

# Labor market informality, risk, and insurance

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## Disclaimer

*"This research uses information from the Chilean Social Protection Survey (Encuesta de Protección Social). I thank the Undersecretary of Social Protection, the intellectual owner of the survey, for the authorization to use the de-identified dataset. **All the results from this research are the responsibility of the author and do not implicate the Chilean Undersecretary of Social Protection.**"*

# Widespread labor market informality in developing countries

- ▶ South America: high informality rates (for 2019, ILO):
  - Lowest: Uruguay (24.5%); Highest: Bolivia (81.5%)
  - Brazil (40.1%), Colombia (62.1%), Argentina (49.7%), Peru (68.4%), **Chile (29.3%)**

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- ▶ Informal workers: employment status cannot be verified by the government

# Informal workers and insurance

- ▶ Informal workers have limited access to public insurance programs
  - Unemployment insurance & employment protection
  - Pensions
  - Paid leaves, Disability insurance
- \* **Formal** jobs are valuable because they offer insurance

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  - Unemployment insurance & employment protection
  - Pensions
  - Paid leaves, Disability insurance
- \* **Formal** jobs are valuable because they offer insurance
- ▶ Informal jobs can be (usually) quickly found
- \* **Informal** jobs are valuable because they are an easy way out of unemployment

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  - Targeting: low income vs “invisible” income
- ▶ Tradeoff: providing insurance vs encouraging formal employment
- ▶ The design of these programs defines insurance level/exposure to risk

# Research Questions

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Essential dimensions:

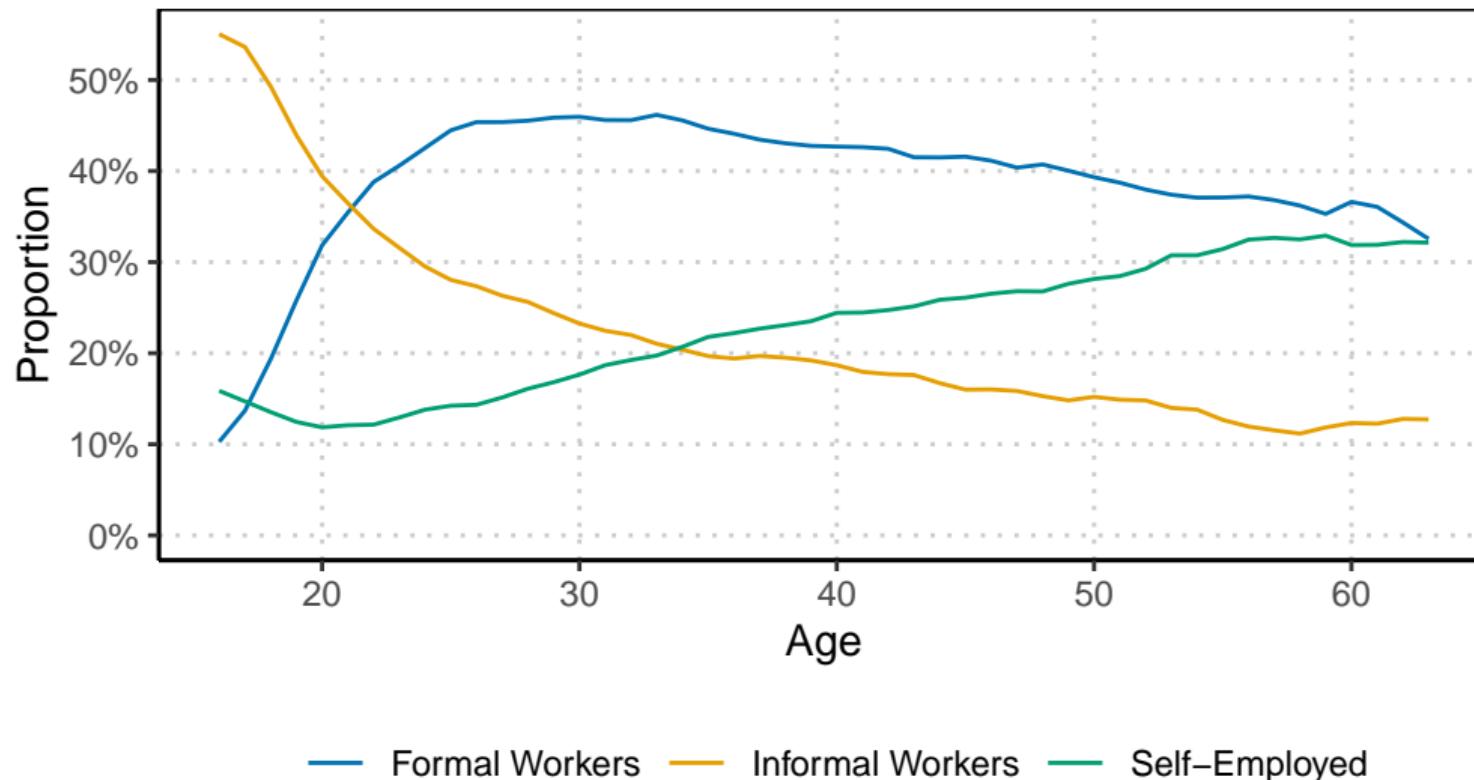
- ▶ Life-cycle
- ▶ Informal sector: **informal employees** and **self-employed**

# Informality over the life-cycle – Chile

Cohorts

Gender/Educ

Other Countries



# This paper

1. Develop a model with employment and savings decisions, risk, and social insurance

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⇒ Wealth-dependent labor market decisions

# This paper

1. Develop a model with employment and savings decisions, risk, and social insurance
2. Rich characterization of informality: informal workers & self-employed
  - Self-employment requires physical capital
  - Different job characteristics (amenities, hours of work)

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2. Rich characterization of informality: informal workers & self-employed
3. Estimate the model with rich microdata & exploiting pension reforms
  - Chilean microdata: longitudinal survey + administrative data
  - Estimate the causal effects of early retirement restrictions

# This paper

1. Develop a model with employment and savings decisions, risk, and social insurance
2. Rich characterization of informality: informal workers & self-employed
3. Estimate the model with rich microdata & exploiting pension reforms
4. Use the model:
  - Learn drivers of employment decisions
  - Compute the value of a formal job
  - Compute the value of the informal sector
  - Analyze pension reforms

# Institutional setting and data

## Encuesta de Protección Social (EPS)

- ▶ Panel survey at the individual level
- ▶ 7 waves (2002-2020)
- ▶ + labor market history

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- ▶ Additional data: employment surveys, administrative data (UI, pension claims)

# Definitions

Self-reported information from the primary occupation + administrative data

Self-reported	Administrative Data	Sector	Example
Employed by a firm	Contributing to pensions	<b>Formal</b>	<i>Office clerks</i>
Employed by a firm	Not contributing	<b>Informal</b>	<i>Construction workers</i>
Self-employed	-	<b>Self-employed</b>	<i>Car/Taxi/Van drivers</i>

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Self-employment is informal [more](#)

- ▶ 16% are contributing to the pensions
- ▶ 33% are registered in the Tax Authority
- ▶ 67-91% are one-worker firm

# Model

# The model in a nutshell

- ▶ Risk-averse individuals **consume, save** and decide **employment status**

	<b>Formal</b>	<b>Informal</b>	<b>Self-employment</b>
Entry	Receive offer	Receive offer	Pay up-front investment

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- If not working:
  - Unemployed or Retired (endogenous)
  - No re-entry after retirement
- Arrival/Destruction rates depend on the sector

# Employment choices

## A. Employment transition: choose sector that maximizes utility more

- Formal/Informal: only when receiving an offer
- Self-employment: paying start-up cost
- Retirement is an option when meeting the requirements

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## B. Accumulate informal earnings and UI benefits [more](#)

## C. Bequeath remaining wealth when dying [more](#)

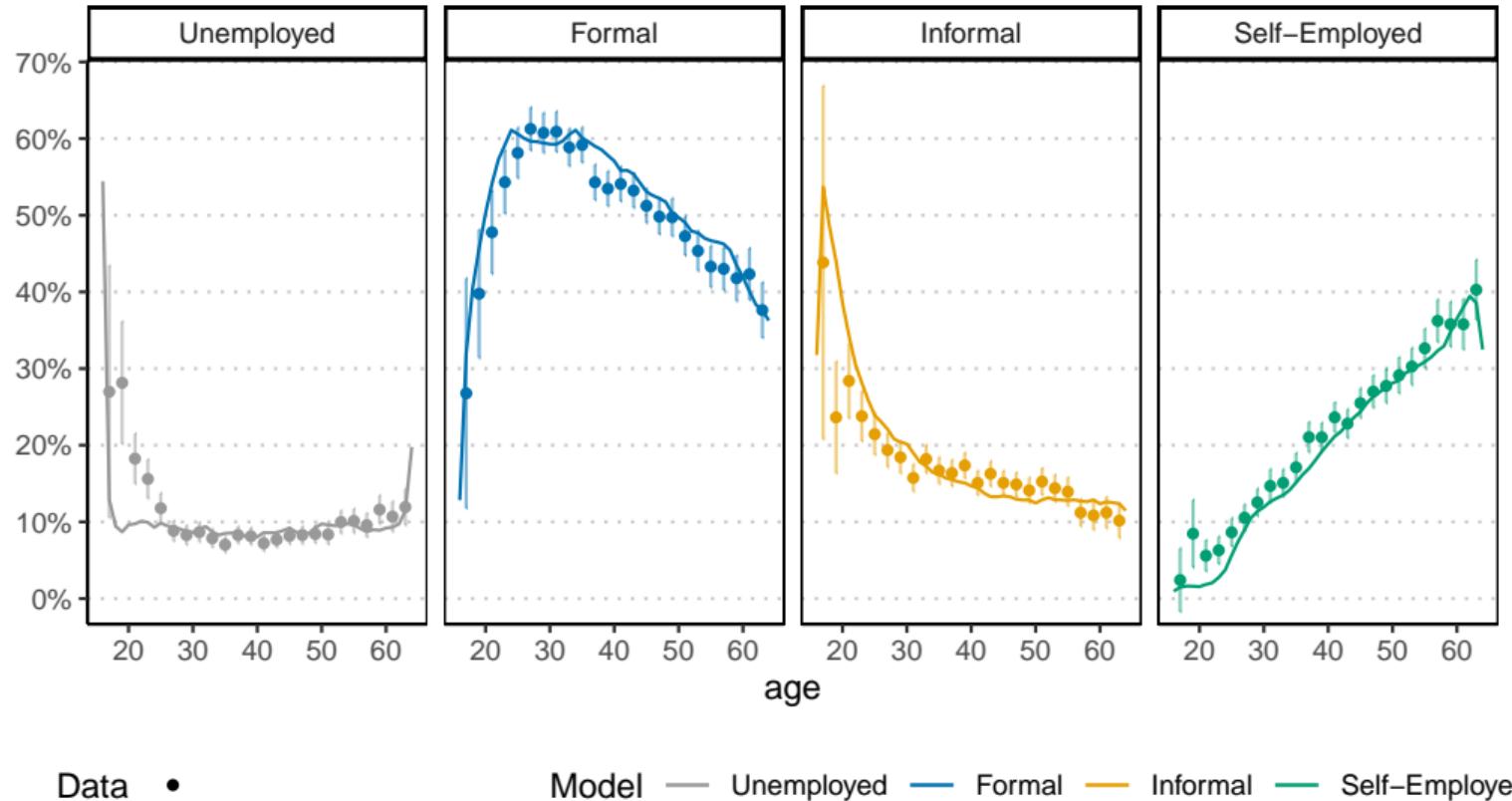
# Results

# Arrival and destruction rates

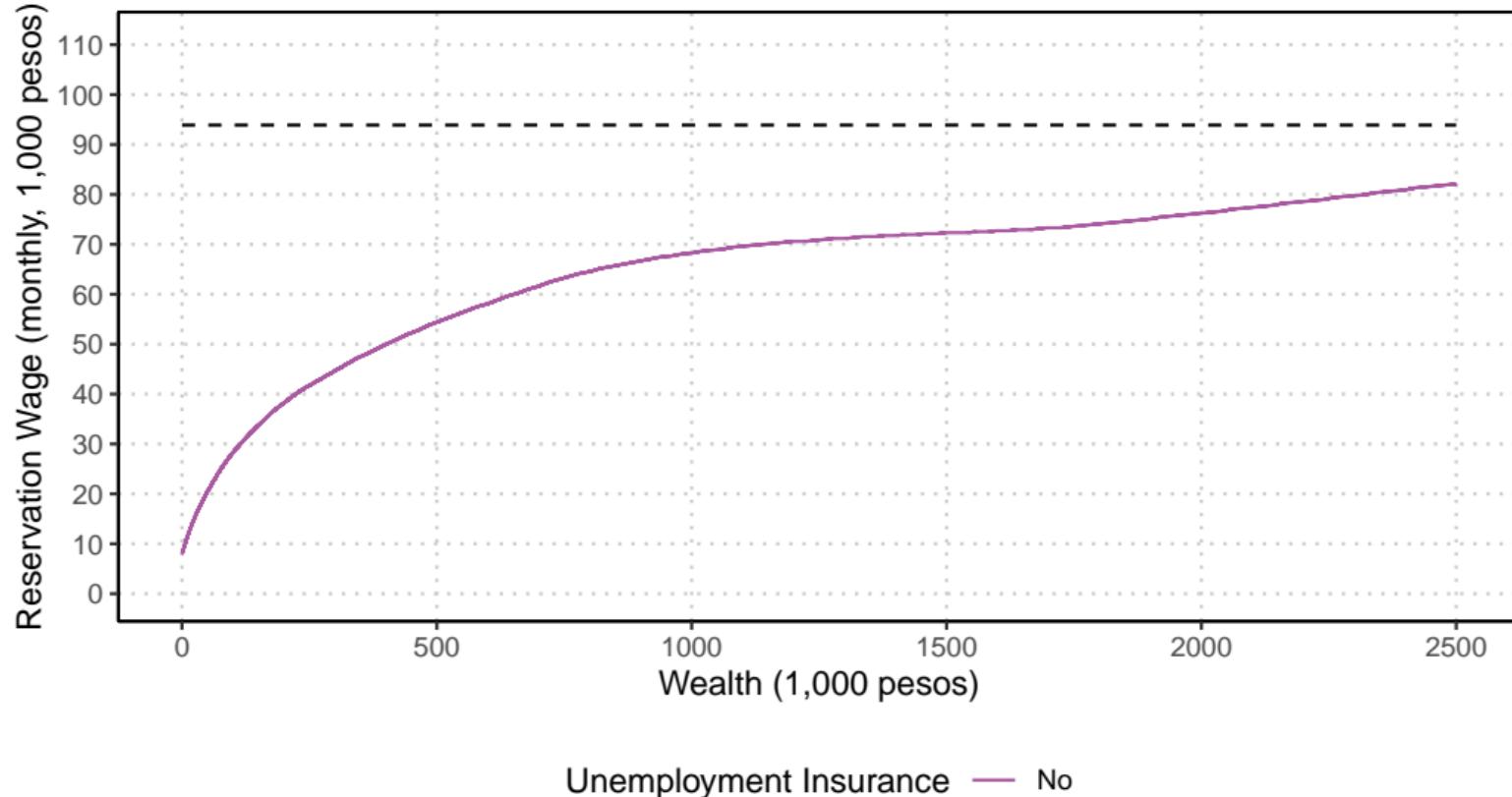
- ▶ Informal arrival rates > Formal rates

	Unemp	Formal	Informal	SelfEmp
Destruction	-	0.022	0.039	0.007
	-	-	-	(0.001)
Arrival Formal	0.112 (0.003)	0.267 (0.019)	0.040 (0.002)	0.172 (0.020)
Arrival Informal	0.391 (0.026)	0.499 (0.074)	0.285 (0.022)	0.944 (0.190)

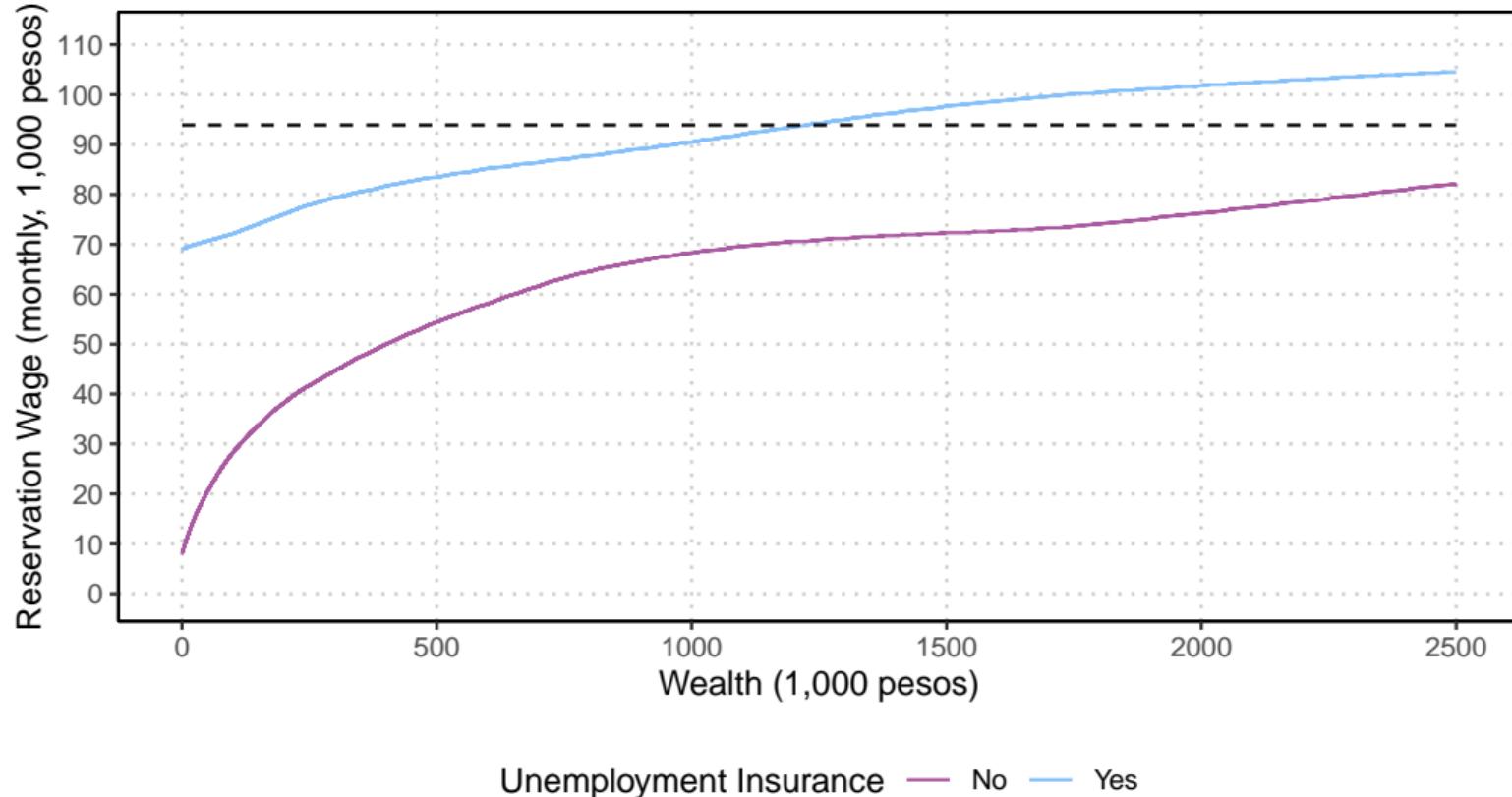
# Sector allocation over the life-cycle



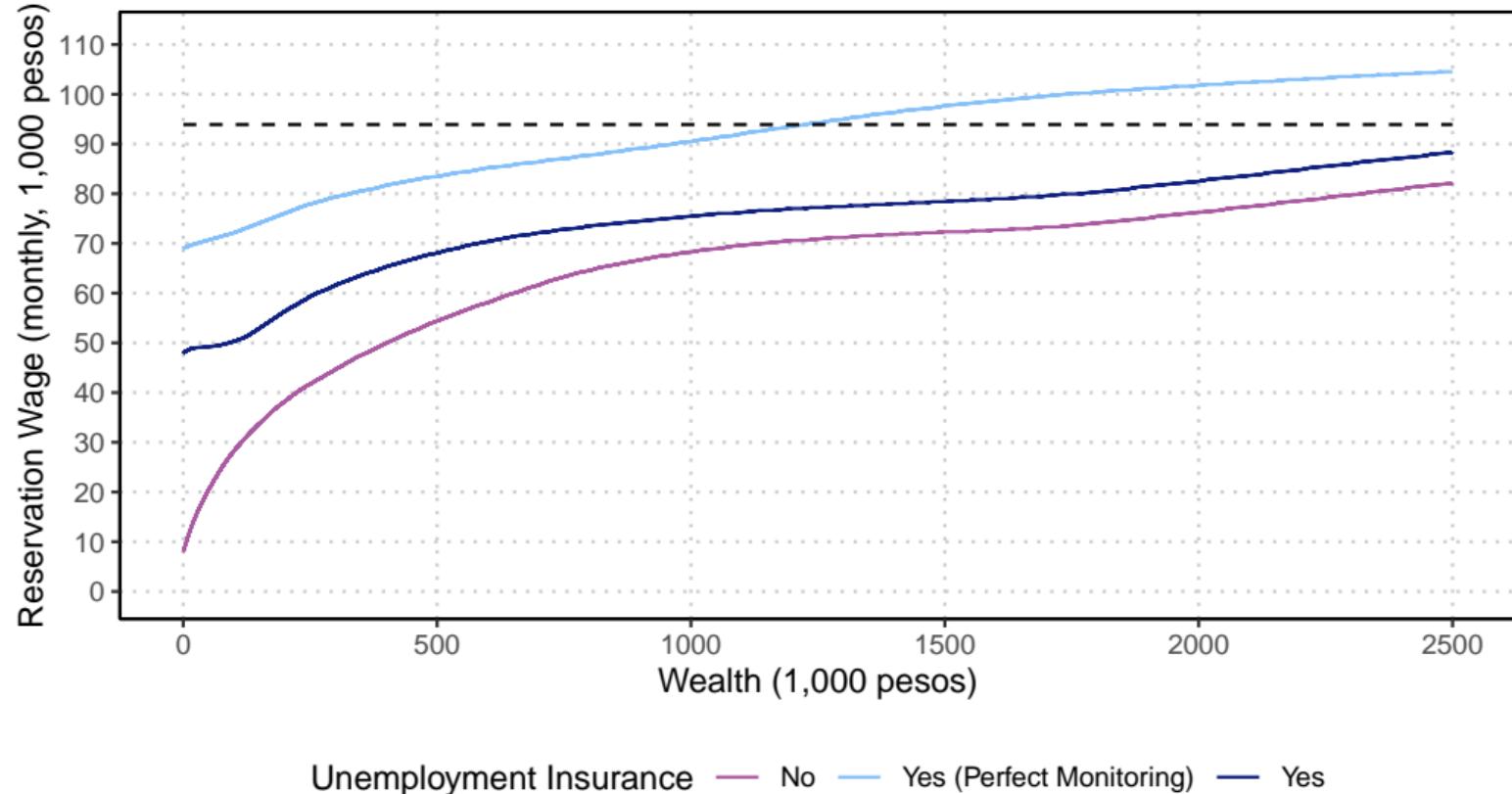
# Reservation wages for the informal sector



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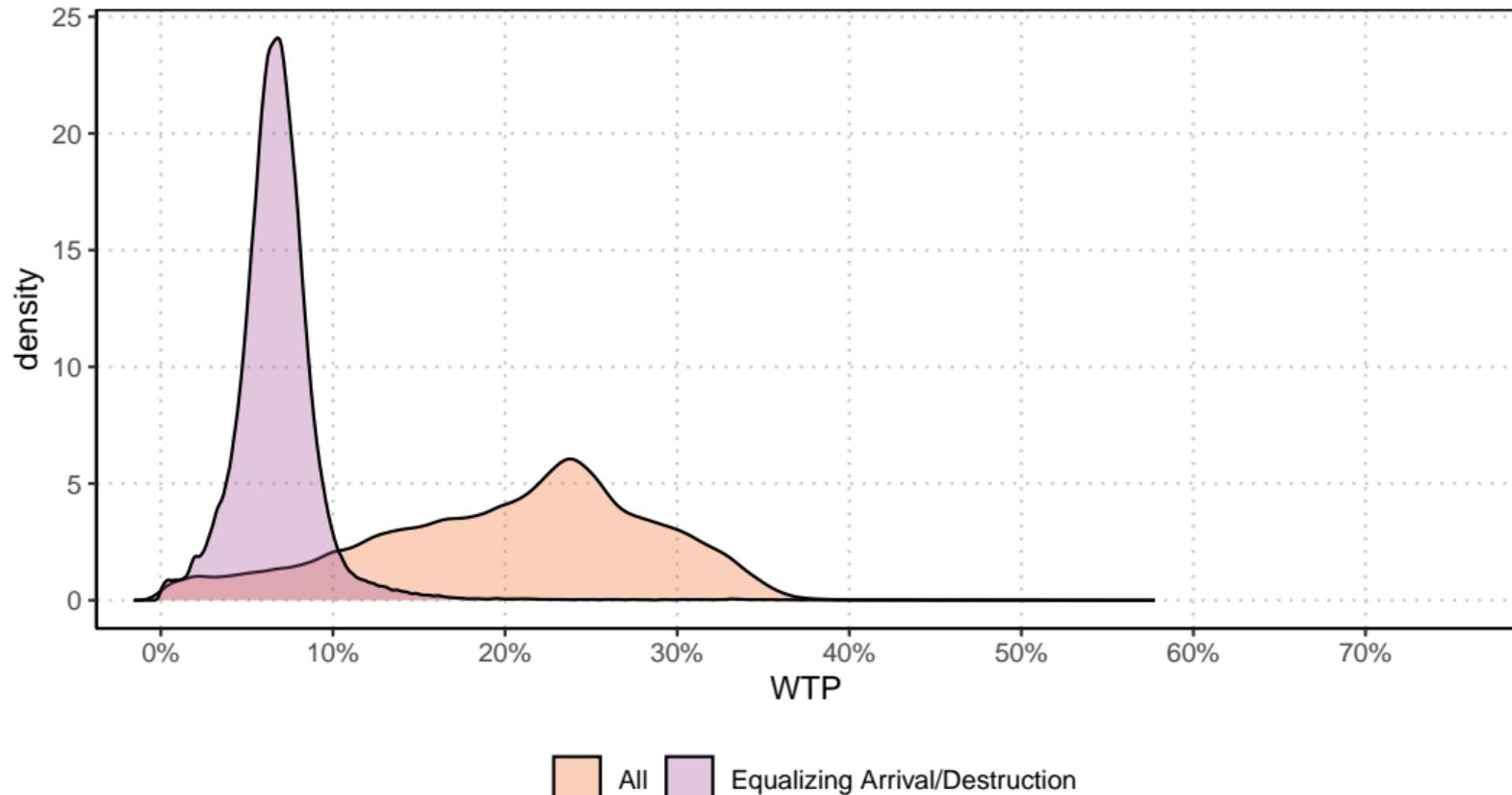


## Willingness to pay for a formal job

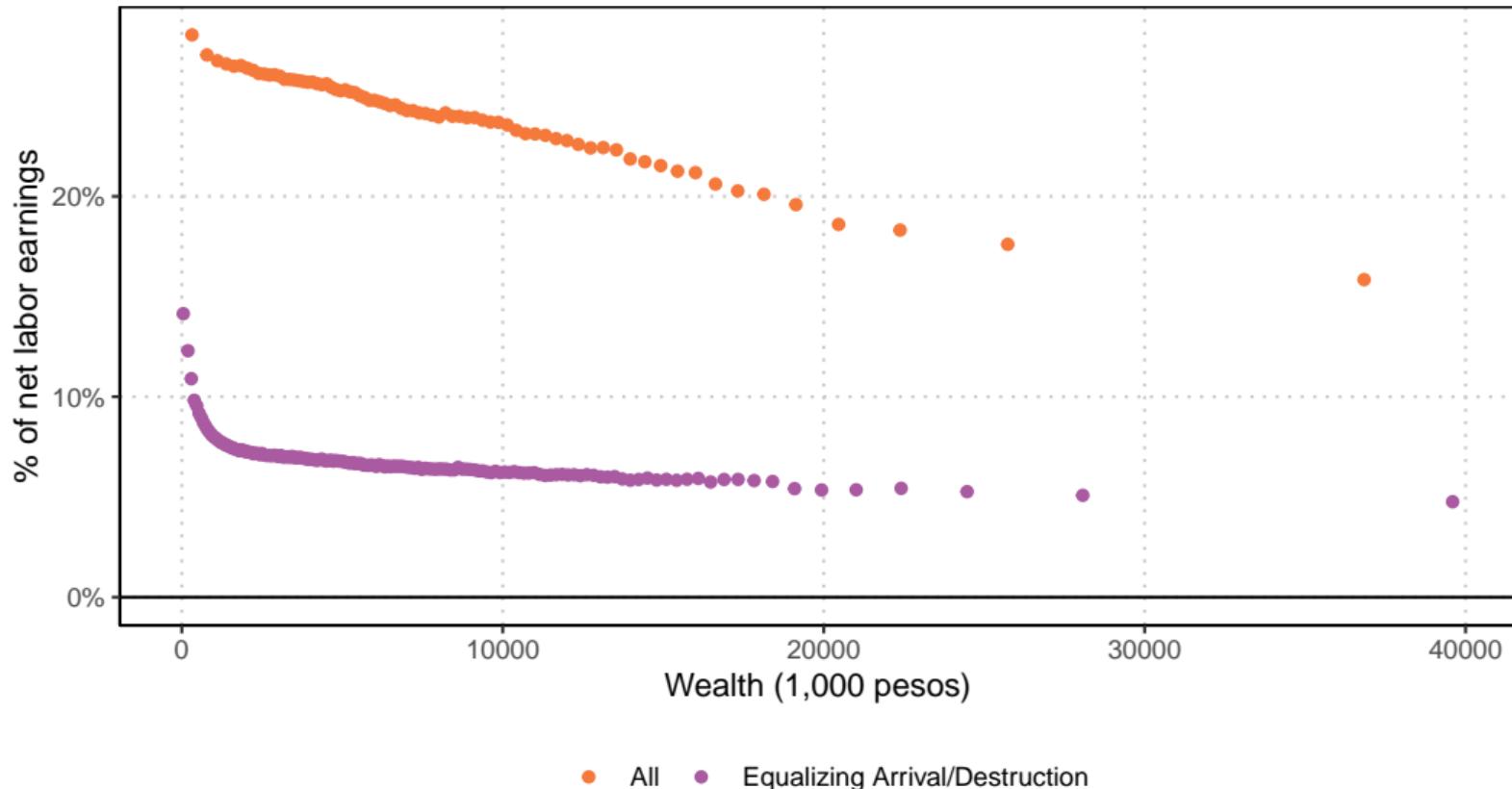
- ▶ Compute their WTP to “formalize” informal jobs (all in net earnings)

Sector	WTP	Amenities	Job stability/Search	Insurance
Informal employees	20.3%	-	13.5%	6.8%

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Informal employees	20.3%	-	13.5%	6.8%
Self-employed	-35.6%	-37.2%	-7.7%	9.3%

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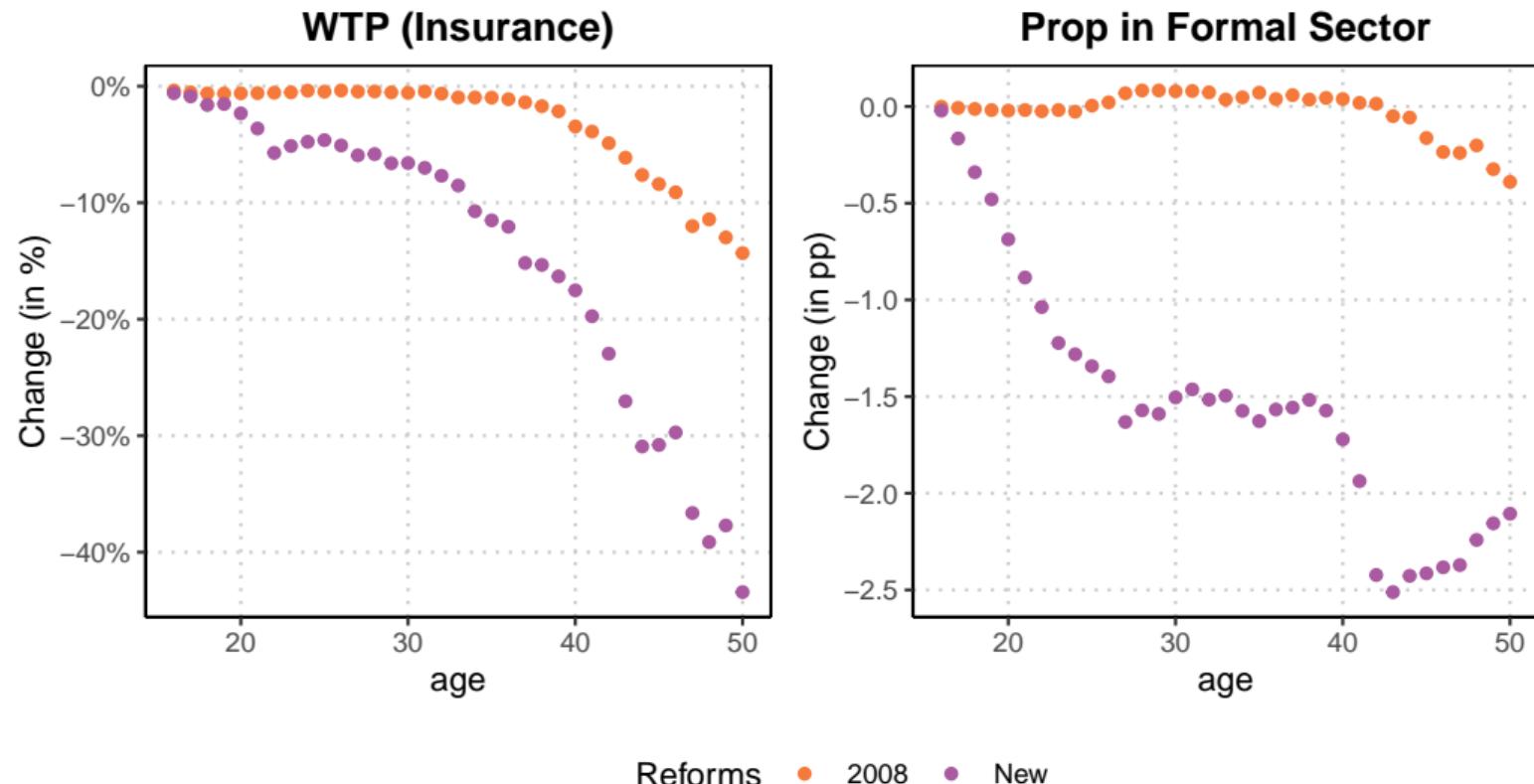
Reform	$\Delta$ WTP Insurance	$\Delta$ Formal	$\Delta$ Inf+Self
2008	-3.4%	-0.02pp	0.01pp

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Reform	$\Delta$ WTP Insurance	$\Delta$ Formal	$\Delta$ Inf+Self
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New	-35.9%	-1.52pp	1.55pp

# WTP and Policy Reforms



## Insurance value of the Informal sector

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  - Average welfare cost is -0.085
  - Heterogeneous by wealth and age [more](#)

# Conclusions

- ▶ Dynamic model with risk, savings, and insurance

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- ▶ Dynamic model with risk, savings, and insurance
- ▶ Use the model to:
  - i. Understand the drivers of life-cycle labor decisions: **savings**
  - ii. Compute the WTP to become a formal worker
  - iii. Relate WTP and policy reforms
  - iv. (Insurance) value of the informal sector

# **Thank you**

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# Appendix

# Presentation

- ▶ Introduction
- ▶ Literature
- ▶ Institutional setting and data
- ▶ (Institutional setting)
- ▶ Empirical Findings
- ▶ Model
- ▶ Estimation
- ▶ Results
- ▶ Conclusions
- ▶ Appendix
- ▶ Additional Results
- ▶ Why Chile
- ▶ Risk and Insurance in the model
- ▶ Wage growth
- ▶ Earnings variance
- ▶ Minimum Wage
- ▶ Family and Spouse
- ▶ Education and Cohorts
- ▶ Pension returns risk
- ▶ Risk Aversion and Self-Employment
- ▶ Value Functions (formulae)
- ▶ Reordering

## Additional results

- ▶ All parameters
- ▶ Transitions
- ▶ Accepted wages
- ▶ Average wages
- ▶ Ability types
- ▶ Self-Employment earnings
- ▶ Wealth
- ▶ Retirement
- ▶ Part-time work
- ▶ Wage correlation
- ▶ Amenities
- ▶ Decision to be self-employed
- ▶ Value Functions
- ▶ No amenities
- ▶ (?) Sensitivity analysis
- ▶ Untargeted moments pension wealth and contributions

## Setting: Chile

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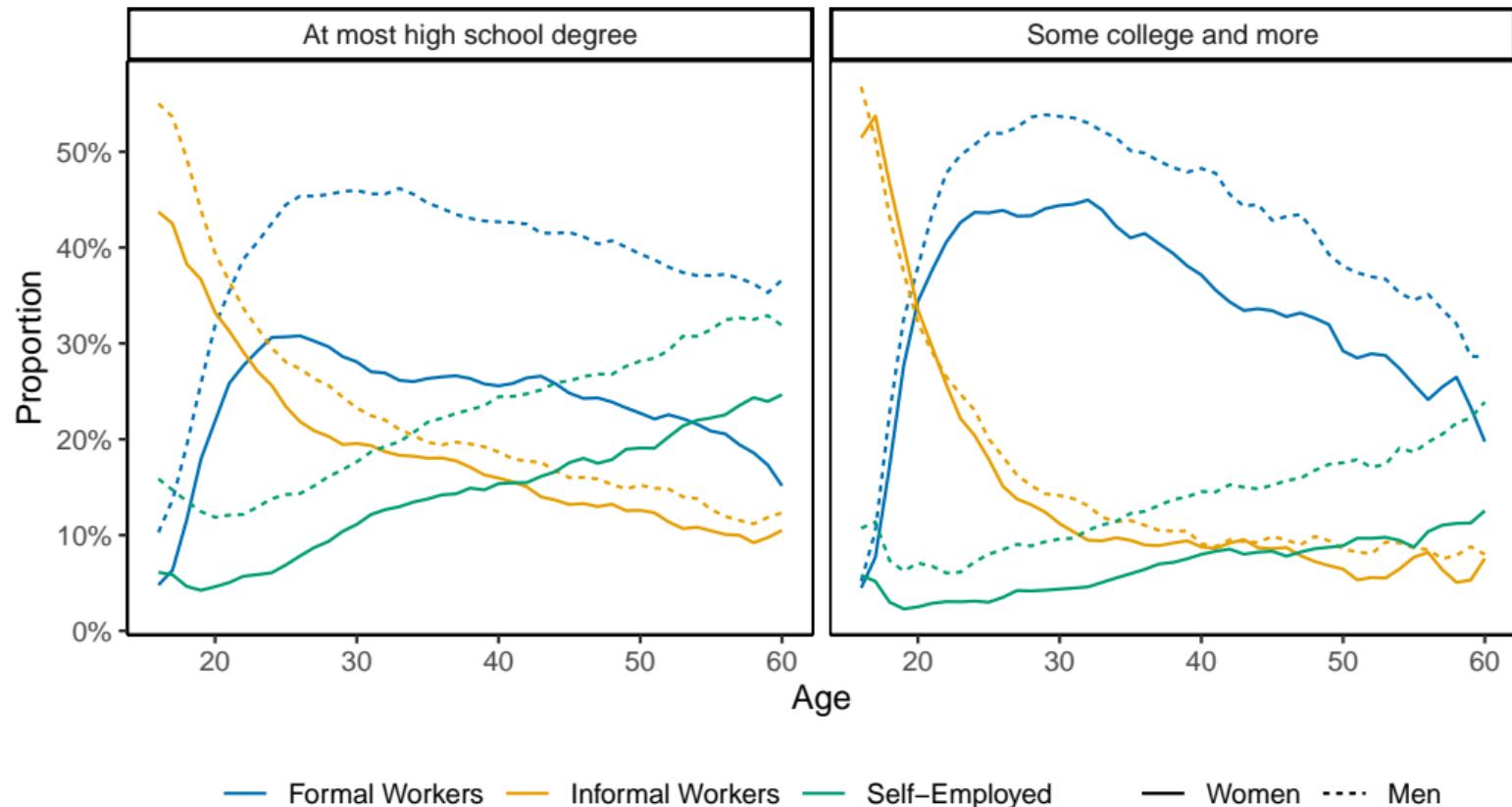
1. Social insurance programs co-existing with labor market informality
2. Country implemented several reforms in those programs
3. Data
  - Long longitudinal survey
  - Disaggregated wealth
  - Administrative data on the pension system

