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A UNIFIED MODEL OF INVESTMENT  
UNDER UNCERTAINTY

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ABSTRACT

This paper extends the theory of investment under uncertainty to incorporate fixed costs of investment, a wedge between the purchase price and sale price of capital, and potential irreversibility of investment. In this extended framework, investment is a non-decreasing function of  $q$ , the shadow price of installed capital. There are potentially three investment regimes which depend on the value of  $q$  relative to two critical values. For values of  $q$  above the upper critical value, investment is positive and is an increasing function of  $q$ , as is standard in the theory branch of the adjustment cost literature. For intermediate values of  $q$ , between two critical values, investment is zero. Although this regime features prominently in the irreversibility literature, it is largely ignored in the adjustment cost literature. Finally, if  $q$  is below the lower critical value, gross investment is negative, a possibility that is ruled out by assumption in the irreversibility of literature. In general however, the shadow price  $q$  is not directly observable, so we present two examples relating  $q$  to observable variables.

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# I Introduction

If a firm can instantaneously and costlessly adjust its capital stock, then, as shown by Jorgenson (1963), its decision about how much capital to use is essentially a static decision in which the marginal product of capital is equated to the user cost of capital. The firm's investment decision becomes an interesting dynamic problem, in which anticipations about the future economic environment affect current investment, when frictions prevent instantaneous and costless adjustment of the capital stock. The investment literature of the last three decades has focused on two types of frictions – adjustment costs and irreversibility.

In this paper, we present a simple, more general framework that encompasses irreversibility as well as adjustment costs that may include a fixed component. Within this more general framework, the optimal investment behavior of the firm is comprised of potentially three regimes: (1) a regime of positive gross investment; (2) a regime of zero gross investment; and (3) a regime of negative gross investment. Most of the adjustment cost literature tends to focus, either implicitly or explicitly, on the first of these regimes. The irreversibility literature is more explicit in its recognition of regimes of positive gross investment and zero gross investment, and it rules out the regime of negative gross investment by assumption. The more general model presented here allows a simple characterization of the conditions giving rise to each of these regimes.

In the adjustment cost literature, based on the seminal work of Eisner and Strotz (1963), the adjustment cost function is typically assumed to be strictly convex and to have a value of zero at zero. Although a few studies mentioned the possibility of fixed costs,<sup>1</sup> there was virtually no formal analysis of these fixed costs. The model presented in this paper incorporates fixed costs.

During the 1970s and 1980s, the adjustment cost literature began to merge with the literature on Tobin's  $q$ . Tobin (1969) argued that the optimal rate of investment is an increasing function of the ratio of the market value of the firm to the replacement cost of the firm's capital – a ratio that he called  $q$ , and that has come to be known as "average  $q$ ." Mussa (1977) showed in a deterministic model, and Abel (1983) showed in a stochastic model, that the optimal rate of investment is the rate that equates the marginal adjustment cost with the marginal value of installed capital, a concept known as marginal  $q$ . While average  $q$  is a potentially observable number, it is marginal  $q$  that is relevant for investment decisions. Hayashi (1982) presented conditions under which average  $q$  and marginal  $q$  are equal.

As indicated earlier, the assumption that investment is irreversible is another type of friction that makes the investment decision an interesting dynamic problem. In a seminal paper on irreversibility, Arrow (1968, pp.

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<sup>1</sup>See Nickell (1978) and Rothschild (1971).

8-9) argued that "there will be many situations in which the sale of capital goods cannot be accomplished at the same price as their purchase. . . . For simplicity, we will make the extreme assumption that resale of capital goods is impossible, so that gross investment is constrained to be non-negative." Arrow showed that in a deterministic model, optimal investment behavior under irreversibility will be characterized by alternating intervals of time corresponding to regimes of positive gross investment and regimes of zero gross investment. When the shadow price of capital is smaller than the cost of new capital, the firm will have zero investment; when the firm undertakes positive gross investment, the shadow price of capital equals the cost of new capital.<sup>2</sup>

We incorporate both adjustment costs and irreversibility in an extended model of adjustment costs. We note that adjustment costs and irreversibility are examined together in a deterministic model by Lucas (1981) and in a stochastic model by Lucas and Prescott (1971). Curiously, both of these papers introduce the constraint that gross investment is non-negative in the formal optimization problem, yet neither paper comments on this assumption, nor does either paper use the term "irreversibility." In effect, these papers take as a postulate that gross investment cannot be negative. In contrast, our model incorporates Arrow's observation that the resale price of capital may be below the price of new capital, and the model includes the special case in which the resale price is zero.

If we were to simply postulate that gross investment cannot be negative, then it would be easy to impose irreversibility in an adjustment cost framework by simply assuming that infinite adjustment costs are incurred at any negative rate of investment, as in Caballero (1991, p. 281). Our approach avoids treating irreversibility as a postulate but rather allows for (and characterizes) cases in which the optimal investment behavior of the firm is never negative. We introduce an augmented adjustment cost function that includes the traditional convex adjustment costs as well as the possibility of fixed costs and the possibility that the resale price of capital goods is below their purchase price and may even be zero. In this augmented adjustment cost framework, investment is a non-decreasing function of the shadow price  $q$ , which is always positive. There are three regimes of optimal investment behavior characterized by two critical values of  $q$ ,  $q_1 \leq q_2$ . Optimal gross investment is positive for  $q > q_2$ , zero for values of  $q$  between  $q_1$  and  $q_2$ , and negative for values of  $q < q_1$ . If the lower critical

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<sup>2</sup>The same relationship among gross investment, the shadow price of capital and the price of new capital was derived in a stochastic general equilibrium model by Sargent (1980). Similarly, Bertola and Caballero (1991) examine the behavior of an individual firm under uncertainty and find that the firm equates the marginal product of capital and the user cost of capital whenever it is undertaking gross investment; when the firm is not investing, the marginal product of capital is below the user cost.

value,  $q_1$ , is negative, then negative gross investment is never optimal and investment would appear to be irreversible to an outside observer. It is worth noting that irreversibility does *not* require infinite adjustment costs at negative rates of gross investment, as assumed by Caballero (1991); indeed, as long as the augmented adjustment cost is strictly positive for all negative rates of gross investment, optimal investment behavior will appear to be irreversible.

In section II we introduce the augmented adjustment cost function and relate optimal investment to the shadow price  $q$ . In section III we discuss the relationship of  $q$  to observable variables. Section IV summarizes and outlines future work.

## II The Model of the Firm

### II.1 The Operating Profit and Augmented Adjustment Cost Functions

Consider a firm that uses capital and a vector of costlessly adjustable inputs, such as labor, to produce a non-storable output. At each point of time, the firm chooses the amounts of costlessly adjustable inputs to maximize the value of its revenue minus expenditures on these inputs. Let  $\pi(K_t, \epsilon_t)$  denote the maximized value of this instantaneous operating profit at time  $t$ , where  $K_t$  is the capital stock at time  $t$ , and  $\epsilon_t$  is a random variable that could represent randomness in technology, in the prices of costlessly adjustable inputs, or in the price of output. Assume that  $\pi_K(K_t, \epsilon_t) > 0$ ,  $\pi_{K,K}(K_t, \epsilon_t) \leq 0$ , and that  $\epsilon_t$  evolves according to a diffusion process

$$d\epsilon_t = \mu(\epsilon_t)dt + \sigma(\epsilon_t)dz \quad (1)$$

where  $z$  is a standard Wiener process.

