Pexels

Nepal's public debt: concerns and drivers

Kshitiz Dahal

Soaring public debt, especially in the wake of the COVID-19 crisis, has been in the center of public debate once again. Historical evidence suggests that unsustainable levels of public debt could lead to a severe economic crisis—for instance, the recent case of Sri Lanka—and if left to fester, long-term economic ruin. The size of Nepal's public debt has been benign for much of its recent history. However, in the last few years, Nepal's public debt has risen so rapidly that it has started to generate some concern. Against this background, South Asia Watch on Trade, Economics and Environment (SAWTEE) undertook a study to assess the public debt situation of Nepal, and in particular, to identify the major drivers of the rapidly increasing public debt levels. This article presents the major findings of the study.

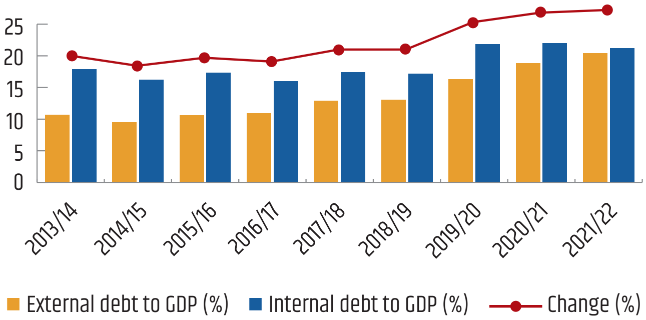
Nepal's public debt: a brief overview

Nepal's public debt stock stood at NRs. 2013.3 billion, or 41.5 percent of GDP, at the end of the fiscal year 2021/22—external debt represented 21.1 percent of GDP and internal debt represented 20.4 percent of GDP. The public debt accumulation over the last few years has increased at an alarming rate—the public debt stock increased from 25.7 percent of GDP in FY 2014/15 to 41.5 percent of GDP in 2021/22 (Figure 1). Internal debt is primarily comprised of longer-term development bonds (about 65 percent) and shorter-term treasury bills (about 35 percent). External debt is largely of concessionary nature—debts owed to multilateral institutions (primarily the World Bank and the Asian Development Bank) account for more than 85 percent of total external debt; Japan, India, and China represent the bulk of total bilateral external debt (Figure 2).

Is Nepal's public debt veering towards unsustainable accumulation?

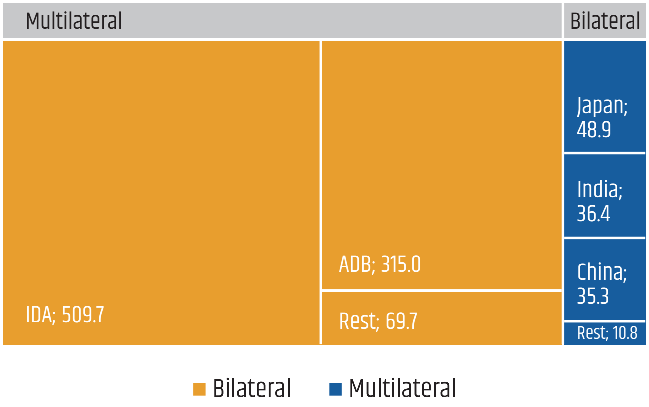
Nepal's current debt volume looks benign when judged against most standard prescriptions in the literature. For instance, a seminal paper by Reinhart and Rogoff (2010)[11] finds a negative impact of public debt on growth only after exceeding the threshold of 90 percent of GDP. However, the rapid rise witnessed in recent years raises concerns, especially when observations abound that the rapidly accumulating public debt has little to show for it in terms of a transformational impact on economic growth. Moreover, the debt servicing payments are projected to increase significantly starting in FY2022/23 (Figure 3). Importantly, the projected debt servicing payments for the fiscal year FY2023/24—NRs. 307.5 billion—represent 17.55 percent of the total projected government expenditure, which has surpassed the share of projected capital expenditure in the budget—17.25 percent—for the first time in the recent history of the country.

Figure 1 Nepal's rapidly rising public debt stock



Source: Public Debt Management Office (PDMO), Government of Nepal

Figure 2 Nepal's external debt, by source



The values in the figure are in NRs. billion. The data is for FY 2021/22.
Source: PDMO

Furthermore, several studies on public debt also suggest that there is no magic threshold and a country's characteristics largely determine what the optimal debt level is for that country. Moreover, historical evidence suggests that a large number of defaults have occurred at a much lower debt-to-GNP level. Finally, a 2022 joint World Bank-IMF debt sustainably analysis, while finding a low risk of debt distress emphasizes that Nepal's dismal exports performance puts it at a "moderate risk of debt distress", and points out that Nepal's public debt is vulnerable to export shocks and growth shocks. Hence, while Nepal's current public debt accumulation may not be a significant issue, except for the fact that the returns on the debt have been questionable, the rapidly rising debt coupled with Nepal's country context, primarily low exports and a sub-par growth for the last few years, indicate the economy is veering towards an unsustainable accumulation of public debt.

