Common labelling and producer organisations: a transaction cost economics approach

Emmanuel Raynaud[1] and Loïc Sauvee[2]

[1] INRA - SAD Ile de France and Université de Paris 1 - Centre ATOM, France

emmanuel.raynaud@agroparistech.fr

[2] ISAB - Département Sciences de Gestion, Cergy-Pontoise cedex, France

Contribution appeared in Sylvander, B., Barjolle, D. and Arfini, F. (1999) (Eds.) "The Socio-Economics of Origin Labelled Products: Spatial, Institutional and Co-ordination Aspects", proceedings of the 67th EAAE Seminar, pp. 134 - 142

October 28-30, 1999

Le Mans, France

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Emmanuel RAYNAUD* and Loïc SAUVEE*

**INRA - SAD Ile de France and Université de Paris 1 - Centre ATOM, France*

***ISAB - Département Sciences de Gestion, Cergy-Pontoise cedex, France*

Abstract

In agricultural and food sectors, actors frequently develop collective quality signs. The objective of this article is to propose an analytical framework of collective quality signs seen as specific asset which property is shared. Using the transaction-cost economics approach, we study the determinants of organisational choices of producers using common quality signs. We put in evidence the importance of contractual hazards in the choice of governance structures. Then we study the various mechanisms that constitute the governance of common quality signs.

Keywords : common labelling, contractual hazards, mechanisms of governance, hybrid forms, quality

INTRODUCTION

In agricultural and food sectors, the actors frequently develop common labels. Some of them are private, like collective brands owned by producers' organisations (for example, Saveol in the fresh vegetables sector or Banette in the milling industry). The others are public, *i.e.* belonging to the State but put at the disposal of private actors (*label rouge* products, PDO, PGI). A last category is a mix of public and private sign (for example, in the French poultry industry the brand *poulet de Loué Label rouge*).

The objective of this article is to propose an analytical framework of common quality signals, seen as assets. We study the governance of these collective assets. To do this, the theoretical framework of Transaction-Cost Economics (TCE) will be mobilised, and especially the study of governance structures (Williamson [1996], [1985]). The paper is organised as follow. In the first section, we explain the choice of a collective quality strategy, as well as elements mobilised in economic analysis to explain the creation of a quality signal. In a second section, we define the theoretical framework developed to study the governance of common quality signals. Then we emphasise the key role played by mitigation of contractual hazards in the choice of governance structures. Finally, we detail the mechanisms of governance, with examples from agricultural sectors.

1. COLLECTIVE QUALITY SIGNS

1.1. Why collective quality signs ?

Numerous collective quality signs are used in agricultural and food sectors in France. The importance of these collective signs can be explained by several factors. Some of them are bound to authorities' decisions, while others depend upon the evolution of the strategy of the actors and of the market structure.

Factors connected to public policies can have several origins. It can be a policy trying to revitalise a sector. For instance, the birth of the French *label rouge* in the poultry sector arises above all from the will of the authorities to support a market in crisis. Authorities can also try to protect some specific territories (*terroirs*), for example for questions of rural development, by the creation of official signs like origin-labelled product. Finally, authorities also try to create official signs when an incomplete or too weak definition of property rights prevents a market from being established (namely products from the farm –like *produits fermiers* or eco-labels etc.). So initiated by an authority outside the market, collective sign can be conceived as a tool put at disposal of the actors for objectives of rural or economic development. Then the state intervenes essentially as a "producer of rights" with regard to these official signs.

Parallel to these institutional factors, the private strategies of the actors are also at the origin of collective signs. A cooperation for the creation of a collective quality strategy can be a source of value for producers involved[2]. On agricultural markets where supply becomes more and more important in variety, the strategies of development of quality signs are an increasing concern.

The major gains induced by the creation of a common quality sign are the existence of scale economies in the promotion expenses. The cost of the creation of a quality sign is weakly correlated to the size of the market. On the other hand, benefits are proportional to the size of the market. There is thus an effective minimum size for the promotion of products (Alchian and Woodward [1987], Rosen [1996]). The level of investment required for an individual producer in the creation of a quality signal (for example a trademark requiring a national campaign of promotion) may be too high. However, sharing the costs of these investments among several producers allows exploiting scale economies, making the cooperation advantageous for the group as a whole[3]. Therefore, the small size of the companies of the sector with regard to their market explains the appeal to collective quality strategies. The reason for horizontal and vertical differentiation of products through collective signs appears to be a possibility of differentiation for small size companies in a context of brand development from major firms in the food processing and retail businesses.

