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Nepal Competitiveness Index

Nepal Competitiveness Index 2025

Supporting Nepal's Journey Towards Effective Planning

Foreword by
Deependra Bahadur Kshetry

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A joint research initiative of

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Asia Competitiveness Institute

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Supporting Nepal's Journey Towards Effective Planning

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About Publishers

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Asia Competitiveness Institute (ACI)

The Asia Competitiveness Institute (ACI) was established in August 2006 as a research center at the Lee Kuan Yew School of Public Policy (LKYSPP), National University of Singapore (NUS). It aims to build intellectual leadership and network for understanding and developing competitiveness in Asia. ACI seeks to contribute to enhancing inclusive growth, living standards, and institutional governance through competitiveness research on sub-national economies in Asia.

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Preface

Nepal's expected graduation from the Least Developed Country (LDC) category in 2026 marks a significant milestone, but it also brings significant challenges such as reduced concessional financing and the potential loss of trade preferences. In this evolving context, ensuring balanced and sustainable progress across all seven provinces is more critical than ever.

To inform this transition, the Asia Competitiveness Institute (ACI), in collaboration with the Nepal Institute for Policy Research (NIPoRe), has launched the Nepal Competitiveness Index (NCI) 2025. This edition focuses on the strategic allocation of Official Development Assistance (ODA) funds by the Nepalese government, assessing how these resources are distributed to meet local needs and promote sustainable growth across the provinces. Given that ODA contributions are often influenced by Nepal's LDC status, our study offers a timely and quantitative evaluation of the potential impacts that graduating from the LDC category could have on subnational disparities.

Since 2013, ACI has been conducting in-depth sub-national economic analyses, including studies across ASEAN countries, which have received widespread recognition at various seminars and forums. In 2022, ACI and NIPoRe launched the first edition of the NCI, providing a data-driven benchmark for assessing provincial competitiveness in Nepal. In the following year, we expanded our analysis to include the rapidly growing digital economy of Nepal. The findings from these reports have been shared with federal and provincial ministries and key development partners, helping to shape more realistic local economic development plans and policies.

Building upon our previous efforts, the NCI 2025 report incorporates findings from the "Provincial Competitiveness Perception Survey" and blends quantitative data with qualitative stakeholder feedback. As Nepal navigates its evolving policy landscape and approaches its LDC graduation, the comprehensive insights from the NCI 2025 are particularly valuable. We are dedicated to continuing this insightful journey to assess and support Nepal's ongoing development.

Professor Paul Cheung, PhD

Director, Asia Competitiveness Institute
Lee Kuan Yew School of Public Policy
National University of Singapore

Foreword

Nepal is set to graduate from the Least Developed Countries (LDC) category to developing countries in 2026 . Graduating from LDC status reflects significant strides in improving social and economic indicators and gaining economic resilience. However, this progress comes with significant new opportunities and challenges. Considering Nepal's current economic and political realities, if improvement in those fields cannot be achieved, Nepal will likely face several difficulties.

Some implications Nepal will face post-LDC-graduation are a decline in annual official development assistance (ODA) net flow and the loss of trade preferences to benefit the LDCs. To benefit from the graduation, Nepal must strengthen domestic capacities, boost productivity, and create policies that ensure sustained economic growth. This is an opportune time for Nepal to capitalise on the opportunities offered by greater global integration while effectively addressing the hurdles of this transition. Considering this, the present edition of the Nepal Competitiveness Index book has a separate chapter on Nepal's LDC graduation plans and possible implications, mainly on provincial governments from an ODA perspective.

Moreover, the book ranks Nepal's seven provinces based on sixty-four indicators categorised into four distinct environments relevant to growth and development. I am sure the key insights from this book will help planners and administrators at the apex and province levels under federalism identify significant areas for policy interventions to improve the provinces' competitiveness.

Unlike previous NCI books, NCI 2025 incorporates findings from the provincial competitiveness perception survey. This not only helps the researchers to rank provinces based on secondary data but also assists in identifying the key gaps between the available data and the ground realities. The present edition will undoubtedly support all stakeholders at the policy level to base on actual situations rather than on perceived conditions in the provinces to rectify anomalies. By doing so, the stakeholders pave the way by creating a conducive environment to facilitate achieving the Sustainable Development Goals (SDGs) by 2030.

In Nutsheel, the NCI 2025 will prove useful for all policy stakeholders interested in supporting Nepal's efforts to make the provincial governments more cooperative. I wish this critical endeavour great success in driving Nepal's sustained growth and prosperity in the future.

Deependra Bahadur Kshetry

Former Vice Chairperson, National Planning Commission (NPC), Government of Nepal
Former Governor, Nepal Rastra Bank (NRB)

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Executive Summary

Introduction

The Nepal Competitiveness Index (NCI) 2025 is the third edition of the book published by the Nepal Institute for Policy Research (NIPoRe) and the Asia Competitiveness Institute at the Lee Kuan Yew School of Public Policy, National University of Singapore.

The NCI 2025 ranks Nepal's seven provinces based on 64 indicators spread across four environments, namely

(i) Macroeconomic Stability,

(ii) Government and Institutional Setting,

(iii) Financial, Business, and Manpower Conditions, and

(iv) Quality of Life and Infrastructure Development.

In addition, the current edition of NCI books also highlights the key insights from the NIPoRe-administered provincial competitiveness perception survey conducted by interviewing 280 business executives from seven provinces. Furthermore, the book also contains a separate chapter that discusses Official Development Assistance (ODA) flows to Nepal in the light of Nepal's LDC graduation plans.

Finally, based on the main ranking and key insights from the provincial competitiveness perception survey and analysis of ODA and Nepal's LDC graduation plans, the book makes actionable policy recommendations.

Research Methodology

The NCI 2025 uses primary and secondary data to undertake competitiveness ranking analysis for seven provinces of Nepal. For the main ranking, the study employs a competitiveness framework designed by the Asia Competitiveness Institute customised to fit into the Nepali context. In addition, the analysis also uses the equal weights methods and *what-if* analysis to compute seven provinces' overall and environment rankings.

On the other hand, the provincial competitiveness perception survey uses stratified, convenience, snowball, and purposive sampling techniques to collect perceptions of 280 provincial business executives, with each province consisting of 40 such executives.

Key Takeaways from Competitiveness Ranking Analysis 2025

Macroeconomic Stability

» **Under the Macroeconomic Stability Environment, Bagmati secured the top position in both 2022 and 2023 due to its robust economic activities, while Karnali and Sudurpaschim consistently ranked at the bottom due to infrastructural and geographic impediments.** Bagmati, known for its strong economic foundations, performed better in economic indicators such as Gross State Domestic Product (GSDP), GSDP growth, and foreign direct investment (FDI). The province also has a strong industrial base pivotal in Nepal's trade and commerce.

» **Gandaki has made notable progress, moving from fourth rank in 2022 to second rank in 2023**, leveraging its rich natural resources to bolster tourism and hydroelectric power, boosting its economic output, and enhancing energy security. Lumbini also improved its ranking, moving from 2022 to 2023. Its growth is supported by diversified economic activities in agriculture and industry, coupled with strategic advantages in trade due to its proximity to India.

» **Meanwhile, Madhesh slipped from second to third place in 2023** but continued to show economic strength through its agricultural sector and trade hub, especially with India. On the other hand, **Koshi demonstrated a favourable recovery trajectory, climbing from fifth to fourth rank thanks** to substantial infrastructure investments supporting agricultural productivity and improved connectivity.

» **Despite some progress, Sudurpaschim and Karnali remain the lowest-ranked provinces in Nepal, each improving only marginally from seventh to sixth place in 2023.** Both regions face significant challenges due to their rugged terrain and remote locations, which restrict industrial activity and limit economic opportunities. Efforts to enhance their economic conditions have been insufficient, particularly in developing key secondary and tertiary industries. The lack of a sustainable industrial base and difficulties in attracting investment exacerbate their struggles. At the same time, geographic isolation and a shortage of development projects hinder their ability to boost economic growth and elevate living standards.

Government and Institutional Setting

» **Bagmati remains the top performer in 2023 in the Government and Institutional Settings Environment.** The key indicators boosting the province in this environment are foreign companies, public and private limited companies, government revenue, and bank deposits.

» **Lumbini ranks second in 2023.** The province's progress indicates reinforcing fiscal management and establishing improved governance structures essential for cultivating a competitive economic environment. Furthermore, the province has demonstrated commendable performance regarding improving provincial government efficacy and the incidence of corruption cases filed per 10,000 population indicators.

» **Madhesh slipped the most among the four environments in the Government and Institutional Settings.** The province has consistently had ruling government coalitions that do not align with the federal government coalitions. This has led to difficulties in executing policies that align with the provincial government's demands and thus continues to affect Madhesh's budget balance.

» **Koshi has progressed from fourth in 2022 to third rank in 2023.** The improvement indicates effective governance reforms and better policy execution. However, the provincial government has yet to work to increase government consumption expenditure to stimulate economic growth and competitiveness.

» **Gandaki's ranking remained the same, in fifth position, moving from 2022 to 2023.** Despite being a comparatively strong performer, the province faces significant challenges, especially across key competitiveness factors such as tax revenue and high dependence on financial transfers from the federal government. Moving forward, Gandaki could prioritise addressing these key issues to enhance its overall and environment-wise competitiveness. Expanding the tax base and improving revenue mobilisation could allow Gandaki to achieve more fiscal autonomy.

» **Karnali performs poorly in the Governmental and Institutional Settings environment.** The province should optimise government consumption expenditure to improve infrastructure and public services, fostering a competitive business environment. Simultaneously, enhancing law enforcement by increasing the police-to-population ratio will strengthen security and stability, attract investment, and promote economic growth. These, all together, could help Karnali perform better in the future.

» **Sudhurpaschim ranks consistently at sixth rank in 2022 and 2023.** The province must enhance its capacity by fostering effective collaboration with the federal government. This collaboration will promote policy stability, optimise resource allocation, and improve governance, ultimately creating a favourable business climate, attracting investment, and boosting economic competitiveness.

Financial, Business, and Manpower Conditions

» **Bagmati remains at the top in 2022 and 2023.** This shows that the province excels in all areas of this environment, including financial deepening, business efficiency, labour market flexibility, and productivity performance. The province should also prioritise implementing diversified incentive policies to maintain its economic competitiveness.

