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This paper analyzes efficiency in an economy with an informal sector that consists of unregulated self-employment, and where there are no costs of being informal, (Albrecht et al. (2009)). First, assuming workers in the formal sector are ex-ante heterogeneous, I show that this type of economy is inefficient. Second, I identify the optimal policies the government can implement, where the informal sector is unobserved (or search effort is unobserved). Allowing the government to use different policies such as social security payment, severance payment, formal tax, and job creation subsidy, I show that the government cannot affect worker's behavior by using severance and social security payments because of the risk neutrality assumption (Lazear (1990)). However, it can achieve an efficient allocation through

a tax-credit policy. This result is interesting since it can guide the way in which social security programs can be implemented in developing countries, where in general social protection programs are assumed to subsidize informal activities.