Supervision 1: Part IIB Paper 8

Professor Munshi

Mutual Insurance

The models of mutual insurance that we studied in class assume that each household's income is exogenously determined. The challenge for the rural insurance network is to smooth the consumption of its members, given these income realizations. One additional mechanism to reduce the variance of consumption would be to reduce the variance in the household's income realizations over time. In particular, the household could send one of its members to the city to search for a temporary job in those periods when it has a low income realization in the village.

(a) Discuss how the temporary migration decision is determined by the degree of risk-sharing in the rural network.

(b) Suppose that some rural communities have better transportation access than others. This will allow them to more easily send migrants to the city. Everything else equal how does this affect risk-sharing in the rural network?