

# Managing the Psychological Contract in Competitive Labor-Market Conditions

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## ABSTRACT

*This paper presents a reconceptualization of the PC by incorporating the marketing concepts of 'value' and 'cost' into its tenets. We illustrate the manner in which marketing language may be incorporated into our understanding of the PC by drawing a parallel between consumer-market transactions for products and labor-market transaction for employment. This paper suggests that to effectively manage PCs in a competitive labor-market must have a detailed understanding of the costs it's willing to bear, as well as the benefits it receives in the employment relationship. Similarly, it must consider what PC features are most likely to be perceived by employees as representing the most attractive value proposition on offer in a competitive labor market. 1.*

## Introduction

In Australia, as elsewhere in the Western world, factors such as the globalization of competition, the 'tightening' of skilled labor markets, advancements in technology, the growth of the knowledge economy, and the need for flexibility and expertise in the workplace have each represented strategic challenges to which firms have had to respond (Aghazadeh, 1999; Barnett and McKendrick, 2004; Harrison and Kessels, 2004; Hiltrop 2006; Rowley and Warner, 2007; Sparrow, 2007). The resultant pursuit of increased responsiveness, productivity, flexibility, and innovative capacity have been the defining characteristics of the 'strategic human resource management' (SHRM) movement that has emerged over the past 20 years (Beer, Spector, Lawrence, Mills and Walton, 1985; Forman and Cohen, 1999; Klingner, 1993; Vogel, 2006; Wright and Snell, 1998). Underpinning SHRM efforts has been the recognition (by both academics and practitioners alike) that an integrated set of effective human resource management policies has a significant positive impact on organizational performance and the development of a sustainable competitive advantage (see Afiouni, 2007; Becker and Huselid, 2006; Fusco, 2003; Greening and Turban, 2000; Herman and Gioia, 2001; Lee, MacDermid, Williams, Buck, and Leiba-O'Sullivan, 2002). The adoption of SHRM has also led to an intensification of competition between firms for high-quality human resources - especially those that compete in competitive labor markets where skill shortages are prevalent (Gardner, 2002; Holland, Hecker and Steen, 2002; Shah and Burke, 2005).

One strategy employed by Western firms facing direct competition for high-quality employees has been to present themselves as an 'Employer of Choice' (EOC) in their respective industry (Lenaghan and Eisner, 2006; Mackes, 2005; Sartain, 2005). Organizational efforts to achieve EOC status have entailed the use of 'employer branding strategies' that borrow specific marketing concepts and principles for the express purpose of marketing firms to their target labor market(s) (Backhaus and Tikoo, 2004; Berthon, Ewing and Kian Hah, 2005). As such, EOC strategies represent attempts by a firm to construct a unique 'employer brand identity' based on a 'value proposition' that sets it apart from competitors in some meaningful way (Herman and Gioia, 2001). The perceived importance of being an EOC is arguably reflected in the growing number of awards dedicated to the process and the effort involved in its achievement. In the U.S., for example, effective EOC strategies are celebrated by certifications such as the 'Contact Center Employer of Choice'™ (see Contact Center EOC Website, 2007). In the U.K. there is the 'Thames Valley Business Awards' (see Thames Valley Business Awards Website, 2007). In Australia and New Zealand, effective EOC efforts are similarly recognized by the 'Davidson Trahaire Corpsych' (AHRI Website, 2007) and 'Hewitt' Awards (Hewitt Best Employers Website, 2007). These EOC awards generally focus on, *inter alia*, a recipient firm's:

- reputation/status within the broader industry and business community;
- linking of HR and business strategy to derive a competitive advantage;

- competitiveness in the labor market;
- flexible work practices and work/life integration;
- strong leadership, inclusive management style, and employee engagement;
- performance-linked competitive reward and recognition systems; and
- emphasis on the development of people's talent and skill as a corporate priority.

In order to achieve EOC recognition, therefore, a firm's brand identity needs to be constructed using a balanced package of explicit SHRM policy offerings (e.g. remuneration package, training and development programs, etc.), as well as other 'psychological benefits' (e.g. work-life balance considerations), that represent value to both its current and potential employees (Backhaus and Tikoo, 2004; Wickham and Parker, 2007). Thus, understanding the value proposition to be embodied in the firm's employer brand is a prerequisite for effective EOC positioning; that is, understanding what the firm is able and willing to offer in the form of tangible and intangible inducements for highly-skilled people to enter, remain, and perform effectively in the employment relationship.

