

Insurance against Poverty

Overview

Stefan Dercon

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This book is a collection of papers, offering new economic research and insights on the relationship between risk and poverty in developing countries, and the most effective policies to avoid that risk will continue to contribute to widespread poverty. The papers are structured around three key questions: How important is risk for poverty? What lessons can be learned from studying existing, often informal, risk-sharing institutions for the design of broad-based social protection? What scope is there for designing new instruments for social protection?

In addressing the first question, contributions in the book present a review of the evidence on how risk affects the welfare of the poor in developing countries and the strategies they use to cope with risk; methodological insights on how to measure risk-related vulnerability to poverty and to identify vulnerable groups; and new theoretical and empirical work on the link between uninsured risk and poverty persistence. Contributions on existing risk-sharing arrangements highlight the strengths and weaknesses of these social institutions and the impact of social protection initiatives on them. The book also contains a number of contributions presenting evidence on successful safety nets and on new instruments such as micro-credit contracts with insurance provisions and drought insurance.

In recent years, ambitious targets to reduce poverty in the world have been approved by the international community. A renewed focus on increasing economic growth in the developing world has also emerged. Growth is clearly an important condition for large-scale poverty reduction, at least provided that the poor can benefit from these increases in growth. Creating opportunities for economic progress and empowering the poor to participate in this process are widely recognised mechanisms to achieve these objectives (World Bank, 2000; UNDP, 2002).

This process of growth and poverty reduction has to take place in a risky environment where shocks often threaten any gains in the living standards of the poor. Natural disasters, drought, conflict and insecurity continue to disrupt local economies. The high incidence of health problems hinders many of the poor to take advantage of opportunities. Economic shocks, including currency crises, commodity price shocks and the contagion effects of world-wide recession, undermine growth and contribute to continuing high poverty. Indeed, the very process of economic reform creates in any case losers, even if it may only be temporary. The extent of shocks and risk do not appear to be reducing in recent decades. Risks seem to be changing, with demographic shifts, AIDS and globalisation shifting risk to different regions, age groups, or different occupational and social classes.

These pressures on growth and poverty reduction have not gone unnoticed in the policy debate. The importance of providing more secure living conditions as an important dimension of poverty reduction has been recognised (World Bank, 2000). Many international agencies, governments and NGOs have developed programs for more widespread social protection. Most of these programmes take the form of safety

nets, ways of providing some protection from the worst effects of shocks. For the poor, it would mean avoiding even more hardship than before.

Few would deny that this type of intervention is important and that there is a genuine role for public action and for development aid in assisting these programmes. However, the arguments for such programmes are often largely cast in humanitarian or equity terms. They are considered part of social programs without much *economic* rationale. In this book, many of the authors take a different stance: that beyond humanitarian concerns, these programs make *economic* sense. In particular, there is an *instrumental* role for better social protection, since it would facilitate a growth process that will also deliver poverty reduction. In other words, social protection may well be good for growth. Since the poor are least able to cope with risk and shocks, and therefore would benefit most from protection, the result is public action contributing to broader equity *and* efficiency.

This conclusion is *not* reached because the authors in this book reject the standard paradigm of mainstream ‘neoclassical’ economic theory, in which competitive forces and incentives are considered the foundations for efficiency and growth. On the contrary, most of the contributors effectively rely on these tools for their research. But the normative prescriptions of basic neoclassical economics, to let the markets work freely without interference, have weak foundations in the presence of risk and uncertainty, since it would require that competitive markets should exist that allow anyone to insure themselves for all contingencies. While even in developing countries some insurance markets exist, their scale and functioning seem far removed from the idealised theoretical construct, suggesting widespread market failure, opening the door for public action even within a simplified textbook world where efficiency is all that matters.

The focus in this book is on risk and its consequences, and our discussion on public action has to be seen in this light. We use vulnerability as referring to the stress on the livelihoods and welfare of the poor arising from risk. Social protection refers to public actions taken to reduce levels of vulnerability that are deemed unacceptable within a society. Public action is not limited to the state: these actions can be taken by the state or NGOs, and may also involve local social institutions and the private sector. We typically use the term social protection, rather than social security. Social security systems are typically identified with highly formalised and extensive systems with specific redistribution and poverty alleviation functions beyond the provision of different forms of insurance and protection. Our focus on the latter is not meant to signify that we do not consider the other functions important – on the contrary – but rather that we want to have a more narrow focus to allow us to draw more specific conclusions for policy from the analysis. Indeed, one of our arguments is that well-designed schemes could have relatively low cost and high social benefits, including in efficiency terms.

