Innovations for Poverty Action

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Agricultural Decisions after Relaxing Credit and Risk Constraints

The investment decisions of small scale farmers in developing countries are conditioned by their financial environment. Binding credit market constraints and incomplete insurance can limit investment in activities with high expected profits. We conducted several experiments in northern Ghana in which farmers were randomly assigned to receive cash grants, grants of or opportunities to purchase rainfall index insurance, or a combination of the two. Demand for index insurance is strong, and insurance leads to significantly larger agricultural investment and riskier production choices in agriculture. The binding constraint to farmer investment is uninsured risk: When provided with insurance against the primary catastrophic risk they face, farmers are able to find resources to increase expenditure on their farms. Demand for insurance in subsequent years is strongly increasing with the farmer's own receipt of insurance payouts, with the receipt of payouts by others in the farmer's social network and with recent poor rain in the village. Both investment patterns and the demand for index insurance are consistent with the presence of important basis risk associated with the index insurance, imperfect trust that promised payouts will be delivered and overweighting recent events.

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