Public Debt and Economic Growth in Nepal

Pratibha Shrestha

Lecturer, Kabhre Multiple Campus

Kabhrepalanchok, Nepal

myselfpratibha41@gmail.com

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ABSTRACT

In case of increasing both internal and external debts in Nepal, this paper investigates the impact of internal and external outstanding debt along with gross fixed capital formation, broad money supply, total trade and national consumer price index on real GDP of Nepal for the period 1975 to 2021. The study applied domestic data sets with ordinary least square series. Unit root and cointegration tests are carried out. The cointegration results confirm long run relationship. The empirical results show that both the internal and external outstanding debts are contributing to real GDP in Nepal. The results are supported by econometric diagnostic tests. Based on the results, the paper recommends that taking public debt and investing in public sector is beneficial for real sector output in Nepal.

Internal debt, External debt, real GDP, Unit root test, Cointegration, Ordinary least squares

Introduction

Increasing demand of public goods in case of raising low level of government revenue, budget deficit has become burden of most of the governments. Governments can increase taxes by printing money, borrow from domestic or external sources and can use previous budget surplus. If budget deficit is financed by borrowing rather than announcing extra tax measures, it creates anobligation on the governments that is known as public debt. Debt financing is followed by the governments because it offers a relief to the current taxpayers and transfer the burden of present tax to future generation reducing the political costs of the governments (Singh, 2004).

Public debt is a worldwide growing phenomenon. Almost of the economies have the common characteristics that under the fiscal sector, public out-

standing debt is continuously increasing.Nearlymost of the developing countries are either under minor or high public debt position. Basically, economists do not regard public debt a chief problem rather they stress that mismanagement and un-sustainability of public debt creates the problem. To have debt at sustainable level, debt ratio should turn down or remain natural. Further, for the sustainable level of debt, fiscal deficit is not necessarily to be at zero and deficits should not push the debt ratio to upsurge or move faster than growth rate of GDP. Research results support that foreign aid is also operative if appropriate debt management policies are established (Musgrave & Musgrave, 2004).

Nepalese economy depends on severely on short-term domestic debt and concessional foreign loans, particularly from multi-lateral agencies like The World Bank, Asian Development Bank etc. that have long maturity. Government of Nepal utilizes Treasury Bills, Development Bonds, Citizens Saving Bonds, National Saving Bonds, and Foreign Employment Saving Bonds instruments to raiseinternal debt. External debt was started in 1950 and it is collected bilaterally and multilaterally. External debt matured at lengthy periods and it is more concessional than the internal debt (Sharma, 1998).

Government of Nepal is generating its resources from public debt and it has become one of the main sources. It helps to achieve targeted economic growth and also helps to narrow down the gap between expenditure and revenue or required level of saving and investment for a targeted growth rate. In Nepal, institutional backwardness makes the functioning of economic development a complicated business. In order to remove such obstacles in the economy, public debt can be used as an inevitable tool. Thus, public debt is the most important source of income for the economic development of Nepal (Acharya, 2015).

Nepal is one of the poorest nations in the world and nearly one fifth of citizens living below the poverty line. The per capita income is about 1191 US dollar which is among the lowest in the world. The economic growth rate mostly hovered around 4.2 percent (MOF, 2021). Human Development Index (HDI) ranking is 142th out of 189 with the value of HDI 0.602 (United Nations Development Program, 2019).

Nepalese economy has low level of economic growth because of physical infrastructure deficiency, traditional and subsistence level agriculture system, low foreign direct investment, deficiency in tourism infrastructure and promotion, wide spread unemployment and underemployment, slow industrialization; energy crisis, narrow financial base, corruption, impunity and administrative delay. Further the economy faced shocks from Earthquake of April 2014 and Covid-19 pandemic (MOF, 2021).

Nepal is facing problem of financing to contest the socio-economic problems. The economy is continuously facing financial resource gaps. Government expenditure is increasing rapidly because of adopting socio-economic inclusive policies basically after 1990s. Total expenditures was Rs. 1513.7 million in 1975 and it reached to Rs.

1079978.8 million in 2021 by folding 713.5 times in 47 years. Government revenue is not satisfying increasing expenditures. Revenue deficit is also increasing. Foreign grants are falling and less stable in filling the resource gaps. Therefore, domestic as well as external debts are becoming key sources of financing in Nepal. That's why both domestic and external outstanding debts are rapidly increasing. The domestic and external outstanding debt were Rs. 476.4 million and Rs. 346.1 million in 1975 and both were reached to Rs. 800320.1 and Rs. 927926.0 million in 2021 by folding 1680.0 and 2681.0 times over the 47 years respectively (MOF, 2022).

