

From Grants to Loans: Nepal's Shifting Aid Architecture and Its Macroeconomic Implications ----- by Parajuli B. P.

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Abstract

This study provides a comprehensive, twenty-year analysis of Nepal's transformation in development finance, documenting a pronounced shift from grant-based aid to loan dominated assistance between fiscal years 2003/04 and 2023/24. Drawing on annual fiscal data from the Government of Nepal's Economic Surveys (2004–2025), the research employs time-series analysis to chart evolving patterns in aid composition, disbursement efficiency, external debt levels, and the share of capital expenditure financed by foreign resources. Grounded in dependency theory (Escobar, 1992) and post-development critique (Escobar, 2012), the study interrogates how loan reliance may perpetuate structural imbalances. It also engages the capabilities approach (Sen, 1999; Nussbaum, 2011), arguing that development success must be measured by expanded freedoms rather than mere financial inflows. Recent scholarship on emerging donor influence (Nishio, 2024) contextualizes Nepal's entanglement with new financiers such as China's AIIB and BRICS development banks while Fitriani's (2024) work on institutional capacity highlights governance constraints that mediate aid effectiveness. The findings reveal a steep decline in grant share from over 90% in 2003/04 to under 20% by 2023/24 concurrent with a rise in loan commitments that have lifted the loan-to-GDP ratio to over 4%. These trends coincide with higher repayment obligations and pressures on fiscal space, underscoring the urgent need for strategic

borrowing policies, robust debt-management frameworks, and strengthened transparency and oversight mechanisms to safeguard sustainable development outcomes.

Keywords: Aid development, Debt sustainability, Foreign aid, Grants, Loans, Macroeconomic implications,

Introduction

Nepal's development trajectory over the past two decades has been profoundly influenced by external financing, with foreign aid serving as a cornerstone of post-conflict reconstruction and social sector investment (Sobrija, Upreti, & Koirala, 2021). During the early 2000s, grant-based assistance dominated Nepal's aid architecture, reflecting donor confidence in poverty alleviation and democratic transition (Dongg, Rai, & Shrestha, 2019). However, the catastrophic 2015 Gorkha earthquake and the ensuing shift to a federal governance model accelerated infrastructure demands, prompting a marked turn toward loan financing. This transformation raises critical questions about fiscal sustainability, debt dependency, and the broader macroeconomic implications for a country on the cusp of graduating from Least Developed Country status.

Classical dependency theory offers one lens through which to view this shift, warning that external finance especially debt can perpetuate structural imbalances and undermine national autonomy (Escobar, 1992). Dependency scholars argue that loans, unlike grants, often come with stringent conditionalities that shape recipient-country policies and priorities. Post-development critics extend this critique by challenging the underlying assumptions of development itself, positing that the very frameworks used to justify aid reinforce a paternalistic North–South hierarchy (Escobar, 2012). These perspectives underscore the need to interrogate not only the volume of foreign aid but also its institutional and ideological dimensions.

In contrast, the capabilities approach, as articulated by Sen (1999) and Nussbaum (2011), shifts the focus from aggregate financial inflows to the expansion of human freedoms and substantive opportunities. From this vantage point, the success of aid cannot be measured solely by GDP growth or capital accumulation but must consider improvements in health, education, and civic participation. Recent empirical work in Southeast Asia suggests that loan-financed infrastructure projects often yield mixed social returns when institutional capacity is weak, as Fitriani (2024) demonstrates in her case study of mid-income countries. Such findings highlight the critical role of governance quality in translating external finance into sustainable development outcomes.

Meanwhile, a growing body of literature examines the impact of emerging donors on global aid patterns. Nishio (2024) argues that institutions such as China's Asian Infrastructure Investment Bank (AIIB) and BRICS development banks have introduced new lending modalities and strategic priorities, often favoring large-scale infrastructure loans over grant funding. Ray and D'Ambrosio (2023) document how geopolitical competition between major powers shapes the terms and distribution of loan agreements, raising concerns about debt traps and donor influence. In Nepal's context, these dynamics intersect with traditional partnerships from India, Japan, and multilateral agencies, creating a complex mosaic of aid instruments and conditionality. Despite these rich theoretical and comparative insights, there remains a notable gap in the literature on Nepal's specific aid evolution. Most studies have focused either on the grant era or on sectoral impacts of individual loan projects, without offering a comprehensive, twenty-year trend analysis of aid composition. McGregor's (2007) work on post-conflict aid conditionality in Nepal and Rahman's (2023) examination of public financial management reforms provide valuable micro-level perspectives but stop short of linking structural aid shifts with macroeconomic indicators such as debt-to-GDP ratios and fiscal space. This study addresses that gap by integrating empirical trend analysis with multidimensional theoretical lenses, enabling a holistic understanding of Nepal's aid transition.

