

**WOULD USING THE PSYCHOLOGICAL CONTRACT INCREASE  
ENTREPRENEURIAL BUSINESS DEVELOPMENT POTENTIAL?**

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# **WOULD USING THE PSYCHOLOGICAL CONTRACT INCREASE ENTREPRENEURIAL BUSINESS DEVELOPMENT POTENTIAL?**

## **ABSTRACT**

This paper identifies a mismatch between the concerns of practicing entrepreneurs and the interests of entrepreneurship researchers. A selective review of the entrepreneurial literature suggests that, despite its agreed importance, the decision to employ others has been insufficiently explored, especially within the growth stage models. Moreover, the individual and organisational theories currently deployed in other areas of entrepreneurial studies are not helpful when it comes to a clear understanding of the employment relationship. Consequently, the paper posits that incorporating the notion of the psychological contract into the field of entrepreneurship may provide a way to develop implementation models that reflect understanding of the process of entrepreneurial business development more helpfully. It is argued that the psychological contract of the entrepreneur as well as the employee needs to be considered.

## **INTRODUCTION**

In 2005 an entrepreneur was complaining that he could not find an appropriate employee for a certain job (Perrett, 2005). He was advised that his expectations were unrealistic and that he was likely to upset his new employees by taking far more than he was giving in terms of their personal expectations. It could have been argued that the employer was breaching the employees' psychological contract (PC) by not being realistic, first, about the expectations the employees had about the company and, second, about what was expected in return. It was apparent that the entrepreneur was not reflecting good human resource practices.

A study of the entrepreneurial literature demonstrates a shortage of research into the role of human resources within entrepreneurial business (Katz et al., 2000; Heneman et al., 2000), and that entrepreneurs focus mostly upon the human resource in terms of human capital (Florin et al., 2003; Zhang et al., 2003), not as a fundamental part of the success or failure of their enterprise. The importance of relationships for successful entrepreneurship will be identified and their absence from the most often-used theoretical framework underpinning empirical work into the entrepreneurial development process (stage models). The lack of an appropriate theoretical model for understanding the nature of an entrepreneur's employment decision-making processes is promulgated and we then introduce the PC and discuss why its well-developed theoretical tenets might form a useful addition to an entrepreneur's tool-kit. Although widely discussed within the human resource management and organisational studies areas, the PC has been discussed only rarely and peripherally within the entrepreneurial studies arena. A significant contribution of this paper will be the notion that entrepreneurs have strong, pre-conceived beliefs and values concerning their employees, which lead to the creation of psychological contracts about their potential employees.

## **METHODOLOGY**

This is a theoretical paper which links two distinct areas of literature: entrepreneurial business development and the PC, creating a substantive level theory (Creswell, 1994). Such theory building is often an important foundation for new theory development where the researchers are still in the discovery phase and the relationship between different constructs is not yet defined (Judd et al., 1991; Sarantakos, 1998), especially in areas where the questions are unclear and the ideas are exploratory (Creswell, 1994). We intend to develop a research plan in order to develop middle-range level theory in the next research stage.

The entrepreneurial literature is addressed, first, to explore entrepreneurship relationships and the omission in current models and second, to identify the paucity of discussion of the employment relationship and the lack of working models of the employment relationships in place for those undertaking the process of entrepreneurial development. The literature on the psychological contract is outlined and a model by Maguire (2002) adapted, identifying the elements likely to affect the willingness of individuals to commit themselves to the goals and motivations of entrepreneurial ventures, and the expectations of entrepreneurs of employees. This paper considers two way PCs between entrepreneurs and their employees. This may provide an understanding of the current state of HR in small and early-stage businesses and why entrepreneurs are taking inadvertent risks in terms of whom they employ. From this we posit a research program to connect employment relationships with the models of the entrepreneurial development process.

