

# Financing Durable Assets

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## Abstract

This paper studies the financing of durable assets in a model with collateral constraints due to limited enforcement. Durability affects the ease of financing: we show that more durable assets require larger down payments of internal funds per unit of capital making them harder to finance, because durability raises the price of an asset and hence the overall financing need more than its collateral value. Thus, financial constraints have a bigger impact on purchases of more durable capital, such as land, structures, and durable equipment. This basic insight has implications for the choice between new and used capital, technology adoption, and the rent versus buy decision. Since new assets are more durable than used ones, unconstrained borrowers buy new assets and sell them when they are used, while constrained borrowers purchase used assets. Financial constraints inhibit technology adoption as constrained borrowers may adopt less durable, low quality assets, that are otherwise dominated technologies. More durable assets are more likely to be rented given their larger financing need. Legal enforcement affects trade in durable assets and technology adoption; weak legal enforcement economies are net importers of used assets and invest a larger fraction in less durable, low quality assets.

*Keywords:* Durability; financial constraints; collateral; vintage capital; technology adoption; leasing.

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# 1 Introduction

Durability is an essential feature of capital.<sup>1</sup> Durability varies dramatically across types of assets; the depreciation rates vary from as low as 1% for new residential structures to as high as 31% for computing equipment.<sup>2</sup> How does durability affect financing?

It is tempting to conjecture that durable assets can serve as collateral facilitating financing. Indeed, this is one of the conclusion of the influential paper by Hart and Moore (1994) who write (page 860):

“Intuitively, as the assets become more durable, they provide the creditor with the security to wait longer before being repaid. ... And hence the debtor need not set aside as much of his initial borrowing to finance early debt repayments, leaving more to finance the initial investment.”

To the contrary, we argue that durable assets are harder to finance. What the argument above overlooks is that durable assets are also more expensive, exactly because they are more durable. We show that this effect dominates. On the one hand, durability does increase the resale value and hence the collateral value which supports more borrowing consistent with the intuition above. But on the other hand, durability increases the price of the asset and thus the financing need overall and indeed increases these by more. This means that the down payment required for more durable assets is larger, making them harder to finance. This result obtains as long as the resale value of capital cannot be fully pledged. If the collateral value can be fully pledged, then durability has no effect on the ease of financing and is hence neutral. We do not assume that durable assets are illiquid in any way, and in fact assume that there are frictionless markets for all real assets; that said, we do of course assume that there are financial frictions in terms of collateral constraints due to limited enforcement as otherwise the question of the ease of financing would be moot.

There is a critical distinction between the durability of assets and their pledgeability. Durability affects both the collateral value and the price of the assets and hence the

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<sup>1</sup>Durable assets include private and government fixed assets and consumer durables. Fixed assets comprise residential and non-residential structures and durable equipment. Consumer durables include motor vehicles and parts, furnishings and durable household equipment, recreational goods and vehicles, and other durable goods. Private and government fixed assets (not including intellectual property) and consumer durables are \$54 trillion and net of government fixed assets are \$41 trillion in 2012 according to the Bureau of Economic Analysis' *Report on Fixed Assets and Consumer Durable Goods for 2003-2012*; the net worth of households and not for profit organizations is \$70 trillion in 2012 according to the *Flow of Funds*. Thus, tangible durable assets comprise as much as 72% of the aggregate capital stock. We focus on durable assets that are tangible although our arguments apply to intangible assets as well.

<sup>2</sup>See Table 3 in Fraumeni (1997) for the Bureau of Economic Analysis' depreciation rate estimates.

overall financing need, and the net effect of durability is to impede financing. In contrast, pledgeability increases the extent to which assets support borrowing and unambiguously facilitates financing. Hart and Moore's (1994) results should be interpreted in terms of the effect of pledgeability, as they consider the effect of the liquidation value of assets, not in terms of durability. Our model distinguishes between durability and pledgeability and predicts that durability impedes financing rather than facilitating it as they conclude. In our view, the prediction of our model is empirically more plausible in terms of its implications for the choice between new and used assets, technology adoption, and the rent vs. buy decision.

We consider an economy with limited enforcement without exclusion in which firms can default and divert cash flows and a fraction of durable assets and cannot be excluded from markets following default as in Rampini and Viswanathan (2010, 2013, 2015).<sup>3</sup> For this class of economies, they show that the optimal dynamic contract can be implemented with one-period ahead complete markets subject to collateral constraints. The collateral constraints imply that firms' promised repayments cannot exceed a specific fraction of the resale value of capital. These collateral constraints are similar to the ones considered by Kiyotaki and Moore (1997), who build on Hart and Moore's (1994) model of debt repudiation, but Kiyotaki and Moore do not consider depreciation in their model.<sup>4</sup>

We first consider an economy in which assets last for two periods, such that new assets are durable whereas used assets are non-durable as they have only one period of useful life left. Since used assets last for only one period their residual value at the end of the period is zero and thus they cannot serve as collateral; thus, the firm has to pay the entire price of used assets up front. In contrast, new assets can be sold as used assets at the end of the period and have hence positive collateral value allowing firms to partially finance new asset purchases by borrowing. This seems to suggest that new assets are easier to finance than used assets. This is incorrect, however, as it misses the fact that the price of new assets must be higher than the price of used assets precisely because new assets last for two periods whereas used assets for only one. Indeed, the down payment required to purchase a unit of new assets strictly exceeds the purchase price of a unit of used assets, as long as the resale value cannot be fully pledged. A buyer of new assets has to pay up front both the cost of using the assets for one period and the fraction of the

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<sup>3</sup>Limited enforcement is in a similar spirit to Kehoe and Levine (1993) except that we assume that firms which default cannot be excluded from markets going forward whereas they assume that default results in exclusion from intertemporal trade.

<sup>4</sup>Bolton and Scharfstein (1990) and Hart and Moore (1998) consider the value of the threat of liquidation in models with incomplete contracts; in both models, liquidation implies that borrowers cannot operate subsequently, that is, are effectively excluded from markets going forward, unlike in our model.

resale value that cannot be credibly pledged. This exceeds what a buyer of used assets has to pay up front which is just the cost of using the assets for one period. Therefore, constrained firms buy used assets which require fewer internal funds per unit of capital, whereas unconstrained firms prefer to buy new assets (at least weakly) and sell them when they are used, consistent with the data. The pricing of used assets in equilibrium depends on whether the marginal investor in used assets is unconstrained or constrained; in the latter case used capital trades at a premium and unconstrained firms strictly prefer buying new assets. When economies differ in terms of legal enforcement, there is trade in used capital across economies and weak legal enforcement economies are net importers of used assets.

We then show that the same basic insight obtains in an economy with standard neo-classical capital and geometric depreciation. Holding the user cost of capital fixed, the down payment per unit of capital is increasing in the durability of capital, that is, more durable capital requires a larger down payment. If one were to hold the price of capital fixed, one would come to the misleading, and opposite, conclusion that the down payment for more durable capital is smaller, because the collateral value is higher; but proceeding this way an increase in durability reduces the user cost making the capital cheaper at the same time.

Since durability impedes financing, financially constrained firms may adopt dominated technologies, by investing in less durable capital that is of “low quality” in the sense that it would be dominated in the absence of financial constraints. Less durable capital is attractive to constrained firms because of the lower down payment required. In contrast financially unconstrained firms invest in more durable capital only. A larger fraction of investment by firms in economies with weak legal enforcement is in less durable, low quality capital; that is, there is more adoption of dominated technologies when legal enforcement is weak. Less durable capital is associated with smaller financing needs. When different types of capital are imperfect substitutes, constrained firms substitute away from more durable assets towards less durable assets and, for severely constrained firms, the composition of investment is determined by the relative down payments.

More durable assets are more likely to be rented given the larger financing need. Renting or leasing, which we use as synonyms, means that the financier retains ownership of the asset affording a repossession advantage as ownership is the exclusion of others from use. This ease of repossession implies that by renting an asset out the owner can effectively extend more credit than a secured lender can. The cost of renting is modeled simply as a cost of monitoring to prevent abuse of the asset. More constrained firms thus rent assets as Eisfeldt and Rampini (2009) and Rampini and Viswanathan (2013) argue. Here we

show that constrained firms rent more durable assets such as structures first and that only more severely constrained firms rent less durable assets such as equipment. Moreover, our theory implies that the increase in durability of cars over the last few decades can explain the increase in car leasing as well as the fact that it is predominantly new cars, which are more durable, that are leased rather than used ones.

Our theory predicts that financial constraints are especially consequential for investment in more durable assets. To the best of our knowledge, this basic prediction about the relation between durability and financing has not been directly tested to date. Nor have the predictions regarding the composition of investment in terms of durability across economies with different legal enforcement been investigated empirically. That said, the empirical evidence on investment in new and used capital and trade in used assets discussed below is consistent with the predictions of our theory.

