

EU-NEPAL

TRADE AND INVESTMENT

DIAGNOSTIC



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List of Abbreviations

DFQF	Duty-Free and Quota-Free
EBA	Everything But Arms
EU	European Union
FDI	Foreign Direct Investment
GCI	Global Competitiveness Index
GSP	Generalised System of Preferences
ILO	International Labour Organisation
ITC	International Trade Centre
LDC	Least Developed Countries
MAPS	Medicinal and Aromatic Plants
MFN	Most Favoured Nation
NPC	National Planning Commission
ROO	Rules of Origin
UN	United Nations
UNDP	United Nations Development Programme
WB	World Bank
WEF	World Economic Forum
WITS	World Integrated Trade Solution

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Executive Summary

Nepal's economic growth has improved in recent decades, driven largely by remittances rather than structural transformation. While poverty has fallen and social indicators have improved, export growth, foreign direct investment (FDI), and employment creation remain weak. Nepal's export basket is narrow, its markets are concentrated, and its firms face high costs, weak institutions, and limited access to technology and finance. These vulnerabilities will become more acute as Nepal graduates from Least Developed Country (LDC) status in 2026 and begins to lose preferential access to major markets.

In this context, the European Union (EU) plays a particularly strategic role. It is Nepal's third-largest trading partner after India and China, accounting for around 4 percent of total trade and almost 7 percent of exports. Within the EU, Germany is the most important bilateral partner, ranking as Nepal's third-largest export destination globally. The EU is also an increasingly important source of foreign investment, particularly in energy, tourism, and manufacturing.

Under the EU's Everything But Arms (EBA) scheme, Nepal has enjoyed duty-free, quota-free market access for all products except arms. This has helped sustain exports of carpets, garments, and pashmina. However, the EU relationship has not generated the scale, diversification, or productivity growth that Nepal requires. Export volumes and values have remained broadly stagnant, and Nepal has not expanded into new products or value-added segments despite having preferential access.

As Nepal prepares to graduate from LDC status, the stakes in the EU market will rise. If Nepal fails to adapt, preference erosion, stricter rules of origin, and growing regulatory requirements could significantly reduce exports, particularly in labour-intensive manufacturing. If Nepal reforms successfully, however, the EU can become a key partner in Nepal's transition toward higher-value, more sustainable trade.

Nepal's Structural Competitiveness Gap

Nepal's weak performance in trade and investment is not primarily due to tariffs or market access; it reflects deep-seated structural constraints that limit productivity, competitiveness, and firm growth. Nepal ranks in the bottom quartile globally on the World Economic Forum's Global Competitiveness Index. Product markets are distorted by taxes, and limited competition. Trade openness is among the lowest in Asia, and border clearance, non-tariff barriers, and tariff complexity remain high. Logistics performance is extremely weak: Nepal is one of the worst-ranked countries in the world on the Logistics Performance Index, reflecting inefficient customs, poor infrastructure, and low-quality logistics services.

These weaknesses translate into exceptionally high trade costs. The ad-valorem equivalent cost of trading goods between Nepal and Germany is estimated at 227 percent—among the highest in the world. Even compared with other South Asian countries, Nepal's bilateral trade costs are far higher. These costs more than offsets any tariff advantage.

Domestic regulation further undermines firms. Businesses face complex and inconsistent tax administration, multiple regulators, high compliance burdens, and widespread informal payments. Labour costs have risen far faster than productivity, while non-wage costs—including social security contributions, gratuity, festival allowances, and bonuses—have created a large tax wedge that discourages formal employment and investment. As a result, Nepal's value added per worker is among the lowest in Asia, even as wages have increased sharply.

FDI has remained extremely low. Investment is also poorly linked to exports: most foreign investment has gone into energy and services rather than into sectors that build export capacity, technology, and value-chain integration.

LDC Graduation, Tariffs, and Rules of Origin

Nepal currently uses the EU's EBA scheme for around 80 percent of its exports to Europe. After graduation, it will no longer be eligible for EBA and will instead fall under either the standard Generalised System of Preferences (GSP) or, if it qualifies, the enhanced GSP+ scheme.

The difference is critical. Under standard GSP, tariffs on Nepal's main EU exports—garments, carpets, pashmina, and accessories—would rise by 6 to 10 percentage points. Partial-equilibrium estimates suggest that this would reduce Nepal's EU exports by USD 18–20 million per year, even before considering the effects of stricter rules of origin. If Nepal were to lose preferential access altogether and revert to MFN tariffs, export losses could exceed 50 percent.

GSP+ would largely preserve duty-free access, but eligibility depends on ratifying and effectively implementing 27 international conventions on labour rights, human rights, governance, and the environment. Nepal has ratified most of these but still needs to complete key commitments, notably ILO Convention No. 87 on freedom of association and the Cartagena Protocol on Biosafety. Moreover, the EU increasingly emphasizes implementation and enforcement, not just formal ratification.

Rules of origin pose an equally serious challenge. Under EBA, most Nepali garments qualify with only single transformation (cut and sew). Under both standard GSP and GSP+, most apparel will require double transformation—spinning and fabric production as well as garment assembly. Because Nepal imports most of its fabric, many of its core exports will struggle to meet these requirements. Failure to comply would push products onto MFN tariffs even if GSP+ is granted, sharply reducing competitiveness.

By contrast, some high-potential products such as cardamom, tea, medicinal plants, wood products, and certain handicrafts face less stringent rules of origin and could expand more easily if supply, quality, and certification improve.

The Way forward

Nepal's relationship with the European Union stands at a crossroads. Preferential access under EBA has allowed Nepal to maintain traditional exports, but it has not delivered diversification, productivity, or resilience. LDC graduation will remove that safety net. If Nepal does not reform, its exports to the EU will decline; if it does, the EU can become a powerful partner in Nepal's transition to higher value, more sustainable trade.

The path forward requires three shifts. First, Nepal must secure and credibly implement GSP+ to preserve market access to the EU market following LDC graduation. Second, it must invest in value-chain upgrading, certification, infrastructure, logistics, and air cargo. Third, Nepal must strengthen its overall competitiveness by improving the domestic business and trade environment, including simplifying tax administration, modernizing customs and border procedures, reducing bureaucratic discretion and administrative delays, and

removing regulatory and procedural barriers that increase the cost of exporting and deter both domestic and foreign investment.

With targeted reforms, strong coordination, and engagement with both the EU and the private sector, LDC graduation can become not a shock but a catalyst for Nepal's long-overdue economic transformation.

Chapter 1

Introduction

For a sustained growth, Nepal needs to attract investments and expand trade but performance in both areas has been poor.

Nepal has made improvement in economic, social and development indicators, but progress has been slow-paced and far from desired level. While indicators like life expectancy, literacy, and access to electricity have shown remarkable improvements, Nepal still lags in terms of economic indicators like income growth and employment generation, and social indicators like access to drinking water and basic social security (See Figures 1 and 2). Economic growth has also been uneven, signalling volatility. By 2023 the percentage of population living below the nationally determined poverty line was 25.16¹ and while this is a remarkable progress, it can be mainly attributed to remittance and less to the structural enhancement of the economy. Essentially growth and development have been primarily driven by external forces upon which we have no control over, depicting unsustainability of growth dynamics.

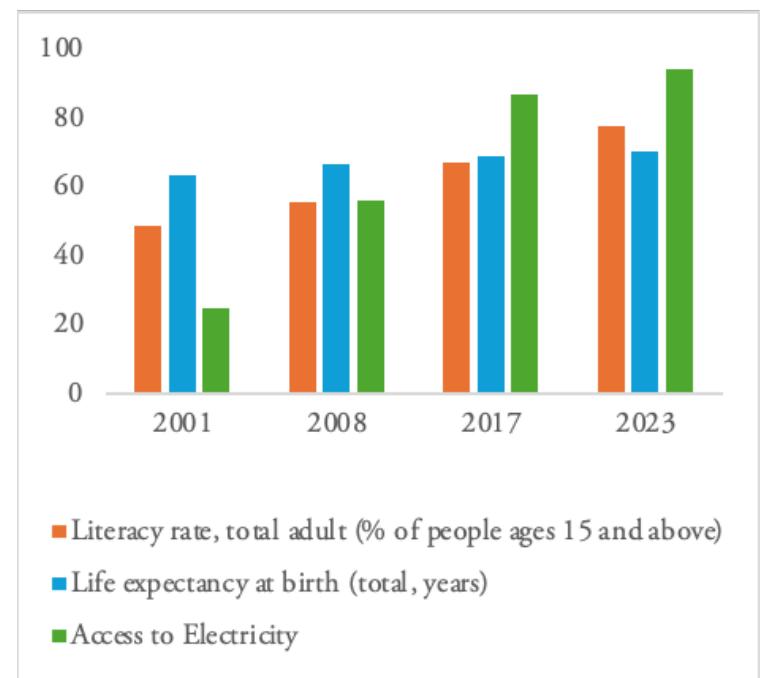


Figure 1: Literacy rate and Life expectancy at birth
Source: Compiled by the author

1 National Statistics Office, *Nepal Living Standards Survey IV 2022/23: Statistical Report* (Kathmandu: NSO, June 2024)



Figure 2: Labour force participation rate and GDP growth rate

Source: National Statistics Office

For a sustained growth, Nepal needs to attract investments and expand trade but performance in both areas has been poor. Foreign Direct Investment (FDI) inflows have remained stagnant over the last decade, peaking at NPR. 20,000 million.² Within the South Asian context, Nepal fares better than only Afghanistan, a country riddled with conflicts. Even countries with experiences similar to Nepal in terms of civil unrest and fledgling political environment like Vietnam and Myanmar have been able to attract foreign investment in recent years. In 2024 Vietnam's FDI inflows totaled \$20.170 billion, Myanmar's FDI inflows were \$1.095 billion, whereas Nepal's total was \$57 million. Despite the formulation of multiple trade policies and the adoption of the National Trade integration strategy in 2023, Nepal's trade performance, particularly export performance has not been satisfactory. The export value index and the export volume index have largely remained stable, suggesting a lack of product diversification and destination diversification.

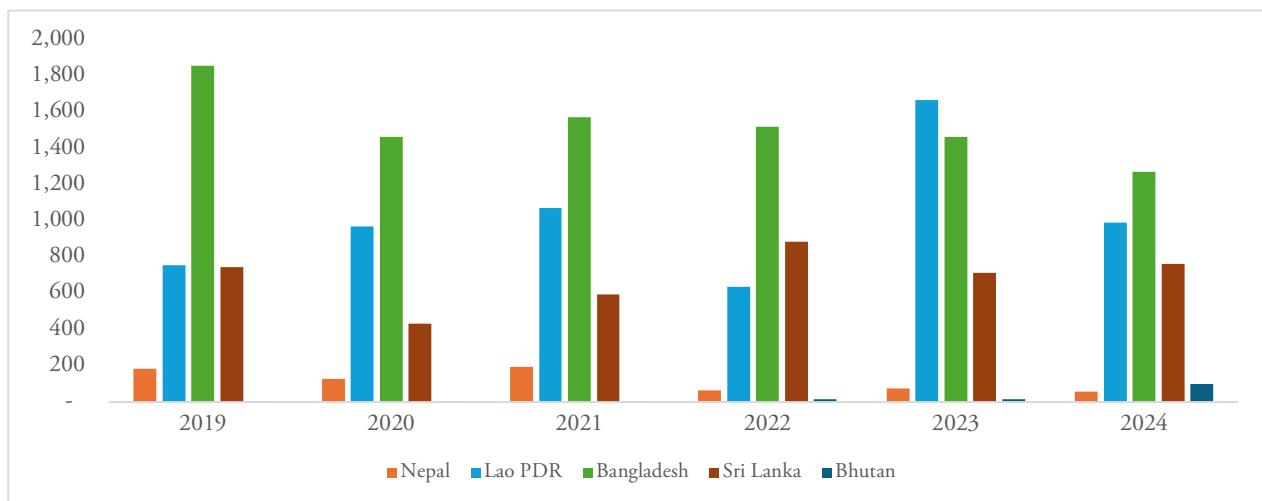


Figure 3: Foreign Investment inflows in millions of dollars

Source: UNCTAD

2 Department of Industry, Ministry of Industry, Commerce and Supplies, Government of Nepal, Foreign Investment in Nepal 2024: (Policies, Procedures, Promotions & Investment Trends) (Tripureshwor, Kathmandu: Department of Industry, July 2024).