## **WHAT IS ENTREPRENEURSHIP?**

Davidsson (2003) identified two main streams of entrepreneurial literature. The first argues that entrepreneurship is about the discovery, evaluation and exploitation of *opportunities*

(Shane and Venkataraman, 2000). This literature emphasises entrepreneurship as a disequilibrium activity where opportunities are defined as ‘situations in which new goods, services, raw materials, markets and organizing methods can be introduced through the formation of new means, ends, or means-ends relationship’ (Eckhardt and Shane, 2003: 4). The second stream viewed entrepreneurship as organisational or firm *emergence* (Gartner 1993) where the evolutionary and dynamic aspects of entrepreneurship are crucial and the focus is on organising activities in a Weickian sense.

		<b>Actions involved</b>	
		Creation of new means and ends relationships	Maximising existing means and ends relationships
<b>Context</b>	New organisations	(A) Change Oriented Venture Creation	(B) Non-change Oriented Venture Creation
	Existing organizations	(C) C Change Oriented Corporate Venturing	(D) Traditional Management

**Figure 1: Distinguishing the emergence and opportunity view of entrepreneurship**  
 Source: Klyver, 2005

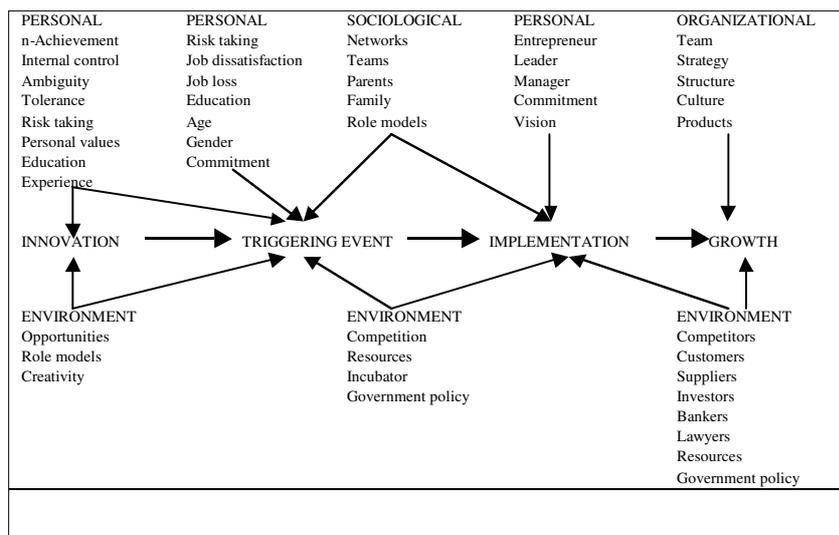
Figure 1 represents two main dimensions distinguishing the emergence view from the opportunity view. Dimension one is whether the actions involved in an entrepreneurial process are defined by creation and identification of new means and ends relationships or maximizing existing means and ends relationships. Dimension two is whether the context involves creation of new organizations or if entrepreneurship takes place in an existing organizational context. **A** is characterised by ventures whose essence is to be an innovative start-up that changes the competitive conditions within an industry and drives the market. **B** involves start-ups that do not change underlying competitive conditions within an industry or the fundamental forces that drive the operation of an existing market, but fill gaps in an existing market by maximizing existing means and ends relationships. **C** includes creation or identification of new means and ends relationships exploited in an existing organizational context, involving an existing organisation changing competitive market conditions by the

introduction of new products, processes or production methods. The opportunity perspective embraces **A** and **C**. The emergence perspective embraces **A** and **B**. **D** is not entrepreneurship from either the opportunity or the emergence perspective but merely traditional management.

One imperative common to **A**, **B** and **C** is a need to establish, develop and manage the relationships both exterior and interior to the enterprise, including the employment relationship. Whilst it is often assumed that human resource issues for entrepreneurs will be constraining because they will be about ‘hard’ processes and systems that will hinder, rather than support a growing business (Kickul, 2001), the ‘soft’ side of human resources is increasingly seen to be fundamental to any business (Storey, 1994) including entrepreneurial ventures. A study of the fundamental approaches to the nature of entrepreneurship within the entrepreneurship literature demonstrates a surprising lack of discussion about human resource management in general and the employment relationship in particular (Katz et al., 2000). Remarkably, none of the most heavily-used models of entrepreneurial development discuss this aspect.