» **Koshi performs strongly in this environment, ranking consistently in the second position in 2022 and 2023.** This stability reflects the province's strong commercial sector that can support economic growth bolstered by workshops and training aimed at innovation-driven provincial prosperity. Moving forward, the province should work on expanding industrial training institutes to enhance workforce skills and align labour supply with industry demands. A skilled labour force boosts productivity, attracts investment, and strengthens trade capacity by improving the quality and competitiveness of locally produced goods and services, driving overall economic competitiveness.

» **Gandaki ranks third in 2022 and 2023.** While the province's stable rankings in both years indicate that Gandaki has maintained its relative competitiveness in this area, there is still room for improvement. The province should strengthen wages and salaries, agricultural wages, total workforce, and industrial training institutes to enhance economic competitiveness through a well-functioning labour market. Higher wages in agricultural and non-agricultural sectors could further improve worker motivation and productivity, attracting skilled labour and thus reducing outmigration. Expanding industrial training institutes could ensure a steady supply of qualified workers, aligning workforce capabilities with industry needs. A well-trained and fairly compensated workforce increases industrial efficiency, boosts agricultural output, and enhances trade competitiveness, driving economic growth.

» **Lumbini ranks fourth in 2023.** The province should improve wages and salaries to enhance overall labour productivity, strengthening economic competitiveness. Fair and competitive wages motivate workers, increasing efficiency and skill retention. As labour productivity rises, businesses experience lower costs per unit, increased output, and greater competitiveness in trade and investment. A more productive workforce drives economic growth, making the province an attractive industry destination.

» **Sudurpaschim maintains its fifth rank in both 2022 and 2023.** The province should work on expanding bank offices to enhance financial activities and support the total workforce, driving economic competitiveness. Increased banking access facilitates credit for businesses, enabling expansion and job creation. Easier financial services also encourage entrepreneurship, improve wage payments, and promote financial literacy among workers. As companies grow and employment opportunities increase, a well-integrated banking network helps mobilise savings and investments, strengthening the overall labour market and economic growth.

» **Karnali ranks in sixth position in 2023.** The province should work on increasing the total workforce in alignment with the growth of secondary industries to enhance value-added per worker and drive economic competitiveness. A larger, skilled workforce supports the expansion of secondary industries, such as manufacturing, by ensuring a steady labour supply. As these industries grow, productivity per worker increases, leading to higher value-added output. This boosts efficiency, lowers production costs, and enhances the province's competitiveness in domestic and international markets.

» **Madhesh ranks lowest in this environment, seventh in 2022 and 2023.** The province should improve overall labour productivity and reduce the unemployment rate (urban) to enhance economic competitiveness. Higher labour productivity leads to more efficient use of resources, increasing output and reducing production costs. Simultaneously, lowering the urban unemployment rate helps integrate more people into the labour market, increasing the available skilled workforce and reducing dependency. These factors foster a more dynamic and competitive economy, attracting investment, boosting wages, and driving sustainable economic growth.

Quality of Life and Infrastructure Development

» Under the Quality of Life and Infrastructure Development environment, **Bagmati maintained its rank as the best-performing province in 2023, driven by strong performance in indicators related to the standard of living and social stability.** This was followed by Gandaki, the second-best performing province, consistently prioritising expenditure and investments in critical development factors such as health and education. **While the performance gap between Bagmati and Gandaki remains, the overall standard of living and social stability is higher in Gandaki compared to those in Bagmati**, with strengths such as high power generation capacity, which has created a conducive environment for developing other critical infrastructure.

» **Comprehensive reforms need to be implemented to improve the overall quality of life and develop its critical infrastructure in Madhesh.** It is the least competitive province in this environment, with the lowest literacy rate among provinces and low mobile penetration. Limited investments and prioritisation in the health, education, and power generation sectors impact Sudurpaschim's competitiveness. However, It has significant potential to improve its competitiveness by focusing on some of these weakest-performing indicators.

» **Building on the positive momentum in Lumbini is critical to improve its competitiveness in this environment further, given that its ranking improved from fourth in 2022 to third in 2023.** Improving physical infrastructure such as roads and power generation capacity could significantly propel overall competitiveness and long-term development. **Koshi and Karnali, which rank fourth and fifth in 2023, are neither at the forefront nor behind in terms of competitiveness but require ongoing development efforts in health, education, power generation, and road infrastructure to enhance long-term growth.**

Key Takeaways from Provincial Competitiveness Perception Survey 2025

Macroeconomic Stability

» The 2025 Provincial Competitiveness Perception Survey provides a detailed assessment of macroeconomic stability across Nepal's seven provinces. It analyses three critical dimensions: regional economic vibrancy, openness to trade and services, and attractiveness to foreign and local investors.

» **Regarding regional economic vibrancy, Gandaki Province excels, registering an 80 percent satisfaction rate concerning economic growth, considerably higher than the national average of 43 percent.** This high level of satisfaction across various age groups reflects strong economic health and robust conditions. **In stark contrast, Madhesh exhibits profound economic challenges, with a 98 percent dissatisfaction rate among its local businesses, underscoring severe economic distress. Koshi and Lumbini provinces show moderate satisfaction levels, suggesting areas with potential for economic advancement.**

» The Perception Survey underscores varied satisfaction levels with trade openness across Nepal's provinces regarding export and import performance disparities. **Gandaki leads with robust export satisfaction at 75 percent and import satisfaction at 70 percent, significantly above national averages**, demonstrating its adequate trade infrastructure. Conversely, provinces like **Karnali and Lumbini face severe barriers, with dissatisfaction rates as high as 80 percent and 78 percent for exports and 55 percent for imports** in Lumbini, indicating substantial challenges in trade competitiveness.

» The survey highlights notable disparities in perceptions of attractiveness to Foreign Investors. **Nationally, dissatisfaction with foreign direct investment (FDI) is high at 87 percent**, reflecting significant barriers to attracting foreign capital. However, **local investment shows a more positive outlook, with a 54 percent satisfaction rate at the national level**. Gandaki Province leads in both categories, showing a 33 percent satisfaction rate for FDI and 85 percent for local investments, indicating its strong appeal to investors. Conversely, provinces like **Karnali, Lumbini, and Madhesh report overwhelming dissatisfaction across both parameters**, signalling substantial challenges in creating conducive investment environments.

» The 2025 Provincial Competitiveness Perception Survey highlights critical areas of strength and concern within Nepal's macroeconomic landscape. **Gandaki Province emerges as a model of economic vibrancy and investor appeal, whereas other provinces, particularly Madhesh, Karnali, and Lumbini, face substantial economic and trade challenges.**

Government and Institutional Setting

» **Entrepreneurs from Madhesh and Lumbini are most dissatisfied with budget formulation transparency.** These provinces report a mere three percent satisfaction score, indicating a need for reforms in fiscal policy transparency. Medium and large business entrepreneurs exhibit the lowest satisfaction, likely due to their frequent interactions with government institutions regarding fiscal policies and tax structures, unlike micro and small enterprises.

» **Bagmati has the highest dissatisfaction with transparency in the budget formulation process among entrepreneurs.** The level of engagement of these enterprises and associations with the government is higher, possibly one reason Bagmati scored higher than the rest of the provinces.

» **Entrepreneurs from Karnali face the highest difficulties in registering a business.** Eighty percent of Karnali entrepreneurs reported problems registering their businesses, partly due to geographic challenges and limited road access. This hinders their ability to reach administrative offices, increasing the time and cost of registration while limiting access to vital information and resources.

» **Entrepreneurs in Madhesh report the highest level of perceived corruption, while those in Koshi report the lowest.** These findings indicate that provinces have fragile governance systems, allowing weak enforcement of anti-corruption measures and local political dynamics to encourage corrupt practices.

Financial, Business, and Manpower Conditions

» **Executives from Madhesh, Karnali, Lumbini, and Sudurpaschim indicate poor access to finance as one of the key limiting factors to expand their businesses.** To address this, the provincial governments should work on further expanding the financial infrastructures in the lower-ranked provinces through increasing formal bank outreach, promoting digital financial services, and supporting microfinance institutions. Additionally, targeted credit programs and policy incentives can enhance easy access to all available financial resources, thus fostering higher economic growth across all provinces.

» **Respondents from Madhesh, Karnali, and Gandaki report a scarcity of qualified professionals to undertake available opportunities in the provinces.** This problem arises from limited industrial growth, low wage competitiveness, and significant labour migration to overseas job markets. The provincial governments could address these issues by investing in in-demand skill development schemes, increasing wages as per the growing living costs, and also creating local job opportunities to reduce the outmigration of Nepalis.

» **Bagmati reports satisfaction with the women's role in local industries.** The business executives' satisfaction with women's roles in local industries is likely due to better access to education, skill development programs, and inclusive workplace policies. Strong industrial presence, higher labour demand, and supportive government initiatives have also created more opportunities for women's participation in the workforce.

» **Respondents from Karnali report the highest dissatisfaction with investment in the workforce.** Limited industrial development, inadequate vocational training programs, and low private-sector investment drive the Province's high dissatisfaction with investment in the workforce. Geographic challenges, poor infrastructure, and high labour outmigration further hinder workforce development, reducing opportunities for skill enhancement and stable employment.

» **Political instability, poor access to finance, corruption, and skills mismatch are significant obstacles in most provinces.** These challenges undermine economic competitiveness by fostering an uncertain business environment, discouraging investment and productivity. Instability disrupts policy and planning, poor finance access limits expansion and entrepreneurship, and corruption raises costs and erodes trust, deterring investors. Skills mismatch also causes industries to struggle for qualified workers, reducing productivity and innovation. These factors collectively hinder economic growth and competitiveness across provinces.

Quality of Life and Infrastructure Development

» **The respondents from most provinces report that their current health spending is not perceived as sufficient to meet their needs and expectations fully.** Gandaki is the only province with higher levels of satisfaction regarding health spending, with only 25 percent reporting dissatisfaction. Concerning the availability of health services, perceptions differ by province. Negative perceptions are exceptionally high in Madhesh, followed by Sudurpaschim and Karnali. Conversely, satisfaction levels are high (over 50 percent) in Gandaki, Lumbini, Bagmati, and Koshi.

