

### Risk and the persistence of poverty

**R**isk is pervasive in developing countries. The standard household risks of sickness, mortality, fire, theft, and unemployment are especially severe for poor families in developing countries. Rural households, most of which derive their livelihoods from the land, face the additional risks of droughts, floods, and pests and diseases affecting their crops and livestock. Insurance provision is still limited, and state-provided social security or more basic social safety nets are often limited or unavailable for particular widespread disasters.

Richer families have reasonable access to insurance alternatives, such as credit and substantial savings. Although these alternatives are generally not options for poorer families, it is well known that such families do employ relatively sophisticated mechanisms to manage and cope with risk. They tend to diversify their crops and income-generating activities, often incorporating nonfarm activities into their income streams and even having family members migrate to reduce the household's overall exposure to risk. Where possible, they build up savings for precautionary purposes, often in the form of livestock or other liquid assets. They also engage in informal mutual support networks in which assistance is provided if a member experiences some form of shock. Nevertheless, given the variety and severity of risks to be dealt with, shocks inevitably have serious welfare consequences.

These consequences are well illustrated by evidence from Ethiopia, where rural households face a considerable risk of drought. For example, about half of the households interviewed in 2004 for a rural panel data survey in 15 communities across the country reported that they faced serious hardship due to drought in the preceding five years, while about a quarter of the sample reported hardship resulting from illness and a similar number reported problems related to illness. Despite increased investment in health services and a relatively widespread, foreign aid-supported safety net to cope with drought, these shocks continue to impose significant welfare costs. The consumption levels of those reporting a serious drought, for example, were found to be 16 percent lower than those of families not affected, and shocks from illness appeared to have similar average impacts. Further, the costs were not just short term: in the sample, it was found that those who had suffered considerably in the 1984–85 famine—the most severe famine in recent history—were still experiencing lower growth rates in consumption in the 1990s, a period of overall recovery, than those who were not seriously affected by the famine. Children born during the famine were found to be up to three centimeters shorter at adulthood than children born before or after the famine, suggesting that famine had serious, persistent health impacts with long-term consequences.

Risk should thus be seen as a cause of persistent poverty, in that shocks cause serious losses of physical assets and human capital. The presence of risk also tends to induce poorer households to become risk averse, even at the expense of otherwise higher

returns: for example, they may choose to grow low-returning but safe crops and to avoid committing resources to more productive capital in order to preserve the liquidity of their asset base. In Ethiopia, efforts to increase farmers' fertilizer use and thereby raise their productivity—a risky undertaking as farmers must still bear the costs of fertilizer even if the harvest fails—are significantly undermined by the lack of protection against poor rainfall.

Evidence from other countries shows similar patterns: risk induces farmers to engage in low-return investment portfolios in rural India and to grow more low-risk, low-return crops such as sweetpotatoes or cassava in Tanzania. Climate and other shocks have been shown to undermine long-term nutrition, educational achievement, and earnings in settings as diverse as India, Indonesia, Tanzania, and Zimbabwe. These studies all show that risk causes poverty to persist.

### Is insurance a solution?

Insurance is not necessarily the best policy intervention to deal with many types of risk, especially in contexts of high poverty. First, rather than insurance, risk reduction and management may be the most relevant response for many types of risk—the obvious examples are conflict and crime. Other examples of risk reduction are preventive health measures, water management, and environmental protection. Second, many types of risk are not easily insurable, simply because they cannot be actuarially priced—as is the case with many of the more common risks in developing countries because even basic data on health, longevity, and climate are often incomplete—or because the risks are unknown, as in the case of rare natural disasters or catastrophes. Third, offering insurance does not remove the need to find ways of actually lifting the poor out of poverty: insurance will prevent a worsening of poverty and may allow more risk-taking by the poor, but it is not a substitute for more general policies to promote income growth.

It is, nevertheless, increasingly acknowledged that designing insurance products suitable for the poor has an important role to play in fighting poverty. However, insurance markets suffer from serious informational problems—possibly even greater than those faced by credit markets. Because it is difficult to observe the exact risk profile of each member of the population, insurance may attract those facing relatively higher risk on average, leading to adverse selection problems that will affect the sustainability of a scheme. Further, people may actually start taking more risks once insured (the so-called moral hazard problem). Premium collection costs can be high, as can the cost of verifying that certain insured risks actually occurred.

Different risks have different specific informational or verification problems. For example, health insurance schemes tend to suffer primarily from adverse selection problems, property or fire insurance are strongly affected by moral hazard problems, and insurance against crop failure suffers from both moral hazard and loss verification problems. These risks are often also highly

covariate, requiring a much larger risk pool. Life insurance has fewer of these problems and typically emerges early in new insurance markets.

