Agricultural activity can be inherently risky due to weather condition fluctuations, pests, or the disease environment for crops. 89% of rural households in India cite drought as the most important risk they face.

Risk-sharing networks and other informal insurance schemes are often to be found to be incomplete, particularly aggregate risk (as opposed to idiosyncratic risk). Therefore, there ought to be latent demand for formal insurance products, but research has shown no great demand for formal insurance in such areas.

This research aims to determine whether informal insurance crowds out the market for formal insurance, and whether formal index insurance provides some value-added.

Results show that jati-based networks compensate for both individual losses and aggregate rainfall shocks (village level).

Characteristics that affect a jati’s ability to indemnify against idiosyncratic versus aggregate shocks include diversification into ‘professional’ occupations, average landholding, and the presence of other jati members in the same village.

The data shows that members of jatis that already informally provide insurance coverage based on aggregate rainfall shocks are less likely to purchase index insurance. A similar type of crowding-out effect is not observed for idiosyncratic shocks.

Basis risk is a significant impediment to the take-up of index insurance.

Formal index insurance appears to increase risk-taking, welfare and average incomes.
Motivation

Nearly three quarters of the 1.3 billion people worldwide living on less than US$1 per day depend on agriculture for their livelihoods (World Bank 2005). Agricultural activity is inherently risky due to fluctuations in weather conditions or the pest or disease environment for crops. In India, 89% of rural landowners cite drought as the single-most important risk they face (Gine et al 2008). A very large literature in economics has emphasized the importance of risk-sharing networks and other informal insurance schemes in helping rural households cope with shocks. Empirical results from many countries and regions convincingly demonstrate that informal risk sharing is incomplete, especially when it comes to aggregate (rather than idiosyncratic) risk, and rural agrarian households therefore have to continue to bear the burden of uninsured fluctuations in income. In this setting, there ought to be a latent demand for formal insurance products, but somewhat surprisingly, we do not observe thriving insurance markets in rural areas of developing countries. Adverse selection and moral hazard problems complicate the provision of insurance against idiosyncratic farmer-specific risks, but recent innovations in “index insurance” products - such as payment conditional on independently measured rainfall – can, in theory, overcome those challenges.

Surprisingly, the take-up of index insurance products has been very low across different countries and regions and across design variations on the products. Other researchers have hypothesized that liquidity constraints, inappropriate pricing, lack of trust in the insurance seller, and complicated product design helps to explain the lack of enthusiasm for formal insurance products.

Research

Our research examines whether the existence of informal insurance crowds out the market for formal insurance, and in the process, provides a rich characterization of the multiple ways that formal insurance products and informal risk sharing networks interact in the market. To do so, our approach combines exogenous natural variation in how well (informally) insured Indian farmers already are that stems from their membership-by-birth into their caste based risk-sharing network, with designed (randomized) variation in the price of the contract offered to those farmers. We first ask whether the presence of informal risk-sharing networks crowds out demand for formal index insurance.

Then we ask whether formal index insurance provides some value-added - even in a context where pre-existing informal risk sharing is present - by allowing farmers to take more risk than they otherwise would. Answering this second question is crucially important for growth policy, since rural economic growth requires farmers to invest in riskier technologies and take other risks in their production and input choices that raise expected returns.
Informal Networks and Formal Insurance

We first show, using a theoretical model that allows for both idiosyncratic and aggregate risk, and for the simultaneous presence of informal risk sharing and index insurance, that informal networks will lower the demand for formal insurance only if the network indemnifies against aggregate risk, but not if the primary role of the informal network is to insure against idiosyncratic, farmer-specific losses. Informal risk-sharing networks may in fact reduce risk-taking if the network primarily indemnifies against idiosyncratic risk, since other network members who are providing the insurance will exert pressure against individuals taking too much risk. When the formal insurance product is imperfect, in the sense of a potential mismatch between the rainfall-index-based payouts and the actual losses incurred by the policy holder due to the remote location of the rainfall gauge (which is known as “basis risk”), then informal risk sharing can play a positive role in covering household losses and enhancing the benefits of index insurance.

