The Effects of Formal Insurance on Informal Risk Management: Evidence from Ethiopia*

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Abstract

We study the impacts of formal insurance on informal risk management behaviors. In theory, formal insurance may induce reduced *ex ante* informal risk management – (i) self-insurance, to reduce the magnitude of a potential loss, and/or (ii) self-protection, to reduce the probability of loss. But empirical tests of those predictions have proved difficult due to the asymmetric information problems inherent to conventional indemnity insurance and to challenges in measuring self-protection effort. We obviate those obstacles using a unique experimental design and an index-based livestock insurance product among Ethiopian herders whose self-protection efforts we directly measure at high spatio-temporal resolution. We find that market insurance indeed substitutes for both self-insurance and self-protection. The effect varies with *ex ante* wealth and understanding of the insurance product.

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