There is no consensus among the economists among the role of public debt on the economy. The early economists were in favor of public debt. They believe on the doctrine that state intervention in the economy and considered money as an absolute form of wealth; therefore, naturally, the flow of money into the national economy was encouraged (Salsman, 2017). The early classical school accused government debt because they believed that government expenditure is unproductive, hence public borrowing distorts private capital and negatively affect the accumulation of capital and growth (Tsoulfidis, 2007). However, classical economists like Thomas Malthus and his successor John Stuart Mill come up with a different approach claiming that public debt does not necessarily act detrimental to the accumulation of productive capital, if they are directed either to balance overproduction of goods or in more advantageous uses (Bilan, 2016).

The Keynesians believe in the role of government interventions for stabilizing economy by countercyclical deficit spending. The classical opinioned that the burden of debt is transferred to future generations and both the internal and external debt had similar burdens in the economy. However, the Keynesians believe that future generations is not involved in transfer of the burden of public debt and there is difference between the internal and external debt (Alekhina, 2007 & Buchanan, 1958)

Also monetarist economists linked the public debt with the crowding-out effect. They emphasized that public debt should not have crowding out effect or it should stimulate private investments so that the real sector of the economy is increased (Abdullatif, 2006).

Empirical literature on public debt and economic growth had mixed results. Some of the empirical results showed that internal debt and external debt increased economic growth (Dauda et al., (2013); Bhatta, (2015); Khan, et al., (2016); Sanchez-Juarez & Garcia-Almada, (2016); Ogunjimi (2019); Liu &Lyu, (2020); Abdulkarim&Mohd, (2021); Upadhyaya, (2021). A few other studies showed that there is negative relationship between the public debt and economic growth (Siddique et al., (2016); Hilton, (2021); Kur et al., (2021); Makun, (2021).

Policy makers as well as economists take economic planning as the key tool of economic development. Economic planning exists in different objectives. To satisfy its objectives, it needs resources. Resources are available through tax and non-tax incomes

of the government. Government incomes through tax and non-tax sources are not sufficient to meet the increasing demands of the people in developing country like Nepal. Hence, public debt becomes a reliable and common instrument for resource mobilization. Public debt is more important for poor country like Nepal, which is always suffering from lack of resources to uplift the standard of living of poor people through public spending.

Due to increasing role and responsibility of central, state and local level governments in fulfilling the mounting desires of people, public debt becomes essential part of fiscal policy. To break down vicious circle of poverty, inclusive economic growth, building public construction works and keeping peace and harmony in the society, public debt becomes one of the important sources of financing. Nevertheless, public debt is continuously increasing in the economies. Public debt itself is not the remedy for economic development if it is not properly utilized. If resources' received from public debt are just consumed on daily recurrent expenditures or such resources do not go to the development projects, debts will become evil to the overall economy. Further, poor implementation of development projects and corruption will further waste such scare resources. If debt levels are too high, then, it depletes domestic resources in refunding debt service. Therefore, it is obligatoryto examine empirically either the domestic and external debts amounts would have boosting or hindering effect on the real GDP for the economy.

Although public debt can satisfy growing resource gap in the economy, it has both positive as well as negative impacts upon the economy. On the one hand, it will suffice resource gap for development activities and enhance economic growth that will uplift standard of living of poor people. On the other, if debt received resources are not utilized in development activities or just utilized to fill recurrent expenditures, or debt financed development projects unable to create resources for debt refunding, it would create negative effects on the economy, or the country trapped into the debt burden due to sluggish growth rate. Sluggish growth rate further reduce tax-payable capacity of the people and the economy traps into the burden of debt. Therefore, there is prerequisite to investigate the effect of public debts on real GDP of Nepal. Hence, this paper investigates causal relationship between public outstanding debts (domestic and external) along with other control variables (gross capital formation, broad money supply, total trade and inflation rate) on real GDP of Nepal. It assumesthat both internal and external outstanding debt have boosting effect on economic growth of Nepal.

