

# Introduction to Contract Theory:

## Quick overview of a few concepts<sup>1</sup>

Contract Theory studies contractual relationships (explicit, implicit, written or not). The theory builds on (i) the existence of a conflict of interest between parties and (ii) the impossibility to observe all relevant pieces of information relative to the relationship.

- *Information asymmetries between parties.* When a party might have private knowledge of some features, we call it *asymmetric information*. When a party takes an unobservable action, we call it *moral hazard*.
- *The contract designer.* We will use the (Multi)Principal-Agent paradigm. Principal (she) maximizes a specified objective function to design a contract, and the design is constrained by limitations imposed by the environment. Also she might be an informed or uninformed party.
- *Environment of the contract.* It includes the length of the relationship, the conditions under which agents accept the contract (individual rationality), and constraints due to strategic use of private information (incentive compatibility, moral hazard). There may be other constraints such as limited liability constraints imposed by law, budget constraints, resource constraints. The design of a contract also depend on the commitment ability of the principal, the possibility to verify outcomes and enforce an agreement.
- *Approaches.* These are the “Complete Contracts” approach (normative and based on rational paradigm) and the “Incomplete contracts approach” (positive, sometimes bounded rational)

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<sup>1</sup>This document is intended to provide only a few take-home messages. It is not a substitute for attending class and taking notes.