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When the Invisible Hand Fails to Catch the Poor: The Relationship between Risk and Poverty

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Insurance Against Poverty
Stefan Dercon, ed.
(Oxford: Oxford University Press, 2005), 484 pages.

In September 1993, Larry Summers, then under secretary of the Treasury in the Clinton administration, met with the Russian prime minister to walk him through the logic of IMF conditionality. When the prime minister protested that IMF measures impinged on his country's sovereignty, Summers responded that the rules governing lending were simply immutable principles of economics, operating in a way similar to the laws of physics.[1] This academic tendency to isolate the economic realm from its larger social implications, with unsurprisingly disappointing results, was later criticized by Joseph Stiglitz in his own account of the IMF, *Globalization and Its Discontents*.[2] Stiglitz's critique, however, is but part of a long tradition of castigating neoclassical economics for being unforgivably disembedded from social realities. *Insurance Against Poverty*, a study prepared by the United Nations University's World Institute for Development Economics Research from a collection of eighteen papers first presented at a 2001 UN conference, tackles this criticism head on by putting the social implications of economic reforms at the center of its analysis. In doing this, as the editor proclaims at the outset, the authors do not seek to reject neoclassical economics, but to explore and extend its applications under conditions of risk, uncertainty and market failure.

The book examines the relationship between risk and poverty in developing countries, seeking effective policies to mitigate the risks that continue to contribute to widespread poverty. The poor in developing countries face a legion of risks, both natural and man-made-drought, flooding, frost, pests, policy shocks, livestock diseases, fire, war, crime and banditry, to name a few. A sad irony of this state of affairs is that people most in need of insurance markets to protect themselves and their livelihoods are those least likely to have access to such markets. The contributors to this volume examine the ways in which various risks affect the welfare of the poor and the strategies they use to cope with the resulting challenges.

Insurance markets for disasters face a number of additional challenges. In general, insurers are willing to distribute risks among a large group of people because their collective behavior can be predicted. But the goal of spreading risk does not work well with disasters. Both the timing and the frequency of disasters are unpre-

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dictable over the short run, meaning that the business of insurance will be profitable only over many years. Few insurers have the patience and capital to take on such an endeavor (in economic terms, they are "ambiguity-averse"). Moreover, the market for disaster insurance is plagued by irrationality. People tend to underestimate the likelihood of disasters until they occur. In the 1995 Kobe earthquake, for example, only 3 percent of the buildings on the fault line were insured. After a disaster, rates skyrocket until the market is forced out of existence. The U.S. government had to step in after September 11th when it became extremely difficult to buy terrorism insurance on the private market.[3]

Poorer countries are especially prone to insurance market failure. Some governments repress markets with excessive regulation; others are too weak to enforce insurance contracts. Within poor countries the lack of capital hinders investment in risky markets like disaster insurance. Poor countries also face greater uncertainty about the future, which makes long-term insurance markets seem unprofitable. A starting point for the analysis in this book is that the link between risk and poverty is directly related to missing insurance markets. The laissez-faire mantra of letting the markets do their work without interference becomes problematic when the demand for social insurance markets is not matched by a supply of such markets; the book contends that public action may be required to correct this market failure.

Arguments for social programs that benefit the poor are usually couched in terms of social equity or humanitarian concern. But, as many of the authors here argue, such programs make economic sense as well. Social protection, in short, may be an important part of promoting economic efficiency and growth. As Dercon puts it, "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."[4]

The papers which comprise the book are written for a policy audience, but their prescriptions are not limited to government action. Many of the authors explore approaches that entail roles for non-governmental organizations, the private sector and informal local social institutions. Historically, the formalized and diverse systems of social protection in Europe and the United States have deep roots in local and less formal groups like trade unions, community organizations and religious institutions. As a result, the editor concludes, formal "sustainable systems in developing countries will need to have a strong local institutional basis."[5] As problems of asymmetric information, which often accompany insurance market failure, are not easily resolvable by direct state action, the focus in this book, for the most part, is on studying and designing institutions, both formal and informal, that incorporate different sectors of society rather than relying on specifically government-led solutions.

One danger of such a holistic approach is a potential lack of focus, leading to vague policy prescriptions. Indeed, the range of topics explored in this volume is

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wide in scope: papers include a test of informal risk-sharing mechanisms using micro-level data from India; household income dynamics and shock responses in rural China; macroeconomic implications of agricultural shocks; the effects of droughts on child health; exclusion and inclusion in the social networks of Ghana; weather insurance; the lack of financial intermediation in developing countries; and the examination of crowding-out effects of public transfers in Mexico, to name a few chapters. Fortunately, instead of putting together a broad survey of the many issues related to social protection programs, each contribution in the volume takes on the more manageable (and more useful) task of focusing narrowly on a specific aspect of protection from vulnerability stemming from risk. The papers are often quite detailed about a particular subject, including a number of empirical studies based on household-level data and fieldwork.