As mentioned above, the most closely related paper is Hart and Moore (1994) who consider the effect of durability on financing, among other things, and conclude that “[i]f the assets become more durable ... [t]he project is more likely to be undertaken” (page 860). Their definition of durability is as follows (page 859): “We say that the assets become longer lived, or more durable, if [the liquidation value]  $L(t)$  rises for all  $0 \leq t \leq T$ .” By interpreting a higher liquidation value as higher durability, they do not distinguish between pledgeability and durability. We argue that the liquidation value should be interpreted as pledgeability, which facilitates financing in our model as well, rather than as durability, which impedes financing in our view. Durability of assets in our model is defined in terms of the depreciation rate, which affects the useful life of the assets and hence both the value in use and the collateral value. In contrast, in Hart and Moore’s (1994) definition durability only affects the collateral value and not the value in use, which we think is a more appropriate definition for pledgeability than durability.

Also closely related is Eisfeldt and Rampini (2007) who study the choice between new and used capital. They argue that used capital is cheaper up front but requires ex-post maintenance costs which makes used capital attractive for constrained borrowers in an economy with collateral constraints. The durability of capital per se does not play a role in their analysis.<sup>5</sup>

A growing literature studies used capital markets empirically. Ramey and Shapiro (2001) document that used capital sells at substantial discounts in data from aerospace plant closings. Eisfeldt and Rampini (2007) show that smaller and more constrained

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<sup>5</sup>Aghion, Angeletos, Banerjee, and Manova (2010) study a business cycle model with two technologies, a one-period investment technology and a two-period investment technology. Their analysis focuses on the implications of the difference in this time-to-build type feature rather than durability.

firms purchase substantially more used capital in U.S. census data on new and used capital expenditures.<sup>6</sup>

Several authors consider international trade in used capital. Sen (1962) considers differences in the relative price of labor as an explanation for the fact that less developed economies are net importers of used capital.<sup>7</sup> Navaretti, Soloaga, and Takacs (2000) show empirically that in less developed economies the share of used equipment imported is higher. LaPorta, Lopez-de-Silanes, Shleifer, and Vishny (1998) and the subsequent literature study the variation in legal enforcement and protection of creditor rights across countries and its economic consequences. Specifically, Benmelech and Bergman (2011) find that weak legal enforcement is associated with both older aircraft and older technologies.

Our model abstracts from several features of durable asset markets that have been considered in the literature including adverse selection,<sup>8</sup> illiquidity,<sup>9</sup> and heterogeneity across firms other than that induced by financial constraints.<sup>10</sup> This allows us to focus squarely on the effect of financial constraints in inducing a preference across assets which differ in terms of their durability.

Optimal durability is also analyzed in the literature on durable goods. Much of this literature focuses on a monopolist's choice of durability and argues that a monopolist has incentives to produce less durable goods than a competitive producer would, a phenomenon at times referred to as planned obsolescence (see Waldman (2003) for a comprehensive survey).<sup>11</sup> In a seminal paper Coase (1972) argues that a durable-goods

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<sup>6</sup>Eisfeldt and Rampini (2006) show that trade in used capital, which is part of capital reallocation which they define more broadly, is procyclical and provide a calibrated model with countercyclical reallocation frictions to match this basic fact. Lanteri (2014) shows that the relative price of used capital is procyclical and proposes a model in which new and used capital are imperfect substitutes consistent with this property.

<sup>7</sup>Relatedly, Bond (1983) studies trade in used equipment in a model with heterogeneous firms which differ in terms of factor prices and utilization rates.

<sup>8</sup>Following Akerlof's (1970) seminal study of the market for used cars, several authors have studied adverse selection in the market for used durables. Bond (1982) finds no evidence that trucks that were purchased used require more maintenance. Hendel and Lizzeri (1999a) consider trade in a durable goods market with adverse selection and heterogeneous consumers and show that trade never breaks down. Hendel and Lizzeri (2002) argue that leasing ameliorates adverse selection in durable goods markets and attribute the increase in car leasing over the last few decades to the increase in the durability of cars which they argue aggravates adverse selection.

<sup>9</sup>Gavazza (2011) shows that aircraft that trade in thinner markets are less liquid and Gavazza (2015) studies the effect of trading frictions and the role of intermediaries in the market for used aircraft.

<sup>10</sup>Stolyarov (2002) and Gavazza, Lizzeri, and Roketskiy (2014) study trade in used cars in a model with transaction costs and consumers with heterogeneous utility from the service flow of durables.

<sup>11</sup>An early literature making this case (including Martin (1962), Kleiman and Ophir (1966), Levhari

monopolist faces a time inconsistency problem resulting in a complete loss of market power and a competitive outcome.<sup>12</sup> Coase (1972), as well as Bulow (1982) and Stokey (1981), show that leasing or renting the durable goods avoids the time inconsistency problem and allows the monopolist to retain market power. Bulow (1982, 1986) moreover shows that, in the absence of rental markets, a monopolist may choose to produce less durable goods than a competitive producer again in order to avoid Coasian dynamics.<sup>13</sup> In these theories, market power is therefore the *raison d'être* for durable goods of low durability and rental markets for durables. In contrast, in our theory assets of low durability and rental markets are an optimal response to financial constraints in a competitive model.

Our model is also related to the literature on technology adoption. Chari and Hopenhayn (1991) show that new technologies are adopted slowly in an economy with vintage-specific human capital and that economies continue to invest in older vintages. In our model firms may choose to invest in less durable capital that would otherwise be dominated since the lower durability makes this type of capital attractive due to financial constraints even though different types of capital are perfect substitutes in production.

Section 2 considers the choice between new, durable assets which last for two periods and used, non-durable assets with only one period of useful life remaining. Trade in used capital across economies with different legal enforcement is also analyzed. Section 3 studies the effect of durability in a neoclassical investment model in which the depreciation rate varies across types of assets. Section 4 considers how durability affects the decision to rent assets instead of buying them. Section 5 concludes. Throughout the paper we focus on firms' investment and financing decisions, but the same basic insights apply to households' choice of consumer durables, as discussed in Appendix A.

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and Srinivasan (1969), and Schmalensee (1970)) is shown by Swan (1970, 1971, 1972) and Sieper and Swan (1973) to be incorrect as the monopolist has the same incentives to minimize the cost of the provision a given service flow as a competitive producer. Barro (1972) comes to a similar conclusion although he also shows that if consumers are less patient than the monopolist, the monopolist may choose lower durability. Schmalensee (1974) finds that with endogenous maintenance the monopolist does distort durability and Rust (1986) shows that with endogenous scrappage the monopolist distorts durability and derives conditions under which the monopolist produces goods of zero durability. Thus, these authors resuscitate the conventional wisdom to some extent.

<sup>12</sup>Kahn (1986) shows that with increasing marginal costs the monopolist asymptotically produces the competitive amount but produces more slowly.

<sup>13</sup>More recently, Waldman (1996) and Hendel and Lizzeri (1999b) find that monopolists may choose lower durability as a way to price discriminate between consumers in models with consumers with heterogeneous preferences for different vintages that are not perfect substitutes.

## 2 A model of durable asset financing

We analyze the effect of the durability of assets on financing in a model with collateral constraints due to limited enforcement. In this section, we consider the case where new assets last for two periods, that is, are durable, whereas used assets have only one period of useful life remaining and are hence non-durable. Thus, firms have a choice between new, durable assets and used, non-durable assets. We show that the purchases of durable assets require more internal funds, despite the fact that their collateral value allows firms to borrow against them, because durable assets are more expensive and hence have a larger financing need. As a consequence, constrained firms buy non-durable assets, that is, used assets, whereas well capitalized firms buy new assets which are more durable. We also consider the pricing of used assets in equilibrium and the effect of legal enforcement on trade in used capital across countries.

### 2.1 Environment

Consider an economy in discrete time with an infinite horizon. There is a continuum of entrepreneurs, which we at times refer to simply as firms. In each period, measure  $\rho \in (0, 1)$  of new entrepreneurs are born and are endowed with net worth  $w_0$ . Entrepreneurs survive to the next period with probability  $1 - \rho$  and hence the measure of entrepreneurs alive in every period is 1. Entrepreneurs are risk neutral and have preferences  $\sum_{t=0}^{\infty} \beta^t d_t$  where  $d_t$  is the dividend at time  $t$  and  $d_t \geq 0$ , that is, dividends are non-negative. We assume that the entrepreneurs' time preference discount factor is  $\hat{\beta}$  and let  $\beta \equiv \hat{\beta}(1 - \rho) \in (0, 1)$ . There are two types of goods, output goods (or cash flows) and assets used for production, which are described in more detail below; output goods are the numeraire.

