



NEPAL

SELECTED ISSUES

June 2026

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April 8, 2026

SELECTED ISSUES

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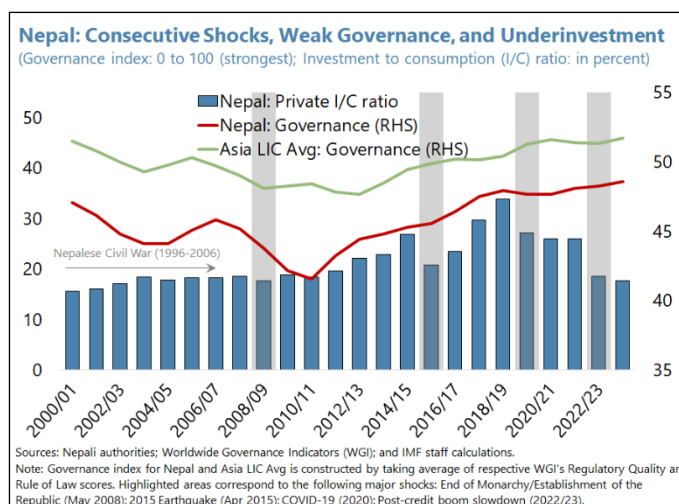
GOVERNANCE, DEMOGRAPHIC TRANSITION, AND MIGRATION IN NEPAL¹

Nepal's recent episode of youth-led protest underscores the importance of strong governance for social trust. Weak governance and high perceived corruption —when combined with demographic pressures and limited domestic economic opportunities— heighten risks of social unrest and weigh on macroeconomic prospects. This paper examines how weak governance—compounded by political volatility and capacity constraints—can fuel youth exclusion, outward migration, remittance dependence, and recurrent social instability, generating a self-reinforcing, low-trust low-investment equilibrium. The central policy message is that durable, inclusive growth requires a well-sequenced reform strategy that frontloads credible governance improvements, unlocks private investment and job creation, and strengthens labor-market and human-capital systems.

A. Governance Weaknesses as a Structural Impediment

1. Weak governance and uneven public service delivery remain a persistent structural constraint on Nepal's development, despite gradual progress in formal institutions. Since FY2010/11, reforms have strengthened

legal frameworks, transparency, and institutional design—particularly in Public Financial Management (PFM)²—while more recent measures under the ECF-supported program have enhanced fiscal transparency, accountability, and elements of the AML/CFT framework. These efforts have improved formal alignment with international standards, but Nepal continues to lag regional and income-level peers across core dimensions of government effectiveness, regulatory quality and the rule of law.



2. The principal challenge lies in weak implementation capacity and limited policy credibility. Limited administrative capacity, uneven enforcement, coordination failures across agencies, and frequent political and bureaucratic turnover undermine reform continuity and raise uncertainty. These frictions are reflected in persistent delays in project execution, low public investment efficiency, and weak contract enforcement in practice, raising transaction costs for firms

¹ Prepared by Yaroslav Hul

² See, for instance, the latest progress report on "Nepal Public Financial Management Multi-Donor Trust Fund (January-June 2025)" coordinated by the World Bank. For more details, see: www.t.ly/h0kVQ

and discouraging long-term private investment. As a result, capital accumulation and productivity growth remain subdued, and the economy is more vulnerable to shocks.

B. Demographic Transition Amid Limited Domestic Opportunities

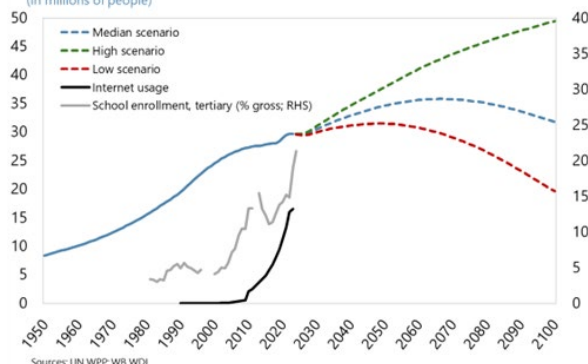
3. Governance constraints have prevented Nepal from fully harnessing its demographic transition as a source of higher growth. The working-age population now accounts for roughly two-thirds of the total population, coinciding with rising educational attainment, greater connectivity, and a gradual shift away from agriculture (National Statistics Office, 2025a; World Bank, 2018). In principle, this combination should support faster growth through higher labor supply, skills accumulation, and reallocation toward more productive activities (Bloom & Finlay, 2009). In practice, however, persistent shortcomings in rule of law, corruption, and low state capacity have constrained the business environment and limited job creation and productive absorption of new labor market entrants. Formal sector expansion has lagged behind labor force growth, structural transformation has been slow, and informality remains pervasive. Youth labor market outcomes reflect these constraints—NEET (not in employment, education, or training) rates exceed 30 percent, youth unemployment is elevated relative to peers, and educated young workers are concentrated in low-productivity informal activities. Women face additional barriers to participation and advancement, further limiting effective use of human capital.

Figure 1. Nepal: Demographic Transition, Youth Unemployment, and Informality

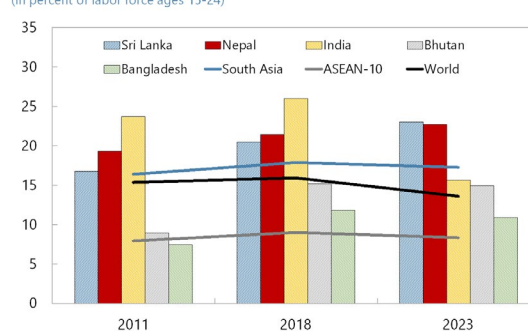
Demographic transition, along with improved education, and better connectivity have raised expectations for opportunity and mobility.

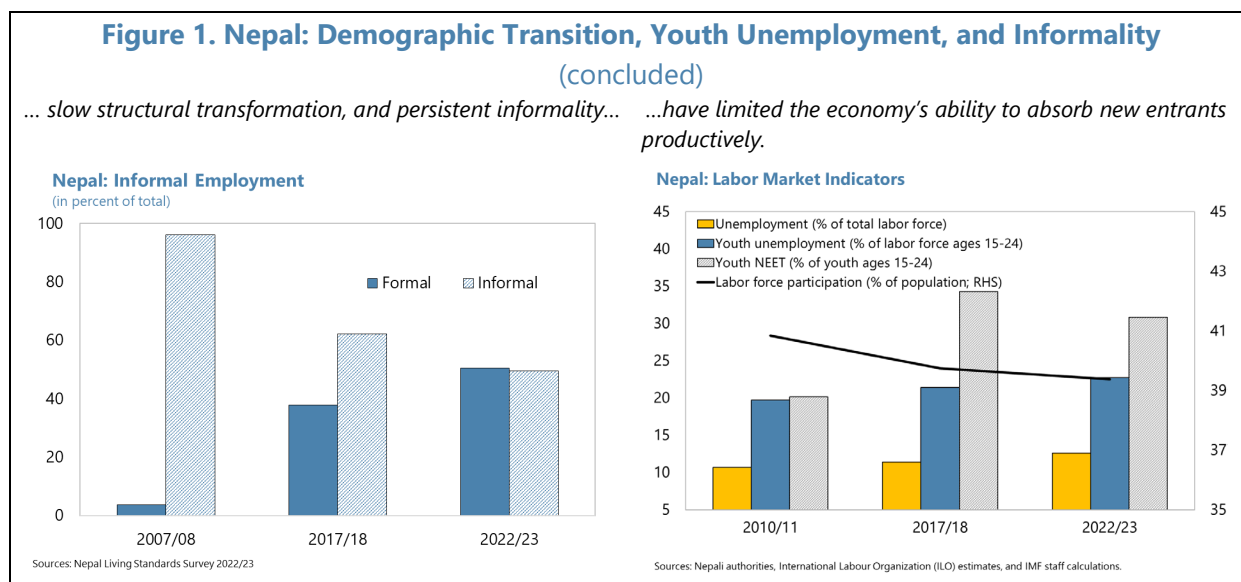
However, weak job creation relative to peers,...