Drivers of Nepal's public debt

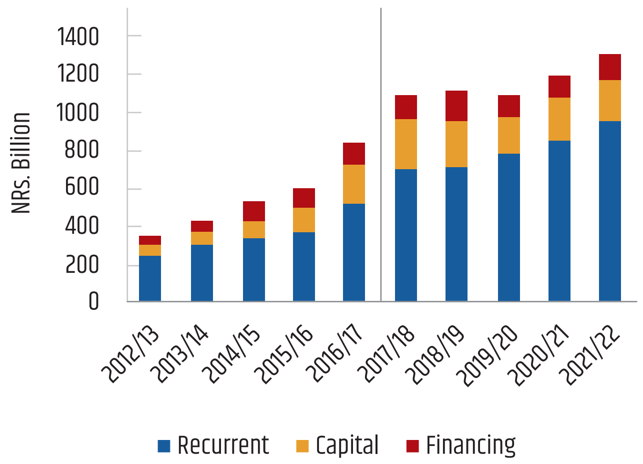
Public debt often becomes necessary during crisis situations. Nepal's public debt stock was also influenced by two such crises—a devastating earthquake that shook Nepal in 2015 (requiring significant reconstruction expenditure) and the COVID-19 pandemic that caused significant loss of health and lives in Nepal and lingering economic devastation. However, given that these events are relatively rare occurrences, their impact on public debt can be expected to be paltry in the context of Nepal's public debt accumulation in the future. Hence, the focus of the study was on the structural factors that risk pivoting Nepal towards an increasingly unsustainable debt accumulation.

One of the factors that have resulted in Nepal's rising public debt is its ambitious growth and development aspirations without a concomitant rise in state capabilities. Nepal's latest development plan, prepared against the backdrop of the introduction of a new constitution and the subsequent elections, has been especially ambitious. For instance, the current periodic development plan set a high target for economic growth (average GDP growth rate of 10.1 percent per annum) and a wide array of socio-economic areas, including infrastructure development, thus requiring significant public investment, and a notable increase in public expenditure. Hence, to meet these lofty goals, every government in recent years has presented an inflated budget, leading to an increased accumulation of public debt. However, the limited state capabilities resulting in issues such as weak project selection and execution, ineffective implementation of plans and policies, the poor state of capital budget expenditure, and slow pace of reforms have reduced the efficacy of government spending, the result being ambitious targets but their non-realization, and moreover, wasteful expenditure, which adds to the public debt stock but does not yield significant benefits.

Nepal's public debt has seen a sharp rise after the implementation of federalism. Nepal's transformation of its governance structure to federalism through a new Constitution in 2015 has produced a structural shift that coincides with increased government expenditure. After the federal government started making intergovernmental transfers to the newly created sub-national governments (7 provincial governments and 753 local governments) starting in FY 2017/18, there has been a sustained increase in the recurrent expenditure of the federal government. For instance, the federal government's budget deficit-to-GDP ratio increased significantly from 6.0 percent in FY 2016/17 to 9.0 percent in FY 2017/18.[2] The direct expenditure of the federal government has not subsided even after the devolution of powers and functions to sub-national governments. Moreover, issues in the implementation of federalism, primarily the duplication of expenditures by the federal and sub-national governments, owing to the lack of clarity on the jurisdiction of each government as well as the tendency of the federal government to not devolve powers, have contributed to increased government expenditure.

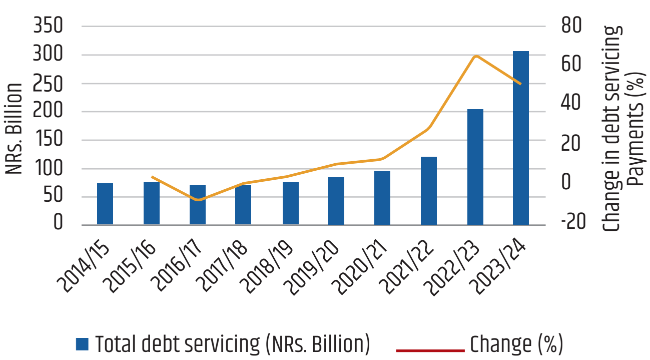
Likewise, another driver in government spending, and hence public debt accumulation, is the exponential rise in social security expenditure. For instance, the social security expenditure in FY 2021/22 was NRs. 225.3 billion compared to NRs. 40.8 billion in FY 2013/14 as per data obtained from the Economic Survey. A significant share of social security expenditure is comprised of social assistance transfers such as old-age pensions, which have been criticized for having electoral motivations. Specifically, political parties are accused of using social security transfers as tools to augment their votes. For example, in the run-up to the 2022 parliamentary election, the two major parties, the Nepali Congress and the Communist Party of Nepal (Unified Marxist-Lenninist) (CPN-UML), announced many plans for handouts, including making the old-age-pension scheme more generous—the Nepali Congress through reducing the qualification age and the CPN-UML through increasing the allowance size for all social security transfers.