The intertemporal problem faced by the firm is the choice of the time path of the capital stock. Capital is acquired by undertaking gross investment at rate  $I$ , and the capital stock depreciates at a fixed proportional rate  $\delta$ , so the capital stock evolves according to

$$dK_t = (I_t - \delta K_t)dt \quad (2)$$

When the firm undertakes gross investment, it incurs costs that we can describe in terms of three components: (1) purchase/sale costs, (2) costs of adjustment, and (3) fixed costs.

Purchase/sale costs are the costs of buying or selling uninstalled capital. Let  $p_K^+$  be the price per unit at which the firm can buy any amount of uninstalled capital, and let  $p_K^-$  be the price per unit at which the firm can sell any amount of uninstalled capital. We assume that  $p_K^+ \geq p_K^- \geq 0$ . The sale price of capital may be strictly less than the purchase price of

capital if capital is firm-specific and/or if there is adverse selection in the market for used capital goods.<sup>3</sup> The purchase/sale cost function is  $p_K^+ I$  for  $I > 0$  and  $p_K^- I$  for  $I < 0$ . It is a (weakly) convex and nondecreasing function that takes the value zero when gross investment is zero. Note that the purchase/sale cost function is twice differentiable everywhere except possibly at  $I = 0$ .

Adjustment costs are nonnegative costs that attain their minimum value of zero when  $I = 0$ . Adjustment costs are typically assumed to be continuous and strictly convex in  $I$ .<sup>4,5</sup> In some formulations, adjustment costs also depend on the capital stock  $K$ , with the partial derivative of the adjustment cost function with respect to  $K$  being negative.<sup>6</sup> We assume that the adjustment cost function is twice differentiable with respect to  $I$  everywhere except possibly at  $I = 0$ . The assumptions made so far imply that the partial derivative of the adjustment cost function with respect to investment is positive for  $I > 0$  and is negative for  $I < 0$ . If the adjustment cost function is differentiable at  $I = 0$ , the partial derivative of the adjustment cost function is zero at  $I = 0$ ; otherwise, the lefthand partial derivative is nonpositive and the right hand derivative is nonnegative at  $I = 0$ .

Fixed costs of investment are non-negative costs of investment that are independent of the level of investment. However, a firm can avoid the fixed cost of investment at a particular point of time by setting investment equal to zero at that point of time.

We take account of all three of these types of costs associated with capital investment. The total cost of investment equals the product of a dummy variable  $d$  and an "augmented adjustment cost function"  $c(I, K)$ . The dummy variable  $d$  takes the value zero when  $I = 0$  so that the total investment cost is zero when  $I = 0$ . When  $I \neq 0$ , the dummy variable  $d$

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<sup>3</sup>In addition to Arrow (1968) cited in the introduction, Nickell (1978, p. 40), Bertola and Caballero (1991, p. 1), and Pindyck (1991, p. 1111) recognize that  $p_K^-$  may be lower than  $p_K^+$  and choose to make the extreme assumption that investment is irreversible. In the literature on consumer durables, Eberly (1991), Grossman and Laroque (1990), and Lam (1989) include a proportional transaction cost when consumers resell durables, which corresponds to  $p_K^-$  being smaller than  $p_K^+$ .

<sup>4</sup>A notable exception is Rothschild (1971) who analyzes investment behavior under concave as well as convex adjustment costs.

<sup>5</sup>In addition, the partial derivative of the adjustment cost function with respect to investment goes to infinity as investment goes to infinity, and this partial derivative goes to negative infinity as investment goes to negative infinity.

<sup>6</sup>For instance, Abel and Blanchard (1983), Hayashi (1982), Lucas (1967, 1981), Lucas and Prescott (1971), and Treadway (1969) all model adjustment costs as a decreasing function of  $K$  for a given  $I$ .

equals one so that the total investment cost equals the augmented adjustment cost  $c(I, K)$ .

The augmented adjustment cost function  $c(I, K)$  represents the sum of purchase/sale costs, adjustment costs, and fixed costs. We assume that  $\lim_{I \downarrow 0} c(I, K) = \lim_{I \uparrow 0} c(I, K)$  and denote the common value of these limits as  $c(0, K)$ . Note that  $c(0, K)$  is *not* the total investment cost when  $I = 0$ , because when  $I = 0$  the dummy variable  $d$  equals 0 and total investment cost equals zero. Instead,  $c(0, K)$  is interpreted as the fixed cost of investment because both the purchase/sale cost function and the adjustment cost function are continuous functions that take on the value zero when  $I = 0$ . Because the fixed cost is non-negative, we have  $c(0, K) \geq 0$ . The augmented adjustment cost function is continuous, strictly convex, and is twice differentiable with respect to  $I$  everywhere except possibly at  $I = 0$ .<sup>7</sup> Let  $c_I(0, K)^-$  and  $c_I(0, K)^+$  denote the left-hand and right-hand partial derivatives, respectively, of  $c(I, K)$  with respect to  $I$  evaluated at  $I = 0$ . It follows from the assumptions made above that  $c_I(0, K)^+ \geq 0$ , but  $c_I(0, K)^-$  may be positive, negative or zero. In addition,  $c_I(0, K)^+ \geq c_I(0, K)^-$ .

## II.2 Maximization: The Optimal Investment Function

Assume that the firm is risk-neutral and chooses investment to maximize the expected present value of operating profit  $\pi(K, \epsilon)$  less total investment cost  $dc(I, K)$ . The value of the firm is thus

$$V(K_t, \epsilon_t) = \max_{I_{t+s}, d_{t+s}} \int_0^{\infty} E_t \left\{ \pi(K_{t+s}, \epsilon_{t+s}) - d_{t+s} c(I_{t+s}, K_{t+s}) \right\} e^{-rs} ds \quad (3)$$

where  $r > 0$  is the discount rate, and the maximization in (3) is subject to the evolution of  $\epsilon_t$  and  $K_t$  described in (1) and (2) respectively.<sup>8</sup>

We will solve the maximization problem in (3) using the Bellman equation derived in Appendix A (where we have suppressed the time subscript  $t$ ):

$$rV(K, \epsilon) = \max_{I, d} \left\{ \pi(K, \epsilon) - dc(I, K) + \left( \frac{1}{dt} \right) E(dV) \right\}. \quad (4)$$

The left hand side of equation (4) is the required return on the firm, and the right hand side of (4) is the maximized expected return which consists of two components: operating profits net of augmented adjustment costs,  $\pi(K, \epsilon) - dc(I, K)$ ; and the expected "capital gain" represented by the change in the value of the firm  $(1/dt)E(dV)$ . To calculate the expected capital gain, we observe that the value of the firm,  $V$ , depends on  $K$  and  $\epsilon$ ,

<sup>7</sup>The properties noted in footnote 5 imply that  $\lim_{I \rightarrow \infty} c_I(I, K) = \infty$  and  $\lim_{I \rightarrow -\infty} c_I(I, K) = -\infty$ .