# Risk and Social Insurance in the paper

	In the model	Not in the model
<b>Risk</b>		
Separation shocks	All sectors	-
Earnings shocks (within job)	Self-employment	Formal and informal jobs
Uncertain prospects job-search	All sectors	-
Longevity risk	✓	-
Returns risk	-	Pension returns, liquid savings returns
Health risk	-	Health shocks
<b>Social Insurance</b>		
Unemployment insurance	When fired	When quitting
Severance payment	Yes	-
Pensions	Yes	-
Welfare programs	Yes	-
Minimum wage	Yes	-
Health insurance	-	No
Disability insurance	-	No

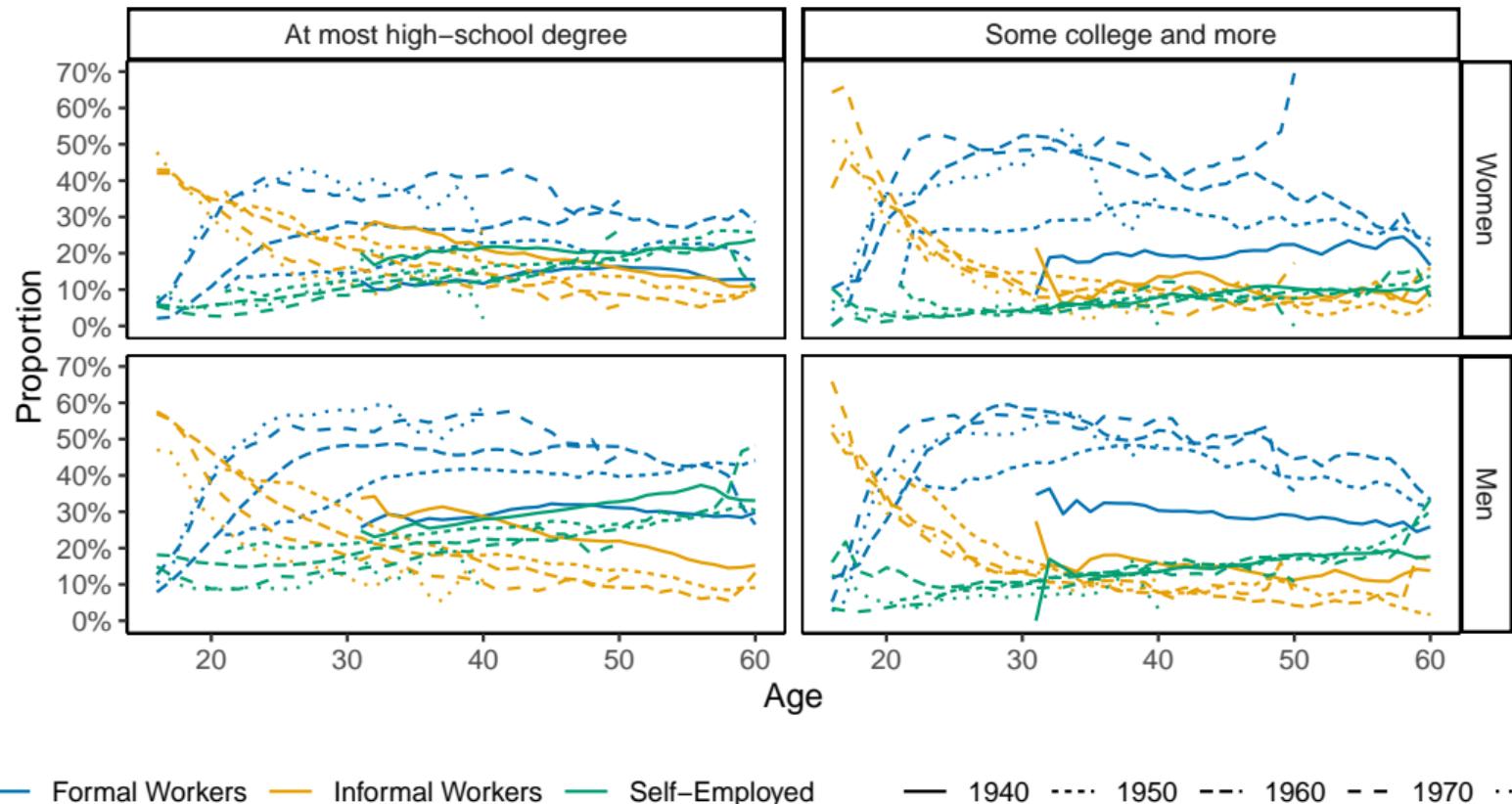
## Earnings variance

- ▶ Using the employment survey, I compute the (de-trended) 1-year log-wage growth
- ▶ Compute the variance for those formal, informal, and self-employed (and remaining in that state)
- ▶ Variance of log-wage increase
  - Formal: 0.100
  - Informal: 0.286
  - Self-employed: 0.631



# Life Cycle - Cohorts

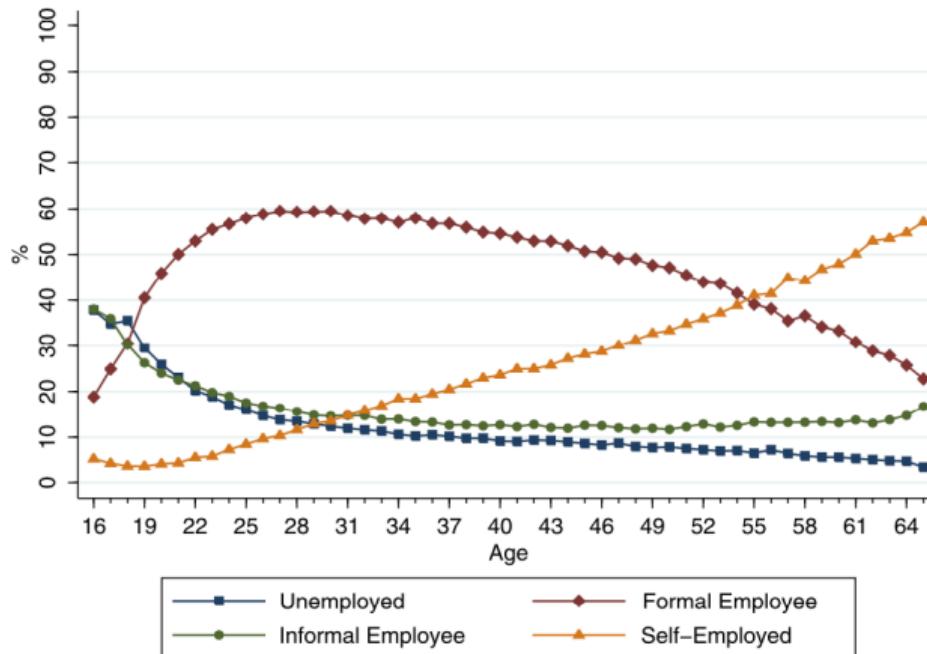
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— Formal Workers — Informal Workers — Self-Employed — 1940 ··· 1950 ··· 1960 ··· 1970 ···

# Life Cycle - Other Countries

[Back](#)



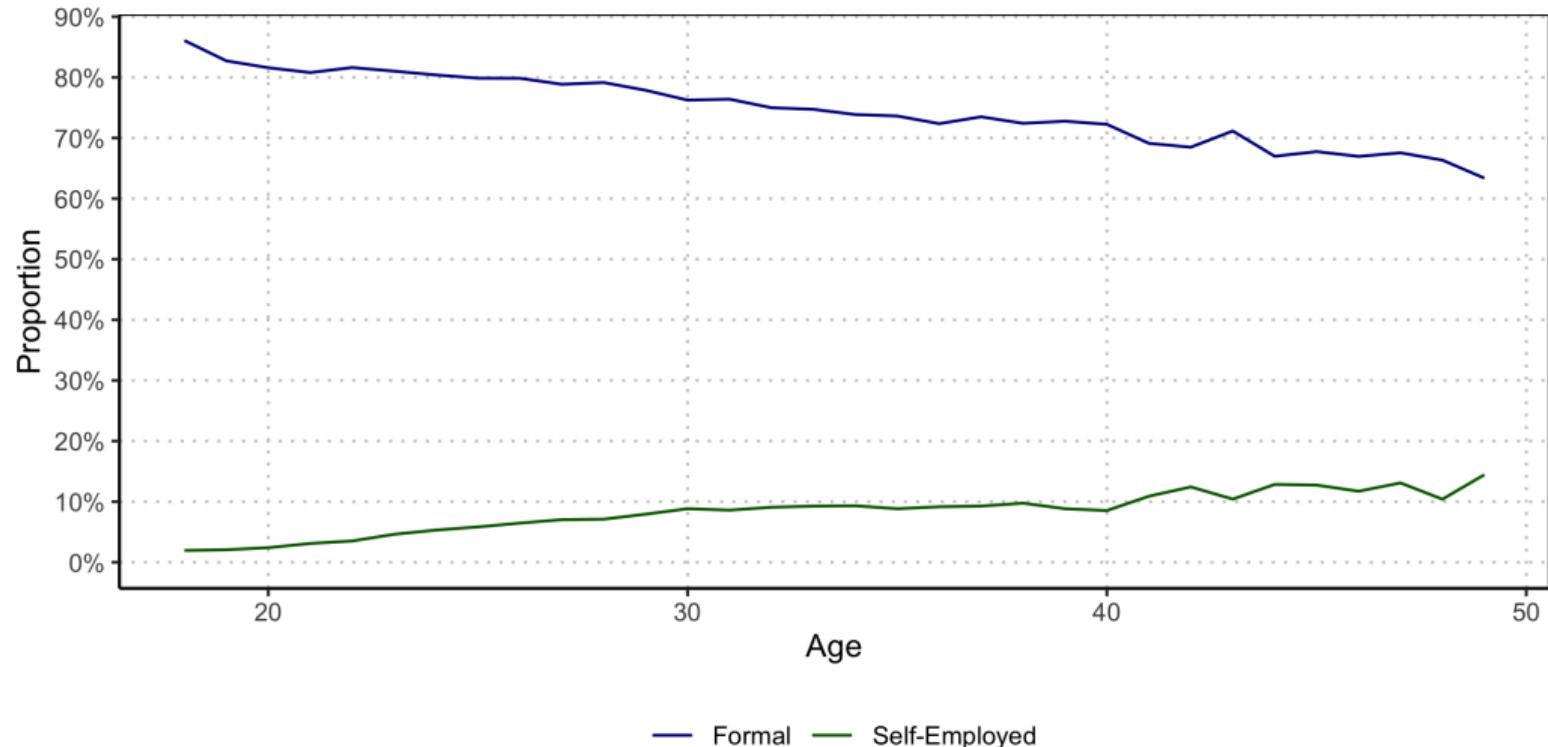
**Fig. 1.** Composition of workforce by age.

Extracted from ?

# Life Cycle - Other Countries

[Back](#)

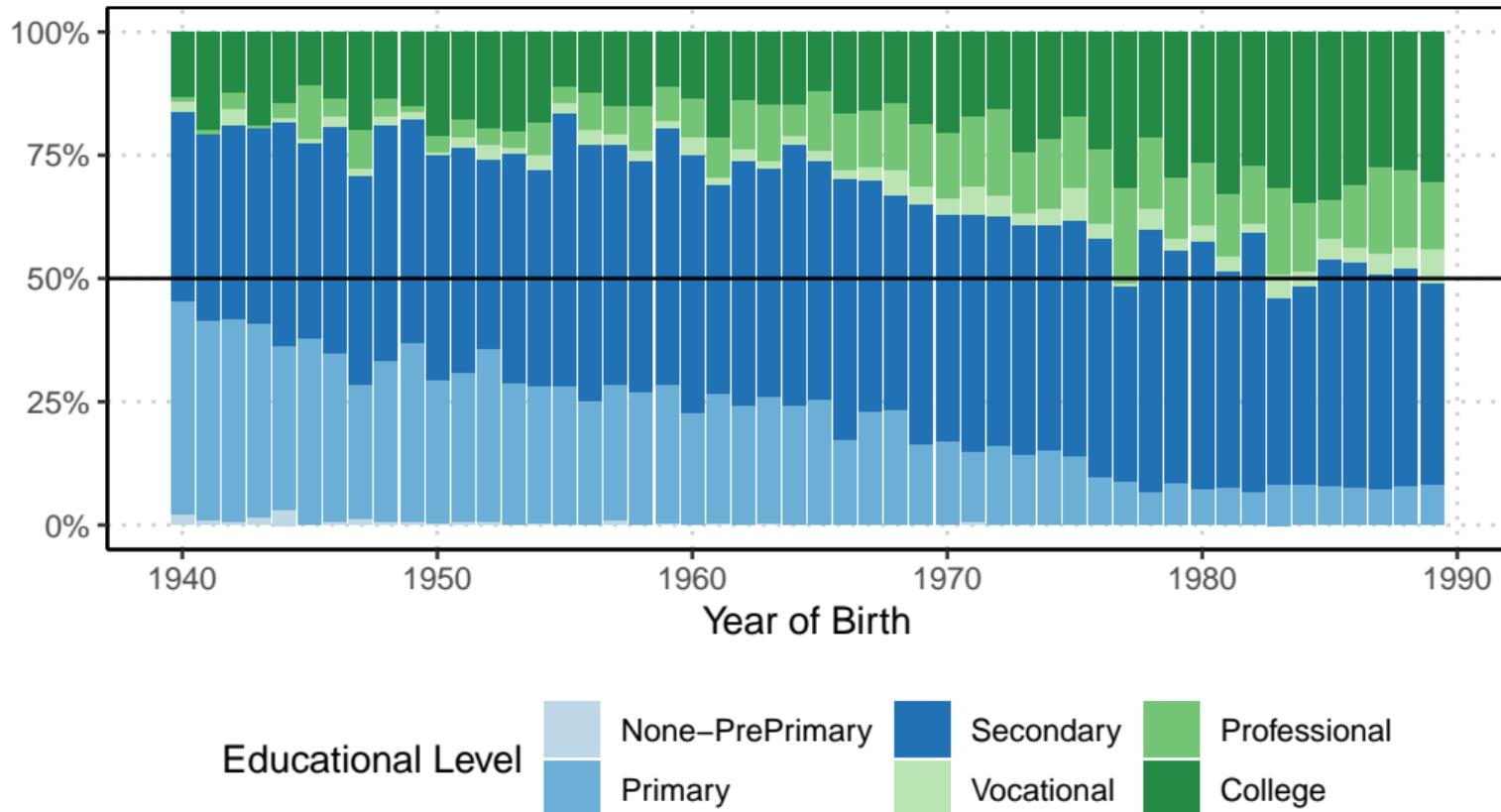
USA



NOTES: NLSY-79. Displayed as % of employed population.

# Education over time

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## 1. **Unemployment Insurance**

[more](#)[payments](#)

- 3% of wages:  
$$\underbrace{(\text{individual account})}_{\text{forced savings}} + \underbrace{(\text{collective account})}_{\text{insurance/redistribution}}$$
- Withdrawal schedule (50%,45%,40%,...)
- Limit of 5 months from the collective account

## 2. **Severance Payment**

- One monthly wage for every year on the job

## 3. **Pension system**

- Individual capitalization with privately managed accounts
- 10% of wages
- Normal retirement age for men is 65
- Early retirement is possible
- Minimum pension policies

## 4. **Welfare Programs** and **Income Tax**

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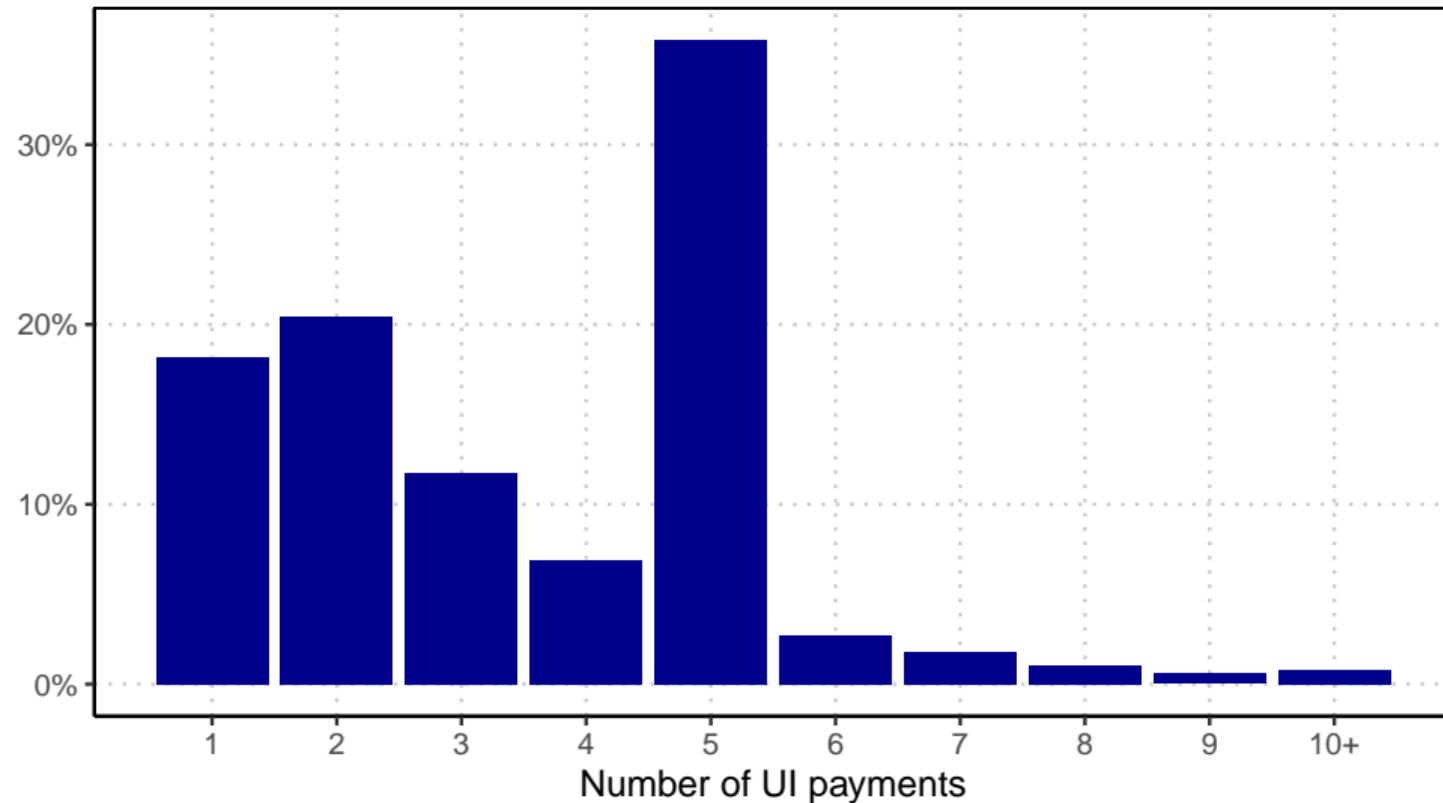
# Social Security

<u>Formal Workers Pay:</u>					<u>Formal Firms Pay:</u>		
7%	0.6%	10%		≈2%	2.4%		
Health System	+	Unemp Insurance	+	Pension Contributions	+	Commissions & Disab. Insurance	Unemp Insurance

- ▶ Using data from a 20% sample of the UI system
- ▶ Among those involuntarily separated in my sample:
  - 72.7% were eligible to use the common funds
  - 43.9% used it

# UI number of payments

[Back](#)



- ▶ Men born between 1941–1989, with at most high school degree
- ▶ Discard individuals who did not switch to the new pension system in 1980
- ▶ Monetary values are in 2004 values (de-trended). 1,000 Chilean pesos  $\approx$  1.50 USD  
Use the information that was reported within 18 months
- ▶ Restricted monetary values from (2002-2008). Labor market information from (2002-2015)
- ▶ Recent data for retirement patterns (up to 2019) and older cohorts to get wealth accumulation at old ages (up to 89 years)

*Table: Proportion among self-employed*

Variable	Value
Formal Accounting	22.0%
Separate Accounting (from HH)	32.4%
Registered in the Tax Authority	32.7%
Only 1 worker	91.7%
Contributing to Pension	15.7%

Note: EME 2009/2011 and EPS 2002-2016

- ▶ Normal retirement age: 65
- ▶ **Early Retirement** allowed if resulting pension ( $y_p$ ) meets the two requirements

$$y_p > \alpha \times \text{Avg Wage}$$

$\uparrow$   
fraction

and

$$y_p > A$$

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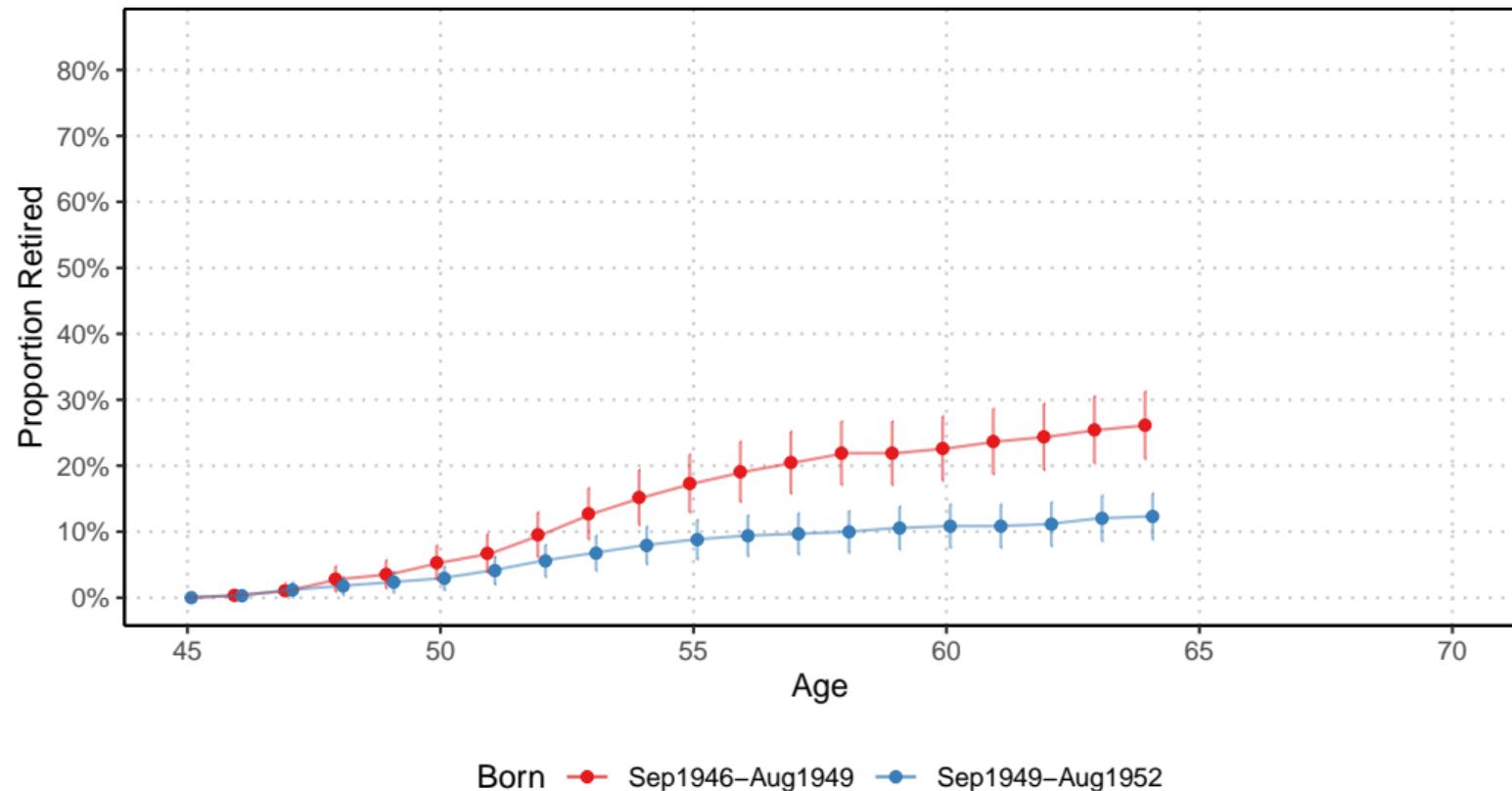
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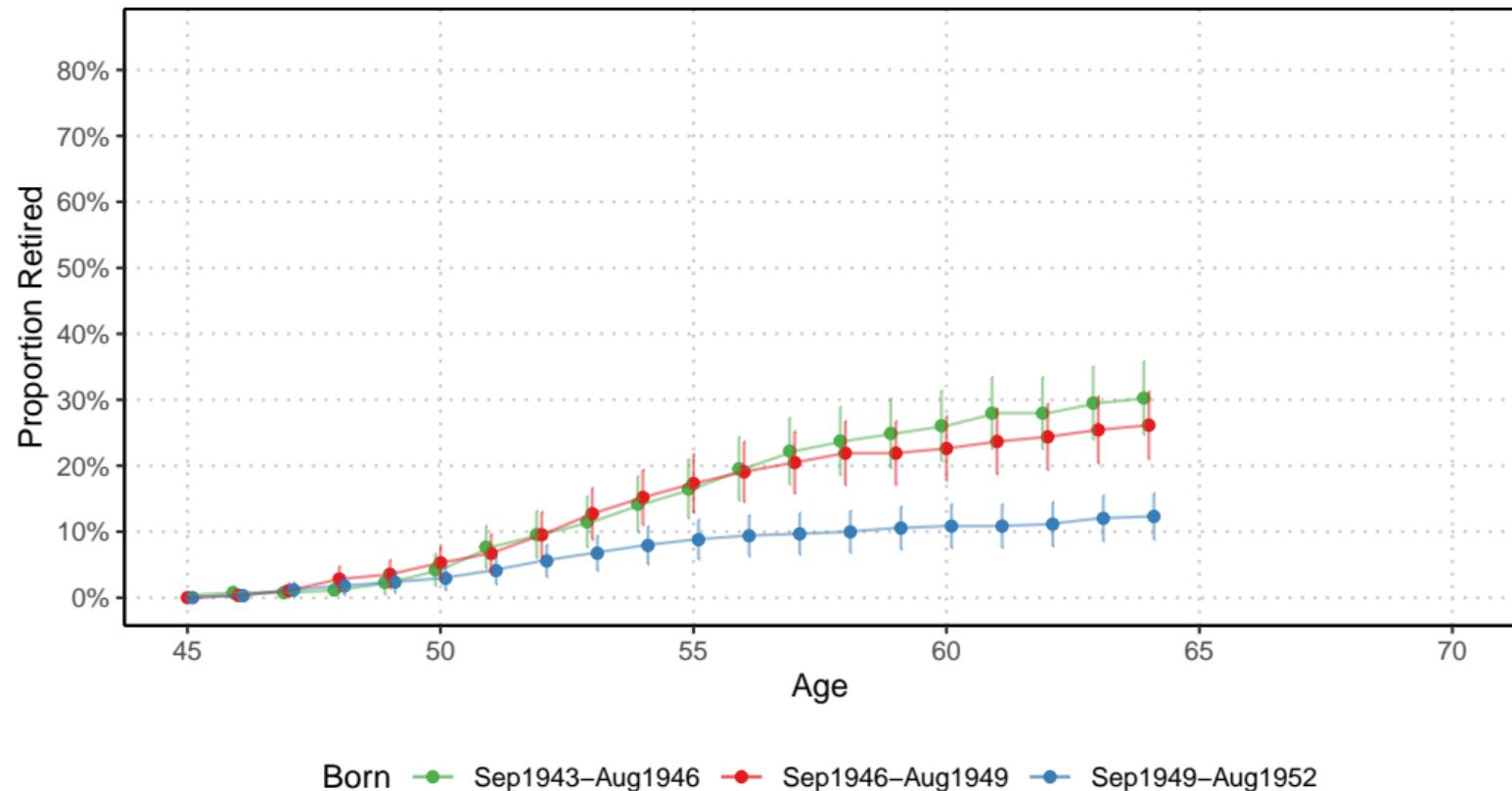
$\uparrow$   
threshold

- ▶ 2004 Reform:
  - Raised  $\alpha$  and  $A$  (gradually)
  - Individuals born before August 1949 were exempted

# 2004 Reform - Delayed Retirement

[Regression](#)[Age 55](#)[back](#)

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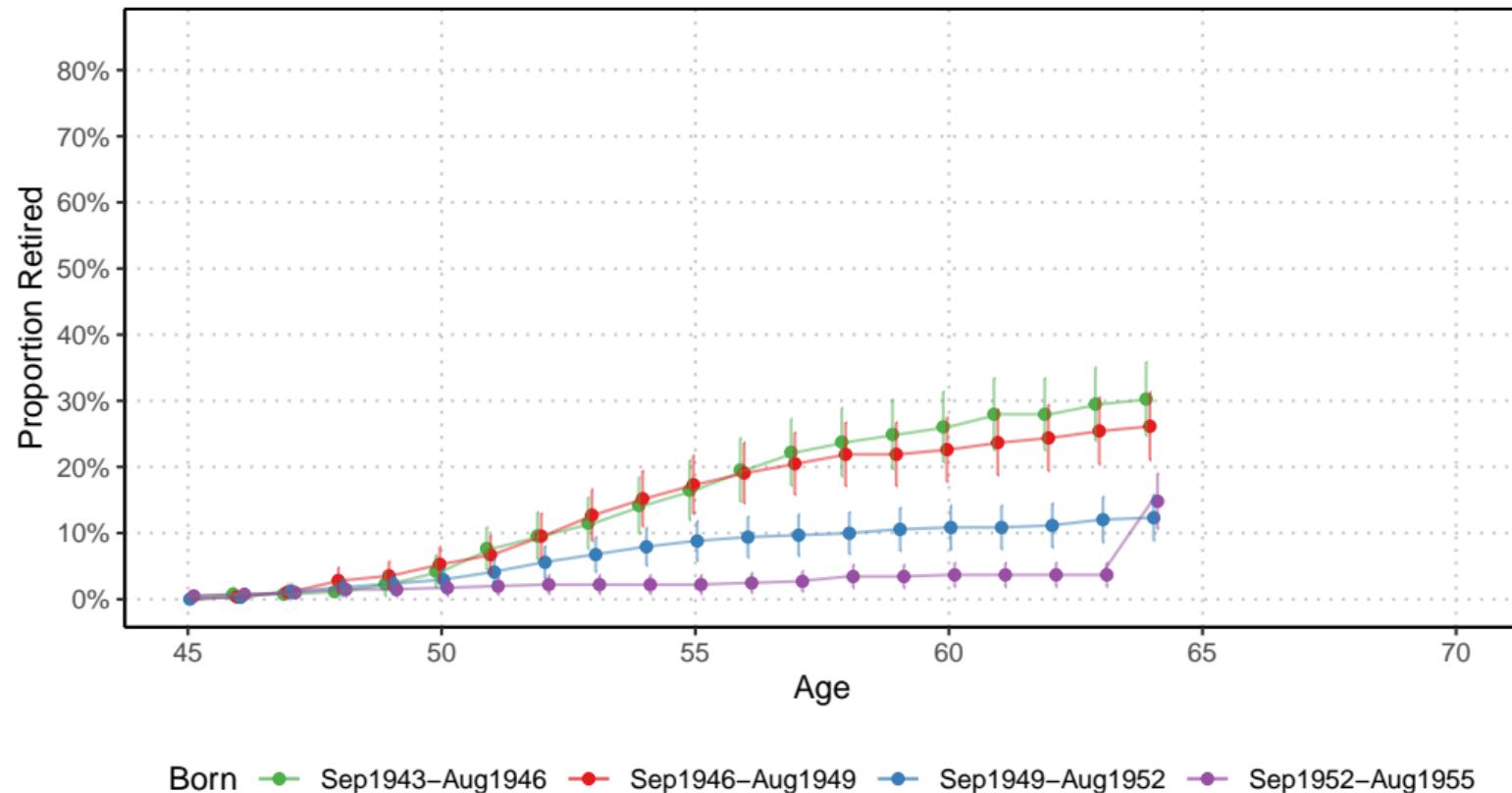
[Regression](#)[Age 55](#)[back](#)