» **Ongoing investment in education, particularly science and technology, must be a priority for many provinces.** The perception survey results indicate that at least 40 percent of the respondents across all provinces are dissatisfied with the availability of educational opportunities. The majority of respondents expressed dissatisfaction in Madhesh and Karnali. Addressing short-term needs as well as systematic issues within the education sector is critical.

» **Road infrastructure and connectivity are essential to accelerating growth and development in provinces.** At the national level, satisfaction levels with the quality of road infrastructure are relatively moderate (at least 40 percent) across all economic sectors (i.e. agriculture and tourism, among others) compared to other indicators of quality of life and infrastructure development. However, **dissatisfaction levels are high in Karnali and Sudurpaschim.** Improving connectivity between provinces and rural and urban areas within a province will boost overall competitiveness.

» Large-scale infrastructure projects play a key role in creating job opportunities and improving the livelihoods of communities. **All provinces have expressed extreme dissatisfaction with their governments' major infrastructure projects, which are the most prominent in Karnali and Gandaki.** Delays in completing provincial pride projects and their contribution towards livelihood creation may hurt perceptions across provinces. Implementing regular monitoring and accountability of large-scale infrastructure projects will be an essential way forward.

Nepal's LDC Graduation Plan and Development Finance

Macroeconomic Stability

- **As Nepal approaches its graduation from LDC status, strategic utilisation of ODA is crucial for addressing provincial disparities in macroeconomic stability.**

- In 2023, Koshi Province saw an increase in ODA, aiding in moderate improvements despite challenges like high unemployment and weak government expenditure. Madhesh Province experienced a significant reduction in ODA, emphasising the need for focused investment in vocational training and healthcare to address its high unemployment and low literacy rates. Bagmati Province received the highest ODA, which bolstered its robust economic growth, though more investment is imperative in addressing public health and educational disparities.

- Gandaki Province also enjoyed increased ODA, supporting its high literacy rates and low unemployment, though it faces issues with revenue collection and agricultural wages. Despite its cultural significance and potential in tourism, Lumbini Province saw a decrease in ODA, highlighting the necessity for enhanced health and education infrastructure. Karnali and Sudurpaschim experienced reductions in ODA; they need targeted funds to improve their poor infrastructure, road networks, and literacy rates.

- Properly channelling ODA to these provinces' specific needs is essential for fostering sustainable economic growth and ensuring successful graduation from LDC status.

Government and Institutional Setting

- **Low Government Consumption Expenditure in Koshi, Bagmati, and Lumbini.** These provinces allocate limited funds to public services due to underfunding or a policy preference for private sector-driven growth. This can harm long-term competitiveness and exacerbate inequalities. ODA can co-finance targeted public investments through conditional grants tied to performance, incentivising spending on social development and skill enhancement programs.

- **Weak Government Strength in Koshi, Karnali, and Sudurpaschim.** Political misalignment between federal and provincial governments makes it challenging to execute development plans. Provinces can promote cross-party dialogues and policy coordination programs through development assistance, facilitating policy alignment workshops and cross-level task forces to formulate joint development frameworks.

- **Low Police Per Capita in Bagmati and Lumbini.** While entrepreneurs in these provinces report satisfaction with security, a low police count increases the potential for crime. ODA can support crime data mapping, community policing initiatives, and security education programs to enhance law enforcement and community safety efficiency.

- **Stagnant Private Sector Growth in Lumbini.** The province has seen no significant increase in foreign and limited companies, indicating low private investment or a large informal sector. ODA can support business incubators, targeted access-to-finance programs, and tax incentives for formalisation, helping create a stronger entrepreneurship ecosystem.

- **Political Misalignment in Madhesh.** Madhesh has consistently ranked the lowest in federal-provincial political alignment, limiting its ability to implement development programs. Development partners can facilitate policy coordination through joint workshops and task forces to improve intergovernmental cooperation.

- **Weak Tax Revenue Collection in Bagmati and Gandaki.** Inefficient tax collection indicates issues with tax evasion and leakage in provincial taxes. To improve tax collection and boost revenue, ODA can facilitate digital tax management, develop online taxpayer databases, and implement technology-based compliance strategies, including satellite imagery and online advertisement registries, to optimise tax collection and enhance compliance measures.

Financial, Business, and Manpower Conditions

- **Declining ODA Trends.** In Koshi, ODA peaked at USD 72.1 million in 2019 but fell to USD 9.57 million in 2021. Similarly, Lumbini's ODA dropped from USD 65.1 million in 2018 to USD 11.3 million in 2023. These reductions indicate a decrease in external financial aid, which may severely constrain the provinces' ability to foster business growth, enhance workforce skills, and promote industrial expansion.

- **Financial Infrastructure Disparities.** Bagmati's financial infrastructure is strong, with Bank Deposits and Bank Credit among the top 20 indicators nationally. This supports economic activities and boosts business growth, investment, and financial inclusion. In contrast, provinces like Madhesh and Sudurpaschim have limited financial infrastructure. Madhesh has a high population-to-bank ratio indicates poor access for entrepreneurs and households. Sudurpaschim struggles with few bank offices, limiting saving, investing, and credit access.

- **Labor Market Challenges.** Koshi, Gandaki, and Karnali struggle with labour market inefficiencies hindering economic growth. Koshi excels in wages and secondary industry but lacks Industrial Training Institutes (ITIs), essential for vocational training that enhances workforce employability and productivity. Without more ITIs, aligning workforce skills with industry demands remains a challenge. Gandaki faces low workforce participation, while Karnali's rate restricts economic activity. Targeted interventions, including increased investment in vocational training and skills development, are needed to improve workforce participation and unlock these provinces' economic potential.

- **Weak Industrial Growth.** Secondary industries and value added per worker are weak in Madhesh, Karnali, and Lumbini. Despite a large labour force, Madhesh's industrial growth is stagnant, reflected by low performance in secondary industries. Karnali and Lumbini also have underdeveloped sectors, limiting economic diversification and industrial progress restricting productivity and wage growth. Official Development Assistance (ODA) could enhance infrastructure and technology, promoting industrial growth and modernising these regions.

» **Need for Financial and Workforce Investments.** Investing in financial infrastructure and workforce development is essential to address financial and labour market challenges. Expanding the banking sector in Madhesh and Sudurpaschim through ODA can enhance access to credit and savings, promoting economic participation and growth. Strengthening ITIs in Koshi, Gandaki, and Karnali is vital for improving labour skills and productivity to meet industry needs. Prioritising industrial modernisation and adopting new technologies in Madhesh, Karnali, and Lumbini will boost competitiveness. ODA investments targeting financial, workforce, and industrial needs will create a strong foundation for economic resilience in these provinces.

Quality of Life and Infrastructure Development

» **Much of the ODA to provinces thus far has been directed towards improving quality of life and infrastructure development, and it has played a significant role in driving progress in these areas.** As Nepal plans to graduate from the LDC status, sustaining this momentum is essential.

» **Future development assistance needs to be more targeted, building upon the progress made in the past decade and supporting Nepal's long-term development.** Strategic allocation of ODA can address systematic challenges and bridge disparities within the education sector, particularly in Karnali and Madhesh. Likewise, ODA can be crucial in building resilient and self-sustaining healthcare systems across all provinces, particularly in Madhesh, Koshi, Sudurpaschim, and Lumbini.

» **Another key area that provinces could particularly benefit from ODA is digital literacy and transformation.** Leveraging the power of development assistance to de-risk private sector investments in the sector could accelerate progress toward digital transformation across all provinces. Provinces must strategically identify areas within health, education, road infrastructure, and digitisation where ODA can have maximum impact.

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The Nepal Competitiveness Index (NCI) 2025 is prepared by a team of researchers at the Nepal Institute for Policy Research (NIPoRe) and the Asia Competitiveness Institute (ACI) at the Lee Kuan Yew School of Public Policy, National University of Singapore. NIPoRe Director Jaya Jung Mahat led the study team of Nischal Dhungel, Samridhi Pant, Juria Sato Bajracharya, Siddhartha Rayamajhi and Dr Yi Xin. The entire study was completed under the advice and guidance of ACI Director Professor Paul Cheung. Anil Chaudhary supported in cleaning and analysing provincial competitiveness perception survey data. Saurav Thapa Shrestha managed the overall design of the document.

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List of Abbreviations

ACI	Asia Competitiveness Institute
ADB	Asian Development Bank
CEHRD	Center for Education and Human Resource Development
COVID-19	Coronavirus Disease 2019
CPI	Corruption Perception Index
DNF	Digital Nepal Framework
EC	Election Commission
EVI	Environmental Vulnerability Index
FDI	Foreign Direct Investment
FY	Fiscal Year
GDP	Gross Domestic Product
GHI	Global Hunger Index
GoN	Government of Nepal
GSDP	Gross State Domestic Product
HAI	Human Assets Index
IMF	International Monetary Fund
ISAS	Institute of South Asian Studies
ITU	International Telecommunication Union
LDC	Least Developed Countries
MCC	Millennium Challenge Corporation
MoCIT	Ministry of Communications and Information Technology
MoEST	Ministry of Education, Science and Technology
MoF	Ministry of Finance
MoFAGA	Ministry of Federal Affairs and General Administration
MoICS	Ministry of Industry, Commerce and Supplies
MoLESS	Ministry of Labor, Employment and Social Security
MoPIT	Ministry of Physical Infrastructure and Transport
NCI	Nepal Competitiveness Index

NGOs	Non-Governmental Organizations
NIPoRe	Nepal Institute for Policy Research
NNRFC	National Natural Resources and Fiscal Commission
NPC	National Planning Commission
NPR	Nepali Rupees
NSO	National Statistics Office
NTA	Nepal Telecommunications Authority
NTIP	Nepal Trade Information Portal
ODA	Official Development Assistance
OPMCM	Office of the Prime Minister and the Council of Ministers
PSC	Public Service Commission
SAARC	South Asian Association for Regional Cooperation
SDM	Spatial Durbin Model
TI	Transparency International
UN-OHRLLS	The United Nations Office of the High Representative for the Least Developed Countries, Landlocked Developing Countries and Small Island Developing States
USD	US Dollars
WBG	World Bank Group
WEF	World Economic Forum

01

Introduction

Chapter 1 Introduction

Introduction

Nepal's post-2022 election political instability, marked by shifting coalitions has hindered development and weakened provincial and national competitiveness.