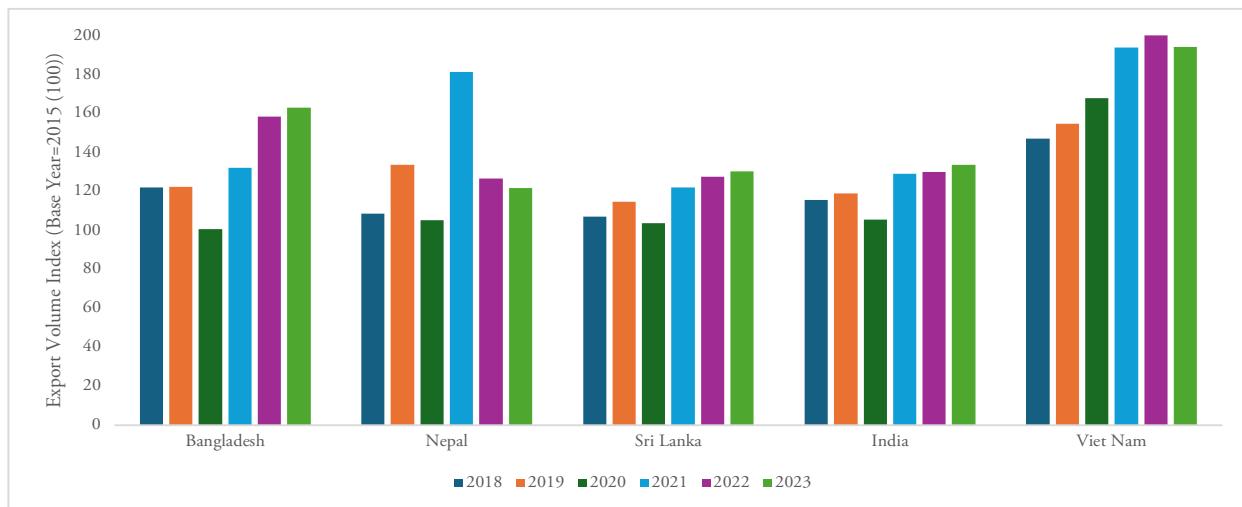


Figure 4: Export Volume index between 2018-2023

Source: World Bank

Trade is concentrated with India and adequate measures to diversify destination is visibly missing. More than 80% of Nepal's total export are destined to India. Unsatisfactory performance in International Market Access Index testifies Nepal's inability to access diverse export markets.³ It thus becomes imperative to permeate into high potential markets.

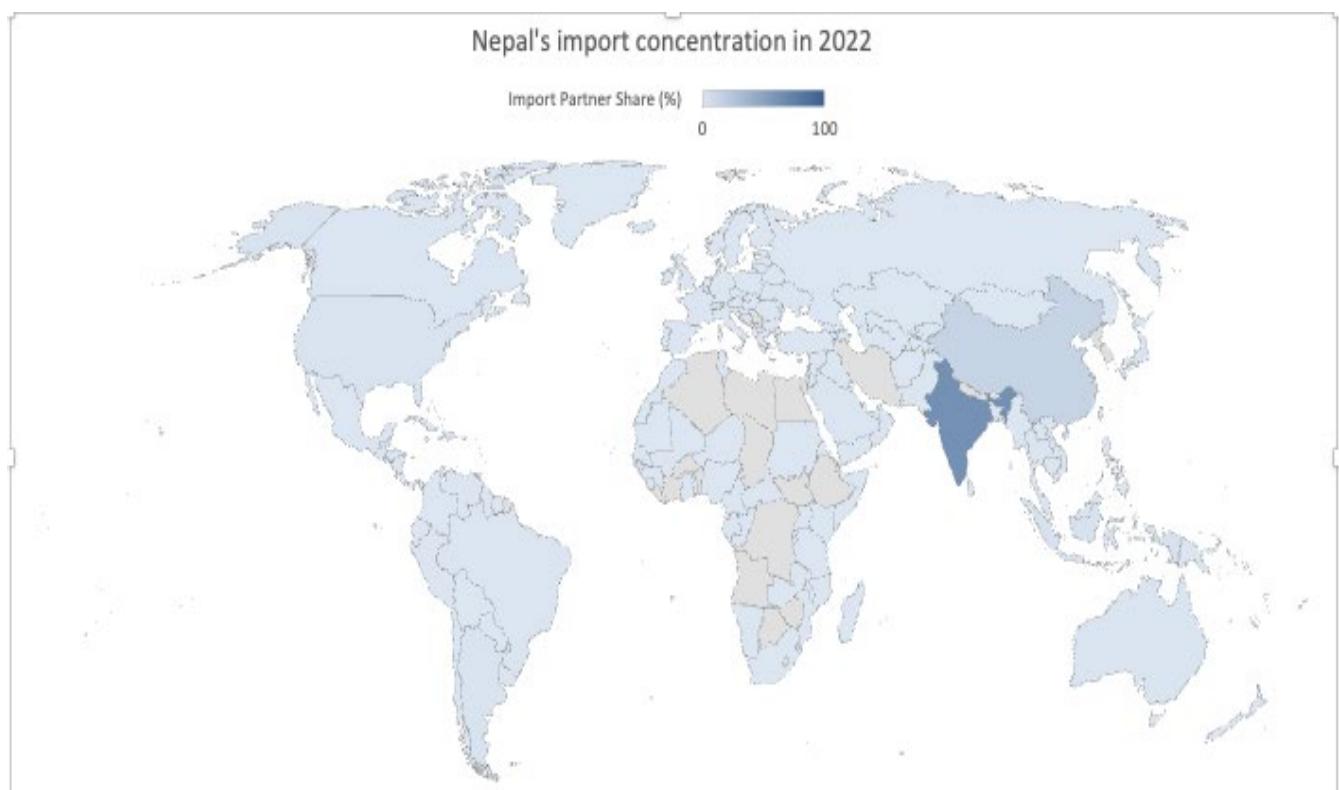


Figure 5: Foreign Investment inflows in millions of dollars

Source: Authors based on WITS dataset

³ Ministry of Industry, Commerce and Supplies, Government of Nepal, *Nepal Trade Integration Strategy 2023 (2023–2028)* (Kathmandu: Ministry of Industry, Commerce and Supplies, 2023)

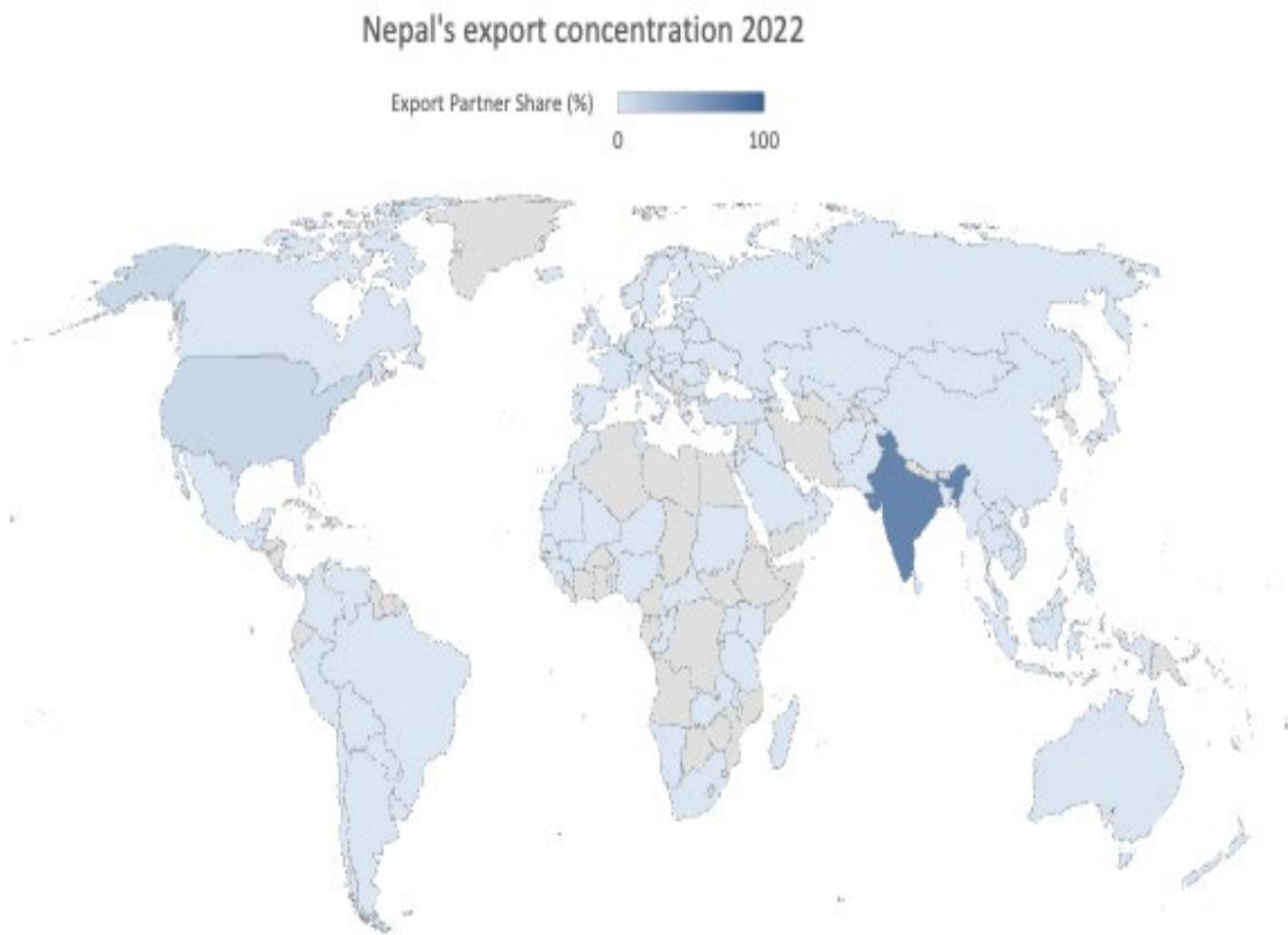


Figure 6: Nepal's export concentration

Source: Authors based on WITS dataset

Following its immediate neighbours, India and China, the European Union (EU) remains one of Nepal's most significant and enduring trading partners. Over the past decade, trade between Nepal and the EU has grown steadily, reflecting the EU's continued importance as a destination for Nepali goods and a source of imports. In 2023, Nepal's total trade with the EU reached €492 million, accounting for approximately 4 percent of Nepal's total international trade, thereby making the EU the third-largest trading partner after India and China⁴. The EU also holds the position of Nepal's third-largest export market, absorbing nearly 7 percent of total exports. Within the EU, Germany has emerged as Nepal's most important bilateral partner, serving as the third-largest destination for Nepali exports globally, with a total export value of USD 39 million in 2023⁵.