Nepal: UN Population Projections
(in millions of people)



Asia: Youth Unemployment
(in percent of labor force ages 15-24)

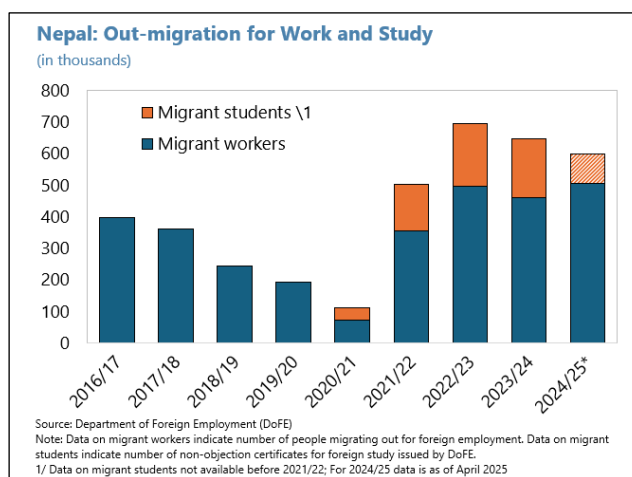




4. Demographic pressures have also raised expectations for opportunity and mobility faster than the economy can deliver. Rather than amplifying a demographic dividend, governance shortcomings have turned the demographic transition into a source of social pressure, widening the gap between rising aspirations and limited domestic opportunities, fueling youth exclusion, and heightening concerns regarding distribution and fairness.³

C. Migration and Remittances: Buffers with Structural Costs

5. Outward migration has become the dominant response mechanism to limited domestic opportunities, particularly for the youth. According to the 2021 National Population and Housing Census, some 2.2 million Nepalese—about 7½ percent of the population or around 12 percent of the working-age cohort—reside abroad, with migration heavily male-skewed.⁴ Between 2011 and 2021, the total number of Nepalese living abroad increased by around 14 percent, and the rising number of applications for

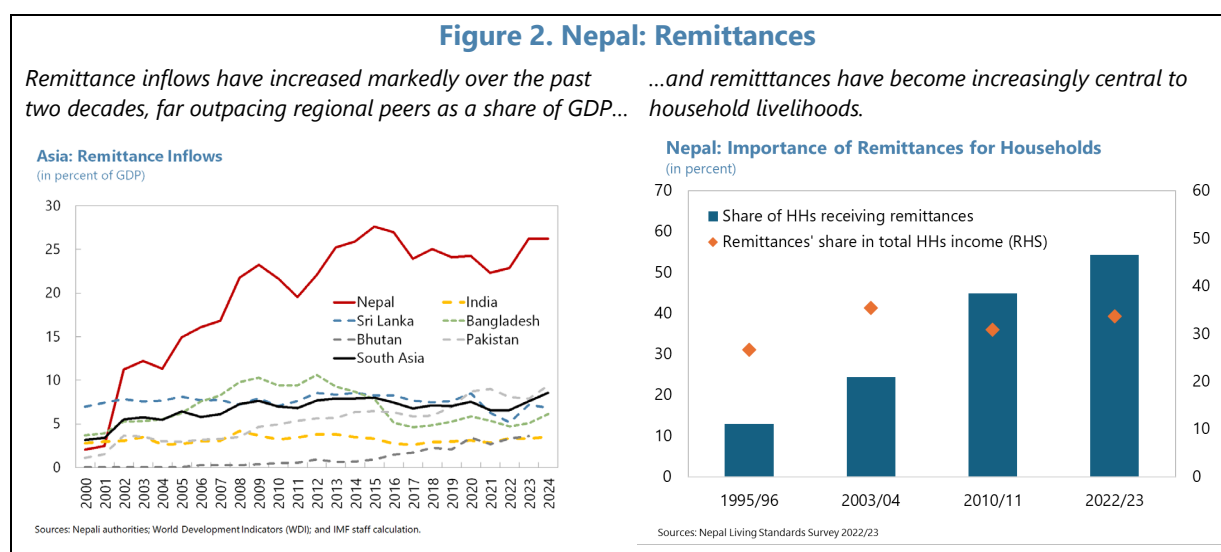


³ Youth exclusion refers to the systematic process where young people (typically 15–24) face disadvantage, marginalization, or lack of access to essential institutions—education, employment, housing, and political participation. It is not just poverty, but a structural barrier preventing the transition to autonomous adulthood, often resulting in social fragmentation, limited life chances, and long-term societal, economic, and political inequality (Paolini et al., 2013).

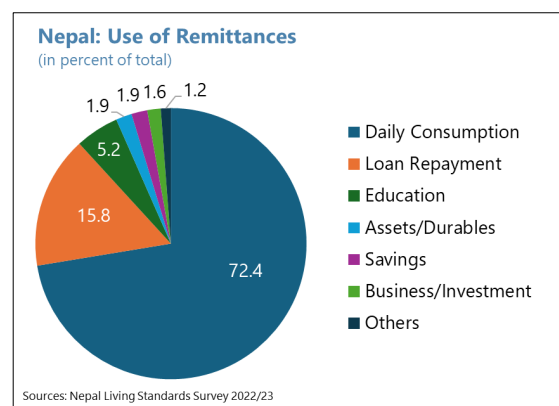
⁴ According to the 2021 Census (National Statistics Office, 2023), around 82 percent of all absentees are male, but the female share has risen from 12.4 percent in 2011 to 17.8 percent in 2021.

foreign employment post-2021 suggests continued migration pressure (National Statistics Office, 2025b). For many young workers, migration offers access to income and opportunity that is difficult to achieve domestically.

6. Remittances associated with largescale migration provide substantial short-term resilience but also reshape incentives and macrostructural dynamics. More than half of households rely on remittances—amounting to roughly one-third of GDP in recent years—to support consumption, reduce poverty, and cushion shocks. At the same time, sustained reliance on external income—especially in the presence of weak governance and shallow financial markets—can weaken incentives for domestic structural adjustment and reduce pressure for improved service delivery and accountability (Abdih et al., 2008, IMF).



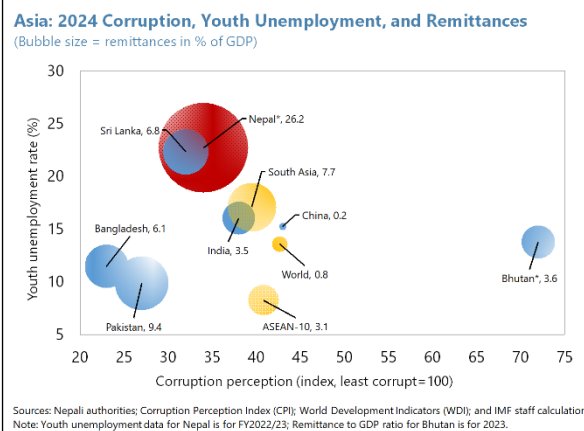
7. In Nepal, remittance use and migration patterns have generated structural costs that weigh on long term growth. Remittances are disproportionately absorbed by import intensive consumption and repayment of low productivity loans, including real estate related borrowing, rather than channeled into productive investment. Over time, this pattern contributes to overvalued real exchange rate, erodes competitiveness, and constrains the expansion of job rich tradable sectors, while migration-induced labor shortages in non-tradable sectors weaken the link between wage growth and productivity (World Bank, 2005).⁵



⁵ See also *Annex III. External Sector Assessment* in “Nepal: 2026 Article IV Consultation and Seventh Review under the Extended Credit Facility (ECF) Arrangement”. The ESA assesses Nepal’s external position in FY2024/25 as substantially stronger than the level implied by fundamentals and desirable policies, with real exchange rate substantially overvalued.

