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microInsurance Innovation facility
PROTECTING THE WORKING POOR

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USING SUBSIDIES FOR INCLUSIVE INSURANCE: LESSONS FROM AGRICULTURE AND HEALTH

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Insurance lies at the intersection of financial inclusion and social protection, and can contribute to a number of public policy objectives, including improving access to health care, increasing food security, and coping with climate change. There is therefore a public policy rationale to invest in the development of efficient insurance markets that provide equitable access to low-income households. Providing subsidies for insurance is a common practice of many governments and donors. In agricultural insurance, for instance, in the middle- and low-income countries surveyed by Mahul and Stutley (2010)[2], 63 per cent of all countries surveyed provided premium subsidies.

This brief presents a framework and lessons from nine subsidized insurance schemes for governments and donors on how to effectively design and implement "smart" subsidies for microinsurance (see Box 1). The brief focuses on agricultural and health microinsurance schemes, as the majority of subsidized schemes fall under these two areas.

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[1] This brief is excerpted from Microinsurance Paper no. 29. The paper is available at http://www.ilo.org/microinsurance. Ruth Vargas Hill and Gissele Gajate-Garrido are part of the International Food Policy Research Institute. Caroline Phily and Aparna Dalal are part of the ILO's Microinsurance Innovation Facility. This study was partly funded by the German Federal Ministry for Economic Cooperation and Development (BMZ), which promotes insurance approaches within comprehensive systems of social protection and inclusive financial systems.

[2] See Microinsurance Paper no. 29 for citation details.

BMZ Federal Ministry for Economic Cooperation and Development

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BOX 1. "Smart" subsidies

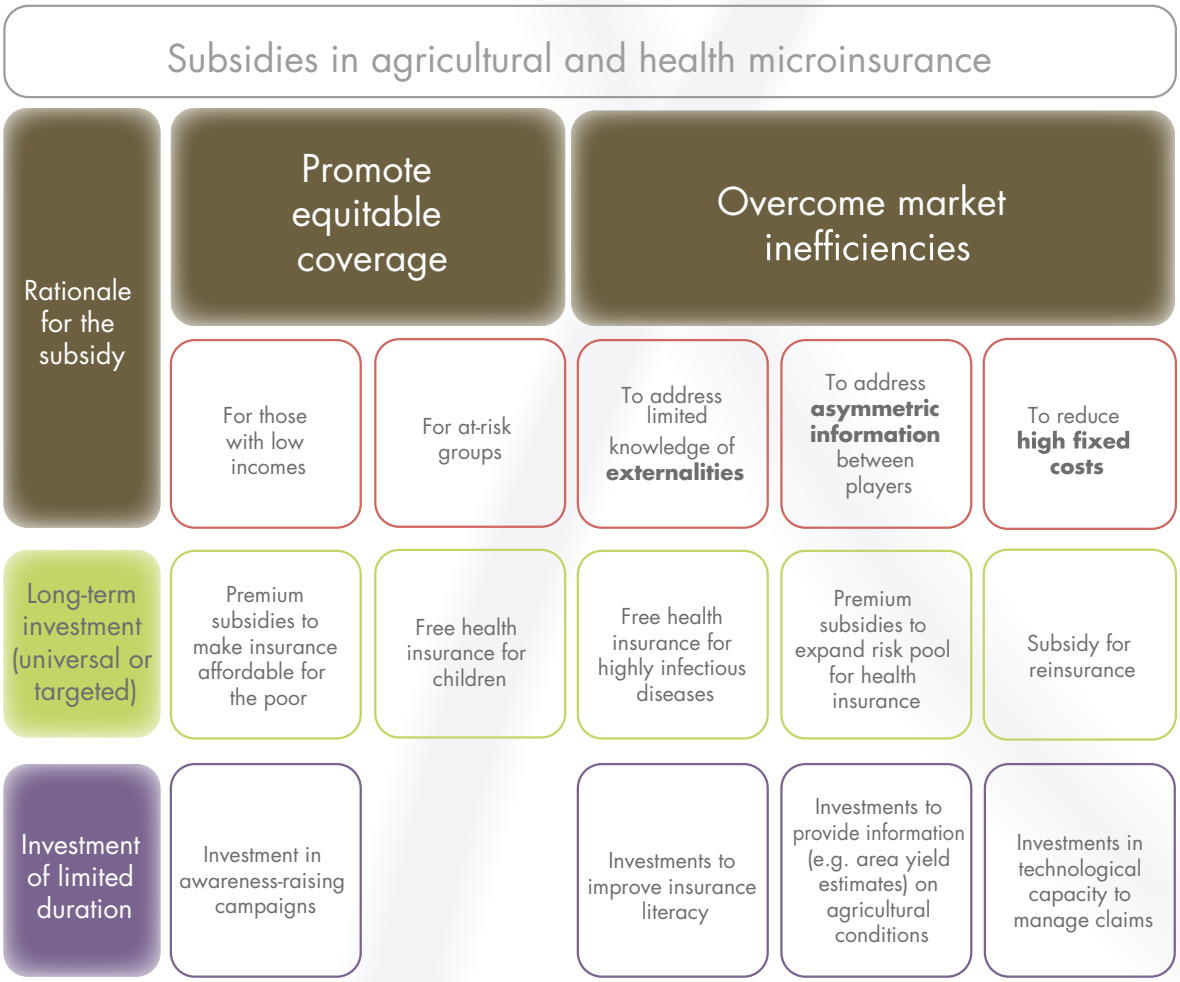
"Smart" subsidies are designed and implemented in ways that provide maximum social benefits while minimizing distortions in the market and mis-targeting of clients (Morduch, 2005). Poorly designed subsidies can undermine efficiencies and incentives within the insurance industry, and encourage over-utilisation of health care by beneficiaries, and overinvestment in risky, and sometimes environmentally damaging, agricultural activities.

