

The Debt-Revenue Nexus: Government Borrowing and the Crowding-Out of Capital Expenditure in Nepal

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Abstract: This study explores the relationship between government debt and fiscal operations in Nepal. The study employs Ordinary Least Squares (OLS) regression analysis using time-series data from 2005 to 2024. The findings suggest that both domestic and foreign debt have a significant positive effect on tax revenues, particularly excise duties, direct taxes, and total revenue. However, the analysis reveals no statistically significant relationship between government debt (domestic or foreign) and capital expenditure. Contrary to the conventional "crowding-out" hypothesis, this null finding indicates that debt accumulation does not directly reduce public investment, nor does it increase it. The results highlight a disconnect in which borrowed funds and the additional revenues they generate are absorbed by recurrent obligations, particularly debt servicing, rather than being channelled into long-term infrastructure and development projects. This study underscores the importance of strengthening domestic revenue mobilisation and managing debt sustainability while cautioning against overstating the crowding-out effect in the absence of negative empirical coefficients. The findings offer valuable policy insights for Nepal, emphasising the need for diversified revenue sources, efficient debt management, and direct institutional linkages between borrowing and capital budgeting to support sustained economic growth.

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1. Introduction

Government debt, comprising both domestic and foreign borrowings, represents the total financial obligations a government incurs to fund expenditures beyond its revenue collections (Clements, Bhattacharya, & Nguyen, 2003). This debt is a critical instrument for financing public spending, enabling governments to undertake large-scale development projects and manage fiscal deficits (Sapkota, 2013). Fiscal operations, encompassing government revenue generation and expenditure allocation, are significantly influenced by the level and management of this debt (Aghion, Hemous, & Kharroubi, 2009). In developing economies like Nepal, where domestic revenue often falls short of developmental aspirations, reliance on debt financing has become a central feature of fiscal policy.

Over recent years, Nepal has increasingly depended on both domestic and foreign debt to finance critical infrastructure, social programs, and post-disaster reconstruction, particularly following the 2015 earthquake (Sharma & Singh, 2020). Domestic debt, sourced from internal financial institutions and the public, has risen markedly, while foreign debt from multilateral agencies like the World Bank and the Asian Development Bank (ADB) has expanded to fund long-term projects in sectors such as energy, transportation, and social development (National Planning Commission, n.d.). While these borrowings are crucial for bridging the investment gap, the subsequent growth in debt-servicing obligations has raised substantial concerns regarding fiscal sustainability and long-term public investment capacity (Shrestha, 2014). A considerable portion of the national budget is now allocated to servicing debt, which potentially crowds out resources for essential public services and capital expenditures in healthcare, education, and infrastructure (Sharma & Singh, 2020).

The theoretical underpinnings of this dynamic are explained by concepts such as the Debt Overhang Theory, which posits that high public debt can deter investment and hinder economic growth by creating uncertainty about future taxation and government spending (Krugman, 1998). However, it is important to distinguish between two distinct theoretical claims: first, that high debt may "crowd out" productive investment by absorbing fiscal space (which would manifest as a negative

and significant coefficient on capital expenditure); second, that debt may simply have no measurable impact on capital spending due to institutional decoupling between borrowing and investment decisions. This study tests both possibilities. Concurrently, the Ricardian Equivalence Theory suggests that rational economic agents may anticipate future tax hikes to repay current debt, leading them to adjust their savings and consumption patterns, thereby neutralizing the stimulative effect of borrowing (Barro, 1974). In the context of Nepal, these theories highlight the potential trade-offs and behavioral responses associated with rising debt levels, questioning whether borrowed funds are effectively channeled into growth-promoting investments or merely sustain recurrent and servicing costs.

Despite the growing debt burden, the specific impact of government debt on Nepal's fiscal operations—particularly its effect on distinct revenue streams like customs duties, excise taxes, and direct taxes, versus its influence on capital expenditure—remains underexplored (Adhikari, 2005; Sharma & Singh, 2020). Most government revenue is used to service debt, which may limit long-term investment in public services and infrastructure, thereby retarding the country's growth. Therefore, examining this relationship is crucial for formulating policies that balance debt sustainability with the need for public investment. This study aims to fill this research gap by analyzing the effects of domestic and foreign debt on key fiscal variables in Nepal, providing evidence-based insights for prudent fiscal and debt management.

2. Materials and methods

This study employed a quantitative, non-experimental research design to examine the relationship between government debt and fiscal operations in Nepal. The design was explanatory in nature, seeking to establish correlations between debt levels and fiscal performance without manipulating any variables (Gujarati, 2004). Secondary, time-series data was utilized for the period from 2005 to 2024. This timeframe was selected due to the availability of reliable and consistent data from official sources, as records prior to 2005 were inadequately maintained.