The economy has limited enforcement. Entrepreneurs can default on promises and retain all their cash flows and a fraction  $1 - \theta$  of the durable assets where  $\theta \in [0, 1)$ . Importantly, entrepreneurs cannot be excluded from borrowing and saving or the market for durable and non-durable assets. Our model of limited enforcement is in the spirit of Kehoe and Levine (1993) but we assume limited enforcement without exclusion whereas they assume the default triggers exclusion from intertemporal markets.<sup>14</sup> For our environment, Rampini and Viswanathan (2010, 2013, 2015) show that the optimal long-term dynamic contract can be implemented with one-period ahead debt subject to collateral constraints. This equivalent problem with collateral constraints is rather tractable and the collateral

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<sup>14</sup>Chien and Lustig (2010) consider the asset pricing implications of limited enforcement without exclusion in an endowment economy.



constraints provide a straightforward decentralization of the optimal contract.<sup>15</sup>

New assets are durable and last for two periods. We denote the amount of new, durable assets an entrepreneur purchases by  $k_d$  and normalize the cost of producing new assets to 1. Since assets last for two periods, there are also used assets in the economy which have only one period of useful life left and are therefore non-durable. Denote the amount of used, non-durable assets an entrepreneur purchases by  $k_{nd}$ . The price of used assets  $q$  is determined in equilibrium. We assume that new, durable assets and used, non-durable assets are perfect substitutes in production and assets of  $k_d$  and  $k_{nd}$  this period generate output  $Af(k_d + k_{nd})$  next period where  $A$  is the total factor productivity and  $f$  is strictly increasing and strictly concave.<sup>16</sup> We study a stationary equilibrium in which the price of used capital  $q$  and the interest rate on one-period loans  $R$  are constant. In equilibrium, well capitalized entrepreneurs provide financing and hence the equilibrium interest rate on one-period loans is  $R = \beta^{-1}$ , where  $R$  is the gross interest rate and we define the net interest rate to be  $r \equiv R - 1$ .

## 2.2 Firm's financing problem

We formulate the firm's financing problem recursively. Given net worth  $w$ , the entrepreneur chooses current dividend  $d$ , investment in durable assets  $k_d$ , investment in used, that is, non-durable assets  $k_{nd}$ , borrowing  $b$ , and net worth next period  $w'$ , to solve

$$v(w) \equiv \max_{d, k_d, k_{nd}, b, w' \in \mathbb{R}_+^3 \times \mathbb{R}^2} d + \beta v(w') \quad (1)$$

subject to the budget constraints for the current and next period

$$w + b \geq d + k_d + qk_{nd}, \quad (2)$$

$$Af(k_d + k_{nd}) + qk_d \geq Rb + w', \quad (3)$$

and the collateral constraint

$$\theta qk_d \geq Rb. \quad (4)$$

The endogenous state variable is net worth and is defined as output plus the resale value of durable assets minus the loan repayments, that is,  $w' \equiv Af(k_d + k_{nd}) + qk_d - Rb$ . The budget constraint in the current period ensures that current net worth plus borrowing

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<sup>15</sup>Our decentralization is in a similar spirit to the decentralization provided by Alvarez and Jermann (2000) except that their solvency constraints are history dependent whereas the collateral constraints in our model do not require history-dependence.

<sup>16</sup>The assumption that new and used units are perfect substitutes and that age or durability per se do not play a role dates back to Wicksell (1934) (see Section 3.4 for the case with imperfect substitutes).

covers the current dividend plus the cost of investment in new, durable assets and used, non-durable assets. The budget constraint next period implies that output plus the resale value of durable assets purchased this period can be spent on loan repayments or carried over as net worth for the next period. The collateral constraint states that the firm can borrow up to fraction  $\theta$  of the resale value of the durable goods the household purchased. As argued above, this constraint is induced by limited enforcement, as firms can abscond with all cash flows and fraction  $1 - \theta$  of assets and cannot be excluded from financial or real asset markets following default.

We now characterize the firm's problem. First, observe that the problem in (1) to (4) defines a well-behaved dynamic program. The return function is (weakly) concave and the constraint set convex. The operator defined by (1) to (4) satisfies Blackwell's sufficient conditions, implying that there exists a unique value function  $v$  that solves the firm's problem. This value function is strictly increasing and (weakly) concave.

Denote the multipliers on (2) and (3) by  $\mu$  and  $\beta\mu'$  and on (4) by  $\beta\lambda'$  and let  $\nu$ ,  $\nu_d$ , and  $\nu_{nd}$  be the multipliers on the non-negativity constraints for  $d$ ,  $k_d$ , and  $k_{nd}$ , respectively. The first-order conditions are

$$\mu = 1 + \nu, \tag{5}$$

$$\mu = \beta\mu'[Af_k(k_d + k_{nd}) + q] + \beta\lambda'\theta q + \nu_d, \tag{6}$$

$$\mu q = \beta\mu' Af_k(k_d + k_{nd}) + \nu_{nd}, \tag{7}$$

$$\mu = \mu' + \lambda', \tag{8}$$

$$\mu' = v_w(w'). \tag{9}$$

The envelope condition implies that  $v_w(w) = \mu$ .

### 2.3 Durability, down payment, and financing need

Consider the minimal amount of net worth that the firm needs to purchase a unit of new, durable assets, which we call the *minimum down payment requirement* for such assets. When the collateral constraint binds,  $b = R^{-1}\theta q k_d$  and so the minimal down payment required per unit of new assets is

$$\wp \equiv 1 - R^{-1}\theta q.$$

In equilibrium, the down payment required per unit of new assets exceeds the price of used capital, that is,  $\wp > q$ , as otherwise new, durable assets would dominate purchasing used, that is, non-durable assets.<sup>17</sup> Why do new, durable assets require a larger down

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<sup>17</sup>Essentially, this is an implication of no arbitrage. If the down payment on new assets were less than the price of used assets, buying a new unit instead of a used one would yield a positive payoff in the

payment? First, since used, non-durable assets have no resale value at the end of the period, they do not support any borrowing and the firm has to pay the full price  $q$  up front, that is, the down payment equals the price of non-durable assets. Thus, we can define the user cost of non-durable assets  $u_{nd} \equiv q$ . In contrast, new, durable assets do support borrowing as their resale value at the end of the period as used assets is  $q$  and the firm can pledge a fraction  $\theta$  of that amount. However, and crucially, the price of new, durable assets is of course higher, as the assets can be used for two periods. Moreover, only a fraction of the resale value can be pledged and hence

$$\wp = 1 - R^{-1}\theta q = (1 - R^{-1}q) + R^{-1}(1 - \theta)q, \quad (10)$$

that is, the down payment required for durable assets comprises two components. The first term on the right hand side can be interpreted as the user cost of durable assets for an unconstrained firm, that is,  $u_d \equiv 1 - R^{-1}q$ , as a unit of durable assets costs 1 to buy but can be resold for  $q$  as used assets next period which an unconstrained firm discounts at rate  $R^{-1}$ . The second term reflects the fact that the resale value can only partially be pledged; the down payment includes  $1 - \theta$  of the present value of the resale value of the used capital next period. The down payment for durable assets thus exceeds the user cost of new, durable assets because the firm also has to finance out of internal funds the fraction of the resale value it cannot pledge. Table 1 summarizes the financing need of new, durable and used, non-durable assets.

To reiterate, durable assets require more internal funds ( $\wp > q$ ) despite the firm's ability to borrow  $R^{-1}\theta q > 0$  against their collateral value, since durable assets are more expensive ( $1 > q$ ) and hence have a larger financing need precisely because they are more durable. We emphasize that the fact that the collateral value cannot be pledged fully, that is,  $\theta < 1$ , is critical for the result as otherwise  $\wp = u_d$  and in equilibrium  $u_d = u_{nd}$  and all firms would be indifferent between new, durable and used, non-durable assets.

If the economy were frictionless, the rental rate of capital, which we refer to as the frictionless user cost of capital  $u^*$  in the spirit of Jorgenson (1963), would be  $u^* = \frac{R}{1+R}$  since the purchase cost of one unit of capital has to equal the discounted value of the rental rate over the useful life of the asset, that is,  $1 = u^* + R^{-1}u^*$ . Notice that we assume the rental rate is paid at the beginning of the period, which is of course of no consequence in the frictionless case, but turns out to be appropriate in the economy with limited enforcement. Moreover, the price of used capital in the frictionless economy would be  $q^* = u^* = \frac{R}{1+R}$ .

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current period and the firm would get an additional positive payoff in the amount of  $(1 - \theta)$  times the resale value of the new unit  $q$ , that is,  $(1 - \theta)q$ , in the next period, an arbitrage.

**Table 1: Durability and Requirements of Internal Funds**

Time	$t$	$t + 1$	$t + 2$
Used, non-durable capital			
Value		$q$	0
Collateral value			0
Borrowing		0	
Internal funds required		$q$	
New, durable capital			
Value	1	$q$	0
Collateral value		$q$	
Borrowing	$R^{-1}\theta q$		
Internal funds required	$1 - R^{-1}\theta q$		

When  $\theta < 1$ , that is, the resale value of durable assets is not fully pledgable, as we assume throughout, the price of used capital satisfies the following condition in equilibrium

$$\frac{R}{\theta + R} > q \geq \frac{R}{1 + R}, \quad (11)$$

where the first inequality follows from the fact that  $\varphi > q$  and the second inequality obtains because  $q < \frac{R}{1+R}$  would imply that  $u_d > u_{nd}$ , that is, durable assets would be strictly dominated.<sup>18</sup> The second inequality implies that the user cost of used, non-durable assets weakly exceeds the frictionless rental rate, that is,  $u_{nd} = q \geq u^*$ . The user cost of new, durable assets  $u_d$  for an unconstrained entrepreneur is

$$u_d \equiv 1 - R^{-1}q \leq 1 - R^{-1}\frac{R}{1 + R} = u^* \leq q = u_{nd}.$$

If the price of used assets is the frictionless price  $q^*$ , then  $u_d = u^* = u_{nd}$ , and unconstrained entrepreneurs are indifferent between purchasing new, durable and used, non-durable assets. Importantly, however, sufficiently constrained entrepreneurs turn out not to be indifferent even in this case, as we show below. If the price of used assets  $q > q^*$  instead, then  $u_d < u_{nd}$ , that is, the user cost of durable assets is lower than the user cost of non-durable assets from the vantage point of unconstrained entrepreneurs as new assets can be resold at a premium when they are used. We characterize the choice between new, durable and used, non-durable assets explicitly in the remainder of this section.