1.2. From the sign to the quality signal

1.2.1. Information asymmetry on product quality

The identification of product quality may be problematic for numerous agro-food products. Industrial economics distinguishes three types of goods depending when quality can be appreciated (Nelson [1970], Darby and Karni [1973]) :

i) Search goods, the quality of which can be easily identified by the consumers before the purchase ;

ii) Experience goods, quality of which is known only after the purchase ;

iii) Credence goods, for which the consumers do not know some attributes of the quality even after the purchase.

Within this typology, there is an asymmetry of information among the producers and the consumers for the last two types of goods. The asymmetry of information on the quality of the products leads at the same moment to problems of adverse selection and of moral hazard (Stiglitz [1987]).

When the consumer is confronted with a heterogeneous supply, inefficiencies induced by problems of adverse selection may exist. A well-known result is to show that when there is a problem of adverse selection, the market can disappear although there are gains from trade (Akerlof [1970]).

When the producer can choose the quality level of his good, there is a problem of moral hazard on the choice of the quality. If the exchange between the producer and the buyer is repeated, the purchase at a time period can bring information about quality in the future. Nevertheless, if the quality level can vary during time, quality at a period of time cannot be fully anticipated (Tirole [1988]). For each period, there is an uncertainty about the quality of goods. If the producer supplied a very good quality in the first period, he should be incited to continue to produce a high quality for the future periods.

1.2.2. Consumers' information and quality signal

The economic analysis, in particular work in the economics of information, shows that on a market characterised by an asymmetry of information on the quality of goods, one means to restore the efficiency of the market coordination is to create quality signals. In this approach, collective quality signs are interpreted as signals that the producers send in order to reduce the asymmetry of information on the quality of their products (Akerlof [1970], Nelson [1970]).

Quality uncertainty induces, for buyers, search and measurement costs (Barzel [1982]). The quality signal reduces the information and search costs for buyers if it reveals the quality differences between the products that are proposed to the buyers. A market where products are "anonymous" turns into a market where products are identified.

In a context of repeated exchange with a problem of moral hazard about the effort on product quality, the creation of a quality signal is also studied as a guarantee of the homogeneity of the considered good[4]. Nevertheless, in this situation, the creation of a quality signal sets the problem of the credibility of this signal. The credibility of a quality signal is defined as the respect by the owner of (sometimes implicit) commitments, of a given level of quality. The creation of a quality signal must reduce *ex ante* the issue of adverse selection. The respect for the credibility of the quality signal sets an *ex post* problem of moral hazard. This problem is particularly sharp for a common quality signal because each individual agent has an incentive to free ride on the product quality reducing the reputation of the quality signal (Rosen [1996]).

Standard industrial economics focuses essentially on the consequences of quality signals for the running of markets, for example uniqueness or multiplicity of equilibria or level of prices. Industrial economics deals with individual quality signals, *i.e.* signals that are owned by a unique firm. Only some recent works have dealt with the question of collective quality signals (for example Linnemer and Perrot [1997], Marette *et ali.* [1998]). In these works, the modalities of management of these common signals between the producers are not studied. So, the organisational modes set up by the producers are often considered as a black box.

Transaction Cost Economics (hereafter TCE) aims at explaining the choice, by economic actors, of organisational modes[5]. Applied to the study of common quality signals, these works focus on the question of the organisation of producers. A common quality signal is then less considered in its dimension of signal than as an economic asset the property and/or use of which is shared. The modalities of management of this asset are then studied, which requires a better understanding of organisational choices.

2. THE GOVERNANCE OF COLLECTIVE QUALITY SIGNS

Considering that the mode of organisation is a decision variable for economic agents, TCE explains the logic of these choices, *i.e.* elements constraining these choices as well as criteria allowing estimating the efficiency of various alternatives. This efficiency is, as we will see, appreciated in a relative way ; this sends back to the various elements which compose a governance structure.