2.1 Sources of Data

All data were extracted from credible official institutions to ensure reliability and validity. The primary sources were:

Nepal Rastra Bank (NRB): Data for independent variables (domestic debt and foreign debt) were obtained from the government budgetary operations reports. Dependent variables related to revenue customs/import duties, excise/import duties, direct taxes, and total revenue were sourced from NRB's government revenue reports. Data for control variables (interest rates and inflation) were taken from the Current Macroeconomic and Financial Situation of Nepal reports.

Financial Comptroller General Office (FCGO): Data for capital expenditure was obtained from this office to complement the NRB records.

2.2 Model Specification

The study used Ordinary Least Squares (OLS) regression analysis to assess the impact of government debt on fiscal operations. The following time-series regression models were employed:

Reduced-form equations:

$$Y_t = \beta_0 + \beta_1 [DD]_t + \beta_2 X_t + \epsilon_t \quad (i)$$

$$Y_t = \beta_0 + \beta_1 [FD]_t + \beta_2 X_t + \epsilon_t \quad (ii)$$

The general time series regression model is:

$$Y_t = \beta_0 + \beta_1 [DD]_t + \beta_2 [FD]_t + \beta_3 X_t + \epsilon_t$$

Where 't' represents time and the notation 'y' represents capital expenditure, custom/import, excise/import, Direct Tax, Total revenue. The variable DD represents domestic debt, FD represents foreign debt and 'X' represents control variables like Interest rates and Inflation and ϵ_t is the error term.

2.3 Variable Description

Independent Variables

Domestic Debt (DD): Government borrowings sourced from within the country, including from financial institutions and the public via instruments like treasury bills (Tapsoba, 2013).

Foreign Debt (FD): Financial resources borrowed from external sources such as international financial institutions and foreign governments (Fosu, 2010).

Dependent Variables

Capital Expenditure (Capex): Government spending on infrastructure and long-term asset creation (Barro, 1990).

Customs/Import Duties: Tax revenue collected on goods crossing international borders, measured in NPR millions (Aghion et al., 2009).

Excise Duty (relative to Import Duties): A ratio variable calculated as total excise tax revenue divided by total import duty revenue. This ratio captures the relative contribution of domestically produced goods taxation compared to import taxation. A value greater than 1 indicates excise duties exceed import duties; a value less than 1 indicates the opposite. The use of this ratio controls for scale effects and allows comparison across years of varying economic activity. **Direct Tax:** Taxes levied directly on individuals and organizations, measured in NPR millions (Tanzi & Zee, 2000).

Total Revenue: The aggregate of all tax and non-tax revenues collected by the government, measured in NPR millions.

Control Variables:

Interest Rate: The cost of borrowing, which influences government spending and investment decisions (Mishkin, 2017).

Inflation: The rate of price increase, which affects the real value of debt and tax revenues (Bohn, 1998).

2.4 Diagnostic Tests

To ensure the robustness of the OLS estimates, several diagnostic tests were conducted:

Stationarity Test: The Augmented Dickey-Fuller (ADF) test was used to check for unit roots. All variables were found to be stationary at I(0) (Dickey & Fuller, 1979).

Heteroskedasticity Test: The Breusch-Pagan test indicated the presence of heteroskedasticity. Consequently, robust standard errors were employed to obtain consistent coefficient estimates (Stock & Watson, 2012).

Autocorrelation Test: The Breusch-Godfrey LM test revealed serial correlation in the residuals. Robust standard errors were again used to correct for this issue.

Multicollinearity Test: The Variance Inflation Factor (VIF) was calculated. The average VIF of 2.53 confirmed the absence of severe multicollinearity among the independent variables (O'Brien, 2007).

The analysis proceeded by running separate regressions for domestic and foreign debt, both with and without control variables, to isolate their distinct effects on the various fiscal outcome measures.

3. Results

The empirical analysis of this study, examining the period from 2005 to 2024, reveals a complex relationship between government debt and fiscal operations in Nepal. Utilizing Ordinary Least Squares (OLS) regression with robust standard errors to address econometric issues, the findings consistently demonstrate a significant and positive impact of both domestic and foreign debt on key government revenue streams, while revealing no statistically significant relationship with capital expenditure. Crucially, the absence of a negative and significant coefficient on capital expenditure means that this study does not find evidence of a classical "crowding-out" effect, wherein debt directly displaces public investment. Instead, the findings suggest a fiscal disconnect: debt accumulation stimulates revenue collection for servicing obligations but has no measurable direct impact on the public investment budget—either positive or negative.