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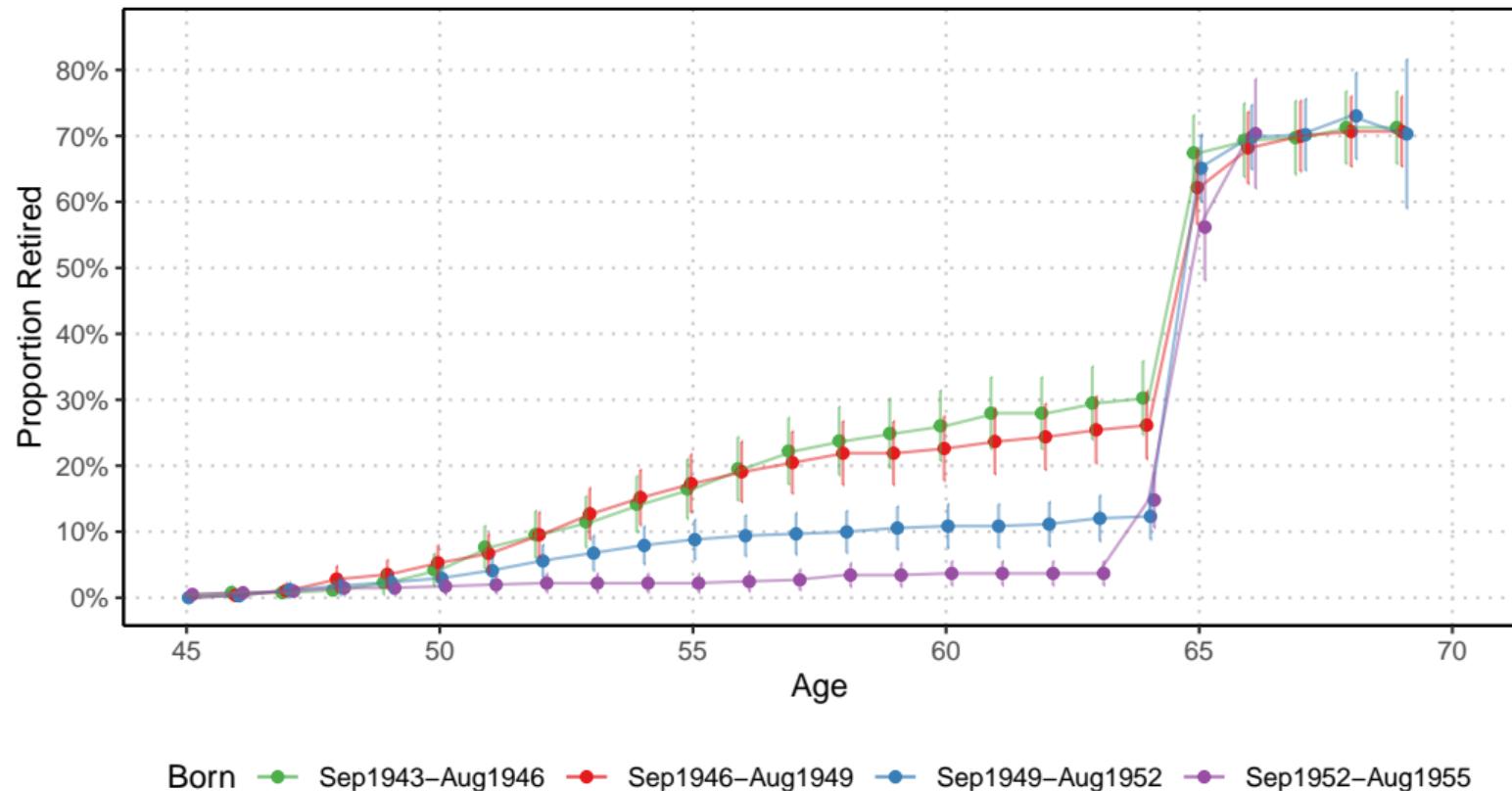
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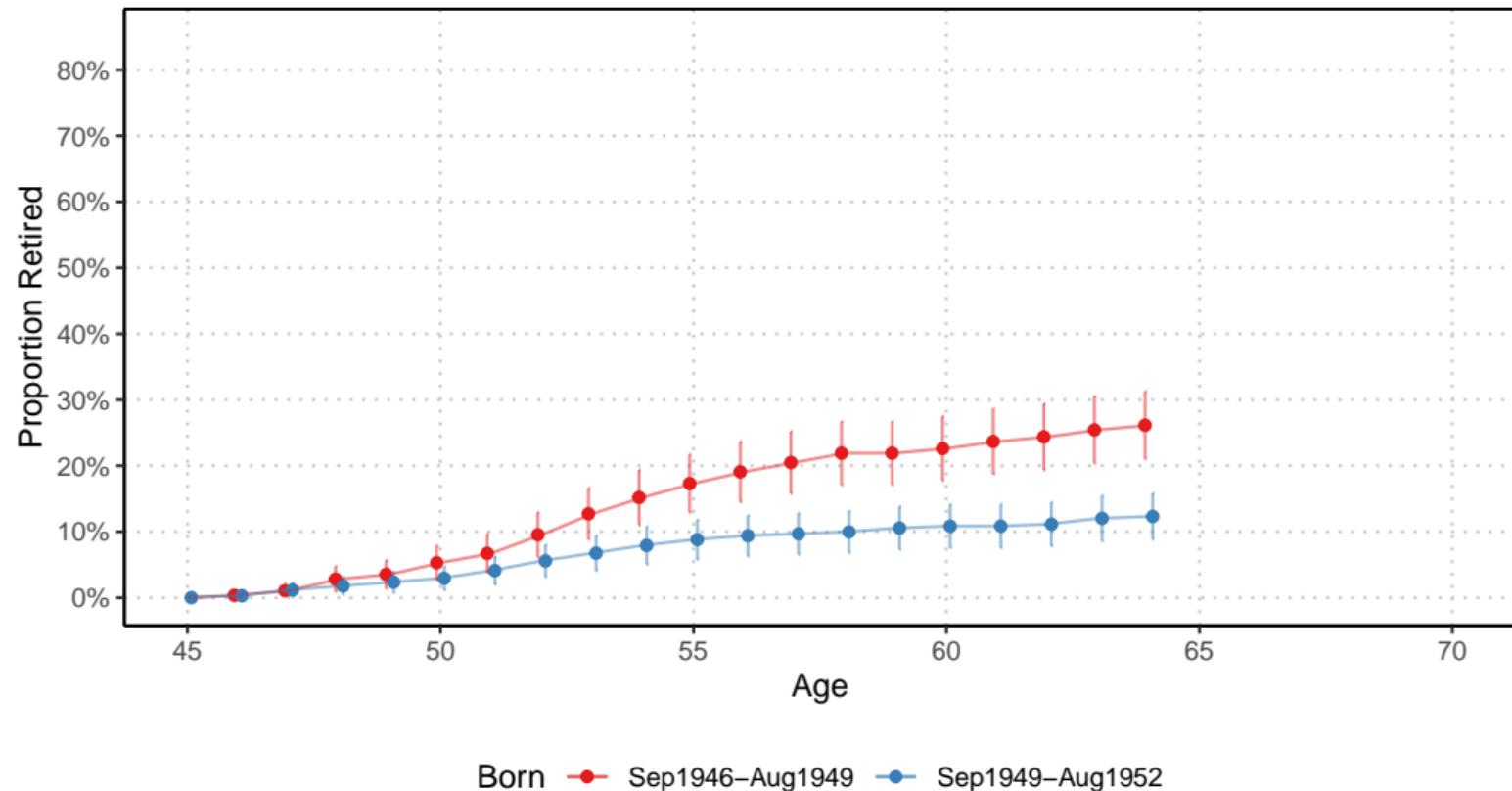
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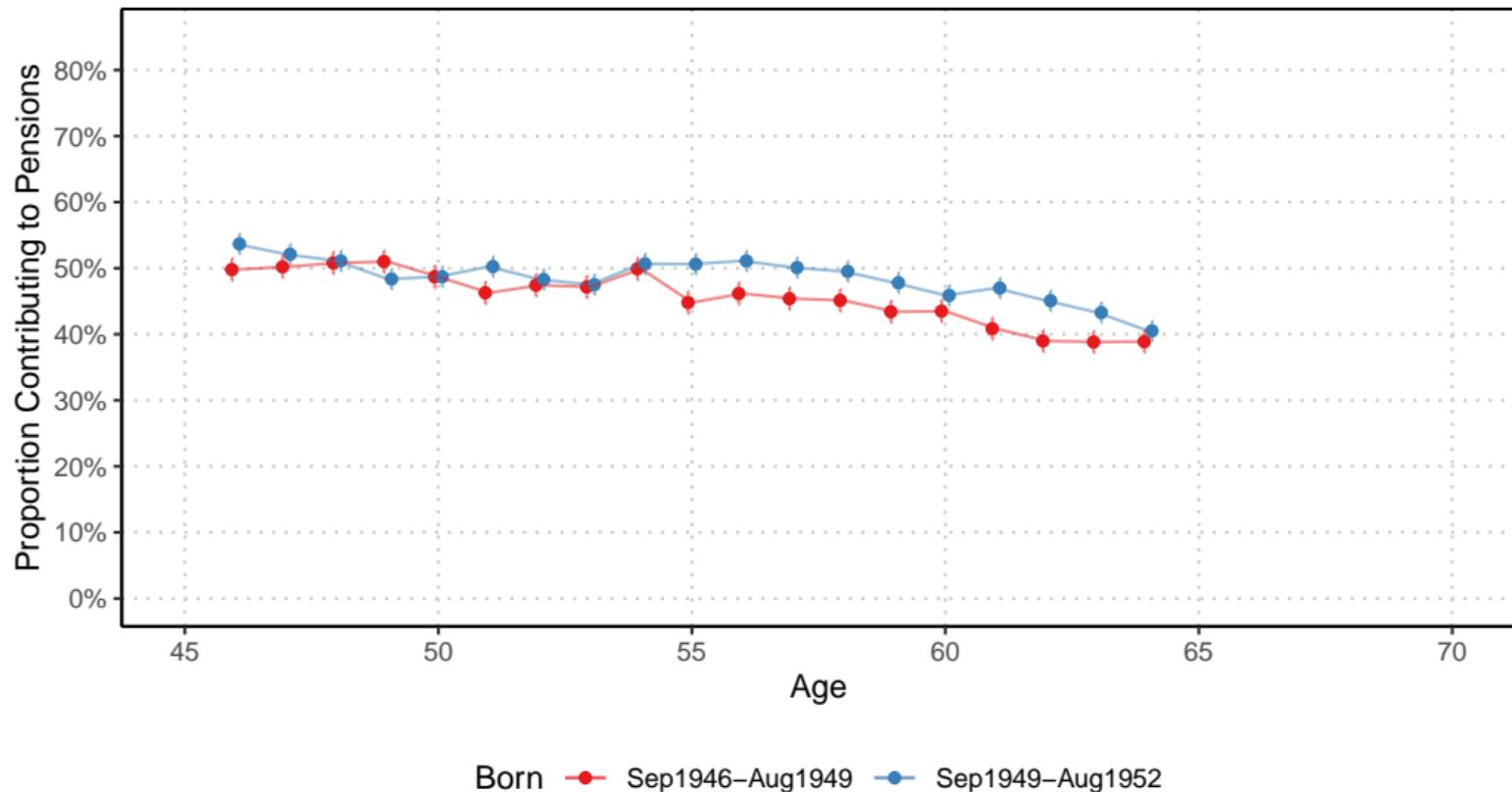
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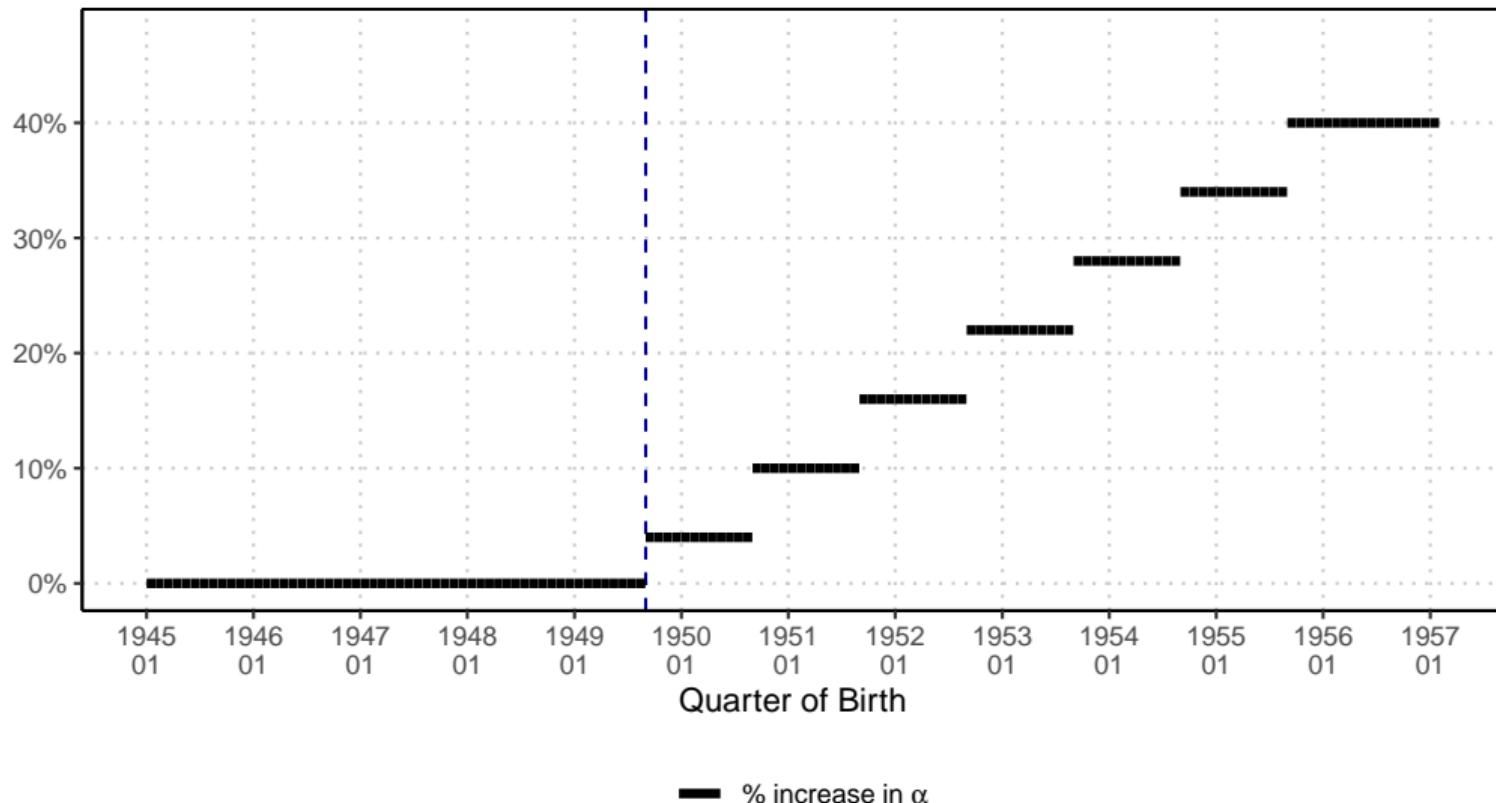
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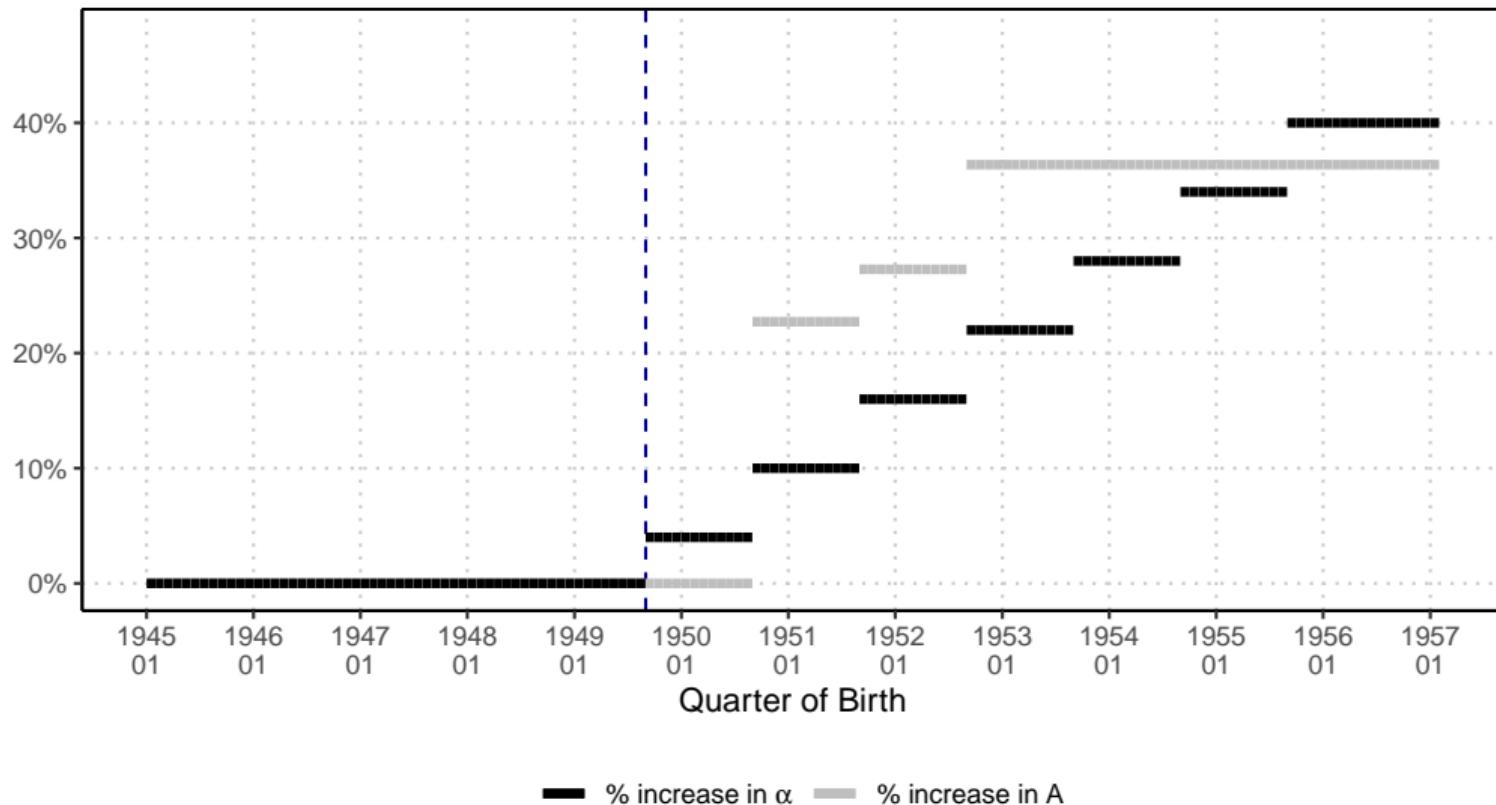
# 2004 Reform – Retirement at age 55

[Back](#)



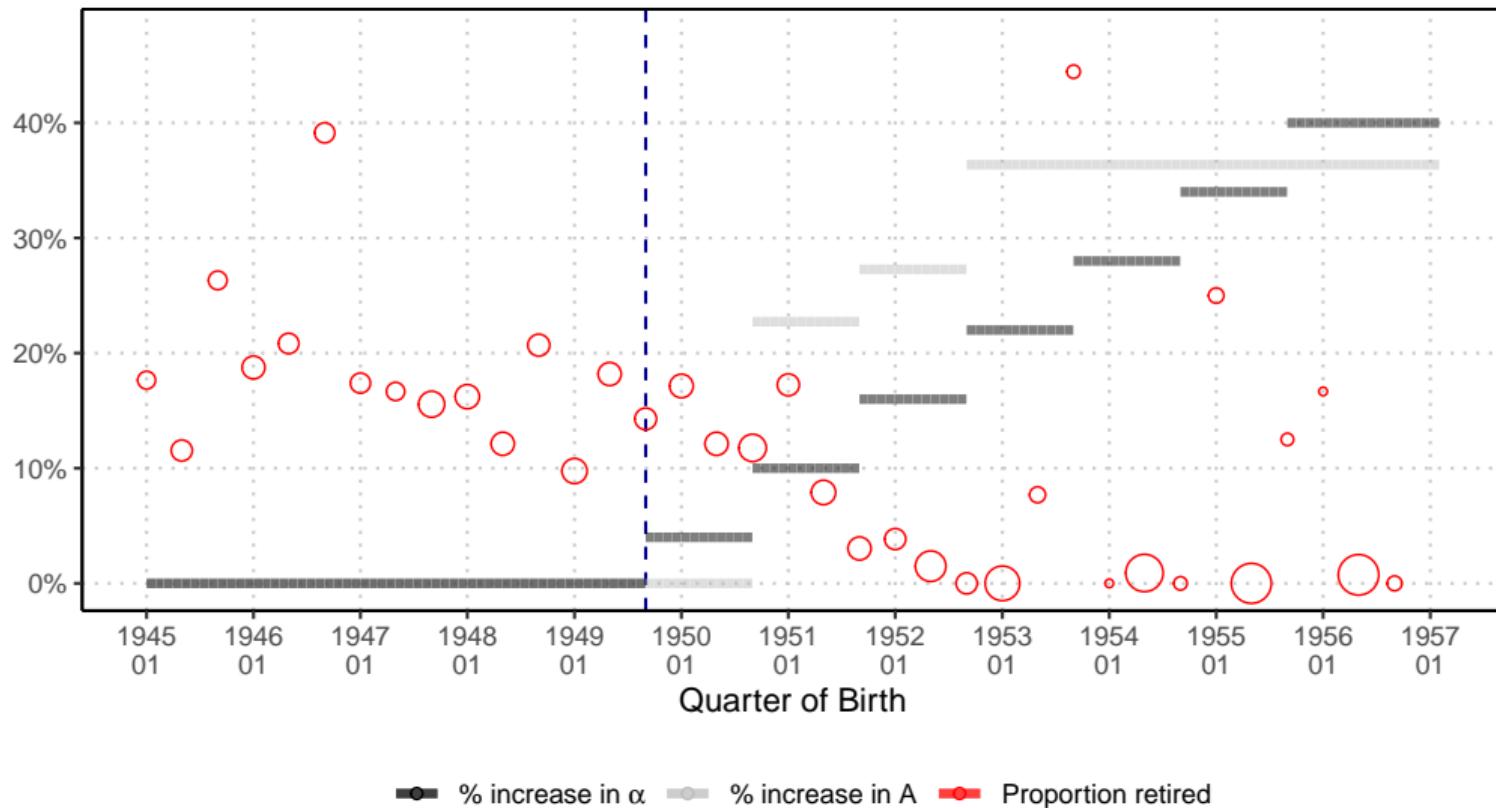
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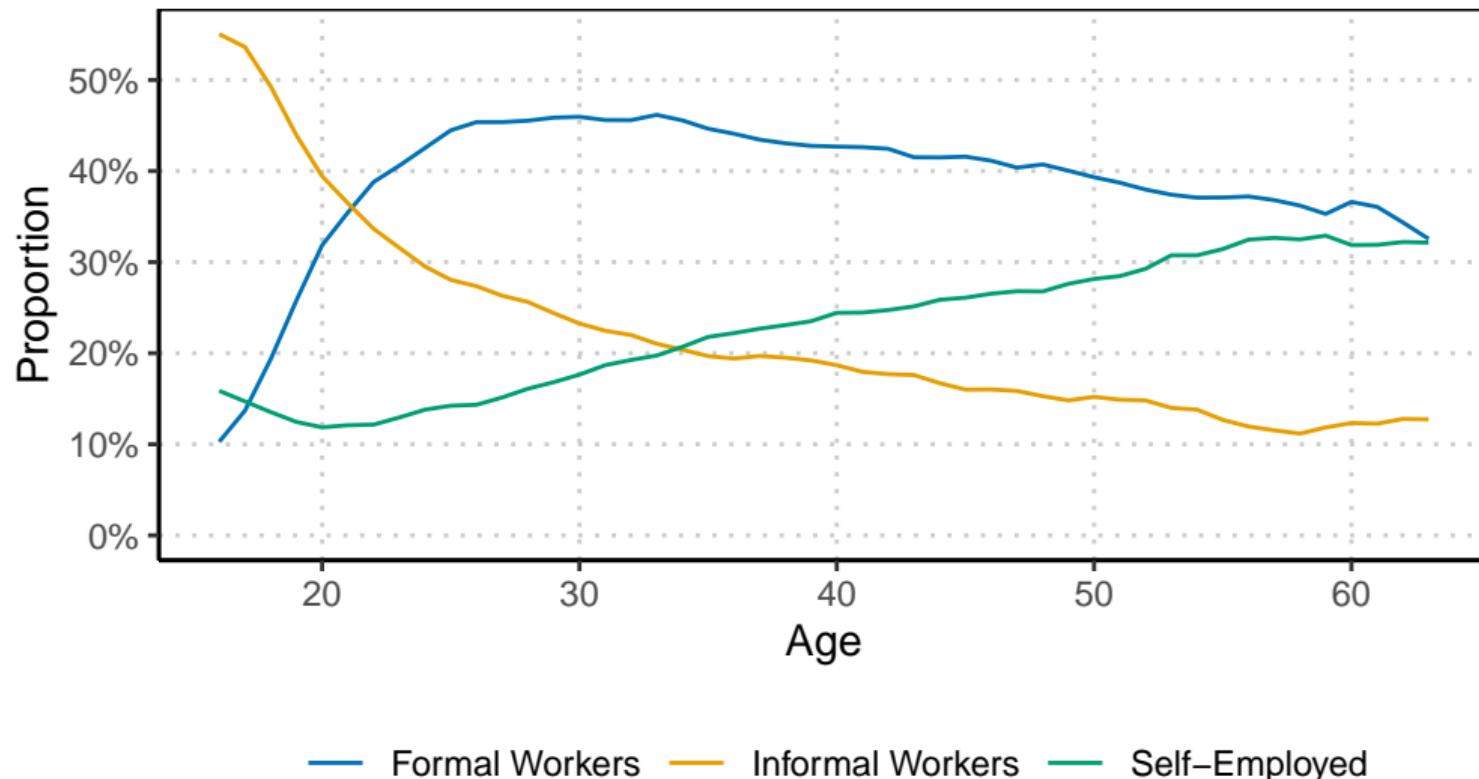
# 2004 Reform – Retirement at age 55

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## Empirical Findings II: Sector heterogeneity

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► Working part-time [more](#)

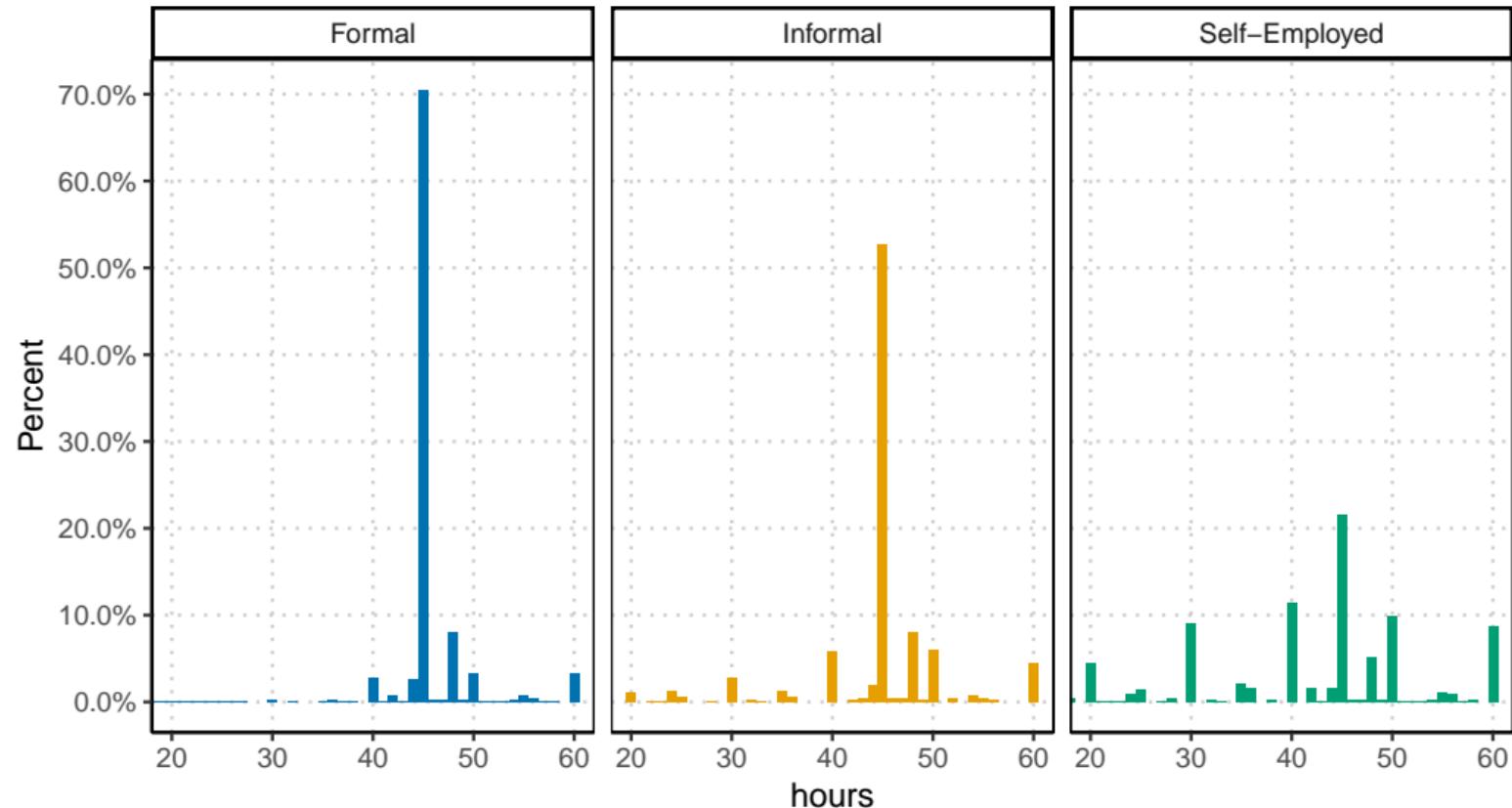
- Self-employed: 24%
- Informal employees: 8%
- Formal employees: 2%

► Working at the firm site [more](#)

- Self-employed: 14%
- Informal employees: 56%
- Formal employees: 70%

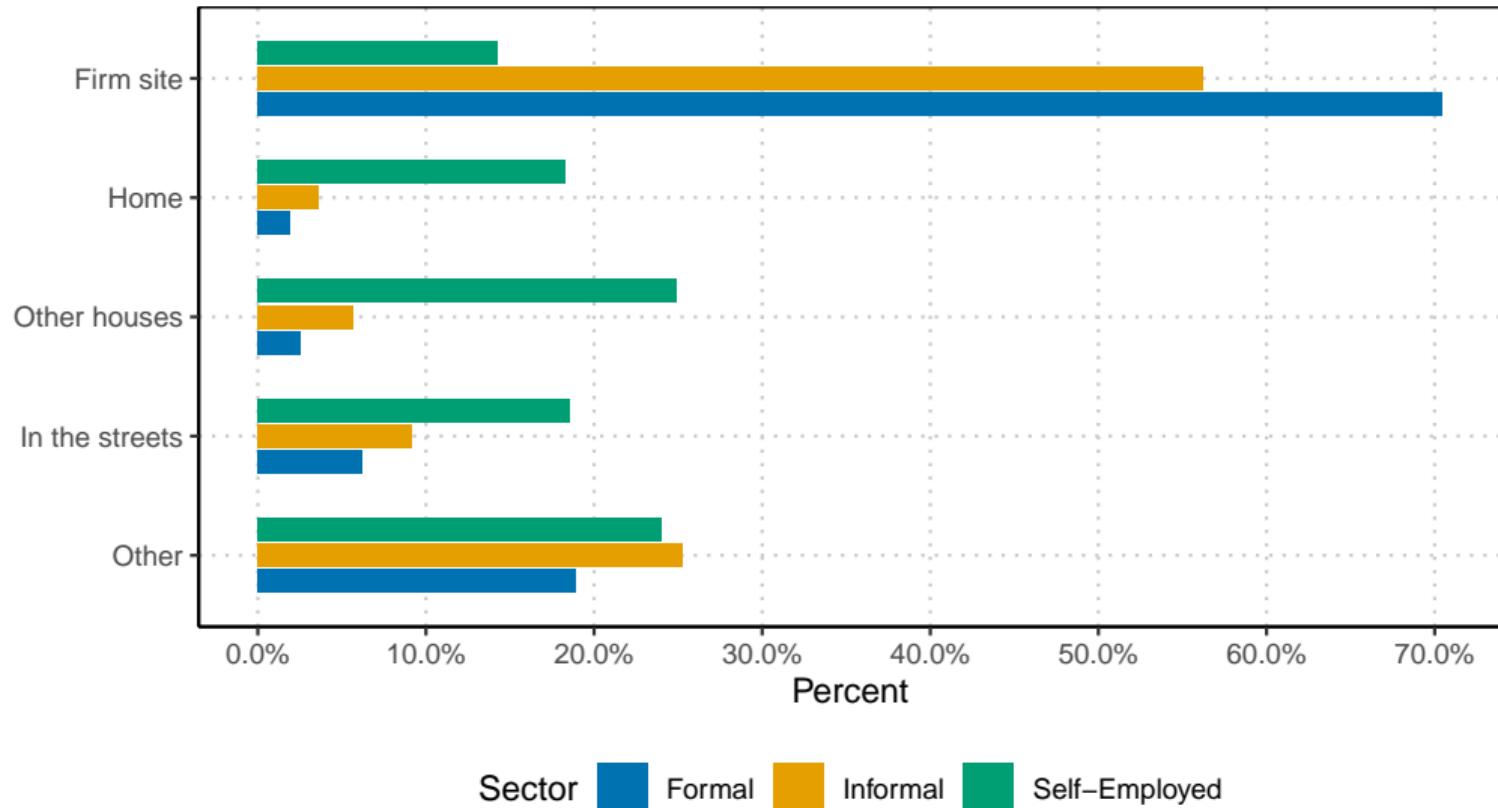
# Hours distribution by sector

Back



# Work place by sector

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# 2004 Reform – Delayed Retirement

Back

Outcome:	Retired (1)	Contributing (2)
(Intercept)	0.246 (0.031)	0.382 (0.027)
T1 (Sep1949–Aug1950)	-0.062 (0.052)	0.018 (0.050)
T2 (Sep1950–Aug1952)	-0.155 (0.037)	0.064 (0.046)
Age Range	63	63
Age fixed-effects	-	-
Observations	7,584	7,584

# 2004 Reform – Delayed Retirement

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Outcome:	Retired (1)	Contributing (2)	Retired (3)	Contributing (4)
(Intercept)	0.246 (0.031)	0.382 (0.027)		
T1 (Sep1949–Aug1950)	-0.062 (0.052)	0.018 (0.050)	-0.040 (0.038)	0.028 (0.048)
T2 (Sep1950–Aug1952)	-0.155 (0.037)	0.064 (0.046)	-0.105 (0.032)	0.044 (0.037)
Age Range	63	63	[50–63]	[50–63]
Age fixed-effects	-	-	Yes	Yes
Observations	7,584	7,584	56,105	56,105

# 2004 Reform – Delayed Retirement

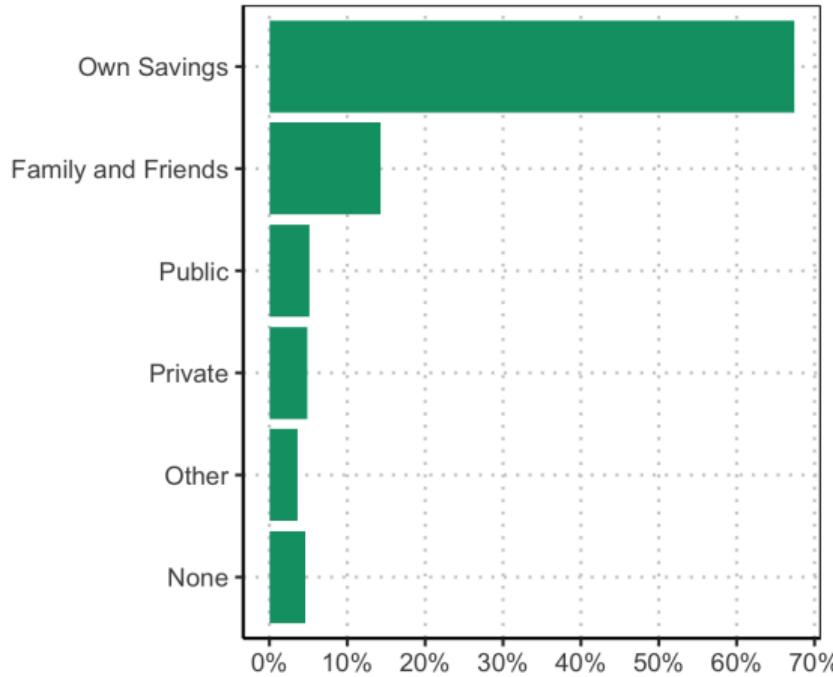
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Outcome:	Retired (1)	Contributing (2)	Retired (3)	Contributing (4)	Formal (5)	Informal (6)	Self-Employed (7)
(Intercept)	0.246 (0.031)	0.382 (0.027)					
T1 (Sep1949–Aug1950)	-0.062 (0.052)	0.018 (0.050)	-0.040 (0.038)	0.028 (0.048)	0.005 (0.042)	-0.007 (0.019)	-0.003 (0.032)
T2 (Sep1950–Aug1952)	-0.155 (0.037)	0.064 (0.046)	-0.105 (0.032)	0.044 (0.037)	0.052 (0.039)	0.003 (0.016)	0.045 (0.030)
Age Range	63	63	[50–63]	[50–63]	[50–63]	[50–63]	[50–63]
Age fixed-effects	-	-	Yes	Yes	Yes	Yes	Yes
Observations	7,584	7,584	56,105	56,105	56,105	56,105	56,105

# Empirical Findings III: Physical capital for self-employment

Back

What was the main source of funding to start self-employment activity?



- ▶ Use panel dimension to investigate wealth held as physical capital
- ▶ 4 groups based on the self-employment status in  $t$  and  $t + 1$

# Empirical Findings III: Physical capital for self-employment

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- ▶ Use panel dimension to investigate wealth held as physical capital
- ▶ 4 groups based on the self-employment status in  $t$  and  $t + 1$
- ▶  $Y_i = \beta_g G_i \times Post_t + G_i$
- ▶ CDF survey

Outcome variable: Indicator for physical capital  $> 0$

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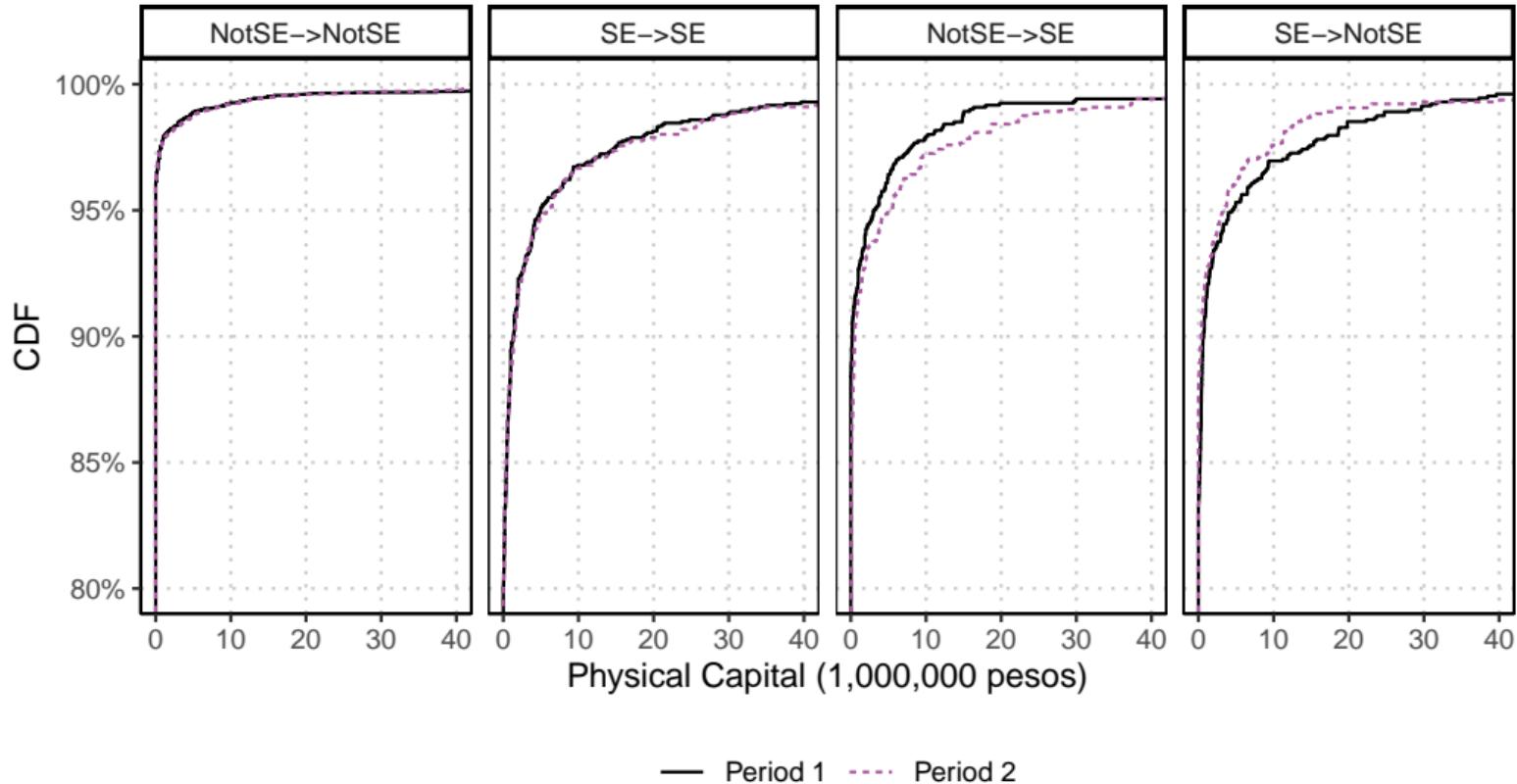
Group	Coeff
Group 00 (NotSE → NotSE)	-0.0002 (0.0017)
Group 11 (SE → SE)	0.0021 (0.0100)
Group 01 (NotSE → SE)	0.0335*** (0.0117)
Group 10 (SE → NotSE)	-0.0451*** (0.0121)

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N Obs 27,926

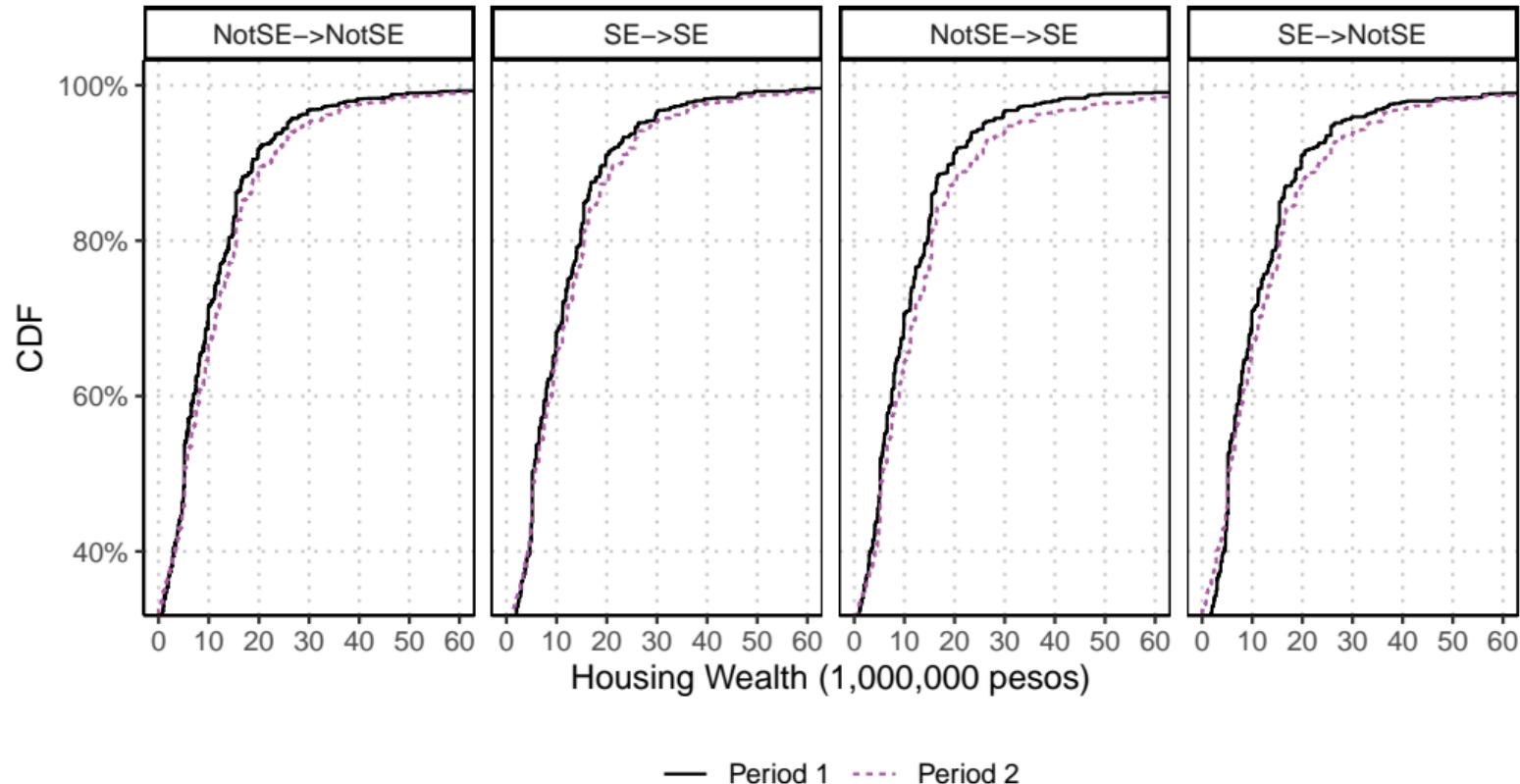
# Self-Employment and start-up costs

Back



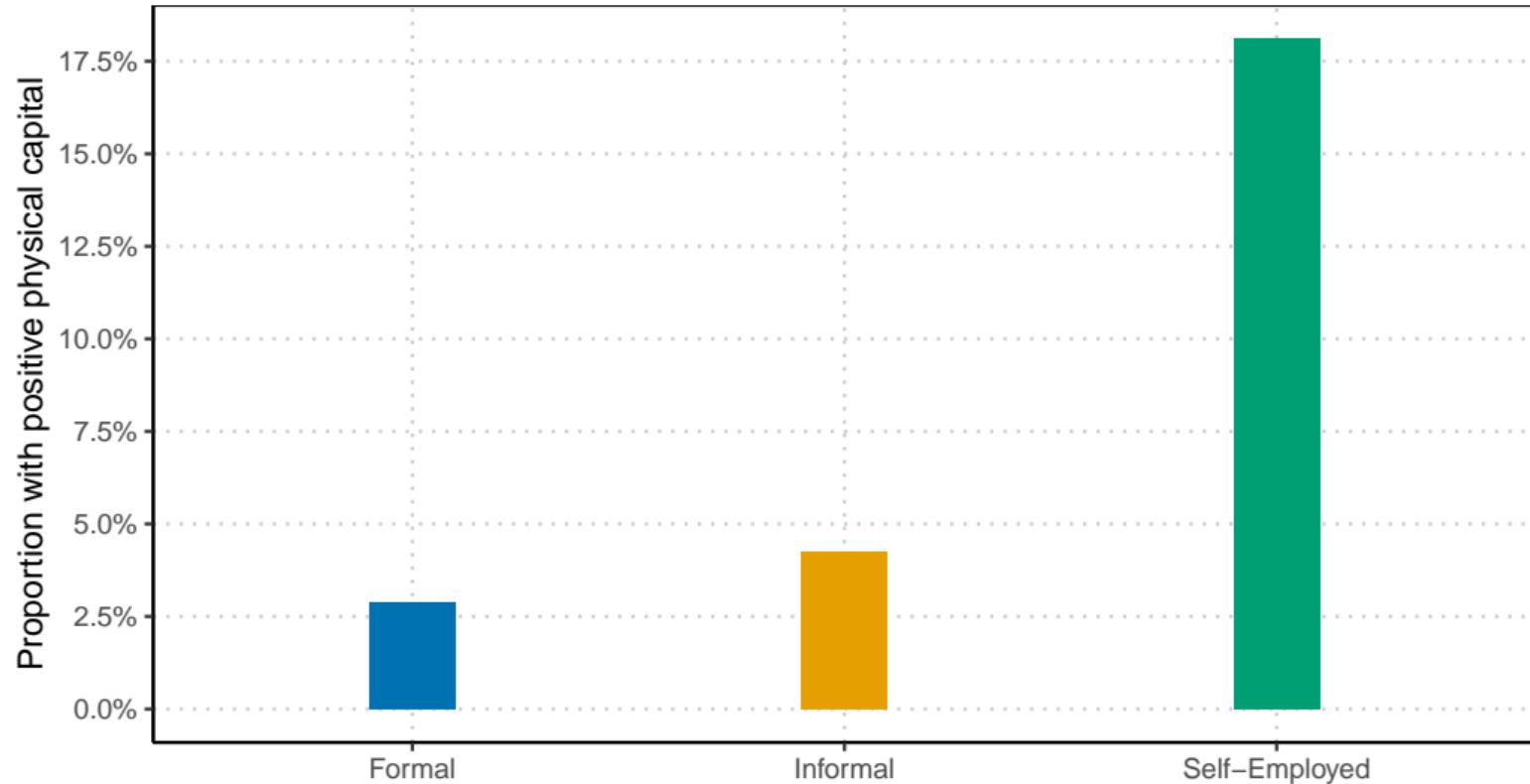
# Self-Employment and start-up costs

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# Physical capital

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$$\tilde{V}_{a+1}^F := \max \left\{ \overbrace{V_{a+1}(b', p', \tilde{k}, F, w),}^{\text{stay}} \right.$$