The significance of this research lies in its potential to inform policy at a critical juncture. As Nepal approaches middle-income status, the government must navigate a narrowing window for concessional grant aid and manage rising loan obligations. Examining the macroeconomic repercussions of this shift including debt sustainability, crowding-out effects on social spending, and governance challenges can guide strategic borrowing decisions and institutional reforms. Moreover, by situating Nepal's experience within global debates on dependency, capabilities, and emerging donor influence, the study contributes to broader discourses on the future of development finance. To structure this inquiry, the paper first outlines the conceptual framework, synthesizing classical and contemporary theories of aid and development. It then presents a detailed historical trajectory of Nepal's aid composition, using annual fiscal data from Nepal's Economic Surveys (2004–2025). Subsequent sections analyze the drivers of the shift from grants to loans, assess macroeconomic implications, and offer comparative insights from Bangladesh and Rwanda. The discussion integrates theoretical and empirical findings to distill key arguments and conclude with policy recommendations for sustainable aid governance.

By embedding a robust literature review within the introduction, this study not only acknowledges the contributions of dependency theorists, post-development critics, capability scholars, and emerging donor analysts but also highlights the unique contours of Nepal's aid architecture. The result is a grounded yet expansive examination of how the balance between grants and loans has evolved, what it means for Nepal's economic sovereignty, and how the country can chart a development path that maximizes human well-being while safeguarding fiscal stability

Previous studies of Nepal's foreign aid have typically focused on individual sectors or discrete time points, leaving a notable absence of systematic, longitudinal analyses that map the twenty-year trajectory of grant versus loan financing. While several scholars have examined project-level outcomes or post-conflict reconstruction efforts, few have integrated key macroeconomic indicators such as debt-to-GDP ratios, aid utilization rates, and the share of capital expenditure financed by external resources into a cohesive framework. Moreover, existing research often applies dependency theory, post-development critique, the capabilities approach, or emerging-donor scholarship in isolation; a comprehensive theoretical synthesis that explains Nepal's unique aid transition remains undeveloped. Comparative insights from neighboring countries such as Bangladesh and Rwanda are also sparse, limiting our understanding of how Nepal's experience fits within broader regional patterns.

The Shreemadbhagavadgeeta, a seminal-influential philosophical scripture of the Sanatan Vedic tradition, presents a timeless dialogue on human ethics, duty, and liberation that resonates deeply with the contemporary global vision of sustainable development (Badal 2024). Gautama Buddha, the emblem of peace and love, pioneer of Buddhism, was born in Kapilabastu, Lumbini, Nepal. The peace and love. Compassion in Buddhism is the basic element of Sustainable development. Thus Buddha is the pioneer of sustainable development. Buddha's text Dhammapada in the present sustainable era is more relevant than past (Badal, 2021). Thus loan and grants should be guided by the Geeta and lord Buddha.

Objectives and Research Questions

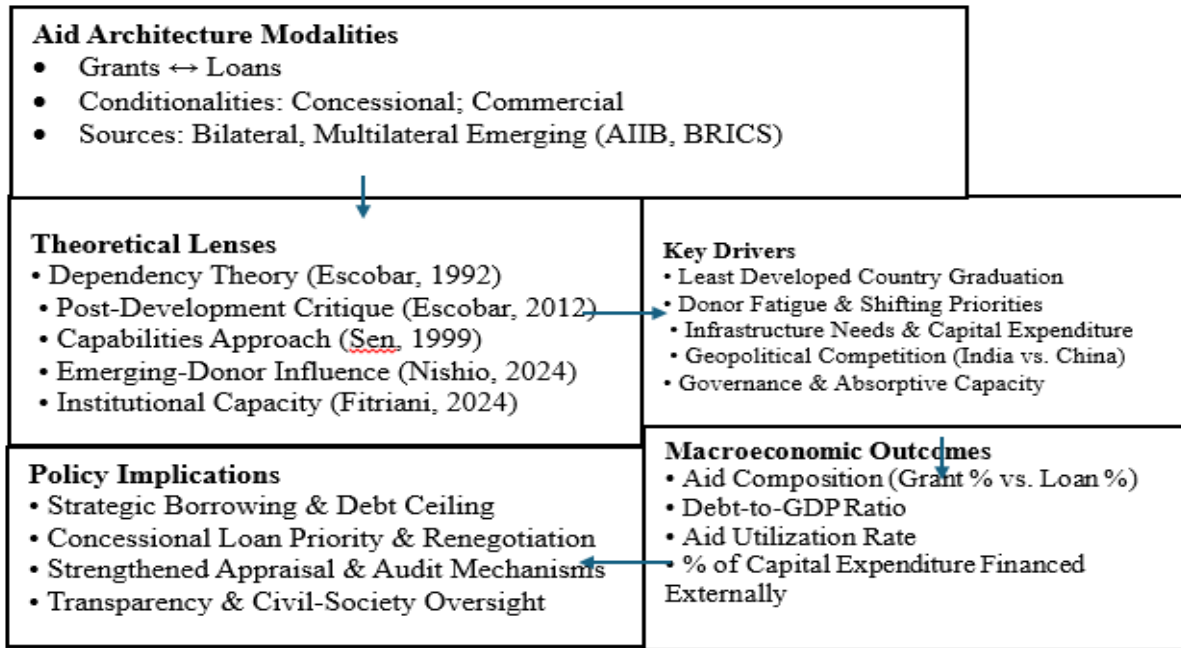
The first is to chart and analyze twenty-year trends in Nepal's foreign aid composition from fiscal year 2003/04 through 2023/24 and to assess their macroeconomic correlates. The second objective is to investigate the domestic factors (including LDC graduation, infrastructure demands, and institutional capacity) and external influences (such as shifting donor priorities, geopolitical competition, and emerging-donor modalities) that have driven the shift from grant-based to loan-