On the foreign investment front, inflows from the European Union market have increased steadily over the years. Since, 2015, investments originating from the European union countries have nearly doubled reaching, NPR 1.130 billion in 2024. Investment has been concentrated in the energy (47%), tourism sector (21%) and manufacturing (15%) sector. Similarly, investments originating from Germany, form a significant share of investments from the EU. Although German investments have fluctuated over the years, in 2024, it comprised 14 per cent of investments from the EU, signifying its potential as a foreign investor.

⁴ GSP Hub, "Nepal Country Profile: GSP and EBA Trade Preferences," *European Union Trade Portal*, 2025.

⁵ European External Action Service (EEAS), "EU to Support Nepal's LDC Graduation Efforts," *European External Action Service*, October 24, 2024.

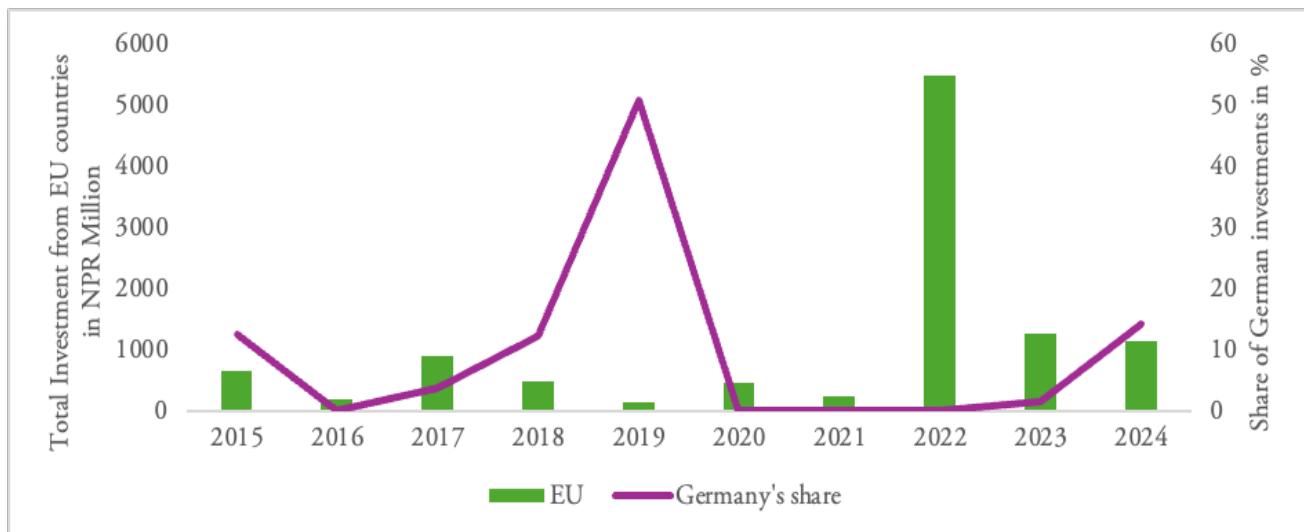


Figure 7: Foreign Investments from EU countries in Nepal

Source: Compiled by the authors based on data from the Department of Industries Nepal

But despite the EU's status as a high-potential market, Nepal has not yet been able to fully realise the available opportunities for export growth, diversification and foreign investment. Among the product categories with the highest potential for export expansion by 2030, Nepal has fully realised or exceeded its potential only in apparel and carpets. Apparel exports, currently valued at USD 56 million, and carpet exports, at USD 26 million, have both surpassed their projected potential levels. These sectors have historically formed the backbone of Nepal's export basket to European markets, benefiting from the country's labor-intensive production structure, and favorable market access.

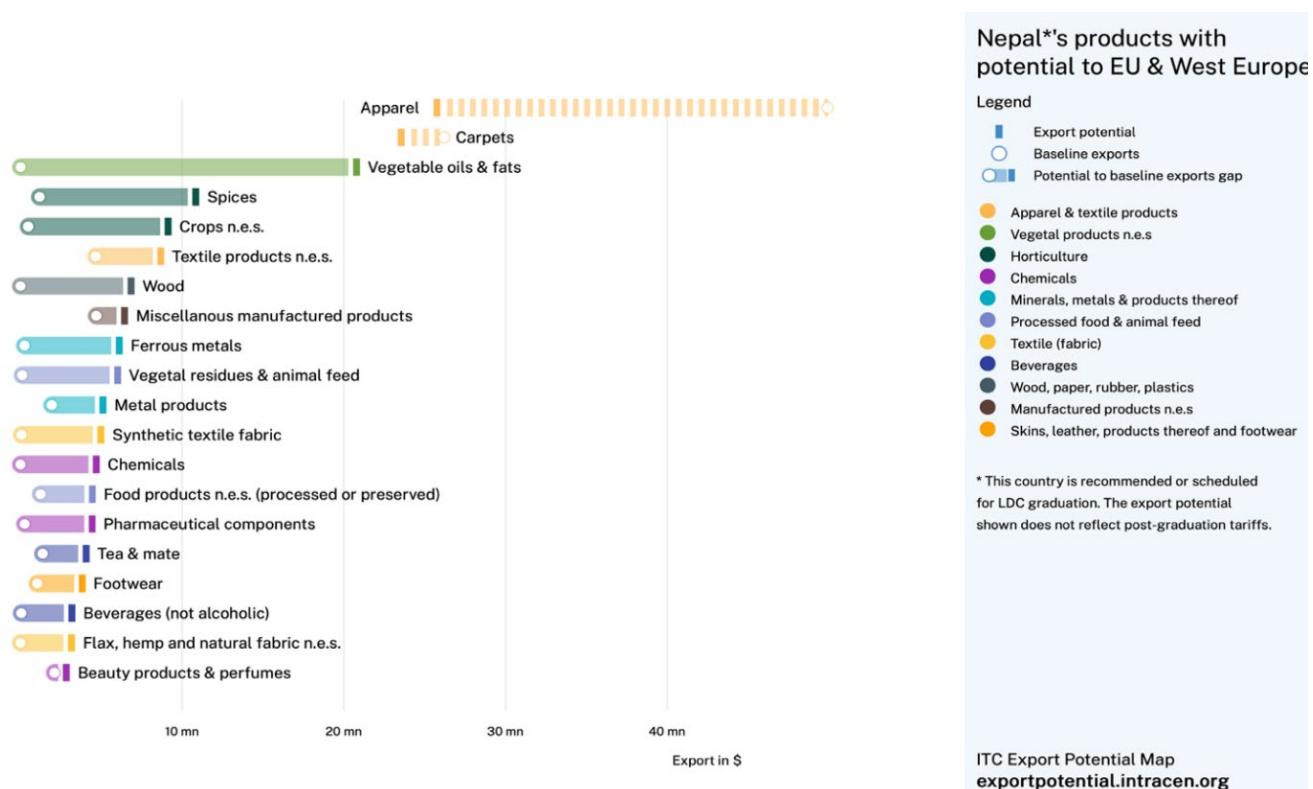


Fig 8. Nepal's export potential with EU

Source: ITC Export Potential Map

Beyond these two traditional sectors, several other products exhibit substantial untapped potential. Spices, particularly large cardamom, present a promising growth area, with a total export potential of USD 11 million, of which only USD 1.2 million has been realised to date. Within this category, cardamom alone accounts for an unrealised potential of approximately USD 7.8 million. Similarly, medicinal and aromatic plants (MAPS), which are increasingly in demand in the European herbal and wellness industries, possess an unrealised potential of around USD 5 million. Additionally, textiles and wood products, including plywood and laminated wood, collectively represent an unrealised potential of about USD 5.7 million. These figures highlight the significant room for growth through product diversification, improved value addition, and better compliance with European quality and standards.⁶

The three-year moving average⁷ of Nepal's top ten export goods consistently features carpets, apparel, and related products. This persistent concentration underscores Nepal's limited success in expanding and diversifying its export base. Moreover, even within these dominant categories, export performance has remained stagnant over the past decade. Such heavy reliance on carpets and apparel also exposes Nepal to significant vulnerability: negative shocks such as sudden shortages of raw materials or intensifying international competition could severely undermine exports. These trends highlight an urgent need for greater product diversification to strengthen the resilience and long-term growth of Nepal's export to Europe and Germany. Nepal currently enjoys preferential market access to the EU under the Generalized System of Preferences (GSP), specifically through the Everything But Arms (EBA) initiative. This arrangement, designed exclusively for Least Developed Countries (LDCs) as classified by the United Nations (UN), grants duty-free and quota-free (DFQF) access for all exports except arms and ammunition. Under the EBA framework, Nepali products enter the European market with zero import duties, providing a considerable competitive advantage over countries not covered by similar preferences. Furthermore, lenient rules of origin (ROO) provisions under EBA enables Nepali exporters to source a portion of their inputs from other countries while maintaining eligibility for preferential treatment⁸.

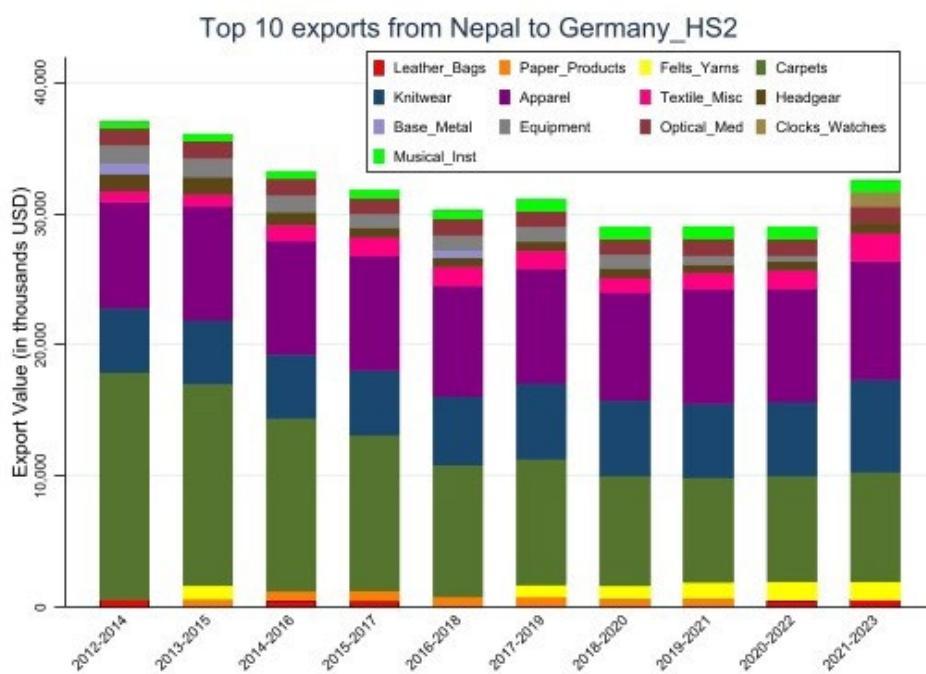


Fig 9: Nepal top 10 exports to Germany
Source: Compiled by the Authors based on data from the BACI

⁶ See International Trade Centre, *Export Potential Map*, <https://exportpotential.intracen.org> for detail export potential by product category

⁷ We have taken 3 year moving average to adjust for shocks like earthquake and COVID.