Research Methodology

To examine the impact of domestic and external outstanding debt and economic growth dependent and independent variables are chosen and defined. The paper takes economic growth is measured by real GDP as dependent variable and it is denoted by RGDP. The key independent variables are domestic outstanding debt (DOD) and external outstanding debt (EOD). Control variables are gross fixed capital formation

(GFCF), broad money supply (M2), total trade (TT) and change in national consumer price index (ΔNCPI)that are included in the equation. Thus, two key independent variables and four control variables are regressed on real GDP of Nepal. The general form of the growth public debt model is:

RGDP = f (DOD, EOD) (1.1)

Where,

RGDP = Real Gross Domestic Product (Rs. million)

DOD = Domestic Outstanding Debt (Rs. million)

EOD = External Outstanding Debt (Rs. million)

An introduction of control variables in the model (1.1), following econometric models is specified to examine the impact of domestic outstanding debt and external outstanding debt along with Gross Fixed Capital Formation (GFCF), Broad Money Supply (M2) and growth in National Consumer Price Index (ΔNCPI) on real GDP in Nepal. The model is:

$$RGDP_t = \alpha_1 + \alpha_2\, DOD_t + \alpha_3 EOD\ _t + \ \alpha_4\, GFCF_t + \alpha_5 M2\ _t + \alpha_6\, TT_t + \alpha_7\, \Delta NCPI_t + \varepsilon_t \qquad (1.2)$$

Where,

RGDP = Real Gross Domestic Product (Rs. million)

DOD = Domestic Outstanding Debt (Rs. million)

EOD = External Outstanding Debt (Rs. million)

GFCF = Gross Fixed Capital Formation (Rs. million)

M2   = Broad Money Supply (Rs. million)

TT   = Total Trade (Imports plus exports) (Rs. million)

ΔNCPI = Annual change in National Consumer Price Index (In percent)

ε_t = is white noise error terms for above equations and t is time subscript.

The paper applies annual data of different variables from FY 1974/75 to 2020/2021 comprising 47 observations of each.All the secondary data related to domestic debt, external debt, real GDP, gross fixed capital formation, broad money supply will be directly downloaded from macroeconomic dashboard of Ministry of Finance, Government of Nepal and these data will be converted to Rs. million multiplying each by 10. National consumer price index data will be imported from Quarterly Economic Bulletin, mid-July (2021), Nepal Rastra Bank.

All variables of each model are converted into natural logarithms to facilitate the calculation of elasticity and to make it possible the transformation of the non-linear models into log linear one. Summary statistics of the individual variablesconcerning to central location (mean) and spread (standard deviation) is calculated.A correlation

matrix of estimating variables is estimated to know how the dependent variable is proportional to all explanatory variables for each model. Unit root is observed with ADF test. To detect the problem and order of serial correlation in the error terms, the paper applied Durbin-Watson (DW test) and Breusch-Godfrey Serial Correlation test. Cochrane-Orcutt method is used to correct the autocorrelation. If serial correlation problem is not handled at first step of Cochrane-Orcutt procedure, then its iterative procedures are conducted. Breusch-Pagan test of error term is conducted to detect the problem of heteroscedasticity and weighted least squares technique is used to minimize it. Variance Inflation Factor (VIF) test is conducted and from the highly collinear pair, one of the variable is delated. Normality of error terms is tested by Jarque-Bera (J-B) test. R-squared and adjusted R-squared tests are applied to measure overall explanatory power of the all explanatory variables. Either individual coefficients of the explanatory variable are significant or not, it is determined by t-test.

Data Analysis and Presentation

Under data analysis and presentation, descriptive statistics of the individual variables, partial correlation, unit root test, cointegration test, regression results, and econometric diagnostics tests are carried out andthe results are interpreted.

Descriptive Statistics of the Variables

The descriptive statistics comprises of the mean, standard deviation, and coefficient of variation and observations at level form of data. The descriptive statistics of each variable is presented in Table 1.1 below.

Table 1.1

Descriptive Statistics of the Variables

Variables	RGDP	DOD	EOD	GFCF	M2	TT	NCPI
Average	692667.3	109329.0	190206.9	231508.4	697752.8	308883.1	43.3
Standard Deviation	735401.6	166391.7	208074.3	361301.9	1212445.4	441769.8	39.8
Coefficient of Variation	106.2	152.2	109.4	156.1	173.8	143.0	92.0

Source: Macroeconomic Dashboard, 2022, Ministry of Finance, Government of Nepal

The results based on large values of standard deviation and coefficient of variation indicated that variables are unstable over the study period.

Correlation Matrix between Dependent and Independent Variables

The partial correlation between dependent and independent variables correlation between the variables is presented in Table 1.2 below.