1.1 Evolving Political and Governance Events

Nepal held its second round of elections for all three tiers of the government in 2022 since it was declared a federal republic in 2015. The elections resulted in no party garnering a majority at the federal and provincial levels. Consequently, the traditional national parties resorted to Nepal's decades-long tradition of forming coalitions to run the country. Less than two years after the elections three coalition governments have been formed. Since the 2022 elections, Nepal has already had two Prime Ministers, with a third one in line to run the government till the next election cycle under the current coalition. This instability at the federal level trickled down to the provincial governments with provinces witnessing the change in government based on the coalition structures formed at the federal level. Such a volatile political environment has pushed development agendas to the backseat, eroding the competitiveness of all provinces and the national economy as a whole, thus further limiting the ability of the provinces to prioritise key competitiveness targets.

In 2023, multiple frauds and scams involving political elites and bureaucrats surfaced, provoking nationwide protests and heightened public scrutiny. Two high-profile national cases that questioned the transparency of Nepal's institutions and had political and economic repercussions were the Bhutanese refugee scam and the Cooperatives fraud. The Bhutanese Refugee Scam revealed the involvement of top bureaucrats and political elites who racked millions from Nepalis to send them to the United States under the United Nations High Commissioner for Refugees program of resettlement of the Bhutanese refugees residing in Nepal. Over 30 individuals, including a former deputy prime minister and former ministers, were prosecuted for treason, organised crime, fraud, and forgery, and 16 of them have been charged with jail sentences. This case tarnished Nepal's international reputation and undermined trust in its governance and institutional integrity.

On the other hand, the cooperative's fraud has shaken public trust in one of Nepal's major institutions – the cooperatives, the third pillar of Nepal's democracy. As of now, more than 55 thousand victims have filed complaints against 503 cooperatives from all provinces that misappropriated their deposits and demanded a compensation of NPR 11.664 billion. Similarly, 1150 people have been accused of fraud, out of which 856 people are absconding (HoR, 2024). Nationwide protests were held by victims demanding justice and accountability from the government. Accordingly, a special Parliamentary Probe Committee was formed in the lower house. The Committee, in its report (HoR, 2024), has made various conclusions on the charges against the offenders of the fraud, but one conclusion has received heightened political attention. The Committee has recommended prosecuting a member of the parliament, and former Deputy Prime Minister and Home Minister of Nepal, Rabi Lamichhane. Lamichhane is the Chairman of a newly established party formed in the 2022 elections that secured significant support from the public, making it the fifth-largest party in the federal parliament.

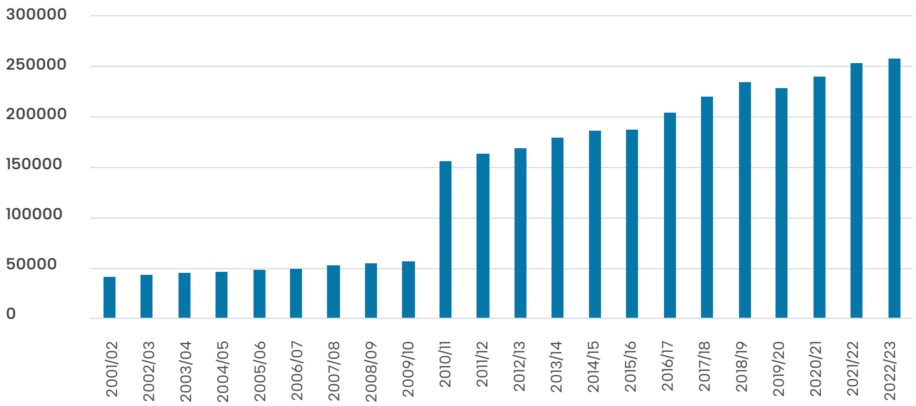
On post-pandemic recovery aspects, Nepal's economic recovery has remained sluggish. The financial activities remained constrained due to two factors. One, consumer spending was reduced massively due to increased inflation due to disruptions in global supply chains, Nepal's currency depreciation against the US dollar, and increased prices of imports. The other factor was the tightening of the monetary policy by the central bank to manage liquidity concerns and declining foreign exchange reserves resulting from the slowdown in remittance inflows and tourism earnings. These resulted in constrained credit availability for consumers as well as businesses. By the end of 2023, the country has reached comfortable levels of foreign exchange reserves as the tourism sector has gained momentum and remittance inflows are increasing. Accordingly, the central bank has relaxed the monetary policy (NRB, Aug 2024), increasing economic activity prospects. On the positive side of the economy, the Upper Tamakoshi Hydropower Project has begun generating electricity, adding 456MW to the national grid. Tourism earnings and remittance inflows hit record highs in 2023 (NRB, 2024), paving the way for increased economic growth

1.2 Nepal's Macroeconomic Outlook

1.2.1 GDP

Nepal's economic growth remained limited between 2001 and 2009, with annual GDP stagnating around an average of NPR 4.8 trillion, mainly due to Nepal's decade-long insurgency (1996 - 2006) and critical political transitions between 2005 - 2008 that resulted in the overthrow of the monarchy from Nepal and election of the country's first constituent assembly. Following years of conflict and political turmoil, Nepal's GDP increased more than three-fold in 2010, reaching NPR 15.6 trillion (Figure 1.1). GDP levels have gradually increased, albeit modestly, over the past decade, with an average growth rate of 4.3 percent. The 2015 earthquake severely disrupted Nepal's economy. However, the GDP growth rate averaged 8.08 percent following its recovery between FY 2016/17 and FY 2018/19. However, the COVID-19 pandemic hit the Nepali economy hard, resulting in a negative GDP growth rate of -2.23 percent in FY 2019/20. While the economy shows continued signs of recovery, it has not reached the pre-pandemic growth levels (Figure 1.2). The economy grew by only 1.95 percent in FY 2022/23, which was the lowest recorded in two decades, excluding the year of the COVID-19 pandemic. The National Statistics Office (NSO) estimated an economic growth rate of 3.87 percent for FY 2023/24 (NRB, 2024), slightly above the World Bank's estimate of 3.3 percent (World Bank, Apr 2024) growth rate. Nepal's GDP recovered modestly in FY 2023/24, supported by the gradual easing of monetary policy, a strong rebound in tourism, trade recovery, and services sector growth. The September 2024 edition of ADB's Asian Development Outlook (ADB, Sep 2024) projects a GDP growth rate of 4.9 percent for Nepal in FY 2024/25, primarily driven by the agriculture, tourism, and energy sectors.

Figure 1.1 GDP (Constant Price) in 10 million (FY 2001/02 – 2022/23)

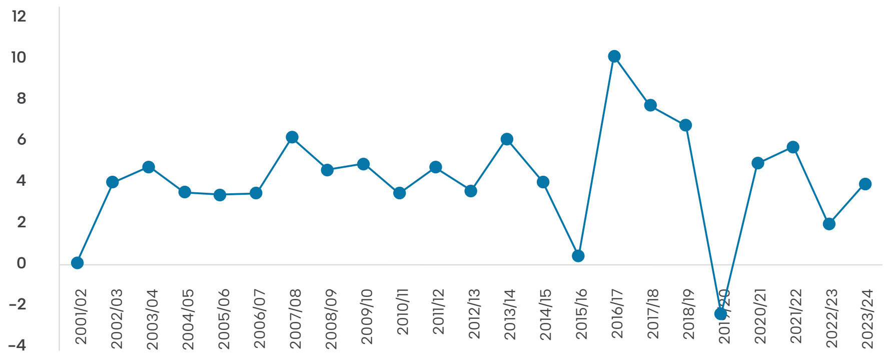


Source: Ministry of Finance, Government of Nepal

Nepal's economy has been historically stuck in a low-growth trap due to many reasons, both internal and external factors, including the decade-long Maoist insurgency, earthquakes, natural disasters, the COVID-19 pandemic, as well as frequent changes in political leadership at the centre and across provinces. In FY 2022/23, the country's economy grew by only 1.95 percent. Nepal's post-pandemic recovery has struggled with decreased domestic demand, increased interest rates, reduced credit disbursements, lack of timely realisation of targeted capital expenditures, and large-scale outmigration of the country's working population. The global economic slowdown and geopolitical uncertainty have increased energy prices and costs of essential commodities, further impacting a wide range of investment sectors of Nepal, which mostly rely on imported fuel and other necessary building materials from outside.

Nepal's per capita GDP stood at USD 1399 in FY 2022/23, an increase of approximately 70.4 percent from USD 814.3 in FY 2012/13. While there is an increasing trend, growth in GDP per capita between 2017 and 2022 has fluctuated, falling twice during this period – in FY 2019/20 and FY 2022/23. Nepal is gradually transforming from an agrarian economy

Figure 1.2 Annual GDP Growth Rate (%) (FY 2001/02 – 2022/23)

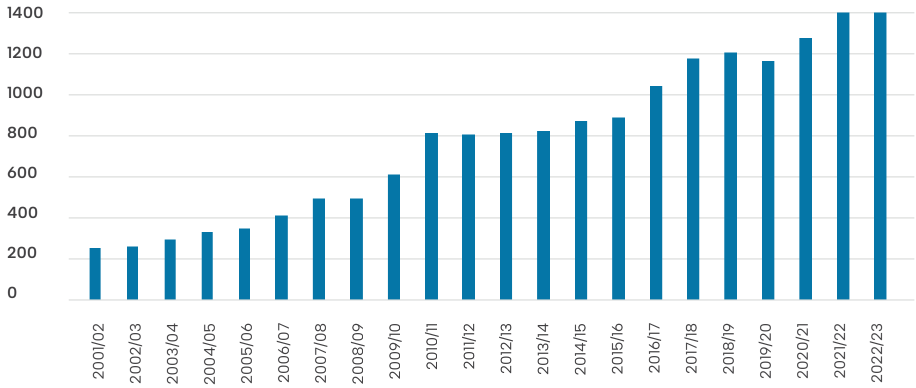


Source: Nepal Rastra Bank

to a service-based economy. Compared to FY 2021/22, the per capita GDP remained essentially unchanged. However, the average growth rate in the last decade was 9.9 percent (MoF, 2023). Regarding its GDP composition, agriculture is still a significant contributor (23.9 percent in FY 2022/23), though the sector's contribution has declined over the past two decades (NRB, 2023). There has been steady and significant growth in the service sector, with the contribution to the GDP reaching 62.4 percent in FY 2022/23. The industrial sector's contribution has remained relatively stable, standing at 13.6 percent.