⁸ GSP Hub, "Nepal Country Profile: GSP and EBA Trade Preferences," *European Union Trade Portal*, 2025.

Despite benefiting from the EBA scheme, Nepal has not achieved significant progress in expanding its exports to the European market. While the EBA arrangement has been instrumental in sustaining Nepal's export performance in traditional sectors such as apparel, carpets, and pashmina, the country has struggled to leverage these preferences for export diversification and penetration into new, high-potential sectors. Although the stringent standards and minimum quality requirements in destination markets remain a key constraint, a range of domestic structural factors also impede Nepal's export growth. Weak institutional capacity, complex regulatory frameworks, limited product market efficiency, an unfavorable business environment, inadequate infrastructure, and bureaucratic inefficiencies collectively constrain production, trade competitiveness, and innovation. These factors not only limit product and market diversification but also affect the entry, survival, and scalability of exporters in the European market. While detailed analysis of all these factors would require a comprehensive trade competitiveness diagnostic, such as the framework developed by the world bank, it is beyond the scope of this study. Nevertheless, a brief comparative analysis of Nepal's trade competitiveness, benchmarking it against major trading partner of the EU and Germany becomes imperative to understand our current position, identify gaps, and draw lessons for enhancing export performance.

Against this backdrop, this note examines Nepal's performance across various indicators that determine the magnitude of a country's bilateral trade and investment flows and presents a case for diversification into the European Union market. We benchmark Nepal's performance against that of several other trading partners of the EU and Germany to assess its relative standing and identify areas for improvement. Second, we analyse Nepal's major export products over the past decade. As Nepal prepares to graduate from LDC status to a developing country, it will cease to be eligible for the EBA scheme after a three-year transition period. Thereafter, Nepal will qualify for preferential market access under either the standard GSP or the enhanced GSP+ scheme, both of which entail higher tariff rates for many of Nepal's key exports. This paper therefore examines the product-wise changes in tariff rates under the GSP and GSP+ regimes and their potential impact on Nepali exporters. Furthermore, since the Rules of Origin requirements are expected to become more stringent with no significant difference either under GSP or GSP+, we also assess their impact and Nepal's preparedness to comply with them.

Chapter 2

Institutions, Markets and Governance

Nepal's regulatory framework, along with its governance mechanisms, infrastructure, product and labour markets, and business and innovation ecosystems, remains relatively unfavourable for enhancing production and trade competitiveness.

Market efficiency, policies and regulatory quality are important predictors of export performance. Market efficiency and regulatory quality shape export performance through several reinforcing mechanisms that operate at the firm, sectoral, and economy-wide levels. Predictable and well-enforced regulations reduce policy uncertainty and compliance costs, enabling firms to make long-term investments in capacity, technology adoption, and workforce skills that are essential for competing in external markets. Efficient border management, customs clearance, and logistics systems shorten delivery times and lower trade costs, which is particularly critical for time-sensitive and intermediate goods trade. At the same time, competitive product and labour markets facilitate resource reallocation toward more productive firms and exportable activities, allowing economies to exploit economies of scale and move up value chains. Where regulatory frameworks are weak, as reflected in distortive taxation, limited competition, and uneven enforcement, firms face higher fixed costs, reduced incentives to formalise, and constrained access to finance and inputs. These structural frictions disproportionately affect small and emerging exporters, hindering diversification and limiting integration into regional and global value chains, ultimately translating into persistently low export performance at the national level.

The relationship between market efficiency, policies, and regulatory quality is further reinforced by the positive association between countries' exports per capita and their performance across composite indicators such as the Global Competitiveness Index and the Business Ready framework (See Figure 10). Although composite indices such as Global Competitiveness and Business Ready do not fully capture the breadth, depth, or context-specific shortcomings of institutional arrangements, they nonetheless serve as essential tools for assessing a country's overall regulatory environment and the effectiveness of its rules governing market participation, competition, and trade. The rest of the section builds on important lessons that can be drawn from Nepal's performance in such composite indices.

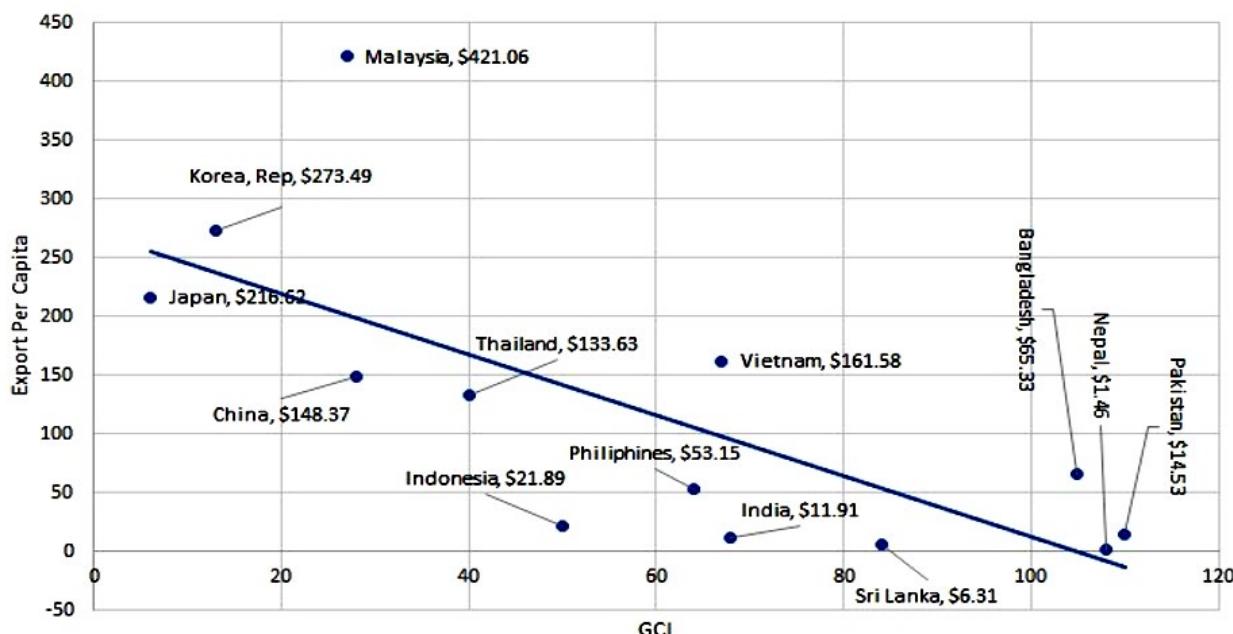


Fig 10. Global Competitiveness ranking and export per capita

Source: Calculations based on Global Competitiveness Report 2019, WEF and WITS

Nepal's regulatory framework, along with its governance mechanisms, infrastructure, product and labour markets, and business and innovation ecosystems, remains relatively unfavourable for enhancing production and trade competitiveness. According to the World Economic Forum's Global Competitiveness Index (GCI)—which assesses the set of institutions, policies, and factors determining a country's productivity level—Nepal ranks in the bottom quartile of the global distribution. With an overall GCI score of 51.6, Nepal is placed 108th out of 141 economies. But Nepal is not an outlier within the South Asian context. When compared to Germany's major trading partners in Asia, Nepal and other South Asian countries perform poorly. Within the region, Nepal ranks above only Pakistan, while countries such as India, Bangladesh, and Sri Lanka perform modestly better.

Country	GCI Rank (2019)	Exports per capita 2023 (USD)
Japan	6	216.62
South Korea	13	273.49
Malaysia	27	421.06
China	28	148.37
Thailand	40	133.63
Indonesia	50	21.89
Philippines	64	53.15
Vietnam	67	161.58
India	68	11.91
Sri Lanka	84	6.31
Bangladesh	105	65.33
Nepal	108	1.46
Pakistan	110	14.53

Table 1: Global Competitiveness Index and export per capita

Source: Global Competitiveness Report 2019, World Economic Forum (WEF) and World Integrated Trade Solution (WITS).

When compared to other Lower Middle-Income Countries beyond the South Asian region like Indonesia and Vietnam, challenges including weak institutions, underdeveloped infrastructure, and limited market efficiency, become further evident. On sub-indicators like trade openness, border clearance efficiency, and prevalence of non-tariff barriers, Nepal lags far behind Indonesia and Vietnam. Nepal's domestic market is characterised by distortive taxes and limited competition, and the prevalence of cartels and collusive practices, all of which has created entry barriers for new and innovative firms.

		Japan	South Korea	Indonesia	Vietnam	India	Bangladesh	Nepal
1	Product Market	6	59	49	79	101	119	132
1.1	Domestic competition	5	66	45	64	46	113	118
1.1.1	Distortive effect of taxes and subsidies on competition	17	61	38	72	57	91	94
1.1.2	Extent of market dominance	2	93	50	47	38	122	124
1.1.3	Competition in services	7	48	67	72	66	105	117
1.2	Trade openness	9	67	62	91	131	119	135
1.2.1	Prevalence of non-tariff barriers	38	77	80	121	66	75	122
1.2.2	Trade tariffs	39	91	73	96	134	130	140
1.2.3	Complexity of tariffs	107	83	69	72	87	34	47
1.2.4	Border clearance efficiency	3	25	61	42	41	116	117

Table 2: Product Market Efficiency

Source: *Global Competitiveness Report 2019, WEF*

Nepal ranks 90th in the Economic freedom of the world report, and 131 in the Freedom to trade internationally component of the index. Nepal's score places it in the fourth quartile, which suggests significant trade restrictiveness and higher costs of exporting and importing. On paper, Nepal has a protectionist trade regime, evidenced by the number of tariff bands and an increase in duties applied to tariff lines. Specific duties are now applied to 113 tariff lines, compared to 51 tariff lines in 2018/19. Additional taxes and charges are also levied on imports such as customs service fees, agriculture service fees, and road construction fees, among others. These para-tariffs are either calculated as a percentage of the customs value or assigned as flat fees per shipment, which are updated regularly via the Finance Act.

In addition to institutional barriers and market inefficiencies, high trade and logistics cost are major impediments to trade expansion with Germany. The ad-valorem trade cost between Nepal and Germany is among the highest not only in South Asia but also globally. On average, trading goods between the two countries involves an additional 227% of the value of the goods, compared to trading the same products with the border. Nepal's bilateral cost with Germany is significantly higher than the other South Asian countries. For instance, compared to the Maldives which has the second-highest bilateral trade cost with Germany in the region, Nepal's costs are whopping 59% higher. Compared to India, which is the best performer in South Asia, Nepal's additional cost is a staggering 131% higher.