Health insurance has been available in many developing countries, although often not as a financial product targeted to the poor, but rather as a product linked to specific health facilities. Life insurance products are commonly linked to credit, but they are increasingly becoming freestanding, as in the case of the life insurance offered by the Indian Self-Employed Women's Association (SEWA) to its members. Rainfall index products, whereby holders receive a payout when rainfall falls below predetermined levels, are increasingly offered as alternatives to crop insurance because they can overcome standard moral hazard and costly verification problems.

But selling insurance to the poor is not without its problems. Studies consistently find that the hypothetical demand for insurance is high, but when insurance products are carefully piloted—as was rainfall-index drought insurance in India and Malawi or health insurance for the informal sector in Kenya—uptake is rarely swift or high, and renewal rates are low, even though these products seem rather attractive to the outside observer. In insurance companies, this phenomenon is well known; it is often said that “insurance is always sold and never bought.” Explaining this phenomenon is harder. The upfront cost of the insurance premium may well explain some people's reluctance, but not at this scale. Lack of uptake could also be related to the fact that insurance is a difficult concept to understand, and taking up an insurance product can often itself be seen to increase uncertainty, given its cost and novelty. Furthermore, in environments where people have limited experience with formal insurance, establishing trust in and credibility of insurance products is essential, but difficult. Poor people are asked to pay cash up front to an institution outside their community in order to receive cash when a particular event occurs—an arrangement rather different from, for example, microcredit, where an institution offers money with a request that it be repaid later.

These problems suggest that the institutional delivery mechanisms of insurance products targeted to the poor are crucial. Offering a new, unfamiliar product to suspicious individuals will always be a hard sell. Educating possible clients in the principles of insurance or building trust between the insurance provider and potential poor clients may be important. One starting point may be to build on local institutions or informal arrangements that focus on local risk sharing. In most communities, people have long collaborated to provide mutual support in the event of crises,

forming networks based on well-defined extended families and social groups. In Europe, much of the provision of social security began with health and unemployment insurance initially developed within cooperatives or trade unions. With public intervention, these mechanisms eventually grew to become fully fledged social insurance schemes. In developing countries, there is ample evidence of functioning self-help groups and cooperatives. More traditional but no less sophisticated institutions such as funeral societies provide cash and in-kind funeral benefits for their members and members' families. These schemes tend to be highly inclusive of the poorest segments of the community.

Working with groups to offer insurance products has considerable advantages. First, dealing with groups reduces monitoring and other information costs, because the insurance agency must monitor only the group portfolio, leaving the association to monitor the individuals within the group. Next, if groups that include the poorer segments of society are chosen, the task of targeting can also be devolved to the level of the group. Further, existing groups already have mutual support systems, making it easy to build on existing informal schemes with complementary activities. Finally, groups can be used to help bridge the information or trust gap between the formal providers of insurance and potential poor clients.

## Conclusion

Risk remains an important cause of the persistence of poverty in developing countries. Insurance may not be a panacea, but it can offer a useful complement to other microfinance and more general interventions to fight poverty. Designing insurance products is relatively straightforward, but the uptake of these products by the poor is likely to be low at first. Building on existing mutual support institutions may offer a cost-effective, group-based mechanism to spread insurance targeted to the poor. ■

**For further reading: D. Clarke and S. Dercon, “Insurance, Credit and Safety Nets for the Poor in a World of Risk,” Working Paper 81 (New York: United Nations, Department of Economics and Social Affairs, 2009); S. Dercon, “Income Risk, Coping Strategies, and Safety Nets,” *World Bank Research Observer* 17, no. 2 (2002): 141–66; S. Dercon, J. de Weerd, T. Bold, and A. Pankhurst, “Group-based Funeral Insurance in Ethiopia and Tanzania,” *World Development* 34, no. 4 (2006): 685–703; J. Morduch, “Between the State and the Market: Can Informal Insurance Patch the Safety Net?” *World Bank Research Observer* 14, no. 2 (2002): 187–207.**

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**Stefan Dercon** ([stefan.dercon@economics.ox.ac.uk](mailto:stefan.dercon@economics.ox.ac.uk)) is professor of development economics at the University of Oxford.



**International Food Policy Research Institute**

2033 K Street, NW • Washington, DC 20006-1002 • USA

Phone: +1-202-862-5600 • Skype: ifprihomeoffice • Fax: +1-202-467-4439 • Email: [ifpri@cgiar.org](mailto:ifpri@cgiar.org)

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