At the provincial level, Gandaki is the only province estimated to have a GDP growth rate of 4.23 percent, above the national average of 3.87 percent in FY 2023/24. The GDP

Figure 1.3 Per Capita GDP (in USD) (FY 2001/02 – 2022/23

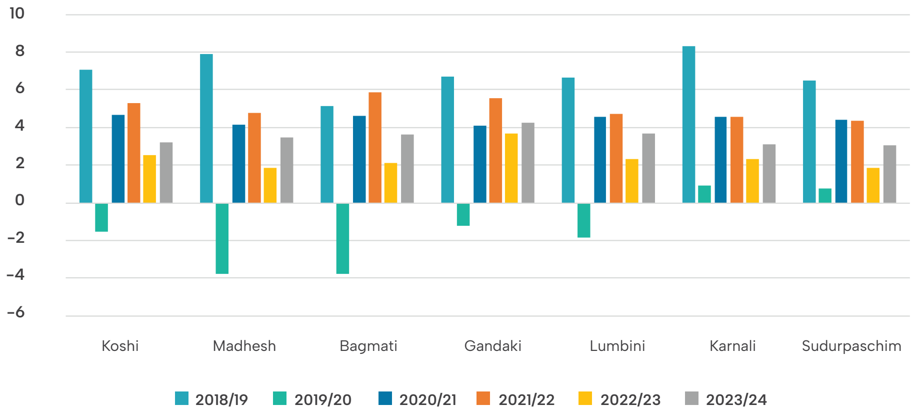


Source: Nepal Rastra Bank

of other provinces' is expected to grow at a similar rate, ranging between 3.06 percent and 3.69 percent, with the lowest growth rate in Sudurpaschim province (Figure 1.4). The COVID-19 pandemic has significantly slowed the growth of provincial economies, but it is on an upward and recovery trajectory. Bagmati has had the lowest average GDP growth rate of 2.7 percent in the last five years, and Karnali with the highest average growth rate of 4.1 percent, followed by Gandaki province.

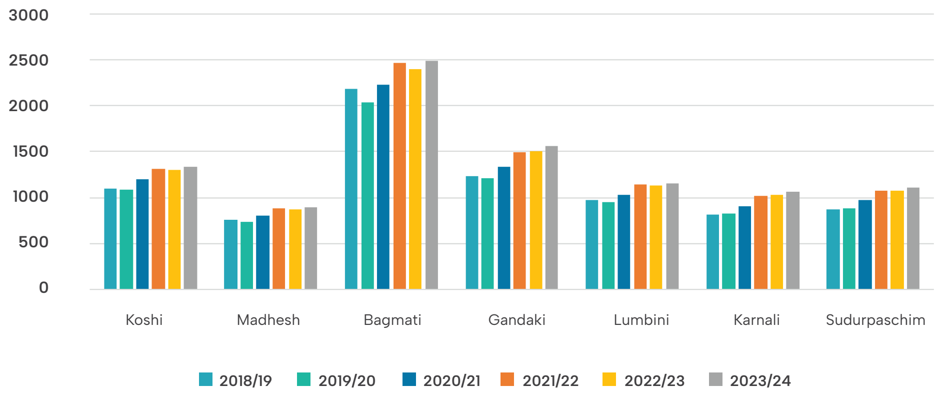
Following Nepal's transition into federalism, Bagmati province has consistently topped with the highest per capita GDP and Madhesh province with the lowest. In FY 2022/23,

Figure 1.4 Annual GDP Growth Rate for Nepal's Provinces (FY 2018/19 – 2023/24)



Source: Nepal Rastra Bank

Figure 1.5 Trends in Provincial GDP Per Capita (FY 2018/19 – 2023/24)



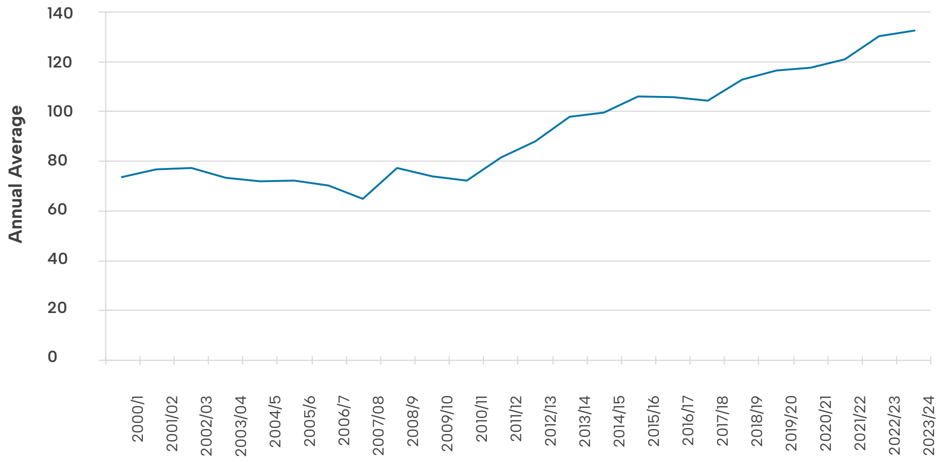
Source: Nepal Rastra Bank

Gandaki and Bagmati provinces were the only provinces with GDP per capita higher than the national average of USD 1399, reaching USD 2398 and USD 1499, respectively. For the last fiscal year (2023/24), the NSO has estimated a national GDP per capita of USD 1434 (Kafle, 2024). Excluding Gandaki and Bagmati, other provinces are expected to have GDP per capita lower than the national average.

1.2.2 Exchange Rates

Exchange rates are crucial in the global economy, influencing international trade and financial flows (Puaschunder, 2019). Exchange rate fluctuations have significant

Figure 1.6 NPR Vs. USD Exchange Rate (FY 2000/01-2023/24)



Source: Nepal Rastra Bank (NRB), Current Macroeconomic and Financial Situation(Based on Annual data of 2023/24)

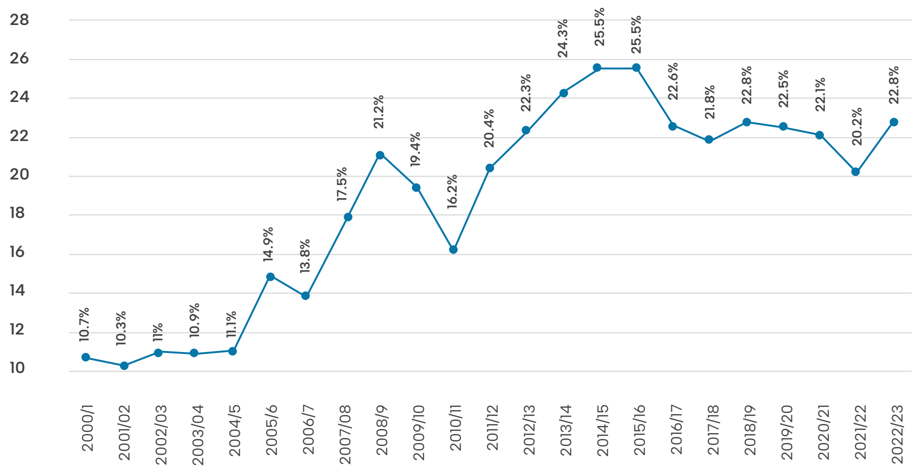
implications for economic growth and performance. Nepal's exchange rate is characterised by a fixed peg to the Indian Rupee (INR), which provides stability and limits competitiveness in international markets (Thapa, 2004; Sharma & Ghimire, 2021). Likewise, the exchange rate has been found to have short-term and long-term effects on Nepal's exports, with policy implications for increasing exports and reducing imports (Joshi et al., P., 2023).

Figure 1.6 illustrates the annual average exchange rate of the Nepali Rupee (NPR) against the US Dollar (USD) from 2000/01 to 2023/24. Over the period, the NPR has experienced a significant depreciation against the USD. In FY 2000/01, the exchange rate was 73.65 NPR per USD, and by 2023/24, it had reached 132.78 NPR per USD. This represents a nearly 80 percent depreciation of the NPR over two decades. While the exchange rate remained relatively stable between FY 2000/01 and FY 2010/11, a more pronounced depreciation occurred from FY 2015/16 onwards. The critical inflexion points, such as in FY 2015/16 and FY 2019/20, highlight periods where the NPR lost value more rapidly, driven by significant domestic and international economic challenges. In FY 2015/16, the rapid depreciation of the NPR was driven mainly by the devastating earthquake in 2015 and the subsequent trade blockade across the India-Nepal border, which led to supply shortages, inflation, and increased import demands. In FY 2019/20, the economic impacts of the COVID-19 pandemic, rising inflation, a widening trade deficit, and political instability contributed to the accelerated depreciation of the NPR.

1.2.3 Migration and Remittances

Remittance inflows are a significant source of external finance for Nepal, whose contribution accounts for almost one-fifth of the country's GDP. Nepal is the most remittance-dependent country in South Asia and stands sixth globally (NIPoRe, 2024). Over the past two decades, the contribution of remittances towards Nepal's GDP has

Figure 1.7 Contribution of Remittance to GDP (%) (FY 2000/01 - 2022/23)



Source: Nepal Rastra Bank (2023)

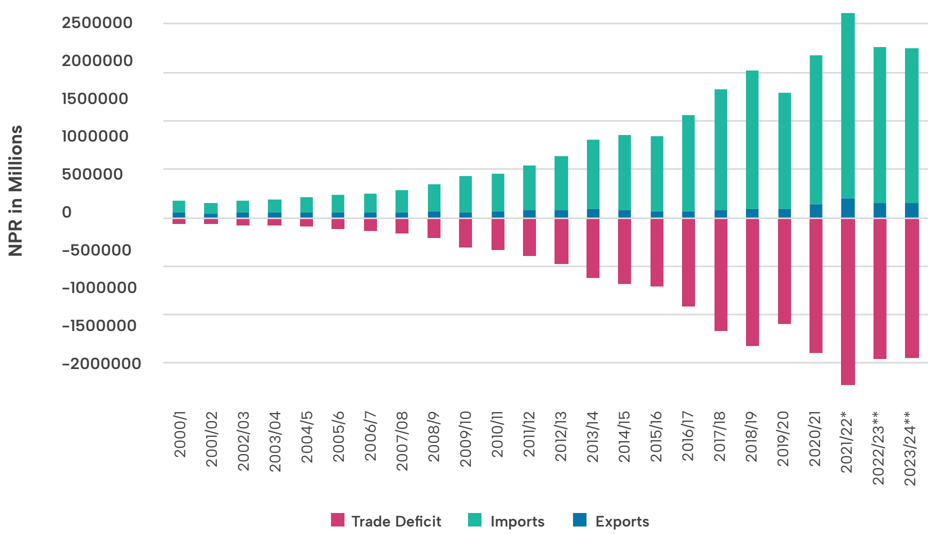
been on an upward trajectory, characterised by a resilient flow even throughout crises such as the 2015 earthquake and the COVID-19 pandemic in 2020. The contribution of remittance to Nepal's GDP increased from approximately 10.7 percent in 2000 to 25.5 percent in 2014. After reaching a peak in 2015, its contribution has remained consistent between 20 percent and 23 percent, or almost one-fifth of Nepal's GDP. In FY 2023/24, Nepal received USD 10.8 billion in remittances (NRB, 2023), exceeding the combined inflow of official development assistance and foreign direct investment.