Country	Ad-valorem equivalent trade costs in percent	Ad-valorem equivalent trade costs excl. tariff in percent
China	65	56
Indonesia	127	115
India	96	82
Japan	85	84
Korea, Rep.	79	77
Sri Lanka	144	136
Maldives	168	146
Malaysia	66	58
Nepal	227	208
Pakistan	133	122
Philippines	112	106
Singapore	143	142
Thailand	91	78
Vietnam	69	65

Table 3: Trade cost

Source: ESCAP-World Bank (WB) Trade cost data

Nepal also imposes significant non-tariff barriers. The Business Ready Report 2024 highlights that 74 percent of respondents perceive customs and trade regulations as constraints, which emphasises the challenges particularly at the procedural, regulatory, and structural level⁹. Complex documentation processes, the need for multiple certifications, and lengthy approval processes significantly increase compliance costs. The ITC (International Trade Centre) survey reports that around 51% of exporters encounter problematic NTMs, with the agriculture sector being particularly affected¹⁰. Testing and certification by other government agencies (OGAs) contribute to delays at customs. On average, these agencies, which include quarantine facilities and laboratories, take 19 hours and 46 minutes, accounting for 20 percent of the total clearance time¹¹. Given that the facilities are located outside the customs area and because of the absence of a single window system for the OGA services, the time taken for testing samples and issuance of certificates is significant. Additionally, exporters often have to rely on Indian Labs to get approval from the Bureau of Indian Standards.

The problems at the procedural level are largely due to Nepal's poor quality of national infrastructure. Nepal's high bilateral trade cost is also reflected in its score in Logistics Performance Index. With a score of 2.51 out of 5, Nepal is one of the worst performers in the world and is the worst performer second to only Pakistan in South Asia. This basically indicates Nepal's inefficient customs and border clearance process, poor trade and transport infrastructure, lack of quality logistics services like transport operation and custom brokerage, among others.

9 World Bank, 2024, "Business Ready Report", (Washington DC: World Bank), <https://www.worldbank.org/en/businessready>

10 Paras Kharel, Kshitiz Dahal, and Nyingtob Pema Norbu, 2024, "NTMs in Nepal: Existing and New Issues in the Wake of LDC Graduation," *ESCAP Working Paper*, July 2024, https://www.unescap.org/sites/default/d8files/event-documents/ESCAP-2024-WP-NTMs-Nepal_0.pdf.

11 Paras Kharel and Kshitiz Dahal, 2021, "Trade Policy Coherence and Coordination in Nepal: An Exploratory Assessment," *Trade and Competitiveness Assessment Volume I*, <https://sawtee.org/publications/Trade-Policy-Coherence-and-Coordination-in-Nepal.pdf>.

	Japan	South Korea	Indonesia	Vietnam	India	Bangladesh	Nepal
LPI¹²	5	25	46	39	44	100	114
Customs	3	25	62	41	40	121	122
Infrastructure	2	22	54	47	52	100	123
International shipments	14	33	42	49	44	104	129
Logistics quality	4	28	44	33	42	102	105
Tracking and tracing	10	22	39	34	38	79	98
Timeliness	10	25	41	40	52	107	89

Table 4: Logistics Performance Index

Source: *Logistics Performance Index, 2018, World Bank*

High logistics costs in Nepal also significantly reduce firm-level competitiveness. In Nepal, traders bear logistic expenses amounting to 32 percent of the actual cost of goods, which covers transport, transit, delivery, storage, and official procedures. This significantly undermines competitiveness in the international market¹³. While Nepal's estimated logistic cost ranges between 14-25 percent of GDP¹⁴, India's logistic costs are estimated between 14-18 percent, and the country is planning to bring this percentage down to 9 percent¹⁵. So far, Nepal has not made any concrete plans to reduce logistics costs. Absent concrete strategies to increase firm-level competitiveness, Nepal's revenue strategy is likely going to remain reliant on heavy taxation on imports.

Box 1: Round table Discussion Highlight (March 31, 2025)

The round table discussion raised concerns over the high logistic cost faced by Nepalese traders, where one of the consultants highlighted the difference between domestic supply side and cross-border export cost, emphasizing the burden borne by traders beyond the borders.

Factors	Within Nepal	Beyond border
Time	20 days	80 days
Cost	15%	85%
Procedural Compliance	40%	60%
Documents Compliance	55%	45%
Risk	30%	70%

12 We use LPI ranking 2018 as LPI ranking 2023 does not rank Nepal.

13 Republica, 2022, "Nepali Traders Face Additional Cost of up to 32 Percent Due to Poor Logistic Facility," December 26. <https://myrepublica.nagariknetwork.com/news/nepali-traders-face-additional-cost-of-up-to-32-percent-due-to-poor-logistic-facility>.

14 Estimates of logistic cost as percentage of GDP vary depending on the methodology. This estimate is based on the heuristic benchmark, which sets the logistic cost of countries with efficient infrastructure at 8 percent of GDP, placing Nepal's logistic cost anywhere between USD 4 to 7.7 billion (14 to 25 percent of GDP); Raskin Maharjan, 2021, "The Logistics-Tech Landscape in Nepal," December 7, 2021. <https://www.linkedin.com/pulse/logistics-tech-landscape-nepal-raskin-maharjan/>.

15 The Hindu, 2024, "Nitin Gadkari Says India's Logistics Cost Will Come Down to Single-digit Percentage in Two Years," October 17. <https://www.thehindu.com/business/Economy/indias-logistics-cost-will-come-down-to-single-digit-percentage-in-two-years-gadkari/article68764060.ece>.

On the investment front Barriers to entry is also evident from the scores received by Nepal in the Business-ready survey. Nepal scored 66.36 out of 100 in the Business Entry pillar, lower than Bangladesh with a score of 74.08 and Pakistan with a score of 91.50. The low scores were driven by restrictions on foreign shareholding in the service sector, lack of digital services including the inadmissibility of electronic signatures, and high paid-up capital requirement.

Firms both small and large face significant regulatory burden. The latest Enterprise survey noted that the senior management of small and medium enterprises spent 6.7 and 9.4 per cent of their time, respectively, dealing with government regulation against 4.9 per cent of the time spent by senior management of large enterprises¹⁶. The findings are consistent with the Enabling Environment for Sustainable Enterprises Survey, 2018 conducted by the ILO¹⁷. The survey reports that a higher share of small enterprises find the regulatory environment to be more problematic than large enterprises. The low uptake of digital services provided by the government of Nepal amongst small and medium enterprises is likely a reason for small and medium enterprises finding the regulatory environment burdensome, for instance, only 35.3 per cent of small firms file taxes electronically compared to 71.6 per cent of large firms¹⁸. Except for a brief period in the 1990s, rationalising legal provisions related to the business environment has never been the top priority. Consequently, several redundant and often conflicting provisions exist. A prime example is the Black Marketing and Other Social Offenses Act. Nearly all provisions of the law have been covered by the Consumer Protection Act, yet the former is still in effect. Large firms also have to comply with multiple regulatory requirements implemented by multiple government agencies. For instance, a hydropower business is regulated by a total of 26 government agencies under seven different ministries, the cement industry is regulated by 27 different governments. Some efforts have been made to rationalise the legal regime. The most notable being a wholesale revision of a bundle of legislation. While a step in the right direction, government efforts should be concentrated on reducing the number of government agencies involved in regulating a particular business.

Firms regardless of their size find tax provisions hard to comply with. Against the South Asian average, Nepali firms spend an additional 22 hours complying with taxes¹⁹. In addition, 20.2 per cent of large firms noted that they were expected to give gifts in meetings with tax officials²⁰. Numerous commissions formed since 2065 *v.s.* to suggest taxation reforms have noted the complexity of the taxation regime²¹. The issue is further compounded by the outlook of tax offices i.e. losses are a deliberate attempt made by firms to evade taxes, and inconsistent judgments rendered by the Supreme Court of Nepal²².

The complexity of the tax regime isn't a result of the current tax codes, but rather because of weak implementation capacity. In consultative meetings undertaking to inform this audit, participants noted that the tax laws in and of themselves weren't the problem. They were in fact, save for a few provisions, in line with global standards. The problem is that the interpretation of the laws is not consistent. Although the Inland Revenue Department has issued explanatory notes for all provisions, businesses often have to navigate the challenges brought forth by inconsistent interpretation by tax officers. To make matters worse, even the court has not offered a consistent interpretation of the provisions in its judgments.

16 World Bank, *Enterprise Survey* (Washington DC: World Bank, 2023), <https://www.enterprisesurveys.org/en/data/exploreconomies/2023/nepal>

17 International Labour Organisation, *Enabling Environment for Sustainable Enterprises* (Geneva: Switzerland, 2018), p.33. https://www.ilo.org/sites/default/files/wcmsp5/groups/public/%40asia/%40ro-bangkok/%40ilo-kathmandu/documents/publication/wcms_655934.pdf

18 World Bank, *Enterprise Survey* (Washington DC: World Bank, 2023), <https://www.enterprisesurveys.org/en/data/exploreconomies/2023/nepal>

19 Small firms spend 90 hours, medium-sized firms spend 122 hours, and large firms spend 130 hours yearly complying with tax provisions.

20 World Bank, *Enterprise Survey* (Washington DC: World Bank, 2023), <https://www.enterprisesurveys.org/en/data/exploreconomies/2023/nepal>

21 Ministry of Finance, *Rajaswa Pramarsha Samitika Sujhav tatha Sifarishharuko Sanghalo* (2066-2078), (Singha Durbar: Nepal, 2078). https://mof.gov.np/uploads/document/file/1629198546_Nepal%20Rajaswa%20Paramasha%20sangalo%20book.pdf

22 Shailendra Upadhyay, *Taxation of Material Losses: Thousand possibilities and One Truth*, Journal of the Institute of Chartered Accountants of Nepal, Vol. 24, No. 2, December, 2021, 37-42, https://en.ican.org.np/_browsable/file/journals/Journal_Issue_December_2021.pdf

The issue of inconsistent interpretation is further compounded by the refusal of the tax office to issue advance rulings. Section 76 of the Income Tax Act provides for advance rulings—explanations regarding the interpretation of provisions of the Income Tax Act should any person request the Inland Revenue department for removal of confusion regarding said provision. The act however, does not make it mandatory for the Inland Revenue Department to issue advance rulings; it rather provides the Inland Revenue Department power to provide rulings. As participants of the consultative meeting noted, the department, in a majority of instances, does not provide an advance ruling. Businesses, as a consequence, have no other option but to bear the costs of inconsistent interpretation of laws in Nepal.

Inconsistent interpretation also highlights the nature of public administration in Nepal. Public administration in Nepal is not entirely impartial. While Nepal's scores on the impartial public administration section have increased, data from the latest round of the Enterprise survey especially with regards the number of firms expected to give gifts for getting an electricity connection, construction permit, and import licenses indicates otherwise. Admittedly, Nepal has reduced this incidence amongst small and medium enterprises but substituted it with expectations from large enterprises (See Figures 11 and 12). Between 2013 and 2023, the number of large enterprises reporting the expectation of a gift for an import license, construction permit and electrical connection has increased, whereas the figures for small and medium enterprises have decreased.