### **HOW SHOULD WE STUDY THE ENTREPRENEURS EMPLOYMENT DECISION?**

Stemming from the influential paper by Churchill and Lewis (1983), many so-called ‘stage models’ of the entrepreneurial development have been produced to represent various allegedly ‘typical’ developmental stages that firms go through as they mature (e.g. Greiner, 1972; Burns and Harrison, 1996; Gray, 1993). Researchers continue to use life-cycle and stage models as frameworks for studying a variety of topics that may all be embraced under the heading of ‘the entrepreneurial development process’. As an example of a stage model of entrepreneurial development we reproduce an often-cited schematic illustration of the development of an allegedly ‘typical’ entrepreneurial venture.



**Figure 2: Influences on Entrepreneurial Process Through Time**  
 Sources: (Bygrave, 1989; Moore, 1986)

The Moore-Bygrave framework posits four stages of the entrepreneurial process (innovation, triggering event, implementation and growth) demonstrating that entrepreneurial decision-making and performance are simultaneously impacted by cognitive and environmental variables; thus, in the cognitive domain, the proportional importance of individual, sociological and organizational factors varies with respect to the stage of the process.

This typical stage-model exemplar of entrepreneurial development reveals two failings. First, there is an unwarranted implicit presumption that growth is both a conscious and a desirable aim for *every* new venture. Second, *the decision to hire an employee* is a milestone conspicuous by its absence. Yet we know that growth is neither a universal objective nor a universal result in the entrepreneurial development process, whilst, in the almost universal opinion of entrepreneurial practitioners, the decision to hire an employee is a prominent milestone in the development trajectory of any venture. A recent study demonstrates that, amid the vast array of possible entrepreneurial developmental patterns, there exist enough clustered similarities for various patterns to be worthy of generic classification: ‘maturity and

decline'; 'on a growth curve' and 'capped growth' (Massey et al., 2006). Whether a firm exhibited one or other pattern of development appeared to relate strongly to the attitude to growth held by the owner or manager; this position was also the consequence of a number of inter-related factors, including age and other demographic attributes. Massey et al. (2006) indicate that amongst the most commonly reported business-related 'milestones' or 'key events' was the employment of staff; all respondents were vociferous in highlighting the generic importance of this decision to employ someone. Often, the discussion that followed the identification of this particular milestone included details of the difficulties owner-managers were facing with regard to human resources in their firms. Especially problematic aspects included the burden of taking on new staff in terms of compliance and the inability to find appropriately trained staff. This study is supported by a large volume of anecdotal evidence: it is hard to hold a conversation with any experienced entrepreneur without their stressing the vital importance of the decision to hire someone as a seminal event in the life of a new venture. However, despite such evidence, the employment decision is strikingly absent from the stage model approach that has hitherto dominated as a framework underpinning researchers' understanding of entrepreneurial development. The absence of research attention to the entrepreneurial employment decision is remarkable, not least because an increase in employee numbers is considered a standard way of measuring the very growth that is at the heart of the stage model approach. Furthermore, growth in the number of employees (as a proxy for employment creation) is also identified as a desirable goal by most government agencies involved in supporting small and medium sized enterprises (SMEs).