<sup>18</sup>If  $\theta$  were 1, that is, if the resale value of capital were fully pledgable, then the limit of equation (11) above as  $\theta$  goes to 1 would imply that the price of used capital again equals the frictionless price.

Finally, to be explicit about the sense in which the new assets with a two period life are more durable, let us define the depreciation rates for new and used assets: new assets depreciate at rate  $\delta_d \equiv \frac{1-q}{1} \leq 1 - \frac{R}{1+R} = \frac{1}{1+R} < 50\%$  in the first period while in second period (when they are used) they depreciate at rate  $\delta_{nd} \equiv \frac{q-0}{q} = 100\%$ . Clearly,  $\delta_d < \delta_{nd}$  and new assets are relatively durable whereas used assets are non-durable.

## 2.4 Dynamics of firm investment

The analysis of the dynamics of firm investment, financing, and dividend policy is facilitated by the fact that the firm's problem is deterministic, conditional on survival. We start by characterizing the firm's behavior in the long run, in which the firm is unconstrained and pays dividends. The first order condition for borrowing implies that  $\mu \geq \mu'$ , that is, the marginal value of net worth is non-increasing and hence firm net worth is non-decreasing. Moreover, once the firm starts to pay dividends,  $\mu = 1$ , and hence  $\mu' = 1$  and  $\lambda' = 0$  from then on. Therefore, the firm reaches a steady state in which it pays dividends and is unconstrained (again conditional on survival).

Consider now the composition of investment for an unconstrained firm. Rewriting the first order conditions for durable and non-durable investment (6) and (7) using the fact that  $\mu = \mu' = 1$  and  $\lambda' = 0$ , we have

$$\begin{aligned} u_d &= \beta Af_k(k_d + k_{nd}) + \nu_d, \\ u_{nd} &= \beta Af_k(k_d + k_{nd}) + \nu_{nd}, \end{aligned}$$

that is, unconstrained firms simply compare the user costs. If  $q > \frac{R}{1+R}$ , and hence  $u_d < u_{nd}$ ,  $\nu_{nd} > 0$ , that is, an unconstrained firm purchases only new, durable assets and sells assets once they are used, that is, non-durable. Moreover, the capital stock of an unconstrained firm  $\bar{k}_d$  solves  $1 = \beta[Af_k(k_d) + q]$  and the firm is unconstrained once net worth reaches  $\bar{w} = \wp \bar{k}_d$ .<sup>19</sup>

We turn to the composition of investment for severely constrained firms next. Rewrite equations (6) and (7) as investment Euler equations as follows:

$$1 = \beta \frac{\mu'}{\mu} \frac{Af_k(k_d + k_{nd}) + (1 - \theta)q}{\wp} + \frac{\nu_d}{\mu \wp}, \quad (12)$$

$$1 = \beta \frac{\mu'}{\mu} \frac{Af_k(k_d + k_{nd})}{q} + \frac{\nu_{nd}}{\mu q}. \quad (13)$$

The budget constraint (2) together with the collateral constraint (4) imply that  $w \geq \wp k_d + q k_{nd}$ . Thus, as the firm's net worth  $w$  goes to zero, so do  $k_d$  and  $k_{nd}$  and therefore

<sup>19</sup>If  $q = \frac{R}{1+R}$ , then the above equation implies that  $\nu_d = \nu_{nd} = 0$  and the unconstrained firm is indifferent between investing in new, durable and used, non-durable assets.

$k_d + k_{nd}$ , implying that  $f_k \rightarrow +\infty$ . The investment Euler equations in turn imply that  $\beta\mu'/\mu$  goes to zero. Combining the investment Euler equations implies that

$$\varphi - q = \beta \frac{\mu'}{\mu} (1 - \theta)q + \frac{\nu_d}{\mu} - \frac{\nu_{nd}}{\mu}.$$

The left-hand side is the incremental investment of purchasing new, durable assets instead of used, non-durable assets. The first term on the right-hand side is the additional resale value of the durable assets (net of debt) which is evaluated using the firm's discount factor  $\beta\mu'/\mu$ . This value goes to zero for severely constrained firms and hence these firms purchase only used capital as  $\nu_d > 0$ . Severely constrained firms simply compare down payments.<sup>20</sup>

The following proposition summarizes our conclusions regarding the composition of investment:

**Proposition 1.** (i) *If  $q > \frac{R}{1+R}$ , unconstrained firms purchase only new, durable assets and sell assets once they are used, that is, non-durable.* (ii) *Severely constrained firms purchase only used, non-durable assets, that is, as  $w \rightarrow 0$ ,  $\nu_d > 0$ .*

Notice that the second part of the proposition does not require  $q > \frac{R}{1+R}$ , that is, severely constrained firms strictly prefer to purchase only used, non-durable assets even if used assets do not trade at a premium, because the down payment for durable assets exceeds the price of non-durable assets as long as  $\theta < 1$ .

## 2.5 Equilibrium

A stationary equilibrium consists of policy functions  $x(w) = [d(w), k_d(w), k_{nd}(w), b(w), w'(w)]$ , an interest rate  $R$ , a price of used, non-durable assets  $q$ , and a stationary distribution  $p(w)$

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<sup>20</sup>To see the intuition for the determinants of the choice between durable and non-durable assets in another way, define the user cost of new, durable assets, which depends on the firm's discount factor, as

$$u_d(w) \equiv \varphi - \beta \frac{\mu'}{\mu} (1 - \theta)q = u_d + \beta \frac{\lambda'}{\mu} (1 - \theta)q;$$

to deploy one unit of new, durable assets the firm has to make the down payment  $\varphi$  in the current period and recovers  $(1 - \theta)q$  next period, which the firm evaluates using its discount factor, as the first expression shows. The user cost can also be written as the user cost of durable assets to an unconstrained firm plus the scaled multiplier on the collateral constraint times the amount recovered next period. An unconstrained firm therefore simply compares the frictionless user costs as the multiplier on the collateral constraint is zero. In contrast, a severely constrained firm discounts the amount recovered next period completely and hence the user cost equals the down payment and such firms evaluate the choice by comparing the down-payment on new, durable assets to the price of used, non-durable assets.

of net worth, such that (i) the policy functions  $x(w)$  solve the entrepreneurs' problem in equations (1) to (4) given  $R$  and  $q$ ; (ii) the credit market clears, that is,  $\sum_w p(w)b(w) = 0$ ; (iii) the used asset market clears, that is, the supply of used assets equals the demand

$$\sum_w p(w)(1 - \rho)k_d(w) = \sum_w p(w)k_{nd}(w);$$

and (iv) the stationary net worth distribution  $p(w)$  is induced by the entrepreneurs' policy functions  $x(w)$ .

We focus here on the determination of the price of used assets. Consider the marginal investor in used assets who is indifferent between investing in new, durable assets and used, non-durable assets and hence  $\nu_d = \nu_{nd} = 0$ . The investment Euler equations (12) and (13) then imply that

$$(1 - R^{-1}\theta q) - q = \beta \frac{\mu'}{\mu} (1 - \theta)q,$$

so the incremental investment required for durable assets equals the discounted resale value. If the marginal investor is unconstrained, then  $\beta\mu'/\mu = R^{-1}$  and the above equation implies that the market clearing price of used assets is  $q = \frac{R}{1+R}$ , which equals the frictionless price. If constrained entrepreneurs are the marginal investors and price used assets, then  $\beta\frac{\mu'}{\mu} < R^{-1}$  and hence used assets trade at a premium, that is,  $q > \frac{R}{1+R}$ . This is the more interesting case that we emphasize in much of this section. Moreover, since  $\beta\frac{\mu'}{\mu} > 0$ , we conclude that  $q < \frac{R}{\theta+R}$  or stated differently  $\varphi > q$ . Thus, the conditions in equation (11) are necessarily satisfied in equilibrium.

## 2.6 Trade in used capital

To analyze the implications of our model for trade in used assets, suppose the world economy consists of two types of economies, economies with weak legal enforcement and economies with strong legal enforcement. We model weak vs. strong legal enforcement simply in terms of the fraction of the resale value of durable assets that can be collateralized, that is,  $\theta_L < \theta_H$ . Moreover, assume that the world loan and used asset markets are integrated and assume that the world market price for used assets is  $q > \frac{R}{1+R}$ . We show that weak legal enforcement economies are net importers of used assets.<sup>21</sup>

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<sup>21</sup>An alternative would be to assume that there are two types of economies, less developed (“poor”) and more developed (“rich”) economies which distinguish themselves only in terms of the initial net worth of entrepreneurs, specifically,  $w_0^L < w_0^H$ , and have the same legal enforcement. The implications for trade in used assets would be similar: less developed, “poor” economies are net used capital buyers as a larger fraction of entrepreneurs are highly constrained.

