



Optimal Policy with Informal Sector and Endogenous Savings

Working Paper No. 833 Keep in mind

The series Working Papers on Economics is published by the Office for Economic Studies at the *Banco de la República* (Central Bank of *Colombia*). It contributes to the dissemination and promotion of the work by researchers from the institution. This series is indexed at Research Papers in Economics (RePEc).

On multiple occasions, these works have been the result of collaborative work with individuals from other national or international institutions. The works published are provisional, and their authors are fully responsible for the opinions expressed in them, as well as for possible mistakes. The opinions expressed herein are those of the authors and do not necessarily reflect the views of Banco de la República or its Board of Directors.

AUTHOR OR EDITOR Luz Adriana Flórez

This paper analyzes the effect of social security and lump sum layoff payment in an economy with an informal sector and savings, where the search effort is unobserved. I characterize the optimal consumption/search/non-participant strategy assuming that workers are risk averse and that formal jobs last forever. After including job destruction shocks I solve the model numerically, and focus on the effects of lump sum layoff and social security payments on workers' decision to be formal, informal or non-participant. I find that severance payments protect formal workers against the unemployment risk. With severance payments workers do not over-accumulate to protect themselves against unemployment, instead they increase the search effort through the re-entitlement effects. In this respect my work resembles that of Coles (2006). I find that in the steady state a high severance payment increases the proportion of formal workers while reduces the proportion of informal workers and those who decide not to participate in the labor market. Even though the optimal policy with severance payment is generous, I find that in the steady state the unemployment rate is low and welfare improves.

The opinions expressed here do not necessarily correspond neither to the Banco de la República nor its Board of Directors.