$$\tilde{V}_{a+1}^F := \max \left\{ \overbrace{V_{a+1}(b', p', \tilde{k}, F, w)}^{\text{stay}}, \overbrace{V_{a+1}(b', p', \tilde{k}, U, 0)}^{\text{quit}}, \right.$$

$$\tilde{V}_{a+1}^F := \max \left\{ \underbrace{V_{a+1}(b', p', \tilde{k}, F, w)}_{\text{stay}}, \underbrace{V_{a+1}(b', p', \tilde{k}, U, 0)}_{\text{quit}}, \right. \\ \left. \underbrace{\int V_{a+1}(b', p', \tilde{k} - X, S, \tilde{w}) dW^S(\tilde{w})}_{\text{move SE}} \right\},$$

$$\tilde{V}_{a+1}^F := \max \left\{ \underbrace{V_{a+1}(b', p', \tilde{k}, F, w)}_{\text{stay}}, \underbrace{V_{a+1}(b', p', \tilde{k}, U, 0)}_{\text{quit}}, \underbrace{\int V_{a+1}(b', p', \tilde{k} - X, S, \tilde{w}) dW^S(\tilde{w})}_{\text{move SE}}, \underbrace{V_{a+1}^{\text{Ret}}(\tilde{k}, y^P, q)}_{\text{retire}} \right\}$$

$$\tilde{V}_{a+1}^F := \max \left\{ \underbrace{V_{a+1}(b', p', \tilde{k}, F, w)}_{\text{stay}}, \underbrace{V_{a+1}(b', p', \tilde{k}, U, 0)}_{\text{quit}}, \underbrace{\int V_{a+1}(b', p', \tilde{k} - X, S, \tilde{w}) dW^S(\tilde{w})}_{\text{move SE}}, \underbrace{V_{a+1}^{\text{Ret}}(\tilde{k}, y^P, q)}_{\text{retire}} \right\}$$

$$\mathbb{E}_F[V_{a+1}(b', p', k', j', w')] =$$

$$\delta_F$$

$$\tilde{V}_{a+1}^F := \max \left\{ \underbrace{V_{a+1}(b', p', \tilde{k}, F, w)}_{\text{stay}}, \underbrace{V_{a+1}(b', p', \tilde{k}, U, 0)}_{\text{quit}}, \right. \\ \left. \underbrace{\int V_{a+1}(b', p', \tilde{k} - X, S, \tilde{w}) dW^S(\tilde{w})}_{\text{move SE}}, \underbrace{V_{a+1}^{\text{Ret}}(\tilde{k}, y^P, q)}_{\text{retire}} \right\}$$

$$\mathbb{E}_F[V_{a+1}(b', p', k', j', w')] =$$

$$\delta_F \max \left\{ V_{a+1}(b', p', \tilde{k} + SP(w), U, 0), \right.$$

$$\tilde{V}_{a+1}^F := \max \left\{ \underbrace{V_{a+1}(b', p', \tilde{k}, F, w), V_{a+1}(b', p', \tilde{k}, U, 0)}_{\text{stay}}, \underbrace{V_{a+1}(b', p', \tilde{k}, U, 0)}_{\text{quit}}, \underbrace{\int V_{a+1}(b', p', \tilde{k} - X, S, \tilde{w}) dW^S(\tilde{w})}_{\text{move SE}}, \underbrace{V_{a+1}^{\text{Ret}}(\tilde{k}, y^P, q)}_{\text{retire}} \right\}$$

$$\mathbb{E}_F[V_{a+1}(b', p', k', j', w')] =$$

$$\delta_F \max \left\{ V_{a+1}(b', p', \tilde{k} + SP(w), U, 0), \int V_{a+1}(b', p', \tilde{k} + SP(w) - X, S, \tilde{w}) dW^S(\tilde{w}), \right.$$

$$\tilde{V}_{a+1}^F := \max \left\{ \underbrace{V_{a+1}(b', p', \tilde{k}, F, w), V_{a+1}(b', p', \tilde{k}, U, 0),}_{\text{move SE}} \right. \\ \left. \underbrace{\int V_{a+1}(b', p', \tilde{k} - X, S, \tilde{w}) dW^S(\tilde{w}), V_{a+1}^{\text{Ret}}(\tilde{k}, y^P, q)}_{\text{quit}} \right\}$$

$$\mathbb{E}_F[V_{a+1}(b', p', k', j', w')] =$$

$$\delta_F \max \left\{ V_{a+1}(b', p', \tilde{k} + SP(w), U, 0), \int V_{a+1}(b', p', \tilde{k} + SP(w) - X, S, \tilde{w}) dW^S(\tilde{w}), \right. \\ \left. V_{a+1}^{\text{Ret}}(\tilde{k}, y^P, q) \right\} +$$

$$\tilde{V}_{a+1}^F := \max \left\{ \underbrace{V_{a+1}(b', p', \tilde{k}, F, w)}_{\text{stay}}, \underbrace{V_{a+1}(b', p', \tilde{k}, U, 0)}_{\text{quit}}, \right. \\ \left. \underbrace{\int V_{a+1}(b', p', \tilde{k} - X, S, \tilde{w}) dW^S(\tilde{w})}_{\text{move SE}}, \underbrace{V_{a+1}^{\text{Ret}}(\tilde{k}, y^P, q)}_{\text{retire}} \right\}$$

$$\mathbb{E}_F[V_{a+1}(b', p', k', j', w')] =$$

$$\delta_F \max \left\{ V_{a+1}(b', p', \tilde{k} + SP(w), U, 0), \int V_{a+1}(b', p', \tilde{k} + SP(w) - X, S, \tilde{w}) dW^S(\tilde{w}), \right. \\ \left. V_{a+1}^{\text{Ret}}(\tilde{k}, y^P, q) \right\} + (1 - \delta_F) \left[ (1 - \lambda_F^F)(1 - \lambda_F^I) \tilde{V}_{a+1}^F + \right]$$

$$\tilde{V}_{a+1}^F := \max \left\{ \underbrace{V_{a+1}(b', p', \tilde{k}, F, w), V_{a+1}(b', p', \tilde{k}, U, 0),}_{\text{move SE}} \right. \\ \left. \underbrace{\int V_{a+1}(b', p', \tilde{k} - X, S, \tilde{w}) dW^S(\tilde{w}), V_{a+1}^{\text{Ret}}(\tilde{k}, y^P, q)}_{\text{retire}} \right\}$$

$$\mathbb{E}_F[V_{a+1}(b', p', k', j', w')] =$$

$$\delta_F \max \left\{ V_{a+1}(b', p', \tilde{k} + SP(w), U, 0), \int V_{a+1}(b', p', \tilde{k} + SP(w) - X, S, \tilde{w}) dW^S(\tilde{w}), \right. \\ \left. V_{a+1}^{\text{Ret}}(\tilde{k}, y^P, q) \right\} + (1 - \delta_F) \left[ (1 - \lambda_F^F)(1 - \lambda_F^I) \tilde{V}_{a+1}^F + \right. \\ \left. \tilde{\lambda}_F^F \int \max \left\{ \tilde{V}_{a+1}^F, V_{a+1}(b', p', \tilde{k}, F, \tilde{w}) \right\} dW^F(\tilde{w}) \right]$$

$$\tilde{V}_{a+1}^F := \max \left\{ \underbrace{V_{a+1}(b', p', \tilde{k}, F, w)}_{\text{stay}}, \underbrace{V_{a+1}(b', p', \tilde{k}, U, 0)}_{\text{quit}}, \right. \\ \left. \underbrace{\int V_{a+1}(b', p', \tilde{k} - X, S, \tilde{w}) dW^S(\tilde{w})}_{\text{move SE}}, \underbrace{V_{a+1}^{\text{Ret}}(\tilde{k}, y^P, q)}_{\text{retire}} \right\}$$

$$\mathbb{E}_F[V_{a+1}(b', p', k', j', w')] =$$

$$\delta_F \max \left\{ V_{a+1}(b', p', \tilde{k} + SP(w), U, 0), \int V_{a+1}(b', p', \tilde{k} + SP(w) - X, S, \tilde{w}) dW^S(\tilde{w}), \right. \\ \left. V_{a+1}^{\text{Ret}}(\tilde{k}, y^P, q) \right\} + (1 - \delta_F) \left[ (1 - \lambda_F^F)(1 - \lambda_F^I) \tilde{V}_{a+1}^F + \right. \\ \left. \tilde{\lambda}_F^F \int \max \left\{ \tilde{V}_{a+1}^F, V_{a+1}(b', p', \tilde{k}, F, \tilde{w}) \right\} dW^F(\tilde{w}) + \right. \\ \left. \tilde{\lambda}_F^I \int \max \left\{ \tilde{V}_{a+1}^F, V_{a+1}(b', p', \tilde{k}, I, \tilde{w}) \right\} dW^I(\tilde{w}) \right]$$

1. Age: discrete from 16 to 100 y.o. (quarterly)
2. Type I: Reform 2004 and 2008 (3)
3. Type II: Ability type (2)
4. Wealth: continuous 12 points
5. Pension Wealth: continuous / 10 points
6. Sector: 4
7. Wage: continuous 11 points
8. Hours: discrete part-time x full-time (2 points)
9. UI status: discrete (3 points)

⇒ State space:  $\sim 12.9 \text{mi}$  points

# Estimation Details

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- i. Model is quarterly from age 16-100
- ii. Pension reforms come as surprises
- iii. Solved numerically
- iv. Weighting matrix: inverse of the diagonal of the var-cov matrix
- v. Global (Controlled Random Search) + local (Brent's algorithm) – derivative free
- vi. Continuous variables are discretized in grid points: capital (12), pension wealth (10) and wage/earnings (11)
- vii. Numerical integration using Gauss-Legendre (for Normal and Beta distributions)
- viii. Interpolation: linear interpolation for 1D,2D,3D
- ix. Numerical derivatives using two symmetrical deviations with a step size of 2.5%

► GMM estimation with moments computed by simulated data

1. Given a vector of parameters:  $\xi$
2. Obtain the solution of the model: policy functions  $P^*(\xi)$
3. Simulate individuals that behave according to  $P^*(\xi)$
4. Compute moments from the simulated individuals:  $M(P^*(\xi))$
5. Choose  $\xi^*$  that minimizes:

weighting matrix

$$\left( M(P^*(\xi)) - M_d \right)' \downarrow \Sigma_{M_d} \left( M(P^*(\xi)) - M_d \right)$$

moments in the data

## 2nd stage parameters

Back

### Estimated Parameters (22)

---

Discount factor ( $\beta$ )	1	(A)
Bequest ( $\psi, \bar{K}$ )	2	(A)

### Moments (212)

---

(A)	39	Median Wealth $\times$ age groups
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## 2nd stage parameters

Back

### Estimated Parameters (22)

Discount factor ( $\beta$ )	1	(A)
Bequest ( $\psi, \bar{K}$ )	2	(A)
Consumption weight ( $\nu$ )	1	(B),(C)

### Moments (212)

(A)	39	Median Wealth $\times$ age groups
(B)	33	Prop Retired $\times$ age $\times$ cohort
(C)	11	Prop Part-time $\times$ age groups

## 2nd stage parameters

Back

### Estimated Parameters (22)

Discount factor ( $\beta$ )	1	(A)
Bequest ( $\psi, \bar{K}$ )	2	(A)
Consumption weight ( $\nu$ )	1	(B),(C)
Amenities ( $\phi_j$ )	1	(D)

### Moments (212)

(A)	39	Median Wealth $\times$ age groups
(B)	33	Prop Retired $\times$ age $\times$ cohort
(C)	11	Prop Part-time $\times$ age groups
(D)	81	Emp-Sector $\times$ age groups

## 2nd stage parameters

[Back](#)

### Estimated Parameters (22)

Discount factor ( $\beta$ )	1	(A)
Bequest ( $\psi, \bar{K}$ )	2	(A)
Consumption weight ( $\nu$ )	1	(B),(C)
Amenities ( $\phi_j$ )	1	(D)
Destruction rates ( $\delta^j$ )	1	(E)
Arrival rates ( $\lambda^{j,j}$ )	8	(E)

### Moments (212)

(A)	39	Median Wealth $\times$ age groups
(B)	33	Prop Retired $\times$ age $\times$ cohort
(C)	11	Prop Part-time $\times$ age groups
(D)	81	Emp-Sector $\times$ age groups
(E)	14	Transitions

## 2nd stage parameters

Back

### Estimated Parameters (22)

Discount factor ( $\beta$ )	1	(A)
Bequest ( $\psi, \bar{K}$ )	2	(A)
Consumption weight ( $\nu$ )	1	(B),(C)
Amenities ( $\phi_j$ )	1	(D)
Destruction rates ( $\delta^j$ )	1	(E)
Arrival rates ( $\lambda^{j,j}$ )	8	(E)
Formal Wage ( $\xi_1^F, \xi_2^F$ )	2	(F)
Informal Wage ( $\xi_1^I, \xi_2^I$ )	2	(G)

### Moments (212)

(A)	39	Median Wealth $\times$ age groups
(B)	33	Prop Retired $\times$ age $\times$ cohort
(C)	11	Prop Part-time $\times$ age groups
(D)	81	Emp-Sector $\times$ age groups
(E)	14	Transitions
(F)	13	Formal Wage Percentiles
(G)	13	Informal Wage Percentiles

## 2nd stage parameters

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### Estimated Parameters (22)

Discount factor ( $\beta$ )	1	(A)
Bequest ( $\psi, \bar{K}$ )	2	(A)
Consumption weight ( $\nu$ )	1	(B),(C)
Amenities ( $\phi_j$ )	1	(D)
Destruction rates ( $\delta^j$ )	1	(E)
Arrival rates ( $\lambda^{j,j}$ )	8	(E)
Formal Wage ( $\xi_1^F, \xi_2^F$ )	2	(F)
Informal Wage ( $\xi_1^I, \xi_2^I$ )	2	(G)
Self-Emp Earnings ( $\sigma$ )	1	(H)

### Moments (212)

(A)	39	Median Wealth $\times$ age groups
(B)	33	Prop Retired $\times$ age $\times$ cohort
(C)	11	Prop Part-time $\times$ age groups
(D)	81	Emp-Sector $\times$ age groups
(E)	14	Transitions
(F)	13	Formal Wage Percentiles
(G)	13	Informal Wage Percentiles
(H)	7	Self-Emp Earnings

## 2nd stage parameters

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### Estimated Parameters (22)

Discount factor ( $\beta$ )	1	(A)
Bequest ( $\psi, \bar{K}$ )	2	(A)
Consumption weight ( $\nu$ )	1	(B),(C)
Amenities ( $\phi_j$ )	1	(D)
Destruction rates ( $\delta^j$ )	1	(E)
Arrival rates ( $\lambda^{j,j}$ )	8	(E)
Formal Wage ( $\xi_1^F, \xi_2^F$ )	2	(F)
Informal Wage ( $\xi_1^I, \xi_2^I$ )	2	(G)
Self-Emp Earnings ( $\sigma$ )	1	(H)
Self-Emp Fixed Cost ( $x$ )	1	(I)

### Moments (212)

(A)	39	Median Wealth $\times$ age groups
(B)	33	Prop Retired $\times$ age $\times$ cohort
(C)	11	Prop Part-time $\times$ age groups
(D)	81	Emp-Sector $\times$ age groups
(E)	14	Transitions
(F)	13	Formal Wage Percentiles
(G)	13	Informal Wage Percentiles
(H)	7	Self-Emp Earnings
(I)	1	Physical Capital

## 2nd stage parameters

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### Estimated Parameters (22)

Discount factor ( $\beta$ )	1	(A)
Bequest ( $\psi, \bar{K}$ )	2	(A)
Consumption weight ( $\nu$ )	1	(B),(C)
Amenities ( $\phi_j$ )	1	(D)
Destruction rates ( $\delta^j$ )	1	(E)
Arrival rates ( $\lambda^{j,j}$ )	8	(E)
Formal Wage ( $\xi_1^F, \xi_2^F$ )	2	(F)
Informal Wage ( $\xi_1^I, \xi_2^I$ )	2	(G)
Self-Emp Earnings ( $\sigma$ )	1	(H)
Self-Emp Fixed Cost ( $x$ )	1	(I)
Abilities types	2	(J),(F-H)

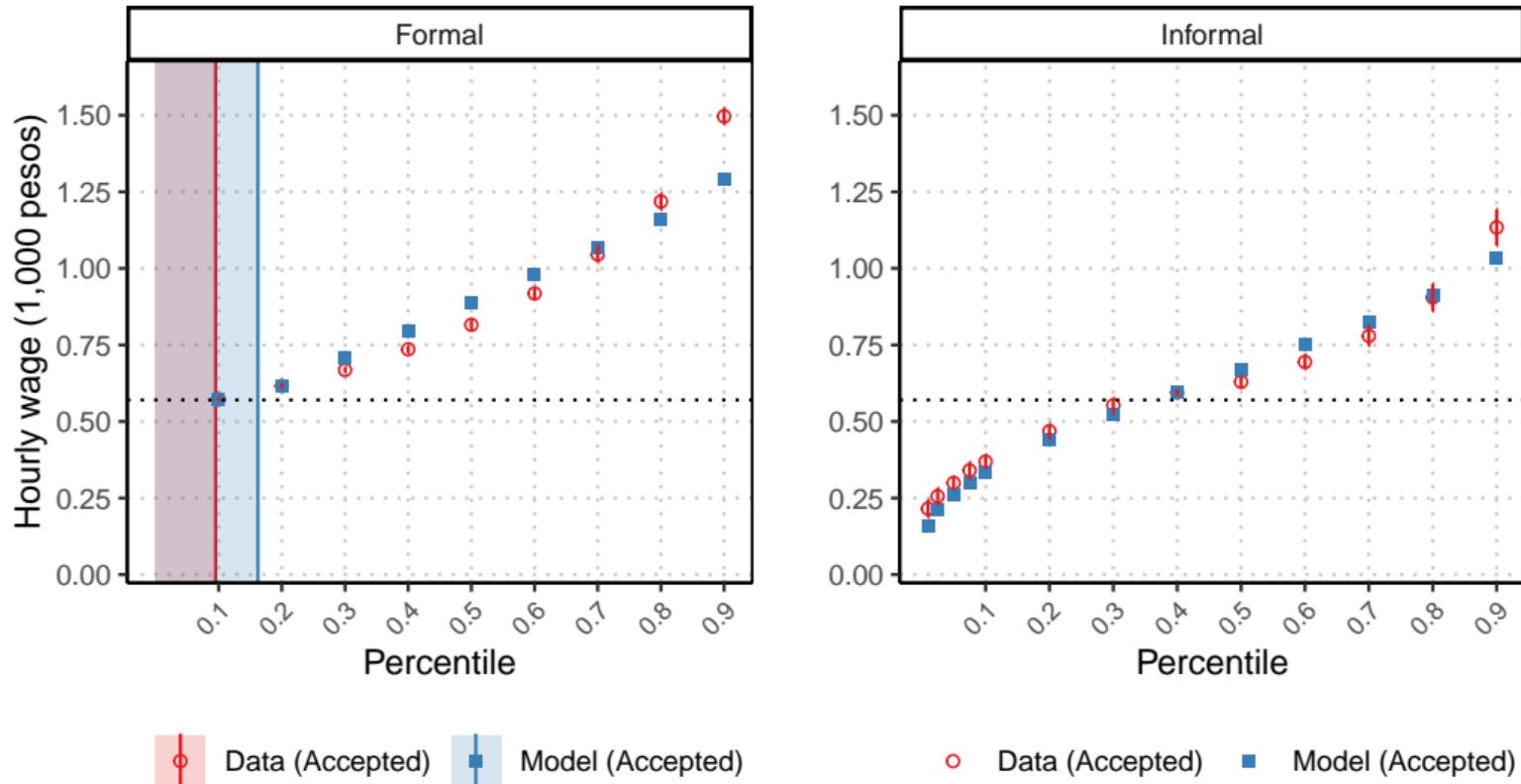
### Moments (212)

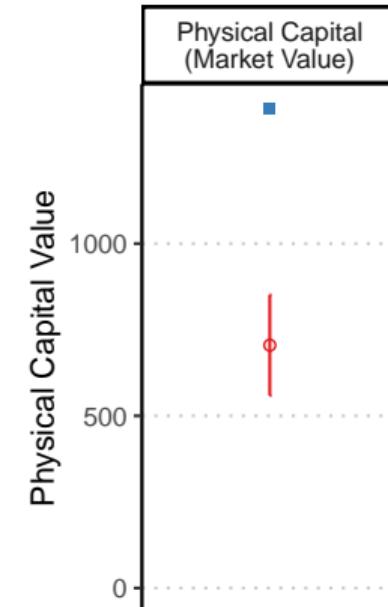
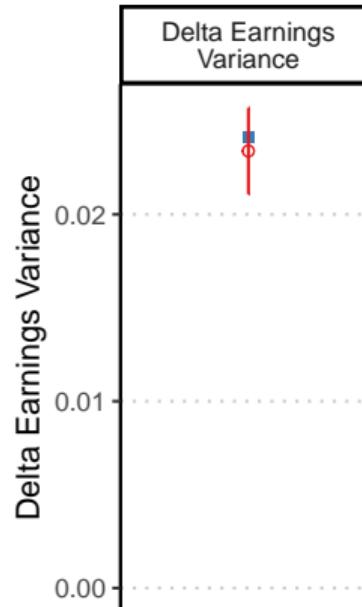
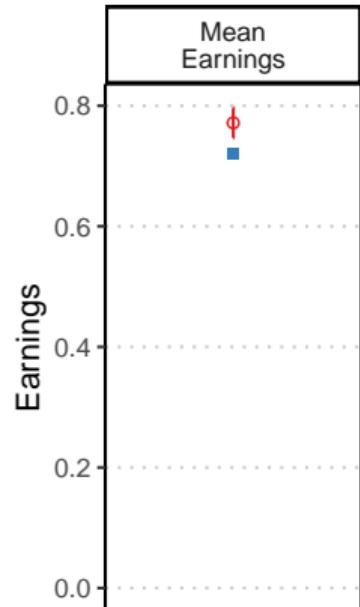
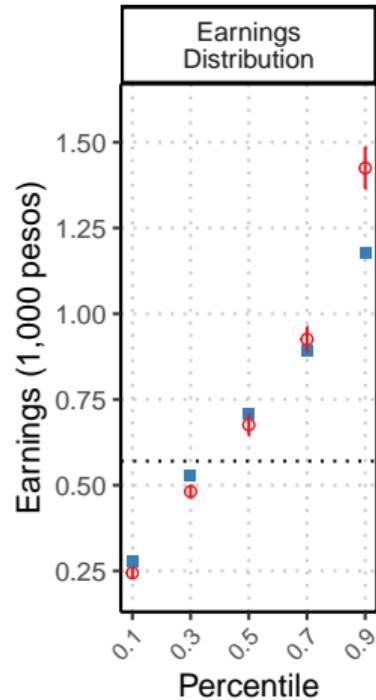
(A)	39	Median Wealth $\times$ age groups
(B)	33	Prop Retired $\times$ age $\times$ cohort
(C)	11	Prop Part-time $\times$ age groups
(D)	81	Emp-Sector $\times$ age groups
(E)	14	Transitions
(F)	13	Formal Wage Percentiles
(G)	13	Informal Wage Percentiles
(H)	7	Self-Emp Earnings
(I)	1	Physical Capital
(J)	1	Wage correlation

Preference	$\beta$	$\nu$	$\psi$	$\bar{K}$	$\phi_S$
estimate	0.94	0.404	214.696	10752.7	1.176
(s.e.)	(0.001)	(0.003)	(62.326)	(2641.1)	(0.018)
Formal Arrival Rates	$\lambda_{U,F}$	$\lambda_{F,F}$	$\lambda_{I,F}$	$\lambda_{S,F}$	
estimate	0.112	0.267	0.04	0.172	
(s.e.)	(0.003)	(0.019)	(0.002)	(0.02)	
Informal Arrival Rates	$\lambda_{U,I}$	$\lambda_{F,I}$	$\lambda_{I,I}$	$\lambda_{S,I}$	
estimate	0.391	0.499	0.285	0.944	
(s.e.)	(0.026)	(0.074)	(0.022)	(0.19)	
Wage (Shape)	$\zeta_1^F$	$\zeta_2^F$	$\zeta_1^I$	$\zeta_2^I$	
estimate	2.268	8.6	1.185	11.389	
(s.e.)	(0.17)	(0.393)	(0.103)	(0.514)	
Self-Employment	$\delta_S$	$\sigma$	$X$	$g_2$	$e_2$
estimate	0.007	0.068	2787.3	0.598	0.647
(s.e.)	(0.001)	(0.003)	(81.5)	(0.011)	(0.011)

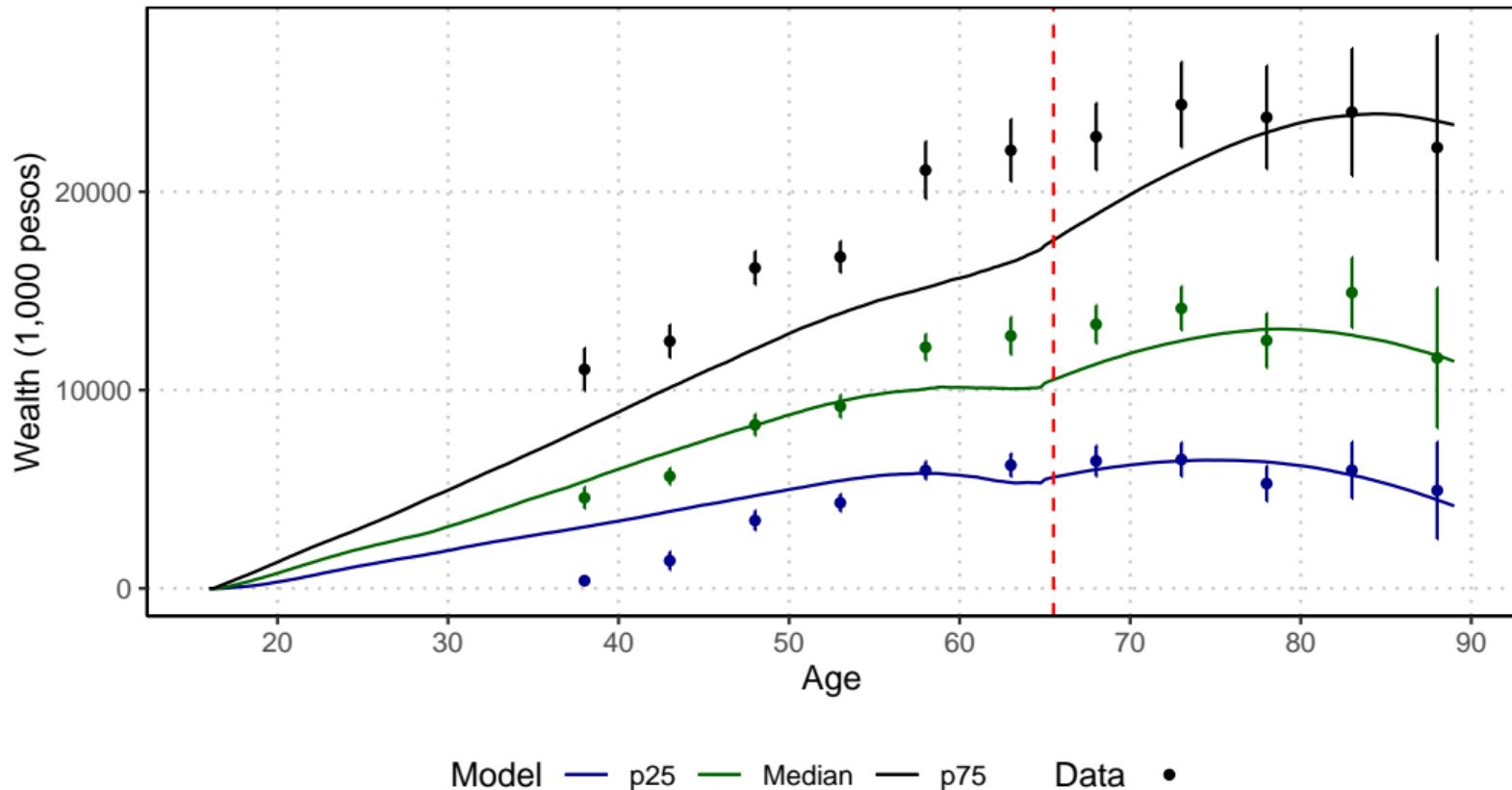
# Accepted wages

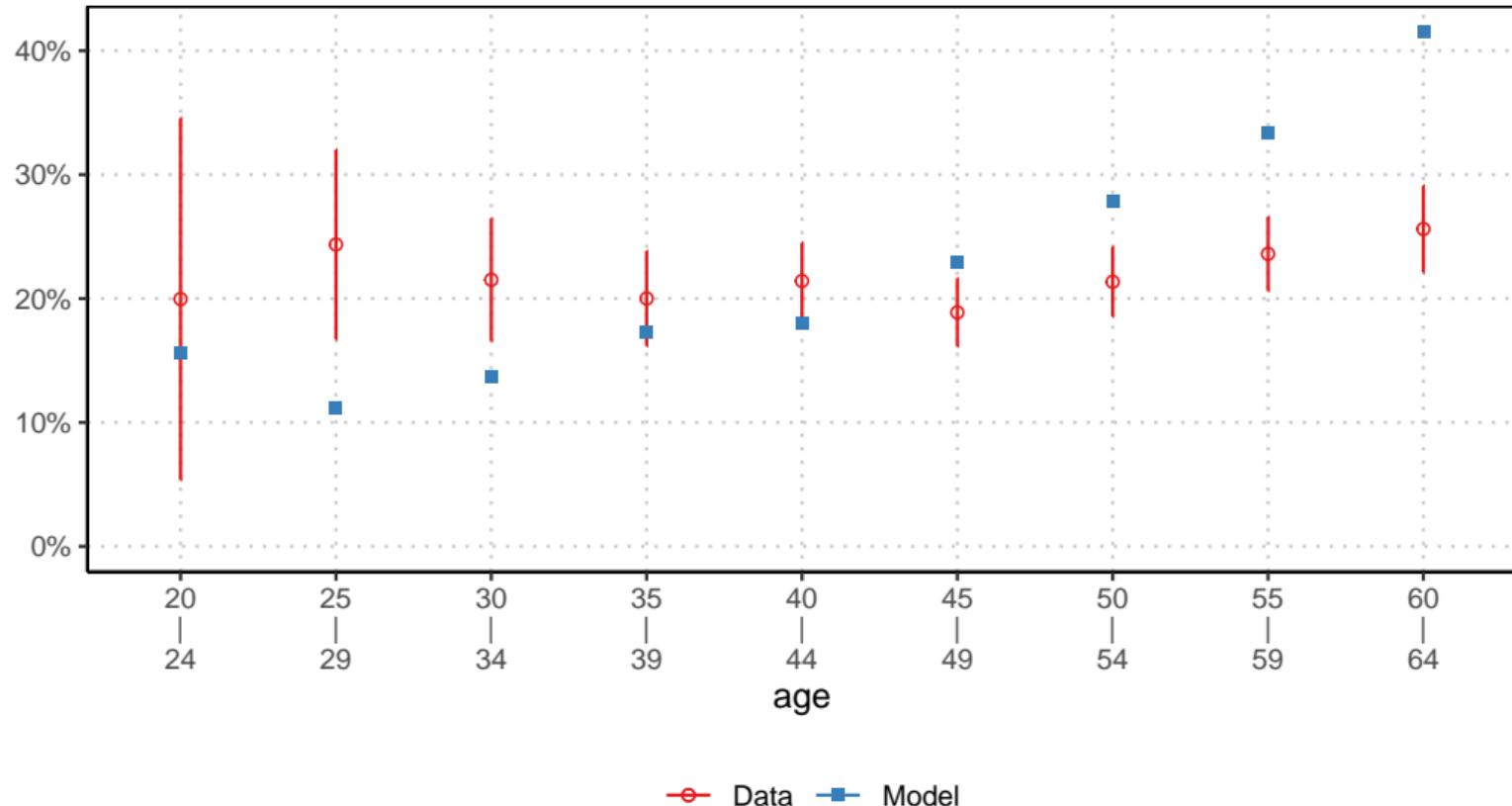
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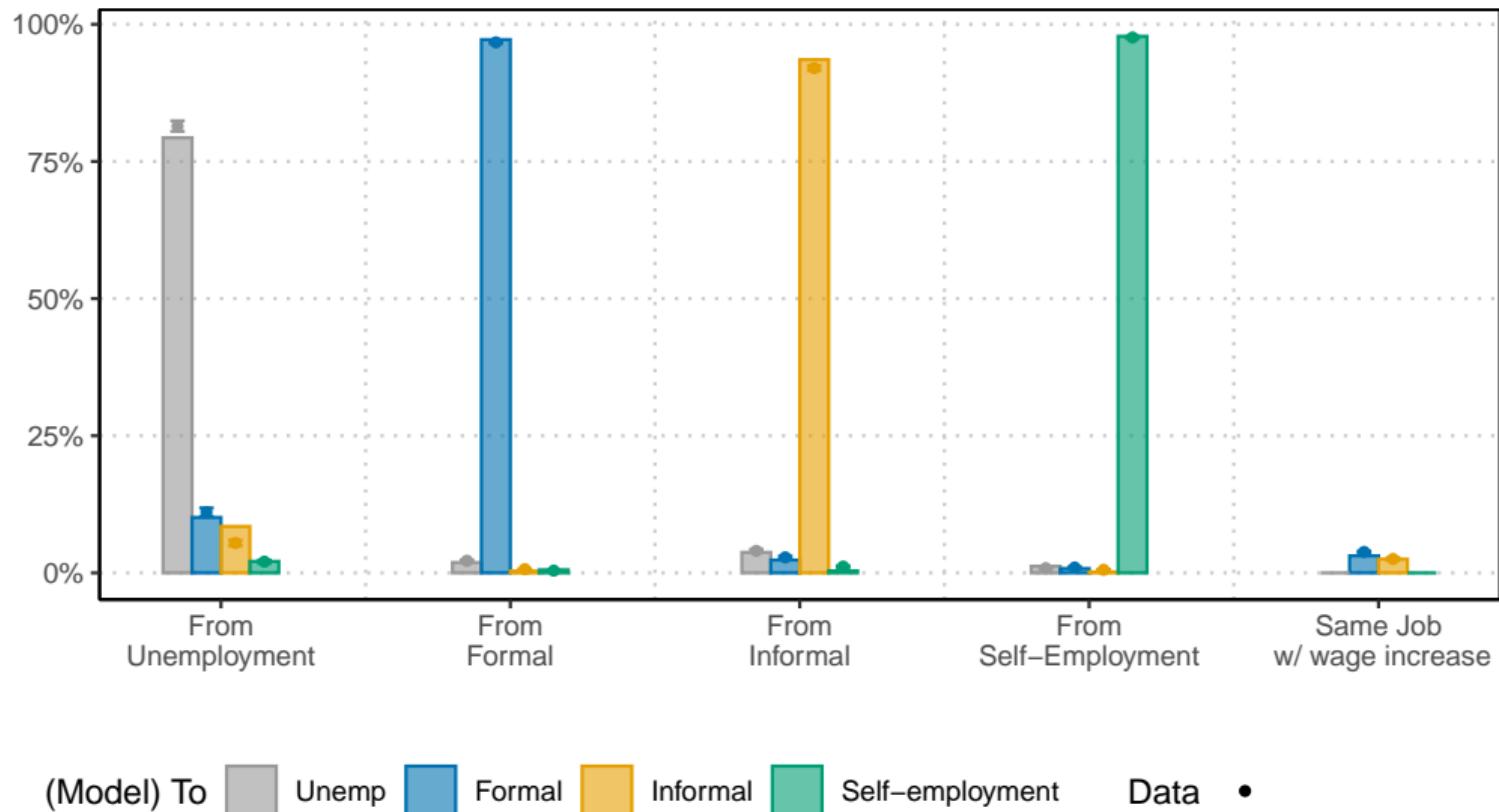
○ Data   ■ Model   ○ Data   ■ Model





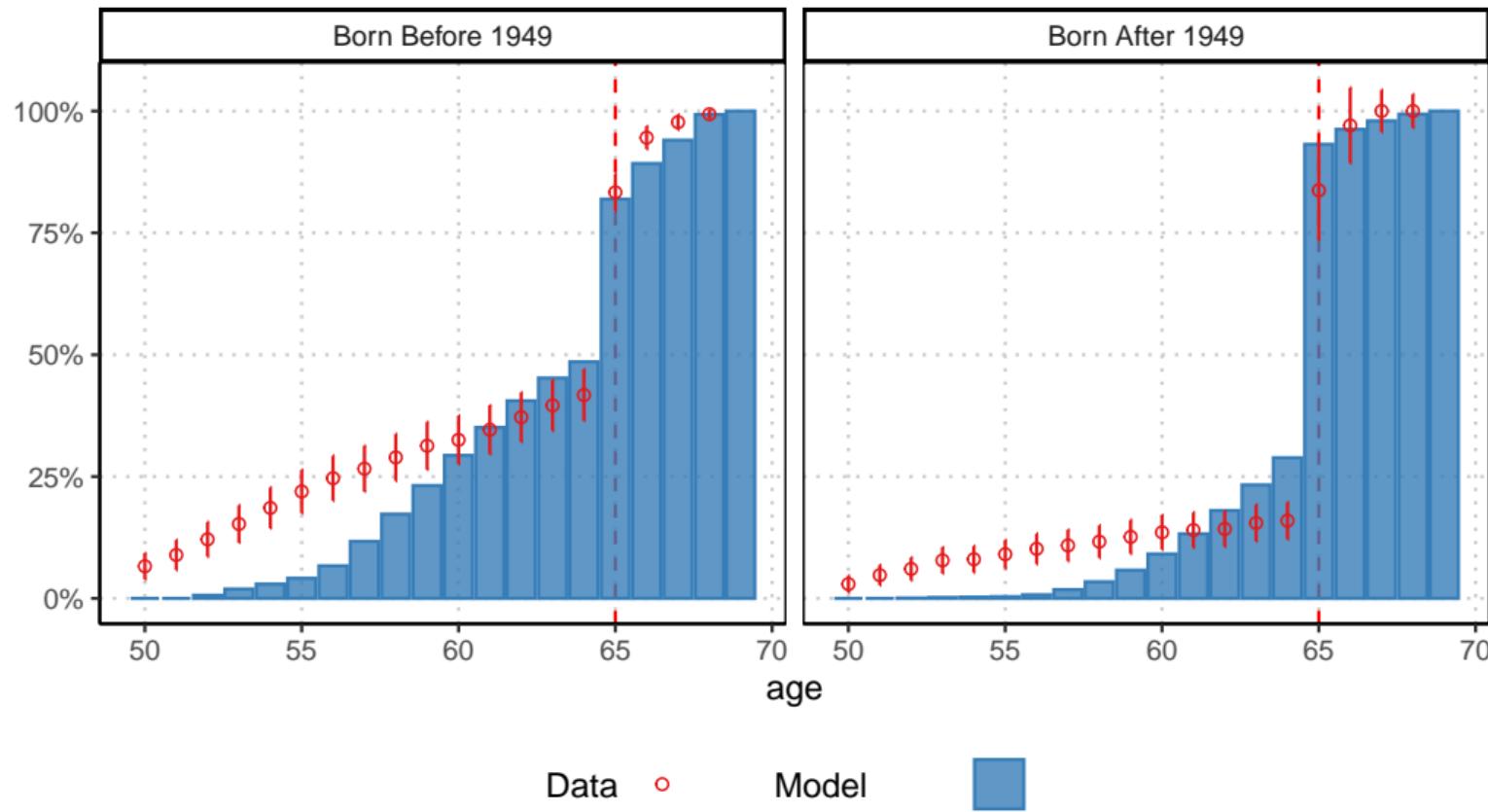
# Transitions

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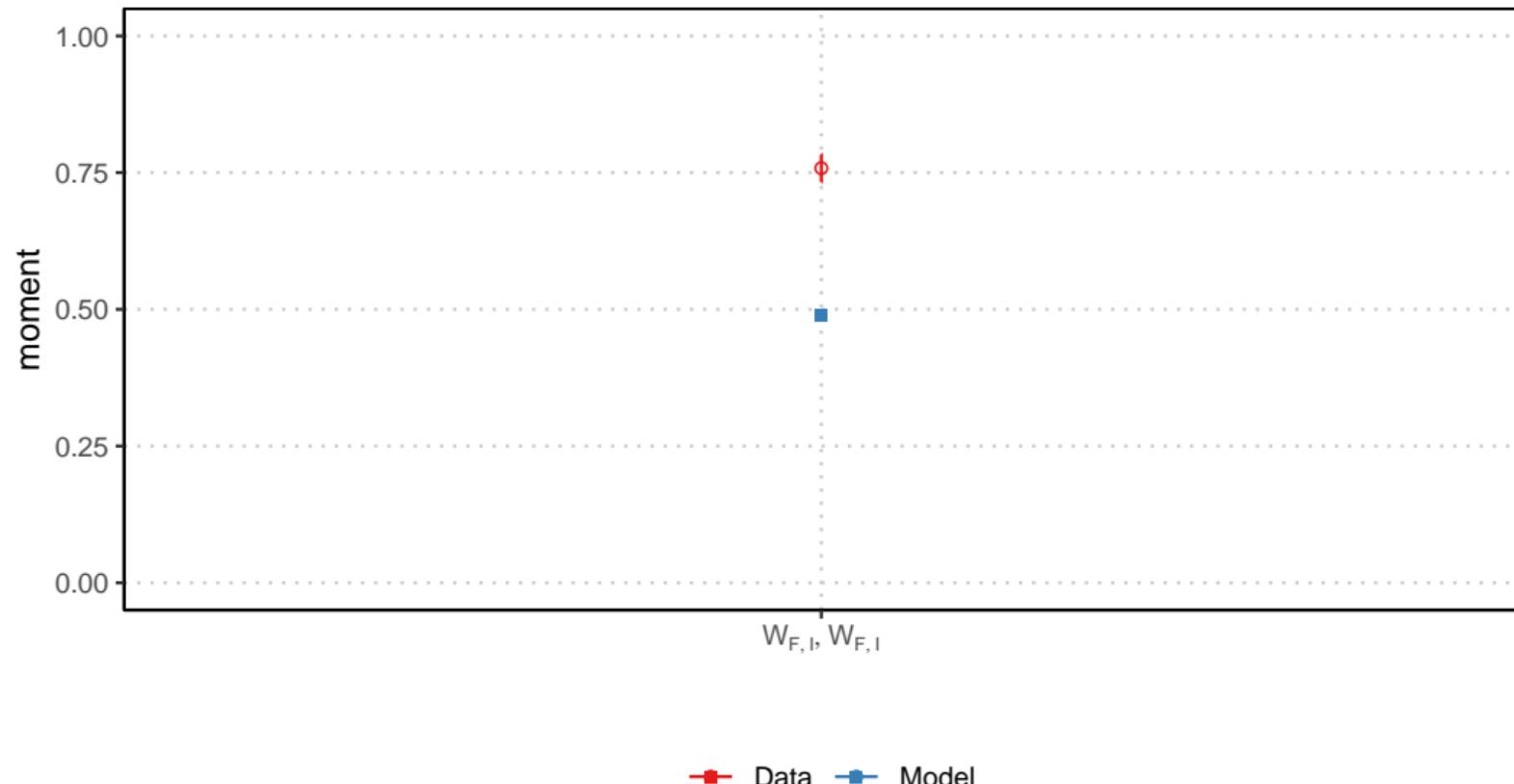
# Retirement age

