

Psychological contract and small firms: A literature review

Vlasios Sarantinos

Abstract

Psychological contract is one of the most well-known terms in the field of human resources management. Used by many as an analytical tool to describe the employment relationship or a theoretical platform to understand employee responses to workplace changes, it is nonetheless an intriguing theme. Going through the relevant literature, the paper focuses not only on the internal working of the psychological contract theory, but also on the organisational linkages and, in particular, on research in small firms. The investigation endeavours to ascertain the depth current literature shows with regard to smaller firms and the formation of the psychological contract in these business entities.

Keywords

Human resource management, employment relationship, psychological contract theory, small firms

Contact details

Vlasios Sarantinos BA, MSc, MA.
Manager, ST & Co JSC
4 Spetson Street
Thessaloniki
Greece

Tel: 0030 6944 279740

Email: vsarantinos@yahoo.co.uk

1. Introduction

The psychological contract is one of the most important notions in the field of HR. In this paper there is an endeavour to present the main theoretical underpinnings of the concept with a critical insight. The paper focuses on the contrasting viewpoints surrounding the PC (psychological contract) and particularly the transition from the traditional form of working agreement between employers and employees to the new flexible model. It is interesting to see how its part of the theory builds up and formulates its conclusions. By juxtaposing the main elements of both bodies of theory it will be possible to ascertain their strong points, their inefficiencies and room for further research. This literature review is also important as it pay attention to a specific area inside the organisational context of the PC. In particular, whilst most of the theory with regards the concept revolves around large organisations, instead the focus here is on smaller organisations as we seek to investigate how well research has covered this ground.

The review is divided into three main parts. The first section presents an overview of psychological contract (PC) theory by examining its definition, particular characteristics and specific issues pertaining to its application in organisations. The second section begins by critically approaching the two central schools of thought that exist in the PC theory, examining the common ground between the two pools of thought and their main disagreements. The third section is in two parts. The first introduces the definition of a small firm and examines the particular characteristics of employee relations (ER) in small firms. This is followed by a critical examination of the breadth of the theory on developing an assessment of the ER and the PC in small firms to identify potential elements that will assist in the research and identify possible gaps that require more attention. The chapter ends with an overall review of the literature, its contribution to the subject and its limitations.

2. Key definitions and dynamics

Trying to define the psychological contract, it can be seen as *'individuals' beliefs, shaped by the organization, regarding the terms of an exchange relationship between the individual employee and the organization* (Beardwell, Holden and Claydon, 2004:520). The basis of this relationship is reciprocity between the organization and employees on

the perceived obligations and expectations from one another (Guest & Conway, 2002; Beardwell *et al.*, 2004). What is clear is that as the PC evolves around individual beliefs and perceptions it is highly subjective and can be particular to each employee (Rousseau, 1995). Exactly because its nature is goes beyond any written contract in reflecting the ER (Rousseau, 1995 and 2000). In essence, the psychological contract constitutes an unwritten agreement between the organization and employees based on mutually accepted promises and obligations among the organization and the employees (Sparrow and Marchington, 1998; CIPD, 2003).

One of the major arguments in the PC theory is whether it can be regarded as ‘contract’ in comparison to formal contracts that have a stipulated content with clear- cut parameters (Arnold, 1996). Contrary views argue that PC offers a viewpoint on a more realistic base according to parties' perceptions and can have a greater influence than a formal contract (CIPD, 2003). Sparrow and Marchington (1998) claim that there is an interaction between employment contracts and the PC as legal terms and conditions will affect perceptions of obligation. In terms of strict comparison, PC is an implicit reflection of the employment relationship resembling a legal contract only on a more broad scale. In terms of power, as discussed later, the instance of a contract breach can cause adverse effects to the organisation and the employees (Deery, Iverson and Walsh, 2006) that are similar to the sanctions in standard contract violations. There are differences between the two concepts, but the similarities are enough to justify the use of the term as a signal of the power it carries in the ER.

