4.6 exhibits that education, health, and drinking water are the important component of social service expenditure. Education under social service expenditure claims a largest share on this expenditure. This alone, in an average, commands 30.96 percent of total social service expenditure during the period taken for the study. The average share of health and drinking water has 13.75percent and 18.12percent respectively during the same period. Table 4.6 also reveals that expenditure on these categories have increased form the early 1990's to early millennium. In FY 1990/91, expenditure under education was Rs. 1716 million, which reached to Rs. 2783.9 million in the FY 2000/01; the highest amount allocated and finally reaches to Rs. 1609.6 million in FY 2005/06. Similarly, the expenditure on health and drinking water was Rs. 366.8 and 538.5 million respectively on FY 1990/91, which increased amounting Rs 948.2 and Rs. 1949.8 million in FY 2005/06 both increased by substantial amount. Table 4.6 exhibits that the rate of change in drinking water and health is more than that of education from the initial year to last year of study period.

Expenditure under different components of economic services reveals different pattern. Of them, agriculture claims a larger share on the expenditure under this head. This expenditure has increased by more than two times from FY 1990/91 to 2001/02 but decreases to Rs. 2800.1 million at the end of study period. In FY 2000/01, the ever-highest amount is observed in the study period, Rs. 6372.6 million was spent under this category. The spending on agriculture however has decreased in the FY 1996/97 and subsequent years from spending of FY 1993/94. This reveals the fact that government is not keen to implement the agriculture perspective plan, which is the master plan of the agricultural development of the country.

Another substantial amount is spent on transportation. This alone shares as much as of average of 26.79 percent of total spending on economic service

during the period under review. Though this expenditure is subject to the project carried out instead of having steady pattern, it has increased in absolute from the early 1990s to late 1990s. Electricity, which has been considered as the major prospects of the country's development, is also having significant amount allocated.

These figures on table 4.6 do not reveal any surprising figures. Under the assumption of infant private sector and democratic governmental set up justifies the need of large resources to be allocated under the social service and economic service. The real debate however should be the productivity of such spending under the different components of social and economic service. Accordingly, there is need of intersectoral comparison to guarantee the high yield so that the society's major objective of poverty alleviation can be achieved with in the desired period.

CHAPTER V

PROBLEMS OF RESOURCE GAP

5.1 Introduction

Resource gap is defined as the gap between gross domestic saving and gross investment. The problem of resource mobilization has received high priority in the literature in the past. The theory of public expenditure is still in its infancy and therefore no universally accepted theory explaining public expenditure growth exists even today (Musgrave, 1969).

Theories provided by many economists in the past receive that as the changes in economic structure of 'a developing economy takes place overtime, resource mobilization becomes easier and also expansion in budgetary size takes momentum. In practice, it is observed that there is two-way relationship between resource mobilization and expansion in budgetary size in developing countries.

Therefore, the real problem for least developed countries is how to mobilize resources in the early phase of economic development then canalize these scarce resources in those areas from where the economy could get return as quickly as possible. This will have multiplier effect in the economy in the later stage (Lohany, 1994).

Increase in government expenditure increases aggregate demand; which increases total output through multiplier effect and it leads to long-term growth by reducing supply bottlenecks in the economy. That is why development economists took a different view from classical one to justify the rapid growth in government expenditure in the early phase of economic development. As a consequence financing resource gap through deficit budget at a limited scale in developing countries came into practice. But in many developing countries deficit financing has created a lot of problems.

Either, because of weak planning or sharp increase in unproductive recurring expenses, deficit financing has led to create economic instability in many developing countries. This has made deficit financing as a major issue of empirical analysis and theoretical discussion. The debate in 1960s and early 1970s was mainly confined on developed countries regarding the efficiency of monetary vis-à-vis fiscal policy in bringing economic stabilization in these countries. Though the debate is still continuing, now the focus is on the possibilities of crowding out of private resources in a situation of excessive dependence on banking system in financing fiscal deficit. If there is crowding out of private resources its implication is reflected on countries rate of growth and overall development (Choudhary, 1976).

This happens as a result of unproductive use of private resources by the government. Another factor to be considered in the context of developing countries is that if the coefficient of government expenditure adjusts rapidly than revenue, it may have chain effect on prices and deficit financing (Heller, 1980). Another problem that might be created by deficit financing is in trade and balance of payment by either generating excessive demand in the economy or exports becoming costlier and costlier.