Having identified the paucity of discussion within the current models of entrepreneurial development, we examined several theories that are currently in use within the entrepreneurial literature, considering their usefulness as a framework for structured investigation of early-

stage entrepreneurial recruitment decision. We considered theories on risk and return (Tobin, 1958); the Capital Asset Pricing Model (Sharpe, 1964), Portfolio Decision Making (Samuelson, 1969; Banks et al., 2002), risk preferences of households (Jorion and Goetzmann, 2000), the presence of labour income (Merton, 1971) and multiple theoretical perspectives now finding currency in the area of ‘Angel’ investments (Wong and Ho, 2006). Unsurprisingly, mechanistic theories of risk and return did not encompass the complexities involved in making an interpersonal decision (whether or not it is regarded as an ‘investment’) such as hiring an employee. We considered trust which is recognized within the entrepreneurship literature as a precondition for rational choice (Loasby, 1997) but any complexities attendant upon it are simply assumed away. What became clear was that, although there is a wide ranging discussion of trust within the entrepreneurial literature (Dubini and Aldrich, 1991; Ryan and Buchholtz, 2001; Dibben, 2000; Clark and Payne, 1997; Lewicki and Bunker, 1995, 1996; Harrison et al., 1997), the researchers studied how different types and levels of trust relate to the criteria used by investors to establish their *cooperation threshold*, which is the point at which individuals decide to commit to an investment, but they did not explore trust in the context of the entrepreneurial *employment* decision. For this we need a context for the ways in which interpersonal contacts (and cognitions concerning them) are developed and applied and so we contemplated social networks and social capital. Recently, the entrepreneurship literature has highlighted the significance of ‘social networks’ and ‘social capital’ in the creation and growth of new ventures, in order to clarify how ideas are developed and capitalized upon (Shane and Cable, 2002; Zhang et al., 2003; Nahapiet and Ghoshal, 1998; Shane and Venkataraman, 2000). When effectively leveraged by individuals, social capital provides them with considerable resources to facilitate the identification, evaluation, and exploitation of opportunities. Unfortunately, it seems either very difficult or somewhat artificial to try to use the concept of social capital or the wider concept of social

networks as an effective framework for *generic* exploration of the early-stage employment decisions of entrepreneurs. Both theories, at this stage of their utilisation within the entrepreneurship literature, identify the importance of the ideas but not the elements that drive them in terms of developing new employment relationships.

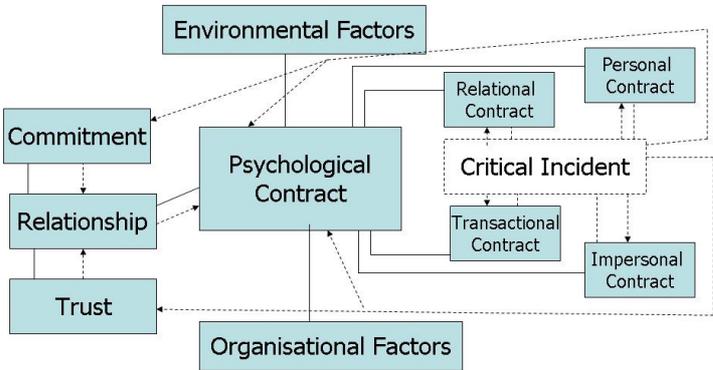
A consideration of the drivers in the employment decision led us to consider Ajzen's (2002) theory of planned behaviour, cited in the entrepreneurship literature for its potential to provide both a theoretical framework and operationalisable constructs for understanding the decision of individuals to make informal (angel) investments in entrepreneurial businesses (Maula et al., 2005; Wong and Ho, 2006). As recruitment is a form of investment decision by the entrepreneur (Mainprize and Hindle, 2005) it is possible that Ajzen's theory may provide a basis for the decision making processes of entrepreneurs with respect to their early-stage employment decisions. This theory deconstructs human behaviour into three distinct but related belief elements: *behavioural beliefs* concern the likely consequences of behaviour; *normative beliefs* concern one's expectations of other people and *control beliefs* concern the presence of factors that may affect performance of the behaviour. Behavioural beliefs produce *attitude towards the behaviour*, normative beliefs produce a *subjective norm* and control beliefs produce *perceived behavioural control*. The combination of attitude, subjective norm and perceived behavioural control forms a *behavioural intention*. When an adequate degree of actual control and opportunity is present, individuals will be able to act upon this intention and perform the behaviour.