3. Psychological contract typology

Psychological contracts have been often defined according to their particular characteristics. For example, Rousseau (1995 and 2000) distinguishes between two types of PC:

- transactional contracts, which are structured with emphasis on material rewards that have a short-term duration and are relatively narrow in their scope; and
- relational contracts, which are structured around less tangible rewards, have a significant duration (often without an implied end-date) and are subject to the individual parties' beliefs.

It is essential to comprehend which type of relationship is relevant in each case. Potentially, an employer offers a relational-type of contract but employees demand a transactional-type contract one creating thus confusion in the organization. Of course in the practice, neither employers nor employees would use this terminology but it is useful in understanding the nature of PC in theory. Guzzo and Noonan (1994) suggested a hybrid combination of PC both with transactional and relational elements. This could also correspond to reality as organizations need to build up for example its credibility to holding a sound transactional deal before going on and establishing a more long-term relational deal that requires considerable more investment in trust and loyalty.

The literature also regards that the psychological contract is adaptive to the various societal elements and further its content can change as the elements from one society to another become different (Rousseau and Schalk, 2000; Thomas, Au and Ravlin, 2003). The latter argument involves issues such as different employment laws that affect the potential of employees to bargain and distinct cultures (eg Western and Japanese cultures) that influence employees on their expectations from the employment relationship (Thomas *et al.*, 2003).

Some researchers argue on the principle of mutuality in the exchange relationship. The argument raised is that in organizations there can be power differentials and therefore employees might not be able to input their expectations ending for the bargain to be one-sided in the advantage of the employer (Lewis, Smithson and Kugelberg, 2002). It should be noted that this argument is theoretical and although it could correspond in practice, there is little empirical evidence to support their precise translation to business practices. In other words, although literature makes important conceptual observations about the PC and its relation with organizations, there is little knowledge of whether organizations take the concept into account and if any apply it in practice (Conway and Briner, 2005).

Another interpretation of the PC was offered by Guest and Conway (1997, 1998 and 2004) representing overall the CIPD mentality on the PC (CIPD 2003, 2004 and 2005a). Whilst other researchers (Sparrow and Marchington, 1998; Rousseau, 1998) view the PC as an analytical tool to grasp the complex changes that occur throughout the organization when new employment practices are adopted, Guest and Conway (1998) view the PC as a

mean to understand the state of the employment relationship in an organization and plotting corresponding changes.

Furthermore, the PC is regarded as a tool through which if organizations adopt certain management practices to establish and maintain a 'healthy' PC change could be instituted more easily and there would be increased levels of commitment and satisfaction (Guest and Conway, 1998, 2004; CIPD 2005a). It is noteworthy that the differences among the two schools of thought caused arguments between two of the most important representatives: Rousseau and Guest, whose publications contrast each other's views on a personal level, with particular emphasis in the terminology of using implied obligations (Rousseau, 1998) or expectations (Guest & Conway, 1998) in the definition of the PC. Compromisingly, there was a definition adopted comprising both aspects (Guest & Conway, 2002).

They start from its antecedents, move to its content and lastly examine its consequences. This framework provides some interesting insights as it examines the various individual characteristics, the organizational climate and influence of HR policies. This mixes with the sense of trust, fairness and reciprocal fulfilment of the obligations and expectations among the contracted parties. Lastly, this produces attitudinal results such as work satisfaction and commitment leading ultimately to employee behaviour judged by work performance and intention to quit. This interpretation offers a positivist view of the PC emphasising its role in analysing the ER.

Both interpretations highlight different aspects of the psychological contract but also have common elements. Due its subjective nature and the numerous factors influencing its course, the PC is highly fluid and frequently merits redefinition and renegotiation (Rousseau, 1995; Guest and Conway, 2002). Equally, that trust between organization and employees along with commitment is important as is the perceived fulfilment of promises. Lastly, it is assumed that HR practices are key in managing the PC effectively as it signals significantly on what the employer expects from them and what they can anticipate in return (Rousseau, 1995).