D. Self-Reinforcing Loop: Low Trust, Low Investment, Instability

8. Governance weaknesses, unrealized demographic potential, migration dependence, and political volatility interact to form a low-investment, low-trust equilibrium. Weak institutions depress investment and productivity, limiting domestic opportunity creation; constrained opportunities fuel outward migration and reliance on remittances; and remittances ease private hardship but, in fragile institutional settings, can weaken incentives for reform as households substitute private spending for underprovided public goods. Political volatility and frequent leadership changes disrupt reform continuity, further undermining credibility and investment.⁶



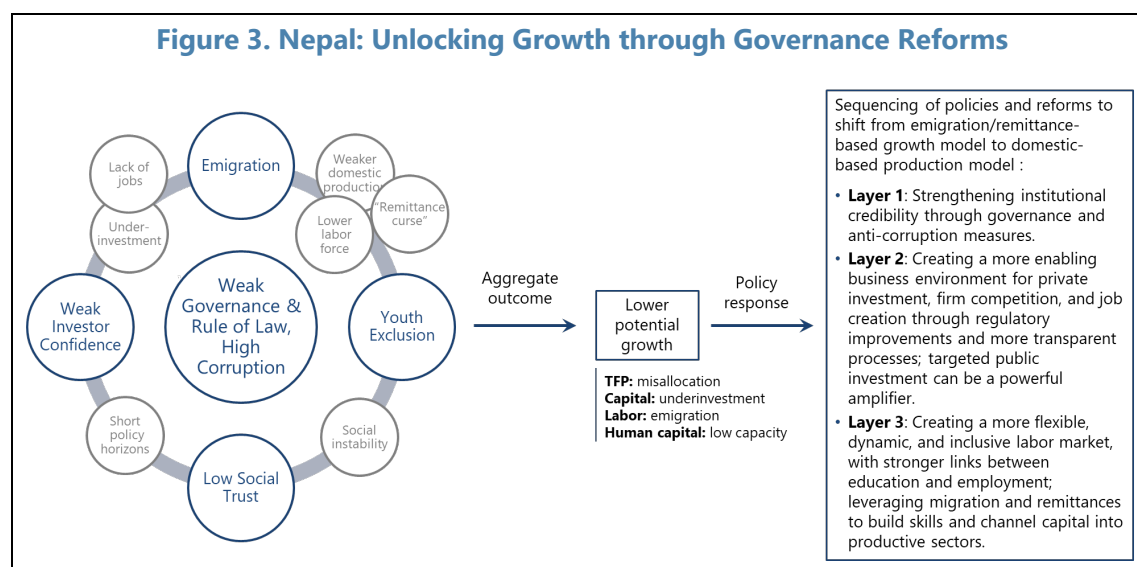
9. This equilibrium is reinforced by perceptions of unfairness and declining social trust, particularly among youth. Weak governance and corruption distort access to education, licensing, and employment, disproportionately affecting educated young workers and women (Bouzid, 2016). Evidence suggests that perceptions of injustice and elite capture—rather than economic hardship alone—are powerful drivers of grievance, increasing the risk of social unrest in contexts of large youth cohorts and uneven opportunity (Mercy Corps, 2015; Farzanegan & Witthuhn, 2017).

10. Macroeconomic costs of political volatility are amplified when institutional buffers are weak. Cross-country evidence indicates that episodes of social unrest carry persistent output losses, with significantly larger effects in countries with weaker institutions (Hadzi-Vaskov et al., 2021, IMF). Nepal's history of political volatility, policy uncertainty, and limited institutional resilience makes these transmission channels particularly salient, magnifying the economic costs of instability and slowing the implementation of growth-enhancing reforms (IMF, 2006).

E. Breaking the Vicious Cycle: Reform Priorities and Sequencing

11. Breaking the low investment, low trust equilibrium requires a sequenced reform strategy anchored in credible governance improvements. International experience suggests that reforms enhancing transparency, predictability, and rule-based administration yield the highest early returns by relaxing credibility and coordination constraints that otherwise blunt the impact of sectoral policies (World Bank, 2025). While progress can occur across multiple fronts in parallel, anchoring reforms in stronger governance increases their effectiveness and durability.

⁶ See Aisen & Veiga (2011, IMF) for cross-country evidence that political instability lowers growth primarily through weaker investment and productivity; and Poudel et al. (2025) for Nepal-specific econometric evidence linking governance (including corruption control and political stability) to growth.



12. The first priority is to strengthen institutional credibility and public service delivery.

Reducing discretion, ensuring even enforcement of rules, and improving transparency in public decision making would lower uncertainty about consistency of policy implementation and improve trust in state institutions. Strengthening the reliability and perceived fairness of citizen-facing systems—including recruitment, licensing, and core public services—is particularly important for reducing grievances among youth.

13. A second priority is to unlock private investment, competition, and productive diversification. As institutional credibility improves, reforms to the business environment, contract enforcement, and market competition can more effectively crowd in private investment. A predictable regulatory framework and level playing field are essential for firm growth, innovation, and job creation in higher productivity sectors capable of absorbing educated labor.

14. Raising the quality and effectiveness of public investment can amplify these gains. Prioritizing and executing projects that relieve binding infrastructure and service bottlenecks can strengthen connectivity, support emerging economic clusters, and crowd in private activity. Stronger project selection, execution discipline, and maintenance planning are critical to raising returns and preserving asset value. In combination, these elements raise long-term potential growth and improve the prospects for productive employment at home.⁷

15. A third priority is to promote labor market inclusion and more productive use of remittances. Strengthening links between education and employment, expanding opportunities for skills upgrading, and supporting labor market institutions that facilitate mobility while protecting basic standards can improve job quality and formalization. Deepening financial intermediation and

⁷ See IMF (2026), *Nepal: Selected Issues, Chapter II: Macroeconomic Benefits of Governance Reforms*.

expanding credible domestic investment options can help channel remittances toward entrepreneurship, skills accumulation, and reintegration pathways.

16. Sustained progress across these reform layers would help gradually rebalance Nepal's growth model toward stronger domestic opportunity creation. By improving governance, raising investment efficiency, and strengthening labor-market outcomes, reforms can reduce reliance on migration as the primary channel for economic advancement while preserving its stabilizing role. Clear communication, realistic sequencing, and broad-based ownership will be important to sustain reform momentum and policy continuity in a context of capacity constraints and political volatility. It will also ensure that gains in credibility and confidence translate into durable improvements in growth and inclusion.

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MACROECONOMIC BENEFITS OF GOVERNANCE REFORMS¹

The Gen-Z protest in September 2005 was, in part, a response to the perceived corruption and governance weaknesses in Nepal. Nepal now has a unique window of opportunity to implement reforms anchored in good governance and anti-corruption strategy to improve the business environment, increase investment, and promote durable and inclusive growth. General equilibrium model simulations for Nepal show that a comprehensive package of fiscal and private sector related governance reforms can raise economic growth, improve public debt dynamics, and reduce inequality.

A. Context

1. Third-party Indicators (TPIs) highlight corruption and governance weaknesses in Nepal. Perception-based TPIs suggest that corruption in Nepal has declined somewhat relative to the past decade but remains highly prevalent (Figure 1) and more prevalent compared to some regional peers. Similarly, governance indicators have improved over the past decade but continue to lag regional peers. Governance gaps are observed in areas such as government effectiveness, regulatory quality, control of corruption, and rule of law.

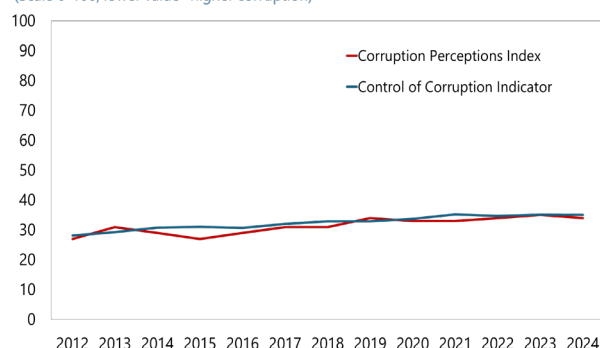
2. There is growing evidence of the negative impact of corruption and weak governance on macroeconomic outcomes in emerging and developing economies. Cross-country empirical evidence suggests that high corruption and weak governance are negatively associated with overall and per capita GDP growth, and contribute to lower tax revenue, reduced investment, and higher inequality (IMF, 2016; and IMF, 2018).² Country-level IMF analysis using the Debt, Investment, Growth (DIG-series) model has estimated the positive impact of fiscal and private sector governance reforms on economic growth (Table 1). High corruption negatively affects private sector investment decisions, including foreign investment, by increasing uncertainty and the cost of doing business (IMF, 2016; and IMF 2017). Corruption also weighs on private sector activity through the financial channel via negative impact on lending practices and financial sector efficiency (Detragiache, Gupta and Tressel, 2005). High corruption lowers the productivity of public investment by reducing the quality of infrastructure per dollar of investment undertaken (Tanzi and Davoodi, 2002). Higher corruption is also associated with lower efficiency in tax collection by weakening compliance and tax administration (IMF, 2011; Imam and Jacobs, 2007; and Fenochietto and Pessino, 2013).