<sup>8</sup>While standard, this expression rules out bubbles in the value of the firm.

which evolve continuously over time according to (2) and (1) respectively. Thus, we can calculate  $E(dV)$  using Ito's Lemma, equations (1) and (2), and the facts that  $(dK)^2 = (dK)(d\epsilon) = (dt)^2 = (dz)(dt) = 0 = E(dz)$  to obtain

$$E(dV) = [V_K(I - \delta K) + \mu V_\epsilon + \frac{1}{2}\sigma^2 V_{\epsilon,\epsilon}] dt. \quad (5)$$

Now define  $q \equiv V_K$ , which is the marginal valuation of a unit of installed capital. Substituting this definition and the expected capital gain from equation (5) into equation (4) yields

$$rV = \max_{I,d} \left\{ \pi(K, \epsilon) - dc(I, K) + q(I - \delta K) + \mu V_\epsilon + \frac{1}{2}\sigma^2 V_{\epsilon,\epsilon} \right\}. \quad (6)$$

To solve the maximization problem on the right hand side of (6), notice that the only terms that involve the decision variables  $I$  and  $d$  are  $-dc(I, K)$  and  $qI$ . Therefore, the optimal values of  $I$  and  $d$  solve

$$\max_{I,d} [qI - dc(I, K)]. \quad (7)$$

It is convenient to solve the maximization problem in (7) in two steps. First, assume that  $d = 1$ , and choose the value of  $I$  that maximizes the maximand in (7) conditional on  $d = 1$ . Then choose  $d$  to be either zero or one.

For the moment, assume that  $d = 1$  and let  $\psi(q, K)$  denote the maximized value of the maximand in (7) given that  $d = 1$ . Specifically,

$$\psi(q, K) \equiv \max_I [qI - c(I, K)]. \quad (8)$$

Let  $I^*(q, K)$  denote the value of  $I$  that maximizes the maximand in equation (8). Given that  $c(I, K)$  is strictly convex in  $I$ , and is differentiable everywhere except possibly at  $I = 0$ , the first-order conditions determining  $I^*(q, K)$  are

$$c_I(I^*(q, K), K) = q \quad \text{for } q < c_I(0, K)^- \text{ or } q > c_I(0, K)^+ \quad (9a)$$

$$I^*(q, K) = 0 \quad \text{for } c_I(0, K)^- \leq q \leq c_I(0, K)^+. \quad (9b)$$

According to equation (9a) the firm equates the marginal cost of investment and the marginal benefit of investment, measured by  $q$ . Notice that  $c_{I,I} > 0$  implies that  $I^*(q, K)$  is a strictly increasing function of  $q$  over the range of  $q$  in equation (9a).

If  $c(I, K)$  is differentiable at  $I = 0$ , then  $c_I(0, K)^- = c_I(0, K)^+$  and  $c_I(I^*(q, K), K) = q$  for all  $q$ . However, if  $c(I, K)$  is not differentiable at  $I = 0$ , then for values of  $q$  between  $c_I(0, K)^-$  and  $c_I(0, K)^+$  there is no corresponding value of the marginal cost of investment. As shown in equation (9b) for values of  $q$  in this range,  $I^*(q, K) = 0$ . Looking at equations (9a)



and (9b) together we see that  $I^*(q, K)$  is a nondecreasing function over the entire range of  $q$ , and that

$$I^*(q, K) \begin{cases} < 0 & \text{for } q < c_I(0, K)^- \\ = 0 & \text{for } c_I(0, K)^- \leq q \leq c_I(0, K)^+ \\ > 0 & \text{for } q > c_I(0, K)^+ . \end{cases} \quad (10)$$

Having determined the optimal value of  $I$  given that  $d = 1$ , we now turn to the choice of the optimal value of  $d$ . If  $d = 0$ , gross investment is also zero, and the value of the maximand in equation (7) is zero. If  $d = 1$ , the optimal rate of investment is  $I^*(q, K)$  and the value of the maximand in (8) is

$$\psi(q, K) = qI^*(q, K) - c(I^*(q, K), K) . \quad (11)$$

The firm will therefore choose  $d = 1$  when, and only when,  $\psi(q, K)$  is greater than zero.<sup>9</sup> To determine the sign of  $\psi(q, K)$ , we now characterize the behavior of this function. Recall from equation (9b) that for  $c_I(0, K)^- \leq q \leq c_I(0, K)^+$ ,  $I^*(q, K) = 0$ . Substituting zero investment into the right hand side of (11) yields

$$\psi(q, K) = -c(0, K) \quad \text{if } c_I(0, K)^- \leq q \leq c_I(0, K)^+ . \quad (12)$$

For values of  $q$  outside the interval  $[c_I(0, K)^-, c_I(0, K)^+]$ ,  $\psi(q, K) \geq -c(0, K)$  because the firm could always choose to set  $I = 0$  and thereby attain a value of  $-c(0, K)$  for  $qI - c(I, K)$ . Thus, the minimum value of  $\psi(q, K)$  is attained for  $q$  in the interval  $[c_I(0, K)^-, c_I(0, K)^+]$ . Outside this interval,  $\psi(q, K)$  is twice differentiable. Differentiating equation (11) with respect to  $q$  and using equation (10) yields

$$\psi_q(q, K) = I^*(q, K) \begin{cases} < 0 & \text{if } q < c_I(0, K)^- \\ > 0 & \text{if } q > c_I(0, K)^+ \end{cases} \quad (13)$$

$$\psi_{q,q}(q, K) = I_q^*(q, K) > 0 \quad \text{if } q < c_I(0, K)^- \text{ or if } q > c_I(0, K)^+ . \quad (14)$$

Thus, the function  $\psi(q, K)$  is a convex function that attains its minimum value of  $-c(0, K)$  when  $q$  is in the interval  $[c_I(0, K)^-, c_I(0, K)^+]$ . Let  $q_1$  and  $q_2$  denote the smallest and largest roots, respectively, of  $\psi(q, K) = 0$ . It follows from equation (13) that

$$\psi(q, K) > 0 \quad \text{if } q < q_1 \text{ or } q > q_2 . \quad (15)$$

The function  $\psi(q, K)$  is depicted in Figure 1 for a given value of  $K$ . The flat segment of  $\psi(q, K)$  for values of  $q$  between  $c_I(0, K)^-$  and  $c_I(0, K)^+$