Table 1.2

Partial Correlation Coefficients between the Variables

Correlation	RGDP	DOD	EOD	GFCF	M2	TT	NCPI
RGDP	1.000	-	-	-	-	-	-
DOD	0.895	1.000	-	-	-	-	-
EOD	0.833	0.870	1.000	-	-	-	-
GFCF	0.860	0.830	0.713	1.000	-	-	-
M2	0.828	0.781	0.745	0.873	1.000	-	-
TT	0.882	0.755	0.644	0.791	0.781	1.000	-
NCPI	-0.765	0.709	0.750	-0.648	0.922	0.863	1.000

Source: Own Calculations

The correlation matrix indicated that there is high degree of correlation (more than 0.80) between dependent and explanatory variables whereas the correlation between all the explanatory variables is moderate (less than 0.80). Hence, there might be prospect that cause and effect relation exist between the independent and dependent variables.

Unit Root Results

The Augmented Dickey Fuller (ADF) test is used for this purpose both at level and first difference (intercept and intercept and trend). Log level forms of data are applied to test the unit root. The log level form unit root results are presented in Table 1.3 below.

Table 1.3

ADF Unit Root Results at Log Level Form

Variables	Intercept		Intercept and Trend	
	τ- statistics	p-value	τ- statistics	p-value
LNRGDP	-0.106944	0.9424	-2.695790	0.2432
LNIOD	-0.138182	0.9388	-2.226631	0.4641
LNEOD	-0.599525	0.8606	-2.241584	0.4557
LNGFCF	-0.954270	0.7616	-1.244592	0.8889
LNTT	0.314412	0.9766	-1.920087	0.6280
LNM2	-1.926025	0.3178	-1.130512	0.9122
LNNCPI	-1.802656	0.3747	-2.861653	0.1840

Source: Own Calculations

The Augmented Dickey Fuller unit root test results confirms that the variables under the study had unit root at level both at intercept and intercept and trend form. The test statistics clearly indicated that log level form series are spurious from unit root.

Thus, first difference data were employed to unit root testing. The unit root results were reported in Table 1.4 below.

Table 1.4

ADF Unit Root Results at First Difference

Variables	Intercept	Intercept and Trend	Order of Integration		
	τ- statistics	p-value	τ- statistics	p-value	
DLNRGDP	-5.738325	(0.0000)*	-5.749530	(0.0001)*	I(1)
DLNIOD	-7.648249	(0.0000)*	-7.558854	(0.0000)*	I(1)
DLNEOD	-6.941295	(0.0000)*	-6.040508	(0.0000)*	I(1)
DLNGFCF	-6.294611	(0.0000)*	-6.298608	(0.0000)*	I(1)
DLNTT	-6.691706	(0.0000)*	-6.739428	(0.0000)*	I(1)
DLNM2	-4.894379	(0.0002)*	-5.244790	(0.0005)*	I(1)
DLNNCPI	-6.159357	(0.0000)*	-6.270306	(0.0000)*	I(1)

Note: An asterisk denotes significant within 5 percent level.

The results show that the log level forms of data at first difference both at intercept and intercept and trend form are completely unit root free and all series are integrated of orders 1. Thus, log level forms of data at first difference are employed to empirical analysis, particularly empirical models.

Cointegration Test Results

The paperapplies Johannsencointegration test with log level form of data to find the cointegration among the variables. The test results are presented in the Table 1.5.

Table 1.5
Cointegration Test Results

Unrestricted Cointegration Rank Test (Maximum Eigenvalue)				
Hypothesized	Max-Eigen	0.05		Prob.
No. of CE(s)	Eigenvalue	Statistic	Critical Value	
None *	0.672672	143.1474	125.6154	0.0027
At most 1	0.548412	92.89165	95.75366	0.0774
At most 2	0.390406	57.11732	69.81889	0.3344
At most 3	0.285061	34.84401	47.85613	0.4563

Max-eigenvalue test indicates 1 cointegrating equations at the 0.05 level

* denotes rejection of the hypothesis at the 0.05 level

Based on the results from cointegration equation, the max Eigen value and their respected corresponding p-value andhaving at least one cointegration equation, there

is long run relationship between the dependent and independent variables.

Regression Results

The empirical results on nexus between public debt and real GDP along with other control variables are presented in Table 1.6 below.