¹ Prepared by Sneha Agrawal, Arpitha Bykere, and Shihangyin Zhang. The authors would like to thank Yaroslav Hul, Pranav Gupta, and Yuanyan Sophia Zhang (APD), Galen Sher (FAD), Yao Deng (LEG), and Alissa Gorelova and Azar Sultanov (RES).

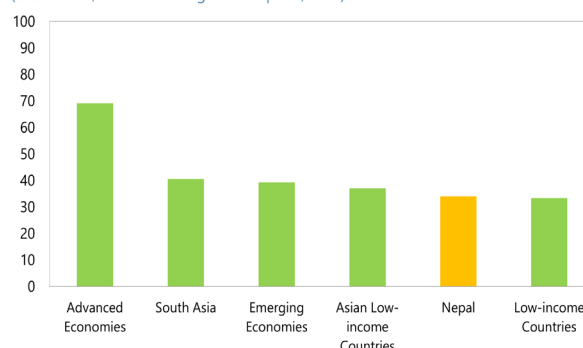
² Also see IMF (2026), *Nepal: Selected Issues, Chapter I: Governance, Demographic Transition, and Migration in Nepal*.

Figure 1. Nepal: Governance and Corruption Third-Party Indicators**Nepal: Perceptions of Corruption**

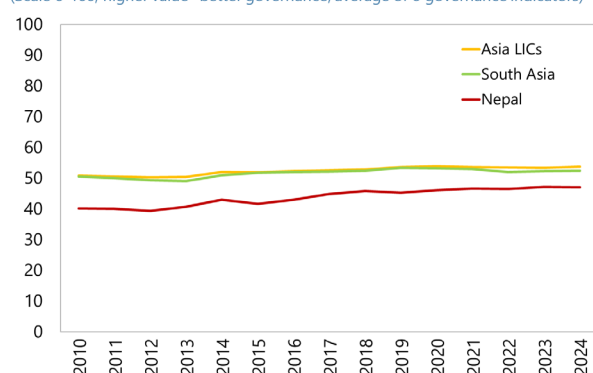
(Scale 0-100, lower value=higher corruption)

**Corruption Perceptions Index**

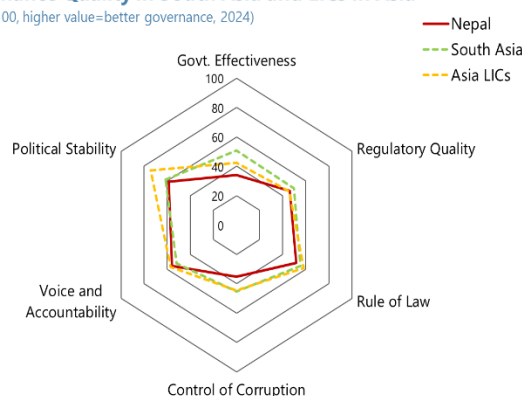
(Scale 0-100, lower value=higher corruption, 2024)

**Governance Quality in South Asia and LICs in Asia**

(Scale 0-100; higher value=better governance; average of 6 governance indicators)

**Governance Quality in South Asia and LICs in Asia**

(Scale 0-100, higher value=better governance, 2024)



Sources: Transparency International's Corruption Perceptions Index measures perception of businesses and country experts about level of corruption in public sector on a scale of 0 (highly corrupt) to 100 (very clean), based on a combination of three or more data sources from 13 corruption surveys and assessments. The Worldwide Governance Indicators (WGI) measure perceptions of governance quality on a 0–100 scale with higher values indicating better governance, based on 35 cross-country sources, including household and firm surveys and expert assessment. The WGI indicator has six indicators: 1) Voice and Accountability: perceptions of extent to which citizens can participate in selecting the government including electoral integrity, and accountability mechanisms for citizens reflected in ability to access information, governmental oversight bodies, and a robust traditional/digital media landscape; 2) Political Stability: perceptions of extent to which political power and governance are secure from destabilization, and likelihood that authority will be challenged or altered through violent, coercive, or unconstitutional means; 3) Government Effectiveness: perceptions of quality of public services, civil services, policy formulation and implementation, and credibility of government's decisions; 4) Regulatory Quality: perceptions of government's ability to design and implement policies and regulations that promote private sector development; 5) Rule of Law: perceptions of extent to which agents respect and follow rules of society, including contract enforcement, property rights, police, courts, and likelihood of crime and violence; and 6) Control of Corruption: perceptions of extent to which public power is used for private gain, including both petty and grand corruption, as well as capture of the state by elites and private interests. The WGI is a composite Third-Party Indicator relying on a variety of inputs from other sources, including Transparency International Global Corruption Barometer Survey, Political Risk Services International Country Risk Guide, and Varieties of Democracy Project. The WGI does not reflect the official views of the World Bank, Brookings Institution, and Natural Resource Governance Institute. Staff acknowledge uncertainty around the measurement of these indexes.

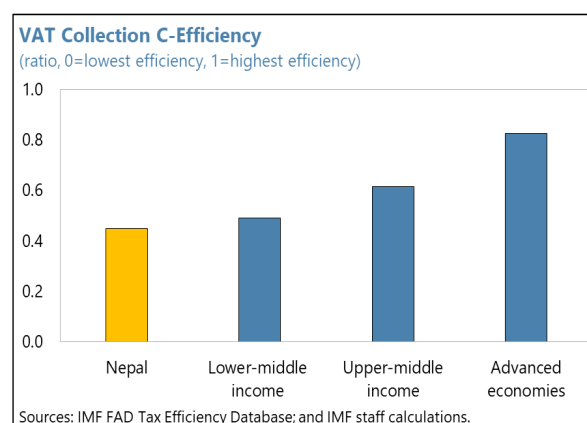
Table 1. Nepal: Estimated Growth Impact of Governance Reforms in DIG Model

Country	Macroeconomic Impact
Sri Lanka	Real GDP increases by more than 7 percent over 10-year period
Congo	Non-oil real GDP rises by 18 percent over 10-year period
Iraq	Real GDP increases by 10.2 percent over 10-year period
Uganda	Non-oil real GDP growth increases by 1.8 percentage points over 5-year period

Sources: Sri Lanka: 2024 Selected Issues, IMF; IMF Working Paper WP/19/121; Iraq: 2019 Article IV Consultation, IMF; and Uganda: 2021 Article IV Consultation, IMF.

3. Given the negative impact of corruption and governance weaknesses on fiscal performance and private investment, governance reforms in Nepal could result in macroeconomic gains. Under the Extended Credit Facility (ECF) program, Nepal has made progress in introducing fiscal governance reforms as well as governance reforms to improve the business environment, such as through the financial sector channel (Table 2). Nepal is currently undergoing the IMF Governance and Corruption Diagnostic (GCD), which will help identify the remaining governance gaps in these areas. The GCD would assess governance weaknesses in public financial management, revenue administration, financial sector oversight, AML/CFT, rule of law, and anti-corruption legal and institutional framework.³ Nepal's new government elected in March 2026 has a strong governance and anti-corruption mandate. The government has published a 100-Point Agenda which includes: increasing transparency in public procurement process; digitalizing public service delivery; automating tax administration; restructuring customs system; issuing a new National Anti-Corruption Action Plan; designing a National Integrity Policy to manage conflicts of interest and protect whistleblowers; and restructuring the National Vigilance Center. The government has also published the Good Governance Blueprint developed by the interim government on strengthening governance and public service delivery in several areas. Moving forward on implementing the governance reforms introduced under the ECF program, the recommendations of the GCD, and the government's governance agenda will help strengthen fiscal governance and reduce distortions for the private sector, promoting durable and inclusive growth. Some examples include:

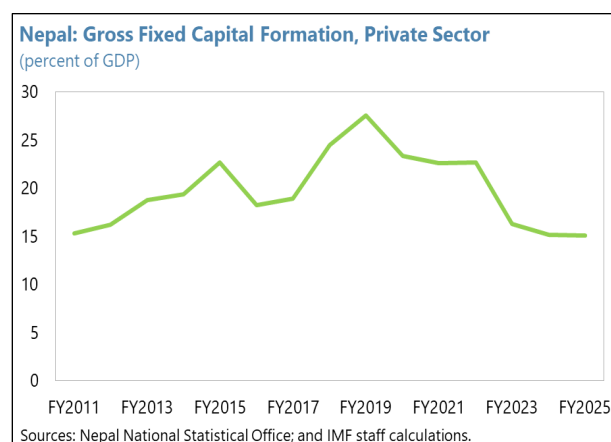
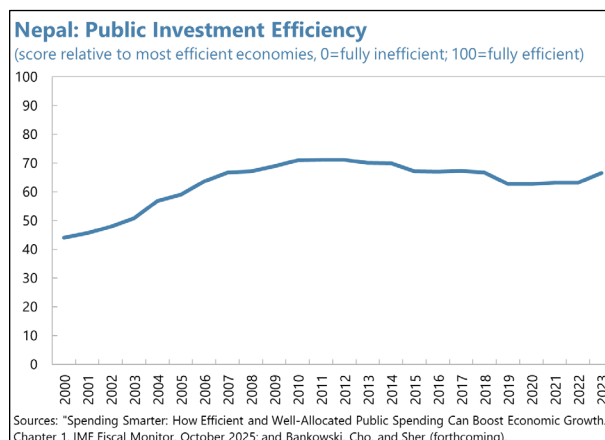
- The Tax Administration Diagnostic Assessment Tool for Nepal has highlighted several areas for improving tax administration and compliance, which could boost revenue.⁴



³ [IMF Staff Concludes the Scoping Mission for the Governance and Corruption Diagnostic for Nepal](#), Press Release, January 21, 2026.