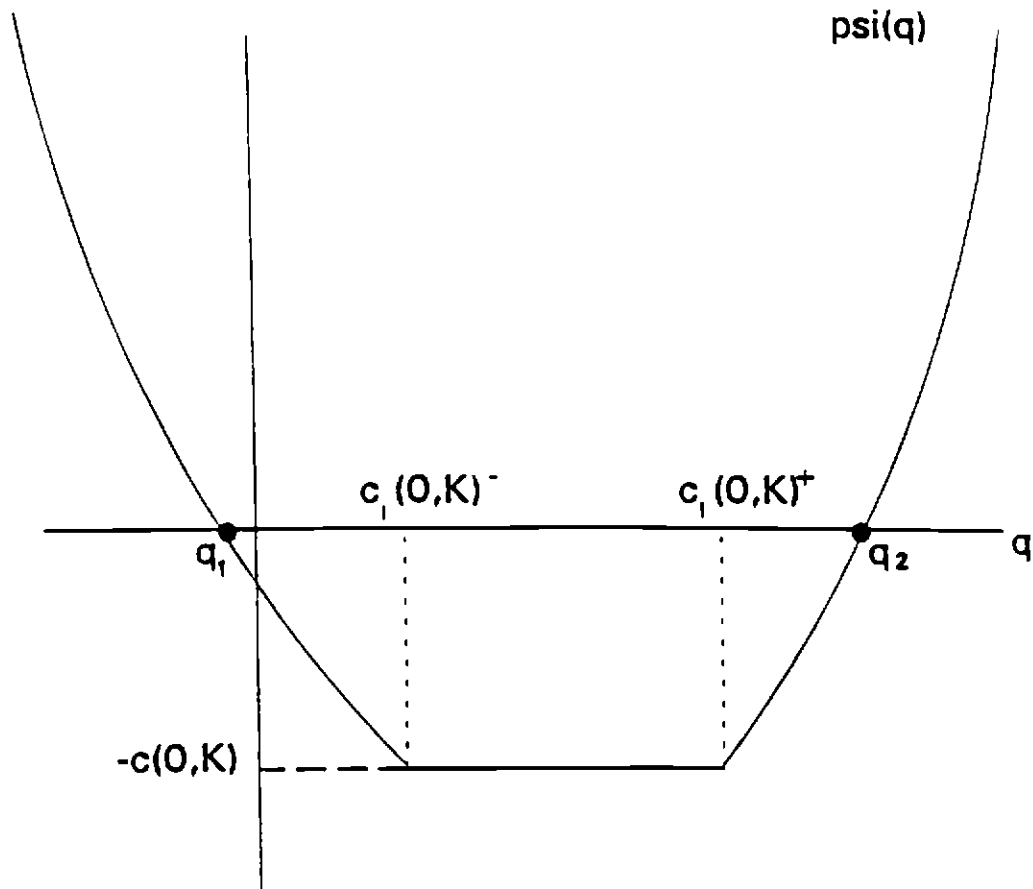
<sup>9</sup>When  $\psi(q, K) = 0$ , the firm is indifferent between  $I = 0$  and the optimal nonzero rate of investment. We assume that at these points of indifference, the firm chooses  $I = 0$ .

corresponds to equation (12). Figure 1 is drawn under the assumption that the fixed cost,  $c(0, K)$  is positive, so that the minimum value of  $\psi(q, K)$  is negative, and the flat segment lies below the horizontal axis. According to equation (13),  $\psi(q, K)$  is strictly decreasing to the left of the flat segment, and strictly increasing to the right of the flat segment. Thus, in the case depicted in Figure 1, the equation  $\psi(q, K) = 0$  has two distinct roots,  $q_1$  and  $q_2$ ;  $\psi(q, K) > 0$  if  $q < q_1$  or if  $q > q_2$ . Thus, optimal investment behavior  $\hat{I}(q, K)$  is characterized by

$$\hat{I}(q, K) = \begin{cases} I^*(q, K) < 0, & \text{if } q < q_1 \\ 0, & \text{if } q_1 \leq q \leq q_2 \\ I^*(q, K) > 0, & \text{if } q > q_2 . \end{cases} \quad (16)$$

Figure 1

The Return to Investing



## II.3 Characteristics of Optimal Investment and $q$

- (1) If there are at least two distinct roots of  $\psi(q, K) = 0$ , so that  $q_1 < q_2$ , then there is a range of inaction in which the optimal amount of investment is zero. However, if there is a unique root of  $\psi(q, K) = 0$ , then  $q_1 = q_2$ , and there is no (nondegenerate) range of inaction; there is only a single value of  $q$ , equal to  $q_1 = q_2$ , for which investment is zero.

Under the assumptions made above,  $\psi(q, K) = 0$  will have a unique root if and only if

- $c(I, K)$  is differentiable at  $I = 0$  so that  $c_I(0, K)^- = c_I(0, K)^+$ , and hence there is no flat segment at the bottom of the  $\psi(q, K)$  function; and
- the fixed cost  $c(0, K)$  is zero so that the minimum value of  $\psi(q, K)$  is zero.

These assumptions are fairly standard in the adjustment cost literature,<sup>10</sup> and under these assumptions there is no range of inaction.

The equation  $\psi(q, K) = 0$  will have exactly two distinct roots and there will be a range of inaction if the fixed cost  $c(0, K)$  is positive so that the minimum value of  $\psi(q, K)$  is negative. In this case, the range of inaction will arise regardless of the differentiability of  $c(I, K)$  at  $I = 0$ .

The equation  $\psi(q, K) = 0$  will have a continuum of roots if and only if

- $c(I, K)$  is not differentiable at  $I = 0$  so that  $c_I(0, K)^- < c_I(0, K)^+$  and hence there is a flat segment at the bottom of the function  $\psi(q, K)$ ; and
- there are no fixed costs, so that the flat segment at the bottom of  $\psi(q, K)$  lies along the horizontal axis.

In this case the equation  $\psi(q, K) = 0$  has a continuum of roots extending from  $q_1$  to  $q_2$ , and there is a range of inaction corresponding to these values of  $q$ . To summarize, either positive fixed costs or non-differentiability of  $c(I, K)$  at  $I = 0$  is sufficient to introduce a nondegenerate range of inaction for investment.

- (2) The largest and smallest roots of the equation  $\psi(q, K) = 0$ ,  $q_1$  and  $q_2$ , depend only on the specification of the augmented adjustment cost function  $c(I, K)$ . They are independent of the specification of the operating profit function  $\pi(K, \epsilon)$  and the specification of the diffusion process for  $\epsilon_t$ .

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<sup>10</sup>See, for example, Abel and Blanchard (1983), Gould (1968), and Hartman (1972).

- (3) If there are positive fixed costs or if  $c(I, K)$  is not differentiable at  $I = 0$ , then there is a range of inaction. At the endpoints of this range, the function  $\hat{I}(q, K)$  is discontinuous. That is, the optimal rate of investment jumps from a negative value to zero at  $q = q_1$ , and it jumps from zero to a positive value at  $q = q_2$ .
- (4) Note that the Bellman equation in equation (6) holds identically in  $K$  at a point in time so the partial derivative of the left hand side with respect to  $K$  equals the partial derivative of the right hand side with respect to  $K$ . Differentiating both sides of (6) with respect to  $K$  yields

$$rV_K = \pi_K(K, \epsilon) - \hat{d}c_K(\hat{I}, K) - \delta q + q_K(\hat{I} - \delta K) + \mu V_{\epsilon, K} + \frac{1}{2}\sigma^2 V_{\epsilon, \epsilon, K}, \quad (17)$$

where  $\hat{I}$  is optimal investment from equation (16) and  $\hat{d}$  is the optimal choice of  $d$ .

