Youth Enterprise Support (Y.E.S)

Reducing the Moral Hazard Problem

Overview

Contractual relations that are structured in a manner to place fully, the burden and/or risk of loss or adverse impact on one party, exclusively, in the event of failure, poses a kind of risk economist and decision scientists refer to as, moral hazard. Moral hazard risk, when crystalized, could create market and/or institutional failure, with grave consequences for the macro economy and further unemployment. This policy brief examines a potential moral hazard risk in the Youth Enterprise Support fund as currently structured and subsequently makes recommendation to mitigate or transfer such risk.

The Policy Issue

The commencement of the Youth Enterprise Support fund in August 2014 has been a feather in the cup of the Mahama Administration as it tries to tackle the intractable problem of youth unemployment in Ghana. The National Youth Policy defines youth as “persons who are within the age bracket of fifteen (15) and thirty-five (35)”. Clearly there are major issues for the architects of Youth Enterprise Support fund to address in terms of youth population size, regional distribution and gender sensitivities. According to the Ghana Living Standards Survey Round 6, youth unemployment is 5.5% (men- 5.5%, women-5.7%) making the situation more dire and pressing. In addition to targeting challenges, the Fund is yet to provide clarity on the importance issue of impact measurement. Policy credibility and program performance are tightly coupled in a manner that requires the rigor of an objective and transparent measurement approach to assess progress rate towards policy goals. Youth Enterprise Support (Y.E.S.) fund needs clear and specific responses to the fundamental question of how to measure efficiency and impact of capital allocated to ensure balanced growth. These policy concerns no doubt will shape the agenda of the Y.E.S Secretariat going forward. This policy brief makes a strong recommendation for an outcome-based measurement model as opposed to outputs approach.

Notwithstanding this commendable policy initiative, the structural model of the fund presents a moral hazard risk which requires immediate policy attention in order to build into the program, resilience and sustainability. The risk implications of program design is particularly disconcerting within the context of a broader fiscal gap at the macro level.

+ 233 342 290 962
+ 233 505 767 865
info@metisdecisions.com

Moral Hazard and Adverse Selection

Moral hazard may be defined as a situation where a counterparty to an economic or financial transaction lacks sufficient incentive to reduce risk due to the other party's full exposure to the risk and burdens of a potential loss or failure. Another way of looking at it is where two parties enter into a contract, and one party undertakes risky behavior, or refuses to undertake value-enhancing activities, knowing that any adverse consequence will be borne by the other party. Moral hazard risk is aggravated by information asymmetry; a situation whereby one party has unique access to information at the expense of the counterparty. Economists have used the moral the hazard phenomenon to explain market failures such as the mortgage prime loans issue that triggered a market failure and a subsequent government bailout of distressed firms during the early years of the Obama administration.

The model of Youth Enterprise Support fund as currently structured presents moral hazard risks due to two key factors:

1. The non-revolving nature of the fund – only non-tax payers will be required to pay back any capital invested. Other beneficiaries who have fulfilled tax obligations are NOT required to repay investments.

2. The potential for adverse selection due to information asymmetry – the prospect of "free" capital poses a risk of system gaming as business ventures with less robust fundamentals would prefer Y.E.S capital injection to other rigorous alternatives on the venture capital market, hence creating a situation whereby "low quality" venture vehicles benefit at the expense of other robust ones.

"Repayment of assistance obtained from YES comes in the form of taxation (paying the appropriate tax to government) and employment creation by the business entities assisted. Any business that receives financial assistance from YES that seeks immediate tax relief will, however, be expected to repay the financial assistance with interest on terms agreed with."

Y.E.S - *From Ideas to Reality*

The Sustainability Question

Evidently, the employment generation outcome of the Y.E.S model is a central policy issue. This however, I will argue, is no substitute for the governance rigor required to meet repayment schedules (in case of debt finance) or shareholder oversight (in case of equity) by the Fund. The forfeiture of this essential corporate governance mechanism aggravates the potential risk for moral hazard.