⁴ Tax Administration Diagnostic Assessment Tool (TADAT), "Performance Assessment Report: Nepal," IMF, 2023.

- The IMF Fiscal Affairs Department's analysis on tax collection efficiency suggests scope for increasing Nepal's value-added tax (VAT) efficiency towards that of upper-middle income countries (Text Figure).⁵
- After rising notably during the 2000s, Nepal's public investment efficiency has declined since the past decade relative to the most efficient economies (Text Figure).⁶ The Public Investment Management Assessment (PIMA) has identified several areas for improving public investment management practices to boost efficiency.⁷
- Private investment has slowed markedly from more than 20 percent of GDP in the pre-pandemic years to about 15 percent of GDP as of FY2025 (Text Figure). Governance and anti-corruption reforms oriented towards the private sector could help reverse this trend.



⁵ Tax collection efficiency, measured by c-efficiency ratio, compares actual revenue with potential revenue. A ratio less than 1 implies both compliance, and design and policy gaps.

⁶ See IMF Fiscal Monitor, Chapter 1, October 2025, and Bankowski, Cho, and Sher (forthcoming).

⁷ Nepal Public Investment Management Assessment (PIMA), Technical Assistance Report, IMF, 2021.

Table 2. Nepal: Recent Governance Reforms and Priorities Ahead

Area	Reforms under ECF Program	Governance Reform Priorities
Fiscal governance	- Approved domestic revenue mobilization strategy (DRMS) - Adopted customs compliance improvement strategy - Published tax expenditure report - Approved PIMA Action Plan and revised National Project Bank Guidelines - Consolidated extra-budgetary units (EBUs) in central accounts - Published financial statement of operational public enterprises (PEs) - Published fiscal risk statement	- Continue to implement DRMS on tax administration, including on compliance and audit, and tax expenditure rationalization - Continue to implement PIMA Action Plan, enforce National Project Bank Guidelines, and enhance capital budget execution and budget credibility - Strengthen financial oversight of PEs and EBUs. Further increase coverage of EBUs in central accounts - Broaden fiscal risk assessment - Upgrade medium-term fiscal framework, and develop a fiscal strategy - Increase digitalization in public administration and services
Financial sector, financial integrity, and other areas	- Completed onsite loan portfolio review (LPR) for 10 largest banks and approved post-LPR roadmap - Implemented onsite Supervisory Information System for commercial banks - Audited NRB's financial statement by internationally experienced auditor - Amended AML law	- Implement post-LPR roadmap to enhance corporate governance of banks, regulatory compliance, supervisory processes, and credit practices. Reform related-party lending - Amend NRB Act to strengthen NRB's mandate and governance, and bank resolution framework - Effectively implement AML/CFT framework to improve financial intelligence, investigation and confiscation framework, and beneficial ownership transparency - Enhance institutional independence of key government agencies and anti-corruption agency, and enforce asset declaration and conflicts of interest systems

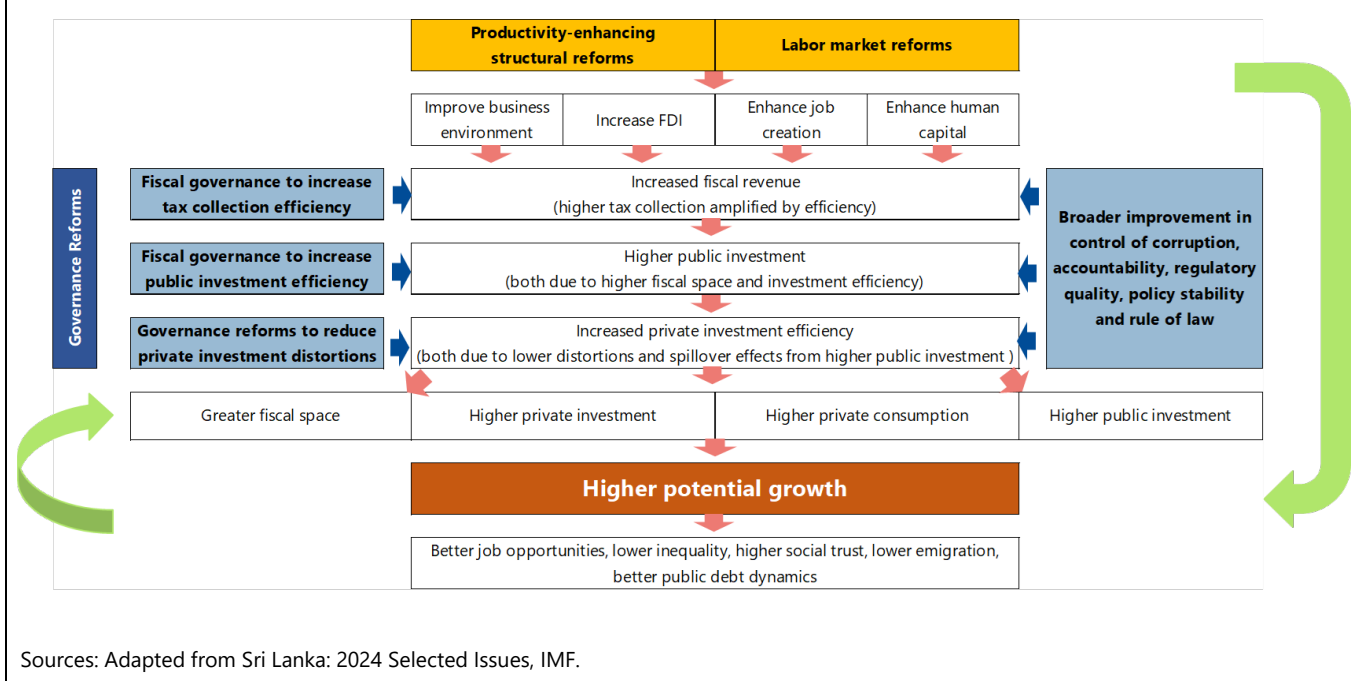
B. Quantifying the Macroeconomic Impact of Governance Reforms

4. The macroeconomic effects of governance reforms can be assessed using the Debt, Investment, Growth (DIG-series) model (Box 1). The general equilibrium model captures interactions across economic agents and estimates the impact of governance reforms on—real GDP, public debt, private investment and consumption, and inequality—by lowering economic distortions in three areas to benchmark levels (Figure 2):

- Fiscal governance reforms in public investment management that raise **public investment efficiency**. This helps crowd-in private investment, leading to higher GDP growth and improving public debt dynamics.
- Fiscal governance reforms in tax administration that increase **VAT collection efficiency**, boosting tax revenue. This creates fiscal space for financing public investment (which crowds-in private investment) and social transfers (which supports private consumption among poor households), raising GDP growth and improving public debt dynamics.
- Private sector-oriented governance reforms that reduce **private investment distortions**, for instance, via improved financial regulations and credit policies, lower red tape, and reduced rent-seeking. This raises private investment, helping increase employment (supporting private consumption, especially among poor households) and tax revenue (creating fiscal space for social transfers to support poor households), boosting GDP growth and improving public debt dynamics.

