EXTERNAL EQUITY IN AGRICULTURE FARM - A NEW APPROACH

Laura GIURCA VASILESCU

University of Craiova, Faculty of Economy and Business Administration
13 A. I. Cuza Street, 200585, Craiova, Romania, laurra2004@yahoo.com

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SUMMARY

External equity of the firm is equity capital derived from sources other than the retained earnings or the internal capital. The external equity could be used to replace debt financing of farm assets. It has been known that debt financing - while holding equity constant - increases a firm’s risk. The additional risk associated with debt financing is often referred as financial risk. Thus, a firm can use external equity to reduce financial risk. Also, external equity mitigates farm liquidity constraints imposed by limited debt-capacity and credit rationing [1]. The availability of external equity would allow farmers to expand and get more efficient production levels or to take full advantage of their management ability without incurring excessive financial risk from high levels of debt. Some farmers may choose to retain their current size but decrease debt levels. The agricultural sector would potentially benefit because a reduction in financial risk would lower the bankruptcy probability in crisis periods.

In fact, the potential benefits of external equity financing for farm business are widely recognized in agricultural economics [2]. In addition, investors who provide external equity may benefit from diversification and the opportunity to obtain higher rates of return on their capital. However, the relatively high transaction costs of equity investment and the possible distortion of management incentives could hinder the development of an equity market.

External equity financing for agricultural production can be also studied under the principal-agent framework. The two key players are: the principal (an investment firm) who provides equity capital and the other is the agent (farmer) who provides the effort [3]. The principal-agent framework allows for an optimal sharing rule or compensation scheme that preserves the farmer’s incentive to work in the world of uncertainty and asymmetric information [4].

REFERENCES