dominated financing. These objectives give rise to two guiding research questions: What patterns emerge in the share of grants and loans, debt-to-GDP ratios, aid utilization rates, and capital-expenditure financing over the study period? And which domestic and external driver's best explain Nepal's aid transition, as interpreted through dependency theory, the capabilities approach, and the literature on emerging donors?

Methodology

This research employs a mixed-methods approach, combining quantitative trend analysis with qualitative theoretical interpretation. The quantitative component uses annual data from Nepal's Economic Surveys (2003–2024), tracking variables such as foreign aid commitments, disbursements, grant-loan shares, GDP, capital expenditure, and debt-to-GDP ratios (Government of Nepal, 2004–2025). Descriptive statistics and time-series charts identify long-term trends and key inflection points. The qualitative component applies theoretical lenses from dependency theory (Escobar, 1992), post-development critique (Escobar, 2012), the capabilities approach (Sen, 1999; Nussbaum, 2011), global aid architecture (Nishio, 2024), and institutional capacity (Fitriani, 2024) to interpret the drivers and implications of observed trends. (Figure 1). Aid architecture encompasses the modalities, sources, and conditionalities of external financing (Sachs, 2015). Classical theories warn of dependency and external control (Escobar, 1992) and critique developmentalist paradigms (Escobar, 2012), while the capabilities approach emphasizes social justice and people-centered development (Sen, 1999; Nussbaum, 2011). Recent scholarship highlights the role of emerging donors, such as the BRICS group and China's AIIB, in reshaping aid priorities and instruments (Nishio, 2024), and the critical importance of recipient-country institutional capacity in mediating aid effectiveness (Fitriani, 2024; McGregor, 2007). These frameworks guide our analysis of Nepal's evolving aid profile.