5. Beyond macro-fiscal outcomes, the DIG model indicates that a comprehensive set of governance reforms have favorable distributional and spillover effects. The model considers “rich” households with access to financial markets capable of saving and investing, and “poor” hand-to-mouth households that consume out of labor income and social transfers, such that consumption inequality can be estimated using the Gini coefficient. In the model, higher economic growth and improved fiscal space allow for increased social transfers, benefiting liquidity-constrained “poor” households disproportionately and reducing consumption inequality overtime. The model also highlights the impact of public investment efficiency reforms in producing spillover effects for the private sector by facilitating technology diffusion, reducing distortions, and boosting investment and productivity.

Figure 2. Nepal: Channels for Macroeconomic Effects of Governance Reforms



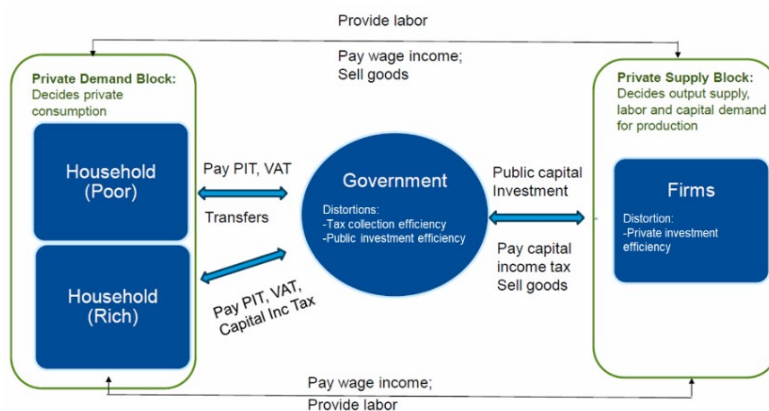
Box 1. Nepal: Debt, Investment and Growth (DIG-series) Model

The DIG model is extended to analyze the macroeconomic impact of governance reforms accounting for country-specific characteristics.¹ Over the past decade, the DIG model and its extensions such as DIGNAR and DIGNAD have been widely used in more than 70 emerging and developing countries to analyze the macroeconomic impact of governance and other structural reforms.²

The DIG model captures the channels through which reforms affect macroeconomic outcomes by capturing interactions among the main economic players. Two types of households decide the amount of consumption and labor supply. The

hand-to-mouth or poor households' budget is constrained by wage income and transfers net of tax payable; and the Ricardian or rich households have access to capital markets on top of wage

income. Firms optimally choose their private capital and labor inputs and leverage public capital to produce tradable and non-tradable goods. The government levies income taxes to finance public investment, pay off debt, and provide transfers to households.



Three types of distortions generate economic loss, which can be mitigated by governance reforms:

- First, standard profit maximization implies that the return to private capital (R_t^k) equals to the marginal product of capital ($\frac{\partial f(\cdot)}{\partial K_t}$), which can be distorted (private investment distortion is (κ)) by the cost associated with the time and resources spent by businesses to obtain access to credit, public resources (electricity, infrastructure, etc.), and regulatory approvals: $R_t^k = (1 - \kappa) \left(\frac{f(\cdot)}{\partial K_t} \right)$
- Second, in the standard capital accumulation equation, public investment efficiency (ϵ_t) determines the fraction of government capital expenditure (I_t^G) that translates into productive public capital (K_{t+1}^G). Weak governance reduces the efficiency of public investment, leading to a lower stock of public capital accumulated per dollar of spending: $K_{t+1}^G = (1 - \delta^G)K_t^G + \epsilon_t I_t^G$
- Third, in the public debt equation, inefficiencies in revenue administration and tax policies lead to revenue loss from value-added taxes on consumption ($\tau_t^C C_t$), taxes on labor income ($\tau_t^L W_t L_t$), and taxes on capital income ($\tau_t^K R_t^k K_t$). VAT collection inefficiency (ϑ) reduces government revenue for financing growth-enhancing expenditures such as capital investment (I_t^G) and targeted social transfers (Z_t) and improve debt dynamics ($B_{t+1}, R_t B_t$): $B_{t+1} = R_t B_t + I_t^G + G_t^C + Z_t - (1 - \vartheta)\tau_t^C C_t - \tau_t^L W_t L_t - \tau_t^K R_t^k K_t$

¹ DIGNAR (Debt, Investment, Growth and Natural Resources) was based on Debt, Investment, Growth (DIG) model developed by Buffie et al. (2012).

² DIGNAD (Debt, Investment, Growth and Natural Disasters) builds on the extension of the DIG model of Buffie et al. (2012) to natural disasters following Marto, Papageorgiou and Klyuev (2018) that captures the challenges of closing infrastructure gaps in developing countries that frequently face natural disasters.

6. The model, including the three economic distortions, is calibrated to Nepal-specific conditions. Steady states are set to historical averages. The three distortions are calibrated as following: First, private investment distortion is calibrated to reflect potential growth dividends from structural reforms that improve the efficiency of private investment (based on [Aligishiev et al. 2023](#) and [IMF Structural Reform Dividends Toolkit](#)), conditional on the steady state of other variables. Second, public investment efficiency relative to the most efficient economies is set at 67 percent, based on estimates from IMF Fiscal Monitor (113). Third, VAT collection efficiency is set at 45 percent based on the methodology from IMF FAD Tax Efficiency Database (113). The model does not simulate the impact of specific governance reforms, but considers a set of fiscal governance and private sector governance reforms, for instance the reform priorities in Table 2, that could jointly contribute to lowering the economic distortions.

7. We consider four scenarios phased in at different pace and depth to illustrate the macroeconomic outcome of governance reforms.

- **Central Scenario:** Governance reforms are gradually phased in over 5 years with all three types of economic distortions reduced to benchmark levels. More specifically, private sector distortions are reduced such that the private investment-to-GDP ratio increases to about 20 percent over a 10-year period to reach half-way to the pre-pandemic average; public investment efficiency rises to 80 percent relative to the most efficient economies; and VAT collection efficiency improves to 52.5 percent to close the gap with upper middle-income countries by half.
- **Alternative Scenario 1 (Deeper reforms):** Reforms phased in over 5 years are more ambitious, such that private sector distortions are reduced that help raise the private investment-to-GDP ratio back to the pre-pandemic average; public investment efficiency increases to 90 percent relative to the most efficient economies; and VAT collection efficiency fully closes the gap with upper middle-income countries.
- **Alternative Scenario 2 (Immediate partial reversal):** Half of the governance reform efforts undertaken in the Central Scenario during the first five years are immediately reversed in the sixth year.
- **Alternative Scenario 3 (Public investment efficiency spillovers):** This scenario examines potential spillovers from public sector efficiency improvements to the private sector. Under this scenario, governance reforms raise public investment efficiency to 80 percent (as in the Central Scenario), which helps reduce private investment distortions by half of the magnitude assumed in the Central Scenario (i.e., a 50 percent spillover effect).

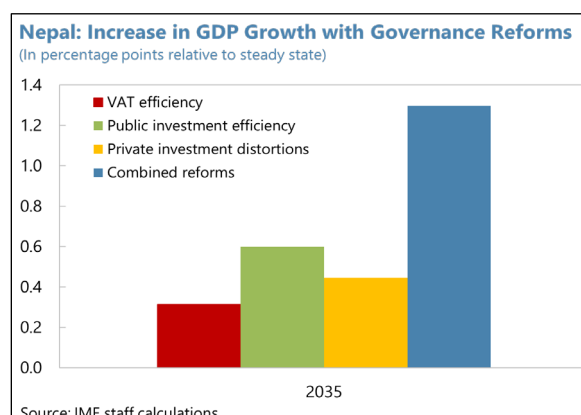
8. The Central Scenario simulation suggests that the three governance reforms stimulate private investment and consumption, lift output, and enhance fiscal performance, with the overall impact maximized by combined reform efforts (Figure 3).