Recapping thus far, both schools highlight important aspects of in terms of the nature of the psychological contract and even from the arguments we can see that the subject matter

is considerably complex and in the majority it has qualitative roots. The problem again is that there is little idea on organisational uptake of the contract; for the most part there are many assumptions and suggestions to but little evidence on the follow up of the theory by companies.

4. The new psychological contract

Traditionally, it was believed that the main expectation of employees in return for their input to the company was a level of employment stability both in terms of working environment and job security (Sparrow and Marchington, 1998; Martin, Staines and Pate, 1998; Beardwell et. al 2004). Nevertheless, the rapid changes in the economic and business life the last decades transformed significantly organizations. Intense competition on a global scale, political developments and numerous other factors forced organizations to adapt its structure towards a leaner, flexible more efficient approach that could withstand competitive pressures (Hiltrop, 1995) As a consequence, there was a restructuring on people management and corresponding changes in the employment relationship

In the past, organization expected loyalty and commitment over a lengthy period of time and employees expected job security and remuneration based over their long duration of service to the organization. Currently, there is need for flexible employees that will be able to constitute themselves more employable through skills and abilities they will accumulate through training, willingness to perform a variety of tasks and thus learn and adapt their portfolio of capabilities. By doing so, employees are deemed as more 'marketable' and consequently more efficient for the organization and more equipped to handle the pressures of the new marketplace (Herriot and Pemberton, 1995; Sparrow and Marchington, 1998).

This description is rather pessimistic for employees and the ER as a whole. Contrasting this picture, CIPD research quite convincingly t argues that the changes have not been so dramatic and employees are not so fearful of their losing their jobs or lost faith in organizations as surveys of the institute demonstrate (Guest and Conway, 2004; CIPD, 2003 and 2005b). In summary, the current state of the psychological contract is pretty much the same as in the past. Employees in majority are satisfied with their jobs, four out of five employees are not worried about losing their jobs and commitment has not

declined in broad terms the last years whilst trust in the organization has declined to an extent according to the latest CIPD surveys (CIPD, 2005b).

Concerning the 'new' workplace there have been indeed being changes in the employment relationship, mainly attributed to global movements in economies and labour markets. Nevertheless, this are not heralds of an ominous future but more part of a transition that is continuous in organizational life (CIPD, 2005b). The most interesting point in this theoretical framework is the recognition of the PC as a tool in the manager's efforts to handle the employment relationship. Substantiating that, Guest & Conway (2002) reported findings from a survey of 1,306 senior HR showing that the psychological contract offers managers a framework within which to contemplate and administer the ER (employment relationship).

The authors propose to view PC as an instrument to assist employers in planting the seeds of change without compromising the co-operation and succour of their workforce in the process. It interprets the fluidity in modern business life as call for organizations to take the most out of their human capital which means to know what employees expect from their employers and PC offers the means to do exactly that (Guest and Conway, 2002; CIPD, 2005a and 2005b). Empirical evidence is relatively split on the 'new' PC as for example Hiltrop (1995 and 1996) provides feedback from managers acknowledging the situation. Contrary, annual research of the CIPD (2005a) shows that employees do not feel that change in the workplace have so dramatic as many elements of the so-called 'old' psychological contract have remained strong in employees perception of the working environment.

It would seem that truth lies somewhere in between. Ignoring the changing workplace and the impact it had to the psychological contract is impossible. New variables have emerged and the employee-organisation input/expectation relationship has shifted but to level everything down is also pessimistic and equally unrealistic. For example people might not be able to cling on to their works eternally but it seems unlikely that a corporation would invest in its human capital to 'throw it away' so easily. Furthermore, PC is highly subjective, fluid and constantly redefined and in a respect means that although employment practices have changed not all employees feel the same nor condone to the new working environment (Fisk, 2002).