To understand this one has to keep in mind that while the world price of used assets  $q$  is the same in both economies, the entrepreneurs' problems differ due to the difference in legal enforcement and hence the policy functions and value functions in the two economies differ. First, consider the problem of an unconstrained firm and recall that the investment of an unconstrained firm solves  $1 = \beta[Af(\bar{k}_d) + q]$  and thus the investment of dividend-paying firms in both economies is identical and independent of legal enforcement. That said, the net worth threshold at which firms start to pay dividends satisfies  $\bar{w} = \wp\bar{k}_d$  and since  $\wp_L = 1 - R^{-1}\theta_L q > 1 - R^{-1}\theta_H q = \wp_H$  this threshold is higher in a weak legal enforcement economy than in a strong legal enforcement economy. Second, consider a constrained firm that is indifferent between new and used assets; combining the investment Euler equations (12) and (13) we obtain

$$\frac{Af_k(\underline{k}) + (1 - \theta)q}{1 - R^{-1}\theta q} = \frac{Af_k(\underline{k})}{q}, \quad (14)$$

which determines the level of investment  $\underline{k}$  at which the firm is indifferent between the two types of assets at the margin. This level depends on legal enforcement and firms in economies with weak legal enforcement are indifferent at a higher level of investment, that is,  $\underline{k}_L > \underline{k}_H$ , as the proof in Appendix B shows. The lowest level of net worth at which the firm is able to invest  $\underline{k}$  is  $\underline{w}_{nd} = q\underline{k}$ , in which case the firm uses only non-durable assets. Clearly, this level is higher with weak legal enforcement, that is,  $\underline{w}_{nd}^L > \underline{w}_{nd}^H$ . Similarly, the highest level of net worth at which the firm invests  $\underline{k}$  is  $\underline{w}_d = \wp\underline{k}$ , in which case the firm only invests in durable assets. Since  $\wp_L > \wp_H$  and  $\underline{k}_L > \underline{k}_H$ , we conclude that  $\underline{w}_d^L > \underline{w}_d^H$ . Moreover, since weak legal enforcement does not allow firms to lever as much, the net worth of firms in such economies grows more slowly. Therefore, firms in weak legal enforcement economies use non-durable, used assets for longer or in other words, a larger fraction of firms in weak legal enforcement economies invest in non-durable, used assets.

The effect of legal enforcement on durable and non-durable investment and trade in used assets is summarized in the following proposition:

**Proposition 2.** *Suppose legal enforcement differs across economies, with  $\theta_L < \theta_H$ , and world loan and used asset markets are integrated with  $q > R/(1 + R)$ . Then weak legal enforcement economies are net importers of used assets. Moreover, firms in weak legal enforcement economies substitute to durable assets at higher levels of net worth, that is,  $\underline{w}_{nd}^L > \underline{w}_{nd}^H$  and  $\underline{w}_d^L > \underline{w}_d^H$  and start to pay dividends at a higher level of net worth, too, that is,  $\bar{w}_L > \bar{w}_H$ .*

Some details of the proof are in Appendix B. The predictions of our model for trade in used assets are consistent with the empirical evidence provided in the literature.



### 3 Technology adoption

So far we have considered the effect of durability in an economy in which capital goods last for two periods, such that new assets are durable whereas used assets are non-durable as they have only one period of useful life left. We now show that we obtain analogous results in an economy with a standard neoclassical investment technology and geometric depreciation. With geometric depreciation, there is no distinction between new and used capital. We hence focus on the depreciation rate as our measure of durability in this section. We show that more durable assets require larger down payments of internal funds. Moreover, constrained firms may deploy less durable types of capital that are dominated from the vantage point of an unconstrained firm. Thus firms may adopt technologies that would be dominated in a frictionless economy. We also find that the fraction of investment in such dominated technologies is larger in economies with weak legal enforcement.

#### 3.1 Effect of durability with neoclassical investment

As a first step, we consider the effect of durability on down payments in an economy as in Section 2 except that instead of assets that last two periods we now consider standard neoclassical investment. Suppose that capital depreciates at rate  $\delta \in (0, 1)$  each period and that capital can be produced at a cost  $q$ , so that the law of motion for capital is

$$k' = k(1 - \delta) + q^{-1}i,$$

where  $i$  is investment (measured in terms of consumption goods). Investment is assumed to be reversible and hence the price of capital is  $q$ . Otherwise, the economy is as before.

The entrepreneur's problem with neoclassical investment is to choose  $\{d, k, b, w'\}$  given  $w$  to solve

$$v(w) \equiv \max_{d, k, b, w' \in \mathbb{R}_+^2 \times \mathbb{R}^2} d + \beta v(w') \quad (15)$$

subject to the budget constraints and the collateral constraint

$$w + b \geq d + qk, \quad (16)$$

$$Af(k) + qk(1 - \delta) \geq Rb + w', \quad (17)$$

$$\theta qk(1 - \delta) \geq Rb. \quad (18)$$

Notice that we have substituted out investment  $i$  and define net worth as output plus the resale value of depreciated capital net of debt repayments, that is,  $w' \equiv Af(k) + qk(1 -$

$\delta) - Rb$ .<sup>22</sup> Defining the minimum down payment requirement as before we have

$$\wp = q(1 - R^{-1}\theta(1 - \delta)) = R^{-1}q(r + \delta) + R^{-1}q(1 - \theta)(1 - \delta),$$

that is, the down payment is the frictionless one period user cost (paid in advance) plus the present value of the fraction of the resale value that cannot be pledged. Suppose we assess the effect of durability on the down payment by simply differentiating the above expression with respect to  $\delta$ . We would conclude that more durable capital requires a lower down payment since  $\frac{\partial \wp}{\partial \delta} = qR^{-1}\theta > 0$ . The intuition is that more durable capital has a higher collateral value supporting more debt finance, as Hart and Moore (1994) conclude.<sup>23</sup> But this argument is misleading or at least incomplete because it keeps the price of capital  $q$  fixed and thus lower  $\delta$  implicitly reduces the user cost of capital at the same time. More durable capital should also be more expensive and taking the effect on the price into account leads to the opposite conclusion: more durable capital requires a larger down payment.

To see this, we fix the frictionless user cost of capital  $u^*$  instead (which is paid in advance and equals the user cost of capital to an unconstrained firm, too). The price of capital depends on the durability and is the present value of the future rental payments, so

$$q(\delta) = \sum_{t=0}^{\infty} \frac{u^*(1 - \delta)^t}{(1 + r)^t} = \frac{Ru^*}{r + \delta}.$$

In turn, the down payment per unit of capital is

$$\wp(\delta) = q(\delta)[1 - R^{-1}\theta(1 - \delta)] = u^* + \frac{u^*}{r + \delta}(1 - \theta)(1 - \delta)$$

and differentiating with respect to  $\delta$  we obtain  $\frac{\partial \wp(\delta)}{\partial \delta} = -q(\delta)\frac{1-\theta}{r+\delta} < 0$ . More durable capital requires larger down payments. The basic conclusion regarding the effect of durability on financing is reversed.<sup>24</sup>

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<sup>22</sup>Denoting values from the previous period with a subscript  $-$ , the flow budget constraint requires that output plus net new borrowing exceed the current dividend plus investment, that is,  $Af(k_-) + (b - Rb_-) \geq d + i$ ; substituting for investment using the law of motion for capital  $i = q(k - k_-(1 - \delta))$  and using the definition of net worth  $w = Af(k_-) + qk_-(1 - \delta) - Rb_-$ , we obtain (16).

<sup>23</sup>The liquidation value (per unit of capital) in Hart and Moore (1994) can be interpreted as  $Lk \equiv \theta qk(1 - \delta)$ ; the collateral constraint (18) can then be written as  $Lk \geq Rb$ . With this interpretation,  $L = \theta q(1 - \delta)$ ; thus, the liquidation value involves both pledgeability  $\theta$  and durability  $1 - \delta$ , as well as the price of the asset. Hart and Moore (1994) consider the effect of the liquidation value  $L$  on financing; we argue that the effect they consider should be interpreted as the effect of pledgeability  $\theta$  rather than durability  $1 - \delta$ .

<sup>24</sup>Two special cases are of interest as they provide a connection to the results in Section 2: first, if

The user cost of capital for a constrained firm depends on the firm's discount factor,  $\beta\mu'/\mu$ , and is the down payment minus the discounted resale value of the depreciated capital, so

$$u(w)(\delta) = \wp(\delta) - \beta \frac{\mu'}{\mu} (1 - \theta) q(\delta) (1 - \delta) = u^* + \beta \frac{\lambda' R u^*}{\mu r + \delta} (1 - \theta) (1 - \delta). \quad (19)$$

The sensitivity of this user cost to durability depends on how financially constrained the firm is in the sense that  $\frac{\partial u(w)(\delta)}{\partial \delta} = -q(\delta) \frac{\lambda' (1 - \theta)}{\mu r + \delta} < 0$ . For an unconstrained firm, the multiplier on the collateral constraint  $\lambda' = 0$  and the user cost is independent of durability. The user cost is also independent of financial conditions for non-durable capital, that is, when  $\delta = 1$  as then  $u(w)(1) = u^*$  independent of  $w$ . Finally, when collateral can be pledged fully, that is,  $\theta = 1$ , the user cost equals  $u^*$  and is again independent of financial conditions and durability for that matter. That said, the key insight here is that in general durability increases down payments and hence the internal funds required per unit of capital, and that the effect of durability on the user cost is larger the more constrained firms are.