Recall that  $q \equiv V_K$  so that  $q_\epsilon = V_{\epsilon, K}$  and  $q_{\epsilon, \epsilon} = V_{\epsilon, \epsilon, K}$ . Now apply Ito's Lemma and equations (1) and (2) to calculate  $E\{dq\}$

$$E\{dq\} = q_K(\hat{I} - \delta K)dt + \mu V_{\epsilon, K}dt + \frac{1}{2}\sigma^2 V_{\epsilon, \epsilon, K}dt. \quad (18)$$

Substituting (18) into (17) and rearranging yields

$$(r + \delta)q = \pi_K(K, \epsilon) - \hat{d}c_K(\hat{I}, K) + \frac{E\{dq\}}{dt}. \quad (19)$$

The left hand side of equation (19) is the required return (gross return before subtracting depreciation) on the marginal unit of capital and the right hand side is the expected return which consists of three components: the marginal operating profit  $\pi_K(K, \epsilon)$ , the marginal reduction in the augmented adjustment cost  $-\hat{d}c_K(\hat{I}, K)$ , and the expected capital gain  $E\{dq\}/dt$ . In the special case in which there is no uncertainty, equation (19) becomes  $(r + \delta)q = \pi_K(K, \epsilon) - \hat{d}c_K(\hat{I}, K) + dq/dt$  which is widely used in the deterministic literature on the  $q$  theory of investment.

- (5) The marginal valuation of installed capital,  $q$ , is the expected present value of the stream of marginal products of capital. This result can be shown formally using the following Lemma (proven in Appendix B).

**Lemma 1** *Suppose that  $\chi_t$  is a diffusion and that  $a > 0$  is constant. Then  $\chi_t = E_t \left\{ \int_0^\infty g_{t+s} e^{-as} ds \right\}$  is a solution to the differential equation  $E_t(d\chi)/dt - a\chi_t + g_t = 0$ .*

Using the fact that  $q_t$  is a diffusion, and applying this lemma to equation (19) yields<sup>11</sup>

$$q_t = \int_0^{\infty} E_t \left\{ \pi_K(K_{t+s}, \epsilon_{t+s}) - d_{t+s} c_K(I_{t+s}, K_{t+s}) \right\} e^{-(r+\delta)s} ds > 0. \quad (20)$$

Thus,  $q_t$  is the present value of the expected marginal product of capital which consists of two components:  $\pi_K(K, \epsilon)$  is the marginal operating profit accruing to capital, and  $-dc_K(I, K)$  is the reduction in the augmented adjustment cost accruing to the marginal unit of capital. The assumptions made above that  $\pi_K(K, \epsilon) > 0$  and  $c_K(I, K) \leq 0$  imply that  $q_t$  is always positive.

- (6) In order for negative investment ever to be optimal, the smallest root of  $\psi(q, K) = 0$ ,  $q_1$ , must be positive so that it might be possible for  $q$  (which is always positive) to be less than  $q_1$ . A necessary and sufficient condition for  $q_1$  to be positive is  $\psi(0, K) > 0$ . It follows directly from the definition of  $\psi(q, K)$  in (8) that  $\psi(0, K) = \max_I -c(I, K) = -\min_I c(I, K)$ . Thus, in order for it to be possible for negative investment to be optimal,  $\min_I c(I, K)$  must be negative. The explanation of this result is straightforward. In order for a firm to find it optimal to give up some of its installed capital which has a positive value, the adjustment cost that it incurs must be negative, i.e., the net sale price of the capital after taking account of the fixed cost and the adjustment cost must be positive. If there is no value of gross investment for which  $c(I, K)$  is negative, then it will never be optimal for a firm to undertake negative gross investment. The firm's behavior would be observationally equivalent to a situation of irreversible investment.<sup>12</sup>

<sup>11</sup>We have chosen the solution to equation (19) that does not contain bubbles.

<sup>12</sup>Caballero (1991, p. 281) specifies the augmented adjustment cost function  $C(I) = I + [I > 0]\gamma_1 I^\beta + [I < 0]\gamma_2 |I|^\beta$  where  $\beta \geq 1$ ,  $\gamma_1 \geq 0$ ,  $\gamma_2 \geq 0$ , and  $[ ]$  is the indicator function. Caballero states that "the irreversible-investment case of Pindyck (1988) and Bertola (1988) corresponds to the case in which  $\gamma_1 = 0$ ,  $\gamma_2 = \infty$ , and  $\beta = 1$ ." In fact, however, if  $\beta = 1$ , irreversibility will occur whenever  $\gamma_2 > 1$ . There is no need to make  $\gamma_2$  infinite to prevent optimal investment from being negative.

### III Relating the Shadow Price $q$ to Observable Variables

We have shown that optimal investment is an increasing function of the shadow price of capital, which we have called  $q$ . In general, we cannot directly observe shadow prices. In this section we discuss how to measure  $q$  when the production function is linearly homogeneous.

Consider a competitive firm that uses capital,  $K$ , and a vector of costlessly adjustable inputs,  $L$ , to produce output according to the production function  $F(K, L, \epsilon)$ . Assume that the production function  $F(K, L, \epsilon)$  is linearly homogeneous in  $K$  and  $L$ , and note that the production function may be subject to stochastic shocks. It is well known that if the firm is a price-taker in output and factor markets, the operating profit function can be written as

$$\pi(K, \epsilon) = H(\epsilon)K, \quad (21)$$

where  $H(\epsilon) > 0$ .<sup>13</sup>

**Case I**  $c(I, K)$  is linearly homogeneous in  $I$  and  $K$ . We can show that if the operating profit function satisfies equation (21), and if  $c(I, K)$  is linearly homogeneous in  $I$  and  $K$ , then

$$V(K, \epsilon) = q(\epsilon)K. \quad (22)$$

In this case, the shadow price of capital,  $q(\epsilon)$ , equals the average value of capital,  $V(K, \epsilon)/K$ , which is observable using security market prices and is known as Tobin's  $q$ . This result extends Hayashi's (1982) result, which was derived in a deterministic model, to a stochastic model that admits irreversibility.

This result is a special case of the following Lemma, proven in Appendix B.

**Lemma 2** Suppose that  $\pi(K, \epsilon)$  and  $c(I, K)$  are homogeneous of degree  $\rho$  in  $I$  and  $K$ . Then the value function can be written as  $V(K, \epsilon) = \Lambda(\epsilon)K^\rho$ , and  $q \equiv V_K(K, \epsilon) = \rho \frac{V(K, \epsilon)}{K}$ .

<sup>13</sup>The operating profit in this case can be written as  $\pi(K, \epsilon) = \max_L [p(\epsilon)F(K, L, \epsilon) - w(\epsilon)'L]$ , where  $p(\epsilon)$  is the given price of the firm's output and  $w(\epsilon)$  is the vector of given prices of the costlessly adjustable inputs. Note that all of these prices may be potentially random. Let  $\lambda \equiv L/K$  be the vector of ratios of the costlessly adjustable inputs to the capital stock. It follows from the linear homogeneity of  $F(K, L, \epsilon)$  that  $\pi(K, \epsilon) = \max_\lambda [p(\epsilon)F(1, \lambda, \epsilon) - w(\epsilon)'\lambda]K$ . The maximand in square brackets is independent of  $K$ , and thus the operating profit function can be written as in equation (21), where  $H(\epsilon) = \max_\lambda [p(\epsilon)F(1, \lambda, \epsilon) - w(\epsilon)'\lambda]$ .