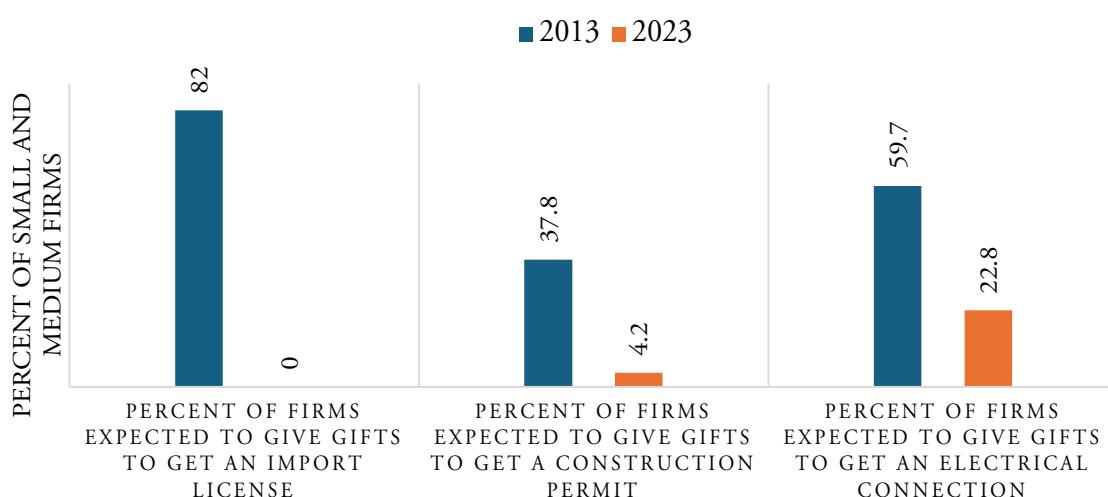


Figure 11: Percent of small and medium-sized firms reporting expectations to give gifts
Source: *Enterprise Survey, 2013 and 2023*

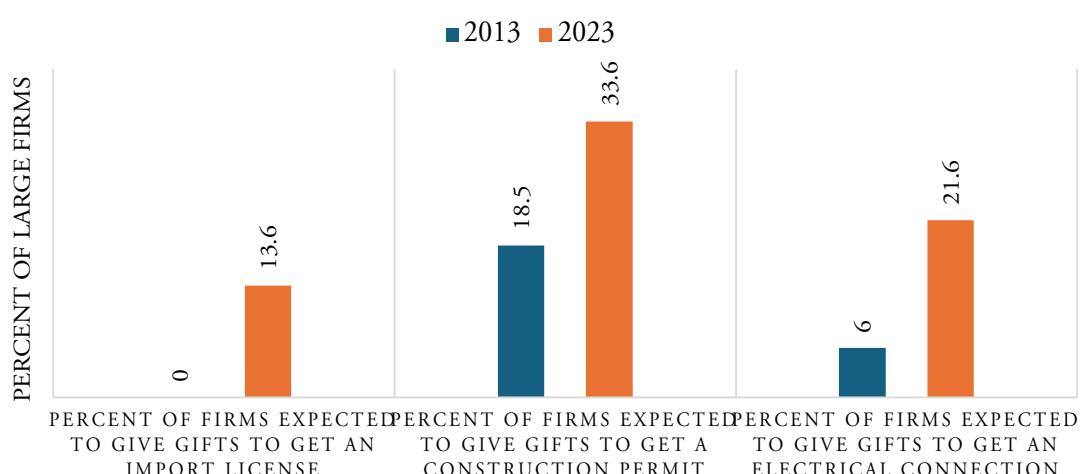


Figure 12: Percent of Large firms reporting expectations to give gifts
Source: *Enterprise Survey, 2013 and 2023*

The most recent Indian German Business Outlook noted that most favourable advantage of India as a location for German investment following political stability, was labour productivity and labour costs, both areas where Nepal needs to work on. Amongst peers, Nepal has the lowest value added per worker (See Figure-13). Between 2012 and 2022, value added per worker grew by 33 per cent whereas minimum wages grew by 141 per cent. For comparison between the same period Lao PDR's value added per worker grew by 112 per cent against a minimum wage growth rate of 80 per cent.

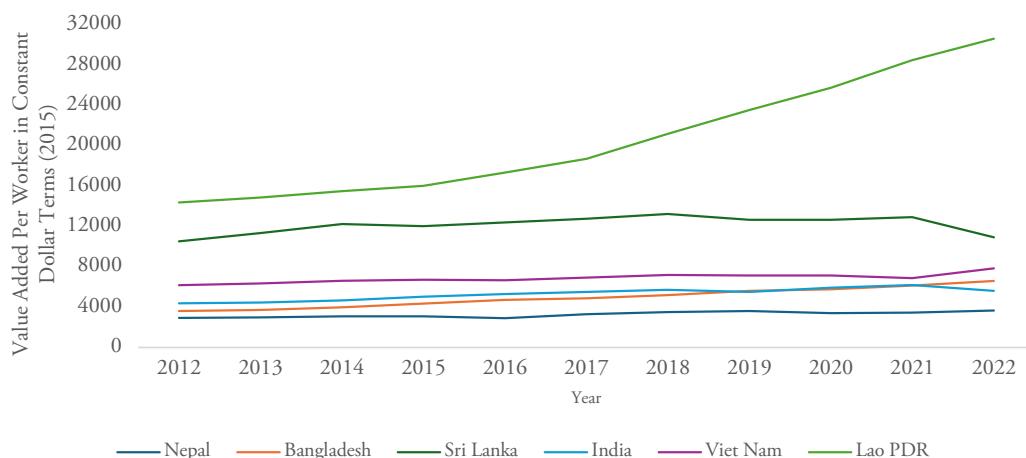


Figure 13: Value Added Per Worker in Constant Dollar Terms (2015) between 2012-2022

Source: World Bank Development Indicators

At the same time, the non-wage costs of employing has increased significantly. The Labour Act of 2017 significantly increased non-wage costs through its ambitious universal social security scheme. Under this scheme, an employee contributes 11 percent of their basic salary, and the employer contributes 20 percent. Given the absence of a headcount provision, the scheme is applicable to all enterprises regardless of size. In addition, the Labour Act also added other costs which include the mandatory provision for festival allowances i.e. amount equivalent to one month's pay on top of a bonus sharing provision of 10 per cent of net profits. Whereas under the previous regime, gratuity payments were only applicable after an employee had completed 3 years of service, the current law makes it mandatory for firms to allocate 8.33 per cent of an employee's basic salary from the day they join work. With these provisions in place, the non-wage costs of employing have increased in Nepal, the effect of which is more pronounced for small and medium enterprises.

Particulars	Labour Act, 2047 vs	Labour Act 2074 vs
Provident fund	10 per cent contributed by an employee 10 per cent contributed by employer	10 per cent contributed by an employee 10 per cent contributed by employer
Gratuity	For the first 7 years of service: Half of monthly salary for each year of service. For 7-15 years of service: 2/3rd of the month's salary for each year of service. Eligible only after the completion of 3 years of service.	8.33 per cent of the basic salary Eligible from the first day of employment
Festival Allowances	No provisions	Equivalent to one month's remuneration once every year
Medical Insurance	No provisions	At least 1 Lakh per year for every worker/1.67 per cent of basic remuneration
Bonus	10 per cent of Net profit	10 per cent of Net profit

Table 5: Comparison of non-wage costs between Labour Act 2047vs and 2074vs

Source: Compiled by the Authors

The added non-wage costs of employment have created a tax wedge high enough to disincentivise formal operation of business. Taken together, bonus provisions, festival allowances, and social security payments, account for 28 per cent of the basic remuneration of employees. Firm costs for employing formally are in reality the cost of minimum wages plus twenty eight percent, excluding severance pay and medical insurance. Large tax wedges discourage formal employment, and compared to peers, Nepal has a higher tax wedge. Given the lack of any data about formal and non-formal employment in Nepal, an adequate picture of the dynamics of the labour market post the implementation of the labour act 2017 is not available. Anecdotal evidence, however, suggests that informal employment has risen with a preference for temporary and piece rate work.

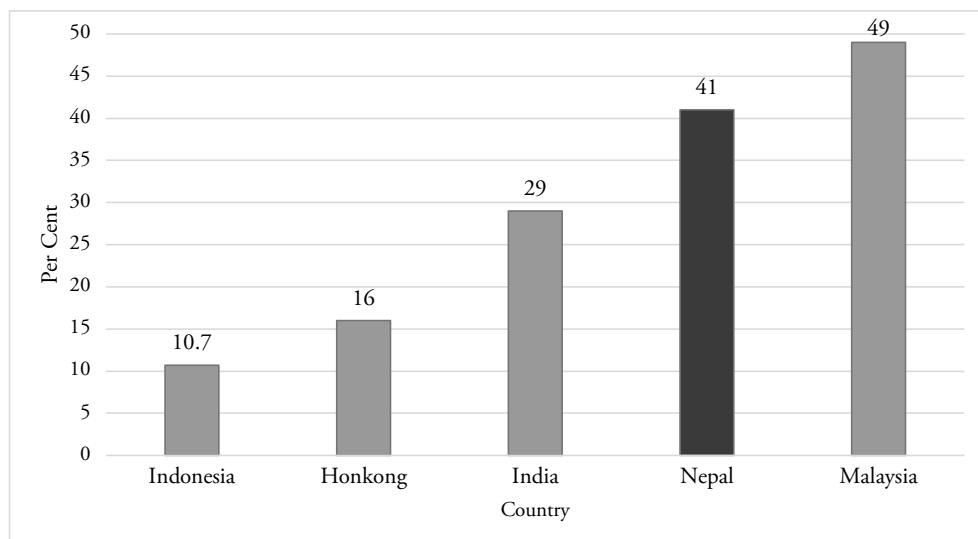


Figure 14: Tax Wedges in Nepal

Source: Compiled by the Author

Disincentive for engaging as a permanent staff member of any firm on part of the employee is an equally pressing concern²³. The government of Nepal's plans for contribution-based social security are ambitious, but it also effectively means that employees cannot access 28 percent of the amount of their remuneration until the age of retirement. The current scheme of contribution-based social security in Nepal is designed as a pension scheme. Contributions made by the employer are deposited in an employee-identifiable unique account and, subject to certain exceptions, are handed over to the employees after the retirement age of 60 in the form of monthly pensions. The entire apparatus is managed by the Social Security Fund, a government-owned and operated autonomous retirement fund. Aside from the Social Security Fund, the Government of Nepal also own and operates two other retirement funds—the Citizen Investment Trust and the Employee Provident fund. Both these funds offer far better services and have a much lower lock-in period for funds collected. For instance, the amounts deposited in the Citizen Investment Trust can be withdrawn in its entirety after deposits have been made for a period of 24 months. The same facility is not available under the mandatory Social Security Fund. While the Social Security Fund does provide facilities such as housing loan, medical insurance, and even dividends from investments made, its popularity nonetheless remains low given the lock-in period, its focus on pensions, and the inability of employees to withdraw the total amount deposited. In fact, there are other privately owned and operated retirement schemes that offer better services, especially by Banks and Financial Institutions for their staff. To that end, employees of banks and financial institutions have so far strongly opposed the Social Security Fund²⁴.