Jati-Based Networks

We test these predictions using a combination of non-experimental and experiment-based survey data from rural India that provides information on each household’s sub-castes (jati) identity. These jatis are the relevant informal risk-sharing groups in rural India. Data on aggregate risk and individual financial losses coupled with inter-household loans and transfers allowed us to construct a rich characterization of each jati in terms of its ability to indemnify against idiosyncratic and aggregate losses suffered by its members. The experimental component of the research markets an index insurance product to members of these different castes, and finds that the demand for the formal insurance products is affected by the characteristics of these jatis in ways predicted by the theory.

We find that jati-based networks both compensate for individual losses and pay out on the basis of aggregate rainfall shocks. We identify from the data certain group level characteristics that differentially affect a jati’s ability to indemnify against idiosyncratic versus aggregate shocks, such as diversification into “professional” (i.e. non-agricultural) occupations, average landholding, and presence of other jati members in the same village. Having identified these characteristics, we examine whether households from jatis with specific risk-sharing attributes are more likely to purchase the formal index insurance contract. As predicted by the model, we find members of jatis that already informally provide insurance coverage based on aggregate rainfall shocks are less likely to purchase the index product, but we do not observe the same type of crowding-out for jatis that cover idiosyncratic shocks well. In other words, formal and informal insurance are sometimes substitutes, but it depends on what role the informal risk sharing network plays before the formal contract arrives.
Basis Risk

We also find that basis risk is a significant impediment to the take-up of the index insurance product, as households more distant from rainfall stations are less likely to purchase the contract. However, as predicted by the theory, this negative effect of basis risk is attenuated for households in jatis that more successfully indemnify individual losses. Furthermore, in villages containing a rainfall station (i.e., no basis risk), household demand for index insurance is not affected by the extent to which the informal network is able to indemnify idiosyncratic risk. In summary, we find that informal insurance is both a complement to formal index insurance and a substitute, depending on the level of basis risk and the nature of the informal insurance arrangement.

Formal Index Insurance Products and Risk-Taking

Finally, we show that a formal index insurance product increases risk-taking in this context. In particular, rice farmers offered the formal index insurance product were more likely to subsequently plant a portfolio of rice varieties that were higher-yield but less drought resistant. Index insurance thus appears to not only improve welfare but to increase average incomes, particularly when the product is well designed (i.e. when rainfall stations are in closer proximity, and basis risk is lower), or when the informal risk-sharing communities are capable of offsetting idiosyncratic household losses at high rates of indemnification.
About the authors

*Mushfiq Mobarak* is Associate Professor of Economics at the Yale School of Management. He is a development economist with interests in public finance (environmental and political economy) issues. He has previously worked at the World Bank, the University of Colorado at Boulder, and at the International Monetary Fund. He has several ongoing field research projects in Bangladesh and Brazil, and his current research interests include projects on water management and hydropower in Brazil, and field experiments exploring ways to induce people in developing countries to adopt technologies or behaviors that are likely to be welfare improving.

*Mark R. Rosenzweig* is the Frank Altschul Professor of International Economics at Yale University. He is one of the principal investigators for the New Immigrant Survey and has testified before Congress on the topic of immigration. Before returning to Yale, he taught at the University of Minnesota, where he was co-director of the Economic Development Center; the University of Pennsylvania, where he chaired the economics department; and Harvard University, where he held the Mohamed Kamal Professorship in Public Policy at the Kennedy School and was director of the Center for International Development. Currently editor of the Journal of Development Economics, Rosenzweig has served on the editorial boards of such publications as the World Bank Economic Review and the Journal of Economic Literature.
The International Growth Centre (IGC) aims to promote sustainable growth in developing countries by providing demand-led policy advice based on frontier research.

Find out more about our work on our website www.theigc.org

For media or communications enquiries, please contact mail@theigc.org

Follow us on Twitter @the_igc

International Growth Centre, London School of Economic and Political Science, Houghton Street, London WC2A 2AE