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Strengthening Public Safety Nets: Can the Informal Sector Show the Way?

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Decreasing household vulnerability to income reduction poses a set of challenges for public policy, the most immediate of which is to determine the appropriate role for public action. A starting point is understanding how communities and families cope with difficulties in the absence of government interventions. Coping mechanisms range from the informal exchange of transfers and loans within families and communities to using more structured institutions. Access to savings and credit provide other buffers, while publicly-owned insurance companies often provide additional means to reduce vulnerability. Looking ahead, some private insurance companies and microfinance institutions are starting pilot programs to test possibilities for providing life, health, and property-related insurance to low-income clients.

This web of private and nonformal mechanisms prompts a series of questions: Will building public safety nets merely displace existing mechanisms? Would it be just as effective to strengthen existing mechanisms rather than create new institutions? Can the private sector and nongovernmental organizations (NGOs) play larger roles? Can we systematically predict when informal insurance and the private sector will be most problematic and most effective? This paper provides some speculative answers and aims to systematize the main trade-offs that arise when evaluating policy options.

Costs of Inadequate Insurance Strategies. Without adequate insurance coverage, households tend to opt for activities that yield less and are less risky, thus potentially reinforcing poverty. Moreover, negative income shocks will have to be absorbed through reduced household expenditures. Reductions might include pulling children out of school, reducing investment in businesses, and reducing consumption of nutritious foods. While current consumption may be temporarily maintained, such actions seriously, and sometimes irreversibly, compromise future livelihood.

Will building public safety nets wind up displacing existing informal support mechanisms—and thus offer limited net gain to households?

Informal Insurance. In general, informal arrangements made to cope with income variability respond to considerations of how to contain potential distress. Some households respond by engaging in safer but relatively less profitable earning activities. Others, when the nature of income variability can be anticipated with a high degree of certainty, plan for crises. Finally, households may share risks, at a given point of time (e.g., receiving a transfer from a household that has not shared the same fate), or pool them across time (e.g., borrowing money during "bad" times and repaying it during "good" times).

Interhousehold Transfers. The distribution of transfers is very unevenly distributed across poor households. Even in the same country there may be large regional differences. The evidence points to several tendencies:

- Despite intergenerational transfers, *elderly populations tend to be much more vulnerable* than younger populations;
- *Large, catastrophic losses are more difficult to handle through private means*;
- *Idiosyncratic events that tend to affect individuals one at a time are easier to address through nonformal insurance,* compared with events that affect entire communities or broad regions;
- *Socially excluded groups among the poor fare worst under systems of nonformal insurance,* while households with extensive community networks may cope with moderate idiosyncratic shocks quite well.

Nonformal insurance systems do not work well for many of the same reasons that private schemes fail: it is often difficult to enforce "contracts," participants may not take adequate precautions against risks, and schemes tend to become increasingly less appealing to richer households as they begin to be perceived as redistributive.

Self-Insurance: Diversifying Asset Portfolios and Reallocating Labor. Households lacking the means to maintain consumption during downturns often turn to income-earning activities that have smaller income variability. Two factors bear on such decisions. First, poor households are risk averse and are willing to forgo a certain amount of earnings to protect consumption. Second, risk avoidance will be a more serious concern for those lacking *ex post* coping mechanisms. A certain degree of poverty entrapment may therefore result when poor and risk-averse households shun new or profitable activities in order to contain income risks.

Indigenous Insurance Mechanisms and Community Institutions. There are various schemes whereby communities create funds to provide for emergencies such as a death or to pay the debts of a person who dies. While many are sustainable, the costs to participants can be expensive or the funds may be unable to sufficiently diversify their risk. This

has prompted NGOs and microfinance organizations to move toward cheaper, community-based products with greater scope for risk diversification.

Household Savings. In the absence of savings accounts and good possibilities for buying and selling assets, rotating saving and credit associations (ROSCAs) can play a key role. In a typical scheme, members contribute funds at regular intervals. With each round of contributions to the common pot, one member of the group is given the whole amount, which is used to buy goods that are too costly to purchase with the typical cash flow of households. The advantages of ROSCAs are that they are simple, funds circulate at all times, and accounting requirements are minimal. However, ROSCAs are inflexible and tie up money that could be needed to address a temporary crisis. In Bangladesh, a variation of the ROSCA, SafeSave, helps clients build up savings by having staff visit them daily to collect contributions. Over time, clients build up a "usefully large" sum. Clients may also borrow against savings.

Microfinance and Microinsurance. Microfinance programs are set up to make small loans to households lacking access to formal credit. The loans are earmarked for the expansion or development of small businesses. The programs help households increase their incomes and savings, and often help provide extra cash to help households cope with consumption shocks. Such loans can also help households start new businesses that diversify income.

On the other hand, by tying households to payment schedules, microfinance can *add* to vulnerability. In the face of a crisis, paying off debt is harder, so the credit-orientation of the programs may often make households less secure. Recognizing this, many microfinance programs are now turning to the possibility of providing "microinsurance" to their clients.

Informal institutions such as those facilitating interhousehold transfers thrive on informal, but well understood, principles of conduct and contract enforcement, and the success of many microfinance institutions has hinged on this fact. But as microfinance institutions consider more complex insurance contracts, proportionately more complex systems of regulation and supervision will be required.

New Directions: Insuring Against Weather Shocks. State insurance companies have often tried to provide crop insurance to poor farmers, but few have succeeded. One approach suggests weather insurance, i.e., insuring the *source* of losses rather than the losses themselves. A farmer who buys rainfall insurance, for example, pays a premium and gets a payout when measured rainfall is low—independent of the actual harvest. Thus, the value of the insurance depends on how highly correlated a farmer's income is with measured rainfall. However, from the insurer's perspective, there is a large risk. Thus, an active reinsurance market will be an important determinant of whether weather insurance can be viable.

Will Public Action Just Crowd Out Private Activity? As with all safety-net policies, the costs of public action must be weighed against expected benefits—and the net benefits may be limited if it crowds out private efforts. The uneven access to informal insurance mechanisms makes consideration of crowding out difficult. Providing public safety nets may lead to the substantial displacement of private transfers for those who receive private transfers, so that their net benefits are less than the full size of the public transfer. But, even in the same region, many households receive few private transfers–and thus their net benefits could be large. Policymakers must, therefore, consider the following:

- What are the costs associated with the private efforts?
- Who gains from the crowding out?
- How is the incidence of crowding out distributed?
- Are public efforts more efficient than private efforts?

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