### **Being an 'Employer of Choice': The Role of the Psychological Contract**

One area of SHRM theory that has enjoyed increasing attention in recent times, arguably driven by the issues discussed above, surrounds the development of the 'psychological contract' (see Cassar, 2001; Cullinane and Dundon, 2006; Guerrero and Herrbach, 2008; Rousseau, 1989, 1995). In general terms, the psychological contract (PC) deals with the pattern of unwritten beliefs held by the employee and firm about what each should offer the other, and what it is that each is obligated to provide in the employment relationship (Anderson and Schalk, 1998; O'Neill and Adya, 2007; Rousseau, 1989, 1995). Unlike the formal employment contract, which sets out the explicit terms and conditions inherent to the firm's SHRM policy regime, the PC is cognitive-perceptual in nature; that is, it is implicit and, from the employee's perspective, is comprised of perceptions and interpretations of organizational actions pertaining to the entirety of the employee-firm relationship (Coyle-Shapiro, Shore, Taylor and Tetrick, 2004; Millward and Brewerton, 2000).

Psychological contracts can emphasize either a 'transactional' short-term perspective, or a 'relational' long-term perspective, depending on the individual employee's attitudes and behavior towards work and the firm (Rousseau, 1995). A transactional perspective focuses on the exchange of contributions that are reasonably explicit, short-term and economic ('monetizable') in nature; such an exchange assumes rational and self-interested parties, and does not result in ongoing interdependence. On the other hand, a relational perspective embraces a more complex exchange that promotes interdependence through a commitment to the collective interest over self-interest; its currency is socio-emotional in nature and, therefore, less obvious. A relational perspective tends to evolve over time, and involves contributions made as long-term investments. Research suggests that the majority of individual PCs tend to contain both forms of exchange to varying degrees, and must deliver mutual benefits to the employee and the firm if the employment relationship is to remain functional (Grimmer and Oddy, 2007; Rousseau, 2004; Rousseau and McLean-Parks, 1993).

The PC concept has received wide support, not only from scholars examining the impact of changes in employment on the individual, but also from managers and employees in the workplace who see it as an important tool for recruiting, retaining and motivating workers (Coyle-Shapiro et al., 2004; Guest and Conway, 2002; Hiltrop 1995a, 1995b; Kabanoff, Jimmieson and Lewis, 2000; Shore et al., 2004). This positive endorsement stems in part from the PC's fit with a Western market philosophy and 'contract culture' that has dominated economic policy and business thinking in the last two decades (Rawsthorne, 2005). Given the broad acceptance of the concept, we argue that effective management of the PC can represent a vital element in the development and maintenance of a firm's EOC status, especially for those firms that must recruit, retain and motivate their human resources within a competitive labor market.

Notwithstanding the acceptance of the PC as part of the SHRM framework, there is a recognized need for the practical implications of its management over the employment relationship life-cycle to be more explored more fully (Aube, Rousseau and Morin, 2007; Conway and Briner, 2005; Shore and Coyle-Shapiro, 2003; O'Neill and Adya, 2007; Tekleab and Taylor, 2003). Echoing an earlier exchange of between two of the leading PC researchers (Guest, 1998a,



1998b; Rousseau, 1998), there have been renewed calls for re-consideration of theoretical and practical issues associated with the PC. A number of recent studies (see Conway and Briner, 2005; Coyle-Shapiro et al., 2004; Shore et al., 2004) provide useful summaries of the issues that we argue have limited its use as a basis for the sustainable development of a firm's EOC status. In order to advance the development and utility of the PC, the need for an expansion of the theoretical perspectives that inform its construction has been identified (Coyle-Shapiro et al., 2004; Cullinane and Dundon, 2006). In response, we suggest that there may be merit in considering the application of marketing concepts, such as 'product', 'cost' and 'value proposition' to assist managers in comprehending the PC concept and its effective management in the workplace. We feel that exploring a marketing perspective offers the possibility of broadening understanding of the PC, and presents an opportunity to define more clearly its role in the sustainable development of a firm's EOC status.

