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Optimal Policy with Informal Sector and Endogenous Savings

Working Paper No. 833 Keep in mind
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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.

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