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# Wage correlation age

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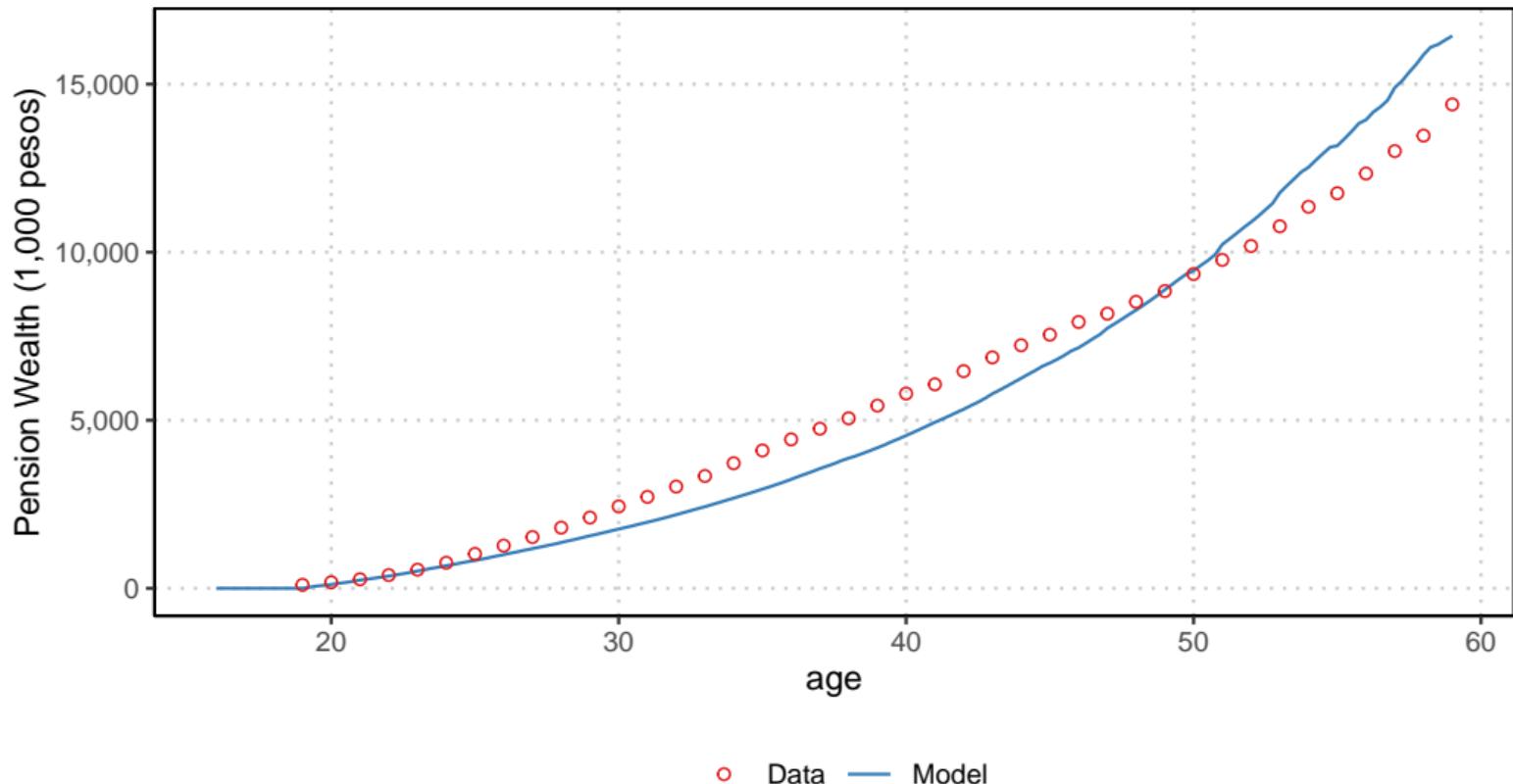
## Amenities

- ▶ Consumption equivalent (intra-period) to yield the same utility as working formally full-time

Sector	Formal	Unemployed	Informal	Self-employed
Consumption Equivalent <i>(baseline)</i>	1.000	0.496	1.000	0.850

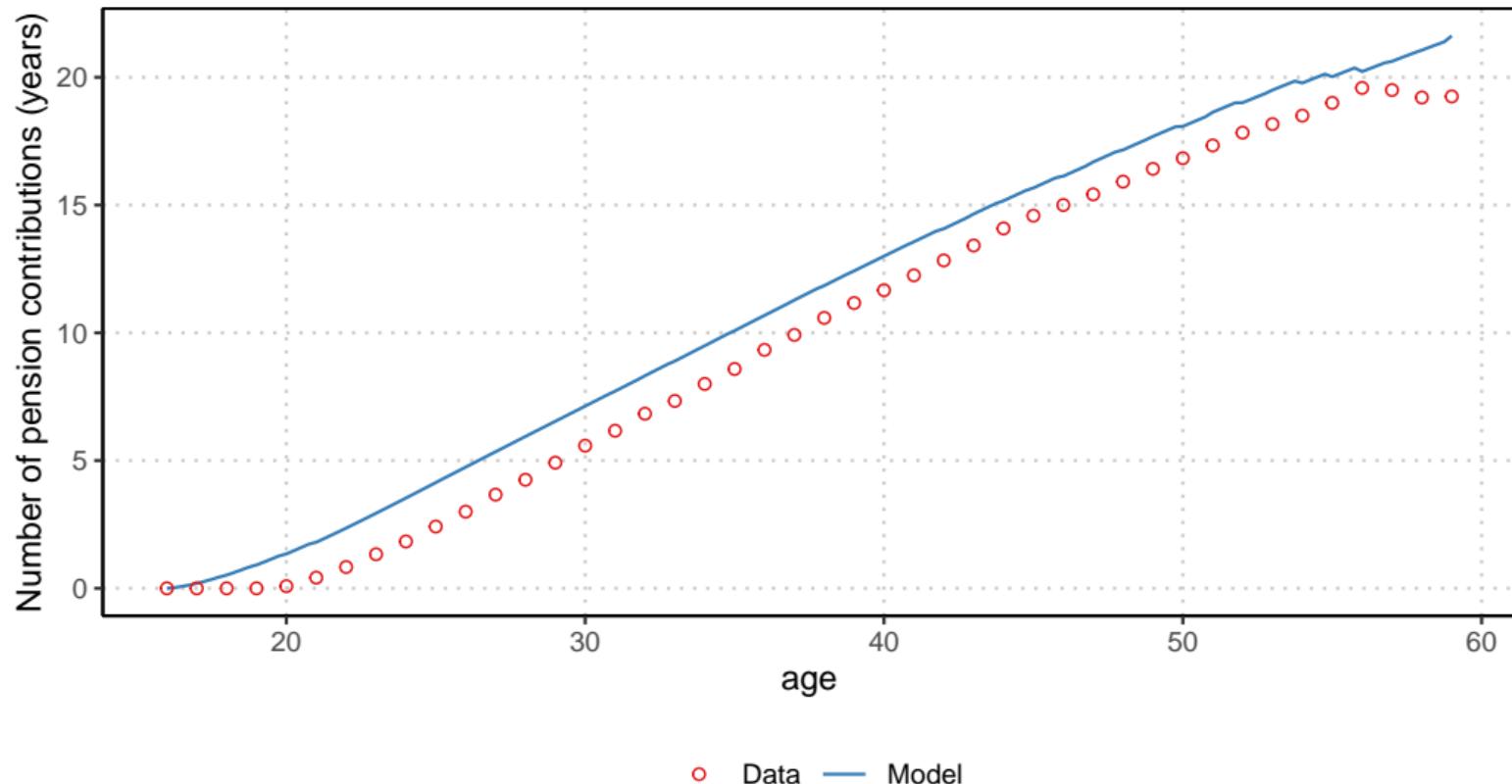
# Untargetted moments: pension wealth

[Back](#)



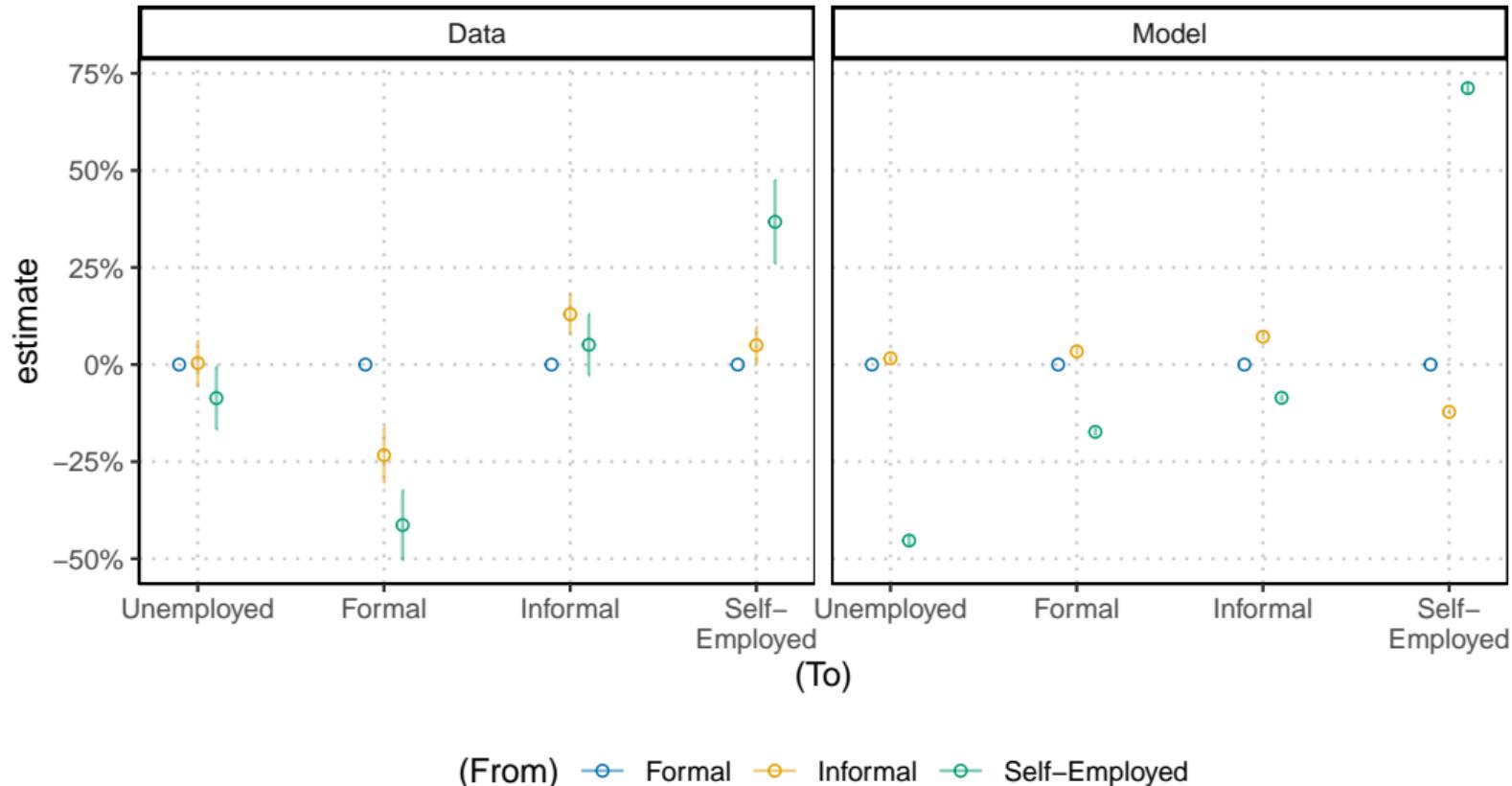
# Untargetted moments: pension contributions

[Back](#)

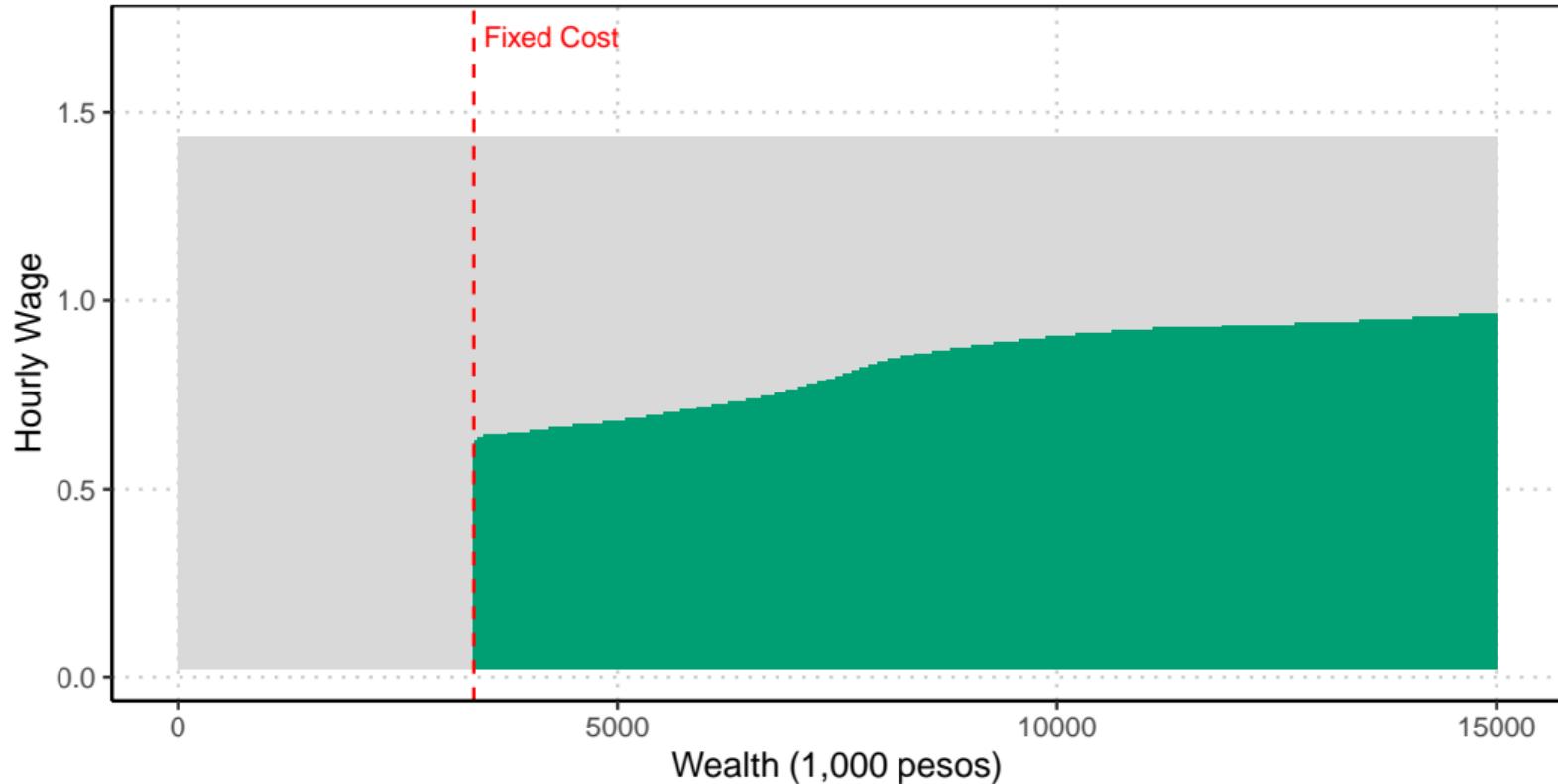


# Involuntary transitions

[Back](#)

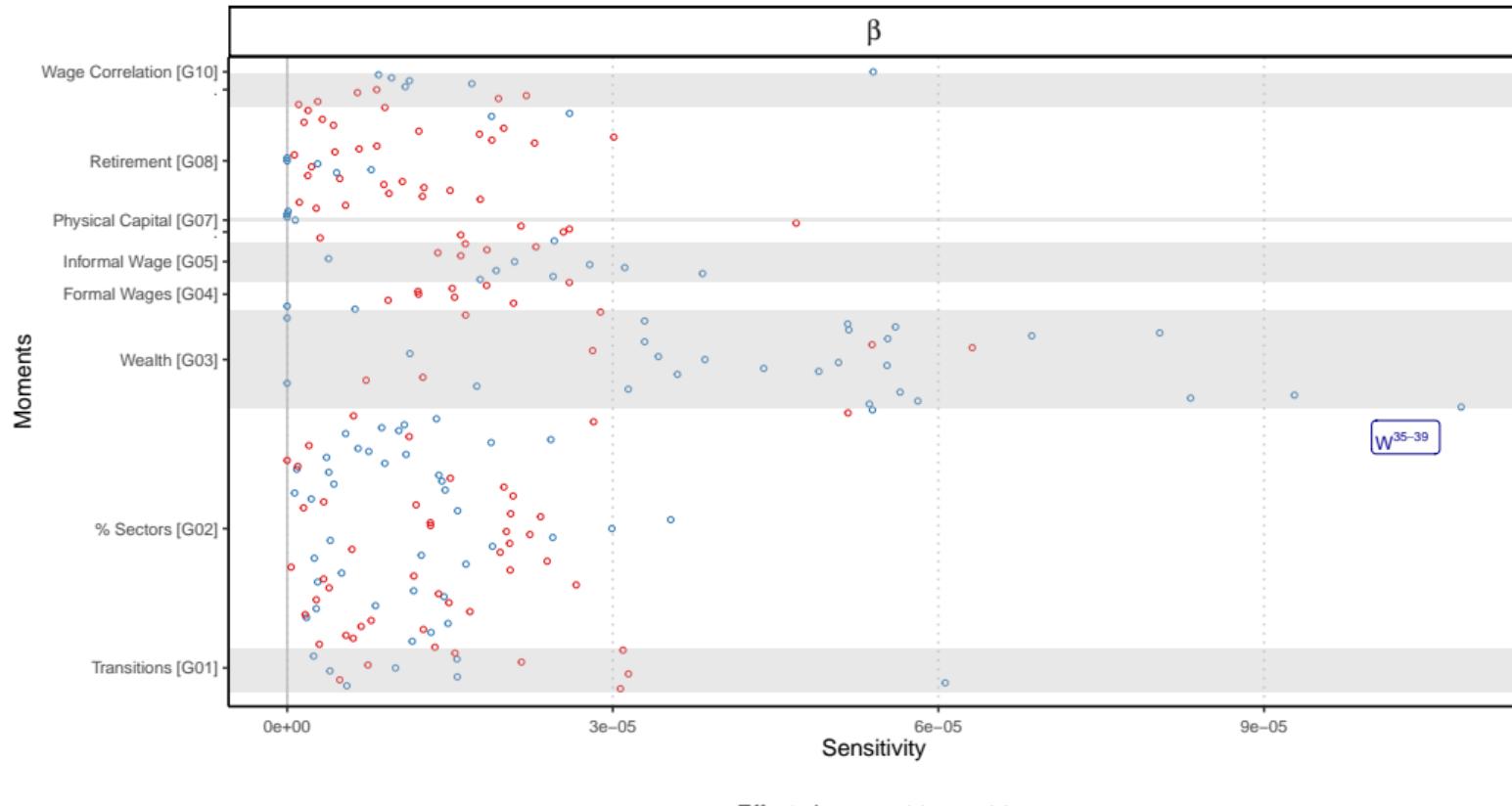


## Formal



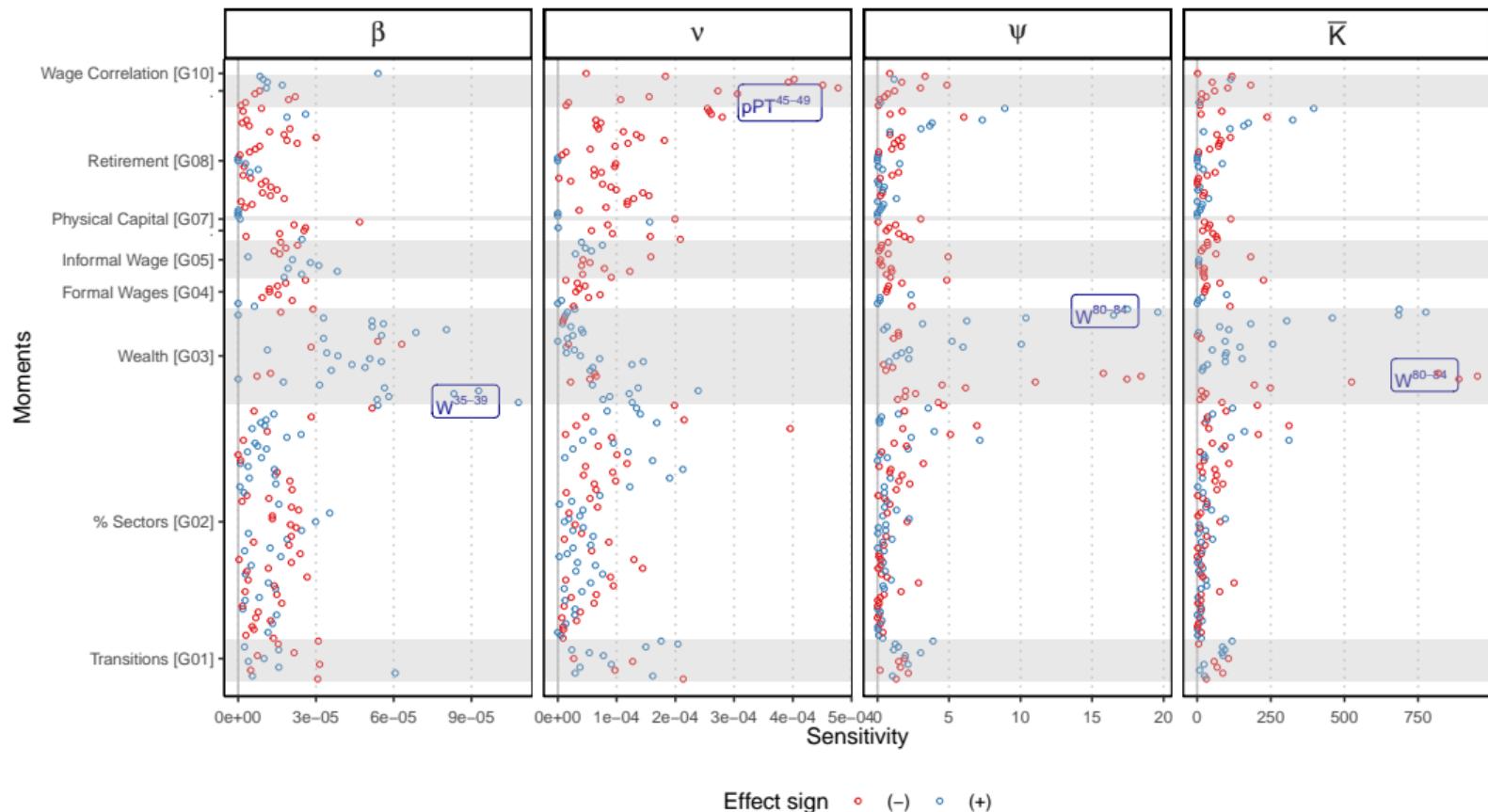
# Sensitivity Matrix

[Back](#)



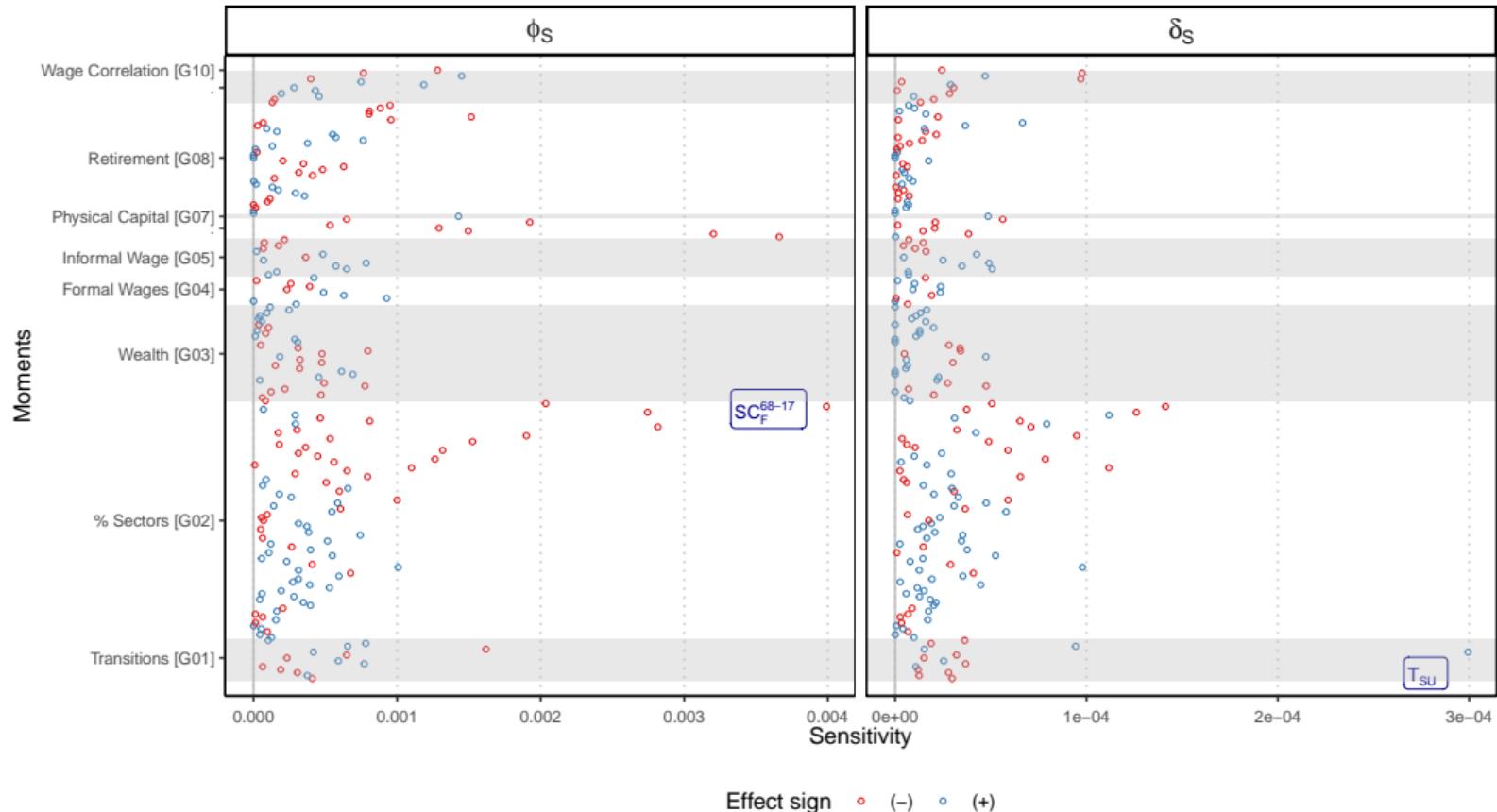
# Sensitivity Matrix

[Back](#)



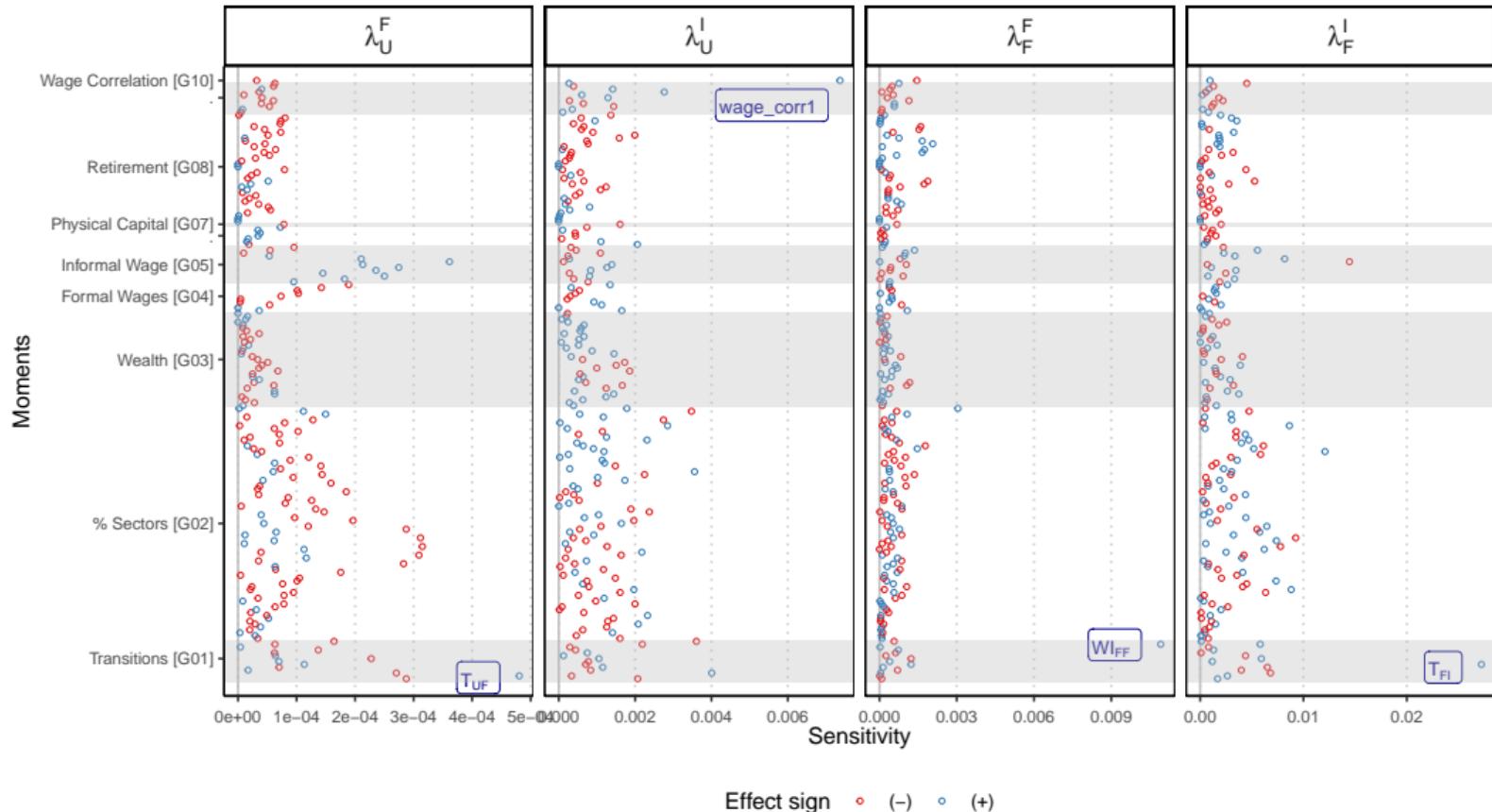
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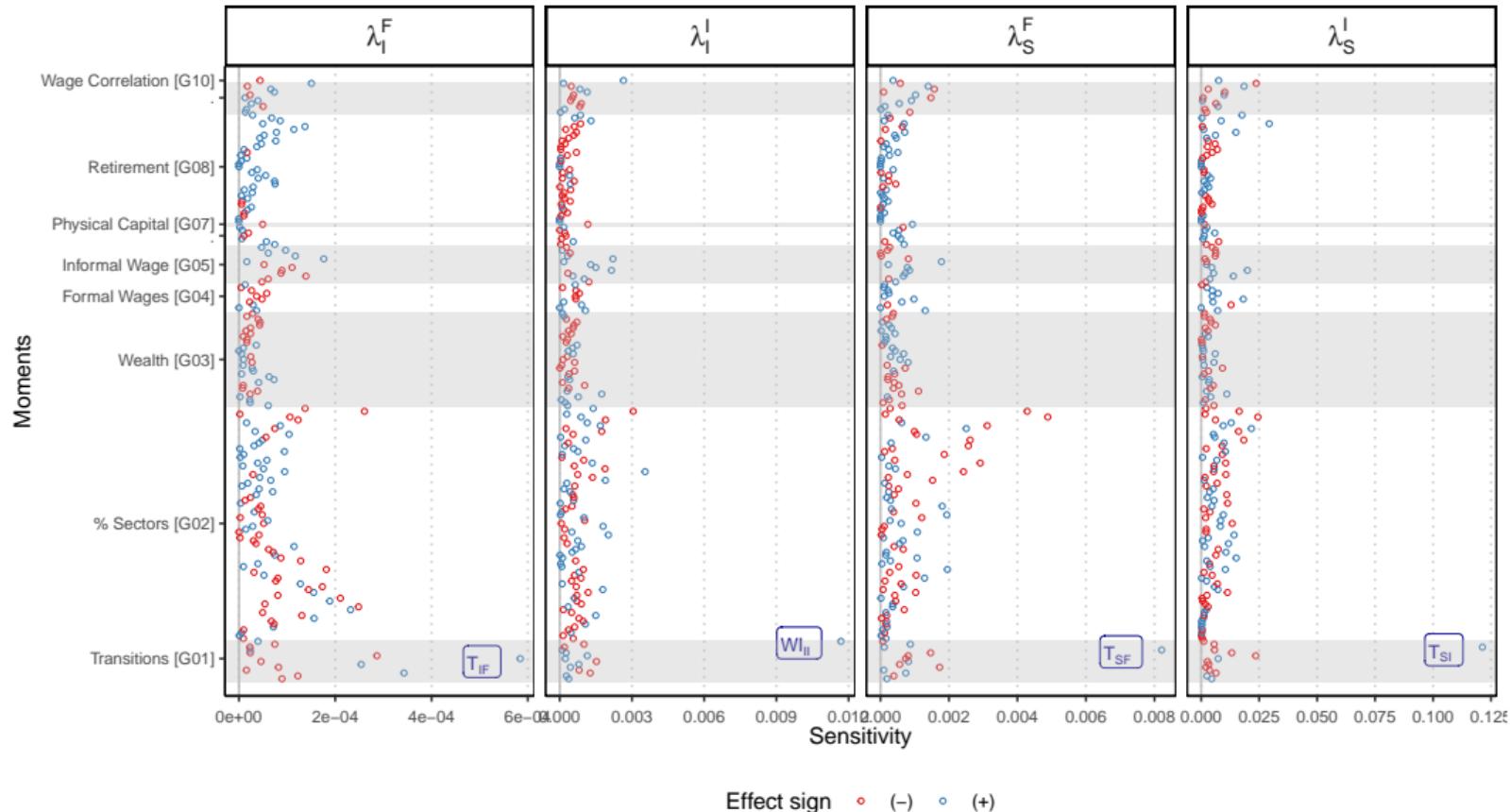
# Sensitivity Matrix

[Back](#)



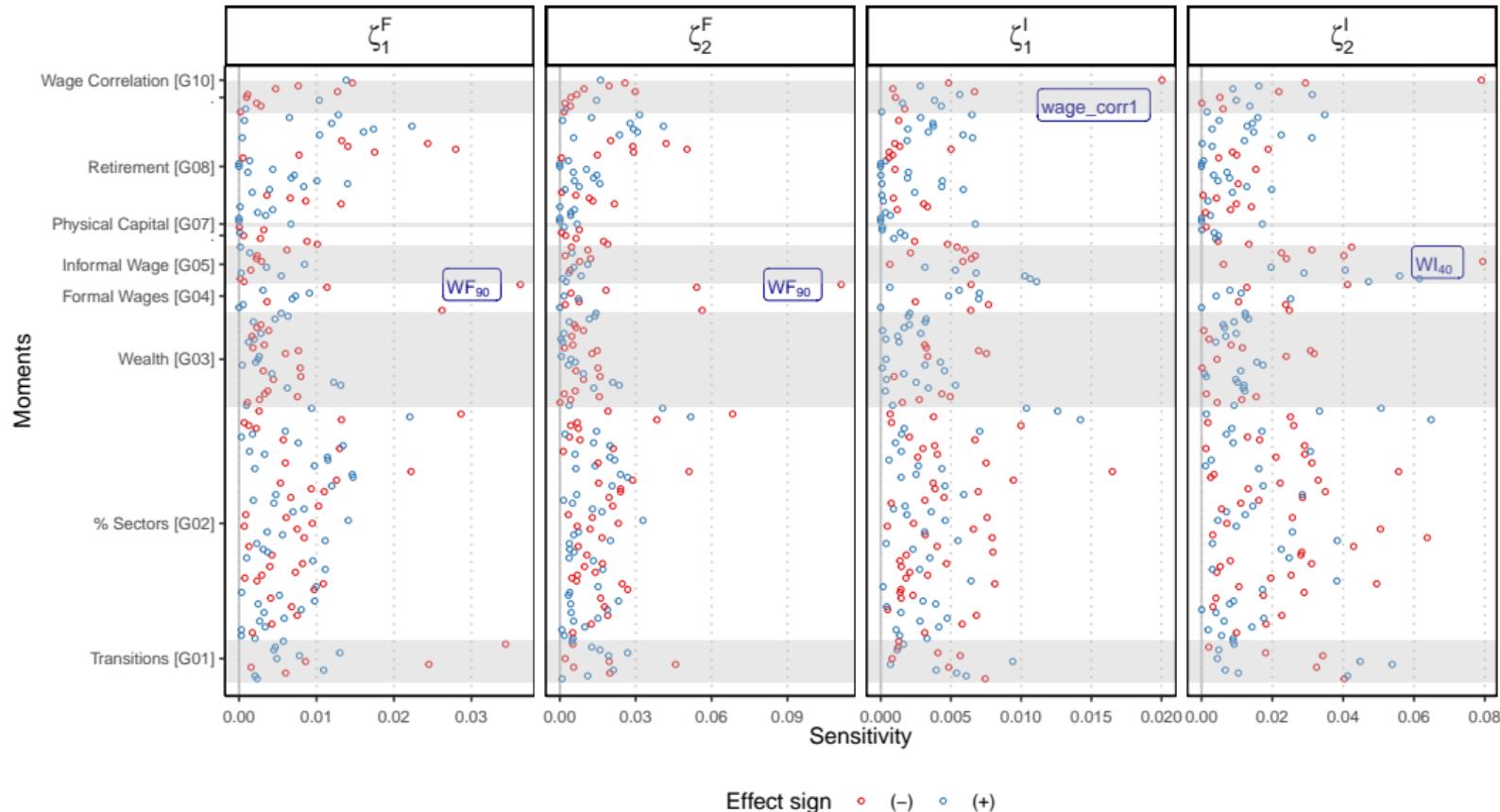
# Sensitivity Matrix

[Back](#)