### **Understanding the Construction of 'Value' and 'Cost' in Market-Based Transactions**

If a consumer wishes to purchase 'fast-food' as a replacement for a home-cooked meal, the reasons could be many and varied. Once the fast-food outlet has been selected, the consumer may either visit the outlet personally (for a dine-in or take-away experience) or phone through an order and have the meal delivered to their door. Regardless of the specifics, from the purchaser's perspective the transaction requires an exchange of money for the fast-food itself along with the benefits associated with it. From the vendor's perspective, there are also benefits derived from the transaction, the most obvious of which is an acceptable level of profitability. Through the exploration of this mutual benefit scenario (as espoused in the marketing literature), a parallel can be drawn with an EOC firm's management of the PC.

When considering what specific fast-food to purchase, the purchaser will take into consideration a wide range of variables. For example, aside from wishing to satisfy hunger, the purchaser might consider purchasing their favorite brand of fast-food because they know exactly what they will get. The purchaser might also consider the opportunity costs (for example, the time factor involved in visiting the outlet, pur-

chasing the food, and returning home in time for it to satisfy the palate) as part of the decision. If considering the home delivery option, the purchaser might additionally consider the reputation of the chosen fast-food outlet in terms of the accuracy and timeliness of its delivery service. Perhaps, to add a touch of excitement, the purchaser may also seek to try an offering that they have never had before. From this brief tale, it is apparent that there are many product/service and non-product/non-service considerations that the purchaser will take into account when deriving their assessment of the costs and benefits involved in the transaction. Once the purchaser has had the opportunity to accommodate their most important considerations, they are then able to conceptualize the value proposition, and enter into the transaction in an informed manner.

From the purchaser's perspective, the transaction for the fast-food typically involving the exchange of money for a product is expected to generate some value over and above the fast-food itself (for example, it might include a 'convenience factor'). In this transaction, the purchaser will assess the product's various features (including purchase price) in terms of the value it represents, that is, as a 'value proposition'. As long as the purchaser perceives the value generated in the exchange as equal to, or greater than the total cost that has to be borne (that is, the cash price plus any associated opportunity costs), then the purchaser will be likely to conclude the transaction, be content with the outcome, and be more likely to consider this transaction again in a similar future circumstance. If, however, the cost to be borne is perceived to be greater than the value returned from the transaction, then the purchaser is likely to be dissatisfied and less likely to repeat the transaction in a similar future circumstance. Thus, put in general terms, where ' $V_p$ ' is the purchaser's perception of value and ' $C_p$ ' represents the total cost the purchaser bears, a satisfactory transaction from the purchaser's perspective occurs when  $V_p \geq C_p$ .

Similarly, from the vendor's perspective, the cash price that it charges for its fast-food is dependent on a range of factors. These will include its direct production costs, indirect opportunity costs, and a profitability level that includes considerations over and above a mere dollar return (for example, 'increases in brand loyalty', and 'repeat business'). In other words, a satisfactory transaction for the vendor occurs when the value it receives ( $V_v$ ) is equal to, or greater than, the

total cost ( $C_v$ ) it bears in the transaction, that is, when  $V_v \geq C_v$ . With these equations, we can see that both parties have a perception of the value they must derive from the transaction for each to consider it valuable and worth repeating in future. If we were the vendor's marketing director, we would endeavour to determine an optimal

value proposition for both parties; that is, the point where the transaction would produce a level of acceptable value perceived from both the vendor's and the purchaser's perspectives. Such a transaction can be expressed as:

$$\text{Purchaser perspective} \leftarrow \cdots (V_p \geq C_p) \rightarrow \text{Transaction} \leftarrow (C_v \leq V_v) \cdots \rightarrow \text{Vendor perspective}$$

The above equation shows an important characteristic common to many market-based transactions; i.e. the basis on which value is constructed by one party may not be completely obvious from the other party's perspective. On the one hand, because only the cash price of the product is presented in the market, the purchaser remains largely unaware of the vendor's total costs in producing the fast-food, and the amount and type of value the vendor requires to maintain a viable operation in the medium to long-term. On the other hand, the vendor may also be unaware of the basis upon which the purchaser constructs their perception of value in a transaction, unless of course the vendor has undertaken requisite and comprehensive market research. The very task of establishing a competitive position in the marketplace presents the vending firm with a fundamental dilemma – how best to determine those product features (including its cash price), which will represent an attractive value proposition to both the purchaser and vendor simultaneously.

