Contract Theory :
Path toward the Third Theory of Microeconomics

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The purpose of this article is to offer an overview of contract theory, a highly successful and active research area in microeconomics, with particular emphasis on its history and influence on modern economics.

According to Bolton and Dewatripont (2005), currently a standard textbook in this field, the theory of incentives, information, and economic institutions is generally referred to in short as contract theory. Contract theory is thus a theory of imperfect markets, mainly because of asymmetric information such as moral hazard and adverse selection.

Contract theory is also a theory of economic institutions and as such applies far beyond markets. The basic model of moral hazard and that of adverse selection both use agency (or principal-agent) relationships as the main analytical framework, in response to various attempts to lay open the black-box nature of the firm in the standard neoclassical model. Furthermore, theories of boundaries of the firm, originating out of Coase's classical work, are today analyzed in the framework of incomplete contracts that leads to the third basic model of contract theory, along with those of moral hazard and adverse selection. Although these basic models are games with specific extensive forms, they are formulated as optimization problems subject to incentive compatibility and participation conditions, and are solved without explicit reference to equilibrium concepts. Contract theory is thus related to both price theory and game theory, but it has developed its own analytical frameworks and tools to solve problems under conditions of asymmetric information or incomplete contracts.

Contract theory is also a theory of incentive design. Incentive design is not important under perfect competition but is crucial when there is asymmetric information or contractual incompleteness. Myerson claims that today, "economists can define their field more broadly, as being about the analysis of incentives in all social institutions." (Myerson 1999) I argue that it is contract theory that enables us to define today's field more broadly.