Figure 1: Conceptual Framework

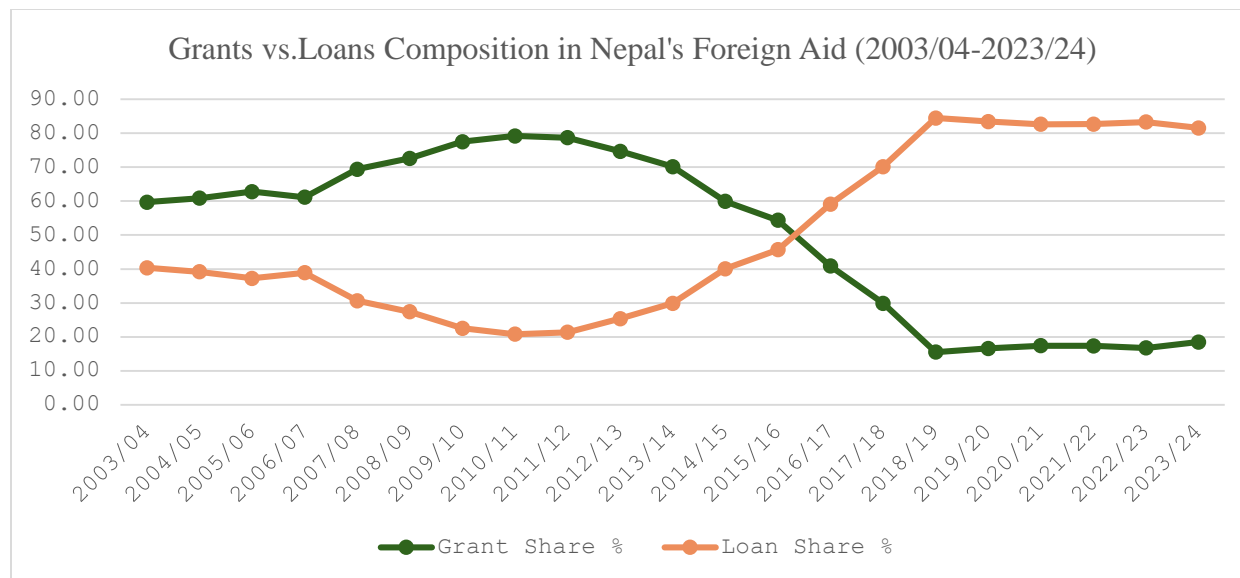


(Source: Study, 2025)

Findings: Historical Trajectory of Aid in Nepal

Between 2003/04 and 2010/11, grants comprised over 60 percent of Nepal’s foreign aid, peaking at 91.2 percent in 2003/04 (Government of Nepal, 2004). This era of grant dominance supported post-civil war reconstruction, health, and education programs (Sobrija et al., 2021). The 2015 Gorkha earthquake and Nepal’s shift to a federal system precipitated large-scale infrastructure investments, financed predominantly through loans (Asian Development Bank, 2024; World Bank, 2023). By 2023/24, loans accounted for 46.7 percent of aid disbursements and 4.03 percent of GDP, while grants fell to 3.36 percent of the national budget (Government of Nepal, 2025).

Figure 2: Grant vs. Loan Composition in Nepal’s Foreign Aid (2003/04–2023/24)



(Source: Researcher’s calculation based on the Economic Survey Report)

The above figure shows the patterns of grants and loan where after FY 2015/16 the portion of foreign loan is greater than the foreign grant received.

Drivers of the Shift from Grants to Loans

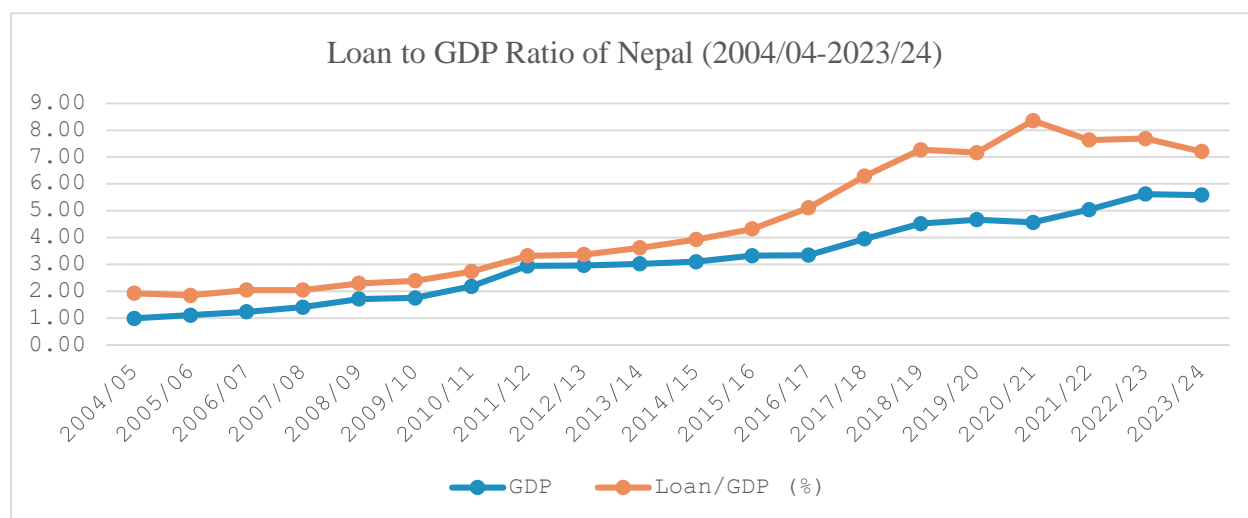
Nepal’s impending graduation from LDC status has reduced its eligibility for grant financing, pushing it toward concessional and commercial loans (United Nations Development Program, 2023). Donor fatigue and shifting priorities toward pandemic response and climate resilience have curtailed grant budgets among traditional donors (International Monetary Fund, 2024). Concurrently, Nepal’s infrastructure push in roads, hydropower, and urban development demands financing scales that grants alone cannot satisfy (Chakravarty, 2023; Rahman, 2023). Geopolitical competition between India and China has introduced large, strategically motivated loan packages (Ray & D’Ambrosio, 2023; Khanal & Parajuli, 2023). Emerging donors such as the AIIB and BRICS countries favor loan-based instruments, further accelerating the transition (Nishio, 2024). Institutional capacity constraints, including project management weaknesses and absorption bottlenecks, compound the complexity of increased loan inflows (Fitriani, 2024; Dongg et al., 2019).