In this paper we consider the second generic component of Ajzen's composite theory - normative beliefs concerning the entrepreneur's *expectations* – as applied to the specific area – decision-making concerning potential employees. The core concept of perceived

behavioural control refers generally to people’s expectations regarding their ability to perform a given behaviour (Ajzen, 2002). If, in thinking about entrepreneurial employment decision-making, one concentrates attention on what various parties to a contractual relationship *expect* of one another, this leads to a consideration of the theory of the PC because of its focus upon the role of expectations and their impact upon emergent employee/employer relationships.

**What is the Psychological Contract (PC)**

A PC consists of an individual’s beliefs regarding the terms and conditions of the exchange agreement between themselves and their organizations (Rousseau, 1989; Guest, 1998). It differs from a formal contract in that it reflects the beliefs, ideals and values held by the individual which lead to a set of unstated expectations about the workplace (Kickul, 2001; Roehling, 1997). Figure 3 demonstrates that commitment, relationships and trust are all going to affect the application of social processes within organisations and how individuals will perceive a critical incident. Individual expectations will be affected by, among other things, organisational culture/climate, HRM policy and practice, an individual’s personal experience, and what potential alternatives are perceived as possible (Guest, 1998)



**Figure 3: The Psychological Contract**

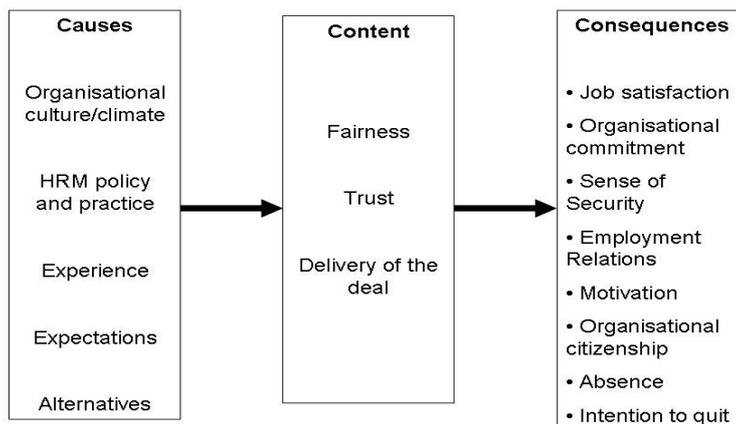
Source: Crossman (2002).

In terms of early-stage entrepreneurial organisations, where there are likely to be close relationships between the founder/leader and the employees of the organisation, closeness of contact will have a strong impact upon both the PC and, consequently, the potential effectiveness of the organisation. Of the various types of contract that operate within Crossman's model, it is likely that personal and relational contracts will have the most impact on how events are perceived by individuals within new or smaller firms.

The importance of the PC upon successfully implanting change strategies has already been noted established ; the deterioration of trust relations and increased cynicism, demonstrated within a poor PC, "are likely to make future strategic programmes more difficult to implement" (Pate et al., 2000: 491). It is argued that the state of the PC will explain the dynamics of the elements affecting the employment relationship and, potentially, the likelihood of successfully utilising or changing aspects of work (Rousseau, 1989). This could seriously impact upon the potential of a new business to achieve its desired outcomes.

The employment relationship is widely held to be an exchange relationship (Maguire, 2002) which includes subconscious, implicit elements (Spindler, 1994). The overall impact of the PC is that employees develop a form of 'equity balancing' (Kickul, 2001). This is what Rousseau describes as a 'reciprocal exchange agreement' (1989). There is an acceptance that 'if you do that, I will do this'. A breach of the contract will mean that the employee believes that, because a promise has been broken, they do not need to work as effectively as before. Kickul (2001), discussing the state of the PC in small firms, concluded that there are five main factors that affect the contract and the way that the employee perceives it: 'autonomy and growth', 'benefits', 'rewards and opportunities', 'job security and work responsibilities' and 'work facilitation'. These are areas that, in the view of the employee, have been in some

way agreed upon and promises, albeit implicit, have been made. If these are not kept, there will be a critical incident, leading to a breach of apparent agreements that have been made. Guest (1998) indicates the causal nature of the relationship showing that the ‘content elements’, (how the individual perceives the promises and the way they have been fulfilled), lead to the reactions that, in turn, lead to the employees’ actual behaviours (Figure 4).