### 3.2 Adopting dominated technologies

Suppose firms can choose between two types of neoclassical capital, one that is more durable and one that is less durable. For ease of reference, we denote these with a subscript  $d$  for durable and  $nd$  for non-durable as in Section 2, although that is a slight abuse of notation here. The economy is as before but there are two types of neoclassical capital of different durability, that is, depreciation rates  $\delta_d < \delta_{nd}$  and different prices  $q_d > q_{nd}$  such that, on the one hand, the frictionless user cost of the more durable capital is lower than that of the less durable capital, that is,  $u_d < u_{nd}$  or  $q_d(r + \delta_d) < q_{nd}(r + \delta_{nd})$ , and on the other hand the down payments required are higher for the more durable capital than for the less durable capital, that is,  $\wp_d > \wp_{nd}$  or  $q_d(1 - R^{-1}\theta(1 - \delta_d)) > q_{nd}(1 - R^{-1}\theta(1 - \delta_{nd}))$ .<sup>25</sup> The two types of capital are perfect substitutes in production.

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capital fully depreciates every period, that is,  $\delta = 1$ , the down payment is  $\wp(1) = u^*$ , which is the down payment for non-durable capital in the previous section; and second, if the depreciation rate  $\delta = 0$ , so capital does not depreciate, then  $\wp(0) = u^* + R^{-1}(1 - \theta)q(0)$ , which is the same expression as for the down payment on durable assets in the previous section (see Equation (10)).

<sup>25</sup>The case in which  $q_d \leq q_{nd}$  is not interesting as durable capital would have a lower user cost and require a lower down payment and therefore dominate. The case in which  $u_d \geq u_{nd}$  is also not interesting as durable capital would then also require a larger down payment and thus would be dominated. Thus, we assume  $u_d < u_{nd}$  and  $\wp_d > \wp_{nd}$  since if durable capital required a lower down payment it would again dominate.

The entrepreneur's problem with two types of capital  $j \in \{d, nd\}$  is to choose  $\{d, k_j, b, w'\}$ , given  $w$ , to solve

$$v(w) \equiv \max_{d, k_j, b, w' \in \mathbb{R}_+^3 \times \mathbb{R}^2} d + \beta v(w') \quad (20)$$

subject to the budget constraints and the collateral constraint

$$w + b \geq d + \sum_j q_j k_j, \quad (21)$$

$$Af\left(\sum_j k_j\right) + \sum_j q_j k_j (1 - \delta_j) \geq Rb + w', \quad (22)$$

$$\theta \sum_j q_j k_j (1 - \delta_j) \geq Rb. \quad (23)$$

The collateral constraint requires that total borrowing including interest does not exceed fraction  $\theta$  of the resale value of the depreciated capital of both types.

To analyze the choice between the two types of capital, recall from equation (19) that the user cost of type  $j$  capital (for a possibly constrained firm) is

$$u_j(w) = u_j + \beta \frac{\lambda'}{\mu} q_j (1 - \theta) (1 - \delta_j). \quad (24)$$

Unconstrained firms never use the less durable, "low quality" capital since when  $\lambda' = 0$ ,  $u_j(w) = u_j$  and  $u_d < u_{nd}$  by assumption. Unconstrained firms evaluate the two types of capital based on their frictionless user costs. The less durable type of capital is clearly dominated from the perspective of an unconstrained firm.

Severely constrained firms in contrast adopt the dominated technology, that is, choose to invest in this less durable type of capital. When  $w$  goes to 0,  $\frac{\mu'}{\mu}$  goes to 0 or equivalently  $\frac{\lambda'}{\mu}$  goes to 1, so

$$u_j(w) = u_j + R^{-1} q_j (1 - \theta) (1 - \delta_j) = \wp_j$$

and  $\wp_d > \wp_{nd}$ . As the firm becomes severely constrained, it evaluates the two types of capital simply based on the required down payments. For a severely constrained firm, the user cost is the down payment. Since the less durable capital requires a lower down payment, such firms choose to adopt otherwise dominated technologies. We emphasize that our model implies that there is new investment in dominated technologies. Financially constrained firms may invest in less durable plants and buildings, and may buy less durable types of equipment, despite the fact that these are dominated, because they involve smaller financing needs in terms of internal funds.

We summarize our conclusions regarding the composition of investment as follows

**Proposition 3.** *Suppose there are two types of neoclassical capital with  $\delta_d < \delta_{nd}$  and  $q_d > q_{nd}$  such that  $u_d < u_{nd}$  but  $\wp_d > \wp_{nd}$ . (i) Unconstrained firms purchase only the more durable capital. (ii) Severely constrained firms purchase only the less durable capital despite it being otherwise dominated.*

### 3.3 Adopting dominated technologies and legal enforcement

Suppose, as in the discussion of trade in used capital in Section 2, that the world economy consists of two types of economies, economies with strong legal enforcement and economies with weak legal enforcement, that is,  $\theta_H > \theta_L$ . As before, assume that there are two types of capital with  $\delta_d < \delta_{nd}$  and  $q_d > q_{nd}$  such that  $u_d < u_{nd}$  but  $\wp_d > \wp_{nd}$ . We can show that a larger fraction of entrepreneurs adopt the dominated technology in the economy with weak legal enforcement. To derive this result we must keep in mind that the policy and value functions differ in the two types of economies. However, taking the investment Euler equations for type  $j$  capital,  $j \in \{d, nd\}$ ,

$$1 = \beta \frac{\mu' Af_k(\sum_j k_j) + (1 - \theta)q_j(1 - \delta_j)}{\mu \wp_j} + \frac{\nu_j}{\mu \wp_j} \quad (25)$$

and combining them for a firm that is indifferent between the two types of capital yields

$$\frac{Af_k(\sum_j k_j) + (1 - \theta)q_d(1 - \delta_d)}{\wp_d} = \frac{Af_k(\sum_j k_j) + (1 - \theta)q_{nd}(1 - \delta_{nd})}{\wp_{nd}}, \quad (26)$$

which determines the level of investment  $\underline{k} = \sum_j k_j$  at which the firm is indifferent at the margin. This level depends on legal enforcement and, as shown in the proof in Appendix B, is higher in an economy with weak legal enforcement.

The effect of legal enforcement on technology adoption in terms of durable and non-durable capital is summarized in the following proposition:

**Proposition 4.** *Suppose legal enforcement differs across economies, with  $\theta_H > \theta_L$ , and there are two types of neoclassical capital with  $\delta_d < \delta_{nd}$  and  $q_d > q_{nd}$  such that  $u_d < u_{nd}$  but  $\wp_d > \wp_{nd}$ . A larger fraction of firms in weak legal enforcement economies invest in less durable capital, which is otherwise dominated. Firms in such economies substitute to more durable capital at higher levels of net worth and start to pay dividends at a higher level of net worth, too.*

The parts of the proof not discussed in the text are in Appendix B. Our theory predicts that in economies with weak legal enforcement, more firms invest in less durable types of capital that would otherwise be dominated and invest in such capital for longer, that is,

until they are older and better capitalized. Thus, new investment in dominated technologies is more extensive in weak legal enforcement economies. The basic mechanism is that durability raises the requirements for internal funds and weak legal enforcement compounds these effects. Indeed, if the resale value of capital were perfectly collateralizable, that is, if  $\theta$  were 1, then dominate technologies would not be adopted at all.

### 3.4 Effect of durability on composition of investment

When different types of capital are not perfect substitutes, as assumed so far, but instead imperfect substitutes, then all firms use all types of capital and durability affects the composition of investment. Consider the following aggregator for capital with constant elasticity of substitution

$$k \equiv \left( \sum_j \sigma_j k_j^\gamma \right)^{1/\gamma}, \quad (27)$$

where  $k_j$  is type- $j$  capital, the substitution coefficient  $\gamma$  satisfies  $-\infty < \gamma < 1$ , the factor shares  $\sigma_j > 0$ , for all  $j$ , and  $\sum_j \sigma_j = 1$ . The elasticity of substitution is  $1/(1 - \gamma)$ . For ease of exposition, we assume that there are two types of capital,  $j \in \{d, nd\}$ , as before, but the results obtain more generally.<sup>26</sup> The firm's problem is to maximize (20) subject to (21), (23), and

$$Af(k) + \sum_j q_j k_j (1 - \delta_j) \geq Rb + w', \quad (28)$$

where  $k$  is as defined in (27). Using the definition of the user cost for a financially constrained firm (24), the first-order condition for type- $j$  capital can be written as

$$u_j(w) = \beta \frac{\mu'}{\mu} Af_k(k) \frac{\partial k}{\partial k_j}.$$

Dividing the first order condition for less durable capital by the one for more durable capital we obtain

$$\frac{u_{nd}(w)}{u_d(w)} = \left( \frac{k_d}{k_{nd}} \right)^{1-\gamma} \frac{\sigma_{nd}}{\sigma_d}.$$

Recall that for unconstrained firms, the user cost is  $u_j(w) = u_j$ , that is, equals the frictionless user cost. Therefore, for such firms, the ratio of more durable to less durable capital is determined by the ratio of the frictionless user costs (as well as the factor shares). In contrast, for severely constrained firms, that is, as  $w$  goes to 0, the user

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<sup>26</sup>The case of perfect substitutes considered so far is a special case of this aggregator with  $\gamma = 1$  and  $\sigma_d = \sigma_{nd}$ . Moreover, if  $\gamma = 0$ , we have a Cobb-Douglas aggregator and  $k = k_d^{\sigma_d} k_{nd}^{\sigma_{nd}}$ . Finally, the limit as  $\gamma$  goes to  $-\infty$  is the Leontieff aggregator.

cost  $u_j(w) \rightarrow \varphi_j$ , implying that the ratio of more durable to less durable capital is determined by the ratio of the down payments for such firms.