Thus, when the operating profit function and the augmented adjustment cost function are of the same degree of homogeneity, marginal  $q$  and average  $q$  are proportional. In the special case where  $\rho = 1$ , equation (21) holds, the augmented adjustment cost function is linearly homogeneous, and Lemma 2 indicates that average and marginal  $q$  are equal, as in equation (22).

We first discuss the content of the assumption that  $c(I, K)$  is linearly homogeneous. Recall that  $c(I, K)$  has three components: (1) a purchase/sale cost; (2) an adjustment cost; and (3) a fixed cost.

- (1) As we discussed in section II, the purchase/sale cost is  $p_K^+ I$  for  $I > 0$  and  $p_K^- I$  for  $I < 0$ . Obviously, a doubling of  $I$  and  $K$  doubles the purchase/sale cost, so the purchase/sale cost function is a linearly homogeneous function of  $I$  and  $K$ .
- (2) In the literature in which the adjustment cost function depends on  $K$  as well as on  $I$ , it is commonly assumed that the adjustment cost function is linearly homogeneous in  $I$  and  $K$ .<sup>14</sup>
- (3) The fixed cost of investment,  $c(0, K)$ , is independent of the amount of investment  $I$ . If this fixed cost reflects the cost of stopping production while new capital is installed,<sup>15</sup> it is proportional to the operating profit function  $H(\epsilon)K$  which is, of course, proportional to  $K$ . In this case, the fixed cost,  $c(0, K)$ , is a linearly homogeneous function of  $I$  and  $K$ , (even though it is independent of  $I$ ).

If the purchase/sale cost, the adjustment cost, and fixed cost are all linearly homogeneous functions of  $I$  and  $K$ , then  $c(I, K)$  is linearly homogeneous in  $I$  and  $K$ , and can be written as

$$c(I, K) \equiv Kc\left(\frac{I}{K}, 1\right) \equiv KG\left(\frac{I}{K}\right), \quad (23)$$

where  $G(\cdot)$  is continuous and convex, and, except possibly at zero, is twice differentiable. In this case,  $c_I(I, K) = G'(I/K)$ , so that equations (16) yield

$$\frac{I}{K} = \begin{cases} G'^{-1}(q) < 0, & \text{if } q < q_1 \\ 0, & \text{if } q_1 \leq q \leq q_2 \\ G'^{-1}(q) > 0, & \text{if } q > q_2. \end{cases} \quad (24)$$

Notice that the optimal investment-capital ratio depends only on  $q$ , and since  $q$  is independent of the capital stock, the optimal investment-capital

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<sup>14</sup>Abel and Blanchard (1983), Hayashi (1982), Lucas (1967, 1981) and Lucas and Prescott (1971) all make this assumption.

<sup>15</sup>Nickell (1978, p. 37) and Rothschild (1971, p. 609) both suggest that the cost of stopping production would give rise to a fixed cost of investment. In addition Rothschild suggests that breaking in new equipment or procedures is costly.



ratio is independent of the scale of the firm.<sup>16</sup> If  $q_1 < 0$ , then the negative investment regime is never operative, and as explained in section II, investment would appear to be irreversible.

**Case II**  $c_K(I, K) \equiv 0$ . Now assume that the augmented adjustment cost function does not depend on the capital stock (formally,  $c_K(I, K) \equiv 0$ ).<sup>17</sup> We continue to assume that the operating profit function is proportional to the capital stock (equation (21)). Under these two assumptions, we show in Appendix C that the value function is a linear function of the capital stock regardless of the specification of the diffusion for  $\epsilon$ . In particular,

$$V(K, \epsilon) = q(\epsilon)K + J(\epsilon). \quad (25)$$

To get an explicit expression for  $q(\epsilon)$  in terms of the underlying stochastic process, we will focus on particular parametric specifications of the operating profit function and the diffusion for  $\epsilon$ . It is not necessary to further restrict  $c(I, K)$ .

Consider a competitive firm that uses capital and labor to produce output according to the Cobb-Douglas production function  $vL^\alpha K^{1-\alpha}$ , where  $0 < \alpha < 1$ , and  $v > 0$  is a productivity parameter that may be stochastic. The firm pays a constant wage rate  $w$  per unit of labor and sells its output at a price  $P$  that may be stochastic. Define  $p = Pv$  and observe that the instantaneous operating profit equals the revenue from selling output minus the cost of labor so that

$$\pi(K, p) \equiv \max_L [pL^\alpha K^{1-\alpha} - wL] = hp^\theta K \quad (26)$$

where  $h \equiv (1 - \alpha)\alpha^{\alpha/(1-\alpha)}w^{-\alpha/(1-\alpha)} > 0$  and  $\theta \equiv 1/(1 - \alpha) > 1$ .

At time  $t$ , the present value of marginal profits accruing to the undepreciated portion of currently installed capital is<sup>18</sup>

$$q_t = h \int_0^\infty E_t \{ p_{t+s}^\theta \} e^{-(r+\delta)s} ds. \quad (27)$$

We calculate the expectations in equation (27), and the value of  $q_t$ , under the assumption that  $p$  evolves according to the geometric Brownian motion

$$\frac{dp}{p} = \sigma dz \quad (28)$$

<sup>16</sup>Lucas (1967) highlights this feature in a deterministic model with linear homogeneous net receipts and convex costs of adjustment.

<sup>17</sup>This assumption is adopted by Abel (1983), Caballero (1991), Eisner and Strotz (1963), Gould (1968), Hartman (1972), Mussa (1977), Nickell (1978), Pindyck (1982), and Rothschild (1971).

<sup>18</sup>As in equation (20), we assume there is no bubble in the shadow price  $q$ .

where  $z$  is a Weiner process with mean zero and unit variance. In this case, the distribution of  $\ln p_{t+s}$  conditional on  $p_t$  is  $N(\ln p_t - \frac{1}{2}\sigma^2 s, \sigma^2 s)$  so that

$$E_t \{ p_{t+s}^\theta \} = p_t^\theta \exp \left[ \frac{1}{2} \theta (\theta - 1) \sigma^2 s \right] . \quad (29)$$

Substituting equation (29) into equation (27) and simplifying yields<sup>19</sup>

$$q_t = \frac{h p_t^\theta}{\left[ r + \delta - \frac{1}{2} \theta (\theta - 1) \sigma^2 \right]} . \quad (30)$$

Now suppose that  $0 < q_1 < q_2$  so that all three investment regimes are potentially operative,<sup>20</sup> and consider the effects of an increase in the instantaneous standard deviation  $\sigma$ .<sup>21</sup> It follows directly from equation (30) that an increase in  $\sigma$  increases  $q_t$  for a given  $p_t$ . If the initial value of  $q_t$  is less than  $q_1$  or higher than  $q_2$ , the increase in  $q_t$  increases investment, which is consistent with Hartman (1972), Abel (1983), and Caballero (1991). But note that if the initial value of  $q_t$  is in the interval  $(q_1, q_2)$ , a small increase in  $\sigma$  will not move  $q_t$  out of this interval, and investment will remain unchanged and equal to zero. Thus, with the more general adjustment cost function introduced in this paper, we have the result that investment is a non-decreasing function of  $\sigma$  for a given price of output  $p_t$ .

