Government expenditure and economic growth in Nepal: a minute analysis

Basudev Sharma
Revenue Administration Training Center, Ministry of Finance, Nepal

Author's email: basudevsharma22@hotmail.com

Accepted 29 October, 2012

Government expenditure is one of the important determinants of economic growth. However, the growth of economy depends on the size, spending capacity, and effective use of capital expenditure in the development process. In Nepal, due to political instability, internal inability, and weak governance situation, capital expenditure is unable to influence economic growth and development. The study suggests increasing the spending capacity of government and regular monitoring in expenditure tracking and effective use of capital expenditure. The government should focus on law and order and fair and transparent use of government investment avoiding corruption and misuse of public investment.

Keyword: Capital expenditure, Correlation, Economic growth, Nepal

INTRODUCTION

The relationship between government expenditure and economic growth has continued to generate series of debate among scholars. Government performs two functions: protection (and security) and provisions of certain public goods (Abdullah and Yousif, 2000). Protection function consists of the creation of rule of law and enforcement of property rights. This helps to minimize risks of criminality, protect life and property, and the nation from external aggression. Under the provisions of public goods are defense, roads, education, health, and power, to mention few. Some scholars argue that increase in government expenditure on socio-economic and physical infrastructures encourages economic growth. For example, government expenditure on health and education raises the productivity of labor and increase the growth of national output. Similarly, expenditure on infrastructure such as roads, communications, power, etc, reduces production costs, increases private sector investment and profitability of firms, thus fostering economic growth. Supporting this view, scholars such as Ranjan and Sharma (2008) Cooray (2009) concluded that expansion of government expenditure contributes positively to economic growth. However, some scholars did not support the claim that increasing government expenditure promotes economic growth, instead they assert that higher government expenditure may slowdown overall performance of the economy. For instance, in an attempt to finance rising expenditure, government may increase taxes and/or borrowing. Higher income tax discourages individual from working for long hours or even searching for jobs. This in turn reduces income and aggregate demand. In the same vein, higher profit tax tends to increase production costs and reduce investment expenditure as well as profitability of firms. Moreover, if government increases borrowing (especially from the banks) in order to finance its expenditure, it will compete (crowds-out) away the private sector, thus reducing private investment. Furthermore, in a bid to score cheap popularity and ensure that they continue to remain in power, politicians and governments officials sometimes increase expenditure and investment in unproductive projects or in goods that the private sector can produce more efficiently. Thus, government activity sometimes produces misallocation of resources and impedes the growth of national output. In fact, studies by Laudau (1986), Barro (1991), Henrekson (2001) suggested that large government expenditure has negative impact on economic growth.

In Nepal, government expenditure has continued to rise due to the receipts from tax revenue, foreign aid and the increased demand for public (utilities) goods like roads, communication, power, education and health. Besides, there is increasing need to provide both internal and external security for the people and the nation.
statistics show that total government expenditure (capital and recurrent) and its components have continued to rise in the last decades. For instance, government total recurrent expenditure increased from Rs. 4,5830 million in 2000 to Rs, 151010 million in 2010 (see appendix 1). In the same manner, composition of government recurrent expenditure shows that expenditure on general administration, defense, internal security, education, health, drinking water, local development, agriculture, construction, and transport and communication increased during the period under review. Moreover, government capital expenditure rose from Rs, 28300 million in 2000 to Rs, 90230 million in 2010 (see appendix 1). Furthermore, the various components of capital expenditure (that is, economic service, social service, defense, agriculture, transport and communication, education and health) also show a rising trend between 2000 and 2010.

Unfortunately, rising government expenditure has not translated to meaningful growth and development, as Nepal ranks among the poorest countries in the world. In addition, many Nepalese have continued to wallow in abject poverty, while more than 30 percent live on less than US$2 per day. Couple with this, is dilapidated infrastructure (especially roads and power supply) that has led to the collapse of many industries, including high levels of unemployment. Moreover, macroeconomic indicators like balance of payments, import obligations, inflation rate, exchange rate, and national savings reveal that Nepal has not fared well in the last couple of years. Given the issues raised above, this paper seeks to examine the effect of government expenditure on economic growth in Nepal.

Theoretical framework

In the Keynesian model, increase in government expenditure (on infrastructures) leads to higher Economic growth. Contrary to this view, the neo-classical growth models argue that government fiscal policy does not have any effect on the growth of national output. However, it has been argued that government fiscal policy (intervention) helps to improve failure that might arise from the inefficiencies of the market. The seminal work of Barro (1990) opened new ground for the investigation of the impact of fiscal policy (government expenditure) on economic growth. In line with this, Easterly and Rebelo (1993) emphasized that government activity influences the direction of economic growth. Similarly, Ram (1986) pointed out that in the endogenous growth models, fiscal policy is very crucial in predicting future economic growth. Many researchers have attempted to examine the effect of government expenditure on economic growth. For instance, Laudau (1983) examined the effect of government (consumption) expenditure on economic growth for a sample of 96 countries, and discovered a negative effect of government expenditure on growth of real output. Brons (1999) examined the association between government expenditures and economic growth in Thailand, by employing the Granger causality test. The results revealed that government expenditures and economic growth are not co-integrated. Moreover, the results indicated a unidirectional relationship, as causality runs from government expenditures to growth. Lastly, the results illustrated a significant positive effect of government spending on economic growth. Komain and Brahmasesrene (2007) investigated the relationships between government expenditure and economic growth for a group of 30 OECD countries during the period 1970-2005. The regression results showed the existence of a long-run relationship between government expenditure and economic growth. In addition, the authors observed a unidirectional causality from government expenditure to growth for 16 out of the countries, thus supporting the Keynesian hypothesis. However, causality runs from economic growth to government expenditure in 10 out of the countries, confirming the Wagner’s law. Finally, the authors found the existence of feedback relationship between government expenditure and economic growth for a group of four countries. Within these theoretical frameworks this study is attempt to analyzed relationship between public spending and economic growth in Nepal.