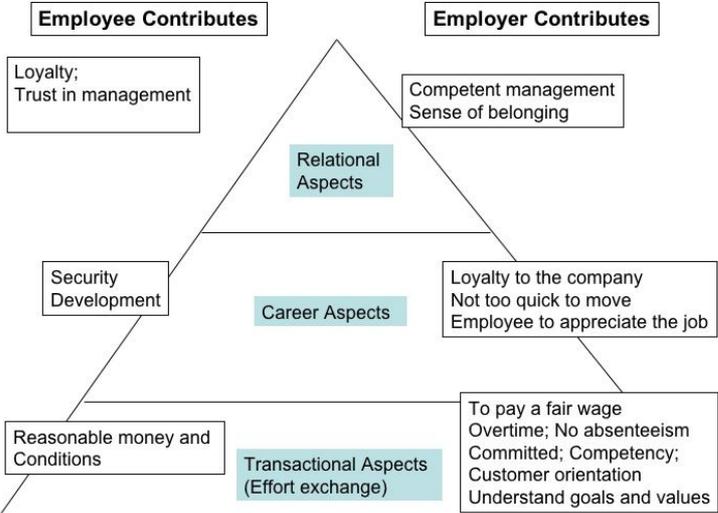
**Figure 4: Guest’s model of the psychological contract**

Source: Guest, 1998

When the nature of the descriptions are analysed in an entrepreneurial context it can be seen that an entrepreneur could have a set of expectations, beliefs and ideals about their employees which could lead to unwritten expectations. In other words the PC can as well be viewed from the point of view of the employer as of the employee. This perspective may be of particular benefit when studying early-stage ventures because these enterprises are so heavily dependent upon their founders and leaders. According to Rousseau and Wade-Benzoni “Psychological contracts refer to beliefs that individuals hold regarding promises made, accepted and relied upon between themselves and another” (1994: 466). Herriot et al. define the PC as “perceptions of mutual obligations to each other, held by two parties in the employment relationship, the organisation and the employee” (1997 in Marks, 2001: 456). Neither definition automatically implies that the only relationships in a PC must be between the

employee and the organisation. The notion of a reciprocal relationship between the entrepreneur and the employee is not ruled out because the difference between the organisation and the entrepreneur may be a blurred distinction. While Marks (2001) argues that, within the overall concept of the PC there are many, multifarious, sub-contracts operating from the point of view of the employee, we argue that it is possible that diverse aspects of the PC also apply and need to be considered with respect to the entrepreneur. According to Maguire (2002) the relationship has expectations at three distinct levels (Figure 5), indicating what each party to the relationship will bring to the workplace.

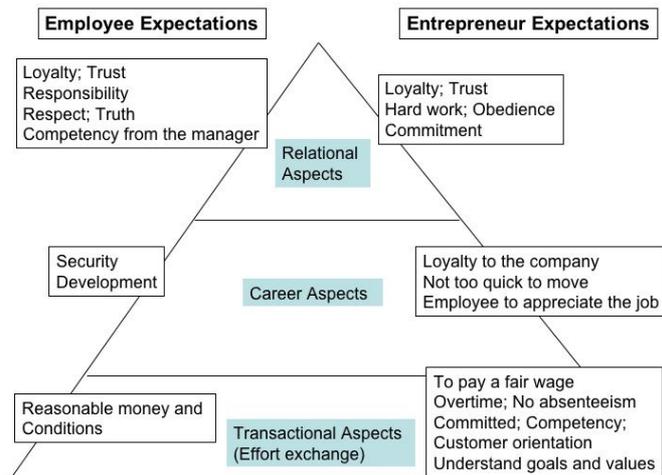
The *transactional* elements are usually overtly considered by all those entering a contract and are often seen (wrongly) to constitute the *total* of the relationship. This limited perception may pertain especially in the circumstances of small or developing enterprises that are often concentrating principally on short-term goals.