Hopefully, with this brief discussion, the idea of how basic marketing tenets explain a relatively straightforward transaction, like the purchase of a product, has been made clear. Let us now consider how the same marketing concepts might be applied in understanding the PC as a value proposition upon which a sustainable EOC position might be based.

### Being an 'Employer of Choice': Marketing and the Psychological Contract

As stated earlier, a functional PC represents an ongoing social exchange process that accounts for the unwritten beliefs, held by employee and employer, about the tangible and intangible inducements each has offered to, and accepted from, the other party in their employment relationship (Rousseau, 1995). Those inducements offered by the firm and accepted by the employee represent the contributions the

employee perceives the firm is obligated to provide, and vice-versa. The exchange of contributions under the PC must provide mutual benefits for it to be perceived as having value. In this way, the inducements a firm is able and willing to offer to recruit and retain its employees must form a crucial element in any employer branding strategy adopted by the firm seeking to achieve a sustainable EOC reputation.

Using a marketing perspective, the establishment of a PC can thus be conceptualised as the result of a process that commences with the firm offering an employment opportunity and a set of inducements; in other words, the firm offers an 'employment product', with features designed to be attractive to those in the labor market the firm wishes to target. In response, prospective employees holistically evaluate the employment product as a value proposition and submit complementary offers of inducements for the firm to assess. When each party accepts the other party's inducements, the employment relationship is then entered into and a PC is established.

Analogous with the fast-food exchange described above, if from the employee's perspective the firm's employment product provides benefits to the employee ( $V_e$ ) that outweigh the employee's total costs of engaging in the employment relationship ( $C_e$ ), then the firm's offering will be perceived as having value. From the employee's perspective, a functional PC will exist when  $V_e \geq C_e$ . Similarly, for the firm, if the employee's acceptance of its employment product creates value ( $V_f$ ) in the form of benefits (such as 'increased productivity' and/or an 'EOC status') that outweigh the total costs of hiring the employee ( $C_f$ ), then from the firm's perspective a functional PC will exist when  $V_f \geq C_f$ . To achieve this outcome, the task of the EOC firm's director of human resources thus becomes the construction of an employment product that represents an acceptable value proposition both to the firm

and the employee. Such a transaction could be

expressed as:

$$\text{Employee perspective } \leftarrow \dots (V_e \geq C_e) \rightarrow \text{Transaction } \leftarrow (C_f \leq V_f) \dots \rightarrow \text{Firm perspective}$$

Hence, the establishment of a functional PC for an EOC would represent the point at which both parties perceive the value they receive from the employment product outweigh the total costs each perceive they bear in the ongoing transaction. In the PC-related literature, these costs are currently represented in the form of either 'economic' or 'socio-emotional' contributions that

are made by both parties to the employment relationship. What this current representation fails to recognize adequately, however, is the importance of opportunity costs linked to the employment relationship, which do not take the form of contributions by one party from which the other party derives a direct benefit (see Figure 1).