- VAT collection efficiency reforms improve tax revenue and expand fiscal space, enabling higher public investment (that crowds-in private investment) and social transfers (that supports consumption). The reforms raise private investment and consumption levels by about 3 percent

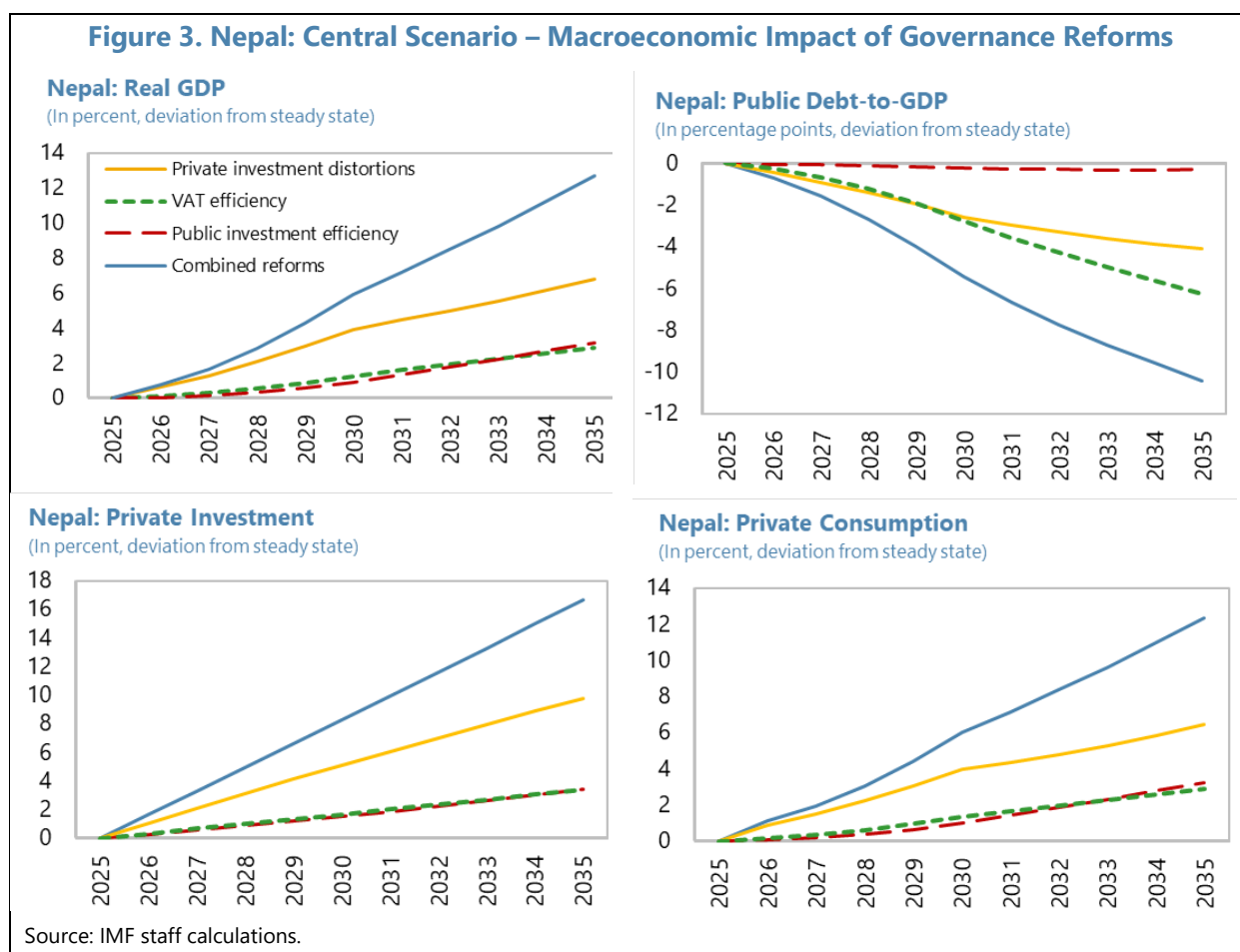
from the steady state over 10 years, boosting output (*real GDP level*) by around 3 percent. The reforms also help reduce the public debt-to-GDP ratio notably by about 6 percentage points.

- Public investment efficiency reforms enhance the conversion ratio of public investment into productive public infrastructure, which facilitates business activity (through higher return on capital) and supports labor income (via higher employment). The reforms increase private investment and consumption by 3 percent from the steady state and output by around 3 percent over 10 years.
- Reforms mitigating distortions for the private sector raise returns to production, stimulating private investment and employment. The calibrated reforms significantly boost private investment (by 10 percent) and private consumption (by 6 percent) over 10 years. This lifts output by about 7 percent from the steady state and broadens the tax base, helping reduce the public debt-to-GDP ratio by around 4 percentage points.
- The combined reform package generates notable macroeconomic impact, with gains strengthening over time. When all three reforms are implemented simultaneously, output (*real GDP level*) increases by nearly 13 percent over 10 years, or on average 1.3 percent annually.⁸

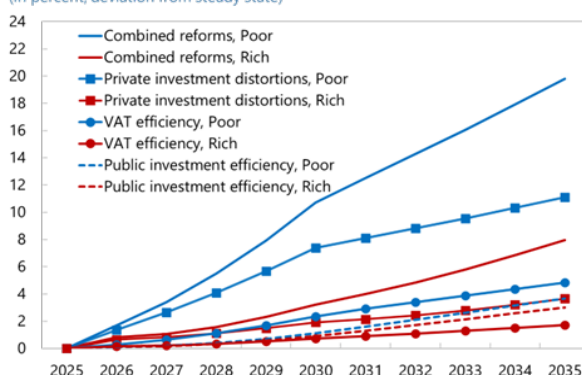
Based on the impact on real GDP levels over 10 years, *real GDP growth* in 2035 would be about 1.3 percentage points higher (Text Figure). The reduction in private investment distortions would deliver the largest standalone effect on growth outcomes. While all three individual reforms deliver gains, coordinated implementation of these reforms produces larger GDP growth effects, underscoring complementarities across policy reforms.



⁸ The projected annual GDP growth is broadly consistent with the IMF [Structural Reform Database](#) (Alesina and others, 2020, IMF 2023).



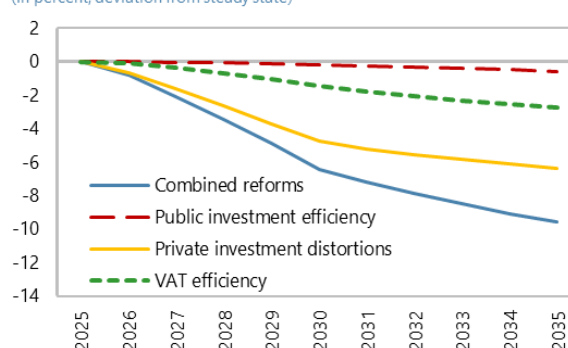
9. Governance reforms contribute to reducing inequality. Figure 4 illustrates the distributional impact of the three governance reforms on “rich” and “poor” households. VAT efficiency reform increases tax revenue, creating fiscal space for social transfers that disproportionately benefits poor households: consumption for poor households increases by around 5 percent from the steady state over 10 years compared to about 2 percent for rich households. Reforms to reduce private investment distortions stimulate business activity, boosting job creation and tax revenue. This helps poor households gain about 11 percent in consumption through wages and social transfers, while rich households see relatively smaller gains (close to 4 percent) due to taxes on capital gains and resource reallocation towards investment. Among the three governance reforms, lowering distortions to private investment delivers the largest boost to the consumption of poor households and the highest distributional benefits, followed by VAT efficiency reforms. A combined package of all three governance reforms results in larger distributional effects, reducing consumption inequality by nearly 10 percent over 10 years.

Figure 4. Nepal: Central Scenario - Distributional Effects of Governance Reforms**Nepal: Private Consumption: Poor and Rich Households**
(In percent, deviation from steady state)

Source: IMF staff calculations.