3.1. Descriptive Statistics

Table 1 presents the descriptive statistics for all variables used in the analysis.

Table 1: Descriptive Statistics of Key Variables (2005-2024)

Variable	Unit	Obs	Mean	Std. Dev.
Domestic Debt	NPR Millions	233	10,902.43	22,803.07
Foreign Debt	NPR Millions	233	3,735.44	7,468.89
Capital Expenditure	NPR Millions	231	30,496.76	115,776.90
Custom/Import Duty	Ratio	231	1.15	0.08
Excise/Import Duty	Ratio	231	0.73	0.14
Direct Tax	NPR Millions	232	11,034.86	12,546.27
Total Revenue	NPR Millions	232	41,445.23	35,456.75
Interest Rate	Percent	233	10.83	1.22
Inflation	Percent	233	14.81	32.32

The statistics show a picture of a volatile fiscal environment. The high standard deviations relative to means for Domestic Debt (SD: 22,803 vs. Mean: 10,902), Foreign Debt (SD: 7,469 vs. Mean: 3,735), and especially Capital Expenditure (SD: 115,777 vs. Mean: 30,497) indicate significant fluctuations over time. This suggests periods of aggressive borrowing and spending followed by consolidation. The extreme volatility in Capital Expenditure is particularly telling, highlighting an inconsistent and often lumpy pattern of public investment. Revenue streams also show substantial variability, with Total Revenue and Direct Tax displaying standard deviations of similar magnitude to their means. The macroeconomic context is equally unstable, with Inflation showing dramatic swings (Mean: 14.81%, SD: 32.32%). This backdrop of inherent

volatility is crucial for interpreting the regression results, as it defines the challenging terrain within which debt and fiscal policy interact.

3.2. The Revenue-Enhancing Effect of Government Debt

The core of the analysis lies in the regression results, which isolate the effect of debt on specific fiscal outcomes. The models were run separately for domestic and foreign debt, both with and without control variables (inflation and interest rates), to ensure robustness. The findings are strikingly consistent: debt accumulation is a significant driver of increased tax revenue.

Table 2: Impact of Domestic Debt on Fiscal Variables (with Control Variables)

Dependent Variable	Coefficient (β)	Robust Error	Std.	t-statistic	p-value	R ²
Capital Expenditure	0.37	(1.14)		0.32	>0.05	0.011
Custom/Import Duty	1.05	(0.44)		2.39	>0.05	-0.0004
Excise/Import Duty	1.86	(0.41)		4.53	<0.001***	0.080
Direct Tax	0.087	(0.035)		2.48	<0.01**	0.043
Total Revenue	0.311	(0.098)		3.17	<0.01**	0.077

*Note: *** p<0.001, ** p<0.01, * p<0.05. Control variables (Inflation, Interest Rate) are included but coefficients not shown for clarity*

As shown in Table 2, a one-million NPR increase in Domestic Debt is associated with a statistically significant increase in Excise/Import Duty revenue ($\beta=1.86$, p<0.001), Direct Tax revenue ($\beta=0.087$, p<0.01), and Total Revenue ($\beta=0.311$, p<0.01). This indicates a reactive fiscal mechanism: rising domestic liabilities prompt the government to strengthen revenue mobilization, likely through policy adjustments or enhanced collection efficiency targeting these specific tax handles. The positive but insignificant coefficient for Custom/Import Duty suggests this revenue stream is less responsive to domestic debt pressures, possibly due to trade policy constraints or administrative factors.

The effect of Foreign Debt, presented in Table 3 shows the heightened pressure created by external liabilities.

Table 3: Impact of Foreign Debt on Fiscal Variables (with Control Variables)

Dependent Variable	Coefficient (β)	Robust Error	Std.	t-statistic	p-value	R ²
Capital Expenditure	1.68	(1.06)		1.59	>0.05	0.010
Custom/Import Duty	7.79	(7.43)		1.05	>0.05	0.030
Excise/Import Duty	6.18	(1.25)		4.94	<0.001***	0.094
Direct Tax	0.55	(0.102)		5.39	<0.001***	0.120
Total Revenue	1.78	(0.284)		6.27	<0.001***	0.170

*Note: *** p<0.001, ** p<0.01, * p<0.05. Control variables (Inflation, Interest Rate) are included*

Here, a one-million NPR increase in Foreign Debt leads to substantial increases in Excise/Import Duty ($\beta=6.18$, p<0.001), Direct Tax ($\beta=0.55$, p<0.001), and Total Revenue ($\beta=1.78$, p<0.001). The coefficients for foreign debt are markedly larger than those for domestic debt across all significant revenue variables. This stronger effect likely stems from the hard constraint of foreign exchange requirements for debt servicing, which compels more vigorous domestic revenue generation to free up or acquire the necessary foreign currency. Again, Custom/Import Duty shows no significant response.