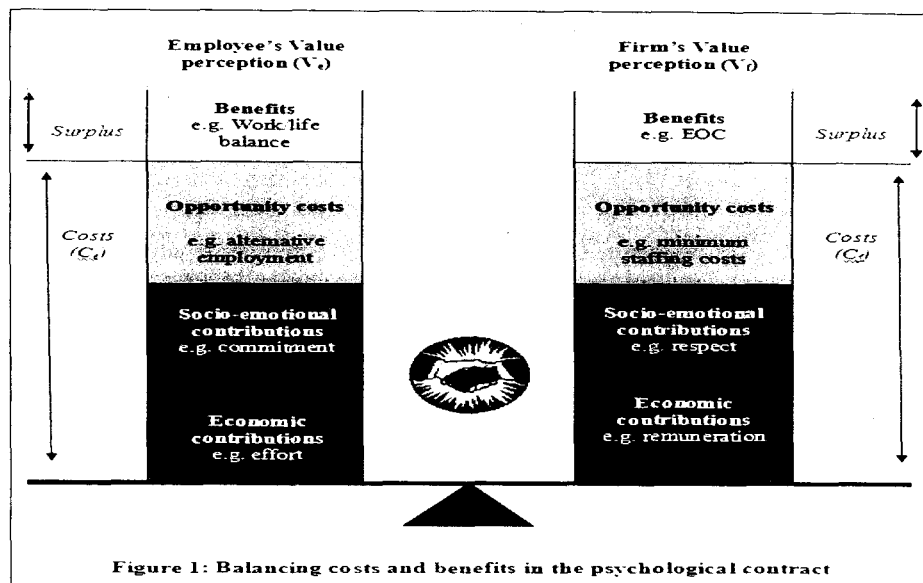


Figure 1: Balancing costs and benefits in the psychological contract

For example, indirect opportunity costs from the employee's perspective might include things such as acceptance of 'lost family time due to weekend work commitments', and/or the resulting 'stress of having an unhappy partner at home'. For the firm, such opportunity costs might include foregoing 'minimum cost labor arrangements' (that is casual employment, outsourcing contracts, or accessing cheaper labor offshore), and/or the 'operational flexibility' that might flow from such arrangements. Taking these opportunity costs into account is likely to prove problematic in trying to construct an EOC firm's employment product to represent an attractive value proposition. This is the case because the implicit and cognitive-perceptual nature of the PC (Rousseau, 1995) means that one party's perceptions of value and the total costs it bears are likely to be obscured from the perspective of the other party.

Also, unlike the fast-food example, where a significant component of the costs borne by the purchaser (specifically the monetary cost in the form of a cash price) is determined by the firm, the determination of costs in an employment relationship operates quite differently. Firstly, the uptake of the employment product is not a 'once-off' transaction, and the costs each party is willing to bear, both in terms of direct contributions and indirect opportunity costs, are the subject of ongoing review and negotiation between the parties. Secondly, where a firm is faced with strong competition for scarce resources, the 'seller' of the resource has much greater bargaining power. In a competitive labor market where conditions are not favorable to the firm, therefore, the employee is both a 'seller' of the scarce resource, that is their own skills and abilities, and a 'buyer' of one of many employment products offered by competing firms; from the firm's perspective it is only one of many 'sellers' of an employment product and one of many 'buyers' of scarce skills and abilities. This means that the



less favorable that labor market conditions are, the more value the firm will need to offer; in other words, the firm will need to offer greater benefits with less direct and indirect costs for the employee in order to attract and retain talented people. In this way, the EOC firm must be able to present an employment product that will be perceived by the employee as a better value proposition than that offered by the EOC firm's competitors.

Given that in such labor market conditions the employee is likely to be in the stronger position, the firm needs to be keenly aware of what features its employment product must have to be perceived as offering benefits that outweigh the employee's total costs. An important point here is that a firm can increase its value proposition to current and potential employees without necessarily incurring higher 'dollar-amount costs' for the firm. Instead, it can offer employment product features in the form of relevant non-monetary inducements (such as workplace flexibility and other benefits important to the individual), but it is imperative that they must have some bearing or impact on the benefit-cost-value equation constructed by the employee. As in the marketing of all products, to achieve this outcome requires quality research to understand what inducements will be relevant to existing or prospective employees who are the 'consumers' of the firm's employment product.

For these reasons, firms seeking to achieve a sustainable EOC status in unfavorable competitive labor markets face a formidable challenge in constructing a value proposition that delivers the greatest perceived value to the employee and the firm, at a cost that both it and the prospective employee deem acceptable. Of course, in labor market conditions favorable to the firm, the challenge is less formidable. In such conditions, less value needs to be offered in order to attract and retain talented people, and both existing and prospective employees are likely to place greater value on the firm's contributions to the employment relationship, and be willing to bear greater total costs in order to enter the relationship.

## Discussion

In this paper we have explored the application of some basic marketing concepts to the conceptualization and effective management of the PC. In doing so, we have highlighted, from a marketing perspective, the manner in which

employees and firms construct and perceive value relative to the benefits and the total costs associated with the employment relationship. This perspective suggests that a firm wishing to achieve a sustainable EOC status in a competitive labor market must, when constructing an 'employment product' for consumption, have a detailed understanding of both the direct and indirect costs it is able and willing to bear, and the benefits it wishes to receive in an employment relationship. Similarly, it must consider what product features (i.e. benefits and costs) are most likely to be perceived by existing and prospective employees as representing the most attractive value proposition on offer in a competitive labor market. It would be naive for a firm to believe that the remuneration and benefits stated in its formal employment contract alone represent the totality of the value proposition the firm can offer. Without such management consideration, the matter of establishing a functional PC and the value that the firm wishes to receive from it are arguably, at best, left to chance.