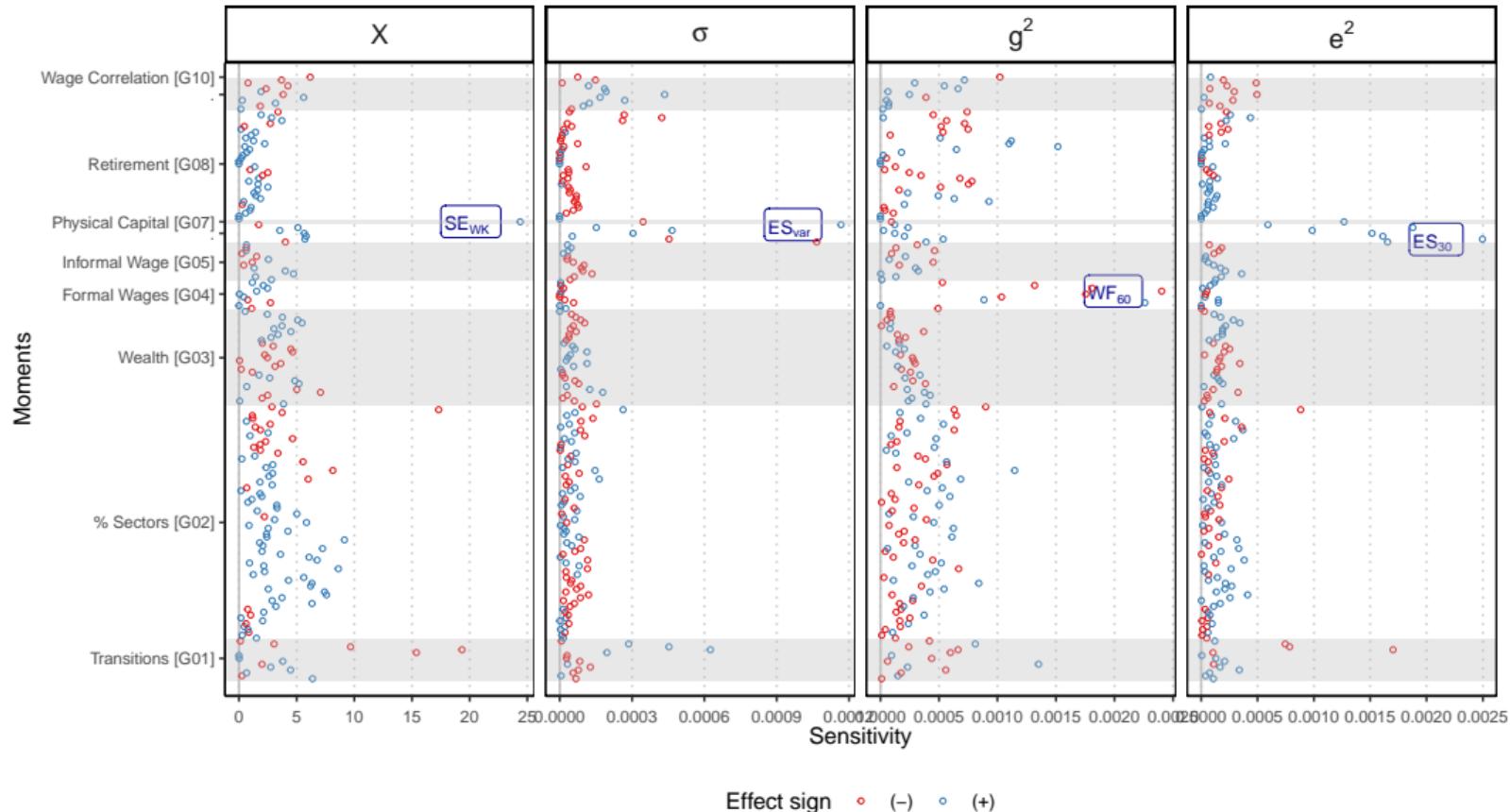
# Sensitivity Matrix

[Back](#)



# Sensitivity Matrix

[Back](#)



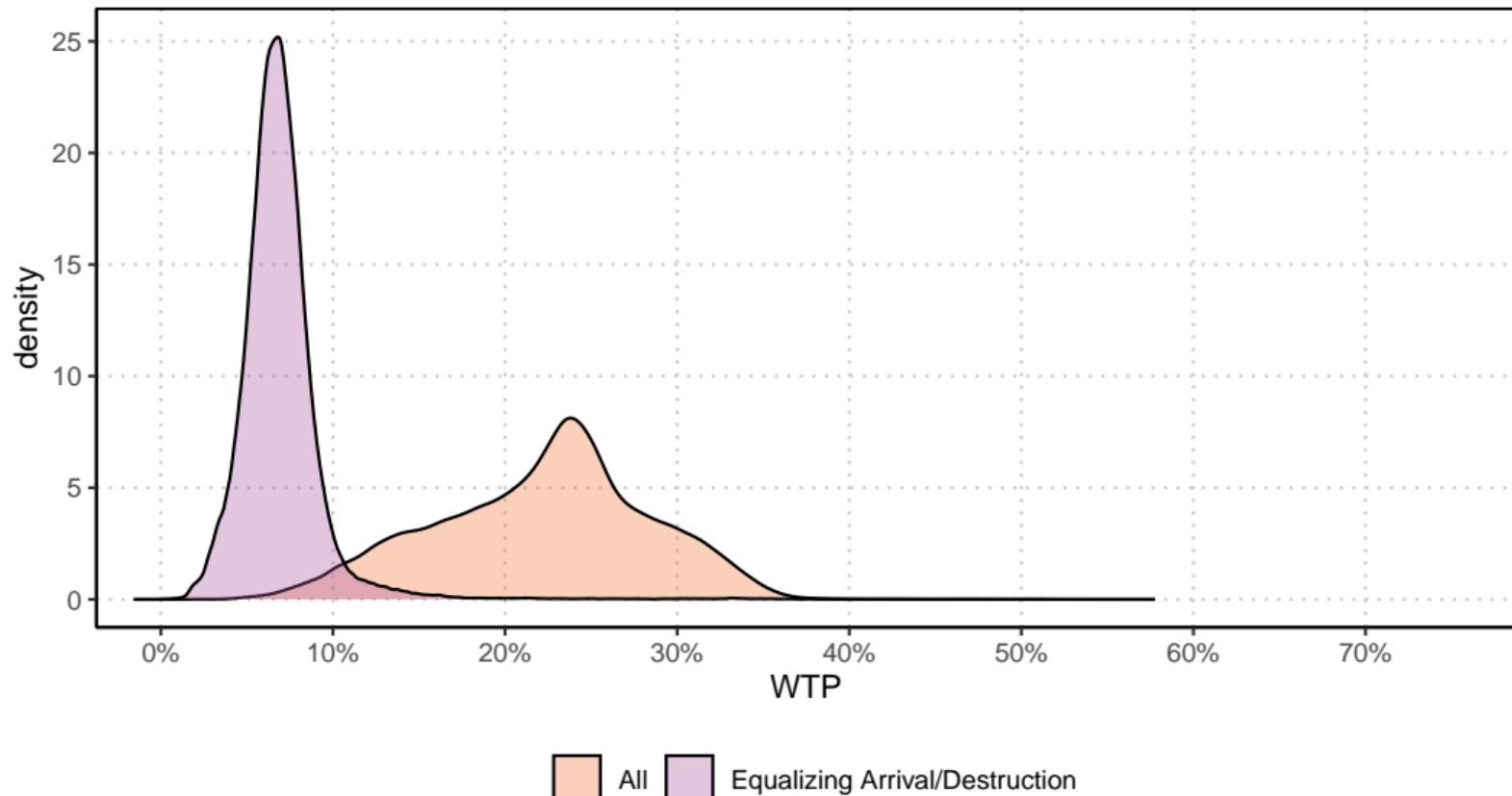
# Value Function

[back](#)



# Willingness to pay for a formal job –

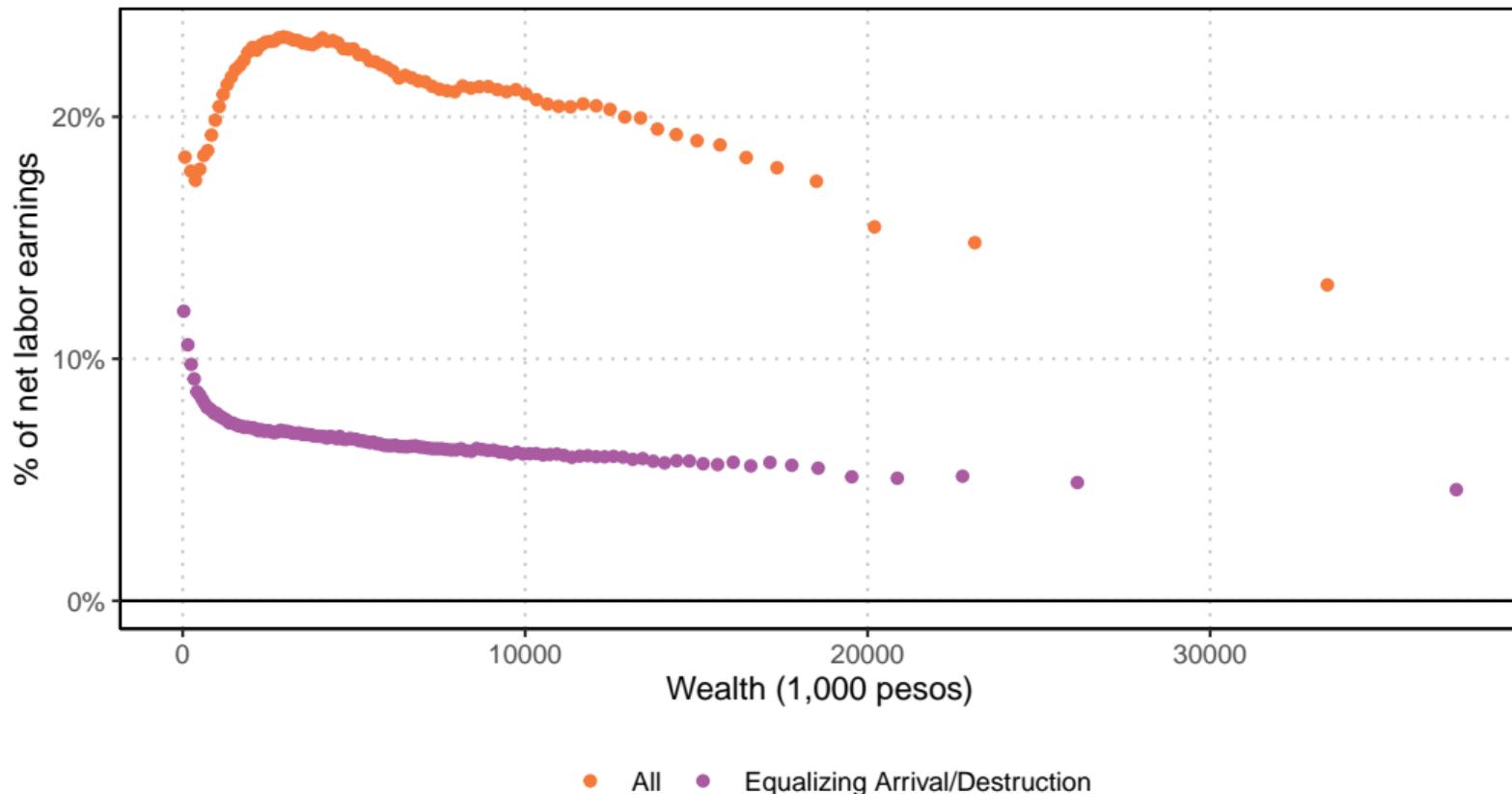
back



□ All □ Equalizing Arrival/Destruction

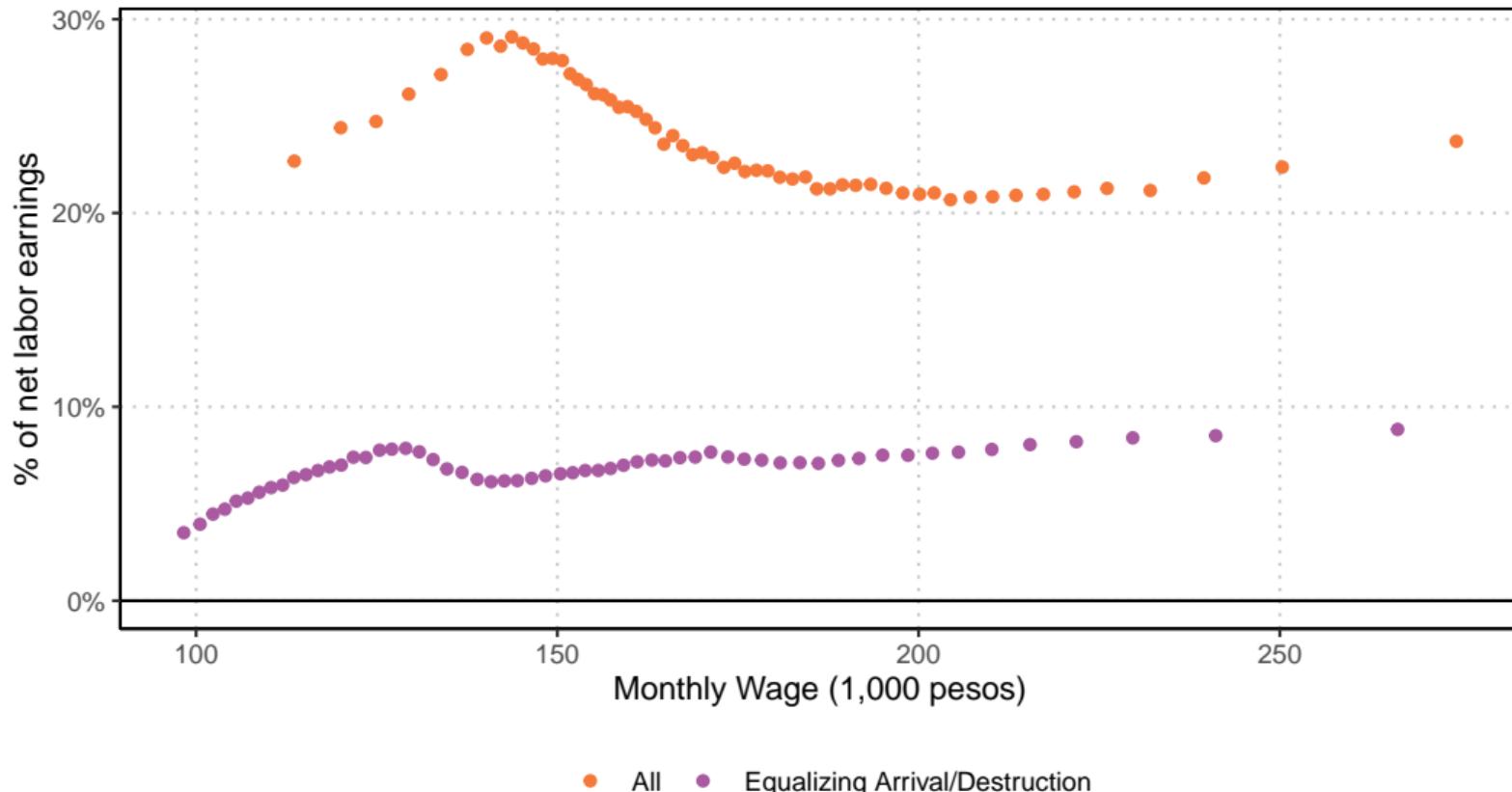
# Willingness to pay for a formal job – capital

back



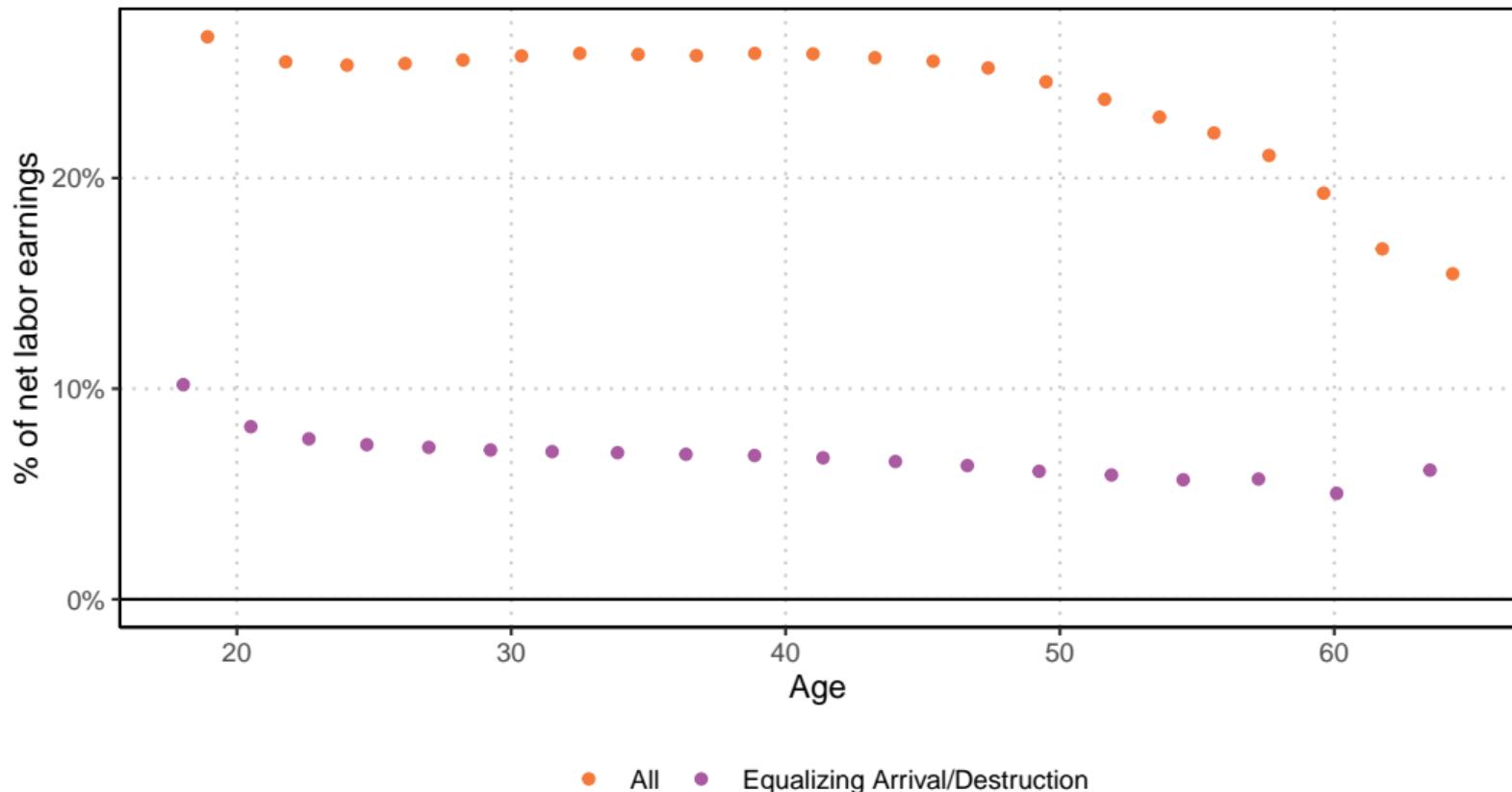
# Willingness to pay for a formal job – wages

back



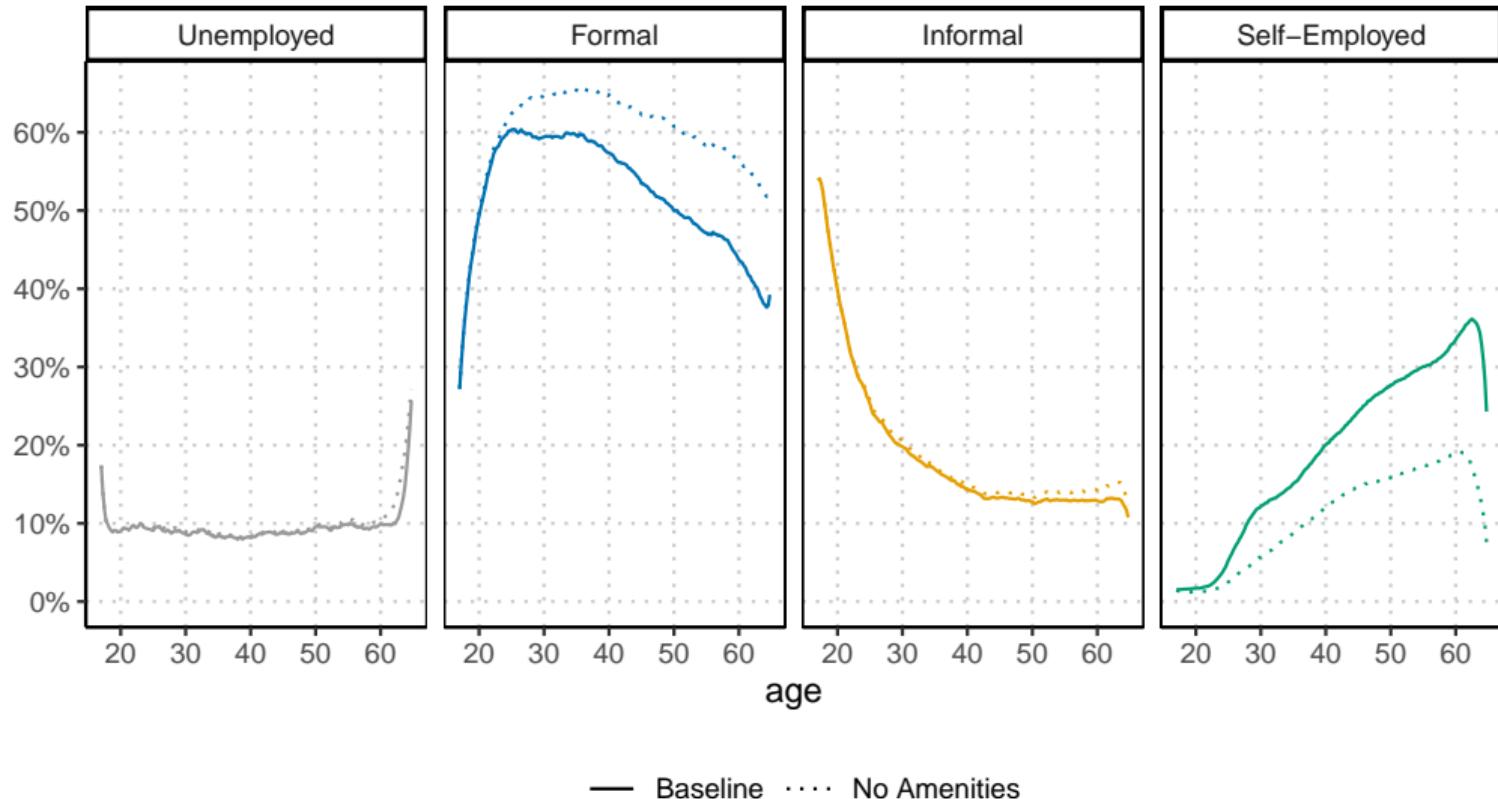
# Willingness to pay for a formal job – age

back



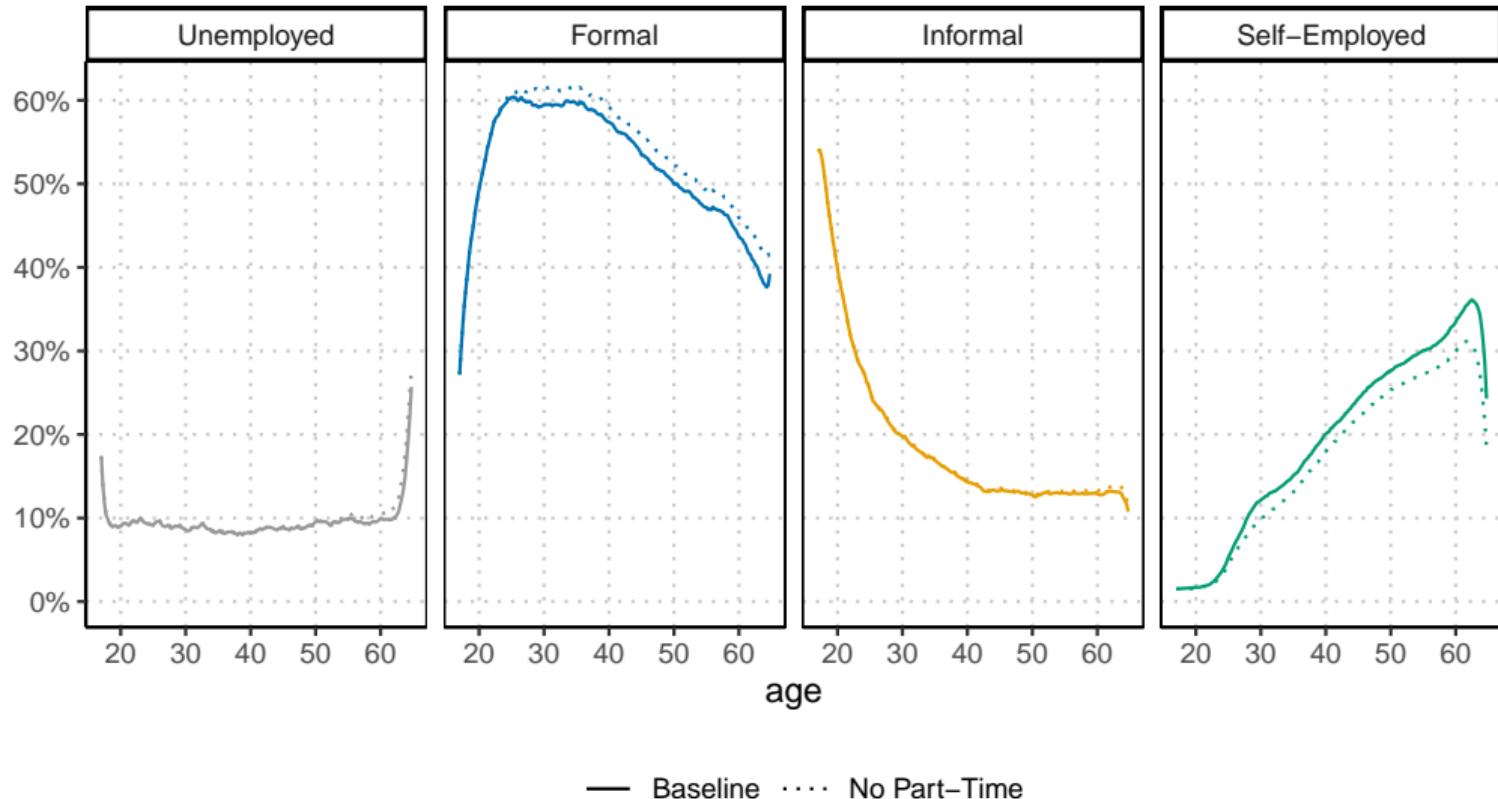
# No amenities

[back](#)



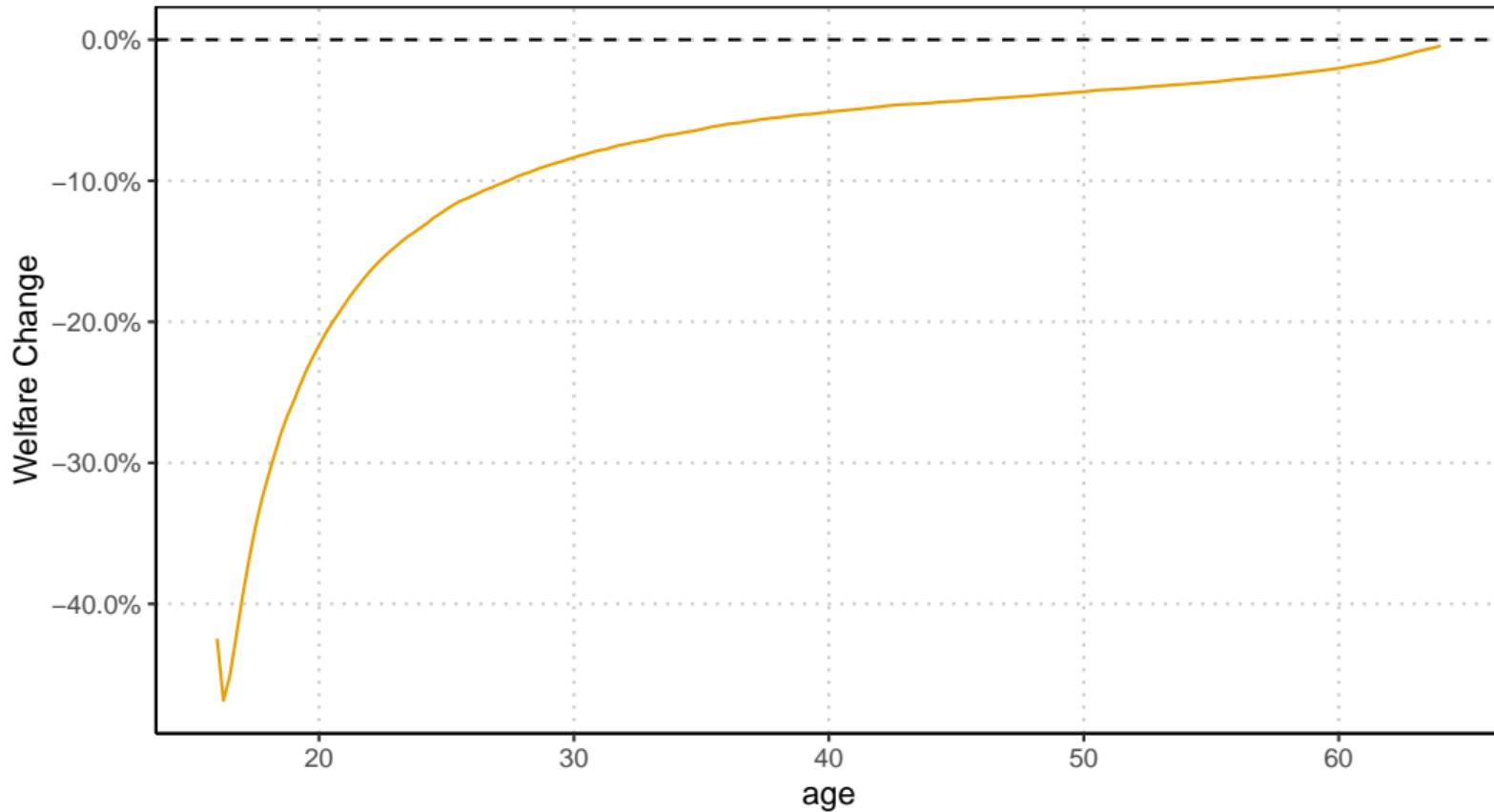
# No Part-time

[back](#)



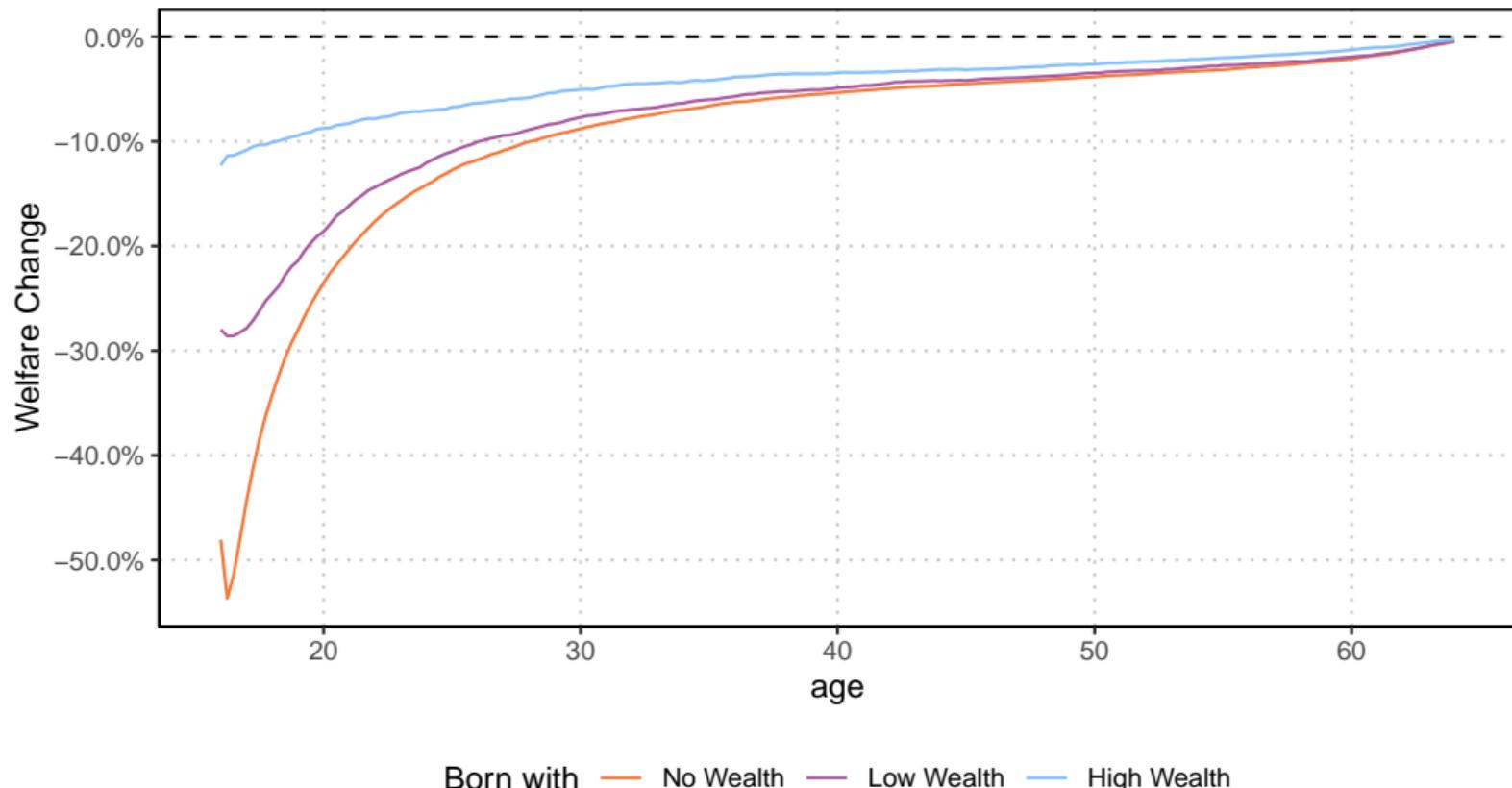
# Closing Informal Sector

[Back](#)



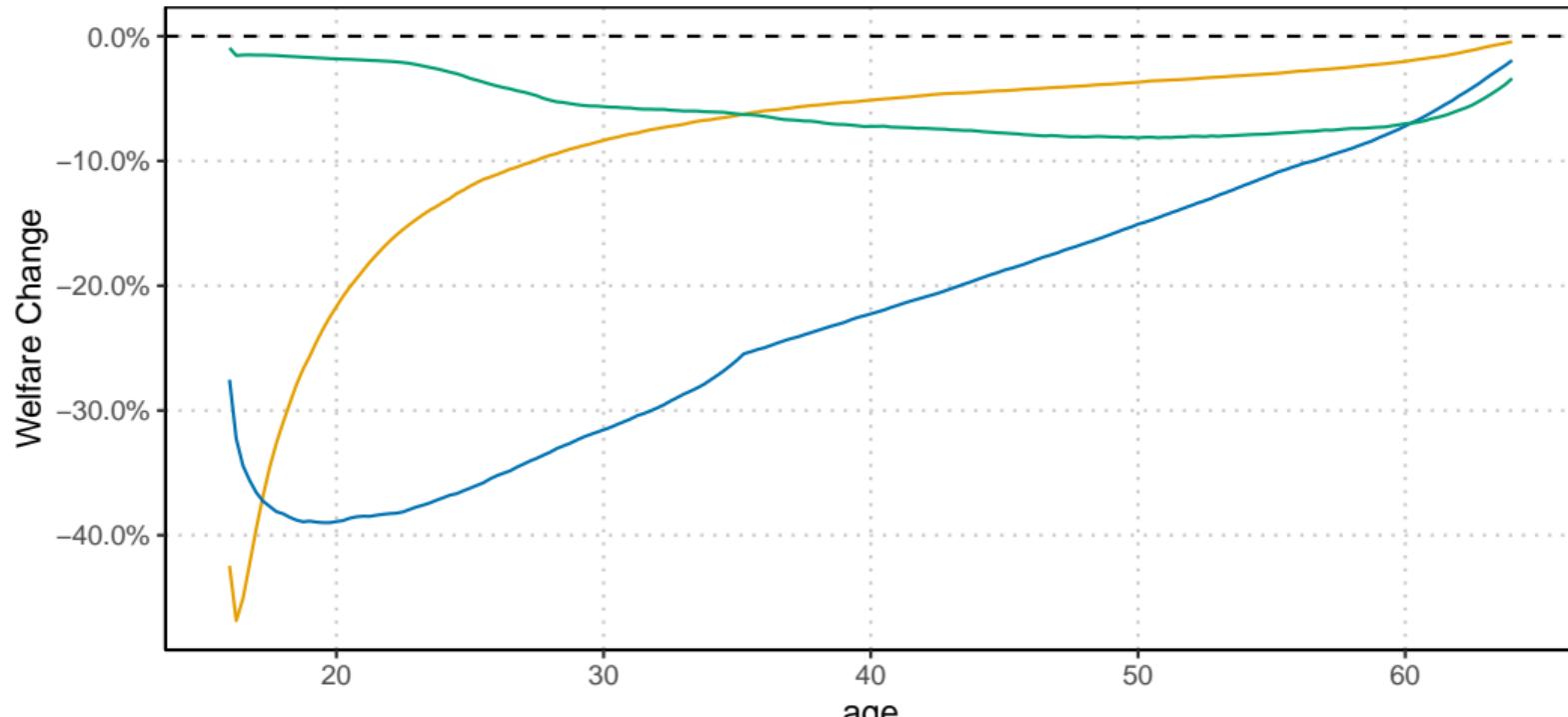
# Closing Informal Sector

Back



# Closing Informal Sector

[Back](#)

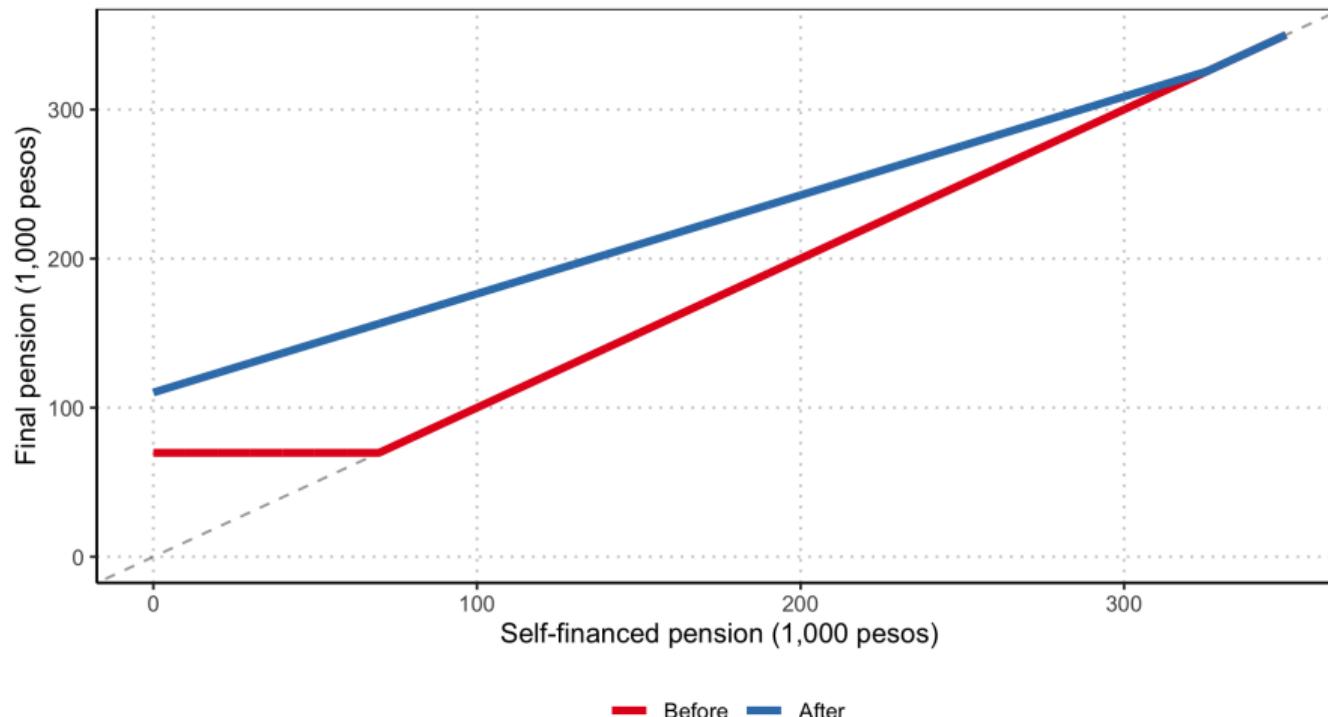


Sector — Informal — Formal — Self-Employment

# 2008 Pension Reform

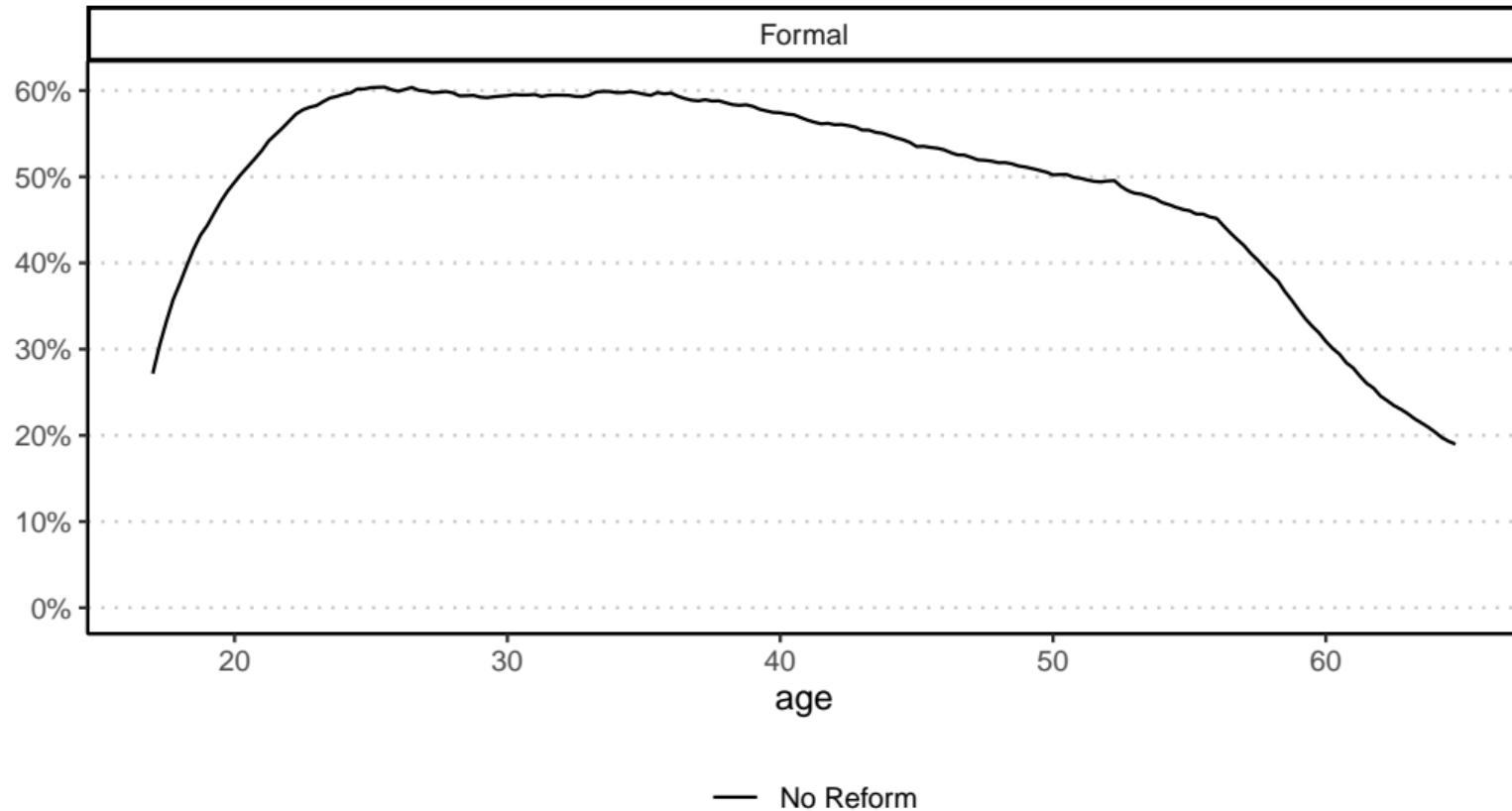
[Full BC](#)[Back](#)