3.3. The Capital Expenditure Dilemma

The most critical and consistent finding across all model specifications is the statistically insignificant relationship between both forms of government debt and Capital Expenditure. As clearly shown in the first rows of Tables 2 and 3, the coefficients for debt on capital spending are positive but carry very high standard errors, resulting in t-statistics below conventional significance thresholds (0.32 for DD, 1.59 for FD).

This null result requires careful interpretation. It does not support a crowding-out hypothesis, which would require a negative and statistically significant coefficient (indicating that higher debt directly reduces capital expenditure). Rather, the finding suggests that in Nepal, government debt levels have no measurable direct impact on capital spending—neither increasing it nor decreasing it. This implies a structural decoupling between borrowing decisions and capital budgeting processes.

3.4. Diagnostic Tests and Robustness Checks

The validity of these inferences is supported by rigorous diagnostic testing. The Augmented Dickey-Fuller (ADF) test confirmed the stationarity of all time-series variables at $I(0)$, rejecting the null hypothesis of a unit root ($p < 0.05$ for all variables), thus validating the use of OLS regression on level data without spurious regression concerns.

The Breusch-Pagan test detected the presence of heteroskedasticity ($\chi^2 = 43.48$, $p = 0.0000$), and the Breusch-Godfrey LM test identified serial correlation in the residuals ($p = 0.0000$). To correct for these violations of classical OLS assumptions, all reported models employ heteroskedasticity- and autocorrelation-consistent (HAC) robust standard errors (Newey-West type), ensuring that the significance tests are reliable.

Finally, Variance Inflation Factor (VIF) scores were calculated to check for multicollinearity. The mean VIF was 2.53, with all individual VIF values well below the conservative threshold of 5. This confirms that the independent variables (domestic debt, foreign debt, inflation, interest rate) are not highly correlated, and the estimated coefficients are stable and interpretable.

4. Discussion

The results reveal that both domestic and foreign debt significantly influence tax revenues such as excise duties, direct taxes, and total revenue while showing no statistically significant effect on capital expenditure. Critically, this null finding does not support the "crowding-out" hypothesis often discussed in the literature. There is no evidence in these data that government debt directly reduces public investment spending. Instead, the findings indicate a fiscal disconnect: debt servicing consumes budgetary resources, but this does not manifest as a measurable negative effect on capital expenditure in the regression framework.

The positive relationship between domestic debt and tax revenues in Nepal is as similar as in other developing economies. Aghion et al. (2009) found that rising domestic debt tends to lead to increased tax collection, particularly when governments are unable to generate sufficient revenue from other sources. Similarly, Afonso & Jalles (2013) discussed how debt-servicing obligations in European economies crowd out spending on capital projects, which limits fiscal space for public investment. In contrast, Siddique et al. (2016) found that in some developing countries, higher domestic debt can result in greater public investment due to favorable governance structures. This discrepancy could be due to Nepal's challenges in managing its debt effectively, where debt-servicing demands often take precedence over investments in infrastructure, as suggested by the findings of Afonso & Jalles (2013).

Similarly, foreign debt positively influences tax revenues in Nepal, particularly excise/import duties, direct taxes, and total revenue, but does not significantly affect capital expenditure. This is consistent with the findings of Pattillo et al. (2011), who observed that foreign borrowing typically leads to higher tax revenues, especially through indirect taxes, but does not necessarily result in increased public investment in infrastructure or long-term development projects. Ghosh et al. (2020) also found that foreign debt burdens often result in prioritizing debt servicing over public investments, with governments in debt-heavy countries focusing on meeting external obligations rather than funding capital expenditure. These trends reflect similar fiscal dynamics observed in Latin American countries, where foreign borrowing often raises tax revenues but does not automatically boost capital spending (Reinhart & Rogoff, 2010).

The absence of a significant effect of foreign debt on customs/import duties in Nepal contrasts with Yusuf et al. (2016), who found that foreign debt is often associated with increased customs revenues in countries with stronger administrative systems. This suggests that Nepal's relatively weak customs and tax administration may be limiting the potential for foreign debt to translate into higher customs revenue. In contrast, Yusuf et al. (2016) noted that countries with more robust institutions could better leverage foreign debt to enhance their customs capacity and boost revenue generation. However, the low R^2 values across all models (ranging from 0.01 to 0.17) indicate that debt variables alone explain only a small fraction of the variation in fiscal outcomes. This suggests that future research should incorporate institutional variables, political economy factors, and external shocks to improve model explanatory power.