The problem with both approaches is that again there is only a theoretical framework addressing the changes in the workplace. As shown, there have been some endeavours to gauge the perception of both managers and employees in the extend the employment relationship and consequently the psychological has changed but there is little evidence to support whether companies actively used the notion of the psychological contract in light of the changes the past two decades. As mentioned before, this is a general limitation in the psychological contract literature. There is abundance of information and at many cases extremely useful but largely speculative. The empirical efforts substantiate some of the respective arguments (Rousseau, 2000; Guest & Conway , 2002; CIPD, 2005a) but they lack focus on how and whether companies actually consider and use the PC (Conway and Briner, 2005).

5. Psychological contract violation

Theory assumes that with the changes in the context of the PC and the renegotiated ER it is likely that some employees might feel that the organization is failing to meet its obligations and view their expectations not being realized. This could affect employee's overall loyalty and performance (Rousseau, 1995; Beardwell *et al.*, 2004). This is known as a violation of the psychological contract (Rousseau, 1995) although we can make a distinction of it in various degrees. It is possible for employees to be aware of the employers inability to meet expectations or that parts of the contract have not been fulfilled timely and thus the reaction might be mild in light of a 'perceived breach'. On the contrary, a 'violation' produces a much stronger and emotional response from the employees (Robinson and Morrison, 1997).

According to Rousseau (1995) there are three main types of contract violation:

- inadvertent, which is the result of divergent interpretations that were made in good faith;
- disruption, which is when both or at least one of the parties wants to comply with the agreement but cannot; and
- renegeing, which is when both or at least one of the parties is unwilling to comply with the agreement.

The effects of PC violation are strongly dependent on the emotional response they trigger to employees. Due to the subjective nature of employee expectations, the reactions in the event of a violation or breach could differ leaving a portion of the employees with a strong sense of injustice on behalf of the organisation and another portion feeling less hurt (Deery, Iverson and Walsh, 2006). As we can see, how will employees perceive a violation to their PC will also be dependent on personal factors such as age, education and past experiences and altogether could create differential perceptions about the employment relationships and perhaps on how to what degree a breach or violation is perceived (Rousseau, 1995; Deery *et al.*, 2006). Equally there can be variations to the way employees will react to a contract violation. According to Rousseau (1995) there are four principal reactions to a perceived violation employees can have:

- exit, which refers to the voluntary termination of the working relationship either from the employer who lays off underperforming employees or from employees who prefer to leave an unreliable organisation;
- voice, which refers to the effort to negotiate the violated parts of the agreement and resolve potential problems that have arisen in a constructive fashion;
- silence, which refers to a passive response with no reaction in hope that conditions will change to more favourable terms in the future but in essence it often ends in perpetuating the existing relationship; and
- destruction/neglect, which refers to passive indifference to one's duties in detriment to the interests of the organisation or more active counterproductive behaviour.

6. Psychological contract theory in focus

Reviewing the main points in the literature of the psychological contract we can see a number of important aspects highlighted especially with regards to its definition, its nature and its proposed application to businesses. The majority of the research, both where there is common ground and where there are disagreements, provides a useful framework for comprehending the basic assumptions the theory ascribes to the psychological contract. The reciprocal exchange of expectations between employees and employers and its subjective nature helps to understand a number of factors that shape the

employment relationship including the societal influences that can make the content of the PC vary from one societal surrounding to another.

The work of Rousseau (1995 and 2000) in particular and the relevant typology provides an important categorisation that facilitates the definition of the PC as well as its content. Equally, the work by Guest and Conway (1998 and 2004), empowers the PC as an important tool for critical analysis of the employment relationship in organizations. It also helps management adopt practices to build a 'healthy' PC that could lead to increased levels of satisfaction and commitment in employees.