2.1. The choice of governance structures

2.1.1. Constraints upon organisational choices

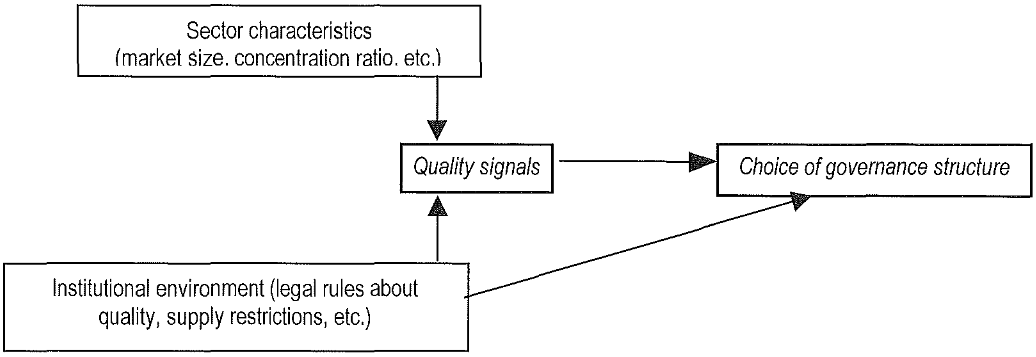
The organisational choices that involve the producers to govern their cooperation are constrained by several elements. One can distinguish two types of constraints. A first level is connected to the behavioural hypotheses about economic actors. The first hypothesis held by TCE deals with the cognitive capacities of the actors. It is supposed that actors have a bounded rationality. They cannot foresee all the contingencies, which may arise during the progress of their cooperation, in particular when uncertainty is important. This hypothesis has a direct consequence on contractual relations : a complete contract to govern relations is not a feasible alternative (Williamson [1985]). It emphasises the importance of *ex post* decision mechanisms that must be created in order to govern the relations between users of the collective signal. The second behavioural hypothesis is that of opportunism. The promises of the agents are not as valid as their commitments (Williamson [1985]). This hypothesis implies that the (incomplete) contracts between actors have to contain a set of mechanisms allowing limiting opportunist behaviours.

A second level of constraints deals with the environment of actors. One can distinguish here two different constraints. Firstly, it is supposed that the institutional environment also influences the organisational choices of actors (North [1990]). By institutional environment, one considers the set of "rules of the game" in which actors will decide their organisational choices (for instance the right of contracts, specific quality legal rules, etc.). This environment is going to influence the relative costs of alternative modes of organisation; sometimes it will prevent some of them and will so influence the arbitration of the actors. A second hypothesis concerns the appeal to courts to insure the management of conflicts. The possibility of conflicts among actors is a consequence of both the contractual incompleteness and the hypothesis of opportunistic behaviours. One hypothesis of TCE is that of an appeal to courts only in the last resort, for complex transactions between firms. Indeed, Williamson [1985], following some legal experts, argues in a convincing way about the limits of courts to adjust some disputes. This hypothesis is relevant for numerous situations in which the judges do not possess all the necessary information and/or competencies for the treatment of the dispute[6]. The prediction is that agents involved in a complex transaction or engaged in a cooperation have a strong incentive to set up a mechanism of conflicts management (for instance an arbitration committee). The figure 1 reproduces the logic of organisational choices by economic actors, according to the various variables and parameters which are able to affect these choices.

2.1.2. Contractual hazards and the choice of governance structure

According to the economic and institutional environments characterising a given sector, the actors have to make strategic choices concerning the differentiation of their products. These choices can lead to the creation of quality signals, individual signals for the major companies of the sector, or collective signals for the others. Gains are expected from these vertical or horizontal differentiation strategies. Nevertheless, whether a collective quality strategy is a source of value, it is also a potential source of conflicts. Each producer has an incentive to take over a wide part of the created value to the detriment of the others, through opportunist behaviour. This opportunist behaviour is a source of contractual hazards between agents[7]. In the case of a common quality signal, there is a problem connected to the public good nature of this signal. The reputation of the signal is shared by the group of producers (Tirole [1996]). Each producer has an incentive to a free ride with regard to the collective reputation, by not following the rules allowing obtaining the expected quality. This type of individual behaviour creates externalities for the group of producers exploiting the common signal. The individual profit that a producer expects to receive from his participation depends upon its behaviour but also upon behaviour of the other producers. Each producer is potentially in a situation of insecurity with regard to the gains that he will be able to get himself.

Figure 1 : The logic of organisational choices



One hypothesis proposed by TCE is that the design of modes of organisation is an answer to the contractual hazards anticipated by the agents. Indeed one expects that the producers, conscious of the gains and the hazards of a collective strategy, design a mode of organisation allowing to obtain maximum net gains, especially a mode of organisation allowing to limit the opportunist behaviour of the producers. A heuristic presentation of organisational choices is proposed by Williamson [1985] and allows introducing the notion of safeguard clauses. These clauses are the set of mechanisms implemented to reduce contractual hazards between producers. Williamson considers that one can represent a governance structure by a triplet : C (p, h, s), where C (.) represents the chosen governance structure, p the price, h the degree of contractual hazards and s the safeguard clauses. Theoretical prediction is that there exists a covariation between variable h and s. When there are contractual hazards anticipated in a relation (h > 0), the governance structure is going to contain safeguard clauses (s> 0).