- ▶ ↑ floor/bonus pension benefits
- ▶ ↑ requirements for early retirement



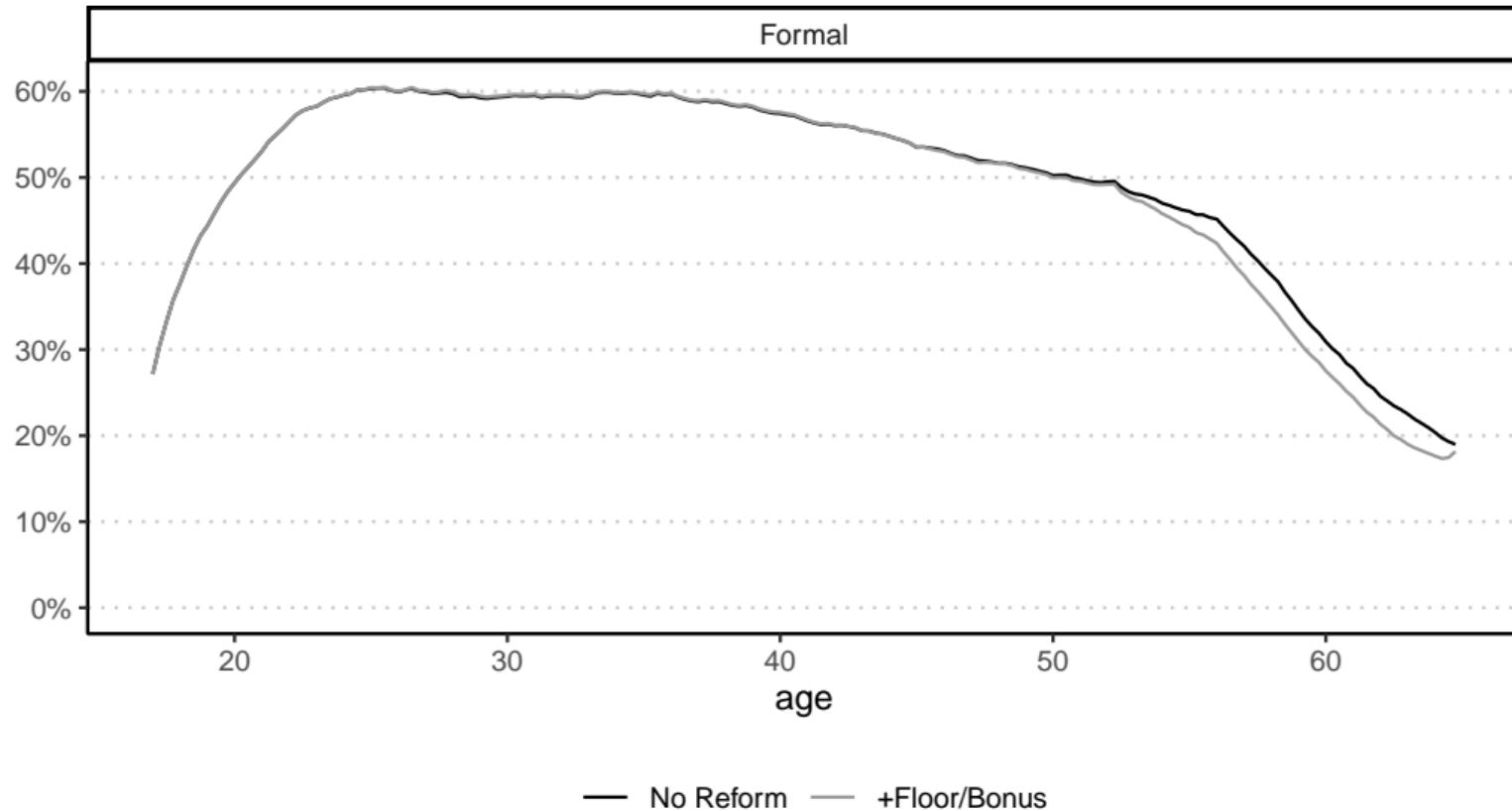
# Pension Reform

Back



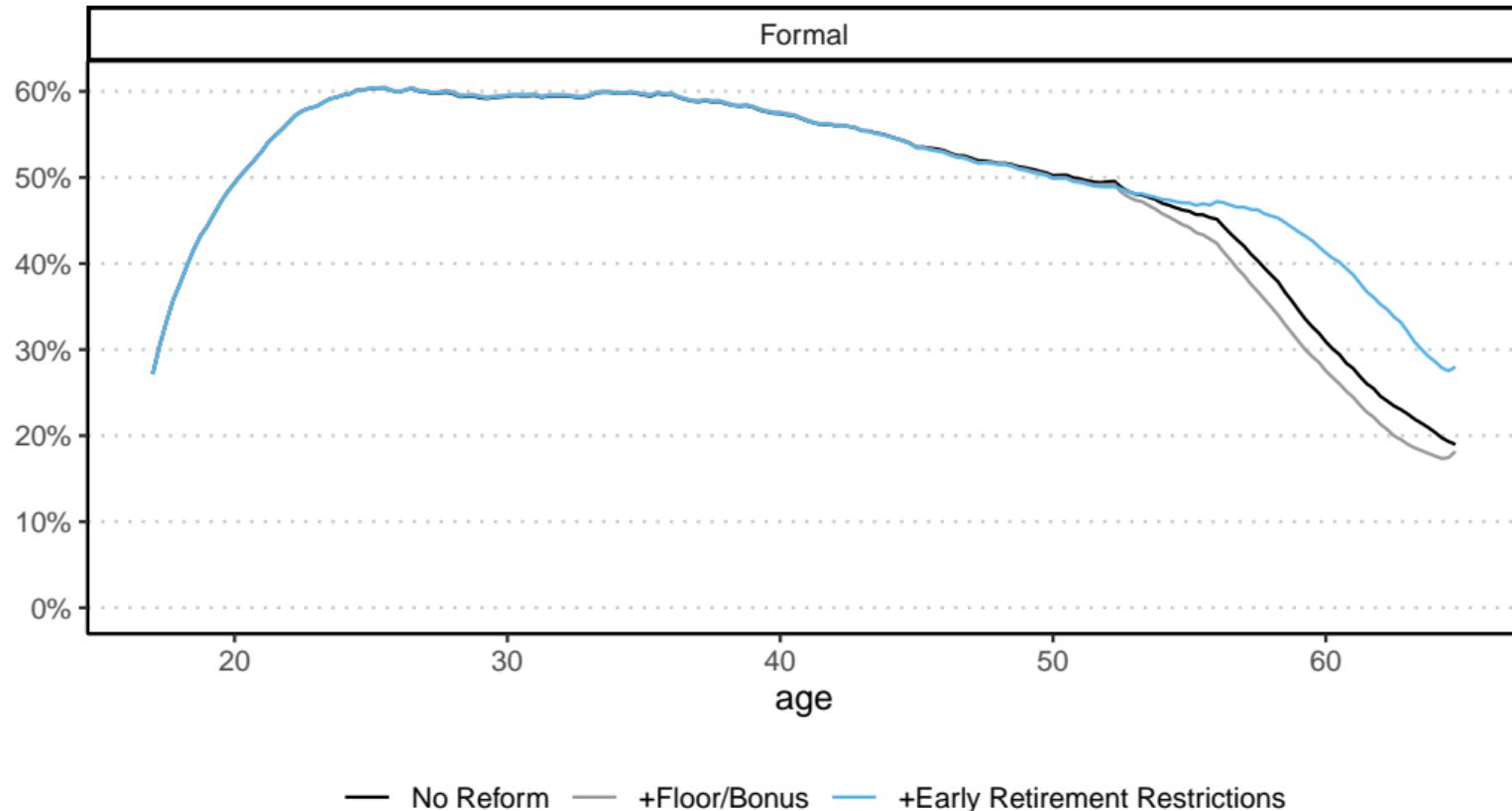
# Pension Reform

Back



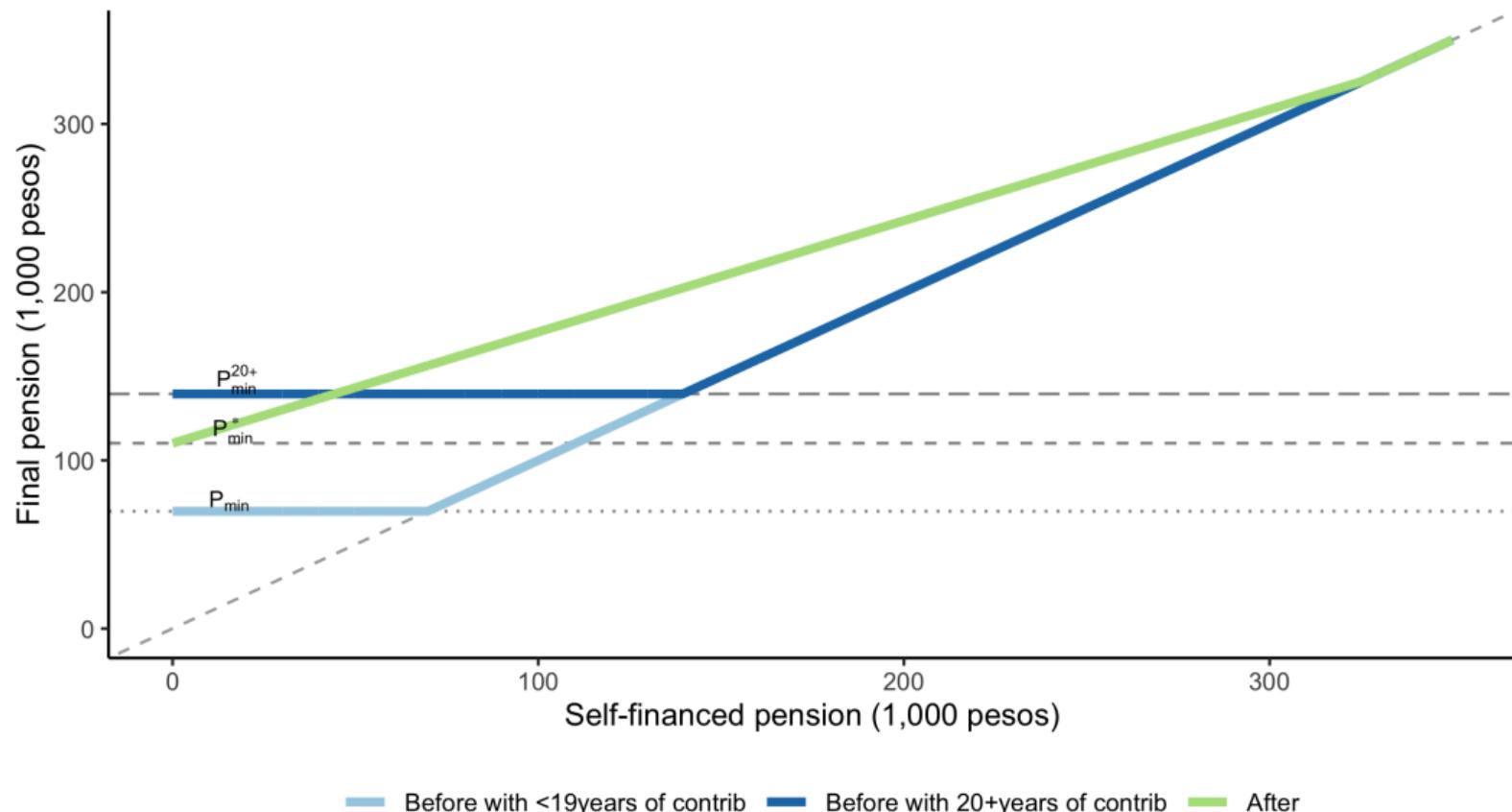
# Pension Reform

Back



## 2008 Reform - New Budget Constraint

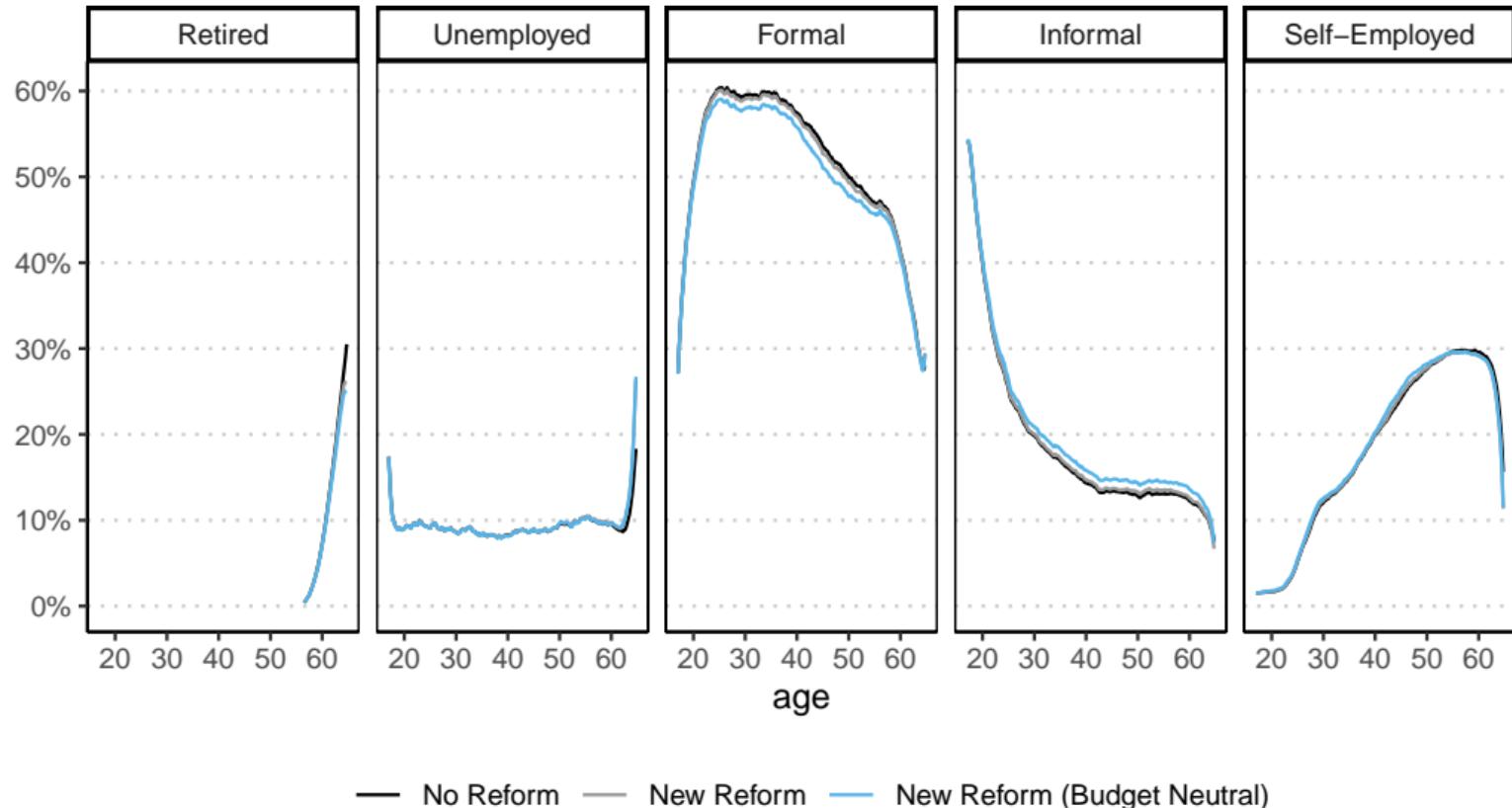
[Back](#)



- ▶ Several proposals including:
  - Raising the minimum pension (pension floor)
  - Increasing contribution rates
  - Individual & collective accounts
- ▶ Estimating raising the minimum pension floor to 125 thousand Chilean pesos

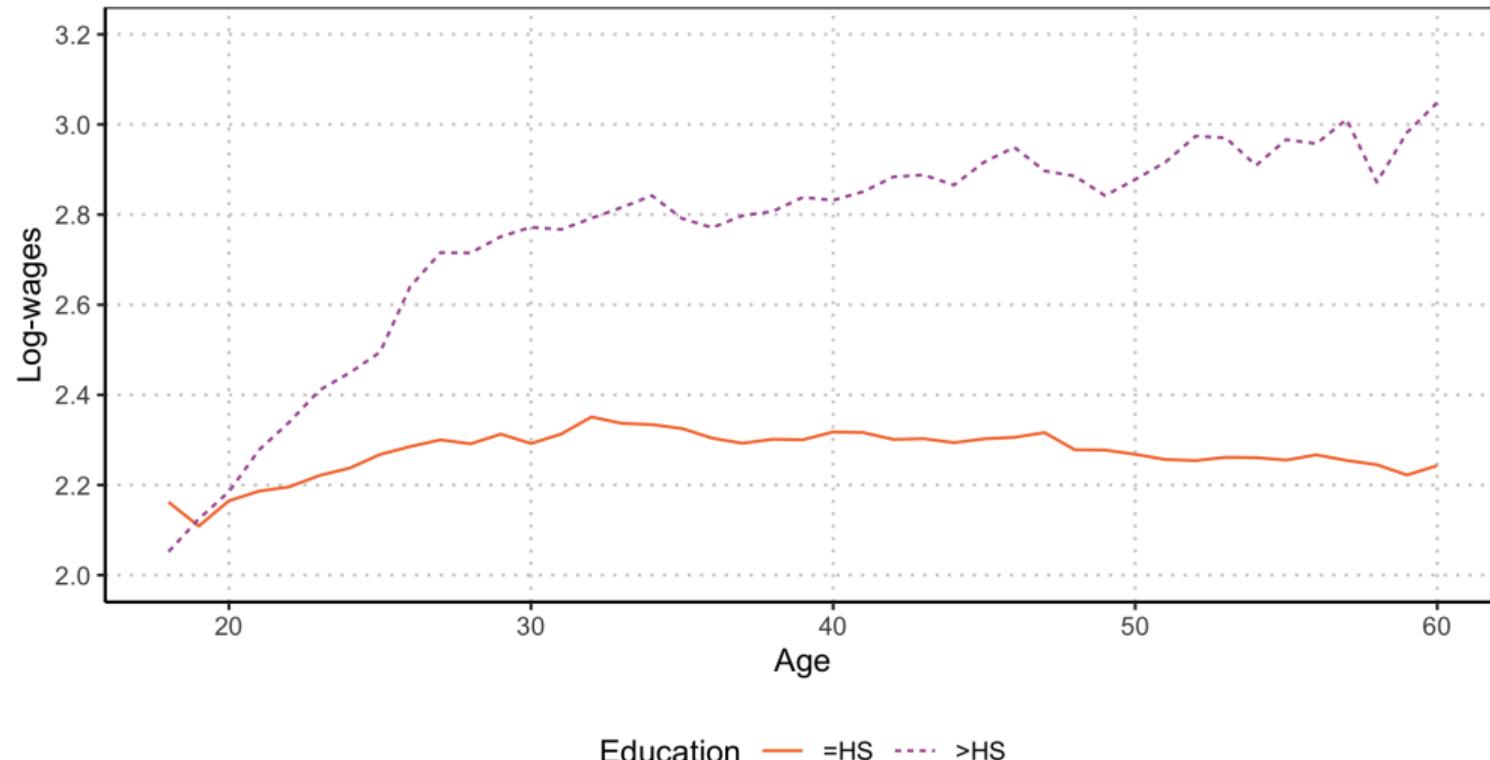
# Pension Reform: New

[Back](#)



Additional

# Modest wage growth for High School or less



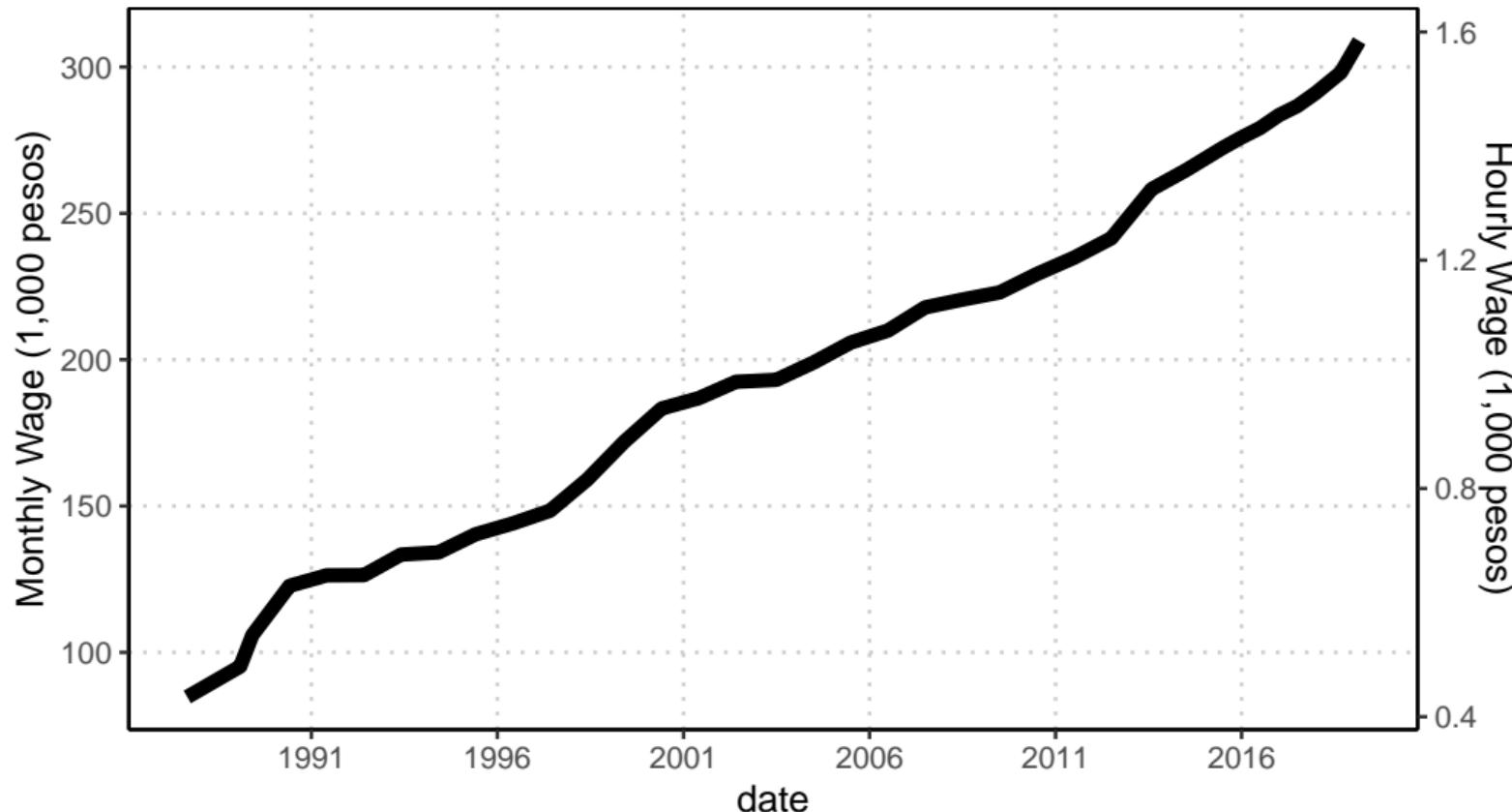
Log-Monthly Wages, for those working full time, de-trended using a linear trend.

# Modest wage growth for High School or less



Log-Monthly Wages, for those working full time, de-trended using a linear trend.

# Minimum Wage



## Spouses' working sector

Own sector ↓	Spouse's sector:				
	Out Labor Force	Unemployed	Formal	Informal	Self-Employed
Informal	-0.0026 (0.0227)	0.0419*** (0.0132)	-0.0429*** (0.0152)	0.0013 (0.0082)	0.0003 (0.0096)
Self-Employed	-0.0857*** (0.0218)	0.0114 (0.0095)	-0.0300** (0.0142)	-0.0051 (0.0071)	0.1068*** (0.0146)
Observations	2,771	2,771	2,771	2,771	2,771
Age FE	✓	✓	✓	✓	✓

# Family composition

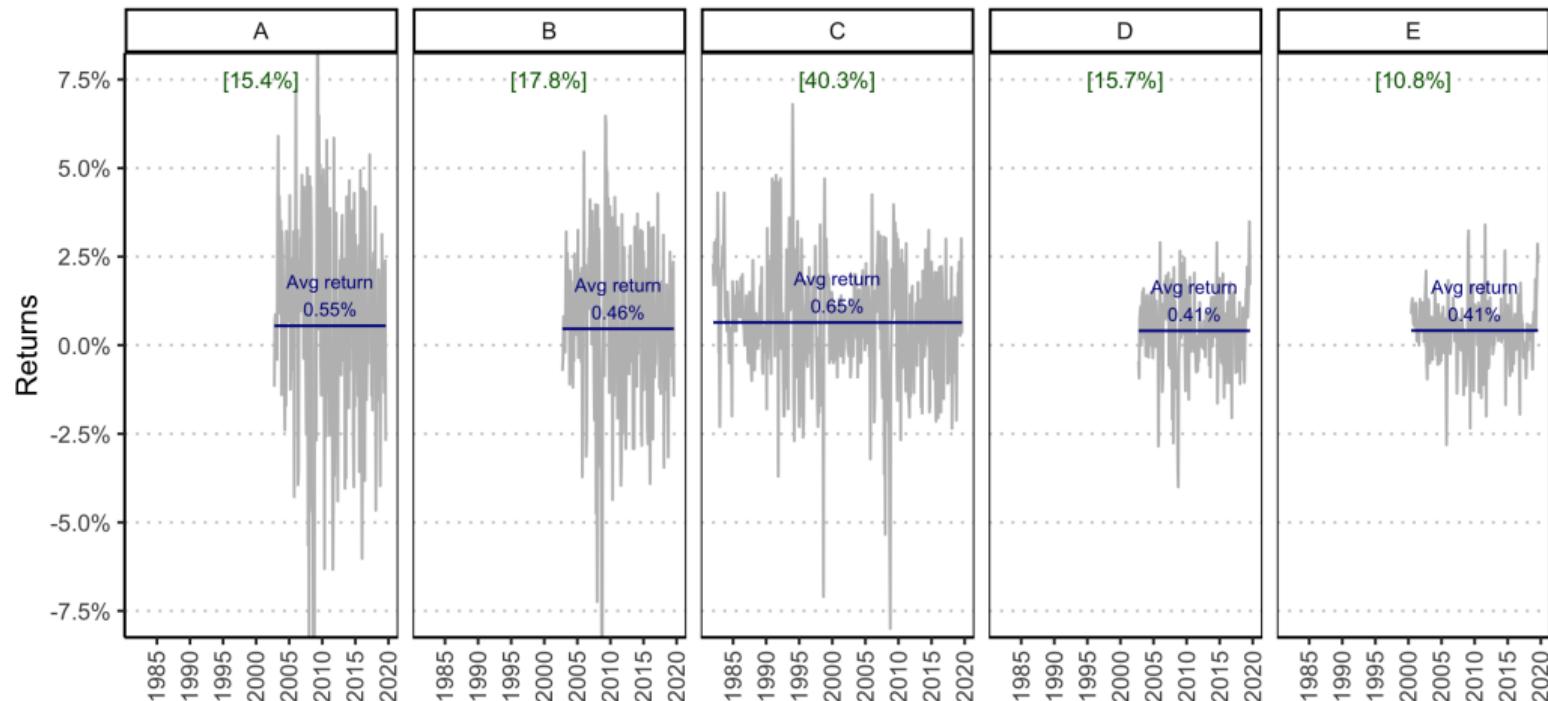
Sector:						
	Out Labor Force	Unemployed	Formal	Informal	Self-Employed	Retired
Married	-0.0473*** (0.0060)	-0.0289*** (0.0046)	0.0973*** (0.0092)	-0.0254*** (0.0056)	-0.0101 (0.0080)	0.0019 (0.0031)
Children 0–6	-0.0343*** (0.0053)	-0.0146** (0.0063)	0.0382*** (0.0124)	-0.0077 (0.0072)	0.0172* (0.0096)	-0.0083*** (0.0025)
Children 7–18	-0.0287*** (0.0053)	-0.0176*** (0.0051)	0.0377*** (0.0100)	-0.0025 (0.0058)	0.0104 (0.0081)	-0.0081*** (0.0026)
Observations	28,010	28,010	28,010	28,010	28,010	28,010
Age FE	✓	✓	✓	✓	✓	✓

# Pension returns risk

- ▶ Pension returns' risk:
  - Estimate an AR(1) model with the monthly pension returns
  - Simulate accrued pension wealth for a fixed wage profile
  - Ratio of 10%-90% is 2.56
  
- ▶ Longevity risk:
  - Mortality tables imply that the 10%-90% survival gap for those alive at age 50 is 26 years

# Pension returns risk

## Monthly Return by Pension Funds Risk



Note: HPA. A is the riskiest fund and E the safest one. The blue lines and blue numbers represent the average monthly return for each fund. The green numbers in brackets are the proportion of pension wealth allocated in each fund.

## Risk aversion and sector of employment

	Formal	Informal	Self-employed
(Intercept)	0.417 (0.006)	0.123 (0.004)	0.189 (0.005)
Risk 1	0.035 (0.017)	0.013 (0.012)	0.013 (0.014)
Risk 2	0.0007 (0.015)	-0.005 (0.010)	0.010 (0.012)
Risk 3	-0.041 (0.010)	0.008 (0.007)	0.054 (0.009)
Observations	15,885	15,885	15,885

# Reordering

# Main findings

1. Important drivers for the life-cycle allocation:
  - Savings influence job search (different reservation wages)
  - Amenities, physical capital and borrowing constraints

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  - Reform  $\rightarrow \Delta$  WTP  $\rightarrow \Delta$  prop Formal
4. Informal sector brings value
  - Welfare loss of 8.5% if access to the informal sector is cut
  - Particularly harmful to young/no-wealth workers ("insurance value")

# Literature

- A. Firms' and workers' formality decision
- B. Social Insurance and Informality
- C. Self-employment in developing countries

# Literature

## A. Firms' and workers' formality decision

??????????????????

Risk-aversion, savings, and social insurance  $\Rightarrow$  Insurance Values

Savings  $\Rightarrow$   $\left\{ \begin{array}{l} \text{job search behavior} \\ \text{self-employment investment} \end{array} \right.$

- B. Social Insurance and Informality
- C. Self-employment in developing countries

# Literature

A. Firms' and workers' formality decision

B. Social Insurance and Informality

[Unemployment Insurance] ????????

[Health Insurance] ??

[Minimum Wage] ???

[Pensions] ??????????

Causal effects of early retirement restrictions

Dynamic model combining main social insurance programs

C. Self-employment in developing countries

# Literature

- A. Firms' and workers' formality decision
- B. Social Insurance and Informality
- C. Self-employment in developing countries

?????

Importance of start-up costs, borrowing constraints, and amenities

## 1. Unemployment Insurance

- 3% of wages:  
$$\underbrace{(\text{individual account})}_{\text{forced savings}} + \underbrace{(\text{collective account})}_{\text{insurance/redistribution}}$$
- Withdrawal schedule (50%,45%,40%,...)
- Limit of 5 months from the collective account

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- Minimum pension policies
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# Empirical Findings

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1. Early retirement restrictions were raised in 2004 for those born after August 1949 [more](#)

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3. Self-employment

- Part-time work and flexible work locations [Hours](#) [Workplace](#)
- Entry associated with investments in physical capital [Regression](#)
- Use own savings [Source of Capital](#)

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⇒ Model estimation

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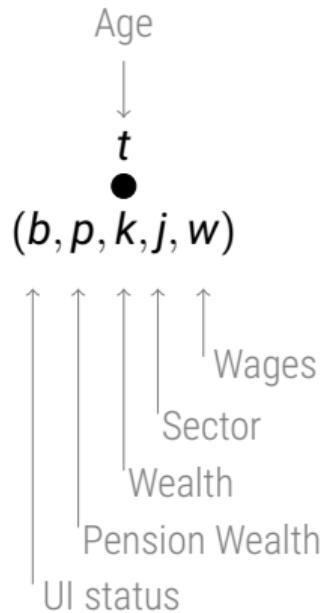
⇒ Modeling choices

3. Self-employment

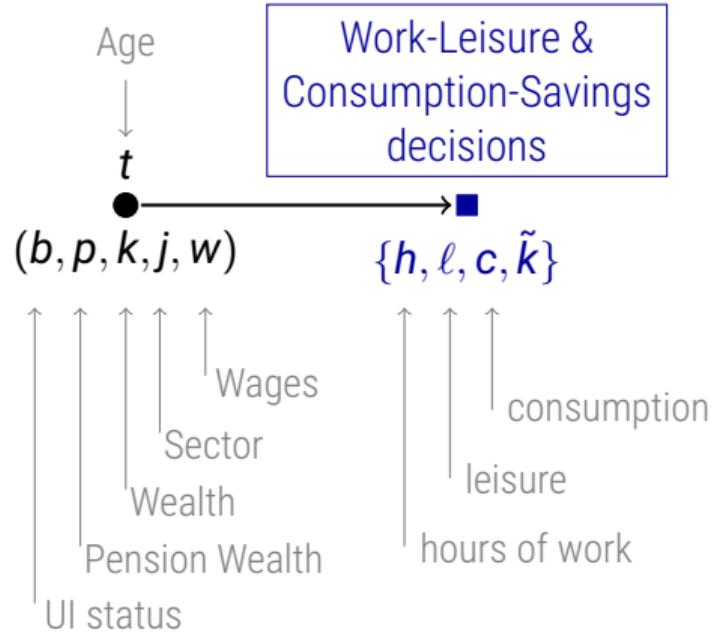
- Part-time work and flexible work locations [Hours](#) [Workplace](#)
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⇒ Modeling choices

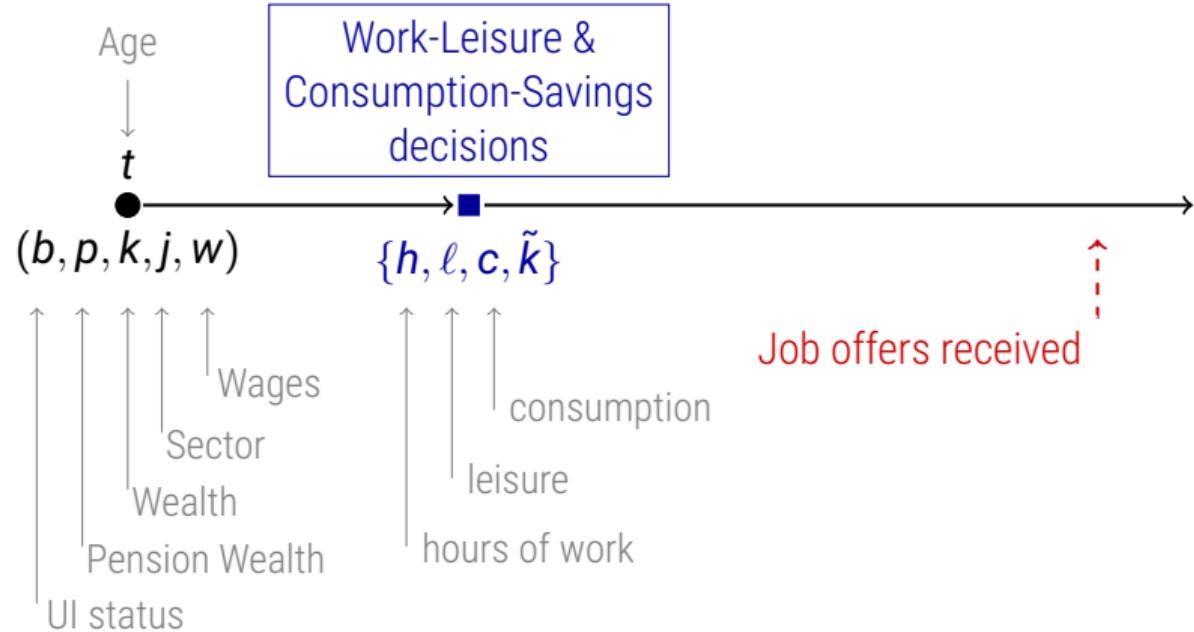
# Model



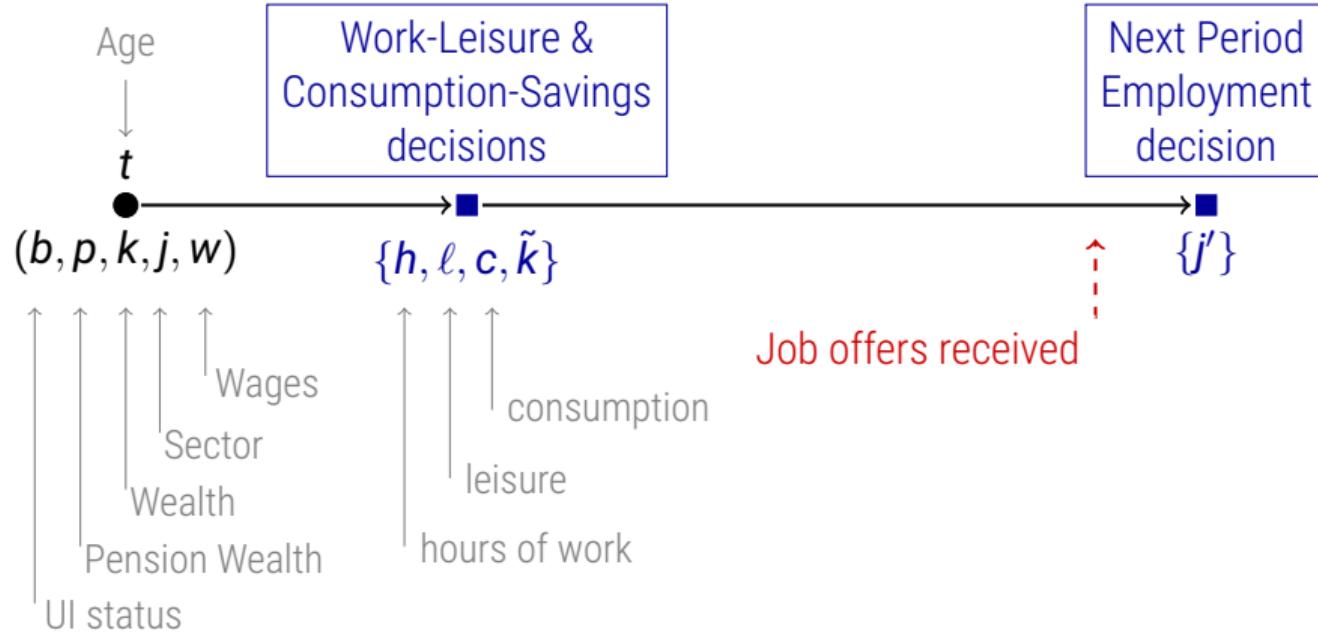
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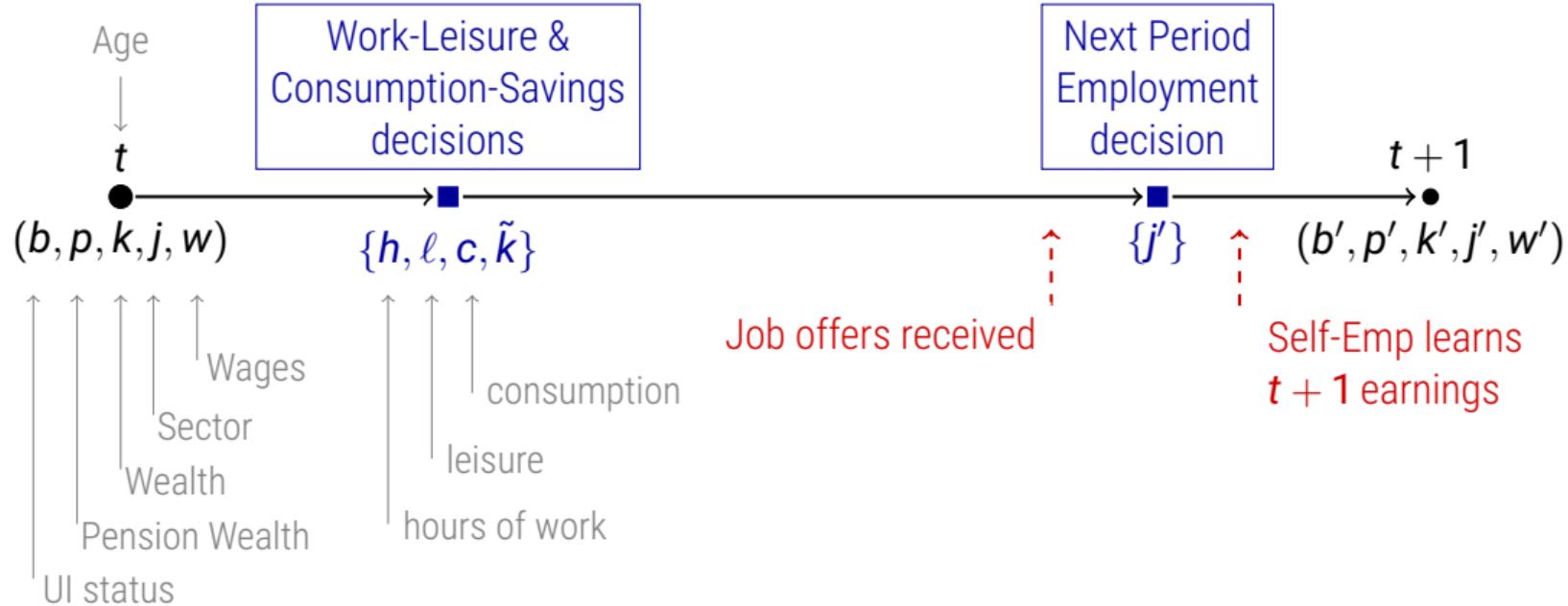
# Model



# Model



# Model



# Model



# Consumption/savings choice

$$V_t(\chi) = \max_{\substack{h, \ell, c, \tilde{k} \\ \text{state space}}} \left\{ \frac{\phi_j(c^\nu \ell^{1-\nu})^{1-\gamma}}{1-\gamma} + \beta \underbrace{\mathbb{E}}_{\downarrow} [V_{t+1}(\chi')] \right\}$$

Job Destruction, Arrival Offers, Self-Emp Earnings, Survival,...