A subsidy should be designed with a clearly stated and well-documented purpose. It should address a market failure or equity concern, and should successfully target those in need with minimum inefficiency.[3] Smart subsidies are designed with a clear exit strategy or with a long-term financing strategy in mind. Additionally, a good monitoring and evaluation system that tracks the performance of subsidies is paramount for the success of any subsidized insurance scheme.

FRAMEWORK AND LESSONS

When considering developing subsidies for insurance to support policy objectives policy-makers or donors should be clear about the objective. There are two broad reasons for providing subsidies to insurance (see Figure 1).

FIGURE 1. Framework for using subsidies in microinsurance



[3] Resources are put to their best use.

PROMOTE EQUITABLE COVERAGE

First, subsidies can be used to improve equity by extending insurance to previously excluded groups, such as low-income individuals. Nearly all subsidies aimed at promoting equity subsidize premiums rather than support infrastructure, capacity or reinsurance. Subsidizing insurance premiums reduces the cost of insurance for targeted households (typically, low-income households or at-risk groups). For example, the experience of the National Health Insurance Scheme in Ghana (see Box 2) shows that national subsidized insurance can increase insurance coverage dramatically, from 1 per cent to 33 per cent, but that there are challenges to reach the poorest segment of the population.

BOX 2. Using insurance to increase access to health care: The case of Ghana

In 2003 the National Health Insurance Act was passed in Ghana, creating that country's National Health Insurance Scheme (NHIS). The scheme required people to pay an annual fee according to their income to access public health facilities. The Government subsidized the poor as well as at-risk population groups (pregnant women, people over 70 years old and children aged 18 or younger) to ensure that they could access health care services.

By the end of 2011, around 8.2 million people (or 33 per cent of the Ghanaian population) were covered under the NHIS, whereas before the creation of the NHIS less than 1 per cent of the population was enrolled in an insurance scheme. Despite this substantial increase, however, the NHIS is not effectively reaching the poorest: less than 2 per cent of Ghana's indigent population is enrolled in the NHIS.

Indigents are not registering for the NHIS for many reasons, such as a lack of awareness, long distances to travel to registration points, or a negative perception of the NHIS. In addition, the current method for identifying indigents through means-testing is vague.

The NHIS still needs to become more effective in reaching the poorest Ghanaians fulfill its mission: to ensure equitable universal health care access for all residents of Ghana.