Our use of marketing concepts has cast attention on the role that indirect opportunity costs (such as 'having an unhappy partner at home') can play in the employee's construction of the benefit-cost-value equation. We suggest that an EOC firm will recognize more fully the indirect opportunity costs employees incur over and above the direct costs currently recognized in the PC literature as 'economic' and 'social emotional' contributions. It is also important to recognize that such opportunity costs and notions of value will necessarily change over an employee's lifetime – for example, the benefits and costs associated with an employment offering will need to change in order to reflect an employee's change from 'being single to being partnered', and/or from having 'no dependents to becoming a parent', and so forth. Indeed, research has shown that changes in the perceived attractiveness of an employer's value proposition can occur in the employment relationship, even as early as the transition period from prospective to actual employee and over the subsequent socialization process (De Vos, Buyens and Schalk, 2003; Thomas and Anderson, 1998). The implication here is that the value proposition offered by an EOC firm must be flexible if the PC is to continue to be perceived by existing and prospective employees as the most attractive value proposition on offer. Unfortunately, the manner in which both parties to the employment relationship construct and perceive value relative to

the benefits and total costs over time is often obscured, thus making the firm's task of managing its value proposition somewhat complicated. The marketing literature may well be able to assist in this regard, as it already possesses a well developed framework for measuring and delivering 'value propositions' to target markets. The framework, known generally as the 'marketing mix concept' comprises a number of 'Marketing Ps' (i.e. product, price, place, promotion, physical evidence, people and process) that when integrated strategically enables the firm to differentiate itself from its competitors on some basis valuable to their target consumers (Constantinides, 2006; Rafiq & Ahmed, 1995). Potentially, the extension of the marketing mix concept to the HR management context may offer a useful way of broadening our understanding of how to construct and manage a functional PC for consumption in an EOC workplace.

Several other issues are likely to compound this level of this difficulty for a firm seeking EOC status. Firstly, the transaction entered into with the purchase of a commercial product or service is a narrow, fixed, and highly time-compressed form of exchange involving primarily tangible items. In contrast, a PC comprises a pervasive, ongoing, and evolving series of exchanges, based around what in large part are intangible items (Rousseau, 1995). Unlike the purchase of a commercial product or service, the exchange process surrounding the PC is embedded in a nexus of social transactions. Whilst in theory it is possible for PC transactions to mimic commercial transactions, in practical terms there will always be some element of social transactions involved in PC exchanges that will need constant monitoring over the life of the employment relationship (McNeil, 2000). Secondly, the PC is by definition idiosyncratic in nature, meaning that the perception of value might recognize an infinite number of benefit and cost considerations, and thus is likely to be unique to each employee (Rousseau, 1995). This may lead to multiple, highly individualized employment products, so-called 'i-deals' (Rousseau, Ho and Greenberg, 2006) having to be managed simultaneously. We may need, therefore, to explore further how other marketing and related discipline theories (e.g. 'consumer decision-making models', 'equity theory', and 'transaction cost economics') might be incorporated to explain the myriad of interactions and influences on the construction and management of an effective PC, especially for firms wishing to establish their reputation as an EOC. Finally, there is

the synergistic quality inherent to a functional PC that derives from its inherent mutuality, and leads to each party deriving benefits from the reciprocal exchange process that each would not have received without the multiplier effect of the other party's contribution.

In conclusion, this paper set out to explore how the application of basic marketing concepts to the PC might serve to underpin a firm's status as an EOC, whilst simultaneously addressing some of the observed theoretical and practical issues that have been identified in the research literature. In so doing, we suggest that the management of human resources in contemporary Western firms can be conceptualized as focusing on the management of an 'employment product', that is, a 'value proposition' around which there is an ongoing process of social exchange of tangible and intangible contributions that occurs between the employee and the firm. We believe that the incorporation of a marketing perspective along the lines explored in this paper offers real potential for broadening theoretical understanding of the PC and its role in establishing a sustainable competitive advantage for an EOC. We also believe that the use of theoretical constructs from marketing and other related disciplines offers alternative forms of language that can open up new avenues for assisting those managers who are not human resource professionals to engage with the PC and its effective management.

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