The theoretical link between risk and poverty appears straightforward on the surface. If risk is uninsured, living standards will go down in the presence of shocks, resulting in poverty. However, this simplified approach ignores the fact that the poor often adopt sophisticated techniques for handling risks and shocks. Some strategies, for example, include informal risk-sharing arrangements such as using savings, assets and transfers from family and friends to cope with risk or pooling resources in a common fund. Groups can also adjust to hardship by diversifying into low-risk activities, migrating, taking on additional or informal employment, adopting new consumption and production patterns or forming social networks. But these strategies, while sometimes optimal in the short term, often retard long-term growth. Switching to low-risk activities naturally yields lower returns. Keeping savings liquid in anticipation of shocks prevents the poor from investing money in productive long-term assets. In short, even where informal strategies help people deal with the daily realities of poverty and risk, they ultimately hurt their chances of escaping poverty permanently. The persistence of such "poverty traps," the book argues, provides the economic foundation for arguments in favor of social protection, since the elimination of these traps could unlock the growth potential of the millions currently mired in poverty, leading to economic benefits for all.[6]

Being poor, in other words, is not just a condition but a *process*, one that contains self-reinforcing feedback mechanisms that perpetuate more poverty. Thus Joachim De Weerdt, in his chapter examining the social networks of a Tanzanian village, finds that poorer people actually have less dense social networks than the rich, leaving them less able to cope with risks.[7]An article by Jean-Philippe Platteau examines the history of informal risk-sharing schemes, such as voluntary reciprocal exchanges and public "endowments," and suggests that their effectiveness is likely to decline as economic mobility and differentiation increase with development, providing an argument for greater public intervention by central agencies as countries

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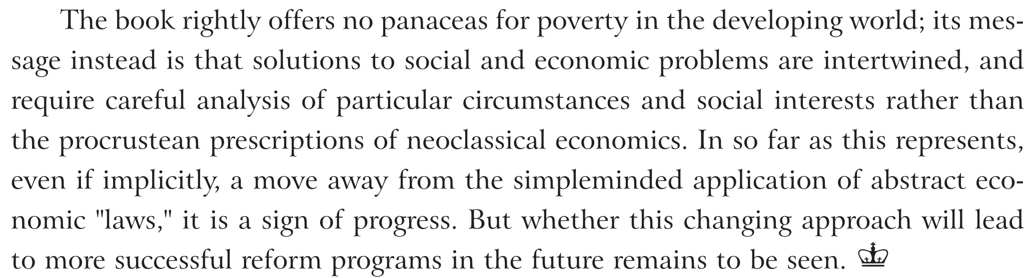
modernize.[8] Informal mechanisms tend to overcome risks by exploiting the information and enforcement provided by social proximity. By their nature, then, such informal mechanisms are limited to small groups and cannot be expanded to society at large. Despite the introduction's stated reluctance to revert to government action as the default solution, some of the authors exhibit an obvious preference for state intervention. Others take the opposite stance. As Jonathan Conning and Michael Kevane argue, corrupt leaders often repress insurance markets with excessive regulation. Given the history of venality and government failure in this regard, they suggest caution when discussing proposals that involve additional regulation or state intervention.[9]

The book rightly offers no panaceas for poverty in the developing world; its message instead is that solutions to social and economic problems are intertwined, and require careful analysis of particular circumstances and social interests rather than the procrustean prescriptions of neoclassical economics. In so far as this represents, even if implicitly, a move away from the simpleminded application of abstract economic "laws," it is a sign of progress. But whether this changing approach will lead to more successful reform programs in the future remains to be seen.



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NOTES

[1] Strobe Talbott, *The Russia Hand* (New York: Random House, 2003), 85.

[2] Joseph Stiglitz, *Globalization and Its Discontents* (New York: W.W. Norton, 2003), 196-9.

[3] James Surowiecki, "The Catastrophe Problem," *New Yorker* 80, no. 42 (10 January 2005), 30.

[4] Stefan Dercon, ed., *Insurance Against Poverty* (Oxford: Oxford University Press, 2005), 2.

[5] Ibid., 3.

[6] Ibid., 66, 107.

[7] Ibid., 197-216.

[8] Ibid., 247-78.

[9] Ibid., 330-57.