2.1.3. The alignment principle as a guide for organisational choice

If one considers that the mode of organisation is a choice of the involved actors, TCE makes the hypothesis that this choice is mainly driven by efficiency considerations. Efficiency criterion is the minimisation of production and transaction costs (Williamson [1985]). This minimisation is realised through the following principle according to which "*transactions, which differ in their attributes, are aligned with governance structures, which differ in their competences, in a discriminating way*" (Williamson [1985]). The analysis is essentially a comparative one : for a transaction or a given sets transactions, various possible alternatives are compared. This approach takes explicitly into account the variety of governance structures and the variety of transactions. The main empirically refutable hypothesis concerns the matching between governance structures and transactions (see Shelanski and Klein [1995] for a survey of empirical studies on the subject).

2.2. The governance of collective quality signs

2.2.1. Three generic classes of governance structures

Although there is a great variety of governance structures in a market economy, a typology between several classes of governance structures has been proposed (Williamson [1996]). The table 1 lists the main dimensions, which allow discriminating between governance structures[8]. Established initially from a binary axis market/hierarchy, this typology evolved gradually to take into account a set of contractual arrangements, between the two polar modes, called hybrid form.

Table 1 : Three classes of governance structures

Attributes	***Market***	***Hybrid form***	***Hierarchy***
Safeguard clauses	0	+	++
Conflicts resolution	Courts	Arbitration	Internal
Type of contract	Classical	Neo-classical	Subordination

++ : strong, + : semi strong, 0 : weak (adapted from Williamson [1996])

An important element allowing distinguishing the hybrid forms[9] from the market governance is the presence, in the former, of safeguard clauses. These clauses are supposed to protect the contractual relation from opportunist behaviours. The conflicts resolution also induces different modalities between governance structures.

For the governance of common quality signals, the choice of a class of governance structure is done, *a priori*, between market and hybrid forms. If a collective strategy implies a cooperation between legally autonomous producers, the hierarchical governance is *per se* excluded from the set of feasible arrangements[10]. In fact, several empirical studies demonstrated that relations among producers involved in a common quality signal are governed by hybrid structures (Ménard [1996, 1997], Raynaud [1997]).

2.2.2. The hybrid governance as a combination of mechanisms

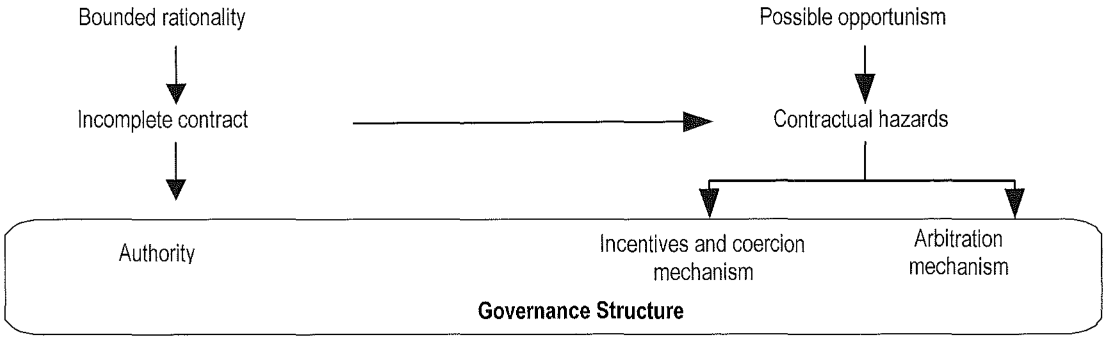
A governance structure tries to establish an order to realise and to share the mutual gains of an exchange or a cooperation[11]. The first feature of this order is a contract, or a set of contracts, where the parts define some mutual obligations. In a situation where contracts are incomplete, all the obligations are not specified *ex ante*. As a consequence, several additional mechanisms are necessary, in particular :

i) Procedures to fill in the gap of the initial contract ;

ii) Mechanisms to enforce the contractual promises (initial commitments).

The figure 2 (adapted from Brousseau and Fares [1998]) reproduces the various mechanisms involved in hybrid governance structures.