LESSONS

- Efficient targeting mechanisms need to be in place. Targeted subsidies have the potential to be more effective than universal subsidies to ensure equity, provided that targeting strategies are well designed and tested before implementation. Targeting that is restricted to the poorest segment of the population may leave near-poor categories without coverage.
- Premium subsidies will be more effective at increasing coverage among low-income populations if combined with other strategies to overcome barriers to purchase insurance. Financial constraints are not the only barrier to demand; governments should assess other barriers to demand and encourage access through parallel activities, such as supporting communication campaigns or effective registration.
- Subsidized premiums must reflect underlying risks. Regardless of the size of the subsidy, it is important that the premium is actuarially priced and based on experience data on health and agriculture risks.

OVERCOME MARKET INEFFICIENCIES

Second, subsidies can correct market failures that may hinder the development of the insurance sector. Market inefficiencies such as high fixed costs may cause underinvestment by insurers. A lack of information amongst insurers about risk profiles and lack of awareness among clients can lead to information asymmetries that prevent insurers from offering insurance and prevent households from making important purchase decisions. The goal of the subsidy is to address the root cause which distorts the market, causing it to fail or function poorly. This requires knowing how the market works and where the imperfections are.

LESSONS

- Even when motivated by equity concerns, governments may find it more effective to first invest to address inefficiencies in insurance markets, before considering premium subsidies.
- Some of the best ways to address externalities and adverse selection in health insurance markets may be to provide publicly funded health care for people affected by infectious disease or chronic conditions.
- Evidence on subsidies for insurance literacy is mixed. Subsidies that encourage experimentation by clients need to be explicit (for example, time-sensitive vouchers) rather than hidden in a lower insurance premium. Enabling people to learn from experience in this way is likely to be more useful for health insurance, which pays out to a few individuals regularly, than for agricultural insurance, which pays all policyholders but infrequently.
- Investing, during the design stage of the scheme, in technology and data collection, as well as in training in operations and monitoring and evaluation, can reduce high fixed costs and help avoid corruption.
- Reinsurance support is best provided by factoring the price of the risk into the subsidy. When governments subsidize reinsurance it should be done in a way that does not expose the government budget to too much financial risk (see Box 3).

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BOX 3. Pricing the premium according to actuarial data

Launched in 1999–2000, India's National Agriculture Insurance Scheme (NAIS) is an area-yield index scheme which pays farmers if the seasonal average yield of the insured crop in the farmers' locale is lower than a threshold yield specified in the insurance contract. The NAIS subsidized crop insurance by essentially providing stop-loss reinsurance for any insurance claims in excess of premiums collected; however, this was done by raising money to cover claims ex-post. This is not advisable because: (i) it leaves the government budget subject to a lot of financial risk, (ii) it results in delays of claim payments as money has to be found after a bad season (or a lot of capital has to be kept aside, just in case), and (iii) the lack of ex-ante planning means that there is no incentive to invest in the technical work to price products properly.

Recognizing the dangers of its risk exposure, the Government of India worked with the World Bank to redesign the NAIS scheme. Two schemes were initiated: the Weather-Based Crop Insurance Scheme (WBCIS), in which payouts are based on weather indices recorded at local weather stations; and the mNAIS (modified NAIS) scheme, in which payouts are based on estimated average yields, as in the NAIS.

The WBCIS and mNAIS differ from the NAIS in a number of ways. One important difference is that they operate on an "actuarial regime", in which the Government's financial liability is for premium subsidies (as opposed to payouts) given to public and private insurers and funded ex-ante, thereby reducing the contingent and uncertain ex-post fiscal exposure faced by the Government under NAIS. Claim settlement times are also substantially reduced as a result. Insurers receive premiums (collected from farmers and premium subsidies from the Government) and are responsible for managing the liability of the mNAIS with the help of private reinsurance markets. By transferring its liability upfront, the Government is now better able to predict its exposure.

CONCLUSION

Governments can and are using subsidies for insurance to achieve various public policy objectives. It is critical that subsidies are designed and implemented carefully. A cost containment strategy needs to be designed for a scheme to grow with controlled costs. Regular monitoring (with the help of technology) is the key to managing costs.

Housed at the International Labour Organization's Social Finance Programme, the **Microinsurance Innovation Facility** seeks to increase the availability of quality insurance for the developing world's low income families to help them guard against risk and overcome poverty. The Facility was launched in 2008 with generous support from the Bill & Melinda Gates Foundation to learn and promote how to extend better insurance to the working poor. Additional funding has gratefully been received from several donors, including the Z Zurich Foundation and AusAID.
See more at www.ilo.org/microinsurance

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