There has been a steady increase in Nepal's labour migration over the past two decades, from only 55,025 labour approvals in 2000 to 771,327 in 2022 (NIPoRe, 2024). The latest Nepal Living Standard Survey (NLSS IV) shows that the proportion of households receiving remittances has increased more than three times from FY 1995/96 to FY 2022/23 (NSO, 2024). Nepal's economy is highly dependent on remittance as it has significantly shaped its overall development trajectory. Penetration of remittances at the community level has helped alleviate poverty, invest in education and healthcare expenses, and improve the overall livelihoods of remittance-receiving families in Nepal. At the macroeconomic level, remittances have played a crucial role in maintaining balance of payments and stabilising the economy. However, the current level of dependency on remittance as a source of economic growth also puts Nepal in a highly vulnerable position to any external shocks. The upward trend in the share of remittances to the GDP is projected to continue at least up to FY 2028/29, with some fluctuations, but within the range of 18-23 percent contribution to the GDP (NIPoRe, 2024).

1.2.4 Trade

Trade has been an instrumental driver of global growth, but its benefits have only reached some countries equally. Despite efforts to leverage trade policies to boost exports, many developing countries have struggled to achieve sustainable export and economic growth (Reis et al., 2010). Nepal's trade performance has been characterised by low export growth and a widening trade deficit (Acharya, 2019; Mansuri, 2021). As a landlocked least developed country, Nepal encounters multifaceted challenges such as supply-side constraints, geographical proximity, logistical, and policy challenges (Paudel & Waglé, 2017; Sharma, 2020) that have been more influential than trade barriers in determining

Figure 1.8 Nepal's Balance of Trade (FY 2000/01 – FY 2023/24)



Source: Nepal Rastra Bank (NRB), Current Macroeconomic and Financial Situation (Based on Annual data of 2023/24)[*Revised, **Projected] export patterns. Nepal has a comparative advantage in products like handmade woollen carpets, Pashmina products, readymade garments (RMG), leather and leather products, handicrafts, and gold and silver jewellery, as well as in the tourism, hydroelectricity, and agro-processing industries. However, sandwiched between two large manufacturing powerhouses, India and China, Nepal faces huge disadvantages relating to economies of scale (Prasai, L. P, 2014).

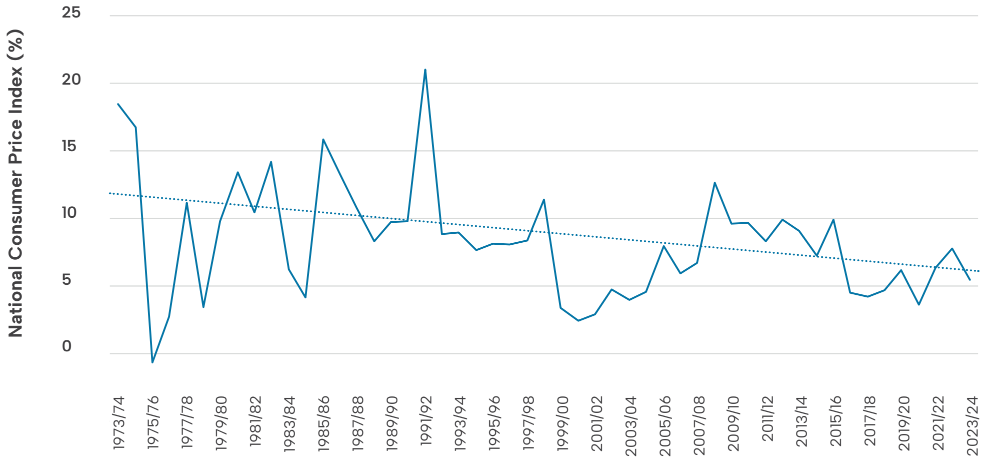
Figure 1.8 illustrates the persistent trends of Nepal's trade balance from FY 2000/01 to FY 2023/24. Over the years, Nepal's trade deficit has steadily widened, which reflects the growing gap between imports and exports (NRB, 2023). A significant rise in exports occurred in FY 2020/21, reaching more than NPR 141 billion, but this growth was not sustained, as exports declined again to about NPR 157 billion in FY 2022/23. The key obstacles to expanding exports from Nepal are primarily due to inadequate workforce skills, limited access to credit, high tariffs on raw materials, and weak trade facilitation (Kharel & Dahal, 2020). Likewise, imports have surged significantly, especially from FY 2013/14 onward, reaching more than NPR 714 billion. The rising inflow of remittances has been a major driver behind the growing import in Nepal (Dhungel, 2019). The substantial rise in imports, driven by increased demand for fuel, machinery, and consumer goods, contrasts sharply with the slow growth in export revenues, which are concentrated in a few sectors such as textiles, carpets, and agricultural products. Thus, the expanding trade deficit in Nepal highlights the declining industrial productivity, structural challenges in improving national and provincial export competitiveness, and prevalent export barriers.

1.2.5 Inflation

Inflation is defined as a continuous price rise or equivalently continuous fall in the value of money (Laidler & Parkin, 1975). However, a sudden increase in the price of a single commodity is not considered inflation. Inflation rates are calculated by the rise in prices of groups of essential commodities that impact relative prices and resource allocation over time. So globally, inflation rates are commonly measured by the price index, consumer price inflation (CPI), calculated as weighted averages of the percentage price changes for a basket of consumer products and services where the weights reflect their relative importance in household consumption in some period (IMF, 2004). For Nepal, the central bank, Nepal Rastra Bank (NRB), calculates the CPI based on a basket of 496 goods and services, approximately covering 97 percent of total national household expenditure. The CPI is calculated with the fiscal year 2014–15 as the base year, with weights derived from the fifth household budget survey (NRB, 2024).

Despite the national economy undergoing several price adjustments based on market dynamics and policy measures, Nepal's inflation rates are highly tied to India's inflation rates. The reasons are that India accounts for two-thirds of the trade, open borders facilitate rapid transmission of price changes, and Nepal's currency is pegged to India's. As a result, a one percent increase in inflation in India causes a 0.72 percent increase in Nepal's inflation (NRB, 2024). Thus, in the long run, the price level in India is the primary determinant of Nepal's inflation, and Nepal's monetary policy is less effective in controlling inflation (NRB, 2007).

Figure 1.9 Inflation trends in Nepal (FY 1973/74 – 2023/24)



Source: Nepal Rastra Bank

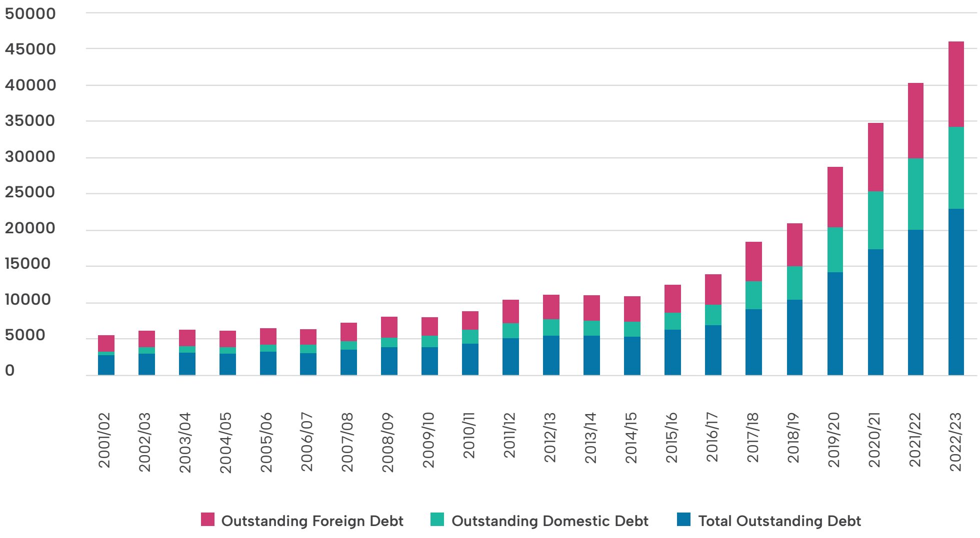
Inflation in Nepal has been volatile in the past decades, given the country's high vulnerability to external price shocks and political instability nationally. Events such as economic liberalisation in the 1990s, the 2015 Nepal earthquake, the 2016 Indian Economic Blockade, the COVID-19 pandemic, and various political turmoil, including a decade-long civil war, have resulted in spikes in the inflation trend. However, the inflation rates have averaged below 6 percent over the past decade.

For FY 2023/24, inflation declined to 5.55 percent from 7.74 percent in the earlier fiscal year. Four factors dampened inflation: subdued demand due to slow economic growth, a decline in inflation rates in India, slashed fuel prices in India and consequently in Nepal, and a reduction of the monetary policy rate by 50 basis points to 6.5 percent. Food and beverage prices declined marginally, while non-food and services inflation almost halved from 8.62 percent in FY 2022/23 to FY 2023/24. While there is no categorization of inflation rates based on the provinces, NRB disaggregates inflation rates based on geography – hills, mountains, and terai, with mountains recording the highest inflation.