Figure 2 : The mechanisms of hybrid forms



In the case of common quality signals, we saw that a producer could behave opportunistically with regard to the common reputation, which induces a mutual dependence between the producers. One expects to find monitoring and/or incentive mechanisms allowing to align the producers' incentives and to guarantee the realisation of the potential gains of the cooperation. As the organisation contains producers within various stages of a vertical chain or producers exclusively placed at the same stage (horizontal organisation), various incentive and control mechanisms will be mobilised. Let us now detail the specific mechanisms found in some agricultural sectors.

2.2.3. Governance of collective quality signs in agricultural sectors

In the case of an essentially vertical organisation like the French *Label Rouge* chicken, the clauses of contracts among producers in the various links of the chain can contain incentives for product quality, *i.e.* a payment conditional on product quality. In the case of a horizontal organisation, where there are no transactions between the actors, the clauses of contracts rather deal with the common exploitation of the brand. Besides constraints imposed to obtain a qualitative level, there are constraints on relations between the producers, for example territorial competition clauses, exclusive dealing clauses, etc. It is for example the case in some *Label Rouge* chains for which there exist clauses of non-competition between the various slaughterhouses of the same *Label Rouge*.

Decision mechanism is also a fundamental element of the governance of shared brand. Because of contractual incompleteness, some decisions should be taken during the progress of the relation : for instance a modification of the quality sign's list of specifications, investments in the promotion of products, termination of a contract, modification of the governance structure.

Because of the very nature of the organisation set up to govern these cooperations, the property rights of each producer remain different. It does not exist, *a priori*, as in an integrated firm, any authority, which possesses the power to impose its decisions. Indeed, in this type of cooperation, every producer that participated in the creation of the common quality signal is owner of it. The property of this asset is a shared property and the producers possess the residual rights of control on their own assets but also on the asset collectively owned (Hart [1995]). This divided property of assets implies the creation of a mechanism of decision-making where each owner possesses the right to make himself heard, *i.e.* where each producer is directly involved or represented. Concretely, this will be done with the creation of an assembly of producers *ex ante* determined, when the cooperation is being negotiated (Ménard [1997]). This assembly possesses the formal right to make decisions about internal functioning and the evolution of the cooperation. It is for example the case in *Label Rouge* chicken with the creation of quality group (formerly known as the certifying body), which is an assembly of the co-owners of the brand. Inside these groups, each category of actors is represented within the board of directors (breeders, incubators, slaughterhouses, etc.) (Ménard [1996]).

Some organisations possess simultaneously vertical and horizontal dimensions. The collective tomato brand, Saveol, in the fresh vegetable sector is an example where the governance structure participates in the management both of vertical relations between the various stages of the chain and of horizontal relations between various producers of the same stage (Sauvée [1998]). In this particular case of collective and private quality signs, the governance structure will combine various mechanisms leading to the creation of a specific private order.

Saveol is a collective brand name involving more than one hundred producers. In fact, this brand name hides a complex hybrid organisational form (Philippe and Sauvée [1999]). The producers are organised through four producer groups, mainly in charge of technical aspects of production. These producer groups are themselves the main shareholders of a private firm called SMO. This firm is the owner of the brand name Saveol and looks after the marketing strategy (product innovation, promotion, sale forces...). The basic feature of Saveol's decision device relies on "the recognition of an authority and subordination principle" (Brousseau and Fares [1998 : 17]). In this negotiation structure, there are two levels of delegation of decision rights. The first level is between producers and producer groups, the second level is between producer groups and SMO. These two levels are complementary and illustrate a case of repartition between technical and marketing aspects in the process of decision making. These devices are also combined with safeguard clauses, in order to mitigate contractual hazards found at various levels. At the end, the complete governance structure devoted to the monitoring of Saveol is a mix of *ex ante* and *ex post* coordination mechanisms.

At the production level, the main contractual hazard found in the fresh vegetable industry is a measurement problem (Foss [1996]), due mainly to quality variability both from one period of time to another, and from one producer to another. On one hand, the producer groups will develop a common technical scheme that will reduce this variability. On the other hand, Saveol's information system works as a coercion/incentive mechanism for independent producers. The behaviour of these producers is thus constrained by self-enforced mechanisms. As Foss[1996] pointed out, it is important to recognise that, in fresh and vegetables sectors, technological scheme "*such as measurement methods and sorting techniques, is one of the way in which (...) transaction costs can be reduced*" (Foss, [1996 : 538]). Doing so, it places producers in a specific information environment. The monitoring of the collective brand Saveol is insured through a pivotal structure, SMO. The role of this pivotal structure is notably to provide safeguard clauses. These clauses involve internal agents (such as producers) but also external agents (such as carriers, with long-term contracts). SMO board of managers represents a collective assembly of producers. Its role is to enforce the commitments of parties through supervision and arbitration (in case of conflicts) mechanisms.