All these issues need careful consideration in a country like Nepal where the resource mobilization has been a major problem in financing growing expenditure expenses. The paucity of resources, in fact, had led to widen the resource gap problem from one year to another. The problem has compounded as a result of growing disaving in the government in a situation where private saving is also comparatively low in comparison of neighboring countries like India and Sri Lanka. In India the share of domestic saving in GDP was more than 23 percent in the year 2000 where as its component in Nepal was 11 percent in the same year (International Financial Statistical yearbook, 2002).

5.2 Problem of Resource GAP in Nepal

A major feature of the Nepalese economy is the persistence of a low saving rate in comparison to investment. This has created resource gap, which has been increasing gradually. “A principal reason for low saving is that, in the public sector, there is usually dissaving which means that private saving also is regularly diverted to the public sector to meet a part of government consumption. In addition, financing of public sector investment is increasingly more dependent upon external sources” (IDS, 1987).

Thus gradually increasing resource gap has been one of the major problems in the realization of development programs in Nepal. A common assumption is that a country after certain time interval of development efforts would be in a position to increase domestic saving rate substantially due to increasing pressure for investment. The existing situation in Nepal is however, completely different. At present she is confronting the problem of meager increase in domestic saving and sustaining higher investment.

Appendix 4 shows that percentage share of domestic saving in GDP has been almost stagnant in the study period where as percentage share of investment in GDP has been increasing. The result is unprecedented growth in resource gap one year after another. The data clearly shows that resource gap was around 7 percent of GDP in 1979/80. It soared to 11.49 percent in 1997/98. The lower resource gap observed in the year 1998/99 wasn't the result of increase in domestic saving but the result of lower investment in comparison to the previous year. This increase in resource gap is clear indication of widening current account deficit from one year to another.

Though there has been steady increase in net factor income and current transfer from abroad during the study period of the last two decades, these components have contributed little to increase the national saving at a faster rate. As a result

the problem of resource gap has increased from one year to another, which has been recovered through massive inflow of external capital.

Thus an unusual phenomenon is observed in Nepalese economy that despite massive inflow of foreign capital, gross domestic saving as a percent of GDP has remained almost stagnant. Lohary (1994) has given following three reasons responsible for this situation.

- a. Higher priority in poverty reduction
- b. Underestimated income and savings
- c. Increase in government dissaving

Closely analyzing the causes, it has found role of first cause isn't highly responsible for lower domestic saving in our country. Theoretically it is possible that if a country focuses more on poverty alleviation programs without trying to maintain proper balance between growth and equity aspects of development, there is possibility of decreasing aggregate saving rate in the economy in the immediate future due to sudden jump in the level of per capita consumption.

Macro economic indicators of Nepalese economy reveal that in Nepal neither there has been big increase in per capita consumption of the poor people nor poverty alleviation programs have been much successful despite setting long term goal of poverty alleviation for different plan periods. In addition, "Although the Nepalese economy passed through a series of crises during the period from 1951 to 1998, the ultra-poor, the poor and lower middle income groups had never been suffered the economic humiliation they are facing today" (Dahal, 2001, p. 10).

Though it is most likely that both income and saving are highly underestimated in Nepal where national accounts estimates are based on very weak database, the third case of growing dissaving in government is more convincing which is analyzed in the next topic revenue expenditure gap.

Table 5.1
Revenue, Expenditure Gap

(Rs. in Million)

Year	TR	TE	R.G.	R.G. as % of TE	Growth Rate of R.G.
1990/91	10729.3	23549.8	12819.9	54.44	-
1991/92	13512.7	26418.2	12905.5	48.85	6.68
1992/93	15148.4	30897.7	15749.3	50.97	22.04
1993/94	19580.8	33597.4	14016.6	41.72	(11.00)
1994/95	24605.1	39060.0	14454.9	37.07	3.13
1995/96	27893.1	46542.4	18649.3	40.07	29.12
1996/97	30373.5	50723.7	20350.2	40.12	9.12
1997/98	32937.9	56118.3	23180.4	41.31	13.91
1998/99	37251.3	59579.0	22327.7	37.48	(3.68)
1999/00	42893.8	66272.5	23378.7	35.28	4.71
2000/01	48893.6	79835.1	30941.5	38.76	32.35
2001/02	50445.5	80072.2	29626.7	37.00	(4.25)
2002/03	56229.8	84006.1	27776.3	33.06	(6.25)
2003/04	62331.0	92107.2	29776.2	32.33	7.20
2004/05	70122.7	102560.4	32437.4	31.63	(2.16)
2005/06	72282.1	110889.2	38607.1	34.82	10.08

Source: Economic Survey, MOF, 1990/91-2004/05.