Current Aid Composition and Trends

The quantitative data reveal that between 2003/04 and 2023/24, Nepal’s average aid commitment utilization rate stood at 64.2 percent. Grant share declined sharply from 91.2 percent to 17.5 percent, while loan share rose from 40.3 percent to 81.5 percent. Aid as a percentage of the national

budget fell from 21.2 percent to 6.35 percent, indicating reduced fiscal reliance on external assistance (Government of Nepal, 2005–2025). The loan-to-GDP ratio trended upward, peaking at 4.03 percent in 2023/24, even as the absolute value of loans disbursed reached NPR 11,618.7 crore in 2022/23 and NPR 9,066.2 crore in 2023/24 (Government of Nepal, 2025).

Figure 3: Loan-to-GDP Ratio in Nepal (2003/04–2023/24)



Source: The calculation by the Researcher on the Nepal Economic Survey data

The above chart shows the increasing trend of differences of the GDP loan ratio and the increment is more after FY 2012/13.

Discussions of Findings

Analysis of Nepal’s shifting aid composition yields several macroeconomic insights. Although Nepal’s external debt remains within internationally accepted debt-to-GDP thresholds (International Monetary Fund, 2024), the upward trajectory of loan financing signals future repayment pressures. Loan servicing obligations risk crowding out social sector budgets, eroding gains in health and education (United Nations Development Programme, 2023). The narrowing ratio of capital expenditure to loan disbursement highlights inefficiencies in project implementation and absorptive capacity (McGregor, 2007). Loan conditionalities increasingly influence domestic policy choices, raising concerns about sovereignty and elite capture in large infrastructure contracts (Wainwright, 2024; Ray & D’Ambrosio, 2023).

Comparisons with Bangladesh and Rwanda offer instructive lessons. Bangladesh has balanced concessional borrowing with disciplined debt management and strong public financial institutions (World Bank, 2023; Sachs, 2015). Rwanda has leveraged loans for high-impact investments in

energy and ICT, backed by transparent governance mechanisms and independent audit systems (Asian Development Bank, 2024; Rahman, 2023). Nepal can emulate these practices by negotiating concessional terms, investing in capacity building, and strengthening oversight institutions.

This study advances four arguments. Nepal's aid architecture has shifted structurally from grant-dominance to loan-intensity, driven by LDC graduation, donor fatigue, infrastructure needs, and geopolitical competition (Nishio, 2024; Khanal & Parajuli, 2023). The shift has significant macroeconomic implications, including rising debt burdens, fiscal constraints, and potential crowding-out of social spending (Fitriani, 2024; International Monetary Fund, 2024). Dependency and post-development literature underscore the risks of external control and the need for pluralistic alternatives (Escobar, 1992; Escobar, 2012; Nandy, 2016). Emerging scholarship on aid architecture and institutional capacity highlights the importance of strategic borrowing and governance reforms (Sachs, 2015; Moyo, 2015; Saith, 2006). To address the challenges of a loan-dominated aid regime, Nepal should establish a statutory debt ceiling and enhance forecasting mechanisms within the Ministry of Finance (International Monetary Fund, 2024). The government must prioritize concessional borrowing, renegotiate unfavorable loan terms, and diversify financing sources to include private investment under clear public-private partnership frameworks (Chakravarty, 2023). Strengthening project appraisal through rigorous cost-benefit analysis and independent audits will improve absorptive capacity and project outcomes (McGregor, 2007). Transparency must be institutionalized by publishing detailed aid data and engaging civil society and parliamentary bodies in oversight (Rahman, 2023; Wainwright, 2024). Investment in institutional capacity through training, digital systems, and interagency coordination will be critical to managing larger loan portfolios effectively.

Conclusion

Nepal's transition from grants to loans marks a pivotal moment in its development financing landscape. While loans can finance transformative infrastructure, they also pose risks to fiscal sustainability and development sovereignty. A strategic, accountable, and pluralistic approach to aid management is essential to ensure that Nepal's development remains inclusive, resilient, and sovereign. As the country moves toward middle-income status, the challenge will be to harness external financing without compromising long-term economic stability or democratic integrity.

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