The case and scope for broader social protection has been made before by many academics. One contribution in particular should be highlighted, the collection edited by Ahmad, Drèze, Hills and Sen (1991), not least since it was an earlier book in the WIDER Studies in Development Economics. It made a strong case for more widespread and broadly conceived social security in developing countries as well for the role of public action in achieving it. Many of the conclusions reached remain valid, such as the only limited lessons from systems in developed countries and the possibilities of specific schemes such as employment guarantee schemes. Besides a more narrow focus on protection from vulnerability linked to risk, the current volume takes a different approach. Rather than a broad survey of the key issues related to

social protection, it contains a number of new and specific theoretical contributions, as well as new empirical work based on detailed micro-level data, all of them with important implications for policy design. There is no attempt to be comprehensive in analysis and conclusions, but rather, it aims to present new insights and inspire further thinking.

Still, there are some close links with the Ahmad et al. (1991) volume. For example, one particular chapter in that book, by Platteau, focuses on traditional social institutions for social security. It provides a starting point for a number of contributions in the current volume as well. Indeed, the emphasis on the understanding existing social institutions to build better social protection is an important conclusion from the current volume. Historically, it is helpful to remember that the highly formalised, but quite diverse systems of social security in Europe or the US have deep roots in community organisations, trade unions and religious institutions. Sustainable systems in developing countries will need to have a strong local institutional basis.

The starting point for the analysis in this book is that the link between risk and poverty can then be seen as directly related to missing insurance markets and market failure. A number of contributions in this book explore this relationship theoretically and empirically. Superficially, the theoretical relationship may seem straightforward: if risk is uninsured, living standards will go down if a bad shock hits. Living standard may fall below some acceptable minimal level and poverty will result, at least until better times arrive. However, this ignores that the poor try to adapt their livelihoods in sophisticated ways to handle risk and shocks. Much of the focus of recent economic research in developing countries, not least by the contributors to this book, has focused on whether and how poor people try to cope with risk and shocks, typically and rather successfully applying insights from savings and portfolio analysis to developing country settings with widespread market failure as well as diverse local institutions to cope with risk. Households use their savings and assets, as well as transfers from friends and family to cope with the consequences of risk. They also address their vulnerability to such hardship by changing their exposure to risk by adapting their livelihoods, for example via diversification or low risk activities, by migration or network formation.

The first chapter in this book by Dercon reviews some of the key theoretical concepts and evidence on responses to risk and their effectiveness, largely drawing on case studies from Africa and Asia. Morduch, in chapter 2, focuses specifically on the evidence from one specific setting, a number of villages in Southern India. Due to the unique data available from these villages in the public domain, these villages have been intensively and independently studied by a large number of eminent researchers. Morduch's study has the additional feature of critically consolidating our knowledge on risk and its consequences in this particular setting. Both studies highlight that despite sophisticated strategies at the level of individuals and groups, much risk remains uninsured. Especially those with limited assets or support networks – typically the poorest – seem to be most exposed.

Two contributions in the book focus on designing measures of the welfare losses linked to uninsured risk, and identify those most exposed to risk. A literature on measuring vulnerability to poverty is growing, and Kamanou and Morduch provide a review in chapter 8. Vulnerability refers to potential states, not actual outcomes, so a measure of vulnerability should be forward-looking. They propose a measure of vulnerability for a group or a population based on the difference expected future poverty and current poverty. Their application to Cote d'Ivoire highlights that

substantial vulnerability may exist even if poverty did not materialise afterwards. Ligon, in chapter 9, proposes an approach, nested within expected utility framework, to identify the extent to which different individuals are exposed to different types of risk and applies it to Indian data.

The strategies employed by households and individuals to respond to risk come at a cost in terms of long term earnings. Low risk activities often give a lower return. Keeping liquid savings to cope with shocks may imply that fewer productive assets are acquired, again resulting in lower incomes. In the long-run, lower incomes are obtained, and this may be a cause of poverty persistence. In this situation, the lack of insurance results in an efficiency loss, while under reasonable circumstances any initial inequality will be exacerbated due to the missing insurance market. In chapter 3, Banerjee shows how failures in the insurance market may result in a poverty trap. In chapter 4, Fafchamps explores different scenarios of how risk affects the evolution of inequality over time. It provides a helpful reminder of the limits of risk sharing and social protection.

Widespread poverty persistence and traps would give a strong argument to increase social protection, since it could unlock the income growth potential of the poor, contributing to growth and poverty reduction. Several contributions explore this empirically. In chapter 1, evidence is presented that strategies in response to risk contribute to lower income and wealth levels. Jalan and Ravallion, in chapter 5, test directly for the persistence of poverty due to uninsured risk by looking at the income dynamics in data from China. They find no evidence for poverty traps, but it takes a number of years before household income recovers fully from a negative shock. Dercon and Hoddinott, in chapter 6, focus on the persistence of poor health outcomes after shocks in adults and children in Ethiopia and Zimbabwe. They find that shocks have big impacts and for children these effects are persistent, resulting in stunting, poor educational outcomes and lower earnings. They also look at the intrahousehold impact of shocks. Boys and girls do not seem to be differentially treated but adult women in particularly poor households are worse protected from shocks. Collier, in chapter 7, looks at the macroeconomic impact of uninsured agricultural price risk in developing countries. He quantifies the negative externalities of these shocks and suggests that they are sufficiently large to justify subsidies to increase efficiency.