Figure in bracket are negative value

Table 5.1 shows the resource gap as the difference between total expenditure and total revenue receipt of GON. It has grown from Rs. 12819.9 million in FY 1990/91 to Rs. 38607.1 million in FY 2005/06. Resource Gap as percentage of total expenditure was the highest in FY 1990/91 as 54.44 percent and the lowest one was found in FY2004/05 as 31.63 percent. In some fiscal years like 1993/94, 1998/99, 2001/02, 2002/03 and 2004/05 the growth rate of Resource Gap were found to be negative as -11, -3.68, -4.25, -6.2 and -2.6. But the

overall scenario of growth rate of Resource Gap as compared to 1990/91 has increased. It was 6.68 in FY 1990/91, attained highest growth rate ever in FY2001/02 as 32.34 and in the final year of the study period (2005/06) it was 10.08. This clearly shows poor performance of internal resource mobilization.

Table 5.2 shows Resource Gap as the excess of total government expenditure over its revenue receipt and foreign grants. This is gross fiscal gap, which is the measure of total resource gap and it also indicates the measure of government indebtedness.

Table 5.2
Revenue, Expenditure, Foreign Grants Gap

(Rs. in Million)

Year	TR	TE	Foreign Grants	RG= TE-TR- Foreign Grants.	Growth rate of RG
1990/91	10729.3	23549.8	1620	11200.5	
1991/92	13512.7	26418.2	1531	11374.5	1.55
1992/93	15148.4	30897.7	3273	12476.3	9.69
1993/94	19580.8	33597.4	2393	11623.6	(6.83)
1994/95	24605.1	39060.0	3937	10517.9	(9.51)
1995/96	27893.1	46542.4	4825	13824.3	31.44
1996/97	30373.5	50723.7	5988	14362.2	3.89
1997/98	32937.9	56118.3	5402	17778.4	23.79
1998/99	37251.3	59579.0	4336	17991.7	1.20
1999/00	42893.8	66272.5	5712	17666.7	(1.81)
2000/01	48893.6	79835.1	6753	24188.5	36.92
2001/02	50445.5	80072.2	6686	22940.7	(5.16)
2002/03	56229.8	84006.1	11339	16437.3	(28.35)
2003/04	62331.0	92107.2	11283	18493.2	12.51
2004/05	70122.7	102560.4	14391.2	18046.5	(2.42)
2005/06	72282.1	110889.2	13827.5	24779.6	37.31

Source: Economic Survey, MOF, 1990/91-2004/05.

Figure in parenthesis are negative value

Table 5.2 suggests that there is no specific trend underlying the growth rate of resource gap. Resource gap in 1993/94, 1994/95, 1999/00, 2001/02 2002/03 and 2004/05 possessed negative growth rate. The highest growth rate was observed in 1992/93 and the lowest positive growth rate was registered in the FY 2003/04. Thus average growth rate of resource gap seems to be increasing at a positive rate.

Table 5.3 measures resource gap as the excess of government expenditure over its revenue receipt and foreign aid. This also indicates the measure of internal indebtedness of the government.

Table 5.3
Revenue, Expenditure, Foreign Aid

(Rs. in Million)

Year	TR	TE	Foreign Grants(FG)	Loans	RG=TE-TR-FG-LOANS
1990/91	10729.3	23549.8	1620	4360	6840.5
1991/92	13512.7	26418.2	1531	6269	5105.5
1992/93	15148.4	30897.7	3273	5962	6514.3
1993/94	19580.8	33597.4	2393	9164	2459.6
1994/95	24605.1	39060.0	3937	7312	3205.9
1995/96	27893.1	46542.4	4825	9464	4360.3
1996/97	30373.5	50723.7	5988	9044	5318.2
1997/98	32937.9	56118.3	5402	11055	6723.4
1998/99	37251.3	59579.0	4336	11853	6138.7
1999/00	42893.8	66272.5	5712	11812	5854.7
2000/01	48893.6	79835.1	6753	12044	12144.5
2001/02	50445.5	80072.2	6686	7698	15242.7
2002/03	56229.8	84006.1	11339	4546	11891.3
2003/04	62331.0	92107.2	11283	7629	10864.2
2004/05	70122.7	102560.4	14391.2	9266.1	8780.4
2005/06	72282.11	110889.2	13827.5	8214.3	16565.29

Source: Economic Survey, MOF, 1990/91-2004/05.