**Figure 5: Three-tier model of the psychological contract** Source: Maguire, 2002

The other two levels depicted in the model are not often overtly so well considered; they may or may not be implicitly considered. Yet *career* and *relational* aspects of a PC are at the heart of long-term successful relationships. If the employer does not, first, reflect upon whether

their expectations are realistic, and second, on the longer-term expectations of their employees, it is likely that an unexpressed mismatch of expectations will occur from the very outset of the relationship. Consequently, we argue that Maguire's (2002) model can be adapted to be more specific in terms of the mutual expectations held by those involved in an entrepreneurial employment relationship (Figure 6).



**Figure 6: Expectations in Entrepreneurial Relationships** Adapted from Maguire 2002

Given an entrepreneurial context, differences from established applications of PC theory emerge from two main factors: the proximity between the partners in the relationship and the strong sense of identity between the entrepreneurs and their organization.

The employee may often expect to be treated almost as a friend and a respected individual, whilst the entrepreneur may often expect the employee to feel the same way about the business as they do. In both cases these expectations are likely to fail, leading to problems with the employment relationship. Moreover, difficulties occur because the entrepreneur has often never been a manager before and is unaware of what such a relationship will entail. Consequently, they are not sufficiently clear about what constitutes realistic expectations of an employee in work terms (Perrett, 2005). The naïve entrepreneurial employer may also tend to be unnecessarily over-directive; case examples taken from *The Age's Business Network* column frequently demonstrate this (e.g. Perrett, 2005).

## **IMPLICATIONS**

This is a theoretical paper, however areas of potential importance can already be postulated.

The area of trust is clearly a concern within the PC, as is the area of social networks since the expectations of both parties will impact the manner in which such networks operate. We believe that a thoughtful consideration of the PC will enable a risk reduction in employment decisions, particularly if the negative is understood.

### **Consequences of poor psychological contracts**

Poor PCs lead to higher turnover, absenteeism and lower productivity and have a direct impact upon the bottom-line (Guest, 1998). It is important for those involved in employing others to be aware of the potential for problems to occur. In the specific case of an early-stage, entrepreneurial business we suggest that many problems emerge owing to unrealistic employer expectations. It appears that, because of the way that success is measured, money is lent and the way that entrepreneurs are advised, they may be over-concentrating upon the financial aspects of their enterprise and will expect their employees to do the same. This is an unrealistic expectation because, however enthusiastic employees may be, it is not *their* company or *their* risk. It is noteworthy that, in Figure 1, 'Manager' is seen as a wide-ranging function covering all aspects of the implementation stage. However, it appears from the secondary data gathered from entrepreneurial cases (e.g. Perrett, 2005 and Massey et al., 2006), that for many entrepreneurs, the term 'Manager' is limited to a very structural and transactional connotation (Maguire, 2002). For them it relates to the control and organisational aspects of a relationship. By using the PC as a basis for developing a way forward, the entrepreneur might become aware that such arrangements are merely a small sub-set of the overall employment relationship. In particular the issue of an employee's career ought to be considered. If entrepreneurs cannot offer future development, they must either

expect to lose their employee and learn to consider themselves as a training ground, or they must change the way they recruit in order to attract those who will not want to leave. This may lead to the need to reconsider completely the profile of the types of employee that entrepreneurs wish to employ. This changed perspective will facilitate both an improved PC and, potentially, a reduction in the overall risk profile of the venture.

