



Strengthening Public Safety Nets from the Bottom Up

Public safety nets in developing countries address the vulnerability of the poor and the near-poor to income disruption, but such formal programs do not operate in a vacuum. Private and informal mechanisms may already exist. The design of public interventions requires a clear understanding of what mechanisms are already available and how (and to what extent) individuals and households use them to cope with income fluctuations. This note surveys some of those design considerations.

Informal Mechanisms: What Type of Risks Can Best Be Addressed by Risk-Sharing Arrangements?

Individuals and households can deal with risk in a variety of ways. Between individuals confronted with different risk profiles, risks can be shared. An individual may also address short-term risk by drawing down funds during periods of income shortfalls and repaying them during periods of higher income. Whether such risk sharing arrangements are successful (or even possible) depends upon the type of risk.

Covariant versus idiosyncratic risk When partners in a community share the same income risks, the demands for support are likely to arise simultaneously, and so risk sharing is not possible. Where risks are idiosyncratic, however, risk-sharing arrangements may very well offer high potential benefits. Given the prevalence of idiosyncratic risks, there is a significant role for mutually beneficial insurance arrangements between households.

Unanticipated risk versus anticipated income variability Advance knowledge about income variability—i.e., regular seasonal fluctuations—allows individuals and households to adjust—i.e., find work during the agricultural lean season. Where shocks cannot be accurately anticipated, an individual's risk-management strategy will depend on his assessment of the probabilities and on his preference and ability to take risks.

Persistent risks Persistent risks put stress on risk sharing arrangements by increasing the demands for transfers and reducing the ability of recipients

to reciprocate soon. Informal insurance mechanisms may prove to be unsustainable in the face of persistent risks.

Community Responses to Risk and their Limitations

Interhousehold transfers

Mutual support in families and communities often takes the form of in-kind or cash transfers which are expected to be reciprocated in a certain way, depending on the community. The importance of transfers tends to vary widely both between countries and within countries, and they tend to be very unevenly distributed among poor households.

Motivations for remittances

The decision to migrate and remit may be motivated by many reasons. Some may be altruistic, such as to increase total household income or to diversify and so reduce variability in family income. Others may be to lay claims to inheritance of family assets, to reimburse for certain investment expenses such as education, or to pay back the older generations. Whatever the motivation for remittances, when family members are engaged in weakly correlated income-generating activities, they are in a much better position to pool risks.

Explaining breakdowns

Informal insurance mechanisms suffer from a number of problems, some of them similar to the ones experienced in private commercial insurance schemes.

Contract enforcement. Given the difficulty of enforcing insurance contracts, there is a tendency for informal insurance to offer only benefits of a small size. If the short-term profit from breaking the contract is greater than the long-term benefits from compliance, enforcement will be difficult.

Moral hazard. If it is difficult to obtain information about a participant's behavior, the participant may engage in riskier behavior and so saddle friends and family with bigger risks than they had bargained for.

Diversity of resources and trajectories. As beneficial as it is for risk pooling to occur among a group of individuals with highly diversified occupations and degrees of income variability, this diversity may undermine the cohesion necessary for the informal arrangement to be sustainable over time.

Self-Insurance by Individuals and Households

Household savings

The most important coping mechanism for households is to use previously accumulated assets. Given that poor households often lack access to formal savings accounts, they tend to keep assets such as livestock, which carry the risk of illness and whose value fluctuates with market conditions. In a number of societies, rotating savings and credit associations play the role of an alternative savings mechanism. Over a fixed period of time and at regular intervals, all members contribute funds to a common pot. At the end of each interval, the pot is given in full to one of the members. This is a fairly simple process with little logistical requirements and can benefit those who lack the discipline to save. It may, however, be too inflexible and unnecessarily tie up a household's money especially during a temporary crisis.

Self-insurance: diversifying asset portfolios and reallocating labor

Households that cannot insulate their consumption level from income shortfalls through insurance instruments or savings, tend to resort to income smoothing. Rather than engage in high-income/high-variability activities, they will choose lower-income/lower-variability activities. Thus a wage earner may voluntarily choose long-term, lower-pay work rather than accept the volatility of the higher-paid daily work market.

Policy Response: Creating New Local and Global Pro-Poor Financial Institutions

Microfinance

Microfinance programs have emerged as important players serving the poor, providing small loans to households lacking access to formal sector banks. Though typically earmarked for the expansion or development of a small business, the funds may be fungible enough to give households access to extra cash in the face of consumption shortfalls. The micro loans allow households to increase their incomes and thereby increase their savings, as well as to develop new businesses that help them to di-

versify their income. However, the rigid payment schedules associated with microfinance programs may actually increase a household's vulnerability.

New Savings Banks

The experience of a new program in Bangladesh called SafeSave shows that the poor are very well able and willing to save when safe and convenient means to do so are available to them. The main constraints for programs such as this one are that there is a significant cost associated with visiting clients daily, and that financial regulations often make it impossible for such institutions to provide flexible deposit-taking services.

Microinsurance

While many microfinance programs are starting to provide microinsurance, most of these programs are just in pilot stages. The results to date have been mixed: credit-life insurance type arrangements seem to be successful, but health insurance has not been, for reasons of moral hazard and adverse selection. Moreover, micro-insurance tends not to be available to the poorest of the poor.

Weather Insurance

In order to circumvent the problems of moral hazard and adverse selection associated with crop insurance schemes, weather insurance schemes have been tried. The extent of the payout depends on the amount of rainfall rather than the farmer's actual harvest. Consequently, farmers will choose to participate in this scheme only if their income is highly correlated with actual rainfall. While this seems to be a very promising arrangement, the main constraint to its use and viability is the need for the insurer to be able to reinsure the large amount of risk he is taking on, and that is possible only if an active reinsurance market for weather risks can be created.

Conclusions

While households may have informal mechanisms to deal with the risks they face, many of them can be costly to the household in the long run. Public policy can complement these mechanisms. In some cases it may be desirable for public policy to supplement the informal mechanisms if the public program provides more equitable and efficient outcomes. Private-sector and market-driven NGOs can potentially play an important role in helping poor households to build up savings and to insure, but many programs are still very small or at the pilot stage.

The World Bank Social Safety Nets Primer series is intended to provide a practical resource for those engaged in the design and implementation of safety net programs around the world. Readers will find information on good practices for a variety of types of interventions, country contexts, themes and target groups, as well as current thinking on the role of social safety nets in the broader development agenda.



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