METHODS

This paper uses the previous literature bilateral correlation and regression analysis to analyze the relationship between government expenditure and economic growth. The framework for the study has its basis on the Keynesian and endogenous growth models. The Keynesian model states that expansion of government expenditure accelerates economic growth. Although, endogenous growth models do not assign any important role to government in the growth process. Moreover, some authors focused on the components of government expenditure that are productive or unproductive, while others submitted that composition of government expenditure might exert more influence compare to the level of government expenditure. From the foregoing discussion, the level of government expenditure and composition of government expenditure are important determinants of growth. Thus, our model expresses economic growth (GDP) as a function of various levels and components of government expenditure that include total capital expenditure (TCAP), total recurrent expenditure (TREC), since they can have lasting impact on economic growth. Thus, the growth model is specified as: $GRY = \beta_0 + \beta_1 TREC + \beta_2 TCAP + U \ldots \ldots \ldots \ldots \ldots (1)$

The variables are measured as follows. Economic growth refers to the changes in real GDP. Real GDP in turn is obtained by dividing GDP at current market price by the consumer price index (CPI). TREC is measured as
**Table 1.** Correlation Matrix of GDP capital expenditure and revenue expenditure

<table>
<thead>
<tr>
<th></th>
<th>GDP</th>
<th>Capital expenditure</th>
<th>Recurrent expenditure</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td>1</td>
<td>0.327</td>
<td>0.416</td>
</tr>
<tr>
<td>Capital expenditure</td>
<td>1</td>
<td>0.435</td>
<td></td>
</tr>
<tr>
<td>Recurrent expenditure</td>
<td></td>
<td></td>
<td>1</td>
</tr>
</tbody>
</table>

Correlation is significant at the 0.05 level (2-tailed). The statistics reported are the Pearson correlation coefficient between all variables used in the analysis. GDP is annual growth rate of GDP. Capital expenditure refer to development expenditure Recurrent expenditure refer to general expenditure. Below 0.20 thinly correlated; 0.20 to 0.49 moderately correlated and above 0.50 strongly correlated.

**Table 2.** Regression of GDP on capital and recurrent expenditure for (2000-2010)

\[
\text{GDP} = -8.07 - 0.003 \text{ CAP EXP} - 0.006 \text{RECURRENTEXP} \quad \text{(1)}
\]

- \(R\)-bar square = 0.275  
- \(F\) = 2.705  
- DW = 2.22

Notes: 1. Figures in parentheses are t-values  
2. The signs * denote the results are significant at 5 percent level of significance respectively

The estimation results reveal that the explanatory variables jointly account for approximately 8.07 percentage changes in economic growth. The Durbin Watson statistic (2.22) illustrates the absence of auto correlation. The estimation results show that the variables- total capital expenditure (TCAP), total recurrent expenditure (TREC), are not significant in explaining economic growth. For instance, 1 percentage increase in total capital expenditure in the ten year causes economic growth to decline by 0.003 percentages. Similarly, a 1 percentage increase in total recurrent expenditure in the previous one year leads to 0.006 percentage decrease in economic growth. These findings are in line with the one reported by Laudau, (1986); Barro, (1991); Skinner, (1992) that government expenditure may slowdown economic growth. The negative impact of total capital and recurrent expenditures may not be unconnected with mismanagement and diversion of public funds by government officials and political appointees. This is not surprising because funds meant for the development have not been properly utilized and in most cases embezzled.

**Nepalese situation**

Nepal is in the process of federalism system in its constitution. Fiscal federalism constitutes the core and difficult area of federalism which measures the degree of division of powers among the constituent units of federations for the financial power is an engine of every activity. It is tough area for natural resources are limited and endowed unevenly from place to palace and constitutional redistribution is not fairly accepted by all concerned. In a geographical area of more than one level of government, allocation of revenue sources and expenditure responsibilities are elementary subject matters of fiscal federalism. Invariably, in all federations the allocation revenue sources follows the allocation of expenditure responsibilities which in turn signifies the division of powers and functions. The federations’ system of divisions of powers and functions easily reflects in fiscal federalism. Other elements of fiscal federalism are the extensions of the two main subjects that as unavoidable problems and their solution. These are fiscal imbalances which are caused by the gap between allocation of expenditure and allocation of revenue sources both vertically between the states and the center and horizontally among the states. These problems quest constitutional methods of solution. Some of the schemes involve fiscal transfer from one level of government to the
other, mostly from the center to the states. In addition, the whole machinery of fiscal federalism is geared by some specific institutions which are this effect. While initiating fiscal federalism it is essential to analyzed relation between state expenditure and economic growth in the Nepalese economic system.

CONCLUSION

Following the results reported in the preceding section, the authors make the following recommendations. Firstly, government should ensure that capital expenditure and recurrent expenditure are properly managed in a manner that it will raise the nation’s production capacity and accelerate economic growth. Secondly, government should increase its investment in, energy, transport and communication sectors, since it would reduce the cost of doing business as well as raise the profitability of firms. Thirdly, government should encourage the education and health sectors through increased funding, as well as ensuring that the resources are properly managed and used for the development of education and health services. Lastly, government should increase its funding of anti-graft or anti-corruption agencies like the Economic and Financial Crime Commission, (EFCC) Commission for investigation of abuse of authority (CIAA), and the Independent Corrupt Practices Commission (ICPC) auditing and accounting agencies in order to arrest and penalize those who divert and embezzle public funds.

REFERENCE