### **Reduction of the risk**

Entrepreneurs are attracted to challenge, not risk per se. While they do not fear risk taking, good entrepreneurs seek to minimise it. However, the literature does not currently recognise the very real risks involved in employing someone in an early stage venture and that these employment risks can be reduced by thinking in the different and more careful way indicated by an understanding of the PC. An example can be given when considering a case described by Hindle et al. (1999) considering the employment of workers with a disability in a call centre. For the sake of seeing whether any performance differences distinguished employees with a disability from employees without a disability, the researchers hypothesised that workers with a disability would under-perform fully-abled workers on several measures of employment performance. However, the key findings of the study were that the only significant differences between workers without a disability and workers with a disability were in terms of length of employment and absenteeism. In these two areas, the statistically significant and more positive performance belonged to workers with a disability. The PC can help to explain these unexpected differences, which have potential implications in three areas for the entrepreneur.

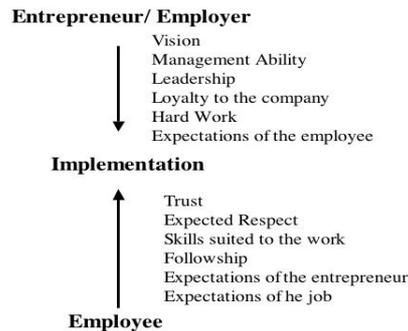
- Both employment duration (turnover) and absenteeism are consequences of poor PCs as defined by Guest (1998);

- Any reduction in either turnover or absenteeism will enable greater opportunities for a development of a more positive PC on both sides; and
- Reduction in these elements should reduce the cost of labour and, therefore, the risk involved in developing an entrepreneurial venture.

The findings of this empirical case were left unexplained by the original researchers. Their important findings could have been anticipated had the initial data been subject to scrutiny in light of theoretical knowledge of the PC. The employer wants consistent work at a certain skill level and does not expect any particularly intense devotion to the company, whilst the disability-affected employees had historically had greater difficulty gaining employment and were predisposed to trust the current employer. Hence, it could be posited, in PC terms, that, by being realistic about the skills actually required for a job, combined with due consideration for the employee and realistic expectations about how an employee will feel about the company, an entrepreneur can perform the employment task much better. Knowledge of the PC could lead to reduced employment costs, less stress and reduced venture risk.

## **FUTURE RESEARCH**

It is too soon to be able to develop sharply-delineated new models at this point but we argue that the concerns and ideas raised in this paper indicate that there is a need for considerable future research in this area. For example, if the implementation section of Figure 1 is now reconsidered, it can be seen that, at the very least, the employee should be added in to this section as per, for example, Figure 7. This is merely an initial suggestion but would add into current models stakeholders currently of great import, conspicuous only by their absence. Accordingly, our initial research proposal is that the elements of the reciprocal relationship of the entrepreneurial PC are established and then such ideas are incorporated into currently accepted theory of entrepreneurial business development.



**Figure 7: Possible changes to Implementation in Figure 1.**

## CONCLUSION

In this paper we have identified a mismatch between the concerns of practicing entrepreneurs and the principal interests and focuses of current entrepreneurship research with respect to the entrepreneurial development of a new venture. We have noted that the crucially important decision to employ others has been insufficiently explored and, currently, does not figure in any of the influential stage-models so often used as theoretical frameworks in entrepreneurship research. We have also noted that, at present, the issues of implementing an entrepreneurial employment relationship are not well defined or discussed. We posit that incorporating the theory of the PC into the field of entrepreneurship may provide a way to develop better models of how to implement and develop a new entrepreneurial venture. At the very least, conscious and overt inclusion of the employment decision into any stage-model of the entrepreneurial development process will reflect the stages of growth more helpfully. We suggest that the ideas shown in Figure 6 should be empirically developed and confirmed so that Figure 1, and similar figures, can be enhanced and amended to reflect the real complexities of developing employment relationships in early-stage ventures, thereby reducing the risk associated with entrepreneurial business development.

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