Risk Sharing and Demand for Insurance: an Experimental Analysis

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Abstract

Uninsured risk leaves poor households in developing countries vulnerable to serious negative shocks hard to cope with, and forces them to engage in costly risk management strategies to hedge against their occurrence. Although mutual support networks have long existed, they are ill-suited to protect against covariate or catastrophic risks. Grounded in a strong rationale, insurance has however failed to fulfil its potential, plagued by serious informational and enforcement problems. In recent years a new form of index-based insurance has arisen as a promising instrument to deliver formal coverage, overcoming the mentioned issues through its particular design. Yet index insurance is not without problems, its key limitation is the imperfect correlation between index and losses (*i.e.* basis risk), a problem that partially explains the low demand it has been met with. Some recent papers argue that informal risk sharing can complement the coverage of index insurance, by partially absorbing basis risk. However, the possibility that pre-existing risk-sharing arrangements hamper formal insurance uptake cannot be dismissed. To shed light on this relationship and the future of index insurance, this paper investigates how the provision of formal insurance interacts with informal sharing arrangements, employing experimental evidence from a rural area in eastern Uganda. We contribute by, for the first time, varying exogenously actual risk sharing, to study its effect on insurance demand, and insurance characteristics, to test whether this effect varies depending on the type of insurance. In addition, we investigate the influence that the provision of formal insurance exerts on risk sharing behaviour.

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