Nevertheless, there is an important limitation to our knowledge of PC, as the majority of the literature is devoted to normative theory and there is little empirical evidence of what happens in practice. Little significance is attached on whether firms acknowledge the concept as a function of their HR departments and whether it is taken into account when designing policies and strategies. Therefore that is ample scope for further evidence-based research and this review of the literature offers a starting point.

7. Small firms and the psychological contract

One issue worth noting about the literature pertaining to the psychological contract and the employment relationship as a whole is that without always expressing it, the focus is on larger organizations with a large number of employees and a specialist department dealing with HR and personnel issues (Wilkinson, 1999). Nevertheless there have been attempts to examine the employment relationship in smaller firms. Initially we need to define what we mean by small firms with emphasis on the employee relations. Most of the standard definitions are based on the size of employees as shown in Table 1.

Table 1. Categorisation of small firms in employee size

Source	Size	Number of employees
Cully <i>et al.</i> (1999)	Small	10 – 24
European Commission (2003)	Micro	0 – 9
	Small	10 – 49
	Medium	50 – 249
DTI (1997)	Micro	0 – 9
	Small	0 – 49
	Medium	50 – 249

In addition to size, small firms are generally regarded to have some important distinctive characteristics. The role of the entrepreneur in the firm and his or her influence in the business is often based on personality, perception and overall idiosyncrasy (MacMahon, 1997; Cully *et al.*, 1999; Beardwell *et al.*, 2004). Due to the small size, the degree of proximity between the manager and the employees is significantly greater than in larger organisations (Goffee and Scase, 1987; Cully *et al.*, 1999; Marsden, 2004). In larger firms, employees have little interaction with the central parts of the decision-making and therefore there is a ‘cold’ and impersonal environment, where issues are only transmitted to employees through the relevant manager of the section (Pohlan, 1999). In small firms, however, employees may see or work alongside the owner/managers and may develop closer relationships with them (Eurofound, 2001).

An interesting debate lies in the literature in regards to the outcome of the closeness in the relationship between employer and employee in small firms. For example, Bolton (1971) and Ingham (1970) claimed that small firms promote an environment that nurtures friendliness between the firm and the employee, mutual respect and an overall harmonious co-operation. The latter was substantiated by Schumacher (1973) in what was called the ‘beautiful house’ concept of small firms. On the other hand, Rainnie (1989) criticized this notion arguing that in fact, small businesses were ‘bleak houses’, dominated by autocratic, oppressive and tyrant managers that in effect exploited their employee. Nevertheless, this approach was criticized as simplistic and entirely pessimistic pointing in fact that it requires a more detail examination in the considerably complex

environment of small firms (Ram, 1994). Empirical studies by Pohlmann (1999) and Welter (1999) in Canada and Germany respectively provided contrary evidence to Rainnie's position. Their core argument was that in fact, small firms provide significant support to cultivate a positive working environment and an equally positive employment relationship and even more interestingly that is accomplished through the informal channels that are generally found in smaller businesses.

Another important attribute in small firms is a generally acknowledged level of informality that exists. The informality is found principally in the management style and is compatible with the needs of the working environment (Ram, 1994; Marlow and Patton, 2002; Mihail, 2004). As Mihail (2004) argues, the informality that exists in small firms is what gives to the owner the capability to infuse flexibility into the business which is necessary for its viability. It is possible to discern, therefore a third viewpoint in the literature in addition to the 'small is beautiful' and 'bleak house' pictures.

This is a middle situation where negative aspects can rise for employees because of the closeness of the relationship, which may offer a balance for employees. They can become actively involved in the decision-making of the company, getting their views to get across much more effectively than in larger organizations and at the same time participate in the establishment of a surrounding based on the informality and the 'familial' relationship necessary for small firms viability (MacMahon, 1996; Moule, 1998; Mihail, 2004).