1.2.6 Public Debt

Public debt is the total amount of money owed by a government to its creditors, both domestic and foreign, when the government's expenses exceed its revenue (IMF, 2024). Governments borrow from internal and external lenders when they cannot generate enough domestic tax revenue to cover the budget deficit and invest in development activities, including infrastructure and social services. The government of Nepal started taking domestic loans in 1962 and foreign loans a year later in 1963 (Upadhyaya & Pun, 2022). In Nepal, public debt is crucial for covering recurrent and capital expenditure and

Figure 1.10 Public Debt Composition for Nepal (FY 2001/02 – 2022/23)



Source: Nepal Rastra Bank

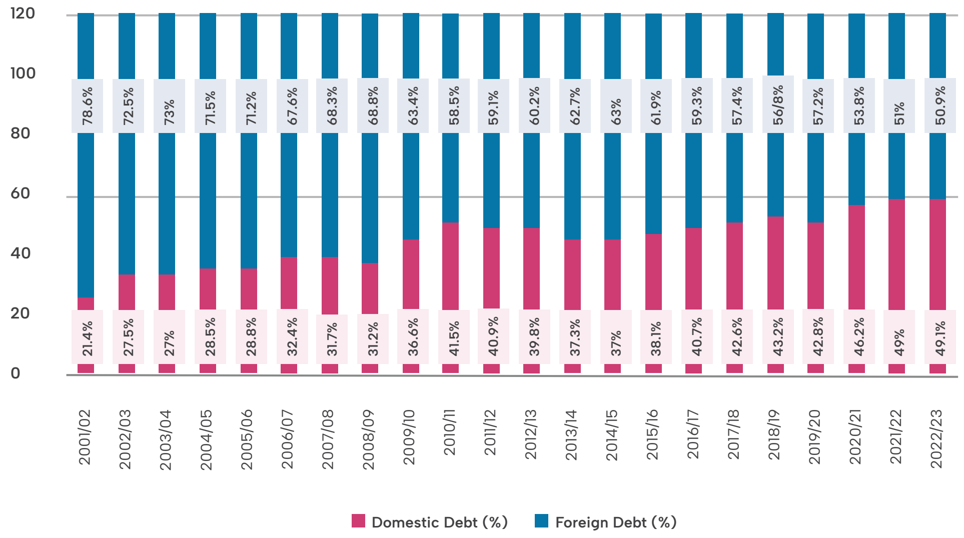
facilitating economic growth and overall development.

The public debt in Nepal increased from FY 2001/02 to FY 2022/23, with the total outstanding debt increasing from about NPR 280 billion to NPR 2.3 trillion (720 percent increase over 21 years). Public debt increased significantly after FY 2016/17 to meet fiscal obligations, mainly attributed to post-earthquake reconstruction efforts, the transition from a unitary form of government to federalism, urgent economic challenges, such as the COVID-19 pandemic, which have substantially impacted the country's financial situation across all provinces.

Domestic and Foreign Debt

Nepal's public debt has grown significantly over the last two decades. This growth can be divided into two main categories: domestic and foreign debt, each with economic implications. Domestic debt is mainly borrowed from internal sources (Treasury Bills, Development Bonds, and Citizen Savings Bond) and has shown an upward trend over the last two decades. From FY 2001/02 to FY 2022/23, outstanding domestic debt skyrocketed from a little over NPR six billion to more than NPR 112 billion (NPR 6,004.37 million to NPR 112,832.92 million), with its share of total debt increasing dramatically from 21.4 percent to 49.1 percent. This reflects a significant shift towards greater reliance on internal borrowing. The most notable increases occurred between FY 2009/10 and FY 2010/11, where domestic debt jumped from about NPR 15 billion (36.6 percent of total debt) to more than NPR 18 billion (41.5 percent of total debt) and again from FY 2019/20 to 2022/23, rising from about NPR 61 billion (42.8 percent of total debt) to almost NPR

Figure 1.11 Share of Nepal's Domestic and Foreign Debt to Total Public Debt (FY 2001/02-2022/23)



Source: Nepal Rastra Bank

113 billion (49.1 percent of total debt).

Foreign debt represents loans from bilateral or multilateral institutions, which also showed an increasing trend but at a different pace than domestic debt. Foreign debt stood at about NPR 22 billion (78.6 percent) in FY 2001/02 and increased modestly to more than NPR 23.4 billion (71.2 percent) by FY 2005/06. The increase continued steadily from NPR 21.7 billion (67.6 percent) in FY 2006/07 to NPR 25.6 billion (58.5 percent) in FY 2009/10 and FY 2010/11. Growth became more pronounced from FY 2011/12 onwards, with significant increases, particularly from NPR 34.3 billion (62.7 percent) in FY 2014/15 to NPR 38.9 billion (61.9 percent) in FY 2015/16. Foreign debt stood at NPR 81.97 billion (57.2 percent) in FY 2019/20 and increased to NPR 116.93 billion (50.9 percent) by FY 2022/23, following a steady upward trend in recent years. As of July 2024, Nepal's leading bilateral lenders are the Japan International Cooperation Agency (JICA) and the Export-Import Bank of China (EIBC), while the key multilateral lenders include the International Development Association (IDA) and the Asian Development Bank (ADB).

Rapid growth in domestic debt, particularly after FY 2015/16, highlights a growing dependence on internal borrowers to finance fiscal deficits and manage liquidity in the banking sector. In the short term, domestic borrowing managed to address short-term budgetary needs. However, the increase in domestic debt also raises concerns. For example, an increase in interest payments will crowd out private investment, potentially leading to reduced credit availability for private-sector investment. After FY 2006/17, the foreign debt increased due to financial needs for large-scale infrastructure projects and other development initiatives that often require external financing. Nepal is one of the least developed countries; hence, it receives foreign finance at relatively lower interest rates than domestic loans. However, it entails risks like currency fluctuations regarding exchange and interest rates, which add to the cost of debt servicing if the local currency deteriorates. At the end of FY 2022/23, external debt accounted for approximately 51 percent of the total public debt, slightly higher than the share of domestic debt. This reflects a government's cautious approach to managing those external fluctuations.

Public Debt as a Percentage of GDP

The ratio of the share of debt to GDP is an essential indicator of a nation's fiscal health, ranking its capacity to manage and pay off its debt. Nepal's public debt as a share of GDP from FY 2012/13 to FY 2022/23 has fiscal management and economic stability implications. During this period, the share in GDP of the reported total public debt oscillated between 28.41 percent in FY 2012/13 and went up significantly to 41.57 percent by FY 2022/23. The most significant growth happened after FY 2019/20 when total public debt went up from 36.86 percent to over 41 percent of GDP. This sharp upward trajectory reflects increased borrowing by the government, admittedly during a period most likely marked by economic challenges, such as the 2015 Earthquake and COVID-19, which stretched public finances and higher spending to deal with the pandemic-related crisis and support the economy.

According to the Public Debt Management Office (PDMO), Nepal is experiencing less pressure on debt servicing in FY 2023/24, with a sharp fall in the interest rates of domestic loans (PDMO, 2023). The average interest rate on domestic debt has fallen to around 3 percent in FY 2023/24 from 10 percent in the previous fiscal year due to excess liquidity in the banking system (PDMO, 2023). Despite eased debt-servicing costs, the country's total public debt has continued to increase due to heavy borrowings after the earthquake in 2015 and the COVID-19 pandemic, with the debt-to-GDP ratio reaching above 44 percent until the second quarter of the current FY 2023/24 from 25.6 percent in FY 2014-15. The Central Bank of Nepal decreased interest rates, substantially decreasing the government's debt-servicing cost. For example, the maximum interest rate on development bonds has recently reduced from 9.2 percent in FY 2022/23 to about 5.92 percent (NRB, 2024). Presently, domestic and external creditors take almost an equal share of the country's debt liability, representing a significant rise in domestic debt in the past couple of years. This balancing act offsets some of the risks of exchange rate fluctuations.

With rising global interest rates, debt servicing became costly for developing countries like Nepal (Dhungel, 2022). Although the International Monetary Fund and World Bank currently classify the risk of debt distress as low for Nepal, mainly because of access to concessional loans at low interest rates, the shift toward commercial loans with high interest rates escalates the possibility into a severe threat (IMF and World Bank, 2022). One study (Upadhyaya & Pun, 2022) on "Public Debt and Economic Growth of Nepal" has shown that the influence of public debt on Nepal's economic growth has no apparent relationship with the level of debt burden and economic growth. That is to say, the debt may be a good instrument for financing development, but its impact depends on how the utilised amount is used. However, suppose the government borrows mainly to finance unproductive expenditures or repair past debts. In that case, it enters into a vicious circle of borrowing with little to no gain in terms of economic growth.

Figure 1.12 Public Debt as Percentage of GDP (FY 2012/13 – 2022/23)

Source: Nepal Rastra Bank

While examining the state of its debt, another critical point that should be considered is Nepal's foreign exchange reserves. The NPR has continuously depreciated against the US dollar, increasing Nepal's debt liability in local currency. Once foreign currency reserves plummet, pay-offs of foreign debt may become increasingly difficult to finance, especially if the government remains on course with heavy foreign borrowing.

Given overall economic structures and debt borrowing practices, Bangladesh provides several practical lessons for Nepal's financial stability. Bangladesh's economic resilience comes from a strong export sector and prudent fiscal management, whereas Nepal is highly dependent upon remittances and foreign aid with a weak export sector (Dhungel, 2023). Although the debt-to-GDP ratio is on an uptrend, Nepal's ratio is still below the South Asian average of 86 percent, indicating that Nepal is still in a relatively comfortable position regarding debt repayment (World Bank, 2023). The recently enacted Public Debt Management Act caps external debt at a third of GDP, aiming to keep overborrowing in check – and ensure that the governments meet and service its debts, which is characterised as manageable by PDMO. Dependence on public borrowing was envisioned to be reduced by strengthening state institutions, enhancing domestic revenue collection, and widening the revenue base, ensuring long-term fiscal sustainability.

Increasing domestic and foreign public debt in Nepal calls for judicious handling of debt obligations on the road to fiscal sustainability in the long term. Growing dependence on domestic debt is a source of concern because the burden of its impact falls on the financial system. At the same time, continued growth underlines the need to handle external vulnerabilities. Nepal should focus on domestic resource mobilisation to foster judicious use of borrowed funds and create an enabling environment that would encourage other sources of financing, including foreign direct investment, to meet the challenges posed by structural barriers.