Figure 4 **Total federal government expenditure**



Source: Financial Comptroller General Office (FCGO)

Figure 3 **Nepal's debt service payment trends**



The values for FY 2022/23 and FY 2023/24 are projections derived from the budget speech for FY 2023/24

Source: PDMO for FY 2014/15–FY 2021/22; MoF for FY 2022/23–FY 2023/24

The changing landscape of official development assistance (ODA) has also resulted in increased public debt accumulation. More specifically, loans have significantly outstripped grants in Nepal's ODA receipts, and this trend has been persistent since FY 2017/18. For instance, at its recent peak in FY 2013/14, grants constituted 66.4 percent of total ODA receipts. The grant component has seen a gradual decline since and the loan component, after overtaking grants in FY 2017/18, now constitutes a significant 67 percent of total ODA receipts compared to 21.5 percent for grants and 11.4 percent for technical assistance. The trend is an outcome of a gradual shift towards multilateral institutions for most of the external ODA. Furthermore, ironically, the shift is a result of Nepal's excellent debt repayment capacity as scarce grants are prioritized for debt distressed low-income nations. As Nepal stands to graduate from the least developed country (LDC) category in 2026, and as its per capita income rises, Nepal may soon face a higher interest rate on its foreign loans. More specifically, the multilateral donors like World Bank and ADB base their allocation of concessional loans on primarily two factors (i) Gross National Income (GNI) and (ii) assessment of creditworthiness. Nepal's GNI is fast approaching the operational cutoff set for concessional loans and, hence, upon assessment of adequate creditworthiness, Nepal's loans from ADB and World Bank will incur less favourable terms—higher interest rates, lower maturity period, and lower grace period.[3]

Finally, institutional weaknesses have resulted in sub-optimal administration of public finance. For instance, as pointed out by various documents, projects that have not undergone the necessary preparations are included in the budget, projects which were not included at the start of the budget are forcefully included during the implementation phase, a mammoth proportion of capital expenditure is spent only at the end of the fiscal year, and there is a major abuse of budget head change and source change. Likewise, there is a weak capacity to mobilize capital expenditure. Furthermore, a narrow revenue base—revenue collection heavily dominated by import-based taxation (about 50 percent of total tax revenue)—means the revenue potential has not been realized.

Conclusion

While Nepal's public debt stock suggests low debt distress, it has been increasing at an alarming rate. Furthermore, the increasing debt financing obligations coupled with Nepal's economic context, primarily conspicuously low exports, imply a need for caution. Moreover, the observation that Nepal's increased public debt accumulation has little to show for it in terms of economic growth creation is an indication that public debt may fast approach an unsustainable territory. Besides transient phenomena, including a devastating earthquake and the COVID-19 pandemic, several factors have contributed to a rapid public debt accumulation, namely overly ambitious growth and development targets without the necessary state capabilities, a nascent and currently imperfect transformation into federalism, a rapidly increasing social security expenditure, the changing landscape of official development assistance, a narrow revenue base, and weak public finance governance. Hence, Nepal needs to make necessary reforms to better manage public finance administration to avoid veering into unsustainable debt accumulation. ■

Notes

1 Reinhart, Carmen M., and Kenneth S. Rogoff. 2010. "Growth in a Time of Debt." *American Economic Review,* 100(2): 573-78.
2 Author's computation using data from Financial Comptroller General Office (FCGO) and Nepal Economic Survey.
The rise in the budget deficit is even stark if we compare it with the budget deficit of FY 2015/16—3.2 percent of GDP—which reflects pre-federalism government expenditure before the surge created by post-earthquake reconstruction expenditure.
3 In the case of ADB, irrespective of assessment of creditworthiness, Nepal will move from Group A (concessional assistance-only) to Group B (OCR blend), which means a less favourable lending terms.

sawtee
www.sawtee.org

P.O. Box: 19366
Tukucha Marg, Baluwatar, Kathmandu, Nepal
Tel: +977-1-4424360/4444438, Fax: +977-1-4444570
E-mail: sawtee@sawtee.org

Design: Bipendra Ghimire

This issue brief is prepared by Mr. Kshitiz Dahal, Senior Research Officer, SAWTEE, based on the study "Nepal's Public Debt: Concerns and Drivers", authored by Mr. Kshitiz Dahal and Dr. Paras Kharel, as part of a project supported by The Asia Foundation. The findings and any views/opinions expressed in this publication are the views of the author(s) and do not necessarily reflect those of The Asia Foundation, SAWTEE and SAWTEE's member institutions.

South Asia Watch on Trade, Economics and Environment (SAWTEE) is a regional network that operates through its secretariat in Kathmandu and 11 member institutions from five South Asian countries, namely Bangladesh, India, Nepal, Pakistan and Sri Lanka. The overall objective of SAWTEE is to build the capacity of concerned stakeholders in South Asia in the context of liberalization and globalization.