## IV Conclusion

In this paper we have extended the adjustment cost framework under uncertainty to incorporate fixed costs of investment, a wedge between the purchase price and sale price of capital, and potential irreversibility of investment. In this extended framework, investment is a non-decreasing function of  $q$ , the shadow price of installed capital, and there are potentially three investment regimes which depend on the value of  $q$  relative to the critical values  $q_1$  and  $q_2$ . Conveniently, these critical values depend only on the specification of the augmented adjustment cost function. If  $q$  is greater than  $q_2$ , then, as is standard in the  $q$  theory branch of the adjustment cost literature, investment is positive and is an increasing function of  $q$ . If  $q$

<sup>19</sup>We assume that  $r + \delta - \frac{1}{2} \theta (\theta - 1) \sigma^2 > 0$  so that the integral in equation (27) converges.

<sup>20</sup>Recall that  $\min_I c(I, K) < 0$  is necessary and sufficient for  $q_1 > 0$ . Either  $c(0, K) > 0$  or  $c_I(0, K)^- < c_I(0, K)^+$  is sufficient for  $q_2 > q_1$ .

<sup>21</sup>When we consider the effects of a change in a parameter such as  $\sigma$ , we are actually comparing the behavior of two otherwise identical firms with different constant values of the parameter in question. This analysis does not apply to the effect on a given firm of a change in the parameter because the firm's optimization problem assumes that the parameters are known with certainty to be constant over time.

is between  $q_1$  and  $q_2$ , then investment is zero. Although this regime features prominently in the irreversibility literature, it is largely ignored in the adjustment cost literature. Finally, if  $q$  is less than  $q_1$ , gross investment is negative, a possibility that is simply ruled out by assumption in the irreversibility literature.

The shadow price  $q$  is in general not observable so we presented two examples relating  $q$  to observable variables. In one example, restrictions on the production function and the augmented adjustment cost function guarantee that  $q$  is identically equal to the average value of the capital stock which is observable using security prices. In the other example, we tightly specify the production function and the diffusion process for the price of output and derive an expression for  $q$  as a function of the contemporaneous price of output. In this example, the price of output does not have a stationary distribution and hence  $q$  does not have a stationary distribution.

In ongoing research we are examining the behavior of  $q$  and investment in the presence of a mean-reverting process for the price of output so that  $q$  will have a stationary distribution. The ultimate goal of this line of research is to derive an econometric specification to apply these models to aggregate and disaggregate data on investment.

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## A The Bellman Equation

Define the value function as in the text, equation (3).

$$V(K_t, \epsilon_t) = \max_{I_s, d_s} E_t \int_t^{\infty} [\pi(K_s, \epsilon_s) - d_s c(I_s, K_s)] e^{-r(s-t)} ds \quad (\text{A1})$$

This can be written as the present value of profits up to a time  $\tau$ , plus the present value of the value function at that moment.

$$V(K_t, \epsilon_t) = \max_{I_s, d_s} E_t \int_t^{\tau} [\pi(K_s, \epsilon_s) - d_s c(I_s, K_s)] e^{-r(s-t)} ds + V(K_\tau, \epsilon_\tau) e^{-r(\tau-t)} \quad (\text{A2})$$

Define  $Z_t \equiv V(K_t, \epsilon_t) e^{-rt}$ , and subtract the left hand side of (A2) from both sides. Divide through by  $\tau$  and take the limit as  $\tau$  approaches  $t$ .

$$0 = \lim_{\tau \rightarrow t} \left\{ \max_{I_s, d_s} \frac{1}{\tau} E_t \int_t^{\tau} [\pi(K_s, \epsilon_s) - d_s c(I_s, K_s)] e^{-r(s-t)} ds + \frac{e^{rt} E_t (Z_\tau - Z_t)}{\tau} \right\} \quad (\text{A3})$$

Note that in the limit  $E_t(Z_\tau - Z_t) = E(dZ)$ , and  $dZ = -rZ dt + e^{-rt} dV$ , so substituting and taking the limit,

$$0 = \max_{I, d} \left\{ \pi(K, \epsilon) - dc(I, K) - rV(K, \epsilon) + \frac{E(dV)}{dt} \right\}. \quad (\text{A4})$$

Equation (A4) is the Bellman equation used in the text.

## B Proofs of Lemma 1 and Lemma 2

### B.1 Lemma 1

Suppose that  $\chi_t$  is a diffusion and that  $a > 0$  is constant. Then  $\chi_t = E_t \left\{ \int_0^\infty g_{t+s} e^{-as} ds \right\}$  is a solution to the differential equation  $E_t(d\chi)/dt - a\chi_t + g_t = 0$ .

Define  $h$  as a short interval of time. If  $\chi_t = E_t \int_0^\infty g_{t+s} e^{-as} ds$ , then

$$\begin{aligned} \chi_t &= E_t \left\{ \int_0^h g_{t+s} e^{-as} ds + \int_h^\infty g_{t+s} e^{-as} ds \right\} \\ &= E_t \left\{ \int_0^h g_{t+s} e^{-as} ds \right\} + \\ &\quad E_t \left\{ \int_h^\infty g_{t+s} [e^{-as} + e^{-a(s-h)} - e^{-a(s-h)}] ds \right\} \quad (B1) \\ &= E_t \left\{ \int_0^h g_{t+s} e^{-as} ds \right\} + \\ &\quad E_t \left\{ \int_h^\infty g_{t+s} [e^{-ah} - 1] e^{-a(s-h)} ds \right\} + E_t \chi_{t+h}. \end{aligned}$$

We now employ the following approximations, which becomes exact as  $h$  approaches zero:

$$E_t \chi_{t+h} = \chi_t + h E_t(d\chi/dt) \quad (B2)$$

and,

$$\begin{aligned} E_t \left\{ \int_0^h g_{t+s} e^{-as} ds + \int_h^\infty g_{t+s} [e^{-ah} - 1] e^{-a(s-h)} ds \right\} \\ = hg_t - ah\chi_t. \end{aligned} \quad (B3)$$

Substitute these expressions into equation (B1) to produce

$$\chi_t = hg_t - ah\chi_t + \chi_t + h E_t(d\chi/dt). \quad (B4)$$

Subtract  $\chi_t$  from both sides and divide through by  $h$ , producing the differential equation

$$0 = g_t - a\chi_t + E_t(d\chi/dt). \quad (B5)$$

### B.2 Lemma 2

Suppose that  $\pi(K, \epsilon)$  and  $c(I, K)$  are homogeneous of degree  $\rho$  in  $I$  and  $K$ . Then the value function can be written as  $V(K, \epsilon) = \Lambda(\epsilon)K^\rho$ , and  $q \equiv V_K(K, \epsilon) = \rho \frac{V(K, \epsilon)}{K}$ .