We have established the following result:

**Proposition 5.** *Consider a production function with a CES aggregator for more durable and less durable capital. The ratio of more durable to less durable assets  $k_d/k_{nd}$  is determined by the ratio of the frictionless user costs  $u_{nd}/u_d$  for unconstrained firms and is determined by the ratio of the down payments  $\varphi_{nd}/\varphi_d$  for severely constrained firms.*

Consider the effect of financial development in terms of an increase in pledgeability  $\theta$ . Financial development does not affect the composition of investment of financially unconstrained firms. In contrast, financial development increases the ratio of more durable to less durable investment for severely constrained firms, as an increase in pledgeability increases the ratio of down payments  $\varphi_{nd}/\varphi_d$ ; an increase in pledgeability reduces the down payment on more durable assets by more.

When different types of capital are imperfect substitutes, our theory predicts that in the cross section of firms, more constrained firms substitute away from more durable assets towards less durable assets and that the relative down payments determine the composition of investment for severely constrained firms. Financial development reduces the distortion away from durable investment for constrained and especially severely constrained firms.

## 4 Renting durable assets

Renting is a significant way in which firms (and households), especially financially constrained ones, avail themselves of durable assets. A key aspect of renting is the associated ease of repossession as argued by Eisefeldt and Rampini (2009) and Rampini and Viswanathan (2013). Renting (or leasing, which we use synonymously here) allows the lessee to deploy assets while the lessor retains ownership which facilitates the repossession of these assets in case of default. In the context of an economy with limited enforcement, we model rented capital as capital the firm cannot abscond with, that is, rented capital can be collateralized fully. The cost of renting is that the lessor has to monitor its use to prevent abuse, for example. But how does durability affect the decision to rent assets instead of buying them (and borrowing against them)?

Consider an economy with neoclassical investment as in the previous section. Suppose there are two types of capital, as before, one which is more durable and one which is less durable, denoted by subscripts  $d$  and  $nd$ , respectively. However, to focus on the rent vs.

buy decision, we assume that the two types of assets are required in fixed proportions. Specifically, there are two types of neoclassical capital which differ in their durability, that is, for  $j = \{d, nd\}$ , type  $j$  capital depreciates at rate  $\delta_j$ , where  $\delta_d < \delta_{nd}$ , and has price  $q_j$ .<sup>27</sup> Denote the type  $j$  capital the firm owns by  $k_j$  and the type  $j$  capital the firm rents (or leases) by  $k_j^l$ . Owned and rented capital of a particular type are assumed to be perfect substitutes. The two types of capital are deployed in fixed proportions, that is, aggregate capital  $k$  is determined by a Leontief aggregator  $k \equiv \min \left\{ \frac{k_d + k_d^l}{\sigma_d}, \frac{k_{nd} + k_{nd}^l}{\sigma_{nd}} \right\}$  where the factor shares  $\sigma_j > 0$  and  $\sum_j \sigma_j = 1$ , which implies that  $k_j + k_j^l = \sigma_j k$ .

The rental rate for type  $j$  capital is  $u_j^l \equiv R^{-1}q_j(r + \delta_j + m)$  where  $m$  is the monitoring cost per unit of capital. Limited enforcement implies that this rental rate has to be charged up front. If the monitoring cost were zero, the rental rate would equal the frictionless user cost of capital, albeit payable in advance.

The entrepreneur's problem with a rental decision is to choose  $\{d, k, k_j, k_j^l, b, w'\}$ , given  $w$ , to solve

$$v(w) \equiv \max_{d, k, k_j, k_j^l, b, w' \in \mathbb{R}_+^6 \times \mathbb{R}^2} d + \beta v(w') \quad (29)$$

subject to the budget, collateral, and technological constraints

$$w + b \geq d + \sum_j q_j k_j + \sum_j u_j^l k_j^l, \quad (30)$$

$$Af(k) + \sum_j q_j k_j (1 - \delta_j) \geq Rb + w', \quad (31)$$

$$\theta \sum_j q_j k_j (1 - \delta_j) \geq Rb, \quad (32)$$

$$k_j + k_j^l \geq \sigma_j k, \quad j \in \{d, nd\}. \quad (33)$$

Only assets that the firm owns can serve as collateral. Introducing aggregate capital  $k$  as a choice variable and equation (33) for  $j \in \{d, nd\}$  (which hold with equality at an optimum) are a simple way to impose the Leontief technology.

The first-order conditions with respect to  $k$ ,  $k_j$ , and  $k_j^l$  using the same multipliers as before and multiplier  $\beta\mu'\eta_j$  on equation (33) are

$$\begin{aligned} \sum_j \sigma_j \eta_j &= Af_k(k), \\ \mu q_j &= \beta\mu'\eta_j + \beta\mu'q_j(1 - \delta_j) + \beta\lambda'\theta q_j(1 - \delta_j) + \nu_j, \\ \mu u_j^l &= \beta\mu'\eta_j + \nu_j^l. \end{aligned}$$

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<sup>27</sup>No assumptions on prices of the two types of capital are required here as the prices affect the cost of owning and renting a particular type of capital in the same way.



The investment Euler equation for purchased type  $j$  capital is

$$1 = \beta \frac{\mu' \eta_j + (1 - \theta) q_j (1 - \delta_j)}{\mu \wp_j} + \frac{\nu_j}{\mu \wp_j}.$$

Assume that the down payment for purchasing a type of capital exceeds the rental rate, that is,  $\wp_j > u_j^l$ , as otherwise renting would be dominated. As shown in previous work, more constrained firms rent capital. To see how durability affects the rent vs. buy decision, suppose a firm is indifferent between renting and owning type  $j$  capital, so  $\nu_j = \nu_j^l = 0$ . Combining first-order conditions we obtain

$$\frac{\lambda'}{\mu} (1 - \theta) (1 - \delta_j) = m.$$

The multiplier on the collateral constraint (scaled by the multiplier on the budget constraint)  $\frac{\lambda'}{\mu}$  at which the firm is indifferent between buying and renting depends on the depreciation rate. More durable assets are rented by less constrained firms, whereas less durable assets are rented only if the firm is sufficiently constrained. Suppose the firm needs both structures, say a plant, and equipment, say machines, for production and structures are more durable than machines, which is arguably the case. Severely constrained firms lease both the plant and the machines whereas less constrained firms lease only the plant and unconstrained firms do not lease either. Similarly, if firms require different types of equipment, for example, aircraft, which are very durable, and ground support equipment, which is less durable, our theory predicts that many airlines lease their aircraft, but only severely constrained airlines lease their ground support equipment.<sup>28</sup> Note also that the model implies that there is no renting of assets which depreciate fully each period, that is, with  $\delta_j = 1$ , and no renting when collateral is fully pledgable.<sup>29</sup>

The key insight is that firms are more inclined to rent more durable assets as such assets are associated with a larger financing need exactly because they are more durable and hence require more internal funds which makes renting them more beneficial as it allows additional financing. Less durable assets are rented only by severely constrained firms, whereas more durable assets are rented even by less constrained firms.

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<sup>28</sup>Analogously, for households this implies that severely constrained households rent both their house and their cars whereas less constrained household buy their cars and rent their house, and unconstrained households own both their cars and their house. This prediction seems empirically quite plausible.

<sup>29</sup>If capital lasts for two periods, as in Section 2, then used, non-durable assets are never rented while new, durable assets might be rented, depending on parameters. This may explain why in practice it is often new assets that are leased, not used ones.

## 5 Conclusion

Durable assets are harder to finance because they require larger down payments. While durability does increase the resale value and hence the collateral value allowing more borrowing, it increases the price of assets and thus the financing need overall by more. Since the effect on the financing need exceeds the increase in collateral value, more durable assets require larger down payments as long as the resale value cannot be fully pledged (that is,  $\theta < 1$  in the model).

Financial constraints are therefore especially salient for investment in durable assets. For firms, these durable assets include residential and non-residential structures, infrastructure, equipment including aircraft, ships, and trucks. For households, durable assets include consumer durables, especially housing, motor vehicles, and household durables. While we emphasize the effects of durability on the financing of tangible assets, the same results apply for investment in intangible capital, for example, organization capital, which can be collateralized only to a very limited extent or not at all (as  $\theta = 0$  is a special case of our model).