The same type of conclusion comes under this tabular presentation regarding resource gap i.e. there is no regularity in the trend of changing resource gap. In some fiscal years, resource gap is found to be decreased as compared to previous fiscal years and in some fiscal years it shows increasing pattern. The economy faced the highest resource gap in the fiscal year 2005/06 registering Rs. 16565.29 million. After this fiscal year 2001/02, resource gap seemed to be decreasing continuously till the final year 2004/05. From Rs. 15242 million in FY 2001/02, it declined to Rs. 8780.4 million in FY 2004/05 and finally reached to Rs. 16565 million in FY 2005/06.

Resource gap observed in table 5.3 has long term repercussion. Some economists like David Koft and Hophman take it as a burden to future generation.

Thus the safe conclusion derived from above analysis is that government dissaving is increasing every year as government expenditure is increasing at a higher rate than the growth of government revenue. Thus ever increasing external capital inflow has not transferred into higher growth rate of domestic saving resulting into higher resource gap.

CHAPTER VI

IMPACT OF PUBLIC EXPENDITURE ON MAJOR ECONOMIC SECTORS

6.1 Conceptual Framework

Total government expenditure in Nepal like other developing countries generally consists of three components.

- a. Government revenue, R
- b. Foreign borrowings, FB (including loan and grants) and
- c. Deficit financing

That is algebraically:

$$GE = R + FB + D$$

Thus change in government expenditure occurs only through the change in these components. About the impact of government expenditure in a economy P.R. legal says, " Financing government expenditure through increase in foreign borrowing or deficit financing will increase money supply, the former through increase in foreign assets and the later through increase in claims on government. The increase in money supply will be faster, since increase in price level and the expectation of future increase in corresponding with growing level of monetization in the economy will make people demand more money, there by increasing money supply (Legal, 1982).

The relationship of GE with other variables is shown in the following simple flow chart.



Where,

GE = Government expenditure

MS = Money supply

P = Price level

GDP = Gross domestic product

6.1.1 Impact of PE in GDP Growth

The analysis of investment and its relation with growth has been one of the most important strategic aspects of macro economic study of a country. S.R. Poudel in his Ph.D. Thesis states “It has been long emphasized that capital accumulation is the strategic factor of growth. The classical theory of growth emphasize that high investment ratio or high rate of savings is an important factor of economic growth,” (Poudel, 1988). About the role of private and public investment he further specifies,” There have been a number of studies on the relationship between investment and growth and also about determinants of the investment. Since it has been a general practice to assume public investment as autonomous, econometric studies are mainly concerned with analysing the determinants of private sector investment” (Poudel, Ibid). Though private investment is the main determinant of GDP growth, like in other developing countries share of public investment is in considerable amount total investment in our country. Thus both private and public investments are taken as the determinants of GDP growth. The specified equation for GDP growth is:

$$Y = a + b_1PI + b_2 PrI$$

Where,

Y = Real GDP

PI = Real public investment

PrI = Real private investment

6.1.2 Impact of Public Expenditure on Imports

Import is generally regarded as an endogenous variable in the macro economic models. Though imports from countries other than India have increased continuously in recent years the largest share of imports is still made from India. Besides exchange rate of Nepalese currency has been pegged with Indian currency, their price structure directly affects ~ our imports. D.R Khanal in his Ph. D thesis observed “One variable that can be expected to influence the imports is prices of India to domestic prices of Nepal” (Khanal, 1988). As the income of the people increases overtime, there might be corresponding tendency of increasing imports propensity also. Thus aggregate private consumption is considered as an additional determinant. To fulfill the envisaged goal of high growth and due to the lack of well-developed private sector, government leads to increase in the imports of capital and intermediate goods. Thus PE affects imports. Another factor that can be considered to influence imports is the foreign exchange constraint. However, the increase in remittance in high proportion every year despite the sick tourism and carpet industry results into higher forex reserve. Thus foreign exchange hasn't been major constraint in Nepal. Lagged imports variable has been applied here to show the effect of past imports. Talking all these factors into account, Import function can be specified as:

$$M = a + b_1 APrC + b_2 PE + b_3 \frac{PII}{PIN} + b_4 M_{-1}$$

In log linear form

$$\ln(M) = a + b_1 \ln(APrC) + b_2 \ln(PE) + b_3 \ln \frac{PII}{PIN} + b_4 \ln(M_{-1})$$