+ 233 342 290 962
+ 233 505 767 865
info@metisdecisions.com

The condition of tax compliance and employment generation as basis of non-repayment of capital invested (or more appropriately, grant) is inherently discriminatory and untenable, for two reasons:

1. Paying taxes is a statutory obligation and any form of non-compliance or breach cannot and must not be remedied through the fulfillment of what ought to be a commercial obligation; debt service. The unintended picture created is that tax compliance may be an option and not an obligation, as long as one remains a youthful entrepreneur.
2. Job creation is a consequential outcome of business growth. Viable businesses that have good value propositions tailored for clearly defined customer segments would inevitably adapt to the uncertain business environment. Managing a shift in scale and focus requires new talent to stay ahead. Creating jobs, is therefore not a reward but a strategic necessity to enable businesses manage risk. To put another way, job creation is a performance indicator that gauges a higher metric i.e. growth.

The point must be made that business growth is a construct and part of its building blocks, inter alia, is financial discipline. Any policy or program design that appear to de-emphasize this basic requirement of discipline, unavoidably increases the moral hazard risk. Clearly, architects of the Y.E.S model must take this potential for moral hazard into consideration as basis for policy review.

Others -Process Risk

According to available literature, these steps are included in the selection and approval stage for any capital allocation under the Y.E.S program:

1. Business plans must be attended with two letters of recommendations from successful entrepreneurs.
2. Investment appraisal to be done by a “panel of experts” including successful entrepreneurs and academics.

It is important to state that the aforementioned steps do not necessarily follow sequentially in the application process. They have been highlighted however for the unique risk they pose.

It is unclear what the risk- control value of mandatory recommendation letters might be for a start-up with no operational history. Y.E.S managers also stipulates that such recommendations should come from “successful entrepreneurs”. Without clearly defining who a successful entrepreneur is, the fund runs the risk of using subjective evaluation models to reach conclusions.

Secondly, investment appraisal is such a delicate practice that even long time practitioners still suffer the undesirable outcome of non-performing portfolios. I will strongly argue, that fund management should be left to fund managers, at all times, without exception. The sixth sense required for effective risk management may elude even the shrewdest of entrepreneurs. So academics and entrepreneurs as investment appraisers pose major capacity constraints that may translate into portfolio risks.

Recommendations

1. Create a fund management policy that enables Y.E.S portfolio to hold, at least, 70% of asset in equity, with clear exit strategy. This will enable business mentoring take a formal and rigorous approach thereby fostering good governance and discipline. 30% can be shared between debt holding and non-repayable grants, as is currently the case.
2. Non-repayable "investment" (grants) must be aligned with high-priority social sectors (e.g., health and sanitation) as a way of encouraging Impact Investing and social entrepreneurship.
3. Debts assets must be channeled into investments with sufficient operational history and demonstrated fiscal performance.
4. Unless a strong case could be made for control value, make letter of recommendation a substitute (option) for reference on applicant/entrepreneur and all directors of applicant enterprise.
5. Hire professional fund managers.

6. Address other risk issues:
    a. Pass legislative framework to govern operation of Youth Enterprise Support.
    b. Create a robust and transparent measurement framework to track policy impact.

The writer is a management consultant and founder of Metis Decisions LLC. Metis Decisions Limited is a professional services company. Contact us for your Employee Surveys, Corporate Training and Mystery Shopping services. For further info please visit www.metisdecisions.com or email to info@metisdecisions.com.

+ 233 342 290 962
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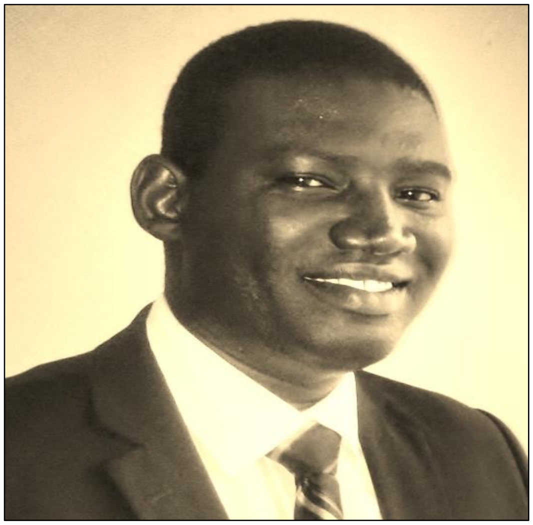

Nkunimdini Asante-Antwi

Director, Metis Decisions LLC

Entrepreneur and management consultant with background in real-estate, banking, fashion retail and non-profit sector. He is also a social and good governance advocate with interest in private sector development policy.

+233 202 952 658

Email: nkunimdini@metisdecisions.com.

Twitter: @Nkunimdini