Nepal: Consumption Inequality

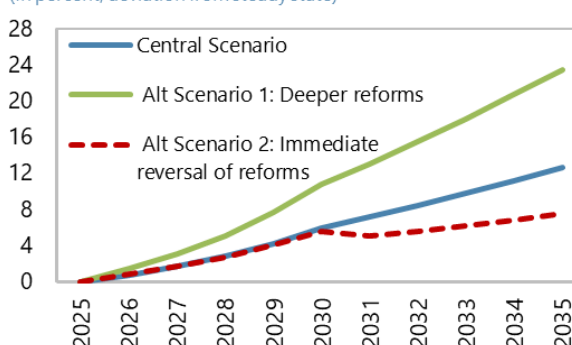
(In percent, deviation from steady state)



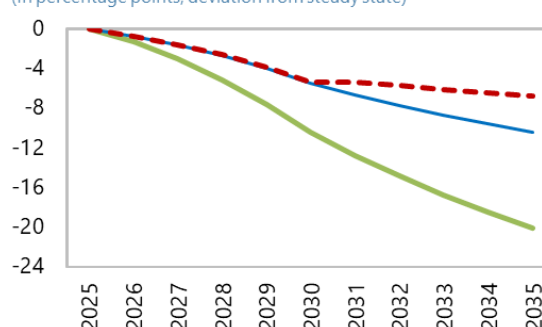
10. While macroeconomic gains vary with the pace and depth of governance reforms, commitment to sustain reform efforts is critical. Figure 5 illustrates the dynamic responses under two alternative scenarios. Alternative Scenario 1—which assumes deeper reforms across all three governance areas—delivers more significant macroeconomic gains. Output (*real GDP level*) rises by 23 percent from the steady state over 10 years, or on average 2.3 percent annually, and the public debt-to-GDP ratio declines markedly. In contrast, Alternative Scenario 2—which assumes that half of the reforms implemented in the first five years are reversed in the sixth year—erodes the macroeconomic gains. Output gains at the end of the 10-year horizon will remain about 40 percent lower than under the Central Scenario, along with reduced fiscal gains. These outcomes highlight the criticality of strong political commitment to sustain the governance reform momentum.

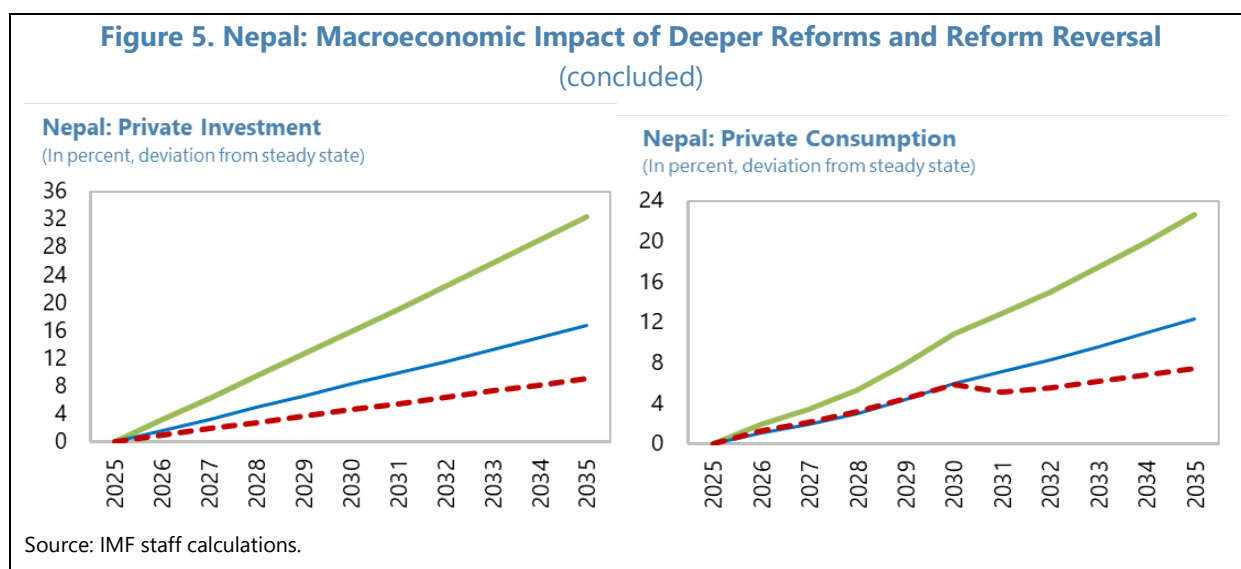
Figure 5. Nepal: Macroeconomic Impact of Deeper Reforms and Reform Reversal**Nepal: Real GDP**

(In percent, deviation from steady state)

**Nepal: Public Debt-to-GDP**

(In percentage points, deviation from steady state)

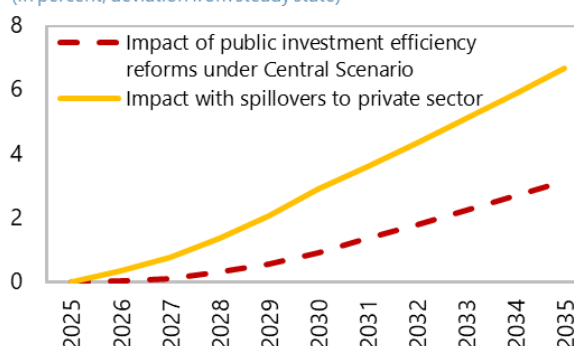




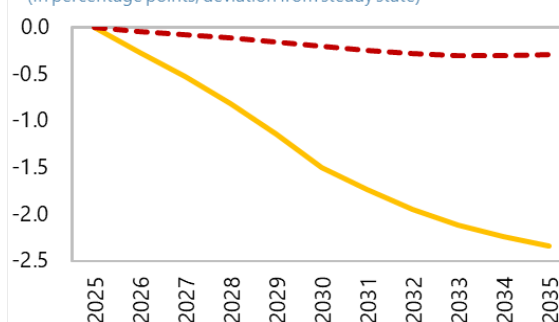
11. Reforms that improve the efficiency of public investment can also produce positive spillover effects for the private sector, amplifying macroeconomic gains. For example, government-led digitalization for business processes can enhance transparency and lower corruption, reducing distortions for private investment and improving the efficiency of existing private capital. Similarly, public investment in physical and IT infrastructure can facilitate manufacturing and services activity and promote labor mobility, stimulating private investment. Alternative Scenario 3 captures this effect by assuming a 50 percent spillover effect on private investment from the increase in public investment efficiency under the Central Scenario. As shown in Figure 6, these spillovers double the gains in output (*real GDP level*) and private investment from the steady state over 10 years compared to the standalone public investment efficiency reform under the Central Scenario (118 and Figure 3). The decline in public debt-to-GDP and boost to consumption are also amplified by the spillovers to private sector due to higher tax revenue, increased employment, and fiscal space for social transfers.

Figure 6. Nepal: Macroeconomic Impact of Public Investment Efficiency Spillovers**Nepal: Real GDP**

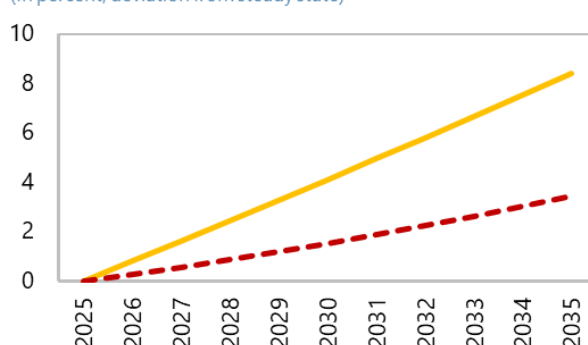
(In percent, deviation from steady state)

**Nepal: Public Debt-to-GDP**

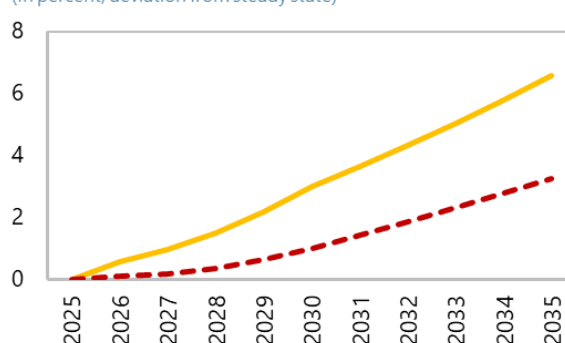
(In percentage points, deviation from steady state)

**Nepal: Private Investment**

(In percent, deviation from steady state)

**Nepal: Private Consumption**

(In percent, deviation from steady state)



Source: IMF staff calculations.

C. Conclusion

12. A comprehensive set of governance reforms implemented gradually in a sustained manner can yield significant macroeconomic gains for Nepal. The DIG model analysis shows that while individual governance reforms would have positive macroeconomic outcomes, implementing a combined package of governance reforms would deliver larger gains in terms of economic growth, distributional impact, and debt dynamics. In particular, governance reforms to address private investment distortions would have significant positive effects on growth. Given Nepal's large development needs, medium-term growth can be supported not only by scaling-up public investment but also by raising its efficiency through governance reforms. Certain governance reforms can strengthen the complementarity between public and private investment, augmenting the macroeconomic benefits and lifting total factor productivity. At the same time, it is critical to sustain the reform efforts over time to secure these macroeconomic gains.

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