In most cases, small firms do not possess the same financial capabilities like larger organizations, or the same power to withstand competitive pressures (Pohlmann, 1999; Eurofound, 2001). There are two main lines of argument with regard to the employment relationship. The first is critical of small firms and contends that in effect this will burden the employee side as owners will try to increase labour turnover and offer lower wages/salaries than larger organizations (Brown and Medoff, 1989; Ram, 1994; Cully *et al.*, 1999). The second questions higher wages and increased monetary benefits as adequate measures of the ER (Pohlmann, 1999). Although larger companies do generally offer larger remuneration packages, this approach does not cover adequately the levels of job satisfaction. Pohlmann, advocates research that employees in small firms feel more accomplished and enjoy a higher regard by their employers on their performance and as such are more satisfied with their jobs.

Last but not least important in the main elements of ER in small firms is the heterogeneity among the various clusters of small firms. It has been noted that there are significant variations among small firms belonging in different sectors (eg manufacturing and services) due to the differential environmental elements specific to each sector that in effect influence the relationship between firms and employees (Curran, 1991; Curran, Kitching, Abbot and Mills 1993). In essence this projects the complexity that surrounds an examination in the small firms field as there can be significant changes in the ER depending on the specific sector a company operates, the relative country and the idiosyncrasy of the manager to name but a few (Eurofound, 2001).

In addition to sector differences, distinctions have been noted in small firms across international contexts that are attributed to societal, legislative and mentality frameworks (Thomas *et al.*, 2003). Characteristically, given that size is one of most important criteria to categorise a small firm (Bolton, 1971; Cully *et al.*, 1999), as countries vary in size in terms of population and economies so do firms. For example, an enterprise that is classified as medium-sized in Germany is classed as large in Greece, where the small and medium-sized category covers enterprises with up to 50 employees (Eurofound, 2001).

Apart from illustrating the potential differences in an international context, there is a practical issue, the difficulty in obtaining data in this case among different countries which is sensible because of the scale such a research would demand but also deriving from the existence of several clusters of small firms across national (Curran 1991; Curran *et al.*, 1993) and international (Eurofound, 2001) levels of heterogeneity. At the very least we must take into account that small firms operate in complex environment that possess several idiosyncratic characteristics that can generate difficulties in research.

In spite of the large number of small firms and the importance for the economies of countries worldwide (Overell, 1996; Pohlmann, 1999; Cully *et al.*, 1999; Mihail, 2004), there has been a significant lack of research and all the issues belonging to its periphery (Cooper and Otley, 1998; Wilkinson, 1999; Pohlmann, 1999; Michail 2004). This could be related to the complexity and uniformity that governs the field of small enterprises as it is difficult to produce generalized assumptions because of the numerous varying factors (Storey, 1994).

8. Conclusions

There are some important characteristics about the PC that are highlighted in the contemporary literature, such as its subjective nature, its definition as part of the employees and employers expectations. In addition there are debates over the 'old' and 'new' types of employment relationship. However, most of the literature focuses on relatively large firms with a set number of managers and workforce. Examining the literature on smaller firms, there is a lack of significant focus on the topic of the psychological contract and generally on the development of human resources management. This may be due to the complexities associated with structure and the strong influence of the proprietor/manager model.

In spite of the lack of a combined approach to reconcile the concept of the PC and small firms, the abundance of research on the former provides a substantial qualitative basis for investigating these two themes. Essentially, there is significant room to try and test the hypotheses of the various schools of thought on the psychological contract on some small firms' setting. Of course there certain constraints that must be taken into account before engaging in such an examination. As the review of the small firms theory suggests, there are numerous complexities among different settings of small businesses varying from market to market and country to country.

This is a limitation, apparent to many surveys with regards small businesses in allowing the formulation of generalised conclusions. Nevertheless, despite the restriction imposed by the complexity of the environment of both concepts, it is possible to undertake research using a combination of qualitative and quantitative criteria to produce comparative studies among different sectors in an attempt to surpass the differences among contexts. In any event, the level of difficult in research further accentuates the need for additional endeavours to enrich these specific parts of the HRM literature whilst opening new opportunities for future directions in research.

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