Constrained firms may use less durable assets even if these were otherwise dominated. Constrained firms also buy used capital, which is less durable, instead of new capital, consistent with the data, and rent durable assets to reduce the demands on internal funds. Empirical work can use the composition of investment, the vintage of capital purchased, and rental choices to identify financial constraints.

Durability exacerbates the effect of legal enforcement on investment. In economies with weak legal enforcement, investment in infrastructure, buildings, and cars and trucks, for example, can be distorted toward lower qualities that are less durable. Moreover, firms and household use less durable qualities and used capital to a greater extent in such economies. And weak legal enforcement countries are net importers of used real assets, consistent with international trade flows.

We emphasize that it is critical to distinguish the durability of assets from their pledgeability both in empirical work and in theory. Durability,  $1 - \delta$  in our model, affects not only the collateral value but also the cost of the assets and hence the overall financing need, with the net effect of impeding financing. Pledgeability,  $\theta$  in our model, affects only the collateral value and unambiguously facilitates financing. Hart and Moore (1994) consider the effect of higher liquidation values, effectively pledgeability, in their model, but interpret their results in terms of durability, concluding that more durable assets are easier to finance due to their higher liquidation value. By distinguishing between durability and pledgeability, we come to the opposite and we think empirically more plausible conclusion.

# Appendix

## Appendix A: Households' choice of consumer durables

This appendix considers households' choice between durable and non-durable goods, which provides a particularly simple version of the main result of the paper. Consider a discrete-time, infinite horizon economy. There is a continuum of households of measure one alive at each date; households survive to the next period with probability  $1 - \rho$  and measure  $\rho \in (0, 1)$  of new households are born every period with net worth  $w_0 > 0$  (to be defined below). Households are risk averse and we formulate the households' problem recursively. Households have preferences  $u(c) + \beta v(w')$  over consumption services  $c$  in the current period and net worth  $w'$  next period, where  $\beta \in (0, 1)$  is the effective rate of time preference (with  $\hat{\beta}$  the rate of time preference and  $\beta \equiv \hat{\beta}(1 - \rho)$ ),  $v(\cdot)$  is the value function, and  $u(\cdot)$  is the utility function which is strictly increasing, strictly concave, continuously differentiable, and satisfies  $\lim_{c \rightarrow 0} u_c(c) = +\infty$ .

Households have access to two types of goods, durable goods and non-durable goods. Denote the amount of durable goods a household purchases in the current period by  $k_d$  and the amount of non-durable goods by  $k_{nd}$ . Durable and non-durable goods provide consumption services and are perfect substitutes in terms of their services, that is,  $c = k_d + k_{nd}$ . The differences between durable goods and non-durable goods are their price and durability: durable goods cost 1 to produce and last for two periods, that is, provide consumption services both in the period in which they are purchased and in the next period; in contrast, non-durable goods cost  $q$  where, in equilibrium,  $1 > q \geq 1/(1 + \beta)$  but provide consumption services only in the period in which they are purchased. Non-durable goods purchased this period are hence worthless next period, whereas a unit of durable goods purchased this period is worth  $q$  next period since it is equivalent to a unit of non-durable goods next period. Households also have a deterministic income of  $y > 0$  each period. Households can buy any amount of durable and/or non-durable goods and can resell durable goods after one period, but do not have access to borrowing or lending otherwise, that is, we set  $\theta = 0$  in terms of the model in the main body of the paper.

We consider a stationary equilibrium of the economy in which all aggregate quantities and the used capital price  $q$  are constant. For simplicity, we focus on the case in which  $q > 1/(1 + \beta)$  (as the economic intuition in the case with  $q = 1/(1 + \beta)$  is similar).

Given current net worth  $w$ , the household's problem can be written as

$$v(w) \equiv \max_{\{k_d, k_{nd}, w'\} \in \mathbb{R}_+^2 \times \mathbb{R}} u(k_d + k_{nd}) + \beta v(w')$$

subject to the budget constraints for the current and the next period

$$\begin{aligned} w &\geq k_d + qk_{nd}, \\ y + qk_d &\geq w'. \end{aligned}$$

Notice that consumption services  $c$  have been substituted out and that net worth is defined as income plus the resale value of consumption durables.

Since the constraint set is convex and the operator defined by the Bellman equation satisfies Blackwell's sufficient conditions, there exists a unique value function that solves the Bellman equation which is strictly increasing and strictly concave. Using the multipliers  $\mu$  and  $\beta\mu'$  for the budget constraints in the current and next period, and the multipliers  $\nu_d$  and  $\nu_{nd}$  for the non-negativity constraints, the first-order conditions for durable and non-durable goods and for net worth next period are

$$\begin{aligned}\mu &= u_c(c) + \beta\mu'q + \nu_d, \\ \mu q &= u_c(c) + \nu_{nd}, \\ \mu' &= v_w(w'),\end{aligned}$$

and the envelope condition is  $v_w(w) = \mu$ . It is not possible that both  $\nu_d > 0$  and  $\nu_{nd} > 0$  at the same time, as otherwise the budget constraint in the current period would be slack.

Over time, an individual household reaches a steady state (conditional on survival) in which the household's net worth and purchases of durable and non-durable goods are constant. In such a steady state, the household only purchases durable goods. To see this, denote the marginal value of net worth in the steady state by  $\bar{\mu}$  and using the first order conditions we have  $\bar{\mu}(q - (1 - \beta q)) = \nu_{nd} - \nu_d$ . Since the right-hand side is strictly positive, we conclude that  $\nu_{nd} > 0$ ; the household does not buy non-durable goods. (If  $q = 1/(1 + \beta)$ , the right-hand side is 0 and hence  $\nu_{nd} = \nu_d = 0$  and the household is indifferent between durable and non-durable goods.) Indeed, using the budget constraints for the current and next periods, we can compute the steady state level of net worth  $\bar{w} = y/(1 - q)$ , which equals the purchases of durable goods  $\bar{k}_d$  and steady state consumption  $\bar{c}$  (while purchases of non-durable goods are  $\bar{k}_{nd} = 0$ ).

Severely constrained households, that is, households with sufficiently low net worth, buy only non-durable goods. To see this notice that the budget constraint implies that as  $w$  goes to 0,  $c$  does too, and  $\mu \geq u_c(c) \rightarrow +\infty$ . Combining the first-order conditions we have  $\mu(1 - q) = \beta\mu'q + \nu_d - \nu_{nd}$  and, since  $w' \geq y$ ,  $\mu'$  is bounded above, implying that  $\nu_d > 0$  as  $w$  goes to 0. Indeed, households do not buy any durable goods on a lower interval of net worth levels. For suppose, by contradiction that for  $w_- < w$ ,  $\nu_d > 0$  (that is,  $k_d = 0$ ) at  $w$  while  $k_d^- > 0$  at  $w_-$ . By strict concavity of the value function,  $\mu_- > \mu$ , whereas  $\mu'_- < \mu'$  since  $w'_- = y + qk_d^- > y + qk_d = w'$ . Using the first-order conditions at  $w$  and  $w_-$  respectively we get  $0 < (\mu_- - \mu) = \beta(\mu'_- - \mu')q - \nu_{nd}^- - \nu_d < -\nu_{nd}^- - \nu_d$ , a contradiction. Moreover, above this interval, durable goods purchases  $k_d$  are strictly increasing in  $w$ . This is obvious if the household only buys durable goods, so suppose the household buys both durable and non-durable goods. In that case,  $\mu(1 - q) = \beta\mu'q$ , and by strict concavity  $\mu$  is strictly decreasing in  $w$  and hence so is  $\mu' = v_w(w')$ , implying that  $w'$  and hence  $k_d$  are strictly increasing in  $w$ .

Intuitively, durable goods force households to save, making households with low net worth reluctant to buy durable goods. Such households buy "low quality" non-durable goods because these are cheaper to them as these goods have a smaller up-front cost, whereas households with high net worth buy "high quality" durable goods because these are cheaper to them since they are less constrained which means that the opportunity cost of the additional funds required to purchase durable goods is lower.

## Appendix B: Proofs

**Proof of Proposition 2.** Total differentiation of equation (14) yields

$$\frac{dk}{d\theta} = \frac{(q + R^{-1}q - 1)}{(\wp - q)^2} \frac{q^2}{Af_{kk}(\underline{k})} < 0.$$

The rest of the proof is in the main text.  $\square$

**Proof of Proposition 4.** Total differentiation of equation (26) yields

$$\frac{dk}{d\theta} = \frac{(u_{nd} - u_d)}{(\wp_d - \wp_{nd})^2} \frac{q_d q_{nd} (\delta_{nd} - \delta_d)}{Af_{kk}(\underline{k})} < 0.$$

The critical levels of net worth are  $\underline{w}_{nd} = \wp_{nd} \underline{k}$ ,  $\underline{w}_d = \wp_d \underline{k}$ , and  $\bar{w} = \wp_d \bar{k}$  where  $\bar{k}$  solves  $Ru_d = Af_k(\bar{k})$ . Since  $\wp_{nd}$  and  $\wp_d$  are decreasing in  $\theta$  the ordering is immediate. Moreover, since lower  $\theta$  allows firms to lever less, the net worth of firms in weak legal enforcement economies grows more slowly. The rest of the proof is in the main text.  $\square$

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