23 The effect is more pronounced in the IT sector. A news item notes that ever since the Government of Nepal announced a flat rate of taxation of 1 per cent for those working in the IT sector on a contractual basis, employees have opted become contractual staff rather than permanent employees. Abhaya Raj Joshi, *Tech founders say Nepal's new tax scheme is pushing workers to foreign firms*, Rest Of World (Kathmandu: 20 December, 2022). <https://restofworld.org/2022/nepals-new-tax-scheme/>

24 In fact, 29 trade unions of Banks and Financial Institutions had jointly issued a statement stating their unwillingness to enroll in the Social Security Fund. The statement highlighted many key points of contentions amongst which was the high lock-in period and the inability to withdraw the funds in its entirety. Online Khabar, 29 Vittiya Karmachar Sangathanle Bhane-Yathasthitima Saamjik Suraksha Kosha Jannau, (Online Khabar: 26 September 2021). <https://www.onlinekhabar.com/2021/06/973940>

Aside from the added cost of employing, the current legal regime also places restrictions on termination of employment. Unlike the previous law, the current law does not require mandatory third-party approval for dismissal of employees. Still, it does, however, require that termination of permanent staff be made only when such certain conditions are fulfilled. Termination of employment in the legislation is framed as a last resort punishment that employers may take after warnings, suspensions, or retention of increment in remuneration as tools no longer work. Even in the case of termination of incompetence, an employer has to establish that an employee's work performance has deteriorated for three or more than three consecutive years as evidenced by work-performance evaluation. Worker protection from unfair termination is indeed an important safeguard that labour legislation should spell out, however, the current legislation places far too many restrictions and establishes multiple layers of criteria before the termination process can be established. The result of this system might very well be an incentive over casual-employment or time-bound contracts or piece-rate contracts, all of which offer flexibility to the employer but do not safeguard the interests and rights of the employee.

The new regime has eased the requirement of seeking approval in the event of collective dismissal of employees, but it has increased the cost of dismissals. The previous regime made it mandatory for firms to pay remuneration equivalent to 30 days of service for each year of employment in case of collective dismissal. This was, however, only applicable to permanent employees. The new law has, however, made it mandatory for firms to make arrangements for severance payments on a proportionate basis in case an employee has not completed a year of service.

Persistent structural constraints such as distortive taxes, limited competition, widespread market inefficiencies, high tax wedges and one of the world's lowest levels of trade openness have hindered investments and restricted firms from scaling or innovating. At the same time, extremely high bilateral trade costs with Germany and Nepal's low Logistics Performance Index reflect inefficient customs, weak infrastructure, and poor-quality logistics services, making Nepal's exports both costly and uncompetitive. These intertwined challenges have kept Nepal's export performance stagnant, narrow in product range, and unable to take advantage of deeper integration into European markets.

Chapter 3

Nepal's LDC graduation and its implication on Nepal-EU trade

Nepal currently benefits from lenient and flexible rules of origin requirements under the EBA scheme but after LDC graduation, these preferential provisions will no longer apply, meaning Nepal will lose the export advantages derived from such relaxed rules.

Currently, LDC-specific preference utilisation rate for EU is highest among all the LDC-specific preferences granted to Nepal; 80 percent of the exports enter EU under EBA scheme²⁵. With Nepal set to graduate from LDC status, a major implication is that it will no longer be eligible for the LDC-specific EBA scheme. After graduation, Nepal will instead qualify for either the standard GSP or the more generous GSP+ scheme. To qualify for GSP+, Nepal must ratify and effectively implement 27 international conventions related to human rights, good governance, labour rights, and environmental protection. The European Commission's proposal for a revised GSP regulation for 2024 to 2034 introduces five additional conventions, which include one human rights instrument, two labour rights conventions, one governance convention, and one environmental instrument, along with an optional human rights convention. Nepal has already signed and ratified 25 of the 27 international conventions but has yet to ratify the Cartagena Protocol on Biosafety to the Convention on Biological Diversity, which it has already signed. Nepal also has not yet signed or ratified the Freedom of Association and Protection of the Right to Organise Convention, 1948 (ILO Convention No. 87).

Box 2: Understanding where Bangladesh, our graduation partner stands

Like Nepal Bangladesh is also set to formally graduate from its LDC status on 2026 and will no longer enjoy EU's LDC-specific EBA treatment post 2029. Bangladesh has gained significantly from EBA: as of 2023, around 91 percent of Bangladesh's total exports were under the preference utilization rate. Since 2001 when the EBA scheme started Ready-made garments (RMG) and apparel export from Bangladesh has grown by approximately 700 %. In 2022–23, EU accounted for 45% of its export earnings—the largest export destination for Bangladesh (Razzaque et al., 2024). However, with LDC graduation Bangladesh will no

²⁵ World Trade Organization and Enhanced Integrated Framework, *Trade Impacts of LDC Graduation: Insights from Country-Specific Market Access Analyses* (Geneva: WTO/EIF, 2020b).

Export competitiveness will depend on whether or not Nepal qualifies for the GSP+ scheme. If Nepal qualifies for the GSP+ scheme, it will continue to receive duty-free market access that is almost on par with the EBA scheme. However, if it does not qualify for GSP+, the average tariff is expected to increase by 5.7 percentage points, which could have a severe adverse impact on Nepali exports to the European market. Nepal will face major tariff increases on all its key export items to the EU as well as on high-potential export products.

For apparel and textiles, which are Nepal's top exports to the EU, the tariff would rise from 6.4 percent to 9.6 percent under the standard GSP. For carpets, which are Nepal's second-largest export to the EU after apparel, the tariff would increase to 6.4 percent. Similarly, Nepal's other potential exports will also face higher tariffs under the standard GSP regime. In contrast, if Nepal is granted GSP+ status, it will retain duty-free access for all its major current exports and many high-potential products. Even for items that do face tariffs under GSP+, the rates will be negligible.

longer be eligible for EBA scheme and will be required to comply with either GSP or GSP+ scheme.

Moreover, the rules of origin (ROO) requirement under the GSP are stricter than the EBA requiring double transformation instead of single. To minimise the potential loss in exports due to LDC graduation, Bangladesh is engaging the secure EU GSP+ eligibility. To qualification to GSP+ is contingent on ratifying and effectively implementing 27 international conventions linked to human rights, good governance, environmental protection, and labour rights. But so far, the Bangladesh government has not been able to make the changes. In addition, it is also worth noting that out of a total of 71 LICs and LMICs potentially eligible for GSP+, only eight countries have been able to enjoy its benefits, indicating that gaining GSP+ access is both rigorous and demanding.

S.N.	Product Name	HS-6	Value of Exports in thousands USD (3 year moving average)	Period	Tariff under EBA	Tariff under Standard GSP	Tariff under GSP+
1	Wallets, purses, key-pouches, and cases	420232	357	2019-2021	0%	3.30%	0%
2	Felt, impregnated, coated, covered or laminated	560290	1318	2021-2023	0%	5.30%	0%
3	Carpets and other textile floor coverings	570110	19707	2012-2014	0%	6.40%	0%
4	Women's or girls' overcoats, car coats, capes, and similar articles	610210	583	2017-2019	0%	9.60%	0%
5	Women's or girls' dresses of cotton, knitted or crocheted (excl. petticoats)	610442	239	2013-2015	0%	9.60%	0%
6	Jerseys, pullovers, cardigans, waistcoats and similar articles	611012	2001	2018-2020	0%	9.60%	0%
7	Shawls, scarves, mufflers, mantillas, veils and the like, knitted or crocheted	611710	1063	2019-2021	0%	9.60%	0%

8	Men's or boys' industrial and occupational trousers and breeches of cotton	620342	442	2013-2015	0%	9.60%	0%
10	Women's or girls' jackets and blazers of cotton, industrial and occupational	620432	1261	2019-2021	0%	9.60%	0%
11	Shawls, scarves, mufflers, mantillas, veils and similar articles of wool or fine animal hair	621420	4702	2021-2023	0%	6.40%	0%
12	Hats and other headgear	650500	1193	2013-2015	0%	0%	0%
13	Bells, gongs and the like, non-electric, of base metal (excl. musical instruments)	830610	405	2012-2014	0%	0%	0%
14	Electrical transformers, static converters (for example, rectifiers) and inductors	850431	859	2014-2016	0%	0%	0%
15	Wristwatches of precious metal or of metal clad with precious metal	91012	545	2021-2023	0%	0%	0%
16	Percussion musical instruments, e.g. drums, xylophones, cymbals, castanets, maracas	920600	898	2021-2023	0%	0%	0%

Table 6: Nepal's top exports to EU and tariff under various regime

Source: Compiled by the Authors

Existing partial equilibrium analyses suggest that Nepal would approximately USD 20 million in exports if it were shifted to standard GSP regime. The estimated loss would be substantially lower (less than a million USD) under the GSP+ treatment. However, the erosion of preferential treatment of any sorts would result in far more severe consequences, with export loss equivalent to 56.8% of the current exports to the EU. The impact is particularly stark for Nepal's top export categories to the EU; apparel/RMGs and carpets. Apparel and RMGs account for up to 30% and carpets account for approximately 19% of the loss in exports.

S.N	Source	Impact	Post EBA status
1	WTO (2020b)	USD 20.6 million export reduction	LDC preference (EBA) -> EU Standard GSP
2	ITC (n.d.)	USD 18 million export reduction (Top EU export losses to Germany- USD 7 million and France-3.5 million.) But, under GSP+ scheme losses would be reduced to less than a million USD.	LDC preference (EBA) -> EU Standard GSP
3	NPC & UNDP (2020)	20.1 % of the bilateral trade; 56.8 % of the total export	LDC preference (EBA) -> MFN

Table 7: Impact on trade and export

LDC Graduation and its implications on Rules of Origin requirements

Nepal currently benefits from lenient and flexible rules of origin requirements²⁶ under the EBA scheme but after LDC graduation, these preferential provisions will no longer apply, meaning Nepal will lose the export advantages derived from such relaxed rules. The withdrawal of these benefits is expected to further strain Nepal's export performance and could lead to an additional decline in exports, an impact that is not captured in the current partial equilibrium effect analysis. Therefore, the current estimates represent only the minimum level by which exports are likely to be affected. Inability to meet the rules of origin requirement would result in exports being treated under the Most Favored Nation (MFN) regime with substantially higher tariff rates, deeming Nepali products far less competitive in the EU market.

S.N.	Product Name	HS-6	EBA	GSP/GSP+
1	Wallets, purses, key-pouches, and cases	420232	CTH or RVC 30%	CTH or RVC 30%
2	Felt, impregnated, coated, covered or laminated	560290	SP	SP
3	Carpets and other textile floor covering	570110	SP or (SP and RVC 60%)	SP or (SP and RVC 60%)
4	Women's or girls' overcoats, car coats, capes, and similar articles	610210	SP (single transformation--manufacture from fabric)	SP (Double transformation -- knitting and making up including cutting)
5	Women's or girls' dresses of cotton, knitted or crocheted (excl. petticoats)	610442	SP (single transformation--manufacture from fabric)	SP (Double transformation -- knitting and making up including cutting)
6	Jerseys & pullovers, of cashmere, knit/crotchet	611012	SP (single transformation--manufacture from fabric)	SP (Double transformation -- knitting and making up including cutting)
7	Wovens of textile breast fibers, unbleached	531010	SP single transformation or (SP and RVP 52.5%)	SP double transformation (SP and RVP 52.5%)
8	Shawls, scarves, mufflers, mantillas, veils and the like, knitted or crocheted	611710	SP (single transformation--manufacture from fabric)	SP (Double transformation -- knitting and making up including cutting)
9	Men's or boys' industrial and occupational trousers and breeches of cotton	620342	SP (single transformation--manufacture from fabric)	SP (Double transformation -- knitting and making up including cutting) or (SP and RVP 52.5%)
10	Women's or girls' jackets and blazers of cotton, industrial and occupational	620432	SP (single transformation--manufacture from fabric)	SP (Double transformation -- knitting and making up including cutting) or RVP 60%

26 Rules of origin are a fundamental requirement for accessing trade preferences. Each preference scheme, whether LDC-specific, a general GSP, or a regional trade agreement, sets its own origin criteria. As per WTO (2020a), complying with rules of origin involves three elements: (i) meeting product-specific conditions such as minimum processing, value addition thresholds, or a change in tariff classification; (ii) providing the necessary documentation to verify compliance, such as certificates of origin; and (iii) ensuring that the goods are not altered during transit to the importing country, often referred to as direct consignment or non-alteration. World Trade Organization and Enhanced Integrated Framework, Trade Impacts of LDC Graduation (Geneva: WTO/EIF, 2020a).