The results of this study are broadly consistent with the global literature on government debt and fiscal policy in developing countries. Calderón & Fuentes (2013) and Zouhaier & Fatma (2014) found a negative relationship between government debt and economic growth in developing countries, suggesting that beyond certain thresholds, debt accumulation hinders economic growth and reduces the fiscal space for public investment. Similarly, Aghion et al. (2009) and Reinhart & Rogoff (2010) highlighted that as debt servicing increases, governments face pressure to increase taxes, often at the expense of long-term investments in growth-promoting sectors.

Governance quality also plays a crucial role in how debt affects fiscal outcomes. Abbas et al. (2017) and Egert (2018) argue that countries with stronger governance structures are better able to manage the challenges posed by high debt. Effective governance reduces the risk of debt mismanagement and helps ensure that borrowing is directed towards productive investments. In contrast, Yasar (2016) found that weak governance in developing countries often leads to inefficient use of debt, further exacerbating fiscal challenges. Furthermore, Asteriou et al. (2018) and Ghosh et al. (2020) emphasize the importance of the composition of debt in determining its impact on economic outcomes. External debt is often less effective in boosting growth in developing countries where institutions are weak and governance is poor, as it tends to be used for servicing past obligations rather than funding new development projects. This dynamic is observed in Nepal, where external debt has been used more for immediate debt servicing than for investment in infrastructure.

Strengthening tax administration could reduce Nepal's reliance on borrowing and improve fiscal sustainability. As Abbas et al. (2017) suggest, enhancing tax collection systems would not only increase revenue but also reduce the country's dependency on debt, thereby making fiscal policy more sustainable. Policymakers should optimize the use of debt by ensuring that borrowed funds are directed towards high-return public investments. As Pattillo et al. (2011) and Ghosh et al. (2020) argue, debt should be used to finance growth-promoting investments, particularly in infrastructure, to ensure that it contributes to long-term development. Improving debt management strategies is crucial. Developing clear guidelines on borrowing and expenditure will help balance the benefits of debt with the risks, ensuring that debt levels remain manageable and do not crowd out critical investments.

5. Conclusion

This study set out to empirically investigate the impact of government debt on fiscal operations in Nepal, with a specific focus on disentangling its effects on revenue generation versus capital expenditure. Utilising time-series data from 2005 to 2024 and robust regression methods, the analysis reaches a conclusive yet challenging verdict on the role of debt in Nepal's fiscal framework.

The findings demonstrate that both domestic and foreign debt exert a significant positive influence on the government's tax revenue, particularly on excise/import duties and direct taxes. This indicates a responsive fiscal system where mounting debt obligations compel the state to strengthen its revenue mobilisation efforts, likely through policy adjustments and enhanced collection efficiency. The effect is notably stronger for foreign debt, underscoring the potent pressure exerted by external liabilities that require foreign exchange for servicing.

However, the most critical finding—and the one that requires careful interpretation—concerns capital expenditure. Contrary to the crowding-out hypothesis commonly invoked in policy discussions, this study finds no evidence that government debt (domestic or foreign) has a negative and statistically significant impact on capital expenditure. The coefficients are statistically indistinguishable from zero. This null result indicates that debt accumulation neither directly reduces nor increases public investment in Nepal based on the available data from 2005 to 2024.

However, the most critical and policy-relevant conclusion lies in what the debt does not do. Despite its clear role in boosting revenue, government debt—whether domestic or international—has no statistically significant impact on capital expenditure. This result is robust across multiple model specifications and withstands rigorous diagnostic testing. It reveals a fundamental structural disconnect: the cycle of borrowing and the associated fiscal tightening to raise revenue operates in a silo, largely decoupled from the budgetary process for public investment. In essence, borrowed funds and the additional revenue they stimulate appear to be primarily absorbed by the recurrent budget, most notably to service the debt incurred, rather than being channelled into a net increase in long-term development spending.

Therefore, this study concludes that in Nepal, government debt accumulation primarily finances a fiscal consolidation loop rather than a development investment loop. The evidence does not support claims of classical crowding-out, but it does reveal a disconnect whereby debt-driven revenue increases fail to materialize as higher public investment. This distinguishes the Nepali case from countries where high debt demonstrably reduces capital spending.

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