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(budget constraint)

$$c + \tilde{k} = (1 + r)k + y^j \left( \begin{array}{c} wh \\ \uparrow \\ \text{labor earnings} \end{array} \right)$$

(leisure)

$$\ell = \overline{L} - h \left( \begin{array}{c} \uparrow \\ \text{stock of hours} \end{array} \right)$$

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$\phi_j$ : amenities from each sector

# Model



# Employment choice

Formal

*Legend*

- random
- choice if offered
- choice

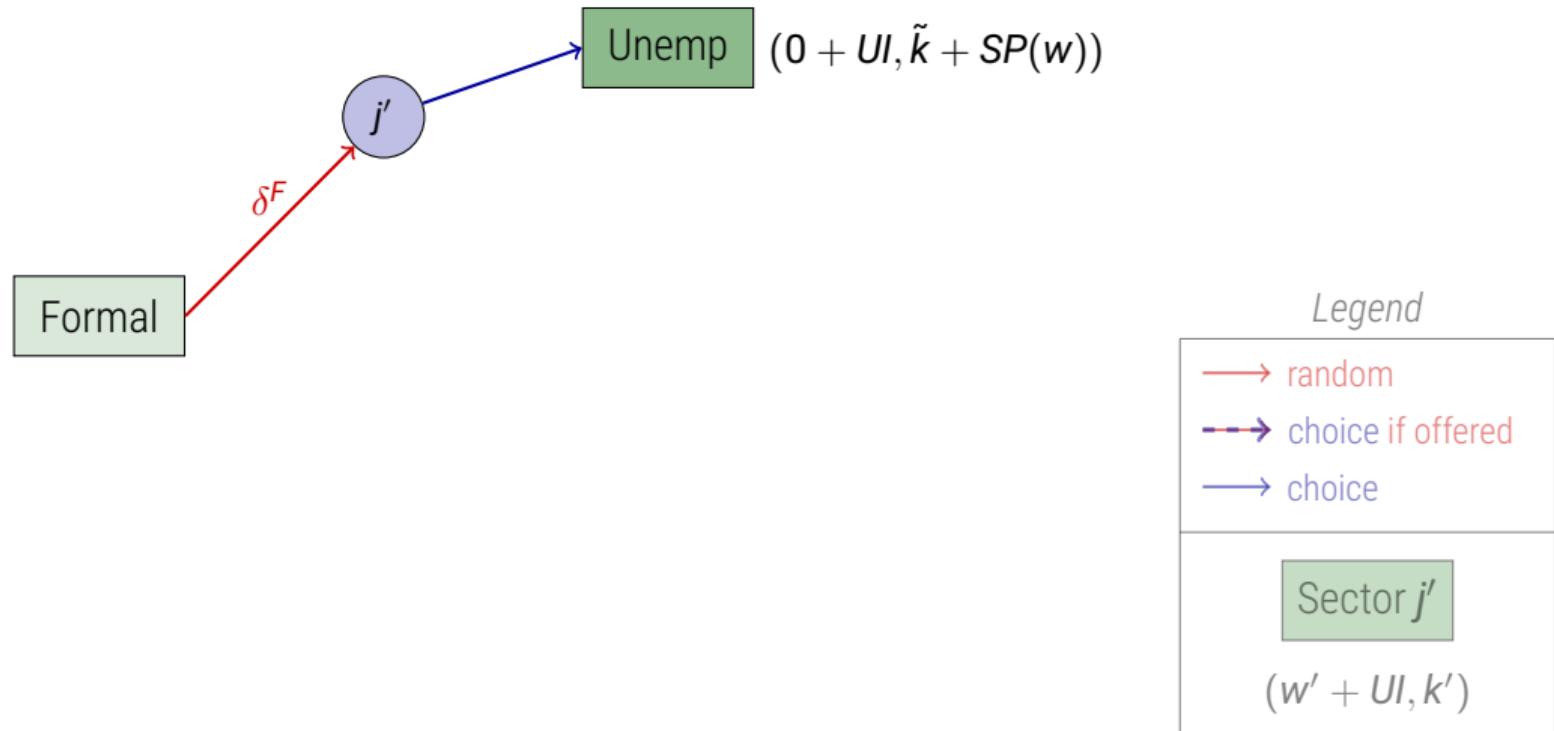
Sector  $j'$

$(w' + UI, k')$

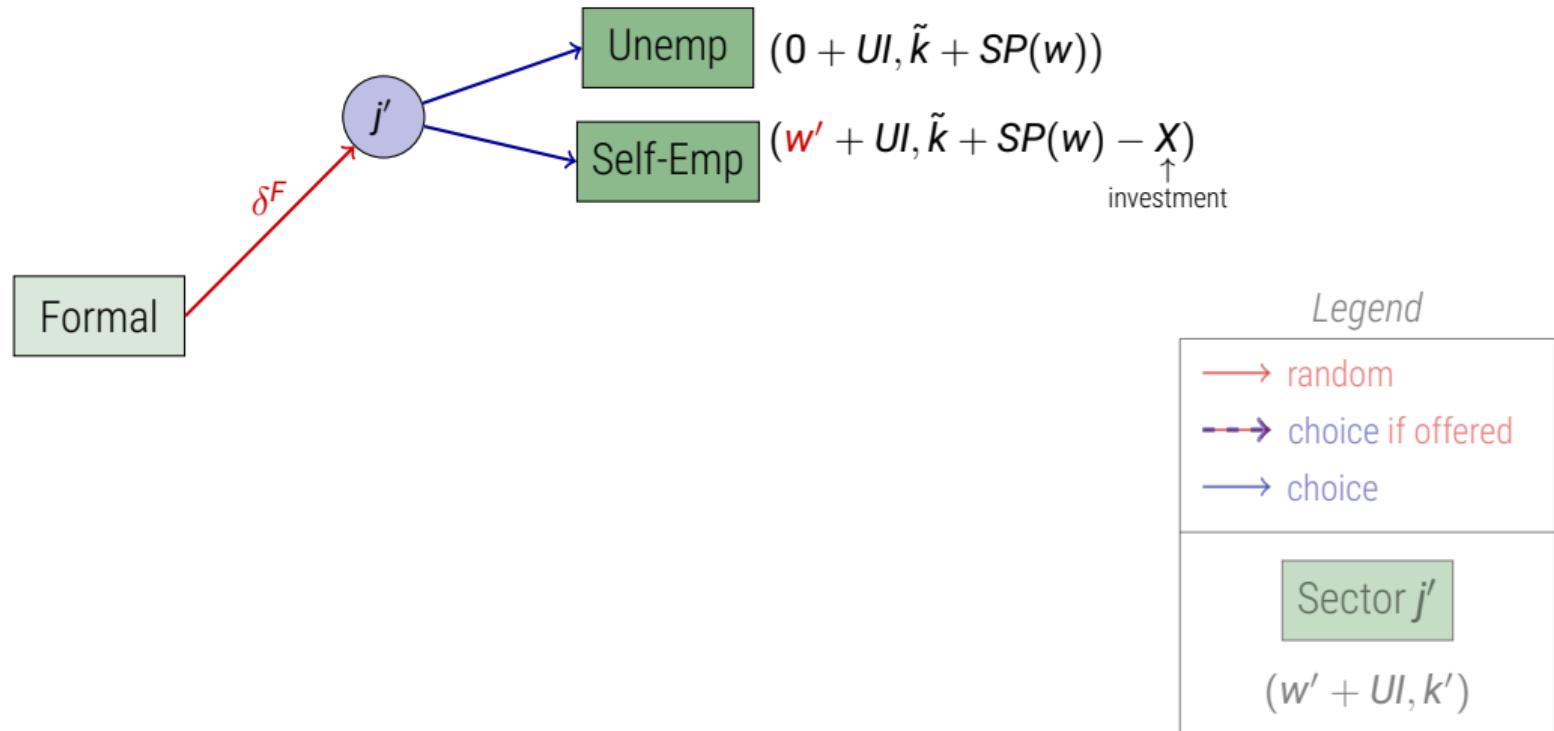
# Employment choice



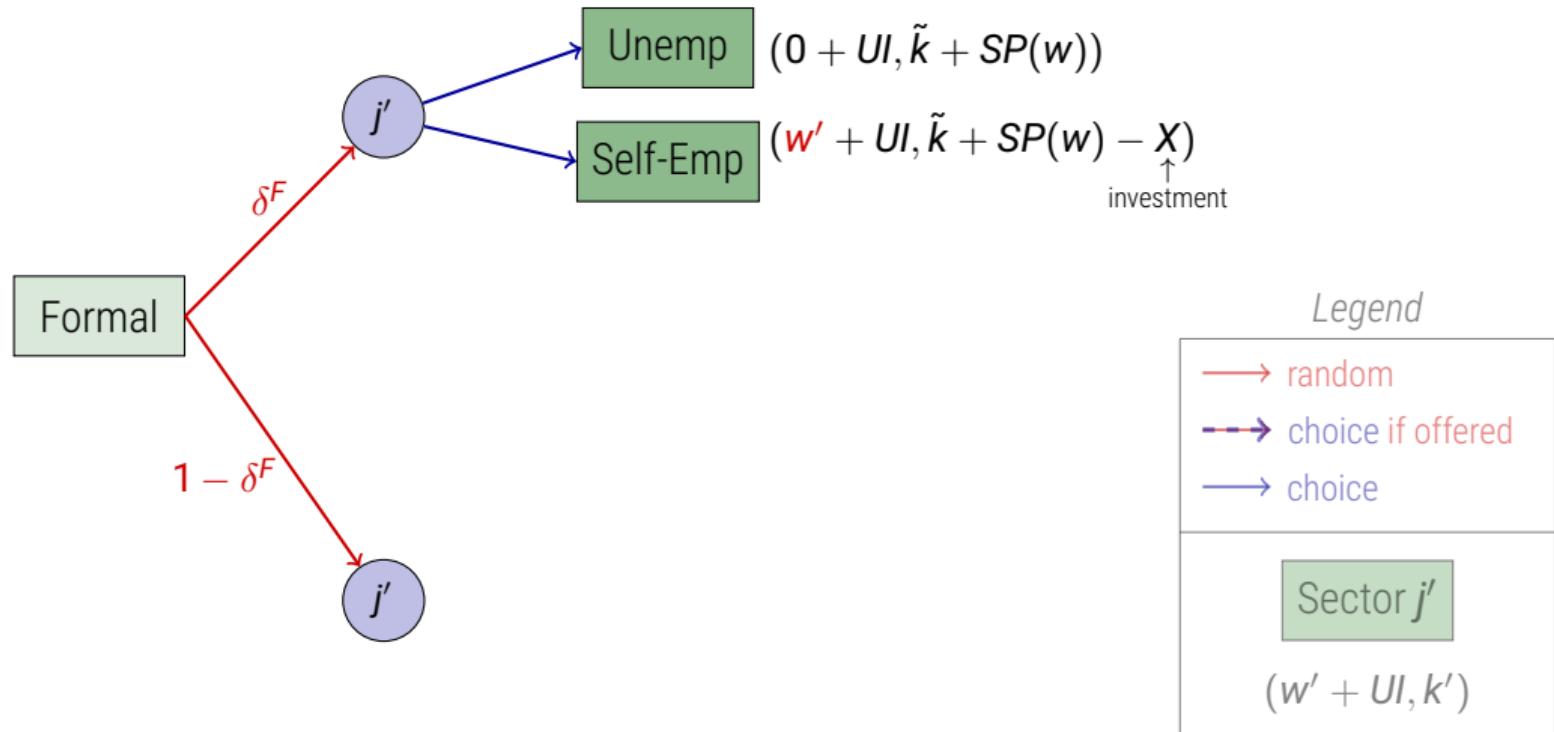
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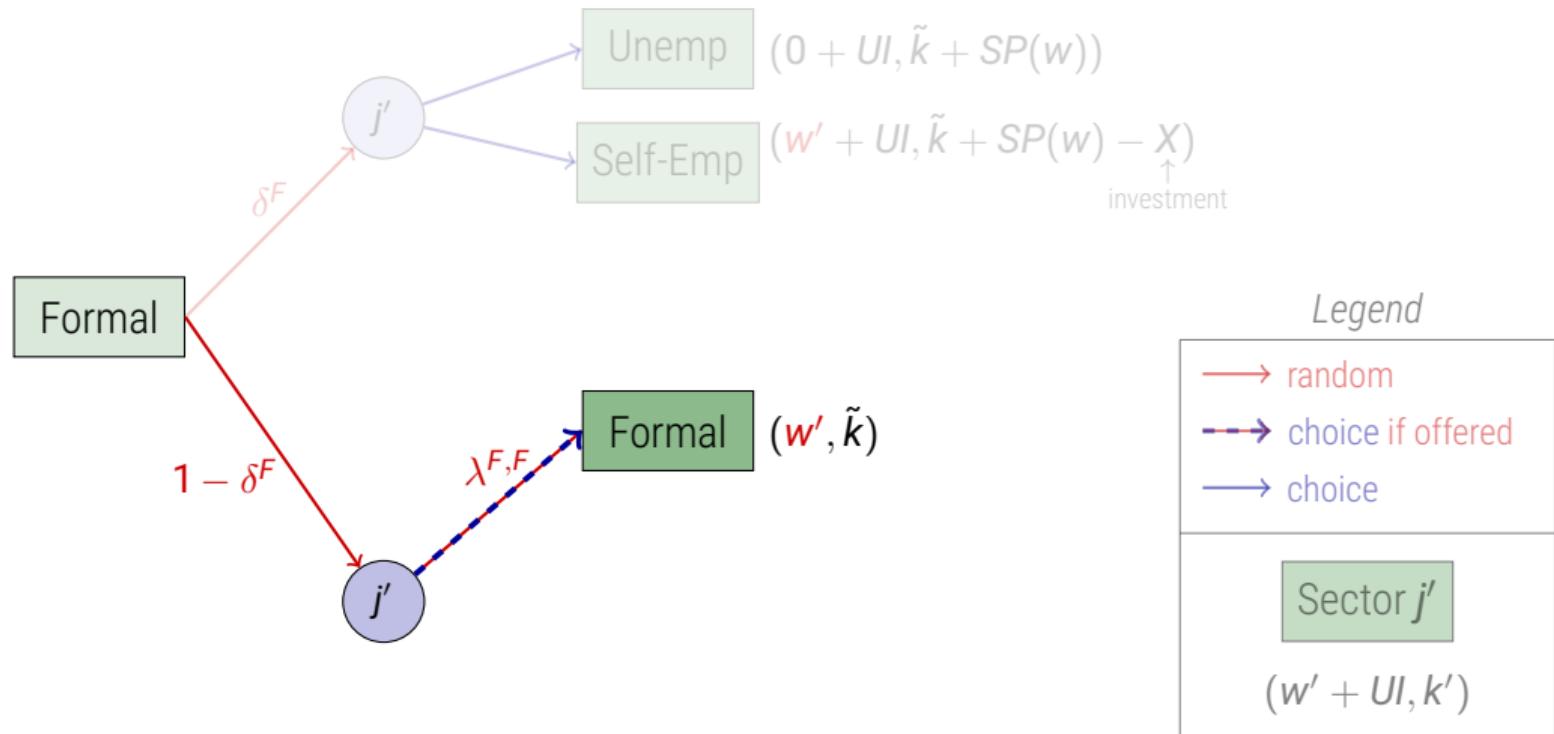
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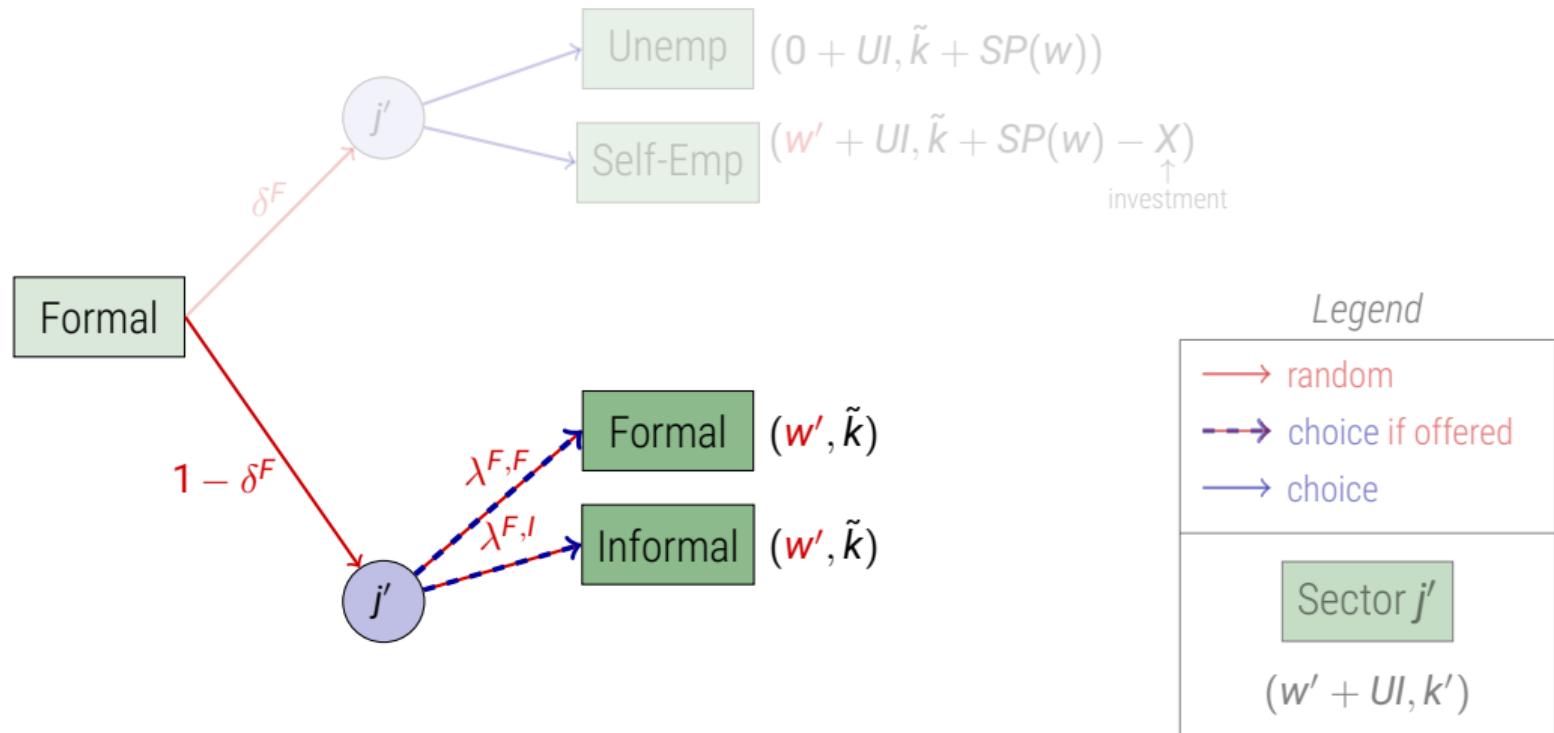
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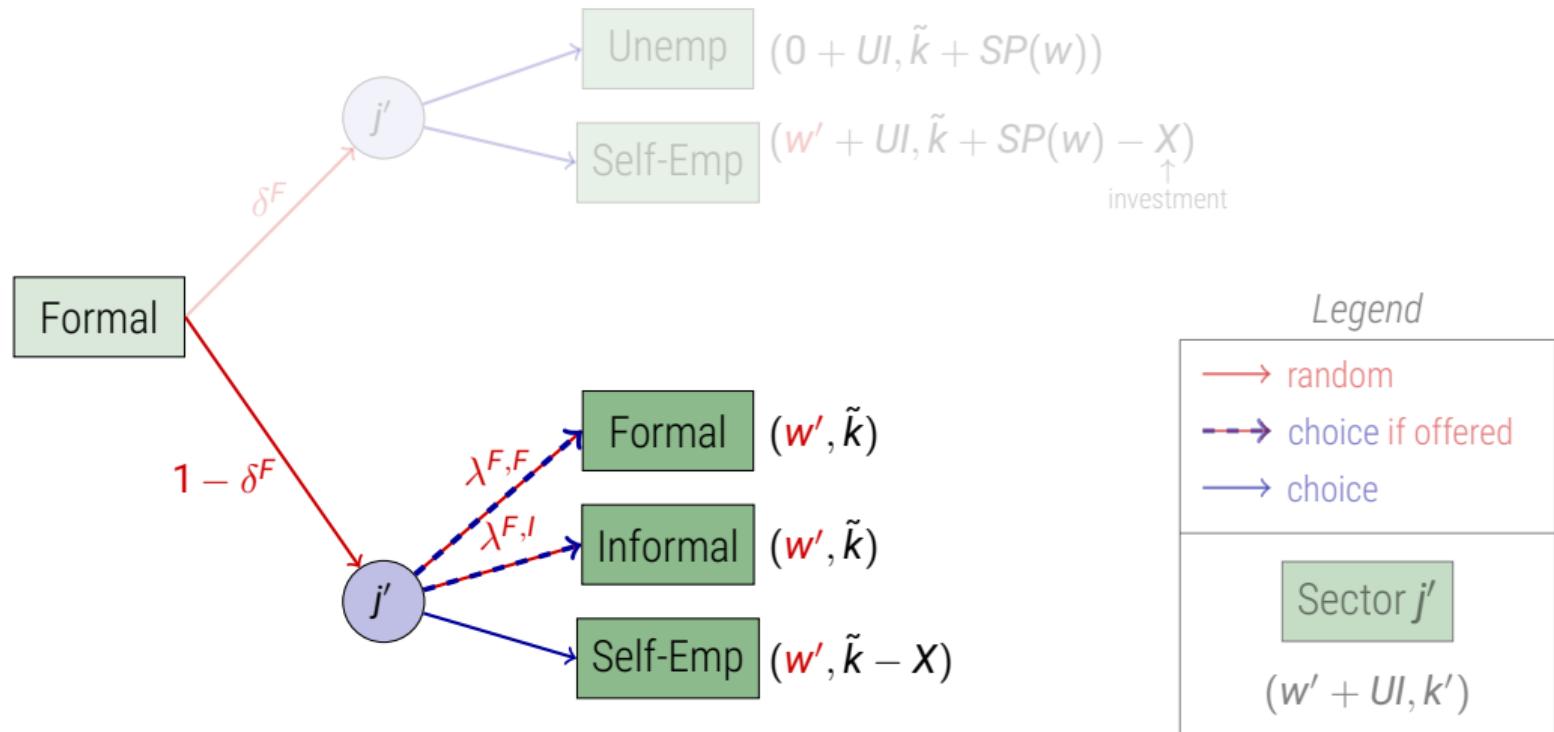
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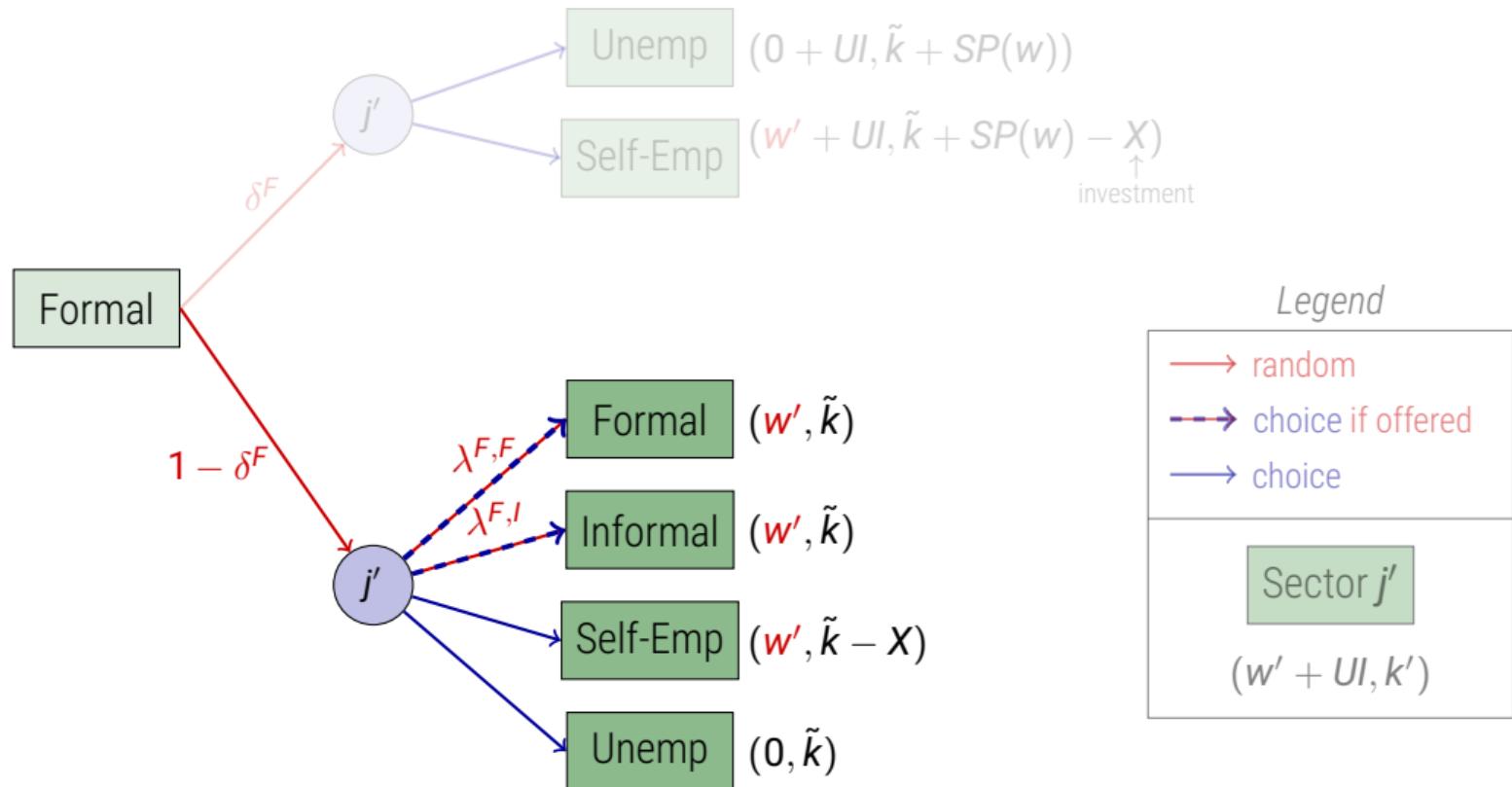
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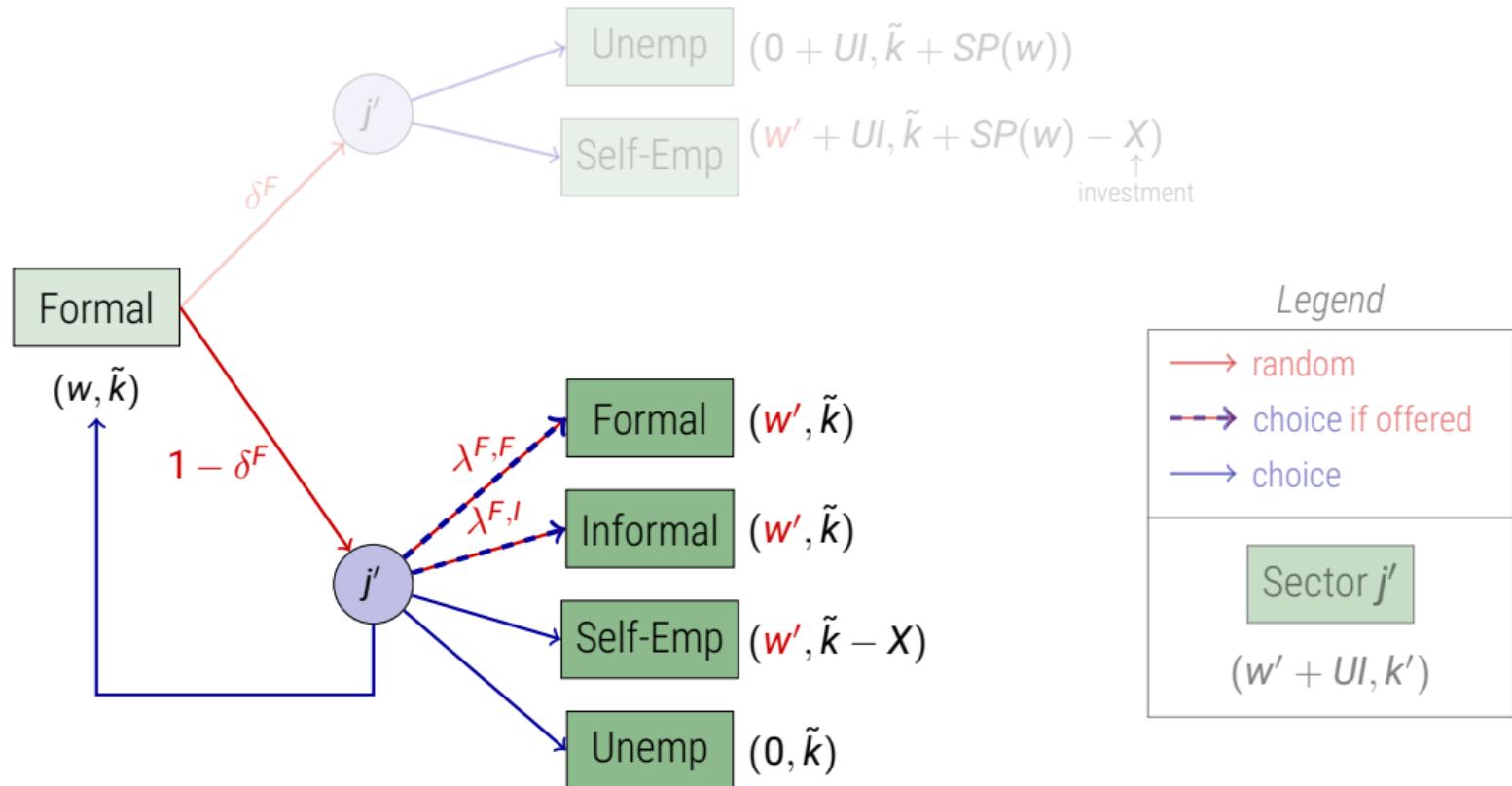
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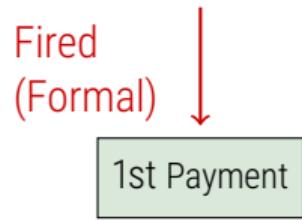
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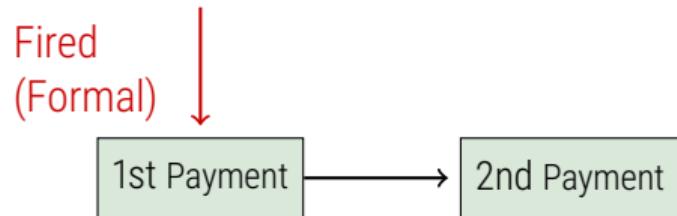
# Model



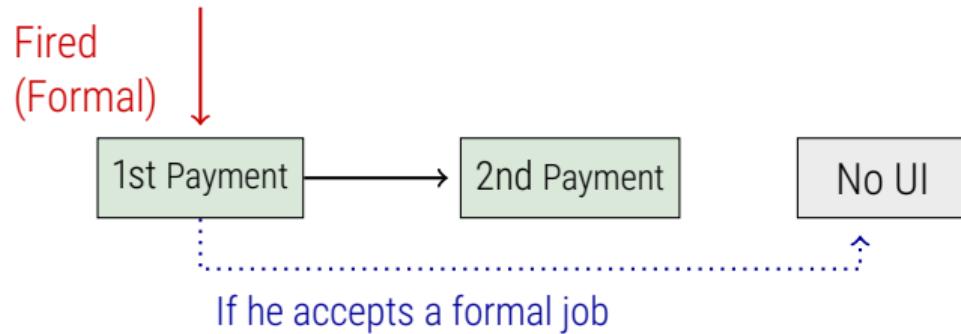
# Unemployment insurance



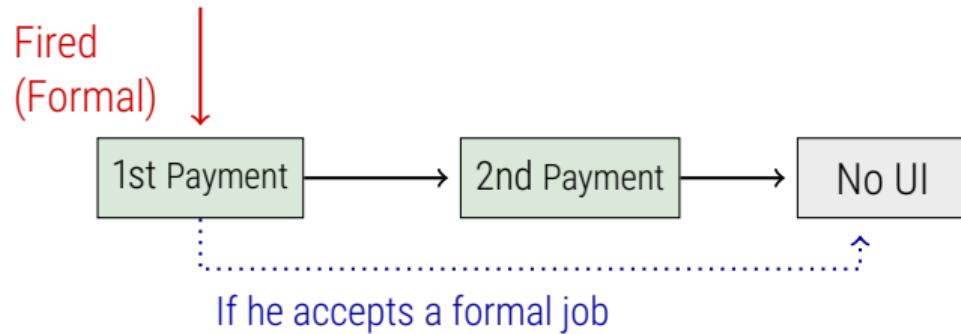
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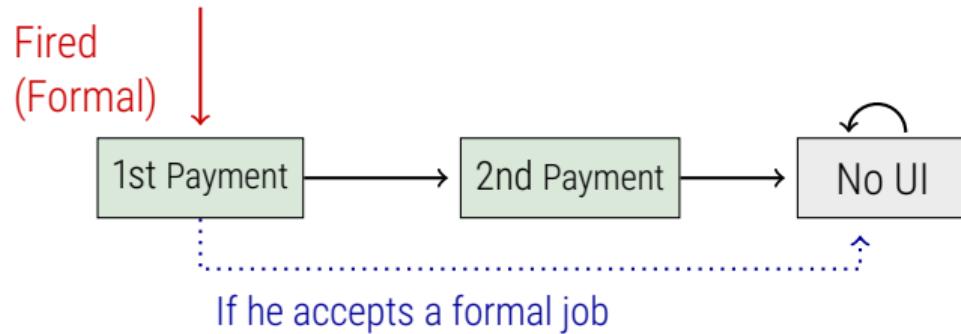
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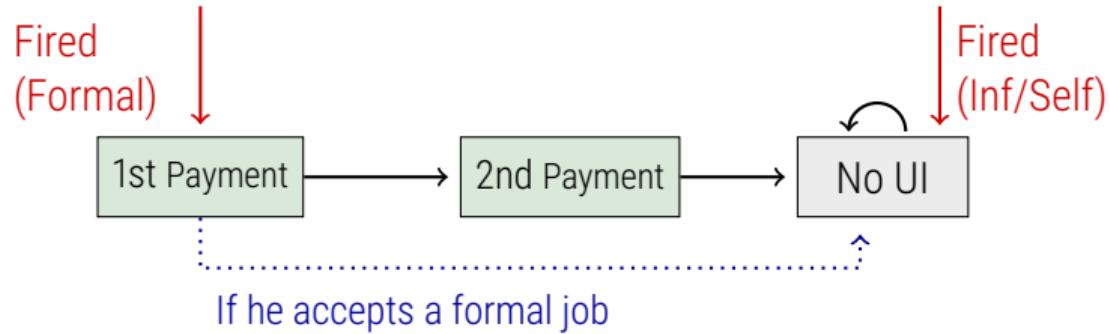
# Unemployment insurance



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# The pension system

Pension wealth

$$p' = p(1 + r^P) + \begin{cases} 0.10w & \text{if formal} \\ 0 & \text{otherwise} \end{cases}$$

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- ▶ Pension benefits:  $y^R(t_R, p)$
- ▶ Early retirement is possible if  $y^R(t_R, p) \geq \max\{A, \alpha\bar{w}\}$
- ▶ Bequeath remaining wealth

$$B(k) = \psi \left[ \frac{(\bar{K} + k)^{\nu(1-\gamma)}}{1 - \gamma} \right]$$

# Types

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  - **Ability**: general and entrepreneurial ability
    - $(g, e)$
    - Affect earnings
- ▶ Three dimensions are independent

# Estimation

## 1. Set and estimate some parameters outside the model

- Set coefficient of risk aversion:  $\gamma = 3$   
????
- Estimate interest rate:  $r = 4.5\%$  and  $r^P = 5.8\%$
- Estimate Self-Employment earnings persistence:  $\rho = 0.68$  (annually)
- Policy values for social insurance, welfare programs and taxes

## 2. Estimate remaining parameters using SMM

[more](#)

### Preferences

- Discount factor
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- Wage offer distributions and Self-Employment earnings
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### ► Choose set of moments related to these parameters

[Moments](#)

# Wages

## ► Average Wages

Sector	Hourly	(%)	Monthly	(%)
Formal	0.897	(100.0%)	174.823	(100.0%)
Informal	0.631	(70.3%)	123.125	(70.4%)
Self-Employed	0.724	(80.7%)	133.001	(76.1%)

- Self-employment start-up cost: 2787.3 (~ 20 monthly earnings)  
50% can be recouped

# Ability types

- ▶ Sub-types ( $g, e$ )

Type 1: (1.000, 0.000)

Type 2: (0.598, 0.647)