A mechanism of conflicts and arbitration management is also indispensable in the governance of a common quality signal. One can guess that because of contract incompleteness, and potential opportunist behaviour of individual producers, conflicts are likely to appear. The exclusion of an owner in a situation where the property of an asset is shared, is not done in the same way as exclusion, by the owner, of an actor who is only user of this asset. However, the possibility of exclusion appreciated as an incentive mechanism is nevertheless fundamental (Klein [1995], Tirole [1996]).

The study of the governance of the collective brand *Banette* is in this respect exemplary. *Banette* brand is a collective trademark of flour and bread used by a group of millers and traditional bakers. The millers are organised in a franchise chain. The peculiarity of this chain is that the franchiser was created by the millers, who are shareholders of his capital (Raynaud [1997]). The members of the board of the franchiser are the franchisees. Within the grouping of franchisees, there is a committee in charge of the management of conflicts, which are likely to arise among the franchisees. This committee, consisting in a group of millers, plays the role of internal court for the resolution of conflicts. In a classic franchise chain a conflict among franchisees within the chain is arbitrated by the franchiser (before sometimes going to the court). Instead, in *Banette* chain, the millers have to create the franchiser and an internal mechanism of conflict management. It is always possible, in the last resort, to deal with courts when the internal management of conflicts did not end in an agreement.

Beyond the variety of the internal modalities of functioning of these various assemblies, it is interesting to notice that the creation of a common quality signal always comes along with the concomitant creation of a private order between autonomous producers. The existence of a collective authority is its main feature (Ménard [1997], Williamson [1996]).

CONCLUSION

The conception of the collective quality sign as an asset which property is shared, allowed us to develop an analytical framework of the organisations governing these collective signs. Identification and mitigation of all forms of contractual hazards related to the monitoring of the sign are the main arguments of the analysis. In this perspective, the search for organisational efficiency, i.e. the minimisation of the costs of organisation, constitutes the principle for the choice of governance structures. The constitution of hybrid forms, such as producers' collective organisations, can be an answer to this search for efficiency. The question of the compatibility of these collective organisations with the competition law is at stake. One can suggest that, far from constraining free competition, these collective organisations result from a search for efficiency in a competitive context.

NOTES

(1) The authors thank Jean-Pierre Huiban, Armelle Mazé, Stéphanie Polin, Geneviève Teil and André Torre for their comments.

(2) We will not detail the interest that there is to adopt a product differentiation strategy in an environment characterised by a strong competition.

(3) For instance, this search for scale economies in product promotion is at the basis of the development of national and international franchise chains (Mathewson and Winter [1995]).

(4) This is clearly stated by Barzel [1982:36] with the example of a canner owning a brand name : "the canner's reputation, or brand name, serves here to guarantee that the product is, and will remain, uniformly good".

(5) For a synthetic presentation of these works, see for instance Brousseau [1993], Carlton and Perloff [1998], Milgrom and Roberts[1997].

(6) Appeal to an expert is a widely used practice but it increases at the same moment the cost and the period of treatment of disputes.

(7) Many forms of contractual hazards has been recognised (Williamson, 1996:14) : (i) hazards of bilateral dependency ; (ii) hazards that accrue to weak property rights ; (iii) measurement hazards ; (iv) : hazards that accrue to weaknesses in the institutional environment. On these four forms of hazards, see respectively : Klein and ali (1978), Oxley (1997), Barzel (1982) and North (1990).

(8) Nevertheless, it is necessary to clarify that, besides the variety identified between these various classes, there is a supplementary variety inside each of these classes of governance structures.

(9) Hybrid forms are "long-term contractual relations that preserve autonomy but provide added transaction-specific safeguards, compared with the market" (Williamson, 1996:378).

(10) Hierarchy sends back to a lateral and/or horizontal integration of the producers involved in the control of the collective quality signal.

(11) According to Williamson (1996:12): "Governance is the means by which order is accomplished in a relation in which potential conflict threatens to undo or upset opportunities to realise mutual gains".

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