11	Shawls, scarves, mufflers, mantillas, veils & similar, of wool/fine animal hair (excluding knitted or crocheted)	621420	SP or RVP 60% or (SP and RVP 52.5%)	SP or RVP 60% or (SP and RVP 52.5%)
12	Hats and other headgear	650500	CTH	CTH
13	Bells, gongs and the like, non-electric, of base metal (excl. musical instruments)	830610	CTH +ALW 30%	CTH +ALW 30%
14	Electrical transformers, static converters (for example, rectifiers) and inductors	850431	CTH or RVC 30%	CTH or RVC 30%
15	Wristwatches of precious metal or of metal clad with precious metal	91012	RVC 30%	RVC 30%
16	Percussion musical instruments, e.g. drums, xylophones, cymbals, castanets, maracas	920600	RVC 30 %	RVC 30%

Table 8: Nepal's top exports to EU and RoO requirement under various regime

Note: CTH = Change in Tariff Heading, RVC= Regional Value Content, SP= Specified Process, RVP = Regional Value Content on Parts, ALW= Allowance to change in tariff classification

Source: ITC, WCO, and WTO Rules of Origin Facilitator

With LDC graduation and the application of more stringent rules of origin, the apparel and textile sector is likely to face the hardest hit. Among Nepal's top exports over the past decade, apparel and textiles constitute the largest share. In 2023, apparel, textiles, and textile articles accounted for more than 70 percent of Nepal's exports to the EU. While current rules of origin for most apparel and textile products require only single transformation, post-graduation, whether Nepal enters the standard GSP or the GSP+ scheme, manufacturers will need to meet the double-transformation requirement to qualify for preferential market access. Failure to comply would expose exports to higher tariffs, thereby eroding the competitiveness of Nepali apparel products in the EU market. Therefore, Nepali apparel manufacturer should be well prepared to meet the double transformation requirement.

S.N.	Product Name	HS-6	EBA	GSP/GSP+
1	Cardamom	090831	NC	NC
2	Medicinal plants	121120	CTH	CTH
3	Wood	44123	SP	SP
4	Textile products	630790	RVC 60%	RVC 60%
6	Footwear	640419	NC +ECT	NC+ECT
7	Black tea	090240	NC	NC

Table 9: Nepal's high potential export products and RoO under various regime

Note: NC = No change on tariff classification required, CTH= Change in tariff heading, SP= Specified Process, RVC = Regional Value Content, ECT = Exception to change in tariff classification.

Source: ITC, WCO, and WTO Rules of Origin Facilitator

Recommendations

Nepal's weak trade and investment performance, combined with its imminent graduation from LDC status, poses as significant economic challenge. Preferential access to the EU under the EBA scheme has partially shielded Nepal's structural weaknesses, but we lack diversification, productivity growth, or competitiveness required for sustained export expansion. As preference erosion becomes inevitable, Nepal must urgently shift from reliance on external trade preferences to a strategy grounded in domestic competitiveness, value-chain upgrading, and regulatory credibility. The following recommendations set out a coherent reform agenda to safeguard Nepal's EU trade and position the economy for post-LDC integration.

1. Secure GSP+ eligibility as a national economic priority

Preserving preferential market access to the EU after LDC graduation is critical for Nepal's export survival. Empirical estimates suggest that a shift from EBA to the standard GSP could reduce Nepal's exports to the EU by USD 18–20 million annually, with further losses likely once stricter Rules of Origin (RoO) are applied. In contrast, qualification for the GSP+ scheme would allow Nepal to retain near-EBA levels of market access.

Nepal should therefore treat GSP+ qualification as a national economic priority rather than a technical trade issue. This requires rapid ratification and effective implementation of the remaining international conventions, particularly ILO Convention No. 87 on freedom of association and the Cartagena Protocol on Biosafety. Beyond formal ratification, Nepal must demonstrate credible enforcement.

2. Build double-transformation capacity in apparel and textiles

The apparel and textile sector, which accounts for over 70 percent of Nepal's exports to the EU, will be the most exposed to stricter RoO requirements following LDC graduation. Under both the standard GSP and GSP+ regimes, most apparel and RMG exports will require double transformation—spinning and weaving or knitting of fabric

in addition to garment assembly. At present, Nepal's heavy dependence on imported fabric makes compliance with this rule extremely difficult.

To address this vulnerability, Nepal must move beyond its current cut-and-sew model and invest in upstream textile capacity. A dedicated textile value-chain development programme should be launched to support yarn spinning, fabric production, dyeing, and finishing, with compliance to EU chemical, environmental, and labour standards built into the design. Targeted incentives such as preferential power tariffs, access to industrial land, and concessional finance, should be focused on firms that invest in fabric and input production rather than only final-stage garment assembly. Without such upgrading, Nepal risks losing its most important export sector even if GSP+ is secured.

3. Make air cargo a pillar of export competitiveness

Nepal's export structure to the EU is heavily dependent on air transport: garments, carpets, pashmina, tea, coffee, medicinal plants, and handicrafts are predominantly shipped by air. Yet air cargo has been largely absent from trade policy discussions, even though time, reliability, and freight costs are decisive for EU buyers.

Nepal should develop an explicit air-cargo strategy for exports, including the use of Kathmandu–Dubai and Kathmandu–Singapore as regional transshipment hubs to reduce delivery times and costs. The national flag carrier and private airlines should be allowed and encouraged to offer preferential cargo block rates for exporters on EU routes. Moreover, the Civil Aviation Authority should be formally integrated into trade policy bodies, reflecting the reality that air connectivity is now a core trade facilitation issue.

4. Invest in EU-grade testing, certification, and traceability

Non-tariff barriers related to food safety, chemical compliance, labelling, sustainability, and traceability increasingly define access to the EU market. Nepal's lack of accredited testing laboratories and certification bodies forces exporters to rely on Indian facilities, raising costs, creating delays, and undermining compliance with RoO and SPS requirements.

Nepal should invest in a network of EU-recognized laboratories for food safety, pesticide residue testing, and textile chemicals, particularly for compliance with the EU's regulation on Registration, Evaluation, Authorization and Restriction of Chemical (REACH) and environmental regulations. In parallel, a national traceability and certification system should be developed for key export sectors such as carpets, pashmina, medicinal plants, coffee, and tea. This would not only reduce compliance costs but also allow Nepal to position itself as a credible supplier of ethical, sustainable, and origin-certified products which is an increasingly important source of competitive advantage in European markets.

5. Reorient the EU export strategy toward high-value, niche value chains

Nepal is structurally unsuited to compete with countries such as Bangladesh or Vietnam in mass-produced, low-margin exports. However, the EU market rewards differentiation, sustainability, and origin-based branding. Nepal should therefore pursue a strategy of value-chain specialization rather than volume-based competition.

Priority should be given to high-potential niches such as premium carpets, pashmina and fine wool products, coffee, tea, cardamom, medicinal and aromatic plants, and high-end handicrafts. These sectors offer scope for branding, geographical indications, sustainability certification, and premium pricing. Government support should focus on branding, compliance with EU sustainability and carbon standards, and marketing rather than on across-the-board subsidies. Such a strategy aligns with EU consumer preferences and Nepal's factor endowments.

6. Reduce trade and transit costs through targeted logistics reforms

Nepal's ad-valorem trade cost with Germany—227 percent—is among the highest in the world and overwhelms

any tariff preferences. High internal transport costs, multiple checkpoints, weak border management, and inefficient transit arrangements with India are major contributors.

Nepal should prioritize the negotiation of a dedicated transit and trade corridor with India for EU-bound exports. Domestically, redundant checkpoints, informal payments, and overlapping inspections must be eliminated through digitalization, risk-based clearance, and single-window systems. Reducing trade costs will yield larger competitiveness gains than any short-term fiscal incentives.

7. Link foreign direct investment to export competitiveness

FDI responds to credible opportunities to integrate into export value chains. Nepal should therefore move from an infrastructure-centric FDI model to an export-linked one. Investment promotion efforts should target sectors that directly support EU-oriented exports, including textiles and fabric, agro-processing, certification and testing services, logistics, and digital services exports. Stronger FDI-export linkages will raise productivity, enable RoO compliance, and make Nepal a more credible supplier to European markets.

Taken together, these reforms provide a practical roadmap for Nepal to transition from preference-dependent exports to a more resilient, competitive, and value-driven engagement with the European Union. Without such a shift, LDC graduation risks exposing and amplifying existing structural weaknesses; with it, Nepal can use graduation as a catalyst for long-overdue economic transformation.

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Annexes

Annex 1. Experts Consulted

S.N.	Name	Organization/Position
1.	Paras Kharel	South Asia Watch on Trade, Economics and Environment
2.	CA Narayan Baja	European Chamber of Commerce- Nepal
3.	Rajan Sharma	Trade and Logistics Expert
4.	Saurabh Shah	United Nations Nepal
5.	Purushottam Ojha	Former Commerce Secretary
6.	Darshana Shrestha	Federation of Women's Entrepreneurs Association Nepal
7.	Nara Bahadur Thapa	Former Executive Director, Nepal Rastra Bank
8.	Pradeep Panthi	Policy Research Institute
9	Pramod Rijal	Independent Consultant

Annex 2. Estimating Nepal's Trade Potential

We closely follow Learner (1988) to measure trade openness, structural barriers to trade and untapped potential. We use cross sectional data of 133 countries and regress each country's exports on their population, GDP at current US dollars, status of human capital as measured by World Bank's "Learning adjusted years of schooling" and binary indicator of landlockedness (1 if a country is landlocked and 0 if it is not).

$$\text{Export}_i = \beta_0 + \beta_1 \text{Population}_i + \beta_2 \text{GDP}_i + \beta_3 \text{Learning Adjusted Years of Schooling}_i + \beta_4 \text{Landlockedness}_i + \epsilon_i$$

ϵ_i , the stochastic error term, is the unexplained part that gives the difference between the actual value of export and the value of export predicted by the Ordinary Least Squares (OLS) regression. The difference between actual and predicted values indicates untapped export potential and the extent of trade barriers or openness. A negative difference suggests high untapped potential due to trade and structural barriers.

	Export (Current USD)
Population	542.1*
	(1.71)
GDP (Current US \$)	0.121***
	(5.12)

Learnings Adjusted 4.72930e+10***
 Years of Schooling (5.86)

Landlockedness 7.78894e+09
 (-0.29)

Constant 283013e+11***
 (-5.20)

N 133

R² 0.842

t statistics in parentheses

* p < 0.1, ** p < 0.05, *** p < 0.01

As indicated by an R-squared value of 0.8412, the regression equation explains about 84.12 percent of the cross-sectional variation in exports. As expected, population, GDP and learning adjusted year of schooling which is a proxy of human capital is positively associated with export at at least 10 percent level of significance. While Landlockedness has negative correlation with exports, it is not statistically significant.

The difference between the actual exports and the predicted value of exports for Nepal is negative 69 billion US dollars, which means that Nepal's untapped export potential is estimated to be around 69 billion US dollars or 0.2 percent of the global trade value.



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