1.3 Key Provincial Plans and Policies

The key provincial plans and policies are presented in the annex section.

1.4 Nepal's LDC Graduation Plans

Nepal was designated to Least Developed Country (LDC) Status in 1971 due to its high poverty rates and low per capita income (UN-OHRLLS, 2024). Since then, the government, with international support, has implemented various poverty reduction policies, infrastructure development projects, and human capital enhancement programs. Significant progress has been made despite challenges such as political instability, geographical constraints, and a need for industrialisation. However, events like the 2015 earthquake, which caused widespread destruction and economic setbacks, and the COVID-19 pandemic, which disrupted global trade and financial activities, significantly delayed Nepal's progress toward LDC graduation. The graduation is now set for November 24, 2026 (CDP, 2024).

Nepal became eligible for graduation at the 2018 triennial review as it met two of the three graduation criteria, viz., HAI and EVI criteria, for the two consecutive triennial reviews in 2015 and 2018. As per the Committee for Development Policy, Nepal has shown improvement in the three critical indices required for LDC graduation:

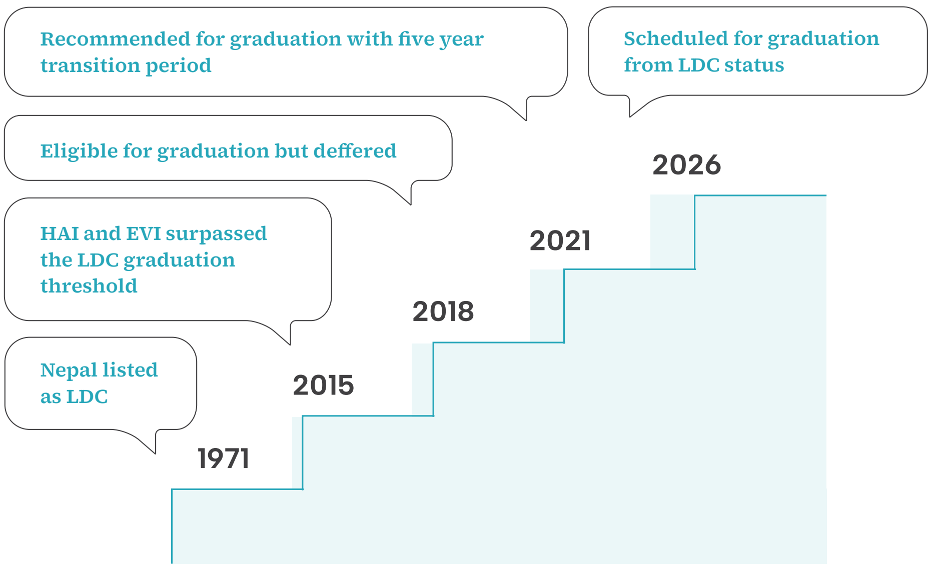
1. **A key criterion is Gross National Income (GNI) per capita, which reached an estimated USD 1,300 in 2024, just below the graduation threshold of USD 1,306. Although Nepal's GNI per capita has steadily increased from USD 1,031 in 2020 to USD 1,241 in 2023, economic growth remains vulnerable to external shocks.**

2. **The Human Assets Index (HAI), which measures health and education**

improvements, reached 76.3 in 2024, exceeding the graduation threshold of 66. This reflects significant progress in areas like adult literacy, secondary school enrollment, and healthcare outcomes such as reduced child mortality.

3. Nepal's Economic Vulnerability Index (EVI) stood at 29.6 in 2024, below the threshold of 32, indicating reduced vulnerability despite ongoing geopolitical and economic challenges.

Besides these three main graduation criteria, some other indexes and indicators are relevant to LDC graduation. Access to water increased from 89.8 percent in 2018 to 91.2 percent in 2022, and access to sanitation improved from 69.2 percent to 80.4 percent. Poverty levels have also decreased, with the national poverty line falling to 15.3 percent, though income inequality and high youth unemployment remain pressing issues. Nepal's Human Development Index (HDI) of 0.602 places the country in the "Medium Human Development" category, although inequality-adjusted HDI scores highlight persistent disparities in development outcomes. The Productive Capacity Index (PCI) score of 40.4 exceeds the LDC average but is lower than that of other developing countries, reflecting infrastructure and energy development challenges.



Source: LDC Graduation, Smooth Transition Strategy, Government of Nepal, National Planning Commission, May 2024

1.4.1 LDC Graduation – Opportunities and Challenges for Nepal

LDC graduation comes with many opportunities and some challenges as well. Some of the key opportunities and challenges for Nepal post-LDC graduation are highlighted below.

In terms of financial assistance, there has been a significant 15.7 percent reduction in Official Development Assistance (ODA), with the ODA-to-GDP ratio dropping from an average of 5.8 percent over the past decade to 3.5 percent (MoF, 2022). This decline, alongside the reduction in total ODA disbursements from USD 1.7 billion to USD 1.4 billion, reflects shifting dynamics in Nepal's development financing landscape. ODA comprises around five to six percent of Nepal's GDP and 23 percent of the government's budget, including 60 percent of development expenditure. After LDC graduation, Nepal may face higher borrowing costs as it transitions to lower-middle-income status, resulting in reduced concessional financing and potential funding gaps for critical development programs.

Nepal will lose preferential market access on the trade front, particularly to the European Union (EU). A 2020 World Trade Organization (WTO) study (2020) estimated that Nepal might lose USD 20.6 million in exports to the EU due to higher tariffs and stricter rules of origin (ROO), especially in sectors like textiles post-graduation.

Nepal's LDC graduation is expected to attract more Foreign Direct Investment (FDI) by signalling a maturing economy (CDP, 2024). The government's Smooth Transition Strategy (STS) focuses on key sectors like hydropower, tourism, and Information Communication and Technology (ICT) to sustain growth post-graduation (NPC, 2024). Nepal's renewables, especially Hydropower, with a potential of 42,000 MW, is a critical area, with current exports to India marking a power surplus era during the wet season. The tourism sector, recovering strongly post-COVID, is poised to benefit from Nepal's natural beauty and proximity to markets like India and China. Additionally, the ICT sector has grown substantially, with its Productive Capacity Index nearly doubling in the last decade, positioning it as a driver of innovation and new economic opportunities.

After LDC graduation, Nepal may face higher borrowing costs as it transitions to lower-middle-income status, resulting in reduced concessional financing and potential funding gaps for critical development programs.

1.4.2 Nepal's LDC Graduation Plans – Lessons from Peers

The countries graduating from LDC status have succeeded through reforms and integration into the global market. One study (Adhikari, 2023) reveals that introducing the Electronic Single Window System (ESWS) in Vanuatu made processes more accessible (helped reduce processing times for issuing biosecurity certificates from four to six days to as little as ten minutes). Revenue increased manifold (from around USD 33 million in 2016 to a current value of USD 134 million since the implementation of the ESWS). Similarly, the e-regulation portal instituted by Bhutan attracted significant investments due to a more transparent and speedy system. Furthermore, Cambodia benefited from free trade agreements with countries like China and the UAE to compensate for losses due to its graduation from LDC status. Likewise, Senegal has benefited from actively executing the African Continental Free Trade Area (AfCFTA), increasing its exports and digitising customs. These examples show how essential strategic economic policies and digital infrastructure have enabled a smooth transition after graduation.

Post-graduation comes with substantial challenges. For example, the Cape Verde economy is highly dependent on tourism and remittances; hence, the country remains highly vulnerable to external shocks (Gay, 2021). The inability to diversify after losing trade preferences further compounded the difficulties. Similarly, Maldives is also highly dependent on tourism; the COVID-19 pandemic made things very difficult, and the country is struggling with the sustainability of its debt (Gay, 2021). The case of Samoa reflects institutional weaknesses where it still needs to foster inclusive growth, and the country is highly reliant on remittances and foreign aid and faces frequent disasters (Gay, 2021). These specific cases present a lesson for Nepal to prioritise the diversification of its economies to reduce vulnerability to external debt and governance problems that deter long-term development.

Nepal has undertaken comprehensive preparations for its LDC graduation through a High-Level Steering Committee led by the Vice-Chair of the National Planning Commission (NPC). The NPC developed an LDC Graduation Smooth Transition Strategy (STS) to address challenges and ensure a seamless transition post-2026 (NPC, 2024) . This strategy involves consultations with provincial governments, development partners, and multilateral agencies, alongside collaboration with other co-graduating LDCs like Bangladesh and Lao PDR. The STS focuses on macroeconomic stability, trade, productive capacity, climate change, and social inclusion and will be aligned with Nepal's current and the sixteenth National Development Plan (FY 2024/25 - 28/29). To ensure smooth implementation, a multi-tier institutional setup is being established, with federal, provincial, and local committees overseeing the execution and monitoring of the transition process. This approach emphasises good governance, social justice, and structural progress to maintain growth and sustainability beyond graduation.

1.7 Conclusion

The Nepali economy has risen and fallen over the past two decades. The key driving factors for these changes include Nepal's post-conflict recovery and reconciliation activities (including drafting of a new constitution) that lasted for almost one decade between 2006 and 2015, the Nepal Earthquake 2015, the COVID-19 pandemic, the ongoing crisis in the Middle East, the ongoing war between Russia and Ukraine, and mass migration of working age Nepalis among others. In addition, the fragile nature of Nepal's coalition-based governments in Kathmandu and across all seven provinces made polycrisis more frequent. Furthermore, Nepal's graduation from the LDC category also poses significant opportunities and challenges. However, if prevalent conditions remain the same, Nepal will have many more challenges than opportunities post-graduation. Working hard to manage all these challenges one after another, the country's provincial governments still struggle to prioritise economic growth over power balance within the province and also with the federal government so as to enhance the overall and environment-wise competitiveness of their respective provinces.

The countries graduating from LDC status have succeeded through reforms and integration into the global market.

To support Nepal's efforts to make the provinces more competitive in the future, all these issues need to be addressed using proper evidence and local expertise. The NCI 2025, through the use of primary and secondary data, attempts to fill an existing gap in this aspect. The next chapter discusses key research methodologies and techniques used in this study to arrive at a set of policy recommendations for each of the seven provinces in detail.