Table 1.6: Regression Results DLNRGDP as Dependent Variable

Variable	Coefficients	Standard Error	t-Statistics	Prob.
DLNIOD	0.134956	0.011572	11.663	(0.000)*
DLNEOD	0.193963	0.043826	4.432	(0.000)*
DLNGFCF	0.253962	0.020631	12.316	(0.000)*
DLNTT	0.118372	0.039384	3.018	(0.004)**
DLNM2	0.317058	0.020186	15.715	(0.000)*
DLNNCPI	-0.109483	0.035728	-3.062	(0.007)**
C	-3.593284	0.692754	-5.196	(0.000)*
		DW = 1.97 N = 46 after adjustments		
$R^{2} = 0.79$		F= 3895.6		
Adjusted $R^2 = 0.78$		Probability of F statistics = (0.000)*		

*Note: The asterisk * and ** denote significant at 1 percent and 5 percent levels respectively.*

The explanatory variables DLNIOD, DLNEOD, DLNGFCF, DLNM2 along with constant term are statistically significant at 1 percent level whereas DLNTT and DLNNCPI are statistically significant below at 5 percent level. The coefficient of determination and adjusted coefficient of determination are 0.79 and 0.76 respectively. It indicates that model is best fit and explanatory variables explain the dependent variable by 76.0 percent. The F-statistics is statistically significantat 1 percent level. It indicates that the model is best fit.

The value of DW statistics is 1.97 and the value isapproximately to 2. The value near to 2 points out that the error terms from the estimated equation may be free from first order autocorrelation. To test autocorrelation of the error terms of first and other orders, the paper conducted Breusch Pagan-Godfrey serial autocorrelation LM Test. The results based on observed R-squared statistics both at lag 1 and lag 2 are 7.93 and 12.3 having the probability of 51.3 percent and 71.4 percent respectively. The result indorses that error terms of the estimated equation are autocorrelation free. Similarly,the heteroscedasticity of error terms of estimated equation is tested withBreusch-Pagan-Godfrey test. The result of the test based on observed R squared statics is 6.62 with the probability of 41.4 percent. Thus, the results validates hat residuals are homoscedastic having constant variance. The normality of the error terms is tested with

Jarque-Bera (J-B) test and the J-B statistics is 5.832 having probability value of 43.9 percent which confirms that error terms are normally distributed. The multicolinearity of explanatory variables is tested with centered Variance Inflation Factor (VIF) values and the centered values are than 5. Hence, there is no severe correlation among explanatory variables.

Discussions on Results

The empirical results infer that both the internal outstanding and external outstanding debts have positive and significant impact on real GDP. The coefficient of DLNIOD is 0.13 and it depicts that one percent increase in the growth rate of internal outstanding debt increases real GDP by 0.13 percent. The coefficient of DLNIOD is positive and significant, meaning that increase in the growth rate of the internal outstanding debt enhances real GDP in Nepal.

The coefficient of DLNEOD is 0.19 and it depicts that one percent increase in the growth rate of external outstanding debt increases real GDP by 0.19 percent. The coefficient of DLNEOD is positiveand significant, meaning that increase in the growth rate of the external outstanding debt boosts real GDP in Nepal. The results confirm that public debt is contributing to real sector output and both internal and external debt does not differ to enhance growth in case of Nepalese economy. Further, it supports the theory that public debt is not always harmful for the economy.

Similarly, the coefficient of DLNGFCF, DLNTT, DLNM2 are positive and significant and it indicated that growth in gross fixed capital formation, total trade and broad money supply are stimulating the real GDP in Nepal. However, the negative and significant coefficient of national consumer price index indicated that inflation hampered the real GDP in Nepal.

The external debt burden of Nepal has increased significantly with a high pace of growth in such a burden after 1990s. The significant growth in debt burden is basically because of the increased investment need of the government for infrastructure building, macroeconomic adjustment and structural reform. However, the empirical results inferred that internal as well as external debt were not deterring economic growth in Nepal. Rather, of the debts were contributing to the economic growth measured in term of real GDP.

Conclusions

Public debt is a good option to finance public investment and accelerate economic growth, provided it is utilized in the appropriate channels. To examine the impact of internal and external outstanding debt on real GDP in Nepal is the key objective of this paper. The short and long-run estimated results show that both the internal and external outstanding debt have boosting effect on economic growth in Nepal. The impact of broad money supply, total trade and inflation measured by national consumer price index appear as insignificant. Therefore, to maintain positive growth, the estimat-

ed result of the interactive analysis suggests that both the internal and external debt along with gross investments should be increased in the Nepalese economy. The debt are not reached to that ceiling after which their effects on real GDP would be negative. Therefore, at present public debt is contributing to growth and taking internal and external debts and investing these amounts in public utility sectors is beneficial for the Nepalese economy.

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