In short, the case for increased social protection in the form of *insurance against poverty* seems strong, with potentially high returns for poverty reduction and growth. What form should it take? It is not necessarily clear that the appropriate public action should be intervention by the state. The causes for the failings of market-based insurance provision, including problems of imperfect and asymmetric information and enforcement problems, are not necessarily straightforwardly solved by direct state action. Furthermore, other agents, including non-governmental agencies or community organisations, may well be better placed to handle these challenges. Existing risk-coping networks – often very informal and based on family, neighbourhoods or ethnic linkages – may contain useful lessons for the organisation and implementation of better social protection. Finally, public action may displace these informal systems, and the extent and consequences of this displacement should be understood.

A number of contributions look into these existing mutual support systems. Most of the economics literature, as reviewed in chapters 1 and 2, focuses on how effective these mutual support systems are to cope with risk. However, the contributions take another perspective. Two look explicitly at the composition of these networks for mutual support. De Weerdt in chapter 10 studied one village in

Tanzania extensively. Some of the factors determining who links up with whom are as expected: similar clan, religion or kinship all increase the likelihood of forming a mutual support group. But strikingly, he finds that the poor in the village have less dense networks than the rich. Goldstein, de Janvry and Sadoulet, in chapter 11, study inclusion and exclusion in networks, by focusing the type of shocks and extent of support that is offered to individuals within households and within the community. Gender and wealth matter at the household level for mutual support; lineage, social interactions and expected inheritance matter at the community level. Exclusion from 'traditional' support is a distinct possibility, and strengthens the case for a careful design of interventions, focusing on specific vulnerable groups. Platteau, in chapter 12, focuses on another important issue related to informal support systems: that over time they are changing and they may become weaker. In particular, he focuses on support systems that involve providing access to productive resources in responses with need, in his case on land. Changes in land tenure arrangements towards more individualised forms of property rights remove this support system in land allocation.

These studies confirm the relative weaknesses of informal mechanisms. They tend to overcome partly the market failures in insurance, by exploiting the information and enforcement possibilities of social proximity. But by necessity they are typically small scale, and the scope for expanding them may well be limited. Their scale limits the risk they can handle to individual-specific risk, while covariate risk, affecting all individuals at the same time cannot be insured. Still, it leaves important possibilities for risk-pooling unexploited. Trying to introduce widespread private or social insurance is not self-evident in such a context. Conning and Kevane, in chapter 15, study some of the impediments to the development of more linkages and intermediation with local financial and mutual support networks. Issues considered include monitoring costs, social norms and power relations.

The presence of informal insurance systems may also affect the impact of transfers as part of social protection measures. First, there is the standard problem of crowding-out: public transfers may reduce private transfers, so that the net welfare impact may be lower than the value of the transfer. Albarran and Attanasio, in chapter 13, analyse the impact of public transfers on private transfers using a unique data set from Mexico. In the presence of informal insurance networks, crowding out may take a specific form, whereby public transfers may have externalities on others not covered by the public safety nets, and it could lead to undermining or even destroying the informal support system. They find that crowding out of informal transfer is indeed taking place.

But the interaction between informal insurance and formal safety nets has another dimension as well. Formal social protection measures may be able to exploit the presence of informal insurance, even if the latter is imperfect. Ligon, in chapter 9, explains how targeting would be irrelevant if risk sharing is perfect. Dercon and Krishnan, in chapter 14, take this up. Even if risk sharing is imperfect, poorly targeted transfers may well be shared in the community, and they find evidence that informal insurance systems compensate for relatively poor targeting of food aid by redistribution in villages in Ethiopia. They nevertheless also find evidence consistent with crowding out of the informal arrangements due to the formal safety net.

A final set of papers focuses on improving the effectiveness of existing interventions and the design of new instruments. Barrett, Holden and Clay, provide a discussion of the case for employment programmes in the form of food-for-work. They provide rules of thumb for when and how these programmes can serve effectively as short-term insurance as well as contributing to longer-term

development. Loic Sadoulet, in chapter 17, discusses the design of an incentive compatible insurance mechanism to improve on existing microcredit contracts, providing suggestive evidence for its potential from Guatemala. Skees, Varangis, Larson and Siegel, in chapter 18, discuss the scope for introducing forms of weather insurance contracts, providing protection against an important source of covariate risk. Such contracts are superior in terms of incentives and data requirements for monitoring to ex-post mechanisms such as disaster relief or alternative insurance contracts such as crop insurance. In the last chapter, some of the findings from the book are brought together, in a broader discussion of the scope and limitations for successful public action to provide insurance against poverty.

References

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