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The Search and Matching Equilibrium in an Economy with an Informal Sector: A Positive Analysis of Labor Market Policies

Working Paper No. 831 Keep in mind
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AUTHOR OR EDITOR Luz Adriana Flórez Publication Date: Friday, 18 of July 2014
This paper contributes to the theoretical analysis of the informal sector in the search and matching framework. Building upon the work of Albrecht et al. (2009), where the informal sector consists of unregulated self-employment, I describe the search and matching equilibrium in an economy with an informal sector where workers are risk neutral and the government can observe when a worker is formal and informal. In this case I solve the matching equilibrium by introducing three policies: unemployment benefits, a formal lump sum tax, and a job creation subsidy. I analyze the effects of these policies on unemployment rates, formal employment and informal employment. I show that these policies affect the incentives of workers to be formal or informal changing the composition of these two types of workers in the labor market.

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Fuente: https://www.banrep.gov.co/en/borrador-831