Where,

M = Real imports

APrC = Real aggregate private consumption

PE = Real public expenditure

PII = Price Index of India

PIN = Price index of Nepal

M-1 = Real lagged imports

6.1.3 Impact of Public Expenditure on Money Supply

Under the fractional reserve system money supply is determined by changes in reserve money and money multiplier. In this framework a rise in reserve money results in the supply of liquidity as banks expand credits with additional reserve. Thus, the money supply can be specified as:

$$MS = mRM$$

Where,

MS Money supply

m = money multiplier

RM = Reserve money

In developing countries including Nepal, money multiplier remains almost constant, and change in money supply resulted through change in reserves money.

The change in reserve money occurs mainly through the changes in international reserves, changes in central bank's claims on governments and changes in central bank's claims on commercial banks and private sector. If the changes in central bank's claims on government are simply the reflections of the fiscal deficits due to the budgetary constraints, the following equation specified by Dr D.R. Khanal in his Ph.D thesis can be applied to see the impact of PE in money supply.

$$RM = a + b_1 PE + b_2 TR + b_3 CPCB + b_4 NFA$$

Where,

PE = Public Expenditure

TR = Nominal total revenue

CPCB = Claims on private sector and commercial bank

NFA = Net foreign assets

6.2 Analysis of Empirical Estimates

In the previous chapters increasing public expenditure trend was observed in the study period. Now the questions arise, whether increasing government expenditure led to the effects desired by the policy makers? What is its long-term effect in the economy?

This chapter is devoted to find the impact of government expenditure on major economic sectors i.e. GDP Growth, Import and Money Supply. For this purpose, various statistical and econometric tools have been used. Using ordinary least square method of regression, values of the parameters have been estimated. To identify the validity of regression estimates and values of the parameters, various statistical tests have been used. On the basis of the values of the parameters, effects of GE on GDP Growth) Money Supply and Import have been analysed in the context of Nepal.

a. Impact of public investment on GDP growth

Hence, GDP growth is taken as the function of public and private investments. The estimated equation of the regression model is

$$Y = 592605.55 + 87.02 + 20.07 \text{ PI}$$

(0.55) (1.612) (4.98)

$$R^2 = 21 \quad \bar{R}^2 = 1.466$$

Parametric value PI is not only positive but also greater than one. It highly supports our hypothesis that public investment makes positive impact o GDP growth; both t and F value are significant. The equation is not so good fit as 21 percent of variation in dependent variable being explained by the independent variable. Perhaps the high parametric value of public investment is due to the fact the highest share of public investment, has gone to build infrastructures, which boost economic activities and thereby GDP growth. The result shown by the regression, as level of GDP is significantly influenced by the level of public

investment, implies that when share of public investment in public expenditure [PE = PI + PC] increases GDP growth is achieved at higher rate.

b. Impact of GE on imports

Imports and exports are two main components in foreign trade. Exports have been mainly considered as exogenous in case of Nepal. Thus an effort has give to estimate imports function. Our main objective of estimating aggregate imports demand function has been to find out that to what extent government spending leads to increase the size of import Beside it has also been attempted to examine the effect of prices and discretionary and control measures, viz, PII/PIN and lagged imports function.

The result obtained from the regression is

$$\begin{aligned} \text{Ln (M)} & -31.89 + 2.67 (\text{Ln AprC}) + 1.02 (\text{LnGE}) + 4.002 \text{Ln} \left[\frac{\text{PII}}{\text{PIN}} \right] + 0.35 (\text{LnM}_{-1}) \\ & (-5.89) \quad (3.48) \quad (1.67) \quad (-3.713) \quad (-2.88) \\ F & = 36.005 \quad R^2 = 94.1 \quad \bar{R}^2 = 91.5 \quad SE = 0.10 \end{aligned}$$

