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Informal Sector Under Saving: A Positive Analysis of Labour Market Policies

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Abstract

A number of authors have utilised theoretical models to analyse informality in the labour market. While such analyses have produced valuable insights they all share a common shortcoming: their theoretical models do not take into account the impact of savings on workers decision to participate in the informal sector. The objective of this paper is to fill this important gap in the literature. To this end, I explore the impact of social security and severance payment policies on levels of informality in the labour market using a search and match model. The novelty of my model is that it allows workers to save. I find that high levels of social security payments, while protecting workers from being liquidity constrained, do increase levels of informality. However, I also find that other social security programs, such as severance payments, can reduce levels of informality while producing gains in efficiency. Severance payments increase the incentives for workers to become employed in the formal sector, reducing thus the size of the informal sector

JEL classification: D91; J32; J64; J65

Keywords: Social security payment, Severance payment, Informal sector, Search effort, Savings

1. Introduction

There is a growing literature of theoretical models that analyse informality in the labour market [Satchi and Temple (2009), Zenou (2008), Bosch (2006), Boeri and Garibaldi (2002), Almeida and Carneiro (2011), Albrecht et al. (2009, 2010), Charlot et al. (2013a,b)]. This literature can be divided into three main groups. First, some authors have utilized theoretical models that view the informal sector as a segmented market (Satchi and Temple (2009), Zenou (2008)). Others have studied the informal sector from the point of view of firms, in order to determine how they decide to post a formal or informal vacancy when the government can punish them for being informal

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