The operating profit function and the augmented adjustment cost function are homogeneous of degree  $\rho$  in  $I$  and  $K$  so that

$$\pi(K, \epsilon) = H(\epsilon)K^\rho \quad (B6)$$



and

$$c(I, K) = G\left(\frac{I}{K}\right)K^\rho. \quad (\text{B7})$$

Then the value function in equation (3) can be written as

$$V(K_t, \epsilon_t) = \max_{I_{t+s}, d_{t+s}} \int_0^\infty E_t \{ [H(\epsilon_{t+s}) - d_{t+s}G(i_{t+s})] K_{t+s}^\rho \} e^{-r_s} ds, \quad (\text{B8})$$

where  $i_{t+s} \equiv I_{t+s}/K_{t+s}$  is the (gross) growth rate of the capital stock. Consider a firm with capital stock  $K_t^{(1)}$  at time  $t$ , and let  $d_{t+s}^{(1)}$  and  $i_{t+s}^{(1)}$  denote the optimal values of the dummy variable  $d$  and the investment capital ratio chosen by this firm at time  $t+s$ . This optimal behavior leads to a capital stock of  $K_{t+s}^{(1)}$  at time  $t+s$ . The value of the firm at time  $t$  is  $V(K_t^{(1)}, \epsilon_t)$ . Now consider a second firm with a capital stock at time  $t$  equal to  $K_t^{(2)} = \alpha K_t^{(1)}$  with  $\alpha > 0$ . This firm has the option of choosing exactly the same values of the dummy variable  $d$  and the investment capital ratio  $I/K$  at every point of time as chosen by the firm with capital stock  $K_t^{(1)}$ . If the second firm were to set  $d_{t+s}^{(2)} = d_{t+s}^{(1)}$  and  $i_{t+s}^{(2)} = i_{t+s}^{(1)}$  for all  $s > 0$ , then  $K_{t+s}^{(2)}$  would equal  $\alpha K_{t+s}^{(1)}$  for all  $s > 0$ . Because the cash flow at time  $t+s$  is proportional to  $K_{t+s}^\rho$  in equation (B8), the second firm has the option of obtaining an expected present value of cash flows equal to  $\alpha^\rho V(K_t^{(1)}, \epsilon_t)$ . Therefore,

$$V(\alpha K_t, \epsilon_t) \geq \alpha^\rho V(K_t, \epsilon_t). \quad (\text{B9})$$

Equation (B9) holds for any  $K_t$  and for any positive factor  $\alpha$ . In particular, consider a first firm that has a capital stock of  $\alpha K_t$  at time  $t$ , and a second firm that has a capital stock of  $K_t = (1/\alpha)\alpha K_t$  at time  $t$ . Therefore, the argument preceding equation (B9) implies that

$$V(K_t, \epsilon_t) \geq (1/\alpha)^\rho V(\alpha K_t, \epsilon_t) \quad (\text{B10})$$

Putting together equations (B9) and (B10) we have  $V(\alpha K_t, \epsilon_t) \geq \alpha^\rho V(K_t, \epsilon_t) \geq V(\alpha K_t, \epsilon_t)$  which implies

$$V(\alpha K_t, \epsilon_t) = \alpha^\rho V(K_t, \epsilon_t). \quad (\text{B11})$$

Because equation (B11) holds for any positive  $K_t$  and any positive  $\alpha$ , the value of the firm is proportional to the capital stock to the power  $\rho$ , and hence the value function can be written as  $V(K_t, \epsilon_t) \equiv \Lambda(\epsilon_t)K_t^\rho$ . Partially differentiating (B11) with respect to  $K_t$  yields  $q_t \equiv V_K(K_t, \epsilon_t) = \rho \frac{V(K_t, \epsilon_t)}{K_t}$  **q.e.d.**

## C The Value Function When The Augmented Adjustment Cost Function Does Not Depend on the Capital Stock

The optimal program of the firm is governed by the differential equation given in the text equation (6). Here we assume that  $c_K(I, K) \equiv 0$ , so we write the augmented adjustment cost function,  $c(I, K)$  as simply  $c(I)$ .

$$rV(K, \epsilon) = \max_{I, d} \left\{ \pi(K, \epsilon) - dc(I) + q(I - \delta K) + \mu V_\epsilon + \frac{1}{2} \sigma^2 V_{\epsilon\epsilon} \right\} \quad (C1)$$

Now suppose that the firm is a price-taker in output and factor markets and has a production function that is linearly homogeneous in  $I$  and  $K$  so that  $\pi(K, \epsilon) = H(\epsilon)K$  (see footnote 9). We will verify that  $V(K, \epsilon) = q(\epsilon)K + J(\epsilon)$  satisfies (C1). Substituting  $V(K, \epsilon) = q(\epsilon)K + J(\epsilon)$  and  $\pi(K, \epsilon) = H(\epsilon)K$  into (C1) and recalling the definition of  $q$  yields

$$\begin{aligned} rq(\epsilon)K + rJ(\epsilon) = \max_{I, d} \{ & H(\epsilon)K - dc(I) + q(\epsilon)(I - \delta K) \\ & + \mu q_\epsilon K + \mu J_\epsilon + \frac{1}{2} \sigma^2 q_{\epsilon\epsilon} K + \frac{1}{2} \sigma^2 J_{\epsilon\epsilon}. \end{aligned} \quad (C2)$$

Collecting terms in  $K$ ,

$$\begin{aligned} [(r + \delta)q(\epsilon) - \mu q_\epsilon - \frac{1}{2} \sigma^2 q_{\epsilon\epsilon} - H(\epsilon)] K = \\ \max_{I, d} [q(\epsilon)I - dc(I)] - rJ(\epsilon) + \mu J_\epsilon + \frac{1}{2} \sigma^2 J_{\epsilon\epsilon} \end{aligned} \quad (C3)$$

In order for (C3) to hold for all  $K$ , the term in square brackets on the left hand side must equal zero, and the right hand side of (C3) must also equal zero. Note that from equation (8) we can write

$$\max_{I, d} [q(\epsilon)I - dc(I)] = \max [0, \psi(q)]. \quad (C4)$$

Setting the right hand side and the left hand side of (C3) equal to zero yields

$$\max [0, \psi(q(\epsilon))] - rJ(\epsilon) + \mu J_\epsilon + \frac{1}{2} \sigma^2 J_{\epsilon\epsilon} = 0 \quad (C5)$$

and

$$H(\epsilon) - (r + \delta)q(\epsilon) + \mu q_\epsilon + \frac{1}{2} \sigma^2 q_{\epsilon\epsilon} = 0. \quad (C6)$$

Note that both differential equations are of the form

$$g(\epsilon) - a\chi(\epsilon) + E(d\chi/dt) = 0. \quad (C7)$$

According to Lemma 1, a solution to the differential equation in (C7) is

$$\chi(\epsilon_t) = E_t \int_0^{\infty} g(\epsilon_{t+s}) e^{-as} ds. \quad (C8)$$

Since equations (C5) and (C6) are both of the form in equation (C7), we substitute from these into equation (C8) to conclude.

$$J(\epsilon_t) = E_t \int_0^{\infty} \max [0, \psi(q_{t+s})] e^{-rs} ds \quad (C9)$$

$$q(\epsilon_t) = E_t \int_0^{\infty} H(\epsilon_{t+s}) e^{-(r+\delta)s} ds \quad (C10)$$

$J(\epsilon_t)$  can therefore be interpreted as the present value of rents accruing to the firm from the augmented adjustment technology, and  $q(\epsilon_t)$  is the present value of marginal products of capital. Note that this solution was derived for any diffusion process governing  $\epsilon_t$ .