Elasticity of GE highlights that one percent increase in real GE leads to increase in real imports by 1.02 percent. This findings is clearly closer to our hypothesis is that there lies positive association between government expenditure and imports. T value is significant and F value is also highly significant even at less than 1 percent significance level supporting our null hypothesis. Elasticity of PII / PIN is high but insignificant (i.e. significance level is more than -3.71). This implies that the substitution between the Indian goods and the Nepalese goods through the price effect isn't strong.

c. Impact of GE on RM

To see the effect of GE on MS, reserve money function (RM) has used. RM has taken as function of GE, TR, CPCB and NFA. Where NFA is the external

factor and remaining are internal factors. The result obtained from the regression is:

$$\begin{aligned}
 \text{RM} &= 2271.30 + 0.18 \text{ GE} + 0.75 \text{ TR} + 4.43 \text{ CPCB} + 0.189 \text{ NFA} \\
 &\quad (1.36) \quad (0.122) \quad (3.31) \quad (7.56) \quad (2.86) \\
 F &= 1353.08 \quad R^2 = 99.8 \quad \bar{R}^2 = 99.8 \quad SE = 1116.24
 \end{aligned}$$

Result shows that GE has significant impact on RM. The parametric value of nominal GE is positive and t and F value are highly significant. Which accepts our null hypothesis that there is positive association between government expenditure and money supply through reserve money. Parametric value of NFA is smallest and which is insignificant. This implies that internal factors have stronger effect on the supply of money in the economy than the external factors.

CHAPTER VII

SUMMARY, CONCLUSION AND RECOMMENDATION

7.1 Summary

This study was undertaken mainly to analyze the past trend of government expenditure with a problem of growing resource gap and to assess the impact of government expenditure in major macro economic sectors of the economy.

It is evident from the analysis that public expenditure in Nepal has been growing over years with an average growth rate of 11.56 percent during the study. Period where as the growth rate of regular expenditure is 15.93 percent which is more than 9.81 percent. Growth rate of public expenditure is reflected higher share in regular expenditure wasn't transferred in growth of GDP by the same scale. The share of GDP to regular expenditure was 6.52 percent and to the development expenditure was 13.76 in 1990/91 and it is reached to 11.47 percent and 5.07 percent respectively. This picture does not fail to meet people expectation and also doesn't support the goal economic development and poverty alleviation.

The growth rate of loan repayment and interest adhered higher in the study period followed by social services and economic services in the regular expenditure front. Share of economic services and social services higher in Development expenditure.

The gradually increasing resource gap has been analyzed in the study. The widening resource gap implies that the burden of debt is increasing to the future generation.

The finding of the impact analysis has been shown in table 7.1.

Regressions	Parameter	F test
Impact		
PI on GDP growth	87.02	Significant
GE on Import	1.02	Significant
GE on RM	0.18	Significant

Source: Chapter VI

The above table shows that there is positive relation between and GDP growth, imports and money supply.

7.2 Conclusion

This study is primarily confined to analyze to the analysis of trend impact and the problems of resource gap of public expenditure during the study period 1990/91 to 2005/06. Trends of public expenditure gives clear threaten to the fiscal discipline and management as the growth rate of regular expenditure has for surpassed to the growth rate of development expenditure.

About the problem if resource gap, it ha been found that the growth rate of revenue is lower than that of government expenditure during the study period leading to widening resource gap. The increase in the resource gap affects the economy adversely in the long run by forcing repay mount of principle and interest payment, if the government is unable to increase revenue substantially.

From, the impact of public expenditure on GDP growth, Imports and money supply, the study concludes: (I) public investment has made significant impact on GDP growth, parametric value of PI isn't only positive but also greater than one and value is significant as well. This implies that one percent increase in public investment results more than one percent increase in GDP.

II) There exists positive association between GE and MS. Regression analysis shows has significant impact on MS through RM. In the same way GE has affected price level through MS.

7.3 Recommendations

Based upon the above conclusions, the following recommendations can be presented.

- a) The government should focus its resource on the core priority areas where resources can be optimally utilized.]
- b) The excessive increase in the regular expenditure should be reduced and development expenditure should be increased to increase its revenue.
- c) Though the reforms packages on fiscal front were lunched from the early years of reforms started in the country, those reforms process did into correspond to expected results.
- d) Maintain the government deficit within a certain limit by redesigning budget in order to improve supply side efficiency.
- e) The following recommendations made by public expenditure Review commission (2001) should be implemented to create conducive fiscal environment for sustainable growth of the economy:
 - i. Streamlining and rationalizing the role of the government, ministries and departments, delegations public focus on key public goods and services;
 - ii. Prioritizing development programs through (a) establishment of more rigorous criteria for project selection and funding (B) identification of project to be cut, merged or given greater resource allocations, and (C) use of project implementation performance system to allocated resources:
 - iii. Identifying a five year expenditure prioritization framework that seeks to increase public savings, provide for debt servicing,

contain the wage bill and rationalize defense and police expenditure.

- iv. Strengthening administrative cost control systems through setting up of clear expenditure norms.
- v. Improving financial management and internal auditing system

Appendix I
Date Used in the Study

Year	MS	RM	GE	TR	CPCB	NFA
1990/91	14223.0	13924.8	23549.8	10729.3	210.9	9338.9
1991/92	16283.0	16786.0	26418.2	13512.7	592.8	16151.7
1992/93	19457.7	18863.1	30897.7	15148.4	544.9	20792.7
1993/94	23833.0	24443.8	33597.4	19580.8	562.0	29125.0
1994/95	28510.4	28405.7	39060.0	24605.1	568.5	36218.1
1995/96	32985.4	32686.3	46542.4	27893.1	649.3	37085.5
1996/97	36498.0	35390.0	50723.7	30373.5	1304.5	37707.6
1997/98	38460.3	41027.3	56118.3	32937.9	1495.5	40191.1
1998/99	45163.8	45995.5	59579.0	37251.3	1191.7	55572.8
1999/00	51062.4	52225.3	66272.5	42893.8	1372.9	65027.6
2000/01	60979.8	61003.7	79835.1	48893.6	2149.6	80467.5
2001/02	70576.9	70566.6	80072.2	50445.5	3340.0	87798.0
2002/03	77155.9	78969.7	84006.1	56229.8	4270.6	88419.1
2003/04	83754.1	80979.5	92107.2	62331.0	3831.1	91408.0
2004/05	93970.0	82989.3	102560.4	70122.7	3522.3	108805.0
2005/06	100206.9	90796.2	110889.2	17391.2	3248.2	107744.0

Where,

MS = Nominal Money Supply

RM = Reserve Money

TR = Nominal Total Revenue

CPCB = Claims on Private Sector and Commercial Banks

NFA = Net Foreign Assets

Appendix II
Date Used in the Study

Year	LnM	LnAPrC	LnGE	LnPII/PIN	LnM ₋₁
1990/91	10.39	12.00	10.58	0.02	10.59
1991/92	10.59	12.03	10.50	-0.05	10.67
1992/93	10.67	12.04	10.58	-0.02	10.87
1993/94	10.87	12.10	10.57	-0.04	11.04
1994/95	11.04	12.10	10.65	-0.02	11.14
1995/96	11.14	12.16	10.75	0.00	11.24
1996/97	11.24	12.21	10.76	0.01	11.40
1997/98	11.40	12.20	10.78	0.00	11.17
1998/99	11.17	12.22	10.73	0.01	11.30
1999/00	11.30	12.27	10.80	0.03	11.38
2000/01	11.38	12.32	10.96	0.04	11.23
2001/02	11.23	12.35	10.83	0.12	11.33
2002/03	11.33	12.38	10.88	0.11	11.82
2003/04	11.82	12.42	10.86	0.12	11.45
2004/05	11.91	12.46	10.96	0.13	11.51
2005/06	12.06	12.50	10.98	0.14	-

Where

Ln = Natural log

LnM = Real Imports

LnAPrC = Real Aggregate Private Consumption

LnGE = Real Government Expenditure

LnPII/PIN = Real Price Index of India upon Price Index of Nepal

LnM₋₁ = Real Logged Imports

Appendix II
Date Used in the Study

Year	rGDP	PI	PrI
1990/91	174908	15660	20002
1991/92	183371	13015	22133
1992/93	188780	12892	27010
1993/94	204397	15782	28648
1994/95	209976	15070	33300
1995/96	221930	16705	35256
1996/97	233040	17477	35284
1997/98	240816	19958	35573
1998/99	251758	20673	30058
1999/00	267096	22313	32584
2000/01	280106	25137	32932
2001/02	279169	24383	33661
2002/03	287857	22698	36349
2003/04	297231	21766	39533
2004/05	305702	22548	42610
2005/06	315301	23342	45725

Where

rGDP = Real Gross domestic Product

PI = Real Public Investment

PrI = Real Private Investment

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